

Good morning and welcome to PepsiCo's Second Quarter 2013 Earnings Conference Call. Your lines have been placed on listen-only until the question-and-answer session. (Operator Instructions). 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

Thank you, operator and thanks to all of you who are listening on the call for your patience this morning as we implemented a solution for technical issues we're having with our website today.

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 second quarter performance and 2013 outlook and then we will move on to Q&A. Because of the delayed start to our call and the fact that I know that this is a busy earnings day for all of you, we've kept our prepared remarks short this morning. We're going to have one question limit and we may not be able to get through the full queue of analyst questions. If that's the case I'd ask you to please call me after we conclude the call this morning and I'll be happy to take your questions individually.

Before we begin please take note of our cautionary statement. This conference call includes forward-looking statements, including statements regarding 2013 guidance and our long-term targets based on currently available information. Forward-looking statements inherently involve risks and uncertainties that could cause our actual results to differ materially from those predicted in such forward-looking statements. Statements made on this conference call should be considered together with cautionary statements and other information contained in today's earnings release and in our most recent periodic reports filed with the SEC.

Unless otherwise indicated all references to EPS and total operating profit growth are on a quarter basis. In addition, references to organic revenue results in this call exclude the impact of acquisitions and divestitures, structural changes and foreign exchange translation. To find disclosures and reconciliations of non-GAAP measures that we may use when discussing PepsiCo's financial results, please refer to the glossary and other attachments in this morning's earnings release and to the Investors section of PepsiCo's website under the Events & Presentations tab. As we discuss our results today, please keep in mind that our Q2 reporting period is the 12 weeks ended June 15 for our North America business and the months of

March, April and May for the vast majority of our businesses outside of North America.

Now, it's my pleasure to introduce, Indra Nooyi.

Indra Nooyi

Thanks Jamie and good morning everyone. I'm very pleased to report another quarter of strong results. In Q2 we had our sixth consecutive quarter of mid-single-digit organic revenue growth. We generated double-digit core EPS growth and drove significant improvement in cash flow. Our organic revenue growth in the quarter was 4.2%, in line with our mid-single-digit long-term target, with particularly strong growth in international beverages, at Frito-Lay North America, Latin American snacks, and snacks and beverages throughout Asia, Middle East, and Africa.

We are encouraged by the continued strength in the top line with our marketplace investments playing an important role in driving solid growth, brand equity and market share results. Organic revenue growth reflected each of our full business units achieving positive net price realization in the quarter. Our overall servings increased 4% with snacks volume growth of 3%. Beverage volume grew 1.5% on an organic basis and our international beverage growth was strong, up 11% on a reported basis and 5% on an organic basis. We had good profit flow through with core gross margins including 120 basis points in the quarter. A&M up 55 basis points, core constant currency operating profit up 11%, and our core operating margin up 120 basis points.

Ex the Vietnam gain and incremental investments, our core constant currency operating profit was up 8% and core operating margins improved by 60 basis points. Our productivity program remains clearly on track. We have targeted \$900 million in savings this year which is the second year of our three-year program and we are well on our way to achieving our current goal of \$3 billion. Year-to-date management operating cash flow excluding certain items was more than \$2.3 billion, a significant increase over the first half of 2012. And we returned over \$2.7 billion to shareholders in the first half in the form of dividends and share repurchases.

These results are especially pleasing in the context of some very difficult market conditions worldwide. Particularly, tough macro challenges challenging the consumer in developed markets, especially in Western Europe, slowing food and beverage growth in the United States, political unrest in several important markets most notably Egypt and Turkey, and adverse weather in the U.S. and Western Europe. We are able to continue to deliver in these trying conditions largely due to the strength of our portfolio,

both the geographic diversity and product diversity. We have a wonderful balance of developed and emerging markets, with the developed markets providing strong cash flow generation and scale-enabled capability that we leverage globally.

Now emerging markets provide tremendous potential of top line growth and margin expansion. This is important. We have a diverse but highly complementary portfolio of brands and products. The high coincidence of snack and beverage purchase and consumption provides numerous commercial opportunity and our nutrition portfolio provides new growth avenues to capture expanding consumer demand. We continue to exploit the potential of our portfolio by sharpening our efforts against a few key platforms. We have stepped up our investments in advertising, marketing and R&D to further strengthen our brands and to accelerate our product innovation.

We have stepped our market based execution across the board. For example, we are driving even greater partnership with our customer by engaging in joint business planning that aligns our product, brands and in-store merchandizing capability with our customer's growth strategy. The scale and complementary nature of our categories makes us a clear partner of choice with our customer to drive their growth. We continue to refine our revenue management capability to drive both greater values for our consumer and price realization for PepsiCo. And in a number of international markets, we have improved the effectiveness of our go to market systems by driving synergies in selling and distribution systems across snacks and beverages.

We continue to execute against our productivity agenda that's funding, stepped up marketplace investments, and at the same time expanding our margins. We now have our team focused on identifying and planning the next generation of productivity projects that will extend our productivity savings beyond 2014. We have also strengthened our global bottling network and systems scale in a number of key markets through our new partnerships with Tingyi in China, with (inaudible) and Polar in Mexico, and in just this past quarter, our partnership with Suntory in Vietnam. And we're driving high returns in invested capital and cash returns to shareholders through highly disciplined capital allocation.

Let me now turn to specific businesses. All our business units performed well financial and in the marketplace in Q2. Let me share with you some of the highlights. At Frito-Lay North America, we generated 3% volume growth and mid-single-digit organic revenue growth, with net price realization widening sequentially from what we reported in Q1. We gained volume share and maintained value share across major channels in the United States. And we

expanded core operating margins by 40 basis points even as we increased advertising and marketing expense.

In Beverages Americas, we achieved another quarter of solid price realization in the United States. We held CSD share in U.S. major channel, with pricing and retail ahead of the category. We drove growth and core operating margin expansion while we increased advertising and marketing spend. We generated 4% core constant currency operating profitability.

And innovation was encouraging, with Mountain Dew Kickstart, Tropicana Farmstand and Starbucks iced coffee each demonstrating potential to become \$100 million plus at retail platforms and contributing to positive price utilization and value share gain. And strong marketing and merchandising led to value share gains by Gatorade sports drinks in our coffee, tea and chilled juice business.

In other developed markets, despite the tough macros, we saw good performance in some of our larger markets. France grew organic revenue 9% and the UK and Germany each posted 3% organic revenue growth. Innovation played a large part of our success with the launch of the naturally sweetened Pepsi Next in France and Trop50 in the UK. We saw very good growth in our developing and emerging markets in Q2, with organic revenue of 11%, made up of 11% in snacks and 10% in beverages and this was driven by execution of our strategy to increase household penetration and frequency of consumption.

We had terrific growth from each of our major developing markets, with organic revenue growth of 7% in Mexico, 15% in the rest of Latin America and 12% in Turkey. And we are especially pleased with our beverage volume performance in Russia where we grew Pepsi, Lipton, 7UP and Russky Dar kvaas each in the double-digits. And we saw the benefits of our Russia platform with strong results in Ukraine. Our emerging markets performance drove the continued great results in our EMEA sector, where organic volume grew 6% in snacks and 9% in beverages and organic revenue grew 14%. Within our emerging markets organic revenue was especially strong in Pakistan and the Philippines, with each growing in excess of 20%.

Organic revenue grew high teens in Jordan, mid-teens in India and Egypt and 12% in Saudi Arabia. We'd like to point out one of our emerging star brands in the region, Mountain Dew. It posted another quarter of double-digit volume growth in the region, marking the 10th consecutive quarter of double-digit volume growth in the region. And Mountain Dew is now our largest carbonated soft drink brand in Pakistan and growing rapidly in India.

And China performed especially well, with organic revenue growth of 22% in beverages and 23% in snacks. We are particularly pleased with our CSD performance in China, with year-to-date volumes up 10%, significantly outpacing the category. In addition, our beverage volume grew 24% in the Philippine, 13% in the in Pakistan, 11% in India and high single-digits in Egypt and Saudi Arabia.

So overall we feel very good about our results in the state of the business. However, in any portfolio there are always areas that need some attention. So let me cover the two areas that we're especially focused on, North American Beverages and Quaker North America. Now, I must say we're making good progress at North American Beverages to accelerate innovation, improve our marketplace execution and drive productivity to improve our competitiveness and profitability. But the fact remains the beverage category in the U.S. has its challenges, especially carbonated soft drinks. Against this challenging backdrop, we are pleased with the progress we've made with our beverage business. We've stayed focused on repositioning our business for long-term sustainable growth. We have made solid progress on brand building and innovation. We have improved marketplace execution. We've stepped up productivity, which coupled with disciplined pricing drove solid bottom line performance.

We are leveraging the strength of the portfolio which is well balanced between CSDs and non-carbs, and within CSDs we possess the fastest growing mainstream brand, Mountain Dew. We will continue to invest in breakthrough innovation and new technologies that have the potential to reframe the beverage category by removing some of the compromises that consumers face with regard to calories and ingredients. In addition as we've said in the past, we're also exploring every possible alternative, including structural alternatives, to further improve our margins and returns in this business and we'll provide an update on our efforts in early 2014.

The second area is Quaker North America, This is a business with great brands, high margins, high returns on capital, and it generates a lot of U.S. cash flow. So there is a lot to like about this business. But a good deal of this business lives in the center of the store and the center of the place, and that makes it a challenge to grow especially as consumers increasingly see convenience. To be short, we've made good progress in this business with improved marketing and execution and we've had some recent innovation wins.

Real Medleys is being extended from a successful new product to a successful new brand platform. It's expanding into bars with double-digit revenue growth and has a lot more potential for growth. Plus the international Cracker business is doing exceedingly well and grew volume

5% in Q2. But we're still in the early innings of capturing the full potential of this business in North America. We are focusing on driving innovation that truly excites consumer and for us it's a work in progress and we have the right resources and talent dedicated to getting this business on a firmer footing.

You know the fact that PepsiCo continues to perform well even as it addresses these opportunities, speaks to the power of our portfolio. We have the products and geographic breadth to participate and thrive in categories in markets that are growing and that gives us the flexibility to address all opportunities in a sensible, responsible way without disrupting our overall financial results. So, as we look ahead to the balance of the year we are confident in our ability to achieve our full year 2013 financial goal. And as we look beyond 2013, we believe we're positioned well to deliver our long-term financial goals which we believe will translate top tier shareholder returns on a sustainable basis.

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

Hugh Johnston

Great. Thanks, Indra, and again good morning, everyone. I will spend just a minute covering the financial results and guidance in a little bit more detail and then we will open up the lines for your questions.

For Q2, organic volume grew 3% in snacks and 1.5% in beverages. Organic revenue grew 4.2%. Our core gross margins improved by about 120 basis points and we increased A&M expense by 13%. Core operating margin improved by 120 basis points and core constant currency operating profit grew 11%. As we've previously disclosed and mentioned in the release, we realized \$137 million pre-tax gain on our Vietnam refranchising and incrementally invested \$46 million pre-tax in the quarter. Excluding the impact of the Vietnam gain in incremental investments, core operating margin improved by 60 basis points and core constant currency operating profit grew by 8%.

Our core effective tax rate was 24.5%, approximately 335 basis points below Q2 2012. And core constant currency EPS grew 19% and 13% % excluding the Vietnam gain and incremental investment. So, between core constant currency division operating profit growth of 11% and core constant currency EPS growth of 19%, we got about 8 points of leverage. About 1.5 points of that came from net interest expense, 5 points came from tax rate which will reverse in the second half as we're forecasting the full year tax rate to come in at approximately 27%, and 1 point from weighted average share count which was down 1% year-on-year. Overall, the quarter came in as expected

with pricing actions, commodity inflation and productivity all in line with our expectations.

On a reported basis, net revenue was up 2% and that was driven by a 1.5 point drag from ForEx and 1 point negative impact from structural change reflecting the China and Vietnam re-franchisings. We generated over \$3 billion in cash flow from operations in the first half, a \$1.8 billion positive swing versus last year. This was driven by lower pension contributions and strong working capital improvements. Management operating cash flow, excluding certain items was more than \$2.3 billion, an increase of approximately \$1 billion over the first half of last year. And we returned over \$2.7 billion to shareholders in the first half in the form of dividends and share repurchases.

Turning to guidance. For 2013, we expect core constant currency EPS growth of 7% off a core 2012 base of \$4.10. We expect organic revenue growth of mid-single-digits, core constant currency operating profit growth of approximately 6%, approximately 1 point of leverage below the operating profit line driven by share repurchases and we expect our core effective tax rate to be approximately 27% for the full year. Within these expectations, we assume positive price mix, low single-digit commodity inflation and productivity of \$900 million. Our productivity assumption is completely in line with the three year, \$3 billion program that we launched last year and the savings will be used to help offset inflation as well as provide funding for investments back into the business.

One of our key investment areas is supporting our brands with advertising and marketing where we'll grow our A&M investment at least in line with sales, meaning you should expect A&M spending of at least 5.7% of net revenue which was our 2012 base line investment. In addition, we're also accelerating our investment in R&D and in innovation. You should also take into account that we intend to incrementally invest the balance of the Vietnam gain in the second half of the year which will impact operating profit growth and margins. We expect the full year operating profit impact of the gain to be offset by incremental investments.

Regarding ForEx, based on current market consensus, we anticipate foreign exchange translation to have an approximately 1 point negative impact on our net revenue and a 2 point negative impact on operating profit and EPS for the full year, including the impact of the Venezuela devaluation. Our full year ForEx outlook for EPS is 1 point more negative than what we shared with you on the Q1 call, which is an incremental \$0.04 versus where we were at the end of Q1. As we anticipate structural changes driven by China and Vietnam, we will have a negative impact of approximately 1 point on a

full year on our net revenue growth. Overall, we're pleased with how the second quarter and first half came in.

For the full year, we are maintaining our constant currency guidance. The world remains a volatile place and we may also choose to incrementally invest in additional long-term value building initiatives such as advertising, innovation and in emerging markets growth capacity. As you model out the third quarter, we expect foreign exchange translation to have up to a negative 0.5 point impact on third quarter revenue and 1 point impact on EPS based on current market consensus rates. We expect revenue in the third quarter will have an estimated one-half of percentage point negative impact from structural changes due to the Vietnam re-franchising.

Division operating profit will be impacted by commodity cost inflations sequentially higher than in the first half as we expected. Incremental investments funded by the Vietnam gain, increased A&M expense and negative ForEx. Below the division operating profit line, corporate costs in Q3 will be above Q2 levels based on the timing of investments, primarily in R&D. Net interest expense will increase sequentially from Q2, reflecting primarily higher rates. And our tax rate will be significantly higher than our half one tax rate as we trend toward our full year estimated tax rate of approximately 27%.

From a cash flow prospective, we expect full year core management operating cash flow, excluding certain items, of more than \$7 billion. We'll continue to drive cash flow through an even more efficient working capital management program and continued tight controls over capital spending. And for 2013, we expect to see continued improvement in our key working capital metrics and to manage net capital spending to approximately \$3 billion which is well within our long-term target of less than or equal to 5% of net revenue . As a result, we'll continue to return strong cash flow to our shareholders.

In total, we expect to return approximately \$6.4 billion to shareholders in 2013. \$3.4 billion in dividends and \$3 billion in share repurchases. Our outlook for 2013 is unchanged from our last call and it's consistent with our long-term targets for net revenue, operating profit and core constant currency EPS. We expect to drive improved full year margins and net ROIC, and generating and returning cash flow to our shareholders remains a top priority for the company.

Operator, we will take the first question.

Question-and-Answer Session

Operator

(Operator Instructions) Our first question is coming from John Faucher from JPMorgan.

John Faucher - JPMorgan

Hugh, I want to talk a little about the gross margin. You talked about sort of more cost pressures flowing through in the back half. I'm assuming some of that's sort of corn in the cadence of the hedging and things like that, as well as may be some of the shorter term raw material impacts. Can you talk about how you see that playing out a little bit further forward? Will there be a corn benefit at some point over the next 12 to 18 months, do you see that roll out? And can you talk just about what you're seeing on sort of the resin side as well as some of the more chemical or petroleum based raw materials? Thanks.

Hugh Johnston

Yeah. Sure, John, happy to. Again a lot of the impact that we're seeing is, we were in the first half overlapping a higher inflation from 2012 and we're lapping lower inflation in the back half of 2012. As to the commodities, it's really a combination of a couple of areas. Some of it is in the whole Ag complex and corn obviously is a piece of that, and some of that is also PET as well in the back half, again driven more by the overlaps than anything else. It will be roughly even between Q3 and Q4 and it should play out as we mentioned earlier. Regarding 2014, it's really premature to comment on that. We're still six months away from that. We try not to get into 2014 until we get to the guidance on that and for me to just start talking about pieces of it probably wouldn't be beneficial to do right now. So, we'll hold on that until we get to our Q4 call in next February.

Operator

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

Unidentified Analyst

Hi this is [Maria Golop], good morning. I'd like to ask about the Vietnam gain. So it's giving you some incremental funds to spend. You previously had a funding budget for 2013 and this adds to it. So my question really is, sort of what type of specific activities are you spending on and in what geographies? And then related to that, why shouldn't we expect sort of an incremental boost to sales in the near term from these investment activities?

Indra Nooyi

Hugh, you want to?

Hugh Johnston

Yeah, I would be happy to handle that. So where you're going to see us invested is largely in international and it will be geared towards top line driving types of activities. Now when we do these things they typically don't pay back immediately, you typically see the payback in one to two year types of time frames. So I wouldn't necessarily expect to see a short term acceleration in revenue driven by all of that. What we're really doing here is extending both the duration and the durability of our strong top-line growth as well as flowing it ultimately through to stronger bottom-line growth. So we feel these are the right decisions to make for the franchise as well as to enhance and solidify our operating performance.

Operator

Our next question comes from the line of Caroline Levy with CLSA.

Caroline Levy - CLSA

I just wondered if you could comment since your international and even your domestic quarter ends a little earlier than many other companies on how June looks and just volume wise, particularly in beverages if you still face huge challenges that then carry through to the third quarter giving you some pause on any recovery in beverage volumes looking out this year

Indra Nooyi

Caroline, we don't really comment on one month's performance, but we'll talk more about it in our Q3 call.

Operator

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

Dara Mohsenian – Morgan Stanley

Indra, you mentioned in your remarks that you're looking for ways to drive margin improvement on the beverage side of the business and obviously the strategic piece of that you probably will be hesitant to comment on. But I was hoping you could comment on what you can do internally to boost beverage margins as you look out over the next few years. And as you look at that business, do you think the lower margin structure that exists versus beverage or CPG peers in general, is that more due to structural reasons such as scale et cetera? Or are there significant cost savings opportunities

you can go after internally on that business beyond what you've already outlined?

Indra Nooyi

Dara, I presume you're talking about North American beverages, because when I was talking about margin improvement opportunities I was talking about North American beverages. Just roughly speaking, our franchise business has got much better margins than an operating business in the beverage world, because you've got the entire cost line to work with. I think in the North American beverage business, as we've mentioned before Dara, we've been investing in many technologies, whether it's processing technology, packaging technology, ingredient technology and one-by-one some of these technologies are beginning to start being commercialized. So as we look at our productivity program and we've talked about the next [branch] of productivity, some of that next branch of productivity is from North American beverages. And that comes from some of these technologies beginning to get implemented in the marketplace. And that's what gives us confidence that there are opportunities to improve margin performance.

On top of that, we've really cranked up innovation machine and the combination of the new innovation coming to the marketplace driving top-line in a category that has slowed down a lot. But our goal is to use the power of our portfolio to drive the top-line growth. Coupled with these new technologies and different ways of working within North America to improve the productivity of the operations is what gives us confidence that we can improve the margins in North American Beverages.

Operator

Our final question comes from the line of Bill Schmitz with Deutsche Bank.

Bill Schmitz - Deutsche Bank

Hey, can you just elaborate a little bit more, just update us on the acquisition strategy. I think you're still sticking with just smaller niche fields that fill in strategic holes. And then maybe just some commentary on some of the noise recently in the press.

Indra Nooyi

Bill, we've been incredibly consistent. PepsiCo is an extremely well architected portfolio geographically. From a product perspective, we are hitting our stride. Every part of the business is functioning well and we do not need large scale M&A to deliver on our financial goals. We do have a strategy to focus on tuck-in acquisitions, and we've said tuck-in acquisitions

in any year will be \$500 million or less. And that's all we are focused on. And I would look beyond the noise and let's just focus on PepsiCo and the performance of the company. And we feel very good about it. Thank you, Bill.

So thank you all for your questions. In closing, let me just say that our performance for the second quarter and through first half of 2013 are excellent indications of how our well constructed and developed portfolio, coupled with disciplined execution reinvestment, can drive high quality top and bottom line results on a sustainable basis. That is the purpose of PepsiCo. And I thank you for your time this morning and for the confidence you've placed in us with your investments. Have a great day.