

## Keurig Dr Pepper(KDP)

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<b>Recommendation:</b> <b>Buy</b>	<b>Price:</b> <b>\$39.49</b> 08-23-22	<b>Fair Value:</b> <b>\$40</b>	<b>Trailing Dividend Yield %:</b> <b>1.94%</b>	<b>Market Cap:</b> <b>\$56.03B</b>
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### *Unimpeded growth following pandemic-struck 2020*

It is no surprise Covid-19 had an immense impact on the food & beverage industry. Putting things into perspective, Chicago-based consulting firm, Technomic, finds overall beverage sales were down 31% on a volume basis and 29% in consumer spending.<sup>1</sup> Yet, this impact appears short-lived with beverage marketing reporting liquid refreshment beverage volume nearing 36 billion gallons in 2021, a 4.3% growth from the previous year.<sup>2</sup>

Beverage marketing also reports retail sales jumped from \$182.4 billion in 2020 to \$204.8 billion, an increase they attribute to increased patronage of on-premise venues like bars, restaurants etc., as pandemic restrictions waned.<sup>3</sup> However, this 12.3% increase in retail sales for 2021 could also be accounted for by higher prices should one account for supply chain induced-effects.

Surprisingly, Keurig Dr Pepper(KDP) has not had a need for this revival with the company reporting a 9.2% growth in its net sales from 2020.<sup>4</sup> Put simply, it's sales growth did not evidence the negative impact of the pandemic. In some ways KDP has benefitted from an underlying mega trend strengthened by the pandemic with a major pendulum swing in the caffeine industry drawing increased commercial involvement with coffee, a major reason behind KDPs formation. A National Coffee Association survey, reports Coffee consumption has soared to a two-decade high, a sign one would associate with a bullish outlook on coffee's future.<sup>5</sup>

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<sup>1</sup> <https://www.bevindustry.com/articles/94108-technomic-study-reveals-covid-19-impact-on-beverage-category>

<sup>2</sup> <https://www.beveragemarketing.com/news-detail.asp?id=701>

<sup>3</sup> <https://www.beveragemarketing.com/news-detail.asp?id=701>

<sup>4</sup> 10-k 2021

<sup>5</sup> <https://www.prnewswire.com/news-releases/coffee-consumption-hits-two-decade-high---spring-2022-national-coffee-data-trends-report-301502866.html>

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## Background

Keurig Dr Pepper Inc. (KDP) is a beverage and coffeemaker conglomerate formed in July 2018 with the merger of Keurig Green Mountain and Dr Pepper Snapple Group. It manufactures and sells the single serve Keurig brewing systems while sourcing, producing and selling coffee, tea among various beverages for its Keurig systems. It also sells coffee beans and ground coffee in bags and fractional packs.<sup>6</sup> Through its Dr Pepper Snapple division, KDP sells sodas, juices, and bottled water among other functional and non-functional drinks. It operates beverage brands in North America such as Dr Pepper, Snapple, 7UP, Canada Dry, Mott's, A&W and the Peñafiel business in Mexico.<sup>78</sup>

In terms of its operations, KDP operates in two distinct subindustries. The first in the Soft Drink Manufacturing Industry and the second in the coffee processing and brewing space. In some ways, it operates across the whole spectrum of the coffee industry since its business actually begins at the tree, continues with harvesting and ends with the long sip of coffee consumer washing down its natural flavors. In the soft drink space it operates among four(4) principal product segments namely:

- Carbonated Soft Drinks (CSD)
- Fruit Beverages
- Bottled Waters (Flavored and Enhanced)
- Functional Beverages (Ready-to-drink teas, Energy and Dairy-based drinks etc.)

As of December 2021, the company operated 30 manufacturing facilities across the United States and Mexico. It also operates a distribution network of 88 distribution centers in the United States and 69 in Mexico. The group also manages the transportation of its products using a combination of a group-owned fleet of more than 6,000 delivery trucks and

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<sup>6</sup> [https://en.wikipedia.org/wiki/Keurig\\_Dr\\_Pepper](https://en.wikipedia.org/wiki/Keurig_Dr_Pepper)

<sup>7</sup> 10-k 2021

<sup>8</sup> It's products can be found in the U.S., Canada, Mexico and the Caribbean

third-party logistics providers.<sup>9</sup> Though it is publicly quoted, the company is majority controlled by the private investment group *JAB Holdings*.

## **Business Strategies**

### ***Product Development & Strategic Acquisitions***

It's an open secret the name of the game in the beverage space is to expand beverage offerings. This has become more important in the background of changing consumers' consumption patterns due to increased health consciousness. To keep up with the trend of evolving consumer preferences, KDP recently launched Dr Pepper Zero Sugar and Intelligentsia K-cup pods for the Keurig Brewing System.<sup>10 11</sup>

It also announced in June, 2022 of the acquisition of the global rights to the non-alcoholic, ready-to-drink cocktail brand Atypique from Station Agro-Biotech, a Quebec-based company that specializes in the manufacturing and marketing of alcoholic and non-alcoholic beverages.<sup>12</sup> Terms of the deal were not disclosed however.

### **Coffee consumption hits two-decade high**

A report by the National Coffee Association (NCA) finds 66% of Americans now drink coffee each day, more than any other beverage including tap water and up by nearly 14% since January 2021, the largest increase since NCA began tracking data.<sup>13</sup> Most interestingly, 27% of coffee drinkers use single-cup systems (27%), the flagship product of Keurig Brewing Systems.

Of course it's hard to predict the sustainability of this consumption rise, but if it's anything to go by, it's that coffee has once again surged to the forefront of the American public culture.

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<sup>9</sup> 10-k 2021

<sup>10</sup> <https://www.bevindustry.com/articles/94253-state-of-the-beverage-industry-csds-benefit-from-familiarity-flavor-choices?>

<sup>11</sup> <https://www.vendingmarketwatch.com/coffee-service/news/21273272/keurig-and-intelligentsia-coffee-announce-partnership>

Intelligentsia Coffee is a Chicago based coffee roasting company that focuses premium coffee.

<sup>12</sup> <https://www.prnewswire.com/news-releases/keurig-dr-pepper-to-acquire-global-rights-to-non-alcoholic-brand-atypique-301574355.html>

<sup>13</sup> <https://www.ncausa.org/newsroom/nca-releases-atlas-of-american-coffee>

## Route to Market strategy

In its 2021 earnings call, CEO Robert Gamgort described to analysts that “ We think our DSD [direct-store-delivery] asset is a competitive advantage.”<sup>14</sup> This statement is important backed by KDPs acquisition of 22 different companies from 2019-21 for strategic

delivery coverage highlights KDP as guided by its route to market/sales execution strategy.<sup>15</sup>



via KDP's 2021 Investor Day presentation

The company highlights on the call several technology investments that allow it to optimize each route. Eric Gardner, an industry consultant provides

an example for the Company-owned DSD-system.

1. KDP has a platform that tracks sales to each individual retailer. Before each sales call, the system generates a recommended order based on past sales.
2. This recommended order is fed into a customized handheld system. A recommended driving route is generated, as are different promotional options.
3. The salesperson negotiates a deal with the customer, using recommended pricing, and promos—after driving to the retailer in the most efficient way possible.
4. They take pictures of the shelves using the handheld—which are then analyzed by corporate. <sup>16</sup>

What's intriguing about KDPs RTM strategy is the potential to sell access to this network to other manufacturers. This is exactly what the company did in 2020 when it signed a distribution agreement to double their volume in New York and New Jersey .<sup>17</sup> This should be good news for shareholders since KDP may have found a way to turn a traditional cost into a stream of revenue.

<sup>14</sup> <https://www.fool.com/earnings/call-transcripts/2021/10/29/keurig-dr-pepper-inc-kdp-q3-2021-earnings-call-tra/>

<sup>15</sup> <https://www.ericgardner.net/keurig-dr-peppers-innovative-route-to-market-strategy/>

<sup>16</sup> <https://www.ericgardner.net/keurig-dr-peppers-innovative-route-to-market-strategy/>

<sup>17</sup> <https://www.ericgardner.net/keurig-dr-peppers-innovative-route-to-market-strategy/>

## Leadership Team

The following is a list and brief profile of 3 executive officers and 1 Board Director as reported by the KDP.<sup>18</sup>

**Robert Gamgort** serves as *Chairman of the Board of Directors* and *Chief Executive Officer* for Keurig Dr Pepper. Before the merger, Bob served as CEO of Keurig Green Mountain (KGM), starting in 2016 when the company was taken private.<sup>19</sup>

Prior to KGM, Bob served as CEO of Pinnacle Foods where he led the company through multiple acquisitions and its public offering. He became CEO for KGM in what appeared to be swift action by private investment firm JAB Holding Company to institute new leadership to turn around Keurig's declining sales at the time.<sup>20</sup>

Effective July 29, Bob will be stepping down from his role as chairman and chief executive officer of Keurig Dr Pepper (KDP).<sup>21</sup>

**Ozan Dokmecioglu** is *Chief Financial Officer & President, International* for Keurig Dr Pepper, having served as Keurig Green Mountain's CFO since May of 2016. Ozan joined Keurig from Kellogg Inc., where he served as Vice President Finance, CFO North America and as Vice President Finance, CFO Europe.

He will succeed Robert at the end of the summer.<sup>22</sup>

**David Thomas (Ph.D.)** serves as *Chief Research & Development Officer* for Keurig Dr Pepper. He most recently served Executive Vice President Research & Development for Dr Pepper Snapple and before that as Senior Vice President for Research & Development.

Dr. Thomas holds 15 patents across a range of ingredient, product and process-related technologies and currently serves on the Science and Regulatory Council for the

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<sup>18</sup> <https://www.keurigdrpepper.com/en/our-company/leadership>

<sup>19</sup> <https://www.keurigdrpepper.com/en/our-company/leadership>

<sup>20</sup> <https://www.usatoday.com/story/money/2016/03/23/pinnacle-foods-ceo-leaves-for-keurig-green-mountain/82156668/>

<sup>21</sup> <https://www.foodbusinessnews.net/articles/21066-keurig-dr-pepper-ceo-stepping-down>

<sup>22</sup> <https://www.foodbusinessnews.net/articles/21066-keurig-dr-pepper-ceo-stepping-down>

American Beverage Association, as well as on the Board of Advisors for the Center for Food Safety, University of Georgia.<sup>23</sup>

**Olivier Goudet** is currently *Managing Partner* and *Chief Executive Officer* of JAB Holdings, a private investment firm which manages money for Germany's billionaire Reimann family and outside investors. Olivier, was hired in 2012 from Mars, the consumer goods giant, which has large pet care operations.

Under his tenure, Oliver has moved JAB's portfolio from one consistent of small publicly traded and independent coffee roasters to one that now sells more coffee than Starbucks. Of course, this has been achieved through acquisitions of various restaurant and beverage companies most notably its \$7.5bn purchase of Panera Bread in 2017 and Dr Pepper a year later for \$18.7bn.<sup>24</sup>

## Concerns

### Stagnating Ventures & Health Concerns

In the last decade or so, there has been a shifting paradigm in how soft drinks are marketed and sold in the United States. This shift away from traditional CSDs to drinks with added benefits has been attributed to of consumers' desire to feel healthier and awareness of the ingredients used in diet beverages. It's not surprising then today's consumer is looking for healthier alternatives including tea, coffee, juice and varieties of water. To this end KDP announced as its first move since its merger it will buy premium water brand CORE Nutrition for \$525 million.<sup>25</sup>

In some sense, the problem isn't really about stagnating interest in carbonated beverages, but rather that almost every other major beverage company is now racking up deals in the health-infused water space. How far Keurig Dr Pepper chooses to venture into the premium water space remains to be seen.

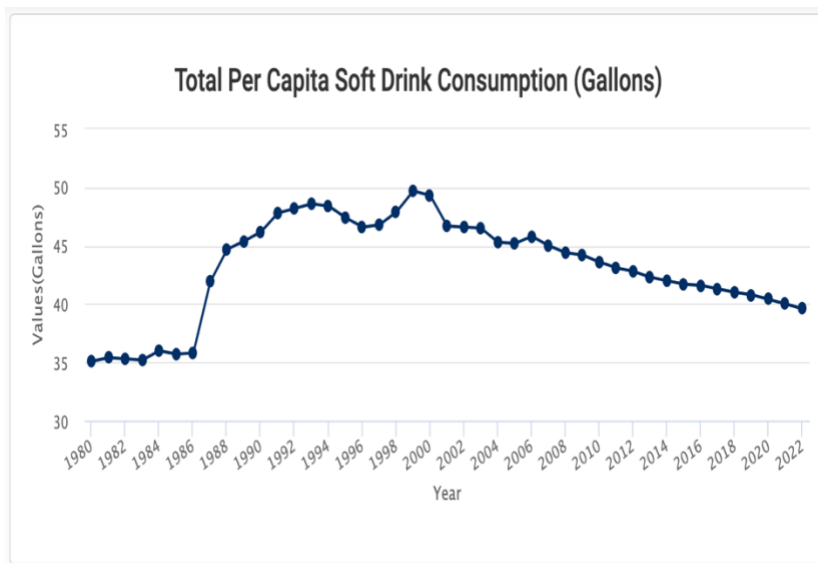
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<sup>23</sup> <https://www.keurigdrpepper.com/en/our-company/leadership>

<sup>24</sup> <https://www.ft.com/content/f32bee39-0ddf-47a3-8560-67838e7c9089>

<sup>25</sup> <https://prnmedia.prnewswire.com/news-releases/keurig-dr-pepper-to-acquire-core-a-premium-enhanced-beverage-company-300720192.html?c=n>

## Rising Inputs Costs & CSD consumption decline



Americans are reducing their consumption of sugar-sweetened beverages according a report by Industry market researcher, Ibis World.<sup>26</sup>

<sup>27</sup> The report states two reasons behind the fall: an increase in health consciousness and an

increase in price. In terms of rising input costs, the report details how relatively high oil prices have driven up demand for fuel alternatives, like ethanol.

This is important since ethanol is primarily made using corn and sugar. In turn, rising demand for ethanol has caused the prices of corn and sugar products, such as high fructose corn syrup( primary soft-drink ingredients), to increase as well and consequently reducing consumption.

Overall, per capita soft drink consumption was estimated to decline at an annualized rate of 0.8% over the five years to 2022 to 39.6 gallons per person, a decline expected to be strengthened by recent increases in oil prices.<sup>28</sup>

## Outlook for US Coffee Pod Pricing

Morgan Stanley reports during the period Keurig was taken private – that is prior to the merger (2016-18) - Keurig focused on lowering pod prices with the goal of increasing household penetration, as pod pricing was the largest barrier to consumer adoption. Keurig also focused on increasing the stability of the brewer pricing system by renegotiating its contracts with its coffee partners (mainly Starbucks and Smucker's), while sharing some of its cost savings with its partners, driving partner satisfaction. Yet in 2020, Morgan Stanley expressed a bearish outlook on coffee pod

<sup>26</sup> <https://www.ibisworld.com/us/bed/per-capita-soft-drink-consumption/1786/>

<sup>27</sup> <https://www.ibisworld.com/us/bed/per-capita-soft-drink-consumption/1786/>

<sup>28</sup> <https://www.ibisworld.com/us/bed/per-capita-soft-drink-consumption/1786/>



pricing informed by recent private label pod growth who have eaten away at Keurig's market share market share from ~43% market share of the US single-serve coffee category in 1Q15 to ~22% volume share in 1Q19TD.

## **Industry Competition**

### **Nestlé to build \$675M beverage factory in Arizona**

Nespresso which placed a bet on coffee a few years ago through a series of acquisitions and a deal with Starbucks to sell its branded products, has re-affirmed its belief in recent consumer habits becoming permanently ingrained. Daniel Jhung, president of Nestlé USA's beverage division stated in an interview that while the creamer segment was growing quickly before COVID, consumer demand accelerated as more people stayed home and made their own cups of premium coffees, lattes and other caffeinated beverages using platforms like Nestle's Nespresso.<sup>29</sup> The factory is expected to provide the company with close proximity to customers and consumers in the western U.S., reducing transport timelines. Currently, much of the creamers are made in an Indiana plant, one of 14 operated by the company in the U.S., before they are shipped to distribution centers across the U.S.<sup>30</sup>

### **Coca-Cola buys rest of BodyArmor for \$5.6B**

Coca-Cola first invested in BodyArmor three years ago when the upstart had about \$250 million in sales.<sup>31</sup> Today, that figure has soared to more than \$1 billion as healthier position energy drinks have caught on with consumers. Putting things into perspective, BodyArmor is currently the second-largest sports drink in the retail channel behind PepsiCo's Gatorade, with sales of more than \$1.4 billion and posting growth of about 50%, according to figures cited by Coca-Cola.

Coca-Cola's acquisition of the remaining stake in BodyArmor has followed a recent trade of acquisition ever since Quincey took over in May 2017 with the company also

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<sup>29</sup> <https://www.fooddive.com/news/nestle-to-build-675m-beverage-factory-in-arizona-creating-more-than-350-j/619316/>

<sup>30</sup> <https://www.fooddive.com/news/nestle-to-build-675m-beverage-factory-in-arizona-creating-more-than-350-j/619316/>

<sup>31</sup> <https://www.fooddive.com/news/coca-cola-buys-rest-of-bodyarmor-for-56b-in-companys-largest-ever-purcha/609219/>

acquiring Topo Chico premium sparkling mineral water, and spending \$5.1 billion to add Costa Coffee, among others.

## Valuation (Free Cash Flow)

### Pro-Forma Model (\$ Millions)

	0 actual	1 assumption	2 assumption	3 assumption	4 assumption	5 assumption
Sales growth		6.8%	6.8%	6.8%	6.8%	6.8%
Costs of goods sold/Sales	45.0%	45.0%	45.0%	45.0%	45.0%	45.0%
Interest rate on debt	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%
Annual growth rate in SG&A		3.0%	3.0%	3.0%	3.0%	3.0%
Current assets/Sales	18.8%	18.8%	18.8%	18.8%	18.8%	18.8%
Current liabilities/Sales	39.2%	39.2%	39.2%	39.2%	39.2%	39.2%
Net fixed assets/Sales	29.0%	Absorbing item				
Depreciation rate	11.2%	11.2%	11.2%	11.2%	11.2%	11.2%
Interest earned on cash and marketable securities	2.9%	2.9%	2.9%	2.9%	2.9%	2.9%
Tax rate	24.4%	24.4%	24.4%	24.4%	24.4%	24.4%
Net fixed assets/Sales	29.0%	29.0%	29.0%	29.0%	29.0%	29.0%
Dividend payout ratio	69.1%	69.1%	69.1%	69.1%	69.1%	69.1%

Year	0	1	2	3	4	5
<b>Income statement</b>						
Sales	12,683	13,545	14,466	15,449	16,499	17,620
Costs of goods sold	(5,706)	(6,094)	(6,508)	(6,950)	(7,423)	(7,927)
<b>Gross profit</b>	<b>6,977</b>	<b>7,451</b>	<b>7,958</b>	<b>8,499</b>	<b>9,076</b>	<b>9,693</b>
<i>Gross profit %</i>	55%	55%	55%	55%	55%	55%
Selling general and administrative	(4,153)	(4,278)	(4,406)	(4,538)	(4,674)	(4,814)
Interest payments on debt	(605)	(605)	(605)	(605)	(605)	(605)

Interest earned on cash and marketable securities	19.0	19.0	19.0	19.0	19.0	19.0
Depreciation	(410)	(438)	(468)	(499)	(533)	(570)
<b>Profit before tax</b>	<b>1,828</b>	<b>2,150</b>	<b>2,498</b>	<b>2,875</b>	<b>3,283</b>	<b>3,723</b>
Taxes	(445)	(524)	(608)	(700)	(799)	(907)
<b>Profit after tax (net profit)</b>	<b>1,383</b>	<b>1,626</b>	<b>1,890</b>	<b>2,175</b>	<b>2,483</b>	<b>2,816</b>
<i>Net profit %</i>	11%	12%	13%	14%	15%	16%
Dividends	(955)	(1,123)	(1,305)	(1,502)	(1,715)	(1,945)
<b>Retained earnings</b>	<b>428</b>	<b>503</b>	<b>585</b>	<b>673</b>	<b>768</b>	<b>871</b>

<b>Balance sheet</b>						
Cash and marketable securities	655	655	655	655	655	655
Current assets	2,389	2,551	2,725	2,910	3,108	3,319
Fixed assets						
At cost	2,904	3,592	4,326	5,111	5,948	6,843
Accumulated depreciation	772	334	(133)	(633)	(1,166)	(1,736)
Net fixed assets	3,676	3,926	4,193	4,478	4,782	5,107
Goodwill and other intangibles	44,038	44,038	44,038	44,038	44,038	44,038
Other assets	937	937	937	937	937	937
<b>Total assets</b>	<b>52,467</b>	<b>52,107</b>	<b>52,547</b>	<b>53,018</b>	<b>53,520</b>	<b>54,056</b>
Current liabilities	4,969	5,307	5,667	6,053	6,464	6,903
Debt	12,876	12,876	12,876	12,876	12,876	12,876
Deferred Tax Liabilities & Other non-current liabilities	7,563	7,563	7,563	7,563	7,563	7,563
Stock	21,799	21,799	21,799	21,799	21,799	21,799
Accumulated retained earnings	5,260	5,763	6,348	7,020	7,789	8,660

	52,467		54,253	55,311	56,491	57,801
<b>Total liabilities and equity</b>		<b>53,308</b>				

Year	0	1	2	3	4	5
<b>Free cash flow calculation</b>						
Profit after tax	1,383	1626	1890	2175	2483	2816
Add back depreciation	410	438	468	499	533	570
Subtract increase in current assets	(156)	(162)	(173)	(185)	(198)	(211)
Add back increase in current liabilities	801	338	361	385	411	439
Subtract increase in fixed assets at cost	(330)	(688)	(734)	(784)	(838)	(895)
Add back after-tax interest on debt	458	458	458	458	458	458
Subtract after-tax interest on cash and mkt. securities	(14)	(14)	(14)	(14)	(14)	(14)
<b>Free cash flow</b>	<b>2,551</b>	<b>1995</b>	<b>2253</b>	<b>2533</b>	<b>2836</b>	<b>3163</b>

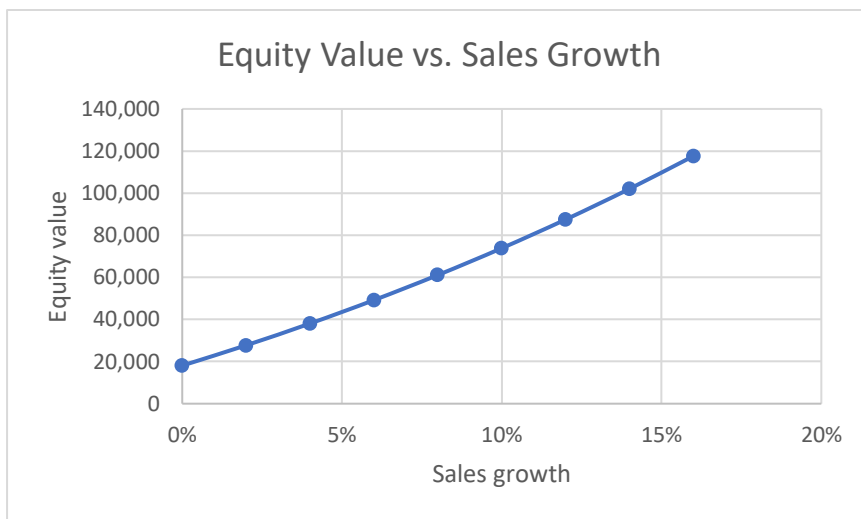
<b>VALUING THE FIRM</b>		
Long-term FCF growth rate (g <sub>LT</sub> )	2.5%	Assumption
Weighted average cost of capital (WACC)	6.91%	Assumption

Year	0	1	2	3	4	5
Forecasted Future FCFs		1,995	2,253	2,533	2,836	3,163
Discounting period		0.50	1.50	2.50	3.50	4.50
Discounting factor		0.97	0.90	0.85	0.79	0.74
Discounted FCF		1,929	2,039	2,143	2,244	2,341

PV short term forecast	10,697
PV long term forecast (Terminal value)	54,433
<b>Enterprise value</b>	<b>65,130</b>
Add excess assets	937
Subtract net debt	-12,221
<b>Equity value</b>	<b>53,846</b>
<b>Value per share</b>	<b>37.92</b>

## Sensitivity to Growth Estimates

Growth	Equity value
	53,846
0%	18,100
2%	27,736
4%	38,089
6%	49,199
8%	61,108
10%	73,860
12%	87,498
14%	102,069
16%	117,621



## Valuation by EV Multiples

### KDP MULTIPLE VALUATION MODEL (AUG 2022)

Symbol	Name	EV/Sales	EV/EBITDA	EV/EBIT	EV/FCFF
MDLZ	Mondelez International	3.52	16.46	19.88	27.66
PEP	Pepsico	3.35	16.31	20.47	40.94
MNST	Monster Beverage	7.65	27.24	28.26	82.22
KO	Coca-Cola	7.37	21.99	24.36	29.39
CELH	Celsius Holdings	1.6	5.36	6.25	10.19
FMX	Fomento Economico	2.92	18.49	27.16	22.89
CCEP	Coca-Cola Europacific Partners	2.04	12.03	16.39	13.83
FIZZ	National Beverage	4.43	21.08	24.31	48.46
SBUX	Starbucks	3.72	13.76	20.33	39.17
KOF	Coca-Cola Femsa SAB de CV	1.53	7.77	10.44	12.95
	<b>Average</b>	<b>3.81</b>	<b>16.05</b>	<b>19.79</b>	<b>32.77</b>
	<b>Median</b>	<b>3.44</b>	<b>16.39</b>	<b>20.40</b>	<b>28.53</b>

**KDP data for 2021 (\$, millions)**

	Sales	EBITDA	EBIT	FCFF
Indicator	12,683	4,032	3,622	2,551
<b>Estimated enterprise value</b>	<b>43,566</b>	<b>66,064</b>	<b>73,889</b>	<b>72,769</b>
Add excess assets	937	937	937	937
Subtract net debt	-12,221	-12,221	-12,221	-12,221
<b>Equity value</b>	<b>32,282</b>	<b>54,780</b>	<b>62,605</b>	<b>61,485</b>
<b>Value per share</b>	<b>22.73</b>	<b>38.58</b>	<b>44.09</b>	<b>43.30</b>

**Key Points:**

It should be obvious KDP's recent growth is consistent of one principal strategy. Specifically, its growth has come from portfolio momentum stemming from its recent acquisitions. Of course, portfolio momentum is not taken to imply KDP has increased its share in its existing markets share but rather it has sought to be exposed to fast growing market segments. This is important since this is the core of its DSD strategy detailed earlier with KDP making 22 acquisitions between 2019 and 2021 from that network. Notably, the acquisitions have been of smaller scale, yet the intent is clear. KDP is acquiring to fill in gaps in its distribution system adding little cost and complexity. And for this reason, KDP looks like an attractive buy.