PRESCIENCE POINT
CAPITAL MANAGEMENT

Kellogg Company

NYSE: K

TARGET PRICE: $39.50

On April 26, 2018, Prescience Point published a research paper (the "Initiation Report") on Kellogg Company ("K", or "the Company"). We predicted Kellogg would be forced to (1) reduce FY'2018 guidance and (2) cut its dividend or lose its credit rating. On 10/31/18, part one of our thesis was proven correct when K slashed its FY'2018 adjusted EBIT and earnings growth guidance. Part two is still playing out. While recently announced asset sales, reduced disclosure, and other actions taken to obfuscate underlying results may buy K some time, we believe it only prolongs the inevitable; a dividend cut or credit downgrade. In this report, we shed light on why K really reduced guidance and explain why we now expect a drawn out and painful period for K shareholders.

Prescience Point Opinions:

- **Revenue growth is a facade, reversal of years of extended DSOs will wreak havoc on growth expectations and cash flow in FY'2019:** Years of transitory benefits from extended terms and stuffed channels are starting to unwind and will be an enormous headwind in the near-term. Kellogg can either (1) spend massively on brand-building to maintain sales growth at the expense of margins or (2) let sales growth falter while trying to salvage profitability; these are the best-case scenarios. We expect revenue growth and margins will both deteriorate.
- **CAO resignation immediately before guidance cut & working capital "unwind" is highly suspicious:** We were already concerned the sudden and peculiar departures of the CEO, CFO, and President of Kellogg North America were a glaring red flag; the resignation of the CAO just months before extremely poor results just adds to our suspicions.
- **FY'2018 adjusted EBIT & earnings growth guidance slashed; K's explanation for the miss doesn't make sense, appears deceptive:** We find the rationale behind drastically lowering FY'2018 adjusted EBIT margin and earnings guidance suspect and full of contradictions with prior commentary. We don't believe management is being forthright with investors.
- **North America re-org/supply chain buildout leads to more obfuscation and a likely scapegoat for poor FY'2019 performance:** It would not surprise us if these restructuring efforts take longer than the Company anticipates. We believe this sets the stage for the re-org/supply chain to take the blame for weak results in FY'2019 (and maybe beyond).
- **K remains more levered than meets eye; dividend cut/credit downgrade risk remains high:** K generates barely enough cash to cover dividends and other short-term obligations. Recently announced asset sales are not opportunistic, but necessary to fund buybacks, pay dividends, and shore up balance sheet.
- **Shares are still dramatically overvalued:** Based on our adjustments, K is still trading at an unjustifiably high multiple of 14.0x EV/EBITDA, while its adjusted leverage ratio of 4.5x remains in-line with high yield CPG peers. Consensus continues to take management's commentary at face value and incorrectly anchors estimates to K guidance; failing to adequately account for the massive unraveling of years of accounting excesses. We reiterate our price target of $39.50, implying ~35% downside.

SHARE PRICE
$61.73

AVG DAILY VOLUME
1.95M

MARKET CAP
$21.4B

NET DEBT
$8.6B

ENTERPRISE VALUE
$30.0B

Thesis Update: We Believe Management is Misleading Investors, Recent Actions Raise More Questions than Answers; Our Conviction Has Never Been Higher

We remain short shares of Kellogg Company and our conviction has never been higher. After two quarters (Q1'2018 and Q2'2018) of relatively in-line results and improved investor sentiment, despite continued deterioration in the underlying fundamentals, the Company missed Q3'2018 estimates and drastically cut FY'2018 adjusted EBIT and earnings guidance.

The Company attributed weak Q3'2018 profitability and reduced FY'2018 guidance to the Direct Store Delivery ("DSD") transition and Multi-pro impact, adverse mix shifts (pack formats and emerging markets), and higher-than-expected cost inflation. In addition, the Company discussed at length how increased re-investments and brand-building spend on single-serve formats (10% of US Snacks revenue, 2% of Kellogg revenue) created near-term margin pressure but improved top-line. Interestingly, the Company said it would not wait to find "solutions" to offset and reduce these additional costs, instead focusing solely on investments for long-term growth.

While we agree about investing for long-term growth, we find this strategy somewhat hypocritical given Kellogg is currently in the final stages of a near decade long restructuring effort (K LEAN, Project K, & Zero-Based Budgeting). Why spend years cutting costs only to throw large sums of money at a small product category without first understanding how to offset those costs? Moreover, we find it even harder to believe how a product category that accounted for only 2% of revenue was the primary driver behind cutting FY 18 adjusted EBIT guidance from 5-7% growth to flat!

Over the last few quarters, we believe management engaged in some very misleading behavior in an attempt to hide poor performance. The Company:

- Indicated it was aware "very early" in Q3'2018 re-investment and brand-building costs were tracking higher than previously communicated, yet reaffirmed FY'2018 guidance and went so far to say it was "confident" in its outlook on its Q2'2018 Conference Call (one month into Q3). Then at the Barclay's Conference in September (two months into Q3) it said it was "confident" in its growth trajectory and margin expansion
- Unexpectedly announced a complete re-org of its entire North America business as part of Project K, despite indicating two-months ago Project K was "largely complete"
- Announced it would eliminate North America business-unit level disclosures
- Removed the working capital slide from its FY'2018 Investor Presentations and stopped discussing working capital on its Conference Calls as reported core working capital levels started to deteriorate for the first time since FY'2015

Contradictory statements and actively reducing/removing disclosures are all hallmark examples of a company trying to hide something. We have already seen the CEO, CFO, President of North America, and CAO all resign somewhat suddenly; did they know something management isn't telling shareholders? All these activities bring more questions than answers and it's clear to us that something doesn't add up.

So, what do we think actually happened?

As we discussed in our Initiation Report, under former CEO Mr. John Bryant, Kellogg instituted massive cost cuts for nearly a decade and used accounting gimmicks and financial engineering to mask its deteriorating performance and boost short-term sales and cash flow metrics. As a result, we believe new CEO Mr. Steven Cahillane faced a precarious situation. He could either work to eliminate the previous accounting excesses and gimmicks by resetting near- and long-term expectations (essentially wipe the slate clean) or continue with the status quo for a Company at the end of a restructuring cycle; shift focus to revenue growth. He chose the latter. At the CAGNY Conference in February 2018, Kellogg announced its "Deploy for Growth" strategy which called for low-single-digit revenue growth and mid-single-digit EBIT growth.

While it may have seemed like a logical decision for Kellogg to focus on revenue growth after years of restructuring, the Company has a bigger problem; the reversal of all the prior accounting excesses including years of stuffing the channel via extended payment terms. The Company may blame high trade inventory on the DSD transition, but we would argue it's only the tip of the iceberg. DSOs have unsustainably benefited from factoring for several years and as the factoring programs slow, the "unwind" will wreak havoc on sales. We believe the aggressive accounting tactics finally caught up with Kellogg in Q3'2018 and we anticipate things may get much worse before they get better.

Kellogg has told investors its growth trajectory would be "markedly different" from prior years and will feature steady, consistent top-line growth and margin expansion. In reality, we believe the <u>Company is at a crossroads</u>. Kellogg can either (1) spend massively on brand-building/re-investment to maintain sales growth at the expense of margins or (2) let sales growth falter while trying to salvage profitability. Moreover, these are the best-case scenarios! It's highly probable revenue growth and margins will both deteriorate.

Finally, what about buybacks, the dividend, and investment grade credit rating?

Our initial claim Kellogg would have to cut its dividend or risk losing its investment grade credit rating was met with heavy skepticism. However, in the last month we witnessed two stalwarts cut their dividend to shore up the balance sheet. General Electric (GE) cut its dividend by 92% and AB-InBev (BUD) by 50%. Could Kellogg follow suit? We think so.

In some respects, Kellogg already started to reduce shareholder return by drastically slowing share repurchases this year. In the LTM ended Q3'2018, Kellogg spent approximately 5x less on share repurchases than it had in each of previous five years.

While slowing buybacks helped Kellogg's liquidity a little bit, at the end of Q3'2018, it still had barely enough cash to cover its dividends and short-term debt obligations. So, what did Kellogg do? It announced it would divest its cookies, fruit-flavored snacks, pie crusts, and ice cream cone businesses and use the proceeds for debt reduction and/or share buybacks. Kellogg indicated these assets were "freed up" after the DSD exit and had difficultly competing for resources/investments within the portfolio. However, we believe these asset sales were <u>not</u> opportunistic, but necessary to fund buybacks, pay dividends, and shore up the balance sheet.

While this may buy Kellogg some precious time, we don't think it can solve the problem; <u>Kellogg is still substantially less profitable, more levered, and more expensive than meets eye</u>.

High Trade Inventories Blamed on DSD Transition, But That's Just the Tip of the Iceberg; Reversal of Years of Extended DSOs will Wreak Havoc on Revenue Growth Expectations

When a company extends payment terms (i.e. increases DSOs) and incentivizes customers to purchase more inventory than they need and/or typically purchase (i.e. "stuffing the channel"), it effectively pulls forward revenue from future periods. So, if a company continuously expands DSOs, it can continue to pull forward revenue. However, this benefit is transitory and will dissipate/reverse as DSOs "unwind" and return to more normalized levels. This process is not instantaneous and can take time (sometimes several quarters), but it can lead to "revenue misses" as the pulled forward revenue creates a "gap" in current/future period revenue. This "gap" can be further exacerbated if a company used additional levers that created other transitory benefits (e.g. change from "sell-through" to "sell-in" model).

Stuffed channel blamed on DSD transition, guided for trade inventory rationalization to negatively impact growth

On its Q3'2018 Conference Call, the Company effectively admitted to stuffing the channel, confirming suspicions outlined in our Initiation Report. We believed the US Snacks business unsustainably benefited from earlier revenue recognition and the one-time "sell-in" benefit from switching to the warehouse model vs. the Direct Store Delivery ("DSD") model. We started to see these benefits reverse in the last few quarters.; US Snacks revenue declined in each of the last five quarters and were below consensus estimates in three of them.

> *In terms of inventory, when we exited DSD, obviously, it was a major transition that we've been talking about for some time now, where the inventory went from our system into the customer's warehouse system. And over time, **we expected that they would have a higher level of inventory as they got used to, obviously, carrying a whole new line of goods**, and that would be optimized over time, which we would expect. So **we've been expecting inventory to come down, and it has not come down**. So we're not calling that it will come down in Q4, but it may because we're just expecting that retailers like us would look for optimal levels of inventory. So we're not saying that it will happen. But just to be precautionary, we're pointing out that it is possible at some point in time, and it's U.S. Snacks that we're talking about.*
>
> *CEO Mr. Steven A. Cahillane, Q3'2018 Conference Call, 10/31/18 [emphasis added]*

US Snacks Revenue Declined for Fifth Consecutive Quarter

($ in millions)	Q3'2017	Q4'2017	Q1'2018	Q2'2018	Q3'2018
US Snacks revenue*	$764.0	$736.0	$762.0	$745.0	$737.0
Y/Y change	*(4.0%)*	*(4.0%)*	*(4.2%)*	*(8.6%)*	*(3.5%)*
Consensus estimate	$756.1	$723.7	$764.0	$767.3	$736.3
Surprise	*0.5%*	*(0.1%)*	*(0.3%)*	*(2.9%)*	*0.1%*

Source: 10Qs and quarterly Earnings Releases
**Restated to include in the impact of Accounting Standard Updates ("ASU's) adopted in Q1'2018*

The DSD transition certainly contributed to high trade inventories (especially in US Snacks), but the real problem is the Company-wide receivable "unwind" after years of extended DSOs
As discussed in our Initiation Report, we believe Kellogg implemented its extended terms program (in FY'2016) in response to aggressive actions from some of its largest customers (e.g. customer wants a large discount for paying earlier or it will delay payment well beyond regular terms). In order to avoid large early payment discounts, Kellogg accepted longer terms. To mitigate the negative net working capital and cash flow impact from the extended payments term program, Kellogg initiated an accounts receivable factoring program.

At the end of FY'2017, Kellogg discontinued its primary securitization program due to declining customer interest and a change in presentation of the gross proceeds on the cash flow statement. We believe declining customer interest suggested (1) customers no longer wanted to purchase more inventory than what was required given elevated channel inventories and/or (2) customers preferred to take advantage of early payment discounts. To us, this signaled factored receivable levels would probably start to decline (i.e. there would be less need to offset the negative impact from extended terms) and the unsustainable benefits after years of extending DSOs would begin to reverse. This process started to unfold over the last three quarters.

Receivables Sold, but Outstanding Stayed Just Under $1.0 billion

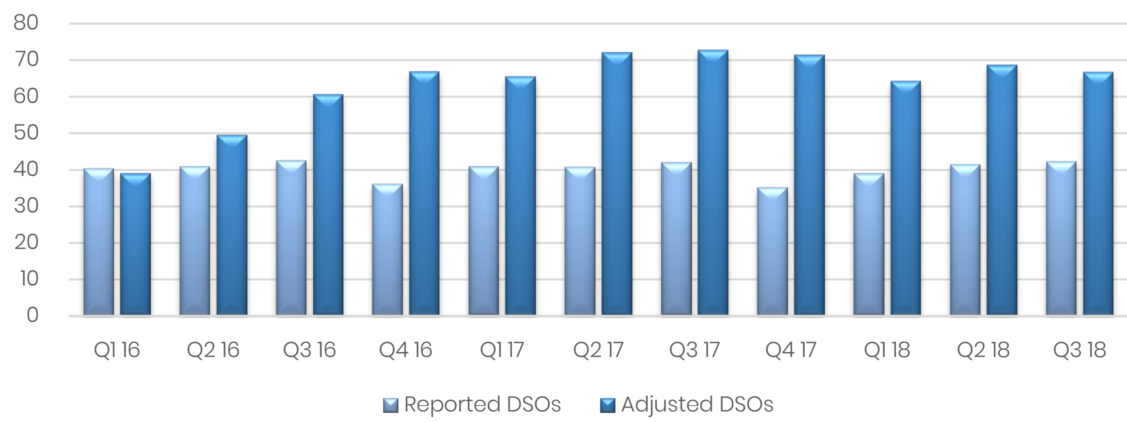
($ in millions)

Source: Company 10Ks and 10Qs

Flat reported DSOs coupled with a decline in adjusted DSOs implies customers are paying on time (or earlier) but could potentially be making fewer and/or smaller purchases as they work through excess channel inventory. We find it highly unlikely customers would actively choose to start paying on-time after years benefitting from extended terms. We think its more reasonable customers were sitting on too much channel inventory and no longer wanted to continue purchasing more inventory than what was required. Instead, we believe customers took (and will continue to take) advantage of early payment discounts; negatively impacting revenue and margins.

In the last two quarters, adjusted DSOs declined 4.7% and 8.5% year-over-year, respectively, while reported DSOs remained relatively flat. It appears customers are sitting on too much inventory and/or would rather have early payment discounts, not a good sign for revenue growth and profitability. While Kellogg may blame brand-building and re-investments, we believe these discounts may have been a contributing factor to weaker FY'2018 profitability. Moreover, the reversal of a stuffed channel/extended DSOs will wreak havoc on sales and cash flow.

Adjusted DSOs Decline, While Reported DSOs Stayed Relatively Flat



Adjusted AR = AR + AR sold, but outstanding
*DSO = Average AR / 3M Sales * 91.25*

CAO Resignation Immediately before Guidance Cut and Working Capital "Unwind" is Incredibly Suspicious

In its 8K on 07/19/18, Kellogg announced VP, Corporate Controller, and Principal Accounting Officer Mr. Donald Mondano resigned to "pursue another opportunity." We find it highly concerning the principal accounting officer resigned just months before the Company cut FY'2018 guidance and shares had the worst day since FY'2000.

As we already discussed, a core part of our thesis is centered around the egregious accounting excess over the past several years, with the majority of the excesses directly related to the US Snacks business (i.e. in North America). So, we find it incredibly suspicious and highly concerning the top two financial/accounting executives (CFO & CAO) and arguably the top two North America business operators (CEO & President, North America) all recently left the Company right as the accounting excesses peaked and are reversing course.

Timeline of Executive Departures & Important Events

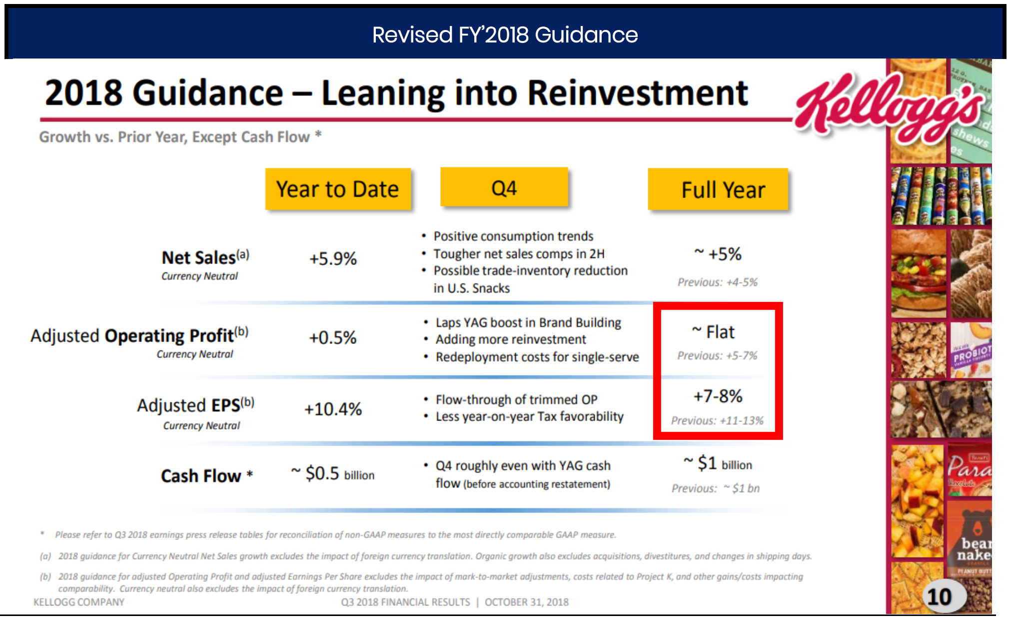
	Date	Accounting Event
Project K Announced	11/02/13	--
CFO Mr. Ron Dissinger resigned	01/13/17	--
Mr. Fareed Khan appointed as CFO	01/13/17	--
CEO Mr. John Bryant resigned, but stayed as Chairman	09/28/17	--
New CEO Mr. Steven Cahillane appointed	09/28/17	--
Adjusted DSOs/factored receivables peak	--	H2'2017
Working capital slide removed from Earnings Presentations	--	Q1'2018
President, Kellogg North America Mr. Paul Norman resigned	02/16/18	--
Mr. John Bryant resigned as Chairman	03/15/18	--
VP, Corporate Controller, Principal Accounting Officer Mr. Donald Mondano resigned	07/16/18	--
Q3'2018 results miss, FY'2018 guidance cut	--	10/31/18
North America restructuring, asset sales announced	--	11/12/18

Source: Company 8Ks

FY'2018 Adjusted EBIT & Earnings Growth Guidance Slashed (As We Predicted); K's Explanation for the Miss Doesn't Make Sense, Appears Deceptive

K attributed guidance revision to weaker Q3'2018 results (particularly gross margin), re-investment in certain businesses, and continued additional brand-building expenditures for single-serve offerings

> *We're bringing down our guidance for currency-neutral adjusted operating profit growth. Some of this reflects Q3 results but also reflects similar dynamics anticipated for Q4. We're putting more investment dollars to work in certain businesses and capabilities, and we decided to continue to expand single-serve even in a high freight cost environment. Again, as Steve mentioned, we could pull back in these areas in order to preserve operating profit, but that would go against what we're trying to do, build momentum for our brands and develop capabilities that will help us sustain sales and profit growth well into the future.*
>
> *CFO Mr. Fareed A. Khan, Q3'2018 Conference Call, 10/31/18*



Source: K Q3'2018 Investor Presentation Slides, 10/31/18

Single-serve is only 10.0% of US Snacks revenue, meaning it's only 2.0% of total revenue. We don't understand how a relatively immaterial product category can have such a material impact on Company margins

Throughout its Q3'2018 Conference Call and Investor Slides, Kellogg highlighted there was "terrific potential" in the single-serve category, however it currently only accounts for 2.0% of revenue. We are highly suspicious brand-building for such a small product category would materially impair Company-wide margins. Instead, we believe underlying profitability across the Company (particularly North America) was weaker than Kellogg had anticipated, and it used the spending on single-serves narrative as a scapegoat.

> *On single-serve, basically, we're seeing a lot of growth in those categories. We like that growth. Long-term, it offers terrific potential. It's already a sizable part of our snacks business, so think about 10% of sales.*
>
> *CFO Mr. Fareed A. Khan, Q3'2018 Conference Call, 10/31/18*

Even sell side analysts were asking Kellogg for an answer (albeit with limited success)

> *Could you just explain a little bit on the evolution of **why is this such a big change? You certainly expand the strategy doing single-serves for a long time now, so I don't perceive that the growth in single-serve was shocking to the Kellogg company.** But I feel like you guys really had a big change of understanding your cost structure of what those products mean. But I just kind of like to understand why that changed so much. And then just to build on that, in the Q1 and Q2 of next year, I think, Fareed, you said that it's a similar magnitude event on what those impacts would be, but you -- could you just confirm that?*
>
> *Citigoup Analyst [emphasis added]*

> ***We chose a high-quality miss versus a low-quality make**. We could have cut back, but the hardest thing to do in consumer packaged goods today is create demand and drive growth.*
>
> *CEO Mr. Steven A. Cahillane, Q3'2018 Conference Call, 10/31/18 [emphasis added]*

> *You have a couple of factors that played out in Q3 that will continue into Q4. And the first of those is our Deploy for Growth investments to really accelerate the top line…in brand building alone, we're greater than the OP decline in the quarter, right? So continue to be very significant. Some of those are around our core brands, some innovation that's coming down the pipeline…The second factor is the single-serve dynamics…those don't get fixed overnight. But over time, as we optimize and streamline some of the supply chain co-pack areas, those margins will come up as probably more of a second half of next year phenomenon. So if you take those together, that's sort of about 2/3 to 3/4 of the pressure. Now in Q4, we do expect continued inflationary pressures in transportation. But from where we saw it at the beginning of the year, it's actually more significant than we expected. We have RGM initiatives on that as well as other cost pressures. But in Q4, you've got sort of a timing balance between those 2 that are going to play out. And then also, we're starting to see some hedging in some of the procurement commodity areas rolling off, and that creates some pressure.*
>
> *CFO Mr. Fareed A. Khan, Q3'2018 Conference Call, 10/31/18*

Kellogg is not waiting to find "solutions" to offset and reduce these additional costs. Is that prudent management? We don't think so

It appears to us the Company is just throwing money at small but expanding product category to show investors it can grow revenue. However, without understanding how to offset and reduce these additional costs, it seems nearly of decade of restructuring and cost cutting programs may have been a waste. Even more concerning; what gives Kellogg confidence the single-serve category will continue to grow? <u>If single-serves slow, it could be a recipe for disaster</u>.

> *We're investing for long-term growth, and building demand and scale for On the Go is a strategic priority for us. **We're also not waiting to find solutions to offset and reduce these costs**.*
>
> *CEO Mr. Steven A. Cahillane, Q3'2018 Conference Call, 10/31/18 [emphasis added]*

"Restrained" FY'2019 operating profit growth guidance gives little comfort these cost pressures will abate anytime soon

On its Q3'2018 Conference Call, the Company indicated some the cost pressures seen in Q3'2018 and Q4'2018 would continue through the first half of FY'2019. Moreover, at its FY'2018 Investor Day on 11/13/18, Kellogg guided for FY'2019 operating profit growth to lag sales growth and be "restrained" due to "significant" investments in brands and capabilities. Without quantitative guidance, it's difficult to say how "restrained" profit growth will be. However, <u>we believe its abundantly clear FY'2019 operating profit growth will be well below initial expectations and any hope of profit growth will be pushed into FY'2020 at the earliest</u>.

> *The co-pack challenges really are solved through investments in the supply chain, many of which are in place. They just don't happen overnight. So **you could see some of these pressures continuing through the first half of next year** as we get co-packing centers put in place, as we have more streamlined back into some of our production lines and we have the capacity to meet the demand growth that we have in place*
>
> *CFO Mr. Fareed A. Khan, Q3'2018 Conference Call, 10/31/18 [emphasis added]*

Timeline of previous guidance reiterations indicates possible deception, something clearly does not add up

At its FY'2018 Investor Day on 11/13/18, Kellogg said it started to see the additional costs play out in early Q3'2018 and decided to not "take off the gas" but continue to push for demand creation. However, Kellogg indicated it could not go public with the information until the end of Q3'2018 even though it knew early in the quarter about these additional costs. We beg to differ.

> *Can you speak to the business planning of 2018 and how necessarily what happened along the journey of 2018, that led to the $100 million delta that you -- I understand the buckets, but like what was the timing and reaction, like why now? It's very rare midyear or 3 quarters through the year that we see this kind of change.*
>
> Analyst
>
> ***We saw the beginnings of this, more than the beginnings of this, very early in the third quarter.*** *Obviously, we talked to you about it at the close of the third quarter, so there's a lag time there. So we made the decision early in the third quarter not to take off the gas but to continue to press against the demand creation. And that's why I said earlier, if there is a mea culpa perhaps we should have worked harder at mitigation [planning] or not taking as much faith in the mitigation plans, because it did get worse. But we made the conscious decision that we were going to continue to execute against our top line strategy but* ***we couldn't become public with it until the close of the third quarter****, which is why it does seem sudden when you're 3 quarters of the way through the year, and you're calling it down. But we knew much earlier than that, that we were making these choices in order to continue the drive our top line strategy.*
>
> *CEO Mr. Steven A. Cahillane, FY'2018 Investor Day, 11/13/18 [emphasis added]*

On its Q2'2018 Conference Call on 08/02/18, Kellogg reiterated FY'2018 adjusted operating profit growth guidance and highlighted it was "confident" in its full year outlook. Keep in mind, Kellogg reported Q2'2018 results more than one-month into Q3'2018. It seems odd to us that if Kellogg was aware "very early" in Q3'2018 that additional brand-building and reinvestment costs were ramping faster than previously communicated it wouldn't take the chance to alert investors on its Q2'2018 Conference Call. We find it even more misleading Kellogg went so far to say it was "confident" in its FY'2018 outlook when it apparently "knew" about these additional costs.

> *Masked by this increase in brand building is a sharp reduction in overhead, mainly related to the DSD exit, but also reflecting good cost disciplines and Project K savings. So Q2 was a quality quarter, marked by an improving top line and heavy reinvestment for future growth and even overcoming unexpected headwinds like the truckers' strike in Brazil.* ***This gives us good confidence in our full year outlook. We are reaffirming our guidance for adjusted operating profit growth*** *of 5% to 7% on a currency-neutral basis...To some degree, our decision to leave operating profit unchanged is related to our first half mix impact, but it also reflects our desire to maintain the opportunity to reinvest more.*
>
> *CFO Mr. Fareed A. Khan, Q2'2018 Conference Call, 08/02/18 [emphasis added]*

Kellogg was given a second opportunity to alert investors about these unexpectedly high costs at the Barclay's Global Consumer Staples Conference on 09/05/18, more than two-thirds of the way into Q3'2018; yet it did not. While the Company did not explicitly discuss or reiterate FY'2018 guidance, Kellogg continued to highlight it was "confident" its growth trajectory was "markedly different" from recent years and featured steady, consistent top-line growth and margin expansion. With nearly two-thirds of Q3'2018 complete, we find it hard to believe Kellogg wasn't well aware it's margins were tracking below guidance. Why not tell investors? We think the Company was scrambling to find a scapegoat and needed more time to craft a story the street would buy. Well, we are not buying it!

> *What excites me most is that we're applying the same intensity and executional focus to this investment in growth that was so successfully applied to a reduction -- to our cost reduction over the course of the last couple of years. This is why **we're confident** that we can ultimately emerge from this investment stage with a **growth trajectory that is markedly different from recent years**, one that features a balance of steady, consistent top line growth, balanced with **steady, consistent margin expansion**.*

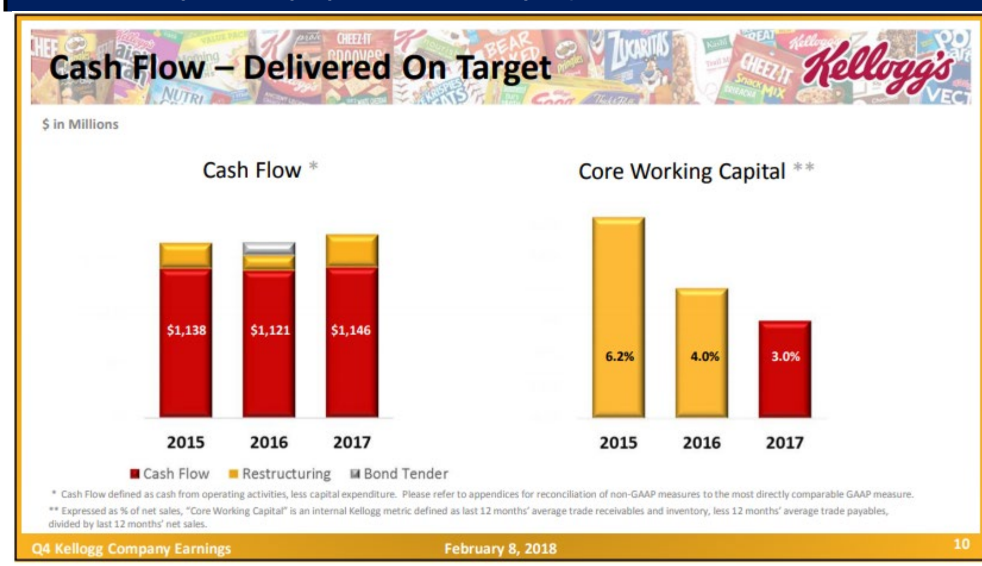
CEO Mr. Steven A. Cahillane, Barclay's Global Consumer Staples Conference, 09/05/18 [emphasis added]

More Obfuscation? Kellogg Removed Working Capital Slide from its FY'2018 Investor Presentations, Just as the Previously Reported Metric Deteriorates

In Q2'2015, Kellogg first included a slide in its Investor Slides that highlighted core working capital ("working capital") improvement. In FY 2015, Kellogg indicated its working capital was "best-in-class" and guided for further improvement to offset the cash requirements of Project K and improve operating cash flow; which would be used for dividends and share repurchases. In subsequent years, Kellogg continued to tout it had "industry leading" working capital levels and guided for long-term working capital levels to be between 3% and 4%. However, in its Q1'2018 Earnings Presentation, Kellogg removed the working capital slide and for the first time since Q2'2015 did not discuss working capital levels on its Conference Call.[1]

Q4'2017: Kellogg highlighted improved working capital

K Management Highlighted Core Working Capital Levels Continued to Decline



Source: K Q4'2017 Investor Presentation Slides, 02/08/18

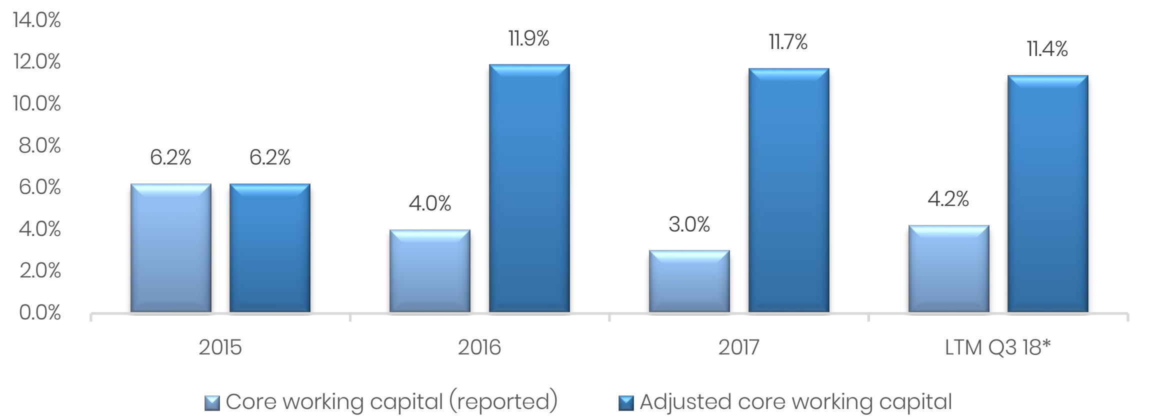
[1] See Appendix for additional Company commentary about working capital levels.

"Reported" core working capital levels deteriorated for the first time since FY'2015, but most investors wouldn't know: Kellogg removed the working capital slide from its FY'2018 Presentations – incredibly misleading behavior
In each of its quarterly Investor Slides in FY'2018, the Company omitted the working capital slide. Historically, the Company was extremely vocal about touting its "Best-in-Class" working capital levels (albeit without acknowledging it factored receivables). Interestingly, LTM "reported" core working capital levels in FY'2018 deteriorated for the first time since FY'2015 and were above its long-term guidance range of 3% to 4%., while adjusted core working capital remained well above reported levels.

Why did Kellogg remove this slide?

We think the Company wanted to avoid any analyst questions about what caused the deterioration and to hide the fact that "reported" core working levels over the last four years was unsustainably low due to the receivable factoring program.

MGMT Removed Core Working Capital Slide As "Reported" Levels Deteriorate



Source: Company filings, Prescience Point estimates
Adjusted core working capital = (LTM average trade receivables + LTM average inventory + receivables sold, but outstanding – LTM trade payables) / LTM net sales.
*K did not report a core working capital metric in Q1 18. Prescience Point estimated the "Reported" metric based on K's definition of core working capital; (LTM average trade receivables + LTM average inventory – LTM average payables) / LTM net sales.

North America Re-Org/Supply Chain Buildout Leads to More Obfuscation and a Likely Scapegoat for Poor FY'2019 Performance

Profit continued to be artificially inflated by excluding recurring "non-recurring" costs from adjusted results
So, not only did the Company massively reduce adjusted EBIT guidance, but it simultaneously raised its Project K & Cost Restructuring guidance more than 50.0% to $157.5 million at midpoint. Remember, the Company excludes Project K and Cost Restructuring activities from its adjusted results. As we argued before, recurring "non-recurring" costs should not be excluded from adjusted results; we believe this is another means of artificially inflating profit.

FY'2018 Project K & Cost Restructuring Activities	
($ in millions)	
Prior guidance	$90.0 - $110.0
Raised guidance	$150.0 - $165.0
% change (at midpoint)	*57.5%*

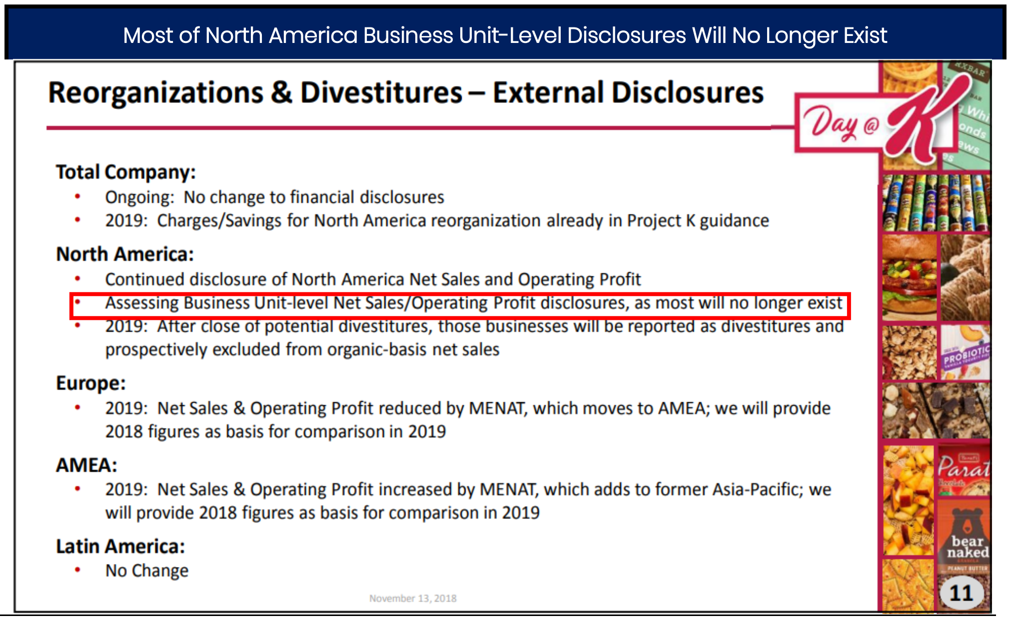
Source: Company 8Ks

Four changes announced to Kellogg's North America organizational structure at FY'2018 Investor Day
In its Press Release on 11/12/18, Kellogg announced four primary changes to its North America organizational structure:

- US Morning Foods, Snacks and Frozen Foods businesses will be consolidated into a single, categories-focused organization comprising 80% of Kellogg North America ("KNA") revenue
- Morning Foods, Snacks and Frozen and Retail Channels sales teams combined within a single Kellogg US sales organization
- Building a consolidated, end-to-end KNA Supply Chain including procurement, manufacturing, logistics, and customer services
- Investing in new eCommerce and Integrated Business Planning capabilities

In addition, Kellogg indicated the reorganization was one of the final planned initiatives under the Project K restructuring program. As such, its up-front costs and ongoing savings were included in the previously communicated financial estimates for the five-year Project K program.

Eliminating North America business unit-level disclosures will obfuscate results; Kellogg may be trying to hide poor underlying performance by providing less granularity
In its FY'2018 Investor Day Slides, Kellogg indicated it was assessing business unit-level net sales/operating profit disclosures, as most will no longer exist. In our experience, limited disclosure can make analysis more difficult, but <u>actively reducing disclosure is usually a reliable indicator the Company is trying to hide something; typically, poor performance</u>.



Source: K FY'2018 Investor Day Slides, 11/13/18

We don't believe the additional Project K restructuring/reorganization efforts were originally planned; just two months ago (September 2018) Kellogg said its Project K restructuring was "largely completed"

At Barclay's Global Consumer Staples Conference on 09/05/18, Kellogg highlighted it had "largely completed" its Project K restructuring. While the Company indicated these recently announced restructuring efforts were "planned" and already included in the previously communicated estimates, it seems contradictory to commentary only two months ago at the Barclay's conference. To us, "largely completed" suggests there could potentially be a few additional small initiatives left in FY'2018 (at most), <u>NOT</u> a complete reorganization of the entire North America business unit AND a new end-to-end supply chain.

> *We've launched our Deploy for Growth strategy. This formally shifts focus toward top line growth now that cost structure has been properly identified. Today, we'll talk more about some of the less visible changes that Deploy for Growth has prompted.* ***We've largely completed our Project K restructuring****. This has reduced our cost structure and it included the transition out of DSD, which frees up resources for U.S. Snacks to invest behind its brands while enhancing its profitability.*

CEO Mr. Steven A. Cahillane, Barclay's Global Consumer Staples Conference, 09/05/18 [emphasis added]

We think Kellogg may be setting up the North America re-org/supply chain build-out to take the blame for poor underlying profitability in FY'2019

In our experience, management teams, analysts, and investors are often more willing to accept lower profitability (or give companies a pass) during times of restructuring, but time and time again, restructuring and re-org plans get pushed out or don't yield the expected cost savings. In effect, restructuring plans become an easy scapegoat to blame for poor profitability or at least it's better than the alternative; admit the underlying business in actually underperforming. We think the case is no different at Kellogg. We believe something happened in Q3'2018 to make Kellogg management realize their profitability expectations (and consensus estimates) were way too high. However, instead of admitting margins were underperforming, Kellogg blamed brand-building/re-investments and announced, what we believe to be, a previously <u>unplanned</u> restructuring initiative. It would not surprise us if these restructuring efforts take longer than the

Company anticipates, and we believe this sets the stage for the North America re-org to take the blame for poor underlying profitability in FY'2019 (and maybe beyond).

K Generates Barely Enough Cash to Cover Dividend/Current Debt Obligations & Is Significantly More Leveraged Than it Appears

K generates barely enough cash to cover dividend and current debt obligations
The only adjustment we made to FY'2018 consensus EBITDA was a 50% addback of Project K/restructuring charges. We believe this estimate is extremely conservative. So, even with conservative estimates, K barely generates enough cash to cover its dividend and current debt obligations. We believe it's highly likely run-rate EBITDA could be materially lower as the accounting excess reverse.

Small Cash Surplus Suggests Limited Capital Flexibility

($ in millions)	
Prescience Point FY'2018 adjusted EBITDA*[2]	$2,321.5
Less: interest expense**	$283.0
Less: capital expenditure**	$545.0
Less: income taxes**	$329.0
Amount left to cover debt obligations and dividends	**$1,164.5**
Less: dividends***	$771.3
Amount left to cover debt obligations	**$393.2**
Less: current maturities of long-term debt	$6.0
Less: notes payable	$202.0
Surplus/(deficit)	$185.2

Source: Company 10Ks, 10Qs, 8Ks
**Prescience Point estimate*
***FY'2018 FactSet estimates*
**** Prescience Point estimate based on 349 million average shares outstanding and FactSet estimate of FY'20 18 dividends of $2.21/share.*

K is significantly more leveraged than it appears
All of Kellogg's peers with net debt/EBITDA above 4.0x have non-investment grade credit ratings. We believe Kellogg's adjusted net debt/EBTIDA of 4.5x suggests it may soon join its non-investment grade peers. Again, while a high net debt/EBITDA does not mean Kellogg's credit rating should be instantly downgraded, we do believe it corroborates the fact that Kellogg has limited capital structure flexibility.

[2] See Appendix for detailed calculated of adjusted EBITDA.

Adjusted Total Debt/EBITDA of 4.5x Suggests Credit Downgrades May Be Imminent	
($ in millions)	Q3'2018
Current maturities of long-term debt	$6.0
Notes payable	$202.0
Long-term debt	$8,715.0
Receivables sold, but still outstanding	$965.0
Estimated amount of extended DPO	$972.5
Cash	($309.0)
Prescience Point Adjusted Net debt	$10,551.5
Prescience Point FY'2018 adjusted EBITDA	$2,321.5
Adjusted net debt/EBITDA	4.5x

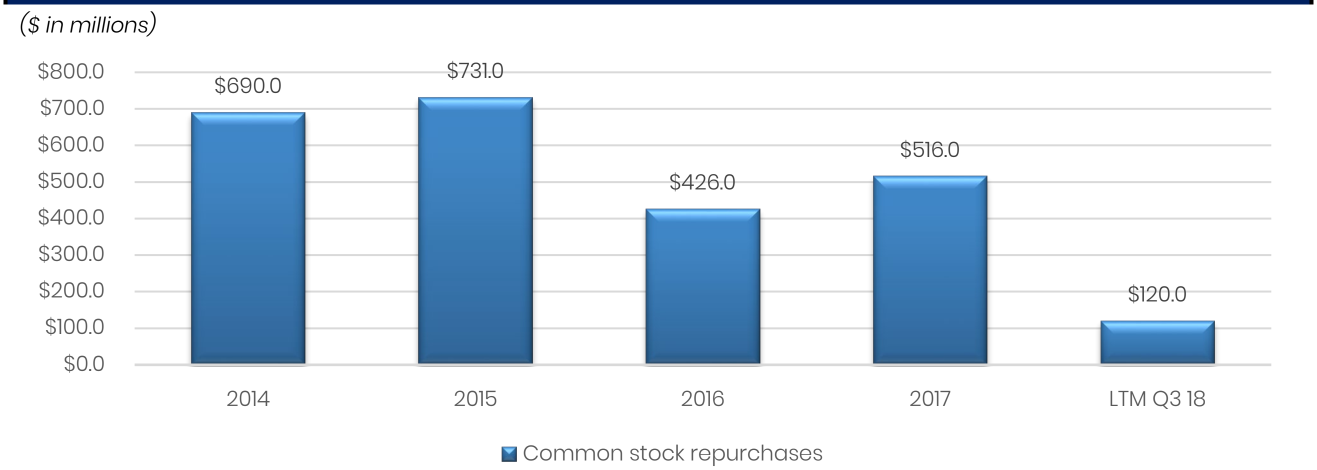
Source: Company 10Ks, 10Qs, 8Ks, Prescience Point estimates

Divestiture is Necessary (not Opportunistic) to Resume Buybacks, Pay Dividend, & Temporarily Save its Credit Rating

Did K slow/halt share repurchases to conserve cash and avoid downgrade?

In December 2017, Kellogg's Board of Directors approved a share purchase plan of up to $1.5 billion beginning in January 2018 through December 2019. As of Q3'2018, LTM share repurchases were $120.0 million (the lowest level in over five years).

Share Buybacks at Lowest Level in Over Five Years



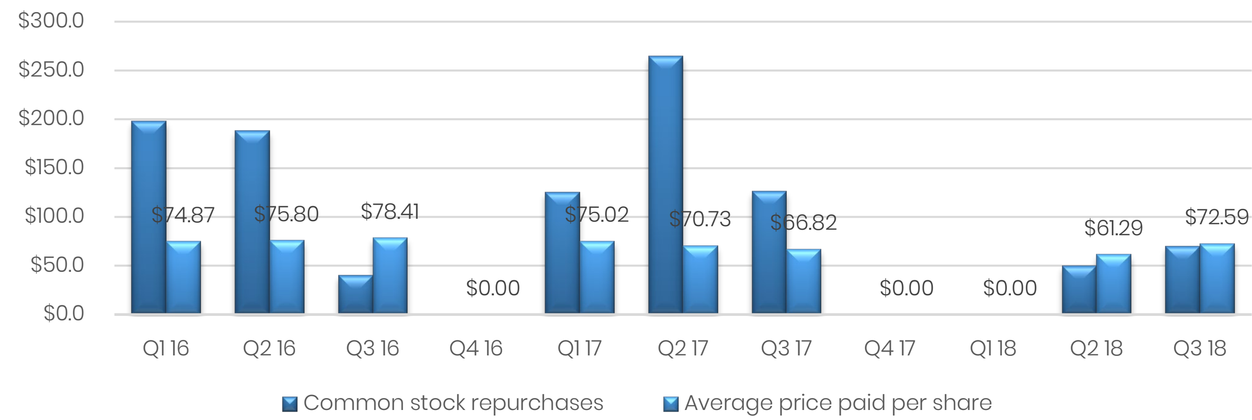
Source: Company 10Ks & 10Qs

From Q4'2017 to Q2'2018, share prices were at or near-multi year lows, yet buybacks were miniscule. If management really believed in the long-term prospects of the business, it should have been buying shares aggressively

Surprising, share buybacks slowed despite the average price paid per share being at multi-year lows. Why would Kellogg not buyback more shares when its average price paid per share was well below prior levels and it had ample authorization capacity? <u>We believe it couldn't buyback shares or it would risk a credit downgrade</u>.

Shares Repurchases Well Below Historical Levels Despite Lower Average Share Price

($ in millions, except per share data)



Source: Company 10Ks & 10Qs

Sale of cookies and fruit snacks businesses is <u>not</u> opportunistic, Kellogg <u>needs</u> the cash for buybacks and debt reduction

In its FY'2018 Investor Day Slides, Kellogg announced it was exploring the potential sale of its cookies, fruit-flavored snacks, pie crusts and ice cream cones businesses. The Company indicated these brands have had difficulty competing for resources and investments within its portfolio. Aggregate estimated FY'2018 net sales for the possible divestitures is $900.0 million. Moreover, Kellogg highlighted it would use the proceeds for debt reduction for future acquisitions and/or share buybacks.

Interestingly, on its Q3'2018 Conference Call, Kellogg highlighted it "resumed investment support" behind several key cookies brands to bring them back into consumption and share growth. At the time, we interpreted this to mean the Company had previously not focused on investments in its cookies business but changed course in Q3'2018. We find it somewhat unusual to re-invest in a product category during the quarter only to announce its sale a few weeks later due to "difficulty competing for resources and investment."

> ***In cookies, resumed investment support*** *behind Keebler Fudge Shoppe, Keebler Grahams, Mother's and Famous Amos is bringing these key brands back into consumption and share growth, stabilizing our share overall. Across our snacks categories, we like what we're seeing in base sales and velocities.*
>
> *CEO Mr. Steven A. Cahillane, Q3'2018 Conference Call, 10/31/18 [emphasis added]*

After realizing profitability was going to be well below expectations and growth would be "restrained" through FY'2019, we believe the Company needed to divest assets and raise cash to fund its dividend, share repurchases, and ultimately save its credit rating (at least temporarily).

Other Stalwarts (AB InBev & GE) Cut Dividends to Improve Balance Sheet; Will Kellogg Follow Suit?

Over the last month, two stalwarts drastically cut their dividend to improve the balance sheet and accelerate debt paydown. While each of those companies had their own unique obstacles, we think Kellogg may follow suit.

AB InBev cuts dividend by 50%
In its Press Release on 10/25/18, AB InBev (BUD) announced it would reduce its dividend from €1.60 per share to €0.80 per share, a 50% reduction. Moreover, AB InBev said the dividend cut would help accelerate its deleveraging program.

> *Consistent with these long-standing capital allocation priorities and in light of recent currency volatility, we are rebasing our dividend payout to accelerate deleveraging toward our optimal capital structure of around a net debt to EBITDA, as defined (adjusted for exceptional items), ratio of around 2x while continuing to prioritize investment in organic growth opportunities and creating greater financial flexibility.*
>
> *BUD Q3'2018 Press Release, 10/25/18*

GE cuts dividend by 92%
In its Press Release on 10/30/18, General Electric (GE) announced it would reduce its dividend from $0.12 per share to $0.01 per share, a 92% reduction. On its Q3'2018 Conference Call, GE said the dividend cut was fundamentally straightforward; to preserve cash and de-lever the business.

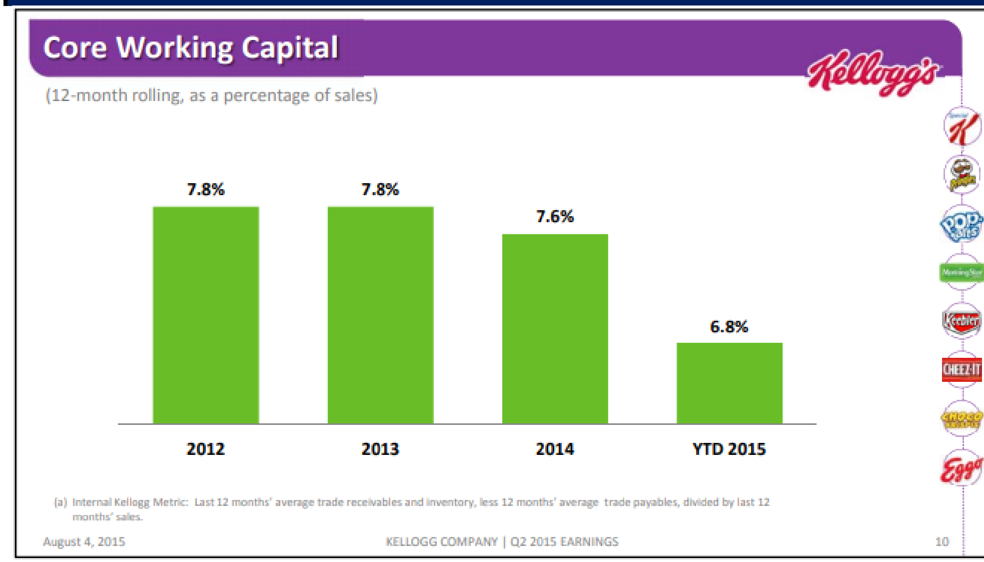
> *The dividend move today, to me, fundamentally is straightforward given our desire to preserve that cash to help de-lever the business. We have a lot of options. We laid these out, I think, in some detail back in June. Certainly, the strategy that we talked about relative to de-risking and focusing the portfolio is very much intact today. How we move through those various options, the timing, the pace of sequencing, is something very much on the table to make sure that we tend to the balance sheet as quickly as we can. We don't want to be rushed. We don't want to be rash, but we need to get after this straight away. And I hope today's move on the dividend is evidence of that intent in action.*
>
> *GE CEO Mr. H. Lawrence Culp, Q3'2018 Conference Call, 10/30/18*

Appendix

Q2'2015: Working capital slide first included in Earnings Presentation; Kellogg touts working capital as "best-in-class"

> *Slide 10 shows our core working capital as a percentage of net sales. As you can see, our performance had flattened out over the past several years. But we have made a lot of progress improving our position recently, and have best-in-class levels of working capital.*
>
> *CFO Mr. Ron Dissinger, Q2'2015 Conference Call, 08/04/15*

K Management First Highlighted Improved Core Working Capital Levels in Q2'2015 Slides



Source: K Q2'2015 Investor Presentation Slides, 08/04/15

FY 2015 Barclays Conference: Kellogg guided to improve working capital "even further" to drive stronger cash flow; cash flow to be returned to shareholders through dividends and share repurchases

> *Back in 2012, 2013, our core working capital was a little less than 8% to sales on a rolling 12 month basis. We showed in our second quarter earnings call that we've dropped that by a point. We are a little under 7%. So <u>we've made good headway in reducing our working capital on our balance sheet and we have plans to improve it even further to drive stronger cash flow</u>. And of course, <u>we return that cash flow to our shareowners, through our dividend program</u> and share repurchases as well.*
>
> *CFO Mr. Ron Dissinger, Barclays Global Consumer Staples Conference Call, 09/09/15*

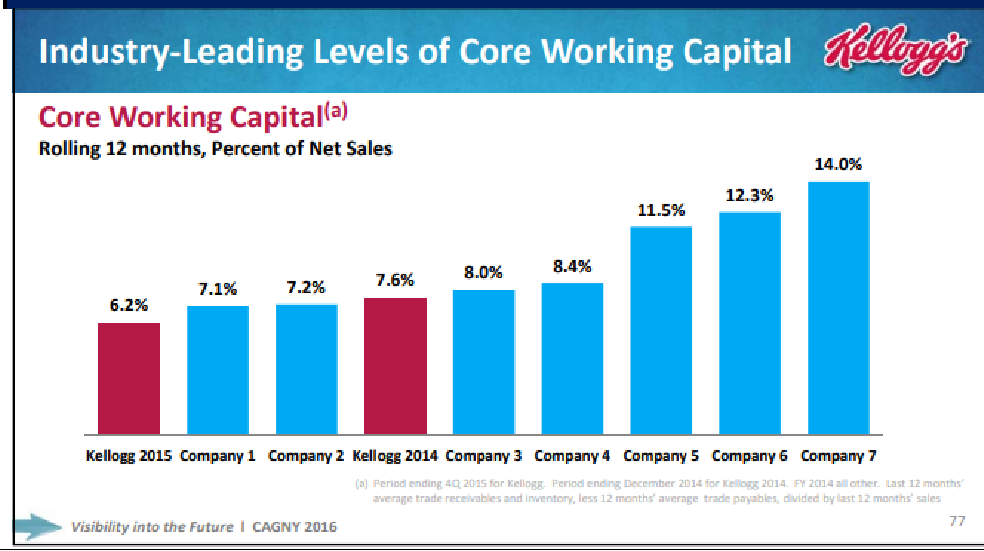
Q4'2015: Working capital "improvements" used to offset the cash requirements for Project K

> *Our cash for Project K is a couple hundred million dollars. And what we're doing is, we are continuing to roll out that supplier financing initiative to offset the cash requirements for Project K. We did just that in 2015, and we were able to offset the cash requirements for Project K based on the improvements we saw in our core working capital. So we're expecting the same thing in 2016, and that is what is allowing us to convert our net income to cash at 100%.*

CFO Mr. Ron Dissinger, Q4'2015 Conference Call, 02/11/16

FY 2016 CAGNY Conference: Touted "Industry leading" working capital metrics

"Industry Leading" Core Working Capital Metrics Touted



Source: K CAGNY Presentation Slides, 02/17/16

FY 2016 Barclays Conference: K guided for long-term working capital levels to be in the 3% to 4% range

> *<u>We have been very disciplined on core working capital</u>, and I'll show you a slide in a minute on the progress that we've made on our core working capital. We've remained disciplined on capital spending as well. <u>We fully expected to get down into that 3% to 4%</u> capital spending range as a percent to sales <u>over the long term</u>.*

CFO Mr. Ron Dissinger, Barclays Global Consumers Staples Conference, 09/07/16

Prescience Point adjusted EBITDA calculation

Prescience Point Adjusted EBITDA	
($ in millions)	FY'2018
Consensus estimate	$2,399.0
(-) Restructuring charges adjustment (50%)	($77.5)
Prescience Point adjusted EBITDA	$2,321.5

Source: Company 10Ks, 10Qs, 8Ks, Prescience Point estimates

Restructuring charges adjustment

In our Initiation Report, we argued excluding "non-recurring" restructuring charges that persist for more than five years does not accurately reflect the costs associated with running the business. If a business needs perpetual restructuring, the costs should not be excluded as "non-recurring." In addition, persistent restructuring charges provide the Company an opportunity to bucket normal recurring costs as "restructuring" and have them excluded from non-GAAP results. An argument could be made that all restructuring charges should be included in comparable operating income (and EBITDA), but to be on the more conservative side, we only included 50% of the restructuring charges in our adjusted EBITDA metric.

Restructuring Charges Adjustment

($ in millions)	FY'2018
Project K & cost restructuring guidance (at midpoint)	$155.0
Prescience Point adjustment (%)	50.0%
Prescience Point adjustment ($)	$77.5

Source: Company 10Ks, 10Qs, 8Ks, Prescience Point estimates

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