Keurig Dr Pepper Inc

NIK MODI: Good morning, everyone, and welcome to RBC's 2020 Consumer and Retail Conference. I'm Nik Modi RBC's HPC beverage, packaged food, and tobacco analyst. What better way to start the conference than with a company that sells coffee? I'm very pleased to be joined by Keurig Dr. Pepper Chairman and CEO Bob Gamgort and Chief Financial Officer, Ozan Dokmecioglu and VP of IR Tyson Seely.

Since the merger of Keurig, Green Mountain, and Dr. Pepper Snapple, KDP has delivered strong double-digit earnings growth and healthy cash flow, supporting consistent progress in deleveraging the balance sheet. KDP has shown an unmatched ability to execute in these challenging times, coming off a quarter with a gain share. There have been total beverages reflecting continued strength from CSDs to coffee. So with that intro, let me kick the call over to Bob Gamgort for some opening comments.

BOB GAMGORT: Thank you, Nick. Thanks for hosting us. And thanks to everyone for dialing in. I hope everyone is well. As we all know, the past 11 weeks have been very eventful. And we've had a number of conversations with investors, really focused on what's happening in the moment, what's happening in the crisis? And I think that's relevant for a couple of reasons. This is unprecedented, and the situation evolves literally on a week-by-week basis.

And then, the other part of it was, in the case of KDP, since the very beginning, we held our guidance. And a lot of people wanted to understand, why is that possible? How is that possible that we were able to do that? And I think this focus on the crisis and how it's evolved, I know we're going to talk about that in a minute. But I just want to step back and say, just focusing on the short term does a bit of a disservice to the KDP story. Because the reality is we performed incredibly well before the crisis, we're holding up nicely during the crisis, and we think that we'll do well in just about any future scenario that you can paint.

And it's really for three reasons. And it goes back to our acquisition strategy. We have smart diversification, both across portfolio and channels. And I say smart, because diversification is good. But our diversification remains within the broader world of beverages. So we have good focus on a broad category.

We have really strong brand positions. That's the second point. That's great to have positions in segments. But you have to have the right brands. And the last part is the one that's hard to talk about on day one, but is becoming clear now in the 2 and 1/2 years since the merger, especially in the last 11 weeks. And that's talent and culture. And we've built a really strong team with a culture of speed that's allowed us to win.

So those are the broader points. Obviously, when you look at the combination of those, it allowed us to perform well before. But it's why we've been able to stick to our long-term targets that we put out all the way back in the beginning of 2018. And we're still sticking with those targets today. And Nick, as you know, the world has changed dramatically since the beginning of 2018.

NIK MODI: Absolutely. So maybe we could just start there in the state of the union, in terms of the pace of change, like you said, is incredibly fast. But can you just help us understand how you've seen consumption, generally speaking, where we have this big pantry load, and then some de-stock, depending on the category. Just where are we in terms of consumption from KDP's point of view?

BOB GAMGORT: Sure. When you look at the total LRB category, again, it's well documented. There was a pantry load. Then there was a de-stocking. And then there's been what I would call a more of a normalization of consumption trends, where it's not about loading up the pantry. It's about day in, day out consumption. And that's the pattern that we're settling into right now. Who knows how long it will last.

And what we're seeing is elevated consumption of LRB in total, so the latest four weeks. We've got the IRI and Nielsen numbers yesterday. The latest four weeks are up 8%. But you're seeing quite a split by segment. So CSDs, juices and juice drinks, ready-to-drink coffee, for example, are very strong. And water, energy, and sports drinks are weaker. Similarly, if you look at categories, you're seeing strength in grocery and large outlet, especially in e-commerce, and you're seeing weakness in convenience stores and away-from-home channels or on-premise channels.

And so that's all stabilizing. And it's gone from the extremes. So the on-premise channels are not what they once were, but they're better than they were at the trough; same with convenience stores. And so it is kind of normalizing at the levels that I just described.

On the coffee side of the business, we've seen real strength in coffee that's been sustained. And in the case of Keurig, it comes from two areas. It comes from household penetration growth, new people coming into the Keurig system. And it has also come from increased consumption per machine. And the numbers on coffee are really strong. In the latest four weeks or so, the single-serve coffee consumption, where Keurig competes, is up about 20%.

We've held share of manufactured pods. What's really interesting is our owned and licensed brands-- Donut Shop, Green Mountain-- have actually gained share in the most recent period. And so it's settling out, but settling out at an elevated consumption level that's favorable to our situation.

NIK MODI: And Bob, when the Dr. Pepper Keurig combination was announced, many questioned the merits and the rationale of the deal. I think it's pretty safe to say people now understand why you did it. Can you just talk about the advantages KDP has relative to other companies in this environment, especially when you consider all the various routes to market that you have?

BOB GAMGORT: Yeah, I think I'll start with the portfolio side. And you're right. People were confused at first. And our point along the way was diversification is good, because the naysayers said it was a fragmented business. We said, if you take a look across CPG in total, you see diversification outside of completely-- but people were in completely different categories.

We're all within the world of beverages. We see a common consumer insight. At the retail level, we see a common buyer and category manager that we're dealing with. And we're now able to come forward for both the consumer and our customer with a complete portfolio to offer beverages across all need.

Similarly, we said that, in beverage, portfolio is really strong, as it is in all CPG. But distribution is critically important. That's very different than most segments of CPG, where distribution is somewhat commoditized. And we have seven different ways that we go to market, and it ranges from direct store delivery, to warehouse direct, to away-from-home and fountain and food service, but all the way up to e-commerce.

And again, if you go back to their early days, there was some skepticism about e-commerce and food and beverage. That skepticism has to be gone by now. And we are very fortunate to have had such a strong e-commerce business in Keurig that we've been able to apply across our entire business. And so that was the logic of the merger.

And in addition to it, obviously, there's synergies that we're able to generate. We're on track to deliver those synergies. We thought there was an opportunity that we could run both companies better by harnessing the power they talked about. And again, I'll leave it with the piece that I said upfront, which you don't know on day one. It's hard to talk about, is the management, talent, and culture. And we've worked really hard over the past two years to build a unique culture that favors speed and flexibility. And it's really the combination of everything we just talked about that wasn't so clear to many people. Although, I have to give you credit as one of the early adopters and believers in our strategy.

We've got a lot of people now who say, it makes sense. We get how this all works in this environment. So we felt like we knew that all along, but I think that this crisis has provided a real spotlight to show off what we do.

NIK MODI: Very helpful perspective. Ozan, turning to you on the balance sheet. Obviously, leverage is something investors worry about. Can you just provide a state of the union on leverage and leverage targets? And given your leverage target, how should we think about Capex spend in this environment and just general reinvestment back into the business?

OZAN DOKMECIOGLU: Of course. Good morning. So as indicated in our press release, our outlook for 2020 remains intact from what we discuss on our Q1, called back in April. Our deleveraging targets for the year end 2020 remains at 3.5 times to 3.8 times. And we have been focused on debt reduction since the merger. In the nearly two years since the July 2018 merger, we have reduced our management and leverage ratio from 6 times to 4.2 times in the most recent quarter. This keeps us on the path of the target that we set in 2018, of being below three times within three years of the merger close.

Also, it is important to note, our business continues to generate high levels of free cash flow, primarily driven by our strong earnings growth and improved working capital year over year. For example, as announced in our Q4 2019 call, our net income to free cash flow conversion ratio for the full year was in excess of 140%. In quarter 1 2020, under the same math, for example, our ratio was approximately 115%.

We also continue to invest in our business. We are in a very difficult different environment now, compared to where we were at the beginning of the year. Capex is one of the most important areas of cash is spent. We will continue to support our business with necessary Capex investment. But we will continually evaluate those projects to make sure they are the right one to be investing behind.

In order to ensure we meet our leverage targets, given this, there will be some delays to discretionary projects that aren't strategic in nature or don't support our growth agenda right away. Some projects could also be delayed because of the COVID-19 impact on suppliers and vendors. Further, as we discussed on our quarter one call in April, we completed those strategic refinancing that extended our debt maturities and enhance our liquidity profile. We issued 1.5 billion of Senior notes and also increased our bank revolver capacity.

This strategic refinancing provides us with the additional liquidity to a level that we believe exceeds our potential needs, even in the event of a protracted downturn. And also, beyond 2021, we expect to continue to generate strong free cash flow. Our large Capex investments will be mostly behind us. And with debt reduction achieved, we will have a strong cash flow and the optionality that comes with it intact.

NIK MODI: Yeah, thank you, Ozan. Bob, maybe we could just move on. I've been getting a lot of questions about the secondary offering that was conducted by JAB. Any color you can provide on that? I mean, any thoughts?

BOB GAMGORT: Yeah. JAB as you know, has been our majority owner all the way back to the take private of KGM prior to the merging of Keurig-Green Mountain and Dr. Pepper Snapple. They've been just a wonderful partner for us. I've said many times, there is no way that we could have implemented the turnaround of KGM at the speed that we did if we didn't have the support of a primary investor like JAB, who had a lot of courage to support and fund our strategy.

We had a very small float after the merger. We saw volatility in our stock as a result of that. And quite honestly, we saw a lot of high-quality investors on the sidelines telling us that there just wasn't enough float in the stock for them to come in. So we had a conversation a year plus ago with JAB about gradually increasing the public float. And that's exactly what they've done.

And in March, when they did their secondary offering, they talked about a goal of increasing the float to 25%. And so with the latest secondary offering that you see, the public float is just over 24%, so very consistent with our desires as management, very consistent with what we've talked about to our investors in the outside world. And we're really right on track with the targets that we put forth.

NIK MODI: Excellent. Maybe Ozan, shifting back to you, now that the panic buying seems to be subsiding, are you getting a better perspective on the path to profitability across the portfolio? Do you think the cost of doing business is higher, lower, no change? Any perspective around that?

OZAN DOKMECIOGLU: I mean, as we look to the future, Nick, we don't have a better crystal ball than anyone else, right? But we are not close to the new normal, which maybe later this year or next year, that come. But as Bob was explaining, what matters for us is that we get ready to weather this COVID-19, a new working environment, and as we have been performing very strongly and very nicely, just to continue that trend.

And then we get out. We will get out, and we will get out stronger, out of this COVID-19, as well. We are approaching as the new management crisis as a matrix and the roof that's focus and prioritization. For example, we are looking at it, the product categories, as the x and y-axis, if you draw product categories on one axis. And the other one is the retail channels. And this is all about prioritization, that we go through.

And as we have also spoken during our quarter 1 April webcast, there are several categories. And we put this in three buckets. For example, the first category is the purchase, for example, under an initial stock up mindset, primarily in March, and no longer going, and in some cases, declining. Then the second bucket that we categorize, for example, loads that continue to be purchased on an ongoing basis, which is we put them in expandable categories.

There is potential for some of these categories to continue to grow, in fact, at the elevated level post-crisis. And some will fall, and many what actually will be categories fall in this bucket, that we believe and we are demonstrating in market, that say data. Finally, the third category that we are bucketing would be the ones that are not relevant to the consumers' current needs, and they've been negatively impacted, some of which will return to the previous growth levels after the crisis is down, down in the, let's say, years to go or even early 2021.

Therefore, when you look actually to our market in performance, that has been announced yesterday, and Bob is going to talk more on that, I believe, that you see that we are performing very strongly in the marketplace. And the proof point is that our CSD category shares that increased in the last week, the last four weeks, as well as the last 14 weeks data. And we are also seeing a strong increase in our coffee category, that our owned and licensed share has been increasing, which it proves the point of our superior in market execution in both hot and the cold beverages at the same time. So Nick, back to you.

BOB GAMGORT: Yeah, great. Hey, thanks. Let me just build on what Ozan said, which I agree with completely. In a lot of our conversations with investors, the way that they're analyzing the marketplace and company exposure to the marketplace is they're looking at it more as, which companies are exposed to which segment? And that is critically important. But what it misses is that that implies that it's a path of exercise. And what Ozan is describing is it's a very active management exercise.

We keep talking about internally as an active mix management exercise. How do we drive the segments and the channels that have the most potential harder, to be able to offset the negative profit impact from the segments and the channels that are weaker? And so exposure is great, but management is more important. And that's what you're seeing in not just the category trend numbers, but our share growth.

And back to my original theme-- we were gaining share before the crisis. We've accelerated our share gains during the crisis. And it's the combination of the portfolio exposure and our ability to actively manage it, that's serving as well right now.

NIK MODI: Excellent. Yeah, maybe Bob, you could just touch on coffee. And we touched on it earlier about household penetration. But the last earnings call, you shared that 27% of the consumers making coffee at home, more often than before the crisis, 2/3 of which believe this behavior will continue even when the restrictions end. But when I go out and about, and I see these shelter in place situations expire, you're seeing lines and lines looking to-- in the Starbucks drive-through, or what have you. How sticky? I mean, what does your research say about how sticky some of this behavior has been over the past eight or nine weeks?

BOB GAMGORT: Sure. And I see the same lines, at QSR restaurants as well. So it's clear, especially for those of us in the Northeast, that people are really anxious to get out and about with life. Our success is not at all dependent upon coffee shop consumption moving in home. We don't have factored in at all.

What we've seen is that, when people were absolutely locked down in their home, per machine consumption went through the roof. And also, we've seen good trends. And we've had good long-term trends in household penetration. I think that will normalize as people go back to work. And people are going to go to coffee shops. But again, if there's a recession, and as people discover how easy it is to make great quality coffee at home, a lot of that consumption will stick, going forward.

The other piece I would point out is, across our portfolio, not just in coffee, but everywhere, we have a number of natural hedges in our portfolio. So we're talking a lot about people consuming coffee in home and how good that is for us. And it is. But you also have to remember that we've got a very substantial away from home coffee business focused on offices that's been hurt badly.

So as the country reopens, and people go back to the office, we may lose some of the peak at-home consumption, although I believe a lot of that will stick. But we're going to pick it back up on the office side. And so we have this ability to play both sides of it, I think, to our advantage.

But one area that's indisputable, that's sticky, is household penetration. When somebody comes into the Keurig system for the first time, the percentage of them that stay is very, very high. Very few people ever leave the system. And so we're not only getting increased consumption per machine, but we're getting people coming into the system. And we know that sticks for the long.

NIK MODI: And just following up on that, in terms of pod pricing, Ozan, maybe this is for you, last quarter, you shared pod pricing actually had increased, that consumers traded up to more premium brands in lieu of coffee shops. How sustainable do you believe this trend will be? And how do you think about pod pricing in a recessionary environment?

OZAN DOKMECIOGLU: I mean, yes. First of all, we are very pleased to see these trends that are happening. But as we have announced several times since the merger time, we had a great visibility to the, let's say, pricing overall in the coffee, single-serve coffee category, whether behind our owned and licensed or our relationship and working with our partner group. And then, no surprise to us, that we, obviously, developed a lot of strategies accordingly and executed very, let's say, nicely. As a proof point, when you look to our margin expansion, in fact, since the year 2016, as we announced before the merger, as well as throughout the merger time. So nothing that has come as a surprise to us with the pricing and what is also happening in the past one month or two months, as well.

For example, category pricing continues to hold up. Over the last several weeks, it's reported in the latest IRI data. We do also expect consumer spending to be impaired for a longer period of time, with the shift towards the value mindset elevating in-home consumption for food and beverage, which we are obviously seeing the benefits of increased and elevated levels of the consumption, both in the single-serve category, as well as, for the most part, of our cold beverage portfolio.

And there's also a range in a national and regional and the store brands at various prices that consumers can access. They should not forget for example, we manufacture 80% of all Keurig compatible pods and participate to all price levels. Therefore, what is happening in the marketplace right now with regards to the pricing, this is the most important point. It is not a surprise to us and has never come as a surprise. And we are managing the mix accordingly, as well as pulling the necessary cost savings to continue to improve our margin profile, as well as our profitability, combined with the strong in market execution, as we have been explaining on this call.

BOB GAMGORT: Hey, Nick, just to add to Ozan again, we've talked in the past, when pricing has been negative, and people, investors or analysts, were asking us questions, as if that was a serious negative. We took the position all along to say, look, we have visibility, as Ozan said. And our proof point is we're able to make these pricing investments while we're expanding margins. So clearly, we have this more than under control.

I think it's the same thing in the current situation. Just like the negative pricing, because we had it planned, was not an issue for us, this positive pricing right now is not a windfall for us either. A lot of that is coming from lower promotion, which goes to the benefit of our retailers and our partners, as well as to ourselves, when we have our owned and licensed portfolio. And another portion of it's coming from mix.

Interestingly, people in this environment are buying more premium pods. So I put this all in the long-term plan and say, just like we were very, very consistent in saying pricing investments was part of our strategy, our current situation is also part of a longer-term strategy, as well, and is not an outlier.

NIK MODI: Excellent. Thank you for what, Bob. Thank you for that follow-up. Bob, two more questions, and then we'll probably be at time.

BOB GAMGORT: OK.

NIK MODI: Based on innovation, I mean, in discussions with retailers recently, it's pretty clear that the hurdle on what makes the shelf in the future is going to be a lot higher, right? I don't think line extensions, flavor extensions, pack extensions are going to cut muster like it did previously. How does that inform or change the way you think about innovation? What does it look like for KDP, going forward? And where do you think you have the most amount of white space?

BOB GAMGORT: Yeah, I think both manufacturers and retailers have experienced this scenario right now, where there have been a number of SKU reductions to improve efficiency, both at retail, as well as in distribution and manufacturing. And we've all enjoyed the benefits of it. So it's an appropriate question to say, now that we've done all this hard work of SKU reduction, which every consumer product company, every retailer, wants to do, but is afraid to do, now that we've been forced into it, and it's serving us well in the short term, let's be thoughtful about what we add in the long term.

So we're OK with a higher bar for innovation, going forward, mainly because we just have fewer, stronger brands. And we put a very high bar on ourselves when it comes to innovation. So if you look at the innovation that we got in before the crisis hit, there were a number of them. But the three big ones that are paying off right now are Dr. Pepper and Cream Soda, Canada Dry Bold, which plays on the whole ginger trend. And then we had launched a product under Donut Shop called All-In-One lattes, which was this first coffee creamer and sweetener all in one pod. All three of those innovations are doing very, very well in this environment.

And so that's the standard that we look at. And again, you see lots of SKU proliferation out there. That's not our strategy. And so a little more discipline around that serves us all well.

We've had some questions about, how should we think about brewer innovation? Since we haven't talked about that, I'll mention it now, especially going into the holidays. I would assure everybody that the retailers who sell our brewers are anxious to get our next wave of innovation. It's really all pre-sold at this point in time. And the commentary about lowered levels of innovation acceptance by retailers does not apply to the brewer side of the business.

And they're looking at a very different holiday season, with a lot of the trends saying, in the environment we've all described, more practical, functional gifts are what consumers are leaning toward. We fit that perfectly, and we've got a great lineup of innovation, which we haven't had a chance to show the world, yet, but we'll talk about more on our next earnings call. We'll have that out in full force for the holiday season.

NIK MODI: Very helpful. And let's cap it off with a question on long-term value creation. So the pieces, I think, it's been pretty clear. Since the new company has formed, including current buying trend, share gains, in the package beverage business and synergies. But a lot of this has played out. And then you've proven your ability to do that. So how should investors think about long-term value creation for the KDP story from here?

BOB GAMGORT: Yeah, I'm glad to hear that you believe this has played out, meaning we've hit our proof points that we've talked about before. But we still have a ways to go to deliver against that. I mean that in the positive sense, which is the targets that we put out in 2018 were very ambitious, but they covered us all the way through the end of 2021. So sitting here at the halfway point in 2020, we still have another 18 months of the merger deliverables that we've talked about still to come for our investors.

And if you think about the targets we put out there, we said 2% to 3% net sales growth. Our guidance for 2020 was above that. We talked about 15% to 17% adjusted EPS growth over that three-year period. We've kept that intact. And in fact, in our first two years, we've delivered EPS growth of just about 20%.

We've talked about deleveraging as a critical part of the value creation, getting below 3x within two to three years. Well, since the merger, we've had free cash flow of $3.8 billion. We've taken leverage from 6x down to 4.2 at the end of the quarter. We paid down $2.3 billion worth of debt, and we paid out about $1.6 billion in dividends.

So those numbers are extraordinary. And obviously, we've delivered the first wave of the $600 million in synergies that we talked about. Those numbers seem all extraordinary. But yet, we still have them in front of us in the form of the next 18 months and the way that I described it. So obviously, based on the way we've talked about our guidance since the beginning of '18, we're very confident in that.

But then, you have to think about, what does the world look like for KDP beyond 2021? At that point in time, our leverage will be below 3x. We're making very significant Capex investment, as we talked about, in new plants and new technology. That will largely be behind us. Our cash flow will continue to be exceptionally strong. And we've got a significant amount of white space in our portfolio.

And the combination of all of those means that we can look at a number of different ways to deploy that cash back to shareholders and/or in the form of growth in our portfolio. And so we're very confident in our three-year targets. And we're very bullish about our future beyond 2021.

NIK MODI: Excellent. Well, we're at time. Bob, Ozan, Tyson, I want to thank you guys for getting us started in a positive fashion with the RBC Consumer Conference. Best of luck for the rest of the year. And stay safe and healthy. Thanks for dialing in.

BOB GAMGORT: Thank you very much. Thanks.

NIK MODI: You bet.

OZAN DOKMECIOGLU: Thank you.