Keurig Dr. Pepper Inc.

Moderator: Gamgort, Robert

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Operator: Good morning ladies and gentlemen and thank you for standing by. Welcome to Keurig Dr Pepper's Earnings Call for the third-quarter of 2019. This conference is being recorded and there will be a question and answer session at the end of the call. I would now like to introduce your host for today's conference, Keurig Dr Pepper Vice President of Investor Relations, Mr. Tyson Seely. Mr. Seely, please go ahead.

Tyson Seely: Thank you and hello, everyone. Thanks for joining us. Earlier this morning, we issued our press release for the third quarter of 2019. If you need a copy, you can get one on our website at keurigdrpepper.com in the Investors section.

Consistent with previous quarters, today, we will be discussing our performance on an adjusted basis, excluding items affecting comparability. And with regard to the year-ago period, our financial performance also takes into account pro forma adjustments due to the merger.

The company believes that the adjusted and adjusted pro forma basis provide investors with an additional insight into our business and operating performance trends. While these pro forma adjustments and the exclusion of items affecting comparability are not in accordance with GAAP, we believe that the adjusted and adjusted pro forma basis provide meaningful comparisons in an appropriate basis for discussion of our performance.

Details of the excluded items are included in the reconciliation tables included in our press release and our 10-Q, which will be filed later today. Due to the inability to predict the amount and timing of certain impacts outside of the company's control, we do not reconcile our

guidance.

Here with me today to discuss our third-quarter 2019 results and our outlook for the balance of the year are KDP Chairman and CEO, Bob Gamgort; our CFO, Ozan Dokmecioglu; and our Chief Corporate Affairs Officer, Maria Sceppaguercio. And finally, our discussion this morning may include forward-looking statements, which are subject to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995.

These statements are subject to a number of risks and uncertainties that could cause actual results to differ materially, and the company undertakes no obligation to update these statements based upon subsequent events. A detailed discussion of these risks and uncertainties is contained in the company's filings with the SEC. With that, I'll hand it over to Bob.

Bob Gamgort: Thanks, Tyson, and thanks to everyone for dialing in. Before diving into the discussion of the quarter, I wanted to take a moment to share the overall value creation model for KDP that we frequently discuss in our investor meetings.

While we always have a number of detailed items that we cover in our quarterly earnings calls, it's helpful to remain focused on the key drivers of value, which are fairly straightforward. We created KDP with a mission of providing consumers with a beverage for every need, whether hot or cold, available everywhere they shop and consume.

We set ambitious 3-year goals on both top and bottom lines, to grow revenue 2% to 3%, operating income 11% to 12%, and EPS 15% to 17%, fueled in part by $600 million of synergies and free cash flow conversion excess of 100% to enable rapid deleveraging to below 3 times.

In cold beverages, we lead the non-Cola CSD segment and have meaningful positions in a number of high-growth and the on-trend cold beverage segments. For example, we're the No. 2 player in premium water. We're also one of 3 companies with near national retail reach through our direct store delivery system. We create value by renovating and innovating our portfolio to leverage that selling and distribution

powerhouse, and by partnering with emerging growth brands that offer access to new segments and clear paths to ownership.

Productivity provides funding for our brand marketing and innovation. In Coffee Systems, we create value through expanding Keurig system household adoption by converting drip consumers to single-serve. Keurig Brewer and coffee innovation combined with effective system marketing drives that conversion.

Unique to Coffee Systems, we share productivity with our partners to lower the price of K-Cup pods, further driving consumer growth, while still continuing to expand our margins. Across the enterprise, we drive exceptional free cash flow that enables us to delever and offer shareholder value optionality in the future. With 5 quarters behind us as an integrated company, we've demonstrated that our value creation model is working with significant potential still in front of us.

With that as perspective, let me now turn to the third-quarter results. All four of our segments again registered underlying net sales growth, and we continue to perform well in the marketplace, growing dollar consumption and market share in a number of our key categories. This top-line performance, which was balanced between volume mix growth and positive net price realization, along with synergies and productivity drove another quarter of strong underlying adjusted EPS growth of 13%, excluding a 6 percentage point year-over-year headwind from the lapping onetime gains in Q3 last year, which Ozan will discuss shortly.

Our cash flow generation also remained very strong, enabling us to pay down $423 million of structured payables and reduce debt by $71 million in the quarter. To date this year, we have generated over $1.6 billion of free cash flow, with our cash flow conversion at an impressive 130%.

We continue to build our roster of brand partnerships during the quarter by agreeing to a long-term master licensing and distribution agreement for McCafe packaged coffee in the US. You may recall that we agreed to a similar arrangement with McCafe in Canada in Q4 of 2018. The US McCafe agreement will go into effect during the second half of 2020.

While McCafe was previously a partner brand in the Keurig System, this

new licensing agreement gives us the added responsibilities of coffee sourcing, manufacturing, distribution, selling, and marketing the brand in all forms across all channels. This new agreement is a testament to the strength of the overall Keurig system and KDP's capabilities in coffee. Retail market performance based on IRI was again solid in the quarter.

We grew dollar consumption and market share in several of our key categories, including CSDs, premium water, shelf-stable fruit drinks, and shelf-stable apple juice. This performance reflected the growth of key brands such as Dr Pepper and Canada Dry CSDs, CORE Hydration, Snapple juice drinks, and Motts apple juice.

As is always the case when managing a broad portfolio, we have a few categories that require additional focus. Falling into that territory are Bai, Snapple teas, and the ramp-up of new allied brands. We believe we have good line of sight to improve performance across all three of these areas, which I'll speak to in a few minutes.

In our US coffee business, volume consumption of single-serve pods manufactured by KDP grew approximately 2%, as measured by IRI, which we know greatly understates actual growth. As we discussed at a recent conference, what's reported in the tracked channels only represents about half of our total K-Cup Pod business with untracked channels, particularly e-commerce, experiencing higher growth rates.

For comparison, our pod shipment growth in the third quarter was 6.1%. And over the past 12 months, K-Cup pods have grown 8.6%. These growth rates are more representative of the growth in the broader category. Dollar market share of KDP manufactured pods and track channels remained strong at 81.4% in the latest 52-week period. In terms of high-level financials on an adjusted basis, our underlying net sales, which exclude the movement in and out of our portfolio of Allied Brands grew 3.1% with growth from all four segments.

This performance reflected strength of volume mix growth and higher price -- net price realization. In addition, we also had a modest benefit from an extra DSD shipping day in our packaged beverages segment. Adjusted operating income grew 8% in the quarter, reflecting the strong underlying net sales growth, productivity, and merger synergies, partially offset by inflation, primarily in packaging and logistics.

Operating income growth would have been even higher if not for the unfavorable comparison versus a year ago of a onetime gain related to the Big Red acquisition.

Ozan will cover the details of that later in the call. The underlying adjusted EPS growth of 13% reflected our balanced top line growth and operating income performance, along with the benefits of continued debt reduction and a lower effective tax rate, all key tenets of our 3-year merger targets.

Turning now to our segments, starting with Coffee Systems. Net sales increased 1.1%, fueled by higher volume mix of 3.1%, partially offset by lower net price realization of 1.9% and unfavorable foreign currency translation of 0.1%. The higher volume mix for the segment was driven by pod volume growth of 6% and brewer volume growth of 8%. Partially offsetting the growth in volume this quarter was lower pod mix, reflecting the mix impact of higher shipments to branded partners for whom we only record a tolling fee.

As we enter the important retail holiday season for brewer sales, our new lineup of K-Duo brewers is now fully on shelf and performing very well. As you'll recall, the K-Duo lineup of brewers provides consumers the ability to brew a large pod of coffee through a traditional drip system in addition to a single cup through K-Cup pods. The line is receiving great consumer reviews online and we are excited about the incremental households that they will unlock.

The K-Duo lineup is being supported with increased marketing across traditional and digital media platforms and continues to feature James Corden as our Brand Ambassador. Consistent with our discussion on our last earnings call, we expected Q3 to be a bit out of sync, which is exactly what transpired. Adjusted operating income declined 3% due to a mismatch this quarter in the timing of pricing, inflation, and brewer investments, including media, market research, and innovation development costs, compared to the positive offsets of productivity and volume.

As we've discussed consistently, the nature of this business leads to volatility in results from quarter to quarter. But when viewed over a slightly longer timeframe, the growth we continue to drive becomes

quite clear. For perspective, on a trailing 12-month basis, K-Cup pod volume advanced 8.6%. Total Coffee Systems operating income grew nearly 5% and operating margin expanded 100 basis points.

Quarterly results have fluctuated both above and below these numbers, sometimes meaningfully; however, we remain focused on the real underlying drivers of growth. Turning to the packaged beverages segment, reported net sales for packaged beverages were again significantly impacted by the unfavorable impact from the changes in our Allied Brands portfolio, which amounted to a 5.8% segment headwind in the third quarter.

Excluding this impact as well as the 0.6% benefit we had from an extra DSD shipping day, underlying net sales grew a healthy 3.1% in the quarter, driven by net price realization of 2.7% and a higher volume mix of 0.4%. As mentioned previously, the impact from Allied Brands will switch from a headwind to a tailwind in the fourth quarter and represents a top line driver in 2020.

Driving the 3.1% underlying net sales growth for packaged beverages in the quarter was Dr Pepper, Canada Dry, and CORE Hydration, the latter of which continues to register very strong growth, with an over 30% increase in retail sales in the trailing 52 weeks. In the case of Canada Dry, double-digit net sales growth was driven by successful innovation launched earlier this year as well as strength in the CORE brand.

The Fansville College Football campaign behind Dr Pepper is also in full swing, delivering strong results for our flagship CSD brand. The campaign is resonating well with consumers and is driving additional in-store displays, higher inventory on-display, retail dollar growth and volume performance that continues to outperform the category.

As we enter the championship drive of the college football season, the campaign will feature new media content, on-pack consumer offers, strong in-store execution, digital and social media as well as the return of our college tuition giveaway program. We are now also rolling out our Green Bottle campaign with a handful of brands, including Canada Dry, in conjunction with the holidays. This campaign is always well received at retail and we expect it to provide good support behind our brands during a key selling season. Also contributing to underlying sales growth

in the quarter were Motts, Sunkist, and A&W as well as contract manufacturing.

As mentioned earlier, there were a few areas where we see performance trailing our expectations: Bai, Snapple tea, and some of the new additions to our Allied Brands. Bai performed below the category in the quarter and we are implementing a number of our programs to address performance, which we will share with you early in the New Year.

While we have gained -- regained Bai distribution that had been lost in Q2 of 2018, we're not experiencing the lift in velocity expected behind our marketing programs. With regard to Snapple, the juice drink portfolio grew retail consumption by double digit and continued to gain share. However, Snapple tea has been underperforming the category. As we close out this year and head into 2020, our focus behind Snapple tea will be on brand renovation.

And finally, let me touch briefly on our Allied Brands portfolio. To refresh everyone's memory, we had significant changes in the Allied Brands portfolio at the time of the merger, hence our discussions since that time of the concept of underlying net sales. As we've said on previous calls, the negative comparison to year ago of Allied Brands turns to a tailwind in Q4 and is no longer a factor as we enter 2020, which will enable us to drop the discussion of reported versus underlying growth.

Our total Allied Brands portfolio generates approximately $350 million in retail consumption and represents 3% of our cold beverage sales. While not large in the absolute, we expect these brands to provide access to higher growth segments. To that point, the ramp-up of the new brands to the Allied portfolio is progressing slower than expected. The reasons are slightly different for each brand. But in total, we see a delayed response in realizing the full growth potential of these brands.

As a result, we now expect the year-over-year net changes in the Allied Brands portfolio to result in a headwind to total KDP net sales of approximately 200 basis points versus the 100 basis points forecasted at the beginning of the year.

The great news is we expect KDP's total underlying net sales growth to

approximately reach 3% for the year, which is at the high end of our targets, driven by very strong growth on our own brands that has been able to offset the slower start on Allied Brands. We also continue to plant seeds to support future growth, such as A Shoc Smart Energy Drink, which, while still quite early, is performing well in the market. We'll discuss more about that in early 2020.

Operating income for packaged beverages in the third quarter advanced a strong 23%, largely reflecting the growth in underlying net sales, strong productivity, and merger synergies, as well as the timing of marketing spending, partially offset by inflation, particularly in packaging, ingredients, and logistics.

And finally, we expect to exit the fourth quarter this year with strong sales growth that will fuel our momentum into 2020. Turning now to the beverage concentrates segment, which represents sales of concentrates to bottlers and syrups to fountain customers. Net sales were up nearly 9% in the quarter, driven by both net price realization and volume mix growth.

The strong volume performance was driven in part by our Fountain Foodservice business and is reflective of the strength in our core brands, such as Dr Pepper, Canada Dry, Sunkist, and Big Red. Operating income for beverage concentrates advanced a strong 20% in the quarter, primarily reflecting the strong growth in net sales as well as merger synergies and productivity.

And finally, turning to Latin America Beverages, net sales for the segment increased 1.5% in the third quarter and operating income of $25 million declined slightly, resulting from higher marketing spending and inflation. With that, I'll hand it over to Ozan.

Ozan Dokmecioglu: Thanks, Bob, and good morning, everyone. I will start with a review of the financials for the third quarter, which was a good one for KDP. I will then transition to our outlook for the balance of the year. Continuing on an adjusted basis, net sales for the third quarter increased 0.5% to $2.87 billion, compared to $2.86 billion in the prior year.

This performance reflected strong underlying net sales growth of 3.1%, driven by higher volume mix of 1.5% and favorable net price realization

of 1.6%. Also in the quarter, we had the additional shipping day in our packaged beverages segment, which added 0.3% of the growth. Partially offsetting the underlying net sales growth and the extra shipping day was the unfavorable impact of 2.7% from changes in our Allied Brands portfolio as well as unfavorable foreign currency translation of 0.2%.

On a constant currency basis, underlying net sales increased 3.3%. Operating income in the quarter increased 8% to $754 million, compared to $698 million in the prior year. This increase reflected strong underlying net sales growth and continued productivity and merger synergies in both cost of goods sold and SG&A. These growth drivers were partially offset by some inflation, led by packaging and logistics and the unfavorable comparison versus a year ago to the onetime $6 million gain related to the acquisition of Big Red.

Operating margin advanced 190 basis points in the quarter to 26.3%, in terms of our segment performance for the third quarter on an adjusted basis. Net sales for Coffee Systems increased 1.1% to $1.07 billion in the quarter, compared to $1.05 billion in the prior year. This performance reflected higher volume mix of 3.1%, which was partially offset by lower net price realization of 1.9%.

The volume mix performance was driven by strong brewer volume growth of 8% and pod volume growth of 6.1%, despite the previously discussed shift of certain pod shipments from the third quarter of 2019 into the second quarter. As Bob discussed earlier, the strong pod volume growth was partially offset by unfavorable mix, reflecting the impact of higher pod shipments to our branded partners in the quarter.

Unfavorable foreign currency translation of 0.1% also impacted net sales in the quarter. Coffee Systems operating income was down in the quarter as expected. Specifically, operating income declined 3.4% to $367 million, compared to $380 million in the prior year, reflecting unfavorable mix, lower pricing, inflation in packaging and logistics, and higher brewer investments including media, market research, and innovation development costs.

We are also lapping the timing of certain adjustments in the prior year related to legacy Keurig Green Mountain's year end, including bonus and stock compensation. Partially offsetting these factors were the strong

volume growth as well as continued productivity and merger synergies. Operating margin in the quarter was 34.5%.

Moving to packaged beverages. Net sales for this segment decreased 2.2% in the quarter to $1.31 billion, compared to $1.34 billion in the prior year. This performance reflected strong underlying net sales growth of 3.1%, driven by the higher net price realization of 2.7% and increased volume mix of 0.4%.

Additionally, the extra shipping day in the quarter had a favorable impact of 0.6%, more than offsetting these growth drivers was the unfavorable impact in the quarter of 5.8% from changes in the Allied Brands portfolio and unfavorable foreign currency translation of 0.1%. Operating income for packaged beverages increased 22.6% to $201 million in the third quarter, compared to $164 million in the year-ago period.

The performance largely reflected continued productivity and merger synergies, strong growth in underlying net sales and the timing of marketing investments. These positive drivers were partially offset by inflation in packaging, ingredients, and logistics. Operating margin advanced 310 basis points versus a year ago to 15.4%.

Turning to beverage concentrates. Net sales for this segment increased 8.8% in the quarter to $360 million, compared to $331 million in the prior year. This performance was driven by higher net price realization of 6.5%, combined with favorable volume mix of 2.3%. The strong net sales growth in the quarter was driven by Dr Pepper, Canada Dry, Big Red, and Sunkist. The shipment volume increased for beverage concentrates was due primarily to Dr Pepper, Canada Dry, Big Red and Sunkist.

In terms of bottler case sales volume, beverage concentrates increased 2.1% compared to the year-ago period. Operating income for beverage concentrates increased 19.6% to $244 million, compared to $204 million in the year-ago period. This performance reflected the benefit of net sales growth, strong merger synergies, and productivity. Operating margin advanced 620 basis points versus year ago to 67.8%.

Turning to Latin America Beverages. Net sales for the segment

increased 1.5% to $138 million, compared to $136 million in the prior year. This performance was driven by higher net price realization of 5.2%, partially offset by lower volume mix of 1.5% and unfavorable foreign currency translation of 2.2%.

On a constant currency basis, net sales increased 3.7%. Operating income for Latin America Beverages totaled $25 million in the second quarter, compared to $27 million in the year-ago period. This performance reflected the net sales growth and productivity, which were more than offset by inflation in logistics and ingredients as well as increased marketing investment.

Turning to interest expense. Interest expense in the third quarter declined $17 million or 10.5% to $145 million and was driven by our continued deleveraging. Net income for the quarter increased 8.2% to $451 million, compared to $417 million in the prior year. This performance was driven by the strong operating income growth, lower interest expense, and a lower effective tax rate compared to the year ago period.

Partially offsetting these favorable drivers was an unfavorable comparison versus the prior year to the $24 million gain from BODYARMOR. This gain, along with the previously mentioned $6 million gain related to the acquisition of Big Red, collectively reduced a year-over-year net income growth rate by approximately 6 percentage points, translating into underlying net income growth of approximately 14%.

Taking all these factors together, our adjusted diluted EPS in the third quarter increased 6.7% to $0.32, compared to $0.30 in the prior year. On an underlying basis, adjusted diluted EPS advanced 13%. Free cash flow was again strong in the quarter, driven by growth in the net income and continued effective working capital management. As a result, in the third quarter, we paid down approximately $423 million of structured payables and reduced net debt by an additional $71 million, for a total of $494 million in payments.

This increases the total amount of debt paid down in the first 9 months of 2019 to $788 million as well as a reduction in structural payables of $188 million. For the first 9 months of 2019, we generated over $1.6 billion in free cash flow, with a free cash flow conversion rate of 130%

and exited the quarter with $74 million of unrestricted cash on hand.

The debt reduction in the quarter, along with our growth in adjusted EBITDA, reduced our debt to adjusted EBITDA ratio, which we refer to as our management leverage ratio to 4.8 times. This aggressive pace of deleveraging continues to be consistent with our expectations. And for perspective, since the merger closed, we have paid down a total of over $1.7 billion of debt.

And finally, in terms of our outlook for the balance of 2019. For the full year, we continue to expect adjusted diluted EPS growth in the range of 15% to 17%, representing $1.20 to $1.22 per share. This guidance is in line with our long-term merger target. We continued to expect net sales growth of 1% to 2%, with underlying net sales growth now expected at approximately 3%, the latter of which is at the high end of our long-term merger target of 2% to 3%.

This net sales growth reflects higher than expected growth from the core business and the slower ramp of the new Allied Brands, resulting in an approximate 200 basis-point headwind impact from the changes in the Allied Brands portfolio. We continue to expect merger synergies of $200 million in 2019. This is consistent with long-term merger target. And we continue to expect these synergies to fully flow through to EPS.

We continue to expect interest expense to be in the range of $550 million to $565 million. This reflects our expectation of significant cash flow generation and continued deleveraging as well as the first half benefit in 2019, totaling $40 million from the unwinding of interest rate swap contracts. We continue to estimate our effective tax rate for 2019 to be in the range of 25% to 25.5% for the year. We continue to expect our diluted weighted average shares outstanding to approach 1.42 billion in 2019.

While we do not provide EPS guidance by quarter, we remind you that we expect quarter four EPS growth to be tempered due to comping the significant onetime gains approximating $17 million related to the core acquisition in 2018. We continue to expect our second half synergies to be greater than our first half synergies. We continue to expect inflation to moderate somewhat in the second half. And finally, in 2019, we continue to expect free cash flow to approximate $2.3 billion to $2.5

billion.

With this strong free cash flow generation, we expect our management leverage ratio to be in the range of 4.4 to 4.5 times by the end of 2019. We also remain confident that we will achieve our leverage target of below 3 times in 2 to 3 years from the July 2018 merger closing. And with that, I will hand it back over to the operator to open it up for your questions.

Operator: If you would like to ask a question, you'll need to press star one on your telephone. To withdraw your question, press the pound or hash key. Please stand by while we compile the Q&A roster. Our first question comes from Bryan Spillane with Bank of America. Your line is now open.

Bryan Spillane: Hey. Good morning, everyone.

Bob Gamgort: Hi, Bryan.

Bryan Spillane: Just two questions for me. Just one, Ozan, on the free cash flow conversion, you know this year you're over 130% and I think what would be implied in terms of getting to the leverage targets, the multiyear leverage targets, that you can maintain a pretty high level of free cash flow conversion. So if you can just give us a sense of whether or not where you stand today at converting over 130% is still -- is sustainable or is there some reason why it would be may be different going forward? And then, I've got a follow-up.

Ozan Dokmecioglu: Yeah. Good morning Bryan. In short, yes, the answer to your question. Right now and for this year, as we just announced, the conversion ratio is 130%. Of course, there are lots of puts and takes. And as we just discussed before, our effective working capital management was the main driver of getting over 100, but we still have continuation of our program into 2020 as well as 2021.

And we are also, as we always do, pursuing new opportunities and explore the new initiatives, which we expect actually our conversion ratio to be very close to around, give and take, 100% conversion. And if we can do better, of course, we will do better. But the conversion ratio

will be high in the upcoming 2 years.

Bryan Spillane: Okay. Thank you. And then, Bob, just on the brewers, the brewer lineup, I guess, going into the holidays. If you go back to the Investor Day, you talked about sort of a bridge of you know to build household penetration from what was, at that point, about 20%, and it was quality modern -- modernizing, making it more convenient, variety, value, right? There was a whole sort of cluster of levers, right, that would drive penetration.

And it just seems at this point, you've got all the brewers now renovated with the new engines, you've got the K-Duo in the market which is more convenient. I mean it just seems like you've ticked off a lot of those different levers. So can you just kind of update us on how you're thinking about brewer lineup today, those sort of clusters? And what it might imply for beginning to accelerate household penetration?

Bob Gamgort: Right. Sure. You're referring to the waterfall that we showed in the Investor Day, where we identified the opportunity to convert households in the range of about 60 million households that could still be converted. And then, we built on that, showed the research as to why people who theoretically should be in a single-serve coffee system warrant.

And then, we redesigned our brewers and our marketing plans to specifically go after those barriers. So job one, if you go back a couple of years, job one was to increase the quality of the brewers, hit the right price points, and then begin to add features. And as you accurately point out, we've been ticking off many of those opportunities, modernizing the look, going into specialty beverages with the K-Cafe, and now, very importantly, going after one of the biggest barriers is the ability to produce a large batch of coffee with K-Duo.

So I would say, as we sit here today, the quality of the brewers is up significantly. You don't have to take my word for it. You can just look at the star ratings online. We've been able to fill out a lot of the basics, hitting the lower end price points. We're now moving higher end as well, and then filling out most of the functionality that we've talked about.

And so we're really happy and that's what's driving the strong household penetration that we continue to experience. But we've got a great pipeline still ahead. There is still a lot of white space to fill in between

all of those. And there are new features and benefits that we can add to existing brewers to make them even more interesting that we'll share with you in the coming months.

So we feel like we got the basics in place, but a lot of upside still left. And then, I would also like remind you that there are drivers of household penetration that aren't directly connected to the brewers. And one of the biggest is having a recyclable pod. And so, that's being implemented as we speak and will be completed by the end of 2020.

And just to give you one final point. We get a lot of questions of, well, you've launched that brewer, so you've got everybody who you are going to get based on that into the system. It takes time. People don't typically replace their brewer until their current brewer breaks. And so we have to layer on lots of different features and benefits to get people. And it really is a slower build than one might think. But it's all moving in that direction. That gives us line of sight to growing household penetration for quite a long term.

Bryan Spillane: All right. Thank you.

Bob Gamgort: Sure.

Operator: Our next question comes from Lauren Lieberman with Barclays. Your line is now open.

Lauren Lieberman: Great. Thanks. Good morning.

Bob Gamgort: Good morning.

Lauren Lieberman: Hey. I wanted to ask a little bit about the Allied Brands. So assuming kind of the slower ramp is about the market performance of what you already have in the portfolio, not a matter of attracting more, I'm sure it's a different story for different brands but anything you can offer, is it sort of the health of the brand, the established brands that you brought in house? Is it noise in sort of the newer segments that you've been entering? And I know this is a short time period, but is this performance sort of impacting at all your thinking about portfolio composition for that Allied piece as you go forward?

Bob Gamgort: Yes, let me give a couple of thoughts on that, Lauren. I think, first of all, as I mentioned, the total Allied portfolio now is about $350 million in retail consumption. So it's important, but it's not as large as it once was. That number may be surprising because you might think, well, I thought the number was much larger than that.

And the reality of it, it was. But if you recall, we acquired some of those businesses. So if you look at the CORE and the Big Red businesses that we acquired in the past year, they're actually larger than the remaining of Allied Brand portfolio that we have left. So it's still good opportunities for us to access different segments and different levels of growth.

But in its absolute, it's not as important as it once was. We talked about the net change in Allied Brands with FIJI and BODYARMOR coming out and some of the new ones coming in Evian, Peet's, and FORTO. We said that was about a 100 bp headwind and now we're saying it's about a 200 bp headwind. Look, if you take the rounding that's involved in that, slightly more than that rounded down to 100 and slightly less than that rounded up to 200.

What we're talking about here is a delay in sales versus our expectation of about $50 million. So it has an impact on our growth rate for sure, but the good news, as I emphasized before is that we've been able to offset that with really good strength in our core owned businesses, which speaks to the health of the portfolio. As we sit here today to answer the part of your question and we look at those new brands, we think it is primarily just a delay. It's just a slower start up.

We're getting the distribution. The velocity is building. It's just not at the rate that we thought it would be and it's a combination of things when you're looking at a new brand, sometimes it's hard to forecast. Evian is a good example. If you look at the latest 13 weeks, we're growing Evian at about 8%. That's below the category because that category is really strong. That category is now growing like 12% to 13%, but 8% is not too bad and it's up significantly.

So we're seeing traction. It's just taking longer to get there. And it really doesn't affect the way that we think about Allied Brands going forward. And as I remind you, we're also continuing to put new partnerships in

place like A Shoc that will continue to fill that pipeline. So, I think this is well contained and well defined and really doesn't change our outlook going forward.

Lauren Lieberman: Okay. Thanks. That's super helpful. Thanks a lot.

Bob Gamgort: Great.

Operator: Our next question comes from Steve Powers of Deutsche Bank. Your line is now open.

Steve Powers: Hey. Thanks. Good morning. I wanted to drill into beverage concentrates, if I could. The performance there was really strong this quarter and price realization seems to be the key driver of both sales and segment margins. Is there anything you're doing differently in that business this year, perhaps with respect to promotional depths or breadth to drive that kind of price realization seemingly without any real degradation of volume?

And if so, what's the runway on that source of profit growth continuing? Is this a one-year step up that we're seeing in 2019 with more normalized growth to resume in the year ahead or do you see more incremental opportunity available to you in 2020 and beyond?

Bob Gamgort: Well, it's hard to know what pricing -- price realization going forward is going to be, to be honest with you. I mean, that's very much driven by the industry in total and other factors like inflation. So that's still to be determined. What you're pointing out, though, is very important is the strength of our brands that are sold in the beverage concentrates segment allow the pricing to be put in and yet the volume holds up nicely.

And remember, these are the sales primarily of brands like Dr Pepper and Canada Dry and then we've got others, Crush, et cetera, Schweppes that go through and are sold by either Coke or Pepsi, but also through a very important channel of Fountain Foodservice, which is restaurants. And as we pointed out a number of times, Dr Pepper is actually the most available brand in the country in Fountain Foodservice. So the brands -- it's a concentrated portfolio of brands with credible strength. That's why we continue to invest so heavily in marketing behind these brands.

They're able to withstand the pricing and what you're seeing in the quarter is that pricing flowing through that was taken, sometimes there's a bit of a delay to get that pricing. And you're seeing that matched up against the benefits of productivity and synergies across the entire business as a result of the integration. And that's why we're getting such powerful profit increase during the quarter. But we -- that's a very robust business. And to your point about pricing, we'll see. We take every opportunity we get going forward, but it's hard to have a forward-looking position on industry pricing.

Steve Powers: Okay. Just to clarify then. So this is reflective of true list price increases that you've taken versus change in the promotional cadence or is it a little bit both?

Bob Gamgort: Well, when you're selling in the Concentrates segment -- I mean, the answer is a little of both. But when you take a look at the Concentrates segment, when you think about pricing, it's different than the way you would think about it in our packaged beverages segment, where we're actively involved in the promotions.

Remember, we're selling to somebody else who turns around and resells our products in the beverage concentrates segment. So that's why it's more of a combination, but it's really more about the absolute pricing that we're giving than its timing or a level of discounting, as you might see in a retail environment.

Steve Powers: Okay. Thank you.

Bob Gamgort: Sure.

Operator: Our next question comes from Nik Modi with RBC. Your line is now open.

Nik Modi: Thanks. Good morning, everyone.

Bob Gamgort: Good morning.

Nik Modi: Good morning. So the question -- I have two ones -- two quick ones, on

Bai. What happened? I guess, was the question. What do you think is really causing some of the weakness and the fact that it's been lagging your expectations? So that would be the first one.

And then the second one, Bob, is just look, I think you guys have obviously done a very good job of integrating at a time where a lot of big mergers have not really gone that well. And I'm just kind of thinking about future layers of value creation and thinking about what's been going on between Coke and Pepsi and their franchising and how it's really worked for Coke. And I just wonder, is this an opportunity for KDP longer term? Just wanted to get your thoughts on that.

Bob Gamgort: Sure. Bai, I think it's pretty straightforward, which was it was a pioneer in the category. It became the No. 1 player by far, and there's a lot of competition -- that's CPG issues to happen every day, what do we need to do? We need to refresh the brand and drive it to the next level with innovation that will keep it ahead of the game.

Forward perspective, when we talk about weakness in Bai, it's still a business that's about $0.5 billion in sales. And on a 52-week basis, according to IRI, grew about 3%. So it's not as if the brand is falling off the edge, it's just not growing at the level that we believe it has the potential to grow. And so it's going to be a combination of renovation on the brand and some innovation that will continue to drive.

And again, as I said, we'll be happy to share that with you in early 2020. With regard to your question about M&A more broadly, we've been very focused on taking the portfolio that we have today and making it work and you're seeing there's a significant amount of upside potential for the foreseeable future. There will be a point in time where we will start thinking about M&A differently. You're also talking about the route to market side of the business, refranchising and driving that.

There's nothing that we would talk about at this point in time. But one of the big value drivers for us is to optimize the distribution that we access and that we have today. And what that really means in the near-term is running it more effectively, which is actually showing up in a lot of our numbers, and also on the margins and bringing in routes from independent distributors, for example, where we see an opportunity to combine them with our own routes and get more scale. We'll be doing

that on the margins, but I look at that as more fine-tuning on top of running the fundamental distribution system we have right now better, rather than a big strategic move like the one that you're referring to.

Nik Modi: Great. Helpful. Thank you.

Bob Gamgort: Sure.

Operator: Our next question comes from Sean King with UBS. Your line is now open.

Sean King: Hi. Thank you. Given the pod volumes during Q2 and then this quarter, despite the rebound, are there any, I guess, channel inventory considerations into Q4? And is there potentially any upside to, I guess, the full-year outlook?

Bob Gamgort: If you look at our pod volume over the long term, it's been really solid. So yes, just to remind everybody, in 2018, pod volume was up about 7.5%. We're running 8.5% on a year-to-date basis, and on a 12-month basis, we're running about the same, about 8.5%. What we called out in the last call was the fact that we knew that we shipped ahead of consumption in the second quarter, 100% driven by partners who wanted to take volume earlier.

To that, we were up 12.8. We said that we're going to get a reaction to that in our numbers in Q3. We did. We're up 6, which is below our long-term trend. Our assumption is, when you look at Q4, is it all reverts back to the main and that there's nothing notable to call out on that. And I think part of the learning over the past 18 months or so, if you look at this business, it's a challenging business to try to forecast quarter to quarter, if you're outside of the company. But when you take a broader view and you don't even have to go much longer than 6 months, but certainly, if you go into 9 months or a year, it's a really steady and dependable business with some quarterly fluctuations. And so our assumption in any situation that unless there's something notable that we would call out, you should assume that it just reverts back to the main.

Sean King: Thank you.

Bob Gamgort: Okay.

Operator: Our next question comes from Kevin Grundy with Jefferies. Your line is now open.

Kevin Grundy: Thanks. Good morning and congratulations on the strong result. A question really for both of you, if you want to touch on this. So, so far so good with the synergy delivery and credit to you and your team for doing that. And you're still targeting the $600 million, but is it kind of take a step back and look at, it's been closing in on 2 years since the deal was announced. You've obviously had a much, much closer look at the different areas of synergy. So a couple of different questions.

And then, Ozan, what do you see as potential upside, if any, to that initial target? And then, Bob, for you, the target was a number that you expected to fully flow through to earnings. But as we've had this conversation on the call and Bai needs some attention and Snapple needs some attention, it's going to be a slower ramp for the Allied Brands. So there's an argument to be made that maybe investment levels need to move higher. Does that give you any pause with the $600 million target? Maybe you do need to invest some of it and that should not potentially flow through to earnings?

Bob Gamgort: Let me talk about the second one first and then Ozan could talk about where the $600 million is coming from. And to your point, now that we're into a -- what's our level of confidence? As you point out, we put these ambitious targets out just about 2 years ago. A lot has changed over that time. We've had to compensate for significant inflation increases, we've seen pricing in the industry, which has had a negative impact on volume.

The points about Bai or Snapple are those -- that's business as usual. You always have brands that are performing well or above plan, look at the strength in CORE Hydration, for example, doing incredibly well. And you always have brands that you can -- you need to fix. And so on balance out of there are no conclusions that you should take from that, that means there's an overall increase in spending or investment required to address those.

It's more just being very frank with you guys about where things are

working and where they're not and keeping you in the loop about where our management attention is. So I think that the most important takeaway for you and any of our investors is that we put out a long-term algorithm and the critical parts of long-term algorithm is top line growth of 2% to 3% and EPS growth of 15% to 17%. And as I say frequently, what you pay for us to do is to manage through all of those changes in the environment and competition and all the noise that's out there and deliver that.

And we're going to have levers that we can pull that were positive versus our original expectations and we use those to offset some of the negative surprises. And I'd just say, in balance, you should take away nothing different other than our original algorithm of the 2% to 3% and the 15% to 17% is intact and the integration is going remarkably well, which supports that.

But specifically, to your question on synergies, let me turn that over to Ozan in terms of how we now think about that as we're into the integration and also the broader concept of value capture, which is synergies and productivity in the way that we think about it internally.

Ozan Dokmecioglu: Sure. So we are on track with our expectations to deliver $200 million in 2019 as we have guided several times, which also makes us to stay 100% behind $600 million of delivery over 3 years, starting 2019 through 2021. So that stays as rock solid commitment and we have great plans to achieve it. As Bob said, we also expect this synergy number to flow through fully in EPS.

And we started to deliver the synergies initially in SG&A, then procurement and logistics following. Obviously, we have several initiatives that are fueling these deliveries, but I just -- given the, let's say, big pockets of the areas of the delivery.

And as Bob also said besides the deal synergies, we also have several base productivity programs, as we call them internally, which is nothing to do with these synergies in both businesses that we have all built in our algorithm and we are also happy to share that we have been executing very nicely behind those initiatives as well.

Kevin Grundy: That's great. And if I could just follow-up with one. Bob, maybe just touch on, you guys decided to make a small tweak to the guidance in early September and then another one today. What happened, I guess, in the month of September that you felt incrementally more cautious on the impact from the Allied Brands, but then incrementally better on the underlying portfolio, presumably, as you move through September? Maybe could you just comment on that and I'll pass it on. Thank you.

Bob Gamgort: Yeah sure. I mean, we thought that the 1% to 2% that we talked about back in September at an industry conference was clarification of a position that was well known. People were struggling with trying to do the math on what the fourth quarter might look like, and so we just decided to clarify. If you recall, when we said, just to clarify, our reported net sales will be in the range of 1% to 2%, consensus was around 1.4%.

So we saw that as a nonevent that surprised us that people thought that was an event. What we are seeing right now, which I think is important to point out is, this is about the time period where the Allied Brands -- new Allied Brands should have kicked in at a higher level than they are. And I just put the size of that on an annual basis, it's about $50 million. But again, the good news is that we're seeing real strength in our core business and that's been able to offset that.

So in balance, it puts us in a position where we have confidence and a 3% underlying net sales growth for the year, which is a very strong number. And it's just the tweak between the Allied Brand and Core, which I think is a net positive. And as I said earlier, I really think the Allied Brand number is more about timing than it is anything else. But when we get around to 2020, we'll talk more specifically about that.

Kevin Grundy: Thank you very much. Good luck.

Operator: Our next question comes from Amit Sharma with BMO Capital. Your line is now open.

Amit Sharma: Hi. Good morning, everyone.

Bob Gamgort: Good morning.

Amit Sharma: Bob, I wanted to go back to your response to Steve's question on the sustainability of beverage concentrates segment. And I want to like broaden it, to not just beverage concentrates, but packaged beverages as well. Is it fair to read from your statements that these are good sustainable margin structure for these businesses as we go into 2020 and beyond?

Bob Gamgort: Well, yes. I mean, if you think about what we've been consistent in saying, which is 2% to 3% top line, 15% to 17% EPS growth, then yes. The implied in all of that is the margin structure that we have in place is solid and sustainable and will benefit from the growth that we're talking about.

So in any integration, you get a boost from synergies and we -- as Ozan just talked about, we also look at ongoing productivity that's above and beyond the synergies, which helps fuel those margins. But you do get to a point where the margins benefit from the synergies, and then you are driving the business based on growth, and the top line growth that we're pointing out to you is accelerating, is driven by an underlying performance. It's about 3%, it's driven by strength in our core brands, and that will continue to drive our total profit as our margins are, we believe, very sustainable.

Amit Sharma: And just a follow-up on that, like if you look at historically, legacy Dr Pepper portfolio versus your competition in North America, that portfolio outperformed on an operating profit basis, right? And now, obviously, expectations for both Coke and Pepsi are much higher. Is that performance gap you expect to continue, like legacy Dr Pepper portfolio should still be outperforming those two companies in terms of the North American performance, right?

Bob Gamgort: Well, just to be -- we don't spend a lot of time thinking about our performance relative on operating profit relative to our peer set. We look at our business and we look at the upside that we have. We see a lot of upside on our business in the absolute. As I pointed out to many people, our portfolio, in many cases, is not in direct competition with Coke or Pepsi, particularly on the CSD side, where our strength is in the non-

Cola segment, with Dr Pepper and Canada Dry leading the way.

So I don't think that has changed at all. And look, to answer your question is, all of our upside that we believe is in the business in total is reflected in the long-term targets that we set forth.

Amit Sharma: Got it. Thank you so much.

Operator: Our next question comes from Laurent Grandet with Guggenheim. Your line is now open.

Laurent Grandet: Hey. Good morning, everyone.

Bob Gamgort: Good morning.

Laurent Grandet: Two questions. I mean, the first one on McCafe. Kraft Heinz has indicated that McCafe will heed their EBITDA by about $200 million in over 12 months. Should we think -- I mean, you will gain that $100 million in your EBITDA, I mean, from mid next year up to mid '21? And could you tell us what's your plan for that brand that now you will carry?

Bob Gamgort: Yes. I mean, first of all, the way that we look at this move of McCafe into the Keurig system really speaks to the value of Keurig systems. It's a vote of confidence. And I would remind everybody that if you look at all of our branded partners, all of them -- nearly all of them at this point in time as the contracts have expired have extended for longer period of time than they ever have before.

So this is just, yes, one more vote of confidence that partnering with Keurig is good for everybody in the ecosystem. We transitioned that over to us in mid-2020. There are upfront investments that are involved with that -- and we'll talk when we talk about 2020, we'll talk about how that impacts our guidance in 2020. But remember, before you take -- take the puts and the takes together, we don't know what the tariff environment is going to be in 2020. That would be a negative. So we've got positives and negatives. And as I said before, it's our job to navigate all of those and be able to deliver the long-term guidance.

I have not seen the number that you're referring to. All I would suggest,

though, is that it's about $300 million in retail sales, not wholesale. I could not get to a number nearly that big based on a retail business of $300 million, and I honestly haven't seen that one. But we'll provide more clarity when we talk about 2020 and how that may impact our results at that time.

Maria Sceppaguercio: And let me just remind you -- it's Maria, is that we already had McCafe in the system. So as you think about incrementality and what it might mean for the business, it was already in. This is a different relationship. It's broader, as I'm sure you know, but it's not wholly incremental, and I think that's important to keep in mind.

Bob Gamgort: Yes, that's a good point. Just -- thank you for bringing that up. I think to put a finer point on that one is we already participated in the financials of McCafe to a level through the K-Cup business that we had. So it's not an unlicensed business that came in. But net-net, this is all incredibly positive for us. We just don't -- I think the number you put out there would be very big and not necessarily incremental. So that's why we're clarifying this.

Laurent Grandet: Okay. Thank you. And a quick one, again, on the concentrate business, which is so profitable for you. So that has some implication about the next quarter and the future. So either -- I mean, your volume -- your sales and volume were very strong in the quarter. Could you tell us, I mean, the level of inventory at beverage later on? And it seems there is a disconnect in performance versus what we are seeing in the Nielsen data?

Bob Gamgort: Well, I don't know how you could see that data, to be honest with you. A lot of this goes through restaurants and places that really we have no ability to -- all I suggest is that this quarter is not a disconnect between our sales and what we believe is consumption out there at all, but we we're really candid on K-Cups when we ship ahead of consumption and calling that out. So we'd be the first ones to call that out. This is reflective, as I said before, of a couple of things.

You got really good volume goals. Our business is very healthy across those channels, and we specifically called out Fountain Foodservice, where our brands continue to be in great demand. This is also reflective

of pricing that was put in place, and there's always a delay on pricing flowing through. And when you have a combination of pricing starting to flow through, combined with volume that holds up in the base of that, yeah, you're going to see some very good numbers, and there's a little bit of what was exactly this quarter a year ago. But there's nothing extraordinary in that number that could -- should cause you to be concerned.

Laurent Grandet: Okay. Thank you very much [Inaudible]. Thank you.

Operator: Our next question comes from Peter Grom with JP Morgan. Your line is now open.

Peter Grom: Hey. Good morning, everyone.

Bob Gamgort: Good morning.

Peter Grom: Bob, I appreciate the color on the tracked versus untracked performance in pods. Is there anything you can share in terms of the price versus volume relationship, kind of where the untrack channel versus what we see in the track? And then the second part, while we are on the coffee business, I appreciate the color on the Q4 pod volume. But brewer volume cycling a very easy comparison. How are you thinking about brewer shipment volume next quarter? Thanks.

Bob Gamgort: Yes. So look, I just -- I'll start with the brewer shipment volume. And again, we minimize the impact of brewer shipment volume. Our objective is to grow household penetration. And I think we have some credibility on that. So we had that conversation when there was a quarter a year ago that you referred to as an easy compare that caused a lot of concern and we're way ahead since then. I mean, we're running it like a 12.5% growth since that time period. You haven't heard us for a second refer to that number, nor do we use that as a predictor of household penetration because we don't believe it's a predictor of household penetration.

So I would suggest that the fourth quarter of this year again household penetration based on the volume that you're seeing is growing mid-single digits. You're seeing brewer growth so far year to date of above 10%.

And that would suggest that we've shipped brewers for the holidays earlier than we have and that's part of the strategy for our customers. So I think that back to my comment I said on pods reversion to the mean, I think if the same rule applies on brewers, over time, it's a very steady number.

The fact that we shipped some earlier is net a good thing because it means we forward position of the product to get early merchandising for the holiday season. But in the end, we don't -- we think this has very little -- is very weak indicator of performance of our pod business, whether it's up or down, we don't spend a lot of time talking about that for that reason.

Having said, let me talk about pods, as you refer to, it's getting increasingly difficult for you guys to track this business using IRI or Nielsen because tracked channels are now representing about 50% of our total sales. And the untracked channels, which are driven by club and e-commerce are largely and some other channels are, in total, growing faster than the track channels.

And that separation is accelerating, as you can imagine with the adoption of e-commerce. We believe our e-commerce business is 2 to 3 times the size of a typical CPG business. So the trend that you're seeing with us is really the leading edge of where you're going to see the rest of the CPG go over time. So when we take a look at our business in the untracked channels, it's growing faster.

But if you're asking about the composition of volume and mix, it's not materially different than what you see in the track channel. Our KDP manufactured share and our owned and licensed share, we believe, is when we look at our untracked channels, it is slightly higher than it is in the track channels, like, for example, away-from-home, offices are in there, and our share in offices of our own brands is higher.

But it's not material enough for you to put too much thought in there. It's just the knowledge that you're only looking at half the market.
And unfortunately, for modeling purposes, the other half of the market is not transparent to you and growing at a faster rate, which we continue to see accelerating. It's good for the business in total and it's just harder to observe from the outside.

Peter Grom: Thanks. Appreciate the color.

Bob Gamgort: Okay.

Operator: Thank you. That concludes our question-and-answer session today. I'll now turn the call back over to management for closing remarks.

Bob Gamgort: Thanks, everyone, for joining the call today. I know we went a bit over and it's a busy day for everyone, but the IR team is around today for any follow-up questions. Thank you.

Operator: This concludes today's conference call. You may now disconnect. Thank you.