Company Name: Kellogg
Company Ticker: K US
Date: 2016-08-04
Event Description: Q2 2016 Earnings Call

Market Cap: 28,850.97
Current PX: 82.42
YTD Change($): +10.15
YTD Change(%): +14.045

Bloomberg Estimates - EPS
Current Quarter: 0.874
Current Year: 3.641
Bloomberg Estimates - Sales
Current Quarter: 3270.667
Current Year: 13044.389

Q2 2016 Earnings Call

Company Participants

- John P. Renwick, IV
- John A. Bryant
- Ronald L. Dissinger
- Adrienne Deanie Elsner

Other Participants

- John Joseph Baumgartner
- Matthew C. Grainger
- Eric Larson
- Mario Contreras
- Christopher Growe
- Robert Moskow
- David Cristopher Driscoll
- Alexia Jane Howard
- Michael Lavery
- Kenneth Bryan Zaslow

MANAGEMENT DISCUSSION SECTION

Operator

Good morning. Welcome to the Kellogg Company Second Quarter 2016 Earnings Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer period [Operator Instructions] Please note that today's call is being recorded. Thank you.

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

John P. Renwick, IV

Thank you, Gary, and good morning, everyone, and thank you for joining us today for a review of our second quarter 2016 results. I am joined here by John Bryant, Chairman and CEO; Ron Dissinger, Chief Financial Officer; and Deanie Elsner, President of U.S. Snacks.

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

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

And now, I will turn it over to John Bryant.

John A. Bryant

Thanks, John, and thank you, everyone, for joining us. We are pleased to report another quarter of operating profit margin expansion. Obviously, we're [ph] still challenged as to our top-line (2:07) growth. Part of this is an industry-wide dynamic, as you all know, and part of this is our exposure to a shift in weight management trends that affected one of our biggest brands, Special K.

That's why it's so important that we continue to make progress on four key priorities we've been updating you on over the past several months. First, investment in food and packaging, which was evident: in Kashi, where we completed the conversion of the entire portfolio to non-GMO; in Frozen Foods, where we completed a packaging transition; and in Special K, cereal and bars, in several markets, as we reframed the brand to inner strength. All of these investments have the consumer in mind and all require near-term investment and transition, but all will bring back growth in the future.

Second, expansion of Pringles, which was reflected in continued growth worldwide, be it because of adding distribution, expanding new platforms like Tortilla or accelerating single-serve offerings. Our [ph] On-the-Go (3:06) brand is growing at a solid mid-single digit rate.

Third, enhancing our sales capabilities, which continued as we launched broader revenue growth management capabilities in certain business units. This moves us beyond trade optimization and analytics toward price/pack architecture and other ways to ensure that we have the right price, on the right pack, for the right occasion.

We completed the organization of our DSD selling and merchandising organization, which will offer improved effectiveness. We continue to expand distribution in high-frequency stores, particularly in emerging markets. This investment in execution will benefit us going forward.

And finally, but perhaps most important in today's industry environment, we made notable progress increasing our earnings visibility based on our strong productivity programs. Not only did we record a higher operating profit margin in the quarter, we also made good progress launching and executing initiatives that will improve our margins for the rest of the year and beyond. We continue to be on track with Project K. We continue to deliver on Zero-Based Budgeting in North America, while rolling it out internationally. And our guidance for 2016 now incorporates higher Zero-Based Budgeting savings, with more of it applying to earnings. This is a key driver behind our more positive stance towards our 2016 earnings guidance.

As we stated at our Day at K Investor Day, we recognize that margin expansion is a major opportunity in the food industry, and we are committed to making significant progress against this objective. Today, we are announcing an expansion and acceleration of our margin expansion plans.

As Slide 4 indicates, we now have a plan that can realize approximately 350 basis points of improvement in our currency-neutral comparable OP margin through the year 2018. This is a bit more and two years earlier than previously communicated.

The chart shows you the key drivers of our margin expansion. The first bucket is productivity. We will continue to generate our ongoing 3% to 4% productivity to offset inflation. And we are expanding Zero-Based Budgeting in the U.S., while rolling it out internationally. Also, we will continue to look for additional Project K initiatives that will help us achieve this 350 basis point improvement with the potential for further savings beyond 2018.

We will also be looking into ways to improve our price realization. We are now establishing more formal revenue growth management disciplines around the world, an extension of the trade analytics we have always done, to help us get better at price realization.

The next area of focus is investing for impact. Our investment model has to change with today's consumer and technology, and we've been rethinking how we support and build our brands to the highest possible return on investment on every dollar we invest. This could mean less reinvestment going forward and more productivity savings going to profit margin.

The last bucket has to do with making sure our foods are on-trend. This involves a more impactful approach to renovation and innovation.

We are moderating our net sales growth outlook for the next couple of years to roughly flat. This reflects the current industry dynamics, but also reflects some of these margin expansion efforts, particularly where they touch upon price elasticity and portfolio optimization. [ph] It enables (6:30) a stronger portfolio and stronger earnings strength. We'll provide more detail in the coming months.

With that, let me turn it over to Ron to walk you through the financials for Q2 and 2016.

Ronald L. Dissinger

Thanks, John, and good morning. Slide 5 shows highlights of the financial results for the second quarter. Keep in mind that when describing our results and outlook, we will be referring to them on a currency-neutral comparable basis, unless otherwise noted. And, in many cases, we'll also give you the same metrics excluding Venezuela. We do this because we know you prefer this basis for analyzing our underlying business performance. And, of course, the appendices to our presentation provided with the detail on both our GAAP and non-GAAP performance.

Second quarter net sales increased by 8.6% and, like last quarter, these results included the impact of pricing actions in Venezuela. Net sales excluding the impact of Venezuela declined by 2%.

Our operating profit increased by 10.6%, driven by savings from Project K and Zero-Based Budgeting in North America, as well as by price increases in Venezuela. Excluding the impact of Venezuela, operating profit increased by 5.3% and exceeded our expectations.

On a comparable basis, earnings per share were $0.91 in the quarter, due to operating profit performance. This included $0.09 of currency headwind, $0.06 of which was due to the mid-2015 currency remeasurement in Venezuela. As a result, currency-neutral comparable earnings were $1 per share for the quarter, which represented a year-over-year increase of 8.7%.

Now, let's turn to Side 6 and the components of the second quarter sales. Volume declined by 1.6%, and roughly the same ex-Venezuela. We'll discuss some of the markets where we saw declines a little later.

Price/mix contributed more than 10 percentage points to sales growth, due to the impact of pricing in Venezuela. The price/mix, excluding the impact of Venezuela, declined by half a percentage point, held down by category, channel and SKU mix in various markets.

And finally, you can see on this chart that the impact of foreign exchange lowered reported sales growth by 15 points, with almost all of it coming from Venezuela. And in the second half, we will have lapped the Venezuelan remeasurement, so its impact will be much smaller.

Slide 7 shows our currency-neutral comparable gross profit margin for the quarter. Venezuela's inflation and currency remeasurement can be a bit distorted, but you can see that, excluding Venezuela, our gross profit margin was flat in the quarter and very close to flat for the year-to-date period.

Our Productivity, Project K and Zero-Based Budgeting initiatives all delivered as planned in the quarter. This was most evident in North America, where our gross profit margin increased meaningfully, in spite of investment in food at Kashi, adverse transactional currency impacting Canada and some adverse mix in Morning Foods and Snacks.

Offsetting this strong North America performance were gross margin declines across our international businesses. These declines were primarily driven by the adverse transactional currency impacts on dollar based commodities and other inputs and a deflationary retailer environment in Europe.

Slide 8 shows a currency-neutral comparable operating profit margin, excluding Venezuela, for the quarter. And on that basis, operating margin increased by 110 basis points in the second quarter. It was led by North America, which is where we have rolled out ZBB.

Operating margin was up internationally as well, though expansion was a bit more modest, owing to the gross margin pressures described previously and to the fact Zero-Based Budgeting is just starting up in these regions.

Slide 9 summarizes the regional financial performance for the second quarter on a currency-neutral comparable basis. I'll focus on the profit and margin performance and then Deanie and John will follow with more color around the top-line.

The first thing that you'll notice is that, excluding Venezuela for Latin America, every region posted profit growth and margin expansion in the quarter.

In North America, operating profit increased by 5%, as savings programs more than offset a decline in sales. Operating margin improved by 1.4 points, driven by Project K savings, the ZBB initiative and lower net input costs.

In Europe, operating profit increased by 4% on flat sales, with an operating margin that increased by 0.5 point, largely on efficiencies and timing of brand building as well as savings in overhead.

In Latin America, operating profit increased substantially because of inflationary Venezuela. Excluding Venezuela, operating profit also increased by 4%. Operating margin, excluding Venezuela, improved by nearly a full point, led by price realization and cost management programs.

Asia Pacific's operating profit jumped by a little more than 17% in the quarter, partially driven by sales growth. Operating margin increased by nearly a full point, as the timing of investments more than offset unfavorable transactional currency impacts.

Slide 10 shows our cash flow for the first half of the year. You may recall that our first quarter cash flow included the impact of a bond tender offer, which lowered cash flow by approximately $145 million. Related to that, we did get a cash tax benefit in the second quarter, so the net after-tax cash impact of the tender year-to-date is approximately $97 million. And still, our year-to-date cash flow through the second quarter was $399 million, which is about $76 million better than that for the year-ago period.

And importantly, we continue to reduce our core working capital as a percentage of sales, both sequentially and year-on-year. This improvement was again led by the accounts payable initiative that has been benefiting working capital over the last year.

We are still on track to deliver our targeted $1.1 billion of full year operating cash flow, after capital expenditure.

Full year capital spending should still be in a range between 4% and 5% of sales, including investment for Pringles growth and Project K.

We bought back shares worth approximately $176 million in the second quarter, bringing our year-to-date total to $386 million, all this under our current $1.5 billion authorization.

Slide 11 shows our latest guidance for the year, again on a currency-neutral comparable basis. Our net sales guidance does not change, but we believe we will come in at the low end of the 0% to 2% range that excludes Venezuela.

Our operating profit guidance moves higher because of Venezuela's profit performance in the first half. And excluding Venezuela, we are not changing our guidance range, but we expect to achieve the high end of the 4% to 6% range. This is related to Zero-Based Budgeting, which is now projected to deliver roughly $150 million to $180 million of savings in this year.

North America has confirmed more savings than anticipated and our international regions now have savings commencing in the second half. We're allowing more of our projected savings to flow to the bottom line, more than offsetting the impact of sales coming in toward the lower end of our guidance range.

Between this higher ZBB savings and the performance of our Venezuela business, we expect our currency-neutral comparable earnings per share to be about $0.11 higher than the range we gave previously. I will point out that on a comparable basis including currency, our earnings per share outlook range actually comes down $0.06, owing to further devaluation of currencies against the U.S. dollar.

Our increased outlook for operating profit has been offset by a higher average share count, due to an increase in share price and dilution from options activity. This $0.06 of additional negative currency translation is from the British pound primarily, following the vote to exit the European Union.

From a phasing standpoint, the additional $0.06 of impact from currencies is evenly spread across Q3 and Q4. Remember, the impact of Venezuela is immaterial in our second half, as we have lapped the year-ago remeasurement.

The Q3 earnings per share will be a little lighter than Q4, owing to the timing of investment, particularly around the Olympics and some media campaigns that were shifted from first half into the third quarter.

Slide 12 shows other elements of our guidance. And first, you can see the currency impacts we just talked about. Interest expense should come in at around $400 million, which includes roughly $150 million from the bond tender, which has been excluded from our comparable results.

Our comparable tax rate will be approximately 27%. Share buybacks are expected to be approximately $700 million to $750 million, though, as I said, a higher share price and increased options exercises will translate into a higher average shares outstanding.

Full year up-front costs remain consistent with our original guidance of between $200 million and $250 million, or approximately $0.40 to $0.50 per share, net of tax, about half of which should be in cost of goods. And full year integration costs are still anticipated to be between $0.02 and $0.03 per share, net of tax.

For both the up-front costs and integration costs, we are showing on the slide the post-tax values as well, from new disclosure rules.

And with that, we'll now discuss the performance and outlook of each of our business units. We'll start with our largest business, U.S. Snacks. And with us today's is Deanie Elsner, President of U.S. Snacks.

Adrienne Deanie Elsner

Thanks, Ron, and hello, everybody. Let's go to Slide 13. Before we jump into our Q2 results, let me quickly re-ground you on what I told you back at November's Day at K investor presentation. First, we're a big business with good profitability. We compete in five different categories, each with their own dynamics and in different aisles of the store.

Second, we have a strong portfolio of great brands, which participate in the mega consumer trend towards snacking. This slide points out the size of some of our key brands.

Third, and importantly, I laid at the opportunities that exist to get this business back to growth again. And I shared with you the key priorities we're focused on this year. Among those were the following: first, expand our margins; next, shift investment to our growth brands, the brands most aligned to today's consumer; next, expand On-the-Go formats to reach consumers across occasions and channels; and finally, stabilize Special K. Today, I want to give you a progress report on each of these priorities.

Let's start with how we're improving our profit margins and Slide 14. As you know, we're driving significant productivity through Project K and ZBB. I'm happy say that we're on track with these savings.

We're also institutionalizing a broader, more disciplined approach to revenue growth management. We've started with Cheez-It, where we reevaluated the price point of our offerings across channels, from large sizes to On-the-Go and single serve. And we're assessing how we invest our trade dollars.

In-market for Cheez-It demonstrates the early impact of this effort. Year-to-date consumption is up 5%, led by volume and strong price/mix. Base sales, up 7.6% and we've increased distribution more than 7% behind an expansion of our price/pack architecture. The brand also posted improved profit margin.

Across our portfolio, our efforts on productivity, cost savings and revenue management are paying off. Our currency-neutral comparable operating margin is up year-on-year, both in Q2 and Q1. In fact, year-to-date, that margin is up 120 basis points, so good progress on margin expansion in Snacks, with more to come.

Our second priority was to shift our investment to the brands that could give us the strongest growth. This is represented on Slide 15. To optimize our return on investment, we concentrated our spend behind our best brands. In Crackers, we're investing behind our big three, Cheez-It, Club and Town House. All three of these brands grew consumption in Q2 and year-to-date. Collectively, they are also gaining share in Q2 and year-to-date. Pringles grew consumption nearly 3% year-to-date. Our core four flavors where we're putting the most emphasis on the shelf, increased consumption 9% year-to-date. And our single-serve offerings have grown at a double-digit rate. So as we get past some phased-out non-core items in the second half, you'll see accelerated growth for us in Salty Snacks.

In Cookies, we've turned on media, for the first time in years, on the Keebler brand, introducing a whole new generation to the elves in the hollow tree. It's early days, but the Keebler brand turned to consumption growth in Q2.

In Wholesome Snacks, Rice Krispies Treats grew consumption by 4.5% in the quarter and Nutri-Grain grew consumption by more than 5%. This means that two-thirds of our wholesome portfolio delivered healthy growth in Q2. Focusing our investment on our growth brands is a key element of our plan this year, and we're seeing good results.

Slide 16 talks about our third priority, expanding our On-the-Go offerings and distribution. We know consumers are snacking more and on more occasions, but we've been missing out on many of these occasions by not having the right pack format in the right channel. This has been a key area of focus for us in 2016. We're expanding formats or pack types across channels to better meet consumers' needs. We've expanded our line of smaller size and single-serve offerings. We've gained distribution. And we've even added capacity, where needed, as with Pringles Snack Stacks and small cans. An example of this is our crackers and cookies caddies or our multi-pack of single-serve items. They have grown consumption year-to-date by 10%, accelerating in the latest four weeks.

Similarly, our Pringles On-the-Go products are up double digits. As we launch these new formats, we're swapping out less relevant SKUs to ensure a more proactive approach to portfolio management. This will result in the in-market data looking a bit mixed today, but improving in the second half. This is a big growth opportunity for us, and we are encouraged by the results.

The final priority we discussed with you at Day at K is stabilizing Special K, represented on Slide 17. We discussed how the shift in weight management trends have had a negative impact on Special K and how that, more than anything else, has pulled down our sales over the past few years. So taking a page from the Cereal playbook, we're overhauling Special K Snacks portfolio to drive consumer relevance and reconsideration. We've done a lot of work over the last year renovating some of the Special K SKUs and launching on-trend foods like Special K Nourish Chewy Nut Bars, and we're seeing positive results. Our Nourish bars are 80% incremental to the Special K bars line and, importantly, their velocities in Q2 were three times greater than the rest of the Special K [ph] bar (23:12) portfolio.

So when we get the food right, this brand can grow. The challenge is that there are food forms in this brand that are simply not as well aligned to how our consumers are eating today. That's why in Q2, consumption for certain lines of Special K declined at a double-digit rate. Stabilizing Special K is mission-critical for us. In 2017, we will make a more aggressive portfolio change to the Special K brand, but we expect to continue experiencing some drag from Special K in the second half of 2016.

So I'll use our Q2 and rest of year outlook as a summary of everything we've discussed, and that's on Slide 18. We're improving our profit margins in this business. We saw that in our Q2 results, and we should continue to see profitability improvement in the second half. Our most important brands are growing and we'll continue to invest in these brands in the second half. We still have drags on our top line, most notably, Special K, but we anticipate less of a drag in the second half.

In Q2, we also felt the impact of some timing-related factors from shifting promotion in addition to the completion of our DSD reorganization. But that is behind us and we've already starting to see signs of improved effectiveness.

So we have a lot of work going on in U.S. Snacks. In the first half of this year, we have improved our profit margins and grown our focused brands, even as we address the drags from Special K in our non-core portions of this portfolio. This gives us the confidence that we will see improved results in the second half.

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

John A. Bryant

Thanks, Deanie. Let's turn to Slide 19 and walk through our business segments' Q2 performance and full-year outlook. In U.S. Morning Foods, like Snacks, our margin expansion efforts are clearly bearing fruit. Project K savings and ZBB efficiencies contributed to an expansion in operating profit margin of nearly four points, an acceleration from Q1's strong performance.

In Cereal, the category came back to flat after down Q1, which is encouraging. Our share was off slightly in the quarter, mainly due to the timing of commercial activity, with our core six brands held firm and remain up in share year-to-date. Toaster pastries, meanwhile, continue to perform well, growing consumption by 5%, with food contribution from the new soda flavors.

As we look to the second half of the year, we continue to expect improvement in top-line performance, particularly timing of promotions like the Olympics. We feel good about our business and strong profit margin expansion should continue to drive profit growth.

U.S. Specialty Channels is shown on Slide 20. The segment posted another quarter of growth in sales, profit and profit margins in Q2.

In Foodservice, we sustained strong growth in Cereal, Crackers, Veggie and Wholesome Snacks; all categories with leading shares. In Convenience, we gained share in Cereal, Salty Snacks and Crackers.

Innovation continues to perform well, and we feel good about the momentum we have in our business. We also feel good about our profit margin performance, which continued in Q2. Good price realization and the early benefits of Zero-Based Budgeting are resulting in improved profitability. We expect this to continue in the second half.

Rounding out North America on Slide 21 is our North America Other segment. During Q2, our North America Other segment posted the lowest sales and profit, as each of its component businesses progressed through transitions.

U.S. Frozen Foods is an example of a portfolio in transition as we have reshaped the portfolio for Eggo and transitioned to new packaging across the entire MorningStar Farms line. Even as we made these major moves, this business posted improvement in profit margins, driven by Project K and Zero-Based Budgeting.

Kashi is also amidst a major overhaul of its portfolio. We are investing heavily in our food. During the quarter, we completed an overhaul of our portfolio, making every product non-GMO verified. We also launched several new products; in fact, we believe this was the most innovation launched in Kashi's history. And finally, we redesigned our packaging across our Kashi portfolio.

In Canada, we leaned into price realization in order to cover the transactional currency impact on our cost of goods. This caused some elasticity impact on consumption in the quarter, but it will help us better offset our adverse cost going forward. The good news is that we continue to see share gains in our renovated and repositioned Special K.

So the North America Other segment is clearly in transition, but we expect to see gradual improvement in sales and profit margins in the second half.

Turning to Slide 22 and Europe, we've been expecting sequential improvement in sales and profit in Europe. We saw that in Q2. Sales were flat following Q1's slight decline, and our operating profit margin expansion led to better profit growth.

We are extremely pleased with our Pringles business, which grew at a double-digit rate. Wholesome Snacks also had another good quarter, growing in a mid-single digit rate, led by the U.K.'s 5.5% consumption growth and broad-based improvement in trends in most markets.

Cereal, though, was disappointing in Q2, mainly in the U.K. The category there remains very soft in a difficult economic and retail environment, and we lost share. [ph] Management worked (28:48) to reposition and renovate Special K. Our efforts to renovate Special K's food and new inner strength positioning are ongoing. And while new Nourish is doing well, this recovery may take some time.

The good news is that in our other cereal markets, including [ph] France, Benelux, (29:08) Southern Europe and Northern Europe, we did see sequential improvement and we continue to generate double-digit growth in Russia. As we look to the second half, we continue to expect sequential improvement in Europe in sales and profit, which will require progress in stabilizing U.K. Cereal.

We have plans in place to address this, including an exciting Olympics program and the inner strength campaign for Special K in the U.K. and big back-to-school insert programs across the region. And, of course, we'll continue to improve our profit margins across Europe.

Slide 23 highlights the performance in our Latin American business in the second quarter. We continue to manage well through a difficult business environment. Obviously, Venezuela presents a unique set of challenges and we're managing that well. We're also operating in a challenging economic environment throughout the region. We're working through these challenges. And in Q2, we realized sequential improvement in sales and profit. Our consumption performance, particularly in Cereal, remained solid, with good growth in Mexico and share gains in key markets like Brazil and Colombia.

Our [ph] Cocoa America soccer (31:13) promotion did well. And innovations like Special K Protein Cereal are helping to stabilize that key brand. We are realizing price across the region, particularly as we cope with adverse transactional foreign exchange. And while we saw initial price elasticity impact on volumes in Q2, it should help sales and profit in the second half. It's never easy in Latin America, but the team there is managing through the volatility and should see sales and profit growth in the second half.

Let's look at Slide 24 in our Asia Pacific business. Our Q2 net sales growth accelerated from Q1 and increased our operating profit margin as well. Our Australia business continued to improve, posting slight sales growth in Cereal in the quarter. Of note has been the turnaround in our biggest cereal brand in Australia, Nutri-Grain. In fact, across the entire Cereal portfolio, we improved the penetration and gained share in the quarter.

In Asia, growth was led by distribution gains in Southeast Asia and strong commercial activation in Korea. Our business in Sub-Saharan Africa continued to outpace the cereal category. Pringles in Asia Pacific grew at a high single-digit rate in Q2, accelerating from Q1.

It's important not to overlook our joint ventures. The results are not consolidated into reported results, but they represent a key element to our emerging markets growth strategy. On a pro forma basis, if they were included in Asia Pacific's net sales, our growth in Q2 would've been nearly 12% year-on-year. We're generating double-digit growth in China, led by granola cereals and our West Africa JV also posted strong double-digit growth, in spite of a challenging macroeconomic environment. We expect continued growth in Asia Pacific in the second half, with added growth from our JVs.

And now, let's wrap up our prepared remarks with a quick summary on Slide 25. Regarding Q2, we continue to make progress on our key priorities for this year, investing in our food, expanding Pringles, enhancing our sales capabilities and executing our savings initiatives. And we're seeing stabilization in key cereal markets like the U.S., Canada and Australia. And reflecting a greater focus on profit margins, we're improving our productivity initiatives and posted earnings that were slightly better than our expectations.

As for our 2016 outlook, on a currency-neutral comparable basis, our earnings outlook improves on the strength of inflationary Venezuela, but, just as importantly, our operating profit outlook, excluding Venezuela, now looks to come in at the higher end of our guidance range, reflecting the rapid expansion of our ZBB effort.

And on our longer-term outlook, new initiatives and accelerated programs are giving us better visibility into how we can improve our profitability going forward. This is going to boost our profit margins, even as we reshape our portfolio to better align with today's consumer as we continue to expand our footprint in growing markets around the world. We'll have more to share on this in coming months.

I'd also like to take this opportunity to thank our employees around the world for their dedicated service to our company.

With that, let's open up the line for Q&A.

Q&A

Operator

We will now begin the question-and-answer session. [Operator Instructions] Our first question comes from John Baumgartner with Wells Fargo. Please go ahead.

<Q - John Joseph Baumgartner>: Hi, good morning. Thanks for the question. John, I'd like to ask about the changes underway in the DSD system. As that delivery sales force reorganization concludes, how are you thinking, going forward, assessing the opportunities for further efficiencies in that route to market, either personnel or overhead related? And maybe where can you better leverage DSD for that increased distribution in Snacks that Deanie discussed?

<A - John A. Bryant>: As I said on DSD, obviously, it's a powerful go-to-market engine. It's one that we constantly look to optimize and improve. Over the years, we've taken things in and out of DSD and we're always looking to make that system more effective and efficient. So we've seen some good progress. We're very excited to have the reorganization behind us. We expect to see the business be stronger in the back half of the year. We're making good progress.

<A - Adrienne Deanie Elsner>: Just to add to that, John, as I talked about the price/pack architecture and specifically the expansion in formats, we have the opportunity in our current grocery channels, that are serviced by DSD, to expand the formats in those channels as well as outside of the traditional grocery channels. And so we will be pushing those initiatives into our DSD system.

<Q - John Joseph Baumgartner>: Is that more of a back half focus or more 2017?

<A - Adrienne Deanie Elsner>: You'll see us expanding as early as we speak, back half now.

<Q - John Joseph Baumgartner>: Great, thank you.

Operator

The next question comes from Matthew Grainger with Morgan Stanley. Please go ahead.

<Q - Matthew C. Grainger>: Hi. Good morning, everyone. Thanks for the question, as well. I wanted to just ask about the revised margin targets. So you're on track to deliver $200 million plus in incremental cost savings this year. And with the ZBB, I think you had around $550 million in total. So even if we assume some incremental savings on international ZBB, right now, the formal cost savings seem to give you visibility to about half to two-thirds of the margin that you're targeting, if that all kind of flows through to the bottom line.

So can you just talk about the other factors that you've mentioned, like improving mix, revenue management, how those bridge the gap to get you to the 18% target? And are you comfortable that there is enough margin for error in your model and in your cost savings pipeline that you can definitely reach that target, even in the event of weaker volumes or higher inflation?

<A - Ronald L. Dissinger>: Sure, Matthew. In short, yes, we are. And let me just run through some of the elements of that 350 basis points of margin expansion. And remember, that's off of a 2015 base. And it's also important to note that, that expansion is based on essentially a flat sales expectation. So, of course, we have a continuation of Project K savings and we've talked about this before. As we look at 2017, 2018, we have in the range of $130 million to $150 million worth of savings.

Our Zero-Based Budgeting program, we communicated for 2016, $150 million to $180 million. We now have visibility for both North America and our international businesses, of savings over that period of $450 million to $500 million. So that's over a three-year period, 2016 through 2018.

The other thing, as we discussed we're doing, is we're putting a more concerted effort behind revenue growth management, to generate stronger price and mix improvement. So we have very good line of sight to achieve that margin expansion goal on essentially a flat sales expectation.

Of course, our goal would be to do a little bit better on sales. If we do, then 18%, the 350 basis points expansion is not a ceiling. It's a target or a goal at this point in time, and we have a strong plan and good visibility to get there.

<Q - Matthew C. Grainger>: Okay. That's helpful. Thanks, Ron.

Operator

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

<Q - Eric Larson>: Yes, this is a question for John. In the early part of your prepared comments, it's kind of a little bit of a tag on the last question, your new marketing model, and I think that you said that it might result in less reinvestment, does that mean that your advertising spending as a percent of sales, which is running roughly about 8% – I think it's amongst the highest in the industry – will that percentage come down over time a little bit? And will actual dollars in advertising ease as you become more efficient? How should we look at that?

<A - John A. Bryant>: It's a good question. As we think about brand-building it's an important part of our mix. What drives our categories are strong brands, strong innovation, good in-market in-store execution. And as we continue to have industry-leading levels of brand-building and we continue to invest in our brands, how we invest in the brands is obviously changing, so the importance of TV versus digital, social, mobile, etc. all that is changing the mix. As we do that and we apply Zero-Based Budgeting to our principles to that work, we're finding: one, we can do some of the non-working activity at a lower cost without impacting the amount of activity that we actually do; and secondly, by changing the mix, we can actually get a better impact and potentially at lower cost.

So I'm not going to give you guidance over the next few years as to where brand-building will go, but I think it's fair to say that we probably can see our brand-building come down a little bit from where it is and continue to drive very strong brands into the future.

<Q - Eric Larson>: Okay. And then, just a tag-on question for Ron and then I'll pass it over, but sort of your new margin target goal for 2018, does it include any additional cash investment? Or is this just a better outlook for all the programs that you already have in place, i.e. Project K and ZBB, is there cash impact?

<A - Ronald L. Dissinger>: So our Project K is on track at this point in time. And it's on track both from an investment and a savings standpoint, so there are no additional cash requirements for us to achieve this margin goal.

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

<A - Ronald L. Dissinger>: Yep.

Operator

The next question comes from Mario Contreras with Deutsche Bank. Please go ahead.

<Q - Mario Contreras>: Hi. Good morning. Thanks for the question.

<A - John A. Bryant>: Morning.

<Q - Mario Contreras>: I just wanted to ask a little bit more on the revenue management initiatives that you have in place. Can you give a little bit more detail on what exactly that entails or at least the detail you can provide now over the next couple of years? And what the type of volume elasticity that you're looking at relative to some of the pricing and productivity changes you plan on making?

<A - John A. Bryant>: Yeah, so we are launching a greater focus on revenue growth management in the company. As you'd expect, we've always had a focus on it, but what we've historically focused on, a lot has been trade analytics. And we're finding there's opportunities in some other areas, such as price/pack architecture, and, of course, continue to drive a focus on mix.

And for those of you who followed the Kellogg Company through the 2000s, we had a significant benefit in price realization in what we called a volume-to-value model orientation. We're actually bringing that orientation back to the company to ensure that we are focused on price/mix.

Our price/mix realization as a company has actually been lagging our peer group over the last few years. And so, I don't view this as a radical shift. I view this is an increased focused in this area. And I really want to see better performance from the company going forward. To give you an example, since we have Deanie on the call, I'll let Deanie talk about one example in the Snacks business.

<A - Adrienne Deanie Elsner>: Yeah, and John is exactly right. The opportunity for Kellogg is greater price realization across all three levers of revenue growth management. So I mentioned earlier the Cheez-It example. And in Cheez-It, we assessed our portfolio pricing across all of our channels. We expanded our formats to meet the needs of consumers by channel and that included large sizes and On-the-Go and smaller sizes, in addition to opening price points. The format's changed by channel. We optimized our trade and that gets really to the trade optimization that John talked about, is a towering strength of Kellogg's and the results and you can see them in Q2, consumption is up 5.4%. We've had strong volume mix. Our base sales are up. Our distribution is up and our operating margin has expanded. And so when you look at revenue growth management holistically and in totality across all three levers, there really is strong opportunity for the Kellogg Company going forward.

<Q - Mario Contreras>: Okay. Thank you very much.

Operator

The next question comes from Chris Growe with Stifel. Please go ahead.

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

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

<Q - Christopher Growe>: I just had a question, if I could, and forgive me if I missed this earlier, but have you said how much the total cost savings will be in fiscal 2016, so adding international, the ZBB? How much more is that contributing to your available cost savings this year?

<A - Ronald L. Dissinger>: Yeah, good point, Chris. So when we started the year, we said we had about $100 million worth of Project K savings. We're still on track to deliver against that. And we said from a ZBB savings standpoint, we expected about $100 million of ZBB savings. We are now at a range of $150 million to $180 million worth of Zero-Based Budgeting savings. So that's allowed us to cover sales coming down to the low end of the 0% to 2% range and increase our operating profit guidance to the high-end of the 4% to 6% range all ex-Venezuela.

<Q - Christopher Growe>: Okay. That's helpful. Thank you. And just kind of related to that, as I listen to the commentary about more savings and the focus on margin, I think that's great. I guess what I'm trying to understand is, as you have more savings coming through, or, I should say, as you better focus on margin, does that allow you to also reinvest to generate better top-line growth? So are there more savings coming through that are allowing you to reinvest and to pursue a top-line growth target along with the margin target or could you speak to that maybe over the next couple years?

<A - John A. Bryant>: So we are continuing to reinvest back in our business, as you mentioned. We've invested back in our sales capabilities. We're also investing back in our food. I think Kashi is an example of investing to go non-GMO is a major investment by the company. And so we'll continue to ensure our food and packaging is on-trend as we go forward. And so there will continue to be investments in that area. So as part of our margin goal, we do have an expectation to reinvest some level of savings back into the business.

We are giving a sales guidance here over next couple of years of flat, and that's less than what we would normally do. A couple of reasons for that; one is what we're seeing is from an economic model perspective, from an analyst perspective, if you put in flat sales and the 350 basis points of margin expansion, we think it's a good way of modeling the company.

Quite frankly, we will shoot to do better than that and actually grow the top-line from an internal perspective, but we're not relying upon that to get to the operating margin expansion. The margin expansion is coming more from productivity and price/mix realization rather than, say, volume-type growth.

In addition to all of that, as we go through the next few years, we might see some elasticity as we improve the price realization. And we might see some parts of the portfolio that is lower profit, that we de-emphasize as we continue to grow other parts of our business, such as Pringles, which has been growing mid to high single digits the last couple of years.

<Q - Christopher Growe>: Okay. Thank you for that color.

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

Operator

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

<Q - Robert Moskow>: Hi, Ron. I was hoping you could help me on one thing that you mentioned. When you said $150 million to $180 million of ZBB this year, I think in the same breath you also said $450 million to $500 million over three years? And I was just wondering. Did I get that right? And if so, does that assume that there's no improvement in 2017 and 2018 on those ZBB savings; that it's kind of like a one-time help and then you just hold onto it each year? Thanks.

<A - Ronald L. Dissinger>: So, Rob, we have $150 million to $180 million visibility in 2016 and then that will build over 2017 and into 2018 to a run rate of $450 million to $500 million. The other thing that I'd point out, so that savings in ZBB...

<Q - Robert Moskow>: Okay.

<A - Ronald L. Dissinger>: Yes, that's on top of Project K. That's on top of our base productivity savings as well, Rob. So we have a lot of productivity savings coming through our P&L.

<Q - Robert Moskow>: Okay. So it's not a cumulative number. It does built each year, which is very different from what I thought. So can you give me a sense of what gives you confidence that it can build to that degree? Is it rolling out in different functions of the organization and geographies? And then what percent of those functions and geographies do think it's in right now?

<A - Ronald L. Dissinger>: So it's certainly in North America. And we have line of sight year-by-year. Rob, some of the things are very easy to change and to get the cost savings. There are other things, within supply chain and other areas of our business, that take a little bit more time to recognize the savings. So we're certainly doing it as quickly as we can.

In terms of the rollout through the international regions, certainly our Europe and our Latin America business are well underway. And we're getting some of those savings end of 2016 related to them. Asia Pacific, we'll see more of that savings coming into 2017. But international overall has a stronger tranche of savings in 2017, whereas North America, their savings really was ramping up here through 2016.

<Q - Robert Moskow>: Can I ask if Kashi is going to go through this process?

<A - Ronald L. Dissinger>: Kashi has been involved in the process throughout 2016 as part of the North America implementation, Rob.

<Q - Robert Moskow>: Got it. Thank you.

<A - Ronald L. Dissinger>: Yes.

Operator

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

<Q - David Cristopher Driscoll>: Great. Thanks a lot. Good morning.

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

<A - Ronald L. Dissinger>: Morning.

<Q - David Cristopher Driscoll>: John, wanted to go back to this sales comment that you're making about 2017 and 2018 and the flat numbers. I want to say that back at analyst day, there was a lot of energy about rebuilding the top-line momentum and getting the company back on revenue growth.

You've made repeated comments about the operating leverage that revenue delivers to the business model. So, you've made a couple of comments here, but I'd just like to push it a little further. Is it you're just trying to set up some kind of super reasonable expectation going forward, i.e. a very achievable numbers at this early date? Or is there something about all the growth plans and reinvigorating Cereal and Kashi and all those things that you just have less confidence in and says, hey, let's take this down to a zero-growth expectation.

<A - John A. Bryant>: Thank you for giving the opportunity to clarify if that's a concern out there. I feel very good about the progress we're making on the top line. If you look back over the last three or four years, we've talked about the importance of stabilizing the large four core cereal businesses. I'm happy to say that if you look at the U.S., Canada and Australia, if you look at the measured data, you can see the categories are stable and our share is stable across those three businesses.

The U.K. continues to be a work in progress. That's one we're not happy with its performance, but we expect to see improving results in the back half of the year in the U.K. So core Cereal is looking a lot better than it was, say, a couple years ago. Special K has been a major drag. In fact, pretty much all the loss of sales the company has had over the last few years has been Special K. And what you're seeing in markets like Canada and the U.S., particularly in Cereal, that business has stabilized. And we've still got some work to do in some snacks, extensions of Special K, but we're feeling better there. And so we do think that the growth from Pringles and so on will keep coming through.

An element of why we're being cautious and saying flat sales again, is because, one, we're being, I think, prudent from a modeling perspective. And clearly, if we can get sales growth, it will give us even more flexibility in the P&L.

So one, I think we're trying to avoid overstating expectations, over-cooking expectations, so we're being prudent on the economics. And secondly, as we do drive for more price realization, as we do deemphasize some lower profit elements of the portfolio, we might see some drag on the top-line, but it's a drag that I wouldn't be concerned about, because we're building a stronger core business over time with a better growth profile. So I think we're just giving prudent guidance at this stage.

<Q - David Cristopher Driscoll>: Thank you. Could I just sneak one in for Deanie? Your largest competitor was complaining of higher trade and promo spending by the competition. Can you discuss your view on promo spending and how rational it is right now in your big categories?

<A - Adrienne Deanie Elsner>: Yeah, I'd love to, Dave. It's never productive to comment on competitors, but I'll give you a perspective of how we are looking at the category. For me, the category dynamics appear pretty rational. If you look both across Cookies and Crackers, both categories are up in consumption. Average price is up in both categories, both on a per pound basis as well as a per unit basis. Quality merchandising is flat. [ph] Features and displays are up, displays are down. (51:32) So it's pretty rational of what you'd expect; it is more competitive.

And I can tell you as we look at this from a Kellogg standpoint, our pricing is very similar to what we're seeing in the category. Our price per pound and per unit, both in cookies and crackers, are up versus year ago in the quarter, but ultimately in the long run to win in this category, you have to do three things. You've got to invest in your brands. You've got to launch innovation consumers' love and you have to drive in-store excitement. And so we're going to continue down our playbook in terms of how to go win in this category. And you'll see us doing that both in Cookies on Keebler as well as a couple of our regional brands as well as in the big three in Crackers.

<Q - David Cristopher Driscoll>: Thank you.

Operator

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

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

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

<Q - Alexia Jane Howard>: Can we ask about the ramp up in your cost-cutting efforts? They've obviously accelerated for the near-term here. If I compare that to the $1 billion challenge where there were execution problems through that cost-cutting program, issues of morale, cultural upheaval, what's different? How are you thinking about making sure you learned lessons from that experience to make sure that this time it's smooth sailing? Thank you and I'll pass it on.

<A - Ronald L. Dissinger>: This is Ron, Alexia. So when you look at Project K, and we've discussed this before with analysts and investors, it's very different than that $1 billion challenge. Where we took capacity out of our network, we were actually closing down facilities. That previous $1 billion challenge, we were simply taking people out of the organization and asking the organization to do the same with less people. That was a bit harder for them to accomplish.

So we feel good about Project K and the integrity of our infrastructure as a result of the actions we're taking there. Zero-Based Budgeting, it's really just a refreshing way to look at our cost structure and ensure that the investments that we have are prioritized and aligned with our strategy, so it's nothing more than that. We're being very thoughtful on how we take costs out of our business and make sure that the investments we're making are aligned with our priorities and strategy.

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

<A - John P. Renwick, IV>: Gary, I think we have time for one last question.

Operator

The last question will come from Michael Lavery with CLSA. Please go ahead.

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

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

<**Q - Michael Lavery**>: You touched on Kashi and its sharing in some of the savings efforts, but obviously there's investments there, too, and that Other segment margins are still down. Can you give us a sense of what that trajectory looks like? And should we expect those margins to increase over the back half or is there some other investments still to come we should be factoring in?

<**A - John A. Bryant**>: On Kashi, we feel very good about where we are from an investment perspective. So now we have the entire portfolio GMO-free, we can turn the marketing program on in the back half of the year. We had a very strong slate of innovation go through here at the middle of the year, so we expect to see Kashi return to growth in the back half of the year.

Now, there are some parts of the Kashi business, some frozen pizza items and some other items, that we've culled out of the portfolio, so that might continue to drag on the business, but they were relatively low margin segments of the portfolio anyway. So we feel good about where we are in Kashi in terms of positioning it for long-term growth.

If I could just say on [ph] K and the Other (55:14) because that is a part of the portfolio that did drag in the second quarter, so a few quick comments more broadly on that segment. Three businesses in there, one is Frozen Foods. In Frozen Foods, Eggo is actually doing reasonably well when you add in non-measured channels. MorningStar Farms has gone through a very difficult packaging transition. That's now complete; turning on the marketing in the back half of the year for that business. And also we did cull out some SKUs on the Eggo business at the end of last year. So when you add all that together, it's had a bit of a rough first half. We do expect Frozen Foods to return to growth in the second half of the year.

Canada, we had significant transactional foreign exchange issues in Canada. We've increased our promotional price points. That's going to lead to some disruption in the market as that sort of settles it's way in. So I think Canada will have a tough year. It's the right long-term decision, but it's going to come with a little bit of short-term pain as we go through that.

And then Kashi, as I said, we do expect Kashi to return to growth in the back half of the year and feel better about it. So in the back half of the year, we have two of the three businesses within North America Other returning to growth. And we think that the segment will look better in the back half than the front half.

<**Q - Michael Lavery**>: Okay. That's helpful. And can I just add one quick last follow-up? On the flat sales expectation, can you give any sense of what the split might be between volume and price/mix?

<**A - John A. Bryant**>: No. Look, we haven't given that sort of guidance. I think we'll wait until each annual discussion when we provide more color as to why it is what it is. But clearly, within a flat sales guidance, you would expect volume to be down a little bit and price/mix providing some benefit. And again, let me reiterate, internally, we'll chase better numbers than that, but we don't want to promise those numbers. Clearly, we want to deliver them, though, when the time comes.

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

Operator

[indiscernible] (57:10)

<A - John P. Renwick, IV>: That went faster. We can do one more.

Operator

Okay. The next question comes from Ken Zaslow with Bank of Montreal. Please go ahead.

<Q - Kenneth Bryan Zaslow>: Hey, good morning, everyone.

<A - John A. Bryant>: Hey, Ken.

<Q - Kenneth Bryan Zaslow>: Just two quick questions, one is when you talk about the flat line growth over the long term, can you segment it between how you're seeing about the U.S. because it seems like there's a lot more activity in the U.S. Would you expect that to be ahead of the rest of the world, just given the activity? And then my second question is when you think about the margin expansion of the 350 basis points, that does include this year's benefit of Venezuela or does that not?

<A - John A. Bryant>: Let me answer the sales question and I'll hand over to Ron to answer the margin question. On sales, I'd say the heavy lifting on margin expansion is going to be more in North America and Europe, just given the size of those businesses. And I would expect those businesses to be slightly lower in growth than the portfolio average, with more growth coming from Latin America and Asia Pacific.

So I would say, again, flat is a range. Flat is not 0.0%. So I would hope that even those two big businesses can be in the flat ballpark in terms of top-line growth. But I wouldn't point out that I expect them to grow faster, say, than the portfolio average. Ron, you want to talk about the margin goal?

<A - Ronald L. Dissinger>: Yeah. Ken, the way I think about the margin growth, so it's off of a 2015 base and I would look at it on an ex-Venezuela business. Venezuela is just distorting mainly the 2016 results, but I think about that growth on an ex-Venezuela basis.

<Q - Kenneth Bryan Zaslow>: Great. Thank you.

<A - John P. Renwick, IV>: All right, Gary, I think we're finally out of time.

Operator

This concludes our question-and-answer session. I'd like to turn the conference back over to management for any closing remarks.

John A. Bryant

Thanks, everyone. I appreciate the time on the call and John Renwick and the team are available for follow-up calls throughout the day. Thank you.

John P. Renwick, IV

Thank you.

Operator

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