

Q4 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
- Amit Sharma, Analyst
- Andrea F. Teixeira, Analyst
- Brett Cooper, Analyst
- Bryan Spillane, Analyst
- Caroline Levy, Analyst
- Dara W. Mohsenian, Analyst
- Judy Hong, Analyst
- Kevin Grundy, Analyst
- Lauren Rae Lieberman, Analyst
- Laurent Grandet, Analyst
- Mark David Swartzberg, Analyst
- Pablo Zuanic, Analyst
- Robert Ottenstein, Analyst
- Steve Powers, Analyst
- Vivien Azer, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning and welcome to PepsiCo's fourth 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 2017 performance and full-year 2018 outlook and then we'll move on to Q&A.

Before we begin, please take note of our cautionary statement. This conference call includes forward-looking statements, including statements regarding 2018 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, which includes a detailed discussion of our fourth quarter and full-year 2017 reported results, and in our most recent periodic reports filed with the SEC.

When discussing our financial results on today's call, we will refer to certain non-GAAP measures, which exclude certain items, such as the impact of the U.S. Tax Cuts and Jobs Act and foreign exchange translation from our reported 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 to find full explanations and reconciliations of these non-GAAP measures.

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 in this morning's release, we concluded 2017 with another quarter of strong operating performance, capping off another successful year. In the fourth quarter, overall organic revenue growth accelerated sequentially from the third quarter to 2.3%, right in line with our expectations. Core constant currency operating profit increased 6%, and core constant currency EPS increased 8%.

We had particularly strong performance in the quarter at Frito-Lay North America, with organic revenue growth of 5%, led by impressive growth in variety packs, Ruffles, Tostitos, Doritos and dips. We also gained market share, both in salty snacks and in the more broadly defined macro snacks categories. The business performed well throughout the year, with strong brand activation and innovative new products propelling the top line, and productivity programs continuing to move margins up.

Quaker Foods North America had very good performance. Hot cereals volume grew mid-single digits, and we gained share in our three key categories of hot cereals, bars and ready-to-eat cereal.

North America Beverages posted sequential improvement from the third quarter in organic revenue performance, with volume trends improving in trademarks, Pepsi, Mountain Dew, Gatorade and Lipton. More importantly, we have robust marketing in innovation lined up for 2018, including the launch of our Pepsi Generations campaign; the launch of Mountain Dew Ice, which was prominently featured with Doritos Blaze at the

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Super Bowl; the introduction of bubly, our new sparkling water that combines refreshing flavors with an upbeat and playful sense of humor to shake things up in the sparkling water category; and further marketing support in packaging innovation, as LIFEWTR enters its second year from launch.

To be clear, while our North American Beverages segment's top line performance did improve compared to the third quarter, overall, its performance still has tremendous room to improve, and we are taking the right steps to realize those opportunities. We remain committed to our strategy to compete on the basis of brand building, innovation and marketplace execution across our portfolio of brands as the best way to create shareholder value over the long term.

Turning to our international segments, organic revenue growth outside North America was fueled by continued strong performance in developing and emerging markets, which posted organic revenue growth of 7% as a group, led by double-digit growth in Vietnam, Turkey, Thailand, Philippines and Argentina, high-single-digit growth in Russia and China, and very solid mid-single-digit growth in Mexico and India.

For the full year, we delivered solid organic revenue growth of 2.3%. We expanded core operating margin by 45 basis points. We grew core constant currency EPS by 9%, exceeding the 8% goal we set out at the beginning of 2017. We generated free cash flow, excluding certain items, of \$7.3 billion, which exceeded our goal of approximately \$7 billion we set out at the beginning of 2017.

Core net ROIC expanded by 140 basis points and now stands at 22.9%. And we met our goal of returning \$6.5 billion in cash to shareholders through dividends and share repurchases. These are impressive results, particularly in light of the challenges posed by global mega trends impacting our industry, from macroeconomic and political volatility, the continued rebalancing of the economic world, to shifting consumer preferences and increasing demand for healthier products, to the disruption of retail caused by the rapid growth of e-commerce and the blurring of channel lines.

Our 2000 (sic) [2017] (06:08) results add to a long run of very strong operating performance. Over the past five years, organic revenue grew at a 4% compound rate, core operating margin expanded by 220 basis points, core constant currency EPS growth averaged 9% annually, core net ROIC expanded more than 750 basis points, our annualized dividend per share increased by 50%, and we returned \$38 billion to shareholders through dividends and share repurchases combined.

Our results for 2017 and over the longer past are a result of our steadfast commitment to manage our business responsibly and sustainably. Our portfolio of businesses has delivered consistently strong financial results year after year, while making the investments and taking the necessary actions to sustain shareholder value creation over the long term. Specifically, the expansion of our geographic reach and product portfolio has made our business more resilient. The power of our customer relationships in retail and foodservice has created advantage in the marketplace.

The strength of new capabilities in e-commerce, research and development, social and digital marketing and design has helped us connect with consumers in new ways. Our environmental footprint has continued to shrink, streamlining our operations and reducing costs. And our commitment to productivity has enabled us to sustainably reinvest in the business, positioning us to capture tomorrow's growth. In a nutshell, we have built a business that balances top line growth, productivity and reinvestment to generate strong financial results in a way that is self-reinforcing and self-sustaining.

The strength of our customer relationships in the United States was reflected in the most recent Kantar Retail PowerRanking survey, where our retail partners, once again, named us as the number one best-in-class manufacturer. And for the first time, we received the top ranking in every functional category, including clear company strategy, most important consumer brands, growth in profitability, sales force and customer teams, insights and category management, supply chain management, and use of digital platforms. Similarly, we were highly ranked in service by Advantage in many of our markets outside the United States, including key markets like China, Russia, the UK and Mexico.

Our annual productivity savings of approximately \$1 billion have been driven by a relentless continuous improvement mindset focused on every aspect of our value chain and guided by our environmental sustainability agenda. We have refined our business model to reduce management layers and accelerate decision making, and have deployed leading-edge technologies to increase manufacturing throughput, reduce logistics costs, and increase go-to-market efficiency and effectiveness.

Further, our robust environmental sustainability agenda has complemented these initiatives. Its focus on reducing water and energy use and eliminating waste has both reduced cost and vastly reduced our environmental impact. For example, in 2017, we accelerated our efforts to minimize PepsiCo's environmental impact, enabling us to streamline costs and mitigate our operational impact in the communities we serve. We have teamed up with disruptive startups, leading universities, governments and innovators to develop biodegradable film resins that meet the sustainable, flexible packaging requirements of our global food and beverage business, a technology to help advance our goal of designing 100% of our packaging to be recyclable, compostable or biodegradable by 2025.

Despite the many challenges we faced over the years, from changing consumer preferences to disruption in the retail environment, to geopolitical turmoil, we have consistently and substantially reinvested savings back into the business to further build capabilities and adopt technologies that we believe will enable us to sustain our top line growth. So, for example, our investment in e-commerce across multiple channels, from e-grocery, to direct to consumer, to pure play, helped drive exceptional growth in 2017.

We are leveraging big data and predictive analytics to sharpen real-time marketing messages, dynamic merchandising and tailored offers. And we're increasingly collaborating with retail customers to make e-commerce a point of differentiation for PepsiCo. As a result, our e-commerce business is now approximately \$1 billion in annualized retail sales, and we are well positioned to capitalize on what is sure to be a dynamic future in this space. In our investment in the world-class design capability

enabled the successful launches of innovative new products like LIFEWTR, and injected excitement and dynamism into our presence at major global events, from the Super Bowl to the UEFA Champions League Final.

Looking to 2018, we are encouraged by a number of factors. The global economy is growing, with developed markets stable and a number of developing and emerging economies showing signs of acceleration. In most of our key markets, the picture is relatively positive, with strong employment, consumer spending, and consumer sentiment data.

And in the United States, our largest market, we expect the recently enacted tax reform to have a positive impact on many sectors and businesses and on the economy overall. However, our outlook is tempered by expectation for challenging industry conditions, including a continued dynamic retail landscape, shifting consumer preferences and behaviors, especially as it relates to the focus on health and wellness, a robust competitive environment, and rising commodity costs.

Despite these challenges, we believe we are poised to continue to perform well, precisely because we have been making the investments and taking the actions to adapt and thrive in the current dynamic environment. For 2018, we will be aided by the financial benefits provided by the recent U.S. tax reform, which will allow us to make incremental investments to further fortify our business. For example, in 2018, we will provide a bonus of up to \$1,000 to full-time front-line U.S.-based associates to reward and recognize their dedication and contribution to making our business better and stronger. And we will invest in training our global associates to arm them with the skills to succeed in tomorrow's workplace.

Furthermore, as a company, we will double down on new capabilities in areas such as e-commerce, digital, and brand marketing to make us even more competitive. We're going to accelerate capital investments to add manufacturing capacity and make our operations more efficient. And we're enhancing cash returns for our shareholders, beginning with the 15% increase to our annualized dividend per share, effective with the dividend expected to be paid in June 2018.

Taken together, these actions are consistent with our philosophy of responsible sustainable management. They extend the durability of our business while strengthening cash returns to our owners, those who have entrusted their capital to us to generate secure, growing returns to provide for their retirements, their children's educations, and all the other noble financial goals they may be pursuing.

With that, let me turn it over to Hugh. Hugh?

Hugh F. Johnston {BIO 15089105 <GO>}

Thank you, Indra, and good morning, everyone. Let me begin with a discussion of our assessment of the impact of the recently enacted U.S. tax reform because it has

implications for our 2018 financial outlook on a number of dimensions. From our perspective, it will affect five key areas.

First, beginning in 2018, it will result in a lower tax rate on our U.S. earnings. Second, it imposes a one-time mandatory tax on our international accumulated earnings that existed as of year-end 2017, regardless of whether we choose to repatriate those earnings, but at a substantially lower rate than would have previously applied to actual repatriation. So net, it provides a much more efficient framework in which to repatriate our international cash.

Third, it decreases our net deferred tax liabilities, as those tax deferred items are now expected to be taxed at a lower rate at the point they became taxable. Fourth, it will allow for much greater mobility of our international cash going forward. And fifth, it will drive higher cash-on-cash returns on U.S. capital projects, as capital spending for the next five years will be immediately deductible for tax purposes.

As a consequence, in the fourth quarter of 2017, we recorded a one-time \$2.5 billion provisional net tax expense, which reflects the deemed provisional one-time repatriation tax of approximately \$4 billion net of a provisional \$1.5 billion benefit relating to the deferred tax remeasurement. The provisional \$4 billion liability associated with the international accumulated earnings is expected to be paid out over eight years, starting in 2019.

We expect a lower overall effective tax rate for 2018. We will accelerate some capital projects into 2018, resulting in an expectation for total CapEx to be approximately \$3.6 billion in 2018. And we expect to make a \$1.4 billion discretionary pension contribution in the first quarter of 2018 to maximize its tax deductibility.

So turning to our guidance for 2018, we expect organic revenue growth at least in line with our 2017 growth rate, or 2.3%, as we expect to continue to benefit from successful product innovation and strong marketplace execution, but tempered by a cautious outlook as it relates to the retail environment and changing consumer behavior. As Indra mentioned, we expect to step up investment spending in front-line workforce training, digital capability, data analytics, e-commerce, and advertising and marketing.

We expect our core effective tax rate to be in the low 20s. and we expect core earnings per share of \$5.70, or a 9% increase compared to 2017 core earnings per share of \$5.23, with the benefit of the lower tax rate substantially offset by the incremental investments.

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 2018, we expect free cash flow of approximately \$6 billion, approximately \$9 billion in cash flow from operations, which includes the \$1.4 billion discretionary pension contribution. On this point, it is important to note the pension funding will reduce our gross debt from a rating agency perspective, and so it creates room for leverage elsewhere within our capital structure.

And we expect net capital spending of approximately \$3.6 billion. As I mentioned, this is a bit above our trend over the last few years as we accelerate some projects into 2018. And we expect to return approximately \$7 billion to shareholders in 2018, with cash dividends of approximately \$5 billion, reflecting the 15% dividend increase Indra mentioned, and share repurchases of approximately \$2 billion. Further, beyond 2018, we see the prospect for even higher cash returns as we begin to fully realize the benefits of greater global cash mobility.

Relatedly, we announced today our new three-year share repurchase program commencing July 1, 2018, providing for the repurchase of up to \$15 billion of common stock.

Finally, as you update your models, I'd like to highlight the following. We expect our rate of organic revenue growth and core constant currency EPS growth to be higher in the second half than in the first half, as we will lap NAB's softer performance and natural disaster-related business disruptions in the second half. We expect variability in the timing of productivity savings, investments, and this includes the accrual of the front-line bonus, and net commodity inflation to contribute to relatively better performance in the second half. And we expect the fourth quarter to have the largest year-on-year core tax rate benefit.

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

Q&A

Operator

Thank you. Our first 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. So, NAB continued to be weak for the second straight quarter. I was hoping you could review your plans there to improve market share performance on the CSD side of the business going forward. And how big a piece lower pricing or greater promotion is within those plans?

You mentioned some tweaks post Q3 in terms of shelf space focus, et cetera, but it did look like you pulled the pricing lever more aggressively in Q4, both in the scanner data, as well as reported results despite the comments on brand building. So, I'd love some detail there. And then also, while we're on the subject, can you review the Gatorade trends in North America from a market share perspective and forward plans for that brand? Thanks.

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

Dara - Hugh, you want to take this?

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

I'd be happy to take it. Thanks, Dara, for the question. A couple of comments on that. First, I want to make clear that our strategy in the beverage business remains as it's been. It's focused on brand building, it's focused on innovation, and it's focused on execution in the marketplace funded by driving incremental productivity.

Second, in terms of 2018, we have increased advertising behind the big brands, and we expect that to have a positive impact. But like most advertising campaigns, that will take several quarters to fully realize the impact. So, we expect sequential improvement in each of the quarters, starting with Q1. Just as a reminder, back on the Q3 call, we did talk about the fact that we expected sequential improvement from Q3 to Q4 and we did, in fact, see that.

Regarding pricing, we expect our pricing to be competitive in the marketplace, but pricing lower is not part of our strategy to gain market share. Price/mix is always complicated when you read the reported results. Particularly in the first month of the year, you saw some increased promotional activity that is much more reflective of timing at a few of our bigger customers than it is of a change in strategy. So, we expect to get the types of pricing that we've gotten in recent years in the North American Beverage business.

As for Gatorade, I think you'll see a full lineup of innovation for the year, both flavor innovation and perhaps some broader things as well, which we'll be talking about as we get further into the year. So, net, it's about innovation and it's about brand building. It's not about pricing as far as our strategy is to continue to see sequential improvement in the beverage business.

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

And more importantly, Gatorade trends are improving, and we feel good about what we're saying the business delivering right now.

Operator

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

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

Good morning, Bryan.

Q - Bryan Spillane {BIO 2147799 <GO>}

Hey, good morning everyone. Just a question, I guess, related to - or a couple questions related just to cash flow as we think about this year. First, net interest expense; Hugh, if you could talk at all about just the movement in rates and how we should think about how

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that might – or potential movement in rates and how that might affect net interest expense?

And then, second, in terms of the CapEx coming up, I think you mentioned in the prepared remarks that some of it's going also to adding capacity. And so, I'm just curious to know, with organic sales growth sort of below the algorithm, but we're adding capacity, is it a modernization, so a need to sort of modernize some manufacturing capacity? Or are there true needs to sort of add capacity?

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

Go ahead.

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

So I'm happy to take that one, Bryan. First, regarding your questions on cash flow and specifically net interest expense, we do operate with zero net floating debt, so rises in interest rates shouldn't have an immediate impact on us in terms of the debt that we carry. We obviously do have refinancing risk as we sort of turn over that debt tower each and every year. But given the cash return, we should be able to manage that successfully, so I don't expect to see significant rises in net interest expense for the year.

As to your question regarding capacity, if you look at the Frito-Lay business in particular, we will be investing in capacity there. We've seen good strong volume growth in Frito-Lay over the last several years and certain of our international markets where we've also seen good strong volume growth, we'll need to add capacity in those markets. So, this is very much capacity, reflective of growth in individual product categories around the world.

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

And most of the capacity increase is in snacks. And we're going to put the capital in 2018 and hopefully, from 2019 we'll start to see the results of the new capacity coming on stream.

Operator

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

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

Good morning, Kevin.

Q - Kevin Grundy {BIO 16423871 <GO>}

Hi, good morning. Good morning, Indra. Indra, I was hoping you could comment on the current Dr Pepper deal. What are your initial thoughts on what you think that may mean for the competitive landscape? And then sort of looking ahead, what do you think that means with respect to the potential for further consolidation in the North American beverage industry? Thank you.

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

We've been reading all the reports that you guys have written to understand the real strategy behind that merger. I'm sure there's some towering strategic logic, but we are still searching for it. You see, the distribution, 80% of distribution of Dr Pepper sits between the red system and the blue system. And so, if the merger is supposed to increase access to distribution, it's between the two of us who control 80% of the distribution and manage it for Dr Pepper. So, let's wait and see over the next few weeks and months to see what kind of a strategy they articulate because it somehow eluded us the strategic logic.

Operator

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

Q - Caroline Levy {BIO 1494597 <GO>}

Good morning. Thank you very much. I'm wondering if you could give us a little detail on your outlook for costs. We understand there's a lot of pressure on distribution, trucking, shortage of drivers, and then, of course, just raw materials. And I think you're hedged out nine months on average on your inputs. But if you could just give us an update because there was, I guess, across the board, operating cost pressure and some raw material cost pressure already in the fourth quarter. Thanks.

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

I'm going to let Hugh answer that. But, hello, Caroline, good morning.

Q - Caroline Levy {BIO 1494597 <GO>}

Hi. Thank you.

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

Go ahead, Hugh.

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

Thanks. Thanks, Indra. Yeah, Caroline, break it up into two pieces. On the commodity side, as you correctly observe, we do have our systematic forward buying program in place, so we're generally out about nine months on all the things that we can be out on. Overall, commodity inflation will be in the low single digits as it's been in the last couple of years.

Regarding labor inflation and OpEx inflation, we've typically seen pressure there in the range of 3% to 4% globally, which is about in line with the inflation in our markets around the world. To date, we haven't seen any pressure that's so substantive that it's disruptive to the algorithm, but we certainly expect some labor inflation pressure in certain markets over time.

Operator

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

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

Good morning, Robert.

Q - Robert Ottenstein {BIO 1498660 <GO>}

Great, great. Good morning. Hugh, you did touch on quite a bit some of the financial implications of tax reform. But I'm just wondering if you could step back, philosophically it sounds like you'll be able to give more money back to shareholders. You raised the share buyback authorization higher than it was in the past. And you increased the dividend at a higher rate than in the past. Can you just talk a little bit more detail about some of the increased flexibility you're going to have? Should we expect higher dividend increases than in the past? Does this change anything on the M&A front? Just a little bit more detail from a strategic perspective.

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

Sure.

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

Go ahead, take the dividend question. On the M&A, I'll just tell you, Robert, we're sticking with our strategy of tuck-in M&As. And if something blindingly strategic and value creating shows up, we'll be sure to talk to you about it. But at this point, our focus is on sensible tuck-in acquisitions. But talk about the other things, Hugh.

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

Yeah. So, Robert, on more broadly, obviously, the tax reform bill allows for a much greater flexibility in terms of the way we manage the company's resources, and, particularly, cash resources around the globe. It, obviously, lowers the cost of capital a little bit in the U.S. as well. So, generally, that's good news for investment in growth.

In terms of our projections going forward on dividend and share repurchase, with this 15% announcement, you've seen the payout ratio go up a little bit. I think that's likely where we're to maintain. This is not a signal of a longer-term increase in the payout ratio over time. So, we talk about dividends once a year, every year.

I'm not going to talk about specifically what will happen going forward. But I think what you see is just a modest uptick in the payout ratio. Beyond that, we'll see what happens as we get beyond 2018 regarding where the cash goes and what we do with it. But as Indra said, our M&A policy has been very tightly focused on tuck-in M&A, and that's where we'll stay.

Operator

Your next question comes from the line of Pablo Zuanic of SIG.

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

Good morning, Pablo.

Q - Pablo Zuanic {BIO 1734343 <GO>}

Good morning, everyone. Good morning and good morning, everyone. Look, just two questions. First, can we talk a little bit about ready-to-drink coffee and ready-to-drink tea? I know you don't fully own those - you don't own those businesses directly, but in a couple of years, both of them could be as big as your sports drinks business if my math is not wrong. Just give us some color there. Obviously, you have the Dunkin' entry with Coke into ready-to-drink coffee. On the tea side, Pure Leaf and Brisk are doing well, but Lipton is declining. Just some color there would help. And maybe a reminder in terms of how that really flows through the P&L.

And the second question, in terms of your water strategy, leaving bubbly aside, obviously, Propel LIFEWTR are helping you gain share in still bottled water. But just remind us of the strategy in still water, Aquafina is still a big chunk of your business there, but how big are the other brands also?

And third and last, related to water, can you give us some color on bubbly? Obviously, your main competitor there, LaCroix, does not advertise. I suppose we will see a big advertising push from bubbly with it being at Walmart. Just some color on the launch would be helpful. Thanks.

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

Okay, ready-to-drink coffee and ready-to-drink tea, both businesses doing very well. Ready-to-drink tea overall has grown every year in the United States and globally. Clearly, Pure Leaf grew at very attractive rates. And core Lipton fell off a little bit, but we have plans to bring growth back to Brisk, to Lipton and to Pure Leaf. So, we feel very good about the plans we have for ready-to-drink tea, which also includes the premium Tea House Collection. So, all the new flavors we are launching. And the sort of re-advertising of core Lipton, I think, is going to give the ready-to-drink tea business that we have a much needed boost.

When it comes to ready-to-drink coffee, Starbucks is still the most powerful brand in the United States and globally. And the joint venture is doing very well. When you have a competitor in the ready-to-drink coffee business going through a powerful distribution system, which is what happened with Dunkin' Donuts coffee, in the short term, you will have some share erosion. The challenge is not to behave crazily through the share disruption because, ultimately, the strength of the product determines who is going to win in the long term.

So, I think, as the year progressed, our ready-to-drink coffee business returned to growth again because the initial distribution share losses steadied. And ultimately, the business has to be won on velocity of the product, and we're doing just fine. And the innovation pipeline on ready-to-drink coffee coming out of Starbucks is very, very impressive. So, we feel good about both.

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In terms of the profit impact to us, it's a joint venture, but we captured the bottling revenue. So, we capture a large portion of the revenue of both coffee and tea, although it's a joint venture with Starbucks for coffee and Unilever for tea, and they're both very successful joint ventures. I wish we had more of them.

In terms of water, clearly, it's a big market and it's growing. And as you know, beverages is a repertoire category. And water in all its forms, still, sparkling flavored; still, flavored sparkling; electrolytic waters; sports hydration, they're all growing categories. At this point, we have our presence in, I think, pretty much every category in water.

And I'll be honest with you. I think we were late to the flavored sparkling water category. I wish we had launched bubly a couple of years ago. But the fact of the matter is we have a very good distribution system. Our customer relationships are excellent, and our customers are very, very happy we're launching bubly. The product tastes fantastic, and in a lot of the testing, it is winning versus competition. So we are feeling good about bubly.

Propel has been doing very well, growing. We feel good about that. LIFEWTR, as you know, is perhaps one of the fastest-growing electrolytic waters that was launched in 2017. And our goal is to continue to support the arts and roll it out globally in 2018 and beyond. So overall, the hydration portfolio is strong. And our goal is to make sure, as a repertoire category, we offer sports drinks, we offer other hydration options, and coffee, tea, carbonated soft drinks, all of the products that the consumer wants.

Operator

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

Q - Vivien Azer {BIO 16513330 <GO>}

Hi, good morning.

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

Hi, Vivien.

Q - Vivien Azer {BIO 16513330 <GO>}

Indra, I was hoping that you could expand on your comment, please, around your outlook for the retail environment. I assume that was a U.S. specific comment. And if you could drill down at all into what you're seeing in c-stores, I think it will be helpful. Thank you.

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

Actually, the retail disruption is happening globally. It's not just a U.S. phenomenon. The success of the newly emerging retail channels is still a work in process because none of them have really established a toehold in the U.S. But between the hard discounters, e-commerce, e-commerce of every kind, the pure play, the click-and-collect, the growth of dollar stores from a few years ago, and of course, the brilliant growth of Walmart, all of this has caused the retail industry to go through a fairly significant change because we are

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overbuilt in grocery in the country, and all of these alternate channels are now beginning to challenge all the square footage in the marketplace. So we are watching and waiting to see whether this disruption is just a low level of disruption that happens over many years or is this going to accelerate. It's something that we're watching.

The good news is that our DSD system reaches virtually any outlet that's out there. Whether it's convenience store, foodservice, whether it's the big supermarkets or the big hypermarkets, we reach every one of them. So we are watching the traffic through these outlets. We are watching what kinds of products are being sold, what are people buying through e-commerce and what are people buying through brick-and-mortar. And more importantly, we're looking to see whether brick-and-mortar stores are really becoming the warehouse to pick for e-commerce, which breathes more life into them.

So, this is an evolving story, Vivien. And the outlook is not perfectly clear because the economics of many of these new digital channels is still being thought through. It's not perfectly clear that they're all going to make money.

Internationally, we have much the same phenomenon. China I think is the cutting edge of digital sales in the grocery channel. We are seeing Europe now grow in terms of e-commerce and the hard discounters taking a much bigger presence there. And we're seeing the same thing in Latin America. So I think China and the U.S. are cutting edge in terms of retail disruption. We're going to have to watch and see how it evolves in the other markets. And our teams are all connected globally and thinking through the best strategy for us to play in this new retail environment.

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, guys, so two questions on a couple things that don't make sense to me. The first one is just if we were to refocus on NAB here for a moment. And look, what looks like a change in the price rationality, at least in the data, despite certainly what you're saying. And it isn't your first quarter of seeing this, so I think it's important because your stock has been weighed down by this concern in the investment community about price rationality in North America.

And look, for years you've agreed with the idea that the price elasticity in the category suggests price rationality. But what we're seeing in the results, not just this quarter, for the past couple quarters, and then in Nielsen on NAB specifically is really suggesting that there is lower rate, there's lower mix, and certainly lower marketing spend at least in the quarter, it looks like in that in NAB. And by the way, your volumes, your shares, and most

probably your sales are not really responding. Meanwhile, your competitors are taking 1.5% to 3% pricing or price/mix systematically and pretty logically.

So I want to give this opportunity to either clarify what I'm missing because we have broken out rate and mix, to your earlier point. And look, I believe that you're not going back on what you said before about price rationality and taking prices up, but we'd really love your assurance and your clarity that we're going to see pricing up - in line with competition I think is the language you used, but in line with the competition going forward in NAB, because it's a very, very important thing obviously for your stock and for the industry. So I really want to delve into the disparity between what we're seeing in the data and what you're saying.

And the second thing, a really easy one but potentially disappointing one, is that it looks like you have \$0.08 on the quarter and \$0.15 on the year from Britvic and Jordan gains and other one-time things, and it looks like it's in your core. And if it is in your core number, I'd love an explanation of why one-time things like this remain in your core. And it looks like from a quarter perspective, that would suggest you're missing EPS, at least our numbers, and it suggests consensus. And your EPS growth for the year was only about 5% excluding those items. So again, there too, I would love some clarity and better understanding. Thanks.

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

Hugh, do you want to take the question and I'll add to whatever you have to say?

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

Yes, happy to do that, Ali. Let me get the second one out of the way first. You're right about the gains. And where that money went was about \$0.03 on the 53rd week and lapping that, about \$0.03 on investment back in ESSA, and about \$0.04 or \$0.05 of business disruption from hurricanes and floods, all of which were one-time items, and they were all in Q4. So hopefully, that helps you tie that one out.

Regarding the question on pricing, as I mentioned earlier, our strategy has not changed. We were, I think in many ways, the author for the industry of the strategy that the basis of competition is around innovation and brand building, and that pricing is something that we would expect to take consistently every year.

One point that that's a little bit hard to comb out of the data, but it connects back to the marketing investments that we're making back behind the big brands, we are seeing promotional price points that are consistent between ourselves and our competitors and full revenue price points that are consistent between ourselves and our competitors. But our velocities on full revenue have been slower than some competitive velocities.

The reason for that, we believe, is because we do need to refocus back on A&M behind the big brands and ensuring that, as we build displays, the displays are very much reflective of those big brands as well in a substantive way, both in the shelf and out on the

perimeter of the floor. We did start to do that in Q4. You'll see more of it in Q1 and even more of it in Q2. So, the strategy remains the same.

I think the full revenue velocity piece is something that probably warrants a little bit further analysis, but I think it captures some of the effect that you're seeing in the numbers. As I mentioned earlier, as you pointed January, the one other factor is, in any given four-week period, you are going to see promotion timing between competition being distortive, but the point they made earlier over the course of a couple of quarters, I think, is more driven by this whole rev promotional mix than it is by us dropping prices further.

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

But the thing to remember, Ali, is when you're redoing the pricing architecture on certain products, it takes two to three quarters for it to play through the system. And second is, the good news is the portfolio works. Any which way you look at it, if you look at 2015 and 2016, NAB performed very well. 2017, there was a confluence of factors that caused some issues. And 2018, we have a strong marketing program, and we're maniacally focused on the business. I just think the overall portfolio works, and that's the benefit of having international, North America, and snacks, beverages and the Quaker business. So, we are feeling good about our prospects.

Operator

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

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

Great, thanks.

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

Good morning, Lauren.

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

Good morning. I was curious if you could talk a little bit more about drivers of gross margin this quarter, down pretty in a fairly healthy way. I don't think we've talked much about that. And then part and parcel with that was anything more on channel mix. Hugh, you did comment a bit on e-commerce, but just curious anything on foodservice or convenience channel trends that may or may not have been contributing to that gross margin performance. Thanks.

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

Go ahead.

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

Yeah. So, happy to do so, Lauren. I think if you look at overall PepsiCo gross margins, NAB is the big driver behind that for all the reasons that we've been talking about. It's a

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different way to sort of look at the financial performance of NAB. But given the deleverage in the system, that's affecting gross margins, as well as operating margins, obviously.

Regarding channel mix, some of the comments that I made earlier that we were talking about regarding c-store and velocities, in particular, it does have some impact in that channel. And as a result, as we invest more behind advertising and marketing, behind the big brands of Pepsi and Gatorade and Dew, I think you'll see improved performance from us in that channel, in particular.

Operator

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

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

Good morning, Laurent.

Q - Laurent Grandet {BIO 19930531 <GO>}

Hey, good morning, everyone. In Q4, we saw the refranchising of the Thai business be enacted with Suntory. Similarly, we saw some more products and territories being handed over to Varun, your bottler in India. So, how should we think about these going forward, the strategy to continue refranchising more aggressively internationally? And also, I mean has your position in the U.S. changed in regards to the franchise model?

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

Internationally, when we find a very good bottler and we believe that they can run the business better than us, we will refranchise the business, and that's what we did in Jordan, that's what we did in Thailand. And we look across our portfolio internationally to see where it makes sense. And I'd say internationally, we're pretty much refranchised in the bulk of the markets or franchised, I should say, in bulk of the markets.

North America, we look at it constantly. We look to see the benefits of doing the refranchising again versus running it ourselves, and all the friction that results when you refranchise a business. And right now, our belief is that we can run it better than going through the whole pain of refranchising and then living with all the friction. We don't believe that going back and forth from owning it, refranchising it, owning it again is a decision we can make lightly. So, at this point, we are focused on extracting the productivity, driving the top line growth and making sure innovation sticks in the marketplace.

Again, let's not forget, 2015 and 2016 were very good years for North American Beverages. 2017 was a year that we would have liked to have had better performance. And now we're going into 2018 with a strong marketing calendar. So, let's wait for the year to play out.

Operator

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

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

Good morning, Judy.

Q - Judy Hong {BIO 3773182 <GO>}

Thank you, good morning, so a couple of questions. One is just on your organic revenue growth guidance of at least 2.3%, which is in line with 2017 growth rate. I guess it's somewhat of a disconnect from the improving macro outlook, some of the robust innovation pipeline that you've talked about. So, I'm wondering if this is really more related to the retail environment and sort of the pricing pressure that you see in these markets.

Or is there some conservatism around how the innovations are going to work out in 2018? And then a little bit of color just in terms of some of the improvement you're seeing in emerging markets, particularly around China and India, as well as what you're expecting for Latin America.

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

Judy, it's a tough question to answer only because, clearly, we'd like to do better on top line growth, and that's what - our innovation is geared to better performance, clearly I think the macro is improving. But for all the positives we're seeing, as I mentioned in my script, there's a whole bunch of headwinds. Retail disruption is one of them. Consumer preferences are shifting in interesting ways.

On the one hand, there's a huge push towards health and wellness. On the other hand, they want to go back to products they know the best, but they're not consuming it in the quantities that they used to consume it in the past. So, it's an interesting dichotomy there. We talk about reinvesting back in the big brands, but a lot of the growth is coming from the small brands, so we have to launch those brands, too.

So, we are just making sure that any guidance we provide to you is sensible and something that we know for sure we can deliver. And that's why organic revenue growth at least in line with 2017 is a sensible guidance. Internally, we'd like to do more, but we want to be very, very cognizant of the headwinds around us, some of which we don't even understand at times because the consumer is not consistent.

In terms of macroeconomics, we are seeing the Chinese market improve. Post the GST, we are seeing the India market coming back. And Latin America, I think in 2017 Q4 going into 2018, we are seeing most of the markets in Latin America improve, too. So, as we said earlier, we're seeing an improving global macroeconomic conditions prevailing across the world. I mean Europe is a standout example. Both East and West Europe, we're seeing really improving macros which helps the business.

Operator

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

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

Good morning, Andrea.

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

Good morning. So, I wanted to go back to Indra's comment on the previous conference call about giving innovation the appropriate space, in particular in beverages. And I would layer with your comments today on the cadence of the quarters. Is it fair to assume that you're likely getting more shelves on better displays?

And Hugh mentioned also on the displays and some of the four initiatives that you had on the trade with the new launches, I read in the first quarter or, usually, I'm assuming you have some visibility because that's usually what the time that it rests in the U.S. And from a promotional standpoint, are you expecting to lift some of the promotions we saw in the fourth quarter, so we can see a better operational EBIT margin division for the balance of the year for 2018?

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

I'll take parts of the question and then, Hugh, you can take other parts of the question.

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

Sure.

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

I think, Andrea, from our perspective, whether it's a classic Mountain Dew or a Pepsi or our core brands, through our DSD system, they go in and they have their space on the shelf. When we launched the right innovation for the marketplace, low-calorie Lemon Lemon or IZZE, they're all great tasting products and Lemon Lemon was voted the best new innovation for last year.

But when it takes space away from the core brands, the velocity is much lower, and we are trading a higher velocity product for a low velocity product. So, one of the things that we have to go back and look at is, should we incubate some of those products in the new distribution system, let them reach a certain size before you put them in the main DSD system because, clearly, they need to be incubated in a different place in the store, especially in the single-serve channels. And that's what we're working through. It's not that we are backing off the innovation. It's how we get that innovation to the market, especially if it's on – not on our big brands.

Let me turn to products like Mountain Dew Ice which we launched as part of our Super Bowl launch. Great tasting, lower-calorie Mountain Dew, tastes just like Mountain Dew, a lemon lemon Mountain Dew – or a lemon Mountain Dew, I should say. We put it through the DSD system. It's a Mountain Dew. It's doing well. But that's a big brand. It's not a

Lemon Lemon, which was a new brand. So, we are trying to tweak this whole small brand innovation which will become big over time, but how do we incubate it in our distribution system and specifically where in the store should it go.

Should it go and take space from our big brands, or should it have new incremental space? The good news is our relationships with the retailers are so strong that they know that we are maniacally focused on driving growth for them. So, they like to give us the space because we handle displays and merchandising very well, and we make it easier for the retailers to do business with us.

Hugh, did you want to add anything on this?

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

I think you covered it well. The only thing that I would add briefly is, these are not either/or types of questions. There is a bit of a balance between the two. And as we talked about our Q3, we may have gotten our balance a little bit off. And we're course correcting that balance. So, I expect that our big brands will get plenty of presence, but that doesn't mean we're backing off on the innovations, particularly of the newer, smaller healthier brands because we know over time that those businesses are going to turn into good-sized businesses for us. They're just taking time to incubate.

Operator

Your next question comes from the line of Steve Powers of Deutsche Bank.

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

Hi, Steve. How are you?

Q - Steve Powers {BIO 20734688 <GO>}

I'm good. Thank you. Good morning.

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

Morning.

Q - Steve Powers {BIO 20734688 <GO>}

Hey. I just want to - I guess I want to revisit Judy's question on the top line growth guidance from a slightly different perspective. So, if we step back and look at fiscal 2017 and 2018 as a whole, just based on the results today and the outlook today, there's just obviously a significant amount of reinvestment that you've been making ahead of the implied base rate algorithm, which I know you addressed in your prepared remarks. So, a reinvestment of productivity wins, reinvestment of the extra week in 2017, effective reinvestment of one-time gains like Jordan and, obviously, tax reform.

And then despite that, as you acknowledged, we're not really seeing advantaged growth at the total company level. So I guess the question is how do you or how should we think about the ROI on all these reinvestments? Is this just symptomatic of a higher cost of growth structurally as you work through changes at the retailer and consumer level, or are there reasons beyond macro improvement to expect better results; i.e., acceleration in 2019 and beyond? Thanks.

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

Stephen, I think some of what you said is right because, as I said earlier, there are a whole bunch of puts and takes. There are headwinds in the marketplace. There are tailwinds. And the investments we are making, think of them in two buckets. Some of the investments we have to make because the cost of business has gone up. Example is all the investments we make in food safety because of FSMA, the investments we have to make in cyber security. You can never fully protect your system, but investments keep going up. Those are investments you make to protect the core business. And they don't result in increased top line, but they prevent major accidents from happening. That's the whole hope. We keep making those investments because that's the nature of the business.

In terms of investments in innovation, advertising to drive the top line growth, our hope is that we get even more attractive top line growth because of those investments. Sometimes there are headwinds on the categories or headwinds on our businesses that dampen the growth. As I said to you in our prepared remarks, we would like that top line growth to be higher, and that's what we are focused on. But when you have the consumer shifting to smaller brands, but doesn't stick with the smaller brands and then comes back to the big brands, our innovation starts to not yield the kinds of benefits that we're seeing.

So I think we're going through a period of incredible disruption between consumer preferences, retail channel changes. And even our 2.3% should be at the high end of top line growth in our food and beverage space. Believe me, we are focused on increasing that growth rate substantially. But at this point, given what we are seeing in the marketplace, I think it's prudent to count on that number because we're saying it's at least in line with 2017. I don't know if you want to add anything, Hugh.

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

Indra, the only thing I would add to that, Steve, is that if you take a multiyear look at this, generally speaking, our revenue growth has been reasonably in excess of our peer group. And I think that's reflective of getting returns on a lot of the investments we've made ex the investments that Indra mentioned that we need to make for defensive purposes, going all the way back to 2012 when we put a substantial investment in the business.

If you look at where we landed in 2017, most of our businesses are performing very well and the PepsiCo portfolio is performing very well. But our biggest revenue business had a challenging year, and that was clearly a drag on the growth rate. And it's going to take a few quarters to course-correct that. I think our guidance is reflective of that. As Indra said, we view our guidance as what we're trying to hit or beat. We obviously know that investors rely on that guidance quite substantially, so we do try to make sure that we are

highly confident in the guidance that we give. But we surely don't view it as a cap, and that's certainly been evident over the last five years of performance.

Operator

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

Q - Mark David Swartzberg {BIO 3344004 <GO>}

Thanks. Good morning, Indra. Hi, Hugh, two questions. And thank you for taking the questions. Frito-Lay North America improved quite nicely in the quarter. So could you tell us a bit about why that was and how it affects your outlook there?

And then really on the other direction, so to speak, Latin America weakened in the quarter, volume weakened. To what extent is that Mexico? To what extent is that Brazil? And I apologize if I missed that in your prepared remarks.

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

In Frito-Lay, all the innovation is working. Distribution is excellent, merchandising is great, and it's all working. And it's a machine that has been fine-tuned over the years and it's working and all of the Power of One programs are working, too. They're doing a lot of interesting merchandising with beverages, and the whole portfolio is working. And I think that's what we expect from Frito-Lay, to deliver flawless performance. I think Q4 was extraordinary, but the hope is that Frito-Lay will continue to deliver nicely going forward. In fact, I think Global Snacks is doing well too.

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

Yes.

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

Latin America, Q4 was the brunt of the extraordinary force majeure actions, earthquake to hurricanes to everything that hit that part of the world. And in spite of that, the fact that they put up those kinds of results I think is extraordinary. And clearly, markets like Brazil are coming out of economic depression. But we're seeing signs of improvement. So I look at Latin America and say, going forward, you should see improving performance. Frito-Lay, solid steady results, as we always seem to expect from Frito-Lay.

Operator

Your next question comes from the line of Brett Cooper of Consumer Edge Research.

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

Good morning, Brett.

Q - Brett Cooper {BIO 17398526 <GO>}

Good morning, a couple questions. Indra, you guys talked a lot about disruption at the retail space. How much of that disruption informed your decision to hold on to the bottling businesses in the U.S.?

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

Control of distribution is what I would say, not necessarily holding on to bottling system because that's really distribution. I think it's important that as retailers just disrupt themselves and you're going to see big changes, our distribution systems don't cause more angst for the retailer.

I'd say when the bottling system was not part of PepsiCo, the biggest friction in the system was having to negotiate with retailers with our bottler alignment. And any of our innovation, we couldn't get it to the marketplace because the bottlers had a different agenda. Now we are largely aligned, and that's why retailers give us such high marks, because when you talk to PepsiCo, you have an aligned system on snacks and beverages that serves the retailer very well. So with retail disruption, that control of distribution system becomes even more important.

But I want to tell you something. If we believe, if we believe, and we haven't come to that conclusion at all, if we ever believe that that distribution system is better in the hands of somebody else and they can do a better job than we do, we are a team that's maniacally focused on shareholder value creation. So believe me, we will make the right decisions. But at this point, it's our belief that we can do a better job running the system. And as you see more innovation, more retail disruption, we cannot afford friction with the distribution system.

Operator

Your next question comes from the line of Amit Sharma of BMO Capital Markets.

Q - Amit Sharma {BIO 20024588 <GO>}

Hi. Good morning, everyone, Hugh, a question for you. Gross margins were weak again in this quarter, have been weak for the last several quarters. As we look to 2018, do we still expect this trajectory to continue and operating cost savings to cover for that? And then a quick one for Indra. Last quarter, you talked about c-stores being weak. Have you seen a full recovery in that channel this quarter?

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

I would say, recovering trend in these channels. Remember, the first couple of weeks of the quarter, the weather was quite terrible across most of the country. And so, after the first couple of weeks, we are seeing recovering trends in the c-store channel. Hugh, you want to talk about gross margins.

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

Regarding gross margins, I mean we don't guide on quarter-to-quarter on lines of the P&L, generally speaking. But as I mentioned earlier, NAB just has such a significant impact on our overall financials given the size of that business. As NAB's performance improves sequentially in the coming quarters, I think you'll see gross margins improve sequentially as well.

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

So, thank you all for your questions. So, to summarize, we are pleased with our results for 2017. We have good plans in place to continue to perform well in 2018. We're committed to continue managing our business responsibly in order to deliver attractive financial returns in a sustainable way. And I just want to thank you for joining us this morning, and thank you for the confidence you have placed in us with your investment. Thank you.

Operator

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

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