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The Coca-Cola Co. (KO)

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MANAGEMENT DISCUSSION SECTION

Dara W. Mohsenian
Analyst, Morgan Stanley & Co. LLC

Good morning, everyone. I'm Dara Mohsenian, Morgan Stanley's Beverage and Household Products analyst. And we're very pleased to have Sandy Douglas here, Coke's Head of North America with us today. North America has really been a success story for Coke in the last few years. Year-to-date revenues growing at 3%. I think, most of us would have been skeptical about that a few years back, and it's really one of the geographies that showed sequential improvement in the Coke portfolio.

So, it's a great time to have you here, Sandy, and thank you very much for coming. I'll turn things over to you.

J. Alexander M. Douglas
Executive Vice President and President, Coca-Cola North America, The Coca-Cola Co.

Thank you. Thanks, Dara, and good morning, everyone. It's fun to come back to this conference each year because several years ago, we were talking about what we were going to do. Last year and the year before, we were talking about what we're doing, and now I'm able to talk a little bit about how it's working and what we're going to do next. And so, the accountability part appeals to me, Dara. And so, we appreciate being hosted by you and everyone attending the conference.

I'm happy to tell all of you that we've continued to make progress since I spoke with you the last time. 2015 was a very strong year for our flagship North American market, and we've continued to build on that momentum in 2016.

Before I get started, though, I'm going to say that this presentation does contain statements, estimates, or projections that constitute forward-looking statements as defined under U.S. federal securities laws, and so you should be guided by the usual cautionary statement.

But let me start with a slide that actually on one piece of paper tells the whole story. It talks about how our North American business model for beverages has evolved over the past 10 years and how that evolution has not only begun, but it's begun to lap and lap again, truly sustainable leadership growth. Essentially, what this illustration shows is how we've evolved the business to operate in a rapidly changing external landscape, and at the same time, adapt in a very intimate way to the changing consumer preferences that are rapidly changing the marketplace in which we compete. Our business metrics are the crucial logic of the business. These five metrics define the guidepost for our business strategy and our execution. Notably, it's led by revenue. Revenue with tension for incidence or household penetration and frequency, and then velocity on the side of transactions.

Our view is that this is the best way to measure growth, to strategize about growth, and ultimately, it follows the consumer in every sense and therefore defines success by what the consumer is willing to spend money on. Obviously, margin growth is the oxygen of the business and reinvestment, and then value share, which defines whether or not we're winning in the category. But all of these metrics come together and they're a logic for strategy, for operation, for execution, and they significantly replace the volume-focused model of a couple of years ago.

We have significantly expanded our portfolio, which now consists of four major brand clusters with clear strategies, clear strategies for growth in each. We've overhauled our sparkling strategy with a segmented revenue approach, focused on selling the right size packages at right prices and almost always smaller. The consumer has spoken, and the consumer loves smaller packages of sparkling whether it's to manage sugar or just have the right amount for a given occasion. And that allows us to evolve the segmented approach with pricing. So, we're able to put the exact – correct portfolio of brands in packages in the right place to serve a wider variety of occasions with a consistent and disciplined approach to rate, price increases.

Next box is premium still beverages. This has been an area of tremendous overhaul in the company. 10 years ago, when I started in this job, we had a long way to go and we set the goal in the short term. While we were a long way from being big, we wanted to be the fastest growing. We pursued the strategies through a number of key acquisitions led by the glacéau acquisition of vitaminwater and smartwater, but strong organic growth as well with brands like Gold Peak and DASANI. The net effect is that our premium stills portfolio today is a crucial part of our growth engine, and our ability to complement a growing sparkling revenue with even faster growth in the premium still category.

Next is an area that I call farm to table, and it's an increasingly important focus for us, as we follow consumer trends. And we have some strong legacy brands here, Minute Maid and Simply, but we're also leveraging external partnerships and investments to move into the fastest growing categories like value-added dairy and organic juices and smoothies. This business for us, which began in the early 1960s when we acquired the Minute Maid Company, and you'll remember the frozen Minute Maid orange juice, has transitioned to be a dynamic growth part of our portfolio, and we have huge aspirations for further growth there.

And then finally, in the box on the right is our energy brands, which we have intentionally outsourced to a company that's really good at energy brands, and we've built a global partnership that you're all familiar with.

We're delivering these strong brands through three muscular routes to market. I mean, when you think of our DSD business, we talk a lot about it, we're in the middle of refranchising now, taking a company-owned bottler and refranchising it out to the best local franchisees whether they are existing or new. When we're done, a third of our local bottling business will be owned by minority owned ownerships. Tied together through a comprehensive new contract, renegotiating a 120 year-old franchise contract, at the heart of which has a change in the way that the company gets paid. In the old days, we used to get paid for gallons of concentrate, that's where the volumetric came from. And today, our bottlers will compensate us only as a percent of their net revenue which makes it possible for us to align in a coherent way, a strategy that's focused on revenue and not volume.

Our bottling partners are also knitted together by a common IT system, by a common supply chain system. But together, they make up local businesses closely tied to the pulse of their communities and the refranchising process continues dynamically and has proven to be a source of short term as well as long-term growth. And then finally, in the middle, you see our chilled business. We're building this out now to be capable of managing multiple brands with an ambition to be the leading chilled beverage company in America over the years to come. And then finally, our foodservice and fountain business, which was our original business, and it's an area where we have significant strength as you know.

Underneath the three routes to market are two world-class customer management organizations, translating into strong brands and advantage routes to market into differentiated value for our customers with one strategic Coca-Cola voice. And then finally, at the bottom, it comes together with one core strategy, which we've shared with you every year that we've been here, which is focused on the action of building strong brands, the wellspring of our value, creating real value for our customers and building the capabilities to sustain and repeat our success.

We believe that in total, this diagram and the boxes within that each present dynamic opportunities for growth, for innovation and for change to follow the consumer, and it is being executed by a great team of people down in Atlanta and across the country, innovating, marketing, selling, and executing across the U.S. every day.

So let me, if I can, tell you a little bit more about why I'm optimistic, not only about the performance we've been having, but the short, medium and long-term potential here in our home market. First, our industry continues to be a very healthy one in North America. When you look across the FMCG space and the beverage industry, you see beverages playing a top-tier growth role really across consumer products. And within that, The Coca-Cola Company has been growing retail value faster than any other consumer goods business, or large one at least.

Since 2014, we've consistently outperformed overall U.S. retail growth and we've grown value share in our business over both the five and 10-year horizons. This value share growth comes from our consistent strength in sparkling beverages and our commitment to revenue growth in sparkling beverages even as packet sizes predictably come down and volume is slower. But it also reflects the significant focus that we've put against building a very strong and competitive still beverage portfolio. The evolution of our model along with the disciplined execution of the core strategy are why we've been able to maintain consistent top tier growth for the last few years. So let me focus a little bit more on how we've arrived here, and why we believe we can maintain this momentum well into the future.

I want to spend time on this discussion really focused on innovation, and that rightfully starts with sparkling. Typically, we think of innovation as just new products, but in fact new approaches and new packages are often innovative opportunities for growth. And I know you're looking at this slide and those of you who are veterans of this conference are saying, oh no, he's going to go through the packaging slide again. The point here is not to make you go through a long-winded approach, but instead just to show you that what we said we do, which is to follow the consumer to smaller pack sizes, is in fact what we're doing.

And one of the questions we get asked a lot is, well, how much runway is this? I mean, if two years ago we were here and we were talking about 12% up from a 10% and now we're sitting here looking at year-to-date these smaller special packs are 15%, where can this go? And the honest answer is, I don't know. What I believe, however, is a long way. I think the consumer wants to have just what they want, whether it's with sugar products or zero calorie products or somewhere in between, and the ability to execute proprietary special packaging to the perfect location in the market has a lot of runway for growth going forward, and continues to grow nearly at double-digit rates in our portfolio.

If you look at all the trends and think about it, where can we go in the future, you think about the marriage of advertising and food occasions and small packages and proprietary packages, and there really is an option for every consumer, and it just comes down to having the right size. And you'll note on this slide, we've included not only Coca-Cola, but Fanta and Sprite and our other major sparkling brands. So, we still have a lot of growth opportunity to capture. And as you can see, as I mentioned, the transaction packs only make up 15% of our portfolios. So, getting better at small will continue to be a big bet for us going forward in this very large and important segment of our business.

When you take a closer look at our sparkling brands, though, I typically spend time with you on Coca-Cola, today I want to focus a little bit on our flavors lineup; Fanta and Sprite, who had two fantastic years, with over $100 million in retail value growth on each brand in the last two years, which is equal to 4% growth on Sprite and 15% average annualized growth on Fanta.

We are focused on capturing the full potential of these brands as well, by executing that same occasion, price, packet strategy and innovating with both new flavors and new packet sizes. For example, we've been consistently stretching our Sprite flavors portfolio with great tasting new flavors, two examples of which are Sprite Cherry, which is freestyle sourced flavor innovation, that's something that came out of our freestyle machine that consumers were making in fountain. We saw its velocity and we put it in bottled can. And then Fanta Blueberry, which launched last year and has contributed nearly one-third of the total growth of the Fanta trademark year-to-date in 2016.

We're also launching compelling new marketing to support these brands in our new Wanna Sprite campaign that LeBron James has done with us. It's a great example of how we're leveraging the power of the Sprite brand, coupled with the strong celebrity endorsement to fuel the brand's momentum.

We love how this unique campaign taps into LeBron's humor and personality to speak to the Sprite drinker in a real and authentic way, a way that's unique to the Sprite consumer and their desire to make their own decisions. Let's roll the ad.

[Video Presentation] (14:22-14:53)

Thirsty? I am. So, let me focus now on stills, where we have very strong brands with significant momentum, but obviously a tremendous future growth opportunity to expand and innovate. For the past several years, we've been working to scale and improve our position in the well established categories, including juices and juice drinks, water, tea, and coffee, while also expanding into new categories, particularly in the farm to table space. So let me share some progress on all of those fronts.

In the past three years, we've grown our total Nielsen measured retail value by $1 billion. $300 million of that growth has come from our strong sparkling portfolio, but $700 million of that growth, or two-thirds, has come from our stills portfolio. Today, our stills brands account for more than 40% of our retail portfolio, which is increasing year after year, and is up three points over the same timeframe.

And these still brands are continuing to grow at strong rates with strong growth across many major categories. Our glacéau portfolio has been a standout this year, led by double-digit growth, again, on our smartwater business. Smartwater just became our company's 12th billion-dollar brand in North America. So, we're excited about the brand's potential to capture more growth, particularly as we move into a sparkling format.

We're also leveraging the strength of our well-established still brands to fuel innovative pipelines. With our momentum in smartwater and with DASANI continuing to grow as the leading U.S. water brand, we're well-positioned to compete in the fast growing sparkling water category. We see huge opportunity here with two very high quality great tasting products, smartwater sparkling and DASANI Sparkling, and we see growth for many years to come in those brands. We're also expanding Gold Peak, our billion-dollar ice tea brand into the ready-to-drink coffee category, which has been growing by double-digits annually since 2011 and shows no signs of slowing down.

Early next year, we'll launch two flavors of both cold brew coffees and bottled tea lattes. And we've also recently signed a deal to produce, distribute and market a line of Dunkin' Donuts branded ice coffee beverages, which will be sold in grocery stores, convenient stores and in Dunkin' Donuts restaurants. Ready-to-drink coffee will become a big bet for us, a competitive opportunity with tremendous growth. And we have more news to come.

And while we continue to scale and innovate within our established still brands, we're also tapping into new fast growing categories like our investments in value-added dairy with fairlife and cold-pressed juices and smoothies with Suja, both of which are enjoying double-digit growth this year. And these are just a few of the latest investments to come from our Venturing & Emerging Brands unit, a unit that will become 10 years old next year, a unit that is solely focused on identifying and nurturing our company's future billion-dollar brands.

So, let's take a look at a quick video all about what our people in Venturing & Emerging Brands are doing for our future.

[Video Presentation] (18:20-21:27)

As you can see, we're putting a lot of effort around innovation and building a strong and leadership growth position in still and new beverages. And in parallel, we've also been working on our business model that focuses on brand building and customer value creation driven by an empowered franchise system. Refranchising our company-owned bottling operations in North America has been a strategic focus of ours for the last six years. And because we believe so strongly in the model, we're committed to accelerating, refranchising and completing a 100% of it by the end of next year.

As of this month, we reached definitive agreements or signed letters of intent to refranchise territories that account for approximately 65% of total U.S. bottler-delivered distribution; volume which equates to 71% of the acquired CCE volume. The map on the screen provides a visual illustration of where we are on that journey.

So the next logical question is, well, how is it going? How are the new expanding bottlers doing? And the answer is, excellent. Our system, sure, with every implementation we're doing a new ERP installation, people are changing, systems are changing, and so it's a high-touch operation. But net-net, I can tell you that the distribution territories that have been refranchised for 12 months or longer are thriving, and the majority of these partners have taken their territories to a higher level and refranchising has actually been a growth tailwind for us. And we remain confident, while we have much to do in the next few months between now and the end of 2017, that we will continue to make these transitions a success.

Additionally, as we implement the IT systems, we're also installing a new customer management model that drives decision-making and rapid partnership with our retail customers. We've implemented a new product supply group, which provides governance to ensure quality and efficiency and speed and agility in our manufacturing, while maintaining scale and benefits in our refranchised model. And we're confident that all of this comes together, this has been tested and worked on for much of the last year in the various stages or last decade in the various stages, they will not only work, but continue to work.

In fact, our customer service and satisfaction scores are the highest they've been in years. Our retail partners are telling us that our process is working through two key industry surveys that I think you're familiar with. In this year's U.S. ADVANTAGE Report, we were ranked number one out of 19 companies for the core channel, which include grocery stores, mass merchandisers, club stores, and value stores. This is actually the first time that Coca-Cola has been ranked number one in customer satisfaction.

And then in this year's Kantar Survey, Coke was ranked number two among all – by all top U.S. retailers, up from four and up from 11 ten years ago. I don't have to tell you that PepsiCo was number one, so we're in for the battle of customer satisfaction as well as the battle of beverages and snacks, and we're in good company in this leadership growth category where we compete.

So let me conclude by summarizing that we see the North America business as a winning business. We see it as a preamble in some respect for The Coca-Cola Company's journey. Muhtar and I and James, as he's joined, have focused on taking early steps to harvest the work that we've done over the last 10 years to cultivate the brands, the categories, the system, ultimately, the design of this business model for growth. We had it begin to work at the end of 2014. We've seen strong results in 2015 and year-to-date this year, and we have a lot of confidence that, as we look ahead, that our best days are ahead.

And the way I would close it with you is this. If you go into one of our brand teams or our customer teams or franchise teams or one of our bottlers or VEB or the innovation area and you ask them honestly, where do you stand versus the opportunity you see? What they would tell you is they stand farther away from the end than they were last year.

The beverage business is a wonderful business. There is always going to be challenges, but the consumer is always going to look for great tasting drinks to move about their life. And the success, the value will come to the business that can move with them to be there with great solutions, can work with customers to generate value, and do it efficiently so that you can generate value for shareholders and we expect to be one of those players.

So, Dara, I'm ready to answer questions.

QUESTION AND ANSWER SECTION

Dara W. Mohsenian
Analyst, Morgan Stanley & Co. LLC

Q

So I'll jump in with the first one here. You mentioned excellent performance so far when you've had bottling transitions that outside the CCR system, which is a bit odd conceptually, given you've had system changes, people changes, et cetera. I mean, normally, when there is a transition, there is some level of dislocation or hiccups. So, given the performance has been strong so far and you've seen a tangible improvement, what should we expect kind of year two, year three as you go through some of these transitions? Do you expect to continue to see a building process? And also maybe what would be helpful is to know where things kind of came in versus what you originally expected as you went through these transitions?

J. Alexander M. Douglas
Executive Vice President and President, Coca -Cola North America, The Coca-Cola Co.

A

Sure. Everyone in here has a crystal ball that's probably better than mine, but the opportunity that these bottlers see as they take these territories is why in every one of the territories there were three or four people that wanted to buy them. And it gets to the essential narrative I just went through. Non-alcoholic ready-to-drink beverages are a great business. We have a good partnership model in the Coke system and bottlers want to be in it.

When they take over these territories, there is a lot of executional complexity, although we're getting better at it because we're repeating it. But there is a tremendous infusion of energy and capital and confidence that happens in these territory transitions. And the best Coke bottlers and the best new bottlers have been selected carefully to take over.

And so, the way I always tell the story about bottling is, you've kind of listened to me so far today talk about the brand and the big customer angle, but in every one of the 50 states in the United States, there's over a 100% difference between the large per cap and the small per cap town, every one of the 50 states. And you think in the age of the big retailer that would've narrowed, but it hasn't.

And what differ there, way back when we were driving horses and pulling trolleys in the franchise systems, the franchise size is how far you could get out and get back before the sun was down, There were 1,350 coke bottlers then. And the difference was not the advertising, it was the same. It was not the product, it was the same. It was the local connections, the relationships, the execution, the philanthropic efforts that define that bottler versus their neighbor or their cross state person, and that's still true.

And so these bottlers who enter into these local communities are doing an excellent job. And my own view is that their opportunity is as big as every opportunity I described. The consumer simply wants beverages, maybe less sugar, maybe less bubbles, maybe less ounces, but they want them and they want them where they want them. And our bottling system is designed to deliver that, but also to work together when they have to have scale.

And I think we get the best of both worlds in our system and we've been really careful to design it that way. That's why, in some respects, I've always sort of look forward to this day because there were a lot of questions a few years ago about why can't you do this faster and I kept saying, trust me, when we get this right, you will be glad we did, because you will have a lot of confidence in the growth potential and that's what we've been producing and I think we'll continue to do so.

Q

Sandy, you mentioned price architecture and refranchising and all these things will help margins when you're getting pricing, but just on the area of cost cutting, I don't think you really kind to went into anything in great detail and there's kind of a revolution going through this industry to try to get G&A down, what are you doing?

J. Alexander M. Douglas
Executive Vice President and President, Coca -Cola North America, The Coca-Cola Co.

A

Yeah, great question. Let me cover that on three levels. One is the natural restructuring of The Coca-Cola Company as we go to our franchise model of the future, which is asset-light, and obviously, the margin structure, the operating margin structure and the economic margin structure of the company changes radically when we return to our core business model.

Within that though, the core model, which is essentially what I manage in KO North America is part of the company's multibillion dollar productivity initiative that Muhtar and James talk about in each quarter on the call, inside of North America, we push it a little harder because a few years ago, I felt that we were underinvested in equity investments and marketing. And so, we not only had to meet the thresholds that were coming through our external productivity program, but we actually had to employ our version of sort of zero-based budgeting, because we wanted to get hundreds of millions of dollars over into front-facing advertising and equity investments, so the people in their [ph] heads (31:44) knew what all these brands were. And we've done that, a significant multi-hundred million dollar shift from less important to more important while also playing our role in the company's productivity program and then in parallel to that through the refranchising dramatically changing the economic and operating cost structure of the company.

But from my point of view, cost and waste have to be the enemy of every executive and you have to be chasing it constantly. But that doesn't mean that it's always just for short-term operating margin. Sometimes you have to share it with operating margin and a little bit of growth, and getting your business growing has been the kind of economic turbocharger of the business I've been describing.

Dara?

Dara W. Mohsenian
Analyst, Morgan Stanley & Co. LLC

Q

Right. So, you laid out that from a stills standpoint, clearly, you've expanded your portfolio over time. As you look at it today, are there any big holes on the still side that you think you need to fill in, or do you think from an organic standpoint you generally have what you need to have success in that category over time?

J. Alexander M. Douglas
Executive Vice President and President, Coca -Cola North America, The Coca-Cola Co.

A

Yeah. I – I mean, my view is that value-added dairy and ready-to-drink coffee were two areas where we saw a tremendous amount of opportunity where we're in the very early stages of working on that. I don't see anything big that's a hole that would lead us to some kind of disruptive acquisition there. I think what the VEB unit does and – is that a lot of really good innovation in beverages happens in the seams between categories. So, vitaminwater was one of those where it's a fruit-flavored water with vitamins, and you didn't expect that to happen there and that became a huge business, or smartwater which kind of sits between sports drinks and water with electrolytes.

Lot of innovation is happening in the beverage category. I mean, thousands and thousands and thousands of new products are launched every year, and VEB's job is to watch all that. So, you're seeing beauty entertain beverages. So, we've got a product called Aloe Gloe, that's one of our investees is working on. We'll see more and more of that I think and more and more experimentation. But in terms of big existing chunks of the portfolio, I think we're more in an organic mode now. But we have an awfully long pipeline of innovation that's working and contributing a significant part of our growth right now.

Dara W. Mohsenian

Analyst, Morgan Stanley & Co. LLC

Great. And with that, I think we're out of time.

J. Alexander M. Douglas

Executive Vice President and President, Coca-Cola North America, The Coca-Cola Co.

Great. Thank you, everybody.