Q4 2016 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
- Bill Schmitz, Analyst
- Bonnie L. Herzog, Analyst
- Bryan D. Spillane, Analyst
- Caroline Levy, Analyst
- Dara W. Mohsenian, Analyst
- Judy E. Hong, Analyst
- Lauren Rae Lieberman, Analyst
- Laurent Grandet, Analyst
- Mark Swartzberg, Analyst
- Robert Ottenstein, Analyst
- Stephen R. Powers, Analyst
- Vivien Azer, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning and welcome to PepsiCo's fourth quarter 2016 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 full-year 2016 performance and our initial full-year 2017 outlook, and then we'll move on to Q&A. We've kept our comments brief this morning and intend to conclude the call by 8:45.

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. 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.

References to organic revenue results exclude the impacts of acquisitions and divestitures, structural changes, foreign exchange translation and, for the fourth quarter and full-year of 2016, the impact of the 53rd week. To find disclosures and reconciliations of non-GAAP measures that we use when we discuss our financial results, you should refer to the glossary and other attachments to this morning's earnings release and to the Investors section of PepsiCo's website under the Events and Presentations tab.

As we discuss today's results, please keep in mind that our fourth quarter comprises the 17 weeks ended December 31 for our North American operations and the four months of September through December for most of our operations outside of North America.

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

Indra K. Nooyi {BIO 1404395 <GO>}

Thank you, Jamie, and good morning, everyone.

As you saw on this morning's release, we concluded 2016 with another strong quarter of operating performance, capping off a very successful year. The operating environment continued to be challenging in 2016. So in this context, I am pleased to report that we achieved or exceeded each of the financial goals we shared with you at the beginning of the year.

To recap, we grew organic revenue 3.7%, in line with our goal of approximately 4%. We met our goal of expanding core operating margins, which were up 80 basis points compared to 2015. Core constant currency EPS grew 9% versus our initial goal of 6%. Keep in mind this includes the impact of deconsolidating Venezuela, which was approximate 2.5 point drag on earnings. Excluding the impact of deconsolidating Venezuela, core constant currency EPS grew 12%. We generated $7.8 billion in free cash flow, excluding certain items. We substantially exceeded our goal of $7 billion. Core net ROIC expanded by 190 basis points and now stands at 21.5%, well in excess of our cost of capital. And we met our goal of returning $7 billion in cash to shareholders through dividends and share repurchases, bringing our 5-year cumulative shareholder cash returns to $38 billion.

And reflecting our continuing commitment to providing attractive cash returns to our owners, I'm also pleased to announce that we are increasing our annualized dividend per share for the 45th consecutive year beginning with our June 2017 payment, to $3.22 per share, which represents a 3% yield based on yesterday's closing share price.

We had notably good operating performance across our operating segments for the year. Our two largest divisions, Frito-Lay North America and North America Beverages, each had strong well-balanced performance with volume gains, net price realization and margin expansion, driving high single-digit core constant currency operating profit growth. And despite the macro volatility and weak currencies in many of our key overseas markets that impacted our reported results, our international divisions delivered very solid organic revenue growth, led by high single-digit growth in our developing and emerging markets businesses as a group, with particularly strong performance in Mexico, China and Egypt, which grew organic revenue in the double digits.

Our results reflect our commitment to plan and manage our business in a way that's self-sustaining and balances delivery of attractive short-term financial results with long-term shareholder value creation. We achieve this by executing a virtuous circle model that combines top-line growth, productivity and significant reinvestment in the business. Our top-line performance is underpinned by strong market positions in growing categories and an enviable portfolio of leading brands. And it is fueled by a product innovation engine built on consumer and shopper insights, deep research and development capabilities, and the broad market reach afforded by our advantaged go-to-market systems.

Our top line growth is also supported by strong collaborative customer relationships. Customers value our relationships with them because we deliver growth. Our brands and products drive basket size and an extremely high velocity off the shelf, and therefore generate significant cash flow for our retail partners. Our customers value our robust innovation, the in-store labor benefits of DSD [Direct Store Delivery], and our sophisticated consumer and shopper insights.

The strength of our customer relationships was evident in the most recent Kantar Retail PoweRanking in the United States, where we achieved the top spot as the number one best-in-class manufacturer, and we earned top marks in the individual categories of most important brands, use of digital platforms, insights and category management, growth and profitability, supply chain management, clear company strategy, and sales force and customer teams.

Beyond this impressive recognition, our capabilities and diligent execution enabled us once again to be the largest driver of growth for our food and beverage retail partners in the United States, which is our largest market. In fact, while we represent less than 10% of retail food and beverage sales, in 2016 we drove 18% of the total retail sales growth of food and beverage. This compares to a net decline in sales for all other $5 billion-plus manufacturers combined.

Our success is also supported by an aggressive and relentless drive for productivity that contributes to current financial performance and provides the funding for investments that will sustain our growth into the future. These substantial investments have largely been directed at capabilities that fuel top line growth. So to strengthen our brands, we've increased our advertising and marketing as a percent of sales by 145 basis points over the past five years and increased it by 40 basis points in just this past year alone.

At the same time, we have directed a higher percentage of our A&M budget from non-working A&M to consumer-facing working A&M to increase returns in our A&M spending. And we have strengthened our capabilities in digital marketing, enabling us to execute marketing campaigns that seamlessly weave together social media, traditional media, and point of sale for greater impact.

We've increased our investment in R&D by 45% since 2011 and have spent approximately $3.5 billion on R&D and food quality and safety initiatives cumulatively over the past five years. In addition, over the past several years, we have amplified our own financial investments in R&D by expanding and strengthening our relationships with key strategic suppliers and academic and research institutions to leverage their capabilities to our benefit.

We've also established a global design center staffed with world-class creative talent. Increasingly, we are incorporating design beginning in the earliest stages of innovation to take into account the entire purchase-to-consumption cycle, and this is resulting in the creation of not just products, but truly memorable experiences for our consumers.

Our R&D capability investments have led to the creation of new products in the short term and to the development of new platforms, ingredients, and packaging with longer-term potential for breakthrough benefits, such as sugar, calorie, fat and sodium reductions, and more sustainable packaging alternatives. Under this robust innovation agenda, net revenue from new products, which we define as products introduced within the past three years, has averaged more than $5 billion since 2013.

And we are pleased to report that in 2016, PepsiCo accounted for over 17% of innovation sales at retail, as measured by IRI in the United States, more innovation than from the next four innovation contributors combined. And it has also advanced our portfolio transformation. For example, we launched a number of new low and reduced calorie drinks in 2016, such as new recipes of Mirinda and 7UP with 30% less sugar, which is rolling out in over 80 international markets.

Meanwhile, we saw great momentum across our nutritious and functional beverages. Naked Juice is on its way to being our next $1 billion brand, while Tropicana launched Tropicana Essentials Probiotics, making it the first brand to bring probiotics to the mainstream juice consumer. Gatorade Frost exceeded $1 billion in measured retail sales, pushing Gatorade over a high watermark of $5 billion in measured retail sales. And our Russia team launched a new J7 apple juice that delivers all the fiber of a single apple in every glass.

At the same time, we grew our portfolio of healthier snacks with Quaker Breakfast Flats, a snack we plan to roll out in more than a dozen countries over the next two years. We are building on the success of Baked Lay's by broadening our lineup of baked products. And we're expanding Sabra, a brand that generates roughly $800 million in estimated annual retail sales. We are expanding it beyond hummus into a range of products, from guacamole and salsa to Greek yogurt dips and spreads.

Simply put, when it comes to transforming our portfolio, we are making considerable progress. In fact, some people are surprised to learn that our beloved Pepsi-Cola trademark accounted for 12% of net revenue in 2016. What we refer to as everyday nutrition products account for approximately 25% of our portfolio by net revenue. These are products that include positive nutrients like grains, fruits and vegetables, or protein, plus those that are naturally nutritious like water and unsweetened tea. And what we refer to as guilt-free products comprises about 45% of net revenue. This broader definition includes the everyday nutrition products plus diet beverages and other beverages with fewer than 70 calories per 12 ounce and snacks with low levels of sodium and saturated fat.

We've also made disciplined investments in our physical infrastructure. Over the past five years we've invested approximately $14 billion in property, plant, and equipment to support the growth of our business, maintain a safe work environment, use less energy and water, and achieve the highest levels of quality and safety in our products.

We also recognize that we're living in an era where all of our stakeholders, from shareholders like you to our consumers, associates, and partners, are all increasingly expecting corporations like ours not only to make a profit, but to do so in a way that's responsive to the needs of the local communities where we operate. And that's exactly what we've been doing, making investments to lift up farmers and workers, small businesses, families and children, from Mexico, where Quaker launched a pin oat malnutrition prevention trial with over 1,000 low-income children; to Pakistan, where we tripled the number of girls benefiting from our I am PepsiCo mentoring and social program; and forging strong ties with local communities. Forging strong ties with local communities isn't just the right thing to do. It's also the right thing to do for our business, reinforcing the bonds that will sustain our success over the long-term.

And finally, we are investing in our most valuable asset of all, our people by: expanding paid family leave; adopting flexible work arrangements; enhancing our learning and development programs; and many other actions. We are building a workplace that is diverse and inclusive and that will continue to attract the top talent in industry in all levels of the organization.

In summary, we've established solid momentum in our business, with strong financial performance generated through a healthy balance of top-line performance and productivity. And we have made, and will continue to make, investments in capability and infrastructure that we believe will strengthen the competitiveness of our business and lengthen the duration of our financial returns. Our results for 2016 reflect the effectiveness of this approach and gives us confidence in our ability to continue to perform well going forward.

With that, I'll turn the call over to Hugh to cover the 2017 outlook. Hugh?

Hugh F. Johnston {BIO 15089105 <GO>}

Thank you, Indra, and good morning, everyone.

Moving on to our outlook for 2017, as we set out in the release, we expect organic revenue growth of at least 3%, as we expect to continue to benefit from successful product innovation and strong marketplace execution, tempered by a cautious macro outlook. And we 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.

Let me touch on the key considerations and assumptions embedded in our outlook. We expect currency to be headwind as a majority of our major currencies, including the Mexican peso, the pound, the Egyptian pound and Turkish lira and others, are expected to devalue relative to the dollar based on the current consensus outlook.

Our guidance assumes a 3-point unfavorable impact on both revenue and core earnings per share. We expect raw material inflation to accelerate, both by an increase in our basket of commodities and additional pressure from transaction ForEx. We expect A&M as a percent of sales to be roughly in line with 2016. We expect continued operating margin expansion through a mix of where we are sourcing the expansion will be more heavily skewed to SG&A versus the COGS you have seen in recent years. And we expect our core effective tax rate to be approximately 24%.

Productivity will continue to contribute to our margin expansion, enabled by several important foundational initiatives we've put in place. First, by investments we have made in technology, starting with our implementation of SAP in the early 2000s, followed by implementation of many other complementary software, hardware and advanced manufacturing technology solutions that we are leveraging on a global scale.

Second, by our aggressive environmental sustainability programs that reduce our use of resources, particularly energy, packaging and water. Third, the global operating model we put in place beginning in 2012 has reduced management layers, increased management spans, promoted best practice sharing and accelerated decision-making.

And the fourth, Smart Spending, our version of zero-based budgeting that is capturing substantial savings across all major discretionary spending categories. For example, by increasing our use of relatively inexpensive teleconferencing by 30%, we also cut travel expense by over 30% and increased the productivity of our associates by reducing the time they spend in airports and on planes.

Our productivity agenda, focused on driving both efficiency and effectiveness, has resulted in approximately $1 billion of annual savings since 2012 and is expected to generate approximately $1 billion again in 2017. Over just the last three years, it has contributed to 140 basis points of core operating margin improvement, and led to a 510 basis point increase in our core net ROIC.

And our productivity programs have driven greater effectiveness across our value chain by increasing manufacturing throughput, expanding SKU capacity, improving job quality for our front-line associates, creating a safer work environment, reducing our environmental footprint, improving product freshness for our consumers and enhancing our customer service.

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 returned to shareholders. So for 2017, we 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; and share repurchases of approximately $2 billion.

Finally, as you update your models, I'd like to highlight the following. As it relates to the first quarter, we expect both our organic revenue growth and core EPS growth rates to be below our full-year guidance levels due to four factors. First, at this stage of the quarter, we expect organic sales to decline at our AMENA [Asia-Middle East-North Africa] division, driven by increased levels of volatility throughout the region and Chinese New Year timing. Second, holiday calendar shifts will modestly impact our top-line results in North America. Third, FLNA and NAB face very difficult operating profit growth comparisons, as they lap both input cost deflation from last year. 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. Our first question comes from the line of Bryan Spillane of Bank of America Merrill Lynch.

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

Hi. Good morning, everyone.

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

Good morning, Bryan. Good morning.

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

Just a question about the 3% organic sales growth guidance for 2017. One, I just want to clarify. Is the 53rd week in the base? And then second, I think, Hugh, you touched on the tough macros as a consideration, so if you can, just expand upon that. Is that a comment about North America, a comment about markets outside the U.S.? Just a little more color there would be helpful.

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

Sure, happy to, Bryan. Two things, one, in terms of the 53rd week, it is not included in the base. So the 3% is an apples-to-apples comparison between 2017 and 2016. That's a clean comparison. Number two, nothing specific in terms of anything attached to PepsiCo's business performance, I think our 3% revenue guidance reflects just a cautious outlook on the macros globally as well as a reflection of what is even a more volatile world relative to the volatility that we've seen in the past few years. So the combination of that increased volatility relative to the recent past and our general caution as we provide guidance at this time of the year has led us to the 3% growth outlook – at least 3% growth outlook.

Operator

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

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

Good morning, Dara.

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

Hey, good morning, guys. So historically, you've had pretty consistent gross margin expansion over the last few years. This quarter was obviously a bit of a change with the modest year-over-year compression. So, Hugh, can you give us some more detail on what drove that different performance in Q4? And it sounds like in 2017, you're expecting muted expansion in terms of gross margin. So I guess what's changed on the gross margin front? And has anything changed in terms of the way you're managing pricing versus your commodity bucket? Thanks.

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

Yeah, happy to, Dara. Two comments on that, number one, the Q4 gross margins were not a surprise to us in any way, shape, or form. I think as we had mentioned during the course of the year, our expectation was for inflation in commodities to pick up a bit in the fourth quarter, and that's exactly what happened. Now when we take pricing, we take pricing for the entire year. So we got a little bit of extra gross margin expansion during the first three quarters as we took our annual pricing, and we got a small amount of compression, 25 basis points, in the fourth quarter.

As we look forward into 2017, in the first half in particular, before we lap the inflation that we saw in 2016, we do expect to see a higher level of low single-digit inflation in commodities. And that combined with our annual pricing outlook will probably result in a bit of pressure on gross margins.

As I mentioned in the script that I just shared with you all as well, I would expect to see more of our operating and margin expansion coming from SG&A rather than coming from cost of goods. That's a result of an intentional strategy. As we saw ourselves moving to a slightly different commodity environment, we focused more of our productivity energy on SG&A to accommodate that to enable continued operating margin expansion.

Operator

Your next question comes from the line of Lauren Lieberman of Barclays.

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

Great, thanks. Good morning. I just wanted to ask about reinvestments of the 53rd week. I thought it was interesting in the press release that you mentioned not just reinvesting in growth, but also reinvesting in productivity. So if you could talk a little bit about that, it would be great. And then also, in the outlook for the tax rate, is there anything incorporated for the change in accounting treatment for stock option? Thanks.

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

Hugh, go ahead.

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

So, Lauren, let me talk a little bit about productivity reinvestment first. We have lots of productivity initiatives over the course of the company, whether it's things like GES, which we've been doing at Frito for a number of years and we've now expanded it into Latin America, as well as different types of capability building that continue the momentum that we've seen on productivity. With the 53rd week, we thought there was a good opportunity to continue to invest and accelerate that. We did so, particularly in Latin America but as well as in other businesses in Europe and to some degree in AMENA as well. That is going to be a part of the SG&A gross margin story going forward.

As relates to your question on tax treatment, the answer is yes, it is included.

Operator

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

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

Good morning, Ali.

Q - Ali Dibadj {BIO 15328592 <GO>}

Hey, how are you?

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

Well, thank you.

Q - Ali Dibadj {BIO 15328592 <GO>}

So I had two questions. One is just to follow up a little bit more on the SG&A piece to it. Particularly in this quarter, it was down quite low, 110 basis points, to our math, I believe. Can you talk a little bit more about what drove that? Was advertising and marketing any piece of that driving downward in the SG&A line for this quarter and then, how we should think about it progressing it forward? It looks like you're going to be focused more on that, but what is that going to be from a SG&A perspective and what the buckets of productivity are for that?

And then a second, if I could, is just on your share repurchase guidance. I think it's about $2 billion; it has been about $3 billion. Can you talk a little bit about that decision-making or is that just again cautious on the operating macro environment so a little bit more cautious on the share buybacks? Thank you.

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

I'm going to let Hugh answer this. I'll just tell you one thing, Ali. As I mentioned in my script, investments in A&M, R&D, those we're not backing off of. We've increased investment in A&M. We've increased investment in R&D and we'll keep investing money in areas that drive the top-line growth of the company, but, Hugh, why don't you talk about the SG&A productivity plan and the share repurchase guidance?

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

Sure, happy to. And, Ali, just to be even more specific on the A&M question, A&M was level for the fourth quarter, so the SG&A increase that you saw, the productivity increase in SG&A for the quarter, was not driven by A&M at all. A&M was level for the quarter as a percent of sales.

Regarding the benefits that we expect to see going forward, I think it's reflective of two things. Number one, it's continuing rollout of things like GES, which obviously make our selling system more effective. And as we take those capabilities in different forms to various regions of the world, you're going to continue to see more benefit in that regard. That's big point number one. Big point number two is around Smart Spending. As I think we've mentioned in earlier calls, we really focus Smart Spending on four categories in this year. We still have another 27 or 28 categories of spend. So you'll continue to see Smart Spending having a significant influence on our SG&A going forward.

Regarding your question on share repurchase, I think, more than anything else, that is driven by the fact that, I believe as you know, certainly many of our investors know, that we have been returning capital to shareholders in excess of free cash flow over the course of the last several years. By moving that number to $2 billion, that basically brings our cash return in line with our free cash flow generation, which obviously puts us in a very sustainable position going forward. Obviously, as everything else, to the degree there are changes in guidance, we'll update it, but, right now, that is our guidance and that's what we would expect for the year.

Operator

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

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

Good morning, Judy.

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

Thank you, good morning. So, Hugh, your comment about the first quarter organic revenue growth that will come in below your full year outlook, I was just trying to get a little bit more color because, I mean, AMENA is not a huge region for you, so for that to be really a big cause, it seems a little bit more exaggerated. And then, also, just in light of softer trends that we've seen in North America for some of the food and beverage categories, I'm just wondering if that also has an impact on your 1Q outlook.

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

Yes, Judy, happy to answer that. You're absolutely right. AMENA is only part of it. If you recall, part of my comments as well reflected holiday timing. Let me point to two things in particular that do have a meaningful impact on the quarter. Number one, New Year's actually this year fell into our 53rd week. In previous years, that's fallen into week one of the new year. So in effect, we lost New Year's out of this year. Now, the reality of it is because it fell into the 53rd week, we also really lost it out of last year as well. It wasn't captured in either year. So that takes away from our Q1 in North America.

Number two was the timing on Easter. We lose a week of the Easter build out of Q1. That moves into Q2. Those two big factors are basically the holiday timing point that I was making, and that focus is very specifically on our North American businesses. Other than that, our North American businesses are performing well. There's no issue with the performance of the businesses, but the holiday timing at both ends of the quarter do have a negative impact on it.

In addition to that, as we mentioned earlier, and this is part of AMENA's numbers, the timing impact on Chinese New Year, the move forward pulled some of that into the fourth quarter, whereas in the previous year, it had been entirely in the first quarter. So those are the specific holiday timing references, but nothing in the first quarter relating to the businesses themselves in terms of negative implications for performance.

Operator

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

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

Hey, great. Thanks. Good morning.

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

Good morning.

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

A quick clarification and then just a forward-looking question. On the clarification, maybe it's too early and I missed something, but I think you guided to 10% core EPS growth coming into the year, back in September. And you just delivered a really solid Q4 that beat expectations, exceeded your own guidance, et cetera. And yet, you're saying you only delivered 9% core EPS growth on the year. So if you can help me bridge that, that would be great. And then on the go-forward, your 3% organic growth guidance this year, 8% core EPS growth guidance, it represents a wider spread that we've seen in guidance starting out the past few years, even with the lower implied buyback.

So that implies really solid margin flow-through. And I'd just like a little bit more color on where that confidence comes from, because the glass half full view is that you feel great about the momentum. I guess the glass half empty view is that today's outlook is a bit more of a stretch that maybe we've seen in the prior few years, so just some comments there would be great. Thanks.

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

Yes, Steve, happy to. Regarding the first one, just to clarify on the numbers, when we talked about 10%, that 10% number was ex-Venezuela. We delivered, ex-Venezuela, 12%. The 9% reference that you heard us talking to earlier was inclusive of the Venezuela overlap. So when you exclude Venezuela, the 10% became 12%. Hopefully, that clarifies it. If not, you can speak to the IR team. But the simple answer is the 10% that we had projected actually became 12% at the end of the year.

Regarding your question around the slightly wider gap between revenue growth and EPS growth, I think the revenue growth, as both Indra and I referenced earlier, is reflective of the fact that we are certainly cautious about the macros and the volatility and we want to ensure, as we do, that we give guidance that we have a very high confidence level that we can hit and, ideally, if the world turns out to be a better place, we can beat.

Regarding EPS, we have a very clear line of sight in terms of our productivity plans for the year. And it's really the productivity plans, more SG&A focused, that will drive the operating margin improvement that will allow us to stay on the 8% EPS guidance.

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

And basically what we're saying is what is under our control, we intend to execute very well. And then, whatever happens in the macro environment, we'll try to manage through it as best we can.

Operator

Your next question comes from the line of Bonnie Herzog of Wells Fargo.

Q - Bonnie L. Herzog {BIO 1840179 <GO>}

Good morning.

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

Good morning, Bonnie.

Q - Bonnie L. Herzog {BIO 1840179 <GO>}

Hi. I have a little bit of a follow-on question regarding the 53rd week windfall. I was curious to hear why the decision was made to shift some of the windfall away from your North America segments to international segments. And then, I was hoping you could give a bit more color on the rising cost environment and how you expect this to change as we move throughout the year. And finally, if you could touch on the flexibility you may have to offset cost inflation with further productivity savings, that would be helpful. Thank you.

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

Hugh, go ahead. This is all walking through the P&L and balance sheet. Go right ahead.

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

Sure, happy to. Good morning, Bonnie. Regarding the 53rd week, we prioritize investment funding not based on where we have upsides, but where the best opportunities are for growth. So some of the reinvestment in the business fell into North America, but some of it fell into our international businesses because we continue to see great opportunities for growth there. Obviously, internationally, the dollar continues to be a bit of a challenge. But that said, we still see terrific long-term value creation opportunities across many of our international businesses, and we want to invest in those businesses. So we took the opportunity with the 53rd week to do so.

As regards our go-forward on SG&A, I think you'll continue to see us, as I mentioned earlier, really drive productivity out of both the selling system and out of Smart Spending in order to continue to see margin expansion, so nothing further to add on that, other than the fact that we do continue to see opportunities there for further cost reduction.

Operator

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

Q - Laurent Grandet {BIO 19930531 <GO>}

Good morning, Indra, and good morning, Hugh. I would like to come back on this productivity effort you are doing, especially around SG&A first, and then I've got a second quick question. So with Kraft Heinz moving away from DSD, what's your assessment of DSD for your operations, as consumer is moving more to e-commerce? And to AMENA, could you give us a bit more granularity in terms of forecasted U.S. beverage growth going forward, the split between non-carbonated beverages and carbonated beverages? Thank you.

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

On DSD, DSD is the strength of our company. Given the nature of our categories, which are high velocity, relatively low value density, DSD is critical because they're impulse, and how we merchandise the product really drives the growth of the category. So we are totally committed to DSD. And we continue to make investments in DSD to modify it as we go along to account for whatever disruption happens in the retail channels. So PepsiCo remains committed to DSD.

Regarding the beverage outlook in North America, we've always tracked liquid refreshment beverage growth as a whole. We've expected for the past decade or more that there will be shifts within the category from carbonated soft drinks to non-carbonated soft drinks, and we've managed the portfolio accordingly. So I think you should focus on LRB [Liquid Refreshment Beverage] as a whole. And our expectation is that the overall LRB category will grow slightly above population growth and around GDP growth. And that's really what our anticipation is for the LRB category growth going forward.

Operator

Your next question comes from the line of Bill Schmitz of Deutsche Bank.

Q - Bill Schmitz {BIO 5038103 <GO>}

Hi. Good morning. Are you guys there?

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

Yes, good morning.

Q - Bill Schmitz {BIO 5038103 <GO>}

Oh, good. Sorry. Sorry, I didn't hear you. I just had a couple quick ones. The first is just on the guidance for operating and then free cash flow. It looks like it's down slightly for 2017. And it doesn't make a lot of sense when you have decent organic growth and what the currency impact is. You're going to do the $1 billion in productivity again. So can you just give us some color on that?

And then the second question is just some of the share trends we're seeing in the U.S. with Frito. So the category is slowing, but also there's some share softness, and the same thing with Gatorade. So as you look into next year, do think that stuff will firm up, or are we just missing something because so much is in untracked channels now that that data is less relevant than it used to be? Thanks.

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

In the case of share in North America, we track LRB share. We track savory share. We track salty share, macro snack share. We track it every which way. And as we've always said, we want to make sure we balance share growth and profitability very, very judiciously. Our goal is never to hit the pricing lever too much in order to gain share. We want to make sure that we keep the pricing architecture across our portfolio very, very consistent over the quarter and over the year. So I wouldn't worry about small perturbations in share in any one quarter, in any one category. This is something we monitor very, very carefully.

And I'd say both Frito-Lay North America and our North America Beverage business as a whole are doing well. Gatorade, in particular, is one of our crown jewels, and the business is performing very, very well. We have a leadership position in the isotonic category. And the business is performing exceedingly well in the category, which involves active thirst, which is really what we track. So, Hugh, let me turn it over to you to answer the first part of the question.

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

Yeah, Bill, regarding free cash flow, you're right. The number is down slightly, driven by two things: number one, the impact of foreign exchange, as you had speculated; and number two, a slightly higher level of CapEx, although lower than our 5% long-term guidance on CapEx. So CapEx will be up a little bit but still inside of the guidance that we've given you in the past.

Operator

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

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

Good morning, Robert.

Q - Robert Ottenstein {BIO 1498660 <GO>}

Hi, thank you, two lines of questions. One, Hugh, just so I'm clear in terms of the free cash flow, are there any other items that you haven't called out yet of size that will impact the conversion in 2017?

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

No, nothing at all.

Q - Robert Ottenstein {BIO 1498660 <GO>}

Great.

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

In fact, we continue to make tremendous progress on working capital, and our cash conversion cycle is actually negative at this point.

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>}

Good morning, Vivien.

Q - Vivien Azer {BIO 16513330 <GO>}

In terms of Frito-Lay, very consistently improving profit growth on a multiyear basis, and it seems that the revenue management that you deployed in the second quarter of 2015 was a good catalyst for that. So I what hoping you can give us an update on future opportunities around revenue management for Frito-Lay? Thank you.

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

I think that's way too detailed a question, Vivien. I'd just say that over time, across the company, not just Frito-Lay, but across all of PepsiCo, we have actually dialed up our revenue management capabilities. We've built revenue management centers of excellence across North America. And we've improved our understanding of household down to a very granular level that allows us to tailor products and packaging for individual households and get the price utilization we need, because we can put the right assortment on the shelves based on the trading area of that particular store and the households that that store targets. I think that's what drives revenue management. And you're going to see that being deployed across North America. And hopefully, that'll result in better revenue realization as we go forward.

Operator

Your next question comes from the line of Caroline Levy of CLSA.

Q - Caroline Levy {BIO 1494597 <GO>}

Good morning. Thanks so much. I was interested in a little more detailed description of what happened with your Mountain Dew franchise. I know Mutant had a C-store rollout, pretty small. I don't know how successful that was, but what your plans are for Dew and then specifically Pepsi, Diet Pepsi, and if you could comment on the demonetization in India and whether that had any impact on your beverage or snack business. Thank you.

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

Caroline, good morning. Good to hear you. The Mountain Dew franchise is alive and energetic, pardon the pun. If you include regular Mountain Dew, Diet, all the variants in Kickstart, it's a thriving franchising and perhaps one of the best-performing franchises in the CSD universe. And we intend to continue to invest behind Mountain Dew. We intend to continue to invest behind Kickstart and the franchise is doing well.

Regarding Diet Pepsi, we had a bit of a hiccup with Diet Pepsi with the rollout of the aspartame-free product, but now with the relaunch of the zero-sugar Pepsi, putting it on the Super Bowl, we're back in business. It's a great tasting product. It is a great tasting product. In fact, I'd say it's the best tasting diet in the market. Try it. And I think our plan is to invest behind the zero-sugar Pepsi rollout and make sure that it is the diet for the Pepsi portfolio.

Q - Caroline Levy {BIO 1494597 <GO>}

Great.

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

And on demonetization, across the board for pretty much all of industry and CPG in particular, because it hit the individual retailers significantly, demonetization had a significant impact on our India business in Q4. And there's still some lingering effects. I'm not sure we are totally out of the woods. It's a big country, a massive change because it's currency that was about 80% of the circulation out in the country that was taken out of circulation, and the implementation had its share of challenges. So our hope was that by the time Q2 rolls by, we would be through the bulk of the demonetization challenges. And the new currency and the digital currency will be back in circulation and we'll be back to retail activity coming back to normal.

Operator

Your next question comes from the line of Mark Swartzberg of Stifel, Nicolaus.

Q - Mark Swartzberg {BIO 3344004 <GO>}

Yeah, thanks. Good morning.

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

Morning.

Q - Mark Swartzberg {BIO 3344004 <GO>}

Indra, on Mexico and the UK, I wonder, because of the vote back in June in the UK and the election here in November and its effect on Mexico or at least the perceived effect, could you lift the hood for us a little bit on those two markets, give us some sense what, if anything, is changing in the way of consumption behavior in Mexico since November, in the UK since June? We look at the data. We read, but you guys are there operating. So I'm just wondering if you're seeing a deterioration in Mexico and an improvement perhaps in the UK in the way people are behaving vis-à-vis your products?

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

We are basic food and beverage. I don't believe political actions impact consumption of our products. And we're not seeing any deterioration in activity versus our products, and the market growth continues.

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

Yeah, Mark, just to expand on that, I was down in Mexico last week and the market looked terrific. Our business looks terrific. I saw no implication there. And in terms of the UK as well, we've seen no meaningful business impact from some of the things happening in the political arena at all.

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

Thank you for your questions. So to summarize, we are pleased with our results for 2016 and that gives us confidence in our performance as we enter 2017. We are committed to continue to manage everything within our control in what we expect will be a volatile and uncertain macro environment in order 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 for the confidence you have placed in us with your investment. Thank you.

Operator

Thank you. That does conclude today's PepsiCo fourth quarter 2016 earnings conference call. You may now disconnect.
