Q1 2017 Earnings Call

Company Participants

- Hugh F. Johnston, Chief Financial Officer & Vice Chairman
- Indra K. Nooyi, Chairman & Chief Executive Officer
- Jamie Caulfield, Senior Vice President-Investor Relations

Other Participants

- Ali Dibadj, Analyst
- Andrea F. Teixeira, Analyst
- Bryan D. Spillane, Analyst
- Dara W. Mohsenian, Analyst
- Judy E. Hong, Analyst
- Kevin Grundy, Analyst
- Lauren Rae Lieberman, Analyst
- Laurent Grandet, Analyst
- Robert Ottenstein, Analyst
- Stephen R. Powers, Analyst
- Vivien Azer, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning and welcome to PepsiCo's First Quarter 2017 Earnings Conference Call. Your lines have been placed on listen-only until the question-and-answer session. Today's call is being recorded and will be archived at www.PepsiCo.com.

It is now my pleasure to introduce Mr. Jamie Caulfield, Senior Vice President of Investor Relations. Mr. Caulfield, you may begin.

Jamie Caulfield {BIO 17051951 <GO>}

Thank you, Operator. With me today are Indra Nooyi, PepsiCo's Chairman and CEO; and Hugh Johnston, PepsiCo's CFO. We'll lead off today's call with a review of our first quarter 2017 performance and full-year outlook, and then we'll move on to Q&A.

We're aware today is a particularly busy reporting day for the CPG sector, so we've kept our comments brief and intend to conclude the call by 8:30. Before we begin, please take note of our cautionary statement. This conference call includes forward-looking statements, including statements regarding 2017 guidance based on currently available information. Forward-looking statements inherently involve risks and uncertainties that could cause our actual results to differ materially from those predicted in such forward-looking statements.

Statements made on this conference call should be considered together with cautionary statements and other information contained in today's earnings release and in our most recent periodic reports filed with the SEC. Unless otherwise indicated, all references to EPS and operating profit growth are on a core constant currency basis. All references to free cash flow exclude certain items. In addition, references to organic revenue results in this call exclude the impacts of acquisitions and divestitures, structural changes and foreign exchange translation.

To find disclosures and reconciliations of non-GAAP measures that we use when discussing PepsiCo's financial results, you should refer to the Glossary and other attachments to this morning's earnings release and to the Investor section of PepsiCo's website under the Events and Presentations tab.

And now, it's my pleasure to introduce Indra Nooyi.

Indra K. Nooyi {BIO 1404395 <GO>}

Thank you, Jamie. I am pleased to report that we are on track to meet our 2017 financial goals, with first quarter operating results right in line with our expectations. Organic revenue was up 2% globally. We delivered positive volume growth in both global snacks and global beverages, along with positive net price realization. And core constant currency EPS grew 7%.

And despite the macro volatility and weak currencies in many of our key overseas markets that impacted our reported results, our organic revenue growth was driven by our developing and emerging markets businesses, with mid-single-digit organic revenue gains. We are particularly encouraged by the broad-based gains we saw in our two largest developing and emerging markets, Mexico and Russia, where growth across snacks, beverages and dairy led to high single-digit organic revenue growth in each of these important markets.

And the developed markets, we grew organic revenue 1%, led by solid performance of Frito-Lay North America and North American Beverages. And we delivered this performance despite facing a few headwinds, including: the timing of the New Year holiday, which fell into the 53rd week of our 2016 fiscal year; a later Easter this year; and the delay of U.S. income tax refunds that dampened Q1 consumer spending across virtually every consumer category.

With Q1 coming in line with our expectations, we remain confident in the full year 2017 outlook we shared with you last quarter, namely, organic revenue growth of at least 3% and core constant currency EPS growth of 8%. We are proud of the strength and consistency of our performance over the years and we expect 2017 to be yet another strong year of achievement. As I wrote in my annual letter to shareholders, our performance has been enabled, in large part, by our anticipation of and response to far-reaching demographic environmental and societal shifts. For more than a decade, it has been clear to us that if we wanted to make our future as bright as our past, we needed to transform our company in a number of critical ways.

With changing consumer preferences reflecting a growing shift towards healthier lifestyles, we needed to continue to transform our portfolio to offer more nutritious products. With increasing strains on natural resources and the increasing importance governments are placing on protecting our planet, we needed to transform our operations to limit our environmental footprint. And we're changing attitudes, values and demographics in the workplace, especially as Millennials enter the workforce in large numbers. We needed to transform our workplace and our culture to make sure we were meeting the evolving expectations of a new generation of associates.

The urgency of responding to these shifts is what gave rise to the approach we call Performance with Purpose. From the start, Performance with Purpose has been more than a slogan. It's been an overarching vision, guiding every aspect of our business. It's about building a healthier future for all our stakeholders. Of course, this begins with generating healthy financial returns for our owners, but that is just the table stakes. Our challenge is to deliver them consistently and sustainably year after year.

And the way we are doing this is by continuing to transform in five areas: first, making healthier foods and beverages for our consumers. To meet the evolving needs of our consumers around the world, we are shifting our portfolio to a wider range of what we call: first, Everyday Nutrition products, which are products with positive nutrients like grains, fruits and vegetables or protein, plus those that are naturally nutritious like water and unsweetened tea; and two, what we call guilt-free products, which includes the Everyday Nutrition products plus beverages with 70 calories or less from added sugar per 12-ounce serving and snacks with low levels of sodium and saturated fat.

As a result, today, more than 45% of our net revenue is derived from guilt-free products. And our Everyday Nutrition portfolio is growing faster than the balance of the portfolio. This transformation has been enabled by a series of critical investments in R&D that are paving the way for new flavors and sweeteners, as well as ingredients and recipes. And we are also investing in advanced manufacturing technologies, like our proprietary frying innovation that can reduce the amount of fat in potato chips by 20%.

You see our commitment to our product transformation and our recent innovation around the globe. For example, in North America, we just launched LIFEWTR, a premium bottled water, PH balanced, with electrolytes for added taste. The brand fuses creativity with design to serve as a source of inspiration by featuring the works of some of today's top visual artists on the package. We also launched LEMON LEMON. It's a sparkling lemonade, a modern take on an old tradition with bubbles, lemon juice and a touch of sweeteners, with just 70 calories per 12-ounce serving. We launched IZZE FUSIONS, a next-generation sparkling beverage, modernized with unique flavors and just 60 calories per 12-ounce serving. And we're expanding the lineup of our highly-successful Smartfood Delight popcorn, that contains just 35 calories per cup. It's made with air-popped 100%

whole grain popcorn, contains no artificial colors, flavors or preservatives and offers gluten-free and non-GMO project verified varieties.

In Brazil, we are launching new Quaker fruit bars made with oats and real fruit. Quaker fruit bars are just 60 calories per serving, have no added sugar, has zero trans fats and are a source of fiber and Vitamin C.

In Russia, our J7 whole fruit line, containing 100% fruit juice and nectars with the fiber of a whole fruit, hit the market earlier this year. In Mexico, we are expanding our global Sunbites franchise with the launch of three product forms, multi-grain chips, popcorn and plantains. And in the UK, we launched Quaker Super Goodness in two forms, SuperGrains and Super Fruits, both made with 100% whole-grain oats with beta glucan, which has been shown to lower blood cholesterol levels.

And we believe there is much more room to grow in the space. For example, working with our retail partners, Quaker Foods North America has the opportunity to return to growth by leveraging one of the most beloved nutrition distribution brands to renew excitement in the center of the store through innovative merchandising.

The second area is generating healthy growth for our retail and foodservice partners. As a result of all the investments we have made to position ourselves for success over the long term, from anticipating consumer trends to building a robust innovation pipeline, to transforming our product portfolio to meet consumers' needs, we are delivering top-tier growth for our retailers. For the third consecutive year, PepsiCo was the largest contributor to branded retail food and beverage sales growth in the U.S. In fact, in 2016, we generated more retail sales growth than all other $5 billion-plus food and beverage manufacturers combined. We're driving growth by leveraging our global scale and driving excellent local in-market execution.

For example, in 2016, we placed with our retail partners more than 250,000 single-serve displays dedicated to our fastest-growing brands with our best innovation, driving growth in single-serve beverages for our retail partners and us. By implementing the GES model pioneered Frito-Lay, our North America Beverage unit is improving order accuracy, reducing out-of-stocks and driving even greater levels of in-store service.

To drive growth with our foodservice partners, in just one year, we placed 20,000 Hello Goodness branded vending units that offer consumers access to foods and beverages from across the PepsiCo portfolio that meet certain nutrition criteria. And we are building a powerhouse e-commerce team, creating global capability in markets from the U.S. to China to the UK and tailoring that capability with retailers to fit their growth strategy.

Third, we are contributing to a healthier planet while boosting our bottom line. One of the central planks of Performance with Purpose, the vision we set out over a decade ago, has been protecting our planet and conserving natural resources. We continue to advance these efforts in a number of ways, including responsible water use, shrinking our carbon footprint across our supply chain and reducing our waste and packaging material, not only because it's the right thing to do, because it's the smart thing to do for business. I am pleased to report that globally, approximately one-third of our plants have now achieved near-zero waste landfill while reducing, reusing or recycling their waste. And our efforts continue.

In January, we activated a wind turbine at our Skelmersdale plant in the UK, which is now providing 25% of the site's electricity with this renewable energy source. These and many other environmental sustainability initiatives are not only shrinking our environmental footprint, they're also substantially reducing our costs and boosting the bottom line.

The fourth area is creating a healthy workplace and culture for our associates. The extraordinary men and women who make up our company are our greatest assets. That's why we're committed to remaining a place that the best and brightest come, not only to earn a living, but to build a life by fostering a healthy workplace and culture. So we've undertaken a broad set of initiatives: to build a work force that's diverse and inclusive; to provide working caregivers the support and flexibility they need to meet their responsibilities at work and home; to foster learning; and to promote more effective ways to work together.

For example, in North American Beverages, we've declared 2017 to be the year of the frontline leader and launched frontline leader excellence training to our almost 3,000 frontline managers, with topics covering employer advocacy, time management and career building. And at Frito-Lay, we are piloting innovative programs to address the continuous need for skilled labor by creating a variety of programs aimed at skill development for our current associates as well as partnerships with local technical schools for development of future talent.

Our workplace and culture are more than the product of corporate policies. It also reflects our values, holding ourselves to the highest standards of excellence, speaking with truth and candor and selling only products we can proudly stand behind.

And the fifth area is promoting healthier communities wherever we operate. Although we're thought of as a global enterprise, we are also members of every local community where we do business. Our associates live there, we make our products there and we often source our raw materials there. For all of these reasons, we have a stake in the local communities we serve and we work hard to meet our responsibilities to them. An important way we contribute to our communities is by creating well-paying jobs, along with the possibility of long, successful careers.

We are also doing our part to be a good neighbor in other ways. For example, in Chicago, for over a decade, we've been the title partner of the largest high school soccer tournament in the U.S., the PepsiCo Showdown. In 2017, there are 216 Chicago area high schools and more than 21,500 student athletes involved in the event, which is built around the theme Make a Difference On AND Off the Field. Relatedly, there is a monthly community service push with the thousands of PepsiCo Showdown student athletes to cultivate leadership for a brighter future.

And throughout Mexico, our Entrepreneurship for Growth program supports youngsters from vulnerable communities to improve their quality of life, to develop enough soft skills through sport and hard skills through technical education. So taken together, these steps form a virtuous cycle that's powering our ongoing transformation as a company, enabling us to do well by doing good and positioning us for success, not only over the short term but also over the long term, adding to both the durability and duration of our shareholder value creation.

So net-net, we feel good about the state of our business. We are on track to deliver our full-year financial targets. And we are managing our business to both the short-term and the long-term in a way that delivers healthy, sustainable returns to our shareholders.

With that, let me turn the call over to Hugh Johnston. Hugh?

Hugh F. Johnston {BIO 15089105 <GO>}

Thank you, Indra, and good morning, everyone. Let me start by picking up on Indra's point regarding healthy financial returns. As much as we are proud of the advancement of our agendas with customers, consumers, our associates and communities, we are equally pleased with the financial gains these initiatives have contributed to our shareholders. Over the past five years, we have generated approximately $40 billion of free cash flow, excluding certain items, and returned $38 billion to shareholders in the form of dividends and share repurchases.

This cash flow has been the result of healthy organic revenue growth, margin expansion, diligent working capital management and disciplined capital allocation, including responsible reinvestment in the business to position it to remain strong and generate attractive returns far into the future. We believe 2017 will add to our track record of balanced earnings growth and strong cash generation for the company and attractive cash returns for our shareholders, which brings me to our outlook for 2017.

As we set out in the release, we continue to expect organic revenue growth of at least 3%, fueled by successful product innovation and strong marketplace execution, but tempered by a cautious macro environment. Foreign exchange is now expected to negatively impact reported revenue by approximately 2 percentage points, which is an improvement of 1 point from our previous guidance based on current market consensus rates. And we continue to expect core earnings of $5.09 per share, which assumes core constant currency growth of 8%, offset by an expected 3 percentage point drag from foreign exchange translation based on current market consensus rates, which remains unchanged from our previous guidance.

In terms of other key considerations and assumptions embedded in our full-year outlook, we continue to expect raw material inflation driven by both an increase in our basket of commodities and additional pressure from transaction ForEx. We continue to expect core operating margin expansion, contributed to by our productivity programs. And we continue to expect our core effective tax rate to be approximately 24%.

Turning to cash flow, we expect to continue to generate strong cash flow and to exercise discipline over capital allocation, with prudent reinvestment into the business and the majority of our free cash flow, excluding certain items, to be returned to shareholders through dividends and share repurchases. So for 2017, we continue to expect: approximately $10 billion in cash flow from operations; net capital spending of approximately $3 billion; approximately $7 billion in free cash flow, excluding certain items; cash dividends of approximately $4.5 billion – recall that we previously announced a 7% increase in our quarterly dividend, to begin with the June payment, and this would represent the 45th consecutive year in which we have increased our dividend; and share repurchases of approximately $2 billion.

Finally, as you update your models, I'd like the highlight the following three items as they relate to the second quarter. First, we expect our rate of organic revenue growth to show sequential improvement. Second, we expect our consolidated core operating margin to contract in the quarter, due to the timing of business investments in Latin America and AMENA. And finally, we expect foreign exchange translation to be a low single-digit headwind on both reported revenue and EPS, based on current market consensus rates.

With that, we're ready to take the first question.

Q&A

Operator

Thank you. Your first question comes from the line of Lauren Lieberman of Barclays.

A - Indra K. Nooyi {BIO 1404395 <GO>}

Morning, Lauren.

Q - Lauren Rae Lieberman {BIO 4832525 <GO>}

Good morning. Thank you. Indra, I found it curious you mentioned you went straight to the tax refund as sort of being an explanation for some of the weakness we've seen in the U.S. I wonder if you could elaborate a little bit on what you've seen as you've kind of come out of the quarter and maybe anything, frankly, distinctive about your businesses, because outside of Quaker, it certainly looks like snacks and beverages were relatively immune to some of the softness we've seen more broadly across CPG. Thanks.

A - Indra K. Nooyi {BIO 1404395 <GO>}

Thank you, Lauren. Let me just say that, clearly, in the first part of the quarter, several things happened. One is the fact that the New Year build up into the 53rd week of 2016 and then we had the slowdown because the tax refunds were delayed. By the time we got to the end of the first quarter, the business started to pick up again. So we aren't really concerned. It's just a timing issue.

I'd just say globally, our business is looking good. Let me quickly give you a snapshot of what we are seeing globally. Europe is doing very well. It's strong. The return to growth has been impressive, so we are feeling very good about Europe, across all parts of Europe. The Latin American continent, outside of Brazil, Argentina and Venezuela, is good, but Brazil, Argentina and Venezuela are causes for concern. The Middle East is retooling itself, and we have to wait for it to figure out how they're going to come out of the oil price decline.

China, the GDP growth is good. Our snacks and nutrition business is doing very well, and our beverage business is slowly recovering. And India is coming out of a bold demonetization now to remonetization. There's good GDP growth and we feel good about our business prospects there, too. And as far as the U.S. is concerned, as we head into the second quarter, we don't have a reason to be worried.

Operator

Your next question comes from the line of Ali Dibadj of Bernstein.

Q - Ali Dibadj {BIO 15328592 <GO>}

Hey, guys.

A - Indra K. Nooyi {BIO 1404395 <GO>}

Morning, Ali.

Q - Ali Dibadj {BIO 15328592 <GO>}

Hi. So although we've been, obviously, pretty positive on Pepsi for a while and certainly understand the timing shifts you went through just recently, your volume growth in the developed markets wasn't perhaps as great as it could be, certainly not as well as we had expected. And when we talk to investors and ask about the risks to the company – and I'm not sure it's all manifested in the quarter or not – but the risk to the company longer term, we kind of talk about three things and I'd love your perspective on it. One is Pepsi's business over-indexing to convenience stores in a time where gas prices are up. Have you seen any of that impact? Two is the company's difficulty, I guess, perhaps inability, to capture impulse purchases online as consumers shift to e-commerce. And then three is if health and wellness ever really impacts snacks like it does the rest of packaged foods? And have you seen any of those things manifested in the quarter or do you think it's all timing? And I guess also, are those perhaps legitimate concerns more broadly going forward?

A - Indra K. Nooyi {BIO 1404395 <GO>}

You know, Ali, those are all very good questions, but every one of these concerns can also be reframed as an opportunity. And that's really what we do because if PepsiCo's business is over-developed in C-stores, we look at expanding in grocery and other channels, whether it's foodservice or vending, as a bigger opportunity. And then we look to see how we can leverage our DSD system to grow our business into new categories in C-stores. And that's what has made us more valuable partners to convenience store retailers.

And in terms of difficulty with impulse on online, we've built a very good e-commerce business. It's growing at impressive rates. I don't want to discuss those rates, but it's growing at impressive rates. And clearly, our challenge is to create impulse online. And we are working on tools with all of our partners to make our categories look like impulse categories online. It's a work in process, but I must tell you that our growth rates are quite impressive.

And in terms of health and wellness and impacting the snacks business, look, snacks are simple pleasures of life. What we are doing is making our snacks more permissible. We're reducing the saturated fat levels. We remove trans fats. We're reducing the sodium levels. If you're going to eat a snack, eat a PepsiCo snack. And there's nothing wrong with eating a snack that's guilt-free. So our goal is to offer you a range of options from sort of fun-for-you products to guilt-free products, which include Everyday Nutrition, both in a snacking form and in a food-like form. And at this point, we are singularly focused on growing the core, expanding out of the core but making sure across the board we make them a lot more permissible. And it looks like that strategy is working at this point.

Operator

Your next question comes from the name of Bryan Spillane of Bank of America.

A - Indra K. Nooyi {BIO 1404395 <GO>}

Morning, Bryan.

Q - Bryan D. Spillane {BIO 2147799 <GO>}

Hey, good morning, everyone. Just a quick question on working capital, Hugh, it looked like it was a use of cash in the quarter. So can you just give us a little more color on that in terms of just the phasing I guess of cash flow for the year?

A - Hugh F. Johnston {BIO 15089105 <GO>}

Yeah, Bryan, happy to. We typically are a user of working capital in the first quarter. If you go back, I think you'll see in most years we have generally had a couple hundred million dollar use of working capital, so same here. What are the drivers? Biggest one is we're starting to build inventory as we get into the hotter seasons, so not atypical in any regard. I think you'll see a pattern that is very, very consistent with what you've seen historically.

Operator

Your next question comes from the line of Dara Mohsenian of Morgan Stanley.

A - Indra K. Nooyi {BIO 1404395 <GO>}

Morning, Dara.

Q - Dara W. Mohsenian {BIO 3017577 <GO>}

Hey. Good morning. So, Hugh, gross margins compressed year-over-year for the second straight quarter. That's a rarity for you guys. Obviously, you'd highlighted it previously, but I was hoping you could discuss your expectation in the balance of year on gross margins and also give us more detail on what drove the compression in Q1, particularly in terms of the balance between pricing realization versus commodity pressure and the commodity outlook in the balance of the year. Thanks.

A - Hugh F. Johnston {BIO 15089105 <GO>}

Yeah, happy to, Dara. As you know, we saw some late in the year commodity inflation after a number of quarters of commodity deflation. When I say late in the year, I'm talking about late in the year 2016. That continued into 2017. And we expect that to continue, as we've shared before, over the course of the year. As you know, our intent is generally to price through commodity inflation. In developed markets, we generally price through 100%. In developing and emerging markets that have particularly high rates of inflation, we've tended to price through between two-thirds and three-quarters right away and then basically manage the rest of the P&L through productivity.

What you saw this quarter, more than anything else, was our pricing in AMENA, in particular, was relatively light. Couple of markets driving that, the biggest one is Egypt, where we've seen particularly high inflation driven by ForEx. And our pricing is in place such that over the course of the full year, we should see margin appreciation. But in the first half of the year, we will likely see margin compression. So you'll likely see one more quarter of that, and then you'll see margin appreciation in the back half of the year. That is going to be driven, more than anything, by the fact that in the developing and emerging markets, we'll be taking more pricing to cover the commodity inflation.

We do like to balance that out, as you know. We don't like to sticker shock the consumers in those markets because we want to keep them in the category. So a phased approach to pricing when we see high inflation, we found generally works best for long-term value creation.

Operator

Your next question comes from the line of Judy Hong of Goldman Sachs.

A - Indra K. Nooyi {BIO 1404395 <GO>}

Morning, Judy.

Q - Judy E. Hong {BIO 3773182 <GO>}

Good morning. So I wanted to delve a little bit more into the Frito-Lay performance in the first quarter. Obviously, it was more of a price/mix-driven quarter with pretty healthy price/mix and volume down. So can you just talk about the acceleration in price/mix specifically and what's sort of driving that? And then with Kellogg transitioning out of the DSD system, have you started to see any positive impact on your business? And then, Hugh, just in terms of the currency impact in EBIT or EPS, that actually didn't change, even though revenue numbers came up a little bit, so is it just more of a rounding situation there?

A - Hugh F. Johnston {BIO 15089105 <GO>}

Yeah, I'll answer the third question first, Judy. It was rounding. So the revenue tipped towards 2% but earnings stayed at 3%, but they both improved directionally, just one tipped over into 2% and the other stayed at 3%. Regarding the Frito-Lay business, two big numbers to point to that I think both cover the volume and also cover the pricing question that you're asking; the two big factors regarding why volume was down in the quarter, and both are temporary in that regard, number one was the New Year's build. As Indra pointed out in her opening, New Year's fell into the 53rd week. In the previous year, it fell into Quarter 1 of the year. That cost us about 1.3 points on volume for the quarter.

The second was some of the challenges that we had in the Sabra business due to some product challenges, which we're now through and have largely solved. That cost us about six-tenths of a point on volume for the quarter. Now, one of the things to keep in mind is we don't get revenue credit for Sabra because it's a 50%-50% JV. We get, obviously, volume credit and we get profit credit. By virtue of that six-tenths of a point coming out of volume but not having an impact on revenue, it probably made it appear that there was more pricing than there is.

Net, I think we've got our Frito-Lay pricing in the right place for the year. And as you see the Sabra volume start to come back, you should see improved volume performance. Obviously, we'll be out of the Easter as well as the New Year's overlap, and the volume will certainly come back because of that. Those were temporary factors, so.

A - Indra K. Nooyi {BIO 1404395 <GO>}

And we're already seeing the volume back.

A - Hugh F. Johnston {BIO 15089105 <GO>}

Absolutely. The exit rate on the quarter is certainly solid.

Operator

Your next question comes from the line of Andrea Teixeira of JPMorgan.

A - Indra K. Nooyi {BIO 1404395 <GO>}

Morning, Andrea. Welcome.

Q - Andrea F. Teixeira {BIO 1941397 <GO>}

Hi. Good morning. Thank you, appreciate it. Good morning, everybody. Just following up on the gross margin that I had asked, from what I understood is like, obviously, a lot of impacts on the international side, but looking into U.S. and Frito-Lay and all and the beverage business as well, what could we expect in terms of like should we expect more of a smoother quarters at the balance of the year? Appreciate that, thank you.

A - Hugh F. Johnston {BIO 15089105 <GO>}

Yeah, happy to. So for Beverages, you saw 1% revenue and 3% operating profit growth. I think you will see that strengthen slightly. And then for Frito, you saw 2% revenue and 4% operating profit growth. Again, I think you should expect to see that strengthen slightly as we get into the balance of the year. Quaker, we certainly expected to see a bit of improved performance. So, I think you'll see all the numbers lift a little bit as we get out of the first quarter and into the balance of the year.

Operator

Your next question comes from the line of Steve Powers of UBS.

A - Indra K. Nooyi {BIO 1404395 <GO>}

Morning, Steve.

Q - Stephen R. Powers {BIO 20734688 <GO>}

Hey, thanks. Good morning. Good morning. So picking up on the pricing theme, it was again a pretty large driver of growth organically in Latin America this quarter. And maybe just could just talk a little bit more about how that played out, snacks versus beverages. But more importantly, looking ahead, do you see that current pricing trend as sustainable, just given some of the comments made by your competitor yesterday, at least with respect to Brazil, as well as the currency reversals we've begun to see since the start of the year? I guess a similar question might relate to Russia and Eastern Europe, as well.

A - Hugh F. Johnston {BIO 15089105 <GO>}

Yeah, I'm happy to handle that one, Steve. We do expect to continue to see solid pricing down in Latin America. A couple things to think about in that regard, our beverage business in Brazil is relatively small, so we are somewhat insulated from some of the commentary that they made. In addition to that, our biggest business in Latin America is Mexico, where we continue to see very strong performance, both from the beverage business and particularly in our very large snack food business. And then, last but not least, obviously, Argentina has very high rates of inflation. That does create a significant pricing benefit in our overall numbers. So I do think we'll continue to see somewhat similar results.

To the degree that the pricing trends need to moderate because of certain countries, I think you'll see, as you saw last year, improved volume performance. That's been our history in Latin America is as the pricing comes down from what are visually high single-digit types of numbers, our volume does tend to pick up. So I'm comfortable with the trends. You may see a bit more balance between volume and pricing is all.

Operator

Your next question comes...

A - Hugh F. Johnston {BIO 15089105 <GO>}

Sorry. The last question was regarding Russia. Again, I think same answer there. You'll probably see less pricing. The pricing was very ForEx driven anyway. So to the degree that the Russian consumer economy continues to strengthen, and as ForEx has less of an impact, I think you'll see us take less pricing but you'll see stronger volumes, so you'll probably get a fairly similar revenue result.

Operator

Your next question comes from the line of Laurent Grandet of Credit Suisse.

A - Indra K. Nooyi {BIO 1404395 <GO>}

Morning, Laurent.

Q - Laurent Grandet {BIO 19930531 <GO>}

Good morning, Indra. Good morning, Hugh. Question about Quaker. I mean, despite Quaker being one of the LTS of all (34:54) PepsiCo brands, it seems the top line has been soft for quite some time, now including this quarter. At the same time, operating margin have reached a new high with 27.4% in the quarter. So could you please give us more color on this business segment and is this first quarter kind of a reflection of what we should see for the entire year?

A - Indra K. Nooyi {BIO 1404395 <GO>}

Great question, Laurent. I'd say the Quaker business internationally outside the United States is doing very well. Solid growth, we are entering new markets. It's doing very, very well. In the U.S., the Quaker North America numbers that you see includes the Quaker hot cereal, which is where the Quaker brand is housed. And then all of the other businesses that go within Quaker North America, including Rice-A-Roni, Pasta Roni, Aunt Jemima, there's a whole bunch of other businesses, ready-to-eat cereals. One-third of the business is the Quaker hot cereals. And the Quaker hot cereals business, I'd say, over the past few years, has been flat to very slightly down. And the only reason why the overall portfolio looks negative is because it's center store business in grocery stores. And the overall center store category is down high single digits, sometimes even low double digits in some quarters.

And so while we are outperforming the center store categories handsomely, I think our next challenge is how do we leverage our relationships with retailers to reinvent center store. And that's a conversation we've been having with some of the retailers to say how can we help you rethink the center store so that we can bring growth back to that category. And we need to do that in order to bring interest back to that whole cereal aisle and, therefore, Quaker. By itself, Quaker remains a much-loved brand and it's profitable. And our hope is that with the rejuvenation of center store, our categories grow, too.

Operator

Your next question comes from the line of Vivien Azer of Cowen.

Q - Vivien Azer {BIO 16513330 <GO>}

Hi. Good morning.

A - Indra K. Nooyi {BIO 1404395 <GO>}

Morning.

Q - Vivien Azer {BIO 16513330 <GO>}

So, Indra, the commentary in terms of category trends in North America exiting the quarter is certainly encouraging, but given how much pricing you saw this quarter and how reliant the business has been on pricing for some time now, in particular in Frito, can you talk about the evolution of price elasticity in your categories and whether you're seeing any shift there given some of the nearer-term consumer softness? Thank you.

A - Indra K. Nooyi {BIO 1404395 <GO>}

Yes. I think to talk about elasticity on a category basis is too general, Vivien. I think we look at elasticity sub-segment by sub-segment. And all the pricing we've put in place in the U.S. is very carefully looking at the elasticity curves. And we look to see what kind of pricing the consumer can adopt, what kind of volume impact it will have and what can we sustain as a portfolio. And I think that what you're seeing right now is pricing that was sensible for the first quarter. And as the year goes on, I mean, look, we put the pricing in place in Q1, or in fact, I'd say Q4 we started putting the pricing in place, and that's ticking through the year. And we modify that as we go along if we believe that we need to change our promotional calendar to accommodate the consumer trends. I don't know, Hugh, if you want to add anything.

A - Hugh F. Johnston {BIO 15089105 <GO>}

Yeah, I completely agree with that. And in addition to that, if you look at our pricing in North America, macro top level, it's generally in the 2s, kind of in the low 2% range. And given commodity inflation is low single digits, I think that's sustainable pricing. Now, the Frito pricing appears a little bit larger than that because of the Sabra conversation that we had earlier, because we were hit on volume and, obviously, it doesn't have an impact on us on revenue. But as that normalizes, I think you'll see Frito pricing in the 2s, I think you'll see beverage pricing in the 2s and Quaker pricing in the 2s, and I think that's a reasonable place for us to be for the long term. I think that's very consistent with what those businesses can sustain in a modest inflationary environment.

Operator

Your next question comes from the line of Robert Ottenstein of Evercore ISI.

A - Indra K. Nooyi {BIO 1404395 <GO>}

Hi, Robert.

Q - Robert Ottenstein {BIO 1498660 <GO>}

Great. Thank you very much. You identified a number of factors that made the first quarter challenging. One of the things that you didn't mention – I was just wondering if you had any thoughts and observations was did you see any kind of weakness in consumer confidence impacting your results post the election in the Hispanic American community? And overall in terms of the U.S. business, did you see the tone of business trying to correct for Easter improve? Thank you.

A - Indra K. Nooyi {BIO 1404395 <GO>}

No. No change in tone of business, and I think consumer confidence continues to remain as positive as we've seen it.

Operator

Your next question comes from the line of Kevin Grundy of Jefferies.

A - Indra K. Nooyi {BIO 1404395 <GO>}

Morning, Kevin.

Q - Kevin Grundy {BIO 16423871 <GO>}

Thanks. Good morning. Hey, morning, guys, morning, Indra. Indra, question for you, if I may, on soda taxes. Naturally, seem to be increasing focus. The law passed in Philadelphia, which received a lot of attention and has had a pretty profound impact on entry volumes. And now we have the vote upcoming in Santa Fe, and then there's reports they have a rather well-known advocate behind such taxes, putting money into that market behind the effort. So, Indra, hoping to get your updated thoughts there on risk to your business and to the industry; maybe even some historical context for how you view this risk now relative to recent years. Thank you.

A - Indra K. Nooyi {BIO 1404395 <GO>}

Thanks, Kevin. Look, at the end of the day, we oppose beverage taxes that are regressive and unfairly target one category or industry. I think, unfortunately, today's beverage taxes are more revenue generation-focused rather than health-focused. But whatever the reason be, from our perspective, we are working on two things: one, making our portfolio deliver products that are lower in sugar and a lot of zero sugar products and beverages with positive nutrition. So that's one part of our strategy, and we've been working on that for 10 years.

The second part of our strategy, making sure we bolster the rest of the portfolio outside of beverages. So when taxes do come in, we can cushion the effect through managing the portfolio in a more intelligent way. And that's been our strategy over the last decade because we anticipated some of these trends early on and we started to re-tool the company for that.

So at this point, let me just say that our strategy is crystal clear and we feel comfortable as to where we are headed.

So let me just close by thanking you all for your questions. To summarize, we will continue to manage everything within our control to deliver attractive results in the short-term as we continue to position the business for long-term success. Thank you all for joining us this morning and, more importantly, thank you for the confidence you've placed in us with your investment. Thank you.

Operator

Thank you. That does conclude today's PepsiCo's first quarter 2017 earnings conference call. You may now disconnect.