Cott

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Russ Miller: My name is Russ Miller. I work with Nick covering house and personal care, beverages, and tobacco, and we're happy to have Jay Wells, CFO of Cott, and Jarrod Langhans from IR representing Cott today. So thank you for joining us, Jay.

Jay Wells: Thank you for having us.

Russ Miller: So Cott has gone through a lot of transition over the past few years. It's really evolved. Can you walk us through pre-DS Services until today, that evolution you've gone through and the strategic rationale behind that?

Jay Wells: Sure. Looking around the room, I see a couple people I've already told this story too earlier today, so my apologies for the repetitiveness of the story but you really need to go back to 2013 and every year, we just do an update of our strategic plan. And as part of the process, Jarrod and I were working, and your look at the free cash flow we were generating for the five previous years. It was $100 million plus free cash flow. It was stable, but still the valuation of our company was low, maybe six times EBITDA at best case. And it was what are the issues, how are we going to solve the problem. And you really looked at it back then. It was really our risk concentrations were our issues.

We were in carbonated soft drinks, which was a declining category and Coke and Pepsi were in the middle of a pricing war, which made it even a more rough category to be in. We were in shelf-stable juice, which as people have moved more and more away from sugary type beverages, not declining anything like carbonated soft drinks, but was a declining category. And on top of that, being a private label company we were very heavily weighted into the big box retailer. And as center store sales continued to be under pressure, suppliers continue to be under pressure.

So those risk factors, our evaluation where it was even though we were generating good free cash flow, what could we do? So as part of the process, Jarrod and I went to the Board and was saying in a period of time when commodities are very benign, while interest rates are very low, we should take this opportunity to use our leverage, to use our balance sheet really to accelerate the pace of diversification, with a goal of diversifying of course away from carbonated soft drinks, away from shelf-stable juice, away from big box retailers with a focus on higher margin, higher growth healthier type beverages, focusing more be it direct to consumer through food services or other avenues outside of retail.

So that was what we took to the Board. And the Board, with their appropriate fiduciary responsibility, say, before we go down this path, let's do a full strategic review and analyze this. So we hired Credit Suisse at the end of 2013-14. We tried to market the company to see if we could get value for our shareholders that way and surprise, surprise, we heard we have too much concentration in CSDs, too much on shelf-stable juice and too much in the big box retailers. And there was no additional value to be had. And really confirmed that exploring other beverages where we could be the predominant player in a category was what we should do.

So through the process, we identified various different areas to focus on, but really what boiled up was focus on water, because the consumer was going to water. It was a category going greatly, but not retail water because we'd already been in that category and there was no profit to be had. So though growing, not an area we wanted to focus on. And that's where we ended up looking into the home and office delivery of water, where it's part water, produce the water products, produce the beverages but it's also delivery of a very heavy product to the consumer, which was growing about at 2% to 3% by volume, 3% to 4% by revenue, an EBITDA margin of 17% to 18%.

And you looked around, there was an opportunity in the market to become one of the dominant players in the market because DS Services was private equity owned at that time and anything owned by private equity is up for sale at one point in time or another. So DS became our top priority. The other category we looked at was coffee, again not interested in retail coffee but it was definitely a growing category by revenue, growing at about 5% when we looked at it. And that's when we identified S&D Coffee and Tea as our secondary target because S&D is a premium custom roasting and grinding for the quick serve restaurants, for the convenience stores. So again not retail focused but more coffee on the go think of it, which is a good growing category.

So those were our two top targets. S&D Coffee and Tea, its owners had died. It was held by a trustee. They were not allowed to sell for a five-year period so they were not interested in even taking our phone call a couple years ago. But DS, we had learned, was entered into an IPO process and that's how Crestview had planned to divest of their investment and we approached Crestview, convinced them to work dual track to the IPO and we were able to convince them that us fully taking them out of that investment now versus a three year time span of an IPO was the right thing for them to do.

And what attracted us to DS Services is it is DS and Nestlé are the two large HOD businesses in the U.S., about 30% market share each with the other 40% being very fragmented. So definitely a leadership position. Nestlé is very focused in the Northeast here and on the West Coast. DS really covers about 93% of the U.S. population. So very good footprint, very good partnerships with what's the appropriate thing to call them, not -- booth partner at a retail partner that was a very good source of new customers, and also Primo Water, which they supply product to and distribute.

So really set up for growth of about 3%, three plus percent organic but then they had a very long history of tuck-in acquisitions because when you look at the other 40% of the market it's very fragmented, a lot of one route, two route type mom and dad type shops. And they had a very good history of buying them at about 1.1, 1.2 times revenue. Within months or weeks synergizes down to 3.5 times because it really is buying a customer list. You leave the routes behind, you leave the depots behind, and you really are just creating greater density.

So a combination of organic growth plus the ability to continue to consolidate the market at very good post synergy multiples. I've said about 3.5 times is what it came down to, really saw that as higher-margin growth in a category where the consumer was going. So we acquired DS at the end of 2014. Worked with them on integration, synergy, capture, getting to know the business and really saw this was a category we wanted to be in.

So at the second beginning of 2016, we acquired Aqua Terra up in Canada, which has about a 50% market share in Canada and really is the leader in the HOD water business up in Canada with the same opportunity of a very fragmented market to roll up. So really completed our North America home and office delivery of water platform.

The other company very similar to DS was Eden Springs over in Europe, which is the leader in home and office bottled water delivery in Europe across 17 different European countries and in Israel with about 20% market share in total. You look at the next comparable peer has about 3% market share. So again, the leading provider of home and office water, again, about a 17% EBITDA margin, growing but at a smaller pace because it's a more mature market in Western Europe, maybe at 1% organic growth but even a more fragmented category with the ability to continue to roll up that market too.

And we completed the acquisition of Eden Springs in August of last year. So that really has allowed us to build the platform, the geographies we are, to really be the market leader in HOD water. We also provide office coffee services from this platform and filtration services also. So really gave us that platform. While we were working on the Eden Springs transaction last year, S&D reached their five-year period of holding. The trustee decided -- who was also the CEO of the business -- to put the business up for sale through a process, not that I wanted to be working on two deals at the same time but this was our top coffee opportunity.

So we did manage to get into the process and acquire S&D also in August last year. And you look at S&D, like I said, they are the leading coffee roasting provider to quick serve restaurants. That's about half of their business and if you go to any quick serve restaurants and you have a good cup of coffee that's probably our coffee. You can't tell by the label but we provide it. Or if you go to a large convenience store and have a good cup of coffee, it's our coffee. And that's really the focus of that business with convenience being about a quarter and quick serve being about half with the rest being their own OCS type routes and other small distributors.

So really has given us the platform for higher-margin growing categories, where we can continue to roll up water, coffee, tea, and filtration, again, and more direct to consumer quick serve restaurants, convenience, and continue to grow organically and through acquisitions. Now, through the process, we have increased our leverage and that's one thing we always talk to people about. At this point, we're probably at -- is it 4.6, 4.7 times EBITDA leverage. And we were comfortable with leveraging up this much in a short period of time because we locked in long-term fixed notes with a low interest. So have maintained above a three times interest cover. So was comfortable with taking our balance sheet up for a short period of time to that level.

Now that we've completed those transactions there is still other things we would like to do, but our focus really is now getting our balance sheet where it should be before we do any more large acquisitions in this. So last year, we generated $150 million in free cash flow. Our guidance is that it will grow to $155 million to $175 million this year and by 20129 grow to $225 million to $275 million with the purpose of that cash is one, to pay our dividend. We spend about $33 million, $34 million a year on dividends. We said we're going to do these small tuck-in acquisitions in the U.S., about $10 million to $20 million a year. About 10 million euros of tuck-insurance over with Eden Springs but then the rest really focusing on deleveraging the company, with a goal to get to the low three times by 2019.

And once we get to the low three times, we'll then look to see if there's other strategic acquisitions out there, but more staying within the three times leverage versus being in the high four times as we are today.

Russ Miller: That was excellent. Total transformation and with that free cash flow guidance, you're compounding free cash flow in the high teens at that level, right? So that's definitely a unique opportunity across (inaudible) for sure.

Jay Wells: And you look at that, it's multiple different small things that are getting us to grow that. One, we haven't talked much about our traditional business, but our goal for our traditional business is really to extract cash out of that business. It's really the cash flow from that business that's strategic, not the business itself anymore because it's really the water, coffee, tea, and filtration solutions is what our focus is. So we're going to run that business stable, stable volume, stable cash. If we have any opportunity to monetize part of it for the right value for the free cash flow, we will to accelerate the leveraging. But really just run that for stability.

On top of that, our water and coffee solutions category should grow topline organically 2%, 3% and you can probably double that as you move down the P&L to the bottom line. And you have synergy capture of $23 million between Eden and S&D that will help us get there. You have the tuck-in acquisitions that I've talked about and coming into this year, we were carrying some high-interest debt that we are taking the opportunity to call and refinance this year, which after we get through all the refinancing this year will provide us about $25 million of interest savings next year. So it's very cost focused synergies that we are concerned on that we should be able to get without a problem. It's interest savings and then it's reasonable growth within our water and coffee solutions category to give us the growth we're looking to deliver on that.

Russ Miller: That's excellent. When you mentioned Eden and S&D, it's been almost a year now. What has exceeded your expectations? What's been disappointing? Have there been any integration hiccups? Have the businesses done nominally well, kind of closing in such a tight timeframe there?

Jay Wells: Let me take S&D first, which overall S&D was the only company I ever did due diligence on that as I diligence, their EBIT had actually went up during the diligence versus down. I've never seen that and that just goes to the quality of leadership. They tell you they're going to do something, they promise to do it and they deliver on it. So the leadership has greatly exceeded my hopes and expectations.

Two, as part of the process, they had a list of targets within their IM that they were going to do, and normally you look at that sheet when you're looking at buying a company and maybe they're getting 10% of it. They've actually delivered on every single target that they said they were pursuing and we saw it in our growth in volume in Q1 where our coffee volume was up 9% in the quarter. We modeled the company at 3%, maybe 4% growth but it just shows they're able to deliver on organic growth over and over again, and you can see it historically. And then you go out and you visit their plants and their plants are set for growth. They have the ability to add another three roasters easily and with every roaster, you pick up another 20 million, 25 million tons of -- pounds, sorry, not tons -- 20 million, 25 million pounds of coffee roasting.

So definitely management top quality, have over performed. Their financial performance has met our bet expectations and their new customer wins have really exceeded expectations. On Eden, a little bit of a different c. When we evaluated them, we liked the company but we saw different types of opportunity. Again, only 1% topline growth because of the markets they're in but we saw a lot of SG&A type savings because they had a corporate headquarters in -- right outside of Geneva. Not a cheap place to have a corporate headquarters. They had regional headquarters over about six different regions across Europe and they had local country headquarters. All good people but many more layers that was cost-effective nor operationally effective.

So we have just finished our restructuring. We have moved the headquarters from outside of Geneva to Barcelona. We have restructured the headcount and very excited with the savings we've generated. We should be saving just for that step five, $5 million a year in SG&A costs. But we've also taken a lot of noise, a lot of hierarchy out of the leadership and they're really set up to succeed where they are delving down and really looking at market segmentation different than they have, because Tom Herrington, who is over our DS Waters Division is actually over that also, and he's bring some best practices from DS over and really seeing that our marketing spend is going to be better focused and really think a 1% growth is easily attainable. Leadership is doing very well.

The one disappointment that I didn't fully factor in is implementing Sarbanes-Oxley in a privately held European country across 18 different countries. That is an effort. So if anybody asks what my biggest worry is about Eden, it's not the performance of the company but we do have quite a task this year on implementing Sarbanes-Oxley in such a fragmented company that's never been a public company before. So key focus for this year. A lot of work for this year, but overall the operations very happy with.

Russ Miller: That's good. So for DS Services specifically, last year you had phenomenal customer growth. I think you mentioned 60,000 or so net new customers compared to 7,000 net new customers the year prior. So that was excellent but then it weighed on your EBITDA, right. So can you talk about that headwind back half of last year early into this year and what you're doing to improve that for now and the back half of 2017 and beyond.

Jay Wells: So you look at DS when we're looking to buy them and we modeled out 1% customer growth a year because what you've got to understand at DS, it really is the route driver, the person driving the truck who has got to install the coolers, got to train the customer, got to build the relationship with the customer, and then deliver the product every other week. And that really is tight part of the funnel that really restricts the amount of growth. So when we looked at buying it, we modeled at 1% growth, which was 15,000 new customers. Last year, we had net 55,000 new customer adds and it doesn't sound like a lot, but what happened is we do have a retail booth program if you go to one of the large warehouse stores where we have a booth, about 80 a week during the summer months where we market to their $41 million customers to buy our water services.

And last year, we changed the arrangement that they were working more under a bundled program than on a discount program. We moved it to a discount, a lot easier sale to the consumer. And then at the same time, there was articles like Flint, Michigan, water supply issues, lead in the water. We saw extreme growth out of this one channel of customers. Now, when you run a retail booth program, unlike a national marketing program, you get customer adds within the geography around the store that you're running the program. So we weren't adding 4,000 customers a week across our entire geography. We were adding 4,000 customers a week across a handful to ten distribution centers.

And the overtime required, the ad hoc routes, we created 40 more ad hoc routes last year than trucks we bought. I don't know what mothball fleet we were pulling out, but it was ad hoc routes, overtime to meet, and just very inefficient program to service these customers, which really had our cost creep up greatly last year. And we saw EBITDA erosion actually because of the very ineffective routes we set up.

On top of that, the customer mix of going through this program was how we had gone from the budget program to a more discount program and factor in the cost to serve. To be honest, I'd say we probably missed the mark a little bit, not by a lot. Maybe $0.50 a bottle of how we needed to change the program, which drove down our mix and profitability a little bit. We have adjusted that. We've gotten the price where it needs to be to get the right margin. So it was a combination of ineffective routes and actually moving from one form of charging the customer to another. We missed the mark by not even 10% of the price but that caused a mix of less profitable customers until we fixed it.

So going into this year, we're doing a couple things. One, we've already starting to build routes in these distribution centers ahead of the marketing efforts to avoid the inefficient cost, the overtime associated with it. We've done the pricing also that I've talked about that will make those customers just as profitable as any other. And third, one thing that happened last year, our most profitable customers are the small commercial customers. So if you go down a strip mall and you go to your hairdresser, they offer you a coffee or a glass of water and you sit down. Those are our most profitable, longest-term customers. With all the customers we were getting, we couldn't add any more customers. So we cut all the marketing programs for those individuals totally last year and had very few adds. If anything, we probably had some net declines in that customer base.

And so what we're going to do is we're really going through the pricing in other areas to control the number of retail residential customers we get through this partner program and really build back our salesforce to have the right balance of mix. So with pricing, building routes beforehand, having the right of mixed customer adds, our intent is to claw back $20 million of EBITDA this year that we created issues with last year.

Russ Miller: So less customer growth but more EBITDA growth at the same time?

Jay Wells: Yes, so versus the 55,000 last year, the goal is like I said, 15,000 to 25,000 this year, but where we had some EBITDA erosion last year for the reasons I talked, to look to grow EBITDA $20 million in that business this year.

Russ Miller: Got it. So we just listened to our internet analyst, Mark Mahaney, talk about the rise of Amazon at lunch. Ecommerce has been a key theme this whole conference and the past few earnings seasons it just seems a bigger and bigger theme. So is ecommerce and opportunity for you guys? Is it a threat?

Jay Wells: I knew you were going to ask me that question. I knew he was speaking at lunch and I had one-on-one so I couldn't attend. So I'm not quite sure but we actually get the question about Amazon a lot. Is it a risk to us? Is it a benefit to us? What you've got to keep in mind, our business is delivering 42 pound, five-gallon jugs of water to homes and offices and picking up their empties and bringing it back. So when it comes to risk, we really don't see it a risk because one, this isn't something you can send in a post. This isn't something that's easily fulfilled. You need to drop off very heavy products and pick up the empties to have refilled. So it's actually a two-way delivery.

So we really don't see a risk that they are going to go into this type of business and become a competitor. If anything, there are some products right now on case pack water if you buy from Amazon, we will actually deliver the product for the end supplier. So if you buy a higher end type water, be it Fiji, be it Voss, we have Fiji and Voss on our trucks. And if you order it online, we are the fulfiller of that. So if anything, when it comes to the more heavier water type products, we are a very fulfilment opportunity for those if there's the right margin to be had to cover the cost of delivery and so on and so forth. So no risk. If anything, maybe a little bit of an opportunity.

Russ Miller: And is Fiji a new account? I'm not sure if I've heard you mention them.

Jay Wells: Just look online. You can find it. We've had that for a while.

Russ Miller: And you've had Voss?

Jay Wells: And my wife tells me it's the fountain of youth. We get two cases every other week delivered to my house. So yes, you can see online all the products we deliver where Voss and Fiji are two of our partners that we do deliver for, customers who want more premium type product.

Russ Miller: That's excellent. Do leverage and refinancing, so you were active earlier this year with a debt swap that you completed. Can you provide some of the details around that and what's coming in September, your plans?

Jay Wells: Sure, so we had one tranche of debt, $625 million at 6.75% that was callable earlier this year. We did use the opportunity of the low interest-rate environment to go out and raise $650 million at 5.5% to refinance that. The demand was high enough that we actually upsized it from $650 million to $750 million because we have another tranche of debt callable in September of this year.

As part of DS deal, they were carrying 10% secured notes that if we had called them, the May call would have been over $100 million and we just were not able to finance that type of May call. So with the extra $100 million that we raised as part of the issuance we just did, we did call early $100 million and did do that refinancing. So we've taken $625 million of debt at 6.75% and refinanced it at 5.5%, eight-year senior notes. We took another $100 million of the DS notes at 10% and refinanced that at the 5.5%.

So that leaves another $250 million of 10% senior notes, secured senior notes that we do plan to call September 1 of this year, with the intent is to probably refinance it with some cash, maybe some ABL, but we probably have to use a little bit of a term debt. And the reason why I say term debt is when you look at our ABL, we have about $200 million drawn on that and we have $250 million of term debt. That would give us $450 million of debt to pay down through our free cash flow to allow us to get our leverage level to where we need it.

After we get through that debt, we do have our $525 million of 5.375 debt that is callable right now if we want to. Don't really want to call debt at that price right now, but if we get through all the rest and looking for more debt to pay down that is callable at this point in time.

And with that, like you said earlier, we should generate $25 million of interest savings back half of this year going into next year and then really as part of our 2019 guidance, really about $30 million of interest savings with refinancing and reduction of interest through just repaying debt.

Russ Miller: Got it. So you were clear that deleverage is the focus for you guys now and you talked before about the evolution of Cott over the past few years to today, but looking forward, what does M&A look like over the next three, five years and beyond?

Jay Wells: And outside of the small tuck-in acquisitions.

Russ Miller: Right, which occur every year.

Jay Wells: Yes, you look at our focus. Our focus is direct to consumer water, that's what I'll call HOD, coffee, both direct to consumer, food service, convenience, tea, same, and filtration, which is very underrepresented. You look at HOD, we have built pretty much the platform that we want and large-scale. We've talked about one opportunity but I would not call that near an opportunity. But you still look at coffee, tea, and filtration. We're very much still unrepresented in the categories and the geographies we are. And there are several targeted opportunities that would be overlapping very synergistic that we do have on our target list. And at the appropriate point in time when we have our balance sheet where it should be, we will look to do additional because we're not fully done the transition we wanted to do.

So through free cash flow let's deleverage as soon as we get down to the right level that we can do these acquisitions and not get to 4 or above type leverage is really our target. That's something we were good to get to but we really feel that as we deleverage and we get into the 3s, our valuation is depressed a little bit because of our leverage. And we really feel we can get a valuation lift by deleveraging. And that's why that's a key focus.

But it doesn't mean we're not done with what we're doing on the larger scale MA. It is just more important to get that lift on our deleveraging, get down to a more sustainable leverage and we don't really see any of those opportunities coming to market over the next year or two. So believe we have the time to do. At the same time, I referred to it earlier, if we do find an opportunity to get fair value for the free cash flow of our traditional business, we will do so to do our deleveraging even quicker. But it is not a market multiple on EBITDA. It is a fair value of that free cash flow that that business generates because it does generate very good free cash flow.

Russ Miller: Got it. We have about a minute. Are there any questions from the audience?

Unidentified Audience Member: Given the focus on deleveraging, how much capacity do you have to do tuck-insurance both financially and then also operationally, so balls in the air?

Jay Wells: I think that for people listening, it was what is our availability to do tuck-insurance based on scale and leverage, and we really feel and you look at the history of the average amount of tuck-insurance that were able to be accomplished a year in both businesses, because both DS and Eden Springs has a very long history of tuck-insurance. And we really feel that $10 million to $20 million in the U.S. and 10 million Euro in Europe is the right amount of just the pipeline that becomes available.

So for me, U.S. synergizes down to 3.5 times. Doing those are deleveraging. I'll do as much of those as I can without worrying about the balance sheet they're small. But it's much more -- you can only do -- as everybody knows, a $100,000 acquisition or a $10 million acquisition, it requires almost the same amount of work. So it's more the size of the pipeline, what it takes.

We'll continue to do them and then two, we have to be careful about doing too many overlapping in the same region because the customer disruption becomes too great. So that’s the only other governor but it really is looking at the pipeline an on average, what I've seen over the last five years in both company, I think that, the essence we have, so I wouldn't say it's a balance sheet governor. It's more of a pipeline and if we do seven or eight one year and they're at the higher end of the scale, we might exceed that range. And if they're smaller size, they'd be at the lower end of the range. And that's what -- it's not the number of deals. It's more the size of the deals that really will govern how much we do each year.

Russ Miller: That's perfect. We're just about right on time. Thank you very much, Jay.

Jay Wells: Thank you very much.