Keurig Dr Pepper, Inc.

Second Quarter 2023 Earnings Call

July 27, 2023, at 8:00 a.m. Eastern

CORPORATE PARTICIPANTS

Jane Gelfand - *VP, Investor Relations and Strategic Initiatives*

Robert Gamgort - *CEO & Chairman*

Sudhanshu Priyadarshi - *Chief Financial Officer*

Maria Sceppaguercio - *Chief Corporate Affairs Officer*

PRESENTATION

Operator
Good morning, ladies and gentlemen, and thank you for standing by. Welcome to Keurig Dr Pepper's Earnings Call for the Second Quarter of 2023. 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 and Strategic Initiatives, Jane Gelfand. Ms. Gelfand, please go ahead.

Jane Gelfand
Thank you, and hello everyone. Earlier this morning, we issued a press release detailing our second quarter results. 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-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.

We will also speak about the concept of underlying performance, which removes the impact of non-operational items in the current and prior years. These items include gains on asset sale leaseback transactions, reimbursement of litigation expenses related to the successful resolution of our BodyArmor lawsuit, a business interruption insurance recovery and a change in accounting policy for stock compensation.

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.

Here with us today to discuss our results are KDP Chairman and CEO, Bob Gamgort, Chief Financial Officer, Sudhanshu Priyadarshi and our Chief Corporate Affairs Officer, Maria Sceppaguercio.

I'll now turn it over to Bob.

Robert Gamgort

Thanks Jane, and good morning, everyone.

KDP's second quarter once again demonstrated our portfolio's resilience and ability to consistently deliver on our total company commitments. Our solid performance was driven by strength in U.S. Refreshment Beverages, encouraging developments in U.S. Coffee, and continued momentum in International.

Consolidated Q2 results were healthy, with strong revenue momentum and sequentially accelerating operating income and EPS growth. Net sales advanced more than 6%, supported by net price realization, modest category elasticities and good share performance across much of our portfolio. For the first time since Q3 2021, reported gross margins expanded, as an improving balance between pricing, inflation and productivity began to emerge. Gross profit dollar growth funded marketing increases across all segments and helped to offset continued cost pressures in transportation, warehousing and labor. As we forecasted, we are in the early stages of a margin recovery that we expect to become more visible in the back half.

Looking ahead to the balance of the year, we are raising our 2023 net sales growth outlook to 5% to 6%. While our full year EPS outlook is optically unchanged, it, in fact, represents greater-than-originally anticipated underlying growth with an enhanced composition to our earnings profile. As Sudhanshu will discuss in more detail, we now expect minimal non-operational items in 2023, setting KDP up for a strong and sustainable earnings base from which to grow in 2024 and beyond.

U.S. Refreshment Beverages performance in Q2 was outstanding, with double-digit revenue growth and strong operating margin expansion. Similar to last quarter, category growth and our own momentum remained pricing-led, with limited volume elasticities across the portfolio. Though demand is resilient, we are mindful of the various pressures facing our consumers and are proactively meeting their needs through product and package innovation along with strong in-market execution. When these elements come together, we see market share gains. In Q2, these were most notable across our CSDs, sparkling water, coconut water and juice portfolios.

Even as price realization begins to moderate in the back half, we remain confident in our ability to drive attractive organic growth by creating value along three key dimensions:

First, by driving growth in core brands through marketing and brand renovation.

Second, by filling portfolio white spaces via innovation and external partnerships.

And third, by enhancing the effectiveness of our omni-channel selling and distribution system.

We delivered on each of these dimensions in Q2.

Focusing first on our core brands: For the second consecutive quarter, Dr Pepper was the largest share gainer in the CSD category, bolstered by the success of Strawberries & Cream and the continued strong momentum of Dr Pepper Zero Sugar, which was, once again, named a top two food and beverage product in IRI Circana's New Product Pacesetter innovation rankings. Squirt also continued to outperform, driven by its multicultural appeal, and in unsweetened sparkling waters, our partnership with Polar has now boosted the brand to the #2 volume share position nationally. We also brought significant excitement to our juice categories, where Mott's and Hawaiian Punch are driving innovation and gaining share.

When it comes to partnerships, our C4 distribution transition is proceeding well. 2023 is a year of transition and investment and, though it is still early days in our distribution rollout, we are driving gains across multiple metrics and remain confident in the growth potential of C4. In KDP-distributed geographies, total points of distribution had increased nearly 60% versus prior year and weighted weeks on display across large format food outlets were up nearly 15% relative to the beginning of 2023. These gains translated into continued velocity and share momentum for C4 and accelerated the brand's already-strong revenue growth even further.

Clearly, our partnership approach continues to create win-win outcomes, making this model increasingly attractive to other high potential companies, including La Colombe which I'll speak more about shortly.

The effectiveness of our selling and distribution engine underpins our success across all the examples I cited. I want to acknowledge the hard work our teams have done to drive improvement across the system where it showed signs of strain during the pandemic. Customer service levels are now significantly improved relative to where we were during the COVID period and, in some cases, exceed pre-pandemic comparisons. Though our work here is never complete, these strides are leading to even tighter in-store and on-shelf execution, as our market share momentum demonstrates.

Turning now to U.S. Coffee where, exiting Q2, we saw several encouraging developments that are expected to benefit segment performance over the coming quarters.

On our last earnings call, I identified three key tenets underpinning our expectations in this segment. First, that at-home coffee category momentum would begin to recover in the back half, as mobility comparisons ease. Second, that we would add approximately two million new households to the Keurig ecosystem in 2023, aided by brewer and pod innovation and the addition of new brands. And third, that segment operating margins would improve meaningfully in the back half, supported by a better balance between pricing, inflation and productivity.

We have even more visibility to these elements playing out today, with Q2 marking an expected trough in both top-line growth and margins. Let's address each point in turn:

First, as anticipated, at-home coffee category momentum began to improve towards the end of the second quarter and has continued to do so in July. The amount of time our consumers are spending at home this year versus last is continuing to normalize. Since we believe time spent at home is the single-largest variable driving at-home coffee consumption, it follows that volume trends are recovering too. We are observing this across broader at-home coffee, within which single serve continues to gain share.

The category recovery is very clear when looking at publicly syndicated data. In Q1, Keurig compatible pod volumes, a good proxy for the total single serve category, declined nearly 4% across measured channels. In Q2, these declines moderated to less than 2%, with improvement particularly notable towards the end of the quarter. Over the last 4 weeks, category volumes are flat to up slightly. Notably, category and KDP volume performance has been even stronger in non-tracked channels, such as e-commerce and unmeasured club.

The category trend is a positive leading indicator for our business, and we would expect sequential improvement in net sales growth in the back half. That said, we are prepared for our volume growth to lag the single serve category in the shorter-term as we focus on optimizing profitability. Pricing across all sub-segments of our K-cup portfolio is now more fully flowing through our financials, including from our partner brands, consistent with our previous expectation that pricing would catch up to inflation, but at a delay. We also exited some of our lowest-margin private label contracts. Both of these elements are now filtering through our results and the syndicated data.

Longer-term, our growth in U.S. Coffee will remain underpinned by driving incremental household penetration for the Keurig system and increasing revenues from our existing 38 million active households, which brings me to the second tenet of our coffee outlook: driving incremental household penetration.

In Q2, we furthered this growth strategy by elevating our presence in cold coffee, which is an important trend among younger consumers. This spring, we nationally expanded the K-ICED brewer platform and specially-formulated Iced K-cup pods, with strong marketing and activation activities across all media and digital channels, including a special, limited-edition Rolling Stones K-ICED brewer that sold out in less than 24 hours. These innovations are off to a very strong start, with the K-ICED brewer family performing extremely well and our Iced pods proving highly incremental to our base business.

And, just last week, we announced a strategic partnership with La Colombe, a super-premium and award-winning coffee brand with wide appeal and untapped potential. The partnership, which includes an equity investment, a sales and distribution agreement for RTD coffee and a K-Cup pod licensing agreement, is a compelling example of our ability to add value to a single partner across both hot and cold beverages, which KDP is uniquely positioned to deliver.

Our collaboration with La Colombe will encompass several exciting strategic avenues:

We will leverage our sales and distribution capabilities to scale La Colombe across the major retail classes of trade. Along with the Peet's brand, we are creating a ready-to-drink coffee platform, which will enable us to better serve the needs of our consumers and retail customers in this important category. We will also work closely with La Colombe to formulate and introduce the brand into the Keurig ecosystem in a K-cup format. Here, too, we are building a super-premium platform as La Colombe joins several recently added brands like Intelligentsia, BLK & Bold and Philz. Additionally, La Colombe's vertically integrated model and specialized manufacturing knowledge are other differentiated elements that could enhance our collaboration over time.

In short, this partnership has strong value creation potential that, when unlocked, will benefit both KDP and La Colombe through our joint ownership model.

Now moving to the third element driving our coffee outlook. We continue to expect segment margins for the U.S. Coffee segment to meaningfully improve both sequentially and year-over-year in Q3 and Q4. Multiple factors led to segment margin contraction over the last two years, and several elements, including sequential favorability in pricing, commodity costs and productivity, are now starting to come together to facilitate a margin rebuild. Pricing to offset cumulative inflation across our K-cup portfolio, including for partner and private label brands, will more fully flow through starting in Q3. Commodity cost pressures, including in green coffee and packaging, are also projected to ease, and efficiency benefits should ramp throughout the year as we have redoubled our productivity efforts following a period focused on mitigating supply chain disruptions. We will work to further enhance these elements going forward, with the expected back half margin inflection an important marker for future profit growth.

Our International segment continues to perform well, even as it begins to lap double-digit growth in the year-ago period. In Q2, Canadian volume momentum was fueled by non-alcoholic and low-alcohol beverages, where we have multiple brands like Atypique and Labatt gaining share. This is an exciting set of emerging categories, where we plan to leverage our learnings across markets. Execution also remains strong in our Canadian coffee business, where KDP manufactured pods grew consumption dollars and gained market share during the period. In Mexico, our DSD network continues to strengthen, which is supporting broad-based share momentum across our LRB portfolio and the ongoing rollout of our partnership with Red Bull. Across the portfolio, Penafiel and its "Ade" extensions into flavored sparkling waters, as well as our CSD brands, continue to perform very well.

Wrapping up, our consolidated Q2 results are yet another illustration of our Modern Beverage Company working to deliver strong, consistent and predictable company performance. We continue to develop

our business for the long-term through investments in innovation, partnerships and capabilities, while demonstrating our ability to work through shorter-term normalization in coffee.

We also continue to deploy our cash to create value for shareholders. You saw this via the equity investment in La Colombe and through the opportunistic repurchase of KDP shares, which continued through Q2 as our share price remained dislocated.

We are raising our 2023 outlook for constant currency net sales growth to 5 to 6% and reaffirming our guidance for Adjusted EPS growth of 6 to 7%, with an improving composition to our earnings profile. We now expect only minimal non-operational benefits within the framework of this guidance, implying double digit Adjusted EPS Growth on an underlying basis.

I'll now turn it over to Sudhanshu to discuss Q2 results and our balance-of-year outlook in greater detail.

Sudhanshu Priyadarshi

Thanks, Bob, and good morning, everyone.

We are pleased with our consolidated Q2 results, which represented another quarter of strong sales growth with reported gross margin expansion, both sequentially and year-over-year, and significant reinvestment in marketing.

Reported sales advanced 6.6% to $3.8 billion, with 6.1% organic growth reflecting strong pricing and a modest decline in volume-mix. Consolidated top-line momentum was driven by U.S. Refreshment Beverages and International, partially offset by a trough quarter in U.S. Coffee, which we anticipated.

Reported gross margin expanded slightly year-over-year to 54.8% as we made progress in offsetting ongoing inflation. This is an important change in trend after nearly two years. Even with continued cost pressures across transportation, warehousing and labor, we reinvested significantly in marketing, with increases across each segment. As a result, total SG&A as a percentage of sales deleveraged 40 basis points year-over-year. Adjusted operating income grew 4.4%, and additional below-the-line leverage helped drive Adjusted EPS of $0.42, 7.7% above prior year.

We continued to deploy our cash in accordance with our evolved capital allocation priorities. Over the past four quarters, we have opportunistically repurchased nearly 22 million KDP shares, including 7 million shares in Q2, in recognition of the significant long-term opportunity in our stock. Combined with our quarterly dividend, we have returned approximately $1.9 billion of cash to shareholders over this timeframe. In addition, since the merger, we have evolved our ownership structure to that of the Modern Beverage Company we are today, increasing KDP's public float from 13% in 2018 to 73% today. This includes the exit of Mondelez, which, earlier this month, completed its final sale of the long-term, strategic equity stake it took following the KGM take-private in 2016.

During the quarter, we continued to strategically invest in promising partnership and M&A opportunities, namely the $300 million investment we made in La Colombe announced last week. KDP's successful track record in scaling beverage brands and strengthening our leadership positions across our key categories make us a sought-after partner for high-potential companies and brand owners. We remain discerning and disciplined around such opportunities, seeking out only those that have compelling strategic merit, create win-win outcomes for both parties and provide significant value creation potential.

Turning now to segment performance.

U.S. Refreshment Beverages sales grew an impressive 11.8%, led by 12 percentage points from pricing, with virtually no volume/mix impact. This resilient volume/mix performance continued to reflect the strength of our portfolio, ongoing market share gains, manageable category elasticities in the face of significant pricing and the contribution from C4 Energy. Segment operating income increased 18.1% and segment margins expanded 150 basis points, as pricing and productivity benefits more than offset commodity, manufacturing and labor inflation and an increase in marketing investment.

In U.S. Coffee, sales declined 5.7% with positive pricing more than offset by anticipated volume/mix pressure, which I'll further explain now. Focusing first on the consumable pods business, as Bob indicated, we are encouraged by the improving consumption volume trends in the single serve category exiting the first half. We see this category trend as the leading indicator for the direction of our business.

However, in Q2, our reported pod shipment declines had yet to reflect any improvement, due to three primary factors. First, the category volume recovery began later in the period and therefore had a limited impact on quarterly results. Second, we lapped a period last year when we were replenishing retailer and partner inventories after supply chain disruptions, creating a difficult shipment comparison. And third, our consumption and shipment volume were impacted by our decision to exit some low value private label contracts.

We expect some lingering impact to our shipment volume from factors two and three as we move into Q3. Even so, revenue trends are projected to sequentially strengthen, driven by positive pricing and moderating volume declines.

On a trailing 12-month basis, brewer shipments declined 11% year-over-year. For perspective, our brewer volumes are still 18% higher than the comparable 12-month period ending Q2 2019, which represents a clean, pre-pandemic comparison. The point here is that, despite all the volatility of the last several years, the surging demand during the height of COVID, and the later stages of normalization we are now working through, demand for the Keurig ecosystem is greater today than it was four years ago among both consumers and retail partners.

Our Q2 brewer shipments declined 10.9%, a sequential improvement relative to Q1, and were impacted by the same factors we discussed last quarter. These include softer discretionary demand for small appliances, including brewers, which saw mid-single digit consumption declines, and additional, albeit moderating, pressure from trade inventory rebalancing. After two quarters of inventory adjustments, we believe these are largely behind us looking out to the back half. Importantly, Keurig-branded brewers gained share of all coffee makers sold in Q2, with recently launched K-ICED brewers seeing good traction in the market. We will further support these new brewers and highly incremental Iced pods in the back half, as we continue to expand our cold coffee platform and offerings.

U.S. Coffee operating income contracted 14.6%. At 30.1%, segment margins were similar to Q1 levels but 310 basis points lower year-over-year. Versus the prior year, this performance reflected a continued unfavorable relationship between pricing and inflation, as well as a significant investment in higher marketing, in part to support our ICED innovation launches.

Looking to the back-half of the year in U.S. Coffee, we forecast a gradual recovery in revenue growth coupled with significantly improved margins. This combination underpins our outlook for a strong

rebound in segment operating income, with positive growth in Q3 to be followed by very attractive gains in Q4.

Our International segment performance in Q2 remained strong, even as we lapped tougher year-ago comparisons. Net sales increased 10.9% on a reported basis, with constant currency growth of 7.0%. Net price realization contributed 6.1% and volume/mix was up 0.9% year-over-year. Segment operating income grew 11.5% on a reported basis and 7.7% in constant currency, reflecting the benefits of the growth in net sales and increased productivity, partially offset by inflationary pressures and a significant increase in marketing investment.

Turning briefly to cash flow: Free cash flow totaled almost $300 million in the second quarter. As we enter the seasonally more-cash generative back half, we would expect our absolute levels of free cash flow, as well as free cash conversion, to meaningfully improve from here.

This brings me to our consolidated outlook for 2023, which we updated in our press release this morning. Our outlook for constant currency net sales growth is now higher at 5-6%, and we continue to expect Adjusted EPS to grow 6-7%. While our EPS outlook is unchanged on the surface, the expected profile of our earnings is now further improved relative to our guidance earlier this year.

Specifically, you will recall that 2022 benefited from several non-operational items and, at the start of this year, we expected to reduce the use of these items by approximately 50% in 2023. I am pleased to share that our EPS forecast now includes only minimal such benefits. As a result, on an underlying basis, our EPS growth is now projected to be in the double-digits versus our prior expectation for a high-single-digit gain. This very strong underlying performance demonstrates the earnings power inherent in KDP's model. It is also effectively an increase to our 2023 growth outlook and will preclude any further upside to EPS expectations for this year, while setting us up for a strong and sustainable base from which KDP can grow earnings in 2024.

Our full year guidance includes the following expectations for below-the-line items. Interest expense in a $470-475 million dollar range; Equity method earnings from Nutrabolt of approximately $40-45 million dollars; An effective tax rate of 22% for the year; And approximately 1.41 billion diluted weighted average shares outstanding.

We have covered a lot of ground today, so I will just finish by remarking on the projected cadence of earnings for the balance of the year. Given the evolution of pricing, inflation and productivity, along with the timing of planned reinvestment over the back half, we expect only modest EPS growth in Q3 followed by very strong results in Q4. With a good first half in the books and enhanced visibility to the balance of the year, we are confident in a robust finish to 2023.

With that, I will now turn the call back to Bob for closing comments.

Robert Gamgort

Thanks, Sudhanshu.

If you haven't done so already, I encourage all of you to read our 2022 Corporate Responsibility report, which was published last month. Highlighted within its pages is the significant work KDP is doing to further our sustainability agenda. We are very proud of our progress across multiple focus areas, including in renewable energy, water stewardship and diversity and inclusion.

To close, Q2 was a very good quarter for KDP across multiple dimensions. Our performance in U.S. Refreshment Beverages was again exceptional and International posted another great quarter. U.S. Coffee is approaching an important inflection, with improved visibility to a significant margin recovery, which we expect to lead to strong operating income growth as we close out this transitional year for the segment.

On a consolidated basis, our efforts to offset inflation are increasingly evident in gross margin stability and marketing reinvestment across all segments, and, as we discussed today, our maintained full year guidance implies double-digit underlying EPS growth with an even stronger top-line outlook. These are all key elements to set us up for ongoing momentum in the back half and, ultimately, into next year.

I will now turn the call over to the operator for questions.

QUESTION AND ANSWERS

Operator
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're using a speakerphone, please pick up your handset before pressing the keys. To withdraw your question, please press star then two. We ask that you please limit yourself to one question and one follow up. At this time, we will pause momentarily to assemble our roster.

Our first question will come from Chris Carey with Wells Fargo Securities. You may now go ahead.

Chris Carey
Hi, good morning, everyone.

Robert Gamgort
Hi, Chris.

Chris Carey
So, clearly, we saw the results on a total company level, but at the same time so much of the debate has been around coffee and I think there's been a bit of a misunderstanding that the underlying consumption of the category has actually been improving through the year. And I think what I hear today is that that improvement has continued to accelerate through the quarter and into the quarter-to-date. And so, I just have a couple specific questions around that.

So first, why do you think that underlying improvement has been occurring? And really I'm trying to get to is some of the content of sustainability. Is it as simple as the away-from-home channel was recovering in the front half of the year and that's normalized and now the at home channel has normalized, as well?

And secondly, it sounds like you expect to remain below consumption in coffee into the second half of the year. Is that a Pod and Brewer comment? And just given the tough comps and you're making some changes to the portfolio, would you expect that dynamic to carry into 2024? Or is this predominantly a Q3, Q4 and then you've normalized from there? So, thanks for any perspective on just underlying durability of this improvement we've seen in the at-home coffee channel and also this dynamic of shifting to consumption and when you think you can start to close that gap over the next two to four quarters? Thanks so much.

Robert Gamgort
Okay, Chris. Let me start at a very high level with the total category, because I think that is most important. We've clearly weathered a storm over the past year or so that's impacted our category and our profitability within there. The negative impacts were on at-home coffee. We saw this category decline in all forms globally. And to answer your question, we have seen that as primarily driven by mobility changes. This is the post-COVID recovery mobility impact. That's largely played out. I think, by the end of the third quarter for sure that will be played out.

We also had some issues in terms of supply chain recovery coming out of COVID where it was a service at all cost mindset and we were also not focused on productivity and, of course, inflation, and that was combined with the lag in our pricing realization. And when you add that all up, that's quite a list of challenges in our coffee business over the past year.

If you look at what the setup is right now, it’s much more constructive. We're seeing a rebound in category and that's largely driven by normalized mobility.

To your specific question about away-from-home versus at home, away from home hasn’t changed that much. If you look at office occupancy, it's pretty stable. It's improving very, very gradually. Over time, if that improves, then we'll get the benefit from that on our away from home coffee business, but that's not something that we're banking on. It's really been an at-home coffee consumption story driven by changes in mobility.

So, we're seeing is rebound in category. As we talked about in our prepared remarks, we're seeing that pricing that we talked about that was lagged now flowing through the P&L, and of course we're seeing a moderation in inflation and the combination of that is very constructive going forward.

And one thing I would point out is that single-serve coffee has and continues to gain share of all forms of coffee over this time period.

In terms of our shipments below consumption, the best way to look at us over the long term, I am not going to talk about 2024 specifically, but our shipments share approximate category consumption over time. Our focus is on category growth. We have about an 80% share of all Pods that go through the system. Mix can change over time, but again we're focused on category. And I think you ought to just think about category rebound as being consistent with how we think about our long-term shift and trends.

But in the short term, we're looking out against a period a year ago, we were still rebuilding shipments from supply chain disruptions, so that's part of it. We've also talked about exiting some of the lowest margin private-label contracts and then we’ve taken some additional pricing on our owned and licensed. We think these are really the right decisions to prioritize margin recovery in a recovering category, and that's what causes a little bit of a separation between consumption and shipments in the short term. But there's no reason to think that's the case over the long term and really, I would point you to category consumption as the long-term indicator.

Operator
Our next question will come from Bryan Spillane with Bank of America. You may now go ahead.

Bryan Spillane
Thanks operator. Good morning, everyone. So, just two quick ones for me. Sudhanshu, just the flip of non-operational gains now not contributing as much, that's obviously good news. Is that a change in

just the way you're going to treat them, backing them out versus including or have things changed, so some of these financial moves like sale-leaseback are just not as attractive anymore?

And then the second one for you, Bob, is 2 million household penetration or new households, is 2 million new households in coffee brewers still a possibility this year? Or might that be little bit below that just given the current environment?

Sudhanshu Priyadarshi
So, Bob, let me take the first one. So, Bryan, no, as we said at the beginning of the year, KDP is focused on delivering best-in-class CPG performance. This also includes our enhancing of the composition of our earning profile. Last year, we had a lot of non-operating items. When we started the year, we targeted 50% reduction, but as you can see from our first half performance, our underlying business performance is great. We are also seeing the margin recovery in coffee in second half, so we have enhanced visibility. So, we believe that now we will have a minimal non-operating and we will deliver a better underlying operating performance this year.

This will also help us in 2024 because we will not have this roughly 50% of headwind from last year. It was roughly, I think it's more than $150 million, $160 million. We had half of that was this year. We don't expect to do that and that will help us in 2024 and beyond. So, there is no change. It's just our strong operating performance that we planned all along.

Robert Gamgort
Bryan, on the two million households, yes, it’s still our target for 2023. As we talked about a number of times, brewer sales are really a great predictor of household penetration. So, the two million is still where we're trending. The one thing I would point out is, as you know, we are heavily fourth quarter loaded, holiday season, gifting, we've done well in difficult environments…in difficult economic environments around that gifting because people go for more functional gifts during that time period. Our innovation pipeline, the promotions, the retailer support that we're getting for the fourth quarter, all looks terrific, but got a lot of game left to be played in the fourth quarter. But as we sit here today, we are targeting two million.

Operator
Our next question will come from Dara Mohsenian with Morgan Stanley. You may now go ahead.

Dara Mohsenian
Hey, good morning.

Robert Gamgort
Hey, Dara.

Dara Mohsenian
So, on the coffee side, you were very clear and comprehensive in your remarks on the second half improvement and what drives the improvement versus the first half. But in theory, it's a pretty big dichotomy. So, I guess it just would be helpful to hear how much visibility you think you have at this point in coffee, particularly relative to some of the first half disappointment, maybe rank order some of the factors you mentioned in terms of driving that sequential improvement. But also just longer-term, broader context for the volatility we're seeing this year and what you think it sort of means for future growth prospects, as we look out longer term.

And then I'm sure coffee will get a lot of the airtime as usual, but we probably would be remised if we didn't touch on the US refreshment and international strength in the first half of the year. How

sustainable do you think are the factors there that have driven the strength as you think about go forward trends from here? Thanks.

Robert Gamgort
Okay. I'll take both of these. I think it's always helpful, and I feel like I remind everybody of this on many of our calls, but I do think it's helpful to step back and look at the coffee category over the longer term. That gives you the best context. There's always short term volatility, particularly in the COVID and post-COVID world. But if you go back, and it's in our press release, if you go back and you take a look at pre-COVID 2019 to our latest period, the CAGR on Pods is mid-single-digits, CAGR on brewers is about mid-single-digits. And so there is a lot of bumpiness and it's been tough for all of you to navigate through the pluses and minuses over the past couple years. But that context is always helpful, and it always serves us really well to look at the longer term trends, which is this is a growing category driven by consumers converting from brewing by the pot to brewing by the cup. We are the drivers of that. Our partners benefit from that. Our retailers benefit from that, so does Keurig, because we participate in 80% of those transactions. So, that's the most important thing for everyone to always takeaway when you look at any quarterly results on the business.

In terms of the back half of the year and visibility, it's a really good question. The area that's been most challenging for us over the past couple years is predicting consumer mobility. And it's not a concept we even thought about prior to COVID, so to be able to match up consumer mobility against in-home coffee consumption we had to learn a lot there. And then also being able to predict it is really a difficult thing to do given the economists are having a tough time doing that. But I think that noise is largely behind us, which is the most important takeaway from this conversation, and we should see a normalization in category growth, as behavior from consumer perspective also normalizes.

The one area where we have had and still have the most visibility to is our margin. And I know that's been another area where there was pressure on the business that we explained as we look forward and we understand coffee pricing in advance, we understand our pricing and we also knew that the agreements that we had with our partners and our private-label partners as well is that we have the ability to recover inflation, but it had a lag effect to it. And there's only so much of that you can talk about before you want to see the proof and you're seeing the proof of that now flow through and we have great visibility to that in the back half of the year.

So, put it on the table, our assumptions for the back half of the year is continued slow and gradual recovery of the category in total. We have and continue to gain share of total at home coffee via single serve. And then an improving margin and that's driven by pricing flowing through the P&L, moderation, and inflation, and our ability to focus on productivity now that our supply chain is in really good shape across the board. Our customer service on coffee has been fantastic.

So, let me talk a little bit about refreshment beverages. It is a fantastic story that I'm glad you raised, because we certainly don't take it for granted nor should anyone else. What's been working for us is three factors. We've been gaining share in a growing category, and I don't mean to make light of it because each one of these is an important double-click, but it's driven by marketing, innovation, and really importantly outstanding retail execution. So, gaining share and growing category is always a positive thing.

Our pricing and productivity have been catching up to inflation. We were chasing inflation for a long period of time. We were able to narrow that gap. And I think importantly, consumer resilience has allowed the category to withstand all the pricing that was required to offset that inflation.

Now, last point is an area that we continue to watch very carefully. We're seeing in general elasticity hold up nicely. But we're seeing some greater elasticities in some of the segments within LRB that we will watch and adjust to. But, if I were to summarize the cold beverage business, growing margin and share, and growing category is certainly a formula for success. We plan to continue to do everything I just said, plus add new partnerships as we've done with C4 most recently and then more recently La Colombe.

Operator
Our next question is from Andrea Teixeira with JPMorgan. You may now go ahead.

Andrea Teixeira
Thank you. Good morning. I have a couple of questions to the Sudhanshu's point on EPS and then a question to Bob on the Pods. First on the flat EPS growth outlook for Q3, what would be the underlying growth ex non-operational items for the quarter because we understand there were no operational items in Q3 last year?

And the question for Bob on the Pods would be the shipment inflection. Should we expect shipments to converge to consumption in Q4? Or kind of like the embedding what the outlook that you gave for the fourth quarter? Or could you bridge the impact for the private-label exit, which is one of the factors that was a headwind in the quarter and also in the second half?

And sorry for the two-parted question, but on the price and improved mix as you exit this private-label, should we expect pricing to lap in Q3? Or do you expect to still have some benefit on pricing for pods into the second half of the year? Thank you.

Sudhanshu Priyadarshi
So, let me take the first one. First, I would urge you to think about back half in total with the cadence between Q3 and Q4 EPS as just a matter of phasing. Our second half growth is expected to be largely Q4 loaded, reflecting the expected flow of investment spend and the cadence of pricing and productivity relative to inflation.

In forecasting quarter three EPS, last year we had no non-operating items in Q3, we had some in Q4, which we expect to be minimal this year. But the reason it is modestly higher year-over-year, there are three key components. One is U.S. refreshment beverages, we are lapping the year ago pricing and we are forecasting heavier investments. U.S. coffee positive OI growth as margin begin to inflect in quarter three and then more to come in quarter four. So those are the two main reasons mostly driven by our decision to invest more importantly. But like I said, let's look at the second half and you will see that we have a strong EPS growth.

Robert Gamgort
Yes, let me reiterate what I said before, which is over the long-term consumption should equal shipments. There's no reason to believe it will be different. As is often the case, you see some separation between the two on a quarter-to-quarter basis. Clearly, there was a time period where we had supply chain issues in which we were under shipping, then we were over shipping to catch up on that.

What's happening right now in the back half of the year is exactly we said is we're seeing on a consumption basis a slow and gradual recovery. In the total at-home coffee category, single-serve continues to gain share of at-home coffee occasions which is important.

And then a couple things I should say that are unique to us, that is causing our shipments to be slightly behind consumption. One is how we're lapping some of the year ago timing of shipments due to recovery. We talked about all the license pricing, and we also talked about some private-label contracts that we exited, all in the direction of making sure that we're rebuilding margin and that'll play out.

So, we had talked previously, about for the year coffee being about up 1% in revenue, and 3% or 4% in OI. And if I look at the way things were playing out and it's hard to forecast it differently, we've got great visibility to margins, so we expect that to strongly inflect in the second half. And that's going to lead to accelerated OI growth. I'll talk about that in a moment.

I think the revenue number may come in somewhat below that on a reported basis. I don't think it's that big of a deal. But the other thing to think about though on the OI growth projection, even if that comes in slightly below that on a reported basis, for Sudhanshu's comments without any non-operational impacts, the adjusted segment on an underlying basis is even stronger than we talked about before.

So, you add it all up and you say the back half of the year there may be some puts and takes here, but the underlying strength of the business is really, really improving and anything that's off any of these projections is really driven by some intentional strategies we put in place.

And then the last thing I would talk about our coffee margin is, there are four drivers of that margin which is pricing, inflation, and productivity and mix. And clearly, we're seeing the pricing flow through. You ask about the second half versus first half, we had virtually no pricing coming through from partners and private label in the first half. That's just starting to flow through in the back half of the year and that will ramp up. And yes, there's some trade-offs in mix and some of the other parts on here, but we have good visibility to improving margin going forward.

Operator
Our next question will come from Lauren Lieberman with Barclays. You may now go ahead.

Lauren Lieberman
Great. Thanks. Good morning. I was hoping we could maybe take a step back and do something a bit educational on coffee. So, in the Nielsen data, I know you guys are more oriented toward IRI, but in the Nielsen data you can see that owned and licensed brands within pods has been losing share and I think that's garnered quite a bit of attention from the investment community. So, I was hoping you could talk about, I know that you've said historically you manage the margin profile of owned and licensed to be comparable to that of partner, but I was curious if you could talk about why we should or shouldn't worry about that from a dollar profit contribution over time and how you manage sort of the, let's call it, the potential conflict of interest with partners versus what's owned in terms of market share and so on and how you manage that relationship?

Also, Bob, you'd mentioned pricing on owned and licensed and I just wanted to be clear if that was new pricing that's recently gone in the market or if that's still to come?

And then finally, I know that inventory destocking for Pods at retail had been a potential watch point that hasn't come up. So, I'm assuming it's a non-issue, but I just wanted to check in on that front, as well. Thanks.

Robert Gamgort
Sure. Yes. Thanks for the opportunity for me to talk about the way the system works. So, again, I go back to the very beginning and say that what we manage is an ecosystem that involves our brands, our partner brands and private-label brands, or retailer brands. And it's really important that retailers are

considered to be a partner in this whole ecosystem as well because, conversion of brewing by the cup benefits all of the interested stakeholders in this.

Our objective is really focused and hasn't changed, which is we want to have a growing system. We want the category to continue to expand. We want the dynamics of that category to be constructive for everybody. Part of that is managing our own brands, which we manage very separately from our partners, so there is no conflict of interest. We manage those as a separate group within our organization that has no visibility into what our partners or private label are doing and it allows us just to maintain focus on the category.

For us, we see the opportunity for more pricing within our brands, within the category. If you take a look at our price gaps versus other forms of coffee, even though there's been pricing in the single-serve segment, the price gaps versus all forms of at-home coffee right now are the narrowest they have ever been. And in fact, we do believe they are at a point where it's actually not doing anything to drive category growth.

Partners, and that includes some of our retail partners and their private-label brands, sometimes they have short-term objectives that are more share-driven. So, we see some of that promotional competition and that shift share between one brand to another, but it really does nothing for the category, which is our focus. And so that's why when I take a look at our pricing, it comes back from being more restrained in the promotional environment, which allows us to protect margin. And again, if you go back to the highest level, the rational decision for us to make is to improve our margins in a growing category.

And then, you did point out something about if owned and licensed brands are losing some share, it might have some negative in mix impact. Fair enough that mix isn't as great as some people think it is as we said before. But I would then also point out that we're looking at pricing inflation and productivity. And the reason that people should believe that we're not concerned about that difference of share is the visibility that we're giving you to improve in margin going forward.

If it were a heavy negative impact on our business, we wouldn't be able to do that. So, we understand all these levers of pricing inflation product to be a mix. And sometimes you have to trade out one for the other. We can do that for the long-term health of the system and the growth of the category, which is what we are focused on.

And then your last point is about destocking of pods. It's not something that we've seen at retail and nor do we expect to see anything of that nature.

Operator
Our last question will come from Steve Powers with Deutsche Bank. You may now go ahead.

Steve Powers
Yes. Hey, good morning. Thank you.

Robert Gamgort
Hey, Steve.

Steve Powers
I wanted to ask on the free cash flow conversion. Sudhanshu, you talked about the improvement to come which is great. I guess is there a way to frame where you think you'll land on conversion for the

year? And as we think ahead, is there any reason that a return to 100% free cash flow conversion or thereabouts is too ambitious for ‘24 and beyond?

And I guess, within that, are there any changes that you're thinking about or that you’ve implemented more structurally with regards to supply chain financing that’d be useful to know. Thank you.

Sudhanshu Priyadarshi
So, it's a great question. As you know, KDP has been highly cash-generative since merger, and we expect to continue to generate significant free cash flow going forward. In our first half, our cash flow generation was lower primarily due to two factors versus last year. One was the lapping on some discrete items and also our proactive choice to selectively reduce a portion of our supplier financing program in a less attractive rate environment.

So free cash flow conversion will be significantly higher in the second half versus second quarter and also first half. Though for the year, it will improve somewhat below 100% for the full year. But, as you know, we look beyond 2023, we continue to target industry-leading levels of free cash flow conversion. So, there's not too many changes. We are still generating a lot of cash. It’s a second half business. You will see it. But we are making some proactive choices with supply chain financing that was very attractive in a low-rate environment, but now it's not that attractive.

Steve Powers
That last point, are you done with those changes? Or do you anticipate there may be still changes to come given where rates are and where they may go?

Sudhanshu Priyadarshi
No. So, we look at it more as the overall capital allocation policy and we have our goal to maintain low leverage, but we generate a lot of cash, so we make those decisions case-by-case. So, I wouldn't say that supply chain financing the number will become zero, but yes, we're looking at case-by-case it’s gradual and we are looking at the benefit, it also has a benefit on operating income.

So, in the beginning, you feel the most pain is the working capital has a short-term pain, but in the long run, it’s beneficial and we make the right economic decision. So, it's case-by-case. Supply chain financing is a proactive choice. We are making the decision based on where we see it is a better economic benefit. But it's gradual and it will not happen everything this year, like we will not reduce everything this year. It will continue for next couple of years. It will be a gradual reduction.

CONCLUSION

Operator
This concludes our question and answer session. I would like to turn the conference back over to Jane Gelfand for closing remarks.

Jane Gelfand
Thank you, everyone. We appreciate your time and attention on what we know is a busy morning. And the investor relations team is available should you have any follow-up questions. Have a great day.

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