Keurig Dr Pepper

September 7, 2022
8:15 AM EDT

Lauren Lieberman: Okay. Great. Thanks, everyone, for joining us this morning. We're going to kick off in this room with Keurig Dr Pepper. We're excited to have newly anointed CEO, Ozan Dokmecioglu, and Chief Corporate Affairs Officer, Maria Sceppaguercio, with us this morning. So, I'm going to get started doing a fireside chat, obviously.

So Ozan, I wondered if you could just spend a moment discussing KDP's business model and how you create value.

Ozan Dokmecioglu: Yes. First of all, good morning, everyone. Also, good morning to you, Lauren, and thanks for having us. It's really a great opportunity for us to share how great business we have.

So, let me start. First of all, Keurig Dr Pepper underpinned a very attractive, very rewarding and very competitive, organic shareholder growth algorithm, which is entirely driven by flexible as well as scalable strategies, which is very important to note.

For example, when you look to the segments of our business, let me start with the Coffee Systems. So, our strategy is focusing on to increase household penetration by approximately two million households every year, which this is what we have been doing, in fact the last two years that we have increased three million units.

Right now, based off our calculations, we have approximately 36 -- our brewers are present approximately in 36 million households in the U.S.A. And the same proportion is in Canada as well. Therefore, we believe that this trend will continue for a while. And not only the growth in Coffee Systems will come as a result of us continuing to increase the household penetration, we also started to realize incremental sources of revenue and the profit with the new introduction of our connected brewer platforms as well as introducing new forms of beverage occasions on the coffee side as well. Therefore, quite a bit of excitement and quite a bit of growth that is still poised for our Coffee Systems business.

Also, we believe that we have approximately still, on an incremental basis, 50 million households that we are targeting to be present over time. So, by de facto, this provides a really very strong growth opportunity for our Coffee Systems business years to come. One can argue 10 years and plus. So, this is what we have been doing. On the cold beverage side, our strategy is focusing on growing our core brands, whether it's marketing as well as a strong in-market execution and the whole brand initiatives that we take around it.

Also, at the same time, we also have some white spaces in the cold beverage that in fact we see great opportunities for us to continue to grow our business. And we do that via internal innovation as well as lots of renovation that we put in the marketplace, which we can discuss the details as well. And at the same time, continuing to establish external partnerships that our model allows us to do.

So, when we step back and look at it, we have been growing our core beverage business very nicely and very effectively in the last four years since the time of the merger. And we also invested quite a bit in our selling and distribution routes. Overall, logistics activities that we also have a company-owned DSD system that stands for Direct Store Delivery, which is a very powerful mechanism that fuels our growth.

And when we combine with all the investments into our brand portfolio as well as the distribution system, in fact, you see a multiplier impact that has been reflected in our business. That's one of the main reasons why we have managed to increase our market share across the liquid refreshment beverages in the past three years in a very sustained manner, and we continue to do that. Therefore, we are very pleased with the real core growth elements of both of our businesses that we have.

Besides the core growth algorithm, we also have an amazing extraordinary free cash flow generation and delivery mechanism that we communicated several times that we expect to generate approximately $5 billion of incremental free cash flow that would help us to create quite a bit of optionality, especially with regards to the inorganic growth. So, we have a great organic growth algorithm. And with the addition of the very strong cash generation that we are having and we will continue to have, have a great play with regards to the inorganic growth optionality as well.

And as we have communicated before, we also believe that the best value in the incremental capital allocation will be driven by the right and disciplined in an organized fashion M&A activities. So that's why we believe that our business model is a very strong one that is very competitive and very rewarding.

Lauren Lieberman: Great. Let's focus maybe first on coffee. So, pricing on pods has been an area of focus since Keurig Green Mountain went private in 2016. And so, it's been five years reducing the price of pods and now with the inflationary environment obviously been going the other way. So how do you feel about where price stands today? To what degree is this an impediment to further adoption of the system in households? And how should we think about the longer-term trajectory of pricing, even like once we get past this inflationary surge?

Ozan Dokmecioglu: Yes. Perfect. That's a great question. First of all, I'd like to spend a little time just to explain the background for some of us that may not be familiar with regards to the strategic pricing alignment that we have been executing in coffee which is very important.

So, at the time of the Keurig private taken, which was back in early 2016, and as the new management, when we did our analysis, we have identified a couple of important barriers in our system adoption, which is increasing the household penetration where it's also driving the single-serve pod category consumption. So, one of the barriers was the price differential of the per serving single-serve versus the bagged coffee. And it was approximately $0.30 back then. And on the basis of, again, our analysis that we have identified, the optimum gap would have been $0.20.

And this is what we have been doing around an organized plan in action. We have actually reduced the pricing overall, the gap, from $0.30 to $0.20, which we are very pleased where we are. Which, in fact, that helped us to drive incremental household penetration as well as helped to grow the pod category consumption at the same time.

Therefore -- and most of this source of this decline basically being provided by the great productivity programs that we have identified and delivered across the year, because when you look to our financials that we announced after we became public and merged, you would see despite of all these investments, still our margins have expanded significantly, which clearly demonstrates that this was around a very planned strategic initiative that we executed very effectively. And today that we kept improving our margins with the exception of what’s going on right down. Therefore, on the pricing side with regards to the coffee, that we believe we are very nicely positioned.

Well, starting 2021, second half, as well as 2022, in order to fight back with the unprecedented inflation that we have been seeing, it is true that we increased our owned and licensed prices, which when you look to the latest scanner data in the IRI and AC Nielsen, you will see that all of our sector, the peer group, in fact, moved the pricing. Therefore, the $0.20, that's the critical part, the $0.20 price differential in fact has not changed, which is very important to say.

And also, at the same time, a couple of further details to your question. When we look today, still per pod, single-serve coffee is significantly cheaper than the away-from-home coffee likes of it, for example, coffee shops. And at the same time, when you look to the latest launches of our brewers, especially on the connected platform that we have been executing successfully over the last 12 to 18 months, and the very latest introduction of our newest addition we call K-Cafe SMART, which provides the optionality to our consumers to brew exactly the same coffee shop-quality and have the experience at a fraction of the cost, which is very powerful.

Therefore, several important elements with regards to innovation, the pricing and the further offering and the future capabilities that we have been offering to our consumers via with our brewers that makes our system even stronger and better positioned for future growth. So, these are the very important elements.

And I'd like to also take a quick segue and explain according to us what's going on with regards to the -- some consumption being flattish nowadays in the single serve coffee. In fact, we believe there's quite a bit of noise that is going on.

Lauren Lieberman: You mean in the data.

Ozan Dokmecioglu: I mean in the scanner data exactly because we believe there is quite a bit of noise and noise comes in different forms and shapes. And first of all, as we went public and announced several times that we ran into some supply chain constraints, especially being able to produce K-Cup pods enough in order to catch up with surging consumer demand at the same time, so that created quite a bit of setback for us, as we have communicated before.

The great news, at the end of Quarter 2, we really got out of even stronger. And right now, we managed to establish all the right levels of the inventory. And we are really doing very well with regards to the case fill rates and satisfying the volume demand that is coming from our customers as well as the consumers at the same time. But that created some setbacks.

At the same time, because of the supply chain issues, the whole industry cut back from marketing investments as well as the consumer promotions. Now with fall, especially now and Quarter 4 and going forward in the winter, all the investments have been established back at the level that the category requires. And we already started to see some improvement in the consumption data, which is the strategy is working, as well as depending on how you look at it between end of 2021 as well as 2022, some pricing actions, as I was saying, implemented across the board. And as one would expect, there will be some adjustment period from the consumer side to the new prices.

So, when we sum up all the things, we see this situation as temporary and we already have some important data that's showing consumption has started to move in the right direction. I just wanted to talk to this one.

Lauren Lieberman: Okay. Great. Okay. So, I was going to ask you how you're feeling about the balance of the year, but it sounds like certainly on the coffee side, even as we may be moving every day closer to a consumer recession, you feel like momentum is coming back into the business. In-stock levels are improving.

Ozan Dokmecioglu: Absolutely.

Lauren Lieberman: Advertising is in place, promotion.

Ozan Dokmecioglu: Absolutely.

Maria Sceppaguercio: And in fact, I think we feel confident more broadly than just coffee, if you wanted to share some --

Ozan Dokmecioglu: Yes, exactly. On the balance of the year, we believe we are very nicely situated to deliver against our latest outlook that we put out there for year to go. We feel very comfortable with it which was, just to remind ourselves, that we increased our guidance on the top line growth to low double digit, while we reaffirmed the EPS growth being at mid-single digit. So that's where we stay and they've not changed at this point.

Maria Sceppaguercio: Yes. We feel good about the balance of the year.

Lauren Lieberman: Great. I'm going to come back to another coffee question. So Ozan, you've mentioned incremental 50 million households, right, the two million a year is sort of the right level after two years at the three million level for household penetration or incremental households in the system. Why is two million the right number? And then also, now the pricing has been addressed and that $0.20 gap is in place and the pods are recyclable, you've got the full pot of coffee option, what do you see or what does your research tell you are the impediments to adoption for consumers that are not yet in the system?

Ozan Dokmecioglu: Well, first of all, we need to take this -- it's a great question. We need to take this from a greater context because, as we refer, it's an ecosystem. And there are so many pieces to that in terms of continuing to grow the household penetration of the system adoption.

Again, when we got back in 2016, we did the research and we have identified several systems, let's say, in the way or some constraints in terms of increasing the system adoption. And in fact, we were knocking them down one by one the last five to six years. And on the basis of our success, that identifying the problems and dealing with those and mitigating them, enabled us to grow approximately two million incremental households on a year-in, year-out basis, which to us, again, it's important to say that we have been increasing approximately three million new households into our system.

So, when we step back and look at it, you asked why two million? Two million is a good number because it matches with the innovation rate of our brewers and the incremental features that we are putting into the marketplace for our consumers but also drives the incremental consumption occasions at the same time. And it takes a while for the households to adopt to the new system.

And when we look to the likes of, for example, Europe, and other developed nations, you would see that the system adoption is in excess of 60%. In some cases, 70%. Right now, we are not even in 30%. We are a bit lower than 30%. But not only this comparison, again, we have very detailed algorithms that provide us the opportunity to be able to address incrementally 50 million households, which actually is one of the main drivers of the many years growth to come in the coffee single serve.

And we should not also forget, Coffee Systems, the single serve, is a very profitable business for everyone, for the retailers, the margins that they have been enjoying, as well as for the brand owners. And also, a great proposition for the consumers for the reasons that we have been discussing.

Therefore, two million, which represents approximately a good run rate and a growth rate that allows us to recruit the new consumers as well as matching with the new features and the capabilities that we are putting via our brewers as well as creating new beverage consumption occasions using our pods. That's why.

Maria Sceppaguercio: Yes. And one of the things that we know is that what drives a consumer to switch or to buy a brewer oftentimes is when the brewer breaks, right? So as that natural cycle occurs in the home and you might be a drip user, you go to the store and you've got options. And that's when you're in the consideration set, but are you going to convert that consumer from drip to single serve to a Keurig system? And we see that often too, right?

So, we sell a lot of brewers, right? We said last year we sold about 11 million brewers or so. And we said three million of them were incremental, like new households. So, there was a big replacement cycle that happens within the Keurig system, but then there's a replacement cycle outside of the system for at-home users that are not in the system today, where they have a point in time to make a decision. Are they going to go buy another drip? Or are they going to go buy a Keurig? And that's another factor that weighs into the two million number.

Lauren Lieberman: Yes. And how do you think about a recession question and current operating environment? So even if the math is that a cup of Keurig coffee is much more affordable than out of home, you still have to buy the machine. So, are you thinking about a deceleration in brewer sales as the consumer environment gets tougher? If not, why not?

And then also, you've said clearly you feel good about the rest of the year, but you sell an appliance, right? And that wouldn't seem to be a great thing to be doing right now, right, given inventory challenges at retail. So, if your business hasn't been caught up with inventory destocking at retail, why not? And is that a risk as we look forward?

Ozan Dokmecioglu: First of all, again, it's a great point here because one of the constraints that we have identified again six years ago was exactly what you are asking and saying, which is the brewer prices and the pods.

So, what we do as a response to that, right now, we have improved our brewers. So, there are several brewers that we put out there as part of our really great and very well organized innovation plan that is hitting several price points, starting from approximately $49 of the brewers all the way to $200. And it depends on the features and the capabilities that the consumers are looking for, but it provides a great price range that everyone can afford. And even the cheapest one has great features that everyone can still brew a great cup of coffee which is very important.

So, this actually addresses exactly the point that you are raising, Lauren, that if there will be a down trade and if someone doesn't want to pay $150 or $170 per brewer, no problem, they can buy $75 or even $50 per piece.

And at the same time, as part of our innovation funnel, we always found opportunities to improve the price points as well as the cost management of our brewers, which was a huge change as part of the new management, as part of the new brewer innovation development. [That is a working] that we have adopted. So, we realized this actually way before, like six years ago, and we have come up with a very strong innovation funnel that has addressed exactly what you are saying.

Therefore, so far, because of all the things we have done, the different price points, different features, different capabilities, and we continue to upgrade our brewer quality in terms of providing incremental benefits to our consumers, we haven't seen any issue with regards to the pricing whatsoever.

When we look to your last part of your question on the potential recession, we believe if there would be some down trade, that's okay. Still, we have the brewers that will address that part. And then you look to our share in the single serve pod K-Cup like we produce approximately 82% of what is being consumed in U.S.A. and around 87% K-Cups that is produced in Canada.

Even if there would be some down trade within the single serve, we will still continue to participate to the economic benefits because we are still the largest producer of private labels along with our peers along with the owned and licensed. That's why we call our business in short all-weather conditions that we still manage to successfully deliver against our business goals.

Lauren Lieberman: Great. And then just on the retailer inventory.

Ozan Dokmecioglu: Oh, on the brewer side.

Lauren Lieberman: Yes.

Ozan Dokmecioglu: Well, when you look, it is true that the data suggests that on the -- not necessarily with regards to our small portion brewer appliance, but over all the appliances, the retail inventory levels, we are seeing that have increased.

But when you look to our, let's say, brewers which is the smaller appliance part, there is a little bit of inventory increase levels, but we are putting incremental measures in terms of the promotions and the marketing investments that is effectively dealing along with the agreement with the retailers as well.

Maria Sceppaguercio: Maybe the one interesting thing about this ecosystem that we don't always talk about is that retailers want to sell brewers, not because of the brewer itself, but because they get the recurring revenue stream of pods. And it's a very -- it is a consumable, right, staple, consumable product and it is recurring. And that's -- so for retailers, that would be one of the last categories they want to deemphasize because they want the pod growth in their stores because consumers tend to go back to where they buy the machine or the brewer to buy their pods.

Lauren Lieberman: Okay. So, no change in August, as we've seen from many companies, about some retailer inventory patterns with regard to brewers. Nothing to speak of at this --

Ozan Dokmecioglu: No, we feel very good with inventory levels and what we are also expecting how to move forward between now and year-end and continue into the 2023.

Lauren Lieberman: Fantastic. Okay. Let's move on to cold. So, you mentioned the share gains that you've enjoyed over the last couple of years and elasticity has been pretty modest given the incredible pricing that's been seen. So just a few words, what would you say are the key drivers of the strong performance? Because the numbers when you look at the data and go, can that be right? It's been pretty impressive.

Ozan Dokmecioglu: Exactly. As you said, our cold beverage overall business results have been really very strong. And there are several drivers to that. When you look to the core brand marketing investments that we have made as well as all the renovation programs that we put out there, coupled with the existing innovation, internal innovation, as we defined, delivered really, really great results because we have been doing them around an organized plan as well as exactly delivering what consumers basically are looking for.

At the same time, we continued to invest in our route to market which, as you know, in cold beverages it’s a very important asset. It's a very strategic asset to have, led by our company-owned DSD system, which is direct store delivery. So, we have been looking for ways to make our system more efficient as well as more effective.

So, it's not like one or two things, it’s really several things that have basically got together. And we should not forget the strong heritage of our brands and they create brand equities and that we kept renovating and innovating ourselves to create incremental consumption occasions as well as serving the new needs of our consumer.

Therefore, it's really a full package that enabled us to deliver really strong great results. And again, with the really strong performance of our distribution system, only amplified and created a true multiplier impact in our very sustained share gains, because we have been gaining share in the last three years, it's not new. And not only we maintain, we actually managed to take it to the next level.

When you look to the last or the latest quarter's syndicated data, you will see that approximately 92% of our liquid refreshment beverage category, which is the higher level of the cold category, either we maintained or increased market share. And this number actually kept getting better and better every quarter around the strategies that we have been deploying.

Therefore, we have been very pleased with the performance of our cold beverages. It is true, we've taken several action plans again to deal with the unprecedented inflation that we have been seeing, but all of our sector players have taken the same pricing, more or less, and we are all parity versus the pre-pricing periods as well. Therefore, we have seen, as you said, modest elasticity reactions against the pricing that we have taken.

And you also talk about a little bit like the downturn and what can be the drivers, in fact, when we step back and look at it, and this comment applies to coffee as well, when we analyze the latest serious recession time lines that took place in 2008 and 2009, the data suggests that both coffee as well as the cold beverages led by CSDs, in fact, held up one of the best, either in terms of the volume or being able to push through the pricing or continuing to take it.

And there are several reasons to that. And a couple of them, both of these categories are really consumer staples. And consumers have established consumption patterns against them, which there are few substitutes. And still a downturn, a potential recession and downturn may take, still very affordable. And we occupy a big chunk of the market that we continue to see the further growth.

Lauren Lieberman: Do you think there's room for further pricing in CSDs? Or have we kind of reached the breaking point of where the consumer will start to push back?

Ozan Dokmecioglu: Yes. Actually, I'd like to answer it a little bit differently because the same comment applies about, again, both the coffee and the cold beverages. In such an unprecedented inflationary environment, our strategy is to try to take as much pricing as possible till the demand gets really impacted, which proves that it wouldn't be a further good business decision. But we are not at that stage right now. When you look to the data as well as our peers' data and what everyone has been doing, we are far, far, far away from that point at this juncture.

But as I was saying that we are monitoring on a daily, on an hourly basis, if the data suggests other ways around then, of course, we will do what makes sense and what is right for the business, but we are far away from that point at this juncture.

Maria Sceppaguercio: You know one thing that I would add, going back to the previous question, that I think is important to emphasize, like in coffee, which is a big partnership model, we have the same model on the cold side.

So, if you think about some of the investments that we made in our distribution network over the course of the past couple of years, they've been significant. And we've added brands such as Polar and others, right, that have really expanded, we're expanding distribution for and they've really helped to drive the top line. So, when you think about share and you think about the business that we've created and the strong direct store distribution network that we have, we keep investing in it and we keep adding technology tools and we keep adding partners. Again, it's part of our philosophy.

So, as you think about even -- I know we'll probably talk about M&A at some point, but if you think about M&A from our standpoint and bringing in partners, it's this win-win philosophy that we have. So, everybody wins when the Keurig System does well. Everyone who is in the system wins when it does well.

It's similar on the cold side, too, and it's very unique. Because most companies have competitors that they're going against and it's a zero-sum game, it's not like that with our philosophy for partnerships. And that's a big driver of our growth in cold side as well and our market share expansion.

Lauren Lieberman: Okay. Great. I am switching to M&A, so thank you. So Ozan, with your recent move into the CEO seat and the significant M&A ambitions and the cash flow generation that you've got, how would you talk about the recent changes in the valuation environment for growth companies? Is that impacting the M&A landscape, the pipeline you're seeing in beverages and how you're thinking about what's in the art of the possible.

Ozan Dokmecioglu: Exactly. And let me expand a little bit more as well on that because it is very important. You are right, we have announced several times with regards to our ambitions and we said that we are acquisitive. But we also said that we are a very disciplined buyer in terms of the M&A transaction. But overall, again, on the back of the very strong free cash flow that we have been delivering and we will continue to deliver, we believe we have several great opportunities with regards to the inorganic activities. But not only that, we also have a very dedicated, very knowledgeable and very experienced M&A team that really knows how to deal in this type of situations.

And moreover, our former Chairman and CEO, Bob Gamgort, has also moved to the Executive Chair role right now with pure focus on the capital allocation led by M&A. Why? Because as we communicated several times, we believe, with regards to the capital allocation, the best shareholder value creation passes through the right and the disciplined M&A action. So, I just wanted to put this in context.

Now a more direct answer to your question, it is true that we started to see some different tone and different discussions with the high-growth companies. And the overall landscape and the overall M&A environment, in fact, has started to shift into being more logical discussions that we have been having. Of course, we will need a little bit more time to see how actionable those discussions are going to be. But as you say, the previously lofty valuation expectations have started to change. Our discussions have started to also move in different directions.

Again, this is important to stress, which we have been very disciplined, and we have been very strict in terms of how we deploy our very important equity as well as the capital funds with regards to the M&A transaction. So, this resulted perhaps of us doing less

M&A deals, which we were okay and we are still okay with it. Because either not doing a deal or establishing, as Maria was explaining, external partnerships, because M&A to us comes in different forms and shapes, both in coffee as well as the cold beverages, that we can establish several partnerships the likes of Polar, for example, and others that we have been doing across this time.

It's better than overpriced and overpayment M&A situation that eventually, will create, for sure, a shareholder destruction. We have never done it and we are not planning to do it as well. Therefore, we believe there are still some opportunities out there for us that we will be continue to looking at.

Lauren Lieberman: So, consumer taste can be really fickle. I think it can be really challenging to pick the emerging winners and who ends up having the staying power. So, I guess as you look at the landscape particularly of high-growth companies, how do you -- what's that filter, right? How do you think through what has staying power?

Ozan Dokmecioglu: Yes. So, first of all, we have several criteria that we look at because we have an established playbook that either when we establish a partnership or do an M&A activity, which we have several examples. For example, one of them which has been very meaningful and sizable, CORE Hydration. Where, CORE Hydration was and where today, is a clear huge success from an M&A perspective, for example, and what we did with that brand. So that to me shows, on a proven basis, the capability and knowledge and execution power that we can put together.

So, there's several criteria that we have. One of -- and let me share with you of them, for example, we are looking to definitely high growth, high margin and providing some platform for us that would create some natural synergies with our base business, led by our distribution system, for example.

But not only distribution system being able to complementary is important, there are other factors which -- what is the growth that is being provided, what kind of synergies we can get, including the typical supply chain synergies, back office synergies, including revenue growth management that we believe we have a very strong revenue growth management strategy and mechanisms that we have been doing.

While we apply a lot of strict, let's say, principles, and there are some good opportunities out there that goes through our filter, there are some others that got eliminated very quickly. Likes of commodity water that we never got into and we are not planning to get into, or refrigerated dairy, which is a very different, let's say, distribution system that is required as well as some pressures on the margins at the same time.

Therefore, when we sum it up, for example, the water -- premium water category, what we have been doing, what we created with CORE Hydration, with Evian, with Polar, that positioned us as the Number 2 player in the premium water. We will continue to double down, it's a great category, again, checking the box of being a fast grower, great margins and also plays to the strength of our distribution system. We will continue to grow, and we will continue to look at opportunities in that category.

At the same time, energy within the overall beverages provides a white space for us. We have a few smaller brands that we are continuing to grow them, ship our way, but we are also looking at some opportunities from an inorganic activity. So that's also a high-growth, high-margin and strong platform that we like to take a more meaningful play.

At the same time, as we have been communicating, lots of blurring lines between the alcohol and the nonalcoholic. And we have been actually playing in the right alcohol category, with the modest business we have in Canada from a size perspective, and with our mixers and all of our brands that indirectly contribute into the alcohol category. So that's also appealing category for us to play.

On the coffee side, we have been also very successful of getting licensed brands and really growing them. For example, a couple of years ago, McCafé brand has been -- become a licensed brand in our portfolio and we have been growing very nicely. And then you look to the latest quarter, McCafé brand has been the fastest-growing single serve category brand at home consumption.

So that shows the strength of our teams and our model in both categories at what we can achieve and the interesting part.

Lauren Lieberman: Okay. Great. We are over time. So, I've got to end it here. But we'll go to breakout. So please join me in thanking KDP for being here this year.

Ozan Dokmecioglu: Thank you.

Maria Sceppaguercio: Thank you.