Sanford C Bernstein Strategic Decisions Conference

Company Participants

- Hugh Johnston, CFO
- Indra Nooyi, Chairman, CEO

Other Participants

- Ali Dibadj, Analyst, Sanford C. Bernstein

Presentation

Ali Dibadj {BIO 15328592 <GO>}

It's your last meeting before lunch. I'm Ali Dibadj, Bernstein's beverages and snacks and household personal products analyst. And we have with us today the CEO and Chairman of PepsiCo, Indra Nooyi. And Hugh Johnston, the CFO.

They kick off a really great set of consumer packaged goods companies that are presenting this week during the conference. And we really hope you can listen to many of those presentations.

Now on Pepsi, they are clearly a house of very, very strong brands from Pepsi to Ruffles to Lay's, Gatorade, Tropicana, you name it. $22 billion brands around the world. Leveraging those brands with a little bit of help from a restructuring and reinvestment plan that started last year, we are really starting to see Pepsi turn the corner, showing signs of improvement.

However, we are starting to see, as well, North American carbonated soft drinks volumes remain challenged, regulation becoming a bigger and bigger issue, emerging markets posing a margin mix threat, activist investors rearing their heads, as well as competition around every corner.

So to give us a sense of how Pepsi fits in that context, we look to Indra during the presentation and Q&A. And as is tradition for the Q&A, if you have any questions during the presentation, please write them on the cards, hand them through the aisles. And we will ask them at the end. With that, Indra, let me hand it over to you.

Indra Nooyi {BIO 1404395 <GO>}

Thank you, Ali. Good morning, everyone. It is a real pleasure to be with you here today. And Ali, thank you for clearing up all the questions that will be asked afterwards.

Before we begin, please take note of our safe harbor statement, which can also be found on our website under the Investors tab. You know, over the past decade, PepsiCo has been the picture of a consistent, durable, high-performing consumer packaged goods company. We generated more than $65 billion in net revenue. We've been consistently delivering mid-single-digit organic revenue growth. We have very attractive core operating margins and returns on net invested capital, each of which stand at 15%. We've grown earnings per share at a 9% compound annual growth rate. We have increased to per share at 14% compound annual growth rate. And we've returned $53 billion in cash to shareholders through a combination of dividends and share repurchases.

And this performance has translated to very strong, consistent shareholder returns, with PepsiCo outpacing the S&P 500 on an annualized basis by 170 basis points over the past five years and 140 basis points over the last 10 years.

At the same time that we've performed, we also made the required investments to transform the Company to address a number of macro trends that are reshaping our Company and position our Company for long-term growth. This is what we did.

We expanded our presence in faster-growing, developing and emerging markets in response to a shift in the sources of global growth. We continue to balance the portfolio of offerings to include more nutritional products and we increased the permissibility of our social snacks and beverages by reducing calories and sodium to address the growing aging population and consumers' growing concerns with health and wellness.

Disruptive technologies have become part of day-to-day operations, driven largely by the Internet. Because social media is becoming an ever-increasing, powerful force, there is a greater availability of sophisticated tools for product formulations. And food safety and security are now greatly enhanced by the fact that more tools are available to ensure ingredient traceability. In response to all of that, we stepped up our investment in R&D significantly and we increased our investment in digital capabilities and food safety and quality.

We also invested to enhance our brand strength and our revenue management skills to give us pricing power and build a culture of productivity to deal with the reality of a rapidly volatile environment and inflationary commodity environment. We designed sustainability into everything we do in response to a growing environmental consciousness. And we completely revamped our talent management processes and composition to address this conundrum of the global talent supply/demand mismatch.

Thanks to all the heavy lifting, the Company we have built is positioned to deliver long-term, top-tier sustained financial performance and value creation for our shareholders. We believe that PepsiCo is capable in the long term of delivering mid-single-digit revenue growth, which is mostly organic. And it is balanced, driven by a balanced portfolio of products, including good for you, better for you and fun for you products. And from a geographical perspective, developing and emerging markets contributing disproportionately to our growth.

We think PepsiCo is capable of delivering high-single-digit EPS growth on a core constant currency basis. And core constant currency operating profit will grow ahead of revenue growth, with margins expanding 30 to 50 basis points a year; and management operating cash flow, excluding certain items, to grow in line with net income growth; and returns on invested capital expansion of 50 basis points per year on average, supported by highly disciplined capital allocation. And healthy return of cash to shareholders through dividends and share repurchases, building on our long track record.

Now, these are the same goals we shared with you early in 2012. And we remain absolutely committed to working to achieve these goals.

So what I'm going to do in the balance of my presentation is to share with you our roadmap to achieve these goals, focused mostly on revenue growth, margin and profit growth, responsible capital allocation, which includes return of capital to our shareholders. And then briefly touch on how we are building talent, reinforcing our culture and executing behind clear, focused priorities to create value.

Let me start with revenue growth. PepsiCo has a well-architected portfolio, competing in two focused categories, both with attractive growth prospects. Both the snacks and beverages categories are predicted to generate global growth of 5% or more. Convenience foods and beverages businesses are fairly evenly balanced, with about half our revenue coming from each. And more importantly, our categories are highly complementary, sharing the same customers, shoppers and consumers.

Within this mix of snacks and beverages sits our very attractive global nutrition portfolio that consists of leading brands, such as Quaker, Tropicana, Naked Juice and Gatorade for athletes. And we are well-positioned within these categories with a clear, global, number one position in global salty snacks. And we have a strong number two global position in beverages, with leadership or parity in a number of very important markets. And we are among the top three leaders in mainstream, everyday nutrition businesses.

You know, we participate broadly in all segments of LRB. So our growth is largely driven by the category growth. In snacks, on the other hand, we are focused on salty snacks alone. So our growth comes not only from growth within our categories. But by also innovating to social occasions from adjacent macrosnack categories.

Geographically, our portfolio spans the (technical difficulty), with a strong presence in developing and emerging markets, which today account for 35% of our total net revenue, which is an 800 basis point improvement compared to just five years ago -- 800 basis point improvement.

Our geographic diversification also gives us a long runway to grow, because the consumption of our products grows as GDP per capita grows. In fact, there is a sweet spot between $10,000 and $20,000 GDP per capita where the rate of adoption and frequency of purchase of our products, both snacks and beverages, really accelerates.

So as we look at our geographic portfolio, there are a number of markets that are in this sweet spot. And that is what is fueling our growth today. Just as importantly, there are many markets yet to enter the sweet spot, representing tremendous future growth potential.

Even in relatively new emerging markets for PepsiCo, we've had good success in quickly ramping up our presence and our competitiveness. Let me just give you one example, in sub-Sahara Africa, Uganda. In that business, we entered 15 years ago. And our CSD business in Uganda has grown by 25 share points in just the past decade. And the same is true in markets such as Tanzania and Nigeria. In Tanzania, our share has grown by 30 points. And in Nigeria, we've grown to a 40 share of the market in a relatively short time. So we have white spaces and are going to go after that growth.

And to complement the strong geographic balance, we also have a very strong brand portfolio that connects with consumers. 22 of our iconic brands have estimated annual retail sales surpassing $1 billion each, a number that has doubled over the past 12 years. And like our products, these brands span everything from fun for you, to better for you, to good for you.

Our brands have typically the number one or number two position in their respective categories. In fact, our Banner Sun, anchored by Lay's, is the number one global food brand overall -- the number one global food brand overall. And Pepsi is the number two global brand in the liquid refreshment beverage category.

But more than the 22 brands that are over $1 billion in retail sales, we have another 40 brands that have retail sales between $250 million and $1 billion. These brands play a very important role in our broader portfolio, whether it is their strong relevance in a local market, their niche appeal in unique channels or their ability to communicate superpremium positioning.

The other thing about our brands is that they are critically important to retailers. Now, here is a slide that shows the 40 largest CPG brands in the US; not just food and beverage. But also includes household products. PepsiCo has nine of the top 40 trademarks in retail. We have four of the top 10 trademarks of retail. And more importantly, we have three of the top five.

This shows both the importance of the categories in which we compete in and how well-positioned we are within these important categories. We are an important partner to our customers because our success is directly linked with their success.

And they are making our powerful brand even stronger. In 2012, we took a number of important steps to increase our brand strength. We increased the level of investment in all our brands by 50 basis points, from 5.2% of sales to 5.7% of net revenue. And we continue to increase our brand support in 2013. We are focusing our investment behind 12 mega brands. And we are levering the scale and size of our biggest brands.

We are also working to increase the effectiveness and efficiency of our investments. We've directed more of our investments to activities that are directly consumer-facing, shifting money from non-working to working A&M by rationalizing the number of agency partnerships and by leveraging and coordinating the creative and production activities on a global basis for our global brands.

An important component of our consumer-facing media is leveraging social and digital media through our highly successful programs like Doritos' Crash the Super Bowl and Lay's Do Us A Flavor. We have strengthened our brands by improving the activation of our global sports properties, like the NFL, Major League Baseball and by leveraging them across multiple brand platforms and by driving execution from national media to local markets to in-store presence.

And for brands like Pepsi, we are finding the interesting intersections between sports and music. For example, we coordinated our global partnership with Beyonce last year -- or earlier this year, linking our sponsorship with the Super Bowl halftime show and to the recent launch of Beyonce's first global ad for Brand Pepsi.

We also continue to refine our tools on how we measure our return on A&M investment by capturing consumer equity scores at a more refined level and better understanding the complex interactions of all elements of our marketing mix on purchase and consumption decisions. Over time, our expectation is that this will lead to higher returns on our marketing investments.

Because our products and brands have such broad appeal, we have tremendous growth runway, with opportunities to create solutions that address each daypart and virtually every cohort group, every need, state and occasion.

We've also invested substantially over the past six years to strengthen our R&D capability across the Company. We created new, long-term research capabilities with outstanding talent. We tightened the linkages between our shopper and consumer insights and R&D, leveraging our proprietary Demand Moments framework, to sharpen the focus of our innovation efforts and make our new products more incremental to our total growth.

Late in 2012, for the first time in our Company's history, we established a design capability. Our goal is to use design in the early stages of innovation to create truly memorable experiences for our consumers. And we are leveraging our global scale by consolidating our investments around promising new platforms, as well as accelerating our ability to lift and shift great ideas from one market to another.

We are also just beginning to explore the opportunity for reverse innovation, leveraging fully our learnings in developing and emerging markets to yield the benefits of thinking more holistically about designing of products here, packaging and equipment that have lower costs without sacrificing quality or performance. In fact, we've set up a value innovation center out in India to see how we can bring emerging market learnings to lower cost of what we do here in the Western world.

We've had good recent successes with innovation that gives us real encouragement that our investments and focus are beginning to pay off. Trop50, Pepsi Next, Tropicana Farmstand, Doritos Locos Tacos, Mountain Dew Kickstart, Quaker Real Medleys, all of these are examples of innovation, recent innovations, that have had remarkable success.

Our goal is to increase the contribution of new products to our total net revenue. And in 2012, we achieved this aim. And we are on track to continue to increase this contribution of new products to our overall revenue.

Revenue management and price pack architecture also play an important role in our revenue growth. By customizing packaging for specific channels, we are able to drive greater distribution. And by offering a greater variety of packages to consumers, we increase our products' relevance to consumption occasions.

Our DSD model gives us access to microlevel trading data. And together with local demographic data, we are able to refine our store-level shelf set to provide the perfect assortment for an individual store's consumers, which in turn helps us increase the velocity of our products. We are also able to use a wide variety of packaging configurations to achieve certain magic price points to appeal to the value-minded consumer.

PepsiCo's strength lies in the fact that our portfolio is diverse. But it is highly focused and, more importantly, related. Our snacks and beverages appeal to the same customers, the same shoppers and the same consumers. They benefit from the same trends of convenience and on-the-go lifestyles. And they have high levels of coincidence of purchase and consumption.

As the second largest food and beverage business in the world, the largest in many key markets, such as US, Russia, India. And among the top five in Mexico and Brazil and Turkey, just mentioning a few, we are viewed as a critical growth driver by our retail partners. This position allows us to work with our customers as one PepsiCo in deep, creative and unique ways to drive the success of our business and, consequently, theirs.

In developing markets -- in developing and emerging markets, actually -- our snacks business is actually supported by our beverage businesses, which tend to be much more established and have larger scale. Our snacks business benefits from our beverages business trade knowledge and relationships. And it also benefits from the marketing powers associated with the beverage business and the media scale that our beverage business uniquely brings to the market.

In developed markets, on the other hand, our snacks business has increasingly benefited from our beverage business-food service relationships. The recent success of Doritos Locos Tacos only happened because Pepsi had a long-term relationship with Taco Bell, with Mountain Dew and all of the beverages in the proprietary Mountain Dew Baja Blast that we've launched with Taco Bell many years ago. And building on that relationship, we were able to bring Doritos Locos Tacos to the market with Taco Bell.

But ultimately, the proof of this relatedness of the portfolio is what happens in the marketplace. We measure the success of our Power of One initiatives by tracking whether PepsiCo is earning an advantaged share of snacks and beverages when these items are purchased together. And we are. Our market share is 2 to 4 points higher in the US when snacks and beverages are purchased together. And this advantage has been growing.

So let me bring all the stuff on revenue together. Our product and geographic portfolios are balanced and well-supported by strong brand-building innovation and marketplace execution. From a category perspective, we expect our global beverage portfolio to grow organic revenue in the low to mid single digits and our global snacks to grow mid single digits. From a market perspective, we expect developed markets to grow in the low to mid single digits and our developing and emerging markets to grow in the high-single to the low-double-digit range.

With this growth profile, we expect about two thirds of our growth to come from snacks. And from a geographic perspective, about two thirds of our growth to come from our developing and emerging markets.

Our business mix will gradually shift to being more heavily weighted towards snacks and being more heavily weighted towards developing and emerging markets than we are today. And this should enable us to sustainably grow our organic revenue mid single digits.

And our recent results bear this out. For the past five consecutive quarters, we have delivered on our mid-single-digit organic revenue growth target.

Moving on now to margin and profit growth. We leverage our $20 billion plus global purchasing scale and centralized procurement to drive lower costs. Our scale also enables us to develop proprietary advantaged agricultural practices and seed varieties that drive higher yields at a lower cost. The scale also allows us to invest in new manufacturing and packaging technologies that increase throughput at a lower cost. It allows us to increase -- integrate our logistics network across the lines of business. And it allows us to operate highly efficient DSD systems that benefit from large (inaudible) sizes. In smaller markets and in big developed markets, we can actually transfer knowledge across the DSD systems.

We continue to optimize our go-to-market models by leveraging new technologies and by continuing to push the boundaries of rethinking how the work actually gets done. Our GES initiative, which dramatically reconceptualizes the traditional plant to warehouse to store model, is a great example of how we are rethinking our go-to-market systems.

And we are also very proud of all the efforts we've made on our sustainability efforts to reduce our impact on the environment and, more importantly, drastically lower our costs by reducing the amount of water, energy and packaging that we use.

We also leverage the scale of our partners, especially in our beverage business, where our primary model outside the United States is a franchise model. For example, as most of you know, recently we partnered with Tingyi, China's largest beverage manufacturer. Through the partnership, the PepsiCo-Tingyi system is 1.5 times the size of the next largest competitor in China. In addition, this partnership is enabling us to more quickly expand our national footprint into white spaces by leveraging Tingyi's existing, well-established manufacturing and distribution network.

Similarly, we benefit from the scale of our bottlers in other markets, with PepsiCo as the number two beverage player on its own. But together with the scale of our bottling partners, our scale improves dramatically. In fact, in our international beverage businesses, our bottling partners almost double our scale when viewed on a system basis.

We are also enhancing profitability and returns by driving productivity. We've executed a comprehensive restructuring program and accelerated our productivity efforts across the value chain -- how we make, how we move and how we sell our products. We have delayered the organization. And we've improved efficiency of the Company. We've reduced our headcount. And we've rationalized our supply chain to reduce our costs and investment in our fixed assets. And as a Company, we will continue to drive productivity across the entire value chain and across all of our businesses.

We have a robust pipeline of projects, from leveraging best-in-class supply chain activities around the world to increasing automation across the value chain, from raw material handling through to the route truck, to implementing new processing technologies, that enable us both to increase asset utilization and reduce input costs. And the sum of all these changes, from small actions repeated millions of times to utilizing new technology that changes the overall cost of key processes, gives us high confidence that we will deliver on the three-year, $3 billion productivity target through 2014.

And we are pleased with the progress we have made. Our current productivity run is about $1 billion per year, which is really double the rate we were at before 2012. And as a result, we are achieving reductions in operating expenses and allowing us to reinvest savings in the business and provide a more competitive cost structure.

Even more encouraging than this, as the organization has engaged and accelerated our productivity efforts over the past few years, we've been able to find more ideas and bigger ideas to drive even more productivity. And a big enabler of these productivity programs has been the globalization of our key functions, like operations and R&D. And the implementation of a common IT platform, including SAP, across all of our businesses globally.

Both of these have allowed us to standardize processes and metrics across the Company, has provided us greater visibility into performance metrics and has allowed us to deploy our best practices globally. We are increasingly adopting new processes to reduce costs by accelerating new business models like GES, implementing new technologies that reduce energy use and material waste or increased throughput through the system. We are designing products with flexible formulations that allow us to make sure that we can work with the right ingredient base when there is commodity volatility. And we are focusing R&D resources on lower-cost design, with no compromise on functionality. And we are driving performance and lower cost by leveraging best practices, both by pushing the performance of every operation to proven best practices within the Company and by raising the bar on the best-in-class with aggressive use of relevant outside benchmarking.

As a result of all of this, we are well down the path on identifying our next big tranche of productivity that will extend beyond our 2014 program.

Let me move now to capital allocation, including how we allocate capital to cash returns to shareholders. Our business generates a lot of cash. A substantial percentage of our earnings converts to cash flow. As you can see from this chart, we have consistently converted on average about 90% of our earnings through core management operating cash flow. And we expect our business to continue to generate strong cash flow, with cash flow growing in line with net income and maintaining at roughly the 90% conversion cycle that we've historically been at.

We have a long and impressive record of returning this cash flow to our shareholders. Over the past 10 years, as we mentioned earlier, we've returned $53 billion to shareholders in the form of dividends and share repurchases. And in 2013, we plan to return another $6.4 billion in cash through dividends and share repurchases.

We fully appreciate and understand that disciplined capital allocation is one of the most important factors in generating attractive, sustained, long-term total shareholder returns. So let me be clear on how we prioritize allocation of capital and drive ROIC improvement.

Our first priority is to invest in the business. We are going to manage capital spending to no more than 5% of revenue. These investments have very attractive returns on investment, well in excess of cost of capital and ahead of our overall

ROIC. With that said, we continually find ways to improve our returns by driving greater fixed asset utilization or by reducing the cost of adding capacity.

Our second priority is to pay dividends to our shareholders. We have raised the dividend for 41 consecutive years through both consistent earnings growth and by raising our payout ratio over time. Continuity of dividends and growth in the annual dividends per share are a point of great pride to PepsiCo. And we view them as a vitally important element of our total shareholder returns.

Our third priority is to strengthen our market positions and create value through responsible tuck-in acquisitions, generally less than $500 million a year in total, which equates to a relatively small percentage of our free cash flow. We've built tremendous capability in the Company evaluating and integrating tuck-in acquisitions. And we have very disciplined strategic and financial guidelines to ensure these tuck-ins are value-creating.

And our fourth capital allocation priority, of course, is to return the residual cash to our shareholders through share repurchases, within the confines of maintaining a capital structure that provides us ready access to the debt capital markets at attractive rates. (inaudible) the CP market from time to time throughout the year. And we strive to maintain a capital structure that gives us access to the Tier 1 commercial paper market.

Our capital allocation approach is an important contributor to our targeted ROIC improvement of approximately 50 basis points per year and will also contribute to total shareholder return through capital appreciation of our equity and dividend yield.

Moving on to talent and culture. The progress we have made and the future achievement of our goals absolutely rests on the quality of our organization, our people and our culture. I think PepsiCo as a Company is blessed with a highly talented and a committed group of general managers and functional experts in all of the areas, like R&D, marketing, supply chain. Many of them have decades of invaluable experience in the industry or with PepsiCo.

Over the past six years, we actually globalized this knowledge base by leveraging all of the information technology I talked to you about. And we've organized in a way that allowed us to seamlessly connect the Company around the globe so that our best practices and ideas traveled faster and deeper into the organization. And where we have needed it, we have augmented our team with exceptional outside (stellar) talent, which brings in new perspectives and skill sets to our Company.

And we've reinforced our culture of execution by aligning our incentives behind those outcomes that are most critical to long-term value creation. Everyone in the organization is focused primarily on delivering market share sensibly, operating profit and cash flow and ROIC targets, along with individual goals related to productivity, marketplace execution, innovation, sustainability and Power of One. The team goals are delivering market share sensibly, operating profit, cash flow and ROIC.

So that's the basic walkaround on why we believe we can deliver our long-term guidance.

And as we look ahead as a Company, our priorities are very clear. In developed market snacks, where we have higher market share than margins, we intend to defend and grow our share of salty snacks. We want to grow organically into the broader macrosnack space. And we want to leverage our beverage business to increase our presence in the food service business.

In developed market beverages, where we have good market positions, we intend to sensibly defend our LRB share and improve margins and returns. We are going to look for every productivity opportunity to make sure we have all the breathing room in that business. We are going to exploit R&D to achieve product disruption and differentiation, as we have talked to you about. And we will continue to explore all options to improve margins and returns in our North American beverage business, as we've previously discussed with you.

In our developing and emerging businesses, where we have higher salty snack shares in most markets and leadership or parity beverage positions in many key markets, we intend to continue to build our strong share positions, capture our fair share of growing beverage occasions and selectively pursue tuck-in acquisitions to build out our scale and our geographic footprint.

And in this nutrition business, where we are one of the leading players globally in everyday nutrition, we intend to continue to benefit from the outsized growth of this category, leveraging the presence and scale of our existing businesses.

By executing on these priorities, supported by our fundamentals of brand building, innovation, supply chain, talent development and Power of One, we are confident that we are positioning ourselves to deliver on our long-term financial goals.

So to summarize, we have transformed our business to sustainably deliver top-tier results in a rapidly changing environment. We are disciplined about capital allocation, with a strong bias to return increasing sums of cash to our shareholders.

Our strategy and priorities are clear. We want to deliver on our financial target, appropriately balancing market share, profitability and returns. And we believe PepsiCo is well-positioned to deliver sustainable, consistent and durable performance and returns.

Thank you. And with that, let me turn it back to Ali. Thank you, Ali.

Questions And Answers

Q - Ali Dibadj {BIO 15328592 <GO>}

Thanks, Indra. As you join us, I'm going to try to take advantage of the time we have left to move relatively quickly through some questions. I may even try to take advantage if there is no one in this room after us to try to go a little bit long. But we'll see.

To start off, I want to go back to a slide -- it was either 11 or 12 in your presentation -- where you talk about three of the top five brands in the US in retail. And all of them were beverages brands. Digging down a little bit deeper into the Pepsi America Beverages business, can you talk a little bit about the volume trends you are seeing? Last quarter, down five, volume, plus five pricing.

What do you think drives that? Do you think that is a secular issue, a cyclical issue? And you may have seen a report or may not have seen a report comparing the cigarette industry to the US carbonated soft drinks industry. Does that philosophy even apply?

A - Indra Nooyi {BIO 1404395 <GO>}

I think the first thing we have to do is talk about LRB, not just about CSD, Ali. Very, very important. If you look at the beverage market in the US, it is a big market. It is highly profitable. Generally, it is a lot of US cash. It is over a $100 billion market, 20 billion eight ounce cases.

60% of the market is non-carbs. And within carbonated soft drinks, colas are a smaller percentage and declining. So I think there is a maniacal focus on colas. It is not the right way to look at a beverage market that is so huge.

If you look at the overall LRB category, it is very important that all the players play a sensible game in this business. And what we have been trying to do is to say, in a category that is growing at populations -- that is the overall growth of the category -- you take some pricing where it is relevant, you get pricing through innovation, you execute better and that is what you have got to do. I think short-term pricing actions to pursue volume is the wrong strategy in this sort of a market.

And the more people focus on carbonated soft drink volume and the more people focus on cola volume, you are going to see more irrational behavior in the marketplace.

Q - Ali Dibadj {BIO 15328592 <GO>}

So this quarter, I think PAB was down 5 in terms of volume and up 5 in terms of pricing. So I understand you don't love talking about carbonated soft drinks. And I get why, because the trends there are difficult. But if you take a step back and look at just PAB, what do you think was driving that volume decline? It wasn't just you; it was for the category overall.

A - Indra Nooyi {BIO 1404395 <GO>}

Well the weather was awful in the first six, eight weeks of the quarter, really bad. Then we had this whole payroll tax issue that hit the consumer. So the consumer went into some distress in the first part of the year.

And as I said, I think, on the earnings call, Ali, do not talk about the year based on the First Quarter, because the First Quarter is always plagued with either a warm winter or a cold winter, you've got the up and down the street that gets impacted with storms or snow or whatever it is. So I think a better run rate is talk about Q2, Q3.

Having said that, the LRB category is going through changes. The market is shifting more towards non-carbs. The market is shifting more to non-cola beverages, like Mountain Dew, which continues to grow and perform at very attractive rates.

And I think what we feel good about, as I look at the LRB category, between sports drinks, tea, coffee, flavored CSDs, we look at each of these businesses, we have phenomenal brands in each of these markets. We are the number one player in pretty much every category. So I look in the future and say, this category has not had much innovation. Layer on what we are doing in R&D, big, profitable category with lots of US cash flow, let's see how this game plays out.

Q - Ali Dibadj {BIO 15328592 <GO>}

So let's see how this game plays out from a structural perspective as well, right? We've seen very difficult trends in carbonated soft drinks for a while, understand that it is, quote, unquote, only 40%, 50% of the category. But how does the trend that you've seen over the past several years of carbonated soft drinks volume continuing to be negative, regulation brewing, consumer self-regulation certainly happening as well, how does that influence how you think about the structure of your North American business, in particular the (inaudible) that you bought and how you think that should look in two years, one year?

A - Indra Nooyi {BIO 1404395 <GO>}

I'm smiling, Ali, because three years ago, I was sitting with investors. And all the sell side people, who told me that I was wrong in saying the CSD market was going to decline, that it was actually going to grow.

We anticipated the decline of the carbonated soft drink market. And we started to invest in technologies to break all of the compromises that people didn't want to make. So for example, when you go and talk to consumers, especially in the United States, they love carbonated soft drinks. They love the bubbles. They love the caffeine. They love the taste of cola. What do they not like? They don't like the sugar levels. And recently, they don't like the artificial sweeteners. So we knew we had to address both these barriers.

When they say they didn't like the sugar levels, they didn't like the extent of sugar in the business, they wanted lower sugar levels. And they wanted it without any artificials. So the investments we started to make in R&D was natural sweeteners that work in colas. Stevia, unfortunately, does not work well in colas. And we started to play around mid-calorie drinks to see how does the taste actually work. And Pepsi Next actually is holding its own. And it is a great tasting mid-calorie product. So we know there is a consumer for mid-calorie product.

So now with the work we are doing on natural sweeteners and the work we are doing on flavoring agents coming through the pipeline, we actually believe that if you let this go too long, another three or five years, the consumer will walk away from CSDs. But while the consumer still remains in love with CSDs, if we can address the barriers to consumption, we can actually bring back the last users. It may never be the high levels of consumption that we had when we were young. The new consumer has too many choices that they are playing around with. But I actually think there is a once-in-a-lifetime opportunity to bring the consumer back to CSD.

Q - Ali Dibadj {BIO 15328592 <GO>}

So you are placing a lot of weight on this Stevia-based Reb D, seems like innovation, let's say.

A - Indra Nooyi {BIO 1404395 <GO>}

I didn't say stevia or Reb D (multiple speakers).

Q - Ali Dibadj {BIO 15328592 <GO>}

I'll say it. See if you blink twice. How does all of that influence what the structure of the bottlers will be going forward?

A - Indra Nooyi {BIO 1404395 <GO>}

I don't know if one influences the other. I think --

Q - Ali Dibadj {BIO 15328592 <GO>}

Shouldn't it, though?

A - Indra Nooyi {BIO 1404395 <GO>}

Yes and no. We can always be a concentrated company and supply those ingredients to the bottlers. I think the bottling business came back to us, as it did to the industry, because the way the bottling equation was set up, given the realities of the marketplace, was a no-win situation for the industry.

So I think it was done both offensively and defensively. Defensively to protect the business, offensively, because if you are going to make a change, you better have control over the most important lever, which is the go-to-market piece, in order to make the change. So I think it was the right decision at that time -- painful decision. I'll be honest with you. But it was the right decision at that time.

I think going forward, if anybody were to contemplate anything structurally with bottling, it requires very careful thought. Because the worst outcome is to do something, just to reverse it in five years after that. The only people that are rich in that process are the bankers. So I think we just have to be very, very sensible in how we think about the separation.

Q - Ali Dibadj {BIO 15328592 <GO>}

And by February, you are going to tell us?

A - Indra Nooyi {BIO 1404395 <GO>}

We are going to tell us what our plans are for North American beverage business.

Q - Ali Dibadj {BIO 15328592 <GO>}

And what is off the table at this point (multiple speakers)?

A - Indra Nooyi {BIO 1404395 <GO>}

I can't share all that with you, Ali.

Q - Ali Dibadj {BIO 15328592 <GO>}

Okay.

A - Indra Nooyi {BIO 1404395 <GO>}

Keep trying.

Q - Ali Dibadj {BIO 15328592 <GO>}

If you take a step back and you talk about the snacks business, the Frito business, which has obviously been very successful in the US, there is a very clear margin differential between the US and the rest of the world. Some country like Mexico maybe a little bit higher.

But on average, as you do believe, as you said, two-thirds of your growth will come from the emerging markets, two-thirds will be snacks, there is a clear weight on your margins, clear downward pull on your margins. How do you think about that? How does that impact how you talk about margins for the overall Company? And what are you going to do to try to help that?

A - Indra Nooyi {BIO 1404395 <GO>}

So we actually run the math on this. Given the growth we have in the developed markets, given that growth we have in developing market and emerging markets -- and remember, all these margins are different. So if you look at sort of a hierarchy of margins, the US sits on top. But in Mexico, margins are pretty attractive. A margin for China or India may be lower.

So the real thing that we balance constantly is we model this thing out, given the differing growth rates, where do we need to get productivity, where do we need to get more growth? We worked this out to say the net result -- will it result in a 30 to 50 basis point improvement in operating margin? And based on the mix of countries, the anticipated growth rates, our productivity initiatives in many markets, we have tremendous confidence that we can get that operating margin expansion.

Q - Ali Dibadj {BIO 15328592 <GO>}

And is it mainly based, I guess -- because you are investing to get distribution in the emerging markets still on snacks and a lot of the other businesses, is it mainly then going to be developed market margin improvement, particularly in North America?

A - Indra Nooyi {BIO 1404395 <GO>}

Not really, because the chart we showed between 10,000 and 20,000, the curve goes up rapidly. So once you put the infrastructure in place, as the growth comes, your margins start improving rapidly. The best example --

Q - Ali Dibadj {BIO 15328592 <GO>}

They are still lower, right? I mean, (multiple speakers) jump 15 basis points in a year.

A - Indra Nooyi {BIO 1404395 <GO>}

Not in a year. Of course not. I mean, if they did, it would be almost irresponsible management, I'd say.

But I would say as the markets grow, margins steadily improve. So they are not as dilutive as you might think they are, because they contribute to the top line. They contribute to the bottom line. And the net results in a 30 to 50 basis point --.

You know, at the end of the day, if you want to maintain a growth company, you have to have a mix of different growth rates in the top line and the bottom line. Markets that grow at very low levels, yes, you can get margin expansion. But that growth might struggle if you didn't have other markets to get the top-line growth going and the bottom line comes with it.

So I think it's a classic growth share matrix, Ali. We're just working this through. And we have got a portfolio where each of the pieces contribute its rate to the 30 to 50 basis point improvement.

Q - Ali Dibadj {BIO 15328592 <GO>}

So it sounds like the belief right now is that there is an organic scale benefit (inaudible) to the emerging markets that improves your margins. What about the inorganic path? A lot of folks have talked about other snacks businesses out there. Your former colleague, Irene, speaks tomorrow here at the conference. What do you think about the Mondelez business and how that could inorganically help you get to that scale faster?

A - Indra Nooyi {BIO 1404395 <GO>}

As a Company, we are architected to deliver high-single-digit EPS growth. As I said to you, in our salty snack business, our growth comes from taking businesses from other snacking businesses. So in the developed markets, we go after every other macrosnack occasion. In emerging markets, we have huge run rate for growth in terms of building penetration and frequency. So we have enough growth on our own.

Our belief is that we do not need any transformational M&A to accomplish our goals. And we are very happy with the PepsiCo portfolio. And that is how it is going to be.

Q - Ali Dibadj {BIO 15328592 <GO>}

Have you been approached to think about that more and do more analysis on that?

A - Indra Nooyi {BIO 1404395 <GO>}

We don't comment on those kinds of things, Ali. All I will tell you is we are very happy with our portfolio.

Q - Ali Dibadj {BIO 15328592 <GO>}

Okay. So stepping back to North American market -- and again, your competitive situation here, clearly, fighting Coke from a category trend perspective. Can you talk a little bit about the pricing trends that you've seen? Does it remain rational? And particularly as we come out of Memorial Day weekend, what have you seen in the marketplace?

A - Indra Nooyi {BIO 1404395 <GO>}

It depends on the region of the country and the category. I think it is more rational now than it was, perhaps, in the later part of the First Quarter, early Second Quarter. But I think any time you see poor weather patterns and you see demand falling off as a consequence, category demand, you tend to see some interesting pricing action as people try to push short-term value. I think by and large, it is getting more rational. Let me go this way. We are being very rational.

Q - Ali Dibadj {BIO 15328592 <GO>}

And are your competitors?

A - Indra Nooyi {BIO 1404395 <GO>}

I think so. So far, we've seen pretty rational behavior from competition.

Q - Ali Dibadj {BIO 15328592 <GO>}

Okay, I'll try to push my time, given that there is no one else in this room. From a cost-cutting perspective, you mentioned some examples out there. And you are ready, you mentioned, for the next tranche of cost-cutting.

How much more room do you think there is? You've talked in the past of an aspirational 500 basis points higher than today's EBITDA margins. Do you think that is still an aspiration. And what are the steps to get there?

A - Indra Nooyi {BIO 1404395 <GO>}

Once we are through with this next tranche of productivity, Ali, let's come back and talk about this. Because talking about it piecemeal doesn't help. What we do is set goals. But then productivity at PepsiCo is a discipline, not just an aspiration. We take every program, we land it. We don't talk about it until we have 90% certainty of delivering it and our program management office has taken it over. So when we are ready to talk about it, let's come back and we'll talk about it holistically.

Q - Ali Dibadj {BIO 15328592 <GO>}

Can you even tell us what the buckets that you are going to go after?

A - Indra Nooyi {BIO 1404395 <GO>}

Everything that I talked about. Best practice sharing, we are dialing that up even more. More shared services. We are looking at everything inside the Company. How do we do work? How do we make our processes more common? How do we reduce the number of spans and layers? We look at -- nothing is off the table.

And you know, this didn't happen because we just woke up overnight and said productivity. It is a journey we've been on for a long time. And by putting in the SAP systems around the Company, it has given us more visibility. So we are able to do this now. If we didn't have those systems, we wouldn't be able to do what we are doing now.

A - Hugh Johnston {BIO 15089105 <GO>}

To that point, Ali, operating expenses (inaudible). To that point, operating expense is a $28 billion bucket inside of PepsiCo. With that size bucket of cost, there is always lots of opportunity to go and do more. And that is really what a lot of management is spending its time on, is, in addition to driving the top line, finding more and more opportunities for productivity. So we view that as a source of fuel for years to come.

Q - Ali Dibadj {BIO 15328592 <GO>}

Okay. A couple quick questions; one on regulation. Tell us your views on what we should expect from regulation in the US and overseas on some of your categories.

A - Indra Nooyi {BIO 1404395 <GO>}

You know, we hear noise about regulation now and then. I think ultimately when the rubber hits the road, good sense prevails, that regulations (are going) to address whatever issues the regulators intended to address that requires a balanced set of actions on phys ed in schools or incentives for healthy nutrition.

Having said that, I don't think we should run a business on hope or hoping that regulation goes away or doesn't happen. What we are doing is transforming the portfolio. As I said, increasing the permissibility of our fun for you products, dialing up our better for you and significantly beefing up our good for you portfolio. At the end of the day, the best portfolio gives you insulation, not necessarily just fighting governmental action. That is what we are focused on.

Q - Ali Dibadj {BIO 15328592 <GO>}

Okay. You mentioned Power of One in the context of Doritos Tacos Locos. Can you give us any other example where you've really found Power of One to be enormously powerful? We keep searching and oftentimes we don't find, perhaps because it is an internal discussion, as opposed to what we see externally.

A - Indra Nooyi {BIO 1404395 <GO>}

I think the best example I can tell you is that as you look into the future, the lines between snacks and beverages are blurring. I don't know if Naked Juice is a snack or a beverage. Many beverages, as they get more viscous, are eating into the snacks occasion. And many snacks that used to be consumed as a dry snack are now being eaten in different ways.

So think about our business as being drinkable, spreadable and one-hand consumable. So if you look at Quaker Real Medleys, it is a spoonable product. But it is also going to be a bar. And it could also be a drinkable (inaudible). So I think increasingly you are going to find people think about the convenience occasion as one continuum.

We keep talking artificially about snacks and beverages only because some people used to track this industry differently. I think that is over. This is convenience. And the best way to think about it is all our products, you can consume with a rip, twist, flip or tear, whether it's the snacks or beverages. And that is the business we are in.

Q - Ali Dibadj {BIO 15328592 <GO>}

And my very last question, pushing time hard, around A&M expense. You had originally said a year ago, approximately in February just down the street, that, look, we're going to increase the advertising spend to 5.7% roughly and keep it at that level. This First Quarter, we saw a 50 basis point increase. Do you think you are going to need to spend it more? And in that context, we have a couple questions about social media -- how does that play into your A&M spend?

A - Indra Nooyi {BIO 1404395 <GO>}

We increased it to 5.7%, as I mentioned in my prepared remarks, Ali. We plan to increase it. Whenever we have reinvestment opportunities, where we see a return on investment in A&M, we intend to put it back in.

Digital media, the ROI metrics, depending on who you talk to, are either very attractive or we don't know what the ROI is. At this point, where we have had engaging digital campaigns, they have actually been able to cut through the clutter. And so our teams are now working on a better metric of a digital ROI, not the metric that many of those companies give us. A lot of digital companies give you ROI, which are good metrics. But we haven't been able to resonate with them. So we are developing our own.

But right now, what we are saying is let's just measure the consumer brand equity from the digital campaign. If the brand equity scores improve, then we know the digital campaign is working, especially in brands that only live in the digital world. That is how we are looking at that.

Q - Ali Dibadj {BIO 15328592 <GO>}

Thank you very much (multiple speakers).

A - Indra Nooyi {BIO 1404395 <GO>}

Pleasure, Ali. Thank you very much for your time.