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Q1 2007 Kraft Foods Earnings Conference Call

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PRESENTATION

Operator

Good afternoon, and welcome to the Kraft Foods first quarter 2007 earnings conference call. Today's call is scheduled to last about one hour including remarks by Kraft Foods management and a question and answer session. [OPERATOR INSTRUCTIONS]

I will now turn the call over to Mr. Chris Jakubik, Vice President of Investor Relations for Kraft. Please go ahead, sir.

Chris Jakubik ***Kraft Foods - VP IR***

Thank you. And good afternoon. Thanks for joining us on our conference call. I am Chris Jakubik, Vice President of Investor Relations. With me are Irene Rosenfeld, our Chairman and CEO and Jim Dollive our Chief Financial Officer. Our earnings release was sent out earlier today and is available on our web site, kraft.com.

As you know, during this call we may make forward-looking statements about the Company's performance. These statements are based on how we see things today, so they contain an element of uncertainty. Actual results may differ materially due to risks and uncertainties, so please refer to the cautionary statements and risk factors contained in the Company's 10-K and 10-Q filings for a more detailed explanation of the inherent limitations in such forward-looking statements. Some of today's prepared remarks will exclude those items that affect comparability. These excluded items are captured in our GAAP to non-GAAP reconciliation within our news release, and they are also available on our web site.

We'll begin today's call by hearing from Irene who will share her perspectives on our performance in the first quarter. Then Jim will provide an overview of our financials. After that we'll take your questions.

Before we get started I would like to highlight some changes we've made to the earnings release. We've simplified our discussion of the key drivers of organic revenue growth and of operating income and earnings. We want to focus more on the underlying health of our businesses and the factors that are most important to your understanding of our progress against the strategic plan we laid out in February. We hope you find these changes useful and welcome any feedback you have so we can continue to improve our communications.

Now, I'll turn it over to Irene.

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

Thanks, Chris. Good afternoon. As we mentioned in our earnings release today, Q1 was a very eventful quarter for Kraft. We became a fully independent company on March 30th. I'm happy to report that the transition has been seamless and our 90,000 employees are eager and energized to write this next chapter in our history. We embarked on our strategic plan to get Kraft growing again and we're making progress. While our I'll share a few examples today, you'll really start to see more evidence in the back half of the year. And most important, our earnings met our expectations. We're on track with our programs and our full year guidance is unchanged.

I'd like to share some thoughts about our results in the quarter and how they position Kraft for the remainder of the year. First, the declines we reported in our earnings and profit margins reflect the necessary planned investments I outlined in February. These investments are targeted at a number of critical areas, all designed to drive consistent, sustainable growth. As a reminder, we're investing in quality, to make our foods truly delicious. Marketing spending to provide the necessary support to our base business. And infrastructure, specifically information systems and expanded distribution in select developing markets.

The second point I want to make is that the early results of these investments in our base business are promising. For example, our investments in quality and marketing support behind our Mac and Cheese business drove double-digit revenue growth and over 1 point of share gain year-to-date. We have now launched DiGiorno Ultimate Pizza into 17% of the U.S. So far, results are ahead of expectations as we head into our national launch in June. And we're pleased that Oscar Mayer Deli Creation Sandwiches have had excellent acceptance by the retail trade.

In February I talked about several other initiatives that we're piloting and I'd like to give you a quick update on a few of them. Our Fresh Creations Prepared Salads are being tested in Boston and Denver. We continue to learn and make the necessary adjustments to our launch plans to maximize the potential of this new category in our North American business. We're taking our cheese snacking display test to more than 200 stores, making it easier for consumers to choose Kraft Cheese when they're looking for healthy, convenient snacks. And our wall to wall sales initiative is also gaining momentum. We're now rolling it out to stores that account for about 20% of Kraft's [alt] commodity volume. But we're just getting started.

And while we've had a number of successes to date, we're continuing to address some of the long-standing business challenges that are impacting our growth. First, we're gaining market share in only about half of our U.S. businesses, in particular, cheese, main stream coffee and salad dressing shares fell in the quarter. That's unacceptable and we are working on solutions but it will take some time to get our shares growing more broadly. And while we saw strong results in our international business this quarter, we do have more work to do.

In sum, I'm encouraged by the signs of progress we're seeing in our results, I continue to be confident that we're on the right track in our game plan to return Kraft to consistent, predictable growth but it will take some time.

And now I'll turn the call over to Jim.

Jim Dollive ***Kraft Foods - CFO***

Thanks, Irene. And hello, everyone. Before I begin, please keep in mind that unless otherwise noted, my comments will exclude the items affecting comparability that were highlighted in our press release.

Now let's get into the numbers, starting with sales. Our organic net revenues were up a solid 3.6% in the quarter with more than 1 point of contribution from volume growth and more than 2 points from favorable product mix. Gains in four areas drove revenue growth. New Better For You offerings primarily in beverages, strength in convenient meals, driven by increased marketing support and new products, snacks growth in North America and Europe, and continued momentum in developing markets. Net pricing was relatively flat in the quarter as price increases on several categories were offset by new product support as well as some dealing back to protect promotional commitments through Easter. We expect the contribution from pricing to increase as the year progresses.

Turning to profits, there are three things to note. First, our gross margin was down 60 basis points driven by investments in quality, new product support and the protection of promotional commitments. Second, our operating income margin declined 120 basis points for the reasons just mentioned, as well as incremental investments in marketing, systems capabilities and distribution infrastructure and the higher margins of divested operations. And third, the benefit from share repurchase activity was offset by the increase in our effective tax rate versus 2006. On the quarter, our effective tax rate was 32.3%, as we benefited from full tax consolidation with Altria. For the year, our guidance remains at 35.5%.

Moving on to the [distant] segments, as Irene said, we're beginning to see improved results where we have made investments in our base business and in reframing our categories. At the same time, meaningful challenges remain in a number of businesses. North American beverages is a prime example. Within beverages, organic net revenues grew 3.9% as we benefited from our investment in Better For You and premium products. Product mix was the key driver, contributing 3.5 percentage points, reflected in the success of our powdered beverage sticks including new Crystal Light sticks with anti-oxidants. In addition the launch of Capri Sun with anti-oxidants is off to a good start.

Finally, coffee growth was driven by our premium products, but this was tempered by share declines in main stream coffee. At the profit line, operating income margin declined 170 basis points as higher grain coffee costs and investments in new products offset solid top line growth.

In North America cheese and food service, organic net revenues were up slightly. Here, cheese revenues grew reflecting solid gains in snacking, topping and spreading cheeses. Sandwich cheese also grew revenues. However, share was down due to heavy branded and private label promotional activity. Partially offsetting the cheese gain was lower food service revenues due to product pruning. Operating income margin was down as we reinvested favorable pricing and mix into a strong, double-digit increase in marketing behind both the base business and new products. While we did lose share of total cheese, we are encouraged by the initial results of our category reframing efforts and expect to see improvement as the year progresses. In fact, our heightened new productivity in cheese should allow us to begin driving both category growth and share gains in the back half of the year.

Moving on to North America convenient meals. Organic net revenues were up nearly 5% driven by three factors. First, we had continued success in the growth initiatives like Oscar Mayer Deli Shaved Meats, Super Premium California Pizza Kitchen frozen [no audio] our quality enhancements in both pizza and mac and cheese drove solid based business growth. Third, we launched DiGiorno Ultimate Pizza and Deli Creation Sandwiches, as part of our strategy to source for the away from home eating occasions. Operating income margin fell approximately 2 percentage points in the quarter, reflecting the impact of divested operations, as well as our investment in product quality, new product support, and increased marketing behind the base business.

On to North American grocery where organic net revenues were flat. Two factors drove these results. First, we continued to see results from new sugar free offerings such as Cool Whip and Jell-O Ready-to-eat Pudding and Pudding Poppers. With it's strong growth, our sugar free refrigerated pudding now represent half of our refrigerated pudding franchise and will be a continued area of focus going forward. These gains were offset by ongoing weakness in salad dressings where revenues were down mid single digits due to category weakness, the lingering softness in [inaudible] salad consumption and continued share losses. We'll share our plans for the [forables] turn around later this year.

Going forward, we're working on ways to contemporize the grocery portfolio with innovations in health and wellness and convenience. But these businesses have been losing share for many years and it will take some time to fix them.

Looking at North America snacks and cereals, organic net revenues were up a solid 4%. In biscuits, new snack products and merchandising gains drove growth in both cookies and crackers. Within that strong performance, Oreo experienced a temporary revenue decline in response to a first quarter price increase. Our main disappointment in this sector was the decline in ready to eat cereal revenues as share losses in kid cereals led to lower volume in the quarter. Operating profit margins in snacks was down slightly. Gains from revenue growth and manufacturing productivity were offset by reinvestments in quality and marketing as well as the impact of the Milk-Bone and Cream of Wheat divestitures. Looking ahead, we expect these same factors to impact the operating income margin of snacks for the remainder of the year.

Now I'll turn to our international businesses which had a good quarter across the board. In the EU, organic net revenues grow about 3%.

This was driven by high single digit growth in chocolate, behind new product introductions from Milka, Freia Marabou and Cte d’Or. Going forward, we're excited about the opportunities to continue to build our EU snacks business as we complete the integrate of the UB Iberia biscuit business. By contrast, the EU coffee was essentially flat as heavy promotional activity in mainstream coffee offset gains from our premium products such as Cte d’Or.

Finally, developing markets had another strong quarter. Organic net revenues grew about 9%. Eastern Europe and Latin America led the way with significant contributions from soluble coffee and chocolate in eastern Europe and strong category growth in chocolate and biscuits in Latin America. Going forward, we expect continued strong performance from developing markets as we invest in expanding distribution.

Finally, on our restructuring program, we spent $88 million on restructuring activity during the quarter, and continue to forecast $625 million of cost for the year. Cumulative savings are up to $615 million, and we continue to expect cumulative savings of $700 million by year end. Now, we'd be happy to take your questions.

QUESTIONS AND ANSWERS

Operator

Thank you. We will now conduct a question and answer portion of the conference. [OPERATOR INSTRUCTIONS] Our first question is coming from Alexia Howard of Sanford Bernstein. Please go ahead.

Alexia Howard ***Sanford Bernstein - Analyst***

Hello, everyone.

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

Good afternoon.

Alexia Howard ***Sanford Bernstein - Analyst***

Hi. A couple of quick ones. First of all, I think you mentioned on the last earnings call that pricing was expected to be taken up in the second quarter this year. Are you expecting that to have a marked impact from the operating margins for the entire company as we go through the quarter of the year, the next few quarters?

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

Well, we have priced a substantial part of our portfolio over the course of the last 12 months. In this first quarter, we spent a fair amount back against some of our new item introductions, as well as to protect our merchandising price points for the Easter holiday, and so we will expect to see greater impacts as we head into the second quarter.

Alexia Howard ***Sanford Bernstein - Analyst***

Okay. Great. And then another -- I guess the second question on just your -- the forthcoming portfolio strategy. It seems as though -- I think I've seen a couple articles recently that you're thinking about focusing on possible acquisitions in eastern Europe and Latin America. I was wondering if you could just give us a bit more color on the type of acquisitions that you're looking at? And then, perhaps on a more direct note, do you have any comments on whether Kraft is considering making a bid to Calgary?

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

Well, Alexia, as I said on a couple occasions, our plan as we've laid it out is predicated on organic growth, and I feel very confident that we can achieve the targets that we've laid out on that basis. Having said that, we will continue to look at opportunities as they arise, and our focus will be on the opportunity to build scale in international markets, work to gain access to new categories, new capabilities or new technologies, and so that's what I would say at this point.

Alexia Howard ***Sanford Bernstein - Analyst***

Okay. Thank you very much.

Operator

Thank you. Our next question is coming from David Adelman of Morgan Stanley.

David Adelman ***Morgan Stanley - Analyst***

Good morning or good afternoon, rather. Irene, can you talk for a second about quality? You've talked about that as an issue a lot. But could you help us understand, perhaps what percentage of the portfolio has an adequate product quality edge versus competition and where you hope that to be at certain points in the future?

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

You know what, I'm not really able to give you a specific number, David. But what I will tell you, that a fairly significant portion of the 3 to $400 million investment that we have laid out in 2007 is behind quality of a number of our base products. We have been pleased to see the response as we have made some of those investments in products like mac and cheese and pizza, and you'll continue to see progress on a number of others as the year progresses. But we really are making investments across the board.

David Adelman ***Morgan Stanley - Analyst***

Okay. And then could you comment regarding your share repurchase activity, if any, since the close of the first quarter, when the $5 billion program became available for your use?

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

We ask Mr. Dollive to comment on that one.

Jim Dollive ***Kraft Foods - CFO***

Hello, David. As we said, we will -- we would be active taking advantage of the opportunity that the distribution of shares afforded us, and we have in fact been in the market doing that. Even though we've been into our earnings period, we have contracted with an outside support group to continue to do that in our behalf. We're not going to get into the specifics of exactly how much we're doing, but we have been active in the marketplace.

David Adelman ***Morgan Stanley - Analyst***

Okay. Thank you very much.

Operator

Thank you. Our next question is coming from Chris Growe of A.G. Edwards.

Chris Growe ***A.G. Edwards - Analyst***

Good evening.

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

Hello, Chris.

Chris Growe ***A.G. Edwards - Analyst***

I just have two questions for you. I guess it's a bit of a follow-up from David, you had mentioned that the bulk of your 3 to $4 million, or a large sum of that, is going to be in quality upgrades. So was that the main reason for the gross margin pressure in the quarter? Because you had good mix. You had a little bit of price. You had a little more cost saves than I expected.

Jim Dollive ***Kraft Foods - CFO***

Well, let me grab that one. The gross margin was a couple of things and some of it is the investments we're making in that quality initiative. We also did see during the quarter some higher commodities coming across in certain areas. We've taken pricing, as I said during my comments, to recover that, but we did invest in protecting our promotional programs and that's been the primary driver of the decline in the gross margin.

Chris Growe ***A.G. Edwards - Analyst***

Okay. And can you quantify the input cost inflation for the quarter, Jim?

Jim Dollive ***Kraft Foods - CFO***

I don't want to give a specific number. But it's -- well, actually it was on the order of $100 million. I will give you directional numbers, on the order of $100 million, and we're seeing it in a couple of different commodities. But I think from a recovery perspective, we're at a much better place than where we've been in the past, and it is our expectation to be able to recover that as the year progresses.

Chris Growe ***A.G. Edwards - Analyst***

Okay. Thanks for that. And then the last one I had just is on the marketing increase. And again, I had expected a little more of that 3 to $4 million being more heavily weighted to marketing. Can you give us rough figures for like what marketing would have done in the quarter, perhaps what you expect for the year?

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

Well, clarify the comment that I made to David. I didn't say the majority of our 3 to $400 million. I said it was an important part of it. I want to start there. A big part of it is about marketing and investments behind new initiatives. And, quite frankly, it's a little early for a lot of that to kick in. You would have seen some increase in our A&C investment in this first quarter, but the bulk of that really will play out in the course of the year as we actually bring some of these new items and some of our base advertising campaigns to the marketplace.

Chris Growe ***A.G. Edwards - Analyst***

So just a small number here in the first quarter, then?

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

Again, it's a contributor to our overall performance in terms of operating margins. But it -- a lot of that is just how it's reported as much as it is the as spent impact on the business.

Jim Dollive ***Kraft Foods - CFO***

And, Chris, if you look at the [mar] increase during the quarter, the largest single component of that was in fact the marketing spending.

Chris Growe ***A.G. Edwards - Analyst***

Okay. Well thanks for that. Thank you.

Operator

Thank you. Our next question is coming from Jonathan Feeney of Wachovia.

Jonathan Feeney ***Wachovia - Analyst***

Good evening. Irene, I want to take -- get a little more into the supply chain here. When you look at the 650 million in cost savings on an annual run rate right now from previously announced restructurings, I guess, 100 basis points of savings for a company that absolutely dominates its -- the segment in terms of sales, and therefore should have -- I would think a ton of efficiencies, especially considering operating at a relatively low margin, it just seems like a low number to me. I guess I'm just wondering, having had some time to take a look at the way Kraft does business and the advantages you have and maybe some overlap, and I know you mentioned wall to wall as sort of a revenue driving strategy, just a better go to market, I mean are there cost savings initiatives that you have in the works, even if they might include some sort of further restructuring?

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

Well, you know, I take it -- we will continue to look across our entire business system at opportunities for cost savings. But we have been very active over the last number of years, 5 to 10 years, in fact, in terms of improving the efficiency of our overall supply chain system as we took Kraft out of the consolidation of a number of our selling organizations, as we globalized our procurement organization and our IT organization, so, we've realized a number of the efficiencies that other companies are talking about right now, we've realized those over the course of time. So we will continue to look at those opportunities and we are. But in the near term, I really believe that our selling capability is a source of competitive advantage and that's really our focus, is on how to have a leverage that to help revenue growth.

Jonathan Feeney ***Wachovia - Analyst***

Okay. And just one other -- it looks like you are increasing advertising/marketing, and I guess if you look at -- it seems like it's been a winning strategy over the years, to not only increase advertising against new products but advertise against the base, a number of companies have seen some acceleration in some core, maybe under-advertised products by spending more against it. If you look at Maxwell house, just to give an example, maybe that's an area where there's been a little bit less advertising and that's showing up in the brand right now. I guess, do you have a ad -- relative advertising spending as a percent of sales in mind? What you think is the right one for Kraft? And are there any areas right now within your core that you think specifically are under-advertised?

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

I'll take you questions one at a time. I think the first point is, without a doubt we believe that reinvestment in some of our core businesses can generate growth. You will see that playing out over the course of the year. In fact, some of the benefits that we're seeing for example on mac and cheese is not just about the quality investment but it's also then about the marketing investment behind it. And you'll see that play out on a number of our core businesses. So, without a doubt, those investments will be a key part of our growth plan.

Jonathan Feeney ***Wachovia - Analyst***

And target of relative ad spend, is there one?

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

Well, we said in aggregate that we're targeting over time to get our total A&C to about 8 to 9% of net revenue, which we believe will put us at competitive levels. We have not talked specifically about a media target, simply because with the evolving media consumption patterns of consumers, some of that money is not going to be spent on traditional media.

Jonathan Feeney ***Wachovia - Analyst***

Perfect. Thank you.

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

You're welcome.

Operator

Thank you. Our next question is coming from Ken Goldman of Bear, Stearns.

Ken Goldman ***Bear, Stearns - Analyst***

Questions on innovation and, Irene, you just touched on this a little bit, but three of your biggest categories are cheese, coffee and meat, they're also three of the more fragmented competitive categories in the space, perhaps some would say less -- there's been a little less innovation than they liked to have seen in recent years, and some also have suggested that as these businesses go, so goes Kraft but two of the three I believe lost market share this period. I'm wondering how you think about improving your product quality? Is it across the board in your lines? Is it more in the products that are perceived as premium, like Gevalia, Starbucks? Or is it mainly in the core cheese, meat and coffee product lines?

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

Well, Ken, just as I answered a moment ago, it's really the quality investment is across the line, because we do believe that the opportunity to make our foods truly delicious can benefit all of our businesses. The priority, though, that we have given to a number of our marketing investments is in terms of their ability to over -- to impact the overall business. So the three categories that you've described are three categories that are very much on our radar screen. I'll tell you that we're feeling very good about our performance on our meat business, and in fact, I think that in many respects is a model for what we're looking to do in a number of our core categories, as we thing about broadening the frame of reference, reinvesting in quality and investing in marketing support. So that is a key plank of our ability to accelerate growth.

Ken Goldman ***Bear, Stearns - Analyst***

Thank you.

Operator

Thank you. Our next question is coming from David Palmer of UBS.

David Palmer ***UBS - Analyst***

Thanks. Irene, you talked about the possibility of a change in the focus for bonus compensation. Since the spin, have you made any changes about how people are going to be paid?

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

We have not made any formal changes in that regard, David. We are reviewing some proposals with our Board, and we will make those public as they are approved and we begin to implement them. But our end in mind is to ensure that the performance and the compensation of our top managers is well aligned with shareholder value.

David Palmer ***UBS - Analyst***

And just a couple category specific questions. Well, actually, first, one on commodity cost, that 100 million directional number you talked about, Jim. That sounds like we're on a run rate to be higher than the 275 million of last year, particularly with the direction we're seeing, I guess, in grains and dairy. Is that a correct characterization? And I guess you're saying that pricing will help you offset it in terms of the margin line going forward.

Jim Dollive ***Kraft Foods - CFO***

Yes, that is -- that's a good characterization but it's not just the -- I mean the grains and the oils are where the focus is right now. But we're also seeing increases elsewhere, coffee and cocoa have also been higher. The key message and the one you were reiterating there is our ability to recover those costs so that they don't become a factor in the overall performance. And I think that is a fair -- that is a fair statement.

David Palmer ***UBS - Analyst***

Regarding the cheese business, there is a lot of discussion in previous calls about your price gap versus private label. In retrospect and seeing some of the performance lately, is it -- is the primary reason that gap getting a little too wide versus private label, that we're seeing some of the weakness?

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

No, we actually -- we've got some other issues that are going on in selected marketplaces and we are prepared to address them over the course of the year.

David Palmer ***UBS - Analyst***

Okay. Thank you very much.

Operator

Thank you. Our next question is coming from Robert Moscow of Credit Suisse.

Robert Moscow ***Credit Suisse - Analyst***

Good evening. I don't know if you've -- you kind of talked about the 300 to 400 million investment, but can you give us a sense of whether it's loaded in the back half or is it a lot of it coming in the first quarter or how is it spread out overall?

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

Robert, it's pretty well spread out over the course of the year, but as you might imagine, some of that investment and the impact of it will lag a little bit. So for example, as we make some of our quality investments, typically it's going to take a two to three month lag before you would -- I'm sorry, a two or three quarter lag before you would necessarily see the impact of that investment. So it just -- the marketplace impact will lag just a little bit.

Robert Moscow ***Credit Suisse - Analyst***

On the sales, you mean, the sales reaction?

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

On the sales reaction.

Robert Moscow ***Credit Suisse - Analyst***

Okay. And then a second question, quickly. One of the concerns I had had was that there had been a shift in your beverage portfolio, away from powder and into ready to drink beverages, but now with the sticks coming out it seems like powdered is coming back. How is Capri Sun doing and Kool-Aid Jammers, and are you -- and I guess your Fruit H20 acquisition, there wasn't much mention of it today.

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

We're feeling very good about the performance of Capri Sun and our entire kid beverage business. We've launched a number of new products, particularly with anti-oxidants that moms obviously are finding quite desirable and we feel very good about that. We continue to work on challenges, in terms of the opportunities for Fruit 20 and some of our other bottled beverages as we look at opportunities in terms of expanding their distribution.

Robert Moscow ***Credit Suisse - Analyst***

Are you partnering with anyone to expand distribution for bottled beverages?

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

I'm not prepared to comment on that today, but as we've talked about that as an issue and an area of opportunity, we're going to continue to explore a variety of solutions.

Robert Moscow ***Credit Suisse - Analyst***

Okay. Thank you very much.

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

You're welcome.

Operator

Thank you. Our next question is coming from Andrew Lazar of Lehman Brothers.

Andrew Lazar ***Lehman Brothers - Analyst***

Irene, I wanted to explore just the wall to wall in a little bit more of a granular fashion. I think you said you're seeing in some some of the test markets in Tampa like a 50 basis point lift in the sales base from the stores where you've done the wall to wall. I'm trying to get a sense, what's the key driver there? Is it primarily more secondary displays? Is it better out of stock performance? Is one -- or are there other things that come from that that I'm not -- how do we measure, what metric do we use to get us into what's actually driving the 50 basis point improvement?

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

I'm not sure we talked specifically about the specific contributions because in any one of these markets obviously it's not necessarily generalizable. But what I will tell you is that the reason that we're seeing a lift, and we believe it has such promise, is because it will impact all of those factors. The relationship with the store manager allows for there to be much more merchandising activity on a more regular basis. It allows us to deal with out of stocks in a more timely fashion. And so, it just all the way around, it allows us, from our perspective, to get some of the benefits that one would have from a store manager relationship that you typically would see on a DSD business with a variety of warehouse products.

Andrew Lazar ***Lehman Brothers - Analyst***

And then, with I guess the large scale divestitures, seemingly not, I guess, a big part of at least sort of a near term plan as you've talked about, have you employed, I guess internally, a -- kind of a rigorous, I guess for lack of a better term, sort of a brand segmentation type of analysis? Like others that operate in multiple categories, Sara Lee or ConAgra, I'm trying to get a sense of which brands, or when we'll have a sense of which brands or businesses sort of deserve a much greater or disproportionate share of the investments and maybe which ones or which areas are perhaps over-resourced? It would seem like -- I realize the whole scale argument, right, but even within that it would seem like some brands and businesses should play a different role than others and you can't focus on --

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

I don't want to confuse the statements I've made about our belief that scale can be a competitive advantage because I do believe it can be with the notion that we're not managing the portfolio. There's no question there are some businesses that have a greater ability to contribute and those are the one that's we're giving greater investment to. There are others that play a different role. We have some very high margin, strong cash generating businesses and our opportunity there is to make sure we can continue to protect their margin generation so that we can use that money to reinvest. So those are not mutually exclusive thoughts. We continue to look at the portfolio very rigorously with an eye toward understanding which of our brands best fit into our long-term performance goals.

Andrew Lazar ***Lehman Brothers - Analyst***

Is that something you think, it may be premature, but, that you might be able to sort of report on, kind of going forward? In other words, where you put a greater level of investment, you're seeing this type of lift, where you haven't -- you're not necessarily seeing it fall off that tremendously. It's all about the returns on what you're spending in each area.

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

I hope you'll see it in our results. So as we make these investments I think it will be clear to you where we're choosing to make some of them. I've certainly signalled a couple of those in February, and I would encourage you to continue to stay focused on what's happening in our cheese business, what's happening in our snacks business, what's happening in our pizza business and our other convenient meals. But I think you -- we'll continue to be able to talk to you about where we stand with respect to the portfolio as our thinking evolves.

Andrew Lazar ***Lehman Brothers - Analyst***

Great. Thanks very much.

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

You're welcome.

Operator

Thank you. Our next question is coming from John McMillin of Prudential.

John McMillin ***Prudential - Analyst***

Hello, everybody.

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

Hello, John.

John McMillin ***Prudential - Analyst***

I don't know if the stock is trading in after hours market but the feedback I've got has been largely positive. Mostly because of the organic sales gain being above my expectation and being kind of towards the high end of your 3 to 4% targeted range. I guess I'm trying to understand the sustainability. One, was an early Easter at all an impact in helping you? Because some other companies kind of mentioned last year that a late Easter hurt them. Were you at all benefited by an early Easter?

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

There's no question we feel that we're off to a good start. It's a little hard to quantify the impact of Easter but we believe it would have had some modest positive impact. But we remain confident that the 3 to 4% target that we've laid out for the full year is quite achievable.

John McMillin ***Prudential - Analyst***

Now, was pass-through a little bit bigger -- in the old days, when you were here at Kraft the first time, it was all about volume and maybe wouldn't have been pleased with the 1% volume gain, a little over 1%. But the -- the price mix was bigger than what I thought. I'm just wondering, to what extent a lot of that was pass-through, or as you indicate, protecting merchandising price points and some kind of shipments ahead of pricing? I guess what I'm really asking, were these sales numbers organic sales numbers in line with your expectations or slightly higher? Because they were slightly higher than ours and I'm just trying to understand the difference.

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

Well, I mean, we feel very good about the mix, the performance of mix in driving our overall revenue this quarter. Over time I'm hopeful that we'll continue to see continued contribution from volume. In the short term it's going to be a little bit depressed by some of the pricing actions that we're taking, and we're still doing some pruning in a couple of our core businesses, [inevitably] food service. But over time we're looking to see the combination of volume and mix driving that revenue number and that's what we believe will make it sustainable.

John McMillin ***Prudential - Analyst***

I wish you told me about that Oscar Mayer Deli Creations before CAGNY so I wouldn't have made my Imus-like statement. But I look forward to eating the product.

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

[LAUGHTER] Thanks very much, John.

Operator

Thank you. Our next question is coming from Edgar Roesch from Banc Of America Securities.

Edgar Roesch ***Banc Of America Securities - Analyst***

Good afternoon. Thanks for taking the question. I guess I wanted to explore mix just a little bit more. I mean, last year you had a lot of SKU reduction and rationalization that helped that mix perform as well as it did. Just wondering if that was much of a contribution at all in this quarter?

Jim Dollive ***Kraft Foods - CFO***

Hi, I'll take that one. Mix certainly did benefit from some of that transition. But if you look at the mix component and in one of the schedules we do revenue, we do show that by segment. It was broad-based. So what we're seeing at the benefit of some of the new product initiatives and some of the other programs we're doing to drive the overall mix of each of the segments.

Edgar Roesch ***Banc Of America Securities - Analyst***

Sounds good. And just one other question on restructuring savings. The 75 million increment in the annual run rate that you achieved during Q1 was a pretty good step-up and accomplished a lot of the step-up that you will for the year. Is it going to be pretty front end loaded this year or was that just a Q1 phenomenon?

Jim Dollive ***Kraft Foods - CFO***

A lot of -- since these are event driven, a lot of it is sequenced by when those particular events unfold. In this case, we had the benefit of some of last year's costs showing up as savings in Q1. So it is -- it does tend to be a bit lumpy. We are on track to hit the cumulative number that we've given for the year. I feel pretty good about that.

Edgar Roesch ***Banc Of America Securities - Analyst***

Okay. Great. And thanks for the new layout on the releases. It's very helpful.

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

Okay.

Operator

Thank you. Our next question is coming from Kenneth Zaslow of BMO Capital Markets.

Kenneth Zaslow ***BMO Capital Markets - Analyst***

Can you talk about the specific initiatives Kraft is taking to change the direction of mainstream coffee and salad dressings? I think you touched on it for a second in the prepared comments.

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

Well, actually, at this point, Ken, I touched on it only to say they continue to be challenges. As we look at some of the less favorable performances in this quarter, we had a couple of hold-overs from the back of 2006. Those are two of them, and I just want to assure you that we are hard at work in addressing those issues. It will be probably a couple of quarters before we're ready to share with you the solutions to them.

Kenneth Zaslow ***BMO Capital Markets - Analyst***

Would you share the solutions to the cheese or the cereal or any of that, just any specifics that we could take away? I think those were the weak ones, the salad dressings, cereal, cheese and salad dressings. Any of those that you could give us specifics now? Or no?

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

Well, I think, for competitive reasons, as you might imagine, I'm reluctant to share any specifics with you until we have begun to trade release some of these products. So we will certainly talk about them as quickly as we can. I think you've had a bit of a peak under the tent at some of the new items we've got coming out in cheese. We issued a press release about our -- what we're doing in terms of our FMI displays, and I think you'll start to see that we've got an exciting pipeline that will start to hit in late Q2, early Q3, and that's why I feel quite confident that we'll start to see those shares and strengthening in those category performances in the back half of the year.

Kenneth Zaslow ***BMO Capital Markets - Analyst***

Maybe I'm getting a little too excited about all of this, but if you can get the salad -- these four categories growing, and you're able to put a three plus organic sales growth number up, is there any reason that it wouldn't be incremental, that we could start to see a better growth number than your expected growth going forward? It seems like if you get these right, which are major categories, the top line sales growth could accelerate from current levels, even.

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

Well, I -- we certainly feel that we're off to a good start, Ken. But we're only at the beginning of a three-year plan. I've been quite clear in saying there is no quick fix. It's a broad portfolio. I think the early stuff is promising. But these initiatives are in the early stages, and I think as the year progresses we'll have a better sense of how quickly they're catching on.

Kenneth Zaslow ***BMO Capital Markets - Analyst***

And my last question is, on the pricing power, which category do you think Kraft has a better sense of being able to get pricing power and which categories do you thing that you may take a hit on the commodities side?

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

Over time our intent is to improve the brand equity of all of our core categories, and I believe we've made some important strides over the last couple of years in terms of just overall closing of the base gaps as well as our investment in quality. So over time we feel very strongly that our intent is to be able to recognize and realize pricing opportunities across the portfolio.

Kenneth Zaslow ***BMO Capital Markets - Analyst***

There won't be any categories that will lag on the pricing power?

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

Well, no. I think we're going to -- there are some that are stronger today, and as we make the necessary investments, they will then be in better position for us to be able to price them. So it will not all happen at once. But over time, our expectation is that by adding value to these core categories, that we will be able to realize the pricing opportunity.

Kenneth Zaslow ***BMO Capital Markets - Analyst***

Great. Thank you very much.

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

You're welcome.

Operator

Thank you. Our next question is coming from Eric Katzman of Deutsche Bank.

Eric Katzman ***Deutsche Bank - Analyst***

Hi, everybody.

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

Hello, Eric.

Eric Katzman ***Deutsche Bank - Analyst***

I guess my first question has to go to the point about kind of inflation and your ability to recover it with pricing. I mean, it's only one or two quarters ago where you were talking about how challenging the business is, and you're not right, and the new productivity is no where close, and yet, today, you sound as if the pricing is a layup ,and that you're going to be able to cover the cost, and I'm just really surprised, given how cautious you've been in general since beyond the [Non-Diarocho] and the CAGNY, that it sounds like you feel pricing is quite doable. I'm kind of wondering why that is, given that the portfolio in the last few years really hasn't shown an ability to price up?

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

Well, let me make it very clear. We do not think pricing by any means is a layup. I think what we said earlier is that we believe that we can recover any of the commodity and some of the key input costs through pricing, much more readily than we were able to a couple of years ago. And I think we all feel very, very strongly about that. That doesn't mean that we do not need to make some necessary investments in a number of our core franchises, both in quality, as well as in building brand equity in the form of marketing support, as well as in terms of new product launches to be able to give us the opportunity to really realize the margin opportunity that can come with that.

Eric Katzman ***Deutsche Bank - Analyst***

But again, Irene, in the core areas where you mentioned that there's cost inflation, coffee, Folgers is doing extremely well, in grains, you said you took a price increase and you lost volume in Oreo. I assume that was in the Nabisco portfolio. Any time you've taken a price increase in cheese, private label has held back and taken share, and you're telling us that the new product development on that stuff is a ways off. So I guess I just don't see how the two necessary -- I understand longer term, what you're trying to get to, but I'm not sure how shorter term those two go together.

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

Well, you know, again, Eric, I think as we start to look through the various categories in the portfolio, an example like Oreo is we did see an impact. There will be a bit of a lag. But we feel that that business will recover in a reasonable time frame. We've got a number of new cheese items, our Live Active line, our probiotics cheeses is coming out in the next couple of weeks. We've got our line of Kraft Selects that is a real premium offering, and we've got a variety of other new products that we believe are the kinds of items that will allow us to be able to add value and then realize the pricing opportunities. So, the ones we're talking about are categories that we feel pretty comfortable, we've got the programming and the necessary investments in place to be able to address them.

Eric Katzman ***Deutsche Bank - Analyst***

Okay. And then let me just switch subjects here on an area we haven't talked about, which is international. Maybe it's an impact from the United Biscuits acquisition in the EU, but those margins were very low, and I'm kind of surprised, given that you had a currency tail wind that was probably pretty significant on the earnings front, and I think most companies are now talking about Europe at least being a much better environment for branded product. So can you kind of talk a little bit more about why margins were less than 9% there?

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

Well, we certainly had some cost challenges in our EU business, which was a big part of the margin impact on the overall category. I think you're aware, green coffee has increased quite a bit and that played a very important role. But, over time, we've continued to look at the opportunity to look more broadly at how we can think about some of these portfolios in a broader way in an effort to be able to capitalize on some of the pricing opportunities that exist, particularly in the higher end of the pricing range in a lot of our core -- in core categories, particularly like coffee, the chocolate business we're seeing some good early success from some of the value added new products that we launched -- that we just launched, and we'll be able to realize the benefit, the margin benefit of that a little bit more over time. So, we did have some challenges in the first quarter, but we really do expect that over time the -- a number of the areas that we're working on are designed to allow us to be able to realize the margin opportunity from some of those categories.

Eric Katzman ***Deutsche Bank - Analyst***

Was there any United Biscuit mix shift in there? Negative? Or was that --

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

Very little.

Eric Katzman ***Deutsche Bank - Analyst***

Very little. Okay. Thank you.

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

You're welcome.

Operator

Thank you. Our next question is coming from Tim Ramey of D.A. Davison.

Tim Ramey ***D.A. Davidson - Analyst***

Good afternoon. In the old days, Kraft had a new product development sort of funnel model where you talked about the percentage of sales that could be expected to come from new products. Have you reestablished that, Irene, and can you comment at all on the health of that new product funnel?

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

Jim, we've chosen not to use that as a metric, simply because that does not speak to the incrementality of that, and so everybody gets very excited about the fact that they've got a high percentage of new product revenue, and then all of a sudden you discover that your net hasen't -- your net top line hasn't increased. So, that's what we've been forcing the team to think about the aggregate impact of some of these new products. I think the challenge is to -- what's the best way to characterize that in a metric is one that we will continue to work on, because I think it would be helpful for you to have a better sense of how full is the pipeline. But I will tell you that I'm feelings awfully good about where we are, both in terms of our -- the investments that we're making to fix the base, as well as some of the opportunities that we're seeing in terms of broadening our frame of reference.

Tim Ramey ***D.A. Davidson - Analyst***

Okay. And just to kind of a follow-up on Eric's question a second ago, if you look at this quarter it was in microcosm similar to what's happened over the course of the last six or several years, sales rose, margins declined and investments were made in brands. At some point we've got to see an inflexion point on that. What causes that inflexion point and how close do you think we are to that point?

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

I would tell you I think as we've laid out our plan, it's going to take all of 2007 for us to begin to see the inflexion point, because we're making some very significant investments, significant, and I think necessary investments in some of the fundamentals of the business in order to not only get our base shored up in the short term, but importantly to plant the necessary seeds for some of the trajectory changing initiatives over the long-term. So I think some of the margin challenges that you saw in the first quarter are going to be with us for the full year, because of the investments that we're making. But our expectation is, as we head into 2008, as we had laid out, we expect to see our income growth exceed the rate of revenue growth.

Tim Ramey ***D.A. Davidson - Analyst***

And just the final question, if we kind of look at $1.50 or $1.75, depending on whether we're looking at GAAP or operating, you pay $1 dividend and you're going to spend a couple of bucks a share in share repurchase in cash each year for the next two years if you fully execute on your 5 billion. Back to that guns or butter question, you seem to be delivering butter. You seem to be delivering shareholder returns in the form of short term cash rather than long-term reinvestment. How would you answer that?

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

Well, we're trying really hard to be mindful of the fact that we want to be able to deliver shareholder value while we are investing in the business. And so we will continue to try to strike the right balance there. But at the end of the day, I believe our shareholders are looking for long-term sustainable growth, and the best way for us to do that is to make some of these investments in the near term. Both in the base business, as well as in some of these longer term growth initiatives.

Tim Ramey ***D.A. Davidson - Analyst***

Thank you.

Operator

Thank you. Our next question is coming from David Driscoll of Citigroup.

David Driscoll ***Citigroup - Analyst***

Great. Thanks a lot. Good evening, everyone. Irene, I would just like to talk with you about the incrementality idea. A couple of people have asked about new products, they're trying to get more detail. We've heard for quite some time about the bigger, better, new products idea. What I'm very curious about, your take, as you really have gone through the portfolio and talked to the new product teams, how do you guys judge the incrementality of new products you're about to launch? That's kind of question number one. Then, also right within the incrementality question would be the idea that, I assume that people in Kraft have been trying to be incremental with their stuff from day one for years now and it just hasn't been working. As evidenced by the margin declines that we've seen in the business. So really, why do you have confidence here that this is really going to turn around, when so many people have kept trying to do this and it just hasn't been happening?

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

I guess I'd give you a couple of thoughts here, David. I think, for starters, one of the reasons for us making the 3 to $400 million investment is so that we don't have to rob Peter to pay Paul. One of the reasons that some of our new products were not incremental is because we funded them by taking money off of our base business to invest in the new product. I think the example I talked about quite a bit was Tassimo. We had lots of challenges on that business, but in particular, we did -- it did force us to take spending off of our base coffee business, and that didn't serve us well. The second opportunity, though, is to continue to push for more of these ideas to become broader platforms. And as you see some of the items that will be commercialized in the back half of the year, you will see that there is a whole pipeline that comes with them, as opposed to it being a single one-off kind of offering. And I believe those two things together is what will really allow us to have bigger ideas.

And I talked a lot about the things we need to do differently. We've always known what we needed to do. What we've been spending a lot of time doing is talking about how we're going to get it done. And I think that the investment and this focus on platforms is really the means by which we can make a lot of our new product ideas much bigger and therefore ultimately more accretive to our overall revenue performance.

David Driscoll ***Citigroup - Analyst***

Great. Thank you.

Operator

Thank you. Our next question is coming from Eric Serotta of Merrill Lynch.

Eric Serotta ***Merrill Lynch - Analyst***

Just wanted to touch on the issue of innovation one more time. It was as recent as October, as Eric mentioned, that you guys were talking about the disappointing state of the new product pipeline. You mentioned new products -- Jim mentioned them at several points in the discussion today. Could you give us your assessment as to how far you've come in terms of progress on the pipeline and how much further there is to go before you get it into what you would call a -- the funnel being full?

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

I guess I'd start by saying that the whole organization is very actively engaged in this task of reframing our categories, and I'm actually quite pleased by what we're seeing in that regard. We're making some good progress. We've got a number of good initiatives in terms of helping us identify quality upgrades and opportunities to invest, marketing support in a number of our categories that have had some long-standing issues. I think we're making some good progress in terms of broadening our frame of reference in our snacks business and the example I shared at CAGNY in our pizza business.

The reality though is that these new ideas are at various stages of validation with the consumer. And so it's far to early for us to declare a victory. I think the challenge now is how fast can we validate them and then how quickly can we commercialize them, and that will take some time, and that's why I keep suggesting that it will take through the back half of the year for us to really fully see the benefits of a number of these investments.

Eric Serotta ***Merrill Lynch - Analyst***

Okay. And on an another issue, portfolio management, you did stress how you were looking to manage the portfolio within the context of leveraging scale. Have you done any segmentation of the portfolio along the lines of percent of sales or number of businesses that aren't currently generating returns on capital equal to or exceeding their cost of capital? Or is that not a way that you've been -- not a tool that you've been using?

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

Well, Eric, I tell you we are using a variety of tools, some of them the ones that you a alluded to, all with an eye for identifying how best to manage the portfolio and which are the categories and the brands that we believe can be accretive to our long-term performance, and that will continue to be the framework that we're going to use to assess the future of our various businesses. We're going to continue to evaluate these brands and categories in terms of their fit with our overall performance.

Eric Serotta ***Merrill Lynch - Analyst***

Okay. And is that a metric or are some of those metrics around that ones that you could share publicly as the quarters unfold?

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

I'd rather not get into the specifics, but I think, as you might imagine, it's the key metrics that really will help us to understand what we see as the long-term potential of these businesses to be accretive to our overall performance.

Eric Serotta ***Merrill Lynch - Analyst***

Okay. Thank you.

Operator

Thank you. Our next question is coming from Pablo Zuanic of JPMorgan.

Pablo Zuanic ***JPMorgan - Analyst***

Good afternoon, everyone.

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

Hello, Pablo.

Pablo Zuanic ***JPMorgan - Analyst***

Couple questions, Irene. First of all, regarding the Board of Directors, seems it's been the early changes that you have become the chairperson, should we expect any changes in the makeup of the board over the next 12 months? And related to that, when you talk to the board, how are they supposed to judge you in the near term? What are the metrics they are looking at? When you talk to them, do you tell them, judge me from March now when I started with my new marketing strategy or judge me from June when I joined the Company? The bottom line is you've been at Kraft now for 11 months. Help me understand that part and then I have a follow-up, Irene.

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

With respect to the board composition, Pablo, we have made, as part of our preparation for our independent, we made the necessary changes to our board to be able to have the number -- requisite number of independent directors and to be able to back-fill the seats that were vacated by a number of the representatives from Altria. We have appointed two new board members, one of whom we hope to elect at the upcoming meeting -- annual meeting next week, and we are now at our full compliment of independent board members, as well as the compliment that we feel very comfortable operating with. So I feel very good about the board, and I think it's working well together, and I think I feel very good about the support that I've received from them. I would tell you that just like every other employee at Kraft, I need to continue to prove my worth and I intend to continue to stay focused on that. I think some of the programs that we have laid out, and the plans that we've laid out, are designed to ensure that we are delivering shareholder value and that's what the board is very much holding me accountable for.

Pablo Zuanic ***JPMorgan - Analyst***

Just to follow up, when you look at some of the initiatives that have been announced. I would argue that somebody might have inherited from Roger or Mary, the cost savings of 1 billion, the company the Roger started, wall to wall is something that Roger started, [inaudible] adjusting merchandise price points is something that Roger is [inaudible], quality initiatives at Tassimo is something that was tried around coffee and that's something that Roger started. Help me understand -- and obviously you are implementing your initiatives, but help me understand what is really new from the Irene Rosenfeld administration?

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

Well, at the end of the day, I think the focus is going to be our ability to deliver on our commitments. I think, once again, that's the way that you need to judge us. I feel very good about a lot of the work that was done over the last couple of years. I think it set us up well to be able to build on where we're going. But I think that single biggest opportunity that we have here is not about what needs to get done. That has always been undeniable. It's about going about getting it done. And I'm hopeful that as this year progresses, and as we see the results of over these next couple of years, that our investors will see steady progress in that regard.

Pablo Zuanic ***JPMorgan - Analyst***

One last one, Irene, if I may. You said before that [inaudible] Oscar Mayer is to follow and obviously you promoted [inaudible] to run North America. You must be very pleased with the performance of Oscar Mayer. From outside, I could make the following comment: The [innovation] of Oscar Mayer in the last five years has been Lunchables. And then, I look at what Sara Lee has done in less than a year, and they've launched Jimmy Dean Breakfast Sandwiches, Breakfast Skillets, Bowls, and I'm certainly other companies in this fashion, they launched package salads and their Hillshire Farm. We have a company with some what less track record and less scale and we've got the [inaudible] Oscar Mayer, and they've done a lot more in a shorter amount of time. So help me understand why is Oscar Mayer such success and what makes [inaudible] so special then?

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

I feel very good about our Oscar Mayer business. I think the revenue growth that we saw from our overall convenient meals was about 5%. I think it's a terrific model of what I would like to see across the Company, and a key driver of that performance has been a number of our new products from the Oscar Mayer group, which includes our Deli Shaved Meats, our Deli Creation Sandwiches and we've got a pretty robust pipeline as you'll see as the year unfolds. So I feel very good about the progress that we're making, and as well as the steps we've taken in terms of improving the overall nutritional profile of our Lunchables business, which has contributed to its performance. So I feel very good about where we are. And as I said before, I feel that it is a very good model for what I would like to see happening more broadly across the North American business and around the world.

Pablo Zuanic ***JPMorgan - Analyst***

Irene, the very last one here, since [inaudible] margins you have said to 7 and 8 should be the inflexion point and we should see an improvement there. When you look at the different levels, what's going to be the main driver? Is it going to be mix? Is it going to be recovering premiums, [inaudible] the brands? Is it going to be the cost cutting? I know it's all of the above, but which would be the main driver would you say that you're focusing on as a way to get margins back up in '08 and after that going forward?

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

I would say our key drivers, Pablo, are volume and mix.

Pablo Zuanic ***JPMorgan - Analyst***

Thank you very much.

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

You're welcome.

Operator

Thank you. We have time for one final question which is coming from Steven Kron of Goldman Sachs.

Steven Kron ***Goldman Sachs - Analyst***

Great. Good afternoon. Thanks for taking the question. Irene, if I could just go back to the pricing and market share for a second, and certainly should Kraft be successful in driving the innovation in the brand support that you're talking about, no doubt pricing power will improve. As we thing about things today, on the one hand you caution us that things will take time, and on the other hand we're looking towards pricing coming up to offset commodity cost inflation at a time when market share in more than 50% of your categories are still eroding. I guess to extend that thought, how are you thinking about the balance of kind of protecting margins versus protecting market share here? And taking that one step further, maybe you could just talk about the pricing strategy? Because it almost seems as though you're taking price to offset commodity costs as opposed to taking price in categories where you feel as though you're further along on the curve in the innovation cycle that can handle the price.

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

Well, first of all, Steven, most of the pricing actions that I've described have been announced already. So it's not -- we've taken them. And as we said earlier, some of that -- the impact was offset by some of the precise projection we did for some of our Easter merchandising as well as some of the investments that we made in new products. So, that's pretty much behind us. The opportunity really is the marketing behind those categories that will come out as the year unfolds and that will be the key driver of our ability to regain our share. But our focus is on regaining our share. As I said at the outset, we're not where we want to be. We're not where we intend to be. But some of the challenges, on the share side in particular, are issues that really were lingering from the back half of 2006 and so it will take some time to be able to work -- to be able to launch the solutions that will address those issues.

Pablo Zuanic ***JPMorgan - Analyst***

Okay. And then just a follow-up, Jim, can you talk a little bit about how you're thinking about kind of the capital structure now that you're kind of free and out of under Altria and talk about leverage and kind of the prioritize the use of cash and capital, be it share repurchases, acquisitions and dividends and things like that?

Jim Dollive ***Kraft Foods - CFO***

Well, we really haven't changed dramatically other than how we go about doing it. Because the first priority has been driving the growth, because ultimately that's going to longer term drive shareholder value. We now have the opportunity to be more aggressive on returning cash to shareholders through things like our share repurchase program, and certainly we now have the ability with our balance sheet to take on more leverage to do just that.

Pablo Zuanic ***JPMorgan - Analyst***

Okay. And if I could, just one last thing, on the margin front, the 120 basis point decline, you touched on marketing, you touched on input cost. You have a systems investments in there as well. Is that the ASP rollout in North America?

Jim Dollive ***Kraft Foods - CFO***

Yes it is.

Pablo Zuanic ***JPMorgan - Analyst***

And how far along are we on that investment at this point?

Jim Dollive ***Kraft Foods - CFO***

That's a multiple year investment. And we'll see most of the step up this year, and then it will be just continuing to spend at sort of an elevated pace for a while.

Pablo Zuanic ***JPMorgan - Analyst***

Okay. Thanks very much.

Operator

Thank you. I'd like to turn the floor back over to Management for closing remarks.

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

Just like to say in sum, this was an eventful quarter for the Company. Our transition to an independent company was seamless. Our people are energized and hard at work to get the Company growing. We met our performance expectations and we're beginning to execute our strategies for long-term growth. I am confident that we're moving in the right direction, and though I'm encouraged by our early progress, as I've said on a couple of occasions, it will take time to restore Kraft to predictable consistent growth. I thank you, and we look forward to updating you in the coming months.

Operator

Thank you. This concludes today's Kraft Foods conference call. You may now disconnect.

THOMSON REUTERS

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PRESENTATION

Operator

Good morning and welcome to the Kraft Foods second quarter 2007 earnings conference call. Today's call is scheduled to last about one hour, including remarks by Kraft Foods management and the question and answer session. (OPERATOR INSTRUCTIONS)

I will now turn the call over to Mr. Chris Jakubik, Vice President of Investor Relations for Kraft. Please go ahead, sir.

Chris Jakubik ***Kraft Foods - VP, IR***

Thank you and good morning. Thanks for joining us on our conference call. I'm Chris Jakubik, Vice President of Investor Relations. With me are Irene Rosenfeld, our Chairman and CEO; and Jim Dollive, our Chief Financial Officer. Our earnings release was sent out earlier today and is available on our website Kraft.Com.

As you know, during this call, we may make forward-looking statements about the Company's performance. These statements are based on how we see things today so they contain an element of uncertainty. Actual results may differ materially due to risks and uncertainties. Please refer to the cautionary statements and risk factors contained in the Company's 10-K and 10-Q filings for a more detailed explanation of the inherent limitations in such forward-looking statements. Some of today's prepared remarks will exclude those items that affect comparability. These excluded items are captured in our GAAP to non-GAAP reconciliations within our news release and they are also available on our website.

We'll begin today's call by hearing from Irene who will share her perspective on our second quarter. Then Jim will provide an overview of our financials, after that we'll take your questions. With that, I'll hand it over to Irene.

Irene Rosenfeld ***Kraft Foods - CEO***

Thanks, Chris. Good morning, everyone, and thanks for joining us. Overall, I'm pleased with the progress we made in the past few months, both in terms of our second quarter financial results and perhaps of greater importance, in how we're implementing the transformation plan we laid out in February. Today, I'm even more confident that our plan is sound and that it's execution will enable us to restore Kraft to reliable growth. I say that for three reasons.

First, our early investments have produced sequential top line improvement. We had solid revenue growth in all major geographies. Second, while our market share and profit margins are clearly not yet where we want them to be, we are increasingly confident that the actions we're taking will lay the foundation for improved results. And third, we're taking other significant actions to further enhance shareholder returns.

Let me provide more details starting with the positive impact on our results from our early investments. In North America we delivered sequential revenue improvement from quarter one to quarter two. That performance was driven by some focused differentiated new products and incremental marketing investments in powdered soft drinks, pizza, and Oscar Meyer. In January, we launched Crystal Light with enhanced benefits like immunity, energy, and hydration, these helped to drive trademark sales up 47% in the quarter.

We introduced DiGiorno Ultimate Pizza to you in February. It's now the hottest thing in frozen pizza representing one-third of all new product sales in the category through June, driving DiGiorno's revenue growth of 12%, and that's even before our national advertising began last week. We have increased confidence that our new Oscar Meyer deli creations sandwiches have the potential to be $100 million platform and highly incremental to our base business. These sandwiches are a great example of our ability to leverage the power of our broad portfolio to better compete with foodservice offerings.

In the EU, reinvestment in our core coffee and chocolate brands has resulted in stepped up organic revenue growth, and in developing markets, our new products, supported by a significant increase in marketing, delivered double digit growth. Net, we feel good about both our sequential growth from the first to second quarter and our 3.9% organic revenue growth for the first half of the year. We'll also continue to improve our sales execution and in store presence. We're seeing higher revenue growth in the rollout markets for our wall to wall sales initiative in North America. In Q3, wall to wall will be in stores that accounts for about 35% of Kraft's all commodity volume. We have, however, slowed the pace of expansion as we refine our sales rep training for maximum effectiveness and we expect to complete our rollout by mid 2008.

Despite this early progress on a number of fronts we have not made progress on market share. Through the second quarter, we're gaining market share in less than half of our U.S. businesses. The investments we are making in the back half will fuel both our top line momentum and improve our share. We now see a much more robust pipeline of new ideas across the Company, new products, new packages, and new advertising campaigns, which make us confident to invest at the high end of the 300 to $400 million range. Importantly, about half of our investment dollars will go to fix key laggards, including our mainstream coffee business in the U.S., North American cheese, and snacks. In coffee, our mainstream brands continue to lose share. Later this quarter, we launch a new higher quality Maxwell House with 100% Aravica beans in a new consumer preferred package.

In cheese, we are not yet comfortable that we've added enough value to our portfolio to manage through record dairy prices. We have a number of key initiatives in the back half to improve share. These include Live Active probiotic cheeses, premium Kraft Single select and a new advertising campaign, for base Kraft Singles.

In snacks our growth lags that of the broader snacking world. In the back half, we will launch a robust new product pipeline, invest in higher marketing spending, and rollout a new Planters campaign to step up our performance. The balance of our spending will go to accelerate new product and marketing activities in high impact categories like convenient meals where we'll continue to build on the strong first half momentum. This higher investment coupled with the fact that approximately three quarters of our incremental spending will occur in the back half of the year, gives us confidence that our share trends will improve especially in the fourth quarter. Consequently, we are raising our organic revenue guidance to 4% plus for the full year.

Let me now turn to our margin performance. As you know, we had expected margins to decline this year, given our growth investments, but higher than expected input costs will place even greater pressure on our margins in the back half of the year. That said, we are at the start of a three year plan. 2007 is a building year, one which will lay a strong foundation for our future growth. We are committed to investing now because it is essential to driving the accelerated volume growth and stronger product mix that will leverage our overhead costs and improve margins over time. While making these investments in the business, we are taking other significant actions to enhance shareholder returns.

Last month, we announced our plans to acquire Danone's global biscuit business. This is a major strategic action that will give us a platform for greater scale, faster growth, and better margins in our international business. On Monday, Danone reported strong first half biscuit growth, further evidence that this acquisition will be an important contributor to our growth strategy. We are not finished reshaping our portfolio. We continue to evaluate our existing brands in the context of our new framework and we'll divest those businesses that don't fit our long term growth plan. We will of course share those decisions with you at the appropriate time.

We're also making better use of our balance sheet capacity. Not only through acquisitions but by executing the $5 billion share repurchase program we announced in February. In fact during the second quarter we repurchased almost 4% of our outstanding shares for $2 billion.

In sum, I'm encouraged by the early progress in our transformation plan. We're doing what we said we would do and we are seeing signs that our investments and efforts will pay off. Of course there's much more to do but I remain confident that we're on the right track, and I look for accelerated momentum in the back half of 2007, and now I'll turn the call over to Jim.

Jim Dollive ***Kraft Foods - EVP, CFO***

Thanks, Irene, and hello, everyone. Before I begin, please keep in mind that unless otherwise noted, my comments will exclude the items affecting comparability that were highlighted in our press release. Now let's get into the numbers starting with sales.

Our organic net revenues were up a solid 4.1% in the quarter. We delivered gains from product mix across most businesses, the result of several new product initiatives and reinvesting in marketing to support our base business. We've begun to see the effects of recent price increases in several categories with net pricing up 1.7 percentage points in the quarter. Volume was down in the second quarter. We have solid gains internationally and in some North American businesses. But these gains were offset by ready to drink bottled beverage weakness, further portfolio pruning in foodservice, and our North American grocery business reflecting both a shift in Easter timing to Q1 versus Q2 last year and continued share challenges in salad dressing.

Turning to profit and earnings, I want to emphasize three points--First, our gross margin was down 130 basis points because higher input costs and our investments in product quality more than offset our gains from pricing and productivity. As Irene mentioned, we anticipate that this will be the case for the balance of the year and therefore we expect lower gross margins in the second half of 2007. Second, our operating income margin declined 210 basis points year-over-year. This includes the gross margin impact as well as increased overhead costs and the higher margins of previously divested operations. Our overhead costs were higher due to our planned incremental investments in marketing, systems capabilities, and distribution infrastructure as well as the absence of last years $18 million gain on the sale of a facility. Third, below the line, we benefited by roughly $0.02 from our share repurchase activity and by $0.01 from a decrease in our effective tax rate versus 2006.

In the quarter our effective tax rate was 32.5% including the positive resolution of some outstanding tax items as well as a change in our mix of earnings by country. As a result for the year, our guidance for taxes is now 33.5% versus our earlier forecast of 35.5%. On the share repurchase front as Irene mentioned, during the quarter, we repurchased 3.7% of our outstanding shares for $2 billion and we intend to continue repurchasing our stock under our current $5 billion repurchase authorization. I'll take a few minutes now to share some highlights of our business segments.

As Irene said we're beginning to see improved results where we have made incremental marketing investments in our base business and in new products that are helping to reframe our categories. At the same time, significant challenges remain in select businesses. We will begin to address these with a number of our second half growth initiatives. I'll start with North American beverages where our focus on health and wellness and premium offerings is paying off.

Organic net revenues grew 4.3% this quarter. This increase was driven by our Crystal Light powdered beverage sticks and Capris Sun ready to drink pouches with antioxidants and functional benefits. Strong growth in Starbucks Premium Coffees and the successful restaging of Tassimo with marketing targeted at a narrower user base of coffee Aficionados. At the profit line, operating income margin increased 130 basis points. The first time margin has been up in beverages in five quarters as the benefits of product mix and pricing more than offset higher grain coffee and packaging costs. Going forward, we will make further improvements in beverages by investing in Maxwell House product quality and packaging as Irene discussed earlier. We expect these actions will begin to halt the longstanding trend of market share declines in the coffee category.

In North American cheese and foodservice, organic net revenues were up 3.3% due mainly to price increases to offset higher dairy costs.

2007 is shaping up to be the year with the highest dairy commodity costs ever. Because of this run up, we recently increased our list prices in cheese for a second time this year, generally between 5 and 12% effective July 9. We expect the cheese will remain a tough competitive environment. Our share of total cheese is down year-to-date; however despite higher costs in the back half of the year, we will fund the necessary investments to improve our share position and plant the seeds for future growth. Our plans include a number of new products and significant increases in advertising and consumer and promotional spending across the line. Operating income margins in cheese and foodservice were down 370 basis points in Q2. We expect them to be down in the balance of 2007 as well. The factors driving both Q2 results and the balance of 2007 are higher input costs and the normal impact of price elasticity on volume and funding for our growth initiatives.

Moving on to North American Convenient Meals. Organic net revenues were up more than 5% driven by successful new product platforms and investments in marketing and quality that are capturing quick meal eating occasions. Irene has already told you about the success of DiGiorno Ultimate and deli creations. I'd also add that our deli shaved meat platform grew 37% in the quarter and now exceeds $300 million on an annual basis and California Pizza Kitchen grew over 20% in the quarter. Operating income margins fell in the quarter negatively impacted by two factors--Higher input costs including investments in quality and new capacity and higher overhead costs driven by incremental marketing investments. Going forward, we expect convenient meals to continue with strong revenue growth in the back half of 2007, and margin performance should progressively improve over the course of the year as launched costs moderate.

On to North American Grocery, where organic net revenues were down 1.8% due to lower volumes, over half of which reflects the shift in Easter timing. As for the overall business, we continue to see strong momentum behind new, better for you products such as sugar free Jell-O Ready-to-Eat Pudding Poppers, however these gains were offset by ongoing weakness in portable and spoonable salad dressings. We'll have new product news and incremental marketing later this year as we contemporize our salad dressing business but these businesses have been losing share for many years and it will take some time to fix them.

Looking at North American Snacks and cereals, organic net revenues were up 3.7% with contributions from volume, mix, and pricing. Three highlights here drove growth in the quarter. First, strong product mix in cookies driven by gains in 100 calorie packs. Second, volume gains in Ready-to-Eat cereal from a rebound in kids cereals driven by new products and renewed marketing support on our sensible solution offerings. And third, strong growth in bars behind the launch of Nabisco 100 calorie bars.

Operating income margins fell 60 basis points due to our Milk Bone and Cream of Wheat divestitures. Excluding the effects of divestitures the benefits of product mix and manufacturing productivity were partially offset by higher overhead costs driven by incremental advertising and consumer spending. For the remainder of the year, we expect our strong new product line-up across the snacks business will result in stepped up organic revenue growth. Now, I'll turn to our international business which had another good quarter across-the-board.

The EU continued its return to moderate growth, increasing organic net revenues by 2% driven by volume and mix gains in coffee and chocolate. Several factors contributed to the coffee and thus the EU success. We saw gains across the EU in Tassimo due to our successful restaging with new marketing programs and new product launch s including Latte Machiato. We executed successful promotions for Jacobs in Germany and for Kenco in the United Kingdom and we increased A&C launching a new campaign for Carte Noire in France. Chocolate revenue also continues to be up as we introduced new products and reinvested A&C behind premium end offerings under the Cote d'Or, Toblerone, and Milka brand name.

Biscuits, soon to be our third core EU growth category contributed 7.4 percentage points to reported net revenue growth. The United biscuits businesses are performing ahead of our expectations driven by global biscuit brands including Oreo. EU operating income margins declined 100 basis points. Here, the benefits of improved product mix were more than offset by higher promotional and advertising spending. Also, last year included the $18 million one-time gain on the sale of a facility I mentioned earlier. Looking ahead we'll continue to invest to improve our coffee and chocolate businesses, and we're excited about the opportunities to accelerate the growth in our EU snacks business once we finalize the acquisition of the Danone biscuit business.

Finally, developing markets delivered another consecutive quarter of solid growth with organic net revenues up double digits. This was due to strong gains in Eastern Europe, Middle East, and Africa, and Latin America including gains in Russia behind both Jacob's coffee and Alpen Gold chocolate and in Brazil, Argentina, and Venezuela from new products and increased marketing support.

At the operating income line, margin was essentially flat. The benefits of higher pricing and improved product mix were offset by higher input costs and higher overhead driven by investments in marketing. Going forward, we expect continued strong performance from developing markets as we invest in marketing support and expand distribution.

And finally, a comment on our restructuring program. In short, savings are coming in faster than we expected. Cumulative savings are up to $660 million. We now expect cumulative savings to reach $725 million by year-end, up from our earlier expectation of $700 million.

On the cost front, we spent $245 million year-to-date. Due to the timing of activities, we now expect total cost of 575 million for the year down from our earlier expectation of $625 million.

Irene Rosenfeld ***Kraft Foods - CEO***

Thanks, Jim. In sum, during our first few months of independence we made good progress in our plans to transform Kraft. Results from our early investments are promising. We had strong revenue growth in all major geographies for the first time in a long while. We have a stronger pipeline of competitively advantaged products that will be launched over the balance of this year and into 2008. We are pricing to recover the majority of input costs. We are delivering faster savings under our restructuring program and we are looking at additional opportunities to reduce administrative overhead. We are making the necessary investments for long term growth and have maintained our full year $1.75 to $1.80 EPS guidance. We would now be happy to take your questions.

QUESTIONS AND ANSWERS

Operator

Thank you. We will now conduct the question and answer portion of the conference. (OPERATOR INSTRUCTIONS) Your first question is from Kenneth Zaslow with BMO Capital Markets.

Kenneth Zaslow ***BMO Capital Markets - Analyst***

Good morning, everyone.

Irene Rosenfeld ***Kraft Foods - CEO***

Good morning.

Kenneth Zaslow ***BMO Capital Markets - Analyst***

Irene you touched on the idea of divestitures and the possibility of that. Can you just lay out the criteria by which you would think about divestitures, what type of businesses would you think, I know you can't give us the exact business but what type of criteria would you be using?

Irene Rosenfeld ***Kraft Foods - CEO***

Well, Ken, we're continuing to evaluate all of our brands and categories in the context of the framework that I laid out in February and we would divest those businesses that don't fit our long term growth plan. And so we're looking at their potential to be able to grow and to be accretive to our performance over the long term.

Kenneth Zaslow ***BMO Capital Markets - Analyst***

Okay, and second question is in terms of the cheese category, can you talk a little bit about the premium to private label and how that is relative to history and how that's going to change the market share dynamics going out?

Irene Rosenfeld ***Kraft Foods - CEO***

Well, we feel very good about our price gaps as we stand here to date. They're much lower than they were a year ago, but I would tell you that our performance is not just about price gaps. We have some work to do I believe in terms of improving the overall value of our offerings and that's what the focus of some of the investments that we're making is on.

Kenneth Zaslow ***BMO Capital Markets - Analyst***

Great. Thank you.

Operator

Thank you. Your next question is from David Palmer with UBS. Please go ahead.

David Palmer ***UBS - Analyst***

Thank you. Share trends in the measured channels as you noted have been fairly dismal lately and it appears that pricing at least in the last month is showing some acceleration and just broadly net revenue per volume is going up in many of your categories. You talked about pricing but could you be more specific about perhaps how much more pricing we would see in your numbers in the second half of the year and what impact do you see that having on your share trends? Thanks.

Irene Rosenfeld ***Kraft Foods - CEO***

Well, David, as you know, pricing accounted for about 1.7 points of our revenue growth in this quarter and as we go forward, we expect that it will play a greater role as we see more price realization. What I have to say is I feel very comfortable that the businesses that we are pricing are showing some strong performance even in the face of the pricing actions and as a result of that, that's given us confidence to raise our revenue guidance for the balance of the year.

David Palmer ***UBS - Analyst***

One follow-up unrelated question about wall to wall. You said you're up to about a third of your stores with wall to wall and you're slowing that deployment a bit for training. Could you perhaps talk about where it's been around for a little while, what benefits you are seeing in those stores, what learnings that you have in terms of what you're increasing in terms of the training?

Irene Rosenfeld ***Kraft Foods - CEO***

Well, we continue to be very excited about wall to wall and the entire initiative. I think it's actually one of our best examples of the opportunity to turn our scale into a competitive advantage. We are seeing higher revenue in our rollout markets and so I continue to be encouraged about the long term possibilities. I suggested that we hoped to see as much as 0.5 a point of revenue growth over the long term and I think we're on track to deliver that. The intent though in making sure that we get the training right is that we are asking our reps to take on a broader portfolio and we are confident that they can do that but we want to make sure as we roll this out that we get it absolutely right and so we expect to be at about 35% by the end of this quarter as I said and we will complete the rollout by mid 2008.

David Palmer ***UBS - Analyst***

So pretty even rollout from here with the remaining 65% by quarter?

Irene Rosenfeld ***Kraft Foods - CEO***

I would say this is a classic case where I think we need to just go a little slower to go faster but the net of it is a very significant initiative and I believe it has the potential to be an important contributor to our long term revenue growth.

David Palmer ***UBS - Analyst***

Thank you very much.

Irene Rosenfeld ***Kraft Foods - CEO***

You're welcome.

Operator

Thank you. Your next question is from Andrew Lazar with Lehman Brothers.

Andrew Lazar ***Lehman Brothers - Analyst***

Good morning.

Irene Rosenfeld ***Kraft Foods - CEO***

Good morning, Andrew.

Andrew Lazar ***Lehman Brothers - Analyst***

Irene, if we think about the lower forecast tax rate for the full year and some other things below the line, it looks like that adds whatever it is, $0.05 or a little more at least to my estimate for the year, yet obviously not changing earnings guidance because of a number of things you're doing around reinvestment. I'm trying to get a sense, of that amount that I've discussed, how much of that is covering incremental input costs which have obviously been a lot more onerous than anybody could have forecast versus the incremental marketing side because I think most had already been looking for probably the high end of your 300 million to 400 million reinvestment anyway so is the majority of that going towards the input costs or truly incremental marketing about that?

Jim Dollive ***Kraft Foods - EVP, CFO***

Andrew, I'll take that, thank you. Clearly, we are seeing a benefit from the lower tax rate this year and that does give us both the ability to help manage the total P&L, to continue to do the investments that we said we would do against the business and we feel terrific about where we are in that. As you look at that gain, it's kind of split about half and half between how much more is going into the marketing program and how much more is helping support the rest of the P&L.

Andrew Lazar ***Lehman Brothers - Analyst***

Okay, and then with respect to the biscuit acquisition, just a follow-up on that one. As we think about the need for scale, in your business internationally and even in Western Europe, they must certainly bring some of that, is your thought does this bring frankly, as you think out a couple of years, does this bring enough scale or is there probably still more that you need to think about or look at doing or does this give you a sense that we're done for awhile on the scale play in Western Europe?

Irene Rosenfeld ***Kraft Foods - CEO***

Well, I think it's a terrific first start for a couple of reasons. It gives us another core category in Western Europe which gives us the potential to be able to invest in infrastructure. I think it helps to improve our margins there and I feel very good about where we are in terms of our net position in that geography. The other benefit as you know is about its ability to help our position in developing markets and in that part of the world, we're going to continue to look at opportunities to improve our scale. It's obviously got terrific population in GDP growth and I believe particularly with our strong biscuit position that we have an excellent platform from which to build.

Andrew Lazar ***Lehman Brothers - Analyst***

Thanks very much.

Operator

Thank you. Your next question is from Terry Bivens with Bear Stearns.

Terry Bivens ***Bear Stearns - Analyst***

Good morning, everyone.

Irene Rosenfeld ***Kraft Foods - CEO***

Good morning, Terry.

Terry Bivens ***Bear Stearns - Analyst***

One quick one and then a more broad one. Jim, probably for you. To what extent did you offset higher cheese cost with sales of some of your inventory into the wholesale market? Was that meaningful?

Jim Dollive ***Kraft Foods - EVP, CFO***

No, not really.

Terry Bivens ***Bear Stearns - Analyst***

Okay, and I guess the broader one for you, Irene, you're the first company I can remember that has attracted investors as disparate as Warren Buffett, Carl Icon and Nelson Pelts, now there has been some publicity around the latter there, Mr. Pelts. Have you met with him yet and if so, is it just a coincidence that you're now mentioning words like divestiture and it seems to be a slightly more aggressive posture towards share repurchase, if you could address that?

Irene Rosenfeld ***Kraft Foods - CEO***

Well, we are continuing to evaluate our portfolio as I said. When I rooted out the strategy at CAGNY, Terry, I made it clear that that was not a Safe Harbor for all of our businesses and we continue to look at them within the context of the framework that we laid out and I think the question I'm asked most frequently by our investors is what about divestitures and so I think it's important to just be explicit about how we're thinking about that. Obviously, we will share decisions on that subject with you as those actions are completed, but it's not a change in our position. It's really just a clearer articulation of how we're thinking about it.

Terry Bivens ***Bear Stearns - Analyst***

Okay, thanks very much.

Irene Rosenfeld ***Kraft Foods - CEO***

You're welcome.

Operator

Thank you. Your next question is from David Adelman with Morgan Stanley. Please go ahead.

David Adelman ***Morgan Stanley - Analyst***

Good morning.

Irene Rosenfeld ***Kraft Foods - CEO***

Good morning, David.

David Adelman ***Morgan Stanley - Analyst***

Irene, first as a follow-up on the divestiture issue. Could you help us understand the percentage of the portfolio perhaps that you'd consider being subject to divestiture? I think in the past the Company has talked about upwards of 5% of sales. Are you now looking at something that's potentially demonstrably larger than that and is the potential of negative business system leverage a serious consideration as you look at potential divestitures?

Irene Rosenfeld ***Kraft Foods - CEO***

Well, actually, David I would say at this point we're looking at something considerably smaller than that. I think we've got a lot of our major activity behind us. We will continue as I've said to look at individual categories and make those decisions and clearly to the extent that they create some overhead issues, we will deal with those as part of our overall assessment of the opportunity, I think we will continue to look at the reshaping of the portfolio but our focus really is on generating organic growth and following the four strategies that we laid out.

David Adelman ***Morgan Stanley - Analyst***

Okay and then let me ask you a second question Irene about the U.S. market share trends. I would imagine when you came back to Kraft, you envisioned, I would assume that a year into your tenure, there would be better market share momentum than there currently exists and I'm curious, you've highlighted a number of problem categories that need to be addressed but is there a more sort of overarching observation you can make about some of the issues the Company faces, not necessarily on a category by category basis to position itself to be able to generate consistent composite market share growth? Thanks.

Irene Rosenfeld ***Kraft Foods - CEO***

Well, David, as I said at the outset and it is part of the reality of timing, we expect, we've always expected our results to improve in the back half of 2007, partly because that was where the bulk of our spending was going to hit and that was when many of our new products were going to hit. We have a much stronger pipeline in the back half of 2007 than we did a year ago and I feel good about that.

Having said that I am disappointed in our North American particularly U.S. market share performance. Some of those issues though are some businesses that have been issues for quite some time and I think that the difference here is that we are facing those issues and we're dealing with them. I've talked about some of the actions that we're taking on cheese, on coffee, on snacks, and even pizza which has some very very strong revenue growth, we are year-to-date losing share in that business and we expect that we will see recovery in the back half. So I don't feel good about our share performance. There's no question that it's not where we want it to be, but we do expect to see overall improvement in the second half especially Q4 as our new items hit and we benefit from the incremental spending that is yet to come.

David Adelman ***Morgan Stanley - Analyst***

Okay, thank you.

Irene Rosenfeld ***Kraft Foods - CEO***

You're welcome.

Operator

Thank you. Your next question is from Chris Growe with A.G. Edwards.

Chris Growe ***A.G. Edwards - Analyst***

Good morning.

Irene Rosenfeld ***Kraft Foods - CEO***

Good morning.

Chris Growe ***A.G. Edwards - Analyst***

Hi, just had a question for you to clarify a statement, I think Jim had made. Your gross margin was down 130 basis points in Q2. Am I correct in the way that you characterize the second half of the year that could be worse than you saw in the second quarter due to input cost inflation on the gross margin side?

Jim Dollive ***Kraft Foods - EVP, CFO***

Yes. I'll take that, Chris, and that's exactly what I was indicating is as we look at these rising commodity costs, they will peak later in the year, not earlier in the year. That said, we are recovering a larger percentage of our input costs than we have in the past and we feel terrific about that but as Irene mentioned the portfolio just isn't where we need it to be in terms of our ability to fully recover those costs. Just to continue for one other thought, the easier thing would be for us to cut the marketing support and do other things and that's not something we're willing to do.

Chris Growe ***A.G. Edwards - Analyst***

Okay, and then if you look at the increase in your total spending, you're now $400 million at the high end of your range and that's up from wherever you were expecting it before, is that increase Irene more marketing or is it more about the quality upgrades if you will in R&D type components of your spending?

Irene Rosenfeld ***Kraft Foods - CEO***

Actually, Chris, about a third of it is investments in quality and about two-thirds of it is in marketing and infrastructure.

Chris Growe ***A.G. Edwards - Analyst***

And that comment if I'm correct, you're talking about the increment from where you were before; is that correct?

Irene Rosenfeld ***Kraft Foods - CEO***

That's correct. That's not the total.

Chris Growe ***A.G. Edwards - Analyst***

Okay, sure, and then just one point, one question to clear it up here on volume. Being down roughly 1% in the quarter and there's some numbers there that are probably pushing that a little lower but with the market share weakness, it would seem like with more aggressive pricing your volumes could weaken. I know there's some programs in place to try and improve that but should we be looking for weaker volumes in the second half of the year because of the price realization that's coming through?

Irene Rosenfeld ***Kraft Foods - CEO***

No, actually, we've said volume is still not where we want it to be. It's actually a combination of factors. The biggest is our continued pruning in foodservice which is still a head wind for us, represented about 1.5 point on the sector in the quarter so it's an issue. We continue to have some chronic problems in a couple of core categories that we are addressing but we do expect to see volume improvement in the back half driven by the programming that we've put in place, and as I said before, I actually feel encouraged by the fact that our volume has held up reasonably well on those businesses that we've priced, so we do expect to see some volume recovery in the back half of the year and I believe the programming that we've got in place will be a key part of that.

Chris Growe ***A.G. Edwards - Analyst***

Okay, great. Thank you.

Irene Rosenfeld ***Kraft Foods - CEO***

You're welcome.

Operator

Thank you. Your next question is from Jonathan Feeney with Wachovia Capital. Please go ahead.

Jonathan Feeney ***Wachovia Capital - Analyst***

Good morning. Thank you. Irene, I wanted to I guess talk about your philosophy around acquisitions. Clearly, your Danone acquisition adds some nice solid overlap for you in scale building but I don't know if it did a tremendous amount as far as accelerating your top line potential. Would you consider acquisitions probably globally that would accelerate your top line? Or is that not a priority of yours right now?

Irene Rosenfeld ***Kraft Foods - CEO***

Well first of all, Jonathan, reiterate the fact that our plan is predicated on organic growth and the guidance that we've laid out there is really predicated on our belief that the strategies that we've laid out can help to accelerate growth in our core categories and I think we're starting to see some early impact of those, of that thinking and those investments. Having said that, we will continue to look for opportunities to expand our footprint as well as to accelerate growth, and certainly the Danone Biscuit is a part of our overall desire to accelerate growth and as I mentioned their first half revenue was up about 5% and we believe that that can definitely be accretive to our performance and particularly as we start to look at some of the synergy opportunities. We will continue to look for opportunities to add-on businesses that we think can further help to accelerate our growth. Okay, and secondly, when you think about wall to wall, I know, could you talk about what the deliverables are as far as I know it's not something that's being looked at as a way to reduce costs across your sales and marketing organization. A year from now, let's say wall to wall is half or more of your stores. What can we look for as specific evidence that that program is working and is transforming your U.S. performance in a way that's meaningful for investors? Well, I'll tell you what the criteria are for our guys. It is going to be accelerated revenue growth and stronger share performance and those are very clear and simple metrics. They all understand exactly what they are looking to do and as I mentioned the early results in the rollout markets are encouraging. But importantly--.

Jonathan Feeney ***Wachovia Capital - Analyst***

On those two metrics?

Irene Rosenfeld ***Kraft Foods - CEO***

On those two metrics but importantly we're only in less than 35% today. We will be up to 35% by the end of the quarter. So it's going to take a little bit of time until we see that performance more broadly across the portfolio, but we certainly believe that this is an important enabler to our acceleration of our overall top line growth.

Jonathan Feeney ***Wachovia Capital - Analyst***

Thanks, and just finally to follow-up on Terry's question a little bit, given there's been a ton of news about all these celebrities buying stock, what is your philosophy on sort of soliciting input from shareholders about the future direction of Kraft? I know, I think you were deliberate in being somewhat hesitant to reveal who you've met with and who you haven't but maybe short of that you can share with us your sort of philosophy about getting that kind of input from shareholders.

Irene Rosenfeld ***Kraft Foods - CEO***

Well, Jonathan, over 100% of our shares have actually traded since the spinoff, and so critically important that I continue to stay in touch with our investor base and I will continue to do so. I think it's very helpful to understand how they feel about our overall strategies and to make sure that they understand the context and the progress that we're making so it's an important part of my ability to be able to return Kraft to reliable growth.

Jonathan Feeney ***Wachovia Capital - Analyst***

Okay. Thanks very much.

Irene Rosenfeld ***Kraft Foods - CEO***

You're welcome.

Operator

Thank you. Your next question is from Eric Serotta with Merrill Lynch. Please go ahead.

Eric Serotta ***Merrill Lynch - Analyst***

Good morning.

Irene Rosenfeld ***Kraft Foods - CEO***

Good morning, Eric.

Eric Serotta ***Merrill Lynch - Analyst***

A couple quick housekeeping questions and a follow-up. First of all, Jim, the tax rate obviously for the year came in lower, is going to come in lower than your guidance. You'd previously talked about '08 going up to I think 37%. Do you still stand by that or is there potential upside from lower tax rate in 2008?

Jim Dollive ***Kraft Foods - EVP, CFO***

Sure. Obviously we are benefiting this year from the resolution of those items I mentioned as well as the mix in countries. We really haven't updated our guidance yet for 2008. Previously we said it was going to be around 37%. Rest assured we are actively pursuing those programs we think will help reduce our long term tax rate and it's really just too early now for us to make any committment on that.

Eric Serotta ***Merrill Lynch - Analyst***

How much of the reduction in the tax rate for '07 was attributable to discrete items like the tax rate, like the audit resolution and how much related to country mix and the like?

Jim Dollive ***Kraft Foods - EVP, CFO***

A little more than half was related to the resolution of some of those specific tax items.

Eric Serotta ***Merrill Lynch - Analyst***

Okay, and then Jim, did I hear you, I guess I don't remember whether it was Jim or Irene who made the comment but did I hear it correctly that about three-quarters of the incremental marketing and quality spending will occur in the second half?

Irene Rosenfeld ***Kraft Foods - CEO***

Yes, that's what I said, Eric.

Eric Serotta ***Merrill Lynch - Analyst***

Now that's three-quarters of of the 400 million?

Irene Rosenfeld ***Kraft Foods - CEO***

Yes.

Eric Serotta ***Merrill Lynch - Analyst***

Okay, looking at that, that would obviously imply that you spent about 100 million in the first half, an incremental 100 million and when I look at the overall SG&A line for the first half, it was up about 340 million or so, so I'm just wondering what some of the drivers were behind the increase in the non-quality marketing portion of SG&A and I realize that even a portion of the $100 million investment is coming in the COGS line, so I guess why was SG&A up, why was SG&A eX-marketing up so much and what's your outlook for the second half?

Jim Dollive ***Kraft Foods - EVP, CFO***

Let me grab that one, Eric. Obviously, we are looking at -- when you look at that line on our P&L it does show a fairly sizeable increase. The largest single component of that increase particularly in the second quarter was our marketing investment and our investment in some other growth initiatives, about 40% of the total change. There are some structural changes that you're seeing in that number. It's a combination of both currency implications as well as the addition of the UB Iberia business that we acquired back in the beginning of the fourth quarter last year. That's about 30 to 35% of the total change, and then we did have recognized in there that $18 million gain from the prior year, that's about another 10% of the change in the quarter, so there's a lot of things in there that drive it. Some structural but the more important one, the most significant one is the investment we're making in our business.

Eric Serotta ***Merrill Lynch - Analyst***

Just lastly, do you see the potential for some structural cost savings on the overall overhead line, on the overall overhead that falls within the SG&A line as we get into the second half and into calendar '08?

Irene Rosenfeld ***Kraft Foods - CEO***

Well, Eric, as we mentioned we're very pleased with the progress we're making against our overall restructuring plan and we are delivering greater savings at a faster pace than we had anticipated. We're going to continue to look at opportunities to drive our administrative costs down and I am hopeful that as we continue to look at opportunities to simplify the organization that we will find some additional opportunities for overhead savings.

Eric Serotta ***Merrill Lynch - Analyst***

Great. Well, good luck. Thank you very much.

Irene Rosenfeld ***Kraft Foods - CEO***

Thank you.

Operator

Thank you. Your next question is from Eric Katzman with Deutsche Bank. Please go ahead.

Eric Katzman ***Deutsche Bank - Analyst***

Good morning, everybody.

Irene Rosenfeld ***Kraft Foods - CEO***

Good morning, Eric.

Eric Katzman ***Deutsche Bank - Analyst***

A few questions, I guess first one, follow-up on Terry's question earlier. Isn't the problem really that the government wants their pound of flesh when it comes to divestitures, so if you're going to get rid of let's say Maxwell House as Pelts is rumored to propose, I mean, huge earnings dilution so unless you really get the sense that you can't fix that business, otherwise, it just doesn't make much sense. Isn't that fair given the tax basis of those assets?

Irene Rosenfeld ***Kraft Foods - CEO***

Yes. In fact that's why divestitures is not a major part of our plan. I feel very comfortable that we have the ability to better leverage the breadth of our portfolio and that's a critical piece of our strategy going forward. I think our scale can be a competitive advantage but having said that to the extent that we have businesses that we don't believe can be accretive over the long term, we are better to put our investments elsewhere and obviously we will consider all opportunities to do that to be able to maximize shareholder value and the tax implications is an important consideration in that equation.

Eric Katzman ***Deutsche Bank - Analyst***

I don't understand why people just get so fascinated with the idea of getting out of a business when it will be hugely dilutive but anyway, let's move on. Just in reference to the the three categories where they are big and your share is under pressure, in Maxwell House odds are it's not going to be easy because you're going up against Procter and Folgers to the extent that they still care about food or beverages. Snacks you got a lot of competition obviously with PepsiCo and others, but it would seem that the one area where you can from a competitive standpoint where you should win is cheese because that's largely private label. So I guess it used to be that anybody who is going to progress at Kraft had to fix or grow cheese. What do you think is just the long term problem there?

Irene Rosenfeld ***Kraft Foods - CEO***

I actually don't think there's a long term problem. I think the issue has been we have been far too focused on commodity costs and price gap as our lever and the reality is it's a growth category, consumers around the world are eating more and more cheese and we're not participating, and so as I said before, I'm not yet comfortable that our pipeline on cheese is robust enough in general and certainly to handle these record high dairy costs, but we are about fixing it. It's just going to take us some time because there's just not enough in the pipeline. We've got a couple of good items coming out in the back half. I've talked about the Live Active product, our Kraft Singles Select product, we've made some changes in our advertising agency that I think will lead us to a stronger program for our base singles product but net-net, we need to get some more innovative products coming out and it will take us some time to do it but clearly cheese is one of those categories where we have the right to win and we will.

Eric Katzman ***Deutsche Bank - Analyst***

Okay and then two quick follow-ups for Jim. Jim, I think previously when you talked about the restructuring, the cash costs have been about 1.1 billion over the life of the programs. Did that change with today's adjustments?

Jim Dollive ***Kraft Foods - EVP, CFO***

We're looking at that. We are running slightly favorable on some of our cash costs just as we're seeing the efficiencies in the total program, but for clarification, we spent about 900 million on cash so far, what we said was the total 3 billion had somewhere in the order of 1.9 billion as a cash component but I think we're going to see some favorability around that.

Eric Katzman ***Deutsche Bank - Analyst***

Okay, and then lastly, did you quantify the gross margin impact from input costs versus the benefit on price?

Jim Dollive ***Kraft Foods - EVP, CFO***

We really haven't gotten into the specifics of how each of the components drive into that. The simple answer is that the gross margin is under pressure because of the rapid increase in the commodity cost.

Eric Katzman ***Deutsche Bank - Analyst***

Okay. So most of -- even with the pricing, the input costs are still overwhelmingly hitting you?

Jim Dollive ***Kraft Foods - EVP, CFO***

I wouldn't call it overwhelmingly. We are pricing to recover the majority of our input costs but we're not there yet in terms of 100%.

Eric Katzman ***Deutsche Bank - Analyst***

Okay, thank you.

Operator

Thank you. Your next question is from Alexia Howard with Sanford Bernstein. Please go ahead.

Alexia Howard ***Sanford Bernstein - Analyst***

Hello, there.

Irene Rosenfeld ***Kraft Foods - CEO***

Good morning.

Alexia Howard ***Sanford Bernstein - Analyst***

I just wanted to talk a little bit about the strategy going forward on Tassimo. It was obviously the write-off in Q4 of last year. It sounds as though you've still got a fair amount of marketing investment going in there. Maybe you could just talk about how much of the downturn in margins in North American beverages over the last few years has been to do with the Tassimo launch and what is the plan going forward? Is it more of a milking strategy at this point, is it -- how are are you thinking about the strategy as we go from here?

Irene Rosenfeld ***Kraft Foods - CEO***

Actually, Alexia, we continue to believe that Tassimo is an important growth engine for us as we go forward. In fact, the fact that we've chosen to go to a more targeted strategy particularly in North America is paying dividends on the bottom line and it's one of the factors that contributed to our strong performance in our beverage segment so I believe that the targeted strategy is paying dividends. We actually expect our Tassimo platform to grow about 70% this year, but we're focused on the right people. We're not trying to appeal to the mass market. It's about targeting coffee Aficionados. We've got some exciting new products in the EU like Latte Macchiato and that's performing quite well for us. We've got some new advertising that is coming out in the back half of the year and actually I'm quite encouraged by the program that is setting up for our Christmas season this year.

Alexia Howard ***Sanford Bernstein - Analyst***

Thank you.

Irene Rosenfeld ***Kraft Foods - CEO***

You're welcome.

Operator

Thank you. Your next question is from David Driscoll with Citigroup Investments. Please go ahead.

David Driscoll ***Citigroup Investments - Analyst***

Hi, good morning, everyone.

Irene Rosenfeld ***Kraft Foods - CEO***

Good morning, David.

David Driscoll ***Citigroup Investments - Analyst***

Just first a comment, Irene. There is, in the old days we had some nice presentation slides that had a tremendous amount of information on it. You guys had stopped doing that when you came on board and I would just say that there's a lot of questions that are being asked today that would have been answered through those slides. If at all possible if you reinstitute those that would be very helpful. Now on to a couple questions here. Jim, can you tell us what was the market share change for Kraft Top 25 U.S. OCI categories? As you recall that was a metric that you used to give out quite frequently.

Jim Dollive ***Kraft Foods - EVP, CFO***

David, we don't have that. What we're really looking at right now is how we're doing in our Top 30 or so categories in the U.S. on a trailing 52 week basis, and as Irene said in her opening comments, we're still not growing share in more than half of them. We're still slightly under half.

Irene Rosenfeld ***Kraft Foods - CEO***

David, we're choosing to look at the top revenue contributors because what I found before, the Top 25 is an important metric but the fact was they were growing and we had a leaky bucket. So I think the relevant consideration is what percent of our revenue is growing and as I mentioned, less than half of our revenue is growing share, and that is unacceptable. We expect to see that number go considerably North over time and in fact, we should see some improvement in the back half of this year particularly in the fourth quarter.

David Driscoll ***Citigroup Investments - Analyst***

Next question would be Jim, can you just give us what the estimate for commodity cost increases is? I don't actually think you said the number on the call. If I missed it I apologize.

Jim Dollive ***Kraft Foods - EVP, CFO***

No, we didn't give a specific number on the commodity cost. We're actually trying to get away from giving that specific number. As I said earlier, what's really important here is the net of how we're doing from a total recovery perspective and we're actually in better shape now than we've been previously.

David Driscoll ***Citigroup Investments - Analyst***

All right. Well, that leads to the next question. Irene, on pricing, we've heard a lot of different companies talk about the environment for actually realizing a price increase is quite good right now. Would you echo those comments and what other color can you give to us about the ability to pass through those price increases?

Irene Rosenfeld ***Kraft Foods - CEO***

Well, David we've priced about 60% of our North American portfolio in the last 12 months and as we mentioned earlier, I expect to see even more realization of that pricing in the back half of the year, so we believe that we will be able to recover a significant portion of our input costs through the pricing actions we've taken. Having said that, it's more than we've been able to do in the past but it still is not sufficient to offset the entire impact.

David Driscoll ***Citigroup Investments - Analyst***

Jim, just one last question, following up on Eric's question on the 2008 tax rate. Given that you guys are fully separated right now, I understand that you may not have completed your '08 plans but the 37% tax rate is enormously higher than where you are right now. Why would anybody believe that that tax rate is a realistic tax rate for '08 given what we're seeing this quarter?

Jim Dollive ***Kraft Foods - EVP, CFO***

Well, remember, in the current year, we continue to have some benefit of our association with Altria, and that is enabling us to get a benefit versus what it will be on a fully stand alone basis. 2008 is our first full year independence.

David Driscoll ***Citigroup Investments - Analyst***

So then you're really sticking to your guns that 37 might be the appropriate rate at this point?

Jim Dollive ***Kraft Foods - EVP, CFO***

Well, we're just not updating the guidance. We are actively looking at programs that are going to help us bring that down but we're just not ready to commit to anything at this time.

David Driscoll ***Citigroup Investments - Analyst***

Okay, I understand. Thanks a lot, everybody. Good luck.

Irene Rosenfeld ***Kraft Foods - CEO***

Thanks, David.

Operator

Thank you. Your next question is from Ann Gurkin with Davenport. Please go ahead with your question.

Ann Gurkin ***Davenport - Analyst***

Good morning. I think you said you all put a price increase through on cheese. Have you protected the retailer for a specific period of time?

Irene Rosenfeld ***Kraft Foods - CEO***

Yes, we have.

Ann Gurkin ***Davenport - Analyst***

Can you give me that time frame?

Irene Rosenfeld ***Kraft Foods - CEO***

Well, basically we told you we took a pricing action earlier in the year and then we took another one effective July 9, and so we are getting ourselves through the 4th of July holiday.

Jim Dollive ***Kraft Foods - EVP, CFO***

And the effective date is the date after the deal protection.

Ann Gurkin ***Davenport - Analyst***

Great, and then for the back half should we look for operating margins on the cheese and foodservice segment to be down like what we saw in the second quarter?

Irene Rosenfeld ***Kraft Foods - CEO***

Yes. I think it's as you heard Jim say, we expect it will get somewhat worse before it gets better as the higher input costs flow their way through the P&L, particularly in the third quarter.

Ann Gurkin ***Davenport - Analyst***

Okay, great. Thank you.

Irene Rosenfeld ***Kraft Foods - CEO***

You're welcome.

Operator

Thank you. Your next question is from Pablo Zuanic with JPMorgan. Please go ahead.

Pablo Zuanic ***JPMorgan - Analyst***

Good morning, everyone. Just a couple of questions for Jim first, and then a couple ones for you, Irene. On the cheese side, Jim, can you give us some sense in terms of economics? If cheese is up 50%, how much of a price increase you need to fully offset that, or if you want to think in terms of cents, but what color you can give there would help.

Jim Dollive ***Kraft Foods - EVP, CFO***

Obviously, cheese is just a percentage of the total cost profile, so when you have an increase in cheese, the revenue increase needed to cover that is significantly less, and I'm not going to get into the specific dynamics there because then I'd have to get into the P&L structure and the cost component on cheese.

Pablo Zuanic ***JPMorgan - Analyst***

Okay. And now when I look at the marketing expenses, one-third going in the first half, was that the plan all along or did you have to delay some of them in the second quarter because of the higher input cost?

Irene Rosenfeld ***Kraft Foods - CEO***

No, actually, I would say it was the plan in the sense that we understood that a number of the new items and some of the marketing ideas that this spending is going to go against would not be ready until the back half and that's one of the reasons I've been saying all along that we expected to see stronger recovery in the back half, and so that's the reason for the spending coming more sharply in the back half than it has so far.

Pablo Zuanic ***JPMorgan - Analyst***

Okay, and just to follow-up on that Irene, if you can tell us when you look at the five divisions in the U.S., which ones are more advanced in terms of the innovation pipeline, in terms of the marketing programs, and which are behind? Can you give us some color there, shades of our progress there?

Irene Rosenfeld ***Kraft Foods - CEO***

I certainly can, Pablo. I think it should be somewhat clear from my remarks I feel very good about our progress on powdered beverages. We're beginning to see some progress on coffee and I think we're addressing an issue that's been longstanding so I feel good about beverages. I feel very good about our position in convenient meals. On the top line we've got some work to do there in terms of margins which will recover as the year progresses. So I think beverages and convenient meals are our strongest performers and have the strongest pipeline.

The balance of our sectors, particularly cheese, snacks, and grocery are the areas that we continue to have some issues but rest assured, we are on top of what those key issues are. It's just going to take somewhat longer for us to be able to address some of them but the progress will accelerate in the back half, as I've said three quarters of our spending is yet to come. We do have a stronger new product pipeline across-the-board which you'll have much more visibility to as these products come out into the marketplace. I expect to see better pricing realization and all of which will, I believe will lead to improved share as well as volume performance.

Pablo Zuanic ***JPMorgan - Analyst***

And one last one if I may. In terms of thinking about commodity exposure, private label exposure, the (inaudible) or the feedback is that we get a lot of commodity type products and obviously you're addressing that through innovation, but for me the definition of a commodity type category is where private label penetration is high. So I look at for example, Heinz, frozen potatoes almost 28, 30% private label market share but Oneida is able to get about 70, 80% premiums to private label and I look at the Planters Snacks and the premium to private label is 5 to 7%. So I'm just trying to get an idea when I think of nuts, hams, cheese, which are so-called commodity type categories, do you see room there to significantly improve premiums from where they are right now through innovation or is there something structural that doesn't make the premiums possible in some of your other products?

Irene Rosenfeld ***Kraft Foods - CEO***

Well, I know I actually think that the opportunity we have is to be able to get stronger volume performance from the premiums that we have. I think over time, clearly as we add more value to a number of our products particularly in cheese and nuts as you suggest, that will help us, but the real opportunity we have is to be able to generate stronger performance and particularly stronger share performance with the gaps that we have today and that will hinge entirely on our ability to restore brand equity to a number of these iconic brands and to innovate with value-added products and that's really what our investment plan is focused on.

Pablo Zuanic ***JPMorgan - Analyst***

And just a last one, any update on the search of a Marketing Officer -- Marketing Director?

Irene Rosenfeld ***Kraft Foods - CEO***

Yes, we are continuing to search. It's a critically important role for us particularly as I'm looking to place much more emphasis on the consumer and the quality of our marketing. We've been actively engaged in an external search and I expect to make an announcement later this quarter.

Pablo Zuanic ***JPMorgan - Analyst***

Thank you.

Chris Jakubik ***Kraft Foods - VP, IR***

Operator, we can take one more question.

Operator

Thank you. Your final question is from Steven Kron With Goldman Sachs.

Steven Kron ***Goldman Sachs - Analyst***

Two questions and they both turn out to be follow-ups here, back just on the cheese business. You mentioned lower price gaps versus last year. You've spent some on innovation and I think you shared that at CAGNY, yet obviously share as you've commented on is down so it begs the question, is the absolute price at this point a bit more important than the gap itself to the consumer and I can't help but think that recent pricing actions just furthers that price point in a category that seems to be obviously a bit more commoditized to the consumer?

Irene Rosenfeld ***Kraft Foods - CEO***

Well, again, Steven, I think we have to stop talking only about price gaps as the root of our issues. There's no question that we're not happy with our share performance on cheese. We do feel that our price gaps for the most part are in a reasonable place, and so I don't believe that that is the solution to our long term opportunity. The issue is really about the quality of our pipeline and the ability to introduce value-added new items, and that's what we've got the team focused on. So I don't think it's about price gaps. Certainly, getting better price realization and seeing how the marketplace reacts in general to these higher input costs will be important and may create some relative dislocation in our position but I feel generally quite good about where our pricing position is on cheese. The issue is the ability of the portfolio to add enough value to be able to be distinguished and competitively advantaged.

Steven Kron ***Goldman Sachs - Analyst***

Okay, that's a good segue into the next question which is Irene, just trying to get a bit of perspective maybe a status update a little bit different from a prior question as it relates to innovation in the U.S. And particularly the speed to market if I recall, if I think back to CAGNY, there was a whole host of pipeline of new products that you were very excited about and it kind of feels like things are a little bit more back end loaded than perhaps I would have thought and we're talking about '08 and I understand that this is an evolving process, but can you maybe talk about your level of satisfaction with the speed to market with some of this innovation?

Irene Rosenfeld ***Kraft Foods - CEO***

Well, I think we're making good progress. We're not exactly where we need to be but I will tell you over the coming weeks we will be talking at the back-to-school conference about a number of our new items and we're just beginning to present them to the trade so I come back to the point I knew that it was going to take us some time in 2007 to get this pipeline jump started and that's why we've been talking about the fact that we expect to see stronger acceleration in the back half. Having said that, our early investments are already showing some results, so it will take us some time as we've said particularly on some of the longstanding issues in some of our core categories, those are a little harder to fix and we are in the process of doing that and we will lay those out as we commercialize them in the marketplace, but I will tell you overall, I think the organization is responding very well to the overall charge of moving faster, of being bolder, of taking some actions, of testing and learning and I'm seeing examples across the Company of progress there and it will be more visible to you as these new products begin to come out in the back half of the year.

Steven Kron ***Goldman Sachs - Analyst***

Thanks very much.

Irene Rosenfeld ***Kraft Foods - CEO***

You're welcome.

Chris Jakubik ***Kraft Foods - VP, IR***

Okay, thank you. For those people with the media who have additional follow-up questions, please feel free to call Claire Regan at 847-646-4538 and for analysts and investors who have follow-up questions please feel free to call me after we hang up. So thank you very much and have a good day.

Operator

Thank you. This concludes today's Kraft Foods conference call. You may now disconnect.

THOMSON REUTERS

PLACEHOLDER TRANSCRIPT

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PRESENTATION

Operator

Good morning and welcome to the Kraft Foods third quarter 2007 earnings conference call. Today's call is scheduled to last about one hour including remarks by Kraft Foods' management and the question-and-answer session. (OPERATOR INSTRUCTIONS)

I will now turn the call over to Mr. Chris Jakubik, Vice President of Investor Relations for Kraft. Please go ahead, sir.

Chris Jakubik ***Kraft Foods - VP, IR***

Thank you. And good morning. Thanks for joining us on our conference call. I'm Chris Jakubik, Vice President of Investor Relations. With me are Irene Rosenfeld, our Chairman and CEO; and Tim McLevish, our Chief Financial Officer.

Our earnings release was sent out earlier today and is available on our website, Kraft.com. As you know, during this call we may make forward-looking statements about the Company's performance. These statements are based on how we see things today, so they contain an element of uncertainty. Actual results may differ materially due to risks and uncertainty. Please refer to the cautionary statements and risk factors contained in the Company's 10-K and 10-Q filings for a more detailed explanation of the inherent limitations in such forward-looking statements. Some of today's prepared remarks will exclude those items that affect comparability. These excluded items are captured in our GAAP to non-GAAP reconciliations within our news release and they are also available on our website. We'll begin today's call with Irene's perspective on our third quarter. Then Tim will provide an overview of our financials and results of operations. After that, we'll take your questions. With that, I'll hand it to Irene.

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

Thanks, Chris. Good morning. As we reported in this morning's press release, we posted organic revenue growth of just over 6% in Q3 and EPS X items that were $0.02 lower than the prior year. Broadly speaking, our top line growth is stronger than I would have expected at this point our transformation plan. At the same time, higher input costs and the impact on our margins are a bigger challenge than I would have anticipated.

To be more specific, I'm encouraged that our top line momentum continues to build and that our businesses are responding to the growth initiatives we launched earlier this year. We had three consecutive quarters of improved organic net revenue growth and in Q3, revenue growth accelerated in every geography. I'm especially pleased that we also had solid volume gains, despite significant price increases. That's a clear sign that our brand equity is strengthening.

In businesses where our investments in quality, marketing, and new products have had time to gain traction, we generated solid volume mix gains and captured market share, despite price increases. Prime examples are mac and cheese, cold cuts, and cookies. And a number of the new products we've launched this year promise be sizable businesses and highly incremental to our base. These include Oreo Cakesters, Live Active cheeses, Easy Mac cups, ultimate pizza, and deli creation sandwiches. In fact, we expect the revenue contribution from new products in 2007 to be more than 30% higher than 2006.

Our growth initiatives in our focus categories are also beginning to generate share gains. In Q3 we gained share in 47% of our North American business. Versus only 38% for the trailing 52 weeks. That's not yet where we need to be. We expect to have over 50% of our revenues growing share in the near term, and at least two-thirds longer term. But we're moving in the right direction and you should see further improvements as more programs hit the market in the fourth quarter.

Highlights include new campaigns for Maxwell House, behind our advantage product and package and Planters, capitalizing on the natured goodness of this iconic snack brand. We'll also have a further step-up in spending on our international growth initiatives. As our wave one investments gain traction in the marketplace, I remain confident that this will set the stage for continued top line momentum and share gains into 2008 and beyond.

Despite our progress on the top line and in market share, we still have some significant challenges. The biggest is our margin performance. We're in a much tougher input cost environment than we had expected. In the quarter, gross margins declined 240 basis points, even after pricing actions and manufacturing productivity. Frankly, we haven't yet rebuilt the brand equity of our portfolio to the point where we can fully recover input cost inflation through a combination of pricing and productivity. This has been particularly true in our North American cheese business where dairy costs in the third quarter were up 40% versus prior year and current spot prices are not reflecting their historical seasonal decline, leading to record high average barrel cheese costs for 2007.

The easy thing to do would be to cut our investments in growth to improve our near term profit margins. But as I said last quarter, the input cost environment will not change our plans to make the necessary investments to improve the quality of our products and to rebuild the equity of our brands. These investments are essential to adding value to our products and therefore to our ability to manage input cost inflation over the long-term. Our investments are also key to driving the accelerated volume growth and stronger product mix that will leverage our overhead costs, lead to higher operating margins, and restore Kraft to reliable growth.

In the face of these extraordinary cost increases, we're also taking more aggressive actions to reduce our overhead costs. To date we've been able to achieve savings at a faster rate while incurring less expense. Cumulative savings under our restructuring program are now expected to reach $775 million this year, versus our expectation of $700 million at the start of the year. And there's more to come. Looking at our total restructuring program, we expect to come in at the same cost and reach higher savings than the $1 billion originally expected.

If you recall in September, as part of our strategy to rewire the organization for growth, I announced a new organizational structure to replace key resources closer to the market, increase accountability, speed decision making, and streamline headquarters. We have now defined the structure, identified the accountable business units and named the leaders of those units. Based on the work to date, I'm even more convinced that our new structure and new leadership team will simplify our operations and increase our agility and competitiveness in the marketplace.

As you might have seen on Monday, we named Mary Beth West as our new Chief Marketing Officer. As head of North American beverages, Mary Beth helped develop our successful go to market strategy for Tassimo in the U.S. and engineered the reawakening of our Maxwell House brand that has just hit the market. She brings a strong consumer centric approach to business challenges and will play a key role in helping to upgrade the capabilities of our marketing teams and improve the effectiveness of our programs. We still have a few more personnel holes to fill, including a new leader for our North American cheese business and we'll be in a better position to quantify the incremental savings from these actions as we exit the year and put the new structure in place in early 2008.

Finally, we continue to take the necessary steps to strengthen our portfolio. To exit businesses where we do not have a clear competitive advantage so that we may allocate our capital and management resources to those businesses that can grow and generate attractive returns for our shareholders. Specifically, we've just closed the sale of our Fruit2O and Veryfine bottled beverage assets we're on track to close the acquisition of Danone biscuits by year end.

In sum, I'm encouraged by the continued progress in the early stages of our transformation plan. We're doing what we said we would do and we are seeing signs that our efforts and investments are paying off. We still have a number of challenges but we are addressing them. And I remain confident that we are on-track to restore Kraft to reliable growth. And now I'll turn the call over to Tim.

Tim McLevish ***Kraft Foods - EVP, CFO***

Thanks, Irene and good morning. Before I begin, please keep in mind that unless otherwise noted, my comments will exclude the items affecting comparability that were highlighted in our press release. In the third quarter, our organic net revenues increased a strong 6.2%. That's up from 3.9% organic growth in the first six months of the year. Volume and mix accounted for about two-thirds of the Q3 growth as many of our wave one investments in quality, new products, and marketing began to hit the market. Net pricing was up 2.3 percentage points versus 1% in the first six months of the year as we have begun to see the realization of price increases taken earlier this year. Overall, we had a great improvement on the top line.

Turning to the drivers of profit and earnings, there are three factors to highlight. First, although our price realization improved in Q3, our gross margin was down 240 basis points versus Q3 last year. Higher input costs and our investments in product quality more than offset pricing and productivity gains. For the year, we expect our input costs will be up about 9% versus 2006. We expect gross margin pressures to continue in Q4, and into 2008 as well. Second, because of the decline in gross margin, our operating increment margin was down 210 basis points. On the positive side, I would note that our overhead costs declined as a percentage of sales, meaning our cost savings are coming through and we began to generate some operating leverage due to a combination of volume mix, growth from our investments, and restructuring savings.

Looking forward, we expect operating income margins to continue to be pressured over the next several months, due to higher input costs. However, in 2008 we will leverage improved price realization, volume growth, and improved product mix while driving down our overhead cost to achieve higher operating margins versus 2007. Third, below the line we benefited by approximately $0.02 from a combination of a lower effective tax rate and our share repurchase activity. In the quarter, our effective tax rate was 31.3%, reflecting one-time adjustments from the impact of various foreign tax law changes. As a result our guidance for the year is now 32.5%, versus our earlier forecast of 33.5%.

On the share repurchase front, during the quarter we repurchased another $1 billion of our stock. And in the first six months, since the spin-off, we've repurchased $3 billion or 5.6% of our shares outstanding, at an average price of $33.02. If you recall, in September we raised our guidance to $1.80 to $1.82, reflecting strong revenue growth, lower taxes, and further share repurchase. Our Q3 results came in very much as we had expected and therefore we remain confident in our guidance, despite the continued cost pressures. I'll take a few minutes now to share some highlights of our business segment results.

We'll start with North America, where Q3 results reflected the launch of most of our wave one growth investments. In North America beverages, organic net revenues grew 5.3%. Our focus on health and wellness and premium offerings is paying off. Capri Sun ready to drink pouches were up strongly from the addition of anti-oxidants, and functional benefits, as well as from teaming up with Nabisco for a back to school promotion. And in coffee, Starbucks premium coffees continued to grow strongly, combined with another quarter of 70% growth from Tassimo as our revised strategy continues to gain traction.

Our market share in coffee was still down in the quarter as gains in the premium segment were offset by main stream weakness. However, October 1, marked the beginning of our Maxwell House reawakening ad campaign in support of our improved offering. Customer and consumer reaction to both the package and the new 100% Aravica blend has been enthusiastic and we expect positive results from the program to begin in Q4 and continue into 2008.

At the profit line, beverages operating margin increased 260 basis points. Volume growth, favorable product mix, pricing and the benefits of our new Tassimo strategy more than offset higher input costs. We expect a similar profile in the fourth quarter.

In North America cheese and foodservice, results were impacted by unprecedented barrel cheese prices. Organic net revenues were up

5.6%, mainly due to price increases reflecting higher dairy costs but operating income margins fell over 6 percentage points as we chose not to price to peak input costs and continued to fund our growth initiatives to lay the necessary foundation for long-term growth of this business. Dairy prices have remained uncharacteristically high throughout 2007, likely leading to record high average barrel cheese prices.

Three major factors have combined to break the historical cyclicality of the cheese curve. Australia continues to suffer from its severe -- from a second year of severe drought. A weak U.S. dollar is making U.S. dairy exports attractive and demand for milk powders has grown globally, particularly in Asia and North Africa. In the face of this, we've taken significant action. About 80% of our cheese portfolio has been priced at least once in 2007. And pricing actions have ranged from 2% to 13% for an average 7% increase overall. However, absolute price levels are causing weak category volumes and driving more consumers to trade down to private label versus historical normals.

As a result, both our volumes and market share of total cheese are down year-to-date. Clearly our pricing and innovation have not been enough to manage this input cost volatility. However, our new initiatives are beginning to move us in the right direction. Live Active, prebiotic, and probiotic cottage cheeses are off to a good start. To date, Live Active cottage cheese has captured a 1.6% share of cottage cheese and is more than 85% incremental. And Live Active natural cheese has a 2.6% share of the natural cheese snacking category. Also, Kraft Singles Select has already gained 1 share point of the processed slices category one month after introduction. Fixing our cheese business will take time and continued investment. As a result, we expect operating income margins in this business to be under pressure for the balance of 2007 and into the beginning of 2008.

Moving on to North America Convenient Meals where revenue momentum has been building with each successive quarter in 2007. The investments we have been making in marketing, quality and new products drove strong volume and mix gains while we've increased pricing across most of the business. The introduction of Ultimate Pizza is helping to turn around our share of frozen pizza. Ultimate share of the category was about 3% in Q3 and all four Ultimate SKUs are in the top 5% of category dollar sales in Q3. Mac and Cheese is also gaining share, up over 0.5 point in the latest 52 weeks, driven by our investments in quality and new products. Easy Mac Cups have been more than 50% incremental to our business year-to-date, and have been a key driver of the double-digit growth of our Mac and Cheese business.

And finally, Oscar Meyer continued to post strong growth behind both deli creation sandwiches and deli shaved meats. In fact, deli shaved meats now have nearly a 10% share of the total cold cuts category. The result, 8% organic net revenue growth for Convenient Meals in the third quarter. However, operating income margins fell in the quarter, negatively impacted by three factors. The impact of divested operations, higher input costs including investments in quality and new capacity, and incremental marketing investments. Going forward we expect profit margins in Convenient Meals to improve as we see continued momentum from our growth initiatives.

On to North American grocery where organic net revenues were essentially flat. We are at the early stages of contemporizing these highly profitable brands. Jell-O is the first and earliest of our efforts. The total Jell-O franchise is up about 5% year-to-date and it was up 7% in Q3 behind strong momentum from new, better for you products. We'll be launching an integrated marketing campaign to rejuvenate dry packaged Jell-O in Q4. Pourable salad dressings will be next as we look to reverse many years of weakness in this franchise. We're upgrading the quality of the packaging and product and we'll be fully national with incremental marketing support in the first quarter of 2008. Some of the costs associated with these activities will weigh in our grocery margins in the fourth quarter.

Looking at North American snacks and cereals, organic net revenues were up 4.6%, led by growth of 5.5% in snacks. Several successful platforms are driving our snacks growth and serve as good examples of the impact of reframing our categories. For instance, revenue growths of our higher margin Nabisco 100-calorie packs was up 51% in Q3. Second, during the third quarter, the introduction of Oreo Cakesters captured a 6 share of the $1 billion snack cake segment with two of the category's top 10 SKUs and a 3 share of total cookies. Considering that we only launched the product in late July, we're expecting even better things to come. Third, our toasted chips platform grew 18% in Q3, versus the prior year and is now over a three share of the cracker category. Our new Garden Harvest chips have captured 1 share point since being introduced with velocities well ahead of competitive products. Despite some promising success our market share performance in snacks remains mixed. While our cookie share is up, we still have areas that need to be fixed, namely Planters and our broader cracker business.

Going forward, we expect our strong new product line-up and better marketing support across the snacks business to accelerate organic growth and improve market share trends. Operating income margins in the quarter fell 230 basis points as solid volume and product mix gains were offset by higher input costs, spending behind our growth initiatives, and dilution from the sale of Cream of Wheat. Clearly, given the high cost of grains, our input costs are on the rise in our snacks business, placing increased emphasis on improving net price realization. As a result, we're considering a combination of list price increases, targeted reductions in trade spending and productivity in order to manage these costs going forward. Nonetheless, we'll continue to invest in the growth of this business and in 2007 we'll have a solid base from which to drive growth.

Now I'll turn to our international business which continued to post solid organic growth as we focus on our investments on our core brands. The EU continued its return to moderate growth, increasing organic net revenues by 4.9 percentage points. In fact, EU organic revenue is up 3.3% year-to-date, its best performance in the last three years. Our two largest growth categories, chocolate and coffee, have been the main drivers. Chocolate delivered double-digit growth this quarter. There are two key reasons. A combination of new product launches and a double digit increase in marketing behind core brands like Milka and Toblerone. And secondly, cooler weather across the EU. Coffee growth was driven by two factors also. Category growth and market share gains from the successful restaging of our Tassimo on demand coffees and new product activity under our core Jacob's brand.

EU operating margins declined 220 basis points. There are two major reasons. First, 2007 is a year of investment to revitalize our core brand equities, through marketing and promotion. In fact, A&C spending ex Tassimo will be at its highest level in three years. The second is higher input costs. Coffee and dairy costs have been on the rise and as mentioned earlier, these businesses, especially in Germany, are not yet strong enough to enable us to fully recover these costs. In fact, with dairy costs now on the rise in Europe, input cost pressure is likely to get worse in the EU before it gets better. Looking ahead, although we'll continue to make the necessary investments to strengthen our core equities in coffee, chocolate, and biscuits, we are actively pursuing additional ways to reduce costs and improve margins.

Moving on to developing markets where we delivered another quarter of solid growth, with organic net revenues up double digits. All regions posted better growth in in the third quarter than in the first half of the year. Our focus on key brands and key products is paying off in each region. This included Jacob's coffee as well as Milka and Alpen Gold chocolate in our EMA region, Oreo and Club Sociale biscuits, Lacta chocolate, and Tang beverages in Latin America and Oreo and Tang in Asia-Pacific. At the operating income line margins was up slightly. The benefits of higher pricing and volume growth were offset by higher input costs and higher investments in marketing and distribution. Going forward, we expect continued strong top line performance from developing markets. However, we expect continued margin pressures as we step up our investment and marketing support and expanded distribution.

Finally, I would like to comment on our restructuring program. Annualized savings from the program are up to $720 million. And we now expect them to reach $775 million by year-end, up from the $700 million level we expected at the start of the year. On the cost side, we have incurred $326 million year-to-date and we now expect total cost of $500 million for the year, down from an expectation of $625 million at the beginning of the year.

As Irene mentioned earlier, we do expect to generate better savings than originally planned over the life of the program and we'll close out the program by the end of 2008. Obviously, the actions we will take to implement our new organization structure are part of our restructuring program, so we would be in a better position to update you as we exit the year. And from 2009 onward, we expect to maintain a normalized level of spending and cost savings initiatives each year, which will be part of our ongoing results.

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

Thanks, Tim. In sum, from an overall perspective, I feel good about our business momentum and the early returns from our growth initiatives. We can see that our investments in quality, marketing, and new products are driving improved organic growth. We're generating solid volume and mix gains despite significant price increases and we're beginning to leverage our cost savings. We still have challenges, particularly in the face of higher input costs, but we're making the necessary investments for long term growth and have maintained our full year EPS guidance of $1.80 to $1.82. I remain confident that our transformation plan will maintain our top line momentum and deliver improved margins in 2008. We'd now be happy to take your questions.

QUESTIONS AND ANSWERS

Operator

Thank you. (OPERATOR INSTRUCTIONS) Your first question is from Alexia Howard with Sanford Bernstein. Please go ahead.

Alexia Howard ***Sanford Bernstein - Analyst***

Hello, there.

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

Hello.

Tim McLevish ***Kraft Foods - EVP, CFO***

Good morning.

Alexia Howard ***Sanford Bernstein - Analyst***

Hi. Couple of quick ones. Marketing spending. I know that we've got this incremental 300 million to $400 million this year that costs marketing, SAP, R&D, and better ingredients. Could you tell us how much of that went into the third quarter and how much is left I guess for the rest of the year?

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

We haven't actually quantified the pieces that went into each of the quarters, Alexia, but as I said, our spending is back half loaded and it will be a combination of Q3, Q4 with more of it skewing to Q4, which is why we're anticipating continued progress on our share growth in Q4.

Alexia Howard ***Sanford Bernstein - Analyst***

Thank you. And then just another quick one about the differential between pricing and input costs, obviously very negative this quarter. I'm not sure whether you can quantify that. But going forward, do you see that differential closing in Q4 or are we likely to have to wait until next year for that gap to start to close?

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

Well, as we said, we're covering only about half of our costs at this point. It's primarily an issue related to dairy and it has a lot to do with the strength of our brand equity and that's why we continue to make the necessary investments. As we look forward to the fourth quarter, I think it's going to look a lot like the third quarter. We should continue to see strong top line momentum and continued pressure on margins. But as we exit this year, as we've discussed, I believe we have programs in place that will allow us to make the kind of gains in our operating margins that we had given in our guidance.

Alexia Howard ***Sanford Bernstein - Analyst***

Great. Thank you very much and welcome on board, Tim.

Tim McLevish ***Kraft Foods - EVP, CFO***

Thank you, Alexia.

Operator

Thank you. Your next question is from Terry Bivens with Bear Stearns. Please go ahead.

Terry Bivens ***Bear Stearns - Analyst***

Good morning, everyone and Happy Halloween.

Tim McLevish ***Kraft Foods - EVP, CFO***

Good morning, same to you.

Terry Bivens ***Bear Stearns - Analyst***

Just a couple of things. I know you probably won't get into guidance until the fourth quarter, but Tim, is there any way we get kind of an advanced look at what you're thinking about in terms of the tax rate? That's a pretty big swing factor here. You've given us one for this year, obviously but any comment there, looking into '08?

Tim McLevish ***Kraft Foods - EVP, CFO***

Yes, well, first of all, as you saw, our rate has progressively come down over the course of the year as we identify opportunities that fall within discrete category within the year. We're now anticipating the 32.5% for full year as opposed to previous guidance of 33.5. Clearly, as we think about the tax rate and as I get more engaged in better understanding where we've been and what the opportunities are, first thing we'll be more thoughtful about how we plan the rate, rather than start out the year with a high rate and then progressively bring it down, we'll be a bit more realistic and thoughtful about what the ultimate opportunities and the full year effective rate will be. And secondly, as I engage in looking at opportunities, I am confident that we will find ways to overall better manage the tax rates, but at this point I'm not prepared to commit to a number.

Terry Bivens ***Bear Stearns - Analyst***

Okay. And just lastly, on commodities, Kellogg I'm sure you're aware talked about some pretty significant input inflation going into next year, be it energy or food ingredients. What is your preliminary view on where that might go, '08 over '07?

Tim McLevish ***Kraft Foods - EVP, CFO***

Well, again, we're not going to get into specific guidance on 2008 but certainly commodity costs are putting pressure across many of our categories and our businesses. It is particularly exacerbating the dairy situation, where dairy costs are, they're unprecedented levels and despite fundamental okay markets in the U.S., we're seeing the prices are holding up there more so than we would anticipate. No question, this is going to provide a headwind in 2008 and certainly in the earlier part of the year.

Terry Bivens ***Bear Stearns - Analyst***

Okay. Thanks.

Operator

Thank you. Your next question is from Steven Kron with Goldman Sachs. Please go ahead.

Steven Kron ***Goldman Sachs - Analyst***

Thanks. Good morning.

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

Good morning, Steven.

Steven Kron ***Goldman Sachs - Analyst***

Couple questions. I guess just following up on the marketing initiatives, the 300 million to $400 million. I guess I was a little surprised that the marketing and administration line was a little bit favorable on the year-over-year basis, so clearly the trade-off of some of the cost benefits that you're seeing, whether it be overhead or other initiatives, it's offsetting the incremental spending. Can you maybe talk a little bit about how you expect that line to trend going forward?

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

Well, again, Steven as we said, our focus is going to be to continue to make the necessary investments in the business and you're seeing that going through. We are continuing to work, though, to offset some of the other input costs. Some of the input cost with continued focus on overheads and so that what you're beginning to see in this quarter is indicative of what we're going to continue to push on going forward. If you remember our fundamental growth formula, it is for pricing and productivity over time to offset input cost and to use volume growth and mix together with a continued focus on overhead cost savings to increase operating margins. So we're seeing some of the early benefit of that. We expect that we'll continue to benefit more from the overhead opportunity in 2008.

Tim McLevish ***Kraft Foods - EVP, CFO***

We continue to drive opportunities to manage the overhead piece of it. We want to continue to invest in the advertising consumer and as Irene mentioned, we want to continue invest in the advertising, consumer and as Irene mentioned, we want to continue investing in building our brand. Right now, we're not able to offset the commodity increase costs with pricing. But as we build our brands we'll be even better positioned to do that.

Steven Kron ***Goldman Sachs - Analyst***

Okay. And then I guess secondly, I think this is the first time I think in like four or five years where cost to the consumer on products that are eaten at home, food at home products is out-pacing that of food away from home. I was just wondering, given your size and diversity of product and customer, whether you could just provide some comments. Clearly the cheese category is feeling the price sensitivity. Trade down to private label as you indicated. What about costs to your other categories, your other brands? Are you seeing the price realization a lot more difficult to achieve and maybe you could talk little bit about how you're thinking about pricing in some of those other categories going forward.

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

I would argue that we're actually seeing better pricing realization as we have come out of the third quarter than we've seen in quite some time and I've been particularly pleased by the fact that our volume and mix have held up in the face of that. As we exit the year, we will continue to see the impact of pricing as it plays through on a number of our categories. But there is no question that we are in somewhat unchartered water on a number of these categories as we reflect the impact of input costs through the P&L.

Steven Kron ***Goldman Sachs - Analyst***

Thanks.

Operator

Thank you. Your next question is from Eric Serotta with Merrill Lynch. Please go ahead.

Eric Serotta ***Merrill Lynch - Analyst***

Good morning.

Tim McLevish ***Kraft Foods - EVP, CFO***

Good morning, Eric.

Eric Serotta ***Merrill Lynch - Analyst***

Just wanted to circle back on Alexia's question regarding the marketing and other quality investment and investment spending in the third quarter. I guess last quarter, Irene, you made the comment that about 75% of the end market activity would occur in the second half. Could you give us some sort of -- I realize you don't want to get into specifics of dollars spent, but could you give us some sort of feeling as to percentage left to go for the fourth quarter?

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

No, we're not prepared to provide that number at this time, Eric, but again, I'll tell you that particularly as we look at some of the launches that are pending, our Maxwell House reawakening program, our Planters campaign launch, a number of other programs on both cheese and biscuits, we are looking to see a continued increase in our spending in the fourth quarter.

Eric Serotta ***Merrill Lynch - Analyst***

And Tim, is it fair to say that your accruals for this type of -- for this investment spending is more evenly weighted through the year than the actual end market activity or benefits that you are likely to see?

Tim McLevish ***Kraft Foods - EVP, CFO***

No, I think we are expensing as we incur the cost.

Chris Jakubik ***Kraft Foods - VP, IR***

Eric, as we have discussed on some of these programs, some of it is allocated throughout the year based on volume. But when you have new products come out that are entirely new to the product, you have to -- you incur the cost as you launch.

Eric Serotta ***Merrill Lynch - Analyst***

Sure. But things like the Maxwell House three stage, have the costs from that been accrued throughout the year in anticipation of it or is that an example of something that is -- that you're expensing as incurred?

Chris Jakubik ***Kraft Foods - VP, IR***

Eric, I think the important take-away here, and I don't want to get into every individual brand, but the important take-away, is as Irene said, about three-quarters of the spend was going to come in the second half of the year and as we look at the third quarter, we certainly had a significant step-up. We're going to have another significant step-up in the fourth quarter as well.

Eric Serotta ***Merrill Lynch - Analyst***

Okay. Thank you.

Operator

Thank you. Your next question is from David Palmer with UBS. Please go ahead.

David Palmer ***UBS - Analyst***

Great. Thank you very much. Good morning.

Tim McLevish ***Kraft Foods - EVP, CFO***

Good morning, David.

David Palmer ***UBS - Analyst***

Just a question about your product improvements and reformulations. I know you were making some changes there. Are those substantial? Is there any way for you to give us a sense of how much of an expense this is, versus the other marketing and pure commodity cost inflation?

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

It's a little bit hard to quantify. Certainly, it is a piece of the impact on our gross margins. It's probably about a quarter of our $400 million incremental cost. But the end result here is the fact that as I mentioned, we're seeing a considerable step-up in the percent of our products that are rated superior to competition. As we go forward, that will continue to be a key driver of our performance and we're seeing the benefit in select categories like Mac and Cheese, where we have made those kinds of investments, we're seeing the impact of that investment in the marketplace.

David Palmer ***UBS - Analyst***

So a quarter of the $400 million is really something that's flows through the COGS line.

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

That's correct.

David Palmer ***UBS - Analyst***

The wall to wall initiative, I might have missed it in your opening remarks, could you perhaps give us an update there, how you're feeling about the progress, I think by mid-'08 you were expecting to have things largely rolled out?

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

We continue to feel good about the program. We are learning, continuing to learn about how best to train our sales reps but we expect to be national by mid-2008 and we are on track.

David Palmer ***UBS - Analyst***

I'll leave it there. Thanks very much.

Operator

Thank you. Your next question is from Eric Katzman with Deutsche Bank. Please go ahead.

Eric Katzman ***Deutsche Bank - Analyst***

Good morning.

Tim McLevish ***Kraft Foods - EVP, CFO***

Good morning, Eric.

Eric Katzman ***Deutsche Bank - Analyst***

A few questions. The first one, the beverage charge of -- the charge within beverages of $120 million, I mean, that seems like a lot. I just don't remember Fruit2O and Veryfine being that big a business. Why is that such a high charge?

Chris Jakubik ***Kraft Foods - VP, IR***

It all has to do with the sales price and the value, vis-a-vis, when we bought it. Unlike a lot of our other brands, it was rather new. Wasn't terribly depreciated in terms of the assets as well as the brand value. So that was -- I mean, you can you do the math. That's pretty much the end result.

Eric Katzman ***Deutsche Bank - Analyst***

Okay. And then I guess Irene, you mentioned that this, we're kind of at unprecedented levels, vis-a-vis pricing and potential demand elasticity but you've been there for 20 years or so, there were periods of inflation back in the late '80s, early '90s. What kind of of experience did the Company have at that point vis-a-vis tradedown by the consumer and is that applicable to today?

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

I think certainly, Eric, some of the past history is applicable and we are seeing in selected categories again, particularly cheese, where the costs are most extreme, we are seeing some tradedown and it comes back to our need to continue to make the necessary investments in brand equity to be able to add enough value to be able to justify our price premium. But having said that, there are a number of factors, despite the fact that as we look at the dairy market, we see some of the traditional metrics all going in the right direction, number of cows, milk production, milk per cow, all of those traditional metrics that we look at that would lead to declining dairy prices at this time of year, we're not seeing that happening. That reflects the fact that there really are some changes happening in the marketplace, as Tim mentioned. So as we move forward here, some of the impacts are somewhat unchartered and we just need to continue to be prepared to address them, which is why we are so focused on continuing to build brand equity, while driving down costs.

Eric Katzman ***Deutsche Bank - Analyst***

Then my last question, thank you for that. My last question, I think you mentioned that you expect EBIT margins to be up in 2008. But can you quantify how much incremental savings you expect from the restructuring efforts, because if you have a continuation of input costs up, and you are also expecting advertising to be up, I assume at a greater percentage than sales, that means that the savings have got to be pretty significant. Can you quantify what dollar amount that should be?

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

Well, as you might expect, it's a little early for us to give a firm number on 2008. We obviously will do that in our fourth quarter call. But as Tim said, we expect to grow margins in 2008 as we committed in February, despite the input costs and it's really going to come from the fact that we're going to see the benefits of our wave one investments, plus some of the beginning of the wave two investments that we're now making as well as the impact of the accelerated restructuring savings. So that's what will contribute to our operating leverage in 2008.

Eric Katzman ***Deutsche Bank - Analyst***

I'll let it go after this. So the restructuring savings, do they really start ramping up in '08? Is that -- have you -- in terms of incremental, is it much more significant in '08 versus what you got in '07 versus '06?

Tim McLevish ***Kraft Foods - EVP, CFO***

If you think about it, we're anticipating being at an annualized level of $775 million at the end of 2007. So there will be incremental. We said that the overall savings will exceed $1billion, so there will clearly be incremental year on year. The 775 is a run rate level. So clearly, 2008 we'll see more benefits from restructuring savings.

Eric Katzman ***Deutsche Bank - Analyst***

Okay. Thank you. I'll pass it on.

Operator

Thank you. Your next question is from Andrew Lazar with Lehman Brothers. Please go ahead.

Andrew Lazar ***Lehman Brothers - Analyst***

Good morning, everyone.

Tim McLevish ***Kraft Foods - EVP, CFO***

Good morning, Andrew.

Andrew Lazar ***Lehman Brothers - Analyst***

In looking at the volume gain that you had, that's certainly a better organic number than we've seen in a couple years maybe, since '05 or so, just trying to get a sense of, with all the new products that you're launching, is there a way to quantify perhaps how much of that was impacted by shipping at a whole bunch of new products that hopefully will start moving off the shelf in the fourth quarter versus just ongoing volume improvements.

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

I would tell you -- we haven't quantified that, Andrew, but I would tell you this is not about pipeline. This is about take-away and the contribution of some of these core businesses that I mentioned in my earlier remarks to our overall performance. I feel very comfortable that the volume gains that we'er seeing are sustainable and real and in fact will continue to build into 2008.

Andrew Lazar ***Lehman Brothers - Analyst***

Then mix has been for a couple years now a really great driver on the top line. It was again in this quarter. Accelerated a little bit from where we've seen, but obviously the comparisons are tough. I know that's something you're expecting to help out again from a contribution standpoint in '08. Does the way you get that mix start to become more difficult, in other words, does it -- now seems like it has to come from a lot of the higher value added new products that you're putting out, versus maybe before where it was one off, SKU reductions, selling less, heavy beverage versus light powder. Things that you shifted by perhaps changing compensation of the sales force, things like that. Does it get harder to do now or is the visibility on the mix part still pretty high in your view.

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

I think the visibility is still pretty high. I feel good about the progress that we've made. As you rightly say, over the last couple of years we benefited from cleaning out some of the less profitable pipes of the portfolio. We've got most of that behind us, though at this point. And so the mix that we're looking at is about the higher margin that comes from competitively advantaged concepts like Cakesters, like Live Active cheeses, for example, that will allow us to realize higher margins in our snacks business, these 100-calorie packs and our toasted chips have very attractive margins.

Andrew Lazar ***Lehman Brothers - Analyst***

The very last thing is just, Tim, I know you said you started to see perhaps some signs of operating leverage in the business, even though we don't see it coming through in totality at given costs and such. Can you just expand on that a little bit? That becomes obviously a lot more critical as we go into '08 and it's tougher for us to see underneath given the impact on margins for cost and investment spending.

Tim McLevish ***Kraft Foods - EVP, CFO***

Sure. Clearly we're leveraging -- we're providing some leverage from the increased volume. And it's our cost savings initiatives, it's the restructuring program and the benefits associated with that that is helping to contain those costs.

Andrew Lazar ***Lehman Brothers - Analyst***

Thanks very much.

Tim McLevish ***Kraft Foods - EVP, CFO***

You may recall that at the gross margin line, we're down 240 basis points but on the operating line we're down 210 basis points, so that 30 delta as a result of that volume leverage and the savings initiatives.

Andrew Lazar ***Lehman Brothers - Analyst***

Thanks.

Operator

Thank you. Your next question is from David Driscoll with Citi Investment Research. Please go ahead.

David Driscoll ***Citi Investment Research - Analyst***

Thank you, good morning everyone.

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

Good morning, David.

David Driscoll ***Citi Investment Research - Analyst***

The gross profit margin was down 240 basis points. Can you give us the split between the raw material inflation and the product quality improvements. This is, I kind of think of this as the so-called self inflicted hit. So what's the difference between things that are out of your control versus things that were in your control on that 240?

Tim McLevish ***Kraft Foods - EVP, CFO***

I don't mean to be cute here, but 100% of those was driven by input costs. Another third of it was attributable to the investments we're making in new products and so forth. And we made up that one-third back from other productivity initiatives. So it's all from input cost.

David Driscoll ***Citi Investment Research - Analyst***

That's helpful. On the commodity cost side, somebody else was asking about this, but can I just ask you if you would be kind enough to give us what percentage of your commodity costs are hedged for the balance of the year. Other companies are willing to provide that level of hedge for 2008 just to give us the ballpark of what kind of exposure do you have. Will you give us some level of guidance on that?

Tim McLevish ***Kraft Foods - EVP, CFO***

I'm sorry, we can't give that kind of guidance. We've got -- certainly, we have some of our input cost hedged and that is a dynamic process, as we use it over the course of the year and going into 2008, clearly we're hedging some ahead but that's not a level of specificity we're prepared to talk about.

David Driscoll *Citi Investment Research - Analyst*

Irene, one final question. Status on divestitures. There's lots of discussion around Post and Oscar. I think in your prepared comments I wrote this down that you said that you would exit businesses that did not provide a competitive advantage. Can you talk about those two big businesses and whether or not they provide a competitive advantage. How do you think about them?

Irene Rosenfeld *Kraft Foods - Chairman, CEO*

David, as I laid out the strategies in February, I made it clear that they were not meant to be a Safe Harbor for all of our businesses and we've given each of our businesses the charge in the face of those four strategies to take a look at what the long term growth prospects look like. We've been very clear to say that the three criteria we are looking at in terms of the potential divestiture is growth potential, relative market share, and overall profitability and we will continue to use those as our screens. Certain of our categories are better positioned to be able to -- with this new framework, to be able to make progress and be accretive over the long-term. Obviously, as we have news to announce on that front, we will give it to you.

David Driscoll *Citi Investment Research - Analyst*

Okay. Very good. Thank you.

Operator

Thank you. Your next question is from Pablo Zuanic with JPMorgan. Please go ahead.

Pablo Zuanic *JPMorgan - Analyst*

Good morning, everyone.

Tim McLevish *Kraft Foods - EVP, CFO*

Good morning.

Pablo Zuanic *JPMorgan - Analyst*

I'm just trying to understand the cheese strategy, at a recent investor conference you talked about five products that you want to focus on and one of them was cheese. Why would the industry leader, with all these marketing innovation, probiotic cheese want to lag into the price increases. I feel there's opportunity here, even all the innovation and brand support that you are putting through of leaving. That's one question. I have a hard time understanding that, this persistent focus on market share where perhaps profitability would be more important in this environment. You would think private label is being more squeezed. And related to that, when I think of the cheese business, I would assume that given your scale, you have to have some cost advantages over your competitors, so you also should have room there to increase prices in this environment. Can you comment on that, please?

Irene Rosenfeld *Kraft Foods - Chairman, CEO*

Yes. Well, as we mentioned, Pablo, we've been quite aggressive in our price increases on our cheese business. We've priced over 80% of the portfolio anywhere between 2 and 13%. We continue to have a premium on virtually every form that we make. So it's not about our shyness as the market leader in terms of a willingness to take pricing. Having said that we're also well aware of the fact that we need to make sure that we are justifying the prices that we're charging and we haven't, across the portfolio yet added enough value to be able to be even more aggressive in those price increases. I think we're beginning to see some of the impact in the kinds of items that we have launched, the Live Active cheeses, our single select product, and some of the marketing actions that we've taken on our base businesses. But bottom line, quite frankly, we need some new thinking on our cheese business and we've been making some key leadership changes over the course of these last few months in an effort to help that business realize the potential that I know it has.

Pablo Zuanic *JPMorgan - Analyst*

Okay. Just to follow-up on that, can you walk us through briefly, in terms of your five North American divisions, in terms of what are the leadership changes, somebody came back from Hershey, you have to look for someone for cheese, just briefly if you can give us some color, please?

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

Well, basically, we just, as Mary Beth West moved into our CMO role, we have back filled Mary Beth with Bob Levi, who is a beverage veteran, been with the Company over 20 years and has made some significant contributions and he will pick up that business as we move forward. As you say, we -- Chris Baldwin has joined us on our snacks business and I am quite confident that he will help us to access what we believe to be terrific opportunity on the snacks front. Our cheese leadership is open right now. We have been public in terms of looking on the outside. I really do want to get some new thinking on that business and in the meantime, [Nick Maragioli], who has been running our Convenient Meals business, has stepped in to serve as the interim leader there. Cheese is really at this moment the only one of our businesses that is open. Ronda Jordan is still very -- managing our grocery business quite effectively and we're beginning to see good progress as we improve the relevant and the contemporariness of that business.

Pablo Zuanic ***JPMorgan - Analyst***

One last one, if I may. Again, going back to Back to School conference, you talked about those five products that you want to focus on and then you also mentioned I believe nuts, salad dressings, and other product there, and Convenience Meals, Oscar Meyer meat. That was about 70% of sales. How should we think about 30%. The experience we have at companies is that when there's not enough investment on those other products they begin to fall off a cliff in terms of sales. Should we think that that other 30% will eventually be sold? How do we thing about that, Irene?

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

The way you should think about that, Pablo, is that we are sequencing our investments. As I said at Back to School, we have chosen to focus on the categories that matter most and the five categories that I laid out there were about 50% of our revenue. As we continued to make improvements in pourables, for example, that will further add to our overall investment. But the reality is, we can sequence these investments and start to get the impact while we then make the next range met phase of investment. So with investments in these five core categories, we have seen a significant step-up in our revenue growth, our organic revenue as we said is up over 6% in this quarter. And so I am confident that by focusing our investments on the areas that can have the greatest leverage, we will be able to make progress but we will eventually get to all of the businesses in the portfolio that need support.

Pablo Zuanic ***JPMorgan - Analyst***

One last one. I understand that by November 14, if you want to make changes to the Board of Directors, that has to be proposed before November 14. Is that true and do you plan to make any -- are there plans for new Directors to be proposed?

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

It is true that November 14, is the filing date. We continue to look at the opportunity to add Directors, qualified Directors to our Board and that will be an ongoing process independent of the November date.

Pablo Zuanic ***JPMorgan - Analyst***

All right. Thank you.

Operator

Thank you. Your next question is from Kenneth Zaslow with BMO Capital Markets. Please go ahead.

Kenneth Zaslow ***BMO Capital Markets - Analyst***

Good morning, everyone. Just had some follow-up questions from the previous questions. Commodities for the quarter, I think you said were up 9%. What is your expectation for the full year? I don't know if you said that.

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

Nine is the number for the full year, Ken.

Kenneth Zaslow ***BMO Capital Markets - Analyst***

And then in terms of, on the cheese side, can you discuss Kraft's Premium relative to private label and is there -- is the Premium relative to private label one of the reasons that you're having a more challenging time pricing through?

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

No, we've been very diligent in managing our price gaps and I feel very comfortable that we're in a much stronger position with respect to our gaps than we have been historically and we are not going to allow ourselves to get out of the proper range, which is why we need to continue to ensure that we've added enough value to the portfolio and that is the focus of the investments that we're making.

Kenneth Zaslow ***BMO Capital Markets - Analyst***

You said something very interesting, you said you're looking for new thinking on the cheese. What are you looking for in terms of the thinking? Are you talking about new product innovation? Are you talking about how to execute? What is the -- what would you be looking for in that division when you're looking for a person to head that out -- head that up?

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

I think it's the opportunity to approach the category from a consumer perspective as I laid out in February. I continue to feel very strongly that cheese is a growth opportunity for Kraft. As we look around the world, consumers are eating cheese. It's growing at a very healthy rate. And our opportunity is to ensure that our offerings within the category are preferred and I think the key to that is to take a more consumer centric approach to the category and both through our marketing efforts as well as our new product innovation.

Kenneth Zaslow ***BMO Capital Markets - Analyst***

And my last question is you didn't discuss at all cereal or the -- at all in the discussion, in the discussion. Is there something we should interpret from that? Is there something wrong with the business? Is there -- was it just an oversight? How do we look at that? There was no commentary on the cereal business?

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

It just wasn't -- you should interpret nothing. It simply was not a significant contributor to the overall results of our snacks segment and that's why we didn't mention it.

Kenneth Zaslow ***BMO Capital Markets - Analyst***

Okay. Great. Thank you.

Operator

Thank you. Your next question is from [Vincent Andrews] with Morgan Stanley, please go ahead.

Vincent Andrews ***Morgan Stanley - Analyst***

I had to step off the call for a moment so if this has already been asked, please let me know. Irene, I'm just wondering if you could give your view of what businesses are operating at an acceptable level of performance right now?

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

A number of our businesses, frankly, on the top line are performing at an acceptable level. As we look across the portfolio I'm quite pleased by the performance of most of our categories, both in North America and around the world. As we mentioned we have seen accelerated revenue growth in all geographies. So I feel very good about that. I would say within North America, our Convenient Meals business was up 8% and if you look at under the covers and look at the contributors to that growth, it's about quality, it's about marketing investment, it's about new product innovation and that is the formula for our future. So I believe that is our model and as we move through the various parts of the portfolio, that is the formula that we're looking for.

Vincent Andrews ***Morgan Stanley - Analyst***

And would you still stand by the idea that in 2009 you're going to hit your stride and you'll fully realize the financial benefits of your investments and you'll deliver your long term targets?

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

Absolutely.

Vincent Andrews ***Morgan Stanley - Analyst***

Thank you very much.

Operator

Your next question is from Jonathan Feeney with Wachovia. Please go ahead.

Jonathan Feeney ***Wachovia - Analyst***

Good morning and thank you.

Tim McLevish ***Kraft Foods - EVP, CFO***

Good morning, Jonathan.

Jonathan Feeney ***Wachovia - Analyst***

I guess I'm sorry to beat a dead horse here, but private label tradedown, what is it about the cheese category that it seems like you held the line maybe a little bit more there, if anything absorbed a little more of those commodity costs, yet it seems like that's the only really place you've called out where you are losing to private label. Is that a fair characterization? What is it specifically about this category that made it such that private label won't raise prices?

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

Well, without a doubt, of all the categories in which we compete, private label is a bigger factor in cheese than it is in our other categories. So you start there. The reality is that to the extent that some of our offerings within the category are not well-differentiated. It puts pressure on our ability to price at a very significant premium. We're still at considerable premiums within each of our forms today but the issue will be can we command an even higher premium. I come back to the fact that products like Live Active have about a 13% margin advantage to our base product. And it's the opportunity to leverage some proprietary technology that goes into the making of that product, together with our marketing opportunities, that then allow us to be able to command higher prices going forward.

But the reality is absolute price points do matter as well. So part of the challenge in cheese is that the entire category is down as the consumer absorbs some of the extraordinary impact of these input costs.

Tim McLevish ***Kraft Foods - EVP, CFO***

We have an unusual situation also with regard to dairy prices, whereas typically at this time of the year, we would have seen them started to come off the seasonal peak and in fact they've held up much more than we would ever have experienced in the past. Usually with the spike in the season, we don't typically, the industry typically doesn't price to that peak. As we're seeing it behave a bit differently, we're going to have to kind of rethink that.

Jonathan Feeney ***Wachovia - Analyst***

Thanks for that. And just, I guess maybe to ask the converse implication of the squeezed, cash-strapped consumer. If we go back to the late '80s, early 90s, last really consumer recession, are there any parts of your portfolio you would expect to receive some of those consumers who maybe are eating out a little bit less? And are you seeing any of that kind of lift today do you feel like?

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

Actually, I think one of the benefits of the breadth of our portfolio is that we expect that that can benefit virtually all of our products. As we continue to think about a consumer centric approach to them and what we need to do to help to make them more relevant to today's consumer. Virtually every one of our segments can benefit from that move from away from home to at home consumption.

Jonathan Feeney ***Wachovia - Analyst***

Thank you very much.

Operator

Thank you. Your next question is from Robert Moskow with Credit Suisse. Please go ahead.

Robert Moskow ***Credit Suisse - Analyst***

Thank you. My question has to do with the guidance for '07. If I look at the implication for fourth quarter, maybe it is just my model, but it looks like it's something like a 12 to 13% EBIT decline and you've been tracking around a 5% EBIT decline for the year. Am I looking at that correctly, Tim?

Tim McLevish ***Kraft Foods - EVP, CFO***

I know we've given our full year guidance and I'll let you kind of sort out the analysis in between it.

Robert Moskow ***Credit Suisse - Analyst***

But is there anything about fourth quarter that's exceptionally worse than the first three quarters of the year?

Tim McLevish ***Kraft Foods - EVP, CFO***

I'd say fourth quarter, you see what's happening coming out of the third quarter, I would expect it probably to look a lot like the third quarter. We continue to expect to have top line momentum. As we've talked about with the input cost, we continue to expect pressure there.

Robert Moskow ***Credit Suisse - Analyst***

Okay. And then secondly, for 2008, the Danone acquisition is hanging out there. You've said to expect I think it was about $0.01. Commodity costs are a lot higher than they were when you first negotiated the deal. Is there anything -- do you have any visibility as to whether margins in that business have held up and when do you think you'll be able to update us on your guidance for how accretive or dilutive that business could be?

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

We'll update you as part of our 2008 guidance but we are on track for our year-end closing. They continue to report strong performance on their biscuit business. As you know, their Q3 growth was almost 7%. So it's a healthy business. Clearly the impact of grains will have some impact. But there are some very strong productivity programs in place and I'm pretty confident that we will be able to continue to benefit from the accretion that we have laid out for you.

Robert Moskow ***Credit Suisse - Analyst***

To help us think about that a little bit more, is there anything you can tell us about your snacks business in Europe in the quarter and how much of a commodity hit it took and maybe we could extrapolate that into the Danone business?

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

I think the better indication is what happened to our snack business domestically. Without a doubt it did take a hit in margin. As we mentioned though, we are looking at a variety of actions, including pricing, trade spending, and productivity to help to manage that going forward and I'm confident that we will be able to do that.

Robert Moskow ***Credit Suisse - Analyst***

Lastly, has the transition to wall to wall in the U.S., has that at all compromised your ability to get baked goods distribution like you had been in the crackers business or do you think that it's more a function of the marketing program that's causing the weakness in crackers?

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

I feel very confident that it is about the marketing programs. One of the key metrics that we look at as we are rolling out wall to wall is the performance of our base biscuit program versus the performance of the warehouse products. And we've continued to see strong incremental growth in the wall to wall markets, and as we look at the base businesses, I'm confident that this has not had an impact on -- adverse impact on the biscuit business. That's one of our most important criteria as we roll this thing out.

Robert Moskow ***Credit Suisse - Analyst***

Thank you very much.

Chris Jakubik ***Kraft Foods - VP, IR***

We'll take the last question.

Operator

Thank you. Your final question is from Edgar Roesch with Banc of America Securities.

Edgar Roesch ***Banc of America Securities - Analyst***

Good morning.

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

Good morning, Edgar.

Edgar Roesch ***Banc of America Securities - Analyst***

Irene, when you talked about '08 costs being up, is that just a continuation of what we're seeing on the ag side, the agricultural side or is the increase in -- this is kind of a specific question, but has the increase in energy started to factor into your outlook as well and maybe spill into packaging?

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

Yes. When we talked about input costs it's not just the raw material input cost. It's the knock on effect on resins and packaging costs as a consequence of the high energy prices. So it's an aggregate assessment.

Edgar Roesch ***Banc of America Securities - Analyst***

Okay. Thank you. And then could you just give me or give us the changes to the Tassimo program, what kind of benefit that provided the beverage segment?

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

Well, as you are aware, one of the most significant changes we made this year was to focus our Tassimo marketing efforts to a more targeted audience and to look at more targeted marketing approaches to that audience and so we are seeing the benefits of that. Our Tassimo business is up almost 70% and at a considerably lower cost than we had year -- than we had a year ago.

Edgar Roesch ***Banc of America Securities - Analyst***

One last kind of bigger picture question. '07 is clearly a year of investment. I would just like to know if you expect to exit the year with a lot of that heavy lifting done and the reinvestment is largely behind you or whether there is further investment in next -- into 2008 as well.

Irene Rosenfeld ***Kraft Foods - Chairman, CEO***

Well, as we said when we laid out the plan in February, this is a three-year plan. Our target in terms of our overall A&C investment is to get to us the competitive levels of 8 to 9% over time and we are committed to making progress against that objective and so as we exit 2007, we will have made progress. We will make continued progress in 2008. And we are looking to then drive our other aspects of the P&L, particularly overhead cost, as our means, together with volume growth, and mix improvement to drive our overall operating margins. So you will see continued investment in the business in 2008 but we are committed to making margin improvement as we said.

Edgar Roesch ***Banc of America Securities - Analyst***

Very good. Thank you.

Operator

Thank you. I would now like to turn the floor over to Mr. Chris Jakubik for any further or closing remarks.

Chris Jakubik ***Kraft Foods - VP, IR***

Thanks everybody for joining us this morning. If any of the analysts have further follow-up questions we'll be around all day. Thanks very much.

Operator

Thank you. This does conclude today's Kraft Foods conference call. You may now disconnect.

THOMSON REUTERS

PLACEHOLDER TRANSCRIPT

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PRESENTATION

Operator

Good morning and welcome to the Kraft Foods fourth quarter 2007 and year-end earnings conference call.

Today's call is scheduled to last about one hour, including remarks by Kraft Foods' management and the question-and-answer session. (OPERATOR INSTRUCTIONS)

I will now turn the call over to Mr. Chris Jakubik, Vice President of Investor Relations for Kraft. Please go ahead, sir.

Chris Jakubik ***Kraft Foods, Inc. - VP Investor Relations***

Good morning and thanks for joining us on our conference call. I'm Chris Jakubik, Vice President of Investor Relations.

With me are Irene Rosenfeld, our Chairman and CEO, and Tim McLevish, our Chief Financial Officer.

Our earnings release was sent out earlier today and is available on our Web site, kraft.com. Also available on our Web site are slides that we will refer to during our prepared comments.

As you know, during this call, we may make forward-looking statements about the Company's performance. These statements are based on how we see things today, so they contain an element of uncertainty.

Actual results may differ materially due to risks and uncertainties, so please refer to the cautionary statement and risk factors contained in the Company's 10-K and 10-Q filings for a more detailed explanation of the inherent limitations in such forward-looking statements.

Some of today's prepared remarks will exclude those items that affect comparability. These excluded items are captured in our GAAP to non-GAAP reconciliations within our news release and they are also available on our Web site.

Today's agenda is as follows: We'll begin the call with Irene providing her perspective on our 2007 results and the outlook for 2008, then Tim will highlight our financials then review the results for each of our business segments. After that, we'll take your questions.

With that, I'll hand it off to Irene.

Irene Rosenfeld ***Kraft Foods, Inc. - Chairman, CEO***

Thanks, Chris, and good morning, everyone.

Turn to Slide 4. As you saw in our press release, 2007 represented a solid start to our three-year plan and more importantly, established good momentum for 2008. Our organic revenue growth of 6% in Q4 and 5% for the full-year was even better than we had expected and it was quality growth.

We had solid gains from product mix throughout the year and volume growth improved as the year progressed. That reflects the payback from the investments with we made in the course of the year. Where we have improved quality, invested in base brand support and/or innovated, we've seen good results and so I remain confident that our plan will return Kraft to reliable growth.

Turning to Slide 5. We continue to see this model at work in the wave one investment areas I discussed in September. In our mac and cheese business, we invested in quality upgrades to our base products and rolled out Easy Mac Cups.

The result, we posted double-digit organic growth and gained a half point of market share in 2007. This followed three years of essentially no growth and more than point of share loss.

Our pizza business finished the year absolutely on fire. It posted double-digit volume growth and gained over 4 market share points in the fourth quarter.

And our back to basics approach in the EU focused on our two iconic brands, Jacobs coffee and Milka chocolate, delivered a fourth consecutive quarter of solid organic revenue growth. For a business that had been flat to down for the past four years, the 3.5% organic growth in 2007 is no small feat.

I'm also encouraged by the early results in three core categories where our programming hit late last year. Coffee where we're adding to our success in the premium segment by beginning to stem our long-standing decline in mainstream coffee. The reason, our recent relaunch of Maxwell House with quality upgrades in product and packaging.

In biscuits where our market share performance improved in the fourth quarter from several new product platforms and in cheese, where despite record high dairy costs in the second half of 2007, we increased our marketing more than 50% in processed slices and introduced Singles Select. That helped to reverse our share declines on processed cheese from the first half of the year.

We also delivered double-digit growth and market share gains in snacking cheese and our new LiveActive cheeses are proving to be highly incremental both to Kraft and to the category. There's still much more to be done in cheese but I feel we're off to a good start.

Turning to Slide 6. More broadly across North America as our investments hit the market our market share trends have begun to improve. On a trailing 52-week basis, we finished the year with businesses representing 47% of our revenue, gaining or holding share, not yet where we want to be but that's up from only 38% three months earlier.

And in the fourth quarter, we gained or held share in businesses representing 50% of our revenue. Over the course of 2008 we'll continue to improve on that trend. We are finally on our way to our longer-term goal of growing share in at least two-thirds of our revenue base.

Turning to Slide 7. Also in 2007, we put strong new leadership in place. Four of the nine members of my executive team are new to the Company or to their jobs and we've replaced half of our key business leaders around the world.

We changed our incentive systems to more directly tie executive rewards to shareholder value creation and we're now executing a reorganization to give more accountability to our business leaders while significantly reducing overhead costs.

We've also strengthened our portfolio. We're exiting businesses that don't fit our long-term growth plan like Fruit 2.0 and Post cereals.

And we're enhancing our future growth prospects, profitability and international footprint with the acquisition of the Danone biscuit business.

Finally, I'm pleased to say we delivered at the high end of our increased EPS guidance. Yes, we did benefit from a lower tax rate but this was on top of better top line momentum from our investments in brand equity. At the same time, higher than expected input costs negatively impacted our margins and put pressure on the bottom line and so in response, we took more aggressive actions to reduce our overhead costs.

Turning to Slide 8. As you saw in our press release this morning, in 2008 we'll spend less and save more on our restructuring program than originally anticipated.

We now expect $200 million more in savings and our cost to deliver those savings will be $200 million less. Our spending on the program will end in 2008, but incremental savings will continue beyond that.

Clearly, we made significant progress on many fronts in 2007. Turning to Slide 9. However, not everything went our way. The biggest surprise was the unprecedented high dairy costs and the fact that they remained at these high levels through year-end.

As you can see from this chart, the 2007 price curve broke significantly from historical normals. As a matter of practice given historical cyclicality, we typically price to the expected average, not the peak dairy costs, in any given year. As a result, when cheese costs stayed high late into the year, our pricing actions did not keep pace with costs, therefore, we're taking additional pricing actions now.

We do expect some moderation in average cheese costs later this year. Nevertheless, as you can see, we're likely to face difficult cost comparisons through the first half of the year, which brings me to our 2008 guidance.

Please turn to Slide 10. Since this is the second year of a three-year plan, let me start with the expectations I laid out last February at CAGNY. At that time, I said in 2008 our operational turnaround will continue to gain momentum as we get growing again on both the top and bottom lines, our top line will grow 3 to 4% organically and operating income growth will exceed revenue growth.

I said we'd continue to invest a portion of our growth back into the business as we launch the next wave of trajectory changing initiatives, and we'd further accelerate our advertising and consumer spending toward our long-term target of 8 to 9% of net revenue.

I also said that by 2009 we'd hit our stride. We'd fully realized the financial benefits of our investments and deliver our long-term targets of at least 4% organic net revenue growth and 7 to 9% EPS growth.

So, how do I feel about those statements today? Turn to Slide 11. I stand firmly behind them. I feel good about our momentum and I'm even more bullish as we enter year two of our three-year plan.

Looking at the numbers, our top line will grow faster than we had expected, at least 4% organically. And remember, that's before the addition of approximately $2.8 billion in revenue from the Danone biscuit acquisition.

In 2007, although pricing was higher than in the past, it represented less than one-third of our organic revenue growth. In 2008 it's likely that pricing will be a much more significant factor as we offset higher input costs. The investments we've made and will continue to make are strengthening our brand equity and enabling improved pricing power.

As a result, we are far better able to recover input cost increases through pricing and productivity, however, we do expect that near-term category volumes will be negatively impacted as consumers adjust to new price levels. Through it all, I remain confident that our continued investments in marketing and innovation will drive further share gains across more of our portfolio, despite our pricing actions.

Now let's look at operating income. While Danone will have a modest dampening effect on margins in its first year, we expect that operating income ex items will grow faster than revenue in 2008.

We also expect that Q4 2007 represented the low point in our margins and they will progressively improve as 2008 unfolds. We will continue to invest in the next wave of trajectory changing initiatives and we'll further accelerate our advertising and consumer spending toward our long-term target of 8 to 9% of revenue.

Turning to earnings per share. Ex items our EPS guidance is at least $1.90. This reflects a 3 point headwind to earnings growth from the increase in our effective tax rate from 31.2% in 2007 to 33.5% in 2008 as we become a fully independent tax filer. If we were to normalize for taxes, our EPS guidance would represent an increase of almost 8% year-over-year.

Turning to Slide 12. To summarize, we've had a solid start to our plan to restore Kraft to reliable growth.

We continue to invest in our growth initiatives. They're paying dividends and at the same time they're strengthening our brand equity and pricing power in the face of unprecedented input costs.

We're successfully reducing costs and overheads to provide additional funding for investment and our strategic actions are strengthening our portfolio and future growth prospects. I remain confident that by 2009 we'll be well positioned to reliably deliver our long-term targets of at least 4% organic net revenue growth and 7 to 9% EPS growth.

And now I'll turn the call over to Tim.

Tim McLevish ***Kraft Foods, Inc. - EVP, CFO***

Thanks, Irene, and good morning.

Please turn to Slide 13. I'll begin my comments by providing some perspective on our financials, both for 2007 and how we see 2008 unfolding. Before I begin, please keep in mind that unless otherwise noted, my comments will exclude the items affecting comparability that were highlighted in our press release.

(Missing audio) 2% for the second consecutive quarter. That's up from 3.9% organic growth in the first half of the year. Volume and mix accounted for about two-thirds of Q4 growth as our wave one investments in quality, innovation and marketing hit the market.

Net pricing was up 2 percentage points versus 1% in the first six months of the year, as we begin to see the realization of price increases taken during the year. Overall, we had steady improvement and established a solid momentum on the top line in 2007.

As Irene mentioned, in 2008 we expect pricing to make a greater contribution to top line growth as a result of improved price realization. At the same time, our first quarter and first half volume comparisons will be difficult as we implement the significant pricing necessary to offset cost inflation.

Nonetheless, during this time of unprecedented price increases, we expect to build market share over the course of the year, which is a testament to the improving strength of our brands.

Please turn to Slide 15. And turning to operating income, our Q4 results were significantly impacted by input costs, particularly dairy.

Although our price realization improved in Q4, our gross margin was down 410 basis points versus Q4 last year. This was primarily due to higher dairy costs. Our pricing and productivity gains were simply overwhelmed by higher input costs and by our investments in product quality.

For the year, our input costs were up about $1.3 billion over 2006. At the same time, our cost reduction programs drove a reduction in overhead costs as a percentage of sales.

This enabled us to fund a double-digit increase in marketing and as a result operating income margin was down less than gross margin.

Looking forward, we anticipate that margins will get progressively better as the year unfolds from the low point in the fourth quarter of 2007.

We will continue to spend on our growth investments. We spent $375 million in 2007 and we'll spend incrementally on top of that base in 2008. As a result of our planned investments, together with the addition of the Danone biscuit business, we expect A&C as a percent of net revenue to be in the mid 7% range in 2008.

That said, first half margins and earnings comparison with the prior year will be difficult. Difficult for two reasons. First is the fact that the full effect of our price increases will lag higher input costs at the beginning of the year, and second is our expectation that input cost comparisons should ease as the year progresses.

I think it's instructive if we turn to Slide 16, I think it's instructive to take a minute to take a look at the magnitude of input cost increases we face coming into 2008. This chart shows commodity prices in each year versus the 10-year average price for each of our 11 largest commodity inputs.

With the exception of almonds and lean hogs, we're starting the year at record cost levels and in the cases of cocoa, wheat and soybean oil, we're starting 2008 at significantly higher levels than the average 2007 costs. Because of this, we have taken and are taking pricing actions as well as focusing on overhead costs to ensure the expansion of operating margins in 2008.

Now, if you'll turn to Slide 17. Turning to earnings per share, we've discussed operating results already so let's look at what happened below the line.

In the fourth quarter, higher interest expense costs us roughly $0.04 of earnings versus the prior year. This is partially offset by $0.02 from lower shares outstanding.

We invested another $500 million in our stock repurchase plan during the quarter and in the first nine months since the spin-off we repurchased $3.5 billion, or 6.5% of our shares outstanding at an average price of $33.13 per share.

Looking forward we expect interest expense to be between 1.2 and $1.3 billion in 2008. This is primarily the result of higher debt levels related to our acquisition of Danone biscuit business and activity under our share repurchase program. And finally, as Irene mentioned, our effective tax rate excluding items will increase from 31.2% in 2007 to 33.5% in 2008.

I'll take a few minutes now to share some highlights of our business segment results. If you turn to Slide 18. We'll start with North American Beverages where organic net revenues grew 6.7%.

Volume and mix were up strongly from new Better for You offerings in powdered and ready to drink beverages. In fact, Crystal Light was functional benefits extended the success of our stick platform. It drove double-digit powdered beverage growth in the quarter.

In coffee we saw continued strong growth in premium coffee from both Starbucks and Tassimo. I'd also note here that since the November introduction Starbucks T-discs for our Tassimo machine are the most successful T-disc launch ever with three times historical customer demand.

In mainstream coffee, Maxwell House trends are improving. As Irene mentioned earlier, we've had an excellent consumer reaction to both the preferred plastic packaging and the new 100% Arabica blend. While it will take time to reverse years of decline, we expect to see further improvement in the months ahead.

At the profit line, beverages' operating income doubled and margin increased 480 basis points. This upside was delivered by the strong growth of higher margin powdered beverages and premium coffee as well as our more targeted marketing strategy for Tassimo.

Please turn to Slide 19. In North America Cheese and Foodservice results were significantly impacted by persistently high barrel cheese prices. Organic net revenues were up 8.4% almost entirely due to price increases in response to higher dairy costs.

While there was some volume growth in the quarter this was primarily due to buying ahead of our price increases and this will adversely affect Q1 volumes. It's important to note, however, that where we have invested, we're seeing results. For instance, our efforts to revitalize processed cheese slices with better marketing and the introduction of Single Select helped to reverse our share declines in that segment.

We delivered double-digit revenue grow and share gains in snacking cheeses in the quarter and our sales of LiveActive cottage cheese are proving to be over 80% incremental to Kraft and about 35% incremental to the category. It's not enough but it's a start to what will be a big focus area for us in 2008.

Turning to operating income margin, it fell 9.9 percentage points as dairy costs rose over 40%, well above our pricing. Despite that, we continue to fund our growth initiatives to stage this critical business for the future. Our 2008 outlook calls for significant margin improvement from our Q4 performance as we recover higher input costs through pricing.

We'll also continue to bring more innovation to market and make further investments in building our brand equity for the long-term. As a result, we expect to show successive improvement in operating margins and share from Q4 levels as the year unfolds.

Now if you turn to Slide 20. Moving on to North American Convenient Meals. The investments we've been making in quality, base marketing support and new products drove 6.8% organic revenue growth, almost entirely due to volume and mix gains and our market share is up in categories representing 90% of the segment revenues.

This growth was driven by such investments as Ultimate Pizza, mac and cheese, Deli Creation sandwiches and deli fresh meats. The benefits of volume leverage, favorable product mix and cost savings led to a 100 basis point increase in operating income margin and that was despite higher input costs.

The success we've seen here in 2007 has provided solid momentum going into 2008 including further benefits from volume growth and favorable mix as well as price increases taken in December to cover higher input costs.

Now turn to Slide 21 and on to North American Grocery where organic net revenues were down 3.5%. Our investments to contemporized Jell-O are driving solid revenue and market share growth in desserts, however, this was offset by continuing weakness in salad dressings.

As we've mentioned before, reversing many years of decline in our pourable salad dressings business is a priority for the grocery management team in 2008. We've upgraded the quality of the packaging and product and by the end of the first quarter will be fully national with incremental marketing support.

Some of the costs associated with these upgrades impacted our Q4 grocery margins and together with our inability to aggressively price into the weak brand equity, our margin was down 3.7 percentage points for the quarter. Going forward, while grocery margins in Q1 will be under pressure from the stepped up level of investment in pourable salad dressings, we expect margin trends to progressively improve over the course of the year.

Now to Slide 22. Looking at North American Snacks & Cereals. Organic net revenues were up 4.7% in Q4 behind strong gains from new product platforms. 100 Calorie Packs were up strong double-digit again in the quarter and ended the year with $230 million in revenue.

Cakesters, after only a half year, has captured over 5% of the billion dollar snack cake market and is on its way to becoming a $100 million product. Our bars business was again up double-digits and Garden Harvest chips helped further fuel the growth of our toasted chip platform.

Marketing investments during the quarter led to improved performance in crackers and snack nuts and we expect to see continued strength in 2008. And finally, solid, ready to eat cereal growth was driven by Honey Bunches of Oats and a continued recovery in our kid's cereal business.

Operating income margins were up 50 basis points. Solid volume growth and productivity offset higher input costs and spending behind our growth initiatives. Going forward, we'll continue to invest in the growth of this business with more innovation and base brand support.

And despite rising grain costs, these investments will enable improved net price realization and lead to market share gains. Finally, the divestiture of our Post cereal business continues to be on track for a mid-2008 closing.

If you turn to Slide 23 and I'll turn to our international business. It continued to post solid organic growth as we focused our investments on our core brands.

In the EU this resulted in a 4.4% organic revenue growth and a fourth consecutive quarter of solid volume and mix gains. Growth from Milka chocolates, Jacobs and Tassimo coffee and Philadelphia cheese were partially offset by continued declines in local categories.

The EU operating income margins declined 170 points. The reason, top line momentum and productivity were insufficient to recover higher input costs, primarily dairy and cocoa.

With dairy and cocoa costs now on the rise in Europe, input cost pressure is expected to worsen in the near-term. In response, we're increasing prices across almost half of portfolio in Q1. As a result we expect to see difficult near-term year-over-year volume and margin comparisons.

At the same time, the integration of the Danone biscuit business is on schedule. It will enhance both our growth prospects and our margin in the EU over the course of 2008 and well into the future.

Now on to Slide 24. Finally, let's look at developing markets. Here again, our focus on core categories and brands delivered another quarter of double-digit organic net revenue growth. Q4 growth was driven by Jacobs coffee and Milka chocolates in our EMEA region and Oreo and Tang in both Latin America and Asia-Pacific.

At the operating income line margin was down 4.5 percentage points. This resulted from a combination of investments in marketing and distribution infrastructure and higher input costs ahead of pricing. Looking forward, Q1 will see soft volumes and a lower profit margins versus a year ago.

This is because of significant price increases related to input costs and a one-time volume reduction in 2008 due a shift to local sourcing with the opening of a new cheese and powdered soft drink plant in Bahrain. However, we expect both these actions together with the integration of the Danone biscuit business to improve our developing market results as the year unfolds.

If you turn to Slide 25. Just a few notes on cash flow before we go to questions. Our full-year discretionary cash flow was $2.3 billion, down approximately $200 million from 2006. The entire decrease was due to the decline in operating income with some offsetting changes on the balance sheet.

Capital expenditures were flat versus 2006, at $1.2 billion. But I would note that we continue to aggressively manage our working capital.

After adjusting for the Danone biscuit acquisition we reduced our cash conversion cycle by four days from 51 days last year to 47 days this year. We had solid improvement in inventory and payables but we see further opportunities going forward.

So to summarize on Page 26, I would echo Irene's earlier comments. We've had a solid start to our three-year plan to return Kraft to reliable growth. We remain confident that our investments and cost reductions will maintain our operating momentum and deliver at least $1.90 of EPS ex items in 2008.

Our strategic actions are strengthening our portfolio and future growth prospects. And by 2009 we'll be well positioned to reliably deliver our long-term targets of at least 4% organic net revenue growth and 7 to 9% EPS growth.

That's it for our prepared comments. Now we'd be happy to take your questions.

QUESTIONS AND ANSWERS

Operator

Thank you. We will now conduct the question-and-answer portion of the conference. (OPERATOR INSTRUCTIONS) Our first question is from Eric Katzman with Deutsche Bank.

Eric Katzman ***Deutsche Bank - Analyst***

Hi, everybody.

Irene Rosenfeld ***Kraft Foods, Inc. - Chairman, CEO***

Good morning, Eric.

Eric Katzman ***Deutsche Bank - Analyst***

I'll keep it to one question.

I guess, it sounds like you're anticipating in 2008 some moderation in input costs, particularly in the second half, and I guess I'm wondering, one, kind of how prudent is that in this type of volatile market, or is that really a function of dairy with the other inputs kind of still expected to be up?

Irene Rosenfeld ***Kraft Foods, Inc. - Chairman, CEO***

Well, Eric, I think as Tim said, we certainly expect to see input costs up at about the same rate as we saw in 2007. The reality, though, it'll be a mirror image of what we saw in 2007, so the moderation comes from the fact that we'll be lapping the spike year ago but we do expect to see input costs up at about the same rate. The good news, though, is that our brands are strengthening and we're able to recover those input costs as a result.

Eric Katzman ***Deutsche Bank - Analyst***

Okay. Thank you.

Operator

Thank you. Your next question is from Todd Duvick with Banc of America.

Todd Duvick ***Banc of America Securities - Analyst***

Good morning.

Irene Rosenfeld ***Kraft Foods, Inc. - Chairman, CEO***

Good morning, Todd.

Tim McLevish ***Kraft Foods, Inc. - EVP, CFO***

Good morning, Todd.

Todd Duvick ***Banc of America Securities - Analyst***

I had a couple of questions for you and, Tim, I guess this probably falls in your camp.

Jim [Dalla] had previously indicated it was important for Kraft to maintain its Tier 2 commercial paper rating and I was wanting to know if you can tell us if your CP rating continues to be a guidepost in your financial policy?

Tim McLevish ***Kraft Foods, Inc. - EVP, CFO***

(Inaudible) talked a little bit more broadly about capital structure and as we see it today.

As you know, when we first became independent we were under utilizing our balance sheet. Over the course of this past year, we've repurchased about $3.5 billion of stock and borrowed $7 billion to buy Danone biscuit. Today I would say the leverage on our balance sheet is pretty appropriate.

I think the leverage metrics are currently in pretty good position which supports our BBB credit profile. I do believe that Kraft is well served to maintain investment grade and I think access to CP markets provides operating flexibility that is a value to us.

Our focus, there may be some mix changes in our leverage structure, maybe we switch some between fixed and floating, maybe it moved the maturity schedules and put in the right currencies and so forth, but overall the levels are pretty appropriate for us. Our focus now is expanding our capacity by improving our cash flows.

Todd Duvick ***Banc of America Securities - Analyst***

Okay. Very good. And just one follow-up question on that.

You've already termed out a portion of the debt related to the Danone acquisition. Can you tell us anything about the timing and the markets that you're considering to term out the remainder?

Irene Rosenfeld ***Kraft Foods, Inc. - Chairman, CEO***

Yes, Todd, I mean, we did go to market for about half of it late last year and we still have the other half of it to go but I can't talk specifically about when and where.

David Driscoll ***Citi Investment Research - Analyst***

Okay. Very good. Thank you.

Operator

Thank you. Your next question is from Tim Ramey with D.A. Davidson.

Tim Ramey ***D.A. Davidson & Company - Analyst***

Good morning.

I'm just continue to wonder about the baseline level of earnings. You always talk about comparability but, really, you know, the best level of comparability is the GAAP earnings and others in the sector have gone to looking at GAAP.

These charges have been with us since you came public. Why do we continue to think that they are non-recurring?

Irene Rosenfeld ***Kraft Foods, Inc. - Chairman, CEO***

Tim, as you know, we laid out a restructuring plan in 2004 that we then updated in 2006. We are finishing up that restructuring plan and we expect to end that as we exist 2008. Our plans then as we go forward and we hit our stride in 2009 will be to report on a GAAP basis and we've made that commitment and we're underscoring it again today.

Tim McLevish ***Kraft Foods, Inc. - EVP, CFO***

It isn't to suggest that we will stop restructuring and spend in further improving our cost structure and improving our brand but just that it will be, as you suggested, reported through GAAP earnings without identifying ex items.

Tim Ramey ***D.A. Davidson & Company - Analyst***

Terrific.

Operator

Thank you. Your next question is from David Driscoll with Citi Investment Research.

David Driscoll ***Citi Investment Research - Analyst***

Just wanted to follow-up on the dairy side. So you've indicated that, I think, that the front half will be the tough part on dairy comparisons but, Irene, I'd really like you to talk to us a little bit more on the strategy on how you repair the cheese margins and why the price increases haven't come at a much faster rate and been much more significant. A 53.8% decline in operating profits is just an absolutely astounding number and I would think that a commodotized category, or one that has much more of a commodity feel to it, would be much more receptive to prices that were predicated on the underlying commodity.

Also in your answer could you just overlay this with the mix improvements from some of the new products that you've launched within that particular business?

Irene Rosenfeld ***Kraft Foods, Inc. - Chairman, CEO***

First of all, David, I think the issue of recovering the input costs has everything to do with our brand equity and our pricing power. So although we actually took some very significant actions on our cheese business, our pricing realization was not as strong as we'd like it to be because we don't yet have suitable brand equity.

As I mentioned, we're starting to see some encouragement on our singles business as we have made some investments in base marketing as well as in new products like Singles Select. But the key to our future in cheese, as it is in so many of our businesses, is continuing to ensure that we have invested appropriately in quality, in marketing support and in innovation, to be able to realize those price opportunities.

Having said that, I think if you look at our results for 2007, you can see that there's already more pricing power. We already have more pricing power across the portfolio than we've had in quite some time and our plan in 2008 is to be able to recover more of those costs.

But it has everything to do with our ability to build our brand equities and to build our innovation pipeline and we still have some work to do on cheese but I think we are at least -- we've made a good start.

David Driscoll ***Citi Investment Research - Analyst***

So you would say the key here is watching market shares and that would be the linchpin before you would want to go much more aggressively on price to prevent margin declines like we saw in the quarter? Is that a fair statement?

Tim McLevish ***Kraft Foods, Inc. - EVP, CFO***

I would say, let me just talk a little bit about 2007 fourth quarter and what happened with raw cheese prices. Traditionally, we see a spike before the holidays in barrel cheese prices and we tend to price to an average and don't hit the peak.

In 2007, which was very uncharacteristic, barrel cheese prices stayed up at that peak level for a prolonged period. They've started to come down now but they stayed up at that level. We didn't price to the peak, we priced to what we expected to be an average and we kind of got caught.

By the time we realized that, it was too late to price as we had already put in place our holiday promotions and so forth. So as we go forward we're going to revisit our pricing paradigm and look at being more precise to raw material input costs as opposed to kind of anticipating what historical patterns have been. So we will more closely price with the barrel cheese prices.

David Driscoll ***Citi Investment Research - Analyst***

That's helpful. Thanks for the color.

Operator

Thank you. Your next question is from Jonathan Feeney with Wachovia Securities.

Jonathan Feeney ***Wachovia Securities - Analyst***

Good morning. Thank you.

Irene Rosenfeld ***Kraft Foods, Inc. - Chairman, CEO***

Good morning, Jonathan.

Jonathan Feeney ***Wachovia Securities - Analyst***

I guess also in that vein, I guess, Irene, you said you didn't get the realization, I guess, because you took some pricing in cheese and foodservice but didn't -- could you talk about the mechanics of that? I mean, what would be, I guess, let me ask it this way. What would be the downside to taking more aggressive, much more aggressive price increases and perhaps not protecting some of your holiday promotions and, you know, suffering the volume penalty?

And in answering that, if be you wouldn't mind commenting, I don't know, Tim, if you'd rather do that, about private label price gaps. Because it's clear to me in this category and a lot of others that some of these store brand and, say, deli cheese manufacturers, are much more under the gun than you are to take pricing. And so, I guess, if you maintain those price gaps I would think that you would be looking at a much softer sort of landing here in terms of operating profit.

Irene Rosenfeld ***Kraft Foods, Inc. - Chairman, CEO***

Jonathan, I think Tim's comment helps to understand the impact on the fourth quarter, which was simply that the curve stayed up and we were priced to a lower level. And we did not react fast enough because historically we would have expected that curve to come down in the back half of the year.

Going forward we will be pricing much more aggressively and we will in some cases be sacrificing, at least in the early months, as the consumers adjust to new higher price points, we will sacrifice some volume. We believe, though, that it will be an industry phenomenon and we will be able to continue to grow share in the face of those pricing actions.

Jonathan Feeney ***Wachovia Securities - Analyst***

And I'm sorry, Irene, are private label price gaps about where you want them right now? Are they wide? Are they narrow?

Irene Rosenfeld ***Kraft Foods, Inc. - Chairman, CEO***

They're about where we'd like them to be. And, again, this is an industry phenomenon and we expect that all of the players in the industry are dealing with the same challenges on input costs.

Jonathan Feeney ***Wachovia Securities - Analyst***

Thank you.

Operator

Thank you. Your next question is from Alexia Howard with Sanford Bernstein.

Tim McLevish ***Kraft Foods, Inc. - EVP, CFO***

Good morning, Alexia.

Alexia Howard ***Sanford C. Bernstein & Company - Analyst***

Can I ask about marketing spending and where things stand at the moment? There was obviously the big step up in overall investment in the business in 2007 and I understand that a lot of that was focused on the fourth quarter.

Can you tell us how much that step-up was in the fourth quarter? And perhaps more importantly, for the whole of 2007, did the consumer marketing as a percent of sales hit that sort of 7, maybe slightly higher than 7% level and where do you anticipate it being during the course of 2008?

Irene Rosenfeld ***Kraft Foods, Inc. - Chairman, CEO***

As you'll see on the year, our aggregate spending hit about 6.9%. So we're making some good progress as we exited 2007 and made the necessary investments in our wave one initiatives.

As I mentioned in 2008, we are going to continue to make progress toward our longer-term target of 8 to 9% revenue and we expect that the aggregate spending including Danone will be in the mid 7% range.

Alexia Howard ***Sanford C. Bernstein & Company - Analyst***

Okay. Thank you very much.

Operator

Thank you. Your next question is from Eric Serotta with Merrill Lynch.

Andy Keller ***- Analyst***

This is actually Andy Keller with (inaudible) Consulting.

A couple of things, Irene. As we head into a very challenging environment in the (inaudible) arena, what are going to be your operating improvement initiatives regarding lean manufacturing, TPN, Six Sigma and what metrics are you using to measure your benefits?

Irene Rosenfeld ***Kraft Foods, Inc. - Chairman, CEO***

Eric, we've got a whole host of manufacturing objectives and initiatives. Clearly, to the extent that we are expecting to see continued record high input costs, and we are expecting that our pricing and productivity together will offset those, we have a whole host of productivity initiatives designed to improve our performance. So I don't want to talk about any specific ones today but I assure you that productivity is a critical piece of our program in 2008 as it has been historically.

Andy Keller ***- Analyst***

What metrics are you guys using to measure manufacturing process? Are you looking at OE, RONA, what's the (inaudible)?

Irene Rosenfeld ***Kraft Foods, Inc. - Chairman, CEO***

We look at ROA, we look at OE, we look at a whole variety of other metrics but the end in mind is to lower our cost per pound on a conversion basis year-over-year.

Operator

Thank you. Your next question is from Terry Bivens with Bear Stearns.

Terry Bivens ***Bear, Stearns & Company - Analyst***

Good morning, everyone.

Tim McLevish ***Kraft Foods, Inc. - EVP, CFO***

Good morning, Terry.

Irene Rosenfeld ***Kraft Foods, Inc. - Chairman, CEO***

Good morning, Terry.

Terry Bivens ***Bear, Stearns & Company - Analyst***

Going back to cheese, Irene, I understand your comments there about why it will be a second half phenomenon there. That's kind of what we're looking at with cheese prices as well. But I'm wondering if it could be a really good second half under the following scenario.

If some of your innovation indeed allows you to kind of keep more pricing than you might ordinarily have, maybe a better contribution from mix, as pricing begins to fall what would prevent the second half from being significantly better? Would it be private label competition since that seems to be kind of stubborn even at the high price levels?

Irene Rosenfeld ***Kraft Foods, Inc. - Chairman, CEO***

Terry, you know, I don't want to get into hypotheticals on our guidance. We're starting the second year of our three-year plan. If in fact we start to see that the market reacts better than we expect to the pricing actions, we will continue to invest in our franchises.

So I hope the optimistic forecasts are accurate. I think we're planning prudently. But if in fact we do see some upside and in fact the volume impact recovers, the volume recovers faster than anticipated, we will be able to continue to make some investments in our franchises.

Terry Bivens ***Bear, Stearns & Company - Analyst***

Great. Thank you.

Operator

Thank you. Your next question is from David Palmer with UBS.

David Palmer ***UBS - Analyst***

Thanks.

Irene, this question's on innovation. At CAGNY, I remember we talked about the innovation pipeline which needed some serious rebuilding and so far this year you've had some market share traction in some categories and you've had some hits.

But I'm wondering given to the changes that you've been making and in management incentives and the organizational changes that you think might help you become more of a focused organization per division on innovation, I'm wondering if you could give us a sense about maybe the real inflection point on your innovation effectiveness? When that might happen in '08, perhaps and what the innovation coupler really looks like today? Thanks.

Irene Rosenfeld ***Kraft Foods, Inc. - Chairman, CEO***

David, I feel much better about our innovation pipeline today than I did a year ago. We're going to share a lot of -- give you a lot more visibility of that at CAGNY.

But just a couple of the items that I talked about are not just new items that we launched in 2007, they're platforms. So Oreo Cakesters, for example, is our entry into a $1 billion snack cake category. We've got a whole pipeline that comes behind that.

Ultimate Pizza is our entry into the upper mainstream pizza segment and you'll see some new items coming in there. LiveActive cheeses is our entry into the $500 million pre and probiotic category. You'll see some additional items there.

So as you look across the portfolio, in addition to some of the actions we're taking on core businesses like our Maxwell House coffee, 100% Arabica product, as well as our pourables items, which have been significantly upgraded, I think you'll see a much more robust pipeline than we had a year ago and that's what gives me the confidence that we can maintain our top line momentum even as we're taking the pricing that we've indicated.

David Palmer ***UBS - Analyst***

Okay. Thank you very much.

Operator

Thank you. Your next question is from Andrew Lazar with Lehman Brothers.

Tim McLevish ***Kraft Foods, Inc. - EVP, CFO***

Good morning, Andrew.

Andrew Lazar ***Lehman Brothers - Analyst***

Irene, it's been interesting to see the industry and the way they're going about pricing. And obviously the whole industry's been playing catch-up because no one expected costs to rise as quickly as they did.

But I'm wondering if some of the price initiatives you're taking now, do you feel good enough about sort of the quality initiatives and where your portfolio is across the board that you can take pricing now, that is more of anticipatory of what may or may not but could happen from an input cost standpoint as we go through the year and even into '09 and beyond?

In other words, will '08 be another year where hopefully you're kind of still catching up but maybe getting closer or is there a potential to really be ahead of it based on what you're trying to do with pricing, like, in the fourth quarter?

Irene Rosenfeld ***Kraft Foods, Inc. - Chairman, CEO***

Look, Andrew, I think there's no question that our pricing power has improved. If you look at the 5% revenue growth that we turned in in 2007, we've got 2 points of pricing in that growth together with 3 points of [all] mix which I think is a stronger performance than you've seen from us in quite some time.

2008, we're going to get a lot closer to recovering input cost. Given the high levels, though, I'm not expecting we're going to go much ahead of that. But I think as Tim said, particularly as we look at markets like dairy, we're looking to get much closer to the marketplace so that we don't find ourselves caught behind.

Andrew Lazar ***Lehman Brothers - Analyst***

Thank you.

Irene Rosenfeld ***Kraft Foods, Inc. - Chairman, CEO***

You're welcome.

Operator

Thank you. Your next question is from Chris Growe with Stifel Nicolaus.

Chris Growe ***Stifel Nicolaus & Company - Analyst***

I just have two questions for you. The first one, I'm just curious relative to your developing markets business, are there ongoing investments there that will continue to kind of constrain the operating margin progress in that division given the strong revenue growth?

Irene Rosenfeld ***Kraft Foods, Inc. - Chairman, CEO***

Well, we're going to continue to make investment, Chris, in the developing markets. We've seen double-digit growth from that geography and we expect that that will continue going forward.

As we look ahead, though, we will continue to take aggressive pricing actions as part of that so I think we will continue to see improvement in our overall margins. There's, in some of our individual markets, there are some one-times in the base that might map that a little bit but in aggregate, we are looking for improved margin expansion from our developing markets as we are from the EU.

Chris Growe ***Stifel Nicolaus & Company - Analyst***

Okay.

And my second question was just relative to North America. You've obviously spent a lot of money on sort of the quality upgrades, the marketing, the R&D, the new products. And throughout the year we saw product mix weakening, product mix benefits to the Company weakening from North America itself.

Is that due to a certain category? Usually beverages can kind of shift there, or is that just related to the new products, we're seeing less of an incremental benefit there?

Irene Rosenfeld ***Kraft Foods, Inc. - Chairman, CEO***

No, actually, I think it was just a mathematical impact and the fact that volumes started to become a bigger part of the equation. So I think you're going to continue to see in 2008, as I mentioned, pricing will play a bigger part in our overall revenue growth and mix will continue to be important.

As we look at the new items in our pipeline, they are generally higher margin than their base counterparts and we expect that trend to continue, as well as the impact that we're seeing on our base business as we migrate some of our base products like Ultimate Pizza, like Jacobs Symphony to the upper mainstream end.

Chris Growe ***Stifel Nicolaus & Company - Analyst***

Did you say where marketing as you defined it ended the year sort of as a percentage of sales, you're talking, like, mid 7s in 2008? Where did it end 2007?

Irene Rosenfeld ***Kraft Foods, Inc. - Chairman, CEO***

6.9.

Chris Growe ***Stifel Nicolaus & Company - Analyst***

Okay. Thank you.

Operator

Thank you. Your next question is from Pablo Zuanic with JPMorgan. Please go ahead.

Pablo Zuanic ***JPMorgan Chase & Company - Analyst***

Good morning, everyone.

Irene Rosenfeld ***Kraft Foods, Inc. - Chairman, CEO***

Good morning, Pablo.

Pablo Zuanic ***JPMorgan Chase & Company - Analyst***

Irene, I guess I'm very (inaudible) on profit margin expansion and I want to go back to a question in the past (inaudible) in two year margins were at 21% of the consolidated level this year around 14%. I know you said you cannot go back to 21%, but in that long-term (inaudible) of 7 to 9% EPS growth, what are you thinking about margin expansion?

And if I can, and hat's really a question but I want to expand a little bit on a point here. If I'm not wrong, your marketing expense was 6.9% at CAGNY. That's what you said in 2006. As a percentage of sales it did not increase. So I'm trying to think is that good or bad.

We may (inaudible) because we've seen your volume grow, we've seen your mix, your innovation, but I'm kind of thinking you're going to go from 6.9 to 8 to 10% that's going to be a drag on margins for a while. So help me think that and combine with that, of course, the idea of the long-term upside on profit margins. Thank you.

Irene Rosenfeld ***Kraft Foods, Inc. - Chairman, CEO***

Let me see if I can help you through that, Pablo. Our 2006 marketing A&C investment was about 6.8% and we took it up to 6.9% so we not only saw a 10 basis point increase but more importantly it was in the face of these unprecedented commodity costs. So I feel very good about that.

As we enter 2008, as I mentioned, we're targeting to be more in the mid 7 range with the addition of Danone and we'll continue to be making some investments but not quite at the same rate as we were making in the past.

The question with respect to margin expansion, let me see if I can help you through that. Clearly, our strategy is working and we will continue to execute that strategy in 2008. We will see margin expansion, as Tim and I said, but it will not come quite as rapidly as we had hoped because of the fact that higher costs are going to necessitate price increases and we will see some dampening impact in the near-term on volume as the market adjusts.

The good news is we clearly are seeing brand strength, our brands strengthening as a result of the investments that we've made and so we expect that over time we'll continue to be able to benefit, we will be able to benefit from the operating leverage that we laid out in our growth algorithm.

Pablo Zuanic ***JPMorgan Chase & Company - Analyst***

If I just follow-up there, if I may.

You know, your operating margins are 10%. I mean, Heinz and Kellogg, maybe different markets, different products, they have 17, 18% margins. There's a huge gap there.

Are we looking at 20, 30 basis points a year only? (Inaudible) your comps in North America and Europe your margins are way below peers and I don't know, is that an issue, you think, of your product mix, your markets or is there room for faster margin expansion?

Irene Rosenfeld ***Kraft Foods, Inc. - Chairman, CEO***

Pablo, there's no question that our EU margins need to expand and we're in the process of taking a number of actions there. We had a very strong performance this past year on the top line in the EU after many years of decline and I think we've got our base business moving in the right direction.

Our focus in 2008 will be to begin to expand margins and we've got a number of initiatives in place to allow us to do that over the next few years. So we're not satisfied with our margins in the EU, but again, I believe that the investments that we've made in our core brands like Jacobs and like Milka will serve us well as we move forward and we start to recover more of the input costs.

Pablo Zuanic ***JPMorgan Chase & Company - Analyst***

Thank you.

Operator

Thank you. Your next question is from Ken Zaslow with BMO Capital Markets.

Ken Zaslow ***BMO Capital Markets - Analyst***

Hello?

You indicated that European commodity costs have now started to increase. The question I have around that is why the delay relative to the U.S.? What has changed and is your pricing ability in Europe better or worse than that in the U.S.?

Tim McLevish ***Kraft Foods, Inc. - EVP, CFO***

Let me say there's a couple differences. Europe, we tend to use more powdered dairy input products and that has lagged a little bit general dairy in North America.

The other thing is we're much more -- cocoa is a much more important input cost in Europe for our chocolate business. So that's the lag.

And I would say, again, it was we continued to execute our strategy in Europe as we do globally to build our brands. We think that it'll give us more pricing power and we'll be better able to withstand the input cost increases.

Ken Zaslow ***BMO Capital Markets - Analyst***

Is the consumer in Europe more willing to take on the price increase than the U.S. or different? Is there any, can you just talk about the consumer acceptance of higher prices?

Tim McLevish ***Kraft Foods, Inc. - EVP, CFO***

I don't think consumers ever like to have higher prices, but I think that there is a general recognition that across all categories, the consumer is going to be facing globally increasing prices as a result of the run-up in commodities. So we'll just keep having to push at it.

Ken Zaslow ***BMO Capital Markets - Analyst***

Great. Thank you.

Operator

Thank you. Your next question is from Robert Moskow with Credit Suisse.

Robert Moskow ***Credit Suisse Securities - Analyst***

Thank you.

My question is, you know, consumer staples investors have more and more been looking at companies with high exposure internationally thinking that North America is under a lot of pressure from a top line perspective and their growth is international. In your forecast for '08 I thought I heard some negative outlook on commodity costs in the EU and volume in emerging markets.

Are you expecting profit growth specifically profit growth to lag internationally compared to the rest of your portfolio? And would you even think that despite maybe an 8% benefit here from currency that profits could actually be flat internationally in 2008?

Irene Rosenfeld ***Kraft Foods, Inc. - Chairman, CEO***

Actually, Robert, we're looking for margin expansion across the portfolio. As I mentioned before, the first half will be a little more challenging because of the higher input costs relative to year-ago, but we expect to see margin expansion across the portfolio and around the world.

Robert Moskow ***Credit Suisse Securities - Analyst***

Okay. So do you -- if you look at international and North America, where do you think more of the profit growth is coming in '08?

Irene Rosenfeld ***Kraft Foods, Inc. - Chairman, CEO***

Well there's no question in the near-term, more of the profit growth will come from North America and, of course, that's almost 80% of our portfolio so that makes you feel pretty good. In the EU, we will continue to build on our base momentum while we expand margins and it will take us a little bit longer to get there.

Robert Moskow ***Credit Suisse Securities - Analyst***

Okay. Thank you.

Operator

Thank you. Your next question is from Vincent Andrews with Morgan Stanley.

Vincent Andrews ***Morgan Stanley - Analyst***

Good morning, everyone.

Irene Rosenfeld ***Kraft Foods, Inc. - Chairman, CEO***

Good morning.

Vincent Andrews ***Morgan Stanley - Analyst***

Just a question on, you know, the last several years, well, let me start here. It seems like your guidance and your plan for this year assumes kind of a run rate of commodity costs going forward and that hasn't been the case at the start of each of the last several years, in other words, commodity prices have continued to increase. What's the risk if that happens again this year and what can you do about it beyond just looking for further price increases?

Tim McLevish ***Kraft Foods, Inc. - EVP, CFO***

Well, we continue to focus on productivity, reduction of overhead, certainly. We can't -- we aren't forecasting what will happen to commodities. Obviously we have taken a view to reflect our earnings guidance.

But we are expecting that we'll continue to see pressure in commodities, particularly in the first half of the year, and particularly because we have the year-on-year comparison where they were at a lower level and we saw most of the increase and most of the commodities coming in the second half.

But we will continue to invest back to build our brands. We think we've gotten good traction there. We think we have better pricing power, but of course, we're going to be continuing to focus on productivity and overhead reduction.

Vincent Andrews ***Morgan Stanley - Analyst***

Okay. Thank you very much.

Operator

Thank you. Your next question is from Eric Katzman with Deutsche Bank.

Eric Katzman ***Deutsche Bank - Analyst***

Thanks for taking the follow-up.

I guess the first question, just more of a technical question, is there, given the changes and, I guess, better performance on the restructuring, I had assumed that there was roughly 500, $550 million or so of cash cost from the restructuring in '08. Is that still accurate or should that be less given the changes?

Tim McLevish ***Kraft Foods, Inc. - EVP, CFO***

I think the cash cost will be about the same. It may drop a little bit commensurately with the reduction in the overall program but I would say directionally that number is pretty good.

Eric Katzman ***Deutsche Bank - Analyst***

Okay. Thank you.

And then as a follow-up, I just, I mean, I'm just not clear exactly, Irene, on the kind of how all this flows in that I think Danone you said would be initially dilutive to margins. The Post deal, you know, roughly $0.07 to $0.13 annualized dilution and margin dilutive once that hits.

How does all that square at the end of the day with margins still being up and input costs being up? I just, maybe it's because I already include the divestiture of Post in our numbers, as I think most analysts have already done. Help me kind of bridge this gap.

Irene Rosenfeld ***Kraft Foods, Inc. - Chairman, CEO***

It's actually very simple, Eric. While margins will be up, they'll be up a little less than they would have been our base business because of the addition of Danone. They've got a very attractive margin.

But as you know, international margins are a little bit lower than the Kraft average so it's just simple math. But the net of it is that the guidance that we've given you assumes margin expansion as a consequence of the pricing actions that we're taking together with our productivity and our overhead leverage.

Eric Katzman ***Deutsche Bank - Analyst***

And that doesn't include any impact of the Post divestiture?

Tim McLevish ***Kraft Foods, Inc. - EVP, CFO***

That's correct.

Eric Katzman ***Deutsche Bank - Analyst***

And is the Post divestiture still, are those numbers, the $0.07 to $0.13, is that still a reasonable number?

Tim McLevish ***Kraft Foods, Inc. - EVP, CFO***

Yes. Let me step back. The guidance that we have given assumes that Post is in for the full-year. We don't know when that will take place and therefore to try to anticipate an additional variable about when it may take place and what actual impact it will have for the year, we chose to keep in there and when we get close to that happening and we can better define a date, we'll update you on what impact it would have. And it's still -- we're generally looking at a mid-year type time frame.

Eric Katzman ***Deutsche Bank - Analyst***

Okay. All right. Thank you.

Operator

Thank you. Your final question is from Virginia Chambless with JPMorgan.

Virginia Chambless ***JPMorgan Chase & Company - Analyst***

Thanks.

Actually, I have a question on the divestiture of Post. I think when you initially announced that you indicated that you're intending for about $950 million of sort of debt transfer, debt assumption by Ralcorp, is that still the intention so that net debt will be reduced by $950 million as part of that transaction?

Tim McLevish ***Kraft Foods, Inc. - EVP, CFO***

Yes, that's what we're intending.

Virginia Chambless ***JPMorgan Chase & Company - Analyst***

Okay.

And then another question on the short-term debt balances. I mean, clearly, pretty large at around $8 billion at the end of the year and part of that is the Danone bridge. But can you sort of give us some guidance on how much commercial paper you're comfortable sort of operating the business with?

Tim McLevish ***Kraft Foods, Inc. - EVP, CFO***

Well, the level of commercial paper is obviously at a peak. We did try to go to market with more of the Danone bonds late last year and the markets were not conducive to going forward. We clearly want to bring the commercial paper down to more normal levels.

We do have $4.5 billion worth of backup, stand-by credit lines and so that puts some limitations on our CP ability. Part of that, obviously, is that we have a bridge loan on funding that that's not drawing on commercial paper.

Virginia Chambless ***JPMorgan Chase & Company - Analyst***

Okay.

Tim McLevish ***Kraft Foods, Inc. - EVP, CFO***

Again, AB2 ratings are quite important to us so we're maintaining our leverage consistent with that.

Virginia Chambless ***JPMorgan Chase & Company - Analyst***

Would a more normalized level of CP be in maybe the $2 billion range?

Tim McLevish ***Kraft Foods, Inc. - EVP, CFO***

I like to keep an active program and on an ongoing basis that's probably directionally correct.

Virginia Chambless ***JPMorgan Chase & Company - Analyst***

Okay. Great. Thank you.

Operator

There are no further questions at this time.

Tim McLevish ***Kraft Foods, Inc. - EVP, CFO***

Thank you.

Chris Jakubik ***Kraft Foods, Inc. - VP Investor Relations***

Well thanks, everybody, for joining us.

If the analysts have any further questions, this is Chris Jakubik, I'll be around all day. For those of the media with questions, Lisa Gibbons will be available and you can reach her at 847-646-4538. Thanks very much and have a good day.

Operator

Thank you. This concludes today's Kraft Foods fourth quarter 2007 and year-end earnings conference call. You may now disconnect.