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Dr Pepper Snapple Group, Inc. (DPS)

Q2 2017 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning and welcome to Dr Pepper Snapple Group's Second Quarter 2017 Earnings Conference Call. Your lines have been placed on listen-only until the question-and-answer session. Today's call is being recorded and includes a slide presentation, which can be accessed at www.drpeppersnapple.com. The call and slides will also be available for replay and download after the call has ended. [Operator Instructions]

It is now my pleasure to introduce Heather Catelotti, Vice President, Investor Relations. Heather, you may begin.

Heather Catelotti

Vice President-Investor Relations, Dr Pepper Snapple Group, Inc.

Thanks, Lori, and good morning, everyone. Before we begin, I would like to direct your attention to the Safe Harbor statement, and remind you that this conference call contains forward-looking statements, including statements concerning our future financial and operational performance. These forward-looking statements should also be considered in connection with cautionary statements and disclaimers contained in the Safe Harbor statement in this morning's earnings press release and our SEC filings. Our actual performance could differ materially from these statements and we undertake no duty to update these forward-looking statements.

During the call, we may reference certain non-GAAP financial measures that reflect the way we evaluate the business, and which we believe provide useful information for investors. Reconciliations of those non-GAAP to GAAP measures can be found in our earnings press release and on the Investors page at www.DrPepperSnapple.com. This morning's prepared remarks will be made by Larry Young, President and CEO; and Marty Ellen, our CFO. Following our prepared remarks, we will open the call for your questions.

With that, I'll turn the call over to Larry.

Larry D. Young

President, Chief Executive Officer & Director, Dr Pepper Snapple Group, Inc.

Thanks, Heather, and good morning, everyone. I'll start by saying that I'm proud of our teams for delivering strong top-line results this quarter, resulting from solid execution behind our focused consumer-centric strategy. In our CSD portfolio, once again, we outperformed the category, growing both dollar and volume share in IRI-measured markets.

We're investing behind our newest brand, Bai, at greater levels than previously planned and are executing against the strategy we communicated back in April. Our results are encouraging, and I'll speak more about that in a moment.

Our allied brand strategy continues to allow us to go where the consumer is going and drive both top-line and bottom-line growth for the business, all of this while RCI continues to improve the operating platform on which we run the business.

For the quarter, bottler case sales increased 3% on just over 1.5 points of positive mix. Our CSDs grew 3% in a continued challenging environment, and our non-carb brands increased by 5% in the quarter.

Dr Pepper increased 2%, driven by: regular Dr Pepper, which grew 2% in the quarter; and Diet Dr Pepper, which grew 1%, again outperforming the diet category. 7UP grew 5%, driven by growth in both the U.S. and the Caribbean. This marks the third consecutive quarter of growth for this brand in the U.S., following our RCI Lean track last year and our new marketing campaign for this year.

Canada Dry grew 6% and Schweppes increased 4% on continued growth in the ginger ale and sparkling water categories. A&W was flat in the quarter. Peñafiel increased 8% on strong performance in both mineral water and [ph] our aids line. (4:00) Squirt grew by 7% and all other CSDs decreased 1%.

In non-carbs, Snapple bottler case sales declined by 1% in the quarter, as strong shipments for a promotional event at a large retailer are expected to sell through in the third quarter. Mott's increased 2% on growth in sauce and Clamato grew 3%. Bai increased 118%, primarily on the acquired volume outside our system, as well as on continued growth in our own DSD system, which grew by 37% in the quarter. Our expectation for the full year is still for volume growth on the brand across all systems of about 40% to 50%, as we continue to gain new distribution and availability and drive trial activity in the marketplace.

Our growth allied brands increased 45%, driven by continued strong growth across BODYARMOR, Core and FIJI, once again demonstrating the continued success and importance of this strategy. All other NCBs declined 4% in the quarter.

Our calendar for the back half of the year is packed with programs that will continue to unlock growth and leverage the power of our priority brands. Dr Pepper will be in front and center again this year during the college football season. This program is right on strategy for the brand and continues to be more successful every year. And we're going to keep that momentum going and make it even bigger this year. We're bringing back our college football celebrity, Larry Culpepper, and his tailgating RV as well as executing national media across TV, digital and social and driving strong activation at retail.

We will continue to communicate our new messaging on 7UP across all platforms, highlighting the versatility of the brand. As I mentioned earlier, the performance of this brand in the U.S. has improved in recent quarters, giving us early-on confidence that we're on the right track with consumers.

And we've got some exciting news on Snapple. For the first time, we'll give consumers a new, more convenient single-serve option as we roll out our 16-ounce plastic bottle that looks and feels just like our iconic 16-ounce glass bottle, complete with a metal cap that pops.

Now, let me talk about the recent performance of Bai, the opportunities for the brand, how we're executing against our communicated strategy and driving sustainable growth for the long-term. On a year-to-date basis, retail sales of Bai are up almost 37% across IRI-measured channels, significantly outperforming both the category and its key competitors. We're seeing strong growth across multiple channels and, importantly, in the grocery and convenience channel.

ACV levels across base Bai flavors and Cocofusion's have continued to improve across all channels; however, there is a great deal of opportunity in the convenience channel with current ACVs in the 50% range. Our current plans for the balance of the year for base and Cocofusion's in this channel should accelerate growth. We've got new authorizations to add over 7,000 new stores across several large national and regional convenience store chains, and that's just C stores. We've also got authorizations for new SKUs in large-format accounts that will go in during the fall reset timeframe and thousands of new cooler placements going in as well.

We're placing several hundred additional [ph] bidrocap displays (7:42) across large-format in the balance of the year. And also just this month, launched our second [ph] biosphere (7:49) market in Southern California. We've seen growth of about 115% over the past year in specific retail change in the Dallas [ph] biosphere. (7:59) So we're taking those learnings and expanding this innovative execution strategy into L.A. and Orange County. And while Bubbles is also showing positive ACV gains, this brand still has tremendous distribution potential across all channels.

As we've said, we're repositioning the brand from a price point, package and shelf-set perspective, so as to capture share in sparkling water. We expect to see improved performance on Bubbles over the balance of this year and 2018.

We said in April that a critical piece of our strategy was not just about gaining new points of distribution, but also about driving trial and getting the brand in the consumer's hands. Because we know of that once they try it, they're likely to buy it again, as demonstrated by the brand's strong repeat purchase rate.

We're currently running trial-driving activity in the marketplace at an even greater level than we originally planned, as trial rates continue to show improvement, and we want to maximize the opportunity through summer selling season.

We will also continue to run some level of activity through the balance of the year. We're also investing heavily in marketing to drive brand awareness as well as to drive trial, spending $20 million in the second quarter, as we had planned.

We recently received our first MROI analytics for Bai and have seen strong response to our TV and social campaigns, so we will continue those through the balance of this year. We're expecting our heaviest marketing investment in the third quarter of this year, capitalizing on these learnings.

Bai's ready-to-drink tea is performing well in certain accounts where it has been repositioned in the tea set, gaining several share points in a short period of time. And our re-launch of antioxidant water is slated for the latter part of this year, driving some upside this year, but more so beginning in 2018. The entire organization and I could not be more excited about the future of this brand.

Now, I'll turn the call over to Marty to walk you through the financials and our guidance.

Martin M. Ellen

Chief Financial Officer, Dr Pepper Snapple Group, Inc.

Thanks, Larry, and good morning, everyone. Overall, second quarter results were in line with our expectations. Our base business results overachieved and we invested more heavily in Bai. Reported net sales grew 6% on strong volume growth of 4%.

Reported segment operating profit declined 1% in the quarter, primarily on heavy marketing investments behind Bai and higher marketing spend for our other priority brands. Marketing spend on Bai was $20 million, and we also increased marketing by $16 million on our other priority brands. Core operating income and core EPS were both flat in the quarter.

Now, let me walk you through the details. Reported net sales increased 6% in the quarter, including the Bai acquisition, which accounted for just over 1 percentage point of our net sales growth. Total Bai sales, including our DSD distribution, accounted for just over 2 percentage points of our net sales growth. And now, Bai

represents about 4.5% of our total company revenues. This represents a meaningful and important positive shift in our portfolio.

Organic net sales grew, as organic volumes were up over 3%. Product mix contributed just over 1.5 percentage points of growth. Net sales growth was partially offset by the loss of our remaining distribution of Rockstar in the quarter.

Reported gross margins decreased 50 basis points from 60.5% last year to 60% this year. The unfavorable impact of unrealized mark-to-market commodity changes decreased gross margins by 120 basis points. Excluding this, core gross margins increased by 70 basis points. The added margin from now owning the Bai brand increased gross margins by 125 basis points, while higher commodity costs and increases in certain manufacturing costs reduced gross margin by 40 basis points each.

Further improving gross margins in the quarter were continued productivity benefits, including those from RCI and lower discounts. These positive factors were partially offset by negative effects of foreign currency and unfavorable mix, mostly from continued allied brand growth. For the quarter, SG&A increased $93 million. The acquisition of Bai added $40 million, including $20 million in marketing and $1 million of transaction expenses.

SG&A also increased due to an unfavorable $18 million comparison of unrealized commodity mark-to-market activity and further increased on a $16 million increase in planned marketing behind our other priority brands. The remainder of the SG&A increase was mostly due to certain operating expenses and additional planned investment behind our DSD front-line workforce. Depreciation and amortization increased $1 million in the quarter.

Other income increased $1 million, which includes a $4 million gain from the termination of our distribution of Rockstar. Reported income from operations declined by $39 million in the quarter; however, $37 million of this decline was due to an unfavorable comparison of unrealized mark-to-market activity. The impact of the Bai acquisition, including $3 million of acquisition and transaction expenses, contributed $10 million of this decline.

Below the operating line, net interest expense increased $11 million, mostly due to the higher debt balances associated with the Bai acquisition. We recognized a $49 million loss in the quarter on the early extinguishment of debt. Other income declined by $20 million, as last year included a $21 million gain on the settlement of a multi-employer pension plan withdrawal liability. Our reported effective tax rate was 33.2% compared to 35.3% in the prior-year period. This quarter's tax rate included a $6 million favorable tax planning benefit.

Moving on to cash flow, cash from operating activities was $410 million, down $18 million compared to last year, primarily driven by timing of payables. Capital spending was $41 million compared to $68 million last year. Total distributions to our shareholders were $381 million, with $204 million in dividends paid and $177 million in shares repurchased.

Before I move on to guidance, I'd like to give a quick update on RCI. We've shared in the past about how we utilize the tools of Lean not only to drive productivity across the business, but also to help drive top-line growth, whether it be closing voids across several of our priority brands, improving display execution or, as Larry just mentioned, the impressive improvement we've seen in our U.S. 7UP business over the past couple of quarters.

Our 2017 Lean tracks are well underway, and I'll mention just a couple of wins that further demonstrate the application of Lean process improvements to drive sales.

As a result of our DSD display execution track, our Texoma region reached their highest display ACV in five years, representing a 61% improvement over the prior year by implementing single point selling training and developing account manager standard work.

And a Northern California region of a large retailer achieved a 50% display rate improvement across our Warehouse Direct business. There's a tremendous amount of RCI activity that happens across the business on a daily basis, so much so that we're going to increase our investment in RCI by actively seeking additional RCI resources to add to our strong bench of highly-trained Lean and Six Sigma professionals. I'm proud of where we're at as a company only six years into our endless RCI journey.

Now, moving to 2017 guidance, we're now expecting net sales growth of about 4.5%, as the recent weakening of the dollar is causing foreign currency translation to no longer have a material impact on net sales. We continue to expect that about 2% of this net sales will come from our acquisition of Bai. Organic volume growth is still expected to be over 1%. And the acquisition of Bai is still expected to contribute just under 1% of our total company volume growth.

There is just over 1.5% price/mix embedded within our growth and about 50 basis points of this price/mix is the impact of our beginning of the year concentrate price increase. Our expected revenue growth also reflects the recent loss of our distribution of the Rockstar brand on the West Coast.

Moving on to cost of goods, given our hedged positions and current market prices for our unhedged positions, we continue to expect packaging and ingredients, excluding the acquired Bai business, to be inflationary by about 50 basis points on a constant volume mix basis.

For your modeling purposes, remember that growth of our non-carb portfolio, including our allied brands, will increase the dollar value of cost of goods and also remember that cost of goods sold is negatively impacted by foreign currency transaction.

Collectively, all the factors I mentioned above, coupled with the added gross margin we realize now being the brand owner of Bai, are expected to result in a full year gross margin increase of about 50 basis points.

Moving to SG&A, excluding our acquisition of Bai, we're still expecting an increase of approximately $30 million, collectively, in general cost increases and expense associated with investments made in our DSD front-line workforce.

We also continue to expect an increase of approximately $10 million to $15 million in health and welfare and risk insurance expenses. RCI productivity benefits will help offset a portion of these increases. We expect marketing investment, excluding Bai, to be about 7.5% of net sales, in line with historical trends.

Now, moving below segment operating profit, our net interest expense is still expected to include an incremental [ph] $15 million (19:35) associated with the debt to acquire Bai. In other income, we will be lapping a $5 million favorable non-cash gain on our acquisition of our Aguafiel joint venture in Mexico in the third quarter of last year.

Other income for this year includes the $28 million gain on our equity in Bai that was recorded in the first quarter and the $4 million gain on the termination of the Rockstar agreement that was recorded this quarter.

Our full-year core tax rate is still expected to be approximately 34%. We continue to expect strong free cash flow in 2017, with stock repurchases of approximately $450 million to $500 million, subject to market conditions. We

also continue to expect capital spending to be approximately 3% of net sales. We continue to expect foreign currency to negatively impact our income from operations in 2017.

The combined effect of both foreign currency translation and transaction is now expected to reduce core EPS by approximately $0.04 for the year, primarily driven by our assumption on the Mexican peso, which we have forecasted at 19 to the dollar for the balance of the year. The impact of Bai on consolidated core EPS is now expected to be $0.07 dilutive, as we have further increased trial-driving activity in the marketplace. Taking all of the above into account, we are still expecting core EPS in the $4.56 to $4.66 range.

Now, let me provide some commentary to help you with your modeling for the third quarter, as certain year-over-year expense increases and lapping the gain I just mentioned should be considered. First, with respect to the acquired Bai business, the brand is still expected to ramp up over the balance of the year. And, importantly, we are expecting our heaviest level of marketing investment behind the brand in the third quarter. As a reminder, we spent $20 million in marketing this quarter. And second, we expect about $5 million of the health and welfare and risk insurance increase to occur in the third quarter.

With that said, let me turn the call back over to Larry.

Larry D. Young

President, Chief Executive Officer & Director, Dr Pepper Snapple Group, Inc.

Thanks, Marty. Before we open the lines for questions, let me leave you with a few brief thoughts. We're focused on driving growth through our priority brand strategy and our business is strong. We're executing against our communicated strategy for Bai, gaining new points of distribution on availability, driving trial and investing significantly behind the brand to drive awareness. Our early results are encouraging, and we are excited about the future of this brand.

Our allied brand strategy is working and continues to drive meaningful growth for the company. RCI continues to drive both top-line growth and productivity across the business. And, most importantly, we remain committed to returning excess free cash to our shareholders over time.

Operator, we're ready for our first question.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Your first question comes from the line of Vivien Azer of Cowen and Company.

Vivien Azer
Analyst, Cowen and Company, LLC
Q

Hi. Good morning.

Larry D. Young
President, Chief Executive Officer & Director, Dr Pepper Snapple Group, Inc.
A

Morning, Vivien.

Martin M. Ellen
Chief Financial Officer, Dr Pepper Snapple Group, Inc.
A

Good morning.

Vivien Azer
Analyst, Cowen and Company, LLC
Q

So my one question has to do with Bai, please. You've clearly made a lot of headway in terms of locking in new distribution from a retail perspective. So can you just remind us, for the 40% to 50% growth outlook, how is kind of the underlying growth evolved in terms of the mix of velocity versus distribution gains? Thank you.

Martin M. Ellen
Chief Financial Officer, Dr Pepper Snapple Group, Inc.
A

Vivien, it's Marty. So it's a combination of the two. I know we shared on the slide this morning where we are in terms of ACV and also where velocities have improved to through the year. So really, we're counting on both. The velocities is really, of course, a hugely encouraging number, because that will entitle us to more space over time and, of course, that is a huge factor.

The other consideration for the [ph] brand now here (24:02) is both the improvement emphasis on Bubbles, which we're really just getting started because we repositioned it, and then some of the other innovation, both water and tea. And we'll get some of that in the back half and depending upon retailer calendars, some of them may push to 2018, but we've considered all that in our guidance.

Operator: Your next question comes from the line of Mark Swartzberg from Stifel.

Mark David Swartzberg
Analyst, Stifel, Nicolaus & Co., Inc.
Q

Oh, good morning, gentlemen. A lot of discussion about Bai, of course, but I wonder if we could take a broader view, either a total carbonated view or a total portfolio view. And what I'm getting at is it seems like you guys are bobbing-and-weaving better than some of your competition, as Walmart price promotes and Amazon does what they're doing. And so I'm not asking for a retailer-specific set of trends, but can you give us a sense, again, whether it's for the total CSDs or for the total portfolio, how your channel performance is laying out for your portfolio, what the comparative strength is from channel-to-channel?

Larry D. Young
President, Chief Executive Officer & Director, Dr Pepper Snapple Group, Inc.
A

Yeah, Mark, I think the biggest thing is as you keep looking at how we go-to-market with our consumer-centric strategy, I mean, our customers really like the data that we bring in, where we have the brands at the right place, the right price points, the right occasions. So it's working very well for us across all of our channels. And the teams go in. Our sales stories are all in – it's fact-based. It's all data. It's points they want to see that help them drive more people through their store.

So it goes across all of our LRB's. I mean, we've got the priority brands. We go in. That's the main thing we sell, priority brands and Bai. Bai is a priority brand now. And our results are showing that it works.

Martin M. Ellen
Chief Financial Officer, Dr Pepper Snapple Group, Inc.
A

Mark, let me add something because I'll probably head-off another question from somebody else. It goes to execution. And we don't underestimate execution. And any of you that have been around us and talked about RCI, quality and delivery from the customer's perspective comes before productivity. We invested in our workforce. This industry has forever had too much turnover and too many open positions. And it leads to poor service. Every order in this company gets filled complete and on time. Shelves get merchandised properly, so they are no out of stocks. Not that there aren't any, but we measure this stuff. We go after this stuff. And this quarter was as much about investing in marketing in our brands. It was investing in the people that are out there executing. And while I can't point to it, we would hope, and expect and believe that some of that effort and work is resulting in our top-line performance.

Mark David Swartzberg
Analyst, Stifel, Nicolaus & Co., Inc.
Q

That's great. And if I could follow-up on that topic, when you look at the absolute growth of, say, C stores versus say, club stores or large format, can you just give us some sense of the complexion of growth, what's performing best, what's slower?

Larry D. Young
President, Chief Executive Officer & Director, Dr Pepper Snapple Group, Inc.
A

Yes, I think as you look at it, as far as growth, Mark, you said not mention any account specific, but Walmart's doing very well, run well with Walmart. Convenience is always a strong, strong focus of ours. We continue to go after the convenience channel aggressively. We noticed it was a little lighter in the second quarter, the entire channel, but we still did well there. So, I think that's kind of where we're driving most of it.

Mark David Swartzberg
Analyst, Stifel, Nicolaus & Co., Inc.
Q

Fair enough, great. Thank you, gentlemen.

Operator: Your next question comes from the line of Laurent Grandet of Credit Suisse.

Laurent Grandet
Analyst, Credit Suisse Securities (USA) LLC
Q

Good morning, Larry and Marty.

Larry D. Young
President, Chief Executive Officer & Director, Dr Pepper Snapple Group, Inc.
A

Good morning.

Martin M. Ellen
Chief Financial Officer, Dr Pepper Snapple Group, Inc.
A

Morning.

Laurent Grandet
Analyst, Credit Suisse Securities (USA) LLC
Q

Yeah, I just want to have, I mean, if you can add some color to all the niche marketing initiatives you are doing on Bai in term of driving the trial and also I mean moving bottles into a different place in the store? So that's one.

And two, if you don't mind, in term of numbers, you said you would spend about $100 million this year in additional marketing, $20 million on core, $80 million on Bai. Right now, you've spent $16 million on core, $20 million on Bai additional. So are you still planning to maintain $80 million for Bai for the balance of the year or rebalance between core and Bai or just spend less?

Martin M. Ellen
Chief Financial Officer, Dr Pepper Snapple Group, Inc.
A

Laurent, it's Marty. Let me take the marketing question here. So, probably a little less on marketing but more in trade and that should be somewhat expected if you think about what we're trying to do short-term to drive trial. If you've been in your large format stores, you've probably seen the three for $5 promotion. If you've been in your C stores, you've probably see two for $4 or price point thereabout, which is what we decided, as Larry said, to just go after and particularly take advantage of the summer and spend our money, mostly our money, right, to do that so we could do it quickly and get the results we've gotten.

So it partly makes sense, too, to spend a little more and get the trial going, particularly as we continue to build it through ACV, because we want to have really strong ACV numbers as we do more national whole marketing.

On the marketing side, as Larry said, we've got our first set of learnings from the analytics that we do to understand return and contributions from marketing. Larry touched on a few things that we're going to emphasize. Their heavy media calendar is picking back up, as I said, so more than a $20 million number in the third quarter, as I said.

So we think right now, we have a really good balance of both what we're doing in marketing and the vehicles that we're spending that money on in terms of effectiveness and then spending the trade dollars, which, of course, the trade dollars come out of net sales. That's the way they're treated on our books, okay? So that puts a little pressure on that, but that's just trial-driving activity. That'll go away at some point here. We do have activity through the balance of the year and then we'll hope you'll see the brand at some different everyday price point.

Laurent Grandet
Analyst, Credit Suisse Securities (USA) LLC
Q

Thank you. And in term of marketing spend, I mean, you said you would spend more in Q3. Should we think about kind of a [ph] 70% to 30% (31:05) between Q3 and Q4?

Martin M. Ellen
Chief Financial Officer, Dr Pepper Snapple Group, Inc.
A

The way I would think about modeling us is take my comments. You're going to have to think about that full-year number from Bai, third quarter being more than $20 million and I said, for the company without Bai, I said we should average something around [ph] 7.5% (31:24), consistent with historical trends.

Laurent Grandet
Analyst, Credit Suisse Securities (USA) LLC
Q

Okay. Well, thank you very much. I appreciate it.

Operator: Your next question comes from the line of Robert Ottenstein of Evercore.

Robert Ottenstein
Analyst, Evercore ISI
Q

Great. Thank you very much. Was wondering if you could talk a little bit about the allied brand pipeline, I think a year or so ago, you mentioned that you were doing a couple of trials of potential new allied brands, and I don't think we ever heard about that. So I'd love to get your thoughts on that.

And then second, what you're seeing in terms of the Hispanic consumer, and there are some reports – Target talked about some weakness in that demographic and wondered if you were seeing that also. Thank you.

Larry D. Young
President, Chief Executive Officer & Director, Dr Pepper Snapple Group, Inc.
A

Yes, yes. I'll start off with the Hispanic. With our brands, that are so strong with the Hispanic community, you saw the growth we had in Peñafiel, the growth we had in Clamato, our flavored CSDs are all growing. So I think we're still doing very well there with the consumer there. The first part of the question?

Martin M. Ellen
Chief Financial Officer, Dr Pepper Snapple Group, Inc.
A

I'll take it. Allied brand pipeline, so there's a lot happening there. We've probably, Robert, looked at, I don't know, listed 15, maybe 20 opportunities in all sorts of – some of the spaces, a lot happening in the ready-to-drink coffee space. We're there with High Brew. There are a lot of things happening. A lot of sub-categories or sub-segments within these larger segments are emerging on the basis of organic or natural. So you'll see. There's an interesting view of maybe around the energy category, in organic energy products or natural energy products.

And so the question continues to be picking the right horses for us to ride. And as I've told many of you before, it's about making sure that our checklist gets fulfilled in terms of: the management; the strategy; we're aligned on the opportunity because we're not going to own these companies, and we're not going to be able to control a lot of decisions; their access to capital, so we don't have to fund them, so that they can have the resources to act as the brand owner, which has a lot to do with not just in product, but selling and marketing.

And we continue to look at them. We believe we continue to have capacity through our system to handle them, so we're not constrained on our side. But if we're going to put the effort in, we have to pick something that we think is going to work and work over the long-term. Some products come and go, and we just can't waste our time with those.

Operator: Your next question comes from the line of Bonnie Herzog of Wells Fargo.

Bonnie L. Herzog
Analyst, Wells Fargo Securities LLC
Q

Hi, good morning.

Martin M. Ellen
Chief Financial Officer, Dr Pepper Snapple Group, Inc.
A

Good morning, Bonnie.

Bonnie L. Herzog
Analyst, Wells Fargo Securities LLC
Q

I just wanted to dig a little bit deeper on the non-marketing expense increase in the quarter. Perhaps you could walk us through how much of that was one-time in nature versus how much of it is trending upwards and expected to continue. And then finally, what, if anything, are you guys doing to bring those expenses back down?

Martin M. Ellen
Chief Financial Officer, Dr Pepper Snapple Group, Inc.
A

Okay, Bonnie. I think I can do this simply for you. If you look at you're A schedules and core SG&A, you'll see in the quarter it's up $74 million. The breakdown is really three numbers. We said $40 million we brought over from Bai. That didn't exist last year, so that's the SG&A, which includes their $20 million of marketing, that's $40 million. $16 million, I said, is our increase in marketing. And most of the balance, three-quarters of the balance, is increased investment in labor and our front-line workforce.

Other than that, there's a few million dollars left over, which is, I believe, less than a 1% increase. So actually, we're pretty happy with our SG&A performance. So you just have to consider those pieces. We're really not comparable year-over-year because we acquired Bai. That's the biggest piece, and then of course, our increase in marketing.

The front-line labor investment, we actually started making last year in the second half. So a lot of the increase in that should go away back half of the year.

Operator: Your next question comes from the line of Steve Powers of UBS.

Stephen R. Powers
Analyst, UBS Securities LLC
Q

Great. Hey, good morning. So, just back to Bai, the results look good, but obviously there were a number of questions raised last quarter, and you're pushing through a lot of change. And the departure intra-quarter of Ben Weiss seemed a bit of a surprise, at least from the outside. So, can you just talk about how you're managing that transition to maintain momentum?

I know you put Lain Hancock in charge. And I think Lain's great. So, Lain, if you're listening, congrats. But I think Lain has spent most of his time in HR and supply chain roles. And this seems a very different assignment. So, maybe just some sort of your perspective there because it's been a question that I've received a couple times since the announcement. Thanks.

Larry D. Young
President, Chief Executive Officer & Director, Dr Pepper Snapple Group, Inc.
A

You're correct. It is a very different assignment, but that's how we create general managers that can run every bit of the business. And we spend a lot of time here on how we develop leaders for the future and we put them in a lot of different roles. And so I think I can tell you he's doing a great job. But I think the people there will tell you that he's doing a great job.

We've still got Ken and most of the team there in place. The momentum is just continuing to build. As I mentioned in my prepared remarks, we couldn't be more excited about what we're seeing for the future.

Ben was a wonderful entrepreneur who created a tremendous brand. And I think we all knew it would be tough for him being in a public company. I mean, we've all seen it in the past. So we thank him for his contributions and we're just thrilled to death with the way the team is under Lain and Ken.

Operator: Your next question comes from the line of Judy Hong of Goldman Sachs.

Judy E. Hong
Analyst, Goldman Sachs & Co.
Q

Thank you. Good morning, everyone. So, Marty, I guess I wanted to just clarify the full-year guidance. I think a few items have kind of changed. You've got more favorable FX versus prior guidance. You've got a little bit more dilution on Bai. You've got higher sales growth forecast now. It kind of seems like your guidance, if I kind of take all the puts and takes, could actually be a $0.05 or $0.10 higher than prior guidance. So I'm just wondering if I'm missing anything in terms of some of adverse headwinds that you didn't specifically call out that's either the same or gotten worse versus prior guidance.

Martin M. Ellen
Chief Financial Officer, Dr Pepper Snapple Group, Inc.
A

Well, I think, Judy, you have it right. We're spending a little more on Bai, as we discussed a minute ago, some lifts to improvement, lower effective FX. We're mid-way through the year. The guidance range is a $0.10 range and at this point, we didn't see any need to want to change our expectation. We'll see where we're at next quarter.

Operator: Your next question comes from the line of Amit Sharma of BMO.

Drew N. Levine
Analyst, BMO Capital Markets (United States)
Q

Hi, there, this is Drew Levine on for Amit. Thanks for taking the question. Just wanted to touch on the Latin America segment, certainly a better margin performance than we were expecting and also some strong sales performance. So just wondering if you could comment on what's driving that, and which countries specifically you're seeing some strength in. Thanks.

Martin M. Ellen
Chief Financial Officer, Dr Pepper Snapple Group, Inc.
A

LAB, for us, is predominantly Mexico. And as we said in our prepared remarks, Peñafiel at just up 8%, that is their lead brand. We look at that business down there, we look at the market down there, and, quite frankly, our team down there just continues to do two things really well, innovate and execute. And it's just that simple. They continue to outperform. And Peñafiel this quarter, as I said, up 8%. And they've done some flavor innovation.

They've introduced a coconut flavor that I think has now become if not three, number four, Peñafiel flavor. And the consumer environment may have gotten a little better down there, but our growth, our performance, is clearly market share gaining in Mexico.

And I wish I could point to something specific or some something we discovered, some secret recipe. Well, if I did, I probably wouldn't tell you, but it's not. They are just doing the basics of the business every single day better than they did it the day before it. And we'd be remiss if we didn't congratulate our team at this point for their performance.

Operator: Your next question comes from Ali Dibadj of Bernstein.

Ali Dibadj
Analyst, Sanford C. Bernstein & Co. LLC

Q

Hey, guys. So two questions on Bai, one is just back to the level of reinvestment, want to get a sense of how you're actually thinking about the ROI on it. Clearly, you're spending more on it than I think you probably had anticipated when you're modeling the acquisition. Dilution, it's gone to $0.07 from $0.02. How do you think about the ROI? I know it's a very short timeframe. You're saying, look, the velocity is good, etcetera. But on an ongoing basis, what do you think the level of spend should be and how do you measure it?

And then the second question I had on Bai was really when you first took it on, you were very, very adamant about it's going to be run separately. It's going to keep its entrepreneurial flavor, et cetera, et cetera. And clearly, that was to, I think, mitigate the problems you did see with Ben being in a public company, you said yourself. And, of course, he leaves as a wealthy man from this entrepreneurial venture. But how does that, I guess, change of plan or messiness, for lack of a better word, impact, do you think, your attractiveness to other potential entrepreneurs to join DPS, as the nicer, better to work with company, right? Has that halo disappeared a little bit, so ROI and then just the attractiveness going forward, given some of the changes? Thanks.

Larry D. Young
President, Chief Executive Officer & Director, Dr Pepper Snapple Group, Inc.

A

Yeah, I'll let Marty handle the ROI. But as far as Bai, in the beginning, we said Bai would be Bai. And it is. It's being run separately. When you're publicly traded, there are certain things that have to be in place. And so we've got those in place. We're still running out of Trenton, New Jersey. We will continue to do that. They know now that they can come to us whenever they need things, different resources. And I've got a tremendous relationship with a bunch of these entrepreneurs that love us to death.

But they also know that whenever it comes into something like if it doesn't work, because a lot of our entrepreneurs have already done it once before, with [ph] fuse and with vitaminwater (42:44) and different ones.

So it's just a learning curve, but they also know that the relationship with us is that we've got this tremendous distribution arm, that we can go out there and get them in places where they can't go anywhere else and how that kind of coverage. So it works both ways. It's a partnership. It's a team effort. And we're not looking at any others we're picking up right now, but we never quit looking. So I think we've got good relationships with all of them.

Martin M. Ellen
Chief Financial Officer, Dr Pepper Snapple Group, Inc.

A

Ali, your question on ROI is actually a very good one because Bai is a different brand than actually all of our other brands. Normally, when we would plan trade, and I'm going to address this from a trade ROI perspective, as

opposed to a marketing ROI perspective. When we normally think about planning trade with more mature brand, we're connecting the dots between an investment, our elasticity models, in terms of the lift from, say, a price reduction, and connecting the dots to the extent that we have to do some of that either to get the lift to create the velocity if needed for the retailer. But, in essence, it's a simple price sort of volume trade-off that's been modeled, we think, quite sophisticatedly.

Now, in the case of Bai, remember, of course, we expect lift from trade and promo pricing, but the real return needs to come from improvement in trial, which will also show up as improvement in household penetration. We know where the household penetration is. We would go to raise the household penetration. We've probably seen a couple points of improvement so far in trial as measured, but we can't get this data real-time. We need to use our services to go out and survey the consumers, do their panel work and come back to us with the data, which may or may not be available to all of you, I'm not sure.

So, but ultimately, that's what we're going to be looking for here very soon. And that will be our ultimate measure of success in driving trial, as opposed to the way we look at trade on our traditional brands.

Operator: Your next question comes from the line of Peter Grom of JPMorgan.

Peter K. Grom
Analyst, JPMorgan Securities LLC

Q

Thank you and good morning.

Martin M. Ellen
Chief Financial Officer, Dr Pepper Snapple Group, Inc.

A

Morning.

Peter K. Grom
Analyst, JPMorgan Securities LLC

Q

I just wanted to ask a quick question on Snapple. You mentioned in the press release that strong shipments from a promotional event are expected to sell through in the third quarter. So, one, have you already started to see the sell-through occur? And I just want to get your thoughts on how we should think about the growth for the brand in the back half of the year. Thanks.

Larry D. Young
President, Chief Executive Officer & Director, Dr Pepper Snapple Group, Inc.

A

Yes, we're already seeing the results for [ph] July (45:27) and so we're pleased with it. There's still a lot more to go. I think we've got our plans with the plastic bottle. We've got a lot of different things out there that we're going to be using with Snapple. The juice side of our Snapple is still doing very well. Juice continues to grow. So as we get going into the selling season for resets, I mean, we're going in with a very strong tea strategy with Snapples, our flavored teas, our straight-up teas and our Bai Superteas. So, I think the trade's really embracing seeing that we can come in and cover all angles of the tea category.

Operator: Your next question comes from the line of Lauren Lieberman of Barclays.

Lauren Rae Lieberman
Analyst, Barclays Capital, Inc.

Q

Thanks. Good morning.

Martin M. Ellen
Chief Financial Officer, Dr Pepper Snapple Group, Inc.
A

Good morning.

Lauren Rae Lieberman
Analyst, Barclays Capital, Inc.
Q

The revenue this quarter, I mean, was incredibly strong, and, remarkably, we haven't talked about that yet. So I think on 7UP, we're all well aware of the more specific actions you've taken in the last couple of months, the renewed advertising, repositioning and so on. But anything else that you think you'd want to call out where something has changed, where you've done something a bit differently that's really kind of kicked in?

And then, as we look at the back half of the year, I know you have a legacy of being conservative, but it feels like the net sales change was more about FX than about the better than expected organic this quarter. So is there anything we should keep in mind sequencing-wise, any kind of timing shift in the second half that hasn't been mentioned yet? Thank you.

Martin M. Ellen
Chief Financial Officer, Dr Pepper Snapple Group, Inc.
A

Lauren, it's Marty I'll take it and Larry can add, if he so chooses. There's a lot of things. We'd like to think that all the effort and money we put into developing our strategy a couple years ago, really going deep with the consumer and using that data to align our marketing campaign, 7UP being a great example, the focus that came from that by us making choices, choices about what brands to focus on as priority and what brands not to and where to direct our resources. And then, we overlay execution and our focus on execution, our focus on the customer, our portfolio. We like our portfolio. We've always said we think we have an advantaged portfolio and particularly in CSDs.

Larry talked about the opportunity we see in tea. And let's not leave out water when you look across our allied brands in Bai and what we've got happening there and the selling stories we're going to have from retailers there.

So we put all that together and say, yeah, I said we overachieved. We did not predict that level of top-line. But we're very satisfied and encouraged and we think that's it's a collection of those activities. There is business to be had. There is share to be gained. In CSDs, I don't know if it's a zero sum game or not, but that doesn't mean we can't gain share and work hard at it. And we're going to continue to do that.

Operator: Your next question comes from the line of Kevin Grundy of Jefferies.

Kevin Grundy
Analyst, Jefferies LLC
Q

Thanks. Good morning, everyone.

Martin M. Ellen
Chief Financial Officer, Dr Pepper Snapple Group, Inc.
A

Morning, Kevin.

Larry D. Young
President, Chief Executive Officer & Director, Dr Pepper Snapple Group, Inc.

A

Morning.

Kevin Grundy
Analyst, Jefferies LLC

Q

Two questions, I'll ask them both concurrently. So the first one, just to sort of clean up the Bai question, Marty. So is it too early to say that the cost of growth will be higher for that brand? This was sort of asked earlier, but so is the nickel more dilutive but the growth outlook doesn't change, maybe there was some conservatism in that, maybe not?

But how should we think about that dynamic, where it's more dilutive, you're spending more behind it, but seemingly the growth outlook hasn't changed? But maybe that's not the case. Maybe the expectation is this is long-term brand-building and as you guys are thinking about it, this is more of a 2018 acceleration than 2017. So just to sort of tie the loop on that and some quantification would be great.

And then, Marty, you just touched on CSDs, so you've done really nicely from a share perspective, as has Coke. And Pepsi continues to donate share. What are you seeing differently from them? I'm not sure how much you want to comment on your competition. I sort of understand that. Are you seeing anything differently from an execution perspective? Are you seeing a share of voice move down? And they've started talk a little bit more about spending behind North America Beverages. So if that's the case and indeed that does play out, do you have enough cushion in your guidance here to match from a spending perspective? Thank you for both of those.

Martin M. Ellen
Chief Financial Officer, Dr Pepper Snapple Group, Inc.

A

All right, Kevin, appreciate your question. Let me talk about Bai. Bai, in terms of donating share, last time I looked, nobody's a charity. Nobody's donating anything. We all go out every day and we work hard. And they work hard, too.

Look, Bai investment, it's a great question. So the cost of growth, end of the year, we talked about upwards of $80 million in marketing, traditional sort of pull marketing. And we've come down a little bit and replaced some of that with trade to drive short-term trial activity.

Clearly, from a marketing point of view, the marketing for that brand, probably for a while, will stay elevated. It's a relative question, relative to what? Well, relative to 7.5% of sales of cores because our brands are mature. Our brands have high household penetration. They have enormous brand awareness and brand equity. We would nowhere need to do the same tactics, of course, on our mature brands that we would on an evolving and more nascent brand.

And we're not going to let this opportunity get away from us. We are not going to be short-sighted here. We have an opportunity to do something. We haven't had the opportunity to do it before. This brand has lots of opportunity. And we're going to go after it, but we're going to go after it with discipline. We're going to put money into what our data says works and pull money away from things that don't work.

I'm not here saying, therefore, that we're going to open up the spigots and spend all sorts of money into 2018, but clearly at some level much higher than historically you would find us doing. The trade, which is not insignificant this year, that's short-term. That's going to drive trial. We'll get a lot of information from that. You will see the

brand move back to some higher everyday price points. So therefore, we won't be funding that margin to the retailer any more.

And then the innovation and I think we're just getting started. I know we probably communicated earlier in the year that some of that would hit later this year. And we have gone back and worked on Bubbles. Larry touched on both the tea and the water probably really'd be more 2018 growth platforms than 2017.

We're really excited about the opportunity to present our portfolio to retailers, who are clearly looking to find more margin. And we've got higher price point value-added brands for them that we think are going to create a really compelling story. So near-term, Bai, yeah, the cost of growth may come somewhat higher, but, again, of course, we'd expect that.

Did we model it all initially? No. But we've had a lot of good learnings. And I don't think the amounts we're going to spend are going to be that material, more so than we thought either. I lost the CSD question somewhere.

Larry D. Young
President, Chief Executive Officer & Director, Dr Pepper Snapple Group, Inc.

A

Well, with CSD, what we're seeing out there, I think Marty touched on our competitors are very, very competitive. They run a great operation. I think we're very fortunate that we've got some of the right brands, some of the flavors that the consumer's looking for. We mentioned that we invest in our brands. We invest in our people. And that's what's delivering our results.

Operator: Your next question comes from the line of Bryan Spillane of Bank of America.

Bryan D. Spillane
Analyst, Bank of America Merrill Lynch

Q

Hey, good morning. And thanks for taking the question. I just had one related to Bai manufacturing. Marty, I think my understanding is that most of Bai is still co-packed or produced by a third party. So, I guess, if you can clarify if that's true? And if so, over time, is there an opportunity to capture more of the profits of the manufacturing profit by bringing more of that production in-house over time?

Martin M. Ellen
Chief Financial Officer, Dr Pepper Snapple Group, Inc.

A

The answer, Bryan, is yes, it is co-packed. Yes, there's an opportunity. We do have a contractual relationship with a co-packer, whom we're working with very closely. That contract will have upwards of five years to go. There are opportunities not just to bring the production in-house, but also the logistics of moving production to other places geographically.

All the Bai product now really gets shipped from the East Coast. So just simple supply chain and logistics would say over time, we need to change the geographic footprint of the Bai supply chain. And we will be doing that. There will be profit upside, not actually insignificant.

Operator: Your final question this morning comes from [indiscernible] (55:13) of SIG.

Q

Good morning, everyone. Look, I have two questions. So first, thinking about your capacity to do further deals in terms of the allied brands and it seems to me that if any of the three allied brands came up for sale in the near term, based on my estimates of valuation, you will not be able to bid, given what your balance sheet is, if you could comment on that.

And the second one would be, going back to Bai, maybe it's a Marketing 101 question, but it seems to me like you're stretching the brand too much and that the core business could suffer as a result, [ph] so thinking of ways to turn (55:47) tea into water, into sparkling water. I can't imagine how Vita Coco or like Gold Peak or brands of that nature would be extendable as much, so if you can explain why Bai is extendable compared to other brands? Thanks.

Martin M. Ellen

Chief Financial Officer, Dr Pepper Snapple Group, Inc.

A

Okay, I'll take a stab at both of those. So Bai, the extendability of Bai, I think, as we look at the brand halo from consumers, it sort of positions it not so much as just an enhanced water, but as this clean-label, better-for-you, pure beverage. So we've done some research on this. It's got to be done in a certain way, though. If your question really goes to, for example, the reason you're seeing maybe tea not as penetrated as maybe we would have thought six months ago, it's because we want to make sure that if it's in the tea set, all of the things we're doing to increase brand awareness and equity through marketing will allow the brand to stand on its own there.

As opposed to the tea, for example, being simply viewed by the consumer as a flavor extension of the enhanced water, because the consumer data would say that the demand space and the needs being satisfied in the enhanced water category, if you will, are going to be different, both in tea and within plain tea and flavored tea, there are even differences there. So there is sort of a method to our approach to this to make sure that the strength of the base and the strength of the marketing around the base can be haloed.

Look, with respect to our capacity to make acquisitions and what may or may not happen to these other allied brands, we've said this, and I'll say it again. There's risk in our strategy of opening up our distribution to go where the consumer is going quickly because we don't ultimately control what happens with these brands and who may own these brands. We have, under the right circumstances, we would look to possibly acquire something, but that's not our strategy. We're prepared. Look, we're prepared to, if necessary, we may have to give one or more of these up over time.

The pipeline is full. You just go to any beverage industry tradeshow and you will see football field rooms full of innovative ideas and people looking for distribution. We can't predict what the future would hold. It is a risk. And, no, we would not step up and acquire all these brands. I can probably say that with certainty.

Larry D. Young

President, Chief Executive Officer & Director, Dr Pepper Snapple Group, Inc.

All right, well, thanks for joining in the call today and for your continued interest and investment in Dr Pepper Snapple Group.

Operator: Thank you. That does conclude the Dr Pepper Snapple Group's second quarter 2017 earnings conference call. You may now disconnect your lines. And have a wonderful day.