Transcripts | **Consumer**

Kellogg Company (K) CEO Steve Cahillane on Q3 2019 Results - Earnings Call Transcript

Oct. 29, 2019 3:30 PM ET | 1 Like
by: SA Transcripts

Earning Call Audio

Subscribers Only

0:00:00 -1:00:26

Kellogg Company (NYSE:K) Q3 2019 Results Earnings Conference Call October 29, 2019 9:30 AM ET

Company Participants

John Renwick - VP, IR and Corporate Planning

Steve Cahillane - Chairman and CEO

Amit Banati - CFO

Conference Call Participants

Jason English - Goldman Sachs

Ken Zaslow - Bank of Montreal

Robert Moskow - Credit Suisse

Ken Goldman - JPMorgan

Steve Strycula - UBS

Nik Modi - RBC

Michael Lavery - Piper Jaffray

Laurent Grande - Guggenheim

Operator

Good morning. Welcome to the Kellogg Company's Third Quarter 2019 Earnings Call. [Operator Instructions]

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

John Renwick

Thank you, Mike. And good morning and thank you for joining us today for review of our third quarter 2019 results and update of our full year 2019 outlook. I'm joined this morning by Steve Cahillane, our Chairman and CEO; and Amit Banati, our Chief Financial Officer.

Slide #3 shows our usual forward-looking statements disclaimer. As you are aware, certain statements made today such as projections for Kellogg Company's future performance 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 this third slide of the presentation as well as to our public SEC filings. A replay of today's conference call will be available by phone through Tuesday, November 5. The call will also be available via webcast, which will be archived for at least 90 days.

As always, when referring to our results and our outlook unless otherwise noted, we will be referring to them on a currency neutral basis for net sales and on a currency neutral adjusted basis for operating profit and earnings per share.

And now I will turn it over to Steve.

Steve Cahillane

Thanks, John and good morning everyone. We're pleased to report another quarter of good progress with solid organic net sales growth and sequential improvement in profitability. In fact, returning to operating profit growth excluding our recent divestiture. We continue to do exactly what we said we do. In other words, we remained on strategy and it's another quarter in which we delivered the results we said we would, in short we remained on plan.

Let's start with strategy on slide #5. Our reshape portfolio is doing what is intended to do. We once again delivered good growth in emerging markets where we built up scale and diversified our offerings. We once grew and developed market snacks, thanks to revitalized brands, effective innovation and On the Go pack formats and we delivered growth in developed markets frozen foods led by innovation and marketing that has driven a particularly exciting acceleration for MorningStar Farms veggie foods.

This portfolio should give you confidence and our ability to sustain steady topline growth even as we work to stabilize developed market cereal particularly in the United States. As a reminder, as divestiture closed during the quarter, we're addressing stranded costs and the transition services are underway and being well executed. We used the proceeds to reduce debt and enhance financial flexibility and we're already feeling the benefit of increased focus behind the rest of our U.S. categories.

And from a portfolio standpoint, we're starting to see the divestitures favorable benefit of improved growth profile and better margins overtime. Beyond our portfolio reshaping, deploy for growth also continues to help us improve our competitiveness. Our focus on winning occasions is reflected in the strong performance of this year's innovations and sustained growth in On the Go offerings.

Our focus on building world-class brand in [Indiscernible] and everywhere from Pringles global momentum to the share gains of our revitalized U.S. snack brands to MorningStar Farms growth reacceleration. We've also made progress on improving service and in-store execution aided not only by investment and capabilities, but also by the improved visibility and holistic resource management that comes from our efforts earlier this year to flatten our organizational structure. And our heart and soul boosters are also generating results, as evidenced by our recent rise in the Dow Jones Sustainability Index ranking released during this quarter.

And the best proof that our strategy is working is in our results. In Q3, we again remained solidly on plan for the year. We said we would return to topline growth this year and we're delivering it.

Slide #6 shows that we sustained our accelerations in organic net sales growth. We again posted organic growth in all four regions and we again recorded positive price realization amidst higher cost inflation. Globally, we grew organic net sales in snacks, frozen and noodles and we grew cereal outside of North America led by emerging markets. Importantly, we again showed growth in consumption and share in key categories and brands around the world.

As a result, we are confident in our ability to deliver on our full year guidance. We said the profit growth would follow as we got past key investments and costs. During Q3, our operating profit excluding the mechanical impact of our divestiture moved into growth for the first time in several quarters. We delivered on promised sequential improvement in gross profit margin and we are seeing savings from the reorganizations we executed earlier this year. As a result, we're on target for our full year guidance for operating profit as well, even as we contemplate some incremental investments during Q4.

Over the past year, we've often said that the hardest thing to do is to restore topline growth and we're doing that. In fact the heaviest lifting and the biggest most disruptive actions are largely behind us. We can now work on restoring profitability as well as on more targeted areas of investment. Remember, we're building a foundation for consistent dependable steady growth overtime and Q3 was another quarter of evidence that the foundation is taking shape.

So with that let me now turn it over to Amit, who will take you through our financial results and outlook in more detail. Amit?

Amit Banati

Thanks Steve. Good morning everyone. Our Q3 and year-to-date results are summarized on slide #8. Keep in mind that the results on this slide are affected by the divestiture of our cookies, fruit snacks, pie crusts and ice cream cones businesses which closed at the end of July. So during Q3, there were two months of the quarter when we no longer had the sales and profit from those businesses.

Net sales were down year-on-year because of about four percentage points of this divestiture impact. But on an organic basis, our net sales were up more than 2% for a second consecutive quarter. Our year-to-date organic net sales growth is well within our full year guidance. Operating profit declined because of about 5 percentage points of divestiture impact suggesting or return to growth excluding it. This return to growth may be a little earlier than you were expecting though it did benefit from some favorable timing of certain investments and costs, which will come in quarter four. Our year-to-date currency neutral adjusted operating profit performance is in line with our full year guidance.

Earnings per share declined mainly because of the above mentioned divestiture impact on operating profit. However, partially offsetting this expected decline was a tax benefit. Our year-to-date currency neutral adjusted EPS is in line with our full year guidance.

Our cash flow was also affected by the divestiture. Remember, the transaction proceeds are not included in the cash flow, but the taxes on those proceeds are as our any upfront cost and working capital timing difference. Through the first nine months, our cash flow trailed last year because of the divestiture impact and timing. We are still on track for our full year guidance with taxes on the divestiture proceeds to offset underlying cash flow in quarter four. So our quarter three and nine month results remain clearly in line with our stated 2019 plan.

Let's now go into more details. As usual, we will start at the top of the P&L with net sales growth on slide #9. Our organic growth was up 2.4% and again we grew organically in all four regions. Among our categories globally, snacks led the growth increasing in all four regions. We also grew in frozen foods and we continue to expand in noodles. Cereal was down modestly due to our North America business, but it continued to grow outside of North America led by emerging markets. Importantly, consumption trends remain solid in key markets and categories around the world. And revenue growth management actions have helped us realize positive pricing even if modestly impacting volume. With 1.6% year-to-date growth an only one quarter left in the year we are obviously confident about achieving our full year guidance of 1% to 2% organic growth.

On the slide you can see the negative impact of our divestiture which closed one month into the quarter and had an impact of negative 4%. It will have a little more impact in quarter four, its first full quarter out of our results. For the full year, we still expect 2% to 3% negative impact on net sales from our divestiture to be offset by the positive acquisition impact of Multipro's consolidation which itself anniversaried early in quarter two.

Lastly, currency translation clipped more than a percentage point of our reported net sales in quarter three. While this pressure did moderate sequentially in part because of lapping last year's U.S. dollar appreciation, it has continued to run more negatively than we had expected.

Now let's turn to our gross profit margin on slide #10. As we have communicated previously, we expect a gross margin to decrease year-on-year in 2019, but for this decline to moderate as the year goes on. And once again, we saw marked sequential improvement in quarter three with a year-on-year decline in gross margin, the smallest it has been since back in 2017 before we exited DSD and reset our margins accordingly.

The chart shows the drivers of the sequential improvement in our gross margin. First, the mechanical bucket, the negative mechanical impact of consolidating Multipro, our distributor business in West Africa has anniversaried and starting in the third quarter, we began to see the positive mechanical benefit of divesting lower margin businesses during quarter three. We're also seeing the improvement in the bucket we call growth related. This bucket continues to feel negative pressure from mix, including mix shifts towards emerging markets and away from developed market cereal. It also reflects investments and costs into our food and packaging. Most notably our push into on the go pack format in North America snacks categories.

Revenue growth management is helping to mitigate some of this impact and over the course of quarter three we started to see some offsets from supply chain investments specifically we opened centralize packing centers over the course of quarter three and we are now starting up newly installed packing lines in certain plants to begin repatriating some co-packed volume.

We are also starting up local production of Pringles in Brazil for the first time. As we get ramped up, these actions will provide more and more benefit to gross margin and expect the overall growth related bucket will continue to improve in quarter four.

The final bucket is what we call ongoing. As we've discussed previously, we not only have higher input cost inflation in this yield, but we are also comparing against notably favorable hedges last yield especially in the first half.

Next, we continue to expect sequential improvement in gross profit margin in quarter four even if not quite as quickly as we would have liked. On SG&A expense, we continue to realize benefits related to organizational restructuring dating back to early this year and quarter three was the final quarter to lap the exceptional infusion of brand building investment that we made during quarter four 2017 through quarter three 2018.

Some of the investment that had been deferred to quarter three has now been moved to quarter four. The result of our good organic net sales growth moderating gross margin decline and year-on-year decrease in SG&A was a slight growth in operating profit before the impact of divestiture. We said profit will follow as we got past unusual investments and costs and it is.

Now let's move below the operating profit line turning to slide #11. As we have discussed previously these below the line items faced important headwinds in the first half moderating in the second half and you can see this in our quarter three results. Our interest expense in quarter three was flat for the first time this year. Remember, in the first half it was up year-on-year due debt added last year for our acquisition in West Africa and voluntary pension contributions.

Other income was also flat year-on-year for the first time this year, as favorability in items such as company owned life insurance offset a narrowing decline in net pension items. And for the first time this year, in quarter three we saw year-on-year favorability on our effective tax rate. Not only have we already lapped the sizable discrete benefits of first half 2018 as expected, but we also realized a benefit in this year's quarter three related to reversing a tax accrual. This is a one-time benefit that will not impact quarter four, but it does take down a full year tax rate estimates to around 20%.

Turning to slide #12, nothing has changed regarding our post divestiture timeline. As you know, the divestiture closed on July 29. So, from a financial perspective, the divestiture will have five months of dilution this year and seven months of dilution in 2020. As we now have greater visibility on transition services, plans around stranded costs and overall financial impact, we can now update you on timing of expected operating profit dilution. For this year 2019, we will likely track towards the favorable end of the guidance range we've previously given for impact on operating profit. Some of this dilution is shifting into 2020, when it may take a little longer to fully extract stranded costs depending on the length of transition services and when we lapse the seasonally largest operating profit of the divested business.

During quarter three, we redeemed debt incurring one-time premiums in interest expense but reducing our overall debt leverage. We still anticipate that this cost of redemption largely offsets the savings on interest expense this year. And again its worth mentioning that far more important than how this transaction impacts our 2019 P&L is, what it does for our overall growth and margin profiles going forward. Not only were these lower growth and lower margin businesses for us, but we can now focus more attention and resources on our best categories and brands. And we are already starting to experience this.

So let's move to our 2019 full your outlook and guidance, which is shown on slide #13. We are making no changes to our full year guidance for net sales, operating profits and cash flow and our earnings per share outlook moves to the favorable end of its guidance range. Currency neutral net sales are still expected to finish the year in the 1% to 2% range. In effect, the five months of divestiture in the second half offsets the four months Multipro acquisition in the first half. Meanwhile, organic net sales growth is still forecast to be 1% to 2% as well. Year-to-date, our organic net sales growth is 1.6% so we have confidence in this guidance range.

Currency neutral adjusted operating profit expectations continue to be in the negative 4% to 5% range as we have communicated since the divestiture. That's where we are running through the first nine months. We mentioned the expected divestiture impact shifting a little into 2020, but this is mostly offset in 2019 by investment that is shifting into quarter four. In addition, we may need to leave room for potential Brexit risk and/or incremental investments. So we are maintaining our guidance range for operating profit. Currency neutral adjusted EPS is now expected to be at the favorable end of the previous guidance range of negative 10% to 11% given our quarter three tax benefit and favorability in other income.

And lastly, cash flow is still expected to finish the year at around $0.5 billion reflecting relatively stable based business cash flow year-on-year, but with a roughly $0.5 billion negative impact from the divestiture. Overall, our full year guidance for these metrics has not changed from the beginning of the year other than layering on the impact of our subsequent divestiture. And if anything over the course of the year we've reduced our reliance on quarter four. Meanwhile, we have paid down debt to enhance our financial flexibility. So we feel good about our financial position heading into the final quarter of the year.

I will now turn it back over to Steve, who will review each of our major businesses.

Steve Cahillane

Thanks Amit. Let's now turn to North America in slide #15. For a second straight quarter, we were able to grow organic net sales in this region in spite of a soft period for cereal. This speaks to the composition of our portfolio and the growth momentum we are seeing in our big snacks and frozen brands. It also speaks to the behind-the-scenes work we have been doing. We have changed our organizational design for better visibility and more holistic resource allocation. We have invested in capabilities such as revenue growth management and digital marketing. Our innovation launches and pipeline are the best we've had in years. Our performance in specialty channels remains very solid and we have overhauled key processes for better service and execution.

Meantime, we've been working to cover cost pressures. Revenue growth management has helped us realize price and we've taken major steps to restore margins on our rapidly expanding On the Go Pack formats. As a result margin declines in North America have continued to moderate sequentially. So in a year of incredible change in North America, there is a lot of great work going into its foundation for future growth.

Let's discuss each major category in a little more detail. We'll start with snacks, our largest category in North America on slide #16. Obviously, this is the business most affected by our divestiture. Nonetheless, it posted another quarter of strong organic net sales growth supported again by strong consumption. From a consumption standpoint, the categories in which we compete crackers, salty snacks and portable wholesome snacks collectively grew by more than 4% in Q3 and our consumption was up 5% gaining share. Behind the share gain was continued momentum by our biggest brands driven by effective brand building, incremental innovation and growth in occasion based pack formats.

Pringles continue to grow consumption led by On the Go expansion and effective in-store activity to go with its new wavy innovation platform. Cheez-It sustained its double-digit consumption growth with its successful Snap’d innovation platform coming on top of double-digit growth in the core offering.

In portable wholesome snacks Rice Krispies Treats sustained its strong consumption growth with double-digit growth in both its core offerings and its new Popper's platform. Pop-Tarts consumption growth remains very strong bolstered by new bites and Nutrigrain has rebounded the consumption and share growth with its own bites offerings. So snacks had another very good quarter.

Let's turn now to cereal in slide #17. Candidly, cereal has taken a little longer than anticipated to bounce back after we pulled back investment in the first half to execute our pack size harmonization program. Our promotional activity as measured by the percentage of units sold on promotion in a scanner data didn't climb all the way back to year ago levels yet and we also delayed some advertising activity in part to enable us to activate additional capacity for certain products. Where we have most return to normal brand activity is in the taste fund segment which underwent its pack harmonization back in Q1. This quarter, our taste fund segments brands collectively grew consumption and share.

Greater consumer activation behind frosted flakes and its mission Tiger program resulted in shared growth for that key brand. We're seeing a good recovery in Honey Smacks with new reformulated foods and we're supporting better performance for brands like Froot Loops, Crave and new Pop-Tarts cereal. It is in a health and wellness in all family segments, which underwent pack harmonization in Q2 that we did not restore activity as quickly as we had planned in quarter three and we're also seeing the impact of eliminating certain underperforming SKUs. In recent weeks we are encouraged to see positive reaction to new advertising campaigns for both Special K and Mini Wheats. We've also reaccelerating growth in the bear naked granola brand and continue to grow cornflakes consumption and share. We expect gradual improvement in Q4 and into 2020. We are not where we need to be yet in North America cereal but we're on it.

And we'll finish our North American discussion with frozen foods on slide #18. We had another good quarter in frozen foods. Net sales lapped strong year ago growth and felt the impact of phasing out certain SKUs. More than offsetting these factors was accelerated growth in MorningStar Farms. MorningStar Farms are leading plant-based meat alternatives brand accelerated its consumption growth to 11% and gained more than a full share point. We're benefiting from some very creative social media, exciting new products and distribution growth at major retailers. So much has been made lately of the emerging ready to cook or refrigerated meat alternative segments and there is no question that this segment has terrific momentum in growth prospects. In fact, we are extremely excited about our new launch Incognito in Q1, 2020.

But, we are also excited about the momentum in prospects in the frozen aisle and not just in burgers but in all meat alternative types. One of our advantages is that we have a very complete portfolio. In Q3 for instance, MorningStar Farms grew consumption by 20% in poultry alternatives almost 6% in breakfast meat alternatives and more than 30% in hotdogs alternatives. We even grew 2% in frozen burger alternatives the segment that has seen the most competition from new refrigerated entries. And to further emphasize our various offerings, we are rolling out new packaging in December as shown on the slide.

In frozen breakfast, our net sales declined slightly because of tough comps and phasing out certain products. However, in our core frozen waffles, pancakes and French toast businesses, which we refer to internally as from the griddle, our overall consumption grew nearly 2% year-on-year. Eggo despite tough comparisons continued to grow consumption led by innovation in the French toast and pancake segments as well as sustained momentum for its premium thick and fluffy waffles sub line. Kashi has also accelerated its growth in this category as we pursue a natural and organic occasion. So we continue to feel very good about our frozen foods business.

Now let's discuss our international businesses starting with Europe on slide #19. Kellogg Europe has now posted eight straight quarters of organic net sales growth. The region's momentum continues to be led by Pringles whose double-digit growth benefited from outstanding commercial programs. These range from gaming oriented promotions to our Asia-inspired rice infused innovation. Growth is also being driven by increased On the Go Pack format offerings and by continued distribution expansion most notably in Russia. Cereal sales continued to stabilize in Q3. Across total Europe, the cereal category remains in modest growth and we've returned to share gains over the past few months.

This has been led by the U.K. where we benefited from effective brand building around brands like Crunchy Nut and the success of innovations like white chocolate Choco Pops. We also continue to grow strongly in Russia aligned to our emerging markets strategy. Wholesome snacks continue to be on a path to stabilization with particularly good performance in the U.K. this quarter led by Rice Krispie Squares. Europe's profit decline in the quarter was related to the timing of costs and promotional investments. So it was another very solid quarter for Europe.

Let's turn to Latin America, which posted another quarter of net sales growth as shown on slide #20. Keep in mind that there is a small divestiture impact on this region as we did offer most of the now divested brands in Puerto Rico. On an organic basis Kellogg Latin America posted net sales growth of nearly 6% year-on-year in Q3 despite lapping a double-digit gain in the year earlier quarter.

In Mexico, we continue to post good topline growth momentum led by continued consumption growth in cereal and lapping year ago acceleration. Additionally, we grew consumption and share in wholesome snacks and posted double-digit consumption growth in Pringles. We also grew [America snack] despite continuing to have to work through challenging macroeconomic conditions in Argentina and cereal and biscuit category softness in Brazil. We continue to perform well in the marketplace and we continue to realize price.

We also continue to build a future for Pringles in Brazil starting up local production for the first time and ramping up distribution through a new distributor. This created some extra cost in the quarter but it will make us that much more competitive going forward. Latin America's operating profit was pressured by these startup costs as well as higher input cost and adverse transactional foreign exchange but also by lapping a notably strong profit growth in the year ago quarter. So despite a challenging environment, we continue to feel good about our business in Latin America.

Finally, our Asia Pacific Middle East and Africa business is shown on slide #21. AMEA remained our fastest growing region in Q3 with net sales growth of nearly 8% year-on-year. The chart on the slide is intended to show you the relative sizes of our three major category groups. And as you can see, we grew in all three in the quarter just as we have year-to-date. In cereal, growth was led by Asia and the Middle East North Africa and Turkey sub-regions. Noodles and other is concentrated in Africa where we continue to grow strongly. Multipro's growth is driven not only by noodles, but also growth in other products it distributes in West Africa. In addition, we continue to expand distribution for Kellogg's branded noodles elsewhere in the continent.

In snacks, growth continued as Pringles maintained its momentum continuing to show strong consumption and share growth across the region with gains in markets ranging from Australia and South Korea to Saudi Arabia and India. Operating profit in the quarter was aided by the reversal of an accrual related to an excise tax matter that has been settled. Yet even without that we are delivering double-digit growth this year. So AMEA continues to be a very exciting region for us.

Let's wrap up with a brief summary on slide #23. We're doing what we said we would do. We're taking bold, decisive actions for the long-term health of the business. We've returned to topline growth and we're now focusing and addressing our profit margins. We told you that 2018 and 2019 would be an investor grow period for us as we implemented changes and invested behind our brands and capabilities under our deploy for growth strategy. Through Q3 we clearly remain on strategy.

We have continued to shape our portfolio toward growth closing on an important divestiture and continuing to build emerging market scale. We have continued to enhance our competitiveness through targeting new occasions, revitalizing world-class brands and improving service and in-store execution. We've continued to build capabilities notably in revenue growth management, innovation, digital media and e-commerce and we've realigned our organization for greater agility and yet through all of this change we've remained on plan.

Organic net sales growth is on track for full year guidance and our best performance in many years. Operating profit is on track for full year guidance with margins continuing to gradually comeback. Earnings per share are toward the favorable end of our guidance range and cash flow is on track for full year guidance. As always, I'd really like to thank our employees for their dedication and hard work and bringing about all of this change while still delivering on our financial commitments. Our people truly are our competitive advantage.

And with that operator, we will now open it up for questions.

Question-and-Answer Session

Operator

Thank you, sir. We will now begin the question-and-answer session. [Operator Instructions] And the first question we have will come from Jason English of Goldman Sachs. Please go ahead.

Jason English

Good morning, folks. Thank you slot me in. I guess, my first question is on cereal as you mentioned in your slides this was the year to see some gradual improvement and we haven't seen it. We've kind of seen erosion instead. As you think about the forward, can you give us more context in terms of the activation plans you have to improve your market share performance and the reported organic sales are surprisingly softer than what we are seeing Nielsen on a fairly consistent basis. Is this a result of maybe you're under shipping consumption due to inventory drawdown of the trade, or is there weakness in all major channels that were not seeing and scanned?

Steve Cahillane

Yes, morning Jason. Thanks for the question. A couple of things. Clearly and I hope I articulated this well. Cereal in the United States is job number one in terms of what we have not delivered relative to our performance across the board and so it's obviously a priority. We underwent as you know, a huge pack harmonization in Q1 and Q2 and even it the Q3. And as I said, we are seeing some return to better performance in our taste and fun for you segment and you can see that in the Nielsen, a better performance not where we want to be but modest share gains where we have not yet seen is in special K and frosted Mini Wheats in particular, which underwent a later pack harmonization. And so there is a couple of reasons for that. One reason is, the delay of investment around frosted Mini Wheats more into the fourth quarter based on coming out of the pack harmonization a little late and not really having the capacity necessary. So that's one.

And number two is, just really making sure that we get the pack harmonization through before we reinvest in the category. So we are not where we want to be, but we are getting more green suits showing and if you look at even the latest four weeks outlook, four weeks is not a trend. But the latest Nielsen IRI data that's been published shows some of the best performance in the year across the broad cereal portfolio actually gaining share through the October 19, report. So we are seeing some modest improvements more than modest compared to where we have been based on the activities in the marketplace. So we are optimistic that we have the right plan as we go into Q4 and into 2020.

The other part of your question around timing shipments and so forth, a lot of that has to do with obviously promotional changes and the pack size harmonization and as we always say, there is always going to be a difference between timing of shipments and consumption. We will always prefer to be obviously on driving consumption and having consumption ahead, overtime retailers and suppliers are only going to get more efficient. It's in everybody's best interest always improve against inventory, bringing inventory down modestly that works for everybody in terms of working capital, in terms of freshness of product, in terms of just overall efficiencies in the supply chain. So I don't think we are seeing anything more than that. But we are pleased that consumption is ahead relative to shipment at this point. But we don't see any over arching theme there.

Jason English

That's helpful. One more question then I will pass it on. I think it was it was Amit, who mentioned in prepared remarks that with the topline now back to what you guys do a sustainable growth focus is now shifting on restoring profitability. I was hoping you could delve in a little bit more on the drivers of that. Clearly, we have seen gross margin erosion but from an absolute perspective your gross margins are still reasonably at healthy levels. It's the overhead party or P&L that looks heavy in context to most your other peers. Is there a structural reason why you think, your overhead should be so high or is that an area that in focus as you think about that restoration of profitability?

Steve Cahillane

Yes Jason, I'll start and then turn it over to Amit. Just an important to note, from a gross margin perspective we're not where we want to be we want to continue to drive that. We're very pleased that we're seeing sequential improvement based on the activities that we put in place. From an overall overhead standpoint, we've seen good improvements in terms of bringing the overheads down. When you look at our portfolio relative to others, we don't have a lot -- we don't really have any commodity type of businesses that don't require brand building. So some of our peers do have those types of commodity businesses in their base, which again would change the comparative, but overall I'd say we're driving towards better margin performance. We're pleased to see the sequential, but we know we still have work to do. Amit you want to.

Amit Banati

No, I think you covered it Steve. I think the only couple of other points I would make is we were pleased with the progress that we are making in gross margin both sequentially year versus year ago but also quarter-on-quarter. So I think if you look at our quarter three absolute gross margin, its grown 110 basis points versus where we were in the previous quarter and obviously that's going to be a focus area going forward. I think the only other thing I'd say on overheads is, scale in emerging markets as we continue to build scale in emerging markets that will certainly help us from a scale and overhead standpoint in those markets.

Jason English

Thank you guys. I'll pass on.

Operator

Next we have Ken Zaslow of Bank of Montreal.

Ken Zaslow

Good morning everyone.

Steve Cahillane

Good morning Ken.

Ken Zaslow

One of the comments that you said starting through the introductory comments was that you're flattening out organizational structure. Can you talk about what exactly have you done and can you give some anecdotes of how that's actually either change the way you operate or have done something strategically to kind of give it a directional change of how that's actually impacting the outlook?

Steve Cahillane

Yes. Thanks for the question Ken. The big organizational changes we've made have been in North America and in Europe and if you think back to the past we had different business units really fully staffed business units focused on snacks, focused on morning foods, focused on frozen across different categories and what we've done is, we've combined it into one portfolio, one Kellogg portfolio which allows for much better resource allocation across. You don't have frozen competing with snacks competing with morning foods for investment. You have ahead of categories who is looking across the totality of the portfolio to say where am I getting the best return on investments, what are some of the most strategic areas for us to invest in and driving better decision making because of that as well as a lighter more nimble organization.

You also have a sales organization that is much easier to understand from a customer perspective. So you don't have somebody coming in selling snacks followed by another person coming in selling morning foods. You have somebody representing the totality of Kellogg both at the headquarter level and at the store level, which is not only more efficient but also more effective. So it's really in that sweet spot of being efficiency and effectiveness together and by and large that's the same focus that we brought to Europe as well. So it's about driving better resource allocation, better investment decisions, faster more nimble decision-making and we're seeing it happening in the marketplace and we're seeing that come through and better decision-making, faster decision making some of the best innovation we brought to bear in the marketplace this year I think is a direct output of some of the changes that we've made.

Ken Zaslow

Thank you very much.

Operator

Next we have Robert Moskow of Credit Suisse.

Robert Moskow

Hi, thank you. One of the things I just wanted the clarification on in the prepared remarks is, I think you said the impact of the divestiture would be less severe in 2019 than you thought. But then it would shift into 2020. Amit, can you help us understand like why that timing is happening and then again if it's a little better than you thought what are you doing with that upside? You said you're reinvesting it for Brexit and maybe for other reinvestment spending. Is that correct?

Amit Banati

Yes. So let me just start with the divestiture impact. So I think as we've got greater visibility on the transition services as we've kind of firmed up our plants around stranded costs, I think we've got just a little more clarity around the phasing of how this will play out. So it's not a significant shift. I think, we had guided to -4 to -5. I think we're now saying that given the visibility that we now have three months into the process we're saying it's probably going to be -4 and I think that 1% we are saying would probably shift into next year. I think the shift into next year is again really driven by transitions services that we expect now to be longer than what we had initially thought. So that's going to drag into 2020.

And then related to that would be when you can extract the stranded cost because the two are obviously linked. And so, I think it's really that timing and that clarity and visibility on the timing that's caused the shift between the two years. And I think, in terms of investments again given this is not a major shift, I think as we head into quarter four a little bit of shift in investments from quarter three into quarter four is what we're looking at.

Robert Moskow

And then one follow-up. Was SG&A down excluding the divestiture in the quarter because I think you described it as an investment quarter, but it's kind of hard to tease that out with the divestiture?

Amit Banati

Yes. So SG&A was down and I think, like I mentioned in my prepared comments, it was a couple of things. One is the benefits that we are getting from the organizational restructuring dating back to the start of the year. So that was one driver and then the second driver was we were lapping the exceptional double-digit increase in brand-building that we had in quarter three 2018.

Robert Moskow

Thank you.

Amit Banati

Thanks.

Operator

Next we have Ken Goldman of JPMorgan.

Ken Goldman

Thank you. Two for me. First Steve, I think you mentioned eliminating some underperforming SKUs in cereal. There's been some I guess industry chatter about the impact of Click and Collect and delivery on grocery shelf sets and by that I mean some retailers have been leaning toward giving facings or bigger facings to the high velocity items or moving facings from lower velocity items at a sort of accelerated rate. I just wanted to know and poke around a little bit is your SKU rate have in any way related to that trend or is this more normal course of business and I don't want to make too big a deal out of that?

Steve Cahillane

Yes. Thanks for the question. It's not related to that. So it's the normal course of flavors that underperforming being replaced by new innovations, we haven't seen literally any real change in total points of distribution. So I would say just normal course of business. Obviously, the price package harmonization which was not normal course of business but in terms of SKU rate more normal.

Ken Goldman

Yes. Perfect. Thank you and then I guess my follow-up is, I know you're not ready to really talk about 2020 in any detail, but there were a couple comments made today that I wanted to make sure I heard correctly. So sounds like the TSA will last a little bit longer than you thought. It sounds like stranded costs will still be a headwind for next year as expected but you did caution a little bit about Brexit and maybe some more investments too. Are you trying to send a signal to investors that hey there's some really good things happening into next year in terms of sales and margins on the core level, but there's some other things that maybe might hold back at least temporarily some of the growth on the bottom line. Is that sort of a message that we're trying to take away from here or is that I'm again reading into that a little bit too much?

Steve Cahillane

Yes, I'd say don't read too much into it Ken. I think, let's start with Brexit, I mean clearly, everyday there's new news in the marketplace and it's hard to determine exactly what if anything will happen. So we've been cautious in terms of that. We don't know any better than anybody else exactly what may or may not happen. In terms of investment opportunities, we're saying we're on strategy, we're on plan. We're very pleased with where we're seeing the portfolio shape up outside of U.S. cereal. If we have the flexibility, give us the flexibility to make some investments in quarter four, we'll strive to do that to put us in the best possible position to continue to drive the momentum that we have in the topline. And so just very much on plan and if we have an opportunity to again continue to invest for the long term then we'll look to do that but I wouldn't read much more than that into it.

Ken Goldman

Thanks so much.

Operator

And next we have Steve Strycula of UBS.

Steve Strycula

Hi, good morning. Two strategy questions. The first would be on revenue management. Steve as you look across the portfolio, how do you think about which categories in which regions have the most runway, we hear more and more companies talking about that being an increasingly important lever to drive price mix especially as a commodity that kind of flattens out and then I have a follow-up?

Steve Cahillane

Yes. Steve, thanks for the question. I wouldn't say really that revenue growth management by category has more opportunities in one category or another category. We're obviously focused on our big categories and our big geographies. And so, you think about cereal, you think about snacks, you think about frozen in North America and driving RGM activity and progress there. You think about snacks and cereal in Europe being another big area and focused on developed markets first before we think about emerging markets. Emerging markets were obviously very-very laser focused on our strategy of the affordability pyramid and thinking about making sure we have locally relevant foods that are affordable for the local populations is the way we think about kind of the broader RGM strategy there and then develop markets more sophisticated modern trade approach to it.

We're pleased with the progress we're making. We're striving towards always driving a better balance between volume and price mix. We're pleased with the type of price mix we've been able to drive this year particularly relative to the last several years, but we're working towards really driving a better balance and always having a volume component as well as a price mixed component that's in the black.

Steve Strycula

Steve to follow up there how do we think about that particularly North America price mix volume balance transition as we think over the next few quarters. And then, on the snacking piece you've done a very nice job there. How do we think about as you look for inorganic opportunities to build it out further? What are your top priorities? Is it doubling down on the U.S. market? Is it looking to new emerging markets where you don't have a footprint or actually building out more of a bulkhead in some of your emerging markets where you have like a half position of footprint? Thank you.

Steve Cahillane

Yes. So I'd say, in terms of the developed markets it's balanced as I said, trying to find the right balance and seeking the right balance between volume and price mix is always important for the long-term and so that's what we seek to do there. In terms of inorganic nothing's really change from what we said, if we find the opportunity to find a great business in a white space in snacking in better-for-you and develop markets that could be interesting, scale in emerging markets is very interesting for us. We're very pleased with the investments we've made in Parati, in Multipro, in [Dufo] and so those are a good kind of template to think about the way we think about opportunities inorganically for us. Beyond that obviously I wouldn't want to single anymore.

Steve Strycula

Thank you.

Operator

Next we have Nik Modi of RBC.

Nik Modi

Thanks. Good morning everyone. Just two quick ones for me. Amit, maybe you can just talk about the commodity cost environment from Kellogg's point of view? I'm talking about obviously recent drought conditions in Australia leading Kellogg's take a price increase here. So anything on the horizon that we should be thinking about? And then, for you just thinking about the European business for cereal and how it's really started to progress nicely and move into the almost positive territory, any learnings from that market that you can apply or you think are relevant from the U.S. market? Thanks.

Amit Banati

So maybe I'll just start with your question on some commodities. Obviously, we're not getting into 2020 guidance on this call but if you kind of look at where current input prices are and spot rates, we should be looking at little less inflation or in the next year compared to 2019. 2019 as you know, we saw mid-single digit inflation year-on-year, so compared to that we should probably be seeing lesser inflation as we look at 2020 based on where spot markets are.

Steve Cahillane

Yes. Nik in terms of Europe as a bellwether and an area to learn from it clearly is that the European cereal business from a category standpoint is returned to growth and we're growing faster than the category especially in quarter three in the U.K. where we saw some very nice acceleration led by Crunchy Nut and Choco Pops and the learnings there are definitely applicable. White chocolate Choco Pops was a huge hit. They've also got some commercial programs and innovations that have been very successful that the U.S. team is studying for relevance in the United States.

Special K actually showing good improvement in Europe and in the United Kingdom really focused on the food. Food being the hero and some of that learning is being applied and as I said even if you look at Special K in the most recent data available some of the stuff that we've brought over from the U.K. and the learnings and the focus on food is giving us reasons for cautious optimism.

So, I think broadly speaking the fact that Europe is in the type of growth it is in cereal is an inspiration for us and there is definitely some learning that can be applied to the U.S. but we've got work to do in the U.S. in terms of cereal. We know that. We're on it and when we get that to where we know we can get it I think the rest of the portfolio really shines through.

Nik Modi

Thanks so much.

Operator

Next we have Michael Lavery of Piper Jaffray.

Michael Lavery

Good morning. Thank you.

Steve Cahillane

Good morning Michael.

Michael Lavery

Can you give a little bit more color on your implied 4Q outlook? You've said things have been on planned so far. You're obviously holding guidance, but it looks like that would likely imply a sequential deceleration in organic EBIT growth maybe down a point or two. You mentioned some of the spending shifts. Can you touch on maybe the magnitude of that and you mentioned Brexit as a risk. It looks like that could slide to next year. What are your assumptions baked in for 4Q as it is and maybe the last piece is just as you talked about some of the centralized packing for the On the Go packs in 3Q, how much was that ramping and should we expect more of a benefit in 4Q? Can just help us put all that together?

Steve Cahillane

Yes. I'll start Michael and maybe Amit will add as well. Obviously, we don't give quarterly guidance and we reaffirmed everything we talked about for a full year and so you can obviously do the math from there. In terms of Brexit obviously, we don't know what if anything that will bring and when it will bring. We're preparing as best we possibly can but there's an array of different potential outcomes there and what we like everybody else are watching. In terms of our On the Go pack formats and bringing things in-house we're making good progress there and that's one of the drivers behind our sequential gross margin expansion. So we'll continue to do that.

And then, beyond that I wouldn't signal anything about next year. Again it's too early to talk about 2020 guidance and we like where we are in terms of on strategy, on plan. We're looking to do the same type of drive the same type of performance in Q4 and when we talk about Q4 results in February, we'll give you a better outlook on exactly the way we're thinking about 2020.

Amit Banati

I think the only other thing I'd add is just the divestiture impact. So in quarter three we had two months of impact. In quarter four will have the full quarter of impact. So in quarter three NSV or the divestiture impact was about 4 percentage points on NSV and about five percentage points on OP. Given we've got three months in quarter four, it'll be around 5% on NSV and an OP it will be around 8% to 9%. So I think that the impact of the divestiture will be more pronounced as we have three months of that in quarter four. And I think as Steve mentioned earlier, we'd also look to see if we could make some investments behind growth opportunities should we have the opportunity to do so.

Michael Lavery

Great, thank you very much.

Operator

Next we have Laurent Grande of Guggenheim.

Laurent Grande

Yes. Good morning everyone. Two questions actually. The first one is, I mean still on the guidance I mean you have stronger margin in the quarter and delivering a bit on EPS. In addition you lowered your tax rate guidance for the year and despite all those positive you just had modestly your EPS guidance for the year. So could you please help us reconcile and as it may prove, your guidance is a bit conservative. And second question is really more on the North American frozen food and MorningStar Farm specifically. Lots of interest recently on prom based burger meat alternative generally. Could you please let us know are you are planning to compete against rather new entrants like impossible or beyond in the category? Leverage your scale especially in the art of home consumption.

Steve Cahillane

Yes. Thanks Lauren. I wouldn't, I'd just be repeating in terms of quarter four guidance. We're pleased about where we are on strategy, on plan. You look at where our sales is and we want to continue to maintain that type of momentum which gets us exactly in the 1% to 2% as we guided towards. And as both Amit and I mentioned if we have an opportunity to invest in quarter four we would be looking to do that and so that's kind of where we stand in terms of the full year outlook.

In terms of the frozen business and in particular our MorningStar Farms business, we believe we have a competitive advantage for several reasons. Number one, we've got a very complete portfolio. We've got frozen. We're going to introduce refrigerated in the first quarter of 2020 and we even have an ambient offering in our [Indiscernible] that were in test right now that we're optimistic about the potential there. So a full-on complete portfolio we have the scale that is Kellogg from a manufacturing standpoint, from a sales standpoint, from an R&D standpoint. I've been trying our food on a very regular basis that we're going to introduce in the first quarter and I am very pleased with the food and very proud of our R&D team that have really created a best-in-class, a refrigerated offering that we're very excited to be launching.

We've had a number of customers trying that as well and so as I look at the totality of what we bring MorningStar Farms, the brand, the heritage the tradition, the insights that we have, the complete portfolio that we have, the poultry offerings which continue to do extremely well, I think we've got a real gem in our portfolio and you'll see more of that come through and I guess I would just end with the fact that even without the refrigerated offering being in the market yet you're seeing a real acceleration as we talked about in our veg business MorningStar consumption was up nearly 11% in quarter three, gaining 120 basis points a share. So we're very pleased with the team and what they've accomplished and believe that the best days for that business are clearly in front of us.

Steve Cahillane

Operator we are at 10:30, so we're going to have to wrap it up. But thanks everyone for your interest and please call if you have any other questions.

Operator

And we thank you sir, to the rest of the management team for your time also this morning. Again the conference call is now concluded. At this time you may disconnect your lines. Thank you. Again everyone take care and have a wonderful day.