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Dr Pepper Snapple Group, Inc. (DPS)

Q3 2017 Earnings Call

CORPORATE PARTICIPANTS

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

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

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

OTHER PARTICIPANTS

Kevin Grundy
Analyst, Jefferies LLC

Caroline Levy
Analyst, Macquarie Capital (USA), Inc.

Amit Sharma
Analyst, BMO Capital Markets (United States)

Laurent Grandet
Analyst, Credit Suisse Securities (USA) LLC

Nik Modi
Analyst, RBC Capital Markets LLC

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

Judy E. Hong
Analyst, Goldman Sachs & Co.

Lauren Rae Lieberman
Analyst, Barclays Capital, Inc.

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

Robert Ottenstein
Fundamental Research Analyst, Senior Managing Director & Head of Evercore ISI's Global Beverages research team, Evercore Group LLC

Peter K. Grom
Analyst, JPMorgan Securities LLC

Bryan D. Spillane
Analyst, Bank of America-Merrill Lynch

MANAGEMENT DISCUSSION SECTION

Operator: Good morning and welcome to Dr Pepper Snapple Group's Third 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.

Thank you, 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 operational 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 measures to GAAP 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 it 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 notwithstanding several weather-related natural disasters in the quarter affecting our business in both the U.S. and Mexico, our teams continued to execute against our priority brand strategy, and we delivered solid results while investing heavily in marketing and trial activities for Bai and further investing in our front-line DSD workforce, which is clearly contributing to our share-gaining performance.

In our CSD portfolio, we once again outperformed the category, growing both dollar and volume share in IRI-measured markets. Our allied brand strategy continues to be successful, allowing us to participate in rapid growth for minimal investment.

In light of softer traffic, cooler weather and higher gas prices, our business performed well in the convenience channel this quarter. We gained both dollar and volume share across all of our LRBs and CSDs. We continue to gain distribution across Bai. And collectively, with our allied brand portfolio, we are gaining a larger share of voice and driving meaningful growth for our retail partners.

For the quarter, bottler case sales were flat on about 2.5 points of positive price/mix. We've estimated that the unfortunate natural disasters negatively impacted our volumes by about 0.5% in the quarter. However, we are pleased to report that all of our employees are safe and our facilities and equipment are intact.

Our CSDs declined 1% and our non-carb brands increased by 6%. Dr Pepper decreased 2%, primarily driven by performance in our fountain business as a result of timing of orders for a large customer. 7UP declined 8% in the quarter on reduced activity in the marketplace, bringing its year-to-date performance down 2%. Both A&W and Schweppes declined 1%.

Canada Dry grew 2% on continued growth in the ginger ale category, and Squirt increased by 1%. Peñafiel increased 5% on strong performance in both mineral water and our [ph] aids line. (4:29)

All other CSDs decreased 3%, lead by the loss of Rockstar distribution on the West Coast, which represented just over 0.5 point headwind to our net sales growth this quarter. In non-carbs, Snapple bottler case sales declined by 5% in the quarter, primarily on diet declines.

Mott's increased 5%, primarily on growth in sauce, and Clamato grew by 7%. Bai increased 108%, both on the acquired volume outside our system as well as on continued growth in our own DSD system.

Our growth allied brands increased 40%, driven by continued strong growth across BODYARMOR, FIJI and Core, once again demonstrating the continued success and importance of this strategy. All other non-carbs declined 1% in the quarter.

As we look to finish the year strong, our marketing calendar for the balance of the year is packed with programs that will continue to leverage the power of our priority brands. Dr Pepper will be the one fans crave during college football season. Our college football celebrity, Larry Culpepper, and his tailgating RV are back with his team for the Larry roadshow.

We'll have national TV, media, digital and social messaging and strong activation at retail. College football-themed packaging and on-package consumer value offers. And once again this year, we'll help worthy students achieve their dreams with our Dr Pepper Tuition Giveaway program.

During the holiday season, we'll highlight our 7UP and Canada Dry red and green bottle program with national media, social and digital execution, holiday-themed packaging and a donation to the Salvation Army for every consumer purchase.

Schweppes sparkling waters will also be front and center for the holiday mixer occasion. And with the continued rollout of our convenient 16-ounce plastic bottle that looks and feels just like our iconic 16-ounce glass bottle, Snapple will give on-the-go consumers a more convenient single-serve option that we believe will also help additional momentum for the brand in the convenience channel.

Now, let me give you an update on our newest brand, Bai. I spoke last quarter about putting even greater levels investment than initially planned behind the brand during the summer selling season to drive both trial and awareness, and we are achieving good results.

During our investment window, we saw trial rates across some of our platforms nearly double, while still maintaining strong repeat across the brand. Our brand equity tracking reflects a significant uptick in aided brand awareness, not only across our base Bai product, but across several of our Bai platforms.

We are also encouraged by the continued growth in distribution and availability across the brand, particularly in the highly profitable convenience channel. Bai remains the fastest growing brand in the enhanced flavor water category, with retail dollars up close to 50% in the third quarter in IRI-measured markets. Our velocities continue to be strong across platforms and channels, and we've recently had some impressive account-specific wins for the brand. We're continuing to execute our strategy to reset Bubbles in the sparkling water set. And in specific accounts where we've placed SuperTea in the tea category, the brand has seen strong growth. We're re-launching our antioxidant water this quarter, complete with a new formula and updated packaging. This will be a 2018 initiative.

As I said, the day we announced the acquisition of Bai, the organization and I couldn't be more excited about the prospects for this brand. We're executing against the strategy we communicated and ensuring that we continue to drive sustainable growth across the 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. Our third quarter results reflect generally strong top-line performance, continued marketing and trial-driving trade investments in Bai and the addition of further resources to our DSD front-line, which are clearly aiding our retail execution. Unfortunately, our financial results were negatively impacted by a default by a long-standing resin supplier to our business in Mexico and the unfortunate natural disasters affecting parts of the U.S. and Mexico.

Core operating income and core EPS declined by 4% and 6%, respectively, as we invested heavily behind Bai, spending $20 million in marketing this quarter, and we incurred the $6 million write-off of prepaid resin inventory that I just mentioned. Furthermore, we estimate that the natural disasters negatively impacted both core income from operations and core EPS by about 2%.

Now, let me walk you through the details. Reported net sales increased 4% in the quarter, including the Bai acquisition, which accounted for just over 1 percentage point of this net sales growth. Total Bai sales, including our DSD distribution, accounted for just over 2 percentage points of our net sales growth. Bai now represents about 4.5% of our total company revenue, reflecting a positive shift in our portfolio. Organic net sales grew on volume growth of about 0.5 point and favorable mix.

Net sales was further increased by just over 0.5 point of favorable foreign currency translation and price increases taken earlier in the year. This net sales growth was partially offset by the loss of our remaining distribution of Rockstar on the West Coast and the effective lapping a favorable true-up of our customer incentive liability a year ago.

Reported gross margins increased 10 basis points from 59.3% last year to 59.4% this year. The favorable impact of unrealized mark-to-market commodity changes increased gross margins by 20 basis points, and continued productivity improvements increased gross margins by 10 basis points. The added margin from now owning the Bai brand increased gross margins by 120 basis points, while the write-off of the prepaid resin inventory and other manufacturing cost increases reduced gross margins by 60 basis points.

Furthermore, we incurred a 30 basis point reduction to gross margin due to accelerating the expensing of higher cost apples for Mott's Applesauce as we were on the LIFO inventory method. Also decreasing gross margins in the quarter were the effects of sales mix, mostly from continued allied brand growth and foreign currency transaction, which reduced gross margins by 30 basis points and 20 basis points, respectively.

For the quarter, SG&A increased $37 million. The acquisition of Bai added $38 million, including the $20 million in marketing expense that I already mentioned. Also, certain operating cost inflation and the additional planned investment behind our DSD front-line workforce increased SG&A. Partially offsetting the increased SG&A was a $6 million favorable comparison of unrealized mark-to-market activity in the quarter.

Depreciation and amortization increased $2 million in the quarter. Other income decreased $3 million, as we recorded a non-cash gain on our step acquisition of our joint venture Aguafiel business in Mexico a year ago. This declined by $6 million in the quarter, as the favorability from volume and sales growth was offset by further investment in Bai and further investment in our DSD front-line.

Other factors, including the resin inventory write-off, the unfortunate interruptions caused by the natural disasters and accelerating the recognition of inflation in the cost of apples, also impacted reported income from operations. And finally, we experienced inflation in certain other operating expenses.

Below the operating line, net interest expense increased $7 million, mostly due to the higher debt balances associated with the Bai acquisition. We also recognize a $13 million loss on the early extinguishment of debt, resulting from the tender offer and redemption, which commenced in the second quarter. Our reported effective tax rate was 36% compared to 29.7% in the prior year, which included a $17 million tax benefit that increased reported EPS by $0.09 last year.

Moving onto cash flow, cash from operating activities was $732 million, up $27 million compared to last year. Capital spending was $85 million compared to $110 million last year. Total distributions to our shareholders were $629 million, with $309 million in dividends paid and $320 million in shares repurchased.

Before I move into guidance, I'll give a quick update on RCI. I've mentioned many times that the structural pillars of RCI are safety, quality, delivery, productivity and growth. But remember that the order of these pillars is nonnegotiable in a Lean environment. After safety, we drive to achieve customer-defined levels of order completeness, on-time delivery, reduced shelf out-of-stocks, improving display execution and meeting all other important customer attributes. We then and only then, drive to improve the profitability of these customer value attributes, while eliminating all others.

Visual management boards are being improved across the organization and are creating the pull for areas of improvement to be achieved. And because of the breadth and scope of our physical DSD footprint, we're adding further RCI resources at the local level to assure these pull activities are worked on every day, further building RCI into the DPS way of doing business.

Now, moving to our 2017 updated guidance, we continue to expect net sales growth of about 4.5%, with no meaningful effect from foreign currency translation. We now expect that our acquisition of Bai will contribute over 1% of this net sales growth, as we now believe the brand's volume will grow about 40%.

Organic volume growth is now expected to be over 1% and the acquired Bai volume, that which is sold by other distributors, is expected to contribute about 0.5 point of our total company volume growth.

There's now about 2.5% of price/mix embedded within our expected net sales growth due to continued strong growth in our allied brands. Our expected net sales growth also reflects the 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 now expect packaging and ingredients, excluding the acquired Bai business, to be inflationary by about 80 basis points on a constant volume/mix basis. This assumption now includes a higher cost for resin purchased in the fourth quarter, given the tightness in the supply of resin, but we have secured the necessary quantity for our business. Also included is the higher LIFO cost, primarily related to apples.

For modeling purposes, remember that growth of 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 just mentioned, coupled with the added gross margin we realize as the brand owner of Bai, are now expected to result in flat gross margins for the year.

Moving to SG&A, excluding our acquisition of Bai, we're expecting an increase of approximately $35 million, collectively, in general cost increases and expense associated with investments made in our DSD front-line workforce.

We expect an increase of approximately $5 million to $10 million in health and welfare and risk insurance as compared to last year. And, as we've done before, RCI productivity benefits will help offset a portion of these increases. We continue to expect our 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 $50 million associated with the debt to acquire Bai. 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 effect of foreign currency transaction is now expected to reduce core EPS by approximately $0.02 for the year, primarily driven by the Mexican peso.

After considering current volume and investment expectations for Bai, the impact of the acquisition on consolidated core EPS is now expected to be $0.11 dilutive. And, as I previously mentioned, we have estimated that the natural disasters that occurred this past quarter have reduced core EPS by $0.02 for the year. Taking all of the above into account, we are now expecting core EPS in the $4.50 to $4.57 range.

With all 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 line for questions, let me leave you with this. Our teams are focused on driving growth through our priority brand strategy through allied communication and execution. We're executing against our strategy for Bai, gaining new points of distribution and availability in critical channels and driving trial and awareness of the brand. Our allied brand strategy is driving meaningful growth for the company. RCI

continues to be the platform on which the business operates. And we remain committed to returning excess free cash flow to our shareholders over time.

Operator, we're ready for our first question.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Your first question comes from the line of Kevin Grundy of Jefferies.

Kevin Grundy
Analyst, Jefferies LLC
Q

Thanks. Good morning, guys.

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.

Kevin Grundy
Analyst, Jefferies LLC
Q

I want to start off on Bai and maybe you guys could talk a little bit more about what led to the downward revision. Some of the results have come in a little bit below what you had expected previously. And then, maybe touch on a little bit some of the challenges that you guys have had, I guess, with respect to forecasting this business, both with respect to top line and with respect to cost controls, given that it's now expected to be a bit little more dilutive. Then I have a follow-up. Thanks.

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

Kevin, it's Marty. Thanks. And I'm going to answer your question and probably provide some more data so I can give sort of a complete review here of Bai, since we suspect many have questions all about the brand. So let me start by saying, we clearly said earlier this year, we're going to drive trial. And we spent $10 million in Q3 doing that and about $22 million year-to-date, mostly on price promotion.

You've probably seen the market large format, lot of 3 for $5s, convenience 2 for $4s. The result of all that has been from when we measure from March to the end of September, we've more than doubled household penetration on trial. It is still single digits but we doubled it, and repeat purchases are still strong. So we think the results of that activity, which have mostly completed now, gave us the desired result in building the brand.

I'll also tell you that we said we needed to deemphasize the club channel. Building a brand in a highly promoted environment is not the way we want to build the brand profitably for the long term. A year ago through Q3, club channel mix was 31%. We've decreased this to 26%. Year-to-date, it was 33% last year. It's now down to 27%.

And if you look at the non-club channels in Q3, the brand grew 45%. We only grew 11% in club. That's a conscious decision. It probably has cost us some volume in net sales because you sell 15-count packs, for the most part, in club, but, again, highly promoted, that's not the way we want to build the brand.

If you look across the distribution – if you look at IRI data for the base, which is the biggest product base, still Bai, quarter-to-date, brand's up 48%; year-to-date, 40%. If you look at shipment volume across the whole space and our side of the business inside Packaged Beverages, brands were 36% in the quarter, 34% year-to-date. We got out of the blocks slow in Q1. It was only 26%. Total shipments out of Bai, so that's to all distributors, up 45% in the quarter, 35% year-to-date. And if you want to look across the total growth the brand had for us across the whole company, 35% in Q3.

So, look, we've got lots of good results here. And, yes, we admitted in past quarters, we did shift some things. We made some conscious decisions that we knew would hurt the growth and profitability in the short term. But I think we've been really clear about what we think it takes to build the brand over the long term. And, of course, finally, inside Bai itself, we did spent $20 million in marketing. I mean we're trying to do all we can to create the right pull activities, and that's a lot of spend in one quarter. So hopefully that, Kevin, provides you with some good information.

Operator: Your next question comes from the line of Caroline Levy of Macquarie.

Caroline Levy
Analyst, Macquarie Capital (USA), Inc.

Q

Thanks so much. Just wondering if you guys could comment on the pricing environment. Pepsi had a particularly disappointing quarter in the U.S. And there's the fear that what's been a very benign and comforting price/mix environment in carbonates and in general, might change. Would just appreciate your insights on that.

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

A

Yeah, Caroline. We've not seen anything out in the market. We've seen a lot of good discipline. Everybody is, I think, putting more of a focus on alternative packages. Some of the smaller packs and also maybe more on some of the promotional activity, but pricing has been very rational. We're very pleased with what we're seeing.

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

Q

Hi. Good morning. It's actually [ph] Adam (25:10) on the line for Bonnie. Wanted to actually just touch on two of your CSD brands; Dr Pepper, I was hoping you can quantify the impact of the fountain foodservice ordered. And really just comment on the brand's health. It seems like scanner data was pretty strong for the quarter, so I was a little bit surprised at the results for the brand. And then also in 7UP, which I know recently has been doing much better as a result of the Lean track started last year, So was a little surprised that the extent of the deceleration of that brand this quarter. So if you could just comment on those two brands, I'd appreciate it. Thanks so much.

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

A

Hi, [ph] Adam, (25:27) it's Marty. I mean, Dr Pepper is easy. Our fountain volume, which many times in a quarter can be affected by the timing of large purchases of concentrate by one of our large partners, made the brand down 3.3% in fountain, which, of course, is not measured. So otherwise, the brand is fine and it's growing.

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

A

And I'll take the 7UP and just to reiterate what Marty said, we have no concerns at all over our Dr Pepper. We're very confident with programs and our growth continuing. But 7UP, as I said in my prepared remarks, we were lapping some very, very heavy activity a year ago in Q3. It's another brand of what we have put together for the fourth quarter, for the holidays with our green and red bottle, we're very confident that we'll bring it back up, and the plans we have for 2018 give us even more confidence that we've got this brand on the right track.

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

Amit Sharma
Analyst, BMO Capital Markets (United States)

Q

Hi. Good morning, everyone.

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

A

Morning.

Amit Sharma
Analyst, BMO Capital Markets (United States)

Q

Larry, there are examples of many, many companies that choose to go outside of their core expertise and end up getting hurt, right? I mean, just talking about Bai, it's still a relatively small part of the portfolio, but your stock price is clearly telling you that people are worried about it. What does it mean from an earnings predictability point of view going forward? Can you talk about that a little bit? And at what point do you make the decision whether the spendings that are going behind the brand are delivering the ROI that you required of them or not?

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

A

Yeah, absolutely. I mean, we look at the spending we're doing right now. We're very confident with the information that we've brought in, especially from our consumer-centric strategy on where we need to be spending. The results that Marty gave you earlier show you that we have doubled the household penetration. Our repeat rates continue to stay at levels we're not used to seeing. We're very confident with what we're doing with Bai. In the beginning, you always spend. I mean, it doesn't mean we'll spend that forever.

We've also had a lot of things in the beginning that we had out there that we've looked at and said, we're going to relaunch some of our innovation. We're going to pull back on it, focus on the base, get the Bubbles reset. We're rebuilding our SuperTeas, the labels. Bai, in my prepared remarks, I told you we've relaunched it.

We're going to see the Bai water just for 2018. I mean, the packaging is beautiful. We were at the [ph] Max convention. (28:23) Everybody that was sampling it just loved it. They loved the packaging. They loved the mouth feel and it's water with antioxidants. So we're looking very, very forward to what we can do with that, but we will

continue to invest. We will watch the return on our market investment. And whenever we see that we've got it where we want it, you'll see that come down.

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, everyone. Another question on Bai, and I'm looking for further upside here, potentially. So right now, if I recollect correctly, Bai is still entirely manufactured outside of your own system. I believe there are some contractual commitments providing you to switch in the short term. Now are you planning to repatriate any production in-house? If yes, when? And what would be the synergies here? And also another question on Bai, results in the UK?

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

A

Laurent, Marty, so, yes. The product is manufactured by third parties under some contracts that will take a few years to expire; however, we are able to take Bai Bubbles, for example. We can take that. We're going to put that in our system. That's actually going to add a good amount of profitability for us next year. We'll talk about next year when we're ready to talk about next year, but that's clearly an improvement for us.

And by the same token, we've now got the brand within our warehouse management system. So there's been a lot of inefficiencies in the way they've moved product between their co-packers and points of distribution. We actually began changing that in the month of October, but it requires that we get them on our SAP system, which took us a little time. If I forgot part of the question, please restate it.

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

A

UK.

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

A

Yes. UK business is going well. They started with Alliance Boots. And again, we made a choice again to sacrifice short-term profitability to build the brand in the market, meaning we're making it in the U.S., shipping it there. So there's not really any real margin to speak of. And we're also putting some local marketing behind it. When we get to a requisite volume point of view, then we can move – we have identified a co-packer there. We just think we'd rather deal with that when we have more volume and when we believe the brand has actually established itself.

Operator: Your next question comes from the line of Nik Modi of RBC.

Nik Modi
Analyst, RBC Capital Markets LLC

Q

Good morning, everyone. I was hoping you can give a little bit of context on your view on the consumer. And I ask because as earnings season has been going through, many companies have been talking about a sluggish consumer environment broadly. But no one has a really good answer, and I'm hoping to try my luck with you guys to see kind of what your view is of what's going on with the consumer. And if you do see general weakness, what

you attribute it to and maybe you can even make a specific comment on C-stores because it looks like you guys did fairly well there. So, was that a result of share gains, or is the entire channel doing okay?

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

A

No. In convenience, we've had a lot of share gain there, added availability. As I mentioned in my prepared remarks, we're doing very well there on volume share and dollar share. Again, we're doing this with Bai and our allied strategy, allied brands and also we are CSDs, so we're winning across that, but we have seen the convenience store channel has been a little slower as a whole.

And I think a lot it's because of some of the weather, higher fuel prices and towards the end of the third quarter, there in August, September. So that's kind of where it's there.

On [ph] CSR's, (32:22) we're seeing that kind of flat. The quick serve restaurants are kind of flat. But I think overall, the consumer is kind of hard to follow right now because we're trying to see how much is going through e-commerce. We don't really know where that's at. So we've kind of tracking a lot of different avenues now to figure out where that consumer is.

Operator: Your next question comes on the line of Ali Dibadj of Bernstein.

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

Q

Hey, guys. So I wanted to hit two things, if possible. I don't think they're necessarily related, but they might be. One is just back to allied brands more broadly from a strategic perspective, given certainly everyone's concerned about Bai and what we saw in Rockstar. It's been something that certainly we've been worried about for more than a year now. And would just love to know how you think about the future of some of the properties of, in particular, BODYARMOR right now, at this point, can you speculate about what the future of it is in your system? And then from a Bai perspective, I don't know if this is a fair question, but you tell me. If you knew what you know now about Bai, would you still have bought it? And then the second...

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

A

Yes.

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

Q

That was a quick answer. The second question, which it may or may not be related, I'm not sure, is just around the front-line investments in DSD. Can you elaborate a little bit about that? The number of people, is it wage increases, is it something else?

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

A

Yeah, absolutely.

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

Q

Thanks.

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

It's a combination of all of them. On the front line, which is the most important, that's how we get our brands out there. Marty mentioned to you RCI and I mean we don't look at any productivity until we know we have quality and delivery for our customers. And we're putting more feet on the street, and we're making sure that those people are compensated fairly. And it's paying dividends for us. You can see by the share gains. And I mean, we're executing on the street. Again, I'll reemphasize on Bai. The answer would I buy it? Yes, exactly.

I mean, whenever you go in and buy these things and look at it, I mean thrilled to death with what's going on. I know we're going to be able to build this brand, but the main thing is that we strive for sustainable growth, that's what we go after.

Operator: Your next question...

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

BODYARMOR, excuse me.

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

Let me comment. Ali's offline. Let me deal with the allied brands because we've talked about this quite a bit. Look, we don't believe it would be possible to actually move into all these growing categories on our own and nobody else in the industry has proven they can do that either. So we partner with these allied brand owners. And so far, the results have been good. And we have no knowledge of what may or may not happen to these brands down the road, but we've been very open and honest by saying, look, these are entrepreneurial-led companies, for the most part.

And, at some point, they will look to monetize their investment, if they are successful. And, of course, the only ones that matter to us are the ones that are successful. And we'll have to see what the future holds for those. It is possible, of course, we could lose one or more of these brands. By the same token, I will tell you, the pipeline of innovation by third-party companies is about as full as we've ever seen it across so many categories: organic energy drinks, [ph] Kombucha ready-to-drink. There's a tea category. (35:53) And we continue to look and we continue to try to identify who we think the successful brands will be so that we can begin partnering with them. This is part of our strategy. And we understand the risks inherent in that strategy.

I want to go back and talk about front-line, because I really want to make this point because many of you have been with us through our RCI journey. When any of us go into a facility, into a branch, a DSD branch, we look are their visual management boards.

I'll be honest with you. Unless we see high levels of on-time order delivery and completeness, which is a key metric, we personally, as senior managers, we don't really care what their cost per case is, which is productivity, until we know that customers are being satisfied, then and only then – we will actually improve productivity. We have improved productivity.

But that is the culture we're building. We do what our customers want us to do. They come first, then we will improve the business. And all of our people are getting aligned around this. And as Larry said in some markets, we've had to add people to get the service levels where our customers demand them to be. And that's sort of our operating model. That is our operating model.

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.

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

A

Good morning, Judy.

Judy E. Hong
Analyst, Goldman Sachs & Co.

Q

So, Marty, on Bai, and I'm not going to ask about the strategy, but I just wanted to clarify some of the numbers and the guidance that you've given. So if I think about the sales impact from the acquired Bai sales, now you're saying it's about a 1%, so it's like $65 million impact this year. It seems like it actually implies a decline versus what I would have backed into 2016 base number.

So first, is the promotional investment that much of a drag in terms of 2017 sales? And then, for earnings dilution, it seems like now you're kind of guiding to the operating income impact for this year, that implies a still a pretty strong fourth quarter profit impact. But I know you did like a $25 million loss year-to-date, expecting maybe a pretty big recovery in the fourth quarter. So what's sort of the inflection that you're expecting in the fourth quarter, at least from a profitability perspective?

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

A

Okay. Well, Judy, in terms of a sales, what I'd tell you, the promotional spending is pretty much all a hit to the net sales line. It's not below the line marketing, it's really trade money. So that's going to take – all things being equal, going to take the net sales number down anyway. And as I said earlier, we're not seeing and we're okay with not seeing the same level of growth in club, so our ability to sort of wean ourselves a little bit away from that, probably hurting our top line expectations somewhat as well, as I said earlier.

But otherwise, look, all the systems, with our system, the other parts of the distribution system, we call them the ISO distributors, are doing just fine. And I'll tell you, I mean, we haven't said it. I mean, the retailers just love this brand. And the clout that it's giving us across the – if you think about our enhanced water and even broader water portfolio, you know all the brands that are in it. When we go speak to retailers now owning this brand, it's meaningful. It gives us a much more meaningful seat at the table to help them across the entire category. And it's given a lot of optimism to our national account people. We have really something strong to go talk about, and, as Larry said, they've seen the innovation and everybody is really encouraged by it.

Granted, coming later than we thought at the beginning of the year, but that's all behind us. So profitability-wise, I think you're really looking at the marketing investment. And it maybe actually reduce, as you'd expect, their general and administration expense. We've helped them take them over some things.

That was obvious, but they're totally focused at their level on sales, marketing and innovation. So I think that is really the marketing below the sales line that's causing some of the further dilution and the promotional spending.

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

Lauren Rae Lieberman
Analyst, Barclays Capital, Inc.

Q

Thanks. Good morning. Obviously, I'm going to continue on Bai, but my biggest question is everything that you guys have just gone through on Bai, both in terms of even the incremental of the investment spending, plans for resetting elements of the portfolio, shifting out of club, all those things that you've talked about previously, I think, and have been very clear on.

Long-term brand building, do this the right way. Where I'm still just a little stuck, though, is on something got worse in the outlook this quarter, right? I think, again, everything you said very, very consistent and very, very clear. It does feel that something changed for the worse.

So I would just like to try to ask one more time, what was that? Was it get more aggressive on getting out of club? What it is there further spending on Bai than we had already had built in our models? I think, for all us, the incremental $20 million or so was in there. So that would be really helpful.

The other thing was just on ginger ale. That's been a nice growth story for you guys, but it did slow this quarter. And there's been some stuff in the press, I guess: A, about "real ginger" and then also activity from some small and disruptive brands on having more artisanal, if you will, ginger ale brands, so clearly trying to capitalize on the trend, but doing it in a slightly different way. So I'd love to hear your thoughts on some of the slowing that you saw this quarter in ginger ale and the outlook from here? Thanks.

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

A

Well, Lauren, it's Marty. Let me handle Bai. What we did say in our prepared remarks, we now expect the volume to be at 40%. We were previously talking 40% or 50%. And I hope everybody appreciates that when we're trying to predict volume growth at those levels of percentages on a relatively smaller base than many of our other brands that tend to be between 0% and 1%, I hope you realize there's a little more variability in the prediction. So, yes, you could say we've tempered the volume a little bit, but I don't know if that's – there's no business reason other than sort of clarifying a foggy crystal ball, just because of the law of numbers here.

Larry, you want to comment on the ginger ale question?

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

A

Yeah, on ginger ale, I think you can look at it the same as 7UP. We had some really heavy activity last year in the third quarter. We have no concerns at all with Canada Dry Ginger Ale at all. I mean, the programs we have, especially going into the fourth quarter, we're very confident with our brand.

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

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

Yes, thanks. Good morning, guys.

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

Good morning, Mark.

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

Morning, Mark.

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

Snapple has been a challenge. And as we think about the way the year has unfolded, earlier in the year, Larry, you thought some channel activations would get the brand to pick up. And, in fact, that's not what happened, of course. It declined again pretty significantly in the third quarter. So it seems like it's really a consumer issue. And innovation is a lot of the issue and maybe you just have to accept that this brand's trajectory is going to be lower than you might have thought at the beginning of planning this year. Is that the right way to think about it, just accept a lower kind of trend for that brand into the future or do you feel good about some innovation that we're not seeing or we're not aware of presently?

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

Yes. We don't ever accept it being down. We recognize we've had some issues with Snapple. We've done a lot of things out here with the – I mentioned in my prepared remarks, the new plastic bottle. That is just coming out, Mark. It has basically started in the Southeast. If you look at the results we had in the Southeast, where we rolled it out, they're up strong single-digit. So that gives us a lot of encouragement going forward.

I think we've got to look at the category, too. The category has slowed down. That's not going to stop us either. We want to continue to see success with Snapple. And we think the programs we have for 2018 and the new plastic bottle is going to bring us back to where to need to be with Snapple.

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

Robert Ottenstein
Fundamental Research Analyst, Senior Managing Director & Head of Evercore ISI's Global Beverages research team, Evercore Group LLC
Q

Great. Thank you very much. I was just wondering, just to kind of change the topic a little bit, some good news out of Chicago, it seems to be led by some of the local merchants and some of the economic impact that they had to endure. Do you see that as a tipping point here and believe that that can halt these laws and regulations that discriminate against your products in the industry or do you see that as more of a one-off?

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

No, it's not going to hurt us, I can tell you that. I think it's become very evident the impact of putting taxes out there like that. We were very fortunate to have our retailers join with us and go in and show the impact. At the hearing, the number of people that were lined up to testify was mind-boggling. I think it's going to be a great help for us. None of these things are a lay-up, but we'll definitely use what we did learn in Chicago and use that in the other markets that we have taxes and markets are going to look at taxes because the other markets, I guarantee you, are looking at that impact right now.

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

Peter K. Grom
Analyst, JPMorgan Securities LLC

Q

Good morning, everyone.

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 follow-up on BODYARMOR and the sports drinks category as a whole in the U.S. So the category has been under some pressure over the past few months, but BODYARMOR has been a clear out-performer. So, first, I would love to get your thoughts on what you see going on with the sports drink category as a whole? And two, how should we think about the growth in share gains for the brand BODYARMOR going forward? Thanks.

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

A

Well, you look at, I mean, BODYARMOR has been very, very successful. I think the sports drink category, you can kind of compare to some of the other categories, CSDs, different ones, where people are looking for something different. They're looking for something that's better-for-you, new niche. This brand is on fire. We have a tremendous relationship with BODYARMOR. The team, we get together constantly. We had our booths together at the [ph] Max convention. (46:42)

It's still early days. It's gaining share every quarter, every four weeks, but it's still small and early. We are very excited about the possibilities with BODYARMOR. It's a great category to be in. And I think you're seeing the changes, like we've seen in the other categories, and was expecting the success of BODYARMOR. Plus, it is a great tasting product, a fabulous brand and a great sales team behind it.

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

Bryan D. Spillane
Analyst, Bank of America-Merrill Lynch

Q

Hey, good morning, everybody.

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

Morning, Bryan.

Bryan D. Spillane
Analyst, Bank of America-Merrill Lynch
Q

Just had a couple of quick follow-ups related to the guidance and the fourth quarter. One is just, I guess, as we look at revenue and revenue growth in the fourth quarter, was there any interaction between some of the disruption in 3Q and 4Q, meaning like did you have shipments that got delayed or didn't maybe occur in 3Q that get pulled into fourth quarter? Or other way around, is there still any, like, ongoing drug from some of the affected areas?

And then, the second question I had was just, if I think if I plug in some of the guidance items, it looks like growth in SG&A, just absolute dollar growth in the fourth quarter, slows from what it was through the year-to-date period. So just wondering if there was something specific about the fourth quarter? Do you have more cost savings coming through or something that would just kind of slow that rate of dollar growth in the fourth quarter?

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

No. Bryan, it's Marty. Just let me take those couple of questions. In terms of guidance implied, vis-à-vis Q4, I would say a couple things. Number one, our little Caribbean business, which we never talk about, part of the LAB business, it is pretty much shut down, as you can imagine, in terms of sales into Puerto Rico. So we pretty much had to take just about most of its revenue out in the fourth quarter.

Look, timing of – concentrate shipments, which have been strong, we tempered that a little bit in the fourth quarter. May be we'll overachieve on that. This is just sort of our forecast at the moment. I would say some of those, I don't – there's just nothing else. Strong allied brand growth is still in there. We've seen no slowdown there, so I think those would probably get you to most of the variation.

Look, SG&A, we've acquired Bai and so a lot of the Bai acquired of SG&A is in there. There's probably a lapping of the DSD front-line investment, because we started that last year. So you're going to see a tempering of that, thereby, an improvement in SG&A trends in the fourth quarter. And I suspect that your largest single factor in SG&A.

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

Kevin Grundy
Analyst, Jefferies LLC
Q

Hi. Thanks for the follow up. I appreciate it. Marty, just a point of clarification on Bai, but I think it's an important one given the brand's contribution to the company's overall organic sales growth. You had said you expect this brand to double over the next couple years, but now, with the more moderate volume outlook, given what you know, I guess, with the lower outlook and where you guys are with respect to penetration rates and then where you are with respect to distribution, where are you now in terms of this brand's ability to double over the next couple of years? Or is this more of a three-year timeframe where you see achieving that goal? Thanks.

Martin M. Ellen

Chief Financial Officer, Dr Pepper Snapple Group, Inc.

A

Oh, no, Kevin. We've seen preliminary plans for next year for the brand, including our best estimate of the innovation, which now is mostly on Bubbles and water, is now mostly a 2018 factor, not an end of year 2017 factor. Yes, growth is only 40% or so this year.

We believe we'll be really close to doubling this brand by the end of next year, so nothing has changed, other than the timing, for the most part, the timing, spending this year on building it and then sort of timing of some of these initiatives rolling into next year.

Larry D. Young

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

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

Operator: Thank you for participating in Dr Pepper Snapple Group's third quarter 2017 earnings conference call. You may now disconnect.