BofA Securities Keurig Dr Pepper Inc (KDP) Webinar

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Operator: This presentation is for Bank of America clients only. If you are a member or representative of the media or press, please disconnect now. Bryan, you may begin.

BRYAN SPILLANE: All right. Thank you, operator. And hello, everybody. I want to welcome you to our fireside chat this afternoon with Keurig Dr. Pepper. So want to thank you for joining. And maybe just to start by a way of background or introduction, KDP was formed in 2018 through the merger of Dr Pepper and Keurig Green Mountain, creating an integrated North America beverage business, spanning both hot and cold beverages. Since inception, KDP has grown its coffee business by expanding household penetration, which has really been enabled by the innovation and the improvements they've made around the brewers. At the same time, KDP has gained share in cold beverages through a combination of renovation and marketing of its core brands, filling in portfolio gaps, the organic innovation, and also external partnerships such as we've seen with Polar and evian and leveraging its distribution network. KDP has also put its free cash flow to work, forming about two dozen distribution territory deals; acquiring the Core water business, the Atypique, non-alcohol spirits business; and also investments in A Shoc and Athletic Brewing. Last week was big news. The company also announced a long-term sales and distribution partnership with Nutrabolt for the C4 Energy brand as well as an $863 million investment for a 30% stake in the total company, which we'll get a chance to talk a little bit more in detail later today. With that, there are a number of members of the management team here with us today. So I want to first thank them and then turn it over to Chairman and CEO Bob Gamgort to introduce the team. So good afternoon, Bob.

ROBERT GAMGORT: Hey, Bryan. Thank you. And thank you for hosting us. I'm going to introduce some of the people we have from KDP in the room. And I'll start with our new CFO, Sudhanshu Priyadarshi. He joined the week after I returned as CEO and has been a great partner for me in these early days and also for the executive team at the strategic level as well as the operational level. As you can see from his background, he brings an impressive depth of experience inside and outside of the beverage industry. And, of course, that will serve KDP very well. And in my role as executive chair, I was very involved in recruiting Sudhanshu. And that has certainly made our working relationship when I returned to the role a seamless experience. And you'll get to hear from him in a few minutes.

I'd also like to introduce three executives who are critical in making our partnership with Nutrabolt happen. And we're pleased that you're going to be able to hear from them directly today. I'll start with Doss Cunningham who's the founder and CEO of Nutrabolt. If you go back and look at his entrepreneurial vision and the leadership that he has displayed, he's really transformed Nutrabolt from an early stage start-up to a global active health and wellness company with a portfolio of leading brands, including the

C4 Energy brand, which is the one that we will be distributing. And I'll tell you, we were very excited to have him as a partner of KDP.

Justin Whitmore is with us. He's our chief strategy officer. He's built an M&A team capability to support our external partnership ambitions. And in that role, he's been a critical driver of our M&A agenda, including the Nutrabolt deal that we're going to talk about as well as the recent investment that we announced in Athletic Brewing.

And then finally, Derek Hopkins, who as you know, will be leaving his role as president of our cold beverage business at year end. We will certainly miss Derek's contributions as a member of our executive team. But we're also fortunate to have him as an advisor to KDP for at least the next year.
During that time, he's going to focus on transitioning his current responsibilities to a new cold president at the appropriate time. He'll ensure that we onboard C4 into our DSD system with excellence. He will represent KDP on some key partner brand boards. And he'll work with Justin to continue pursuing partnerships and M&A, and in doing so, picking up some of the slack for me as I move from the executive chairman role back into the CEO role. So, Bryan, given that we have these gentlemen with us in the beginning of this call, I think it would be great if we started with any questions you might have on Nutrabolt.

BRYAN SPILLANE: Yeah, sure. Thanks, Bob. So maybe just a-- maybe to start with a multipart question and maybe starting with you, Bob. Can you just talk a bit about-- share KDP's strategic approach to M&A, which is, obviously, much broader than just outright acquisitions?

ROBERT GAMGORT: Sure. There's always a lot of excitement on partnerships and M&A. And clearly, this is one to be very excited about. It's always important for me just to take a moment and put it in the context of the overall KDP strategy because the primary focus of the majority of our organization is delivering a very attractive organic shareholder return algorithm.

And, Bryan, you said it perfectly. We've done that in the past and will continue to do so through innovation and renovation and productivity and efficiency and then outstanding execution across the numerous route to markets that we're able to leverage. If you look at our track record over the past four and a half years or so as a public company, when we run that organic playbook, we generate the industry-leading free cash flow conversion. And that combined with our manageable dividend payout ratio gives us meaningful discretionary free cash flow. And that gives us the optionality to invest in inorganic value creation for our shareholders.

So when we talked during the investor day in 2021, we highlighted $4 billion of available discretionary free cash flow between 2022 and 2024. We later increased that to $5 billion-- that was this year-- because we were able to reflect additional cash proceeds related to our Body Armor investment and the legal settlement. And so we have a wide range of options to deploy that cash to create value.
If you look at our track record, we believe that strategic M&A is the opportunity that creates the most value. And as a result, we've established a focus and disciplined M&A strategy and, as I mentioned

before, a good M&A team who's focused on those partnerships under Justin. We'll talk about the Nutrabolt partnership specifically. But I view that as a great example of our strategy in action.
We announced the long-term sales and distribution partnership for the C4 Energy brand. We also made an $863 million investment in exchange for 30% ownership stake in the entire Nutrabolt company. And then net of anticipated cash tax benefits, that's a multiple of less than four times next year's sales. For us, the partnership enables us to expand our reach into a very important segment that we've had numerous conversations with you on in the past, which is energy. And we've been historically underdeveloped.

We get an opportunity to partner with the best in class management team. And we did it through a flexible partnership structure that allows each team to focus on what it does best. And I think, very importantly, it aligns incentives for everyone towards long-term value creation. So a big part of that value creation comes from leveraging our company-owned direct store delivery system to increase availability for C4. And there'll be other opportunities as well. But that's really a core benefit of this partnership. And I'm sure that's something that we'll get a chance to hear more about from Derek.

BRYAN SPILLANE: So maybe just a follow-up on that for Justin, given that you spend all of your time, I guess, looking at deals, can you just talk a little bit about Nutrabolt, your perspective on the strategic rationale, maybe how this is similar or different to some of the other deals that KDP has executed recently?

JUSTIN WHITMORE: Thanks for the question, Bryan. So we're rigorous in assessing strategic fit and the potential for value creation in every deal we look at. And as we look at deals, most of the opportunities check some of the boxes. Some check many. But it's really rare to find a case like Nutrabolt where the strategic fit is this compelling. We have aligned visions on the future of the energy category. We have a common belief in the potential of the Nutrabolt portfolio, the shared comfort with balance but ambitious growth goals. And we have tightly aligned cultures that I think will mesh well to make this all come together. So with that in mind, I think we can focus on the category, the consumer, and the brand so you can fully understand our thinking.

It starts with the space, which is attractive. In the US, energy drinks are approaching $20 billion and growing at almost double digits. Within energy, we've seen well-established mainstream brands continue to grow solidly. But in recent years, a new segment within energy has emerged-- performance energy. Now, performance energy brands focus on developing products that offer functional benefits like muscle endurance or boosted metabolism. And we're seeing broad-based consumer demand for functional benefits like these when they're combined with great taste. And these factors have pushed performance energy sales growth above 25% year over year. In fact, performance energy now represents about 15% of the total US energy market.

So as we dug into the energy space collectively, we were intrigued by these strong category dynamics and expanding consumer needs. And as we evaluated the brands driving this segment shift, Nutrabolt C4 Energy offerings stood out. There's triple-digit growth year over year.

There's leading velocity levels within the performance energy peer set and, more importantly, across energy overall; solid positioning across good for you and better for you; functional benefits squarely aligned with the rapidly expanding total addressable market that I've already discussed; zero sugar; zero calories; great taste; a sizable and profitable active nutrition business that's well positioned to fuel growth. And finally, during our extensive due diligence in the space, we found this to be one of the best managed and organized private companies we've come across. So when you take the category, take the consumer, and you take the brand story together, we think the strategic rationale hangs together quite nicely, Bryan.

BRYAN SPILLANE: All right, thanks for that. And maybe, Derek, given the distribution partnership and the platform that KDP has, can you give us a little bit more insight into how you plan to integrate C4 Energy, drive availability, and, again, maybe compare and contrast how you see the C4 fitting in versus maybe some of the other partnerships that you've done in the past?

DEREK HOPKINS: Sure, Bryan. Thanks for the question. I think you can probably tell by now that we're pretty excited about bringing C4 into our distribution system but also equally excited about working with Doss and his team to drive success together. Nutrabolt has great products, whether it's the powders or the beverages. We'll be responsible for distributing the ready-to-drink beverages in the vast majority of our DSD system. And like other distribution agreements that we've signed since the merger, such as Polar or evian, for example, this truly is a win-win for both parties on many fronts. Let me elaborate a bit on that but also the distribution agreement.

So C4 has clearly demonstrated great velocities. And we believe that we are actually entering this relationship at a great time in the brand's life cycle where we can actually leverage the strength of our system for the C4 brand. C4 is going to have a tremendous amount of focus in our system. And like other brand partners, we'll be able to leverage our distribution to drive great execution.

And we'll do this really three ways-- on top line, three ways that we will really focus on. The first one is around really driving distribution, both the breadth and the depth. We know we have a collective opportunity here. And we are really excited about the upside. We'll focus on increasing the display penetration across all channels and then finally, ensuring that we are winning with cold placements as we know that is core to energy growth.

We'll begin to actually phase the brand into our DSD territories starting in Q1 of 2023. In fact, we had a large team integration meeting yesterday between the two teams to start the work on that important endeavor. This is a long-term distribution agreement that has benefits to both parties because what we're thinking about, really, is the brand's development together for many, many years. It has auto renewals that have been built in. And importantly, it also survives an IPO or a change of control. And I think also importantly, we'll earn equity based on hitting executional milestones. So we've got incentives very, very much aligned.

I think, Bryan, it's always-- maybe my last point, it's always important to understand that when we bring a brand like C4 into our system it truly is a win-win situation, as I mentioned earlier. I mean, if you think about it from C4 standpoint, we'll expand the distribution and availability for the brand, which will ultimately accelerate the growth of the brand. And for us, given the brand's high velocities, really high scale, high quality scale to our system, particularly in C-stores, this is going to allow us to increase our drop sizes, our frequency, and ultimately benefit our entire portfolio. So we're really excited about bringing this in.

BRYAN SPILLANE: Yeah, Derek, I was going to follow up on-- I guess my impression is what C4 really helps-- one area that really helps your DSD network is in those small format stores where your drop sizes maybe not as large as some of your competitors. So can it be big enough to move the needle at some point over time? Or we could actually see it impact maybe the margins in packaged beverages? Just as we look at it from a high level, can it be big enough to move the needle?

DEREK HOPKINS: Well, I think the-- if you take a look, obviously, scale is important in DSD system. And you can get there through different ways. You can get there through brands or additional territory. As you know, we've actually added scale to our business over the last few years by adding contiguous territories. This is another way of adding very healthy scale to our system.

I think the simple answer is yes, it will add scale in our C store system. We see this brand growing significantly. And the more that it grows, the more scale that it grows. And it's also-- like, the energy segment and the brand itself is a very profitable brand from a distribution standpoint. So we continue to see the brand growing, adding scale, and driving, I think, healthy profitability within our system.

ROBERT GAMGORT: Yeah, Bryan. It's Bob. I just had one comment to what Derek just said. And that is, as you know, sales, dollar sales of the energy category and C-stores was actually greater than that of carbonated soft drink. And so to be able to now address a gap in our portfolio with a high-velocity brand like this has the win-win that Derek talked about. It's great for C4 increasing availability and merchandising. But for us, it really does start to move the needle on our ability to address the C-store opportunity across our entire portfolio.

BRYAN SPILLANE: Right, and then maybe to turn to Doss. I guess a couple of questions. First, maybe if you can just give us a little bit of insight from your perspective what really difference the C4 Energy brand from other brands in the category?

DOSS CUNNINGHAM: Yeah, so first, I just want to thank the KDP management team for the kind words up front. The C4 brand is part of Nutrabolt. Nutrabolt is founded in 2002. Nutrabolt has been focused on the functional better-for-you space, building performance products since its inception, products that are backed by clinically safe ingredients.

Our initial focus has been in active nutrition where we built the C4 brand, global leader in pre workout. We've acquired and grown the XTEND brand, a leader in the post workout recovery space. And so it's a company that has a rich history in building performance products. And although not as fast growing as our beverages, the active nutrition segment is a tremendous business for us with strong market share positions and very attractive margins.

Four years ago, we decided to really try and take the brand equity that we felt with C4 and move into a new, much larger category being the energy drink space. And while the energy drink space is expected to achieve close to $20 billion in size, the performance segment is also quite sizable at $3 billion with very, very strong growth.

Performance energy is the fastest growing segment within energy. And although C4 once again is relatively new to the space, it has been received incredibly well by our customers, our consumers. The brand now commands almost 11% market share in the segment with retail sales growing more than 150% in the last 12 months.

So with the strong velocities and the great track record we have, we think there is a lot of great runway for future growth. As I mentioned up front, we have almost two decades of experience building performance products. The C4 Energy leverages this heritage as leaders in this space. So what we're really building with C4 Energy is something that is very authentic to what we do and what we have strong capability and demonstrated over the years.

Additionally, we're very invested in knowing our consumer and their needs. The C4 brand is really a multi-product offering to meet the needs of our athletes, fitness enthusiasts, and our performance and active lifestyle consumers. The launch of C4 Smart Energy which happened back in early 2020 was our first move beyond the moment of sweat, thinking about how we can help people, whether it be at work or on the road or in the office, really, gain performance benefits but more of the mental or cognitive kind.
So there's a lot of history once again in our focus around performance products. And I think as we've been able to find new avenues for growth, we've been able to really demonstrate strong brand differentiation. And our consumers have supported us along the way.

BRYAN SPILLANE: Doss, as you enter this relationship and you're going to have the ability to see what wider distribution and brand recognition, you've been very successful using influencers and brand ambassadors across Nutrabolt. So does this at all change that? Will you maybe intensify some of those efforts around some of the people you've partnered with in order to help drive the message even further as distribution grows?

DOSS CUNNINGHAM: C4 is a great growth story for a variety of reasons, some that Justin mentioned earlier. We have a lot of things working well for us right now, including the strong velocities that we've demonstrated at retail. There's, I think, a commitment from retail to continue to award us with more doors, additional shelf space, better optimization within the shelves that we're already on.
So we think that we're going to continue to build our brands. We're going to continue to be a strong innovation partner. But what we're really excited about is how we're able to take what we've done so well and enhance that by our partnership with KDP. There's still a ton of white space.

We've been very successful in the first four years getting our product out there. But when we think about the strategic rationale for the partnership, we really think that the KDP distribution network will give us additional horsepower to cover more ground and really get the brand out there even further. So I think from a brand-building perspective, we're going to continue to do the things that work so well for us. And then this partnership is really about supercharging our ability to gain distribution and grow our household penetration.

BRYAN SPILLANE: OK, and then, Derek, as we're thinking about KDP's energy strategy just broadly, you've got distribution for some existing brands like A Shoc. So does this impact at all some of the legacy relationships? And then I guess even going forward, are there any other constraints around maybe partnering with other brands in energy specifically?

DEREK HOPKINS: Sure, so talk a little bit about that as we sell-- obviously, we sell multiple brands in most categories that we compete in, as you know Bryan, whether that's CSDs, waters, and also yes, energy as well. We feel this is actually critically important as we're able to bring a category story and also solutions to our retail partners. And we have built the capability and, I believe, the proof point that we can grow each of these brands within a given category. We've done this with CSDs and waters.

And I think water is a really good example where we're the number 2 water player with CORE, evian, Polar, and Vita. In fact, with CORE, we own the brand. If you look at evian, Polar, and Vita, we're partners. And in every case, we've actually grown share on all of these brands within the same category. You know what? We're talking about C4, we actually look at it as a big complement to our current energy portfolio, both in its size and also in its positioning. It certainly is going to allow us to take a better portfolio category solution to our retail partners. And I mentioned earlier, and as you brought up, very importantly gives us much better scale in the energy segment and, therefore, the C-store channel.

Within energy, C-store is going to be-- C4 is going to be our primary focus. But it's not an exclusive agreement. And we'll continue to sell Xyience, A Shoc, and Venom as well. But as we said to Doss, we would be excited to partner with Doss to continue to expand within the energy category together with him. So hopefully, that provides some clarity there.

BRYAN SPILLANE: That's helpful.

JUSTIN WHITMORE: Hey, Bryan.

JUSTIN WHITMORE: Bryan, this is Justin. I'd like to quickly build on Derek's comments there. One of the many core benefits of these partnerships is the learning we get from working alongside a pioneer like Doss. And we view this similarly to the benefit of our investment in Athletic Brewing and the learnings we're getting in that space and how it informs our potential alcohol strategy. So I think it all comes together.

BRYAN SPILLANE: And then maybe Justin or Bob, just in terms of the structure of this transaction, just why a minority interest versus an outright acquisition? And maybe the answer is Doss didn't want to sell. But just the-- why one versus the other, or is one more attractive than the other?

JUSTIN WHITMORE: Yeah, Bryan, this is Justin. I'll take that one. The investment model that we've chosen enables KDP to do several things. We participate in upside value creation generated from the distribution partnership and broader growth of the Nutrabolt portfolio, which is exciting. We partner with Doss and his talented team who will remain deeply engaged in the next leg of value creation. I think you've heard that on the call already.

We ensure aligned incentives and focus, allowing Doss and his team to do what they do best, which is innovate, which is grow compelling brands. And we also use KDP's infrastructure and relationships, which will create new openings for growth. And finally, we enable KDP to increase our ownership stake across future capital raising scenarios as we work together to compound growth from here. So overall, we see this as a winning structure. And we think this will have meaningful benefit to KDP's P&L over time.

BRYAN SPILLANE: And then on-- after this transaction, your leverage is generally still pretty low, generate a lot of cash flow. So maybe can you talk a little bit about just priorities or uses of cash from here?

ROBERT GAMGORT: Yeah, this is Bob. I'm going to take that one. First, I'll just talk about M&A. And M&A, I view as an important subset of our overall capital allocation. And then I'm going to ask Sudhanshu to take you through the capital allocation policy. But I think it's important to just step back since our 2018 merger and recap all that we've done from an M&A and partnership activity. And as Derek talked about before, it's really across a couple of segments.

So first of all, premium water. So think about what we've done since 2018. We acquired CORE. We entered into a long-term distribution partnership with Evian. We extended our distribution agreement with Vita Coco. We also invested in their IPO. And we entered into a franchise agreement with Polar. So that was our focus on the premium water segment. And it was successful because it enabled KDP to become the number 2 player in premium water.

In our investor day, we talked about alcohol as a potential new platform. And, of course, we haven't sat still there. We learned a lot about the space because we've got a ready-to-drink alcohol business in Canada. We currently have a licensing arrangement with ABI for Clamato. And we're the number 1 player in mixers.

So recently, we expanded our reach and our category learning. As you mentioned, we acquired Atypique, which is a non-alcohol cocktail business in Canada. And we also invested in the Athletic Brewing Company. And Justin had mentioned earlier, in addition to expanding our reach, these moves allow us to partner with experts and insiders in the industry who then help us inform what our next move will be. And that'll be the case certainly with these investments in alcohol.

And then in energy, since 2018, we got Xyience as part of the Big Red acquisition. We made the investment, seed investment in A Shoc. We've done the Red Bull distribution deal in Mexico. And now, we have this really great partnership with Nutrabolt. So it's the same point in terms of it really allows us to close some white space and partner with experts.

I think the most important takeaway, before I hand it over to Sudhanshu to talk about use of cash, is we did all of that activity. And we built those new positions in premium water, alcohol, and energy. And we deployed about $1.5 billion cumulatively across those three platforms over the past four and a half years. We did it all at reasonable valuation multiples. And we're able to accomplish that because of the flexibility and the creativity we have with our partnerships. So a very efficient yet effective M&A effort that gives us even more optionality to use the remainder of that cash for some other opportunities. So Sudhanshu, why don't you pick up on total cash deployment strategy?

SUDHANSHU PRIYADARSHI: Thank you, Bob. And hi, Bryan. It was nice to see you last week. So as we have discussed previously, KDP's cash generation is a powerful tool to generate shareholder value. Bob mentioned at our 2021 investor day, we highlighted that our strong discretionary cash flow forecast over the next three years could be leveraged into $20 billion of potential M&A capacity.

There, our intention was to highlight the flexibility provided by our cash generation, not to suggest that we expected or intended to spend $20 billion on transactions and certainly not on one large deal. So I think there was some confusion there. Since that event, the macro-environment has evolved considerably. Inflation, as you know, and interest rate have accelerated beyond any official expectations at that time, making leverage much less attractive.

And furthermore as Bob discussed, we have only invested $1.5 billion over four and a half years in all the M&A and partnerships to establish strong positions in three attractive white space categories. So we don't believe we need a large cash outlay to expand our business, I just wanted to make sure I clarify that here.

BRYAN SPILLANE: Yeah, thank you for clarifying that because you can even see it a little bit in the bond spreads. I think the fixed income world still has this concern-- or they're putting a risk factor around a $20 billion deal. And, again, it-- that doesn't seem-- in terms of the nature and the transactions that you guys have put together, it seems like more smaller ones in different types of forms versus doing a huge $20 billion deal.

SUDHANSHU PRIYADARSHI: Yes, Bryan. And further, we have also adjusted to the changing landscape by keeping our powder dry and preserving our strong balance sheet with ample liquidity. You will recall that at the end of our third quarter, our management leverage ratio has reached a very healthy 2.7x. But given the strong cash generation of our business and the rising interest rate environment, we believe it makes sense to continue to reduce our leverage over time and establish a new long range target, long-term target of our leverage in the range of 2.0x to 2.5x. So that's our target financial policy now.

[INTERPOSING VOICES]

SUDHANSHU PRIYADARSHI: So let me finish that. So we are also focused on growing our dividend while targeting a reasonable 45% payout ratio and buying back shares opportunistically, obviously, if a pricing disconnect presents itself. We also have an opportunity to use buybacks to reduce compensation-related share creep that has increased our share count since merger. And we plan to do this over time. Any questions, Bryan?

BRYAN SPILLANE: Yeah, so that's-- no, that's very helpful, very clear. And maybe, Sudhanshu, it's just-- maybe we can maybe shift the conversation now more towards the base business. But before we do that, just because this is your first KDP interaction with a large group of investors, maybe can you give us just a little bit of detail in your background, what your vetting process was for looking at KDP, and ultimately, what attracted you to come over to KDP.

SUDHANSHU PRIYADARSHI: No, thanks, Bryan. It's a great question. So as you may have seen from my background, I've spent more than 20 years-- I have 20 years of global experience in general management, finance, and strategy. I spent most of my career in CPG and retail, mainly at PepsiCo and Walmart. And most recently, I was CFO at Vista Outdoor, a sporting and outdoor goods company where we drove significant organic and inorganic growth during my tenure.

As I just shared, I've spent 14 years of my career at Pepsi. I also spent time in the DSD organization. And I know the industry well. The beverage category is super exciting. And KDP's business model with industry-leading free cash flow generation makes it much more exciting. I've had a great first four weeks working with Bob, our team, and our board when we had a chance to meet last week. So I've made a great decision.

Now, let me come back to my initial observations. I'm impressed with the optionality at KDP to successfully manage the business through a variety of macro conditions. That's been referred to as our all-weather business model, which is an accurate description and a competitive advantage in which the company is able to succeed in virtually any environment.

We are well suited to continue to grow organically. And I just mentioned before, our strong discretionary cash flow after dividends provides for meaningful inorganic growth potential. The company has done an amazing job since merger deleveraging and now has the luxury of a very strong balance sheet and the flexibility and optionality that provides. The talent, culture, and value system at the company really resonated with me and I continue to be impressed with the passion, resilience, and winning attitude across the organization. I believe our strong partnership model that seeks win-win outcomes for all the players is enabled by this culture and is highly unique. And that's the reason I joined KDP.

BRYAN SPILLANE: Thank you for that. And I guess maybe to follow up-- and this is either for you or for Bob or maybe for both. Just wrapping up what's been a pretty dynamic 2022, maybe can you give us a little bit of insight on just your initial thoughts on the operating environment and maybe the consumer landscape as we start to look into 2023?

ROBERT GAMGORT: Sure, let me start off. And then, Sudhanshu, you can add some thoughts that you might have as well. I think a dynamic is a generous word, Bryan, for 2022. Not the word I would have chosen, but—

[LAUGHTER]

We're going to come back, obviously, with our Q4 earnings in February with formal guidance. But I want to give you a couple of thoughts. If you think about the story in 2022, there are always a lot of moving parts. But it really was a story about the relationship between inflation and pricing.

I was just looking back to some of our materials from the early part of 2022. And the official forecasts at that time-- the official forecast about inflation at that time was that it would be transitory, such a great word, which turned out to be absolutely incorrect as we all know. I think the good news is we operate in a very rational industry. And the industry reacted with a series of pricing actions, fairly aggressive in nature, to try to protect margins.

But the timing of the pricing versus the acceleration of the inflation meant that margins never fully caught up during the year. That's the downside of 2022 that we've all lived through. The positive side of it is despite all of that aggressive pricing, consumer elasticities have held up really, really well. So that's a good platform to say, let's talk about 2023.

In having a number of conversations with the investment community, I think it's appropriate to start with inflation because there's a lot of-- there are a number of questions and, I think, a good degree of confusion in that space. If you think about-- as we think about inflation in 2023, we expect moderating inflation rates but on an absolute basis that translates into year-over-year growth in absolute input costs.

And I think the surprising part for everybody will be that when you look at a likely three-year stack-- obviously, I can't fully predict it. But if you look at what it's likely to be between 2020 and 2023, we could see cumulative cost inflation for the industry in the range of 25% to 30%. And to offset that, we've all taken significant pricing, which I'll get to in a minute, what I think about pricing.

Now, the reason there's some confusion is because when you look at some individual cost components on a spot basis, they are, in fact, declining. But most companies don't buy that way. They're covered for inputs 9 to 12 months out. So companies won't get the benefit in 2023 from this current spot pricing. Don't fully get the benefit of that. But also, they didn't absorb-- we all didn't absorb all the impact of inflation in 2022. And you also have to remember that there are other cost components that you can't track easily on a day in, day out basis that are persistently inflationary. And that the top one on our list is labor.

So inflation is moderating on a rate basis. But it is definitely up on an absolute basis 25% to 30% cumulative over a three-year basis. What's the wild card for 2023? Consumer elasticities. So we are-- we've been in uncharted territory for a better part of the year now. We have never seen pricing like this. Therefore, most elasticity models are really not that relevant in this environment. But everything is held up nicely. And I'll be clear, there is no sign of weakness as we speak. But I think that is the metric to watch for everybody in the industry in 2023 because we just don't know.

So from our standpoint, we don't want to sit back and hope for elasticities to hold up. We want to be much more proactive and intentional about that. So we have a very strong intention in 2023 to increase our marketing investment. We've had incredible brand strength. We've built market share. And we want to make sure that continues on top of all of the pricing.

If you go back to COVID, the whole industry cut marketing budgets. And they haven't been fully restored. So to be clear, we see 2023 for us as uniquely a good opportunity to restore brand budgets. As Sudhanshu said, we are minimally impacted by foreign exchange. That gives us a unique opportunity to increase our investment.

And we can still deliver competitive or better returns than the peer group average in the industry in actual dollars and not be so concerned about returns on an adjusted for constant currency basis because we think the actual dollars are what matters. So those are my thoughts about inflation, elasticity, pricing, and investment into marketing. Bryan, if you're OK with that, I'll ask Sudhanshu to pick up on a couple of things that he's observed as we build our 2023 plan.

BRYAN SPILLANE: Yeah, sure.

SUDHANSHU PRIYADARSHI: Hi, Bryan. As Bob said we will formally guide in February when we talk to you all. But the key drivers will be the relationship between inflation, pricing, and our increased marketing investments to ensure that we continue to have the brand strength. In addition, there are a few specific items related to KDP that are worth highlighting.

Bob mentioned FX. Being a North America-focused company, we will benefit relative to large multinationals as foreign currency translation has a muted impact on KDP. As we see it now, forex is likely to be a drag of only a percentage point of growth on both the top line and adjusted EPS, far below the expected impact for others.

As you know, after years of enjoying a very attractive financing environment, we now face rising rates that are likely to be with us for some time. Obviously, this will result in higher interest expense for us next year, reflecting two notable factors. The first, we just talked about the first half of the call, is specific to the Nutrabolt transaction, which we closed earlier this week. This will have an impact on our interest expense for 2023 as we financed the transaction through a combination of cash on hand and short-term financing, both of which have a cost associated with them. And the second is while the majority of our debt is fixed, we do have exposure to floating rate debt.

Finally, as it relates to SG&A, we will be lapping a onetime benefit in 2022 related to stock compensation, which combined with the increase in marketing investment Bob just mentioned, will result in higher SG&A in 2023. So I just wanted to provide some color for our 2023.

BRYAN SPILLANE: And so I guess if we tie that all together, if we were thinking about a high single-digit type EPS growth algorithm, given all of those variables, is that in the range of possibilities? Or we'd be looking at something different from that in '23?

ROBERT GAMGORT: Yeah, I think we're still looking at all of the puts and takes on this, Bryan. And so we have a lot of game left to be played here. So I think that we'll come back in February with a definitive answer on that. And I think we've given quite a bit of context to how we're seeing 2023 right now. But it's a bit early to lean in on that.

BRYAN SPILLANE: OK, thank you. And maybe just, Sudhanshu, if I could follow up just on one point. The $863 million Nutrabolt transaction, a couple of questions about just how Nutrabolt affects this year. One is if we're thinking about, there's-- if you use cash, there's interest income that you lose. If you finance, there's interest expense. So if we're netting that out, is that a 3% rate, 4% rate, just a ballpark of mid-single digit rate? Just how we should think about just the cost of that $863.

SUDHANSHU PRIYADARSHI: So you're thinking about it the right way, whether it's interest cost or interest income. I think for your modeling, mid-single digit rate is a good way of using it.

BRYAN SPILLANE: OK, and then the second thing is, again, as we're thinking about Nutrabolt, you'll have a full year of carrying the financing. But there's some transition that also goes with bringing Nutrabolt in. Not all the territories transfer right away. There's going to be some expenses related to that. So I mean, it-- again, the numbers aren't that big. But it just seems like as we're thinking about earnings per share, there could be a little bit of dilution in year one. Is that the right way to think about it?

ROBERT GAMGORT: No, we're not thinking-- we're not thinking about dilution, Bryan. But we are-- we're thinking about minimal positive impact in 2023. I think we'll see a nice uptick in 2024. But the way you described it is right. Takes time to get the business into our system out of current distributors and into the Keurig system. There are costs to exit those contracts. There are some investments we'll be making in our DSD system to be able to scale up in certain markets as we just talked about before-- helps cover our C-store business. And so when you add that all up, the way we've described it is minimal impact in 2023, but ramping up to a very nice impact in 2024.

BRYAN SPILLANE: OK, all right, thank you. And then maybe, Bob, if we can just flip to the coffee quickly. And there's been a lot of discussion in the markets about household penetration. Can that continue to increase? I think people are looking at the growth in pods, volume growth in pods relative to household penetration. And there's an implication that maybe usage rates or attachment rates are declining. So can you just give us your perspective on those topics and how you're thinking about just the coffee business as you move into '23?

ROBERT GAMGORT: Absolutely, so I've heard a lot of those questions and some of those theories. And as I've talked about all the way back to 2018, I would suggest that the difference is the time frame in which you take a look at this. And if you recall, I joked at the end of our fourth call as a public company when somebody congratulated us on a great year in coffee. And I said, it's remarkable how four terrible quarters added up to one great year. Because every quarter, there was a new theory and a bunch of stress and anxiety. And then when you look at the year, like, holy cow, look at the growth in that business. It's the same thing that's going on right now.

And let me just take a moment and give you a sense of this because we are always consistent in saying you got to look at our business over enough of a time period that it smooths out the short-term noise. And the problem is, if you project off the short-term noise, you can be too high or too low. And that's exactly what's happening right now.

We had some time to think about it after talking with a number of investors. And now, I understand where they're coming from. So first of all, if you take a look at the time between 2019 and 2022-- let's look at that four-year period in there. There's a huge amount of noise. And most of it is coming from COVID. And it has to do with consumer mobility in-home versus out-of-home coffee. That's what this is all about. Obviously, we're the leading player in in-home coffee. We do have a position in out-of-home coffee. But really, it's been the movement in and out.

So if you took 2019 in the early days of COVID and you projected that forward, you would have a long-term forecast that was too high in terms of household penetration as well as attachment rate. The reverse is also true. If you now project off of the last year or so where you're now recovering out of that COVID period and mobility is normalizing, you're going to project way too low. You're going to look-- it's going to look like falling attachment rates, declining household penetration.

And so if I look at that entire period instead, 2019 to 2022, and take out the noise and just straight line 2019 to the end of 2022, you're going to see the category volumes are incredibly consistent with long-term trends. And that's tracking at mid-single digit growth rates. And all of the analysis that we have done suggests that that is very much still to come.

And I think that what is happening now is I would characterize 2020 and '21 as at-home coffee heavily influenced by COVID. Mobility declined. People spent more time at home. Obviously, they're going to adopt the Keurig system faster. And they're going to drink more coffee per machine. We're now in a recovery period.

So I would call the recovery period 2022 and 2023. And what you're seeing there is a return to the long-term trend. But that means it's going to look like a deceleration in attachment rates versus the peak and a deceleration in household penetration versus the peak. But when you draw the line through the two, it's exactly on the long-term trend.

The other thing I want to point out is that we've now looked at in-home coffee of all formats, not just single serve globally. What I just described is happening for nearly all forms of coffee in nearly every market around the world. So it tells you that this phenomenon is not a US issue and it's not a Keurig system issue. In fact, while this is all going on, the Keurig system is growing its share of total coffee occasions. So we're expanding share in a category that's had a lot of noise.

So I'll give you some thoughts on 2023 just to help you on this and help everybody because I know there's been a lot of concern. We're still going to get some mobility headwinds in 2023. Our expectation is we're back to normal mobility by the end of the year. But every time people move from in-home to out-of-home, you see a bit of a drag.

Let's also be clear, we took a lot of pricing as an industry in 2022. That's going to have a carryover effect, particularly in the first half of the year. And there is some elasticity. That seems to be a surprise to people. But it's modest, and it's manageable. But it's not 0. There is some elasticity.

So when I take a look at 2023, I would suggest that we all expect a revenue growth rate around mid-single digits. And that revenue growth rate is going to be a combination of pricing and volume. And then we're going to be through the noise of mobility changes by the end of 2023. And I would suggest that 2024 looks like at this point in time, we'd be very much on the long-term trend.

BRYAN SPILLANE: OK, thanks for that. And maybe, Bob, just on pod pricing, if you could touch briefly on the extraordinary amount of pricing. Coffee typically has been a pass-through category, pods less so. But there was a lot of focus early on for you all to get pod pricing at a more affordable level, I guess, or the average. So just what happens here? If green coffee costs begin to roll over, would you expect to see more of that pass-through dynamic across pods? Doesn't even necessarily specifically have to be for KDP. Or do we think it’s a little less pass-through than what we see in roast and ground and other parts of the coffee category?

ROBERT GAMGORT: So it's definitely less pass-through on the pod side than it is compared to roast and ground. Because it's just that-- it's a different value proposition that we're offering consumers. Having said that, the pricing relationship that we manage is really-- we look at it in two different ways. We look at it within pods. There's a premium segment. There's a mainstream segment. And there's a value segment. And we look at the relationships between all of those. And while we don't control them, it's something that we try to track for, I'll call it, the health of the entire system. And I would say that those relationships and pricing from entry level all the way up to super premium, now when we have brands like Intelligentsia in our system, have held up really nicely. They've all moved in tandem because of inflation. But the relationship, the relative comparison between those are very much intact.

We also look at the price of Keurig K-Cup pods versus other forms of coffee on a per cup basis. And we made a very important correction in the early days of taking KGM private to get that relationship more in line. And we were very candid that we thought the pod pricing was very much out of sync with where it should be relative to other forms.

That relationship is still intact. In fact, in some cases, it's continued to improve. So that pod pricing on a relative basis to other forms of coffee still looks very good. But everything is moved up because of inflation across the board. And so we think that that all holds up.

I think if you were to take a look at what is the biggest leading indicator to make sure that everything I just said is true: is single-serve coffee and is the Keurig system gaining share of all forms of at-home coffee? And the answer is, it is. So it's continuing to pick up absolute share, which tells you that the relationships and the pricing relationships and the strategy in place right now are very sound.

BRYAN SPILLANE: All right, thank you for that. And then maybe-- I know you touched on it a little bit earlier in terms of cold and how strong or how inelastic the demand has been. So maybe can you just touch a little bit on that as you're looking at that going forward? And is it simply more marketing equals the elasticity holds? Or is there anything else you're observing in terms of consumer behavior there?

ROBERT GAMGORT: Yeah, we've seen-- it's quite unprecedented, the level of inflation that's been incurred and the level of pricing that's been put in place to try to offset that. And, again, I would emphasize that pricing has not yet caught up to inflation. I've heard a couple of comments about companies margining up. I said, no, pricing was taken up. The margining is down, not up. But it will catch up at some point in time.

Elasticities are holding up incredibly well. Brand strength matters. Marketing matters. Pack sizes matter. The right promotions make a big difference. And so we continue to invest. And as I said, in 2023, we will increase our investment in that because we haven't restored the cuts that were in place in COVID across the industry. And we think this is the time to do it with all that pricing out there. You've got a market I think going forward-- and time will tell -- but I think going forward, when we think about pricing, it's going to be more nuanced in approach. We have a really strong RGM capability. It has helped us considerably over the past couple of years. But it really pays off when you have to be more nuanced. And what I mean by that is more emphasis on pack size strategy, promotional price points, and strategies rather than just blanket pricing increases.

But make no mistake, our target is to protect our margins. We take pricing to cover our margins. Sometimes the difference between the inflation and the pricing is a bit out of sync. But that is our goal. I just don't see us taking wide scale pricing actions in the near-term future. I think it's going to be much more subtle.

BRYAN SPILLANE: OK, and then maybe just to close. We're almost at the hour. Talk a little bit about the transition, the CEO transition from your perspective, maybe on-- now that you’re a boomerang-- like how long you intend to stay, when do you start succession planning. Just how you're thinking about the seat from here and what the process-- what the path forward is.

ROBERT GAMGORT: Bryan, thanks for that. Now, they're going to call me Boomerang Bob or something like that.

[LAUGHTER]

Maria is saying it in my ear right now. Thanks, I appreciate that.

BRYAN SPILLANE: [LAUGHS] You're welcome.

ROBERT GAMGORT: So here's the-- here's an amazing statistic I hadn't really thought through actually, which is, I was actually out of the CEO role for 100 days. And when I was in that executive chair role, I was very engaged with the company on a number of different areas and, obviously, was on the last earnings call and very much involved in the partnership activity that we just talked about up front.

Therefore, because I was out for 100 days and engaged, the restart has been relatively easy. And it's been great working with the teams, with some new members who have been promoted, and some new members like Sudhanshu who have been added. There's been a really good blend of that and a lot of energy and excitement to get going here because we really do have a great business.

I'm also chairman of the board. So what I would tell you is that the core responsibility of every board is CEO succession. So we are appropriately in the process of updating our plan and also rebuilding our succession pipeline. That is not a process that can be rushed. There's no way to do it. There are no quick fixes in something like that, nor should there be. So that's why I returned as CEO, not interim CEO. And I will remain in the role as long as I need to be.

BRYAN SPILLANE: All right, well, thank you for that, Bob. Really helpful to get the insights. And I want to thank you, Sudhanshu and the rest of the team, for spending time with us this afternoon. On behalf of all of the investors who dialed in, I want to thank you all for your time. And wish you a really happy holiday and look forward to talking in the New Year.

ROBERT GAMGORT: Bryan, happy holidays to you and to everybody who's on. And thank you, again, for hosting. It was great to talk with you.

BRYAN SPILLANE: You're welcome. My pleasure.

[MUSIC PLAYING]