

FINAL TRANSCRIPT

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KFT - Q2 2006 Kraft Foods Earnings Conference Call

Event Date/Time: Jul. 24. 2006 / 5:00PM ET

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PRESENTATION

Operator

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Good afternoon, and welcome to the Kraft Foods second quarter 2006 year-end earnings conference call. Today's call is scheduled to last about one hour, including remarks by Kraft Foods management and the question and answer session. (OPERATOR INSTRUCTIONS). I will now turn the call over to Mr. Chris Jakubik, Vice President of Investor Relations for Kraft. Please go ahead, sir.

Chris Jakubik - Kraft Foods Inc. - VP IR

Thank you and good evening. Thanks for joining us on our conference call. I am Chris Jakubik, Vice President of Investor Relations. With me are Irene Rosenfeld, our Chief Executive Officer, and Jim Dollive, our Chief Financial Officer.

As you know, during this call we may make forward-looking statements about the Company's performance. These statements are based on how we see things today, so they contain an element of uncertainty. Actual results may differ materially due to risks and uncertainties. Please refer to the cautionary statements and risk factors contained in the Company's 10-K and 10-Q filings for a more detailed explanation of the inherent limitations in such forward-looking statements.

With that out of the way, let me explain today's program. Jim is going to start by providing an overview of the numbers related to our updated guidance, as well as our second quarter performance. And then Irene will make a few comments before we take your questions. I will now turn it over to Jim.

Jim Dollive - Kraft Foods Inc. - CFO

Hello everyone. Before we discuss the second quarter results, I wanted to begin with the change to our earnings guidance that was issued today. Specifically we increased our GAAP earnings per share guidance by \$0.23 from a range of \$1.55 to \$1.60 to a new range of \$1.78 to \$1.83. This increase was driven by an anticipated \$0.13 onetime gain related to the redemption of our interest in United Biscuits, which we expect to complete in the third quarter. Additionally, our outlook is \$0.10 favorable due to the timing of cost recognition under our restructuring program. We have not changed the anticipated savings in 2006 from restructuring, only the timing of events.

For our total \$3.7 billion restructuring program we currently expect costs and benefits will match our original expectations.

Beyond these changes to reported earnings, the other elements of our guidance remain unchanged at 3% or greater organic revenue growth on a comparable 52-week basis, \$3.4 billion from discretionary cash flow and proceeds from announced divestitures, and an effective tax rate of 33%.

Now let's talk about the quarter. And please keep in mind that all comments will exclude items affecting comparability as highlighted in our press release. Starting with sales, on a reported basis net revenues in the second quarter were \$8.6 billion, an increase of 3.4% above the second quarter 2005. Divestitures were a 1.1 percentage point drag on net revenue growth, and currency was unfavorable another 0.4 percentage points. Excluding these two factors, organic our net revenue growth in the second quarter was up 4.9%.

Product mix contributed 3.6 percentage points driven by three factors. First and foremost was our emphasis on revenue as our topline measure and how that has clarified objectives across IT organization. Second, was the benefit of our efforts to remove underperforming product lines. And third, was the higher revenue profile of new products, including higher value and more premium product offerings.

Pricing was up 0.4 of a percentage point, driven by price increases that had been taken over the last -- over the past year to cover higher energy and packaging costs. This benefit was partially offset by lower net cheese pricing, reflecting the drop in cheese costs. Volume was up -9 percentage points, with Oscar Mayer meats and crackers in North America, together with our business in Brazil, leading the way.

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The shift in Easter enhanced volume growth by just under 1 percentage point in Q2, mainly benefiting the North American Cheese and Grocery businesses. In addition, our pruning and product line discontinuation efforts continued. Items eliminated accounted for approximately 2% of our volume in Q2 last year, although we have not estimated the incremental impact on this year's volume.

To put things in context, it is useful to look at the first six months revenue growth, which removes the Easter impact. Reported net revenue growth in the first six months was 2.1%. Divestitures and currency were each a drag on net revenue, representing 1.4 and 0.8 percentage points, respectively. Excluding these items, organic net revenue year-to-date grew 4.3%. This consisted of a mix improvement of 3.3 percentage points, net pricing of 1 point, and flat volume.

Moving to gross profit. Second quarter gross profit margin was up 20 basis points to 37% from 36.8% last year. The increase in gross margin was driven by ongoing manufacturing efficiencies, positive mix, and the divestiture of lower margin businesses.

Our total commodity costs in Q2 were up about \$60 million, as higher packaging and energy were partially offset by lower cheese costs. Price realization and our ability to recover increasing costs improved in many of our businesses. While energy and packaging costs are expected to remain high, we do expect gross margin comparisons to improve during the balance of the year and we more fully benefit from declines in other costs.

That brings us to marketing, administration and research costs. Our advertising investment was up about 10% versus last year, and is contributing to our strengthening fundamental. This higher level of brand building investment was covered by a reduction in our overhead costs. Similar to the first quarter, this higher level of brand building investment and the overhead reductions are being leveraged against solid organic revenue growth. As a result, our operating income margin grew 90 basis points to 16.6%.

Moving to the bottom line, net earnings, excluding onetime items and discontinued operations, was up 7% for the quarter at \$852 million, and diluted earnings per share on that same basis rose 8.5% to \$0.51.

Both net income and earnings per share were negatively impacted by a higher effective tax rate, which increased 390 basis points 33.4% from 29.5% in Q2 last year.

Moving onto the business segments, we will start with North American Beverages, which delivered strong topline growth in the quarter. Organic net revenue growth of 5.6% was primarily driven by two factors, double-digit growth in coffee driven by Maxwell House and Starbucks, and continued strong demand for our single serve powdered beverage sticks, mainly Crystal Light and the new Kool-Aid Singles. Beverages' ongoing operating company's income, or OCI, declined 3.1%, and margin declined 140 basis points.

Here a significant variable benefit from product mix was offset by investments behind the introduction of Tassimo hot beverage system, higher packaging and energy costs, and a modest increase in green coffee. Looking forward to the second half of the year, we expect to continue to invest behind the expansion of Tassimo, which will pressure OCI margin for Beverages.

Turning to North American Cheese & Foodservice, organic net revenue was down 0.3% due entirely to product price declines related to lower cheese costs. That said, volume was up over 1% and mix was favorable by almost 2 percentage points. On the plus side, volume benefited from a combination of the shift in the timing of Easter shipments, market share gains in several cheese segments, and new products, including Kraft Crumble. On the minus side these volume gains were partially offset by the discontinuation of lower margin product lines in the Foodservice business.

Ongoing OCI for Cheese & Foodservice rose 5.6% to \$244 million, and margin increased 70 basis points from a year ago to 16.3%. There were a number of drivers in the margin gain, including volume growth, improved product mix and lower cheese costs, which were partially offset by lower selling prices and higher market expending.

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Stepping back, it is important to keep in mind that the low level on cheese costs will impact Cheese & Foodservice revenues going forward, however, with improved brand fundamentals and strong productivity, we do expect margins to continue to strengthen.

Let's move on to North American Convenient Meals and some strong numbers. Organic net revenue was up almost 7% behind strong volume growth, favorable product mix and price increases. The key driver was Oscar Mayer, and the business is doing great. Deli Shaved Meats are growing strong double-digits and continue to drive market share gains in cold cuts. Breakfast meats are gaining traction, mainly from bacon. And the improved nutritional profile on Lunchables with good marketing support continues to drive growth of that franchise.

Ongoing OCI Convenient Meals was up 21%, and margin increased 210 basis points to 18.2%. Here volume growth, higher meat pricing and lower dairy costs were partially offset by higher packaging and energy costs. In the back half of the year we expect a strong competitive response to our successes, and we will be investing more heavily in marketing to protect our recent gains.

Next is North American Grocery where the shift in Easter had a meaningful effect. On a reported basis, Grocery's net revenue in Q2 was down due to the divestiture of the Canadian Grocery business. However, organic net revenue, which excludes divestitures, acquisitions and currency, grew 2.8% in the second quarter, benefiting from the shift in Easter. On a year-to-date basis, Grocery organic net revenue was up 0.4%. Ongoing OCI was up 5.9% to \$305 million, mainly due to the revenue gains in volume, mix and pricing.

Moving on to North American Snacks & Cereals, organic net revenue rose 6%. Crackers were the key driver of the revenue gain with contributions from three areas, new varieties of Wheat Thins, ongoing momentum of Triscuits, and some benefit from the Easter shift.

Cookies were up slightly in the quarter, and this was versus a strong Q2 last year. Also, our bar products continue to drive significant growth, led by South Beach Diet Bars. Within cereals, adult products are doing well, led by Honey Bunches of Oats and Grape-Nuts Trail Mix.

The adult cereal gains were offset by kids' cereal. We are addressing this through the rollout of reformulated kids' cereals that conform to our Sensible Solutions guidelines, including a resumption of advertising. Ongoing OCI in Snacks & Cereals rose 12.4% due to \$282 million, and margin increased 90 basis points from the year ago level to 17.5%.

There were a number of key drivers in the earnings growth, including higher volume, favorable product mix and increased prices. These gains more than offset incremental investments in health and wellness initiatives, as well as higher packaging and energy costs.

Looking forward, the solid organic growth driven by base business momentum should continue. However, this will be somewhat offset by the divestiture of the pet snacks business for the next twelve months.

Next is the EU, where we had a good quarter. Reported net revenue was down 3.1%. However, excluding the impact of currency, organic net revenue grew 3.5%. Three factors drove the organic growth, product mix gains from premium offering by Tassimo coffee and Cote d'Or chocolate, volume growth in both coffee and chocolate, and the benefits of past price increases in coffee.

Our European cheese business had a more difficult quarter where positive product mix from Philadelphia was offset by processed cheese declines in Italy and the UK.

Turning to profit. Ongoing OCI for the EU was up 4.8% to \$173 million. Positives in the quarter included volume growth, positive product mix, lower overhead expenses, and an \$18 million gain from the sale of a facility. These positives were partially offset by incremental investment in Tassimo, and a negative \$14 million impact from currency.

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Looking forward, we expect the environment in Europe to remain demanding, particularly in coffee with price competition from retailer brands. Also, we continue to invest in the expansion of Tassimo, and we are enthusiastic about the opportunities presented in our pending acquisition of the United Biscuits businesses in Spain and Portugal.

Finally, developing markets, Oceanic and North Asia had another quarter of solid performance. Reported net revenues in the quarter grew 14.2% to just over \$1.1 billion, or 12.2% on an organic basis, driven by strong mix and pricing gain.

Latin America and Eastern Europe were the key drivers, with the most significant contributions coming from chocolate in Brazil, biscuits in Venezuela, and coffee in Russia and Ukraine. In Asia-Pacific revenues were essentially flat with the benefits of pricing in China and Southeast Asia offset by cheese category weakness in Australia.

Ongoing OCI for Oceania grew 8.8%. Here our strong revenue growth was partially offset by incremental investments in marketing and in building our infrastructure as we invest in the future growth of these markets.

That is the second quarter of 2006. It was a good quarter, with solid contributions from existing and new products, driven by improving business fundamentals. We continue to drive our cost restructuring efforts, and we made further progress focusing our portfolio with the sale of Milk Bone and the announced acquisition of United Biscuits Iberia. With that, I will turn it over to Irene.

Irene Rosenfeld - Kraft Foods Inc. - CEO

Good evening. While I have been on the job for four weeks, and I have to say I'm delighted to be back at Kraft. It is truly an honor to lead this Company, which has been an important part of my life for over 25 years.

At this point, as you might imagine, I'm still reacquainting myself with the business. In fact, I feel a little bit like Rip Van Winkle. Much has changed, and many of the challenges that were evident when I left have begun to be addressed. But there is more to be done. There's no question in my mind that Kraft has great brands and talented people, but we need to get it growing faster.

As you heard today through the efforts of the Kraft team that work has begun. We have made good progress on improving the business fundamentals. We're managing price gaps. We are enhancing the quality of our products, and we are increasing our investment and the effectiveness of our consumer spending, all of which will be key to our success going forward.

We've also a good progress on the restructuring of our assets, our portfolio and our organization, which are delivering the anticipated cost savings; savings we can use to continue strengthening the fundamentals.

But frankly, that is not enough. It won't be enough until we are able to accelerate our growth, because no one here aspires to be an average company in the food and beverage industry. That is why I came back to Kraft. My goal is to help step up our performance and get us growing faster.

To understand how best to do that during my first 100 days I'm doing a lot of listening and learning. I have spoken at length with all the members of my senior team. I've met with members of our Board. I'm spending time with our employees at all levels and in all functions in our operations around the world. I'm visiting with a number of our key customers. And listening to our consumers, because at the end of the day I believe they are the final arbiters. They're the ones who will ultimately determine our success.

I want to ensure that I fully understand the issues we face and the opportunities in front of us before developing or revising any plans. Only then can I be confident that we are doing the right things to get Kraft growing at a faster rate. My expectation is to share my thoughts with you in early 2007.

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In the meantime, I would ask you to be patient. Patience is not one of my virtues, and I know it doesn't come naturally to most of you. But this is a big organization, and we need to do the hard work to ensure that we have an aspirational but achievable plan to accelerate our growth. It can be done. It will be done, and we will make progress. In fact, our second quarter results provide early signs of improving momentum. But meaningfully accelerating that momentum will not happen overnight.

In closing, let me say I'm excited to be back leading this Company of great brands, great people, great capabilities and tremendous potential. I am energized by the opportunity to step up our performance and to accelerate both revenue and income growth. I look forward to sharing our progress with you.

Chris Jakubik - Kraft Foods Inc. - VP IR

Now we would be happy to take any questions you might have. We would like it if you kept your questions focused on the quarter, which Jim and I are happy to answer. If you do have questions for Irene, please keep in mind that she has been on the job only four weeks and just starting her assessment of the Company.

I will turn the call over now to the operator who will explain the procedure for signaling if you have questions.

QUESTIONS AND ANSWERS

Operator

(OPERATOR INSTRUCTIONS). David Adelman from Morgan Stanley.

David Adelman - Morgan Stanley - Analyst

Irene, I wanted to ask you a couple of interrelated questions. Without the specifics, which I can understand your hesitancy to address, could you talk to where you think conceptually the biggest opportunities are to accelerate Kraft performance? And do you think that a transformational change is necessary to address either the product line or the geographic exposure?

Irene Rosenfeld - Kraft Foods Inc. - CEO

I'm really not prepared today to give you the specifics on that, but without a doubt those will be two of the areas that I need to focus on as we look at opportunities to accelerate our growth.

David Adelman - Morgan Stanley - Analyst

Irene, by what point in time would you be disappointed if you don't start seeing manifesting itself in the financial results an impact of the change you hope to bring?

Irene Rosenfeld - Kraft Foods Inc. - CEO

It is a little too early to tell. I'm going through my first 100 days here. I'm asking lots of questions. And it is going to really take me the next couple of months to really get a handle on what we need to do to accelerate growth.

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David Adelman - *Morgan Stanley - Analyst*

Lastly, what surprises you coming back to the Company? In other words, it has been a couple of years, what are your initial impressions? What has changed, what hasn't changed?

Irene Rosenfeld - *Kraft Foods Inc. - CEO*

I feel very good about the progress that we have made on the fundamentals. As I mentioned, I think the progress that we have made in addressing a number of our price gaps, in improving our product quality, and the step up in marketing investment that Jim spoke about are all very strong positives, as well as some of the progress that we made in restructuring, particularly the assets in the portfolio.

I think the big opportunity continues to be to accelerate our growth. And in particular, I'm really focused on removing the barriers that really are getting in the way of our ability to grow faster.

Operator

Eric Katzman with Deutsche Bank.

Eric Katzman - *Deutsche Bank - Analyst*

Why don't I ask the first question of Irene and I will come back. I guess, Irene, maybe this is too specific, but I guess one of the things that Roger attempted to do was take an organization that was kind of sidled off between international and domestic, and he has made organization I guess more global in its approach. And in many cases, put people who had more international experience in positions of greater responsibility.

I guess, one, do you think that that is the right approach in today's role to have a more global platform, or in order for the company to move faster, does it need to stay I guess more local? And then I guess I will have a follow-up for Jim.

Irene Rosenfeld - *Kraft Foods Inc. - CEO*

I think that is actually going to be one of the most important issues that I'm going to be addressing on my upcoming trip. As I think about the progress that we've made, I think the globalization of our focus and a number of our key functions is serving us quite well. I think the art will be in the balance of those two objectives.

As I head out over these next couple of weeks I'm looking to -- I will have completed my tour of all of our North American headquarter facilities in the next couple weeks. And then I will be heading to Europe and Asia by the end -- which I will have completed by the end of August. That will be a key focus to really understand what is the right balance between global and local.

Eric Katzman - *Deutsche Bank - Analyst*

Thank you. And good luck with that and safe travels. Jim, can you talk a little bit, obviously we have all been very focused on the commodity markets. You, perhaps more than most, have a view towards a broad base of commodities. We hear concerns about high fructose corn syrup. We hear concerns about resin costs, sugar. Maybe you could just go through the keys and just say how those are factored into your outlook, both on a short-term basis in the second half of '06, but even just longer term if you care to throw that thought out there.

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Jim Dollive - Kraft Foods Inc. - CFO

I will just give you a broad sense, without getting into all of the specifics on these commodities. But obviously, the area that has had everybody's attention for awhile has been energy and its implications on packaging. That comes as no new news. The more recent activity has been in the grains markets, influenced both by some of the outlook in the current crops, as well as some alternate uses on those grains, particularly as they get pulled into the energy complex.

For Kraft though, we have had some offsets because we took the rise in cheese costs and some of the other commodities a few years ago. Those have become less of an issue, and in fact cheese costs have come down. Milk production here in the U.S. continues to be fairly strong. It was off a little bit in the last month, but that compares a very strong prior year in the month of June. So collectively it looks good.

I think the real issue for us to look on commodities is how we manage that overall, particularly within the brand value complex. Given how we have strengthened the fundamentals, I'm feeling a lot better about our ability to recover those higher commodity costs. When you couple that with productivity in the restructuring programs, those are the things that are going to drive our profitability as a Company.

Eric Katzman - Deutsche Bank - Analyst

And then just lastly, if I could just get more specific. Just one thing, how -- there is one area that is I guess seems to be very, very tight in likely kind of 20% price increase is high fructose corn syrup. I know the negotiations are just in the early stages. But is that a big commodity for you?

Jim Dollive - Kraft Foods Inc. - CFO

It is not one of our major -- we have a lot of commodities, and we touch almost all the food-based commodities. Certainly we have corn and the derivatives of corn that we follow closely. It is not one of our major commodities. And as I'm sure you well know, we do take positions from time to time to protect ourselves against any interim fluctuations in commodities.

Operator

Dave Nelson with Credit Suisse.

Dave Nelson - Credit Suisse - Analyst

Congratulations on the quarter and welcome back, Irene. First of all for Irene, a big picture, and maybe there's no comment, but what might have you learned at PepsiCo that could help you with Kraft?

Irene Rosenfeld - Kraft Foods Inc. - CEO

Well, PepsiCo is a fabulous company and there are lots of good things that I think that are going well, and then there's lots of good things that are going well around here. I think the focus on growth is probably the single biggest opportunity that we as a Company have here. I think the opportunity to really ensure that we are focusing as much on our top line as we are on our bottom line is the place where I'm going to be spending most of my time.

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Dave Nelson - *Credit Suisse - Analyst*

And then maybe for Jim, following up really on maybe Eric's comments, there on the gross margins you indicated you expected to improve as you move through the year. I guess this is despite higher energy costs. Is that mainly due to the decline in cheese that you're seeing?

Jim Dollive - *Kraft Foods Inc. - CFO*

It is. Cheese is a key component of it, but it is a combination of our ability to take the pricing actions and have them stick and the productivity and cost restructuring efforts that we're taken, in conjunction with a less aggressive increase in our total cost profile. Part of that reflects, in fact, cheese costs coming down. We have also seen some coffee costs start to come down as well, and those are to major commodities for us.

Operator

Andrew Lazar with Lehman Brothers.

Andrew Lazar - *Lehman Brothers - Analyst*

Good evening and welcome back, Irene. Let me add my welcome back as well. I guess just two things. One, Irene, one of the things you mentioned specifically in your remarks was feeling better, at least in your initial impression, on where the price gaps were, let's say. I'm assuming that versus when you were last at Kraft.

Thinking about perhaps your experiences in the last couple of years since being at Kraft, would you -- are you willing to state at this point that those price gaps are also perhaps where they need to be versus best in class consumer companies, as opposed to just let's say versus where Kraft was a couple of years ago?

I'm trying to get a sense of, without specifics, where's the level of reinvestment that is going to be needed? Things might be better than they were, but relative to where you need to be versus like your best in class consumer peers, how much more is there to go?

Irene Rosenfeld - *Kraft Foods Inc. - CEO*

Obviously something like that, it is a little too early to tell, and I need to gauge the business. But I will say that the comment I made about price gaps are really not about price gaps relative to a couple of years ago. It is where we stand relative to our competition. I think we are making some important progress in our core categories. I think there are still some places we need to continue to focus on that. But I feel better about where we are relative to our pricing principles in a number of our core categories.

Andrew Lazar - *Lehman Brothers - Analyst*

Perhaps you could comment, and you touched on this a little bit, perhaps how much of your time or focus have you been, and you plan to put more in the near-term towards really analyzing Kraft's business, based on where you see a true competitive or structural advantage versus the time let's say that you are spending on purely operational issues?

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Irene Rosenfeld - Kraft Foods Inc. - CEO

I think at the end of the day, the operational issues are really going to be the near-term execution of whatever our long-term strategies are. I really, as I mentioned before, my focus over these next couple of weeks is to have an opportunity to visit a number of our key locations. I have met with a number of our employees. I've actually sent out a number of surveys to get input with respect to some of their thoughts about what our greatest growth opportunities are, where we should be investing more aggressively, what is working that we need to share more broadly? And most importantly, what is getting in the way of our growth? And really those actions are going to guide the plans as we put them together over the coming months.

Andrew Lazar - Lehman Brothers - Analyst

And a very last quick one, I guess for Jim. Can you give us an estimate perhaps on what percent of the overall portfolio that you have thus far taken pricing actions on, what percentage you haven't? And is the price equation -- the price value equation still the issued perhaps to taking pricing in some of those areas where you have not yet done so?

Jim Dollive - Kraft Foods Inc. - CFO

As we said, I think it was in the last conference call we had, in the North American portfolio over the past 12 months about half of the businesses have taken pricing actions. We do look at where it is appropriate to do that based on the competitive dynamics, as well as our underlying cost option.

Internationally it is probably a little higher than that because we have taken pricing in some of the developing markets, given some of the cost increases there as well. I think the more important point though is we have taken those price increases and we're continuing to see our shares improve as we strengthen the overall business fundamentals by getting the price gaps right, by putting the marketing support behind the business. I'm actually feeling better about where we are today than they were when we started this process a few years ago.

Operator

Pablo Zuanic from JP Morgan.

Pablo Zuanic - JP Morgan - Analyst

Good evening everyone and congratulations, Irene. I guess the first question I have, in your remarks you said that you would not announce a new plan for the Company until early 2007. I'm assuming that regarding the spin from Altria, I suppose that spin itself could be quite a distraction, so that will not happen until you announce your plan. And probably you want to implement that plan before that spin happens. If you're talking to all Altria, how much of a distraction would the spin be?

Irene Rosenfeld - Kraft Foods Inc. - CEO

As you know, the timing of the spin is an Altria decision. My feeling is that we need to step up our performance regardless of who owns the company. That really is our focus here. As I mentioned before, I think we're making some good progress on the fundamentals, but we are looking at the opportunities to accelerate our growth, and that is going to happen independent of a spin.

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Pablo Zuanic - *JP Morgan - Analyst*

Just to be clear, when you say accelerated growth, 4.3% growth in the first half of '06 is pretty good. That is almost best in class in food. But what do you really mean by accelerating the growth? Are you more focused on volume or are we talking about topline growth of 8, 9%?

Irene Rosenfeld - *Kraft Foods Inc. - CEO*

I think actually -- first of all it is about sustainable performance and is also about balance between top and bottom line. We feel very good about our progress on the topline in the first half and in this most recent quarter. But the challenge really is to make sure that we are seeing equally strong progress on the bottom line at the same time.

Pablo Zuanic - *JP Morgan - Analyst*

I guess you are increasingly -- you're implying that the growth in the first half is not sustainable then?

Irene Rosenfeld - *Kraft Foods Inc. - CEO*

No, I just -- the goal here is to insure that top half and bottom half continue to grow in parallel.

Pablo Zuanic - *JP Morgan - Analyst*

Thanks for that. Jim, just a couple of follow-ups. Just to begin in terms of the price gaps, can you give us examples of products or divisions where you're not yet happy with where your price points are in terms of gaps, where you're still having problems. I'm not talking about whether you are going to increase prices, but where are you still having problems in terms of price gaps?

Jim Dollive - *Kraft Foods Inc. - CFO*

A lot of the focus was in North America and many of the key areas are, in fact, in very good shape. Now we did say at the beginning of year there were a couple of businesses that we were going to be investing more in, one of which was the salad dressing area, and we're in fact doing that.

We have seen some increased competitive activity in our frozen pizza business. And we'll keep an eye on that, but that is not one that is going to be a lot of concern or focus for us. The objective on all of these is to make sure we stay competitive and that we continue to enhance the overall brand value, including not just the price gaps but the marketing support and the other investments that go along with that.

Pablo Zuanic - *JP Morgan - Analyst*

Do you mind if I make one last one. Can you just discuss the coffee market, the competitive environment, pricing environment both in the U.S. retail foodservice and in Europe? It seems like you're quite glad with the trends there, but just give us more color on the coffee market for Kraft?

Jim Dollive - *Kraft Foods Inc. - CFO*

Certainly the coffee market is an important one for us both domestically and internationally. Within the domestic business, we did see some very strong gains here in Q2. And some of that is both on the base Maxwell House brand, as well as the strength

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we are seeing in the Starbucks business. In Europe we also had a very good quarter on coffee, but that is a much more competitive environment. And we have -- that is one that's going to require some more effort, I think, as the retailer brands continue to be fairly aggressive on price points.

The other thing to remember about coffee is the evolution of that whole category, where they are moving to more on demand. We know we've got a very competitive proposition with our Tassimo business system. And we're going to continue to invest behind the expansion of migrating that category both in Europe and the U.S. to our advantaged on demand system.

Pablo Zuanic - *JP Morgan - Analyst*

I think Sara Lee (indiscernible) has indicated that they are not entirely pleased with the growth so far of the port market, the single server market in the U.S. Would you share those comments?

Jim Dollive - *Kraft Foods Inc. - CFO*

The U.S. is in an early launch mode for us, and we are really only in select markets in the U.S. I do think the whole evolution of the on demand business, which is a change in fundamental consumer behavior, it takes a little more time to develop. There are some parts of the world -- in certain pockets in Europe where it is an already established behavior, so it was a lot easier for us and our competitors to gain access into those markets. But into the newer markets where it does change consumer behavior, that takes a stronger consumer spend and it takes a little bit more time to develop those.

Operator

Chris Growe from A.G. Edwards.

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

I will add my welcome too, Irene. My first question, actually just one couple of parts. If I'm understanding correctly in terms of your acceleration of growth, are you willing to give up some price and mix realization for better volumes, or should we assume that the mix and the pricing takes precedence?

And a sort of related question. I'm just curious of any word on the SKU rationalization program, at least the program that we said we knew before, and it was implemented.

Irene Rosenfeld - *Kraft Foods Inc. - CEO*

That is obviously some things I'm going to be spending a lot of time on in these upcoming trips of mine. It is a little too early to tell about what -- in terms of what the balance is going to be. But I think the thought of trying to make our overall business system less complex will have a long-term benefit for us. I think it is playing itself out in the progress that we have made in our restructuring. I'm very supportive of some of the actions that we had taken, particularly a number of the items that had been discontinued or relatively low margin. I do see that as continuing to be an important part of our overall restructuring efforts.

Terry Bivens - *Bear Stearns - Analyst*

Irene, if I could jump in here for a second. It is Terry Bivens from Bear Stearns. Chris and I are kind of doing the daily double here. But clearly at Pepsi your mantle was one of a person who is very good at marketing.

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Granted, it is early days, but I would be very interested to get your take on what you find initially in terms of the level of marketing, and more specifically, product innovation at Kraft. Whether you think -- you have talked a lot today about accelerating the earnings. I think clearly one way to do that is perhaps with stronger innovation, which would require stronger marketing, which would have its effect on the earnings stream. I would like to get your impression on that if I might. Bearing in mind it is early days, but I suspect you're not totally unfamiliar with the things you are looking at now.

Irene Rosenfeld - Kraft Foods Inc. - CEO

As I mentioned before, the focus I have been really having with the various conversations I've had across the organization is to talk with the organization about what are the greatest growth opportunities? Where should we be investing more aggressively?

As I look across the pipeline, I see a number of areas that I feel very good about. At the end of the day, I do have a tremendous passion for the consumer. My focus is really going to be to work with the organization to ensure that we're getting some of those ideas out to market as quickly as we can. That we are making sure that we're really optimizing them in terms of our overall support. And that at the end of the day what we are offering to the marketplace are truly innovative ideas for the marketplace as a whole and not just simply new ideas for Kraft.

Terry Bivens - Bear Stearns - Analyst

Just one quick follow-up for Jim. Jim, could you give us an indication -- you had a pretty nice bump up in advertising this quarter. Where were the primary areas where you allocated that increase, if you don't mind?

Jim Dollive - Kraft Foods Inc. - CFO

The increase was across many of the businesses. There wasn't just one single business that had the dominant effect. It was spread more broadly across some of the businesses. The only places where it might have been down less, and I don't have all the specifics in front of me, were comparisons to where we may have made some unique spending initiatives last year. But overall it was a broad-based increase. And if need be, Chris can get back to you with the specifics on that.

Terry Bivens - Bear Stearns - Analyst

Fair enough. Thank you very much.

Operator

Jon Feeney from Wachovia Securities.

Jon Feeney - Wachovia Securities - Analyst

Good afternoon and congratulations, Irene. My only question for Irene would be, one of the -- your extensive experience at both Kraft and PepsiCo -- one of the issues that Kraft has faced as a function of the categories, particularly cheese and meats it participates in is the increasing role of private label, particularly as retailers consolidate. And the strength of private label at one point at least in recent Kraft history making some certain price gaps unsustainable.

Do you think over the course of time that private label will increase share in those key categories, and perhaps others of Kraft? And maybe if you could talk about some of the strategies that PepsiCo and things at Kraft, big picture, that you have seen that can allow you to maintain or grow share of category?

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Irene Rosenfeld - Kraft Foods Inc. - CEO

I don't have a crystal ball in terms of the future development of our categories. What I will tell you is that at the end of the day it is all going to be about brand value and it is going to be about what the consumer wants, and to what extent we're satisfying her needs. And that really is going to be my major focus.

I think the key for us is to make sure that we're really looking at some new solutions to some old issues. One of my favorite things, if you do what you always did, you'll get what you always got. I think our opportunity is really to step back in a number of our core categories and really to identify some innovative approaches.

I feel particularly good as I look at Oscar Mayer, for example. I look at the impact that our daily shaved launch have had on the sliced meat business. I look at the impact that our reformulated Lunchables have had on the growth of that category. And I'm confident that if we focus on the ideas that are really, truly consumer driven that we can really help to really impact the trend of those categories.

Jon Feeney - Wachovia Securities - Analyst

Thanks. Just for Jim, on the quarter, it seems like you have seen improving trends out of the European Union. Can you comment about the consumer environment there? Have we finally reached the high watermark of the hard discounters, and now it is getting to be an easier environment, or would you just say you're out executing your competitors?

Jim Dollive - Kraft Foods Inc. - CFO

I would not want to declare victory in the EU environment given the -- how demanding that space is. I think we have seen some very good execution within our businesses within Europe. Our objective is to try and get it up as much impossible, but by no means am I declaring victory. I think one of the nice things we've got now is we're picking up a new category with the acquisition of the United Biscuits Iberia Portugal business. More importantly we're regaining our Nabisco trademarks for that entire geography. So that gives us an additional leg within which to compete in that market.

Jon Feeney - Wachovia Securities - Analyst

Just finally, in the U.S. I guess I would ask -- you're getting some pretty impressive price mix here, and I think some others maybe not quite so strongly. Is it easier than you expected to raise pricing this year? Has the environment becomes such that retailers are more receptive to some of the cost pressures you're facing this time around? Has that exceeded your expectations over the past few months?

Jim Dollive - Kraft Foods Inc. - CFO

Obviously, when you've got everybody sharing in some of these common to industry cost increases and everybody is filling the same pressures, what helps us is the strengthening of our brand fundamentals. Those have come together, I think, to help us recover those kinds of cost increase.

The mix gains that we have been seeing, as I said before, a couple of different things driving it in terms of the focus of the organization, but also the pruning activities that are going on. I would like to see a little more volume growth out of the business. We probably won't see the same robust mix growth we've had out of the business, but the combination of the two I feel pretty good about.

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Operator

David Driscoll from Citigroup Investments.

David Driscoll - *Citigroup Investments - Analyst*

Congratulations, Irene, on the new position. Welcome back. I would like to ask about the guidance. Jim, Irene, is it simply that you had a nice number here. Certainly the margin performance was very strong, yet you didn't raise the core part of the guidance that we all are looking at, not including those items that we're all going to not count when we put our FirstCall numbers out.

Consequently, is the way to read this is simply, Irene, that you're not willing to change guidance at this point until you have had an opportunity to truly review the business? As I would look at this result here today, it sure look strong. You beat expectations in the marketplace, yet you're not raising guidance.

Jim Dollive - *Kraft Foods Inc. - CFO*

Let me jump in and I will grab that one, because I think you are exactly right on in terms of our thought process. Irene is new to her position, and we really didn't want to preempt her review of the businesses. We felt very strongly about reconfirming the previous guidance rather than signaling any revisions, or worse yet, not giving any guidance or any confirmation of guidance.

I think obviously with the year-to-date revenue growth -- organic revenue growth at 4.3%, solid EPS delivery, and the strengthening of our fundamentals we feel pretty good about where we are, but we just want to let Irene get her feet on the ground and get started.

David Driscoll - *Citigroup Investments - Analyst*

That is as straightforward as I could ask for. Thank you. Second question here, and last question -- this is for Irene. We've had headcount reductions. We have three CEOs in five years. I'm not sure quite how many new strategies have been announced at the Company. What is your assessment of morale at Kraft right now? And then just second point to that question, do you think the top-level management is as strong today as it was when you left the Company a few years back?

Irene Rosenfeld - *Kraft Foods Inc. - CEO*

Again, part of what I'm going to be spending my time over these next 100 days is really assessing our overall talent, and that is really what I need to find out. I think that I feel good about a number of folks in our key positions. I think the real challenge, as we look forward here, I'm finding that the message of let's get growing is resonating quite well with employees. I think they're anxious to address some of the opportunities to talk about where they see opportunities for growth, and to help me work with them and our senior team to remove those barriers that are getting in the way of their ability to grow their businesses.

So net net I feel very good about the response that the organization has had to the message that I have taken out to them. I look forward to these coming weeks to really understand more about what they see as the issues and the opportunities.

Operator

Ken Zaslow with BMO Capital Markets.

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Ken Zaslow - BMO Capital Markets - Analyst

Again, welcome back, Irene. I'm going to actually lay off the questions on you -- so take it easy on you. Jim, can you discuss the product pipeline going forward and the marketing spending? Is there going to be any changes to that in this kind of period where we're just wait and see?

Jim Dollive - Kraft Foods Inc. - CFO

I'm not going to get into the new product initiatives. We've had some terrific new items come out, and we are going to continue to leverage those, as well as look for new opportunities.

The other thing we have said, and I think this is still appropriate -- this is still in fact still appropriate is the reason for the cost restructuring program and some of the activities we have undergone is so we can reinvest back against the business. That is exactly what we're doing. As we generate these cost savings from the cost restructuring initiatives, we're putting them back against the business to drive the overall topline momentum and use that as our model going forward.

Ken Zaslow - BMO Capital Markets - Analyst

There's not going to be any holding back of new products or marketing spending in the next six or so months?

Jim Dollive - Kraft Foods Inc. - CFO

I'm not going to preempt any discussions about the next six or so months. I think the rest of the marketplace is not going to wait for us, and we just need to stay competitive overall.

Ken Zaslow - BMO Capital Markets - Analyst

In terms of your pricing increases over the last call it six or seven quarters, what percentage did that come from new products at all, or was it only just pure price increases? And if it came from mostly just pricing increases, what do you think the sustainability of that is, given that the industry tends to only give pricing increases over a long-term period on new product innovation?

Jim Dollive - Kraft Foods Inc. - CFO

The pricing increases really haven't come from new products. When talk about a pricing increase, we're really talking about the base businesses and the recovery of costs. On that basis I think they are very much sustainable.

The other piece I think you're referring to is on some of the new product initiatives where we are bringing in items that have a premium relative to the base brand. That is also contributing to the mix benefit that we see, and I think that as well is sustainable.

Ken Zaslow - BMO Capital Markets - Analyst

My last question is in terms of your commodity, if you start looking at commodity expense increases, this quarter it was 60. Last quarter it was 100. The quarter before that it was 200 million. Are we at a point in time that we're going to actually start to see even no increases by the fourth or even next year?

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Jim Dollive - Kraft Foods Inc. - CFO

I'm not going to get into predicting the exact numbers on the commodities, but I think the more important question than just the commodities is our ability to manage those within the overall portfolio of our businesses. And I feel a lot better today than where we were two years ago in our ability to do that.

Operator

Ed Roesch with Banc of America.

Ed Roesch - Banc of America - Analyst

Good evening and nice quarter. Looking at the SG&A rate here, you had nice leverage for the second quarter in a row. I understand you are getting restructuring benefits offset by increased advertising investment. Could you just rank a couple of the items that drove that leverage? And topline obviously must be giving you some leverage on your sales force.

Jim Dollive - Kraft Foods Inc. - CFO

The topline was the key leverage in terms of the profile, but the overall -- in our press release the overall MAR that we talk about, marketing, admin and research, was flat on a year-to-year basis.

What you are seeing in that number (indiscernible) what is happening in that number is we have got increases in the marketing support offset by the overhead components. There's also a little bit of currency at play in there that is a favorability from that side. The real challenge here, and the thing that is affecting it, is the cost restructuring initiatives we're putting in place and the progress we're making on, not just restructuring programs, but managing the overhead costs in aggregate. That is the avenue we're using to reinvest back in the businesses. I feel very good about where we are in that process. And we're going to continue to try and lever that capability for the overall total program.

Ed Roesch - Banc of America - Analyst

Thanks for that. You mentioned some incremental competitive activity in Convenient Meals. Could you mention a few categories where you are expecting that?

Jim Dollive - Kraft Foods Inc. - CFO

The one I was thinking mostly of is the Oscar Mayer business, which has had some terrific success probably for the last year and a half. Right now some of our competitors are perhaps not as focused in meat category as we are due to other challenges, other issues. But I don't expect them to have their attention diverted forever. I think they will look at the gains we have. They will want to defend their business, and we will try and find ways to continue the success that we've enjoyed.

Operator

Steven Kron from Goldman Sachs.

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Steven Kron - *Goldman Sachs - Analyst*

A couple of questions. First, I want to go back to international for a second, if I could. Jim, you mentioned the pending acquisition of United Biscuits business. Can you just touch on what you envision being able to do more specifically within the Nabisco business now that you have 100% control of the trademarks? Is it deeper penetration at soft discount retailers? Is it being able to bring new product news overseas a little bit easier? Essentially what does your management of this business now do for you having 100% control?

Jim Dollive - *Kraft Foods Inc. - CFO*

First of all, we haven't closed on this transaction yet, so it is still pending. Biscuit category obviously is a key global core for us, and this gives us back our trademarks in Europe, Middle East and the North Africa area. It will help us overall from that profile. We have had some terrific new product initiatives elsewhere in our global biscuit business and we should be able to leverage those within that environment.

This also gives us a stronger position in Spain and Portugal overall, and that will help both businesses synergistically. Then we will just look for where else we can go with these businesses as a growth opportunity.

Steven Kron - *Goldman Sachs - Analyst*

Assuming the transaction closes on time, how quickly can you ramp up the introduction of those products to those regions?

Jim Dollive - *Kraft Foods Inc. - CFO*

I think it is too early for us to tell because we really have got to get in to look at the integration process and figure out how quickly we can do that. I think you can rest assured that our objective will be to do that as quickly as we possibly can.

Steven Kron - *Goldman Sachs - Analyst*

Just one last one on the cereal category. Can you maybe just talk a little bit about the competitive landscape, maybe the pricing environment out there? Last quarter you mentioned that you were just getting back on air with reformulated kids' cereal. Is the sales recovery on the kid side maybe progressing a little bit slower than you had expected?

Jim Dollive - *Kraft Foods Inc. - CFO*

I really won't give get into previewing any pricing initiatives within any of the categories. Obviously, you're well what is going on in the industry was some recent announcements.

As far as the marketing side goes, we have gotten two businesses, the Honeycomb business and I believe the Pebbles business back on air. Both of those have started to show some nice positive recovery versus where they were when we were off air.

Operator

Ann Gurkin from Davenport.

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Ann Gurkin - Davenport - Analyst

Welcome, Irene. Jim, if we could just talk a little bit -- as you look in the back half are you finding that you need to spend more to support brands due to increased or anticipated increased competitive pressure?

Jim Dollive - Kraft Foods Inc. - CFO

I wouldn't say we have to spend more, I would say if we see the opportunity to spend more and see the opportunity to grow our business businesses faster, if that makes sense to do, that is what we would like to do. We're driving the cost savings so we are able to do that.

Ann Gurkin - Davenport - Analyst

But have you built in more spending in your second half outlook?

Jim Dollive - Kraft Foods Inc. - CFO

Again, I'm not going to get into the specifics, but overall we are looking at an increase in our total marketing support.

Ann Gurkin - Davenport - Analyst

Can you just tell me how your cookie and cracker portfolio did in terms of volume versus the category in the second quarter?

Jim Dollive - Kraft Foods Inc. - CFO

Well, the category had some changes in it, but overall we had good performance in terms of cookie share. We were a little bit off in terms of our cracker share, but the cracker category had exceptionally strong growth. Our total portfolio within biscuit continues to do well.

Operator

Eric Serotta from Merrill Lynch.

Eric Serotta - Merrill Lynch - Analyst

Irene, you mentioned a phrase like tearing down barriers to growth. I'm wondering from an initial top-level view what you see as those primary barriers? Are they organizational structures, management layers, are they coming from some other areas? I realize you're only on the job -- only back on the job for four weeks here, but if you could give some initial impressions I would appreciate it.

Irene Rosenfeld - Kraft Foods Inc. - CEO

That is exactly what I'm looking into. The reason I'm asking the question is because I do believe that as I have talked with the organization, they talk about things that are getting in the way. I think I need to understand more about what some of those issues are and what are the opportunities. That will be my focus. My sense is that in many respects it is about process changes more so than anything else. Those are very simple changes for us to make.

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Eric Serotta - Merrill Lynch - Analyst

And then a quick question for Jim here. You had very impressive product mix, or mix improvement, in the quarter, and you cited several of the factors behind that. I know one of the factors that has driven volatility and mix in the past -- mix contribution has been the movements in ready-to-drink Beverages. Was there any material impact from -- I think you cited a modest decline in certain ready-to-drink Beverages. Did that have any material impact on the overall mix for the Company?

Jim Dollive - Kraft Foods Inc. - CFO

Yes. The answer is it did because of the relative value of that, and we have been pruning some of those particular items, particularly some ready-to-drink businesses in Canada. But when I look at each of the segments, every one of the segments had positive mix. While it may have been skewed a little bit within the ready-to-drink business in North America, the mix was broad-based across every one of our segments.

Eric Serotta - Merrill Lynch - Analyst

Sure, understanding that though could you possibly quantify how much the ready-to-drink impact had on overall mix?

Jim Dollive - Kraft Foods Inc. - CFO

I would be hard pressed to do that, and I haven't done the calculations to see what individual component was. It definitely was a contribution, but it was a big contribution relative to some of the other ones. But again I go back to every single business having strong mix for us right now, given the other fundamental changes that are going on.

Operator

David Palmer from UBS.

David Palmer - UBS - Analyst

Congratulations Irene. A quick question for you. Just another one of your comments about removing impediments for growth, you talked about processes as being perhaps one area that you can improve. But do you think Kraft's breadth of businesses -- in other words the complexity of the organization -- is potentially an impediment to growth?

Irene Rosenfeld - Kraft Foods Inc. - CEO

Again, it is too early to tell. I believe that my focus over these next 100 days needs to be to ensure that we've got the right plan in place to accelerate growth, that we have identified those things that are getting in the way. I think importantly, the opportunity to really unleash the power of our people to go get it done is one of our single biggest opportunities. That is really what I'm going to be focused on.

David Palmer - UBS - Analyst

Thanks. Jim, I think you mentioned that you thought the cheese margins would continue to be up, or perhaps you were just talking about the entire division, would continue to be up in the second half. There have been times in the past where margin

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gains from cheese price in the commodity cheese price decreases were difficult to maintain. Could you talk a little bit about why you think the margin gains will continue to be maintained in the second half?

Jim Dollive - Kraft Foods Inc. - CFO

That is easy, and there are two reasons. One, is the fundamentals, because of the strengthening brand value of the investments we have made behind just doing that. The second is also some of the cost initiatives that are going on, and those are unique to Kraft. We will see that show up in the gross profit margin, some of which will be invested back in marketing support.

David Palmer - UBS - Analyst

Clearly there were investment costs made behind Tassimo this quarter. Could you perhaps give us a sense of how sales would -- the way sales are going, will there be a changing ratio of investment to sales in the coming quarters, such that we might seem a nice boost to profit in this line from the evolution of Tassimo?

Jim Dollive - Kraft Foods Inc. - CFO

It is too early to make that judgment call, and this is an investment mode for us. I think we said it will continue to be an investment mode for the balance of this year. As I said, this is -- we need to invest to educate consumers on the proposition that this offers, and that takes a little more activity than a simple line extension.

Operator

At this time I would like to now turn the floor back to Mr. Chris Jakubik for his closing comments. Please go ahead, sir.

Chris Jakubik - Kraft Foods Inc. - VP IR

Thanks very much. Starting at 7 PM today a replay of his call will be available. It will run until Monday, July 31 at midnight Eastern time. The number to call for the replay is 877-519-4471 or 973-341-3080 with the confirmation code of 752-6152.

Additionally, the replay will be available on our corporate website, Kraft.com, a few hours from now. For members of the media who have listened to the call and have additional questions, please contact Perry Yeatman, Vice President External Communications, at 847-646-1045. And for analysts having more detailed questions involving nonmaterial information, I will be available to take your calls. Thank you and have a good night.

Operator

Thank you. This does conclude tonight's Kraft Foods second quarter 2006 year-end earnings conference call. You may now disconnect your lines at this time, and have a wonderful evening.

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