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 Third Quarter of 2021. This conference call is being recorded, and there will be a question-and-answer session at the end of the call. I would now like to introduce Keurig Dr Pepper's Senior Director of Investor Relations, Mr. Steve Alexander. Mr. Alexander, please go ahead.

Steve Alexander: Thank you. And hello, everyone. Thanks for joining us. Earlier this morning, we issued our press release for the third quarter of 2021. If you need a copy, you can get one on our website in the Investors section. Consistent with previous quarters, today, we will be discussing our performance on an adjusted basis excluding items affecting comparability. The company believes that the adjusted basis provides investors with additional insight into our business and operating performance trends. While the exclusion of items affecting comparability is not in accordance with GAAP, we believe that the adjusted basis provides a meaningful comparison and an appropriate basis for discussion of our performance. Details of the excluded items are provided 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 2021 results are KDP's 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 on 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.

Robert Gamgort: Thanks, Steve. And good morning, everyone. As we approach the completion of our three-year post-merger period, we're looking forward to our next chapter of transformation and growth. We're entering that phase from a position of strength, with top line momentum fueled by new tools and capabilities, robust innovation, and the right team and culture to enable continued success. Importantly, we're also nearing our targeted leverage ratio, which enables us to shift the use of our industry leading cash generation from debt reduction to a new set of options for increased value creation.

We have successfully navigated the macro dislocation that has occurred over the past 20 months and expect to be able to do the same in the face of the new challenges that are causing incremental disruption across the economy. The escalation in input cost inflation, coupled with labor shortages and supply chain disruptions, including constraints on transportation, impacted us in the quarter and will likely persist for some time. As part of the offset, we have increased price and utilized a wide range of RGM initiatives across our portfolio, along with stepped up productivity, alternate sourcing and supplier strategies, and other cost mitigation activities.

Given the strength of our brands, driven by increased investment in innovation and marketing, we have been successful in limiting the elasticity impact of the pricing to date. Our third quarter results provide a good example of KDP's ability to manage through challenges and deliver strong and balanced results.

We posted another quarter of high-single digit constant currency net sales growth, with all four business segments reporting strong increases. We also delivered double-digit adjusted diluted EPS growth, while increasing marketing investment in the quarter. As discussed last quarter, we believe it's helpful to highlight our results on a two-year basis because we are layering strong current year performance on top of strong year-ago performance, which we believe sets KDP apart from most companies. On this basis, constant currency net sales advanced 13% versus the third quarter of 2019 and adjusted diluted EPS was up 38%.

On a year-to-date basis, results were similarly strong compared to 2019. KDP's in-market performance for the third quarter was as strong as our financial performance. We continue to grow share in carbonated soft drinks, reflecting core brand growth and successful innovation and renovation. Most notably, our new zero sugar varieties. Sunkist continued to post strong double-digit consumption growth behind its new flavor lineup and is now the number one fruit flavored CSD brand in the category. Other CSDs posting strong growth in the quarter were Canada Dry, A&W and Squirt.

The Dr Pepper brand also continued to perform exceptionally well, consistently gaining market share on the strength of double-digit consumption growth. This growth has accelerated with the recent launch of this year's Fansville campaign, which celebrates the passion consumers have for college football and Dr Pepper. In market performance of our key non-carb beverage brands such as Snapple, Bai and Core continued to be impacted by supply chain challenges that capped growth. The supply chain situation is already showing signs of improvement, with Snapple's latest four-week consumption well above its 13-week trend and Bai growing consumption by nearly 15% in the most recent periods behind the success of Bai Boost.

On a two-year stack basis, in market performance of our cold beverages was very strong, with nearly 75% of the portfolio's retail sales base expanding market share. We continue to drive our newest brand partnerships and deepen existing ones. In the case of Polar, we expanded availability outside of the Northeast region, achieving a 3.7% share and 60% ACV distribution in markets for which KDP is responsible for the brand. We also invested in Vita Coco's recent IPO.

And as part of that transaction, extended our distribution agreement with them. In coffee, our K-Cup pod shipments advanced 6% in the quarter and are up almost 7% year-to-date. This reflects continued strong at-home performance and a modest improvement versus year ago in away from home coffee, although the latter continues to be down significantly versus pre COVID levels. Market share of KDP manufactured pods and track channels was 83%, up almost a full point versus year ago.

As we discussed during our recent Investor Day, we expect to add at least 2 million new Keurig households in 2021, continuing our long-term growth trajectory and clearly showing no pullback following our accelerated level of 3 million new Keurig households added in 2020. We will provide a final 2021 household penetration number when we report our Q4 earnings. Brewer shipments grew 2.2% in the quarter, successfully comping a 34% increase in the third quarter last year. On a year-to-date basis, brewer sales are up 22% versus year ago. And compared to the third quarter of 2019, brewer sales are up 44%.

Driving this impressive growth is effective marketing and our comprehensive quality and innovation strategy that is widening choice, functionality and price points of our brewer portfolio. The most recent example is our new MultiStream Technology, which delivers a richer, more balanced and flavorful cup of coffee. Our newest brewer is the Keurig Supreme Plus SMART, initially launched on keurig.com in July and now rolling out to retailers in time for the holidays. In addition to incorporating MultiStream Technology, this Internet-connected brewer also features our new BrewID technology, which recognizes the specific K-Cup pod in use and automatically customizes brew settings.

The brewer SMART technology also enhances our successful auto delivery business by utilizing SKU level pot consumption data to automatically replenish consumers via shipments direct to home. Both our auto delivery and broader ecommerce business continued to expand in the quarter on top of the exceptionally strong growth experienced last year. We also continue to innovate in pod sustainability and have begun the introduction of Easy Peel lids to our recyclable K-Cup pods in order to make the recycling process simpler for consumers. In addition to the good progress we've made in coffee pod sustainability, the accomplishments in our companywide ESG efforts continue to be recognized.

Recently, we received the Reuters Responsible Business Award for the social and human capital category, recognizing our 20-year journey of putting farmers first by improving 1 million lives in our coffee supply. A top 10% ranking among 350 food and agriculture companies by the World Benchmarking Alliance, a United Nations affiliated organization that focuses on improving private sector performance against the UN Sustainable Development Goals. A number two ranking out of 50 of the largest CPGs and retailers in North America by the nonprofit As You Sow in their assessment of plastic usage and packaging sustainability progress. And LEED Gold certification for our new Frisco headquarters.

Before turning it over to Ozan, I want to highlight the increase in our outlook for 2021 net sales growth to 7% to 8% as communicated in our press release this morning. We continue to expect adjusted diluted EPS growth in the range of 13% to 15% as pricing, productivity and revenue growth are being leveraged to offset significant and accelerating industry inflation, as Ozan will now discuss in his comments.

Ozan Dokmecioglu: Thanks, Bob. And good morning, everyone. Continuing on an adjusted basis, I will briefly review our performance for the third quarter, which was another strong one for us. I will then turn to our outlook for the balance of 2021. Constant currency net sales increased 6.8%, fueled by higher volume mix of 3.2% and favorable net price realization of 3.6%. Importantly, all four business segments posted growth, driven by successful innovation and strong marketing, along with continued solid in-market execution. For the first nine months of 2021, constant currency net sales grew 8.4% versus year ago. And on a two-year basis advanced 13.3% versus the same period in 2019.

Adjusted gross margin in the quarter advanced 50 basis points versus a year ago to 56.4% of net sales, reflecting higher pricing and productivity, partially offset by significant and accelerating inflation in cost of goods sold. Adjusted operating income in the quarter grew 6.5% versus year ago to $931 million, driven by the strong and balanced net sales growth in the gross margin expansion as well as productivity and merger synergies in SG&A. These positive drivers were partially offset by significant inflation in transportation and logistics and significantly higher marketing investment. On a constant currency basis, adjusted operating income increased 5.7% versus a year ago.

Adjusted operating margin declined 30 basis points, reflecting our decision to reinvest in marketing to drive brand strength. Excluding the increase in marketing, adjusted operating margin was up versus year ago. For the first nine months of 2021, adjusted operating income increased 7.6% versus year ago. And on a two-year basis, adjusted operating income was up 21% versus the first nine months of 2019. Adjusted net income in the quarter advanced 13.3% versus year ago to $631 million, primarily driven by the growth in adjusted operating income and lower interest expense, largely reflecting lower interest rates stemming from the strategic refinancing completed in the first quarter of 2021, lower outstanding indebtedness, and realized gains on interest rate swap contracts. Also benefiting the growth in adjusted net income was a lower adjusted tax rate.

Adjusted diluted EPS in the quarter grew 12.8% to $0.44 compared to $0.39 in the year ago period. For the first nine months of 2021, adjusted diluted EPS advanced 13.9% versus year ago. And on a two-year basis, adjusted diluted EPS was up 32% versus the first nine months of 2019. Let me take a moment to discuss the inflationary pressures and supply chain challenges we have referenced this morning that are impacting the broader economy and our industry. We are experiencing significantly higher inflation this year than we expected at the start of the year, which we were managing with pricing, productivity and accelerated growth.

For perspective, we expect all-in inflation this year, which includes inflation in cost of goods sold, transportation, warehousing and logistics, and SG&A, to be up approximately 6% versus year ago. This inflation has accelerated in the second half of 2021. Our updated guidance for 2021 incorporates all of these considerations, and we are confident that we have the tools and management disciplines in place to deliver our guidance for both revenue and earnings growth. Let me now turn to our segment performance in the third quarter. Coffee Systems constant currency net sales increased 4.6%, driven by higher volume mix of 5.7%, partially offset by lower net price realization of 1.1% which continued to moderate as expected.

The value mix performance reflected pod shipment volume growth of 6.3% and brewer volume growth of 2.2%. The pod volume growth reflected continued strong momentum in our at-home pods and improved performance in our away from home business, although returning to offices continues to be slow and this business remains well below pre pandemic levels. The 2.2% increase in brewer shipments, which is on top of the 34% increase in brewer shipments in the third quarter last year, was fueled by continued strong consumer purchases stemming from successful brewer innovation and a double digit increase in marketing.

During the quarter, we took pricing in our brewer portfolio, and more recently, took pricing on our owned and licensed coffee brands, given the escalation in coffee commodity pricing. As a reminder, most of our partner contracts require the partner to be responsible for coffee beans. Therefore, the increased commodity costs and any pricing they chose to take for these brands does not follow through the KDP profit and loss. Adjusted operating income for Coffee Systems increased 1.1% to $377 million, driven by the net sales growth and continued productivity and merger synergies, partially offset by inflation and a double-digit increase in marketing investment in the quarter.

This marketing investment supported the launch of our new Keurig Supreme Plus SMART brewer, featuring our new BrewID technology platform. The campaign was executed nationally via digital, social and earned media and was amplified by experiential activations. On a constant currency basis, adjusted operating income increased 0.5% in the quarter. Adjusted operating margin in the quarter was 32.6% compared to 34% in the year-ago period, largely reflecting the significant increase in inflation and marketing investment. Packaged Beverages constant currency net sales grew 6.8% in the quarter, with volume mix growth of 1.5% and higher net price realization of 5.3%, reflecting continued growth in both our company owned DSD operations and warehouse direct business.

The majority of our liquid refreshment beverage portfolio contributed to this growth, with CSDs, notably Dr Pepper, Canada Dry and Sunkist particularly strong, along with Polar, Vita Coco and Mott’s driving growth. Adjusted operating income for Packaged Beverages increased 2.6% in the third quarter to $312 million, driven by strong net sales growth, productivity and merger synergies, partially offset by inflation, particularly in transportation, as well as marketing investment and increased operating costs to meet continued strong consumer demand. On a constant currency basis, adjusted operating income increased 2.3% versus year ago.

Adjusted operating margin for packaged beverages was 20.2% in the quarter compared to adjusted operating margin of 21% in the year-ago period, largely reflecting the impact of inflation and higher marketing investment. Beverage Concentrates constant currency net sales increased 10.8%, reflecting favorable net price realization of 11.4%, resulting from higher pricing and lower trade expense, slightly offset by lower volume mix of 0.6%. The growth in net sales also reflected a continued recovery in the fountain foodservice business due to increased consumer mobility in the restaurant and hospitality channels, with brand Dr Pepper driving the growth. Offsetting this growth was the decline in bottle can concentrate shipment volume.

Adjusted operating income for Beverage Concentrates increased 9.1% to $289 million, driven by the net sales growth, partially offset by a strong double-digit increase in marketing investment. This increase reflected investment behind Dr Pepper Zero Sugar and the Dr Pepper college football campaign. On a constant currency basis, adjusted operating income advanced 8.7%. Adjusted operating margin in the quarter totaled 73.7% compared to 75.3% in the year-ago period, reflecting the impact of significantly higher marketing investment. Excluding the increase in marketing, adjusted operating margin was up versus a year ago.

And finally, Latin America Beverages constant currency net sales grew 14.5%, reflecting strong volume mix growth of 10.5% and favorable net price realization of 4%. Liquid refreshment beverage in-market execution in Mexico continued to be strong across all channels, which drove significant net sales growth for key brands, namely Peñafiel and Clamato. Adjusted operating income increased 48% to $37 million. And on a constant currency basis, adjusted operating income increased 36%. This strong operating income performance reflected the net sales growth and productivity, partially offset by significantly higher marketing investment and inflation. Adjusted operating margin in the quarter advanced 350 basis points to 23.7% despite the meaningful increase in marketing investment.

Free cash flow in the quarter continued to be strong at $676 million, driving year-to-date free cash flow to $1.6 billion. This strong free cash flow performance for the quarter and year-to-date periods represented free cash flow conversion ratios of approximately 107% and 100% respectively.

During the quarter, we reduced our outstanding bank debt by $325 million and structured payables by $2 million. We also ended the third quarter with $200 million of unrestricted cash on hand. Due to our growth in earnings and reduction in bank debt, we improved our management leverage ratio to 3.2 times at the end of the third quarter of 2021. Since the merger close in July 2018, we have reduced our management leverage ratio by 2.8 times and continue to expect to achieve a management leverage ratio at or below 3 times at year end.

Let me now move to our outlook for full-year 2021. For the third time this year, we increase our guidance for constant currency net sales growth to reflect the significant momentum in the business. And we now expect growth in the range of 7% to 8%. This compares with our original 2021 guidance for constant currency net sales growth of 3% to 4% and our most recent guidance of 6% to 7%. We continue to expect adjusted diluted earnings per share growth in the range of 13% to 15%. And we expect to continue to invest significantly in marketing to maintain our top line momentum.

Supporting this guidance, we expect the following. Adjusted interest expense is now expected in the range of $495 million to $500 million, reflecting the realized gains on interest rate swap contracts that benefited the third quarter. Adjusted effective tax rate is expected in the range of 23.5% to 24%. Diluted weighted shares outstanding are estimated to be approximately 1.43 billion. And finally, our management leverage ratio is expected to be at or below 3 times at year end.

With that, let me hand it back to Bob for some closing remarks.

Robert Gamgort: Closing out 2021 completes the three-year commitment established in January of 2018 at the announcement of the merger. Clearly, a lot has transpired since then, and throughout this time, the KDP team has remained focused, flexible and resilient. With one quarter left to go, we are confident that we will significantly over deliver our net sales commitment and achieve our 15% to 17% adjusted EPS commitment.

I will now turn back to the operator for your questions.

Operator: If you would like to ask a question, please press star one on your telephone keypad. Again, that is star one to ask a question. We'll pause for just a moment to compile the Q&A roster.

Your first question comes from Bonnie Herzog with Goldman Sachs.

Bonnie Herzog: I wanted to ask about your top line which continues to be much stronger than expected and it's impressive that you guys have taken up your sales growth guidance yet again. So, given this, how does this potentially change your thinking regarding your preliminary outlook for 2022? Does it give you any more confidence in your ability to deliver on a mid-single digit top line growth? Or possibly above this? And if so, do you think your initial outlook for mid-single digit EPS growth next year could ultimately prove conservative, given that lever? Just wanted to get your thoughts on that.

Robert Gamgort: We're very happy with revenue growth that we've seen. If you recall, when we put the company together, we talked about revenue – three-year revenue guidance of 2% to 3%. And we've far exceeded that. It's driven in a really healthy way through a combination of growth across the entire business, core business growth, and innovation. And it's fueled by great marketing as well and our execution at retail. So, the drivers behind it are sustainable. The contributions from our brands and the innovation pipeline is very strong.

Again, as we sit here in – during the investor day in October and we're looking out over the future, we think that mid-single digits is the right target. Remember that everybody is getting some revenue growth off of the pricing that we're putting in place right now. So, it's hard to look down the road and forecast what pricing will be over the next three to five years. So, we base it more on what the underlying volume growth is in a normalized pricing environment and are comfortable that mid-single digit is the right commitment for us to make over the long term. Obviously, the trends that we're seeing right now are stronger than that.

Operator: Your next question comes from the line of Chris Carey with Wells Fargo Securities.

Chris Carey: The pricing in the Packaged Beverage business, I think, was the highest in over a decade unless I'm mistaken. Clearly it makes sense. Elasticities are not what they historically have been. They're not in any category right now. Can you just talk about maybe how this pricing evolves over the next year, six quarters? I think KDP was a little bit slower to ramp pricing as aggressive as some of your other domestic peers. When does revenue growth management become a bigger dynamic here? When do you think volumes could potentially be impacted by pricing? I imagine the price of the model will be more pricing driven ahead. Again, the concept of higher pricing makes sense. But it's historically high, of course, and just wanted some more perspective on how this evolves over time and whether RGMPs comes in relative to list price and just how you're thinking about how this evolves over the next year or so.

Robert Gamgort: The questions that you're asking are on the minds of everybody in the industry. The fortunate thing is that we operate in a wonderful industry, beverages, and I'm including coffee in that as well, that is incredibly rational. So, the objective is margin protection. And what we've all faced is an unprecedented level of inflation, certainly unprecedented in all of our working careers for the North American market level of inflation. There are three ways to offset that – pricing. And I would include RGM in pricing, and I'll talk more about that. Pricing, productivity. And then there's another lever, which is reinvestment back in the business. And so, we can pull those levers in different magnitudes based on the level of inflation and what we believe the impact will be on the overall business.

What we're seeing right now is that there's been a significant amount of pricing across the industry. The data that I have doesn't suggest that we were slower than anyone else. I think we were right in line. Different parts of our business realized the pricing faster than others. So, for example, our BC business has an immediate impact. When you take pricing, it hits the P&L. There's a delayed response in some of our other businesses, as it has to reach retail. And you have to protect some of the promotions in place. So that may be what you're thinking about there. But certainly, there's been extensive pricing.

The impact of elasticities has been better than historical, and in part it's because of the way we've taken pricing and also the strength of the brands. And we've been able to find a way uniquely within I think the industry to continue to have positive gross margin in the quarter, for example, which gives us the opportunity to reinvest back in our business, which makes pricing even more positive because you continue to invest in your brand strength. So, I would suggest that that's the framework we approach 2022.

And any prediction I would make in the future about elasticities, what do I think inflation is going to be, how do I think pricing will respond to that, not productive because it's impossible for anybody, including the Fed, to predict what's happening going forward. What I would say is that we manage this in a very dynamic manner. When there is more inflation, the industry has put on more pricing. And we have the other levers that I talked about in terms of productivity and reinvestment to pull to protect margin. And that's why we're confident in the guidance that we put out in October 1 in an environment as volatile as this. We still have the ability to manage our way through that.

Operator: And your next question comes from Bryan Spillane with Bank of America.

Peter Galbo: It's Pete Galbo on for Bryan. I guess just on bev con– obviously, there's a natural gap between shipment volumes and bottler case volume, but I think bottler case volumes were maybe a little bit lighter than we had expected and there wasn't a ton of detail around what happened there in the press release. So, just anything there would be helpful. And I think, Ozan, just there were some comments, particularly on the bottler and can part of the Bev Con business, just how are your franchisees managing inflation? How is it impacting their ability to serve – having to do anything kind of to accommodate them for their rising costs?

Robert Gamgort: Let me kick it off, Ozan, and then I'll turn it over to you. The timing between shipments – our shipments and bottler case volumes is always quarter to quarter some disconnect. They equalize over time. There's nothing notable there. And the best way to look at the underlying health of our business, and it's more of a leading indicator, is to look at the consumption numbers, the offtake numbers from IRI and Nielsen because that's the leading indicator of consumer demand that will pull our brand through, whether it comes through our system or through another entity's system, it's still our brand and that's reflected in those numbers.

And you can see that they're exceptionally strong, particularly on Dr Pepper, which is the largest brand that flows through multiple systems. So, everything is very positive there. There's nothing to note. Ozan, you want to talk a little bit about the inflationary impact on our partners and how they offset that.

Ozan Dokmecioglu: Of course. Particularly on the bev con, as you were saying, Bob, bev con comes in two pieces. One is the bottlers and the distributors that we work as well as our fountain foodservice business. And specific answer to the question, Pete, on the mechanism of our bottlers and distributors pricing, most of our bottlers and distributors are on incident pricing, which, as you know, is a quite a bit sophisticated algorithm that starts from the shelf prices, then goes to the bottlers and distributors and reflects to us. Therefore, this is a best-in-class in terms of pricing adjustments that take place in the marketplace. And that also includes the sophisticated revenue growth management strategies that we deploy on a consistent basis.

Therefore, as Bob also alluded a couple of minutes ago, the whole sector took some forms and shapes of pricing actions, either shelf price improvements or using a sophisticated revenue growth management strategies. And as a result of that, there's a net flow through to our bev con business. And given the nature of the bev con that we ship and sell and transfer the concentrate, the increase in the pricing in that segment reflects in our numbers right away. Right away meaning a little earlier than the packaged beverages, for example, that takes a little bit gap between the price improvements, we turn into the finished product, ship it and sell it across the board. So, that will be our algorithm that make us to realize very good margin improvement from the pricing in bev con.

Operator: And your next question comes from the line of Andrea Teixeira with J.P. Morgan.

Andrea Teixeira: Just want to kind of like go back to the supply chain points that I think you kind of managed really well. Can you kind of give us an idea of how, at this point, the packaging side will be able to manage and how it positions you into 2022?

And, Bob, I wanted to go back to also to – just to clarify your point about protecting profitability. I know it's early to say, and obviously, when you gave the 2022 preliminary outlook, it kind of implies the margins are probably going to be on a gross margin basis. I don't know, but that you're going to have a similar algorithm or protect profitability. Is that still going to be more of financial deleverage and below the line or you may be able to protect your gross margin?

Robert Gamgort: I'm going to tackle the first one on supply chain and then, Ozan, you want to talk a bit about 2022 and margins after I finish that. With regard to supply chain piece, like everyone, this has just been a rolling pattern of challenges. So, last time we talked to you, we were having some issues with regard to packaging availability, particularly in the area of Snapple and glass, which required us to move faster to our PET conversion and starting up the plant much faster than we expected. That is largely behind us. And as I said, you're seeing improvements in those businesses. And so, at the moment, that is less of the issue.

Our bigger challenges, and I think consistent with the industry, is actually transportation right now. Customer pickups, as well as shipments that we make that are not through our own fleet are increasingly challenged where pickups don't happen as scheduled and transportation is unreliable, as well as incredibly costly. And then again, like everybody, we're facing some rolling labor issues as well that are not adequate from time to time to be able to service the demand. So, our supply chain team has done incredibly well in navigating through all of these. As you know, we have new supply chain leadership. And Tony, who has joined us, made an immediate impact on that. And so, we're seeing a lot of improvements. But it continues to be incredibly volatile.

Ozan, you want to talk about the margin side?

Ozan Dokmecioglu: Actually, I like to expand a little bit because, obviously, the whole inflation and the pricing algorithm is so interrelated to each other. As we shared with you, and I'm sure you are seeing this every day, like everyone else, we are experiencing a significant increase in inflation, particularly in packaging materials, labor, lately coffee beans, corn and glass, and so forth, which is a broad base of our input costs, combined with transportation. And the latest one, we are seeing pressure on the labor shortage as well as the availability.

As we also shared with you a little while ago, we expect overall inflation rate for 2021 to impact us negatively around 6%. And also, inflation has accelerated through 2021, with the second half being higher than the first half. So, what does this mean? This means that we are entering into 2022 at a higher second half run rate. So, we expect that at least the first couple of quarters of 2022 to face tougher comps than the second half of 2021. Having said that, during our Investor Day, October 1, we also shared with you that our long-term outlook is for continued adjusted operating margin growth fueled by primarily three things – productivity, mix and overhead leverage – while we continue to invest in our brands to continue to drive our strong growth.

Therefore, at this point in time, our 2022 outlook is our best estimate based on a range of assumptions, which is very important to articulate, and this is how we have been managing the enterprise for a while, which is a balance between the inflation, pricing, productivity and business investments. Obviously, the more we know, we will update you and the timing of that update would be during our February 2022 call that will announce our quarter four and the full-year results. But in summary, we believe in the strength of our plan and the algorithm that we put in front of you that will deliver over time.

Operator: And your next question comes from Kevin Grundy with Jefferies.

Kevin Grundy: Congratulations on another strong result. Bob, I wanted to kind of zoom out a little bit. I have a more strategic question for you this morning just as it pertains to your distribution assets and the potential to move into alcohol following PepsiCo's announcement with Hard Mtn Dew. As you know, the legacy Dr Pepper company has long viewed its bottling assets as strategic. I think there's been some questions over the years about potentially taking a look at doing something more strategic, spinning them off, refranchising, etc. But it was collectively something the board thought never made a lot of sense. You mentioned the Vita Coco investment there.

That's been a long-term relationship. It's part of the allied strategy. The Polar deal that you guys entered into made a lot of sense as well. So, my question is this. I'm sure the PepsiCo announcement is in no way lost on you. I just wanted you to comment this morning on the potential for Keurig Dr Pepper to move into the alcohol space, to take a look at your own distribution assets. Is that something that you're entertaining? Is that something that you think makes a lot of sense?

Robert Gamgort: Let me give you a point of view on this space here. On alcohol, in particular, is an area that we look at, it's very similar to the way we look at beverages in total. So as we said, when we put the other coffee with cold beverages, that we thought there was an opportunity to look at beverages holistically. It's the same with alcohol. Now, the complexity of distribution is one that has been pointed out by many including us. And I think that what you referenced with regard to Pepsi is very interesting in how they're being creative around that. What you're seeing is really the intersection of two opportunities.

One is portfolio expansion to new territories, as well as consolidation in the distribution assets to make sure that they are at scale and therefore more efficient. And so, we look at both of those opportunities. And the one that you point out is there is some overlap. So, it's an area that we continue to study. As we had pointed out on the Investor Day, we participate in alcohol in a variety of ways that I think was surprising to people. We talked about the business we have in Canada, where the distribution environment is very different. The fact that we do licensing in the alcohol space, and we think that our brands can play in alcohol nicely, the fact that we're the number one mixer company which has us participating in alcohol consumption occasions at a much higher rate. And we put all of that knowledge and objective together to think about that.

So, I think, in short, there's a lot of complexity to do this in the US. It's interesting to see how others are looking at it. We look at beverages holistically, and so it's certainly on our radar screen. It'll be something in the broadest sense that we'll be talking about in the future.

Operator: And your next question comes from the line of Brett Cooper with Consumer Edge Research.

Brett Cooper: Bob, the leadership team that you brought in comes more from outside of non-alcoholic beverages versus what we typically see in the space. So I was just hoping three years into the deal, you can talk about where you see the state of your route to market business, your observations on what the accepted view of operations was versus how you as a team are seeing it, and then how you look at managing evolutions in the industry, whether those are the ecommerce, the rising penetration of electric vehicles altering convenience store purchases and/or the rise in non-ready-to-drink beverages?

Robert Gamgort: First of all, I'll start with the team. We're really proud and pleased with the team that we have in place right now. We continue to build capabilities. If you look at where we have drawn team members, especially at the most senior levels, and you see it at the EL, executive team level. But I would also say, at the level of direct reports to the executive team, it's very similar. Wide range of packaged goods experience with a focus on beverages. We like to pull people from all elements of beverages. So, we have non-alcohol as well as alcohol experience. We have a number of people who in that individual have experience in both.

We also have people who have a number of experiences both within North America as well as international experience. And we think that this combination of skills, experiences, backgrounds and style make us much stronger as a team. And we will continue to add talented team as well as promote and upgrade talent from within as we've done. So, it is a critical part for our ongoing success to make sure that we've got the management team who can really lead the business of the future.

So, let's talk about some of the future-looking comments or questions that you ask right there. Again, we go back to our original thesis for putting the two companies together is that beverages historically had been managed in silos. And we thought if we took a look at it from a consumer perspective that we would be better off and it's exactly what we've seen, is that consumers don't think about beverages in formats, the silos. They think about needs and occasions and they use multiple beverage formats, brands, products, etc., to satisfy those needs.

So, by taking a consumer first, need-based approach, it has really informed our innovation pipeline, both in the cold and hot side to great success, as you see, it's driven our marketing programs. And it helps us think about partnerships going forward, whether that's a partnership like Polar that was our most recent one, in which we have a long-term franchise agreement with them, but not ownership. Or partnerships where we have seen investment or ultimately acquire the business as we've done with others.

When you think about our distribution assets, which is another area that you point to, we put the company together in 2018, and talked about seven different ways that we went to market. We ranged from direct store delivery to wholesale direct, to franchise – our fountain foodservice which is our on-premises business. But the other one that we talked about at that time was ecommerce, and there was very little appreciation for ecommerce, particularly in beverage in 2018. And that's changed dramatically.

We have seen the percentage of our ecommerce business grow. We've talked to you before. That's north of 10%. It's higher on our coffee business. It grows significantly faster than our average business. And we are in position to be the market leader, the category leader in this space, driven by the historical strength of Keurig. And now with Keurig, where there's always been a substantial ecommerce business, the fact that we are selling brewers that are smart brewers that can recognize the pod, that can trigger an order direct to consumer based on actual SKU level consumption, suggests that we are thinking way ahead in terms of what the next steps are in terms of distribution routes, as well as efficiency.

My last point is it ties back to the question that Kevin asked, in addition to portfolio whitespace and finding new points of distribution, we think our CSD asset is a competitive advantage. But we also believe in consolidation and distribution in the industry. And we'll look for ways to continue to consolidate distribution and drive more efficiency and effectiveness through that really important asset to us. So, I think I've covered all of your forward-looking points. If there's anything else on there or anything I missed, let me know.

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

Lauren Lieberman: I was wondering if you could just talk a little bit about Polar. I know it's still relatively early but had been expanding distribution. And I was just curious if you could talk about some of the uptake you're seeing and what you're doing also to build awareness of that brand because it's one thing to put it on the shelf, another for people outside of the Northeast to pick it up off that shelf.

Robert Gamgort: As you know, Polar continues to be responsible for the brand in their territories. And we've expanded outside of the Northeast for them. Right now, we're at 60% ACV distribution in the territories for which we're responsible. We're happy with that. It continues to grow. We've achieved now just under a four share of that category, which is a sizable and growing category. And we're happy with the trajectory that we're on. I was out just recently doing retail in a number of markets across the country, and I was really pleased with the level of distribution and display activity that we're getting. And in stores in which we haven't gotten it fully slotted onto the shelf yet because of timing, I saw a lot of off-shelf display pressure, which will continue to grow the brand.

The Polar team is responsible for marketing the brand. And it's something that we work with in conjunction – work with them on. And I agree with you that, as this distribution base continues to build, and we have great push activity behind it, needs to be supported with an increasing amount of consumer poll activity. And that's something that we're continue to work with them on. But I think that the foundation is in place to be able to activate that. And overall, we're just really pleased with how that business is trending.

Operator: Your next question comes from Sean King with UBS.

Sean King: First off, I'm glad to see you're starting to move pricing higher on the pod side for the owned and licensed brands. But first off, do you expect or are you seeing the partner brands following on price at retail? And then second, over time, can you get pricing on the partner brand manufacturing contracts, given the higher costs you're seeing?

Robert Gamgort: Let me talk a little bit about just pricing in total on pods and then, Ozan, why don't you pick up on the partner agreements and potential pricing there. I think pricing is always an interesting conversation in the context of K-Cup pods because we have intentionally been lowering the price, although I know for analysts and investors that was always something of concern. We always point out that that was an intentional strategy that has continued to drive household penetration. And we knew that the price was too high.

And we're able to back up those price investments with strong levels of productivity because, as the price came down, we were able to expand margin. That's certainly the proof point that it was intentional. We had that well under control. We are seeing an increase in the underlying price of coffee. And while that is a lesser component of a finished K-Cup pod than somebody who's selling roast and ground coffee, it still is of a magnitude where we know that pricing is appropriate and required.

So, we pass it on immediately in the form of pricing in our owned and licensed brands. And we do think that's the right thing to do, given the inflation. But it's a little more complex in the partner situation as well as private label. And I think, Ozan, why don't you talk that through because it's a good opportunity to remind everyone how our contracts work and what they're likely to see inside and outside of the KDP P&L.

Ozan Dokmecioglu: And as we say, use the generic term partners, and obviously, we include the branded partners we have as well as private label. It's one group for us. And as we shared with you, not the specifics, but in general terms, our partner contracts are for long-term duration. So, they are not for the short term. And the contracts obviously specify all the details in terms of the working relationship. So, when we do the double click, we also see that, as KDP, we are not responsible to source the coffee beans for the most of our partner group. So, what does this mean?

This means that any fluctuation, plus or minus, in the coffee bean procurement, responsibility of the profit and loss management lie with the partner group. That also obviously includes the pricing on the shelves that we have zero saying and it's their business and their job to decide how they manage their pricing. And in some instances that we are responsible in terms of the coffee bean supply, we use our broad hedging strategies and techniques by considering all these puts and takes and protect ourselves at all times. So, this is our overall working relationship from the core manufacturing side of our business and how we set the algorithm between the partner groups as well as the branded ones as well as the private label.

Operator: Your next question comes from the line of Laurent Grandet with Guggenheim.

Laurent Grandet: Actually, the question I've got is very much the same as Sean. I'd like to re-dig more a bit about these. So I understand about the coffee bean and all these, but what about the pod manufacturing. You said in your pre remarks that the manufacturing went up for your pods? So, are you able to pass through some of that increased cost of manufacturing the pods? I'm not talking about the coffee here, but more the pod by itself to either your product level or Smuckers, Dunkin, or Nestle, Starbucks?

Robert Gamgort: Ozan, you want to pick that up.

Ozan Dokmecioglu: First of all, we are not at a position to disclose all the detailed relationship between us and our partners. I'm sure you will appreciate. But if I want to make, let's say, overall general statement on that one, we always look to several pieces as a kind of basket between – from the manufacturing perspective, that includes some of the input cost. As you said and as I said that we are not responsible for the most part from the coffee beans. But there are some other elements, as you say, but that's why we have our overall productivity programs.

That's why we always look for further efficiencies in our business in order, first of all, to help us to improve our margins as we have been doing as well as to whether these types of non-persistent or persistent inflationary environments. Therefore, it wouldn't be right just to look to one piece element and try to make sense out of it, but rather we need to look holistically and that's how we were managing not only coffee, but all segments of our business on the basis of the relationship with pricing, the inflation, productivity as well as the business investments.

And as we have also spoke, we also improved our pricing on the owned and licensed that will be impacting our numbers. And you will see in the data as well starting quarter four onwards. And as we also said that we are very pleased both on the coffee beverages as well as cold beverages that the sector is very rational and very responsible to manage the inflation and the pricing relationship. Therefore, we are very pleased, Laurent, with our algorithm and our working relationship with our partners in all pieces of the elements.

Robert Gamgort: I think just to build on that, as I said before, just to reemphasize, our objective is margin protection. Our levers to pull are a combination of pricing, productivity and reinvestment. And we have different mechanisms in different contracts to be able to protect margin against that, using that entire basket. And in the case of coffee, which has been the most inflationary item within the manufacturing and delivery of a K-Cup pod – as we said, we're not responsible for it for most of our partners. And in the case of our own brands, we immediately took pricing, which by the way, as you can see, didn't really show up at all in Q3 based on the timing of the pricing and the lag on that. So, that's the actual pricing that we put in place, and we've seen across the industry as more to come.

Operator: Your next question comes from the line of Dara Mohsenian with Morgan Stanley.

Dara Mohsenian: Just a follow up on that. Look, obviously, the guidance for 2022 is below your long-term algorithm because of the cost pressures. So clearly, there's some ability not to fully price away those commodity costs. Theoretically, with the conversations we've been having today, heritage DPS is in good shape to do that. You talked about some pricing on your owned and licensed brands. So just to be very clear, I assume the gap for 2022 is that the cost pressures you're seeing on the manufacturing side for your partner brands, understanding you're not responsible for the coffee grounds themselves, but you're not fully getting the pricing to offset that. So, A, is that the case just to be explicit about it? Seems clear, but just to be explicit. And, B, is that more just a lack of ability to sort of respond short term and you can make up for that in future years as you think about it? Or is it more just the contracts are set the way they are in terms of pricing and the way the relationships work, it's more of sort of a standard pricing over time as opposed to responsiveness to commodity costs. Just to clear that up?

Robert Gamgort: First of all, I think you're connecting things that aren't connected right now. So you're looking at our 2022 guidance, which was our initial guidance that we were in a position to – I think really felt obligated to provide some guidance in October, four to five months in advance of when we normally would. And as we've shown, since the very beginning, we pick our guidance and our commitments really seriously. We're pretty much the only company that held on to guidance during COVID. So, when we put a number out there, we treat it as a commitment and an obligation.

And so, when we're sitting there in October, operating an incredibly volatile environment that nobody can predict, we feel that it was important to set expectations for 2022 that was friendly to investors, so that they could plan appropriately. So, connecting coffee contracts and our ability to price or not, which I think we just explained in great detail over the last two questions to our guidance for 2022, I think is not appropriate. Having said all that, I'm going to say what we said a couple times today. Inflation is one input cost. We are managing around a range of inflation.

One of the pieces that I think is not well understood is as soon as we talked about inflation, immediately, I see reports jump to commodities and hedging. Let's be clear, the inflation that the industry is seeing right now is way beyond commodities. It's packaging, it's labor, transportation. Some, if not most of those, cannot be hedged and are impossible to forecast. So, everybody is getting exposed to a high level of inflation. We're exiting 2021 at the highest run rate of the year. Nobody can fully predict how that's going to flow through in 2022. But if you're entering the year at the highest level of the previous year, that would cause you to say, okay, there's going to be increasing pressure and we're going to have to offset that through a range of pricing, productivity and reinvestment.

Last point I would make as you think about 2022 is we're really clear. Our marketing is up in 2021 versus 2020. We intend for our marketing to be up in 2022 as well. The industry took down marketing in 2020 versus 2019 reluctantly, but the whole industry did it. Our objective is to build it back because we think investment in our brands behind innovation is the most important thing, and it's fueling the top line. So, there's an assumption in 2022 that we're going to reinvest. And you can figure that into the estimates as well. So, that's our outlook for 2022. It's early. We're going to provide a lot more information when we're in our normal position of doing so in early February. We take our commitment seriously. And we're really pleased with the growth of our business and believe that the right thing for us over the long term is to continue to invest in growth and not cut marketing spend to be able to offset any margin pressures.

Dara Mohsenian: Can I just follow-up with one question? If you see manufacturing costs continue to move up on the partner side in coffee, do you think you can get incremental pricing over time? How do you think about just that piece of it? I understand there are a lot of moving pieces and you're still delivering solid growth for next year.

But I'm just trying to understand that one piece of it. Obviously, we're seeing a lot of responsiveness to the costs on the heritage DPS side, right, a very strong pricing this quarter. So, I'm just trying to understand that one piece of it.

Robert Gamgort: There are variety mechanisms for us to recover inflation on the pod side of the business. Pricing is one of them. Productivity is another. My last point on this one is – I said this for the past three years that the focus on pricing on coffee, while it makes sense from a traditional CPG perspective, makes no sense in the coffee pod business when the company is intentionally trying to lower prices. And even in an inflationary environment, we're trying to keep prices down. We're only passing on the coffee costs because they are excessively high.

With regards to the rest of our business, we have a significant amount of productivity and mechanisms to take more pricing if we choose going forward. But remember, our overarching strategy is to try to keep prices down even in the face of inflation and protect our margins through a combination of productivity and pricing. In this business, we have leaned on productivity because it's available to us much more than pricing because it's the right thing to do for the ecosystem of Keurig.

I recognize that concept is very different concept than traditional CPG. I would also say it's the beauty of the Keurig system because it truly is an ecosystem. That's an overused phrase, but it's true in the case of Keurig. And that's what makes this thing work over the long term. You can't focus on one metric because if you do you have you run the risk of damaging the long term growth of the system. And you could see that, if anything, we're accelerating the growth of the system, which really drives everything.

Operator: And your final question comes from the line of Robert Ottenstein with Evercore.

Robert Ottenstein: And just want to follow-up on a couple of questions. We've covered a lot of ground. So just one, as you look at the growth opportunities in the M&A, how does international expansion rank in terms of priority? Is that something that you see as natural, particularly maybe in Mexico, or particularly in areas where you have the brand in the US, but maybe not overseas? Or you can use your expertise in other areas? So that's the first question. And then second, as you look at these commodities, there's a traditional hedging playbook, right, that you guys have traditionally used, but you've got prices now at unprecedented levels with a steepness in the curves like aluminum that I don't think any of us have ever seen. Does that change your strategy in terms of the duration of the hedges?

Robert Gamgort: Let me hit the first one and then, Ozan, you want to talk about hedging and duration of our positions and how we think about that. On the international side, with regard to M&A specifically, as we talked about in our Investor Day, we're really excited about being able to use our high levels of discretionary free cash flow to look beyond debt reduction as we're just about to reach our long-term leverage targets. And we talked about the capacity to do $20 billion worth of M&A. There are four areas that we talked about in that portfolio, whitespace distribution and consolidation within distribution, adding capabilities to our business. And then we also talked about market expansion or international.

So, it's one of the top priorities. I don't want to rank them because it's going to be dependent upon not just our needs and our opportunities, but what is available and what kind of partners are on the other side. We've got really nice business in Mexico. We hadn't talked about it very much. And we were proud to share with you the business that we built in Mexico at Investor Day. Similarly, in Canada, we have a nice business there that we have really driven nicely. And we believe that both of those markets are – we've got a position there with management, infrastructure capabilities that are scalable. And so, we see opportunities in those two markets.

And then I really don't want to talk beyond that because our objective is to make sure that we leverage the investments that we already have in place and scale them before we look at completely open territory, although that's not off the table, and see a lot of exciting opportunities across all of North America, not just in the US. Ozan, you want to talk about the hedging in our commodity position.

Ozan Dokmecioglu: Absolutely. And I like to expand a little bit on this because this is a very important topic and is ever changing, especially times of COVID proved how vigilant and flexible and adaptive we need to be.

First of all, when we look to the sources of the inflation, you will see that that's across the board. That includes, as you were saying, Bob, the main commodities that we buy that we have several sophisticated hedging strategies and techniques that we apply. But that is not all. There are other elements of the cost of goods sold that are being increased as part of the general inflation. That includes transportation, warehousing, which is hard to being able to hedge, for example, and even some parts of our portfolio in the packaging like polypropylene which is the main material that we use in the K-Cups. The traditional hedging techniques do not work there.

But having said that, what is important for us that we manage this again in a very basket driven basis by looking to several scenarios and assumptions. And of course, we do change our hedging strategies and policies on the basis of the expectations as well as taking very different blends of positions again, depending on which segment of our business. But beyond that, we are also very active to protect ourselves because inflation comes obviously as an increased price, but the availability is also important. Therefore, we have been very active of trying to find alternative suppliers. And beyond that alternative supplier, also diversifying geographically the sources of the input to fulfill our business requirements.

Therefore, when we say hedging, it summarizes quite a bit, but it's not all there are several legs to how we manage the overall cost of goods sold base of our company. That includes the supplier relationship. That includes the diversification. That includes the geographical diversification at the same time. Therefore, it's a very vigilant part of our business that we are all over and spending a huge amount of time to get it right. And what matters at the end of the day that we manage this complex situation on the basis of the various assumptions and still continue to successfully deliver against our financial commitments. As we have been doing a little bit more than three years, I think the model that we have adopted has proven to be successful, and we will continue to act as such.

Operator: I would now like to hand the conference over to management for closing remarks.

Steve Alexander: Thank you very much for joining us today. The IR team is around all day. So, if you have any questions, feel free to reach out to us. We're here.

Operator: This does conclude today's conference call. Thank you for your participation. You may now disconnect your lines.