Keurig Dr Pepper, Inc.

Fourth Quarter 2022 Earnings

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CORPORATE PARTICIPANTS

Maria Sceppaguercio - *Chief Corporate Affairs Officer*

Robert Gamgort - *Chairman and Chief Executive Officer*

Sudhanshu Priyadarshi - *Chief Financial Officer*

PRESENTATION

Operator
Good morning, ladies and gentlemen and thank you for standing by. Welcome to Keurig Dr Pepper's earnings call for the fourth quarter and full year 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 Chief Corporate Affairs Officer, Maria Sceppaguercio. Ms. Sceppaguercio, please go ahead.

Maria Sceppaguercio
Thank you and hello everyone.

Earlier this morning, we issued our press release for the fourth quarter.

Consistent with previous quarters, we will be discussing our performance on an Adjusted basis, which reflects constant currency growth rates and excludes 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 and the use of constant currency growth rates are 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-K, 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.

Today we will also speak to the concept of underlying performance, which removes the impact of previously disclosed non-operational items. In '22, these items included strategic asset investment program gains, reimbursement of litigation expenses related to Body Armor, a business interruption insurance recovery and a change in accounting policy for stock compensation.

Here with us today to discuss our results are KDP Chairman & CEO Bob Gamgort and our Chief Financial Officer Sudhanshu Priyadarshi. Also with us this morning is the IR team, including Jane Gelfand, who we are excited to welcome this week as our new Vice President of Investor Relations & Strategic Initiatives.

I'm confident that many of you know Jane from her time on the Street, as well as her most recent role at Wayfair, where she led a number of finance functions including Investor Relations and Treasury. Jane is replacing Steve Alexander who, after more than 16 successful years in Finance, Commercial and IR with KDP and predecessor companies, has decided to take some time off for family and travel. We are pleased that Steve has agreed to stay on through April to support the transition.

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 upon 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, Maria, and good morning everyone.

In 2022 we continued to advance our vision of a Modern Beverage Company by expanding our portfolio to reach more beverage consumers, needs and occasions and by enhancing our unique selling and route to market capabilities to make our brands available at every point of sale.

Our full year financial results were in line with or above our guidance, with revenue growing by 11% and Adjusted diluted EPS expanding by 5%.

Since our Q3 earnings call, we had the opportunity to engage with many of you twice. First at our early December in-person event, where you met the KDP management team and board of directors and, again on our mid-December Fireside Chat, during which we discussed our investment in Nutrabolt, including the distribution agreement for C4, and answered questions regarding recent trends in the categories in which we compete.

Those conversations provided us with a good sense of what's top of mind with our investors, which we will build upon during today's call. I'll start by providing perspective on the macro and category environments we faced in 2022, discuss how we created shareholder value over the past year and offer thoughts on how we see 2023 shaping up, both in terms of the macro environment and our strategy to continue winning.

Sudhanshu will follow me with specifics on our Q4 and full year 2022 results, provide more detailed guidance on key metrics for 2023 and discuss the evolution of our capital allocation policy.

While it seems like a long time ago, we started 2022 with the lingering effects of supply chain disruption, primarily driven by a final COVID wave that reduced labor availability in late 2021 and early 2022. We felt that impact most acutely in our coffee business, where strong 2021 consumer demand had depleted our inventories and, in our still beverage portfolio, where we faced a range of supply shortages. We implemented supply recovery programs that yielded strong customer service improvements with replenished inventory levels.

By Q2, our concerns around COVID and supply chain disruptions were quickly supplanted by industry inflation in ingredients and materials, labor and transportation that was outpacing significant pricing. Elasticities held up well in the categories in which we compete, which enabled strong revenue growth, driven by both the higher pricing and increased volume, but came at lower margins. For perspective, we faced total cost inflation in 2022 of 16% - far above our expectations going into the year - and we implemented pricing actions across our portfolio that averaged in the low-double-digits. Pricing realization was strong and accelerated throughout the year, yet it consistently lagged the timing of the escalating inflationary impact on our P&L.

As we approached the end of the year and entered 2023, we became more focused on the potential impact of recession on our consumers, despite seeing minimal evidence of changing behavior to date. We are monitoring consumer behavior closely and are taking proactive steps to ensure our brand strength continues into 2023 and beyond.

Of course, the wide range of challenges of 2022 is a continuation of the rolling set of obstacles we have navigated since the onset of COVID in 2020. In this context, we have discussed the benefits of our all-weather business model. This is more than a punchy sound bite – it reflects our ability to manage our broad portfolio and unique routes to market to deliver strong and consistent shareholder returns in an unpredictable and changing environment, as we did in 2022 and every year since forming KDP in 2018.

In addition to delivering our ambitious financial commitments over the past five years, we've also been immersed in an integration and transformation process that created a Modern Beverage Company that today can consistently deliver attractive, high-quality, dependable returns, with a well-capitalized balance sheet. Toward that end, we have evolved our capital allocation policy to reflect that of a more mature KDP and to be contemporary with a changing macro environment, marked by rising interest rates.

During the integration and transformation stage, we had a strong focus on rapid deleveraging - using all levers available to us to do so - while still investing in building our capabilities and brands. We took advantage of compelling opportunities to monetize non-strategic assets through sale leaseback transactions, which enabled us to simultaneously invest, delever and drive strong returns for our shareholders.

As we shift from integration and transformation to activation, we are planning for a step-change reduction in the use of non-operational benefits, starting this year. That means our underlying *operational* growth will exceed our Adjusted growth in 2023. Of course, our guidance will continue to be for Adjusted metrics, and we will report results on the same basis as we've always done, but we will also highlight operational performance from time to time, to provide you with a better sense of the underlying strength of our business.

Strong cash flow remains a hallmark of KDP. As we discussed in December, we plan to deploy our cash to improve our long-term targeted leverage ratio to 2.5x or below, while still funding strategic growth projects and attractive return of cash to shareholders.

With the learnings from 2022 in mind, I'll shift to a discussion of our 2023 outlook, starting with the most pressing industry topic from last year – inflation. Our plan assumes the rate of inflation will moderate to the mid-single-digit range. That translates to a cumulative inflation rate of approximately 30% over the past three years - clearly unprecedented in our lifetimes.

Regarding the inflation outlook for 2023, recent spot price declines of key inputs might lead some to believe there could be industry deflation.

The reality is, we don't buy on a spot basis and the underlying commodity cost doesn't reflect the total delivered cost to us. Such is certainly the case in coffee, where C prices dropped in late 2022; however, the differential, which includes everything in our fully landed coffee cost, such as broker fees, sea freight and premium coffee up-charges, was up meaningfully. Labor is another area in which we're continuing to see persistent inflation.

To offset the continued impact of inflation, we have upped our game in productivity, reduced our discretionary costs and increased pricing. The realization of 2022 pricing actions will continue to flow into our P&L during 2023 and, in some areas where continued inflationary impacts are not yet fully covered by pricing, we have implemented additional revenue growth management actions to address key margin gaps.

The combination of moderating inflation and continued pricing realization means that we expect year-over-year improvement in gross margin in 2023, but not yet returning to 2019 levels.

With higher gross margins in view for 2023, the conversation shifts to demand. A key focus point for us in 2023 is the financial health of North American consumers and its impact on price elasticities for the categories in which we compete. Therefore, we believe it's prudent to expect that lower, but still positive, year-over-year price realization, combined with modest elasticities, will yield KDP net revenue growth of approximately 5% in 2023.

It's also important to be proactive in ensuring the continued strength of our brands by increasing our investment in growth in 2023. As we are all aware, industry marketing budgets were reduced during COVID and many haven't yet been fully restored. While we have learned to be significantly more efficient with our brand spending, 2023 is the right time to increase our absolute investment behind key segments and brands, as well as to support a strong lineup of innovation.

The improvement in our gross margin, combined with 5% revenue growth, will enable us to deliver year-over-year improvement in operating income growth, even with our increased brand investments and the headwind of comping significant non-operational benefits in 2022.

Taking all of the macro and company-specific factors discussed this morning into account, we expect Adjusted EPS for 2023 to grow by 6% to 7%. Removing the impact of the previously disclosed non-operational items from 2022 implies Adjusted EPS growth that is toward the high end of our long-term algorithm.

Our expectation for continued strong value creation in 2023 is rooted in the success of our unique and flexible business strategy over the past five years…

In Cold Beverages, our focus is on driving growth:

First, in core brands through marketing, brand renovation and continued strong in-market execution. In 2022, we continued to build upon or hold the significant share gains we achieved over the past few years in total Liquid Refreshment Beverages and key segments such as CSDs and premium water.

Second, by filling white space in our portfolio through innovation and partnerships, such as our strategic relationship with Nutrabolt for C4 energy and our Red Bull agreement in Mexico, as well as our expansion into new platforms, such as non-alcohol beer with our investment in Athletic Brewing, and better for you drinks in Foodservice through our partnership with Tractor Beverage.

Third, by enhancing the effectiveness of our omni-channel selling and distribution system, including e-commerce, where we are one of the food and beverage leaders, and our company owned direct store distribution system. Over the past several years we have built a stronger direct route-to-market capability, through investment in capabilities and tools and acquiring key DSD distributor territories – all of which have driven consistently strong market share performance across our brands and segments.

In Coffee Systems, we are focused on growth…

First, by driving household penetration growth for the Keurig system every year. Given the large number of remaining addressable households, we have line of sight to continued household growth well into the future. As we enter 2023, we have built a U.S. installed base of 38 million households, which, along with our installed base in Canada, consume more than 13 billion cups of coffee manufactured by KDP annually.

Second, by expanding the roster of coffee partners in the Keurig system. In 2022 we welcomed back Community Coffee and added new coffee brands such as BLK & Bold, the first black-owned nationally distributed coffee brand, and Intelligentsia, one of specialty coffee's most pioneering and innovative brands.

Third, by creating new platforms to drive incremental revenue and profit growth from existing Keurig households, such as connected brewers, and new beverage formats and occasions. In 2022 we expanded our lineup of connected brewers with the introduction of the K-Café Smart, which has received outstanding consumer and professional reviews, expanded the Keurig app, which works with both connected and non-connected brewers, to help consumers make barista-quality specialty coffee beverages at home, and expanded availability of our Keurig Slim Plus Iced brewer and expanded our brew over ice pods. In 2023, Iced will be a significant focus area for Keurig, with expanded K-Iced machines and pods, supported by dedicated marketing and focused retailer support.

And finally, KDP's extraordinary free cash flow enables the potential for incremental shareholder returns through strategic capital allocation, including M&A and partnerships, opportunistic share repurchases and growing our dividend within our stated payout ratio of 45% of free cash flow.

With that as important context, I'll hand it over to Sudhanshu to discuss 2022 results and our 2023 outlook in more depth.

Sudhanshu Priyadarshi
Thanks, Bob, and good morning everyone.

I joined the Company three months ago because I believed KDP represented a unique investment and value creation opportunity, and my conviction has grown significantly as I've gotten to understand the business better.

This conviction will be reflected in my perspective on our 2022 results, the important learnings as we look back on the year and the implications for 2023.

Starting with Coffee Systems…

Before jumping into specific numbers, I'd like to share my perspective on the coffee category.

Coffee is an attractive, long-term growth category.

KDP operates primarily in the at-home coffee segment in the US and Canada, where we are the industry leader. The at-home segment comprises the vast majority of all coffee drinking occasions and single-serve is the clear winner, consistently growing share of at-home occasions.

There has been significant noise between 2019 and 2022 in both the at-home and away-from-home coffee categories, primarily due to shifting consumer mobility, and we acknowledge that it has been a challenge for investors to separate the signal from that noise.

After significant at-home coffee volume growth in 2020 and 2021, due to increased consumer time spent at home, we began to see a deceleration in 2022. This occurred globally, in all forms of at-home coffee, which is quite unprecedented. There are several factors at play causing this concurrent decline. We believe the primary contributors are a reduction in "time spent at home" for consumers, which we know correlates with coffee consumption, as well as some elasticity impact of significant pricing actions taken in 2022.

Specific to the US, consistent with the global trends, volume for the total at-home coffee category decreased 6% in IRI, with all major forms declining – including bagged, canned and single-serve. However, single-serve coffee outperformed, enabling it to gain share of total at-home coffee consumption.

KDP's owned and licensed brands demonstrated relative strength in 2022, despite having among the highest price increases in the single serve segment, with the fourth quarter representing its highest share position since before COVID. Driving this strength was strong innovation that resonated with consumers, and reinstated promotions in the second half as pod supply was restored.

We saw a similar trend at play in coffee brewers in the US, where small appliance volumes were challenged in 2022, comping against growth in 2020 and 2021 that was primarily fueled by time at home, as well as in part by stimulus checks. Although not immune from this dynamic, Keurig-compatible brewers also gained share of all coffee makers in 2022.

Moving to the financials…

For the year, the segment grew net sales 6.2%, with pricing up 7% and volume/mix down 0.8%.

Pod revenue also advanced 6.2%, reflecting the benefit of pricing and a 1.4% increase in volume.

Brewer volume declined 5.2% in 2022, comping the double-digit growth we have experienced each year since the onset of COVID.

As you know, our goal is not brewer sales, but rather household penetration and we added more than two million new households to the Keurig system in 2022, modestly above our long-term annual target.

Innovation is a key driver of household penetration, and we are pleased with the performance of our 2022 brewer innovation slate and excited about what's coming in 2023.

While top-line growth in Coffee Systems was solid, the challenge in 2022 was operating income, which declined 7.5%, as inflation exceeded net realized pricing – compressing margins. We expect an improvement in the relationship between inflation and pricing going forward, leading to a year-over-year improvement in gross margin in 2023.

Specifically, our 2023 outlook projects KDP Coffee Systems to deliver 3-4% net sales growth and 5-7% operating income growth. Removing the impact of non-operational items in 2022, this implies higher Coffee Systems operating income growth in 2023. We expect a strong recovery in margins, reflecting the strength of KDP's owned and licensed brands and a favorable relationship between pricing and inflation, particularly in the second half of the year, which will be significantly stronger than the first half.

While the Keurig system is unique, its scale of $5 billion in net sales and OI margins above 30% are consistent with a best-in-class CPG business. While we continue to manage the business to drive household growth and extract incremental value from our existing installed base, I think it makes sense to assess Coffee Systems using the same conventional metrics as you would any other CPG business. That translates into net sales and operating income performance, the outlook for which we are sharing with you today for the year ahead.

Our 2023 outlook reflects the following factors that we believe are most relevant to consider:

First, while mobility has recovered significantly from 2020 lows, it still remains below pre-COVID levels, and we expect its continued recovery in 2023 to represent a headwind for at-home coffee consumption, especially in the first half.

Second, the industry's pricing actions taken in 2022 will have a carryover benefit in the first half of 2023, which will have a modest negative impact on volumes. As discussed, total at home coffee volumes declined during 2022 and these category trends have continued in early 2023, although single-serve importantly continues to outperform.

Third, we see a rapidly evolving retail environment for small appliances, with challenges in key mass and department & specialty retailers, impacting the availability of our brewers. We're targeting alternative channels such as e-commerce to pick up the slack; however, we believe it's reasonable to expect a modest decline in Keurig brewer shipments year-over-year in 2023.

These factors, which will have an influence on 2023 results, in no way alter our bullish long-term outlook for the coffee category, or our expected outperformance for the single-serve format.

Turning now to our Cold Beverages business, which performed very well in 2022 and enters 2023 with strong momentum…

Beverage Concentrates had an exceptional year in 2022. Net sales grew 16.4%, with net pricing up 14.7% and volume/mix up 1.7%.

Dr Pepper brand drove the performance, largely reflecting the expansion of Dr Pepper zero sugar and strong in-market support.

Dr Pepper zero sugar retail dollars and volumes each grew in the strong double-digits during 2022, outpacing the zero sugar segment, reflecting net price realization, strong velocity growth and incremental distribution gains.

Beverage Concentrates Adjusted operating income grew 16.9%. This reflected the favorable relationship between pricing and inflation, as the shared benefit of bottler pricing actions was only minimally offset by inflation, given the margin structure of the business.

During the year, we also benefited from the opening of our Newbridge, Ireland concentrate facility, which represented a dual source of concentrate manufacturing for KDP. The new facility had a smooth and successful start-up in 2022.

Looking ahead to 2023, we continue to be excited about the Beverage Concentrates business, particularly given our strong innovation offerings, including the first quarter launch of Dr Pepper Strawberries & Cream.

We expect the segment to post operating income growth in 2023 that moderates versus the strong 17% growth achieved in 2022. This reflects our expectation for a reduced benefit of pricing in response to the expected lower level of year-over year inflation.

Continuing with Packaged Beverages…

For the year, we grew net sales 12.4%, with pricing up a strong 12.1% and volume/mix up 0.3%. Elasticities for the business remained modest, due to the strength of our brand portfolio.

This strength is most evident in our in-market performance, where we gained share in categories representing 92% of our US retail sales base, leading to expansion of our total LRB share.

We are pleased with our strong ongoing in-market execution, which has enabled us to maintain the cumulative share gains achieved in CSDs since 2019 and continue to strengthen our #2 share position in premium water, driven by significant growth of CORE Hydration, Polar and Vita Coco. Our partnership with Polar is a great example of our win-win partnership approach, as Polar is now the #2 national sparkling water brand in the grocery channel and is gaining ground in all other channels.

In the juice category, Motts continues to be a standout, driving double-digit growth in both pricing and volume for the year and gaining an impressive 3.6 share points in a category in which its primary competitor is private label.

Adjusted operating income for Packaged Beverages grew 1.2% in 2022, as our strong net sales growth and productivity were largely offset by inflation, as well as a negative year-over-year non-operational comparison. Similar to Coffee Systems, Adjusted operating margin for Packaged Beverages compressed for the year, due to the timing disconnect between inflation and pricing, despite our ability to realize more pricing in Cold Beverages than in Coffee Systems.

Importantly, Packaged Beverages exited the year with strong underlying momentum.

Turning to 2023, we expect a strong net sales growth for Packaged Beverages that moderates versus the 12% growth in 2022, as the impact from carryover and select new pricing actions is expected to be less significant than the pricing benefit realized in 2022. Net sales will also benefit from our recently announced distribution partnership for C4 energy drinks. The integration is well underway and tracking our plans.

Packaged Beverages has a strong innovation lineup planned for the year, beginning with an active first quarter. In CSDs, the highlight will be the Q1 launch of Dr Pepper Strawberries & Cream, which has garnered strong consumer response, achieving a 1% share of CSDs in the very early stages of the launch. In addition, we just launched Core Hydration+, a nutrient enhanced water that offers distinct functional benefits, and we are launching a new variety for our highly incremental Snapple Elements line in March. We plan to increase marketing investment to support the core business and this new innovation.

Packaged Beverages operating income is expected to be strong in 2023, with margin expanding, due to a better relationship between pricing and inflation, and we expect the segment's underlying performance to be even stronger, driven by gross margin expansion, partially offset by marketing investment.

Ending with Latin America Beverages…

Latin America Beverages had another outstanding year, delivering strong and balanced net sales growth of 23%, with both net pricing and volume/mix up significantly.

Our performance was led by Penafiel, which delivered strong double-digit sales growth and continued to gain share. Clamato was also a standout, with double-digit sales growth and a significant increase in market share.

Adjusted operating income for the segment grew 18.5% in 2022, reflecting the strong top-line growth and productivity that more than offset inflation and a significant increase in marketing investment.

In 2023, we expect continued momentum in Latin America Beverages, reflecting strong commercial plans to drive incremental distribution, continued strong in-market performance and our distribution partnership with Red Bull Mexico.

Turning briefly to the consolidated results for the fourth quarter, which are addressed in detail in our press release.

Consolidated net sales grew more than 12%, reflecting higher net pricing and a modest volume/mix decline. Growth was balanced across our portfolio, with all four segments expanding net sales at a double-digit rate in the quarter.

Adjusted gross profit advanced almost 11% and gross margin contracted 80 basis points but improved sequentially on a year-over-year basis.

Adjusted operating income grew 13.2% and Adjusted operating margin expanded 20 basis points.

Adjusted EPS in the quarter grew 11% versus the fourth quarter of 2021 to $0.50.

Turning to our 2022 full year results.

Total company net sales grew 11%, with growth in both net price and volume/mix, reflecting the strength of our portfolio.

Adjusted gross profit grew almost 8% and gross margin contracted 170 basis points, due to the timing of pricing and productivity lagging double-digit inflation.

Adjusted operating income grew 4%, reflecting the double-digit growth in net sales and a year-over-year benefit from the Company's strategic asset investment program, largely offset by the contraction in gross margin and significant inflation in transportation and warehousing costs. As a result, Adjusted operating margin contracted 180 basis points.

Adjusted EPS grew 5% to $1.68 for the year, consistent with the guidance.

Turning now to our balance sheet, cash flow generation and evolved capital allocation policy.

Free cash flow conversion was exceptional in 2022 at 111% - well ahead of our long-term target of approximately 100%.

Operating cash flow totaled $2.8 billion for the year, and free cash flow grew to $2.7 billion.

Our strong cash flow generation is a powerful value creation tool. As Bob discussed, we evolved our capital allocation policy to reflect changes in the macro environment.

With the interest rate increases over the past year, our hurdle rate for deploying cash has increased and it is appealing to maintain strong liquidity and ample dry powder.

As discussed during our December fireside chat, we believe it makes sense to continue to reduce our leverage over time and have established a long-term management leverage target of 2.0x to 2.5x, which compares to 2.8x at the end of 2022.

From a capital allocation perspective, in addition to internal organic growth investments, our top priority is value-enhancing M&A and strategic partnerships, along with opportunistic share repurchases to return value to shareholders and manage share creep, as well as growing our dividend within our 45% stated payout ratio target.

Our focus in 2023 will be the integration and expansion of our 2022 partnerships and investments, so we currently do not expect M&A to represent a significant use of cash in the near-term.

Our capital allocation actions in 2022 already began to demonstrate our updated priorities. During the course of the year, we invested almost $1 billion in attractive new growth platforms, namely our 30% equity stake in Nutrabolt, the acquisition of Atypique and equity investments in Athletic Brewing and Tractor Beverages. We also continued to strengthen our DSD network with a number of territory deals to further increase our scale and effectiveness. At the same time, we returned $1.5 billion to shareholders through our quarterly dividend, which we increased by 6.7% in September, and the opportunistic repurchase of 10.6 million shares.

I'll close with our outlook for 2023:

We expect 2023 constant currency net sales growth of 5% and Adjusted EPS growth of 6% to 7%, the latter representing a year-over-year growth improvement versus 2022. Foreign currency translation is expected to approximate a half a point headwind to both net sales and Adjusted EPS growth. Removing the impact of non-operational items, this implies significantly higher Adjusted EPS growth.

Included in our guidance are the following assumptions:

Interest expense in a range of $465 (million) to $470 million, reflecting the rising interest rate environment and including approximately $45 million related to financing the Nutrabolt transaction.

Regarding Nutrabolt, we expect some net sales benefit from our distribution agreement for C4. As previously discussed, 2023 is expected to be a transition and investment year for the partnership and therefore we are not expecting any material impact on earnings this year.

However, we do expect equity method income from our 30% stake in Nutrabolt to approximate $40 (million) to $45 million, which offsets the Nutrabolt-related interest expense. This equity method income will flow through non-operating other expense and income.

The effective tax rate is estimated at approximately 22%.

Diluted weighted average shares outstanding are expected to approximate 1.42 billion.

From a timing standpoint, we expect EPS for the first quarter to be roughly even with year-ago, reflecting our belief that Q1 will have the highest rate of inflation, the largest marketing increase and the smallest productivity benefit of the year. Q1 will also be comping significant non-operational benefits in the year-ago period.

We expect EPS growth to strengthen in the balance of the year, as inflation moderates and productivity benefits ramp.

I will now turn it over to Bob for closing comments.

Robert Gamgort
We formed KDP in 2018 as a pure play beverage company focused on the North American market. In the US alone, there are 1.2 trillion beverage consumption occasions in play every year. Beyond population growth, that number doesn't change much, nor do the fundamental consumer needs for beverages. What has and will continue to change is which beverage formats consumers choose to satisfy their needs and where consumers purchase their beverages.

Compared to 2017, we served an additional 6 billion beverage occasions in 2022, through portfolio innovation, renovation and new partnerships. By executing our concept of a Modern Beverage Company, which reflects our holistic view of all beverage opportunities, we've been able to better satisfy consumer needs, leading to our accelerated growth rate.

We remain excited about the significant growth opportunities ahead. In 2023 and beyond we'll continue to leverage our business model to capture even more of the trillion-plus beverage occasions each year in North America.

I'll now turn the call over to the operator for questions.

QUESTIONS AND ANSWERS

Operator
Thank you. We will now begin the question-and-answer session. To ask a question, you may press star then one on your touchtone phone. If you are using a speakerphone, we ask that you please pick up your handset before pressing the keys. To withdraw your question, please press star then two.

Today's first question comes from Chris Carey at Wells Fargo Securities. Please go ahead.

Chris Carey
Hi, good morning.

Robert Gamgort
Hey, Chris.

Chris Carey
So I just want to clarify one thing, then a fundamental question. Clearly, the non-operating adjustments have been a sticking point with investors. I gather from your comments on this earnings call that you're well aware of these dynamics and are making some changes going forward with specifically the guidance range, reflecting potentially the clean base.

But I want to be crystal clear about this, the use of these non-operating contributors, and I appreciate there's an investment offset, but these will be a thing of the past and we can look at somewhat clean results going forward. Obviously, there's going to be dynamics every quarter, but these sorts of programs will be sunsetted. Is that what I'm hearing? Then I have a fundamental question.

Robert Gamgort
Yes. Thanks, Chris. As we mentioned in the prepared remarks, we've been in really an integration and transformation phase since the integration period or since the merger in 2018. That is complete, and we've moved from the integration phase to an activation phase. And so that causes us to think about how we build a company that is contemporary, as I said, with the current environment and also one that is reflective of a more mature KDP that can deliver consistent returns that are reliable by investors over time. So that's why it made sense to use some of these non-operational benefits in the past when we're in a mode of transforming, integrating and we were also delevering and investing heavily in the business.

But as we look forward on here, we're making a significant step change in the use of non-operational benefits, actually beginning in 2023. And we're committed to continue moving in that direction in the future. So I think the most important thing from an investor perspective is that the $1.78 in EPS, which reflects the midpoint of our 2023 guidance, is a good, reliable number that could be the focus of valuation.

Chris Carey
Okay. Very clear. Just on the expectation for gross margin expansion. I'm trying to frame that in a context of –you gave an outlook for inflation and also, you're saying that you're going to be investing into marketing, so something like a mid-single-digit inflation. Is that a COGS and SG&A, is the right way to think about that inflation overall and then there'll be marketing on top of that? That's quite a bit of increase. So I'm just trying to frame the gross margin expansion needed to offset that. So any context

there would be helpful. Thanks.

Sudhanshu Priyadarshi
Hi, Chris, this is Sudhanshu Priyadarshi. Yes, you're right, we expect a substantial improvement in our gross margin, but it will not go back to 2019 level. But we’ve said before, we would like to invest in marketing, so we will be reinvesting in marketing. So you will not see the flow through from gross margin to OI all the way. You will see some flow-through, but we expect that we should start investing money in our brands, and we talked during our December fireside chat so that's our plan. So yes, you're right, gross margins will improve, but we will reinvest in marketing, so you won't see all of them flowing through to OI.

Operator
Thank you. And our next question today comes from Bryan Spillane with BoA. Please go ahead.

Bryan Spillane
Thanks, operator. Good morning, everyone.

Robert Gamgort
Good morning, Bryan.

Bryan Spillane
Bob, so my question was just around Coffee Systems, and I appreciate the perspective you gave on the perspective for ‘23. But we're getting a lot of questions about holiday sell-through, both in terms of some of the retail disruption, but just whether consumers are making other choices about small appliances at the holidays.

And maybe if you could talk a little bit about in the outlook for this year, how much of the brewer decline do you think has just been, there's been a bit of a pull forward in the last couple of years. How much of it do you think is disruption at retail? Or how much do you think is just a function of consumers being sensitive about how they're spending their discretionary dollars?

Robert Gamgort
Yes. Good question. Let me start with something I said a number of times in the past, especially when we've had quarters where the brewer sales were up significantly, and that is, we're not in the business of selling brewers. We're in the business of driving household penetration.

And while there is a correlation between brewer sales and household penetration, there's not this direct causation that we've talked about a number of times in the past. And what I mean by that is there are three reasons consumers buy brewers: it's a new household; it's a replacement of an existing brewer; or it's an upgrade. And so there's a number of factors that you can see brewers sales down, and it has no impact on household penetration, because it means that somebody has delayed an upgrade, for example.

So two things to point out in 2022 versus 2021, obviously, in Q4 is we were delivering 3 million new households in 2020 and 2021. So obviously, in 2022 with 2 million households, you would expect to sell fewer brewers. The other part is we have seen a challenged retail environment, and we referred to that in our script, particularly in specialty channels in some mass customers as well. And while we're working with them to continue to drive growth of the whole category and our brewers specifically, we also think it's smart to continue to look for other opportunities to pick up that consumer demand elsewhere, where the consumer demand is moving a lot of that, as you know, is moving towards e-commerce.

Having said all of that, I think your question on consumers making other choices, the reality of it is KDP brewers or Keurig brewers picked up share of all coffee makers and of small appliances. So it's not a decision to buy something in place of it. There's clearly been some pressure on small appliances in general. And some of that is the rebound effect post-COVID, but some of it is also due to some retail pressure that we described in the prepared remarks.

Operator
Thank you. And our next question today comes from Kevin Grundy with Jefferies. Please go ahead.

Kevin Grundy
Great. Thanks, good morning, everyone. Bob, just to follow-up on Bryan's question, but very succinctly, as you pull this together, look at household penetration, your confidence in the business, is your Coffee Systems business, is the expectation that this grows mid-single-digits longer term? I think that's really important, because it's a key debate for the stock.

And then just my follow-up unrelatedly, just on the advertising and marketing increase. Bob, maybe just a little bit more color there on the magnitude of the increased key areas of spend, I think that would be helpful for folks as well. Thank you very much.

Robert Gamgort
Sure. As we've talked about our long-term target for household penetration is 2 million households per year. We actually delivered slightly more than that in 2022. We did deliver significantly more than that in the previous two years. All our indications this year is the 2 million is still the right number to assume for household penetration going forward.

And your question about mid-single-digits going forward, absolutely where we are. That's what we talked about in the December fireside chat. We gave you the context of the long-term trends. And also, we looked at the first half of the COVID period and then the COVID recovery period and how there's been some shift between there. But 2 million households and mid-single-digits is still what we have in view.

Operator
Thank you…

Sudhanshu Priyadarshi
Bob, I can take the marketing question. So as we've said, our marketing spending will increase in 2023, but our learnings and marketing returns will decide which brand and how much we spend. So we don't have a top-down marketing target, we will watch our brand performance and elasticity during the year, and then we'll make the decision of which brands we invest in.

Operator
Thank you. And our next question today comes from Lauren Lieberman with Barclays. Please go ahead.

Lauren Lieberman
Great, thanks and good morning.

Robert Gamgort
Hey, Lauren

Lauren Lieberman
Hey. So I know we want to look forward, and you've talked about plans on non-operating items for next year. But I did want to talk about the gross margin performance in the fourth quarter, because my understanding had been that the expectation was for gross margin expansion and that went the other way and then we had another sale leaseback gain. So I think it's important for people just to understand what went on with gross margins this quarter when that changed versus an expectation for the things to be improving already. Thanks.

Sudhanshu Priyadarshi
So Lauren, this is Sudhanshu. So for Q4 specifically, we saw the pricing, it continued to build, but still lagged inflation, especially in the coffee segment. So that's the other issue. But our full-year inflation for last year was 16% that was higher-than-expected, as Bob mentioned during our script. So we've seen that relationship improving, but we did not see in coffee what we were expecting in Q4. But you're seeing that in relationship between pricing and inflation is improving and that's the reason we are committed that in 2023, our gross margin will expand.

Lauren Lieberman
Okay. And is that going to be a beginning in Q1, do you think? Or is it later in the year that that starts to kick in?

Sudhanshu Priyadarshi
It will be later in the year. As we said, we don't buy on spot, so it takes six to nine months to see the price included, but you will see that in the second half. And I talked about that in my prepared remarks. So you will see that in the second half, you will see the improvement in gross margin more as we will see the benefit of commodity…not deflation…

Robert Gamgort
Moderating.

Sudhanshu Priyadarshi
…but moderating inflation on commodity.

Robert Gamgort
Yes. And look, we have good visibility, obviously, for the early part of the year and what our commodity pricing is in the first quarter, and from a coffee perspective is where we see the highest inflation and then it improves from there.

Operator
Thank you. And our next question today comes from Brett Cooper at Consumer Edge Research. Please go ahead.

Brett Cooper
Thanks. Good morning. You've talked about the underutilization of your bottling system. I was hoping to get a sense of how much of a step adding in brands like Nutrabolt is to raising that utilization to your desired levels. Or is there more that needs to be done to get to where you want to be? Thanks.

Robert Gamgort
Yes. I think what we've talked about in the past is that we have a tremendous asset in our company-owned direct store distribution system with significant opportunity to run more high-quality volume through that system. When we do that, you get two benefits. You get the cost benefit, because you're leveraging that fixed cost against a higher base. And the second part of it is you improve your

effectiveness, because what that allows are higher drop sizes and more frequent store visits.

So the area where we've had the biggest opportunity was in C-stores. We're incredibly strong in large outlets, but our C-store business has been one where we have the most opportunity that's heavily driven by the fact that we had a gap in energy. And as you know, energy on a dollar basis is the largest segment within C-stores.

So C4 is a significant step in that direction. And it allows us to really increase our scale in the C-store area, which has the benefits I described earlier. And we feel like we're just getting started on that. That business has a tremendous trajectory for growth. And as we talked about before, we feel like we're not done yet in that space or some of the other areas where we have white space in our portfolio. So much more to come there, much more opportunity in front of us.

Operator
Thank you. And our next question today comes from Bonnie Herzog with Goldman Sachs. Please go ahead.

Bonnie Herzog
Thank you. Good morning. I had a question on your pod volumes, which were a bit weaker than expected in the quarter and did decelerate on a three-year stack basis for the full-year. So I wanted to better understand how you're thinking about this. And then your attach rates which are also declining, and I know you touched on this, but just more color there would be helpful.

I'd love to hear more about the changes you've seen in consumer behavior within the home and then ultimately, why you have the confidence that essentially attach rates might actually improve or accelerate this year. Thank you.

Robert Gamgort
Yes. Bonnie, what I think is most interesting is if we just take a step back and say, “Let's look at at-home coffee in total.” So we're a leader within at-home coffee, but we participate in this bigger category. I think what's most noteworthy in 2022, is there was a volume decline in all forms of at-home coffee globally, and single-serve actually grew its share of coffee consumption in the US. So from our perspective, on a relative basis, single-serve continues to outperform within at-home coffee. But at-home coffee volume decline was about 6% for the year. That's pretty notable.

Our belief is that the biggest driver of that is consumer mobility. If you look at the first part of COVID, as we talked about in December, you would see acceleration in attach rates. If you looked at it in the recovery period from COVID, you see a deceleration in attach rates. And what happened, especially in the second half of 2022 is that there was this global slowdown in volume of coffee that's driven, we believe, primarily by mobility, but on a secondary basis, it'd be driven by some elasticity, because there was significant pricing in there.

Why do we have confidence in this? Because the Keurig System continues to outperform year in and year out within at-home coffee. None of us believe that at-home coffee is a long-term problem. In fact, it has significant tailwinds. This is just an adjustment as people are spending less time at home, more time out of home. We know that the number one driver of at-home coffee consumption is time spent at home. And it's as straightforward as that, and we expect to see the recovery in the category of at-home coffee to occur as mobility improves throughout the year.

Bonnie Herzog
Thank you.

Operator
Thank you. And ladies and gentlemen, our final question today comes from Filippo Falorni with Citi. Please go ahead.

Filippo Falorni
Hey, good morning, guys. On the pricing front, can you talk about how much of your pricing plan for 2023 is carryover pricing from 2022 and how much is new pricing? And then in terms of the new pricing where it's concentrated, is it mainly on the beverage side or on the coffee side? Are you planning for price increases there as well? Thank you.

Robert Gamgort
Yes. The great majority of the pricing that shows up in our 2023 P&L is carryover from 2022, and I'll remind you that we took extensive price actions in 2022, and they did not flow through to the P&L all the way through in ‘22. So that's happening. We did take some additional pricing actions in the early part of ‘23 on our packaged beverage business to close some of the remaining margin gaps. So that will flow through as we move into the remainder of 2023, but that's all that we have planned right now.

CONCLUSION

Operator
Thank you. Ladies and gentlemen, this concludes today's question-and-answer session. I'd like to turn the conference back over to the management team for any closing remarks.

Maria Sceppaguercio
Hi, everyone. This is Maria. We are around today to take your questions. We'd love to connect with you afterwards if you have any. Feel free to call as usual. Have a good day.

Operator
Thank you, ma'am. This concludes today's conference call. And we thank you all for attending today's presentation. You may now disconnect your lines, and have a wonderful day.