Keurig Dr Pepper Inc.

Third Quarter 2022 Earnings Call

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PRESENTATION

Operator
Good morning, ladies and gentlemen, and thank you for standing by. Welcome to Keurig Dr Pepper's Earnings Call for the Third Quarter of 2022. 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 Vice President 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 2022. 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, which excludes items affecting comparability and presents growth rates on a constant currency basis. 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 meaningful comparisons 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 us today to discuss our results are KDP CEO Ozan Dokmecioglu and our Interim CFO, George Lagoudakis. Also joining us for Q&A are KDP Executive Chairman Bob Gamgort 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.

And with that, I'll hand it over to Ozan.

Ozan Dokmecioglu
Thanks, Steve, and good morning everyone.

Given that this is my first earnings call as CEO, I would like to start today's discussion with my thoughts on the KDP operating model and strategic approach that makes us unique in the CPG space. Our focus continues to be on managing our business for a range of potential macro outcomes and leveraging the all-weather business model we have created to drive success, regardless of the environment we may face.

Our results this quarter and the consistency of our performance since merger are a testament to the strength of this model, which has continued to perform well in the highly volatile macro environment our industry has faced since the onset of COVID. And, most recently, our portfolio has performed well with significant levels of inflation and pricing, along with a challenged consumer landscape, demonstrating its recession resistance, with elasticity impacts remaining modest and our market share positions remaining strong.

Our business model starts with an attractive and competitive organic total shareholder return algorithm, which is driven by a flexible and scalable strategy.

In Cold Beverages, our strategy is focused on driving growth: in core brands, through marketing, brand renovation and in-market execution; by filling whitespace in our portfolio through innovation and partnerships, such as our Polar seltzers partnership and the recently announced Red Bull selling and distribution agreement in Mexico, which we will touch on a bit later; and by enhancing the breadth, depth and effectiveness of our omni-channel selling and distribution system, including our company owned direct store distribution system. The investments we have made in selling and distribution over the past several years have built a stronger go-to-market capability that has driven consistently strong market share performance across all the brands and beverage segments.

In Coffee Systems, we are focused on driving household penetration growth for the Keurig system at the rate of approximately 2 million new households every year. Given the number of remaining addressable new households for the Keurig system, which we estimate at more than 50 million, we have line of sight to household growth well beyond the next 10 years.

We are also focused on increasing revenue and profit growth from our existing 36 million Keurig households through new platforms, such as connected brewers, and the new beverage format and occasions.

In addition to our core algorithm, KDP's extraordinary free cash flow enables the potential for incremental shareholder returns through strategic capital allocation. We believe that M&A is the most attractive and value-accretive option for the deployment of our capital, given our disciplined approach and proven ability to create value for KDP and our shareholders. We also see opportunistic share buybacks and investment in our internal growth projects as attractive uses of our capital.

We view our North America geographic focus as a distinct advantage, particularly in the current macro environment, as we can execute our organic and inorganic growth strategies in what is arguably one of the world's most stable and predictable operating environments. In addition, while most companies, including KDP, report profit and loss growth rates on a constant currency basis, a strong U.S. dollar reduces cash flow and profits when foreign currencies are translated into U.S. dollars. This impact is minimal for KDP.

The third quarter results we reported today provide a great example of our strategy and operating model at work delivering for shareholders. Specifically, net sales advanced 12%, Adjusted operating income increased 2% and Adjusted diluted earnings per share grew 4.5%. Our cash flow was again strong in the quarter, bringing our year-to-date free cash flow to almost $2 billion, driving a free cash flow conversion ratio of 114%. This performance continues to demonstrate the strength of our brands and in-market execution, in an environment with broad-based inflation and reduced consumer purchasing power, as our elasticities continue to be modest.

These consolidated results were in line with our guidance, with outperformance in our Cold Beverage segments offsetting some pressures in Coffee. With just one quarter left in the year, we continue to expect consolidated results to be on track with our guidance, as Cold Beverages is expected to continue performing well and Coffee strengthens considerably, as it moves past supply chain issues earlier in the year and the significant green coffee pressure experienced in the third quarter. This is what we mean by the benefits our all-weather business model provides, reinforcing the advantages of our uniquely diversified beverage portfolio. We continue to expect the fourth quarter to represent a step change in total KDP performance as we anniversary the spike in inflation across the business in the fourth quarter of last year and our Coffee business performance accelerates.

As has been the case throughout 2022, broad-based inflation continued to impact margins in quarter 3, as the significant pricing actions we have taken to date have not yet fully caught up to inflation. We experienced total cost inflation in quarter 1 of 15%, which escalated further to more than 17% in quarter 2 and, in quarter 3, it remained at the 17% level.

In the fourth quarter, we will begin comping the significant inflation spike in the year-ago period, which reduces the rate of inflation on this year's profit and loss. As a result, we expect the contribution from previously taken pricing actions to catch up to inflation in the quarter, which will enable us to deliver margins above last year.

Our Cold Beverages business continues to perform exceptionally well and posted significant sequential improvement in margins. Our Packaged Beverages and Beverage Concentrates segments combined grew both net sales and operating income by 14% in the quarter, maintaining a combined operating margin even with year-ago.

In Coffee, net sales advanced 5% led by pricing that was partially offset by lower volume/mix, while the impact of broad-based inflation, including the highest year-over-year green coffee costs, weighed on operating income. Pricing continued to advance but has not yet fully caught up to inflation.

The good news is peak green coffee inflation is largely behind us, causing the impact of inflation on the coffee profit and loss to moderate significantly as we lap the inflation spike in quarter 4 last year.

Along with these improving trends heading into the fourth quarter, our Coffee segment top line is expected to strengthen, as the benefit of pricing and brand investment builds and the supply issues we encountered in the first half are truly behind us. Taken together, we continue to expect meaningful, sequential improvement in Coffee segment net sales and operating income growth in the fourth quarter.

Turning to in-market performance, let me provide some perspective on what we are seeing in terms of trends in our categories, including pricing, elasticities and consumer mobility. Starting with the Cold Beverages.

In liquid refreshment beverages, the category continued to perform well, with dollar consumption in the quarter and year-to-date periods up 10% and volume down less than 2%. Elasticity in the category continues to be modest, even as pricing was up in the low double-digits for both periods and consumer mobility continued to increase.

KDP's LRB dollar consumption increased more than 11% in the quarter, growing LRB share in both the quarter and year-to-date periods, reflecting the benefit of pricing that was only modestly offset by volume which remained quite resilient with elasticities below the category in both periods.

We continue to benefit from healthy categories, a strong portfolio of leading brands and very effective in-market execution.

The strong performance in the quarter was broad-based and led by share gains in premium waters and seltzers, teas, apple juice and fruit drinks. In carbonated soft drinks, our performance also continued to be strong, with dollar consumption up 12% in both the quarter and year-to-date periods with our share up year-to-date. We are pleased that we continue to expand on the impressive share gains we generated over the past couple of years.

Within carbonated soft drinks, our Zero Sugar innovation continues to perform well, with modest elasticity impacts and stronger velocities than the overall zero sugar and diet category.

In premium water, CORE Hydration grew dollar consumption 35% in the quarter, driving almost two full points of share growth. Snapple, led by the success of our Snapple brand refresh and Snapple Elements, drove dollar consumption growth of 15% and share growth of almost one full point in the quarter. And in seltzers, our partnership with Polar continues to drive growth for the brand, with ACV increasing six points and share gains of two points.

Moving to coffee, before discussing category dynamics, let me quickly share some context on our business and the performance improvements that are now beginning to materialize.

You will recall that the combination of consistently strong consumer demand and supply constraints led to a pod shortage starting in late 2021. Consequently, we pulled back on our demand investment, as did most of our partners, and launched the coffee supply chain recovery program to increase pod output and rebuild finished goods inventories for all parties in the Keurig ecosystem.

We completed the program last quarter and have now restored inventories across the ecosystem, which enables us, along with our partners and customers, to resume investments in demand-generating programs to drive category growth.

As a result, the single-serve pod category continues to recover from supply constraints, with dollar consumption up 6% in the quarter, advancing to 7% in September and off to a good start in quarter 4.

There has been considerable noise in the broader at-home coffee category numbers, well beyond single serve coffee, that is worth discussing further.

A combination of increased consumer mobility, retail price actions and a reduction in advertising and promotion spend, the latter related to the single service supply challenges, negatively impacted at-home coffee category demand over the summer. Our analysis suggests that consumer mobility had the outsized impact.

With mobility returning to more normal patterns once the school year started, we are seeing sequential improvement in at-home coffee demand. Importantly, single-serve coffee outperformed all other forms of at-home coffee during quarter 3. Further, the away from home coffee category, while still down significantly versus pre-COVID levels, continues to improve with further runway as return to office behavior builds.

Looking specifically to KDP coffee performance, KDP Manufactured pod consumption was up 4% on a dollar basis in the third quarter, with owned and licensed brand consumption growing by 5%, as the McCafé, Donut Shop and Green Mountain brands posted strong growth. Performance strengthened during the quarter, with year-over-year dollar and volume share advancing sequentially in September versus July and August and continuing to improve into the fourth quarter. KDP continues to maintain its strong leadership position in the category, with market share for KDP-Manufactured pods at approximately 82%. Moving forward, we expect mix to shift for KDP Manufactured pods from private label to branded, as Community Coffee comes on board beginning late this year.

Turning to brewers. Today, we are confirming that we are on track to add 2 million new households into the Keurig system in 2022, which is consistent with our long-term algorithm. As discussed many times, we expected the elevated rate of 3 million new households that we attracted in 2020 and 2021 to normalize post-COVID and that's exactly what's happening in 2022.

Of course, we don't need to sell as many brewers to support 2 million new households as we did to support 3 million, which explains the 15% decline in brewer shipments in the third quarter. Remember, we are in the household penetration business, not the brewer sales business, as we largely break-even on brewer sales and generate nearly all of our profits from attracting new consumers into the Keurig ecosystem.

Taking a longer-term perspective, quarter 3 brewer sales were a healthy 16% above 2019 and on a year-to-date basis, brewer shipments are up more than 30% versus the first three quarters of 2019. In addition, single serve brewers continue to hold the number one position in the at-home brewer segment and KDP continues to grow share, driven by strong innovation across all consumer price points.

Finally, our Latin America Beverages segment continued to post exceptionally strong results in the third quarter. Net sales advancing 29% and operating income was up 14% -- the latter, on top of 48% growth in the third quarter of last year. Leading this strong performance in the quarter were Peñafiel, Clamato, Mott's and Squirt.

Earlier this month, we announced a strategic partnership to sell and distribute Red Bull in Mexico starting in quarter four. The majority of the revenue we generate in our Latin America Beverages segment is from Mexico, and we are excited to enter into this win-win partnership with Red Bull, which will strengthen our position in the energy category, improve our go-to market scale and drive efficiencies over time.

And now I will hand it over to George to cover our third quarter performance in a bit more detail.

George Lagoudakis
Thanks, Ozan, and good morning everyone.

I will start with a brief review of our third quarter business and financial highlights and then provide details on our segment results. As usual, we will be discussing our performance on an Adjusted basis.

Total company net sales increased 11.8% to $3.6 billion, with growth across all segments, led by continued exceptional performance of our Cold Beverage business. Higher net price realization of 12.1% was only slightly offset by a volume/mix decline of 0.3%.

Adjusted gross profit grew 8.6% in the quarter, reflecting our significant pricing that is beginning to approach the level of inflation we experienced in Q3. Also benefiting the performance was productivity. As previously discussed, we incurred our highest quarterly year-over-year increase in green coffee costs this year, pressuring our gross margin, which declined versus year-ago to 54.8%.

Adjusted operating income increased 2% in the quarter, as the increase in gross profit was partially offset by increased outbound transportation, warehouse and labor costs, as well as higher marketing investment to support our back half plans. As a result, Adjusted operating margin declined 250 basis points to 26.1%.

Adjusted net income increased 4.3% in the quarter, primarily reflecting the operating income growth and lower interest expense.

Adjusted diluted EPS increased 4.5% in the quarter to $0.46. Free cash flow remained strong at $686 million, driving our free cash flow conversion ratio to 105% in the quarter.

Turning now to our segment performance in the quarter.

Packaged Beverage net sales grew 13.6%, driven by higher net price realization and volume/mix that was even with a year-ago. This impressive volume/mix performance reflects the strength of our brands, coupled with effective marketing and strong in-market execution.

As a result, we continued to hold our multi-year share gain in CSDs, and we gained additional share in other LRB categories, including premium unflavored waters, seltzers, teas, juice and fruit drinks. In an increasingly challenging economic backdrop, our packaging mix capability across our portfolio enabled consumers to easily pursue options that fit their budgets. Mini cans were notably our fastest growing CSD package by volume in the quarter.

Our continued in-market effectiveness was supported by highly effective marketing investment during the quarter, including the Season Five launch of the highly successful Dr Pepper Fansville episodic drama. In recognition of its continued brand strength, Dr Pepper was recognized by Kantar as one of the top 20 most valuable global food and beverage brands.

Turning to Snapple, this important brand was a standout in Q3, registering the strongest share performance in the tea category, led by Snapple Elements. Launched earlier this year, with reimagined packaging and bold new flavors, Elements has driven strong trial and repeat rates and it's proving highly incremental to the brand.

Adjusted operating income for the Packaged Beverage segment increased 7.9%, after accounting for a double digit increase in marketing investment, as pricing and productivity more than offset higher inflation in the period.

Turning to Beverage Concentrates, which posted strong and balanced growth in the quarter. Net sales advanced 17.3%, with favorable net price realization and higher/volume mix. The strong net sales performance was fueled by Dr Pepper, Canada Dry and Crush.

Adjusted operating income for the segment increased 21%, driven by the strong net sales growth and lower marketing expense due to timing.

Coffee Systems net sales grew 5.2% in the quarter, driven by our recent pricing actions and higher pod shipments. Volume/mix declined in the quarter, as a 3.5% growth in pod shipments was more than offset by a decline in brewer shipments. As Ozan mentioned, brewer shipments were down 15% versus last year, but 16% above the pre-COVID period.

Adjusted operating income for the quarter decreased 15.7%, primarily due to broad-based inflation, which included the highest year-over-year green coffee costs this year. Higher price realization and productivity continued to lag inflation, but we expect an improved relationship in Q4, as the year-over-year inflation rate moderates significantly from the Q3 peak and the contribution from previous pricing actions becomes fully realized in the coffee P&L.

And finally, Latin America Beverage net sales advanced an impressive 28.8%, balanced between higher net price realization and increased volume/mix. The strong net sales performance in the quarter was led by Peñafiel, Clamato, Mott's and Squirt.

Adjusted operating income increased 13.5%, reflecting the strong growth in net sales and productivity, partially offset by inflation and a significant increase in marketing investment, which increased at a faster rate than the sales growth.

I would like to now spend a moment discussing our expectations for the balance of the year. Our strong execution gives us confidence in our outlook and we are reaffirming our guidance for full year net sales growth in the low double-digit range and Adjusted diluted EPS growth in the middle single digit range. Supporting this guidance, we expect the following assumptions.

Adjusted interest expense is expected to approximate $425 million. Adjusted effective tax rate is expected at the high end of our guidance range of 22% to 22.5%. Diluted weighted shares outstanding are estimated to be approximately 1.43 billion.

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

Ozan Dokmecioglu
Thanks, George. Before moving to question and answer, let me spend a moment on recent organizational announcements. On Monday, we announced the appointment of our new CFO, Sudhanshu Priyadarshi, who will be joining us on November 14.

Sudhanshu is a seasoned global finance, strategy and operations executive with significant global experience, including in the beverage and retail industries. He will be a strategic partner to our team, as we deliver against our commitments, scale our business for growth and continue to successfully navigate the complex macro environment. We look forward to introducing him to you soon.

Earlier this month, we announced a strategic realignment of our supply chain organization to accelerate enterprise-wide productivity and speed of decision making. In doing so, we leveraged our strong supply chain bench, promoting three experienced supply chain leaders, with Roger Johnson becoming our new Chief Supply Chain Officer. The move builds on our strong supply chain foundation and we believe positions us well as we head into 2023.

In closing, we believe that our attractive organic growth, coupled with our significant inorganic value creation opportunity, will enable us to continue to drive strong total shareholder return results over time. We are excited about the talent and structure we are building to continue to execute against our opportunities with excellence.

I will now hand it back to the operator for your questions.

QUESTION AND ANSWER

Operator
And our first question here will come from Bryan Spillane with Bank of America. Please go ahead.

Bryan Spillane
Thanks, Operator. Good morning, everyone. So, Ozan, we got a lot of questions this morning about brewer shipments being down in the quarter, as much as they were. I know you talked a little bit about this dynamic even earlier at the Barclays conference back in September. But can you help put this into a little bit more context?

How this tracked relative to what your expectations were. Maybe also just how you've planned for holiday this year against this backdrop where there's certainly going to be less discretionary spending. And maybe within that, just how you're addressing maybe the value equation of the Keurig system, against the backdrop of consumers tightening their belts.

Ozan Dokmecioglu
Sure, thank you very much, Bryan. First of all, let me address your first question on the brewers and the decline. As we have discussed, we remain on track to add 2 million new households into the Keurig system in 2022, which is consistent with our long-term trend as we have been talking, and as expected, lower than the elevated rate of 3 million that we experienced in 2020 and 2021, during the period of increased at home COVID behavior.

Therefore, it is very logical that we would need to sell fewer brewers in 2022 to support the additional 2 million incremental households, versus the 3 million that we have generated in 2020 again, and in 2021. As we have said many times in the past, shipments and consumption are not comparable over a short period of time, such as one or two quarters.

And again, we are not in the number of brewer sales business. As we communicated many times, we don't generate or make money on the brewer sales. And there were years I'm sure you will remember that we sold much less than what we are targeting this year, for example, and still generated 2 million incremental households.

So, what matters is the composition of the annual sales that goes to the replacement cycles and several other factors that at the end generate the incremental households. So, that's very important to note.

Now, the second part of your question, in terms of our plans and how we see the ecosystem and so forth. As we also communicated before, we still see 50 million incremental households that to be recruited into our Keurig ecosystem. That means if you take a long-term horizon, minimum 10 years and plus, plenty of growth is waiting us around the corner.

And that's what we have been executing against. And then we look to the near end as you ask, the holiday programs, and so forth, as we always do. We have very effective trade in the consumer programs, including and coupled with our innovation, that we have been putting in the marketplace with regards to our brewers in a very successful manner that is ready to have another good Q4 holiday season, as well as continued into 2023.

Therefore, we see absolutely no problem. And there is not any reason for us to deviate from our long-term target of creating 2 million incremental households on a year in, year out basis. And that's what we are going to do.

Operator
Our next question will come from Lauren Lieberman with Barclays. Please go ahead.

Lauren Lieberman
Great, thanks, good morning. I'm going to ask my real question, but just a put a fine point on your responses now Ozan to Bryan's question. Just want to be clear that your expectations for 4Q brewer shipments, and what's embedded in your guidance is very much in line with this expectation for the deceleration in household penetration because I think, again, it's the plan versus market reality, I think that people are asking about. So, that's just to validate that approach.

My second and real question was just to talk a little bit about private label performance in pods. I mean, you spoke a bit about it also in your prepared remarks, but we have started to get some questions there on seeing a little bit of a perk up in private label.

So, if you could talk about your participation in private label, how this has an impact or doesn't in terms of the margin business. And if you expect that private label performance to change at all, going forward, when you've two dynamics. One is reinstating marketing, you and your partners on branded coffee, but on the other hand, continued increased inflation to the consumer. And so perhaps more impetus to trade down. Thanks.

Ozan Dokmecioglu
Thank you, Lauren. And so I will break your question, I believe, into four parts. And the first part, the answer for your first part of the question, yes, absolutely. And our guidance, not only on a planning stance basis, but in reality as well, that includes to deliver 2 million incremental households for 2022. And we are quite certain on our numbers. As you know, we have the tracking mechanism. And that's where we are, at this point in time.

When we step back and look at it with regards to the slowing down the consumption, obviously, there are quite a bit of noise that we need to do a double click and provide the context. A combination of the increase in mobility, especially in the summer months, following the post-COVID environment, along with the retail pricing actions, combined with the less investment into advertisement and promotion, as well as consumer activities, which the latter one completely led due to supply chain pod supply issues that we have encountered. And then we got out of it fully at the end of quarter two.

So, all these combinations, and our analysis also suggests that the mobility increase was the outpaced one, an outsized one that impacted negatively the consumption in terms of the pod consumption. However, with the investments coming back, and with life going back to more normal, like the school season kicking in, and also people are starting to go back to more to the offices, we started to see improvement in the consumption. For example, when you look to the market data, in September versus July and August, you will see an improvement. And we are also off to a good start into quarter four, which is October.

Therefore, we have reflected all these into our plans for the remainder of the year. And we are quite certain that our growth in the single serve will continue, both from a top line and a bottom-line perspective. And as we said in our prepared remarks as well, quarter three had the highest absorption rate in terms of the green coffee beans, which created quite a bit of pressure in our P&L in Q3.

The good news is that is behind us. Therefore, the inflation rate that we are going to see in quarter four is going to be significantly less versus the first three quarters that we have seen, due to the spike of our base last year. Therefore, several factors that will enable us to deliver a very good quarter in coffee in quarter four. So, that's the important part.

And the last part of your question with regards to the private label. When we actually look to the entirety of our portfolio, we will see that our private label exposure is limited. Especially when you look to the carbonated soft drinks, we have very limited competition coming from the private label. When you look to the fruit juices, that is true there's a healthy amount of competition in the private label, yet as the data, I'm sure that you have looked at it, we continue to increase market share in that category, which we have been really doing well on the basis of our innovation and market execution in the strong brands of portfolio that we have.

And on the coffee private label, please remember that we are still the largest producer, and the manufacturers of the single serve K-cup pods for the private label sector, as well. So, if the private label increases share or there's a trade down going on, we will still contribute and participate to the economics of that, given that we are still producing a vast majority of the private label K-cup pods.

That's why we believe that our ecosystem is really intact, again, goes back to our all-weather business model between the cold beverage and the coffee. And we expect to have a very strong Q4, across the enterprise. Bob, would you like to add anything?

Bob Gamgort
Yes. Good morning. I think it's, as we said over the past four years is always helpful to look at the Keurig system not on a quarter-by-quarter basis but over the long term. There are a lot of fluctuations up and down. But every time you step back and look at the performance of the ecosystem over six months, nine months, or a multiyear basis, the trends become really clear.

So, let's go back to that. We've always had 2 million households per year, as our target, as Ozan said, that gives us more than 10 years line of sight to more than 10 years of very attractive growth as we convert more than 50 million households, or more than 50% of U.S. population, actually.

What we saw during COVID are a couple of things that changed. The household penetration went from 2 million to 3 million. We always said it was going to revert back to 2 million. We saw an increase in attachment rate. We said it was going to normalize, which it has.

We also, I would remind, you saw a spike in premium coffee brands at the expense of private label and our point of view was that would normalize, over time. We're relatively indifferent to that given that we participate against all of those.

The biggest concern that investors had when we talked to them was not that any of what I just said was going to happen, but rather there was some sort of pull forward so that the 3 million would translate into less than 2 million, going forward. Whereas we sit here today, here's the good news.

We're on our long-term trend of 2 million which we always said. Attachment rate is back to normal levels and healthy and the balance between private label and premium and mainstream is back to where it was before, and we participate in all of those.

The only noise in this period, as Ozan talked about, is when you go from 3 million to 2 million, you don't need to sell as many brewers to support that.

But as we said, we're not in the brewer business, we're in the household penetration business, and 2 million households is exactly where we want to be. And it sets this up for a very, very good future in this ecosystem.

Operator
Our next question will come from Nik Modi with RBC Capital Markets. Please go ahead.

Nik Modi
Yeah, thank you. Good morning, everyone. Ozan, and maybe even Bob, I'd love to hear your thoughts on the deal environment in terms of valuations, any things that you guys have been looking at that seem attractive, obviously, not getting into the details, but given your commentary historically about cash flow cushion and balance sheet and the desire to do more deals, I just would love some context on that.

And then just a quick follow up on the coffee side. Some of the work we've done would suggest there's been a fair degree of increasing interaction between pods, away from home coffee, like cafes, Starbucks, and packaged bottled coffee that you can buy at retail. And I was just curious if you had any thoughts on that. Have you looked into that at all? Thanks.

Bob Gamgort
I'll start with the M&A environment. Ozan, then you can pick the second part of that question up. As, Nik, we monitor the M&A environment, we continue to see what we described previously, as the relatively easy funding situation for high growth companies starting to change, and that continues to do so. New investment for them is becoming more challenged.

If you look at the public valuations as a marker for the few companies in this space that match that high growth criteria, you can see the change in investor sentiment reflected there, pretty aggressively.

So, we continue to see an opportunity for us to be a catalyst. Our goal is always to create win-win partnerships. We're not out there trying to buy something at a low price; we're really trying to step in and be able to solve a number of challenges for these high growth businesses, by creating a partnership that works for everybody.

And take a look at what's happened just in the recent past with Polar, and Tractor Beverage, and Atypique. And now in this call, we're talking about Red Bull in Mexico. If you think about it, every call, we talked about a new piece of news where we're layering in more strategic businesses or segments into our business.

And as that continues to build, it makes us a stronger company, going forward. I would also add to that list all of the independent distributor acquisitions that we've made over the past couple of years that significantly strengthens our distribution system. So, we're going to continue to do so.

I would say that as we continue to engage in these discussions, and we have numerous discussions right now, we're very clear in our strategic priorities. We're really confident in our ability to assess the value to KDP and KDP shareholders. And we're incredibly flexible in our approach on how to make these partnerships work.

If you look at the track record of our success in creating value and growth for the partners I just described, as well as the continued growth that we have on our long-term partners like Evian and Vita Coco and McCafe, that is very attractive to emerging beverage companies.

And so it allows us to have a seat at the table in a number of these conversations. And we're very optimistic they will continue to play out in the way that I described. Ozan, do you want to talk about the interaction between coffee?

Ozan Dokmecioglu
Absolutely. And actually, I like to double click on that, because it's a very important point, Nik, that you mentioned. Let me start with at-home consumption. So, at the onset of COVID, due to the lock downs, and so forth, we have seen a significant increase in our attachment rate with regards to the single serve consumption at home, both in USA and Canada.

And over time, with the mobility increasing and as we were expecting and in line with our plans, which is a kind of post COVID scenario, that the attachment rate started to come down.

And please bear in mind, before the COVID times, our attachment rate has been very, very stable for a long time. Therefore, COVID was the only exception that made it spike and then came down more or less to the previous COVID levels, as we speak right now. Therefore, that's an important point to note.

At the same time, when COVID hit, obviously our away from home office business, which is how we define for the most part, not all but for the most part, also saw significant declines. Albeit, right now, we are seeing improvements but it's still significantly lower. Again, the office coffee business that we have versus the pre-COVID levels.

Therefore, we see this as an opportunity, both in quarter four and beyond, that along the office habits build back that we will see our fair share in that segment at the same time. So, there are quite a bit of interactions, between the two.

And also, as you said, right now, again, with the mobility increased, especially in some where we see that the coffee shop products being consumed more, as one would expect, with some moderation at the at-home consumption.

Therefore, as you said, there are quite a bit of intersection points that when you step back and look to our portfolio, the good news is we are playing in all in terms of the overall Keurig ecosystem that we manage which is very important, and goes back again, another very strong leg to our all-weather business model that we have successfully put together. Thank you.

Operator
Our next question will come from Chris Carey with Wells Fargo Securities. Please go ahead.

Chris Carey
Hey, good morning. Can you just confirm maybe the key drivers of the profit delivery in coffee this quarter, between the green coffee inflation you're seeing versus other inflation, like other

commodities or supply chain inefficiencies? I'm just trying to frame the coffee operating profit performance in the context of pricing, which is building and mix which is more favorable for pods in the quarter, which should be mix accretive.

And then just connected to that, I wonder if you could just maybe frame how you see these coffee margins over the longer-term horizon, if this is a structural reset, because maybe the cost of doing business is higher, or this is just about commodity inflation and you should be catching up to these inflationary headwinds, over time.

And I apologize, this is just a kind of confirmation on the model. But the extra week in Q4 that's going to land in coffee, would you expect to grow above the impact of the extra week. So, I apologize for all that. But thanks for the context.

Ozan Dokmecioglu
No problem. Thank you very much. So, I will break up your question into three components. So, first of all the major drivers and how are we looking to the profitability of coffee in quarter three.

The major determinant and the driver of coffee P&L in Q3 was the absorption rate of the coffee beans, green beans, which is obviously our raw material that we use in terms of the negativity that it caused in our P&L. Why? Because when you look to our base last year, you will see, and we alluded to this during our quarter two call, as well, last year, we had several hedges that came off in Q3, which means that our inflationary step up was significantly higher in Q3 with regards to the coffee beans versus the other quarters. The good news--that's behind us. That's one of the reasons why we have solid plans, and we expect to see significant profit improvements in quarter four, as well.

At the same time, our pricing continues to build up and we believe that in quarter four, we will be in a position that our pricing will fully catching up to the inflationary factors. As you said, the inflation was broad-based. It's not only coffee beans, but across the other materials and the ingredients that we have been using.

But our algorithm clearly suggests that Q4 will be a very good inflection point not only for coffee, but for the cold beverage business that we also have. And it's basically mirroring coffee P&L. We expect to mirror, more or less, what has happened in the cold beverages as we have been expecting and communicating, which was the pricing, quarter in quarter out, was getting closer to the inflation and at one point that pricing would be fully sufficient to overcome not only the absolute impact of the inflation but the margin percent wise as well.

And that's what has happened in our, for example, when you look to Beverage Concentrates and the Packaged Beverages segments that we have announced, and we expect that positive trend to continue into quarter four.

So, coffee is a little behind, like a quarter, but that's what's going to happen, exactly. And we should not also forget that, obviously, we are continuing to build the productivity programs and Q4, as has always been the case, would be the highest delivery quarter for us, at the same time. Therefore, we see Q3 coffee inflationary trends in relation to the pricing and the negative operating income delivery as a transitory quarter for us, and we expect a very strong quarter four for the reasons that I have just articulated.

Absolutely, we do not expect any structural issue or reset with regards to the coffee margins, going forward. And as I say, we will we see a very strong, actually, improvement in quarter four.

There is not any reason, and as we discussed before, obviously, coffee margins is one of the highest in our overall CPG industry, as well at the same time. Therefore, we were very pleased, and we are very pleased, and there is no structural change that we are forecasting for any reason.

The last part of your question with regards to the 53rd week, extra week in coffee, as we said before, it is true that we have few days, not even a week, because of the holiday season and most of the retailers being shut. And the consumption in that, sorry, the sell out in that week, which is the last, very last week of December is the slowest. And it's almost minimal--not is almost--but it is very, very small number that wouldn't change our profile with regards to the quarter four. It will have a little impact to the growth rates, as well. That's why we have not quantified that number that we spoke before and communicated given the very minimal impact on our numbers. Thank you.

Operator
Our next question will come from Bonnie Herzog with Goldman Sachs. Please go ahead.

Bonnie Herzog
Thank you. Good morning, everyone. I wanted to circle back to brewers with a question, hoping you could touch on your inventories, which are quite high up 60% this year. So, wondering how much of this might have to do with retailer inventory levels of brewers being elevated and then therefore, retailers aren't ordering or buying as many brewers. If that is something that's going on, how big of a risk do you believe this is in the next quarter or two for you?

And then a quick clarification of your mid-single digit EPS guidance for this year. Last quarter, you mentioned you expected your second half EPS to be up high single digits, driven largely by Q4. So, just wanted to verify that high single digits in 2H is still expected or is maybe mid-single digit growth more realistic. And that would, I guess, result in your full year EPS growth possibly coming in at the low end of mid-single digits? So, just clarification on that, too, please. Thanks.

Ozan Dokmecioglu
Sure. Thank you, Bonnie. So, let me start with the brewers. We need to get the context right in terms of the brewer POS, as well as the sellouts.

As I explained, due to the supply chain issues that we started to encounter late 2021 and impacted a good chunk of the first half of this year, as well, there were little investments in the category, including the brewers, because simply we didn't have, including our partners, including our retail partners, to sell enough. Therefore, that definitely curtailed the demand. So, that this is a fact.

Now, at the same time, given all the supply chain issues that the whole appliance world has faced in the last two years, we have been continuing to execute and co-manufacturing and bringing to the USA in order to keep our pipelines intact. When you step back and look at it, the small appliances at the retailers that you will see some longer inventory levels that they are facing.

But please make sure that when you do the double click in that number, and you see that the single serve the brewers small appliances, in fact is doing way better than the overall, the small appliances retail number.

Therefore, the headlines that we are seeing, if we don't do that double click real is quite a bit of misleading. We do not see that kind of inventory long term being carried by the retailers. That's number one.

Second, it is also true that we have a little bit more than, more inventory than the previous years. It's just because of two facts. First, we wanted to be ready for the holiday season that we are facing.

And we are also increasing, significantly, investments behind the ecosystem, along with our partners, along with the customer, retailer customers, as well. Therefore, right now, we are seeing a very good traction that we started into quarter four. Therefore, we are not worried at all with regards to the inventory levels that we have.

And always there are ups and downs that we have faced in the last seven years at Keurig business. Therefore, the overall system and the brewers, including the consumption in relation to the investments, is one big circle. And we are pretty mature and intact on that one.

Bob Gamgort
Let me add just one comment here because I think, Bonnie, your question and Bryan also, were also hinting at potential concerns about the environment in Q4. Let me make a couple of points on the holiday season, this year.

One of things that we've seen is that whenever there's a challenging economic time, gifting tends to shift from the indulgent or frivolous to functional.

And there's no better functional gift than a Keurig Brewer. We have a wide range of price points from entry level all the way up to premium. We have an incredibly wide range of retail distribution, from e-commerce to all channels of brick-and-mortar distribution. And we're already seeing a number of retailers very early, are already pushing Keurig as one of their premium or prime promotions, going into the holiday season. And we continue to expect to see more of that. So, I know there's some concerns, as you guys have articulated, about inventory levels and purchase power and small appliances.

But as Ozan pointed out, if you double click on this, you see that single serve brewers and Keurig, in particular, are doing incredibly well. And we expect them to have a strong holiday season. But again, all consistent with driving 2 million households of penetration, which is what all of this is about.

Ozan Dokmecioglu
Exactly. Thanks, Bob. And also, the second part of your question with regards to the EPS. Yes, quarter four is expected to be the strongest quarter of the year, as we expect to deliver margin improvement and accelerate EPS growth. There are several drivers to that, which the full benefits of price realization.

And as we announced publicly, we have taken another round of price increase behind our carbonated soft drinks portfolio early quarter four that will continue to deliver further top line and contribute to our profitability and also lapping spike in inflation, this quarter.

If you would remember, last year in quarter four in 2021, we had a big inflation step up, which means that we are lapping less increase this year, compared to the first three quarters of this year. So, that will drive further profitability and the full realization of productivity this year that will accumulate in quarter four. And again, led by supply chain issues that we ran into, especially behind our coffee business last year, we had several onetime unexpected costs, including the customer penalties that we stated publicly as well, that will not happen this year.

Therefore, lots of reasons why quarter four will be another strong quarter from the top line, as well as especially bottom-line perspective, and we also expect to deliver a positive margin improvement, which would be a good inflection point for this quarter. Thank you.

Operator
Our next question will come from Brett Cooper with Consumer Edge Research. Please go ahead.

Brett Cooper
Good morning, everyone. Just one quick question. I wanted to double click on the supply chain organization change. And I was hoping you can help us understand the rationale for the change, whether that change is a leading-edge change for the enterprise and then, help me understand how that nets higher productivity. Thanks.

Ozan Dokmecioglu
Absolutely. We always look for opportunities across our business, either how we operate, the ways of working, that we also align our organization, accordingly.

As you know, approximately two years ago, we moved a little bit from the functional to more business unit led organization structure. And these latest moves are in support of that move, taking it to the next level; nothing new, is around the edges. And not that we have any issues, or we have encountered in our supply chain or any unresolved issues that we are trying to tackle.

To the contrary, as we have been talking at many different platforms that our supply chain organization, as well as its supply chain fundamentals, improved drastically across two businesses that we have in the cold beverages, especially in coffee.

Therefore, this organizational change is making our supply chain to get even closer to the businesses that we do expect to see faster decision making with at the right time with the right players around, which will eventually impact our productivity programs, as well.

And a little bit more info on how this change may impact our productivity programs a bit, the first six to nine months because of the supply chain issues that we have faced, especially in coffee but not limited to coffee. In some brands, important brands like Snapple, as we communicated publicly, CORE and Bai and a little bit in the CSDs that we ran into some supply chain issues. In fact, the focus, whether we liked it or not, that went towards correcting all those issues that we have faced, because that’s what we should have been doing. And, putting those problems behind us.

And with the new organization that we made, the small changes now will enable us to focus on much more productivity delivery, either in quarter four or next year, as well. So, this is the sum up of the impacts that we expect from the latest supply chain changes. Thank you very much.

Operator
And our last question today will come from Andrea Teixeira with JP Morgan. Please go ahead.

Andrea Teixeira
Thank you. Good morning. So, I also want to have a clarification on the coffee side. I’m sorry for going back to that and then Bob on M&A. First, can you comment a little bit on the sell out for the brewers from a replacement standpoint, which I understand is still bigger than the new households, of course, the Razor/Razor Blade model, we would like more households, but I don’t want to underestimate what’s happening on the future to single serve.

And then Bob, on the Red Bull distribution agreement in Mexico--first, congratulations on that. And should we see more of this view as in isolation, but or perhaps testing the waters for potentially expanded agreement, including the U.S.? And if not, given your firepower in M&A, how we should be thinking about opportunities in energy. Thank you.

Ozan Dokmecioglu
Absolutely. Thanks Andrea. Let me start with the coffee and the brewer part. First of all, we are very pleased and, more importantly, the brewer sales exactly in line with what we were expecting. So, that's very important to note.

So, when we look to the composition of our total sales, as you know, we never broke that apart in terms of so many brewers that we sell goes to the replacement and other factors, as well. But you are absolutely right, replacements have been and will play a much larger role in terms of the percent of our sales in our brewer units. That is a fact.

But what is also important, as we have been saying, the incremental household that we will be driving that has too many levels to that one.

For example, when we, which we did improve the, our brewer qualities, obviously the life expectancy of the brewers extended, which means that the replacement cycle got longer, which means that we require less brewers to sell. But that still enables us to deliver the 2 million incremental households that we have been delivering, very successfully, albeit 3 million both in 2020 and 2021 with no pull forward as well from 2022, or even the beyond years.

Therefore, replacement brewers has been and will be our realities. And we will continue to improve our brewer qualities and expect them to further extend the lifecycle. And also, we have increased and continue to increase our innovation cycle in the brewers, which would enable us to tap to the new consumption occasions and with the new format as well, that will further give us the incremental top line, as well as the bottom line.

Therefore, we are quite pleased with the overall brewer performance that we have put together and feeding our ecosystem. Bob, on the Red Bull?

Bob Gamgort
Yeah, I'll refer back to our investor day a little over a year ago, where we talked about the role of M&A and partnerships. And we said that we had a number of criteria. One is we want to add on to our existing portfolio and leverage the infrastructure we have in place, particularly, our DSD system.

We were really interested in new platforms, particularly in energy and alcohol, where we saw good whitespace opportunities. And we also talked about we've got these incredibly strong businesses in Canada and Mexico that we really don't talk much about. And we saw opportunities there.

So, quite simply, when I look at the new arrangement with Red Bull in Mexico, we think about that hits on energy. And it hits on continued expansion in Mexico. Atypique was expansion within Canada. So, we're beginning to add into these opportunity areas that we identified about a year ago in a more aggressive way.

And all I will say on the Red Bull Mexico piece is our goal is to do what we do with all of our partnership, which is demonstrate incredibly strong value added for our partners, drive growth for them. And that always leads to more opportunities in the future. And I would expect that that would be the same in the case of this one.

Before--I think I'm turning it back over to you, Ozan--before I do that, I have to, in my new role here, I have to say we didn't get a single question on our Cold Beverage business today. And I want to give a shout out to our Cold Beverage team who delivered another incredible quarter of revenue growth, market share performance, record profitability, and they continue to hit it out of the park, and they kind of feel left out on some of these calls.

So, I will acknowledge their strong performance as it shows up in our EPS and our overall financial delivery to KDP. So, Ozan, I'll turn it back over to you.

Ozan Dokmecioglu
Yes, thank you very much. Thank you very much to all of you, as well. Steve.

CONCLUSION

Steve Alexander
Yes, this is Steve with the IR team. Chethan and I are around all day if you have any questions and we thank you all for your time participating on the call today. Thanks and have a great day.

Operator
The conference has now concluded. Thank you for attending today's presentation. You may now disconnect your lines.