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The Coca-Cola Co. (KO)

Q1 2019 Earnings Call

CORPORATE PARTICIPANTS

Timothy K. Leveridge

Vice President & Investor Relations Officer, The Coca-Cola Co.

James Quincey

Chief Executive Officer & Director, The Coca-Cola Co.

John Murphy

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

OTHER PARTICIPANTS

Stephen Powers

Analyst, Deutsche Bank Securities, Inc.

Lauren R. Lieberman

Analyst, Barclays Capital, Inc.

Bonnie Lee Herzog

Analyst, Wells Fargo Securities LLC

Judy Hong

Analyst, Goldman Sachs & Co. LLC

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

William B. Chappell

Analyst, SunTrust Robinson Humphrey, Inc.

Bryan D. Spillane

Analyst, Bank of America Merrill Lynch

Peter K. Grom

Analyst, JPMorgan Securities LLC

Brendan James Metrano

Analyst, Evercore Group LLC

Kaumil Gajrawala

Analyst, Credit Suisse Securities (USA) LLC

Brett Cooper

Analyst, Consumer Edge Research LLC

Laurent Grandet

Analyst, Guggenheim Securities LLC

Drew N. Levine

Analyst, BMO Capital Markets (United States)

MANAGEMENT DISCUSSION SECTION

Operator: At this time, I'd like to welcome everyone to The Coca-Cola Company's First Quarter 2019 Earnings Results Conference Call. Today's call is being recorded. If you have any objections, please disconnect at this time. All participants will be on listen-only mode until the formal question-and-answer portion of the call. I would like to remind everyone that the purpose of this conference is to talk with investors and, therefore, questions from the media will not be addressed. Media participants should contact Coca-Cola's Media Relations Department if they have any questions.

I would now like to introduce Mr. Tim Leveridge, Vice President and Investor Relations Officer. Mr. Leveridge, you may now begin.

Timothy K. Leveridge

Vice President & Investor Relations Officer, The Coca-Cola Co.

Thank you. Good morning and thank you for joining us today. I am here with James Quincey, our Chief Executive Officer; and John Murphy, our Chief Financial Officer.

Before we begin, I'd like to remind you that this conference call may contain forward-looking statements, including statements concerning long-term earnings objectives and should be considered in conjunction with cautionary statements contained in our earnings release and in the company's most recent periodic SEC report.

We've posted schedules under the Financial Reports & Information tab in the Investors section of our company website. These schedules reconcile certain non-GAAP financial measures, which may be referred to by our senior executives during this morning's discussion, to our results as reported under generally accepted accounting principles. Finally, during today's call, when our senior executives refer to comparable performance, they're referring to comparable performance from continuing operations.

Following prepared remarks this morning, we will turn the call over for your questions. Please limit yourself to one question. If you have more than one question, please ask your most pressing one first and then re-enter the queue to follow-up.

Now, let me turn the call over to James.

James Quincey

Chief Executive Officer & Director, The Coca-Cola Co.

Thanks, Tim, and good morning, everyone. 2019 is off to a good start, with strong underlying performance, as we leverage our transformation as a total beverage company. We continue to win in a growing industry. The nonalcoholic ready-to-drink beverage industry grew value 4% in the quarter. And we gained global value share, with a balanced contribution from both developed and emerging markets, led by strong performance within our sparkling soft drink business.

During the quarter, we delivered 6% organic revenue growth cycling 5% last year. Growth was broad-based, with positive performance across each of our operating segments. Of course, there are often timing impacts on a quarterly basis. And we did see a net benefit in this quarter, which John will cover in more detail.

But to be clear, we delivered strong top-line growth in the quarter, which we converted into 16% comparable currency neutral operating income growth and comparable EPS was up 2%, which was comprised of 13% comparable currency neutral EPS growth, partially offset by an 11% currency headwind. So our disciplined growth strategies are working well and we're on track to deliver our full year guidance.

As you know, our industry continues to evolve. And our approach to addressing this encompasses our system acting with discipline to drive growth. First, innovating and investing in our core categories and brands as well as in emerging spaces; this encompasses everything from massive categories like hot beverages to emerging ones like kombucha. And it allows us to proactively address innovation opportunities that stem from blurring category lines.

Second, we're looking at how we operate as a company, from our existing geographic segments to our new Global Ventures segment. Third, our system is aligned and engaged with improved execution. Our bottling partners are investing for growth, including cold drink equipment and incremental feet on the street as well as implementing more segmented revenue growth strategies.

At the same time, we're investing in digital capabilities. We engage with consumers, interact with our customers and reduce costs across our enterprise.

So starting with our brands, constant innovation is crucial for sustained growth. Brand Coke, which includes our flagship product and its many variants, has momentum because it has been continually updated to maintain its relevance. Over the past three years, innovation has helped accelerate global retail value growth each year, including up to 6% growth in 2018.

This growth is in large part because of the success of Coke Zero Sugar, which didn't happen, of course, overnight. We refined and expanded Zero Sugar over time, and we see more growth ahead.

Coke Zero Sugar succeeds because it builds on the brand edge of original Coke on its taste, its upliftment, on the energy boost that the product provides, all this in a product that doesn't have calories or sugar.

So what's next for brand Coke? You'll see us to continue to innovate to capture additional consumption occasions and need states. One example that I talked about before is Coca-Cola coffee, which we tested in several Asian markets last year.

Coke coffee was designed to reach consumers during specific occasions and channels like the mid-afternoon energy slump at work. We've learned from these pilots, and we now plan to launch in more than 25 markets around the world by year-end.

We're also pursuing another logical extension on the Coca-Cola brand with our test of Coke Energy. This takes one of the original brand edges of Coke, its energy boost, to a new level and a new taste. This product is designed for the white spaces where the energy category isn't well developed.

But our approach to innovation is not limited to brand Coke. We're taking other brands and pushing into new spaces to offer consumers what they want by leveraging the brand edges.

For example, innocent, our leading juice business in Europe, expanded into plant-based beverages. And within our Challenger brands, Simply, our premium juice brand in the U.S., recently launched a new line of smoothies.

We're also improving the way we operationalize our innovation pipeline. Within our Explorer brands, almost half of our country category combinations are growing volume double-digits, which is up from about a third a year ago.

While we often talk about innovating in products, our evolution is just as much about changing how we work. Our organizational needs are ever-changing, as our portfolio and competitive environment become more complex around the world. So we're adapting.

One example is the creation of a new operating group, Global Ventures. The goal is to accelerate some of our businesses, like innocent and Costa coffee, that have the potential for growth across traditional borders.

While the acquisition of Costa coffee plays a significant entry point into hot beverages, it's also more than that. Costa is a platform in coffee overall. This requires more and better connectivity than ever before.

We spent the first three months ensuring the transition from Whitbread went smoothly while building connections within our existing business units. And Costa is performing in line with expectations. As we look to the second quarter, we'll be launching our first ready-to-drink Costa products. Expect to hear more about that in the weeks ahead.

Turning now to our geographic performance, we saw good results in many markets around the world. Our emerging and developing markets are growing organic revenue double digits. And our developed markets are performing well, delivering mid-single-digit organic revenue growth.

In EMEA, we grew organic revenue 14%, driven by continued growth in Europe and Turkey and improved performance in Russia. We also benefited from our European bottlers increasing their inventory levels as a safeguard for potentially disruptive Brexit.

Across Europe, revenue growth management initiatives and Zero Sugar innovations are creating sustained momentum in the majority of our markets. Not only has this benefited price/mix, but unit case volume was up 4% for our European sparkling soft drink portfolio. This performance was balanced with growth in our tea and hydration categories as we broaden out the portfolio.

Turning to North America, our results continue to mount steady progress, driven by strong marketing and execution. Organic revenue was unfavorably impacted by 2 points for one less day in the quarter and the Easter shift, and grew 1% driven by disciplined price/pack management and solid value growth within sparkling soft drinks, juice drinks and value-added dairy.

Our sparkling portfolio benefited from the continued strong performance in Coke Zero Sugar and new flavor innovations like Orange Vanilla Coke, which helped drive 6% retail value growth for brand Coca-Cola in our flagship markets.

Unit case volume declined by 1% in North America as we continue to focus on providing consumers with smaller pack sizes. For example, mini cans grew 14% in the quarter, contributing to transactions and outpacing volume while driving significant value for our system and our customers.

In Latin America, we delivered 6% organic revenue growth in an increasingly difficult operating environment. Argentina's economic environment worsened. High inflation increased the salary gap and impacted private consumption. The volume here declined double digits, but we gained value and volume share by adjusting the price/pack architecture to focus on transactions and maintaining our consumer base.

In Mexico, we're working with our bottling partners to ensure our revenue growth management initiatives continue to drive momentum. And Brazil, Brazil is on an upward trajectory. Our turnaround plan is working, with volume up 5% and transactions up double digits in the quarter. Incremental cooler placements and increased availability of our refillable packages are helping to drive this acceleration.

Finally, in Asia Pacific, we saw good performance in China and India, along with accelerating momentum in our Southeast Asia business unit, which drove 4% organic revenue growth for the segment overall. Execution around Chinese New Year was strong, contributing to 9% volume growth and double-digit transaction growth in China.

In Japan, our system continues to deal with the supply chain impact from natural disasters last year. Manufacturing capacity remains tight, but is improving, with additional lines ramping up in the second quarter. So we expect this to ease the capacity shortage, but full recovery will take until next year.

In Japan, unit case volume was even. New product launches drove momentum in tea and coffee during the first quarter, while we cycle the benefit of a strong innovation pipeline in sparkling soft drinks last year.

So, in summary, we had a good start to the year. Our strategy of being more consumer-focused and creating value for our customers is working. And we are confident we will deliver our full year targets and drive shareowner value.

I'll now turn the call over to John.

John Murphy

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

Thank you, James, and thanks to all of you for joining us. Today, I'd like to cover three topics: one, our financial results in the quarter; two, our outlook for the remainder of the year; and, three, I'd like to say a few points on our currency hedging program.

So starting with our financial performance in the quarter, as James said, we got off to a good start to the year. You'll see that the composition of organic revenue growth in the first quarter was the inverse of what we saw last year, driven more by price/mix than volume.

Price/mix was 5%, cycling 1%, and trending ahead of our recent run rate, driven by strong price/mix in North America, EMEA and Latin America, and while concentrate shipments grew 1%, cycling 4%, adversely impacted by one less day in the quarter.

Of course, with a portfolio as diverse as ours, there will often be variability in timing from quarter-to-quarter. The largest timing impact we saw was in Europe, where our bottlers increased safety stock in advance of a potentially disruptive Brexit. This benefited both global price/mix and concentrate shipments since Europe comprises high revenue per case markets. After normalizing for the estimated 2 points timing benefit and impact from one less day in the quarter, the best way to think of the underlying top line performance in the first quarter is 5%.

Over the remainder of 2019, we expect a more balanced volume and price/mix. Importantly, I'm really encouraged by our organic performance in the first quarter and the sustainability of that growth going forward.

Turning now to margins for both gross and operating margins, we delivered another quarter of underlying margin expansion. In line with our expectations, our geographic groups were the primary driver, the function of continued

innovation, revenue growth management strategies and the effective management of our cost structure. However, comparable margins contracted in the quarter due to the impact of acquisitions and currency.

At the gross profit level, we saw underlying gross margin expand about 30 basis points. Currencies and net acquisitions impacted gross margin by about 100 basis points and 80 basis points, respectively. This was expected with the impact from net acquisitions, driven primarily by bottler transactions within our Bottling Investments segment.

At the operating profit level, the continued focus on productivity as well as the timing of certain expenses drove a 240 basis point expansion in underlying operating margin, but this was offset by about a 130 basis point impact from currencies and about a 130 basis point impact from net acquisitions. As James noted, comparable EPS grew 2% in the quarter, which was comprised of 13% comparable currency neutral growth, partially offset by an 11% currency headwind.

Finally, we generated free cash flow of \$335 million in the quarter, in line with our expectations. Strong underlying cash generation was offset by the impact of currency headwinds, along with an increase in capital expenditures and cash tax payments.

Looking now at the remainder of the year, we are confident we can deliver the full year guidance we have spoke about previously and is included in our release. We do expect the quarterly phasing to be a bit uneven. So let me just highlight some considerations to factor into your models. The timing benefit we receive from bottlers stocking up in anticipation of Brexit totaled roughly \$0.02 into the first quarter EPS.

And as we move forward, we expect this to reverse this year. This is a fluid situation, but our current estimate is that our bottlers will hold their safety stock through the second and third quarter. So for modeling purposes, I would say the \$0.02 out of the fourth quarter.

Before giving a currency outlook, I'd like to highlight a few points. Since CAGNY, we've taken a close look at how we manage foreign exchange in over 70 functional currencies. For developed market currencies, I believe we have the right hedging strategy to mitigate fluctuations to cash flows.

This approach has provided a significant cash flow benefit over the past five years, which is important for our company, given our large domestic cash obligations including the dividend.

Our challenge is emerging market currencies, given the increasing importance of emerging markets to our earnings base. While we have not underperformed versus other approaches, there has been a limited amount we can do to hedge this exposure in a cost-efficient manner. Going forward, we will continue to evaluate our approach to optimally manage this area and will provide insights, if and when that approach evolves.

I've also looked at how to a better job on overall communications. So going forward, in quarters where it is significant, we will begin calling out hedging as a component of the overall currency impact, so it's clear what gains or losses we'll be cycling next year.

For example, in the first quarter of 2019, the currency impact to operating income was not materially affected by hedging activities, and it's primarily the result of a change in spot rates.

We will also provide preliminary currency outlook for the following year, once we have better insight into our hedging activity further out our year. I expect this to be on the third quarter earnings call.

Returning to our near-term outlook, in the second quarter, we expect a seven point currency impact to operating income. This includes a two point impact from hedging activity, driven almost entirely by gains we are cycling from the prior year.

We are hedged through options near current market rates for the G10 currencies as well as for certain emerging market currencies. So we have downside protection in the quarter, and some upside opportunities should the dollar weaken.

As we move into the back half of the year, we expect the impact from currencies to become less of a headwind each quarter. However, while we are hedged on the hard currencies through the end of 2019, we do have some exposure to fluctuations in emerging market currencies, and our currency outlook will reflect this accordingly. As always, our Investor Relations team will be happy to answer any questions as you build out your models for the year.

So in summary, organic revenue growth is strong and is broad-based. Currency and acquisitions impacted margins in the quarter, but pricing and productivity are driving underlying margin expansion. And we are confident in our ability to deliver our full year guidance.

Operator, we are now ready for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Our first question comes from Steve Powers with Deutsche Bank. Your line is now open.

Stephen Powers

Analyst, Deutsche Bank Securities, Inc.

Q

Great. Thanks. Good morning.

James Quincey

Chief Executive Officer & Director, The Coca-Cola Co.

A

Good morning.

Stephen Powers

Analyst, Deutsche Bank Securities, Inc.

Q

I guess, James, congrats on the quarter and I think the prepared remarks gave a lot of clarity. I wanted to start actually stepping back and talk about a bigger picture issue, just in terms of innovation. You've talked a lot about incremental innovation in how you work and how you introduce new products since you've taken over as CEO and about the need to try more, not be afraid of failure, but also when you do fail, to fail fast and fail cheaply.

And I guess my question is, as you step back, just how do you assess your progress against those innovation objectives? You cited some things in the prepared remarks that have shown promise, but what metrics are you specifically tracking when it comes to innovation?

And maybe if you could, could you share some of it with us? Is it simply a matter of accelerating the number of new product innovations and introductions and, if so, have those, in fact, accelerated or are there other metrics in terms of success rates or product contributions to growth or the balance of innovation across categories and geographies; just a little bit more context around how you're approaching the measurement of innovation success?

James Quincey

Chief Executive Officer & Director, The Coca-Cola Co.

A

Sure. Let me offer you a couple of thoughts, Steve. One metric that we track, and I think we put some numbers in our CAGNY presentation, if I remember correctly, is looking at the contribution of innovation to overall volume or revenue growth or gross margin growth.

So, just tracking quite simply what was existing and what was new, and what's contributing to the base, and that is useful to us not just to know what's new and what's existing, but on the thesis that, the most important thing is to work out how to stay relevant. There are innovations which are about new products, but there innovations about marketing and packaging, which is all aimed to help us stay relevant.

So, innovation shouldn't be seen just as narrowly as the physical liquid product. It needs to be also seen as the packaging in the market. So we do measure the narrow, which is the product, but we're also interested in the broad.

And ultimately, what that ladders up to is driving the framework we've talked about which is the Leader, Challenger, Explorer and the zombies. So in the end, the innovations in the product, the packaging, the marketing, the execution, the cold drink, it's all about getting more quality leadership positions.

And so we're measuring there how many of the Leaders are growing faster than personal consumption. Are they expanding their leadership position? How many of the Challengers are gaining a decent amount of value share each year, because if they don't gain a decent amount of value share each year, they'll never arrive at being Leader?

And how many of the Explorers are growing double digits? We called out in the script just then that half the Explorers are growing double digits and it was only a third last year.

So, innovation should be seen as in service of creating a quality leadership for the brands. And that's the kind of the highest level metric that we look at in the end.

Operator: Thank you. And our next question comes from Lauren Lieberman with Barclays. Your line is now open.

Lauren R. Lieberman

Analyst, Barclays Capital, Inc.

Q

Great. Thanks. Good morning.

James Quincey

Chief Executive Officer & Director, The Coca-Cola Co.

A

Good morning.

John Murphy

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

Hey, Lauren.

A

Lauren R. Lieberman

Analyst, Barclays Capital, Inc.

The volume performance in Asia was really notable this quarter. And so, I know in the release, you mentioned China, Southeast Asia and India, but could you just walk through sort of specifically what's driving the performance, even like just talk about it as a sequential acceleration? And also, I'm sure it's quite small, but you did mention this Authentic Tea House launch in China. And I just know that's been a, sort of, tough country category combination for you historically. So if you could comment on that because if you put it in the release, it must be worth talking about. Thanks.

Q

James Quincey

Chief Executive Officer & Director, The Coca-Cola Co.

Yeah, okay. I think the first thing I would say is that the Asia Pacific volume growth in the first quarter was very much in line with the volume growth in 2018. I think the question that was out there was in the fourth quarter when it softened a little, was that a blip or was that the emergence of something else. And I think at least with the first quarter, the fourth quarter looks more like a blip. So I think it's a retaking of the momentum we had in 2018.

A

Specifically what was driving it was, for example, in China, we had very strong performance by the whole Coca-Cola trademark as well as emphasizing kind of single-serve water and the kind of the recreating value in the water category that's been an ongoing theme for us in the China business. Obviously, all of that was wrapped together with a good Chinese New Year, tremendous activation on the marketing programs there, so really a solid quarter by the Chinese business.

In India, we did well. Good performance by the sparkling, but we also had in the case of India, really strong growth in the juices. Maaza, which is the local mango-centered juice business, was up very strongly, along with some of the Minute Maid local Indian fruit flavors, so a nice performance there.

We also saw Southeast Asia do better. Philippines, Thailand, Indonesia, Vietnam, they were all in double digits, so a really good performance across Southeast Asia.

And Authentic Tea House, I know it made it into the release and I think it's starting to continue to do well. So we're pleased with the initial results. It's definitively in the category of Explorer. So it's growing. But I think there's a long, long road to go before we are happy with where we end up in tea in China.

Operator: Thank you. And our next question comes from Bonnie Herzog with Wells Fargo. Your line is now open.

Bonnie Lee Herzog

Analyst, Wells Fargo Securities LLC

All right. Thank you. Good morning.

Q

James Quincey

Chief Executive Officer & Director, The Coca-Cola Co.

A

Good morning.

Bonnie Lee Herzog

Analyst, Wells Fargo Securities LLC

Q

So I had a question on your margins. The underlying margins were quite impressive in the quarter, ex FX and acquisitions. So I was hoping you could help bucket some of the key drivers behind the strength in the quarter. And then maybe give us a sense as to how much of the benefit you got from productivity savings versus the lift you might be getting from some of the strong pricing you're seeing? Thanks.

John Murphy

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

A

Thank you. Let me start with a quick walk forward on gross margin first, and then I'll cover operating margin. As I mentioned in my remarks, the underlying margin expansion, what's 30 basis points in gross margin, was led by EMEA and the benefits of Brexit was clearly part of that. But there was also a positive benefit of geographical mix overall. And this was partially offset by North America due to growth in the finished good businesses.

I think, importantly, we need to take into account the currency headwinds, and they were particularly related to the Argentinian peso. And we also were cycling some hedge gains from prior year. In addition to which we also had a structural impact, mainly driven by the acquisition of the Philippines bottling business. And there was a slight offset there on the Canada bottler refranchising.

On the operating margin front, the underlying expansion of 250 basis points was due to EMEA and the Brexit impact, where we have a higher revenue and would've had no expenses there and in North America also due to productivity across the board and the timing of some expenses.

And we also saw, though, the headwinds on operating margin on the acquisition front and the currency headwinds due to the peso and hedging gains, as I mentioned before. So underlying margin expansion net positive, but clearly been impacted by the headwinds on currency and acquisitions.

Operator: Thank you. And our next question comes from Judy Hong with Goldman Sachs. Your line is now open.

Judy Hong

Analyst, Goldman Sachs & Co. LLC

Q

Thank you. Good morning.

James Quincey

Chief Executive Officer & Director, The Coca-Cola Co.

A

Good morning.

John Murphy

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

A

Morning, Judy.

Judy Hong

Analyst, Goldman Sachs & Co. LLC

Q

So, James, I guess I'm just trying to get a little bit more color just in terms of your organic revenue growth outlook for the full year. I think in the fourth quarter call you talked about some of the cautions around some of the macroeconomic volatility in markets like Middle East and Argentina. It seems like first quarter certainly came in a little bit better, even setting aside some of the timing noise. So how are you thinking about the 4% number? Do you feel like there is maybe some cushion as you kind of think about the volatility perhaps being a little bit less or certain markets actually doing a little bit better than you thought? Thank you.

James Quincey

Chief Executive Officer & Director, The Coca-Cola Co.

A

Sure. I mean, I think, firstly, it's certainly encouraging to come out of the gate in the first quarter with a strong start. And as you say, taking the timing aside, I think we can call the first quarter a 5%. It's obviously our smallest quarter, so there is still a long way to go in the rest of 2019. And I think it's still a question of the macros versus what we can execute against ourselves, very much as it was in the last call. I think since we last spoke, the IMF has come out and reduced its forecasts for the year again.

So I think the macro environment remains of a lower level of growth than it was in 2018, and a degree of uncertainty as to how some of the bigger issues around trade are going to play out. Depending on the week, it can be blowing a little more optimistic, a little more pessimistic, but I think fundamentally, the macro environment remains very similar to what we have been planning against for the last number of months.

Obviously, what we're focused on is the execution against our strategy. We think we have a strategy that's right for the consumers and the customers for 2019 and well into the future. We and the bottling partners are focused on executing against that. We're going to have to deal with the ups and downs of some of the trickier parts of the world, whether that's Argentina or the Middle East or other places that are under pressure.

But we think we have a plan that's going to work. So I think, in the end, it comes down to we are confident in our guidance. We had a good start in the first quarter, although it's the smallest quarter. And we'll continue to focus on managing what we can manage to deliver a good result in 2019.

Operator: Thank you. And our next question comes from Ali Dibadj with Bernstein. Your line is now open.

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Q

Hey, guys. So I was just wondering about the SG&A improvement. It looked pretty strong in the quarter, notwithstanding some of the gross margin impact and FX impact. What's underlying that, in particular, given a little bit of detail, John, a moment ago? But I guess I ask in the context of the \$3.8 billion restructuring target that was set a few years ago and whether there's an opportunity to up that number. It certainly seems like you have more room there, understanding a lot of moving parts.

And then, the second thing is related to Coke Energy. You mentioned it, James, in your opening remarks. If you have any detail further about the arbitration there, that would be helpful as well. Thanks, guys.

John Murphy

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

A

Thanks. Ali, on SG&A, we had a slight increase in comparables at 1.1%. And there's a couple of things in there. One, it does reflect the integration of the new businesses, but it's offset by currency and the structural impact. So when you look the comparisons, take those into account. We did have some savings in SG&A during the quarter,

the benefit of the ongoing productivity work that we've been doing, plus some timing of expenses in North America.

And as we look to the future, I couched our ongoing work on productivity in under the whole margin expansion arena, where we will be embedding into just the way we operate a critical focus across the enterprise on driving cost at every cost of sales line. We see opportunities to continue to drive our concentrate supply business more efficiently through harmonization of formulas, et cetera.

There is ongoing opportunity in the OpEx arena to drive more efficiency, particularly with some of the digitization initiatives we have underway. And then finally, there's always ways to, I think, be more effective and efficient with our marketing spend and that's a key area of focus going forward across the enterprise.

Operator: Thank you. And our next question comes from Bill Chappell with SunTrust. Your line is now open.

William B. Chappell
Analyst, SunTrust Robinson Humphrey, Inc.

Q

Thanks. Good morning.

James Quincey
Chief Executive Officer & Director, The Coca-Cola Co.

A

Morning.

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

A

Hey, Bill.

William B. Chappell
Analyst, SunTrust Robinson Humphrey, Inc.

Q

Can you talk a little more on the innovation, especially on the coffee side? Just trying to understand, I guess, one, how the Coke coffee works with Costa and also kind of timing of some of these launches? Will they be in North America? Will they have an impact in 1Q, 2Q, 3Q? Just a little more color on how that flows through the year would be helpful. Thank you.

James Quincey
Chief Executive Officer & Director, The Coca-Cola Co.

A

Sure. I think firstly, the way we are seeing the opportunities for innovation in a product sense is, in a way, it's a blurring edge or partly it's a blurring edge of some of the categories. So the opportunity to have a Coke and coffee variant of Coca-Cola is really at that juncture of what are the benefits the people see in Coke versus what are the benefits they look for in coffee, especially perhaps in some of the markets where the occasions are less well developed.

Said another way, in the developed economies, three-quarters of what people drink is already a commercial beverage. So they have a certain view as to what drinks go for what, on what occasions.

But in the emerging economies, only a quarter of what they drink is a commercial beverage. So there is still a lot of, in a way, creating of the occasions and connecting of brands and benefits to certain occasions. So there's opportunities to expand categories and to leverage the blurring at the edges.

And I think Coke coffee is a great example of that, started out in Southeast Asia, in that afternoon slump and really married the benefits of Coke with coffee in a very unique way. And there's nothing about that that detracts from some of the more direct coffee drinks that we've launched.

Obviously, we've got Georgia coffee. We've got some other coffee drinks in the U.S. with partners. And we see a great opportunity to bring Costa ready-to-drink to the marketplace. We'll be doing that later in the second quarter. So as we do that, of course, it's likely that will be concentrated in the markets where Costa already is.

And we'll be coming up with that later in the second quarter. And as for how we foresee the rollout of the coffee platform, not just the ready-to-drink, but the vending and being a beverage partner with beans and machines. That, we'll come back to later in the year as we've had time to really solidify the expansion plans with the management of Costa.

Obviously, we closed the acquisition well ahead of schedule. The integration has gone well and is ahead of schedule, taking the business and the services out of Whitbread and connecting them to the Coke system. And we are currently working through the various stages of the synergy plans we see ahead.

Operator: Thank you. And our next question comes from Bryan Spillane with Bank of America. Your line is now open.

Bryan D. Spillane

Analyst, Bank of America Merrill Lynch

Hey, good morning everyone.

Q

James Quincey

Chief Executive Officer & Director, The Coca-Cola Co.

Good morning.

A

Bryan D. Spillane

Analyst, Bank of America Merrill Lynch

John, I guess just a couple of balance sheet-related questions for you. One is, you look at the, I guess, long-term debt in the quarter went up and even net debt went up.

Q

And I know part of that is the Costa acquisition. But I guess I was a little surprised to see net debt that was going up. So if you could just talk about kind of the evolution of the balance sheet and debt balances going forward first.

Then second, just related to your comments earlier on currency hedging, can you just give us a high-level view of what the trade-offs are? So currency hedging has been a part of Coke for a long time. So if you decided not to do it, I guess, with the emerging market currencies, just what's the trade-off? What benefit do you derive from doing it now that you might give up if you change the policy going forward?

John Murphy

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

A

Okay. Let me start with the balance sheet question and just a few key highlights from the quarter. First of all, our cash, our balance is slightly lower and that was driven by the acquisition of Costa.

We saw an increase in our non-current assets \$7.2 billion, also driven by Costa and CHI, and that's affecting two line items. One is, the intangibles increased by \$5.5 billion. And secondly, there was an increase of \$0.5 billion in our plants and equipment line.

We do have lower short-term debt balances, driven by lower commercial paper balances. In the first quarter, we did issue long-term euro debt, which, combined with those lower cash balance, as I mentioned, is driving net debt slightly higher. So our net debt-to-EBITDA is at 2.7x, slightly above our target of 2.5. But we do expect to get that back to within range fairly quickly. So that's on the balance sheet.

With respect to the hedging question, I think there is a couple of points to consider. First of all, when you look at why we do it in the first place and why we've taken the approach we've taken, we know we have U.S. cash outgoings slated in the course of the year. And it's important for us that we have certainty with respect to the inflows in order to cover those obligations. So having that certainty is really important and is a key factor.

Historically, we've also wanted to smooth the impact over time periods. And when you take the long view on that, I think the Treasury team has done a really good job on it. You know, over the last few weeks, we did actually take a look at what would've happened over the last 10 years if we had deployed other approaches. And for developed currencies, I think the hedging program we have in place by far delivered a better outcome than if we had done nothing or if we had been sort of more inactive in this area.

The area, and I mentioned it in my remarks, the area that's a challenge will be working with our emerging currency portfolio. And, as you know, the cost of hedging the more volatile currencies sometimes is not worth doing. And we don't have – I don't think anybody has actually – a perfect model or system to cover the risks implicit in dealing in more volatile emerging currency. So that's an area that we will continue to work on. In the short to medium-term, we do have some positions which we believe are prudent and again give us more certainty in the short-term and allow us to minimize the downside.

Operator: Thank you. And our next question comes from Andrea Teixeira with JPMorgan. Your line is now open.

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

A

Hi, Andrea.

Peter K. Grom
Analyst, JPMorgan Securities LLC

Q

Hey, good morning, everyone. This is Peter Grom on for Andrea.

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

A

Hey, Peter.

Peter K. Grom
Analyst, JPMorgan Securities LLC

Q

So I just wanted to ask a quick follow-up on Coke Energy. So, James, in the prepared remarks, you talked about launching in white spaces where the energy category is not yet developed. Is that more looking at specific countries across the world or are you speaking to maybe a particular sub-segment of the category that you think is under developed? Thanks.

James Quincey

Chief Executive Officer & Director, The Coca-Cola Co.

A

Yeah. I mean, Coke Energy, again, this is something that obeys the dynamic of the blurring of some of the categories and the boundary we are seeing in some of the categories. So with every category, and energy is no different, there is a very core to the category, a central proposition that everyone understands the category to be. And then, at the boundary of the category, people have made innovations by adding other ingredients and starting to connect to benefits from other categories.

And in the case of the energy category, there's been a lot of growth in the central core of what the category stands for and that's what's propelled the category forward in largely in North America and Europe and a few other parts of the world. The energy category in itself is still in development in many emerging markets. And therefore, there's an opportunity, in complement to the core brands within the energy category, to work at the boundary.

And Coke Energy obeys that dynamic. I mean, it's got the credentials and some of the origins to be able to connect to some of the energy need states. So we see that as a space where the energy category can grow. And we see that across our whole series of geographies. And we're going to experiment with Coke Energy and see how it works and then, obviously, refine the proposition. And we think it will help complement the other brands that sell successfully in this category.

Operator: Thank you. And our next question comes from Robert Ottenstein with Evercore. Your line is now open.

Brendan James Metrano

Analyst, Evercore Group LLC

Q

Hey, good morning. This is Brendan Metrano for Robert. John, a quick follow-up for you. Could you quantify the benefit to gross and operating margin from that concentrate build in EMEA? And then for James, wondering if you could expand on trends in Brazil and Mexico and some of the initiatives that you're implementing in those markets. Brazil seems to kind of be turning for a lot of staples companies and Mexico is obviously an important business for you guys. Thanks.

John Murphy

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

A

Okay. Let me take the Brexit question. Yes, the timing benefit to margins on Brexit was 70 basis points in the quarter.

Brendan James Metrano

Analyst, Evercore Group LLC

Q

And that was for gross and operating?

John Murphy

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

A

Operating.

Brendan James Metrano

Analyst, Evercore Group LLC

Q

Operating.

John Murphy

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

A

Yes.

James Quincey

Chief Executive Officer & Director, The Coca-Cola Co.

A

We'll give everyone a shot at a question before we come back to the second one. Is there someone else?
[indiscernible] (45:51).

Operator: Our next question comes from Kaamil Gajrawala, Credit Suisse. Your line is now open.

Kaamil Gajrawala

Analyst, Credit Suisse Securities (USA) LLC

Q

Hey, good morning, guys. I wanted to ask a little bit for a little bit more detail on the Coke brand. And maybe specifically you've had Coke Zero Sugar for a period of time. Now, you have Orange and coffee and Energy. How do you know you're not overextending the brand, and maybe the underlying business becomes less stable and a lot more reliant on the newest innovations?

James Quincey

Chief Executive Officer & Director, The Coca-Cola Co.

A

Yeah, great question. I think there's a difference between what's central to the brand and what are innovations that are likely to be either in or out or in a way non-core to the identity – or the most central part of the brand. And so, I would see brand Coke and what it stands for. And, therefore, Coke Zero Sugar adds a key part of what the Coca-Cola brand is.

Now, things like coffee, that's at the beginning. We'll see how that develops. Clearly, that's a product variant. That's crossing over into another category with coffee. And, obviously, there is a danger there, as you say, that it starts to change the nature of Coke itself. Orange and Vanilla, I think, is a flavor we've done – we've had some history with flavors. Whether it will ultimately end up proving to be one of those ones that endures and is available in the market, but doesn't get support or not; time will tell. There are a number of them and they are different in different countries. And I think they add some interest and some connection to the brand, but they are ultimately not marketed in that sense and they're really driven by availability.

In the end, what we have to steward is the vibrancy of the total brand. And, of course, those variants that make up the core of the brand, we do that through a whole series of metrics, whether it be consumer metrics or in-market metrics. And I think that is a key challenge and an imperative, not just for the brand teams, but for the management as well.

Operator: Thank you. And our next question comes from Brett Cooper with Consumer Edge. Your line is now open.

Brett Cooper

Analyst, Consumer Edge Research LLC

Q

Good morning. I was wondering if you guys can talk about the process of expanding information or innovation from the original market. Particularly interested in whether it is pushed from the center and pulled from the country. And then what happens between test and further rollout? And, I guess, and then the final thing is just can you talk about the speed of doing that and is that where you want it to be? Thanks.

James Quincey

Chief Executive Officer & Director, The Coca-Cola Co.

A

Well, I think the nature of being in CEO or in corporate management is nothing's ever as fast as you'd like it, but that's a challenge on how to improve its speed rather than something you can live with philosophically. I think, look, the reality is that you get a bit of everything. When there is a successful innovation in a market, there is a very high likelihood that one of the neighboring markets will have seen it and moved on it before anyone from the center needs to say anything.

In the end, we have to set up a system that allows that. Why? Because it's impossible for an enterprise as large as Coke to have everything directed from the center. It's just not possible to know everything and it's not possible to issue enough instructions to all the different markets.

The system has to rely on the center focusing on the highest leverage decisions. That could be moving an innovation around the world or ensuring that an innovation stay in a certain form. But it tends to be directed at a few big decisions and then a focus on talent and culture and the system that can allow an organic amount of self generation.

So to take the example we talked about so far today, Coke with coffee that started out in Asia Pacific. They came up with one variant. The next market then started to move on it before it was really something that the center was worrying about or looking at. They actually then updated the formula, so it already went from 1.0 to 2.0 by the time we got to the second country based on some of the learnings. And then as it's got moved out further yet, there have been further revolutions of the formula.

Obviously, one of the things we've done from the corporate center is try to make sure there's some unity in how the variant is being thought about and how the formulas are being developed, because ultimately we have to push against the trend that every market thinks it necessarily has to make the thing better; and, therefore, you end up with 200 versions of everything. It doesn't have to be one version, but 200 is also probably the wrong answer.

And so, we do apply a process of pressure to get into a corridor that we believe is appropriate to both satisfy local consumer differences, yet drive the growth of a global brand and an efficiency of an overall supply chain.

Brett Cooper

Analyst, Consumer Edge Research LLC

Q

Thank you.

John Murphy

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

A

I had one additional comment. Just from my experience over the last couple of years, Brett, is that I think we've moved from more of a hub and spoke model to a network model. Our R&D centers now reporting into local operations. We have one in Shanghai, Tokyo, Brussels and Mexico. And they're very much wired together and connected to our business units. So the speed at which stuff is moving around has increased a lot over the last two years, not where we would ideally want it to be, but it's certainly a key part of the overall process that James just referenced.

Operator: Thank you. And our next question comes from Laurent Grandet with Guggenheim Securities. Your line is now open.

Laurent Grandet

Analyst, Guggenheim Securities LLC

Q

Good morning, James. Good morning, John.

James Quincey

Chief Executive Officer & Director, The Coca-Cola Co.

A

Morning.

John Murphy

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

A

Morning.

Laurent Grandet

Analyst, Guggenheim Securities LLC

Q

I'd like to focus on Coke Energy again. Could you please update us on the Coke Energy launch in Europe, the reception from bottlers and retailers and maybe already from consumers, if sales are incremental to the Coke franchise or if it's taking share from competition, any update on the coming launches outside of Europe? That will help. Thank you.

James Quincey

Chief Executive Officer & Director, The Coca-Cola Co.

A

Yeah, sure. I think the headline, unfortunately, Laurent, it's too early to tell. It's only really just gone. It's only really just been launched. The first sales are only just being made. It seems to have resonated well in the first couple of weeks. And so given how early on it is, we're not at a stage where we can really make a good call on where are the incremental sales coming from. Obviously, they're still small at this stage. So I think it's too early to tell. Obviously, we'll be looking at it in the coming weeks and months and we'll be able to become clearer as we go forward.

Operator: Thank you. And our final question comes from Amit Sharma with BMO Capital Markets. Your line is now open.

Drew N. Levine

Analyst, BMO Capital Markets (United States)

Q

Hi, everyone. This is Drew Levine on for Amit. Thanks for taking the question. I just wanted to ask about the competitive environment in the U.S. Your main competitor said that they are at least not losing share on their cola brand anymore. So just wanted to see what you're seeing in the market if you're happy with your market share performance in colas. And then kind of related to that, in sports drinks, any plans to expand the scope of BODYARMOR or additional support for the sports drinks, given some plans by you competitor to increase spending on their own brand? Thanks.

James Quincey

Chief Executive Officer & Director, The Coca-Cola Co.

A

Yeah, we've got a good strategy in the U.S. focused on investing in the brands, building out the portfolio, working with the new network for bottlers post refranchising to execute the strategy in the marketplace with a packaging approach for smaller packaging. We have a standing strategy in the U.S. that has been successful in allowing us to help the industry to grow for our customers and for us to be able to gain share within that total industry and that again played out in the first quarter this year. So we think it's a strategy that works for us.

Obviously, as other parties, large or small, invest in the industry, I think it says two things. One, it says that the industry is attractive because it's got growth and profitability. That's why people want to enter. And it says we need to up our game because the industry is going to become more competitive. And I think that's, in the end, good news for The Coca-Cola Company and certainly has been over the last number of years in North America.

We've been focused on driving sparkling beverages and that's continuing to do well, particularly Coke Zero Sugar. BODYARMOR has had a good start in the sports drinks category, certainly been one of the things that's been driving growth in that category.

So we're going to continue to invest. We're going to stick to our overall game plan. And we'll focus on working to make our brands as relevant for consumers and our plans as value creating for the customers, so we can remain competitive in this attractive industry.

Operator: Thank you. Ladies and gentlemen, that concludes our question-and-answer session for today's call. I would now like to turn the call back over to James Quincey for any further remarks.

James Quincey

Chief Executive Officer & Director, The Coca-Cola Co.

Thank you, everyone, for joining the call today. To conclude, we had a solid start to the year. We capitalized on our momentum coming out of 2018. And we'll continue to drive our strategies for the remainder of the year.

We remain confident we will deliver our full year guidance. As always, we thank you for your interest, your investment in our company and for joining us today. Thank you.

Operator: Ladies and gentlemen, thank you for participating in today's conference. This does conclude today's program. And you may all disconnect. Everyone, have a wonderful day.

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