Keurig Dr. Pepper Inc.
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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 Second 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 second 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 results -- 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 adjusted and adjusted pro forma basis provide investors with 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 and 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 to discuss our second 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 key 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 the risks and uncertainties is contained in the company's filings with the SEC. With that, I'll hand it over to Bob.

Robert Gamgort: Thanks, Tyson, and thanks to everyone for dialing in. The second quarter was another good one for KDP. All four of our segments again registered underlying net sales growth with Coffee Systems leading the performance this quarter. We also grew dollar consumption and held or grew market share in a number of our key categories. A recent slate of innovation is performing well in the market, and we remain confident on our plans in this area for the balance of the year, which I'll talk about shortly.

Operating income advanced nearly 10% despite of more than 3 percentage point headwind related to the comparison against a gain recorded in Q2 last year in connection with the Big Red acquisition and a onetime reimbursement from a resin supplier. The significant operating income growth combined with lower interest expense versus the year ago period drove a 15% increase in adjusted diluted EPS for the quarter, which is right in line with our long-term targets.

Free cash flow generation of $575 million for the quarter was also robust, which enabled us to repay debt of more than $300 million in the quarter and nearly $720 million in the first half of the year. The quarter marks a significant milestone for us as it closes our first 12 months as a combined company. Before we jump into the details of the latest quarter, we believe it's helpful to recap what KDP has delivered in its first year as a public company.

From a financial results perspective, at the time of the acquisition announcement, we targeted a 3-year average adjusted diluted EPS growth rate of 15% to 17%, fueled by top line growth of 2% to 3% combined with expansion in margin resulting from $600 million in acquisition synergies and ongoing productivity programs.

We delivered well above the high end of our expectations in year 1 with

12-month adjusted diluted EPS growth of nearly 30% and operating margins expanding by 250 basis points, as we delivered synergies at the pace we committed to last year. Debt reduction is also an important part of our value-creation story, and we are well on track to reach our target of reducing leverage to below 3x by July of 2021, having paid down approximately $1.65 billion worth of debt and returning over $860 million in dividends to our shareholders in our first 12 months.

Additional year one achievements include growing retail dollar consumption and gaining or maintaining market share in the majority of the categories in which we compete, signing eight new Allied and partner agreements; acquiring that CORE Hydration and Big Red businesses and strengthening our innovation pipeline; launching seven new Keurig brewers and over a dozen brand extensions across our cold portfolio; breaking ground on a state-of-the-art K-Cup manufacturing facility in Spartanburg, South Carolina where we remain on track to begin production in late 2020; launching our Drink Well. Do Good. Corporate responsibility platform and commitment; leveraging our expanded operations, broadened community presence and combined resources to make it even greater positive impact for our stakeholders; and most importantly, uniting 25,000 employees under our common mission to become the new challenger in the beverage industry by being the first company to bring hot and cold beverages together at scale. In that respect, we believe we're just getting started towards realizing our full potential.

With that year one context in mind, you will note that the second quarter of 2019 was a continuation of our strong value creation story. I'll start with in-market results based on IRI. Retail market performance was solid in the quarter. We grew or held market share in the key categories of CSDs, single-serve coffee, premium unflavored still water, shelf-stable fruit drinks and a ready-to-drink coffee among others.
This performance reflected the growth of key brands such as Dr. Pepper and Canada Dry CSDs, CORE Hydration, Peet's and FORTO ready-to-drink coffees and Snapple juice drinks. In our US coffee business, retail consumption of single-serve pot, manufactured by KDP, grew approximately 5% and our KDP manufactured dollar market share was essentially even with the year ago at 81.6%. Turning now to the financials on an adjusted basis.

Our underlying net sales, which excludes the movement in and out of Allied Brands grew 2.6% due to volume and mix growth and higher net price realization. In addition, we also had a modest benefit from the shift of Easter into the second quarter of this year. Offsetting this growth was the expected unfavorable impact in our Packaged Beverages segment from the changes in our Allied Brands portfolio. Specifically, on a year-over-year basis, the net change in our Allied Brands portfolio reflects Evian, Peet's and FORTO continuing to ramp up as compared to the established FIJI and BODYARMOR businesses last year that have since exited. In speaking about the balance of the year, you should expect this headwind to abate in the last quarter of 2019.

Adjusted operating income grew nearly 10% or 230 basis points to 25% of net sales primarily reflecting strong productivity and merger synergies, both of which benefited our cost of goods sold and SG&A. These positive drivers more than offset inflation, particularly in packaging and logistics as well as the unfavorable comparison versus the year ago period, which included the previously mentioned onetime benefits totaling $21 million in connection with the Big Red acquisition and reimbursement from a resin supplier in the second quarter of 2018. Adjusted diluted EPS increased 15% to $0.30 in the quarter compared to $0.26 in the prior year period driven by the growth of operating income and lower interest expense.

Turning now to our segments. Starting with Coffee Systems, which had a very strong quarter in part due to timing. Net sales increased 4.3%, fueled by higher volume/mix of 8.3%, partially offset by lower net price realization of 3.5% and unfavorable foreign currency translation of 0.5%. The volume/mix growth for the segment was driven by shift in volume increases of nearly 13% for K-Cup pods and 19% for brewers.

This growth was due to the underlying strength of the business and timing related to some earlier shipments as requested by our branded partners. Partially offsetting this growth was lower pod shipment mix due to higher timing-related sales increase to branded partners for whom we only record a tolling fee.

You will note that the timing impact of partner shipments drove our total pod shipment volume in the quarter to be above our consumption rate. On a longer-term basis, you should expect our pod shipment

volume growth to be in line with category growth, which has been approximating 6%. The strong brewer volume growth also reflected some benefit of timing related to the retail inventory build for our back to school and the holidays as well as the K-Duo innovation launch in Amazon Prime Day, the latter of which was a record-breaking day for us this year. Specifically, the K-MINI had the highest one-day volume than any brewer deal on Amazon and the K-Café had another strong quarter.

Our new K-Duo lineup of brewers provide 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. Early feedback from consumers is very positive, and we've confident that this innovation will continue to bring households that were not previously single-serve users into our system. With K-Duo Essentials now on shelf, K-Duo and K-Duo Plus shipping later this month and our recently introduced K-Café and K-MINI already in the market and performing well. We are supporting these innovations with significant marketing across traditional and digital media platform starting in Q3.

We're also excited to announce that our marketing campaign features the return of the talented and energetic James Corden as our brand ambassador. We will continue with our Brew The Love campaign, this time putting the spotlight on the new K-Duo brewer. Operating income for Coffee Systems increased more than 8% in the second quarter, reflecting the strong growth in pod sales and productivity.

One final note on Coffee Systems. We continue to keep a closer eye on the recent news out of Washington regarding additional China tariffs. Recognizing this as an ever-changing landscape, if the current proposal planned for September is enacted, Coffee Systems will face a headwind approximating $10 million to $15 million in the remainder of 2019, as Q4 is our peak quarter for brewer shipments and we would have little time remaining in the year to implement steps to offset.

As we mentioned previously, we've already taken actions to diversify our brewer supply base, and we continue to explore additional opportunities to mitigate the impacts that potential tariffs may pose, all of which would benefit us in 2020.

Turning to the Packaged Beverages segment. Net sales for Packaged Beverages were again significantly impacted by the expected unfavorable impact from the net changes in our Allied Brands portfolio, which amounted to a 6.3% headwind to this segment in the second quarter. Excluding this impact as well as the 0.5% benefit we had from the shift of Easter into the second quarter, underlying net sales grew 1% in the quarter, driven by net price realization of 2%, partially offset by lower volume/mix of 1%.

Driving the underlying net sales growth for Packaged Beverages in the quarter was the continued strength of Dr. Pepper and Canada Dry, each fueled in part by innovation. In the second quarter, we launched a limited time offering of Dr. Pepper Dark Berry, which was released in conjunction with Marvel Studios Spider-Man: Far From Home. In addition, Diet Canada Dry Ginger Ale and Lemonade and Canada Dry Ginger Ale and Orangeade, which were launched earlier this year, continued to perform well.

Also contributing to the underlying sales growth in the quarter were Sunkist and CORE Hydration as well as contract manufacturing. On the other hand, Bai was soft in the quarter. We recently regained some distribution that we lost in Q2 last year and our increasing in-market support. We expect these actions to improve Bai performance over the next few quarters. Operating income for Packaged Beverages in the second quarter advanced 18%, largely reflecting strong productivity and merger synergies as well as higher pricing and the timing of marketing investments, partially offset by inflation, particularly in packaging and manufacturing input costs.

Looking ahead to fall, the start of college football, we're excited to announce the return of our highly successful Fansville marketing campaign behind Dr. Pepper. As you may recall, the Fansville campaign had a storyline that evolves over the course of the college football season culminating in the college football championship. In addition to TV, the campaign includes digital and social media, print advertising, in-store support and our usual college tuition giveaway program. The Fansville campaign was very effective last year, and we expect it to resonate with consumers again this year.

Turning now to the Beverage Concentrates segment, which represent sales of concentrates to bottlers and syrups to fountain customers. Net sales increased 3.1% driven by net price realization of 4.4% partially offset by lower volume/mix and unfavorable foreign currency translation. The growth in net sales continued to be fueled by Dr. Pepper as well as increases for Canada Dry, Schweppes and A&W. Operating income for the Beverage Concentrates segment advanced 4.2% in the quarter primarily reflecting the growth in net sales.

And finally turning to Latin America Beverages. Net sales for the segment increased 3.7% in the second quarter, reflecting both higher net price realization and favorable foreign currency translation, partially offset by lower volume/mix. Operating income for Latin America Beverages of $20 million in the second quarter of 2019 was approximately $6 million below the year ago period primarily due to lapping a $5 million benefit related to the reimbursement by a resin supply in the year ago period as well as the impact of inflation. Partially offsetting these drivers were the benefits of net sales growth and continued productivity.

As I discussed upfront, the newly combined organization is highly focused and executing well, accomplishing a great deal in a short period of time. We're pleased to have this quarter contributed to our successful year one while recognizing that we're only just beginning and our sights are set on much more. With that, I'll turn it over to Ozan.

Ozan Dokmecioglu: Thanks, Bob. And good morning, everyone. I will start with a review of the financials for the second quarter, which was another strong 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 second quarter decreased 0.4% to $2.81 billion compared to $2.82 billion in the prior year. This performance reflected strong underlying net sales growth of 2.6% driven by higher volume/mix of 2.1% and favorable net price realization of 0.5%. The shift of Easter into the second quarter of 2019 also added 0.2% of growth. More than offsetting this underlying growth and the calendar shift was the expected unfavorable impact of 3% from changes in our Allied Brands portfolio as well as unfavorable foreign currency translation of 0.2% in the quarter. On a constant currency basis, net sales declined 0.2%.

Operating income in the quarter increased approximately 10% to $702 million compared to $640 million in the prior year. Excluding more than 3 percentage point headwind from the year ago benefits that Bob mentioned earlier, operating income advanced more than 13% in quarter 2 2019. The growth in operating income reflected strong productivity and synergies in both cost of goods sold and SG&A. These growth drivers were partially offset by inflation, led by packaging and logistics. Operating margin advanced 230 basis points in the quarter to an even 25%.

In terms of our segment performance for the second quarter, on an adjusted basis, net sales for Coffee Systems increased 4.3% to $990 million in the quarter. This strong performance reflected higher volume/mix of 8.3% that was partially offset by lower net price realization of 3.5%. Unfavorable foreign currency translation of 0.5% also impacted the quarter. On a constant currency basis, Coffee Systems net sales advanced 4.8%.

Operating income for Coffee Systems advanced 8.2% to $331 million compared to $306 million in the prior year. Driving this performance were the benefits of the net sales growth, some of which reverses in quarter three due to timing and productivity. Partially offsetting these factors was inflation in packaging and logistics. Operating margin advanced 120 basis points in the quarter to 33.4%.

Moving to Packaged Beverages. Net sales for the segment decreased 4.9% in the quarter to $1.31 billion compared to $1.38 billion in the prior year.
This performance reflected underlying net sales growth of 1%, driven by higher net price realization of 2%, partially offset by lower volume/mix of 1%. In addition, the shift of Easter into the second quarter had a favorable impact of 0.5%. More than offsetting these growth drivers was the expected unfavorable impact from changes in the Allied Brands portfolio that totaled 6.3% in the quarter and unfavorable foreign currency translation of 0.1%.

Operating income for Packaged Beverages increased 18% to $190 million in the second quarter compared to $161 million in the year ago period. This performance largely reflected the strong productivity and

merger synergies as well as the timing of marketing investments. These positive drivers were partially offset by inflation in packaging and manufacturing input costs. Operating margin advanced 280 basis points versus year ago to 14.5%.

Turning to Beverage Concentrates. Net sales for the segment increased 3.1% in the quarter to $370 million. This performance was driven by higher net price realization of 4.4% partially offset by lower volume/mix of 1.1% and unfavorable currency translation of 0.2%. On a constant currency basis, Beverage Concentrates net sales advanced 3.3%.

The net sales growth was driven by Dr. Pepper, Canada Dry, Schweppes and A&W. The shipment volume decrease for Beverage Concentrates was due primarily to Dr. Pepper and Crush partially offset by higher volume for Canada Dry. In terms of bottler case sales, Beverage Concentrates increased 1.9% compared to the year ago period. Operating income for Beverage Concentrates increased 4.2% to $246 million compared to $236 million in the year ago period, reflecting the benefit of the net sales growth. Operating margin advanced 80 basis points versus year ago to 66.5%.

Turning to Latin America Beverages. Net sales for the segment increased 3.7% to $141 million compared to $136 million in the prior year. This performance was driven by higher net price realization of 3.8% and favorable foreign currency translation of 1.3% partially offset by lower volume/mix of 1.4%. Operating income for Latin America Beverages totaled $20 million in the second quarter compared to $26 million in the year ago period.
This performance reflected the unfavorable impact of comping with $5 million benefit in 2018 that Bob mentioned previously as well as inflation in logistics and input costs. Partially offsetting these factors were the benefits of the net sales growth and productivity.

Turning to interest expense. Interest expense in the second quarter declined $37 million to $138 million. This improvement reflected a $13 million benefit from unwinding several interest rate swap contracts in the quarter combined with the benefit of our continued deleveraging. Net income for the quarter increased 19% to $423 million compared to $356 million in the prior year. This performance was driven by the

strong operating income growth and lower interest expense partially offset by a higher effective tax rate. Taking all of these factors together, our adjusted diluted EPS in the quarter increased 15% to $0.30 compared to $0.26 in the prior year.

In terms of leverage, we paid down $303 million of debt in the second quarter. This increases the total amount of debt paid down in the first six months of 2019 to $717 million. In addition, at the end of the second quarter, we had $106 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 4.9x. This aggressive pace of deleveraging continues to be consistent with our expectations. For perspective, since the merger closed, we have paid down a total of approximately $1.65 billion of debt.

In terms of cash flow, we generated $1.1 billion of free cash flow in the first 6 months of the year. 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 expect net sales growth to approximate 2%, which is also in line with our long-term merger target of 2% to 3%. This net sales guidance includes an approximate 100 basis points 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 our long-term merger target, and we continue to expect these synergies to fully flow through to EPS.
We now 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 during 2019 as well as the first half benefit in 2019 totaling $40 million from the unwinding of interest rate swap contracts. In the second half of 2019, we are not currently planning to unwind any additional interest rate swap contracts.

Also impacting the expected interest expense in the year is the exclusion from our adjusted results of noncash amortization of the fair value adjustment related to the merger on a portion of our debt. In finalizing our measurement period associated with the merger, we made this change to recognize this as an item affecting comparability to be

consistent with the manner in which we treat amortization of intangibles.

The effect of this reduces full year 2019 interest expense by $26 million and 2018 adjusted pro forma interest expense by $22 million, having virtually no impact on our overall year-over-year results. 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 are not providing EPS guidance by quarter, we continue to expect EPS growth versus 2018 to be tempered in quarter three due to comping the significant one time gains recorded in the prior year, totaling approximately $30 million related to previously disclosed gains on Allied Brands. 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 4.5x by the end of 2019. We also remain confident that we will achieve our leverage target of below 3x within three years from merger closing.

And with that, I will hand it back to the operator to open it up for questions.

Operator: As a reminder if you would like to ask a question, please press star one on your telephone keypad. Again that's star one if you would like to ask a question. Your first question comes from Bryan Spillane of Bank of America.

Bryan Spillane: Bob, maybe just a couple of follow-up questions related to the coffee business. One, if I caught it right, it sounds like the category is growing pods at 6% and you're growing at 5%. So if you can kind of talk about that gap. And then second, I guess, given the category growth at 6, how we should think about that in terms of household penetration for brewers?

Robert Gamgort: Yes. We talk a lot about quarter-to-quarter, month-to-month. I think this

business is actually very stable and very predictable and I say stable, stable at the growth rate we've all talked about, which is mid-single digit. So if I just step back for a second and talk to you about the last 12 months and I'll address your specific question. If you look at over the past 12 months, we said at the end of the year when we give our once-a-year omnibus research that household penetration was growing at 7%. If you take a look at the pod category growth based on IRI over the past year, it was growing at 6.2%. And if you look at our shipments over that same time, it's 7.7%. So all of this triangulates around a growth of 6% to 7%. And in any given quarter, we're going to be above, we're going to be behind, but it's pretty remarkable how much the household penetration in the category and our shipments all track to the same number, which has been 7% over the past 12 months.

The one piece that's interesting, and we're exploring ways to help you guys get more visibility of this, is that we are seeing IRI is now consistently underreporting, both our consumption as well as the category consumption. And that's because in this category, probably more than any other food and beverage category, unmeasured channels driven by e-com, for example, are accelerating and taking a bigger chunk of the total pie. So we're thinking about how we can get you guys exposure to that, but we know that IRI is understating our consumption as well as the category. So I step back and say, we said household penetration growing at 7%, our pod shipments have been 7.7% over the past 12 months, that's all within the right range that you should think about.
And therefore, to go right back to your question, a plus 6% versus plus 5% is within the margin of error that it almost doesn't matter.

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

Lauren Lieberman: I was hoping you could just talk a little bit about new partnerships owned or partnerships, in particular in the energy space. So there's new agreements for Runa and for A Shoc and you're the minority investor in A Shoc. So talk a little bit about kind of portfolio strategy with those brands? How they fit in and kind of early, we think as Runa has been under your purview in the market for most of the quarter, so anything there would be helpful.

Robert Gamgort: Yes. I think it's very early days for both. So there's not a lot to comment on there. I would think by the next quarter, we'll have more to talk about. But the strategy here behind energy is one that, I think, speaks to our desire to fill in whitespace in our portfolio and energy is an attractive category, both in terms of size, growth and profitability, and we certainly should close some of that gap. As well as it speaks to the way that we go about addressing those gaps. And I think the A Shoc example is a really interesting one because we're partnering with Lance Collins who developed Core and Fuze and NOS and a bunch of other products as well that have been very successful. And we went into this one side-by-side with him based on the concept with a pre-negotiated formula to buy it out at certain milestones. So it's very early days. It's only in, I think, four markets, LA, Texas, Illinois right now and we'll see how that goes and give you an update next time around, but we're bullish on the opportunity there, and I think more importantly, it gives you an indication of where we want to go with partnerships.

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

Judy Hong: So I had a question about your sales guidance. So when I kind of look at the first half or second quarter, it looks like sales actually came in a bit short of, I think, what most people expected even with the timing benefit on the coffee sales. So I know you're keeping the 2% for the full year, which does imply a pretty big acceleration in the back half. So my questions are, one, was second quarter in line with your expectations from a sales perspective?
And then can you just walk us through how we get to sort of this 2% for the full year, which I think implies the Allied Brands kind of impact actually turning to be a tailwind in the second half of the year? So that seems also like a big step-up as well. So if you can kind of address those issues as it relates to your sales guidance.

Robert Gamgort: Sure. I think it's a couple of things. I think first of all, just with the conversation with guidance from an overall perspective, back in January of '18, we talked about a long-term outlook where we said 2% to 3% over a three-year period, 15% to 17% EPS over a three-year period. So we've just stuck to that. And as you know, we have to navigate a lot of different changes in the marketplace, but we feel confident that we'll stick to that framework, and we'll stick to it over the long term unless

there's some big change to take it a different direction, which we don't foresee.

So having said that, I think the hardest part for you guys on the outside to model has been the impact of this Allied Brands. And all I would say is it impacts us through Q1 through Q3, and then in Q4 of this year, it goes away. And there really, you're getting an even comparison, and I will be very happy to not talk about underlying net sales at that point and just talk about reported net sales at that point in time. And so I think that's part of it as well. So it's a combination of the two. The other part is, we also said that we would be ramping up the growth over time because the Keurig business we were still into the strategic pricing implementation and so that 2% to 3% again is a long-term target and that's why we take a look at the year the way that we described it.

Judy Hong: But on the Allied Brands impact am I right in thinking so year-to-date, I think the impact was a negative $160 million or so and you're guiding to $110 million negative for the full year. So if third quarter is a negative, it sounds like the fourth quarter you all of a sudden have a pretty meaningful acceleration...

Robert Gamgort: Well, remember, when you get to the fourth quarter, the comparison against very substantial businesses of FIJI and BODYARMOR are now out of your base and you have the benefit of a growing Evian piece and FORTO in the business for this year. And so yes, you would expect fourth quarter to look materially different than we've seen in the first three quarters of the year, and I think that's been the hardest part to model for us.

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

Amit Sharma: Ozan, just a very quick clarification. Can you quantify the margin impact of the pre-ship in the Coffee Systems business in the quarter?

Ozan Dokmecioglu: Amit, we are not going to get into the specifics of that, but as part of the quarter two growth is reversing in Q3 due to timing of the retail stocking approvals and the timing of the pod shipments to all our partners as they requested. But as Bob explained I believe in a great detail, one would expect to see 6% to 7% of pod growth on a continuous

basis. Some quarters may be a little bit plus or minus, but that's what averages on an annual basis as well. So on the basis of that, there will be some correction that we're expecting in Q3, but on an annual basis, our guidance still holds, which is a mid-single-digit growth.

Amit Sharma: Got it. And then Bob, I just want to make sure that I heard this right. So as you're talking about strategic price implementation, are you suggesting that we'll start to lap the impact of that later this year or certainly in 2020? And if that happens like, does that mean the price mix becomes less of a headwind in 2020 and beyond that?

Robert Gamgort: No. I'll go back to what we said in January of '18 because it's playing out exactly as we discussed. We said that volume would be mid-single digit. The strategic pricing investment would continue for a period of time, but would moderate over the horizon that we put out there for our targets. And again, that's exactly what's happening, 7% household penetration over the past 12 months, 7.7% shipment growth. I think what's interesting is when you take a look at our Coffee Systems revenue, in 2018, it was negative 0.4%. On the latest 12 months, it's positive 1.5%. If I just look at year-to-date 2019, it's positive 3%. So we're not saying anything different than what we said all the way back in 2018. All I would suggest is now 12 months into the official close of the merger, essentially 18 months since we communicated the first outlook, it's playing out exactly as scripted. There's no change in our thought process around the Coffee Systems business.

Amit Sharma: Okay. That's maybe I didn't see it properly. I think that's what I'm saying that as you go into 2020, that price headwind starts to moderate even more, especially as you lap...

Robert Gamgort: It's already been moderating. It will continue to moderate over the three-year horizon, but we never gave a timing of saying pricing investment would stop on a certain date. We said it would moderate over time, and you're seeing the slope of it right now. If you go back all the way to January of '18, you could put the slope out between then and now and see that improvement and that's exactly what we expect to continue. And again, I just want to make one other point on this. We have visibility internally as to what the pricing is going to be because these are based on long-term contracts for the great majority of our

agreements. And so I know it's a challenge for you to model, but it's not a challenge for us to manage because we see it and we also know that we have the appropriate productivity and cost projects in place to offset that pricing. And the evidence that you're seeing is that we've been able to handle this pricing investment at the same time we're expanding margin and accelerating volume growth. So it's not a big mystery to us. In fact, it is not a mystery at all. We have it mapped out. It's just a challenge for us to get out and communicate details to the outside world here. But just know that internally we have good visibility of it.

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

Kevin Grundy: Bob, can you speak to the pressure on the Bai business. This was of course a sizable acquisition from the Allied portfolio a few years ago. So disappointing performing well below expectations at this point. Can you talk about some of the factors driving the weakness, competitive dynamics, lack of investment, lack of innovation, maybe just drill down a bit more on your plans to turn that brand around?

Robert Gamgort: Yes, sure thing. Bai is now north of $400 million in sales and on a 52-week basis, it's growing about 6% with a weak quarter. We lost some distribution along the way. We've since regained that, but you're seeing it go through the system. And so as I said, we expect it to improve in the coming quarters. Friends got a lot of likes to it, there are elements of Bai, for example Bai Super Teas are growing at an incredibly good rate. The core business is reasonably healthy. Bai Bubbles hasn't been as strong. So if you really drill into it, the core Bai business is quite strong and some of the newer additions to the Bai portfolio are adding even further growth. But this was -- we analyze these things very extensively and this was all driven by some distribution changes, not velocity changes in the business. And so we're still bullish on the brand going forward. And as I said a number of times before, when you get to a certain scale, like crossing $400 million, approaching 500 million in sales, you're not going to see 20%, 30% growth rates. It's just the natural evolution of all of these brands where when it was acquired, it was in the steep part of the growth curve, continues to do very well. Now it's going to be more in a moderate growth curve going forward. But none of us are happy with a negative even for a quarter, so that's quickly being addressed.

Operator: Your next question comes from Steve Powers of Deutsche Bank.

Stephen Powers: I guess one follow-up question to Brian's initial one. The 6% that you cited for the category consumption this quarter is, just to be clear, is that an all-channel number because it looks like the measured channels, at least as I see it, the Nielsen data, it looks like it was tracking 5% plus alone. So I would expect it may be closer to 7% if the untracked was as strong as we talked about before just for final clarity, that would be great.

And then my real question was just more on the negative pod mix that we saw this quarter. Directionally, not really a surprise, but I just wonder if you're able to quantify the magnitude because it's bigger this quarter with the timing element and then stepping back, I guess really what I'm asking about is how do you recommend we think about pod mix going forward to the extent that we should expect that to remain in a bit of a structural headwind on revenue growth even as pricing maybe gets a little bit better?

Robert Gamgort: Okay. Let me start with the last one and I'll come back to the category piece. The best way for you to guys to take a look at this is go back to how I started this. Look at it over a 12-month basis and know that what we said about the coffee category over a 12-month basis has come 100% true in terms of what our projections have been.
There's variation quarter to quarter. And so the key is when you see variation by quarter, a good assumption is that it goes back to the average again over time. And so I can explain the mix very easily in the second quarter. The shipments above consumption was all driven by certain partners requesting more volume early, that could be in advance of a promotion, it could be because they're doing some internal changes to their own warehousing or supply chain and they want to make some movements, build some inventory. This is for us normal course of business quarter-to-quarter or month-to-month and it all flattens out over time.

Because this situation was accelerated shipments from our traditional branded partners, you will recall, in that situation, we receive a tolling fee on those products versus a complete product fee. For example, if we

supply a private label partner, we source the coffee, we do everything and we charge them a full product price. In the case of branded partners where we receive the coffee from them, we're just charging a tolling fee. So by its very nature, it's going to show up as a negative mix if you sell more of that volume versus all other volume. It's just mechanical and has no impact on the business at all from a profitability standpoint, nor does it impact the business over time.

So my suggestion as you think about what will be the third quarter and the fourth quarter pod growth, you have to make some adjustments to say, we've now shipped in advance of consumption and we're being completely transparent with you on that. That's got to come out at some point. That doesn't go up forever. But the mix also will normalize as well because that was specifically due to partner shipping in advance and there's no structural change to our business at all from a mix perspective.

So let me move now to the category piece. The exact category number and this is all channels that can be measured by IRI. On a 52-week basis, it was 6.2%. Interestingly for KDP, it was 6.2%, which means we held KDP manufacturer chair exactly even over the 52 weeks. For the second quarter, we said 6%, the exact number was 5.6% for the category. What we're saying though is there are channels, club, department stores away from home, but e-commerce is the biggest one right now that are not captured at all by even an IRI all-channels metric. And those are more significant than a typical CPG product and growing faster than what you can see in the measured channels. And that's where you get the point about over a 52-week basis, it suggests that our consumption growth was 6.2% and yet over that same time period, we shipped 7.7%. Our perspective is that's not us over shipping the category, that's reflecting what's actually happening in the unmeasured channels. And again, we have empathy for the fact that you're trying to build models and don't have access to the data that we do. We're trying to think about an orderly way in which we can give you insight into what the unmeasured channels are. And I imagine we're kind of a pioneer on this, but this is an issue you're going to face in a lot of categories as e-commerce becomes more significant, I just think we're further ahead of the curve. So hopefully, I answered your two questions. Let me know if you have any more clarification needed on that?

Stephen Powers: No, that's perfect.

Operator: Your next question comes from Laurent Grandet of Guggenheim Securities.

Clay Crumbliss: This is Clay Crumbliss on for Laurent. Bob for you, just on the Dr. Pepper franchise. It continues to perform really well and it's not just driving the top line, I think it's contributing quite a bit to the margin expansion that you're getting. Can you just talk about how you see that playing out over the course of the year? And then longer term kind of the same, just what do you see are the strengths of that brand and what's going to help it continue to do what it's doing?

Robert Gamgort: Yes. We haven't been in the CPG industry for a very long time. You see certain brands that's real gems, and this is one of them. It's got very unique positioning, unique product offering. It is one of the brands that the heavy consumers of it absolutely love and it continues to expand household penetration. It used to be at one time a very regional brand, it's now a national brand. And so if you take a look at the brand development, there's still opportunity to increase household penetration in the regions of the country where it was less established. This is a good story of getting everything right in terms of marketing, strength, limited-edition innovation and great execution.
And I would remind you that part of the reason why the profitability shows up as even stronger on this brand is because the way it flows throw our P&L, is more than half of that business is distributed through Coke and Pepsi system, in which we sell concentrate to them and the concentrate shows up on the P&L as a much higher margin mix, and therefore, when you grow the Dr. Pepper brand, a big chunk of that goes to that very profitable Coke and Pepsi system that shows up as a real profit generator on the P&L. So we have, no, -- everything that we take a look at on the Dr Pepper brand has continued strong performance on there, there's still a lot of upside on that brand.

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

Bonnie Herzog: I actually wanted to circle back on your operating margin growth, which was really impressive this quarter. So hoping you guys could maybe break out the contribution from synergies just a bit more in depth. And

then looking forward, should we expect a meaningful ramp in the contribution from these cost synergies as you get maybe even deeper into the integration process?

Ozan Dokmecioglu: Yes. First of all, as we reiterated many times and we are on that trajectory, in terms of delivery $200 million of merger synergies in 2019, 2020 and 2021, in total $600 million. So we are confirming that trajectory as well as for this year. And as we also said, besides the deal synergies, you also have -- has the defined base productivities. And as we spoke probably 10, 15 minutes ago, we expect both deal synergies and the base productivities to continue to ramp up as we go throughout 2019, which means the second half, we expect to deliver overall productivities a little higher and better number compared to the first half.

So when we look to the margin expansion, you're right, it's a very good number, but please bear in mind, when you go back and look to January 2018, the guidance that we put that did foresee a healthy margin expansion, and we are happy to share with all of you that we are exactly delivering what we said we would. And we do expect further margin expansion to happen, again in line with our guidance, no surprise, in the upcoming, let's say, two more years after 2019.

And the balance is quite healthy between the legacy KGM and legacy DPS businesses, which reflects as a good combined company margin growth and we are exactly on our trajectory in terms of what we said we would do.

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

Brendan Metrano: It's Brendan Metrano for Robert. Bob, just want to circle back on Packaged Beverages just for a couple of points. First, can you give us some insight into how the new Allied Brands like Evian and FORTO are progressing that gives you confidence that those will ramp up and sort of replace the brands that you've lost? And then secondly, any impact from weather in April and May that you'd kind of call out as unordinary this quarter?

Robert Gamgort: Last one, I'll go first. No meaningful impact from weather. On the

Allied Brands, it will take time. I mean you take a look at it, and we're starting from a much smaller base than the two businesses that came out of the system. That's really clear if you take a look at the -- how big they were versus where we're starting. But they're all moving in the right direction. And over time, the growth trajectory that they're on plus additional brands that we're at will more than offset that. But the way that we forecast it is we've been conservative in not assuming that they are a replacement, for example, starting in 2020, that it's going to take some time to build on that.

The one thing I would add though is, if you take a look at brands that we'd added into our portfolio from an own standpoint, that no longer show up in Allied Brands, Core being a great example. Core is quite a remarkable story, now $250 million in sales and it's growing north of 40%. Now, like Bai, my previous conversation on Bai, there will be a point, which it hits critical scale and is not going to be growing at that trajectory, but to have been able to add a business that was once in Allied into our portfolio that that's meaningful in size with that kind of growth rate is another way that we're able to manage the portfolio growth in that 2% to 3% long-term range that we talked about previously.

Brendan Metrano: And then one real quick follow-up, just in terms of -- in that Allied portfolio and just within Packaged Beverages, how are you and are you, I guess, thinking about CBD at all?

Robert Gamgort: Well, the basics of CBD are it has to be legal first, proven to be safe and proven to be effective. And all three of those are either unknown or a question mark at this point in time. My theory on this one is that if it is proven to be safe, legal and effective and the government gives a big green light and all the other issues that are surrounding a pop-up in effect becomes caffeine and it becomes something that this can be added to a lot of different beverages, and if it gets to that point, we'll participate in it, but we're not going to be on the bleeding edge of something that is frowned upon by the government and unsure from a consumer safety standpoint.

Operator: Your next question comes from Bill Chappell of SunTrust.

William Chappell: Bob, as we go into the holiday season, I know it's still only August, but what's the plan, the thought for brewers in terms of -- you rolled out several last year, the goal was to kind of increase household penetration, didn't know if you really need that many more or if it's better -- if your money is better used on kind of supporting pods or supporting brands or -- how you look at it as we go into kind of the next year?

Robert Gamgort: Yes. Household penetration is a growth engine for this higher business. When household penetration grows, it benefits all parties who are involved in it, the partners who do business with us, the retailers who sell our machine and our pods as well as whom we supply their branded pods. And of course, it benefits our owned and licensed business. So if you can pick one metric to drive across the entire Coffee Systems business that would benefit everybody, including our specific P&L, it would clearly be household penetration growth.

The way that we think about brewers is not how many brewers that we want to sell or how many do we need; we think about barriers to household penetration. And we talked before about the work that we've done to understand all of the people who should be in the Keurig system and why they're not in there right now.

And if you step back and think over the past two years, we've increased the number of households who have a Keurig machine by 20%. So that's a meaningful accomplishment itself. Yet at 22%, we think that number should be, as we said before, more than double that.

And then the question would be how long is it going to take and we don't know. We're moving along at a nice 7% rate. And the question is, could we accelerate that over time? The reason that K-Duo becomes important is because it fills the gap in the need states for brewers that we know a fairly sizable segment of the non-Keurig households need, which is treat with the idea of brewing one cup at a time and would probably do it during the week, but I want the ability to make a pot of coffee on weekends or when company comes over.

And so therefore we introduced the Duo specifically to address that group and that's very similar to what we've done in the past with the K-MINI, which targets a specific demographic and price point with the K-Café, which goes towards people who are interested in specialty coffees,

cappuccinos and lattes. So our -- just to go back, our goal is of increased household penetration, brewers are the vehicle to do so and the way that we think about innovation in brewers is to address people who are not in the system who we want to have come into the system. And that's why it makes sense to invest a disproportion amount of marketing in driving household penetration.

William Chappell: Got it. And then on the pod manufacturing efficiency, should we look at this quarter where margins aren't moving quite as much as some of the low-hanging fruit is starting to -- has been picked? And maybe any update, I think there is a South Carolina plant that's soon to be up and running, and will that have meaningful benefits anytime soon?

Robert Gamgort: What we know is -- again, I would suggest you take a look at our margin and our progress over time because it's not evenly distributed quarter by quarter. And I think one of the things that we've all learned in the past year is we never want to overreact to the positive or the negative on any quarterly numbers. I would recall the conversation we had about brewer unit sales back in the fourth quarter of 2018 that scared everybody off and we said, don't worry about it.

Similarly, when we're up double digits, we also say it's not a meaningful metric. So I would suggest that there's really no incremental news on margin at all based on this quarter that it's part of the long-term trend. The point that I made a couple of times is we know that there's pricing investment. We talked about it; we've been incredibly transparent. We have great visibility of it going forward because we have long-term contracts with a great majority of our partners, but we also know that we have a reservoir of productivity and projects to offset that pricing. So we would not have negotiated the deals that we did if we didn't have the ability to address them through productivity. And one of those projects is the state-of-the-art manufacturing facility in South Carolina and that will be up sometime in the next year or so, but that's just part of that project in getting towards that goal. I don't know if you have anything to add to that, Ozan?

Ozan Dokmecioglu: Exactly. I mean when you again go back and look to the guidance that we put out there, actually almost a little bit more than 18 months ago, we said on a Coffee stand-alone basis including '18 through 2021, we

expect margins to improve 600 to 700 basis points. And as you know, we improved almost 300 basis points of our margins in Coffee Systems in 2018. And you see the improvement as we've announced in the first two quarters or year-to-date 2019 and we are doing pretty well, I must say. So you would expect to see further margin improvement, again in line with our guidance between now and end of 2021. And I think all these things, as Bob said, have been pointing out and still pointing out the great visibility we have, the relationship between the top line, which relates to the pricing, and the strategic moderating of that allowing a huge visibility and great road map in terms of improving our base productivities between the cost of goods sold as well as the overhead.

And that's what we have been executing and that's what we will continue to execute. As Bob said, we have too many projects, Spartanburg is very important, last guy on the block, but it's one of them and we'll just continue to execute.

Operator: This concludes the Q&A portion of today's call. I'd like to turn it back over to management for any closing remarks.

Tyson Seely: Thanks, everyone, for dialing in today and joining us. I know we went a little bit over. The IR team is around today for any additional follow-ups, and we look forward to talking to you. Thank you.

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