

## ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Kellogg Company and Subsidiaries

### RESULTS OF OPERATIONS

#### Overview

The following Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") is intended to help the reader understand Kellogg Company, our operations and our present business environment. MD&A is provided as a supplement to, and should be read in conjunction with, our Consolidated Financial Statements and the accompanying notes thereto contained in Item 8 of this report.

Kellogg Company is the world's leading producer of cereal and a leading producer of convenience foods, including cookies, crackers, toaster pastries, cereal bars, fruit snacks, frozen waffles, and veggie foods. Kellogg products are manufactured and marketed globally. We currently manage our operations in four geographic operating segments, comprised of North America and the three International operating segments of Europe, Latin America, and Asia Pacific. Beginning in 2007, the Asia Pacific segment includes South Africa, which was formerly a part of Europe. Prior years were restated for comparison purposes.

We manage our Company for sustainable performance defined by our long-term annual growth targets. These targets are low single-digit (1 to 3%) for internal net sales, mid single-digit (4 to 6%) for internal operating profit, and high single-digit (7 to 9%) for net earnings per share on a currency neutral basis. See "Foreign currency translation" section on page 15 for an explanation of the Company's definition of currency neutral.

For our full year 2008, we exceeded our net sales target with reported net sales growth of 9%, and internal growth of 5.4%. Consolidated operating profit increased 4.5%, on internal growth of 4.2%, in line with our target. Reported diluted earnings per share grew 8%, within our target, to \$2.99 per share, while currency neutral EPS grew 10%.

| Consolidated results<br>(dollars in millions except per share data) |             |             |             |
|---|-------------|-------------|-------------|
|   | 2008        | 2007        | 2006        |
| Net sales   | \$12,822    | \$11,776    | \$10,907    |
| Net sales growth: As reported                                       | 8.9%        | 8.0%        | 7.2%        |
| Internal (a)  | <b>5.4%</b> | <b>5.4%</b> | <b>6.8%</b> |
| Operating profit  | \$ 1,953    | \$ 1,868    | \$ 1,766    |
| Operating profit growth: As reported (b)                            | 4.5%        | 5.8%        | .9%         |
| Internal (a)  | <b>4.2%</b> | <b>3.1%</b> | <b>4.3%</b> |
| Diluted net earnings per share (EPS)                                | \$ 2.99     | \$ 2.76     | \$ 2.51     |
| EPS growth (b)  | <b>8%</b>   | <b>10%</b>  | <b>6%</b>   |
| Currency neutral diluted EPS growth (c)                             | <b>10%</b>  | <b>7%</b>   | <b>11%</b>  |

- (a) Internal net sales and operating profit growth for 2008 exclude the impact of currency, a 53<sup>rd</sup> shipping week and acquisitions. Internal net sales and operating profit for 2007 and 2006 excludes the impact of currency. Additionally, internal operating profit growth for 2006 excludes the impact of adopting SFAS No. 123(R) "Share-Based Payment". Accordingly, internal net sales operating profit growth is a non-GAAP financial measure, which is further discussed and reconciled to GAAP-basis growth on page 13.
- (b) At the beginning of 2006, we adopted SFAS No. 123(R) "Share-Based Payment," which reduced our fiscal 2006 operating profit by \$65 million (\$42 million after tax or \$.11 per share), due primarily to recognition of compensation expense associated with employee and director stock option grants. Correspondingly, our reported operating profit and net earnings growth for 2006 was reduced by approximately 4% and diluted net earnings per share growth was reduced by approximately 5%.
- (c) See section entitled "Foreign currency translation" for discussion and reconciliation of this non-GAAP financial measure.

In combination with an attractive dividend yield, we believe this profitable growth has and will continue to provide a strong total return to our shareholders. We believe we can achieve this sustainable growth through a strategy focused on growing our cereal business, expanding our snacks business, and pursuing selected growth opportunities. We support our business strategy with operating principles that emphasize profit-rich, sustainable sales growth, as well as cash flow and return on invested capital. We believe our steady earnings growth, strong cash flow, and continued investment during a multi-year period of significant commodity and energy-driven cost inflation demonstrates the strength and flexibility of our business model.

## Net sales and operating profit

### 2008 compared to 2007

The following tables provide an analysis of net sales and operating profit performance for 2008 versus 2007:

| (dollars in millions)               | North America  | Europe         | Latin America  | Asia Pacific (a) | Corporate   | Consolidated    |
|-------------------------------------|----------------|----------------|----------------|------------------|-------------|-----------------|
| <b>2008 net sales</b>               | <b>\$8,457</b> | <b>\$2,619</b> | <b>\$1,030</b> | <b>\$716</b>     | <b>\$ —</b> | <b>\$12,822</b> |
| <b>2007 net sales</b>               | <b>\$7,786</b> | <b>\$2,357</b> | <b>\$984</b>   | <b>\$649</b>     | <b>\$ —</b> | <b>\$11,776</b> |
| % change — 2008 vs. 2007:           |                |                |                |                  |             |                 |
| Volume (tonnage) (b)                | 1.3%           | -2%            | -2.6%          | 6.3%             | —           | .9%             |
| Pricing/mix                         | 4.5%           | 3.9%           | 6.9%           | 1.8%             | —           | 4.5%            |
| <b>Subtotal — internal business</b> |                |                |                |                  |             |                 |
| <b>business</b>                     | <b>5.8%</b>    | <b>3.7%</b>    | <b>4.3%</b>    | <b>8.1%</b>      | <b>—</b>    | <b>5.4%</b>     |
| Acquisitions (c)                    | .9%            | 5.5%           | —              | 3.4%             | —           | 1.8%            |
| Shipping day differences (d)        | 1.9%           | 1.2%           | .5%            | 1.0%             | —           | 1.7%            |
| Foreign currency impact             | —              | .7%            | -1%            | -2.2%            | —           | —               |
| <b>Total change</b>                 | <b>8.6%</b>    | <b>11.1%</b>   | <b>4.7%</b>    | <b>10.3%</b>     | <b>—</b>    | <b>8.9%</b>     |

| (dollars in millions)        | North America  | Europe       | Latin America | Asia Pacific (a) | Corporate      | Consolidated   |
|------------------------------|----------------|--------------|---------------|------------------|----------------|----------------|
| <b>2008 operating profit</b> | <b>\$1,447</b> | <b>\$390</b> | <b>\$209</b>  | <b>\$92</b>      | <b>\$(185)</b> | <b>\$1,953</b> |
| <b>2007 operating profit</b> | <b>\$1,345</b> | <b>\$397</b> | <b>\$213</b>  | <b>\$88</b>      | <b>\$(175)</b> | <b>\$1,868</b> |
| % change — 2008 vs. 2007:    |                |              |               |                  |                |                |
| <b>Internal business</b>     | <b>5.9%</b>    | <b>-6%</b>   | <b>-1.5%</b>  | <b>11.0%</b>     | <b>-2.8%</b>   | <b>4.2%</b>    |
| Acquisitions (c)             | -8%            | -6%          | —             | -6.2%            | —              | -1.0%          |
| Shipping day differences (d) | 2.5%           | 1.2%         | -9%           | .8%              | -1.9%          | 1.8%           |
| Foreign currency impact      | -1%            | -1.9%        | .4%           | -1.8%            | —              | -5%            |
| <b>Total change</b>          | <b>7.5%</b>    | <b>-1.9%</b> | <b>-2.0%</b>  | <b>3.8%</b>      | <b>-4.7%</b>   | <b>4.5%</b>    |

(a) Includes Australia, Asia and South Africa.

(b) We measure the volume impact (tonnage) on revenues based on the stated weight of our product shipments.

(c) Impact of results for the year-to-date period ended January 3, 2009 from the acquisitions of United Bakers, Bear Naked, Navigable Foods, Specialty Cereals and certain assets and liabilities of the Wholesome & Hearty Foods Company and IndyBake.

(d) Impact of 53rd shipping week in 2008.

During 2008, our consolidated net sales increased almost 9% driven by our North America business with increases in both volume and price/mix for the year. Internal net sales grew over 5%, building on a 5% rate of internal growth during 2007. We had a fifty-third week in our 2008 fiscal year which contributed almost 2% to our reported growth over the prior year as did our acquisitions. For further information on our acquisitions refer to Note 2 within Notes to Consolidated Financial Statements beginning on page 35. Management has estimated the pro forma effect on the Company's results of operations as though these business combinations had been completed at the beginning of either 2008 or 2007 would have been immaterial. Successful innovation, brand-building (advertising and consumer promotion) investment as well as our recent price increases continued to drive growth. Declines in volume in both Europe and Latin America were more than offset by growth in pricing/mix due to our price increases. Asia Pacific had a particularly strong year experiencing

growth of 8% driven by cereal sales across the operating segment.

For 2008, our North America operating segment reported a net sales increase of almost 9% with internal net sales growth of 6%. The growth was broad based and driven by our price realization and strong innovation. The major product brands grew as follows: retail cereal +3%; retail snacks (cookies, crackers, toaster pastries, cereal bars, and fruit snacks) +6%; frozen and specialty channels (frozen foods, food service and vending) +9%. While retail cereal grew 3% for the year, we had a relatively soft share performance in the fourth quarter facing aggressive price-based incentives from our competitors. In addition, while we estimate our consumption was up 2% across all channels, reductions in trade inventory also adversely affected shipments. As a result, our fourth quarter internal net sales declined by 3% which was up against a tough comparable of 8% growth in the prior year. Our snacks business grew 6% in 2008 on top of 7% growth last year. Our growth came from volume, price increases, and successful innovations such as *Townhouse Flipsides* and *Cheez-It Duoz*. We saw net sales growth in all product categories — toaster pastries, crackers, cookies and wholesome snacks. Our "Right Bites" 100 calorie cookie and cracker packs performed well as we saw an increase in demand for portion controlled portable food. Our specialty and frozen channels grew over 9%. Our food service business performed well, achieving mid single-digit growth for the year. Frozen realized strong sales driven by innovations such as *Bake Shop Swirlz*, *Mini Muffin Tops* and *French Toast Waffles*.

Our International operating segments collectively achieved net sales growth of 9%, or 5% on an internal basis. Europe's internal net sales grew by almost 4% attributable to price/mix, as volume was down slightly. The UK and continental Europe have been impacted by the economic crisis which has consumers searching for value and retailers reducing inventory. Snacks products are performing well across the region, especially in the UK driven by *Rice Krispies Squares*. Latin America's internal net sales growth was 4% attributable to our price increases and driven by cereal sales in Mexico and Venezuela. This year's growth is on top of last year's 9% growth. Volume was down for the year due to the economic environment which is impacting consumer confidence. Asia Pacific had a very strong year with 8% internal net sales growth. The growth was volume driven and broad based in both retail cereal and retail snacks.

Consolidated operating profit grew by almost 5% on an as reported basis and 4% on an internal basis. Operating profit in all areas was impacted by significant cost pressures as discussed in more detail in the "Margin performance" section beginning on page 14. North America grew by 6% driven by growth in net sales and lower exit costs which offset higher

commodity costs. Costs associated with the peanut-related recall of Kellogg products adversely impacted North America's operating profit by \$34 million or 2% of the full year operating profit. See the "Subsequent event" section on page 18 for more details. Operating profit declined slightly in both Europe and Latin America due to increased commodity costs and cost reduction initiatives. Asia Pacific's operating profit increased 11% on an internal basis due to strong top line growth. On a consolidated basis, operating profit from acquisitions decreased internal operating profit by 1%, in line with our expectations, with Europe and Asia Pacific being particularly impacted by our Russian and Chinese acquisitions, respectively.

## 2007 compared to 2006

The following tables provide an analysis of net sales and operating profit performance for 2007 versus 2006:

| (dollars in millions)               | North America  | Europe         | Latin America | Asia Pacific (a) | Corporate   | Consolidated    |
|-------------------------------------|----------------|----------------|---------------|------------------|-------------|-----------------|
| <b>2007 net sales</b>               | <b>\$7,786</b> | <b>\$2,357</b> | <b>\$984</b>  | <b>\$649</b>     | <b>\$ —</b> | <b>\$11,776</b> |
| <b>2006 net sales</b>               | <b>\$7,349</b> | <b>\$2,057</b> | <b>\$891</b>  | <b>\$610</b>     | <b>\$ —</b> | <b>\$10,907</b> |
| % change — 2007 vs. 2006:           |                |                |               |                  |             |                 |
| Volume (tonnage) (b)                | 1.7%           | 2.2%           | 6.5%          | -.9%             | —           | 2.1%            |
| Pricing/mix                         | 3.8%           | 3.1%           | 2.3%          | .6%              | —           | 3.3%            |
| <b>Subtotal — internal business</b> | <b>5.5%</b>    | <b>5.3%</b>    | <b>8.8%</b>   | <b>-.3%</b>      | <b>—</b>    | <b>5.4%</b>     |
| Foreign currency impact             | .5%            | 9.3%           | 1.6%          | 6.7%             | —           | 2.6%            |
| <b>Total change</b>                 | <b>6.0%</b>    | <b>14.6%</b>   | <b>10.4%</b>  | <b>6.4%</b>      | <b>—</b>    | <b>8.0%</b>     |

| (dollars in millions)        | North America  | Europe       | Latin America | Asia Pacific (a) | Corporate      | Consolidated   |
|------------------------------|----------------|--------------|---------------|------------------|----------------|----------------|
| <b>2007 operating profit</b> | <b>\$1,345</b> | <b>\$397</b> | <b>\$213</b>  | <b>\$88</b>      | <b>\$(175)</b> | <b>\$1,868</b> |
| <b>2006 operating profit</b> | <b>\$1,341</b> | <b>\$321</b> | <b>\$220</b>  | <b>\$90</b>      | <b>\$(206)</b> | <b>\$1,766</b> |
| % change — 2007 vs. 2006:    |                |              |               |                  |                |                |
| <b>Internal business</b>     | <b>-.1%</b>    | <b>14.2%</b> | <b>-4.7%</b>  | <b>-9.5%</b>     | <b>14.4%</b>   | <b>3.1%</b>    |
| Foreign currency impact      | .5%            | 9.7%         | 1.5%          | 7.2%             | —              | 2.7%           |
| <b>Total change</b>          | <b>.4%</b>     | <b>23.9%</b> | <b>-3.2%</b>  | <b>-2.3%</b>     | <b>14.4%</b>   | <b>5.8%</b>    |

(a) Includes Australia, Asia and South Africa.

(b) We measure the volume impact (tonnage) on revenues based on the stated weight of our product shipments.

During 2007, our consolidated net sales increased 8% on strong results from broad based growth across our operating segments. Internal net sales grew over 5%, building on a 7% rate of internal growth during 2006. Successful innovation, brand-building (advertising and consumer promotion) investment and in-store execution continued to drive broad based sales growth across each of our enterprise-wide product groups. In fact, we achieved growth in retail cereal sales within each of our operating segments.

For 2007, our North America operating segment reported a net sales increase of 6%. Internal net sales grew over 5%, with each major product group contributing as follows: retail cereal +3%; retail snacks (cookies, crackers, toaster pastries, cereal bars, fruit snacks) +7%; frozen and specialty (food service, club stores, vending, convenience, drug and value stores)

channels +6%. The significant growth achieved by our North America snacks business built on internal growth of +11% in 2006.

Our International operating segments collectively achieved net sales growth of approximately 12% or 5% on an internal basis, with leading dollar contributions from our businesses in the UK, France, Mexico, and Venezuela. Internal sales of our Asia Pacific operating segment (which represents approximately 5% of our consolidated results) were approximately even with the prior year, as solid growth in Asian markets was offset by weak performance in our Australian business.

Consolidated operating profit for 2007 grew 6%, with internal operating profit up 3% versus 2006. For 2007, Europe contributed a strong 14% internal growth rate, driven by increased sales and stronger gross margins, as well as lower up-front costs. Despite a strong sales performance, operating profit in our North American segment was dampened by continued commodity cost pressures and significantly higher up-front costs associated with cost reduction initiatives as more fully discussed on page 16. Our Latin America and Asia Pacific operating segments suffered operating profit declines, primarily driven by lower gross margins due to increased commodity costs, as well as the previously mentioned weak performance in our Australian business.

## Margin performance

Margin performance is presented in the following table.

|                  | 2008                         | 2007   | 2006   | 2008         | 2007 |
|------------------|------------------------------|--------|--------|--------------|------|
|                  | Change vs. prior year (pts.) |        |        |              |      |
| Gross margin (a) | <b>41.9%</b>                 | 44.0%  | 44.2%  | <b>(2.1)</b> | (.2) |
| SGA% (b)         | <b>-26.7%</b>                | -28.1% | -28.0% | <b>1.4</b>   | (.1) |
| Operating margin | <b>15.2%</b>                 | 15.9%  | 16.2%  | <b>(.7)</b>  | (.3) |

(a) Gross profit as a percentage of net sales. Gross profit is equal to net sales less cost of goods sold.

(b) Selling, general and administrative (SGA) expense as a percentage of net sales.

We strive for gross profit dollar growth to reinvest in brand-building and innovation. Our strategy for increasing our gross profit is to manage external cost pressures through product pricing and mix improvements, productivity savings, and technological initiatives to reduce the cost of product ingredients and packaging. For 2008, our gross profit was up \$188 million over 2007, an increase of 4%. Our gross profit would have increased by an additional \$5 million excluding the impact of foreign currency.

Our decline in gross margin for 2007 and 2008 reflects the impact of significant cost pressure with higher costs for commodities, energy, and fuel being partially offset by the impact of cost reduction initiatives and increased

pricing. For 2008, these cost pressures represented 10% of 2007's cost of goods sold, primarily associated with our ingredient purchases. In 2007, these cost pressures represented 6% of the prior year's cost of goods sold. In 2008, acquisitions negatively impacted margin by 50 basis points.

For 2009, we expect inflationary trends to continue although we plan to offset the expected 4% to 5% of cost pressures by savings from cost reduction initiatives of up to 4% to keep the gross margin percentage approximately flat year over year.

For 2008, our SGA% decreased over the prior year due to our strong net sales growth, lower expense related to cost reduction initiatives recorded in SGA, continued discipline in overhead spending and efficiencies in advertising and promotion. For 2007, our SGA% was negatively impacted by the reorganization of our direct store-door delivery (DSD) operations. Total program costs of \$77 million were recorded in SGA expense, as discussed further in the "Exit or disposal activities" section.

### Foreign currency translation

The reporting currency for our financial statements is the U.S. dollar. Certain of our assets, liabilities, expenses and revenues, are denominated in currencies other than the U.S. dollar, primarily in the euro, British pound, Mexican peso, Australian dollar and Canadian dollar. To prepare our consolidated financial statements, we must translate those assets, liabilities, expenses and revenues into U.S. dollars at the applicable exchange rates. As a result, increases and decreases in the value of the U.S. dollar against these other currencies will affect the amount of these items in our consolidated financial statements, even if their value has not changed in their original currency. This could have significant impact on our results if such increase or decrease in the value of the U.S. dollar is substantial.

The recent volatility in the foreign exchange markets has limited our ability to forecast future U.S. reported earnings. As such, we are measuring diluted earnings per share growth and providing guidance on future earnings on a currency neutral basis, assuming earnings are translated at the prior year's exchange rates. This non-GAAP financial measure is being used to focus management and investors on local currency business results, thereby providing visibility to the underlying trends of the Company. Management believes that excluding the impact of foreign currency from EPS provides a better measurement of comparability given the volatility in foreign exchange markets.

Below is a reconciliation of reported diluted EPS to currency neutral EPS for the fiscal years 2008, 2007 and 2006:

| Consolidated results                    | 2008          | 2007          | 2006          |
|---|---------------|---------------|---------------|
| Diluted net earnings per share (EPS)    | \$ 2.99       | \$ 2.76       | \$ 2.51       |
| Translational impact (a)                | 0.04          | (0.07)        | —             |
| Currency neutral diluted EPS            | <b>\$3.03</b> | <b>\$2.69</b> | <b>\$2.51</b> |
| Currency neutral diluted EPS growth (b) | <b>10%</b>    | <b>7%</b>     | <b>11%</b>    |

- (a) Translational impact is the difference between reported EPS and the translation of current year net profits at prior year exchange rates, adjusted for any gains (losses) on translational hedges.
- (b) The growth percentage for 2006 has been adjusted for the impact of our adoption of SFAS No. 123(R) "Share-Based Payment," which reduced our fiscal 2006 operating profit by \$65 million (\$42 million after tax or \$.11 per share), due primarily to recognition of compensation expense associated with employee and director stock option grants. Correspondingly, our reported operating profit and net earnings growth for 2006 was reduced by approximately 4% and diluted net earnings per share growth was reduced by approximately 5%.

### Exit or disposal activities

We view our continued spending on cost-reduction initiatives as part of our ongoing operating principles to provide greater visibility in achieving our long-term profit growth targets. Initiatives undertaken are currently expected to recover cash implementation costs within a five-year period of completion. Each cost-reduction initiative is normally up to three years in duration. Upon completion (or as each major stage is completed in the case of multi-year programs), the project begins to deliver cash savings and/or reduced depreciation. Certain of these initiatives represent exit or disposal activities for which material charges have been incurred. We include these charges in our measure of operating segment profitability.

### Cost summary

For 2008 we recorded \$27 million of costs associated with exit or disposal activities comprised of \$7 million of asset write offs, \$17 million of severance and other cash costs and \$3 million related to pension costs. \$23 million of the 2008 charges were recorded in cost of goods sold within the Europe operating segment, with the balance recorded in SGA expense in the Latin America operating segment.

For 2007, we recorded charges of \$100 million, comprised of \$7 million of asset write-offs, \$72 million for severance and other exit costs including route franchise settlements, \$15 million for other cash expenditures, and \$6 million for a multiemployer pension plan withdrawal liability. \$23 million of the total 2007 charges were recorded in cost of goods sold within the Europe operating segment results, with \$77 million recorded in SGA expense within the North America operating results.

For 2006, we recorded charges of \$82 million, comprised of \$20 million of asset write-offs, \$30 million for severance and other exit costs, \$9 million for other cash expenditures, \$4 million for a multiemployer pension plan withdrawal liability, and

\$19 million for pension and other postretirement plan curtailment losses and special termination benefits. \$74 million was recorded in cost of goods sold within operating segment results and \$8 million in SGA expense within corporate results. The Company's operating segments were impacted as follows (in millions): North America-\$46; Europe-\$28.

Exit cost reserves at January 3, 2009 were \$2 million related to severance payments. Exit cost reserves were \$5 million at December 29, 2007, consisting of \$2 million for severance and \$3 million for lease termination payments.

#### Specific initiatives

During the fourth quarter of 2008, we executed a cost-reduction initiative in Latin America that resulted in the elimination of approximately 120 salaried positions. The cost of the program was \$4 million and was recorded in Latin America's SGA expense. The charge related primarily to severance benefits which were paid by the end of the year. There were no reserves as of January 3, 2009 related to this program.

We commenced a multi-year European manufacturing optimization plan in 2006 to improve utilization of our facility in Manchester, England and to better align production in Europe. The project resulted in an elimination of approximately 220 hourly and salaried positions from our Manchester facility through voluntary early retirement and severance programs. The pension trust funding requirements of these early retirements exceeded the recognized benefit expense by \$5 million which was funded in 2006. During this program certain manufacturing equipment was removed from service.

All of the costs for the European manufacturing optimization plan have been recorded in cost of goods sold within our Europe operating segment. The following tables present total project costs and a reconciliation of employee severance reserves for this initiative. All other cash costs were paid in the period incurred. The project was completed in 2008.

| Project costs to date<br>(millions) | Other cash            |              | Asset<br>write-offs | Retirement<br>benefits<br>(b) | Total       |
|-------------------------------------|-----------------------|--------------|---------------------|-------------------------------|-------------|
|                                     | Employee<br>severance | costs<br>(a) |                     |                               |             |
| Year ended December 30, 2006        | \$12                  | \$ 2         | \$ 5                | \$9                           | \$28        |
| Year ended December 29, 2007        | 7                     | 8            | 4                   | —                             | 19          |
| Year ended January 3, 2009          | 5                     | 3            | (3)                 | 3                             | 8           |
| <b>Total project costs</b>          | <b>\$24</b>           | <b>\$13</b>  | <b>\$ 6</b>         | <b>\$12</b>                   | <b>\$55</b> |

(a) Primarily includes expenditures for equipment removal and relocation, and temporary contracted services to facilitate employee transitions.

(b) Pension plan curtailment losses and special termination benefits recognized under SFAS No. 88 "Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits."

| Employee severance reserves<br>to date<br>(millions) | Beginning of<br>period | Accruals | Payments | End of<br>period |
|--|------------------------|----------|----------|------------------|
| Year ended December 29, 2007                         | \$12                   | \$7      | \$(19)   | \$—              |
| Year ended January 3, 2009                           | \$—                    | \$5      | \$( 3)   | \$ 2             |

In October 2007, we committed to reorganize certain production processes at our plants in Valls, Spain and Bremen, Germany. Commencement of this plan followed consultation with union representatives at the Bremen facility regarding the elimination of approximately 120 employee positions. This reorganization plan improved manufacturing and distribution efficiency across the Company's continental European operations, and has been completed as of the end of the Company's 2008 fiscal year.

All of the costs for European production process realignment have been recorded in cost of goods sold within our Europe operating segment.

The following tables present total project costs and a reconciliation of employee severance reserves for this initiative. All other cash costs were paid in the period incurred.

| Project costs to date<br>(millions) | Employee<br>severance | Other cash   |                     | Total       |
|-------------------------------------|-----------------------|--------------|---------------------|-------------|
|                                     |                       | costs<br>(a) | Asset<br>write-offs |             |
| Year ended December 29, 2007        | \$2                   | \$1          | \$ 1                | \$ 4        |
| Year ended January 3, 2009          | 4                     | 1            | 10                  | 15          |
| <b>Total project costs</b>          | <b>\$6</b>            | <b>\$2</b>   | <b>\$11</b>         | <b>\$19</b> |

(a) Primarily includes expenditures for equipment removal and relocation, and temporary contracted services to facilitate employee transitions.

| Employee severance<br>reserves to date<br>(millions) | Beginning<br>of period | Accruals | Payments | End of<br>period |
|--|------------------------|----------|----------|------------------|
| Year ended December 29, 2007                         | \$—                    | \$2      | \$—      | \$ 2             |
| Year ended January 3, 2009                           | \$ 2                   | \$4      | \$(6)    | \$—              |

In July 2007, we began a plan to reorganize our direct store-door delivery (DSD) operations in the southeastern United States. This DSD reorganization plan was intended to integrate our southeastern sales and distribution regions with the rest of our U.S. DSD operations, resulting in greater efficiency across the nationwide network. We exited approximately 517 distribution route franchise agreements with independent contractors. The plan also resulted in the involuntary termination or relocation of approximately 300 employee positions. Total project costs incurred were \$77 million, principally consisting of cash expenditures for route franchise settlements and to a lesser extent, for employee separation, relocation, and reorganization. Exit reserves were \$3 million at December 29, 2007 and were paid in 2008. All of the costs for the U.S. DSD reorganization plan have been recorded in SGA expense within our North America operating segment. This initiative is complete.

During 2006, we commenced several initiatives to enhance the productivity and efficiency of our

U.S. cereal manufacturing network, primarily through technological and sourcing improvements in warehousing and packaging operations. In conjunction with these initiatives, we offered voluntary separation incentives, which resulted in the retirement of approximately 80 hourly employees by early 2007. During 2006, we incurred approximately \$15 million of total up-front costs, comprised of approximately 20% asset write-offs and 80% cash costs, including \$10 million of pension and other postretirement plan curtailment losses. These initiatives were complete by the end of 2007.

Also during 2006, we undertook an initiative to improve customer focus and selling efficiency within a particular Latin American market, leading to a shift from a third-party distributor to a direct sales force model. As a result of this initiative, we paid \$8 million in cash during 2006 to exit the existing distribution arrangement.

During 2008 we finalized our pension plan withdrawal liability related to our North America snacks bakery consolidation which was executed in 2005 and 2006. The final liability was \$20 million, \$16 million of which was recognized in 2005 and \$4 million in 2006; and was paid in the third quarter of 2008.

#### Other 2008 cost reduction initiatives

In addition to investments in exit or disposal activities, we undertook various other cost reduction initiatives during 2008.

We incurred \$10 million of expense in connection with a payment for the restructuring of our labor force at a manufacturing facility in Mexico. This cost was recorded in cost of goods sold in the Latin America operating segment.

We also incurred \$17 million of expense for the elimination of the accelerated ownership feature of certain employee stock options. Refer to Note 8 within Notes to Consolidated Financial Statements for further information. This expense was recorded in SGA expense within corporate results.

During 2008, we also began a lean manufacturing initiative in certain U.S., Latin American and European manufacturing facilities. We are referring to this initiative as K LEAN which stands for Kellogg's lean, efficient, agile network. This program will ensure we are optimizing our manufacturing network, reducing waste, developing best practices across our global facilities and reducing future capital expenditures. We incurred costs of \$12 million for consulting recorded in cost of goods sold primarily within our North America operating segment. The total cost and cash outlay for this program is estimated to be \$65 million. This project is expected to be primarily complete by the end of 2009.

#### Interest expense

As illustrated in the following table, annual interest expense for the 2006-2008 period has been relatively steady, which reflects a stable effective interest rate on total debt and a relatively constant debt balance throughout most of that time. Interest income (recorded in other income (expense), net) increased from approximately \$11 million in 2006 to \$20 million in 2008, resulting in net interest expense of approximately \$288 million for 2008. We currently expect that our 2009 gross interest expense will be approximately \$280 million.

| (dollars in millions)         |       |       |       | Change vs.<br>prior year |      |
|-------------------------------|-------|-------|-------|--------------------------|------|
|                               | 2008  | 2007  | 2006  | 2008                     | 2007 |
| Reported interest expense (a) | \$308 | \$319 | \$307 |                          |      |
| Amounts capitalized           | 6     | 5     | 3     |                          |      |
| Gross interest expense        | \$314 | \$324 | \$310 | -3.1%                    | 4.5% |

(a) Reported interest expense for 2007 includes charges of approximately \$5 related to the early redemption of long-term debt.

#### Other income (expense), net

Other income (expense), net includes non-operating items such as interest income, charitable donations, and gains and losses related to foreign currency exchange and commodity derivatives. Other income (expense), net for the periods presented was (in millions): 2008-\$12; 2007-\$2; 2006-\$13. The variability in other income (expense), net, among years reflects the timing of certain charges explained in the following paragraph.

Charges for contributions to the Kellogg's Corporate Citizenship Fund, a private trust established for charitable giving were as follows (in millions): 2008-\$4; 2007-\$12; 2006-\$3. Interest income was (in millions): 2008-\$20; 2007-\$23; 2006-\$11. Net foreign currency exchange gains (losses) were (in millions): 2008-\$5; 2007-\$8; 2006-\$2. Income (expense) recognized for premiums on commodity options was (in millions): 2008-\$12; 2007-\$7; 2006-\$0. Gains (losses) on Company Owned Life Insurance ("COLI"), due to changes in cash surrender value, were (in millions): 2008-\$12; 2007-\$9; 2006-\$12.

#### Income taxes

Our long-term objective is to achieve a consolidated effective income tax rate of approximately 30% in comparison to a U.S. federal statutory income tax rate of 35%. We pursue planning initiatives globally in order to move toward our target. Excluding the impact of discrete adjustments and the cost of repatriating foreign earnings, our sustainable consolidated effective income tax rate for 2008 was 31% and was 32% for both 2007 and 2006. We currently expect our 2009 sustainable rate to be approximately 31%. Our reported rates of 29.7% for 2008 and 28.7% for 2007 were lower than the sustainable rate due to the favorable effect of various discrete adjustments such as

audit settlements, international restructuring initiatives and statutory rate changes. (Refer to Note 11 within Notes to Consolidated Financial Statements for further information.) For 2009, we expect our consolidated effective income tax rate to be approximately 30% to 31%. This could be impacted if pending uncertain tax matters, including tax positions that could be affected by planning initiatives, are resolved more or less favorably than we currently expect. Fluctuations in foreign currency exchange rates could also impact the effective tax rate as it is dependent upon the U.S. dollar earnings of foreign subsidiaries doing business in various countries with differing statutory tax rates.

#### Subsequent event

On January 14, 2009, we announced a precautionary hold on certain *Austin* and *Keebler* branded peanut butter sandwich crackers and certain *Famous Amos* and *Keebler* branded peanut butter cookies while the U.S. Food and Drug Administration and other authorities investigated Peanut Corporation of America ("PCA"), one of Kellogg's peanut paste suppliers for the cracker and cookie products. On January 16, 2009, Kellogg voluntarily recalled those products because the paste ingredients supplied to Kellogg had the potential to be contaminated with salmonella. The recall was expanded on January 31, February 2 and February 17, 2009 to include certain *Bear Naked*, *Kashi* and *Special K* products impacted by PCA ingredients.

We have incurred costs associated with the recalls and in accordance with U.S. GAAP we recorded certain items associated with this subsequent event in our fiscal year 2008 financial results.

The charges associated with the recalls reduced North America full-year 2008 operating profit by \$34 million or \$0.06 of EPS. We expect a similar impact in 2009. Of the total 2008 charges, \$12 million related to estimated customer returns and consumer rebates and was recorded as a reduction to net sales; \$21 million related to costs associated with returned product and the disposal and write-off of inventory which was recorded as cost of goods sold; and \$1 million related to other costs which were recorded as SGA expense.

## LIQUIDITY AND CAPITAL RESOURCES

Our principal source of liquidity is operating cash flows supplemented by borrowings for major acquisitions and other significant transactions. Our cash-generating capability is one of our fundamental strengths and provides us with substantial financial flexibility in meeting operating and investing needs.

#### Credit environment

The U.S. and global economies began a period of uncertainty starting in 2007. Financial markets continue

to experience unprecedented volatility. Beginning in the third quarter of 2008 and thereafter, global capital and credit markets, including commercial paper markets, experienced increased instability and disruption.

Our Company's financial strength was evident throughout this period of uncertainty, as we continued to have access to the U.S. and Canadian commercial paper markets. Although interest rates on our U.S. commercial paper increased by an average of 200 basis points during the period from mid-September through October 2008, the average interest rate we paid for commercial paper borrowings in 2008 declined to 3.5% from an average of 5.4% in 2007. Our commercial paper and term debt credit ratings have not been affected by the changes in the credit environment, and the amount of our total debt outstanding remained relatively flat over the past three years.

If needed, we have additional sources of liquidity available to us. These sources include our access to public debt and/or equity markets, and the ability to sell trade receivables. Our Five-Year Credit Agreement, which expires in 2011, allows us to borrow up to \$2.0 billion on a revolving credit basis. This source of liquidity is unused and available on an unsecured basis, although we do not currently plan to use it.

We monitor the financial strength of our third-party financial institutions, including those that hold our cash and cash equivalents as well as those who serve as counterparties to our credit facilities, our derivative financial instruments, and other arrangements.

We believe that our operating cash flows, together with our credit facilities and other available debt financing, will be adequate to meet our operating, investing and financing needs in the foreseeable future. However, there can be no assurance that continued or increased volatility and disruption in the global capital and credit markets will not impair our ability to access these markets on terms acceptable to us, or at all.

#### Operating activities

The principal source of our operating cash flow is net earnings, meaning cash receipts from the sale of our products, net of costs to manufacture and market our products. Our cash conversion cycle (defined as days of inventory and trade receivables outstanding less days of trade payables outstanding, based on a trailing 12 month average) is relatively short, equating to approximately 22 days for 2008, 24 days for 2007 and 26 days for 2006. The decrease in 2008 was the result of a decrease in days of inventory outstanding, while the decrease in 2007 reflected an increase in days of trade payables outstanding.