Cott Corporation

May 09, 2017
04:10 PM EDT

Judy Hong: I'll get started here. We've got two more. I know it's been a long day, but just stick with us for another hour or so. I'm really thrilled to welcome Jerry Fowden from Cott Corporation, as well as Jarrod Langhans from Investor Relations. And I think it's really the first time we've had Cott here, so we're excited to have both gentlemen here today.

Cott has made a tremendous transformation over the last few years, really, from a business-concentrated and private-label soft drink manufacturing to a diversified beverage services provider across water, coffee, tea, and filtration. In addition and maybe at the same time, Cott's focus on its 4 C's is really enabling healthy free cash flow generation and more flexible balance sheet to really enhance shareholder value.

With that, I'll turn it over to Jerry for prepared comments, and then we'll do a quick fireside chat. So, Jerry?

Jerry Fowden: Thank you, Judy, and, of course, good afternoon, everyone. It's very nice of Goldman's to provide us this opportunity to be here today. As Judy mentioned -- first time.

So before we begin, I'd just like to ask people to take a quick glance at our Safe Harbor statement on the screen, something I'm sure you're all very familiar with. So with that, on to our presentation.

I'll kick things off today by providing a short overview of Cott, and then I'll move on to our vision, key business drivers and the investment highlights. And after that I can join Judy for the Fireside Chat.

So as Judy mentioned, Cott's a highly diversified company, and that's with regards about product and channel spreads that today means we are no longer overly dependent on any one product, channel or customer as shown in the pie charts.

This slide also explains the two business segments we operated. One, being the water and coffee solutions segment, which really provides direct-to-customer bottled water, coffee, tea, and filtration services. The customers across 20 countries where we are market leader in all but one of those. We have a number 1 or 2 position and, I think, in one of those 20 markets, we are number 3. Driving revenues of some $2 billion with 2.3 million customers with a growth outlook of around 2% to 3% per annum on the top line.

This segment includes businesses such as DS Services here in the US, Aquaterra in Canada, Eden Springs, the market leader across Europe as well as S&D coffee and tea, where we saw particularly good growth in this first quarter of 9% at S&D and overall topline growth of 4% for the quarter across this overall segment -- a little bit ahead of our longer-term guidance.

The other segment is our traditional business that produces sparkling and value-added and flavored waters, carbonated soft drinks, shelf stable juices, as well as many other products such as energy drinks, iced teas, et cetera. This business has revenues of around $1.7 billion, very high asset utilization, strong free cash flow, but produces its products for around 500 of the world's largest retailers and brand owners as opposed to the much more fragmented 2.3 million customers of our water and coffee solutions business.

So our accelerated organic growth and transactional diversification strategy have supported our strong financial performance over the past few years, a position caught well with regards our goal of driving a mid-teen compound annual growth and free cash flow as we look out over the next three years.

As you can see here, our revenues, free cash flow, and EBITDA have all risen substantially as we've executed against this strategy, and this performance has also been positively reflected in our market cap and shareholder returns over that period of time. With our first quarter sharing 28% revenue growth and a 15% improvement in adjusted free cash flow.

On slide 5, I've laid out Cott's vision, which is to become the leading North American and European water, coffee, tea, and filtration provider within the home and office delivery sector, food service, convenience, and hospitality. Since announcing our original strategy, we've refined our vision and the drivers of the vision as shown on this slide. And our current priorities are designed to strengthen the business and to continue to progressively move the business to one that demonstrates higher margins and higher free cash flow alongside much lower customer concentration and, hence, all around be a more attractive and lower-risk company.

The drivers of this vision can easily be summarized as to drive sustainable topline organic growth from our water and coffee solution segment of around 2% to 3%; to continue to undertake very small, highly value accretive overlapping tuck-in acquisitions in the home and office water category, office coffee services and filtration services in the markets we're already in. Three, to take advantage of synergy capture across this platform of new businesses that we've built up. Four, to maintain our high free cash flow generation from our traditional business -- no growth, but stable free cash flow is the message there. And, five, to strengthen our balance sheet as we look out over the next three years or so through strong compound growth and free cash flow, significant interest cost reductions from the refinancing of some expensive coupon debt that rolls off driving rapid deleveraging.

With a free cash flow yield at the end of 2016 of 9% and the ability for further free cash flow growth, we believe current and new investors will benefit from our free cash flow as it rises and the valuation should follow that free cash flow in the deleveraging.

So this leads me to the five investment highlights that support our view as we look forward. By far and away, the most attractive of which being the cash flow that Judy and I have mentioned. But let's look at each of these five highlights in turn.

On slide 7 you can see how we've strengthened and diversified the business over the last few years, such that we're much less dependent on any single customer, product, channel, or geography. You can see in the pie charts that we operate in the growing categories such as HOD water, sparkling of value-added waters, out-of-home coffee and tea, as well as within the more mature categories of carbonated soft drinks, which today are down to just some 11% of our overall EBITDA mix. And private label today represents just some 27% of our EBITDA mix.

Alongside this, you can see growing segments that we broadly call "Better For You," now account for over two-thirds of our EBITDA mix. So, in total, you have a business that's more diverse, lower risk, and higher margin. And while we still recognize that we have a lot to do to complete this transition, we think we're well positioned to that over the coming years.

Slide 8 highlights the growth characteristics of the various Better For You beverages that we're present within. And, as you can see, the US Home Office water category is around 3% growth, water filtration around 9%, out-of-home coffee consumption, so buying that coffee on the move from a convenience store or gas station or quick-service restaurant, around 6% growth. And then tea across the hospitality sector in the 3% to 4% growth range. And attractive set of market backdrops for our new business.

Slide 9 highlights the leading international platform that were built in water and coffee solutions where you can see our operations in 20 countries, and the numbers represent our market position, whether it be number 1 or number 2. And, what's more, these are still very, very fragmented marketplaces. Once you go past the top one or two players, and you can see that in the pie charts, which means that there is significant opportunity to do small, overlapping, tuck-in acquisitions of independent operators after just 2, 4, 6, 8, 10 routes from a family business, but quickly synergized down within a matter of months to 3 to 4 times hosting the synergy EBITDA range.

In effect, you are just buying or adding customers that, to a large degree, can be consolidated into existing depots and the existing routes, thus providing immediate improvements to route density and depot synergies. You can see in the pie charts, 39% of the US HOD business is still in the hands of independents, but it's over 60% in Europe. So the opportunity for these small tuck-ins is almost endless.

Slide 10 shows the many financial and strategic reasons for us setting out on this plan to build our water and coffee solutions platform alongside the clear synergy benefits that now we have a collection of these businesses, we can gain from them working together. You see savings from a combination of common systems, procurement savings associated with our scale in terms of cooler rack purchases, coffee brewer purchases, bottle and other purchases as well as back office SG&A savings and, eventually, on the Eastern Seaboard of the US, depot and route combinations and consolidations between DS Services and S&D Coffee and Tea depots.

The cost synergies from Eden and S&D are expected to be around $23 million over the next four years with some $4 million in the plan for this year.

Now turning to slide 11, the most important point, the free cash flow and cash generation. Over the last eight years our business has generated around $100 million of free cash flow a year. Last year it was some $150 million of adjusted free cash flow. And as we look to this year, we think it will be in the range of $155 million to $175 million. And then looking out to 2019, we see it being over $225 million. This free cash flow goal is not driven by any one dependent factor or operationally outperforming everyone else that's in the market. It comes from a nice blend of half a dozen different elements meaning that if there was any bump in the road, or slip-and-trip on one of these, the vast majority of this free cash flow improvement would stay intact.

And the six elements are to continue our free cash flow at a stable level and good cash extraction from our traditional business -- not growing, but stable cash extraction. Drive the top line of water and coffee solutions organically 2% to 3%, it trickles down the P&L to improve cash flow. We'll have a full contribution from S&D and Eden in 2017. We strive to around $65 million higher

EBITDA and higher additional free cash flow, 2017 versus the past year, 2016. Capturing $23 million of synergies over four years; executing on these small highly value-created tuck-ins that are actually deleveraging in their own right at 3x to 4x post-synergy multiple. And, finally, as mentioned earlier, the ability to refinance some high-coupon debt in 2017, in particular, the first element of which we just completed in March where we refinanced our 6.75 debt at 5.5% with 80 in maturity.

And with strong demand, we took an additional $100 million and immediately redeemed $100 million of our secure 10% DS Services debt where the balance becomes callable in September this year. And we would intend to remove that additional $250 million in September from a combination of our ABL cash-on-hand and maybe some element of a term loan, and that should give us some nice prepayable debt to continue to pay down from our free cash flows over the next couple of years and leave all the rest of our debt in good, long-term low coupon fixed. So by the time we'd done that, and we're in quarter 4 of this year, you're looking at around a $25 million per year cash interest saving on a full-year basis from the end of this year.

So this strong free cash flow generation should allow us to rapidly delever to the low 3x range as we exit 2019 and move into 2020. This rapid deleveraging is something we've done in the past, and we're very clearly committed to doing it again.

So to finish the presentation and this topic of free cash flow, it's worth highlighting our free cash flow yield, and this is some information prepared by a large financial institution at the end of 2016, where you can see it shows a 9.5% free cash flow yield for ourselves and compares it to appropriate peers such as high cash flow consumer companies, beverage bottlers, and other route-based service segments.

So when you look at this free cash flow yield coupled with that mid-teen compound growth, its free cash flow over the next three years and being over $225 million by 2019, I think it lays out an attractive kind of profile of what we intend to do over the next few years.

So, on that point, I'll, kind of, sit down and join Judy for any questions from her and anyone else.

Judy Hong: Great, thank you, Jerry, and feel free to e-mail questions to events@GS.com with #Staples, or, obviously, you can raise your hand for questions as well.

Let me start with a bit of a big-picture question, Jerry, and, certainly, you've made a pretty big transformation in your portfolio, a DS acquisition, and you also made a number of acquisitions in 2016 -- Aquaterra, Eden Springs, and S&D Coffee. So what do you think your competitive advantage is and really playing in that area, right? Because some of us are not as familiar with that part of the business. So what is cost competitive advantage and playing in that area beyond, sort of, just extracting some of the cost savings?

And as you think about taking that platform, what is, sort of, the longer-term vision of that platform for Cott?

Jerry Fowden: Big question, Judy.

Judy Hong: Yes.

Jerry Fowden: I think one of our pluses is the culture that we follow as a company, and I know that might sound a little bit broad-brushed, but I genuinely do believe it. We have been following, ever since the business was in a very tough spot in 2007, 2008, Judy knows that time -- what we call our 4 C's. The first one is customers, that everyone talks about, so I understand that. The other three are cost, CapEx, and cash flow. That's to be very low cost, and when people looked at traditional Cott versus 20 or 30 peers, we were the lowest of all of them in SG&A as a share of revenue. That's something we believe in, and everyone thinks he has a high life these days, I travel economy worldwide, whether that's to Tel Aviv, Europe, within the US. Occasionally, my team might be up front, but our policies drive a frugal way of looking at things.

Our CapEx is very tightly and rigorously managed, meaningfully lower than our depreciation, and we focus very much on free cash flow, believing that money in the bank doesn't lie. And as we become a bigger business and a more diversified business, yes, we need to adjust some of that philosophy, but, still, a strong believer of those four C's at the back of everything.

Now, then when you come onto the more specifics, and you think of a business like DS Services and what's some of our competitive advantage, well, in the route-based services business, customer acquisition and route density are a couple of the key keys to the business. Customer acquisition because of the success of driving the business in the top line, and route density because of the profit improvement and margins and the ability that gives you to be successful.

And with our 2,100 route network in the US that covers 93% of the US population, that national platform makes us a very good partner for other businesses that none of the other operators have a national platform. So even the other large operator you saw in the pie chart, really only covers half, or just over half, of the country. So we have an exclusive long-term, multi-year retail booth program with a large club store, whereby we have the exclusive rights to mine their customer base while people interested in home and office water services, and that probably drives some quarter to one-third of all our new customer sign-ups. And that's something that our scale and network brings to the equation.

That same scale and network covers 95% of the manufacturing and delivery of five-gallon bottles and the collection of the empties for Primo water. That's another company whose name you might know, if you ever see those five-gallon water jugs in a Lowe's or a Home Depot, it would be Primo and, yes, they have to acquire the customers, do the billing, the receivables, run that business. But we're really providing 95% of the supply chain manufacturing delivery and collection.

So the national footprint and the scale provides real advantages in customer acquisition, and then route density being one of the two leading players with net organic customer additions each year. This year our target is 15,000 to 25,000 net incremental new customers. Each of those, plus the small tuck-in acquisitions on top, add to your route density, and that route density drives margin improvement and really is an enormous barrier to entry. No one else is really going to enter this market in any scale because you just can't have routes that the whole guy drives around 10 blocks all day long. That's his whole patch. And those 10 blocks, it might be one block on a Monday, another block on a Tuesday, that kind of density.

Our average route truck does no more than 20,000 miles in a year and more than half of that mileage is depot to first stop, last stop back to the depot. So that gives you an example of the route density that supports the economics.

Judy Hong: So some of the more recent acquisitions, like the Eden Springs or DM, S&D Coffee. It sounds like S&D may be going a little bit better. Maybe Eden is kind of on track. So can you talk a little bit about how those integrations have been going and versus your expectations how those are tracking, so far?

Jerry Fowden: Yes. I mean, Eden Springs, just to help people because it's further away from here, is really the DS Services of Europe. It has a 20% market share not a 30% market share. It's in multiple countries instead of multiple states. But the only real differences to that business are it's 100% commercial business, it's not in a blend of homes as well as offices, and that's culturally what's always been the way within Europe. We might pilot a few home tests with our booth partner in some countries, but it's a commercial business, which drives a longer average life because a commercial customer's life is longer than a residential customer life.

But given it's just like DS Services, really, the cooler purchase program, the routing systems and software, the IT backup and support, the styles of marketing programs are all very much the same. One additional difference is the European HOD water market, it is about a flat to +1% growth market versus the 3% we showed earlier for the US HOD water market. But it's still 61% fragmented, so the opportunity for this endless small tuck-ins is even greater than here in the US. So that 1% growth plus a long runway for small tuck-ins still built a very attractive outlook in terms of our economic model, and I'd say, kind of, eight, nine months in, the euro exchange rate might be causing us $1 million to $2 million worth of challenge, but the synergies are probably running $1 million to $2 million better than we would have built into our acquisition model.

So net-net everything is on plan, and I think -- you can tell I come from the UK -- I think I've seen 1.18 to 2.08 of the sterling exchange rate since I've been here in 2009. So we might be a couple of million down on the exchange rate at the moment, we might be a couple of million up in another year or two's time. I don't think that undermines the strategy.

And in terms of S&D Coffee and Tea, if Jay, our CFO, was here, he'd say it's probably the only acquisition he's every done where during the due diligence, the EBITDA was where we reviewed, the adjustments went up, which is a very nice feeling to get. You all know, you normally find a few things you don't like to find, and then you argue over the overall price for a while. A good business, well-run business, the CEO's been there 38 years. A highly respected company in its space, which is the custom roasting and grinding of coffee as well as iced teas and specialty coffee extracts and ingredients. And I think we all know that Starbuck's have their own roasting and grinding but if ever any of you buy a coffee on the move from anywhere else, it's probably our coffee.

So it's a scale business that supports the vast majority of the restaurant, convenience, gas, and coffee on the move market here in the US. This year we're rolling out cold brew coffee that's advertised by many of our customers. We just signed up another national QSR chain we didn't have before, because they want to sell more coffee, and they believe S&D is the right partner to improve their offering and help them do that. And one of our convenience chains just bought another gas station chain, and they'll remove the coffee from that other one and take S&D across the portfolio.

So that was behind a 9% volume improvement for Q1. So the EBITDA went up in diligence, and the business is outperforming our expectations. So one on track, one a bit ahead of the game.

Judy Hong: And how is the fragmentation in that part of the coffee solution business?

Jerry Fowden: And it depends on how you want to define the market, as always. But I would say there's probably three largest players in that space, which is the focused food service hospitality QSR supplier, custom roasting of coffee. One of them is Canadian parentaged to it here in the US. Each has slightly different geographic footprints, have slightly different focus within their portfolio, and I would say if you look back over any period of time, last five, last 10, or last 15 years, S&D has probably made progressive and gradual headway in its market share versus the others. So they seem to have a good track record there.

Judy Hong: Now, I think the last year, a lot of the focus was on the DS side of the business. You had too many new customers that, I think, put some strain in your cost structure. So it seems like Q1, the revenue growth improved, but the margins, I think (background noise) some opportunity to the upside. So can you just talk about where you are in terms of some of the fixes that you've put into place and how you feel about the rest of the year on that side?

Jerry Fowden: Yes, and very similar to your question, someone in one of the one-on-ones earlier on, because Judy's kept us kind of back-to-back busy all day said, "Surely, with all these acquisitions, not everything has gone to plan," and I kind of said, "Yes, you're dead right." And it never does, and we might all wish it to, but it doesn't. And I'd say ever since I joined the business in 2009 with a stock price of $0.88, it's been kind of eight or nine years hard slog of two steps forward and one backwards.

But I say is if it stays in that ratio, you're still going forward. And probably of the two large challenges for the last 12 or 18 months, one was macro. We have second-largest business units in the UK, and the country decided to become 20% less wealthy in global terms overnight, and devalued its currency. It caused a few headwinds, cost of goods up, translation of earnings down back into dollars, so we're fighting our way through that one.

And then the other one was probably more self-inflicted as we look back on the benefit of hindsight. We changed some of our marketing programs from a bundled program to a pay-as-you-go program. That was much easier for customers to understand and sign up to. It was around the time that every TV news was saying "Don't trust drinking municipal water." Flint, Michigan, lead in New York's (inaudible) water, et cetera. So our new customer sign-ups zoomed up. We cut some of our other marketing programs to try and slow that down, but to help you put it in context, we had 7,000 net new customer additions in 2015, and we had 55,000, I think it was, Jarrod, net new customer additions in 2016.

Up front marketing costs increased route drivers, because we had service level agreements with signing up these new customers were being polled left, right, and center, to make sure these customers were installed within the set number of days. As we said, route density and route efficiency is the backbone of the financial performance in the business. And pulling all your drivers left, right, and center with nearly an eightfold growth in customer additions did not produce efficient routing, and we suffered overtime costs and friction costs.

Some people called it a quality problem to have, but the last word we're having it was still a problem. So we have set out this year to target 15,000 to 25,000 new customers, still growth, still would grow our market share, but much more modest growth. We have slightly adjusted by certain channels our pricing to allow us to moderate some of that growth. A simple Keynesian price up, demand down a bit, and since we want demand down a bit to avoid the friction cost, that should help in the process.

So lower customer sign-ups, lower up-front marketing cost, higher pricing, avoiding the friction and distraction of route inefficiency. We believe we'll have our DS business, some $20 million-plus growth in EBITDA this year. That should put us nicely back in, kind of, mid-17, you know, 17.5% halfway from 17% to 18% EBITDA margins and still have us with a higher customer base, improved route density, better business than before. But we need to avoid the slips and trips of last year, and I think you mentioned Q1. Q1 shows, so far, we're on track with that. Top-line revenue was up 2% reported, close to 4% on a per-day basis. EBITDA was up 3-and-a-bit million, 13,000 new customer sign-ups. Had good operational efficiency, so we see that progressively improving as we go through the year.

Judy Hong: I think we're running a little bit late here, but I'll ask a couple of quick ones. The UK, obviously, affects as a bit of a (ph) challenge. Pricing has also been a bit tough there. So what are you seeing in terms of the pricing environment? I think CCE actually talked about the promoted pricing at retail getting a little bit better, so are you kind of seeing the similar trends?

Jerry Fowden: Yes. We're predominantly private label, which is the everyday low price models, all the promotional ups and downs we don't see as much. Most of our pricing was a requirement because sugar is bought in euros, so, in effect, the price of sugar went up for us, because we're selling in pounds. Aluminum is bought in dollars, so our price of cans went up. Resin is predominantly a dollar-based commodity, cost of resin for the P.E.T. bottles went up.

Never easy taking pricing with big-box retailers. We serve them all, Tesco, Sainsbury's, Morrison, Dasdo (ph) in the UK. So we have finished our discussions with our business partners, or another way, we've had our three months of haggling, and we have now agreed pricing to be implemented by the end of this Q2. But we'll largely address that embedded commodity cost increase from foreign exchange in Q3. We could be still a few hundred thousand dollars lack in Q3, and maybe on the target or a little bit ahead for Q4, which sets us up well for lapping this depressed first and second quarter this year.

So we've done that. We think our prices are fine. There's two other things in this area. The UK will introduce a sugar levy in April next year. One benefit of our large traditional business is we have one of the world's best R&D and concentrate centers. We have managed to reformulate the vast majority of all our UK private label products to just skim under the 5 grams of sugar per 100 ml, which is where the lower levy is triggered. We've added some sweetness enhancers, some sweetness modulators, adjusted the concentrates, so these products have come through with good blind taste test scores versus the current product.

So we'll start shipping these adjusted products by the end of the year, so we'll have a soft change, use up all our inventories, and we'll not be incurring the 18 pence-per-liter levy in April next year on the vast majority of all the private label we're producing and, obviously, anything we contract manufacture for our brand owner is up to them to cover that levy.

So we may actually see versus the international brands that aren't going to change their recipes. Last time, a big, famous red cola changed its recipe. It didn't go too well, so we presume they're not going to change their recipes. So they will have to go up in the sugar-sweetened products by 36 p. on a 2-liter product, and we won't. So there may actually be some widening of the price gap at the retail level as we go past the levy of the UK.

Judy Hong: All right, I think we're not going to be able to get to all the questions, but thank you both and thank you for the presentation here today.

Jerry Fowden: Thank you, Judy, and thank, everyone, for your time. Thank you very much.

Judy Hong: Let's all stay here for Sam Adams for Boston Beer presentation. The last one, thank you.