

A Refreshing New Strategy in the Beverage Industry

The changing beverage marketplace has resulted in some major transformations amongst the industry's chief competitors. The Coca-Cola Company and PepsiCo Inc. have both recognized the changes and have taken action to preserve their success with their all-important systems of bottlers. We expect these changes to be beneficial including the opportunity to focus on innovation and to improve the cost effectiveness of bringing the product to market.

In 1899, two lawyers from Tennessee secured exclusive rights to bottle and sell Coca-Cola for only one dollar (www.coke.com). Asa Candler, then President of The Coca-Cola Company, was not convinced that selling the product in bottles was the way to go. No one could have predicted how popular Coca-Cola and its main competitor, Pepsi-Cola, would become.

The relationship between company and bottler has always been very important. Today, 54 billion beverages of all types are served every day.¹ Products from PepsiCo Inc. (PEP) and The Coca-Cola Company (KO) account for more than two thirds of the sales in the carbonated soft drink (CSD) category.² These companies have battled with each other for many years and in the process have had to adapt to consumer shifts and increasing complexity concerning product distribution. Once again, the marketplace for non-alcoholic drinks in North America has evolved away from the current model. To achieve longer term profitability and growth, PepsiCo and The Coca-Cola Company have both decided to buy the majority of their North American bottling operations. In this report, we will explain how the market has changed and why we expect PepsiCo and The Coca-Cola Company to be better off in the future.

To begin, we need to explain the traditional role of the parent company and its system of bottlers. The parent company (The Coca-Cola Company, PepsiCo), also called the "concentrate company," is basically in charge of producing the concentrate or syrup that is used in a manufacturing process which ends up as a bottle or can of Coke or Pepsi on a shelf in a store. More importantly, it is the concentrate company's job to create demand through advertising, marketing, and strategic planning. The bottlers buy the concentrate and then manufacture the product so that it can be distributed to a network of retailers and dealers.

One major change that has taken place has been the consolidation of the retail industry. In particular, the discount retailers (Walmart & Target) have allocated a larger portion of square footage to food. For example, about half of 2009 revenues for Walmart (WMT) was attributed to grocery. This compares to 28% of revenues only five years ago. For Target (TGT), food accounts for 16% of sales. Currently, Walmart is the largest grocer in the U.S. with about double the market share of the next largest competitor, Kroger (KR). In 2001, Walmart and Kroger were neck and neck. In 2007, the top fifteen food retailers accounted for 64.4% of U.S. sales compared to 50.1% in 2001. Exhibit 1 shows the evolution of market share from 2001-2007.³ The growth of Walmart is especially impressive.

¹ The Coca-Cola Company 2009 10-K: p. 1.

² Wendy Nicholson, Vivien Azer, Ryan Wood, "Review of 2009 Trends in Category Market Share, Pricing and Promotion," *Citigroup Global Markets U.S. Drinks and Snacks Digest* (February 23, 2010): p. 28.

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Exhibit 1: Market Shares in US Sales of Supermarket Items

Rank	Operator	2001	2002	2003	2004	2005	2006	2007
1	Wal-Mart Supercenters & Neighborhood Markets	9.8%	11.1%	11.7%	13.0%	14.2%	15.3%	18.2%
2	Kroger	9.2%	9.0%	8.9%	9.3%	9.3%	9.5%	9.5%
3	Safeway	6.0%	6.1%	5.3%	5.2%	5.2%	5.0%	4.9%
4	Costco	3.2%	4.1%	4.3%	4.3%	4.2%	4.7%	4.8%
5	SuperValu	1.8%	1.7%	1.7%	1.7%	1.7%	4.0%	4.7%
6	Wal-Mart Sam's Club	3.2%	3.3%	3.4%	3.0%	3.6%	3.6%	3.9%
7	Publix	2.8%	2.8%	2.8%	3.1%	3.2%	3.1%	3.1%
8	Target Stores	N/A	N/A	N/A	N/A	2.4%	2.7%	2.9%
9	Alford	4.4%	4.6%	4.5%	4.5%	3.5%	2.6%	2.9%
10	Delhaize	2.8%	2.6%	2.6%	2.6%	2.6%	2.8%	2.5%
11	Meijer	0.7%	0.9%	1.1%	2.0%	1.9%	1.8%	2.0%
12	H.E. Butt	1.3%	1.9%	1.8%	1.7%	1.6%	1.6%	1.7%
13	Great Atlantic & Pacific	1.6%	1.5%	1.2%	1.3%	1.1%	1.0%	1.3%
14	Winn-Dixie	2.4%	2.2%	1.9%	1.8%	1.5%	1.0%	1.0%
15	Giant Eagle	0.9%	0.9%	0.9%	0.9%	0.8%	0.9%	1.0%

Note: Total sales based upon Census Bureau estimate of grocery store sales plus reported sales of supermarket items at Wal-Mart supercenters, Costco, Sam's Club, Target (from 2005), and BJ's Wholesale Club.

Source: Company reports and JPMorgan estimates.

In North America, 19% of revenues for PepsiCo were allocated to Walmart (including Sam's Club) up from 13% in 2006.³ In short, the food retail segment has become more concentrated and more powerful. The demands for better service from The Coca-Cola Company and PepsiCo have increased. Retailers require more flexibility, innovation, and speed.

Consumer beverage choices have shifted production away from the bottlers. Consumers have become more health conscious. Consumers are now more concerned about calories and are interested in drinks that are convenient and healthy. Consumers are buying less carbonated soft drinks and more in new beverage categories. These new categories of beverages include sports drinks, liquid tea, liquid coffee, energy drinks, and bottled water. Exhibit 2 illustrates the change in market share over a five year time frame.⁴

Exhibit 2: Change in Market Share (2004 – 2008)

	2004	2005	2006	2007	2008
CSDs (ex. Energy)	72.6%	68.9%	65.4%	62.2%	61.6%
Water	13.2%	15.4%	17.2%	19.3%	19.7%
Sports Drinks	4.8%	5.7%	6.2%	6.3%	6.1%
Juices	5.6%	5.7%	5.8%	5.9%	6.0%
RTD Tea	2.8%	3.0%	3.7%	4.3%	4.4%
Dairy-based	0.4%	0.4%	0.5%	0.5%	0.5%
Energy Drinks	0.5%	0.8%	1.2%	1.5%	1.6%
Other	0.0%	0.1%	0.1%	0.1%	0.1%
Total	100.0%	100.0%	100.0%	100.0%	100.0%

Source: Beverage Digest

³ PepsiCo 2009 10-K: p. 8.

⁴ John Faucher et al., "The Coca-Cola Company and Coca-Cola Enterprise – Nobody Expects the Bottler Acquisition," *JPMorgan North America Equity Research* (February 26, 2010): p. 7.

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Overall, The Coca-Cola Company and PepsiCo have maintained their total share of the non-alcoholic beverage industry through product expansions, innovation, and acquisitions, including transactions such as PepsiCo's acquisition of Gatorade and the Coca-Cola Company's acquisition of Odwalla. The manufacturing process to produce a can of Coke is different from producing a bottle of Powerade. The added complexity of certain products has shifted the manufacturing process away from the bottler. Generally, most sports drinks, teas, juices, and dairy based drinks are manufactured at the concentrate company while carbonated drinks and bottled water are manufactured by the bottler. Those drinks produced at the concentrate company are called, finished goods.

These changes have resulted in less profit for the bottlers. The bottlers did not benefit from the growth and higher profitability in finished goods. Capacity utilization has been down with lack of growth in carbonated soft drinks. Also, bottled water, which was able to offset some of the lower growth in carbonated soft drinks, has been slowing over the last couple of years. In the future, most analysts in this sector agree that higher growth products will require a more complex manufacturing process. Under the old model, this would have been bad for bottlers. Years ago, most large bottlers made a significant capital investment which counted on sustained growth in carbonated soft drinks. Profit strained, the bottlers were less willing this time around to invest in new beverage categories. This was one of the reasons why the bottlers missed out on the popularity of non-carbonated soft drinks.

The combination of concentrate company and bottler should yield cost savings and efficiencies allowing for additional reinvestment. Overcapacity and redundant distribution will be rationalized. One example is the sale of both fountain and bottled products to the same location by two different distribution channels. Going forward, one channel will service that particular customer. The combination should lead to a greater use of warehouse distribution versus the current direct-store-delivery system, which is used by the bottlers. The warehouse delivery system (product gets delivered to the retailer's distribution center and the retailer ships the product to the store) is one that is in demand from large retailers given the lower cost, leaving the retailer with the opportunity to extract more profits from the customer without raising prices. In addition, a more efficient distribution system and less negotiation between organizations (pricing/volume decisions) should allow the product to reach the market more quickly.

Despite the ownership structure, the concentrate company and bottler relationship has always been strong. Both entities need each other to survive. We believe the recent transactions are a positive strategic move for both The Coca-Cola Company and PepsiCo and for the industry. The Coca-Cola Company and PepsiCo are clearly protecting their investment in their key bottlers and securing their strategic position given changes in the consumer and retailers. Going forward, we expect that these companies will continue to adapt to succeed. These particular transactions make sense and should allow these companies to remain competitive and innovative.

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