Q4 2023 Earnings Call

Company Participants

- Amit Banati, Vice Chairman and Chief Financial Officer
- John Renwick, Vice President, Investor Relations & Corporate Planning
- Steve Cahillane, Chairman and Chief Executive Officer

Other Participants

- Chris Carey, Wells Fargo
- Ken Goldman, J.P. Morgan
- Max Gumport, Exane BNP Paribas
- Michael Lavery, Piper Sandler
- Peter Galbo, Bank of America
- Robert Dickerson, Jefferies
- Robert Moskow, TD Cowen
- Tom Palmer, Citi

Presentation

Operator

Good morning. Welcome to Kellanova's Fourth Quarter 2023 Earnings Call. All lines have been placed on mute to prevent any background noise. After the speaker's remarks, there'll be a question-and-answer session with publishing analysts. At this time, I'll turn the call over to John Renwick, Vice President of Investor Relations and Corporate Planning for Kellanova. Mr.Renwick, you may begin your conference call.

John Renwick {BIO 19769692 <GO>}

Thank you, operator. Good morning, and thank you for joining us today for a review of our fourth quarter results and a discussion of our outlook for 2024. I'm joined this morning by Steve Cahillane, our Chairman, President, and Chief Executive Officer, and Amit Banati, our Vice Chairman and Chief Financial Officer.

Slide number 3 shows our forward-looking statements disclaimer. As you are aware, certain statements made today, such as projections for Kellanova's future performance, are forward-looking statements. Actual results could be materially different from those projected. For further information concerning factors that could cause these results to differ, please refer to the third slide of this presentation as well as to our public SEC filings.

A recording of today's webcast and supporting documents will be archived for at least 90 days on the Investor page of www.kellanova.com. As always, when referring to our results and outlook, unless otherwise noted, we will be referring to them on an organic basis for net sales and on a currency-neutral adjusted basis for operating profit and earnings per share. Included in our press release are financial results for the fourth quarter 2023, as well as the first three quarters and full years of 2023 and 2022, recasting WK Kellogg Co. in those periods as discontinued operations in accordance with applicable accounting guidelines.

These recast financials will be the basis of comparison used in the year-on-year growth rates we provide today for all items except free cash flow, which was not recast. Keep in mind that the accounting guidelines for discontinued operations are such that the recast financials for the periods prior to the spinoff include expenses related to providing transition services to WKKC, such as warehousing and IT-related expenses, but they do not include the reimbursement for those expenses, which Kellanova is receiving from WKKC under a transition services agreement.

For periods after the spinoff, that is from Q4 2023 on, both the expenses and the reimbursements will be included, which will impact year-on-year comparisons. This also creates a difference from the carve-out financials that you would have seen from WKKC as different accounting guidelines apply to carve-out financials.

And now I'll turn it over to Steve.

Steve Cahillane {BIO 4718688 <GO>}

Thanks, John, and good morning, everyone. It's a real pleasure to be able to present to you results for Kellanova for the first time. Allow me first to point to you to Slide number 5, and remind everyone of Kellanova's more focused, more growth-oriented portfolio. And let me also remind you of our updated and sharpened strategy. This strategy, appropriately called differentiate, drive, and deliver, is shown on Slide number 6. This strengthened portfolio and sharpened strategy were in full force during our initial quarter as Kellanova.

We delivered another quarter of solid results as summarized on Slide number 7. We began the quarter with our transformational spinoff, which we executed successfully from a transactional, financial, and operational perspective. We did not let this transformational transaction distract us from the task at hand, delivering results. In the quarter, we delivered results for net sales, operating profit, and EPS that all were better than the guidance ranges we provided back in November. Our organic net sales growth remained at a rate that is above our long-term algorithm, even in spite of challenging industry conditions marked by rising elasticities in our categories around the world.

Importantly, the strength of our diverse emerging markets was again evident. We continued to restore profit margins that had been pressured by last year's soaring input costs and rampant supply impediments. And this led to operating profit growing at a rate that exceeded our long-term algorithm as well. Meantime, we

delivered more free cash flow than we had anticipated, further strengthening our balance sheet and financial flexibility, which was used to opportunistically accelerate share repurchases.

Importantly, we have shifted our focus back toward demand generation after a few years of having to focus more on supply. And we solidified our plans and assumptions for 2024 accordingly, as outlined on Slide number 8. We are affirming the 2024 guidance we gave back in August at our Day@K Investor Event, underscoring the dependability we intend to continue to exhibit as Kellanova.

While it could take a couple of quarters before these negative industry trends abate, we are confident that our return to a full commercial plan will gradually stabilize and improve our volume as the year progresses. Our innovation is bigger and better than last year's supply-related pullback. Our highly differentiated brands are fully supported with A&P investment and we are back to normal levels of merchandising.

We are also confident in our sustained momentum in emerging markets, another point of differentiation for Kellinova. Meantime, we also expect margin expansion in all four regions in 2024. The result is an outlook for an on-algorithm net sales and operating profit growth and free cash flow generation that is strong enough to incrementally invest in future growth and future margin expansion. This investment in future growth includes incremental capital expenditures for adding much-needed capacity for Pringles in our emerging markets, as we've discussed previously.

But we're also investing in margin expansion, as shown on Slide number 9. Consistent with our long-term plans to optimize our global supply chain network, we have commenced two optimizations of production facilities, one in our North America frozen foods business and one in our European cereal business. These are high-return projects that require very little cash up front and will start delivering savings by late this year.

All of this is contemplated in our guidance. And even after deploying some of the savings into growth-oriented investments, particularly behind snacks and emerging markets, these actions enable us to get to our medium-term operating profit margin of 15% by 2026, a little earlier than we had previously indicated, while also progressing on our strategy's ambition to deliver best-in-class service through agile, flexible supply chain.

Our focus is also on growing the right way, and Slide number 10, shows some of the ways our Better Days Promise Program manifested itself during the fourth quarter. We unveiled new, more ambitious targets for Kellanova, sustained our legacy of helping our communities, and linked these activities to our commercial endeavors, and we continue to be recognized for our efforts.

So now let me turn it over to Amit, who will walk you through our financials, before I come back and discuss each of our businesses in more detail.

Amit Banati {BIO 16339861 <GO>}

Thanks, Steve. Good morning, everyone. Slide number 12 summarizes our results for the fourth quarter and full year for Kellenova. As John indicated, the year-on-year growth rates are based on recast results for the four quarters of 2022 and the first three quarters of 2023. As you can see, our results for the quarter came in above the guidance we had provided, and they complete a full year in which we maintained our focus on delivering consistent on algorithm results, even amidst the incremental work of executing the spinoff.

Net sales increased by about 7% on an organic and recast basis in quarter four, featuring decelerating volume declines and price mix growth that is moderating as we lapped significant revenue growth management actions in the prior year. For the full year, Kellanova's organic net sales growth was about 8%, well above our long-term growth target. Operating profit in quarter four increased by 30% on an adjusted and currency-neutral basis and comparing against a recast 2022.

This was driven by the solid top-line growth as well as by a restoration of our underlying gross profit margin and reimbursement for expenses related to transition services we are providing to WK Kellogg Company. For the full year, Kellanova's operating profit increased by 18% on the same recast basis. Even taking into account the year-over-year impact of expense reimbursement for transition services provided to WKKC in Q4 '23, which did not exist in the year-earlier quarter, our year-on-year growth in operating profit was still in double-digits for the quarter and the year, well ahead of our long-term target.

Earnings per share on an adjusted and currency-neutral basis increased by about 19% year-on-year in quarter four and by 7% year-to-date, as strong operating profit performance more than covered significant headwinds from macroeconomic factors that drove up interest expense and pulled down pension income. Finally, free cash flow came in higher than we had expected in Q4, finishing the year at $968 million. Free cash flow is not recast for discontinued operations, so the decrease from last year is solely related to one-time outlays related to the spinoff and the absence of North America cereals cash flow in the fourth quarter.

Now let's take a look at each metric in closer detail, starting with our net sales growth on Slide number 13. As expected, price elasticities continue to rise around the world in quarter four, putting pressure on volume, though this volume again came in better than projected due to better performance in our emerging markets. Price mix continued to moderate sequentially from recent quarters, as expected, as we lapped some of our largest revenue growth management actions last year. The result was another quarter of elevated organic net sales growth, though to be clear, about half of that came from our Africa joint ventures, where substantial pricing is needed to cover a devaluing currency, and shipments were unusually strong. That said, even excluding that business, we sustained organic growth that was in-line with our long-term target.

Moving across to the non-organic drivers of net sales, the divestiture of our Russia business, which occurred in July, clipped about a percentage point from our overall net sales growth in quarter four, just as it did in quarter three. Foreign currency translation was a headwind of about negative 6 percentage points in quarter four and about negative 4 percentage points for the full year. This reflected primarily the Nigerian Naira, which continued to devalue during fourth quarter and was only partially offset by strength in the Euro, Pound Sterling and Mexican Peso. While we don't provide guidance on foreign exchange rates, if today's rates held for the year, we would likely experience an impact on net sales that is similar to the impact that we saw in Q4.

Now, let's discuss our profit margin recovery starting with gross profit on Slide number 14. In quarter four, we continue to grow gross profit and restore gross profit margins. As in the previous quarters, this restoration of margins was aided by revenue growth management, productivity, and improved supply and service levels. In addition, the other half of the quarter's margin expansion was driven by reimbursement of expenses related to transitional services provided to WKKC, which did not exist in the year-ago quarter.

You'll notice that at 34% in quarter four, Kellanova's gross margin is structurally higher than Kellogg Company's margin, and it continued to come in higher than we had anticipated. We expect to continue to improve gross margin in 2024.

Turning to Slide number 15, we see that in quarter four and the full year, we also grew operating profit driven by growth in net sales and the higher gross profit margin. Meantime, operating profit margin improved year-on-year in quarter four and the full year. Remember, the 12.3% margin you see for 2023 is recast for discontinued operations, so it does not include reimbursement for transition service expenses during the first three quarters. We expect our operating profit margin to reach 14% in 2024.

Moving down the income statement, Slide number 16 shows how our adjusted basis earnings per share growth in 2023, even on a recast basis, felt the year-on-year effects of macro-related headwinds within our non-operating below-the-line items. These below-the-line pressures were expected and were experienced year-on-year in quarter four and the full year, even comparing to a recast 2022. And for all the reasons we have discussed previously foreign currency translation was modestly positive to earnings per share in 2023, including quarter four, as strengthened European and Mexican currencies more than offset what is a relatively small impact from Nigerian naira at the EPS level. Recall that due to our ownership structure, while the naira had a large impact on net sales, its impact on operating profit and EPS is much smaller.

Turning to Slide number 17, we are pleased with our cash flow generation and balance sheet. Noting that we have not recast free cash flow for discontinued items, we finished 2023 only modestly below 2022, despite the absence of the spun-off North America cereal cash flows for a quarter and despite one-time cash outlays related to the spin-off. In fact, the combination of these spin-off factors amounted to

about $300 million of negative impact. If you added that back, you can see that our free cash flow would have come in above 2022 levels. Our balance sheet after the transfer of net debt to WKKC remains solid with debt leverage remaining well below our targeted ratio of net debt to trailing EBITDA of three times.

Now let's discuss our 2024 guidance shown on Slide 18. The 2023 base is recast for discontinued operations, and because these figures may differ from WKKC carve-out figures and our internal management figures, we've chosen to continue to provide you with absolute dollar guidance for operating profit and earnings per share in 2024. After all, 2024 is what is really important, as it is the first full year in our current P&L structure.

Let's go through each metric. For net sales, we affirm our guidance for growth within our long-term targeted range, specifically calling for 3% growth or better in 2024. Across most of our businesses, price-mix growth will moderate as we continue to lap prior actions, and industry-wide elasticities will fade gradually during the year. The exception is Nigeria, where currency influenced pricing actions will likely continue, which we assume produce meaningful elasticity impact on volume.

Organic growth, of course, excludes currency translations, which based on today's exchange rates would be a headwind of 5% to 6%. For adjusted basis operating profit, we continue to provide absolute dollar guidance because year-on-year growth rate can be impacted by discontinued operations accounting. We are firming the range of $1.85 billion to $1.9 billion. This incorporates a negative impact from currency translation which based on today's exchange rates would be approximately 2%.

Versus recast 2023 figures, this implies growth in operating profit in the mid-teens. After taking into account the year-over-year impact of expense reimbursement for transition services provided to WKKC for four quarters in 2024 versus only in the fourth quarter in 2023, this year-on-year growth is still in the mid single-digits, solidly on our long-term target. Our guidance implies continued margin expansion as an improving gross profit margin more than offsets a strong increase in brand investment.

We expect to reach a 14% operating margin in 2024. Adjusted basis earnings per share is still expected to be in the range of $3.55 to $3.65. We make no change to our previously communicated expectation for an increase in our effective tax rate to 23%. Our outlook for interest expense is about $310 million, and we expect other income to be around $50 million.

And we are firming our outlook for free cash flow of approximately $1 billion, with year-on-year growth driven by operating profit, partially offset by capital expenditure, temporarily elevated for expanded Pringles capacity in emerging markets, and modest cash outlays related to our two network optimization projects.

These network optimization projects are addressed on Slide number 19. At our Day@K Investor Event in August, we cited network optimization as one of the drivers of our margin expansion, and we are now ready to discuss specific initiatives. The two projects we are announcing today are both high-return projects. Only about half of the project's upfront costs are cash, even before asset sales, and the projects collectively become cash-neutral by 2025.

In 2024 specifically, upfront costs will amount to about $160 million, with less than $40 million of that in cash, and this has been incorporated into our cash flow guidance. Savings for the project start very quickly, with a small portion of the overall $75 million coming as soon as the second half of 2024, and this too is incorporated into our guidance. In fact, this is a contributor to our operating profit margin expanding to 14% this year, as implied by our operating profit guidance. Importantly with this announcement, we can also now be more specific about the timing of our medium-term goal of a 15% operating margin. We expect to reach that margin in 2026.

So let's summarize our financial condition on Slide number 20. In what was our debut quarter as Kellanova, our fourth quarter results came in as guided, from net sales to earnings per share. The business remains in good shape, with margin restoration proceeding ahead of pace and volume performance on a path of gradual improvement. Consequently, we have affirmed our guidance for 2024, even amidst challenging industry and macroeconomic conditions.

Our medium-term goal of attaining a 15% operating profit margin has been accelerated to 2026, as ongoing margin expansion drivers are now augmented by network optimization initiatives, which get started this year, subject to consultation. And we continue to generate strong, free cash flow that along with our deleveraged balance sheet gives us financial flexibility. This flexibility has been on display in the form of opportunistic share buybacks during quarter four and in our decision to elevate capital investment to expand capacity for our rapidly growing Pringles business. So we enter 2024 in a strong financial condition.

Let me now turn it back to Steve for a run through of our businesses around the world.

Steve Cahillane {BIO 4718688 <GO>}

Thanks Amit. Slide number 22 splits our portfolio into category groups to help remind you of their relative sizes and growth rates. This view shows you how much each category group contributed to our strong organic net sales growth in the quarter and for the full year.

Now let's review each of our regions which are our reporting segments. We'll start with Kellenova North America in Slide number 23. North America's fourth quarter results continued to show the impact of rising elasticities across all of our categories. Recall that we entered 2023 with low service levels due to economy-wide bottlenecks and shortages, and therefore we elected to launch less innovation and

to return to merchandising only after we were strongly confident that service levels had returned to normal levels.

This in conjunction with category elasticity suddenly and rapidly rising negatively impacted our volumes, particularly in the second half. Despite lapping an unusually strong year earlier period, North America's operating profit grew strongly year-on-year in the fourth quarter. Even accounting for the reimbursement of expenses related to transition services provided to WKKC in this year's quarter four, North America's operating profit grew in the mid-single digits year-on-year, continuing to restore underlying gross profit margin and operating profit margin by more than projected. So, in spite of slowing categories and amidst the organization undergoing significant change related to the spinoff, North America again delivered financially. Within its key category groups, we can see the deceleration and top line growth caused by the rising elasticities.

Slide number 24 shows our North America snacks business, which experienced slowing category growth rates during the year. Volume growth rates in our categories did not worsen in the fourth quarter, though elasticities continued to edge higher. We continue to feel the impact of less innovation year on year, particularly in crackers, and this will be addressed in 2024 when we return to a full innovation launch calendar.

And we did see year-on-year increases in display activity, and our return to merchandising and improving quality of displays will continue to gain traction as we head into the new year. It was a similar story in frozen foods shown on Slide number 25. Along with the frozen breakfast category, Eggo's consumption turned to a decline in the fourth quarter on rising elasticities.

MorningStar Farms continued to gain share, but in a declining veg-vegan category. We believe these conditions are transitory for both categories and expect better performance in 2024. So let's talk about what to expect from North America in 2024, indicated on Slide number 26.

First, with supply impediments well behind us, we are returning to full commercial activity in 2024. This starts with a full slate of innovation launches, and it includes a full year of robust merchandising and display activity. We will also continue to support our focus brands with increased brand building investment. The results should be improved in market performance and a gradual return to volume growth. And if you've been watching, the Pop-Tarts Bowl and Cheez-It Bowl, as well as the upcoming Pringles activation for Sunday's big game, are good examples of how we plan to show up in 2024.

Now let's turn to Kellanova Europe in Slide number 27. Here we finished the year with another strong quarter, yet again delivering organic net sales growth on top of prior year growth. In a market that is extremely price sensitive, we were again able to realize double-digit price mix growth through effective revenue growth management actions, though elasticity did rise, impacting volume. Our organic net

sales growth was 10% in the quarter and 9% for the full year. Europe delivered strong operating profit growth in the fourth quarter and the full year. Granted, this was lapping a sharp year-ago decline, but it did feature strong top-line growth and better margin recovery than expected, getting its operating profit margin back to flat for the full year.

On Slide number 28, you can see that snacks, which represent over half of our sales in Kellanova Europe, continued to lead our growth in this region. Our double-digit organic growth in net sales, both in the quarter and for the full year, was across all of our across all of our major sub-regions. Revenue growth management actions drove the growth, while volume declines remained relatively modest. The salty snacks category has slowed but remained in high single-digit growth across key markets, and Pringles in the fourth quarter was tracking to gain share, led by the U.K., and Spain.

In portable wholesome snacks, we have managed to outpace the category in the U.K., and Italy. In cereals shown on Slide number 29, you can see that we grew net sales organically in the quarter. This, too, was led by revenue growth management actions, while elasticities have been running higher in this category than in our snacks categories. We finished 2023 with organic net sales growth of about 1%.

Slide number 30, points to some elements to watch for in Europe in 2024. We expect to deliver a seventh consecutive year of organic growth. The growth will be led by snacks, with Pringles continuing to be supported with innovation and brand building and portable wholesome snacks in key markets, notably Pop-Tarts and Rice Krispies Squares. We're also excited about launching Cheez-It in key European markets in the second half. In cereal, our focus will be on optimizing our cereal portfolio in conjunction with the manufacturing network optimization that we're commencing this year.

Now, let's look at our emerging markets regions starting with Latin America on Slide number 31. In the fourth quarter, Latin America's net sales grew 5% on an organic and recast basis with volume declines moderating even in spite of sizable impact from our SKU rationalization and price pack architecture initiatives. The region finished the year with strong 8% organic net sales growth. Operating profit declined in the fourth quarter against a substantial year earlier gain. But despite some incremental investments and transitory cost pressures, it finished the full year with 8% growth on an adjusted and currency neutral basis.

Slide number 32 shows that our snack sales were flat on an organic basis in the fourth quarter comparing against a notably strong year earlier period. Pringles continued to perform well. In-market data shows sustained double-digit category growth for our major salty snacks markets with Pringles gaining share in Brazil and holding share in Mexico. And we continue to outpace the portable wholesome snacks category in Mexico, though we did see rising elasticities in cookies in Brazil. Our Latin America snacks business finished the full year with 7% organic net sales growth.

In Latin America cereal shown on Slide number 33, our organic net sales growth was strong in the quarter and for the full year. Specifically, sales grew 10% in the quarter and finished the full year with 9% growth. Cereal category consumption growth has held up in the mid to high single-digits across much of the region and we gained share in Mexico.

As we look to 2024 a few things to watch for in Latin America are shown on Slide number 34. We expect a seventh straight year of organic net sales growth. The growth should be led by snacks particularly behind Pringles innovation and distribution expansion and we also expect good growth in cereal. Margins should improve reflecting price-pack architecture and other RGM initiatives and operating efficiencies as well as moderating input cost pressures.

Slide number 35, shows the financial performance of our AMEA region. This region sustained its strong momentum in the fourth quarter when organic net sales growth reaccelerated to 22% on a combination of price mix growth and volume growth led by Africa. For the full year our organic net sales growth was 17%. Now obviously a large portion of this currency neutral growth came from Nigeria where currency devaluation necessitated significant pricing actions.

Nevertheless, the rest of AMEA posted solid growth in the quarter as well. Margins continued to recover year-on-year and operating profit grew 25% in the quarter on an adjusted and currency neutral basis in spite of substantially higher brand investment and despite lapping strong prior year growth. Its operating profit increased by 20% for the full year.

Within AMEA, we see on Slide number 36 that snacks grew organically at a double-digit pace in the fourth quarter and for the full year. This growth was led by Pringles in emerging markets across Asia, Africa, and the Middle East, as well as in more developed markets like Australia, Korea, and Japan. Pringles continued to gain share overall principally due to outperformance in Thailand, Australia, and Japan.

In cereals shown on Slide number 37, we sustained organic growth, posting 4% growth in the fourth quarter and 6% growth for the full year. This was led by emerging markets in Africa, the Middle East and Asia. And we finish with noodles and other shown on Slide number 38.

Revenue growth management actions continued to be taken in Nigeria as we try to keep up with weakened currencies, but volume also grew in the double-digits in the fourth quarter reflecting the strength of our brands and our execution as well as timing of shipments. Meanwhile, we also continue to expand our Kellogg's noodles business outside of Nigeria and this also contributed to our volume growth in the quarter.

We expect AMEA to sustain momentum into 2024, as discussed on Slide number 39. To deliver the region's seventeenth straight year of organic net sales growth, we expect to see strong growth if moderating from 2023 rates in noodles and other. We

expect to see sustained momentum in snacks, led by Pringles. And we expect to sustain growth in cereal led by emerging markets. Margin expansion should continue, led by our businesses outside of Nigeria. In those markets, input cost pressures are finally moderating and productivity and operating leverage continue to contribute positively.

So, let me summarize with Slide number 41. Simply put, the Kellanova era is off to a good start. We've executed well the spinoff and the post-spinoff operations, including transition services, and we delivered our initial quarter ahead of our expectations. We're now shifting back to a focus on demand generation after a few years of supply focus. We're very excited about our 2024 commercial plans, which feature a return to a full complement of innovation, brand building, merchandising, as well as sustaining momentum and scale building in our emerging markets.

We're also pleased with our progress and plans for restoring and expanding profit margins, which has proceeded faster than we had anticipated. Our outlook for 2024, first shared with you as far back as last August, remains intact, calling for another year of on-algorithm sales and profit growth. And we're not sitting still. We're already creating the future. For instance, we are adding much-needed capacity for Pringles in emerging markets. The international expansion of Cheez-It continues, with launches coming in Europe. And we are commencing network optimization initiatives that will both expand margins and fuel growth investments.

In sum, we are on track and ready to deliver as Kellanova, and the future certainly is bright. Of course, none of this would be possible without the grit and skill of our supremely talented Kellanova employees, all of whom are as determined as ever to differentiate, drive, and deliver. And now we'd be happy to take your questions.

Questions And Answers

Operator

(Question And Answer)

Thank you. We will now begin the question-and-answer session with publishing analysts. (Operator Instructions) Our first question for today comes from Peter Galbo of Bank of America. Peter, your line is now open. Please go ahead.

Q - Peter Galbo {BIO 18820151 <GO>}

Hey, guys. Good morning. Thanks for taking the question. Maybe just first a comment. Hopefully, the edible Pop-Tart is going to make its way down to Cagney. I think a lot of people would enjoy that.

A - Steve Cahillane {BIO 4718688 <GO>}

Peter, he didn't survive the bowl game, in case you weren't watching. We'll have to find another way, Steve.

Q - Peter Galbo {BIO 18820151 <GO>}

Just to clarify your comments on the guidance, understanding organic sales, the plus 3, and I think you said your current rate is a headwind of 5% to 6% on top line from FX. The operating profit range though, the dollar range, did I hear you correctly that that included a two-point hit, or is that in addition? So we should be taking that into consideration on the dollar range. Thanks very much.

A - Amit Banati {BIO 16339861 <GO>}

Yeah, Peter, yeah, that does include, the operating profit does include the currency headwind, so just confirming that. Like I mentioned, it's approximately around 2% at today's rates. So that 2% is built into the dollar numbers that we've given.

Q - Peter Galbo {BIO 18820151 <GO>}

Great, and that's the same on EPS as well, the 2%?

A - Amit Banati {BIO 16339861 <GO>}

Yes. EPS is probably slightly lesser, yeah.

Q - Peter Galbo {BIO 18820151 <GO>}

Perfect, thank you.

Operator

Thank you. Our next question comes from Robert Moskow of TD Cowen. Your line is now open, please go ahead.

Q - Robert Moskow {BIO 6299775 <GO>}

Hey, thank you for the question. Steve, you called out, a return to stronger innovation stronger in North America and normal merchandising activity. Can you give us a sense of the phasing throughout the year like the retail tracking data? Looks very, very weak in the U.S., is that due to a comparison to the prior year? Or does it just going to take a while for your innovation and merchandising to get you back to your normal growth rate.

A - Steve Cahillane {BIO 4718688 <GO>}

Yeah, it's going to -- Rob thanks for the question. It's going to be throughout the year really -- we started with displays coming back to prior years, better than prior year in the fourth quarter. In the first quarter, I'm going to see the quality of those displays improving that will continue into the second quarter as well and just to remind 2023 was a year of pullback on innovation culling of SKU's, clearly focused on supply and making sure that we could have that supply in the market.

In the U.S., though, for example, we've got Pringles harvest blends, which we brought in the second half of 2023. We've got Cheez-It innovations, Cheez-It

Crunchy, which is hitting now. We've got Pop-Tarts, Crunchy Poppers. We've got innovations around Nutri-Grain. We've got a Rice Krispies treats with peanut butter. We've just got many more innovations than we've had in prior years, and that will roll throughout the year. We've also got distribution growing where it had been declining. You should see momentum growing, really starting now and picking up all through the year. That gives us really good confidence in the top-line guide that we gave. The other thing I had, Rob, is a higher brand-building investment as well, which we phased into the first half of this year as well to really drive that quality of display, that quality of merchandising.

Q - Robert Moskow {BIO 6299775 <GO>}

So when do you think we'll see the top-line growth really show up in the retail tracking? Is it going to be like third quarter kind of thing, or could it happen as early as 2Q? There's not really an inflection point per se. I think you're going to see a cumulative improvement with probably the third quarter being, the one where it'd be most notable, and then we'll exit the year with lots of momentum. So it'll be cumulative throughout the year, and growing from the second into the third quarter.

Okay, thank you.

Operator

Thank you. Our next question comes from Chris Carey of Wells Fargo. Chris, your line is now open, please go ahead.

Q - Chris Carey {BIO 21810941 <GO>}

Hi, good morning, thank you for the question. So I just wanted to touch on this innovation and merchandising comment again, just try to contextualize 2023. Can you maybe just help understand 2023 market share performance between, say, some of your branding or some of your extensions, innovations, say, your base business relative to innovations that you had done through the year that perhaps received less support or less merchandising?

Really just trying to understand, is it the core where you started to see some of the share erosion, or was it some of the newer products that you had launched in 2023 that perhaps didn't get as much support? And going into 2024, those are really the opportunities for you to kind of recapture some of this relative share momentum.

A - Steve Cahillane {BIO 4718688 <GO>}

Yeah, thanks, Chris. So it's much less the core than it is some of the innovations that we really didn't support with quality display merchandising. And so if you look at Cheez-It, this snapped and puffed. And if you were to look at the cases on display for those, dramatically down as we focused on the core supply. And we have owned it. We've returned to merchandising later than our competitors. We were more conservative when it came to that merchandising, overly focused on making sure that we had high 90s fill rates before we returned to merchandising.

So that's what you see in the share. We don't see any deterioration in our brand health. In fact, we see our brand health really at very high watermarks across Cheez-It, Pringles, Pop-Tarts, Rice Krispies treats. And so that gives us the confidence to talk about the quality merchandising returning and our share performance improving as we go throughout 2024. Again, coupled with more brand investments in the first half of the year. When you look at our brand investment, we didn't pull back in 2023. We publish advertising only on a full year basis. You'll see advertising up in 2023, that's going to continue into 2024.

Q - Chris Carey {BIO 21810941 <GO>}

Okay, so really, we should be looking at the strength of additional innovation, adding to market share performance with maybe the base business thing, a little bit of an uplift as well. Okay, and then.

A - Steve Cahillane {BIO 4718688 <GO>}

Yeah, that's right, because I mean, the comparisons are going to be against a year where we really didn't innovate, and now we're getting back to kind of pre-COVID levels of innovation.

Q - Chris Carey {BIO 21810941 <GO>}

Right, right, okay. And then, just from a competitive standpoint, can you maybe just give any context for what you're seeing in the environment from a pricing and promotion standpoint? And then, I think one of the categories where promotion or, excuse me, competitive activity has especially weighed has been on the Eggo business. So, maybe you can just provide a higher level thoughts on competition and maybe just a drill down on that specific business. Thanks.

A - Steve Cahillane {BIO 4718688 <GO>}

Yeah. So you're probably asking about the U.S. the frequency of promotions continues to return to pre-pandemic levels, so 2019 levels. The depth of those promotions is really kind of back to approaching those levels off a higher base. And so I'd say, the whole market is pretty benign and stable. You don't see, I've heard some of the noise around because volumes are down, is there going to be, high levels of discounting and, increased frequency of promotion. We're not really seeing that. You know, for us, we're getting, we're trying to get back to the pre-2019 levels, as I've mentioned a couple of times now in terms of frequency to drive quality promotional displays. But not seeing anything other than that, really.

Q - Chris Carey {BIO 21810941 <GO>}

Okay, thank you.

Operator

Thank you. Our next question comes from Tom Palmer of Citi. Tom, your line is now open. Please go ahead.

Q - Tom Palmer {BIO 20130502 <GO>}

Good morning, and thanks for the question. I wanted to maybe just kick-off on operating profit. At the Investor Day, you laid out some dollar expectations by segment. Obviously, several months have passed, and some segments have maybe done better or tracking better than you'd anticipated, and some maybe not quite. Maybe just an update there. Are there any more changes as we think about the operating profit distribution across those segments versus what you had laid out?

A - Amit Banati {BIO 16339861 <GO>}

Yeah, at the Day@K, we had kind of given you the absolute dollar guidance just to kind of help set up your models. I think we don't intend to provide regional guidance going forward on an ongoing basis. But that said, I would that said, all the regions for '24, we'd expect them to be within their long-term algorithms growth rates that we had shared at Day@K.

Q - Tom Palmer {BIO 20130502 <GO>}

Okay. Thank you. And then on the reorganization announcement today for the frozen and serial businesses, what drove the decision to make these changes? I mean, presumably neither is linked directly to the serial spinoff, but was the timing at all related to kind of increased bandwidth now that the spin's been wrapped-up?

A - Steve Cahillane {BIO 4718688 <GO>}

There's a little bit of that, but really it's more, if you think about what we've been through as an industry, focused on supply, focused on getting through the pandemic, focused on bottlenecks and shortages, the ability to really dedicate resources towards, effectiveness programs and efficiency programs like this was challenging.

And so we're through that right now, and we see good opportunities in the frozen business, so we, we'll be closing a plant and moving production to our more efficient plants. In the UK, subject to consultation, we've got our Manchester plant, which is a very large plant, which is underutilized. We can move that production into two facilities. So straightforward, programs in terms of the type of efficiencies they'll drive. We're confident that, it's, they're terrific programs, but it's really a matter of having the bandwidth pre- or post-pandemic, post bottlenecks and shortages that will allow us to ongoing look for programs like this to continue to drive effectiveness and efficiency.

Q - Tom Palmer {BIO 20130502 <GO>}

Thanks.

Operator

Thank you. Our next question comes from Robert Dickerson of Jefferies. Your line is now open. Please go ahead.

Q - Robert Dickerson {BIO 17963496 <GO>}

Great. Thanks you so much. First question, I heard you mention increased global distribution on certain power brands, as we call them, some in Europe this year, maybe in some other cities in Asia. Could you just kind of briefly discuss, add some color to what could be the opportunity there with a brand like Cheez-It and kind of what the timing is of that non-U.S., distribution?

A - Steve Cahillane {BIO 4718688 <GO>}

Yeah, Rob, we get asked a lot, why is Cheez-It primarily a U.S., brand? Why not expand it 10 years ago? And I think it's a fair question. The company was very busy expanding Pringles around the world and you see, obviously now it is a global brand, growing all around the world, recognized everywhere. And that's the long-term ambition for something like Cheez-It, which is the next out of the gate. But you start with seeds. And we launched in Canada. We launched in Brazil and Mexico. And this year, the back half of the year, we'll be launching in major markets in Europe. And so it's a long-term play. It's in our guidance. It's not really, it's not going to be a material driver of top line.

But five years from now, it's going to be a much bigger brand internationally than it is today. And that's really the plan. We learned from the Canada launch. We applied those learnings to Brazil, then to Mexico. And we've got a terrific plan for the back half of the year in Europe. And so it's a long-term play. Then you look at the rest of our portfolio, Rice Krispies Treats, is already a multi-country brand, growing nicely in Europe, growing nicely in Australia, New Zealand. You look at Pop-Tarts, there's potentially room for that to be an international brand down the road. So, we look at our portfolio. We like what we see in terms of international expansion. But we're going to do it in a very prudent and pragmatic and practical way to drive long-term growth.

Q - Robert Dickerson {BIO 17963496 <GO>}

All right. Super. And then maybe just a very simple quick follow-up. I heard you say that you expect gross margin to improve for the year. Could you just maybe provide us with kind of, how you're viewing the cost side of the equation in terms of COGS inputs is that deflationary? And then, kind of given some of the commentary around, maybe more positive volumes in the back half, should we be expecting also maybe a little bit better gross margin back half year-over-year relative to first half year-over-year? Thanks.

A - Amit Banati {BIO 16339861 <GO>}

Yeah. Gross margins have come in better than expected. And so I think, the supply chain is performing well. We're seeing costs come out of the supply chain that had gone in, in the last couple of years. In quarter four, first quarter of Kellanova, our gross margin came in at 34%. And we'd expect that in 2024, we'd be approaching 35%. So, that's kind of the outlook for the year. So, pleased with the progress that we are making and, certainly the progress that we're making in gross margins is ahead of what we had shared at Day@K, that's allowed us to continue to be on our guidance on an operating profit basis.

I think in terms of the drivers, you'll obviously have the benefit of wraparound pricing and some continued revenue growth management into this year. The input costs, I would say, deflationary on commodities, a couple of commodities continue to be inflationary, net-net slightly deflationary, you look at labor and other parts of a supply chain where there is inflation overall, I'd say costs are broadly neutral. So, that combination should drive continued progress on gross margin, and I think it'll be fairly balanced across the quarters. We'd expect our A&P to be more front loaded as we get back to full innovation but the gross margin progress should be fairly balanced across the quarters.

Q - Robert Dickerson {BIO 17963496 <GO>}

All right. Super. That's, great. Thanks so much.

Operator

Thank you. Our next question comes from Max Gumport of BNP Paribas. Your lines now open. Please go ahead.

Q - Max Gumport {BIO 21236637 <GO>}

Hey, thanks for the questions. With regard to the comment about all regions being within their long-term algo in 2024 was that just on operating profit or does that apply to organic net sales too?

A - Amit Banati {BIO 16339861 <GO>}

I think to organic net sales as well.

Q - Max Gumport {BIO 21236637 <GO>}

Okay, then, as a follow-up, so for North America, that would be low single digits to mid-single digits. Could you just walk through the drivers of what's getting North America to organic sales growth in 2024, particularly given the decline we just saw in 4Q and the weakness that was addressed in the obscure trends that we're seeing? Thanks.

A - Amit Banati {BIO 16339861 <GO>}

Yeah. North America, I'll just start. North America will probably be towards the lower end of that range, so probably more low single digit. But, as Steve elaborated, it's a return to merchandising, innovation, all of that should result in low single-digit growth in North America.

Q - Max Gumport {BIO 21236637 <GO>}

Got it. And the last one for me, the shipment timing in AMEA that you called out, should we expect that to reverse at all in 1Q? Can you just go over what happened there exactly in terms of the African noodles shipment benefit? Thanks.

A - Amit Banati {BIO 16339861 <GO>}

Yeah. Yes, so a couple of things driving the strong volume growth in AMEA and, it was all in Africa, JVs. One is, we are expanding our noodles business across the continent in South Africa as well as in Egypt, so we're seeing strong volume growth and, that expansion is seeing good traction, in terms of share and, leading share positions in South Africa as well as in Egypt, so that's a source of volume growth and that will continue in 2024.

I think in Nigeria specifically, we've had to take a lot of pricing given what's happened with the currency and the elasticities have been pretty good and better than expected. There has been some ordering by our customers, at older prices, so, you are seeing acceleration of the orders, to take benefit of the old pricing, and in an environment where you're taking successive price increases, you kind of see that timing of shipments play through. Hard to kind of predict when that would unwind because, as you know, the currency is devalued further in January and, we'd be taking further pricing, but we'd expect that to, to adjust during the course of 2024.

Q - Max Gumport {BIO 21236637 <GO>}

Great. Thanks very much.

Operator

Thank you. Our next question comes from Michael Lavery of Piper Sandler. Your line is now open. Please go ahead.

Q - Michael Lavery {BIO 20141239 <GO>}

Thank you. Good morning. Just wanted to get started on margins. On Slide 19, you show the progression to the 15%, but the starting point for 2023, you have as 12, perhaps a similar slide at Investor Day, was it at 13? I guess just first, it was -- is that just restraining costs from the recast? Because I think WK Kellogg's margins would have been lower. So, is it restraining costs that drive that, or is there something else that pushed the starting point down? And then conversely, with obviously you being just as confident or more in getting to the 15 and maybe sooner, is the network optimization the key piece of that, or are there other puts and takes we should keep in mind as well?

A - Amit Banati {BIO 16339861 <GO>}

Yeah, so just on the 12 versus the 13 at Day@K, they are on different bases. So the 12 that you see right now is on the discontinued operations basis, which is, we've now done that work, and that's what we'll be reporting against. The 13, which we had given at Day@K, was an internal management estimate, and really the difference is the 12 does not include reimbursement for, for the first nine months, the TSA reimbursements for services that we're providing to WKKC. That's the way the discontinued operations accounting works.

So that's really the difference between the 12 and the 13. And I think, like I said, we expect in 2024 to be at 14 margin. So, very pleased with that, obviously. And I think, that's structurally higher than where we were as Kellogg's. And I think it's just a proof

point of a higher growth and a higher profit portfolio that we have in Kellanova. And then I think, to our confidence in getting to the 15 margin by 2026, yes, the network optimization projects are a contributing factor. And we'll continue to look at further opportunities. But you know, all the other drivers, advantage brands, our top five brands have higher margins. They're 50% of our sales. We'd expect them to grow faster, scale in emerging markets, getting back to a full productivity program in our supply chain, some continued revenue growth management. All of those would also be contributory factors to get to that 15%.

Q - Michael Lavery {BIO 20141239 <GO>}

Okay, great. You mentioned the transfer of services agreement as a key piece of how to think about 2024 EBIT. Can you give us a sense of how much that's got a fixed component versus variable or just a little bit of how that might be structured?

A - Amit Banati {BIO 16339861 <GO>}

Yeah, so it's about $40 million to $50 million a quarter, right? So, it'll flow through all of 2024. I think, as we stop providing those services to WKKC and as WKKC contracts for those, for those services directly, those costs will drop off from Kellanova and the reimbursement will drop off as well. So the vast majority, as this thing kind of concludes, right, as we step down from the TSAs, we'd expect the costs to stop and the reimbursement to stop.

I mean, I think a good example, of that is warehousing. Right now, the warehousing, we are providing the warehousing. So, we are incurring the costs and then WKKC is reimbursing that to us. Once the TSA is done, they'll have their own warehousing and they'll pay for the warehousing cost directly. So, the costs will stop, the reimbursement will stop. Is it a 100% one-to-one? No, but I think, the vast majority of that is variable. There is a small fixed element and I think, we've got plans to address that and that's included in the 15% by 10% size, or target.

Q - Michael Lavery {BIO 20141239 <GO>}

That's really helpful, color. I just want to make sure I understand it. When you were talking about the $1,850 to $1,900 EBIT guide and the comparisons that would fall within that, it sounded like some of the TSA drove, I think you said around a mid-teens growth rate, where without that it'd be about mid single-digit. So, if that's 40% to 50%, is there a margin on that, or how does it contribute to EBIT if it's just the reimbursement?

A - Amit Banati {BIO 16339861 <GO>}

I think it's just timing, because the growth rate, so when you look at 2024, we are getting reimbursement for all four quarters. In 2023, we got reimbursement only in quarter four, because that was when the spin happened. So the reason why it's in that teens growth rate is that in '24 you've got four quarters, in '23 you've got one quarter. So it's purely because of the way, the timing of the spin and the difference coming from there.

Q - Michael Lavery {BIO 20141239 <GO>}

And a function of the comparison in the recast number is not -- okay, that's perfect. Thank you so much.

A - Amit Banati {BIO 16339861 <GO>}

Yes.

A - Steve Cahillane {BIO 4718688 <GO>}

Yep.

Operator

Thank you. Our next question comes from Ken Goldman of J.P. Morgan. The line is now open. Please go ahead.

Q - Ken Goldman {BIO 15002920 <GO>}

Hi. Thank you. I just wanted to make sure -- 100%, because I'm still getting some questions about this. You mentioned, Amit, that the operating profit number, the 1,850 to 1,900, does include the headwind of 2% from FX. In the press release, it does say, though, that these impacts? And you're talking about mark-to-market adjustments and foreign currency translation? Are not included in the guidance provided. Am I just misinterpreting one of those or they seem to be in conflict with each other but I'm sure I'm just missing something.

A - Steve Cahillane {BIO 4718688 <GO>}

No. Yes, Ken. Sorry. It's just that our guidance is typically on growth rates which are currency neutral. So the table just has that always but we've elected to go with absolute dollars just to help you model. So ignore the labeling. There is a little bit of that currency impact that Amit talked about in those absolute figures.

Q - Ken Goldman {BIO 15002920 <GO>}

Perfect. Thank you for that clarification. And then not to harp too much on the reimbursements but is it, and I know you're not going to talk explicitly about 2025 yet, but it would seem that if you're getting a, I don't know, roughly $140 million benefit in 2024 that some of that, kind of goes away because you didn't have -- and again, it's not exactly maybe that much because it depends on the timing of everything. But is it fair to say you'll have some kind of headwind in '25 as those roll off? Again, with the caveat that it's too early to really discuss specifics.

A - Amit Banati {BIO 16339861 <GO>}

Yeah, I think, there are costs which we are getting reimbursed. So I wouldn't characterize it as a benefit. We're incurring the costs on behalf of WKKC as part of the services we are providing them. And they are reimbursing us for those expenses that we are incurring. We would expect those expenses to drop off. And, there's no

markup on the service. So we would expect those expenses to drop off and then the reimbursement to drop off.

Now, is it a one-to-one? Not completely, but, I'd say the vast majority of those. And I think, like I mentioned in the warehouse example, that warehouse right now, we are paying for it and we get reimbursement. Once they drop off, they'll pay for it directly.

Q - Ken Goldman {BIO 15002920 <GO>}

No, I get that. And I'll ask this offline. I think I'm more asking about the growth percentage. I'll ask it offline, though. I'd like to have a clarification later.

A - Amit Banati {BIO 16339861 <GO>}

The growth percentage is related to the timing.

Q - Ken Goldman {BIO 15002920 <GO>}

Yeah, no, I get it. I'll ask later. It's not worth holding up the call for it. Thank you.

Operator

Thank you. I will now pass back to John Renwick for any concluding remarks.

A - John Renwick {BIO 19769692 <GO>}

Okay. Well, that is up at 10:30. If you do have follow-up questions, please do not hesitate to call us. And thank you, everyone, for your interest.

Operator

Thank you for joining today's call. You may now disconnect your lines.

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