MFIF

Keurig Dr. Pepper (NYSE: KDP)

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We are overweight Keurig Dr. Pepper's 4.597% 2028 notes. After Keurig Green Mountain's successful acquisition of Dr. Pepper Snapple in July 2018, KDP has become a prominent diversified manufacturer in the beverage industry. The combined company issued $8B in unsecured notes to finance a portion of the acquisition, increasing leverage over three turns to ~5.5x pro forma. We believe the 28s are the most attractive portion of the issuance, trading at a spread of 162 bps, and will tighten from rapid deleveraging, Coffee Systems segment growth, and synergies realized from the combined companies. Management has indicated it intends to reduce net leverage two turns to under 3.0x (relative to ~4.9x LTM) within 2-3 years and is committed to retaining its investment grade rating. We believe that KDP's focus on paying down debt coupled with $600 million in targeted synergies through 2021 will allow the company to improve its credit profile. Overall, we believe this is a bond to own during the deleveraging and integration phase (2-3 year horizon). <u>The combined company has a proven management team that has navigated through merger integrations and deleveraging phases in the past.</u> As KDP reduces debt, integrates the two businesses, and withstands market fears over private label coffee pod growth, we believe the 28's will trade tighter in the sub-140 bps levels.

Market Data

Bond Maturity: 5/28/2028
Rating: Baa2/BBB
Price: $104.43
Coupon: 4.597%
Spread: 162 bps
YTW: 4.00%
Call Date: 2/25/2028
Call Price: $100
Issuance Size: $2.0B
Mod. Duration: 7.20
LTM PF EBITDA: $3,077
LTM PF Debt/EBITDA: 4.89x

Contents

Figure 1: Capitalization Table

Type	Maturity	Rate	Debt Outstanding ($MM)	xLTM Adj. EBITDA	Price	Yield	Spread
Commercial Paper	N/A		1,079		N/A	N/A	N/A
Total Commercial Paper			**1,079**	**0.35x**			
Senior Unsecured Revolver*	2/28/2023	LIBOR+125	0		N/A	N/A	N/A
KDP Unsecured Term Loan A*	2/8/2023	LIBOR+95	2,000		$ 96.75	4.73%	N/A
Senior Unsecured Note	1/15/2020	2.000%	250		$ 99.33	2.73%	32.77
Senior Unsecured Note	5/25/2021	3.551%	1,750		$ 101.11	2.99%	72.54
Senior Unsecured Note	11/15/2021	2.530%	250		$ 98.61	3.05%	81.50
Senior Unsecured Note	11/15/2021	3.200%	250		$ 100.25	3.03%	78.04
Senior Unsecured Note	11/15/2022	2.700%	250		$ 97.82	3.31%	108.66
Senior Unsecured Note	5/25/2023	4.057%	2,000		$ 102.90	3.27%	104.21
Senior Unsecured Note	12/15/2023	3.130%	500		$ 99.31	3.26%	103.02
Senior Unsecured Note	5/25/2025	4.417%	1,000		$ 103.77	3.69%	141.21
Senior Unsecured Note	11/15/2025	3.400%	500		$ 98.29	3.66%	135.64
Senior Unsecured Note	9/15/2026	2.550%	400		$ 91.40	3.86%	153.38
Senior Unsecured Note	6/15/2027	3.430%	500		$ 96.42	3.92%	156.71
Senior Unsecured Note	5/25/2028	4.597%	2,000		$ 104.28	4.00%	162.28
Senior Unsecured Note	5/1/2038	7.450%	125		$ 131.23	4.89%	228.70
Senior Unsecured Note	5/25/2038	4.985%	500		$ 102.40	4.77%	217.56
Senior Unsecured Note	11/15/2045	4.500%	550		$ 92.74	4.96%	220.31
Senior Unsecured Note	12/15/2046	4.420%	400		$ 92.42	4.90%	212.55
Senior Unsecured Note	5/25/2048	5.085%	750		$ 102.61	4.89%	209.83
Total Unsecured Debt			**13,975**	**4.89x**			
Total Debt			**15,054**	**4.89x**			
Market Capitalization			39,405				
Cash			83				
Enterprise Value			**54,376**	**17.67x**			

*KDP Unsecured Term Loan and Revolver are pari passu with Unsecured Bonds

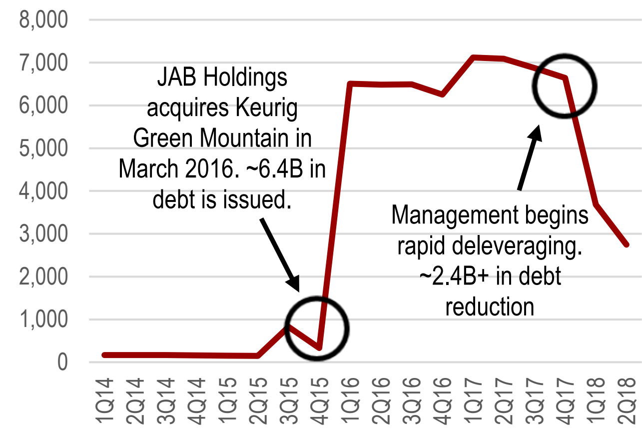
Source: Company Filings, Bloomberg Terminal, MFIF Analysis

Management Has a Proven Track Record of Deleveraging
Current KDP and former Keurig Green Mountain (KGM) CFO Ozan Dokmecioglu has a proven track record of deleveraging and balance sheet management. In January 2016, JAB Holdings took KGM private at a ~78% premium, requiring ~$6.4B in LBO debt. Under Dokmecioglu as KGM CFO, ~$2.4 billion in debt was paid down, thus reducing net leverage from ~5.5x to ~2.7x within a 2-year timeframe. This subsequently also resulted in KGM earning multiple rating agency upgrades. As Dokmecioglu finds himself in a similar leverage situation with KDP, we are confident that management will deliver on their deleveraging goals and ease the concerns that investors have. With ~$2.5B in expected free cash flow in FY19 per MFIF estimates, management will be able to pay down debt and reduce net leverage to the stated 3.0x target within 2-3 years.

Required Debt Repayments Have Not Been Priced In
Under the terms of the company's 2023 unsecured bank loan, the company's leverage must fall under 4.0x by March 2021. Current market sentiment reflects a high level of uncertainty over short term debt repayment, but this cap on company leverage should ease investors' concerns over management's rapid deleveraging. A mandated repayment schedule makes the prospects of achieving 3.0x net leverage in 2-3 years convincing. Additionally, this cap on leverage eases concerns over KDP issuing debt in the future to make large acquisitions. Given KGM's ~5.5x net leverage in March 2016 and KDP's ~5.5x PF leverage after the merger, KDP is grouped with many companies in the industry that have sought inorganic growth or issued large sums of debt at the expense of debtholders. In an industry that has become largely acquisitive and capital intensive, a 4.0x leverage ceiling makes a long-term investment more attractive.

Moody's Negative Outlook to be Mitigated by YE2020
During a February 2019 strategic review, Moody's determined that KDP's high business diversity is offset by a high level of leverage. Moody's subsequently attached a negative outlook to the company's Baa2 rating. Management has been consistent about their desire to get net leverage under 3.0x within two to three years. Moody's has said that if these management targets are achieved, leverage would return to an appropriate level for a Baa2 rating. Once management reduces leverage to our anticipated levels and satisfies the leverage ratio mandated by the company's 2023 bank loan, we expect Moody's to drop its negative outlook. Our predicted net leverage of ~3.3x at YE2020 places KDP back in line with Baa2 peers.

Figure 2. KGM Management's Debt Reduction



Source: Bloomberg Terminal, MFIF Analysis

Risks

- JAB Holdings owns a significant equity stake in the company (~72% share)
- Private label pods pose threat if manufactured by 3rd party (non-KDP)
- Management's synergy guidance falls short of expectations
- Healthy trends in the carbonated beverage industry prove to deter buyers from KDP soft drinks
- KDP joint-ventures become non-accretive to top-line
- Bottling partners such as Fiji Water exit company agreements

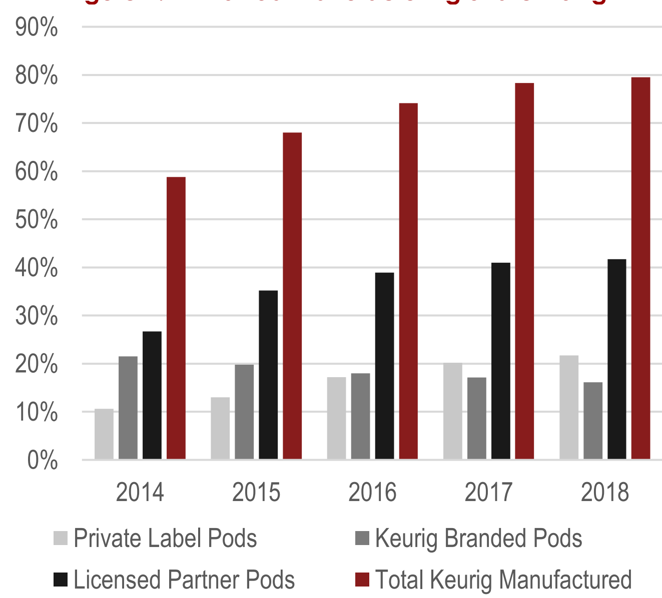
Figure 3. KDP 28's G-Spread

Source: Bloomberg Terminal

Market is Underpricing KDP's Pod Production Moat
In recent quarters, the market has become concerned about private label pods disrupting KDP's leadership in the North America pod market. KDP's North American pod market share has dropped from ~43% in 2013 to ~17% in 2018. While investors are worried about the prospects of this segment, the decline in market share belies Keurig's growth in the segment. First, despite private label gaining share, Keurig is the manufacturer of the majority of private label pods. In terms of margins, Keurig makes approximately the same amount of money on these cheaper private label pods as they do on their own branded ones per CEO Robert Gamgort. Thus, management has implied that their profitability is indifferent to whether they gain market share through partner brands or their own pods. Instead of focusing on brand market share, Keurig's nominal pod production share is robust. 82% of available pods on the market are manufactured by Keurig either through partner brands or internal production. This number has increased from 78% in 2017 per IRI data. In spite of the rapid growth of private label pods, KDP still has the same strong foothold on the coffee market as before.

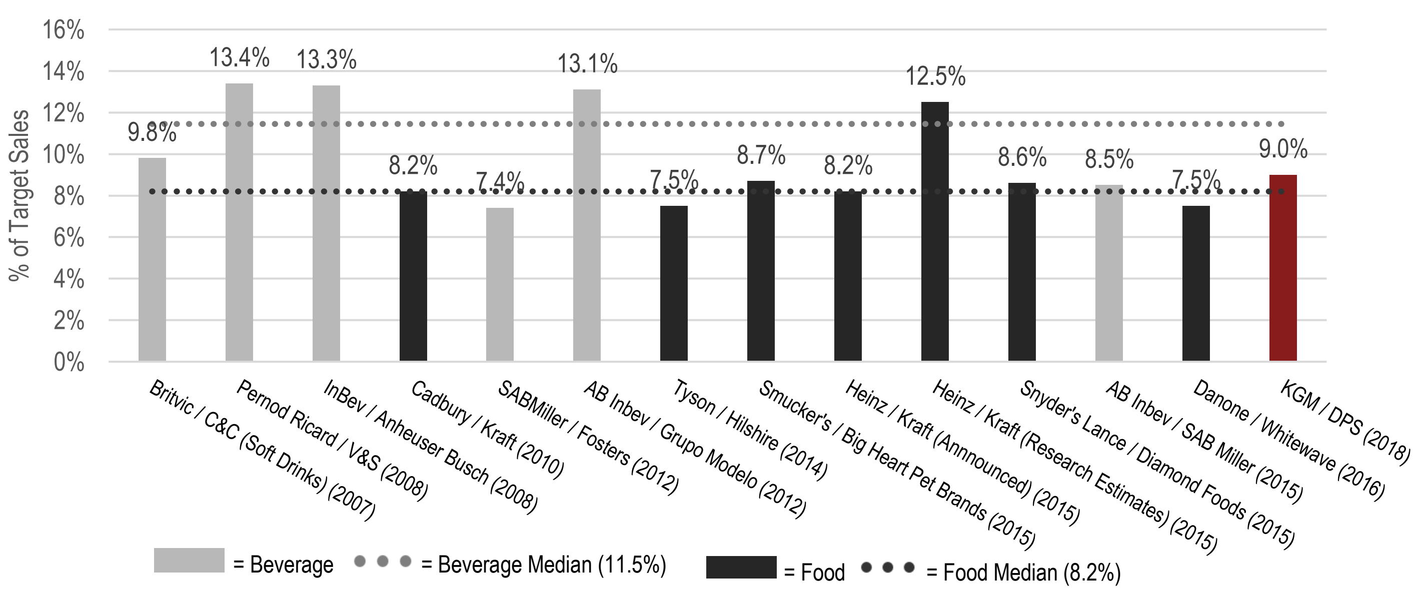
Encouraging Synergy Possibilities for Distribution
Keurig Green Mountain's merger with Dr. Pepper Snapple created a diversified beverage manufacturer with leadership positions in specialty coffee, juice, soft drinks and brewing systems. Management has targeted $600M in synergies ($200M per year) by 2021. The market is hesitant to accept these targets and many are choosing to wait on the sidelines during the integration. This is reflected in KDP's wider spreads relative to competitors STZ and TAP. We are confident in management's ability to reach these targets given CEO Bob Gamgort's successful merger integration track record at Pinnacle Foods and a synergy target that is well in range of comparable mergers as shown in Figure 5. Not only did both KGM and DPS have ~$500M in COGS direct spend overlap, but they also now have access to their respective distribution networks. DPS's expertise in the DSD and convenience retail segments differs from KGM's dominance on the online marketplace and direct-to-office sales. We expect access to the respective combined marketing channels, doubled warehouse capability, and overlap of distributors to increase margins and provide potential further upside.

Figure 4. KDP's Pod Manufacturing Share Rising



Source: IRI Data, MFIF Analysis

Figure 5. Targeted Synergies in Line with Comparable Transactions

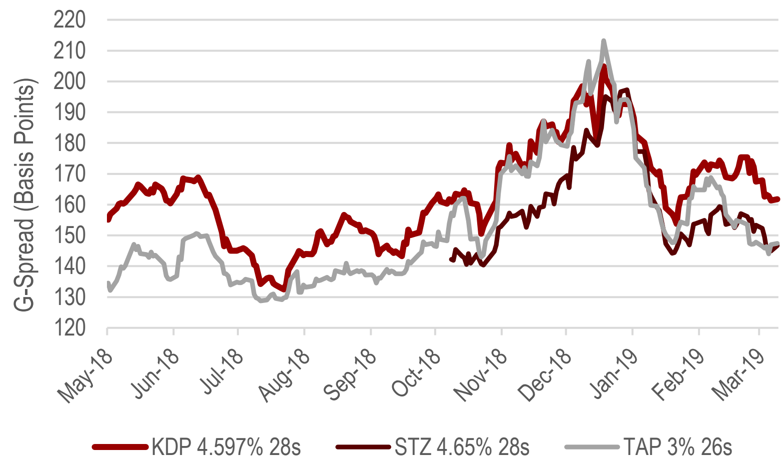


Source: Company Presentation, MFIF Analysis

KDP Unjustifiably Trades Wide to Peers

Since its May 2018 issuance, KDP's 4.597% 28s have traded in line with both STZ's 4.65% 28s and TAP's 3% 26s. However, since KDP's 4Q earnings call in February, the notes have traded ~15 bps wide to both peers. This is largely applicable to uncertainty over management's post-merger integration plan and the growth prospects of KDP's coffee segment. We believe that this unjustifiable widening relative to the peers incorrectly reflects KDP's deleveraging outlook and potential coffee pods manufacturing growth.

Figure 6. Relative Valuation



Source: Bloomberg Terminal

Ultimately, management's planned ~2.0x in deleveraging, margin expansion from merger synergies, and continued leadership in the coffee pod retail market will cause the notes to tighten past STZ's 4.65% 28s and TAP's 3% 26s. STZ set a net leverage target of 3.5x, while KDP's management team consistently reiterates their desire to bring net leverage under 3.0x. Not only is KDP's business model significantly more diversified than STZ, but the company's credit agreements put a firm 4.0x cap on KDP's leverage starting in March 2021. TAP's management wants to deleverage until net leverage is 3.75x, then reinstate a dividend payout ratio of 20-25%, funded through an aggressive savings target of $700 million by mid-2019. We are doubtful of TAP's aggressive cost cutting to repay debt because the company will need to commit significant cash flow if it chooses to fix its lagging mainstream beer business. <u>Overall on a relative value basis, we feel more comfortable investing in a management team that has a proven track record of aggressive deleveraging and merger integration.</u>

Figure 7. Competitor Comparison

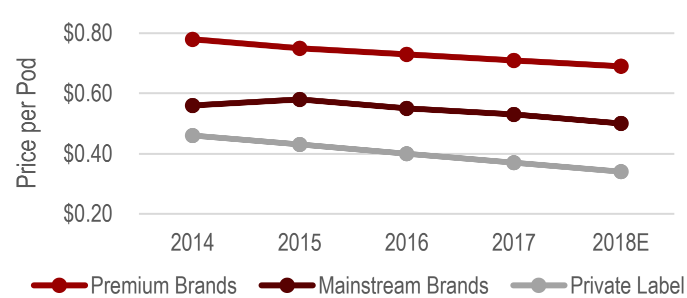
LTM Data (MM)	KDP	STZ	TAP
Market Cap	39,405	32,289	12,884
Enterprise Value	54,376	45,991	22,543
LTM EBITDA	3,077	2,910	2,456
EBITDA Margin	28%	36%	23%
PF Debt/EBITDA	4.89x	4.41x	4.23x
PF Net Debt/EBITDA	4.87x	4.37x	3.80x
EBITDA/Interest	4.88x	8.43x	8.24x
Liquidity	2,483	2,015	2,558
Moody's Rating	Baa2	Baa3	Baa3
G-Spread (bps)	162	145	147

Source: Company Filings, Bloomberg Terminal, MFIF Analysis

Increasing Coffee Pods Affordability to Drive Growth

The critical path to growth for KDP's Coffee Systems segment is making their pods more affordable to their customers. Currently, KDP's premium and mainstream brand pods average $0.69 and $0.50 per pod respectively. Per a KDP market study, <u>~90% of consumers outside of the Keurig system no longer find K-Cup pods "too expensive." Furthermore at $0.30, over 75% find K-Cup pods "a bargain."</u> As KDP reduces the associated costs and price of its pods, higher volumes will drive growth and increase household penetration for the segment.

Figure 8. Rising Affordability of KDP Coffee Pods



Source: Company Presentation, MFIF Analysis

Figure 9. Summary Model

Keurig Dr. Pepper (NYSE: KDP)

USD, Millions

	2017	2018	1Q19E	2Q19E	3Q19E	4Q19E	FY19E	FY20E
Revenues								
Beverage Concentrates	$ 1,282	$ 1,331	$ 299	$ 369	$ 341	$ 363	$ 1,371	$ 1,412
Packaged Beverages	4,871	5,069	1,213	1,419	1,376	1,212	5,221	5,430
Latin America Beverages	487	506	118	142	141	125	526	547
Coffee Systems	4,135	4,114	957	958	1,064	1,176	4,155	4,197
Total Revenue	**$ 10,775**	**$ 11,020**	**$ 2,587**	**$ 2,889**	**$ 2,922**	**$ 2,875**	**$ 11,273**	**$ 11,586**
COGS	$ 4,869	$ 4,891	$ 1,138	$ 1,271	$ 1,286	$ 1,265	$ 4,960	$ 5,009
Gross Profit	5,906	6,129	1,449	1,618	1,636	1,610	6,313	6,577
SG&A	3,451	3,514	749	838	847	799	3,233	3,301
Operating Income	**2,455**	**2,615**	**700**	**780**	**789**	**811**	**3,080**	**3,277**
Net Interest Expense	759	630	146	145	145	145	580	528
EBT	**1,696**	**1,985**	**554**	**635**	**644**	**667**	**2,499**	**2,749**
Income Taxes	513	528	147	169	171	177	665	731
Net Income	**$ 1,183**	**$ 1,457**	**$ 407**	**$ 466**	**$ 473**	**$ 489**	**$ 1,834**	**$ 2,018**
EBITDA Reconciliation								
Net Income	$ 1,183	$ 1,457	$ 407	$ 466	$ 473	$ 489	$ 1,834	$ 2,018
(+) Net Interest Expense	759	630	146	145	145	145	580	528
(+) Taxes	513	528	147	169	171	177	665	731
Operating Income	2,455	2,615	700	780	789	811	3,080	3,277
(+) D&A	229	462	103	116	117	115	451	463
Adjusted EBITDA	**$ 2,684**	**$ 3,077**	**$ 803**	**$ 895**	**$ 906**	**$ 926**	**$ 3,531**	**$ 3,740**
Free Cash Flow								
Adjusted EBITDA	$ 2,684	$ 3,077	$ 803	$ 895	$ 906	$ 926	$ 3,531	$ 3,740
Capex	(202)	(180)	(45)	(51)	(51)	(50)	(198)	(203)
Cash Interest	(759)	(630)	(146)	(145)	(145)	(145)	(580)	(528)
Cash Tax	(513)	(528)	(147)	(169)	(171)	(177)	(665)	(731)
Gross FCF	1,210	1,739	465	531	538	554	2,088	2,278
Working Capital	(45)	457	100	100	100	100	400	400
Net FCF	**$ 1,165**	**$ 2,196**	**$ 565**	**$ 631**	**$ 638**	**$ 654**	**$ 2,488**	**$ 2,678**
Total Debt	$ 4,479	$ 15,659	$ 15,054	$ 15,004	$ 14,979	$ 14,954	$ 14,954	$ 12,854
Total Cash	95	83	335	603	904	1,221	1,221	598
Credit Metrics								
Debt/EBITDA	1.67x	5.09x	4.61x	4.34x	4.30x	4.24x	4.24x	3.44x
Net Debt/EBITDA	1.63x	5.06x	4.51x	4.16x	4.04x	3.89x	3.89x	3.28x
EBITDA/Interest	3.54x	4.88x	5.16x	5.79x	6.06x	6.08x	6.08x	7.08x
FCF/Debt	26%	14%	15%	17%	15%	17%	17%	21%

Source: Company Filings, MFIF Analysis