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The Coca-Cola Co. (KO)

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MANAGEMENT DISCUSSION SECTION

Steve Powers

Analyst, Deutsche Bank Securities, Inc.

All right. Good morning. Welcome back. I'm Steve Powers, the U.S. Beverages, Household and Personal Care and Tobacco Analyst at Deutsche Bank. And we're thrilled to have back at the conference The Coca-Cola Company and new CFO, John Murphy. John is going to run us through a presentation for about 30 minutes, and then we'll have time for a bit of Q&A at the end.

And with that, I'm just going to hand it right over to John.

John Murphy

Executive Vice President and Chief Financial Officer, The Coca-Cola Co.

Good morning, everybody. Nice to be here. Let me start with the usual forward-looking statements slide to run through. Three topics, I'd like to cover today. First of all, talk a little bit about the context for us becoming a total beverage company; secondly, how we are creating a platform for sustained performance to deliver against that ambition; and then thirdly, how that's translating into our shareholder value of both in the short and longer term.

Starting point for the beverage company concept is the industry that we're playing in. We compete in a great industry. We believe there's a compelling opportunity, it's multi-category $1.5 trillion base. It has been outpacing the growth in other consumer product categories over the last three years which we expect to continue, and one of the elements that we believe is especially attractive about our industry is it's diversified across multiple channels with strong pricing power both in the developing and in the developed world.

The long-term growth potential for both the industry and indeed for our company within the industry is significant. If you think about the world divided into developed markets versus developing and emerging, on the left hand side, here you can see that commercial beverages represents approximately 70% of beverage consumption in the developed world. We have a 21% share of cold beverages and we have a very small position today in hot beverages.

On the flip side, when we look at the developing and emerging world, it's little bit the reverse. About 30% of beverage consumption is commercialized-only and our share position within that is about half of what it is in the developed world. So either in terms of absolute growth potential or relative performance in both the developed and the developing world, the opportunity is significant. As a company, we like to say we're 133 years young. We're building on some pretty strong foundation in that regard.

Over the last number of years, we've seen an ongoing diversification of our portfolio. And while today our core business is still predominantly in sparkling soft drinks, we've made consistent progress on some of the other growth categories, namely juice, hydration, teas and coffees. We have actually a strong global position in a number of these categories. We're number one player in sparkling; juice, dairy, plants; hydration; tea and coffee and with our partnership with Monster, number two player in energy.

One of the great benefits of our business model is the partnership we have with our bottling partners around the world and that's allowed us I think to develop a very unique footprint globally with, however, a local touch and local connections to those markets. We've got over 225 bottling partners today. We operate in over 20 channels. We have a pervasive presence in over 28 million customer outlets and a significant investment and competitive advantage with our cold drink presence in those markets.

Over the last couple of years, James has talked a lot about building a platform for sustained performance for some time to come. And I'd like to touch upon some of the pillars that underpin that platform. I'm not going to talk a huge amount today on some of the enablers, particularly the growth culture that is so important to foster to enable these platforms to come to life but they are – it is a key part of the overall equation.

Let me talk about each one, the work we're doing around portfolio, growth and expansion; how we're working with our bottling partners to bring this to life around the world and with a company who is expected to play an outsized role in the communities in which we operate. I think the collaboration that we are building and that we enjoy with many stakeholders is something that's important to highlight also. So on the portfolio, there's three elements to our portfolio expansion approach that I think are worth highlighting.

First of all, we continue to invest and to leverage the innovation that we develop in our global network around the world. We have innovation centers based in Shanghai and Tokyo and Brussels and in the United States, in Pasco in Florida, and under the particular focus under Beverages for Life on tailoring formulations and ingredients to consumer needs, offering more personalized solutions through packaging, through product solutions and implementing an approach to revenue growth management around the world that we know works.

Secondly, a major advantage of being in over 200 countries is that any given time, you can think of those as laboratories, a huge opportunity that we have going forward is to be able to do a better job of leveraging the experimentation that's underway in many parts of the world and being able to lift, shift and scale the things that are working well and to enjoy the benefits of that in a scale fashion.

The third area that's really important element of our overall portfolio equation is to be suitably opportunistic on the M&A front, and over the last three to four years, we've had some significant additions to the portfolio which I'll touch upon in the course of the presentation. That all of course needs to be underpinned by a continuous elevation in our marketing capabilities to stay ahead of and to anticipate consumer needs and trends.

Few examples of how that's coming to life. One of the [ph] paradoxes (00:08:33), one of the biggest beneficiaries of Beverages for Life is our brand, our number one brand Coca-Cola. Bringing a much more consumer-centric approach to all aspects of the portfolio has allowed us to, I think, bring more news and interest and relevance to the Coca-Cola trademark.

We've seen a steady [ph] outpost (00:09:03) of innovation, be it Coke Plus in Japan with a functional ingredient that meets the needs of the Japanese consumer; be it a Coke and coffee that's been launched in places like Vietnam, Australia and been rolled out across over 20 markets; be it Coke Energy, which we are in the early stages of rolling out around the world. That combined with the revenue growth management equation that I mentioned earlier is allowing us to see tremendous rejuvenation of a brand that has been, as you all know, around for a very long time.

Q1 retail value growth of 7% [indiscernible] (00:09:56) we've enjoyed in a long time. In 2018 for the first time in a number of years, the Cola share within NARTD group. And as part of our broader growth from where we see revenue growing ahead of transactions, ahead of volume and ahead of calories, the Coke trademark is leading the way for us.

Second example of the approach we're taking on portfolio is learning how to lift, shift and scale and do a better job of it. Three examples come to mind. Last year in Europe, we converted our tea business to Fuze and we're now the market leader in 11 European markets. Smartwater has been a tremendous acquisition as part of the Glacéau business. Today, we have it rolled out in over 32 markets and it's playing at a premium position and with lots of runway ahead.

And just to my previous role in Asia, we kicked off a project just over a year ago to develop a tea brand, authentic tea house, a non-sweetened tea brand that's on trend in many markets across Asia, and we're using that as a number of umbrella brands to build a position in this growing and important category. And indeed, it's a brand that I think has got legs beyond Asia in the future.

A third example is the recent acquisition of Costa. I've received a lot of questions this week and in the last couple of months on the rationale for Costa. This chart here I think summarizes quite nicely the – underneath the Costa umbrella, we see multiple revenue streams. The retail store business represents the lion's share of today's base, but as we go forward, we're proud to serve the express model, ready-to-drink and solutions for at-home in packaged bins and/or in the future in pods. We see a tremendous opportunity ahead. To participate in the hot coffee segment, which I showed earlier, we today have a very low position.

Since the acquisition finalized in January, we've been moving with speed to accelerate this business with particular focus on the approach to serve the express and the ready-to-drink. Ready-to-drink, we're launching this month here in the UK, rolling out to at least six markets over the course of the coming months. The express, we also have accelerated plans to move beyond the current base that we have in the markets, and to roll it out across a number of markets working in partnership with our bottling system.

Costa is also going to benefit from some of the partnerships the broader Coke system enjoys. Two that come to mind, the Cricket World Cup that's underway at the moment in England and the Olympics next year in Tokyo. So we see those partnerships giving Costa a tremendous opportunity to build its brand position. Let's take a step back from some of those examples, on an overall basis, we've talked before about a framework to drive our portfolio going forward, the Leader, Challenger and Explorer model. Since we've introduced that framework within our organization over the last couple of years, we're now moving ahead to operationalize this and to have it as part of the way we do business.

And as you can see on the right hand side of the chart, we're making progress, early stages for sure, but we believe that this is the right approach to truly understand what does it take to kick off our position in a category to graduate from there to challenge meaningfully inside of the category and then from there to build ultimately a leadership position. We know from our existing portfolio that leadership in a category is the most important criteria to drive profitability, and we believe that this framework is the right one for the kind of transformation that we are going through around the world.

The framework is only a framework though it doesn't really deliver unless it gets executed. And I know we have this week and even in the room today some of our bottling partners. Just been a significant I think shift in focus from volume to value over the last three to four years which is allowing our system to be much more integrated and aligned right through to the point of sale. We're seeing a commitment to building scale and investing. We're seeing improved execution across the world, and they're just evidence of, I think, the increasing alignment that we have with our system, and we're seeing results globally that pay that off whether it's in terms of outlet coverage, investment in cold drink equipment which we know gives us a [ph] mix and a (00:16:02) return on investment and importantly our continued expansion of our portfolio.

I talked at the outset about collaborating with stakeholders being a key part of our overall growth equation. And on this chart here, it's a busy chart but I think it's an important one to highlight some of the areas that we're focused on. We've had in place for a number of years now a commitment to replenish 100% of the water that we use. That was a commitment that we achieved three years, four years ahead of track in 2015.

Last year, James rolled out a World Without Waste initiative, and the idea is that by 2030, we'll have – for every bottle that we have in the market, we will withdraw one making a lot of progress on that, not only as a system but also working with our industry peers and indeed across industries. James will be at the Vancouver Consumer Goods Forum this week and I know this is one of the key topics on the agenda.

Sugar reduction is a key priority and the work we're doing on recipe management, increased focus on smaller packs is paying off and we're making meaningful progress in this arena. We have a commitment to reduce the carbon footprint by 25% over the next couple of years. We believe we're on track to do so, but also believe that this is an area that will require further focus in – from across the system.

Muhtar Kent kicked off a 5by20 program a number of years back to – at the end of day to empower 5 million women across the world that work in our supply chain and we're very much on track to meet that commitment. We're proud with the work that we do and across the world, across our system to respect and protect the rights of workers. And in the agricultural area, we are making and advancing on the whole sustainability agenda. So a lot of noise here, a lot of detail on the chart, but I wanted to emphasize that it's a critical part of the broader growth and relevance equations that we have as a system.

I'd like to move on then to talk about how is that platform converting into shareowner value. Over the last seven quarters, we've seen the output from the Beverages for Life vision translating into a higher and more sustained top line growth. And our long-term targets which you can see here in the green is one we believe is very achievable as we continue to manage the many areas that I've just covered.

We also have a very strong focus to drive margin expansion across all areas of the business. I think it's important to highlight that within our portfolio, essentially we have three types of business, sort of the core business that we enjoy in our various geographic segments in both North America and international, the Global Ventures Group that contains Costa and Monster, Innocent and the tea business in Turkey Doğadan and our Bottling Investments Group primarily located now in southeast-southwest Asia which we continue to hold for the time being.

And so within each of those areas, we see a number of levers that we can leverage to continue to make progress on margin expansion. I sort of think about the three businesses that we have against a number of really critical levers. One on the top line is to continue to leverage the revenue growth management approach that we know works. We know that bringing science and the application of that science to developing price/pack architectures that are appropriate to consumer needs, customer needs and mark-by-market work, and delivers a better quality top line.

We know that innovation directed against smaller packages, directed against premiumization is a second way to improve quality of top line. Across the businesses, we have different opportunities on driving synergies in the supply chain. And here, I'm just talking about our own business. I know our bottling partners too have got a proven track record of being able to deliver their own synergies in this space. And with a marketing and SG&A base of over $5 billion, $6 billion, we see ongoing opportunity to drive greater efficiency and effectiveness. So key message here is lots of levers, lot of focus, and I believe we are on the good path to delivering against our margin needs.

We're also committed to moving the needle on free cash flow. Over the last couple of days, I've talked quite a bit about some of the elements that I'm particularly focused on. We see three big buckets where we can make tangible progress over the next couple of years. In the middle, I'll talk a little more detail. Working capital is [ph] as I hear now, (00:22:29) this year and next year opportunity. Reducing one-time cost that has been inherent in the transformation over the last two to three years is the second area. And then thirdly is achieving an optimal level of capital investments over the next few years as we continue to move our business towards a core concentrate type model and have less needs to invest in protecting bottling investments.

On the working capital front, I think it's worth just to drill down. We are below where we should be relative to our peers in two areas, in our payables and in our inventory outstanding. And you should expect to see progress on these two areas starting this year and continuing into next year. And the amount involved here is not insignificant. We see at least $1.5 billion opportunity in the next couple of years in this space.

Our approach to capital allocation remains pretty consistent I think with what we've communicated in the past. The devil, however, is always in the details and so having a pretty obsessive focus on first of all generating cash from operations and then the four areas I highlight here are in that order of priority for us. Reinvesting back in the business, continuing to grow our dividend which is such an important component to many of our share owners, being opportunistic when it comes to M&A but also being very disciplined in going after the right ones, and then finally having a share repurchase program at the moment is designed to offset dilution.

We also have a fifth area of opportunity is to pay down some of our debt. We're slightly above our target range at the moment as results of the Costa acquisition, but we expect to get back into the 2.5 times net debt leverage over the next year or so. And so with that, I think it's a good balance of maintaining financial flexibility to invest as opportunities arise but at the same time having the right capital structure in place to support the business going forward.

So with all that being said, having a leadership position in a growth industry, creating and institutionalizing across our global system [ph] this platform that (00:25:39) for sustained performance, working closely with our bottling partners across the globe and instilling a culture that's focused on growth is, I think [ph] a permission (00:26:01) to believe that our long-term growth algorithm that we have talked about in the past on organic revenue 4% to 6%, operating income 6% to 8%. Earnings per share, the currency neutral is 7% to 9% and free cash flow conversion at 90% to 95% over time are very achievable.

I'd like to close with just a final comment on the – as we look to the future, we think it's a very bright one ahead. We're well positioned today with the work that's been done over the last number of years and with the focus that we have on becoming a total beverage company. The top line momentum that we have established over the last seven to eight quarters is I believe something we'll continue to enjoy through the transformation we're doing. We have an aligned and engaged partnership system and a very strong focus internally on some of the areas that we know are critical to creating shareowner value.

So with that, I'll hand it back to Steve. Thank you very much.

Steve Powers
Analyst, Deutsche Bank Securities, Inc.

Okay. Thanks, John. [indiscernible] (00:27:38).

John Murphy
Executive Vice President and Chief Financial Officer, The Coca-Cola Co.

Thank you.

QUESTION AND ANSWER SECTION

Steve Powers
Analyst, Deutsche Bank Securities, Inc.

Q

So you've been in your current role for round about three months...

John Murphy
Executive Vice President and Chief Financial Officer, The Coca-Cola Co.

A

Yes.

Steve Powers
Analyst, Deutsche Bank Securities, Inc.

Q

...out of your prior role for six-plus months. As you made that transition from an operational leadership role to the head of a finance organization, I guess what have been your -in interacting more with investors, what have been your key learnings? How is that frame what you would define as your key objectives for the next couple of years and how might you communicate differently or how might the communication from The Coca-Cola Company change over time?

John Murphy
Executive Vice President and Chief Financial Officer, The Coca-Cola Co.

A

Yeah. It feels like a lot longer than three months. But I think probably the most important part of that 90 to 100 days has been the opportunity to talk at some length in some detail with investors and to understand what's on their mind, what they like, what questions they have and then make sure that there is line of sight from what they're looking for or ask right to the company. And so I think we've been able to – from where I'm coming from, I think I can maybe offer to the organization sort of that connection point between what investors are thinking about, what operators are doing and make sure that they are really well connected, that will be number one.

I think the second point that I'd make is that the world is a big place. When you take on a global role, [ph] we (00:29:20) often talk about in today's environment where it keeps getting smaller every day, well, it's gotten pretty large for me over the last few months. And what I mean by that is that having a global portfolio to manage presents both a lot of opportunity, but also challenges [ph] there's never a day where there's not (00:29:42) some part of the world going to surprise you, and yet having a pervasive presence in over 200 countries, I believe, is a tremendous competitive advantage that we are not leveraging, yet as well as we could be.

And then the third area that's really interesting in my new role is the partnership with James and with Brian Smith, our President, and the opportunity to have a seat at the table with them to be part of this story that's unfolding for our company and for our system.

Steve Powers
Analyst, Deutsche Bank Securities, Inc. **Q**

One topic of conversation has been pretty continual. You addressed in the presentation the path to 90-plus-percent free cash flow conversion.

John Murphy
Executive Vice President and Chief Financial Officer, The Coca-Cola Co. **A**

Yes.

Steve Powers
Analyst, Deutsche Bank Securities, Inc. **Q**

It sounds like, as I interpret your message, a steady progress over the next couple of years, starting this year and progressing forward. The other one has just been the ability or inability of The Coca-Cola Company to grow dollar based EPS.

John Murphy
Executive Vice President and Chief Financial Officer, The Coca-Cola Co. **A**

Yeah.

Steve Powers
Analyst, Deutsche Bank Securities, Inc. **Q**

As you stand here today given the external – it's a big world, [ph] domestic (00:30:56) world – external challenges that you continue to face, what's your confidence level in your ability to grow dollar based EPS as you look beyond 2019?

John Murphy
Executive Vice President and Chief Financial Officer, The Coca-Cola Co. **A**

First of all, I think it is probably the number one topic that's on our agenda right now is to have dollar-based EPS growth as a priority. We all know, many people here know we've sat around $2 for some time though, regardless of the kind of progress we've made. So in the – I think it's both a short and a mid to long-term answer. I think in the short-term, the job description is to minimize the downside for any continued volatility.

There continues to be some volatility out there particularly with some of the emerging market currencies that are important to us. And so, our treasury program is designed to do so in the short term. And we do I think an excellent job on the developed market currencies. Emerging markets not as easy to manage in the short term. But mid to longer term, I think it's where I think for me an opportunity to sort of take a step back and challenge the way we do things.

In the world of economics, if you have devaluation of a currency, there should also be corresponding inflation. And in some parts of the world, the relationship between one and the other is clearer than in other parts. And I think part of the job description going forward is to really understand how we can line those up better through our pricing strategy and through our innovation agenda. So I see that has been an area where we perhaps have not been as focused in the past, but that needs us to really step up in the future.

Thirdly, I'd say that the dollar cycle has been a longer one than the historical ones. While you cannot predict what happens to a currency, it's based on what one knows today. If I look out to 2020, 2021, it seems like it could be more benign to us, which should give us more opportunity.

Steve Powers
Analyst, Deutsche Bank Securities, Inc.

Q

One of the things that you highlighted in the presentation was continued, maybe even elevated focus relative to history on consumer-centric M&A.

John Murphy
Executive Vice President and Chief Financial Officer, The Coca-Cola Co.

A

Yeah.

Steve Powers
Analyst, Deutsche Bank Securities, Inc.

Q

I guess what criteria are you looking for, financial, strategic in order to – given where the balance sheet currently resides to make a further push into M&A?

John Murphy
Executive Vice President and Chief Financial Officer, The Coca-Cola Co.

A

Yeah. It's a pretty dynamic area in the organization at the moment, a couple of reasons. James talks a lot about empowerment. He talks a lot about taking risks and there's good news associated with that, but it also has its potential downsides and one of the downsides is you end up chasing every attractive opportunity around the world. So I think it's important that we have in place the appropriate balance between being opportunistic [ph] while being (00:34:51) disciplined.

So one of the areas that we have instituted is much greater focus on not just the strategic rationale because that's quite easy for people to frame up, but does that marry with a financial outcome, short and longer term and for me, is it scalable. Doing acquisitions that support a single country's agenda is interesting but not really that value creating when I think about the bigger picture for the company. And so having opportunities that are scalable across markets to leverage our competitive position in those markets, I think, is something we should have much more on the agenda.

Steve Powers
Analyst, Deutsche Bank Securities, Inc.

Q

The other side of M&A is divestments.

John Murphy
Executive Vice President and Chief Financial Officer, The Coca-Cola Co. A

Yes.

Steve Powers
Analyst, Deutsche Bank Securities, Inc. Q

There's been a lot of discussion this week and in general about the passive investments that sit on your balance sheet, your equity investments that contribute to net income, but not as much to cash.

John Murphy
Executive Vice President and Chief Financial Officer, The Coca-Cola Co. A

Yes.

Steve Powers
Analyst, Deutsche Bank Securities, Inc. Q

I think if you take a look at those things, whether or not those are in balance, as you approach that, where does that rank on your priority list and how are you approaching the investigation of those past investments and how will you approach potential rebalancing of those equity stakes?

John Murphy
Executive Vice President and Chief Financial Officer, The Coca-Cola Co. A

Yeah, I think it's a really important area. First of all, from a sources of cash perspective, I've been offered the opportunity to challenge everything. We have a balance sheet that has got stuff on it that has been there for a while, and I think it's appropriate to take a look at every line item [ph] and say (00:36:48), does it still make sense to have this going forward to some things that I think do not necessarily, we have just sold a building, in the process of selling a building in New York that we have had in the balance sheet for a long time. It's a lovely building, but not really that core to – we're not a real estate company – not core to our needs going forward. So that makes sense.

We have equity investments in different companies, and I think it's important not to have a blanket approach to whether we should have them or shouldn't, but to be thoughtful in working through them. And if it makes sense to continue to have them, so be it, and if it doesn't, then move into phase 2 and think of ways to offload them. But that's a pretty dynamic conversation that needs to be done in a thoughtful way.

Steve Powers
Analyst, Deutsche Bank Securities, Inc. Q

Just tying – setting aside the strategic rationale for having them or not.

John Murphy
Executive Vice President and Chief Financial Officer, The Coca-Cola Co. A

Yes.

Steve Powers
Analyst, Deutsche Bank Securities, Inc. Q

Tying it back to the cold hard financial objective that was started with free cash flow conversion and EPS growth, selling down those equity stakes would theoretically help your free cash flow conversion.

John Murphy
Executive Vice President and Chief Financial Officer, The Coca-Cola Co.

A

Yeah.

Steve Powers
Analyst, Deutsche Bank Securities, Inc.

Q

Right? But most scenarios that I can think of, it becomes EPS dilutive. So as you think – granted there are other reasons besides EPS and free cash flow, but as you think about the decision to potentially sell down for the equity stakes, how does that balance between the pluses of free cash flow conversion versus the minuses of EPS growth or EPS – raw EPS [indiscernible] (00:38:31)?

John Murphy
Executive Vice President and Chief Financial Officer, The Coca-Cola Co.

A

No, it's an important factor. Like the theory is that if you decide to sell an existing asset that you can deploy the cash from it to other uses that would in some shape or form offset the income that you would lose, so whether that's paying down debt or investing in the business that can deliver a decent return. You can't look at the – as in just on one side of the coin. You've got to be – it's got to be a holistic proposition.

Steve Powers
Analyst, Deutsche Bank Securities, Inc.

I think we are at the end of our time. So John, thank you very much.

John Murphy
Executive Vice President and Chief Financial Officer, The Coca-Cola Co.

Thank you very much.

Steve Powers
Analyst, Deutsche Bank Securities, Inc.

Thank you all for joining.

John Murphy
Executive Vice President and Chief Financial Officer, The Coca-Cola Co.

Thank you.