# US Beverages

## KO, PEP – A Prescription for North America

Equities

Americas
Beverage

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**The fates of both KO and PEP depend on a solution to U.S. Beverages**

Clearly, the U.S. Beverage businesses of KO and PEP (particularly in CSDs) have not lived up to their promise following each company's bottler acquisitions in 2010. While each company's stock performance can show improvement based on other factors (Intl Ops for KO, Snacks for PEP), the fates of both companies, in our view, depend longer-term on a solution to U.S. Beverage challenges. KO cannot likely refranchise without greater U.S. profitability, and NAB challenges need to be addressed at PEP—split or no split.

**Time to address core supply chain costs (manufacturing and distribution)**

Over the past few years, volume shortfalls, SKU complexity, and a lack of real pricing have all played a role in depressing U.S. Beverage margins (despite incremental productivity along the way). However, all of these factors have been made worse by a U.S. supply chain that we think is antiquated, overly complex, and expensive.

**Comparisons with CCE (in Europe) and ABI (domestically) yield insight**

We estimate that CCE spends ~30-35 cents on product manufacturing and distribution for every dollar of revenue it records (<65% fixed); by contrast, KO and its U.S. bottlers likely spend ~50 cents on manufacturing and distribution for every revenue dollar (~90% fixed). This makes KO (and PEP) far more vulnerable to volume deleverage. Separately, despite producing ~60% the bottle/can volume of KO and PEP in the US, ABI operates with only 12 manufacturing facilities (vs. 82 at KO, 90 at PEP). Going forward, we thus see a need for more aggressive and more explicit supply chain actions (i.e., making manufacturing/distribution at KO/PEP more efficient and more variable).

**Fewer, larger plants; fewer miles traveled (not in our trucks)…a $1-1.5B+ oppty**

We envision a scenario in which KO and PEP reduce their U.S. plant footprint by ~50% (40+ facilities), and subsequently rationalize (and outsource) basic distribution—leading to a 10-15% reduction in manufacturing and distribution (~$1-1.5B, ~600 bps of NAB margin improvement). Simply articulating such a vision may make it easier to mobilize outside stakeholders. That said, as we see no such efforts by either KO or PEP on the horizon, we find it difficult to be more constructive. We reiterate our Neutral ratings.

## We all know the U.S. CSD business has been highly challenged, but why is it so important?

Clearly, the U.S. Beverage business for KO and PEP (particularly in core CSDs – still ~55-60% of PEP's U.S. Beverage business by volume, and ~65-70% of KO's U.S. Business by volume) has not lived up to its promised improvements following KO's acquisition of CCE's North American operations and PEP's acquisition of PBG and PAS in 2010. In fact, since that time, volume declines in core CSDs have persisted steadily (actually accelerating in 2013), putting significant pressure on the overall portfolio.

**While the stock performance of both KO and PEP can show improvement on other factors (international ops for KO, Snacks for PEP), the fates of both companies depend longer-term on a solution to U.S. Beverages challenges**

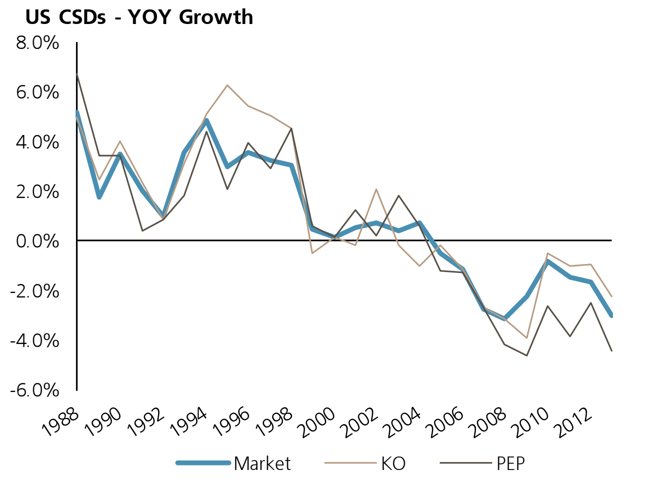
While it is true that non-CSDs have generally performed better than CSDs volumetrically (leading to modest volume growth at KO since 2010, and less significant declines at PEP), we focus in today's report on CSDs (and related direct-store-delivery distribution considerations) for several reasons:

1. CSDs remain at the heart of both the KO and PEP systems, and continue to drive a majority of system economics (and expenses).[1]

2. Relative non-carb strength can offset CSD weakness to a degree, but it is unlikely to make up for it—especially given that many non-carb categories operate at below-average margins (relative to optimized CSD operations).

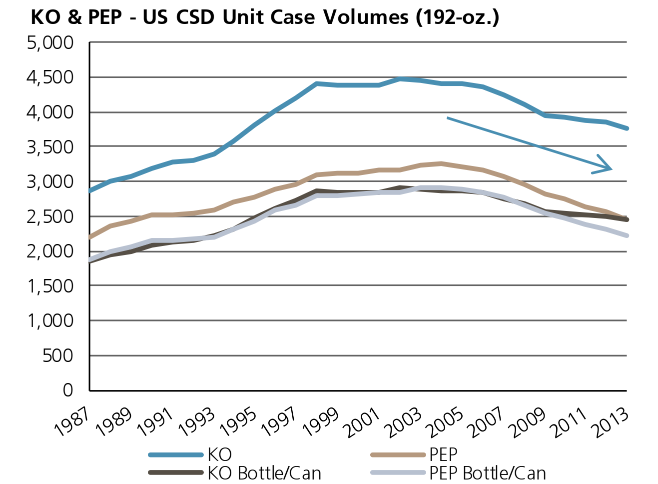
3. Within both the KO and PEP systems, CSD and non-CSD operations are in many ways still separate. While there are overlaps (multi-category cold-fill operations oftentimes align), improving core CSD operations is in many ways distinct from questions of non-CSD/non-DSD efficiency.

**Figure 1: Clearly, the core CSD business of KO and PEP in the U.S. has not lived up to its promised improvements following each company's 2010 bottler transactions**




Source: Beverage Digest, UBS estimates

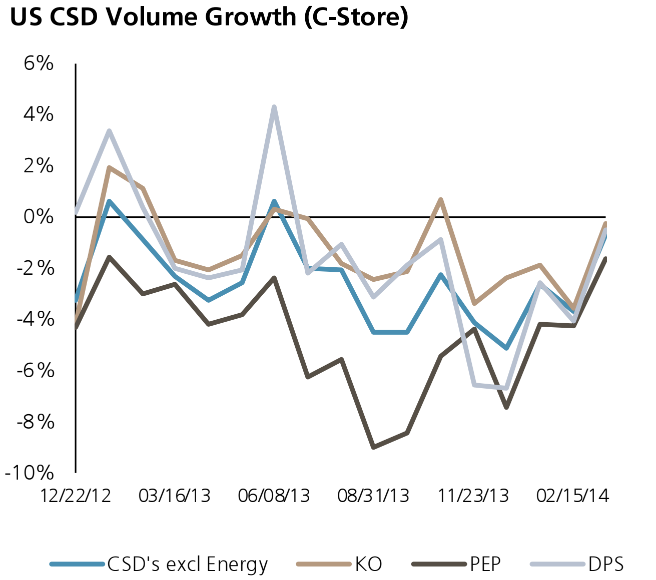
**Figure 2: Since that time, volume declines in core CSDs have persisted steadily (actually accelerating in 2013), putting pressure on the overall portfolio**




Source: Beverage Digest, UBS estimates

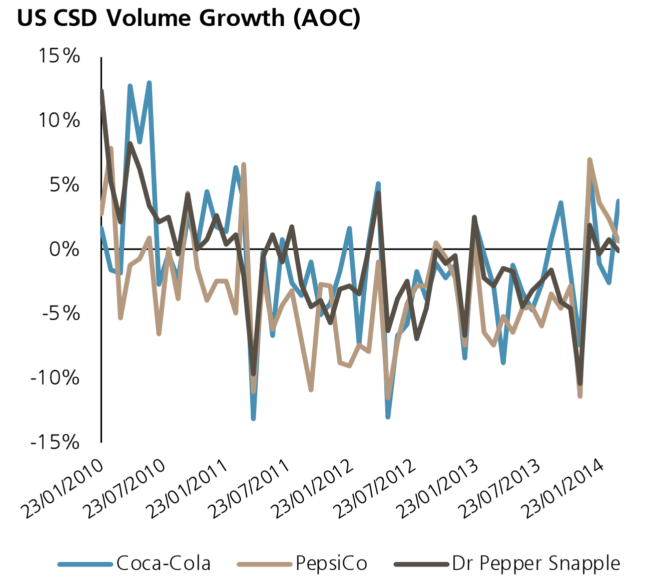
[1] In North America, KO owns 67 beverage production facilities. 54 of these are CSD facilities located in the U.S. alone (i.e., excluding Canada).

**Figure 3: Such trends are evidenced both in higher-margin C-store outlets (immediate consumption venues)…**




Source: AC Nielsen, UBS

**Figure 4: …as well as in core grocery/mass (future consumption), despite still-aggressive promotional behavior by both manufacturers and retailers alike**




Source: AC Nielsen, UBS

Exacerbating the negative P&L impact of CSD volume weakness has been the fact that it has come despite what we would characterize as still-aggressive pricing behavior. While the industry has positioned recent pricing as "rational" (and it may well be given the potential elasticity impacts of even higher pricing), we note that at only ~1-2% per annum, it has failed to keep pace with underlying cost inflation.

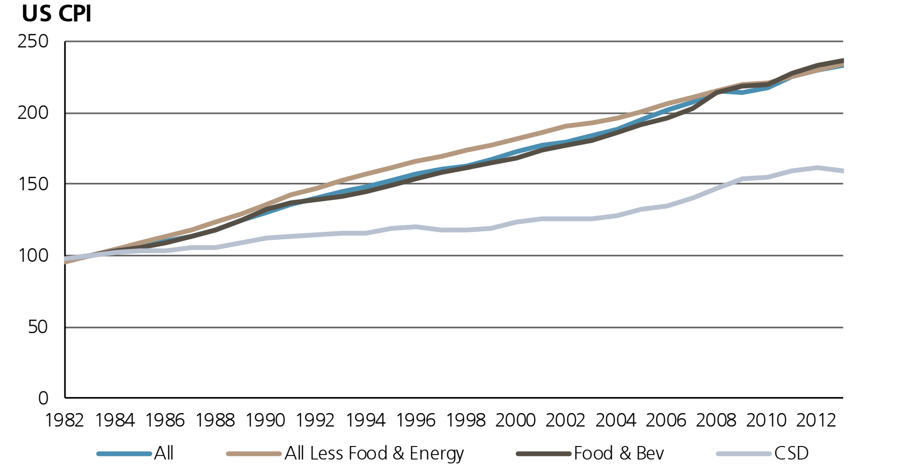
Clearly, since the early-1980s (based on government data), CSD inflation has been outpaced by overall inflation, whether measured by total CPI, Core CPI, or peer Food & Beverage categories. Most recently, while realized price/mix has seemingly been more constructive in already-higher-priced C-store channels, price-based competition remains paradoxically intense in margin-challenged grocery and mass (where a majority of industry volume still resides). This is concerning to us, as it appears the industry is desperately trying to preserve volume of questionable profitability in future consumption outlets (in order to maintain utilization and absorb fixed costs, as we will discuss later), while leaning increasingly heavily on a C-store channel where price gaps with grocery likely do have limits.[2]

Potentially most troublesome, however, is the fact that the only time in the last three decades where CSD industry pricing exceeded broader inflation for longer than one year (according to government data) was in the 5-year period *preceding* KO's and PEP's acquisitions of CCE and PBG/PAS, respectively. In other words, in real terms, it would appear that the industry has grown *more aggressive* these past few years in terms of price competition, not less.[3]

[2] Over the prior 52 weeks, Regular Coke was priced ~90% higher per ounce in C-Stores vs. AOC outlets, according to Nielsen data.

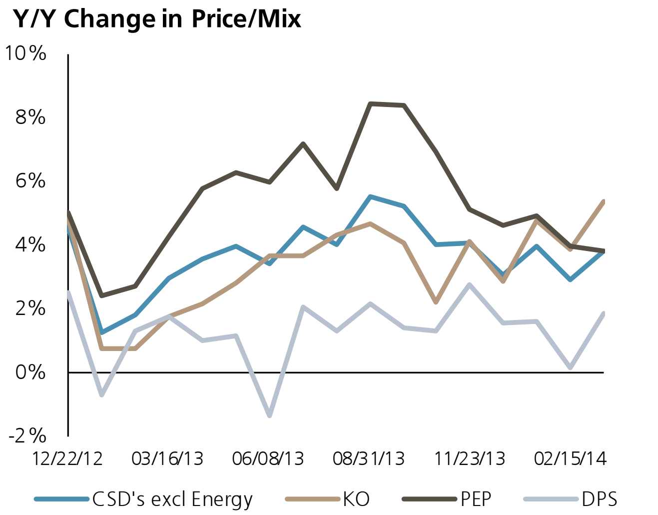
[3] As a silver lining, in a recent meeting with KO management, CFO Gary Fayard conceded that (in retrospect) the industry would have been better served by taking more pricing when faced with the commodity inflation of 2011 (following a playbook that CCE pursued, to the

**Figure 5: Since the early-1980s (based on government data), CSD inflation has been outpaced by overall inflation, whether measured by total CPI, Core CPI, or peer Food & Beverage categories**



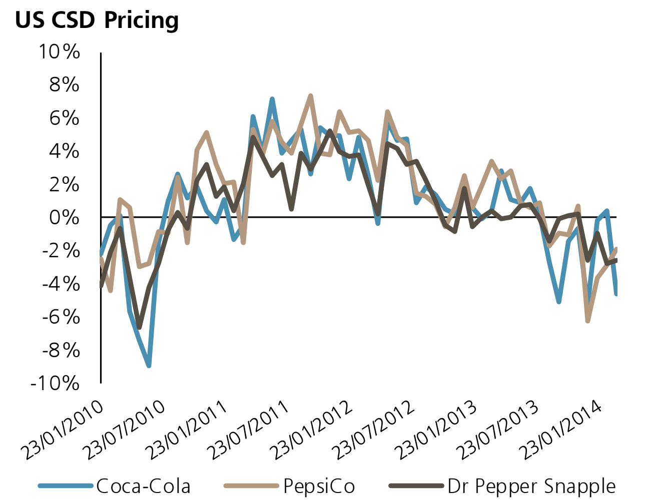

Source: U.S. Bureau of Labor Statistics, UBS

**Figure 6: Most recently, while realized price/mix has seemingly been more constructive in already-higher-priced C-store channels…**




Source: AC Nielsen, UBS estimates

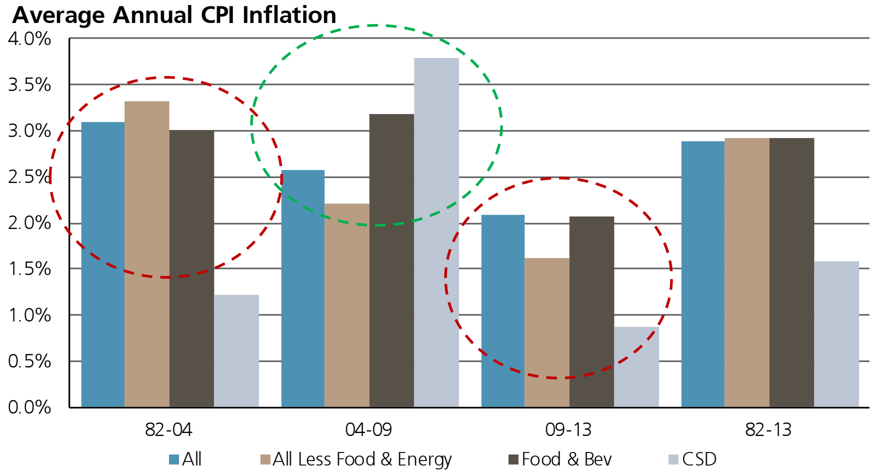
**Figure 7: …price-based competition remains paradoxically intense in margin-challenged grocery and mass (where a majority of industry volume still resides)**




Source: AC Nielsen, UBS estimates

consternation of KO at the time, under similar circumstances in 2008). We agree and hope such a shared sentiment bodes better for future pricing conditions.

**Figure 8: Potentially most troublesome is the fact that the only time in the last three decades where CSD industry pricing exceeded broader inflation was in the 5-year period *preceding* KO's and PEP's acquisitions of CCE and PBG/PAS, respectively; the industry has arguably grown *more aggressive* in terms of price competition, not less**



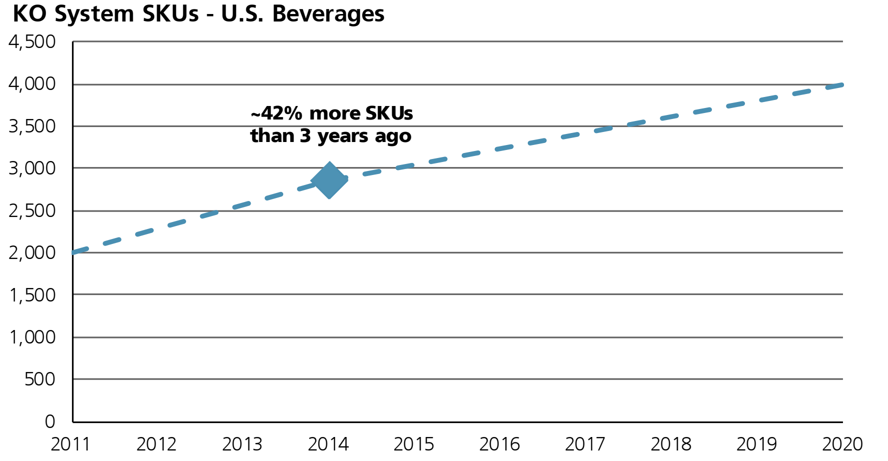

Source: U.S. Bureau of Labor Statistics, UBS analysis

Finally, further challenging system profitability is the fact that the U.S. marketplace (and hence each company's portfolio) is becoming vastly more complex and heterogeneous. New flavors, new packages, new beverage types, new brands, new sweetener combinations, new promotions. All of these equate to additional SKUs and higher supply chain management costs, all else equal.

In 2011, Brian Kelley, then Chief Product Supply Officer at Coca-Cola Refreshments, said the following at an investor event when describing one of the outgrowths of KO's OBPPC (Occasion, Brand, Package, Price, Channel) strategy, "You heard a lot of talk today about building out a segmented OBPPC strategy. Well you have to have a product supply system that can deliver that and that means deliver more SKUs. Today we have 2000. Soon we will have double that. We look out 10 years and say by 2020, we will likely have 4000 SKUs."[4] Based on a recent conversation with KO's IR, we estimate that KO is well on their way to meeting that expectation, with 40+% more SKUs in place relative to three years ago.

[4] Coca-Cola North America Market Tour, 9/21/2011.

**Figure 9: Further challenging system profitability is the fact that the U.S. marketplace (and hence each company's portfolio) is becoming vastly more complex and heterogeneous; KO expects to double its U.S. SKUs between 2011 and 2020, and we estimate that it is well on its way**

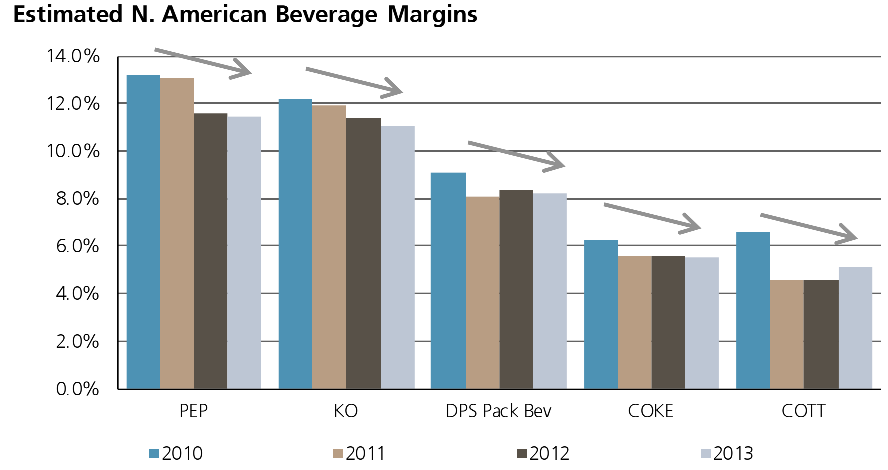



Source: Company reports, UBS estimates

As a result of the above trends (volume declines in core CSDs, increasing complexity, a lack of adequate pricing in real terms, and perhaps a net mix-shift towards lower-margin non-carbs), we have seen industry margins decline over the last several years—despite productivity efforts and multiple attempts to rejuvenate growth. This is a reality that makes KO's refranchising efforts difficult (in our view, there is simply not enough margin in the system to apportion some to third parties, while allowing KO to retain what it deems its fair share) and has led to calls for PEP to split off North American Beverages altogether.

**Given perpetual CSD volume declines, increasing SKU complexity, a lack of adequate pricing, and a net mix-shift towards lower-margin non-carbs, we have seen industry margins decline over the last several years—in spite of productivity efforts and multiple attempts to rejuvenate growth**

**Figure 10: As a result of the above trends, we have seen industry margins decline over the last several years—despite productivity efforts and multiple attempts to rejuvenate growth**




Source: Company reports, UBS estimates

In our view, this lack of progress in North American Beverages is especially important. While KO and PEP could each be better stocks without North American Beverages improvement (KO on the back of international improvement, PEP on the back of Snacks), we do not feel either can realize their full potential without North American Beverages pulling more of its weight. North American Beverages currently accounts for ~45% of KO's revenue and ~30% of PEP's. Moreover, for KO, we view higher profit margins in the U.S. as a likely prerequisite to any future holistic refranchising. Similarly at PEP, NAB stabilization is assumed in any future improvement scenario—whether integrated as part of the current PepsiCo algorithm (as management would have it) or stand-alone (as Trian, among others, would prefer).

**Figure 11: For KO, we view higher profit margins in the U.S. as a likely prerequisite to any future holistic refranchising; under status quo operations, any potential split will likely result in suboptimal conditions for distributors and/or a centralized Product Supply organization**

| **Status Quo Scenario** | | **Total Coke System** | **KO Economics** (1) | **Bottler/Distributer Profit Share** | **KO Share of System Profits** |
|---|---|---|---|---|---|
| Revenues *(Illustrative)* | $ | 100.00 | 25 | 75 | |
| Op Profits *(Illustrative)* | $ | 11.50 | 8.75 | 2.75 | **76%** |
| Operating Margin | | 11.5% | 35.0% | **3.7%** | |

| **Improvement Scenario** | | **Total Coke System** | **KO Economics** (1) | **Bottler/Distributer Profit Share** | **KO Share of System Profits** |
|---|---|---|---|---|---|
| Revenues *(Illustrative)* | $ | 100.00 | 25 | 75 | |
| Op Profits *(Illustrative)* | $ | 17.00 | 8.75 | 8.25 | **51%** |
| Operating Margin | | 17.0% | 35.0% | **11.0%** | |

(1) Assumes KO desires to retain at least 25% of System Revenues and earn a 35% margin.

Source: UBS estimates

## What needs to be done?

Against this backdrop, the most critical issue for us is not that North American Beverages represents a challenging business, but rather that we see neither KO nor PEP today taking aggressive enough actions by which drive improvement (assuming, as we do, that the demand environment remains suboptimal). This is not to say that KO and PEP are not trying. Both are. But each seems content to focus on (in our view) relatively modest cost-cutting, invest back to varying degrees in marketing and R&D support, and (for lack of a better word) "muddle through" a difficult environment.[5] PEP has seemingly placed marginally more focus on price realization, R&D (i.e., a potential sweetener innovation), and heretofore elusive synergies with Frito Lay as a way forward (while deemphasizing the need to win in colas). KO, by contrast, appears more focused on traditional levers of success—i.e., marketing, Red/Black/Silver, and rekindled volume growth, with OBPPC-based mix

**In our view, neither KO nor PEP today are taking aggressive enough actions by which drive profitably improvement**

[5] In fairness, "muddle through" is an imperfect description—perhaps more appropriate for PEP than KO. Of the two companies, PEP appears more resigned to CSD volume declines, and is more focused instead on revenue realization/stabilization. By contrast, KO is more aggressive and optimistic about an ability to return its business to growth, in spite of marketplace obstacles.

driving net modest pricing. The challenge for us is seeing much different in these plans versus what each company pursued in 2012 or 2013. Both companies are promising more by doing more, but at the same time (again, at least as it appears from the outside) are putting little that is new on the table.

So, what *should* be done? Clearly, precise solutions are difficult to define from the outside, especially in a business as large, fast-moving, and complex as either KO's or PEP's is in North American Beverages. That said, we do think any future solution should have the following key components:

**In addition to marketing and R&D investment, we look for more constructive pricing, and more aggressive actions on supply chain costs (i.e., manufacturing and distribution efficiency)**

1. **Continued investment in R&D, non-CSDs, and selective marketing**. On this front, we think the industry is performing reasonably well.

2. **More net realized pricing, especially future consumption CSD pricing**. While we acknowledge competitive challenges (KO vs. PEP mistrust), cross-category challenges (e.g., growing price gaps with water), retailer challenges (i.e., the perception of CSDs as a traffic driver), and especially elasticity/deleverage challenges (made worse if retailer support diminishes), we think it imperative for CSD pricing to at least keep pace with underlying inflation after years of tracking below.

3. **Far more aggressive attention on supply chain costs and efficiency**. To date, both KO and PEP have saved hundreds of millions of dollars ($500+M) in their North American Beverage operations (dating back to original CCE and PBG/PAS deal synergies). However, the vast majority of those savings have come not from manufacturing and distribution costs (where a majority of costs likely reside, and where volume deleverage is most damaging) but instead from overhead and selling cost reductions, and improved procurement. This is not to diminish what has been achieved, nor what potential continues to exist in these non-manufacturing/distribution cost buckets. However, especially if we assume continued volume pressure, we think it imperative that KO and PEP now take steps to more aggressively lower and variablize their manufacturing/distribution costs.

It is on this last point (#3) that we will focus the bulk of our attention.

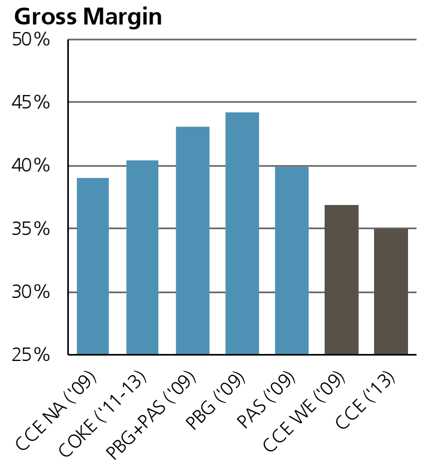
## Why is more pricing not enough?

For years, there have been calls by some outside observers in favor of higher U.S. CSD pricing (we would count ourselves among that contingent). However, oftentimes, this discussion can fail to appreciate how much of the U.S. CSD manufacturing and distribution cost structure is effectively fixed, and thus the core issue of volume deleverage and utilization loss. Clearly, one can debate whether volume elasticity on sustained and steady price increases would be as severely negative as elasticity observed around promotions (we think not, over time); however, there would be some negative impact, and it would likely be material—further straining an already-volume-starved system. In other words, in order to be able to more effectively take price, we believe KO, PEP, and the U.S. Beverages industry broadly must first take steps to (a) scale capacity down to today's volume levels, while (b) making costs more variable to allow for more volume leakage over time (should it come).

Here we think a comparison with CCE's operations in Europe are revealing. Versus U.S. bottlers, CCE operates with a lower gross margin (driven mainly by higher

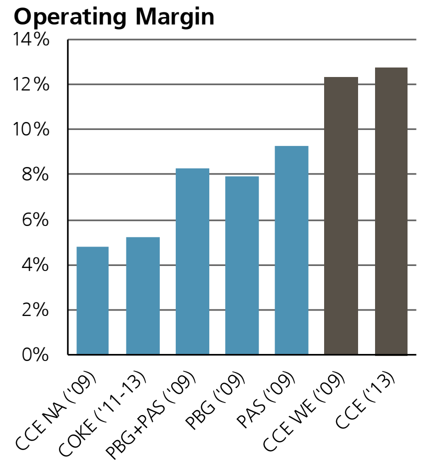
concentrate prices—i.e., a higher percentage of revenues going to KO), but a far higher operating margin due do materially lower SG&A costs.

**Figure 12: Versus U.S. bottlers, CCE operates with a lower gross margin…**



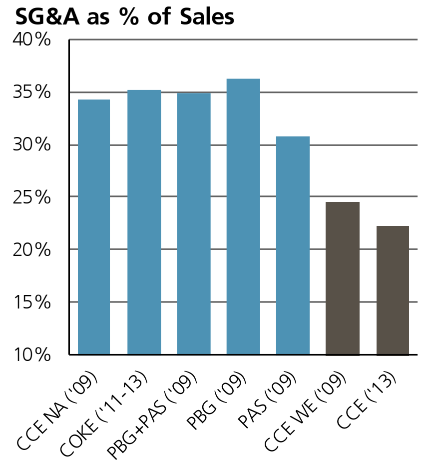

Source: Company reports, UBS

**Figure 13: …but a far higher operating margin…**




Source: Company reports, UBS

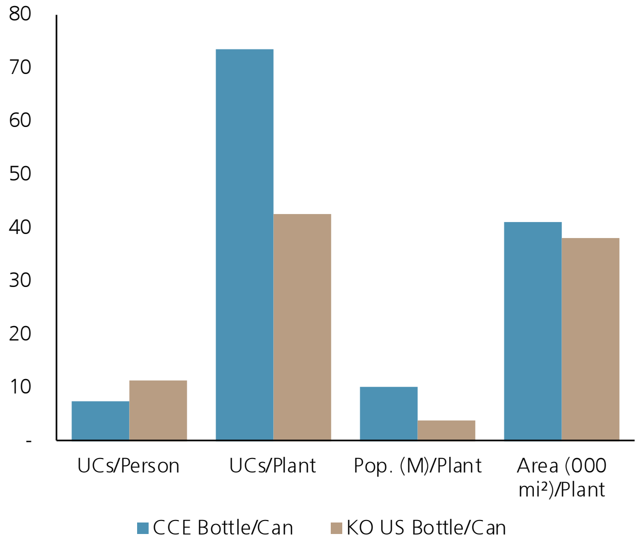
**Figure 14: …due do materially lower SG&A costs**




Source: Company reports, UBS

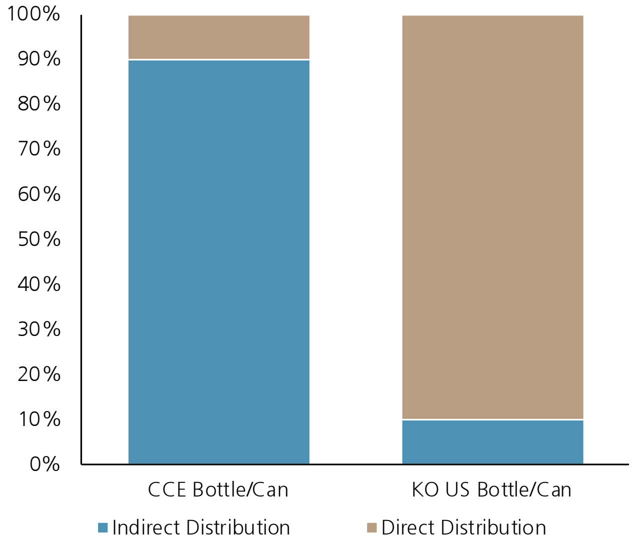
While there are differences in portfolio complexity between the U.S. and Western Europe (the U.S. being more diverse), competition (the U.S. more intense), and velocity (U.S. per capita consumption greater)—all of which simplify CCE's European operations relative to the U.S.—we view the key differences in the above economics being that CCE in Europe has (a) a more consolidated/rationalized manufacturing footprint, and (b) importantly leverages 3rd-party distributers (who themselves are tasked with optimizing logistics) for 90% of its shipments (i.e., indirect distribution). By contrast, KO's (and PEP's) manufacturing infrastructure in the U.S. is more fragmented, leading to both plant inefficiencies and waste in miles traveled for their direct store delivery, or DSD fleet (90+% of which is company-owned).

**Figure 15: Although KO's system in the U.S. is higher velocity (more Unit Cases/person), CCE's in Europe is more consolidated, with more Unit Cases/plant, more consumers/plant, and more area served (mi²)/plant**




Source: Company reports, UBS estimates

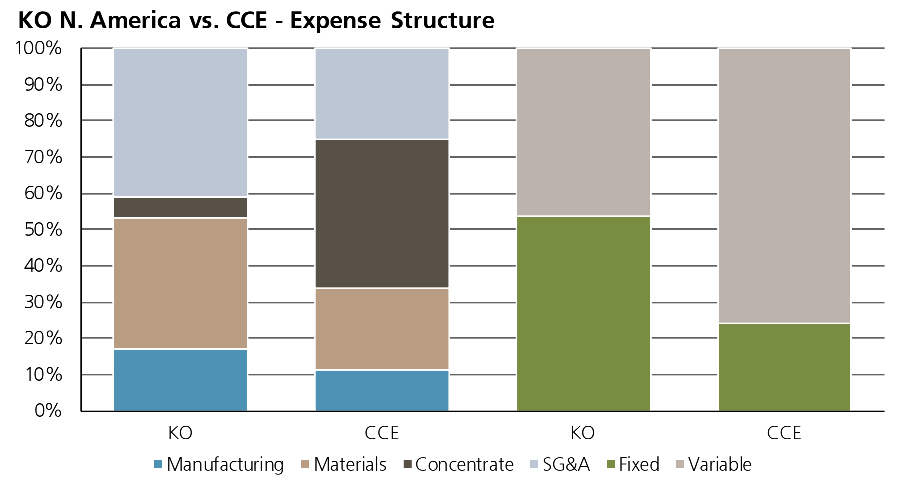
**Figure 16: CCE also importantly leverages 3rd-party distributers (who themselves are tasked with optimizing logistics) for 90% of its shipments; by contrast, KO's (and PEP's) fleet is 90+% company-owned and operated**




Source: Company reports, UBS estimates

In our estimation, CCE spends only 30-35 cents on product manufacturing and distribution for every dollar of revenue it records, and no more than 65% of this is fixed (perhaps less, based on past company discussions). By contrast, KO and its U.S. bottlers likely spend ~50 cents on manufacturing and distribution for every dollar of revenue recorded, and we estimate 90+% of that is effectively fixed. While the reduced cost of delivery for CCE is a clear benefit, we believe the variability of CCE's expenses is just as important. Largely as a result (in combination with other expense controls), CCE was able to preserve its bottom-line results even as volumes disappointed throughout much of 2012 and 2013.

**Figure 17: We estimate that CCE spends ~30-35 cents on product manufacturing and distribution for every dollar of revenue it records (~65% or less fixed); by contrast, KO and its U.S. bottlers likely spend ~50 cents on manufacturing and distribution for every dollar of revenue recorded (~90% fixed)**

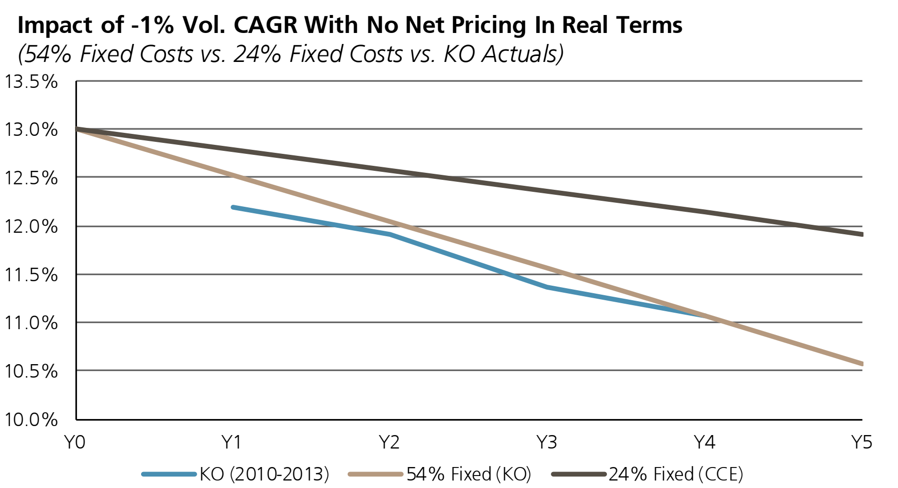



Source: Company reports, UBS estimates

All told, both CCE in Europe and KO in North America operate with low-double margins today; however, we estimate that only 24% of CCE's cost base is "fixed" in the near-term, versus 54% of KO's. As a result, KO's cost structure is far more susceptible to the deleveraging impact of lower volumes—a factor, which again, we believe explains a good deal of KO's declining North American segment margins these past several years.

**If KO and PEP wish to take more price in U.S. CSDs, we believe they must work first to restructure and make more variable their supply chain costs**

**Figure 18: We estimate that only 24% of CCE's cost base is "fixed" in the near-term, versus 54% of KO's; as a result, KO's cost structure is far more susceptible to the deleveraging impact of lower volumes**




Source: Company reports, UBS estimates

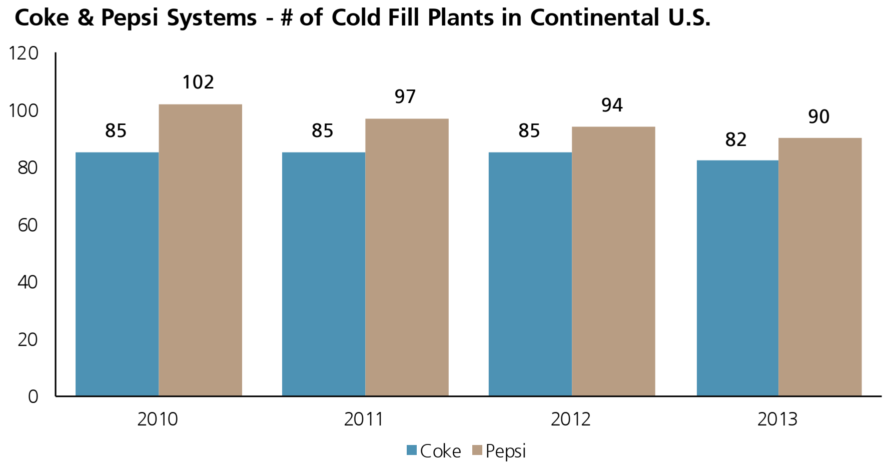
## But haven't KO and PEP been reducing costs and pursuing efficiencies?

As alluded to earlier, both KO and PEP have reportedly achieved hundreds of millions of cost savings in the U.S. (~$500+M) since their bottler acquisitions in 2010. However, the vast majority of those savings have come not from manufacturing and distribution costs (where a majority of costs likely reside, and where volume deleverage is most damaging) but instead from overhead and selling cost reductions, and improved procurement.

Although both KO and PEP have reduced their plant footprint in the U.S. since 2010 (PEP by ~10%, KO by ~5%), both companies still operate with 80-90 CSD facilities (note that this excludes additional facilities dedicated to juices, waters, isotonics, etc.). To be fair, KO and PEP have worked to standardize warehouse and plant floor layouts, implement automation and logistics technology (more needs to be done here), standardize and upgrade fleet, and generally improve service levels. However, these efforts only address supply chain inefficiency issues on the periphery. In our view, neither has yet adequately attacked the root of the problem (an overly complex manufacturing footprint and thus distribution system), or alternatively articulated why doing so more definitively would be suboptimal.

**Although both KO and PEP have reduced their plant footprint in the U.S. since 2010 (PEP by ~10%, KO by ~5%), both companies still operate with 80-90 CSD facilities**

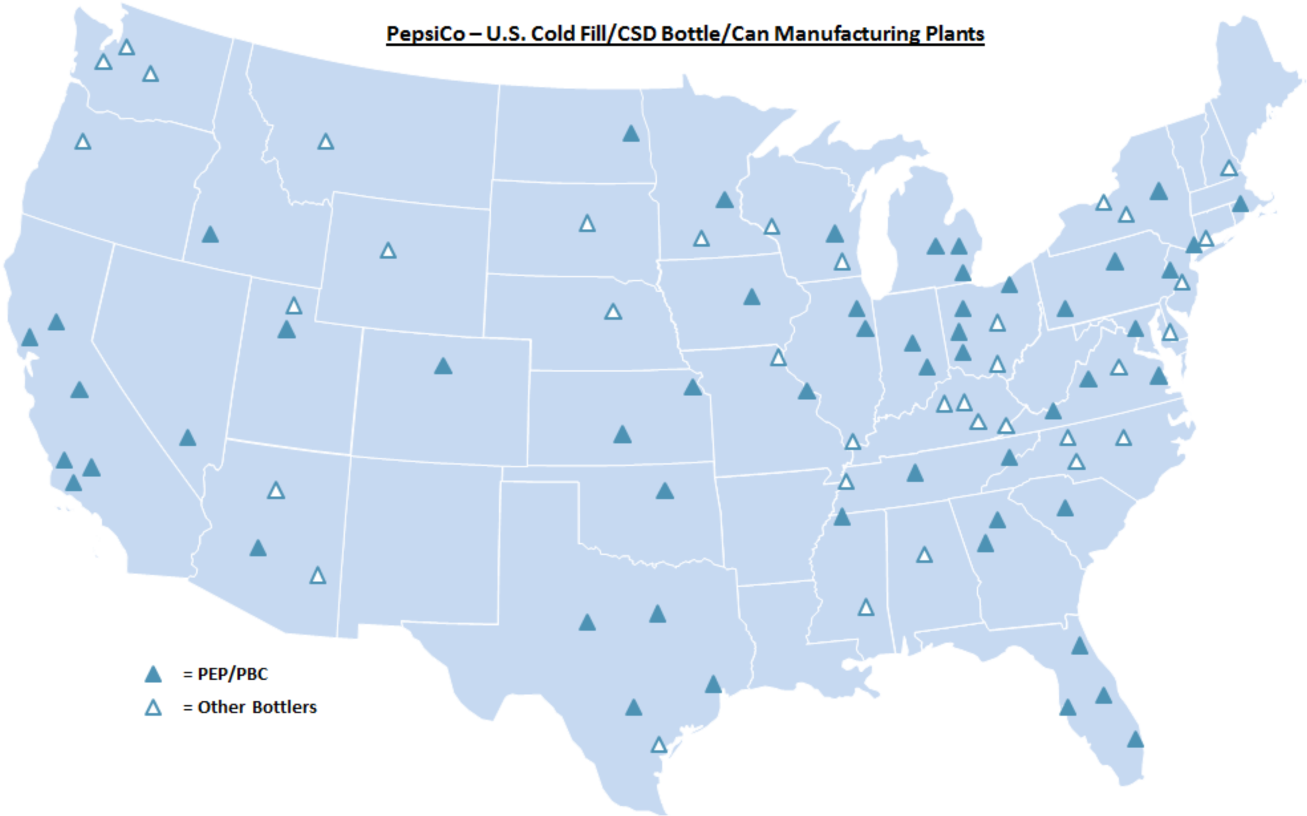
**Figure 19: Although both KO and PEP have reduced their plant footprint in the U.S. since 2010 (PEP by ~10%, KO by ~5%), both companies still operate with 80-90 CSD facilities**




Source: Beverage Digest, Company reports, UBS estimates

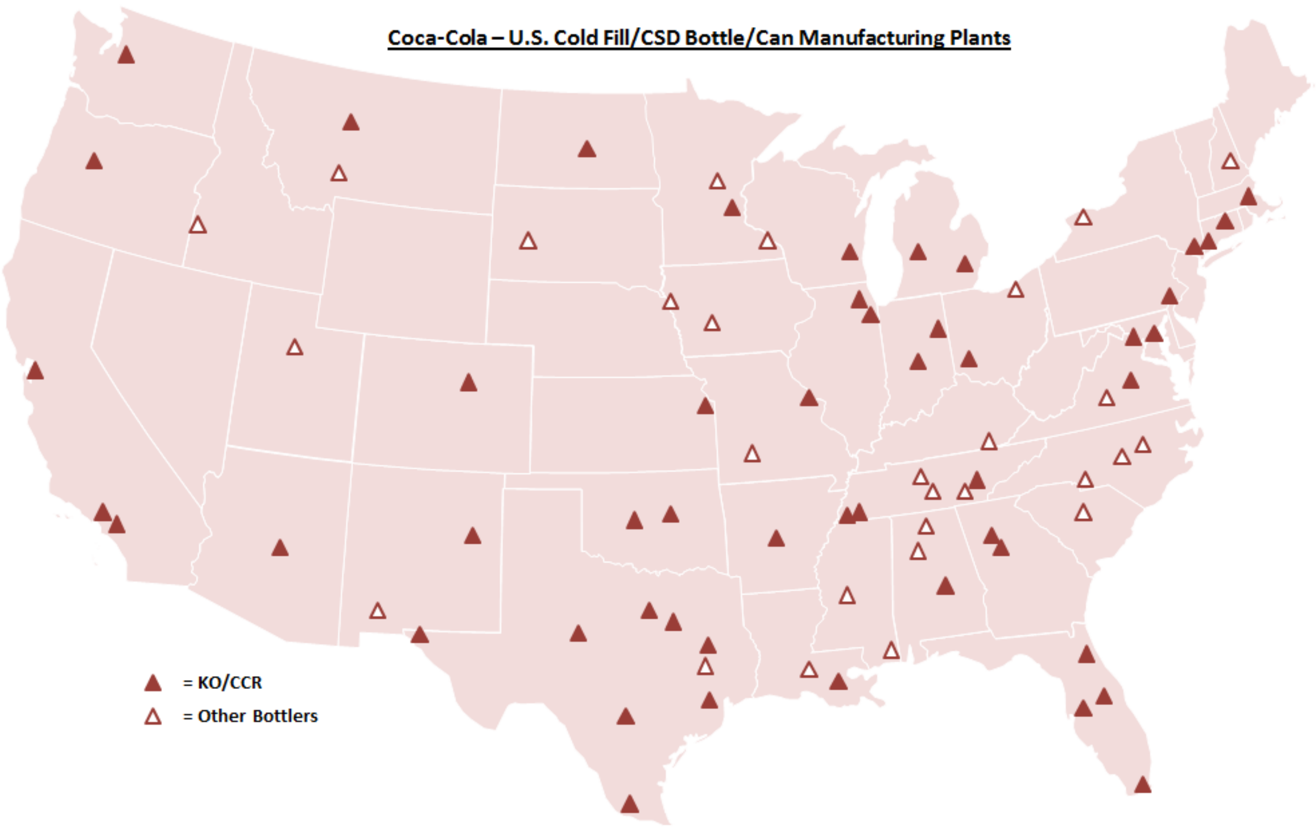
A simple view of each system as presented on a map of the U.S. illustrates (we believe) their suboptimal layout (each grew as a by-product of history rather than by intentional planning). On average, it takes only 250-300 miles to reach 10 neighboring plants from any one location in either the KO or PEP system. Moreover, the average minimum distance to the next closest plant in either system is <100 miles (as the crow flies).

**Figure 20: A simple view of each system as presented on a map of the U.S. illustrates their suboptimal layout (here the PEP system)…**



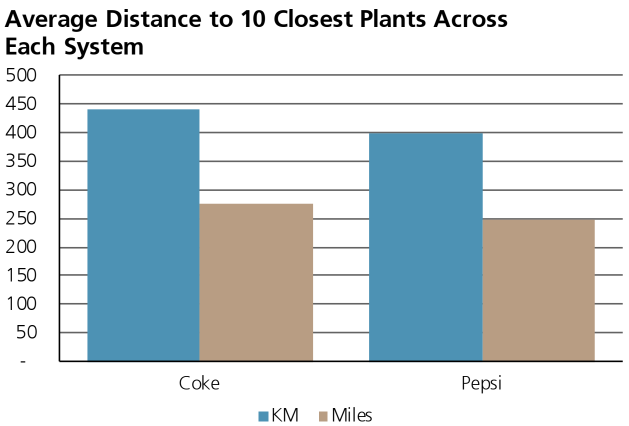

Source: Beverage Digest, Google Earth, UBS estimates

**Figure 21: …as each grew as a by-product of history rather than by intentional planning (here the KO system)**



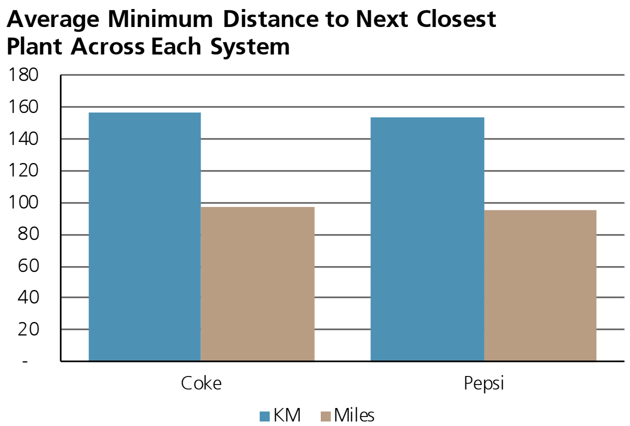

Source: Beverage Digest, Google Earth, UBS estimates

**Figure 22: On average, it takes only 250-300 miles to reach 10 neighboring plants from any one location in either the KO or PEP system**




Source: Beverage Digest, Google Earth, UBS estimates

**Figure 23: Moreover, the average minimum distance to the next closest plant in either system is <100 miles**




Source: Beverage Digest, Google Earth, UBS estimates

Not only are KO and PEP CSD facilities in the U.S. overly congested, in our view, but they are also subscale, with most facilities averaging <20K square meters in size (based on initial calculations made from satellite imagery). We estimate that only 23 KO facilities are larger than 25K square meters today, and only 24 PEP facilities.

**Not only are KO and PEP CSD facilities in the U.S. overly congested, in our view, but they are also subscale**

**Figure 24: Not only are KO and PEP CSD facilities in the U.S. overly congested, in our view, but they are also subscale…**

| *(Square Meters, 000s)* Facility Size | KO System | CCR | Other |
|---|---|---|---|
| Mean | 20.5 | 23.3 | 15.3 |
| Median | 18.0 | 19.7 | 12.8 |
| Min | 1.6 | 4.5 | 1.6 |
| Max | 64.8 | 54.3 | 64.8 |

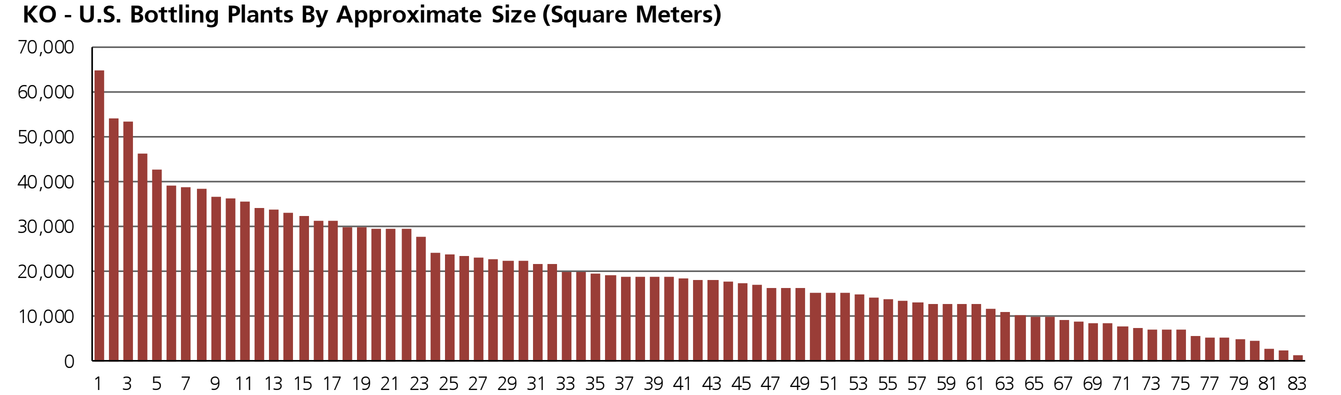
Source: Google Earth, UBS estimates

**Figure 25: …with most facilities averaging <20K square meters in size**

| *(Square Meters, 000s)* Facility Size | PEP System | PBC | Other |
|---|---|---|---|
| Mean | 18.5 | 20.8 | 14.9 |
| Median | 17.1 | 18.5 | 13.1 |
| Min | 0.9 | 5.5 | 0.9 |
| Max | 42.8 | 42.8 | 34.5 |

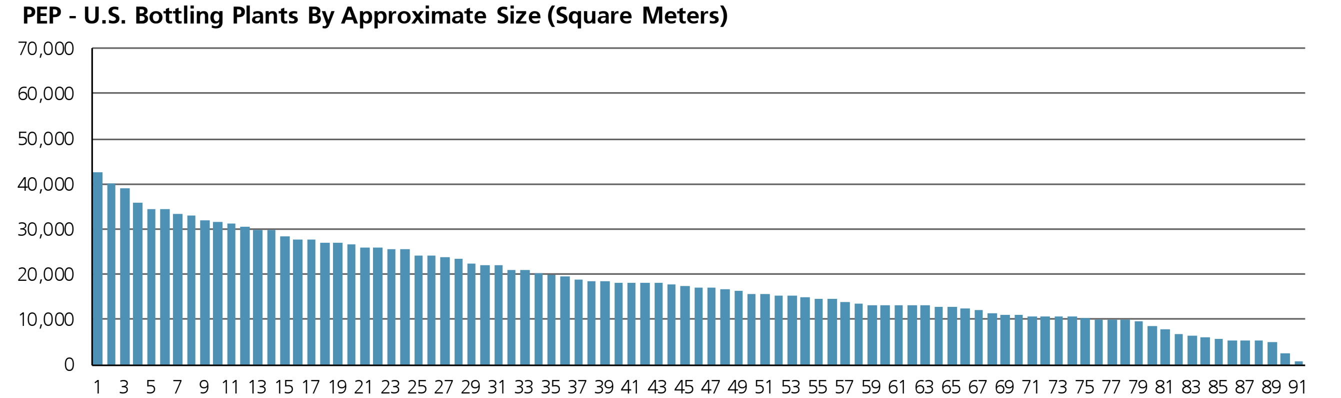
Source: Google Earth, UBS estimates

**Figure 26: We estimate that only 23 KO facilities are larger than 25K square meters today…**




Source: Google Earth, UBS estimates

**Figure 27: …and only 24 PEP facilities**

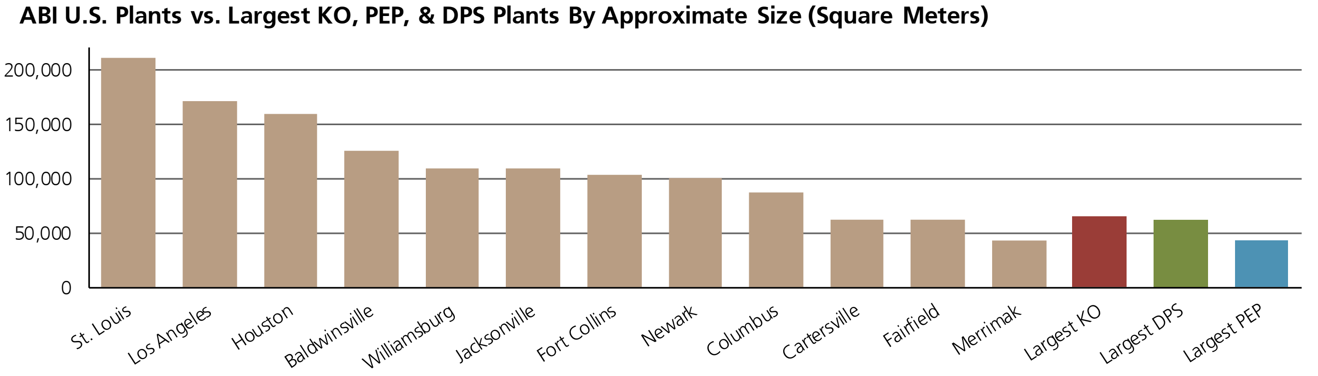



Source: Google Earth, UBS estimates

Compare this with the ABI system, which contains only 12 core manufacturing facilities (excluding a smaller Goose Island Brewery facility in Chicago), the smallest of which is >40K square meters. In fact, across the entire ABI system, we estimate an average facility size of ~100-110K square meters. In other words, despite producing ~60% the bottle/can volume versus the KO system in the US, ABI operates with only 15% the number of manufacturing facilities.

Now, clearly, soft drinks is not beer, and vice versa. The beer manufacturing process requires a larger footprint to begin with, leading naturally to larger facilities. However, as the soft drink portfolio becomes more complex (i.e., less reliant on a relatively few number of core SKUs), we believe the benefits of localization are being trumped by the complexity of having only certain SKUs manufactured in certain locations (thus sometimes requiring cross-shipments and dual-handling before full pallets can be assembled).[6] As a result, we see a need for fewer, but generally larger plants growing across both the KO and PEP systems—and with it, more streamlined distribution.

**Figure 28: Compare this with the ABI system, which contains only 12 core manufacturing facilities, the smallest of which is >40K square meters**




Source: Google Earth, UBS estimates

[6] For example, KO reportedly has an overcapacity of lines in large PET and cans across the system, but is relatively constrained in small PET production.

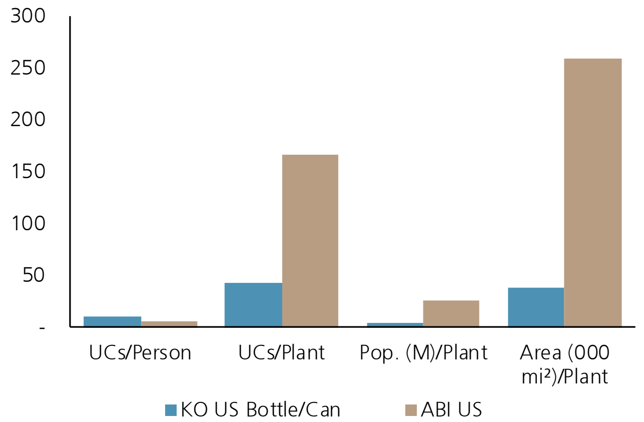
**Figure 29: Across the entire ABI system, we estimate an average facility size of ~100-110K square meters**

*(Square Meters, 000s)*

| Facility Size | ABI |
|---|---|
| Mean | 111.9 |
| Median | 105.9 |
| Min | 43.2 |
| Max | 210.6 |

Source: Google Earth, UBS estimates

**Figure 30: Despite producing ~60% the bottle/can volume versus the KO system in the US, ABI operates with only 15% the number of manufacturing facilities**




Source: Company reports, UBS estimates

## Defining the potential future state

**We think that both KO and PEP would be well-served by painting a clearer vision for success when it comes to future state manufacturing and distribution than has been accomplished thus far**

Clearly, defining an exact blueprint for success from the outside oversimplifies the challenges. In reality, significant consideration must be given to where each company is starting from, such that what is right for PEP may not be right for KO, and vice versa. That said, we do think that both KO and PEP would be well-served by painting a clearer vision for success when it comes to future state manufacturing and distribution than has been accomplished thus far. And this does mean *both* manufacturing and distribution.

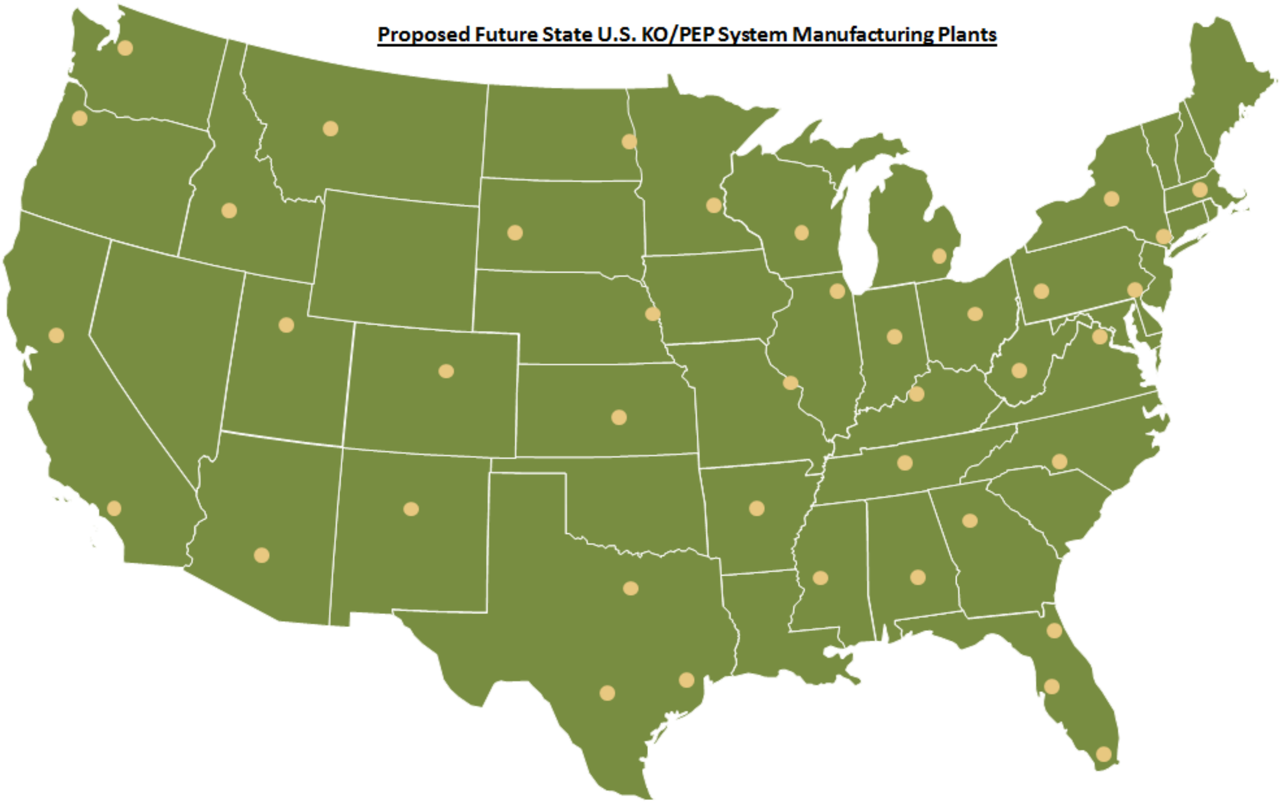
To date, when questions of manufacturing and distribution have been raised, they more often than not focus on the distribution side. To whom will KO franchise out distribution, where, and when? Can PEP better integrate the Snacks and Beverage go-to-market models, or at least leverage Snacks best practices like GES within Beverages? Etc.

For our part, those are important questions, but they should be answered at least in conjunction with (if not following) the resolution and initial implementing of an updated manufacturing plan. Where should CSDs be manufactured in the U.S.? In how many locations? In what sized facilities? Can they be better integrated with non-CSD production? What would facilitate the most streamlined route to market alongside manufacturing scale improvements and footprint optimization?

As an initial stalking horse, if KO and/or PEP reduced/reconfigured their manufacturing footprint along the "future state" proposal diagrammed below (41 plants in total, each averaging perhaps ~40K square meters as opposed to today's ~20K average, and each located near major interstate junctions), we estimate that roughly 50% of the U.S. population would still reside within 50 miles of these facilities (and perhaps as much as 75% within 100 miles). Theoretically (after allowing for implementation costs), this could facilitate both more efficient manufacturing and more streamlined downstream distribution, which we think

could be outsourced to contracted trucking companies (e.g., other basic food and beverage distributors), wherever possible—again, to achieve cost variability.[7]

**Figure 31: As an initial stalking horse, if KO and/or PEP reduced/reconfigured their manufacturing footprint along the "future state" proposal diagrammed below, we estimate that roughly 50% of the U.S. population would still reside within 50 miles of these 41 facilities (and perhaps as much as 75% within 100 miles)**




Source: Beverage Digest, Google Earth, http://mcdc.missouri.edu/websas/caps10c.html, UBS estimates

**Clearly, neither PEP nor KO can get there overnight, but we do think it reasonable to envision a scenario where both KO and PEP are able to reduce manufacturing and distribution costs by 10-15% over time (~$1B-$1.5B in net savings)**

Clearly, neither PEP nor KO can get there overnight. The current U.S. systems are highly complex, and neither KO nor PEP yet has full control over system assets (thus each still has to negotiate a solution with other stakeholders internal to the system before full improvements can be made).

However, we do think it reasonable to envision a scenario where both KO and PEP are able to reduce manufacturing and distribution costs by 10-15% over time (~$1B-$1.5B in net savings). This would lead to ~600 bps of NAB operating margin improvement, and would contribute ~270 bps to KO's overall business and ~190 bps to PEP's (based on each company's current structure).

Moreover, simply articulating such a vision/objective may make it easier to get outside stakeholders to cooperate (whether other bottlers within each system, retail partners, and/or future would-be franchisees, in the case of KO).

[7] Merchandising responsibilities could either remain with KO and PEP, or transfer to labor is provided by the distributors. DPS has already experimented with both models in markets where it partners with 3rd-party beer distributors.

In the meantime, however, while demand trends remain difficult, competition remains elevated, and clarity around future paths to margin improvement remain opaque, we find it difficult to become more constructive on either KO or PEP shares. We reiterate our Neutral stance on each.

**Figure 32: Clearly, neither PEP nor KO can get there overnight, but we do think it reasonable to envision a scenario where both KO and PEP are able to reduce manufacturing and distribution costs by 10-15% over time (~$1B-$1.5B in net savings); this would lead to ~600 bps of NAB operating margin improvement, and would contribute ~270 bps to KO's overall business and ~190 bps to PEP's (based on each company's current structure)**

| | KO/PEP NAB Estimated Current State | KO/PEP NAB Aspirational Future State | Notes | KO/CCE Combined European Current State Benchmark |
|---|---|---|---|---|
| **Revenue** | **100.0%** | **100.0%** | | 100.0% |
| Plant/Manufacturing Costs | 15.0% | 12.8% | ~15% reduction, **$475M** (225 bps in NAB, 100 bps at KO overall, 70 bps at PEP overall) | 10.0% |
| Input Costs | 30.5% | 30.5% | | 25.7% |
| Concentrate Costs | 5.0% | 5.0% | | 5.0% |
| **Gross Margin** | **49.5%** | **51.8%** | | **59.4%** |
| SG&A | 38.0% | 34.2% | ~10% reduction, **$800M** (380 bps in NAB, 170 bps at KO overall, 120 bps at PEP overall) | 31.2% |
| **Operating Margin** | **11.5%** | **17.6%** | | **28.1%** |

Source: Company reports, UBS estimates

**Statement of Risk**

Risks to our price target for KO, PEP, DPS, and MNST include any material changes in:

(a) General consumer preferences and/or government regulation pertaining to the consumption of Beverage products (including taxation, restrictions on sales, the introduction or subsidization of substitute products, etc.);

(b) Government regulation with respect to commerce and/or taxation in general;

(c) Macroeconomic trends, interest rate, and/or credit environments within any of our companies' key markets;

(d) Competitive intensity between Beverage companies within any of our companies' key markets;

(e) Customer (i.e., retailer) or supplier relationships as related to our coverage companies;

(f) Commodity cost and/or foreign exchange fluctuations;

(g) Weather, as related to Beverage consumption;

(h) Our companies' own ability to execute, whether with respect to R&D, sales and marketing, and/or ongoing productivity efforts;

(i) Our companies' stance towards M&A (whether related to acquisitions, JVs, divestments, or otherwise), or the prioritization of cash in general (whether related to organic business investment, dividends, share repurchases, etc.).

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| **UBS 12-Month Rating** | **Definition** | **Coverage**[1] | **IB Services**[2] |
|---|---|---|---|
| **Buy** | FSR is > 6% above the MRA. | 47% | 33% |
| **Neutral** | FSR is between -6% and 6% of the MRA. | 42% | 34% |
| **Sell** | FSR is > 6% below the MRA. | 11% | 23% |
| **UBS Short-Term Rating** | **Definition** | **Coverage**[3] | **IB Services**[4] |
| **Buy** | Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event. | less than 1% | less than 1% |
| **Sell** | Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event. | less than 1% | less than 1% |

Source: UBS. Rating allocations are as of 31 March 2014.
1:Percentage of companies under coverage globally within the 12-month rating category. 2:Percentage of companies within the 12-month rating category for which investment banking (IB) services were provided within the past 12 months.
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**UBS Securities LLC:** Stephen Powers; Megan Cody, CPA.

## Company Disclosures

| Company Name | Reuters | 12-month rating | Short-term rating | Price | Price date |
|---|---|---|---|---|---|
| **Anheuser-Busch InBev**[16] | ABI.BR | Buy | N/A | €77.07 | 08 Apr 2014 |
| **Coca-Cola**[4, 6a, 6b, 6c, 7, 16] | KO.N | Neutral | N/A | US$38.90 | 08 Apr 2014 |
| **Coca-Cola Enterprises**[16] | CCE.N | Neutral | N/A | US$46.19 | 08 Apr 2014 |
| **PepsiCo Inc**[2, 4, 5, 6a, 6b, 6c, 7, 16] | PEP.N | Neutral | N/A | US$83.47 | 08 Apr 2014 |

Source: UBS. All prices as of local market close.
Ratings in this table are the most current published ratings prior to this report. They may be more recent than the stock pricing date

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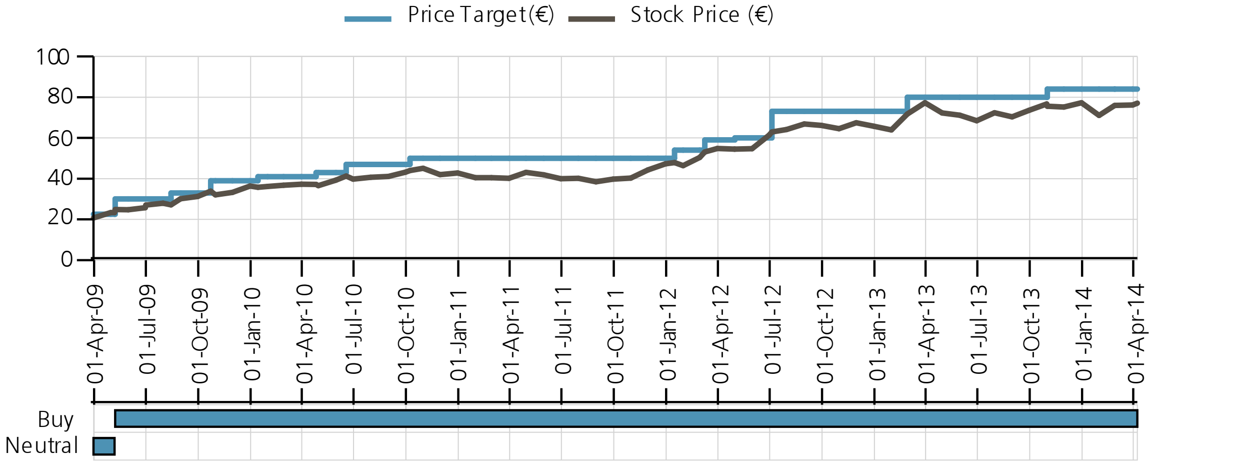
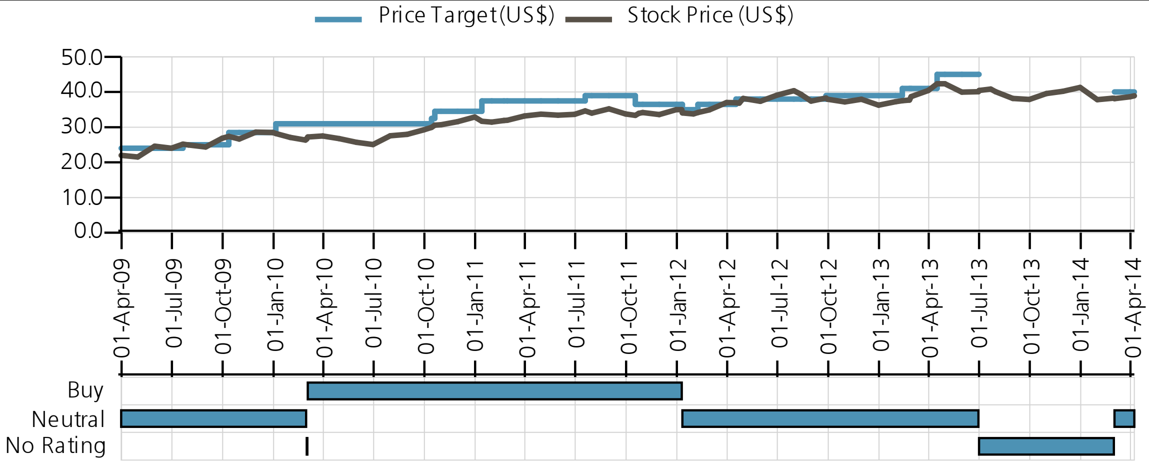
**Anheuser-Busch InBev (€)**



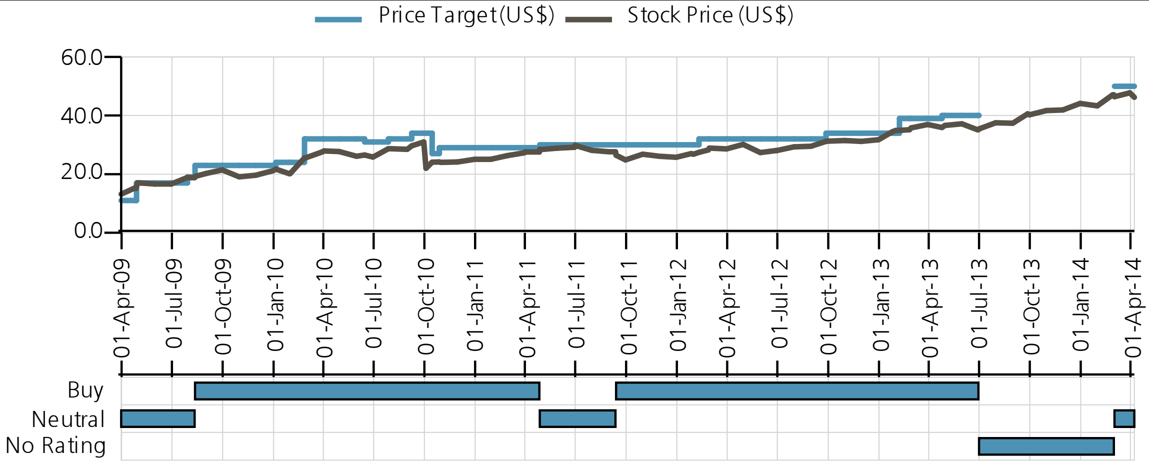

Source: UBS; as of 08 Apr 2014

**Coca-Cola (US$)**



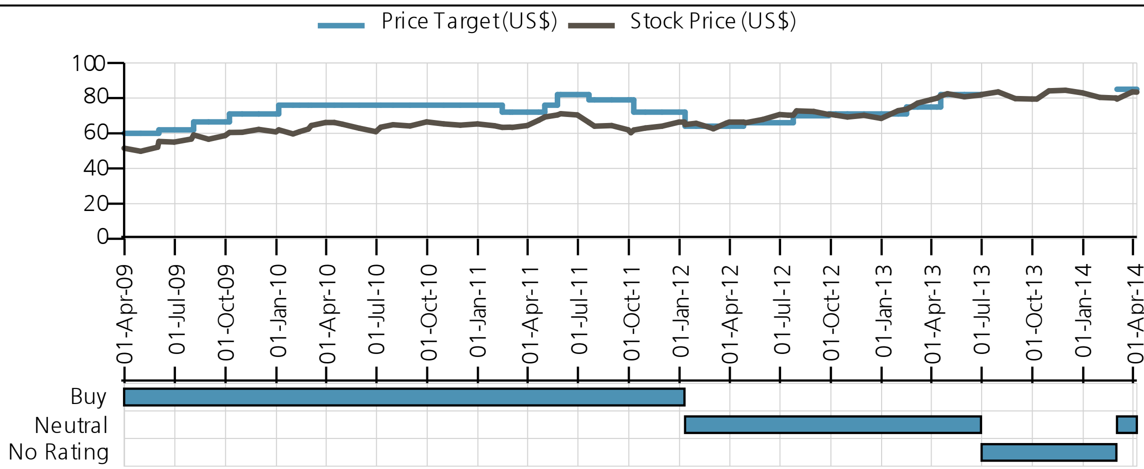

Source: UBS; as of 08 Apr 2014

**Coca-Cola Enterprises (US$)**




Source: UBS; as of 08 Apr 2014

**PepsiCo Inc (US$)**




Source: UBS; as of 08 Apr 2014

Additional Prices: Dr Pepper Snapple Group, US$51.62 (08 Apr 2014); Monster Beverage, US$65.85 (08 Apr 2014); Source: UBS. All prices as of local market close.

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