# FINAL TRANSCRIPT

**Cott Corporation**

**First Quarter 2017 Earnings Conference Call**

**Event Date/Time: May 4, 2017 – 10:00 a.m. E.T.**

**Length: 60 minutes**

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## PRESENTATION

**Operator**

Welcome to Cott Corporation's First Quarter 2017 Earnings Conference Call. All participants are currently in listen-only mode. This call will end no later than 11:00 AM. This call is being webcast live on Cott's website at www.cott.com, and will be available for playback there until May 18, 2017.

This conference call contains forward-looking statements, including statements concerning the Company's future financial and operational performance. These statements should be considered in connection with cautionary statements and disclaimers contained in the Safe Harbour statements in this morning's earnings press release, and the Company's Annual Report on Form 10-K and quarterly reports on Form 10-Q, and other filings with U.S. and Canadian securities regulators. The Company's actual performance could differ materially from these statements and the Company undertakes no duty to update these forward-looking statements except as expressly required by applicable law.

A reconciliation of any non-GAAP financial measures discussed during the call with the most comparable measures in accordance with GAAP is available in the Company's first quarter 2017 earnings announcement released earlier this morning or on the Investor Relations section of the Company's website at www.cott.com.

I will now turn the call over to Jarrod Langhans, Cott's Head of Investor Relations.

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**Jarrod Langhans - Head of Investor Relations, Cott Corporation**

Good morning and thank you for joining our call today. Today, I'm accompanied by Jerry Fowden, our Chief Executive Officer; Jay Wells, our Chief Financial Officer; and Tom Harrington, who oversees our Water & Coffee Solutions segment. Jerry will start this morning's call with some of his thoughts on our operations and free cash flows thus far in 2017 relative to expectations, as well as progress on our strategy as we continue to build shareholder value through strong compounded annual growth and free cash flows over the next few years, before turning the call over to Jay for a discussion of our first quarter consolidated financial performance and go-forward expectations as well as an overview of our traditional business. Tom will then cover our Water & Coffee Solutions segment before we finish with Q&A. Following our prepared remarks, we will open the call up for questions.

With that, let me now turn the call over to Jerry.

**Jerry Fowden - Chief Executive Officer, Cott Corporation**

Thank you, Jarrod, and good morning everybody.

As I look at our first quarter's performance, I think the best way to describe it is very much in line with our expectations. Simply put, we expected 2 percent to 3 percent top line growth from our Water & Coffee Solutions business, flat North American traditional business volumes, a challenging time



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in the U.K. given the significant devaluation of the British pound and last, but by no means least, continuing improvement in gross margins and free cash flow.

With that said, and while that sounds so simple, a lot went on during the first quarter of the year, much of which sets us up well to deliver on the full-year view we provided last time we spoke. Key elements of our full-year expectations were: full-year revenues in excess of $3.7 billion; 2 percent to 3 percent growth from our Water & Coffee Solutions segment; the execution of our three-point improvement plan at DS Services designed to deliver a $20 million-plus earnings improvement; capturing $4 million of 2017 Eden and S&D synergies; flat volumes within our North American traditional business; the significant first-half challenges in our U.K. operations from foreign exchange headwinds, as well as some lost volume; and attractive opportunities to refinance elements of our existing debt at lower rates, the achievement of which we expect to drive growth in free cash flow and lead to full-year adjusted free cash flow in the range of $155 million to $175 million.

So let's review our actions of first quarter's performance in each of these areas and how they support our full-year expectations and longer-term goals.

On revenue, we're on track to deliver our goal of in excess of $3.7 billion of full-year revenue, with 30 percent FX neutral revenue growth in the quarter and 28 percent reported revenue growth given the continuing foreign exchange headwind. Our Water & Coffee Solutions segment delivered over 4 percent first quarter pro forma revenue growth with S&D leading the way. DS Services revenue was up



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over 2 percent despite one less trading day, up 4 percent on a per day basis, and we started to see the benefits of our three-point improvement plan come through in earnings and the confidence this momentum will build as the year progresses.

We executed the Eden Springs head office restructuring during the quarter, which will improve Eden's business efficiency and lower SG&A cost, thus we feel confident of achieving or exceeding our full year 2017 Eden and S&D synergy goal.

As mentioned, we got off to a great start within S&D Coffee & Tea, who have won a significant number of new pieces of business leading to a 9 percent growth in coffee volume this quarter. We held North American traditional business actual case volumes flat with 9 percent growth in contract manufacturing and 5 percent growth in value-added and sparkling water, offsetting the ongoing decline in the market and private label carbonated soft drinks and shelf stable juices.

In the U.K., because of FX-related challenges, we agreed price changes with our customers that should offset the FX-related commodity cost increases by the second half of the year, which, along with our installation of our value-added water line, should see us back in top line growth by the end of the year.

Now, with regard to the opportunity to refinance elements of our debt, you will have seen we raised $750 million of 5.5 percent notes and utilized the proceeds to redeem all our 6.75 percent notes



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as well as redeem $100 million worth of our DS Services 10 percent coupon notes. These and other potential refinancing and debt reduction actions that Jay will comment on in more detail should lead to around $25 million per year reduction in our cash interest cost once completed.

Thus, with these refinancing actions, our good top and bottom line momentum in our Water & Coffee Solutions segment and the various actions and price changes already agreed within our U.K. business, we're on track to deliver our 2017 adjusted free cash flow goal of $155 million to $175 million, with Q1 adjusted free cash flow improving $7 million. We're also well on track for our mid-teen compound annual growth and adjusted free cash flow to some $225 million to $275 million by the end of 2019.

While we still have more to do in terms of executing our strategy, I believe we're on the right track and we will stay focused on being a low-cost company that follows the four Cs and sticks to the strategy we have laid out. There will always be challenges such as Brexit and its associated sterling devaluation, but as we've done in the past, we'll address any such issues that arise with a bias to action and a hands-on approach towards execution such that we continue to build a more resilient, higher margin, cash-generative, lower risk business, and thus, long-term value for our shareholders.

On that note, I will pass over to Jay to cover the quarter's financial performance as well as provide more detail on our traditional business performance during the quarter. Tom will then cover our Water & Coffee Solutions segment before handing back to me to wrap things up.



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**Jay Wells - Chief Financial Officer, Cott Corporation**

Thank you, Jerry, and good morning everyone. As Jerry noted, this quarter's consolidated results were very much in line with what we had laid out during our Q4 earnings call where we continued to see some segments in our business grow, in particular our Water & Coffee Solutions segment where we have seen very good growth at S&D Coffee & Tea, top line recovery at DS Services, and on-track performance from Eden Springs. We have also continued to see volume stability within our Cott North America business, while our Cott U.K. business has been challenged with the loss of some volume from one of the larger U.K. retailers that we will lap by the end of Q2, and FX headwind that we will offset by the second half of the year with agreed changes to customer pricing.

Against this backdrop, consolidated revenue increased by 28 percent to $896 million, 30 percent on an FX neutral basis. Revenue increased as a result of the additions of S&D and Eden, as well as good top line growth from DS Services, with revenue from our Water & Coffee Solutions segment up over 4 percent on a pro forma basis, offset in part by the anticipated pressures on our Cott U.K. operating segment, predominantly as a result of the devaluation of pound sterling versus the U.S. dollar and euro, and some loss of volume in our U.K. traditional business. On a full year basis, we continue to project revenues of over $3.7 billion.



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Gross profit increased 45 percent to $311 million driven by the additions of Eden and S&D, as well as growth and margin improvement from DS Services, offset in part by adverse foreign exchange rates. Gross margins were up 400 basis points at 34.6 percent.

Adjusted EBITDA, including an adjustment for stock-based compensation costs, increased 21 percent to $88 million ,due primarily to the additions of Eden and S&D and improvement in DS Services performance, offset in part by $5 million of adverse foreign exchange and lower volume in our Cott U.K. operating segments.

Please note that this is the first time we are treating stock-based compensation costs as an adjustment to EBITDA. We have made the adjustment to both 2016 and to 2017 to ensure comparability, and we will include this as an EBITDA adjustment going forward as this is the norm within our peer group and we believe this will eliminate an issue we have seen with external computations of our free cash flow.

Interest expense was $36 million after issuing $750 million of senior notes at 5.5 percent and an eight-year maturity, with the proceeds to be utilized to redeem all $625 million of our 6.75 percent senior notes as well as closing on the redemption of $100 million of our 10 percent senior notes tomorrow. This refinancing, in conjunction with redeeming the remaining portion of our 10 percent senior notes in September of this year, should allow us to generate around $25 million of interest savings.



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Turning to income tax, as discussed during our Q4 earnings call, we made the determination to place a valuation allowance against our existing and future Canadian and U.S. net operating loss carryovers and other tax assets. These valuation allowances remove a significant portion of the tax benefits that we have been recording on a reported basis, and as a result, we reported tax expense of $1 million in the quarter compared to a tax benefit of $10 million in the prior year.

Cash taxes in the quarter were minimal at $1 million compared to $4 million in the prior year. We now expect our reported tax expense for the year to be some $10 million and cash taxes to be less than $10 million, with cash taxes continuing to be at this low level for several years to come.

As Jerry noted, free cash flow remains a key focus within our business and strategy. During the quarter, we saw a 15 percent improvement in adjusted free cash flow usage and we continue to be confident in delivering $155 million to $175 million of adjusted free cash flows in 2017, with capital expenditures between $165 million and $175 million for the full year.

On commodities, our commentary from our Q4 earnings call remains intact. That being, if you take FX out of the equation, it currently looks like we will see some pressure on a net basis as small declines in certain categories are projected to more than offset—be offset by increases in other categories such as PET resin.



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With regard to the impact of foreign exchange rates, we continue to anticipate an adverse foreign exchange impact on 2017 EBITDA of roughly $12 million to $18 million, predominantly in the U.K. and heavily weighted to the front half of the year, which will result in another $5 million-plus of adverse FX in the second quarter which would largely be removed by Q3 and Q4 based on agreed customer pricing changes, but I'll comment more on that in a few minutes.

So with that said, let me now cover the operating performance of our Cott North America and Cott U.K. operating segments. Let's start with our Cott North America operating segment.

For the quarter, we saw continued growth in value-added and sparkling water of 5 percent as well as contract manufacturing growth of 9 percent, allowing the overall business unit to keep actual case volumes flat despite continued market declines in carbonated soft drinks and shelf stable juices. As we progress through the year, we anticipate value-added and sparkling water will grow in the high-single to low-double-digit range as we now have lapped significant product rollout with a large retail customer in Q1 of last year. With respect to contract manufacturing, we expect to continue to see good growth as the previously announced new contract manufacturing agreement ramps up during Q2.

While Cott North America's revenues were down 4 percent at $301 million due to ongoing mix shifts within the business, gross margin as a percentage of revenue was fairly stable at 11.2 percent and operating income was up slightly. All in all, we were pleased with the results of our Cott North America



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business unit as growth in value-added and sparkling water and contract manufacturing continues to offset ongoing market and private label CSD and shelf stable juice declines.

Now turning to the U.K., as most of you know we expected to see $10 million of EBITDA pressures within our U.K. operating segment in the quarter due to the adverse impact of foreign exchange rates from the devaluation of the British pound as well as volume pressures. Overall, the results were in line with these expectations, and as we look forward, we will lap the loss of volume by the end of the second quarter and we will see the adverse foreign exchange impact largely removed in the second half of the year as our customer-agreed pricing initiatives progressively come into effect.

The combination of these factors, in addition to a value-added water line we're in the process of installing in the U.K. to meet strong customer demand, should result in volume stability and local currency top line growth by the end of the year and a much better outlook for 2018. We have almost completed the reformulation of a majority of our U.K. customers' private label recipes and we'll be ready to supply our customers with great tasting, low sugar products prior to the start of the levy. We expect most of these reformulated products to be below the proposed 5 grams of sugar per 100 ml requirement to trigger the new sugar levy. We are therefore in very good shape in relation to the implementation of the sugar levy in April of 2018 and may even find our business advantaged as our price gaps expand as many companies and brands will continue to be above 5 grams of sugar and will



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thus have to pay a minimum levy of £0.18 per litre, allowing us to provide our customers with even better relative value.

I will now hand the call over to Tom to cover our Water & Coffee Solutions segment.

**Thomas J. Harrington - Chief Executive Officer, DS Services, Cott Corporation**

Thank you, Jay, and good morning everyone. Let's start with DS Services. Over the first quarter, financial metrics were in line with the commentary from our Q4 earnings conference call. Revenue was up 2 percent at $263 million despite one less trading day, but on a per day basis, DS revenue was up 4 percent as we begin to see the benefits from the execution of our three-point improvement plan. Our gross profit, operating income and EBITDA margins were all up for the quarter.

From a customer perspective, we ended the quarter with net new customer additions of 2 percent and we believe we've positioned the business for success as we enter our higher production and marketing quarters. We have improved the phasing and execution of our marketing efforts for with both our retail booth program as well as our commercial customers. This action is delivering better cost management and improved service and installation for new customers.

All in all, I'm excited with the early signs for 2017 and I'm confident we will see further improvement as the year progresses.



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Let me update you on the status of the three-point improvement plan we discussed on our Q4 update call. Thus far, it is delivering the intended results. First, customer profitability and pricing.

Our customer growth plan for 2017 is on track. We've implemented pricing where appropriate and have taken other pricing actions that we'll enjoy in the back half of the year. We're in the process of bringing on new sales associates to focus on areas where we want to increase our customer base, in particular on commercial customers in high-priority density areas with a focus on driving higher profits.

Second, sales, marketing and logistics. With our pre-mapped targeted sales and marketing channel, we have new routes and route sales representatives in place in advance of our marketing events in each region. This will enable our current routes in these areas to not be negatively impacted as the new customers come on board. Once these routes are full, we will then re-route each location, similar to what we do when we add tuck-in acquisitions in order to ensure the routes are as efficient as possible. In addition, we're focusing our efforts during periods in which we see the highest returns and success rates with our marketing programs, the summer months.

Third, further executing Cott's four Cs. We have taken actions to further implement Cott's four Cs, which are and will continue to drive more efficient production and operations throughout the year, and will assist in meeting our $20 million plus of profit growth for the year.



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As we look over the next three quarters, we remain confident in delivering our 2017 3 percent revenue growth goal through roughly 2 percent to 3 percent top line growth in the first half of the year, followed by some 3 percent to 4 percent top line growth in the back half of the year based upon the phasing of our marketing activity, pricing, as well as timing of some inventory sourcing we had in the back half of last year.

Now, turning to Eden and S&D. We were pleased with the results of both Eden and S&D and remain excited about the platforms we're building in HOD water, coffee and tea. Both businesses are meeting or exceeding expectations, and we see further opportunities to add to each of these businesses in addition to their organic growth. Looking at the quarter, we were pleased with the $232 million of revenue that these businesses contributed to our consolidated results.

As noted in our fourth quarter call, our S&D team landed a number of new contracts which they have successfully on boarded, including the refurbishment or maintenance of some 4,000-plus brewers, part of a new customer coffee program now rolled out. These efforts assist in generating normalized coffee volume growth of 9 percent. In addition, we continue to track in line with our synergy and integration plan at S&D.

We've also seen good results at Eden, which is tracking in line with its acquisition model, even with some foreign exchange noise as a result of operating throughout 18 countries. As noted in our Q4



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call, Eden is well on its way to meeting and exceeding synergy expectations during 2017, which we would expect to offset any currency pressures that may result.

In addition, we've relocated the administrative headquarters of Eden and retained all key management representatives that we had targeted for relocation. The transition has gone smoothly thus far, and we are pleased with the efforts we've seen from the key members on the management team.

Looking out over the remainder of the year, we continue to believe that both S&D and Eden are on track to deliver their top line and bottom line acquisition model targets that we discussed on our last call.

I will now turn the call back to Jerry.

**Jerry Fowden - Chief Executive Officer, Cott Corporation**

Thank you, Tom. At this point, as I summarize the first quarter and look to the second quarter, I believe the themes and drivers of our business will be fairly similar; top line revenue growth, synergies, and overall performance improvements within our Water & Coffee Solutions segment should be pretty much in line with or better than our expectations. Volume performance in our North American traditional business should continue to remain stable with the benefits of growing sparkling and value-



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added water, as well as contract manufacturing growth offsetting the market and private label decline in carbonated soft drinks and shelf stable juices.

While the foreign exchange pressure in our U.K. operating segment will continue during the second quarter, the business will meaningfully improve in the second half as we have lapped our customer volume loss, which, along with the agreed U.K. customer pricing, should offset the embedded impact of sterling's devaluation on our commodity costs. Thus, we should be back in top line growth by the end of the year.

In addition, we will start to see some benefit from our refinancing on cash flows in Q2 and these benefits will rise as the quarters progress, such that by Q4, when we have refinanced the balance of the DS notes, we will be at run rate savings of around $25 million a year.

When you pull these items and their phasing together with our first quarter free cash flow improvements, we are well on our way to our $155 million to $175 million 2017 adjusted free cash flow goal and our mid-teen compound annual growth in free cash flow across 2017 to 2019.

We know that while we've made a lot of progress in reshaping the business, we still have a long way to go as we build our vision to be North America and Europe's leading service provider for water, coffee, tea and filtration solutions. We believe as we execute against this vision and our free cash flow



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grows, the valuation of our company will follow and shareholders will benefit from this improved valuation.

At this point, thank you all for listening and I'll turn the call back to Jarrod to open up the lines for Q&A.

**Jarrod Langhans - Head of Investor Relations, Cott Corporation**

Thank you, gentlemen. During the Q&A, so that we can hear from as many of you as possible, we would ask for a limit of one question and one follow-up question per person. Thank you for the time. Operator, please open up the line for questions.

## Q & A

**Operator**

At this time I'd like to inform everyone that in order to ask a question over the phone, you may press star, one on your telephone keypad. Again, that is star, one on your telephone keypad. To remove yourself from the queue, you may press the pound key.

Your first question comes from the line of Derek Dley with Canaccord Genuity. Your line is open.

**Derek Dley - Analyst, Canaccord Genuity**

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Hi, guys.

**Jerry Fowden - Chief Executive Officer, Cott Corporation**

Morning, Derek.

**Jay Wells - Chief Financial Officer, Cott Corporation**

Good morning.

**Derek Dley - Analyst, Canaccord Genuity**

Just as it relates to DS, can you give us some commentary just on sort of the cadence of the benefits from your three-point plan that you had? I believe last quarter you said you expect $20 million for the year with really two-thirds of that coming in the back half of the year. Was that similar to what we witnessed here in Q1?

**Jerry Fowden - Chief Executive Officer, Cott Corporation**

Yes. I'll make a quick comment and then ask Tom to expand on a number of the initiatives that are going in place. I think, Derek, while there was a lot of information in the prepared remarks, we highlighted that we've taken certain pricing, but there is also additional pricing that has already been agreed that takes effect from June, and, of course, when you look back at last year, the comparables become a lot easier in the back half.



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So, we have said we were looking at around 2 percent to 3 percent top line growth in Q1 and Q2 rising to 3 percent to 4 percent in the back half of the year, giving an average of 3 percent top line growth or more than $20 million of EBITDA improvement for the year. While Q1 has come in pretty much as expected and actually, with one less trading day, you could look at a 4 percent per day revenue growth.

But let me ask Tom to expand on a number of the individual programs we're driving in that three-point improvement plan.

**Thomas J. Harrington - Chief Executive Officer, DS Services, Cott Corporation**

Yes. Good morning, Derek. This is Tom. As Jerry said we have the pricing benefit that comes in the second half of the year and hence the way that we've modeled the 2 percent to 3 percent in the first half followed by 3 percent to 4 percent in the back half. We are making, however, investments in the ability to properly serve those customers and have phased those in. So, we talked about a food program with a large retailer. It is about installing the right number of routes to do two things: properly install the customers and then to maintain and improve our service levels to the existing base that we have, so that work was implemented in Q1. We'll see some further work done in Q2 as we build that confidence and then prepare for better growth in the back half of the year.



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The other part of the phasing is really around the addition of sales representatives. So, we've begun the work to hire those associates and you may recall they're intended to work on a highly profitable commercial segment of our business and that's an important component of our go-forward plan in Q2, and frankly into Q3.

**Derek Dley - Analyst, Canaccord Genuity**

Okay then.

**Jerry Fowden - Chief Executive Officer, Cott Corporation**

Does that cover things off, Derek?

**Derek Dley - Analyst, Canaccord Genuity**

No, that's great. Thanks a lot for the colour. Then just one more, if I may. Just in terms of S&D and Eden, it sounds like the integration there is going very well, perhaps slightly better than expected in S&D. Can you just give us a comment on some of the initiatives or activities that you've done to drive these synergies and how we should expect synergies to sort of play out over the course of the next three years? I'm assuming the front half is more cost synergies, the back half is more revenue synergy.

**Jerry Fowden - Chief Executive Officer, Cott Corporation**



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Yes. I'll comment a little bit on S&D and I'll ask Tom, who I know has been very close and has been leading the reorganization of the HQ at Eden Springs. But overall, we were looking for $23 million of synergy across a four-year period from building this combination of water, coffee and tea and filtration businesses. Four million dollars of that synergy was phased in for this year, and I can say that I feel pretty comfortable that we will meet, likely exceed that, principally based on the benefits that we will get from the restructuring of a number of HQs and the location of the HQs within Eden Springs, and I'll ask Tom to expand on that.

One comment that Jay had pointed out to me, a lot of the costs associated with that integration and HQ relocation have gone through in Q1 and some of you will have seen that in the SG&A line, predominantly linked to the Eden Springs HQ relocation.

**Jay Wells - Chief Financial Officer, Cott Corporation**

One more thing to add, Jerry, before I let Tom talk because you asked about cost and revenue synergies front-end and back-end loaded. Of our $23 million in synergies, they are all cost synergies; we haven't factored any revenue synergies into the equation. So I just wanted to clarify that before handing over to Tom.

**Jerry Fowden - Chief Executive Officer, Cott Corporation**



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Then on S&D's top line, I think you might recall, Derek, we've mentioned they had a number of new customer wins in the pipeline. Our targeted volume growth for S&D we had said was plus 3 percent in volume and obviously, the revenue if coffee prices are constant would then be in line with that. If coffee prices are up, the revenue growth would be even stronger; vice versa if coffee prices are down.

We saw 9 percent volume growth in S&D in the first quarter and that included shipments and the installation in 4,000 new customers, which is one of those customer initiatives that we referred to. So, we feel very much on the top line side of the equation. S&D is off to a very good start indeed.

But, Tom, please comment on Eden Springs.

**Thomas J. Harrington - Chief Executive Officer, DS Services, Cott Corporation**

Yes. Derek, in terms of the biggest effort we've executed in terms of the synergy plan was the relocation of the headquarters, but I'm sure you can imagine we don't close an office in Switzerland on Friday and then open on Monday, so there is in fact a phasing.

All the communications with the affected associates have occurred. We actually opened the Barcelona office Tuesday of this week, so now we have a place for the new associates to go. So, we've enjoyed some benefit; we'll see more benefit in the future once we finally officially close the HQ in Switzerland in the next quarter or two and re-establish the HQ in Barcelona.



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The Eden team did a great job. These are tough things to do, but we actioned it at the end of the year and they've successfully executed the plan to-date in terms of that capture.

**Jerry Fowden - Chief Executive Officer, Cott Corporation**

Well, I hope that kind of fills in the gaps, Derek.

**Derek Dley - Analyst, Canaccord Genuity**

Yes. Thank you very much.

**Jerry Fowden - Chief Executive Officer, Cott Corporation**

Thank you.

**Operator**

Your next question comes from the line of Amit Sharma with BMO. Your line is open.

**Amit Sharma - Analyst, BMO Capital Markets**

Hi. Good morning everyone.

**Jay Wells - Chief Financial Officer, Cott Corporation**

Good morning.



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**Jerry Fowden - Chief Executive Officer, Cott Corporation**

Good morning, Amit.

**Amit Sharma - Analyst, BMO Capital Markets**

Jay, can you help us? Just remind us the commodity inflation outlook that you have and then how much are you building for in the model for this year? And any change …

**Jerry Fowden - Chief Executive Officer, Cott Corporation**

Well, I'll start with a comment on that and then perhaps Jay can add.

The vast majority of the commodity outlook we have for this year, frankly, Amit, is FX-related. We said that there's $12 million to $18 million of foreign exchange headwind this year by far, far and away dominated by the devaluation of sterling versus both the euro as well as the dollar. It's not just a dollar issue, and two-thirds of that $12 million to $18 million foreign exchange headwind presents itself in the form of higher commodity costs for those commodities that are bought in euro such as sugar, or dollars such as aluminium for the cans, that are then sold in our U.K. business. That's why Jay highlighted on the call that we now have firmly agreed price changes within the U.K. that will be implemented over the next two to three months such that by the time we get to the back half of the year, we will have mitigated that embedded impact of foreign exchange on the commodity costs in the U.K..



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Now, what I'll do is pass back to Jay because he did make some comments in his prepared remarks about the overall commodity landscape when you take FX out of the equation.

**Jay Wells - Chief Financial Officer, Cott Corporation**

Right. Amit, you got to look. We have about $900 million of commodity exposure overall in our Cott North America business and what I refer to is we're seeing some small increases in certain commodities like PET, which is being mostly offset by decreases in other smaller type of ingredients and packaging-type items, and also with some type of pressuring. So net-net with that type of spend, not modelling any type of significant net impact of commodities in my modelling.

**Amit Sharma - Analyst, BMO Capital Markets**

Got it. Then just a follow-up to that, and maybe perhaps for Tom, I mean coffee prices are increasing and still S&D had pretty good volume performance in the quarter. Are you seeing any or hearing from your customer any pushback from a volume perspective as you pass on these high coffee prices to them?

**Jay Wells - Chief Financial Officer, Cott Corporation**

Amit, it's Jay. If you don't mind, I'll answer that because I've been spending a lot of time on their hedging policies and other types of areas. What you've got to remember with 90 percent of our coffee volume, they're almost back-to-back type of agreements with our customers.



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We're basically hedging the price of coffee on their behalf and we hedge out, on average, is it six or is it 12 months? So when you look at movements in coffee, you really have to look a year out versus two years ago to really see where their coffee prices are going.

But it really is—we operate the business on a spread and that's really how we run the business. So coffee prices move up, coffee prices move down, but it really is our customer who is managing the hedging of it, the pricing of it, and we just work on a spread on the coffee. So, we're not seeing any issues or ramifications on it, and if you really look at, as I said, one year out versus two years out, actually the hedged price of coffee is down a little bit one year versus two years ago.

**Amit Sharma - Analyst, BMO Capital Markets**

Got it. Then last one from me. Tom talked about maybe pre-building some of the sales and route capabilities ahead of the volume increase in the back half. Can you quantify or help us think about, what would that mean in the first quarter from a higher investment perspective that gets better leverage in the back half?

**Jerry Fowden - Chief Executive Officer, Cott Corporation**

I'll let Tom think about the number. I say I cut my words, it gives you 30 seconds to work it out, Amit.



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I think you'll recall what we highlighted in our deep dive study towards the end of last year that we had identified the desire to increase our commercial customers, in particular, and that being the commercial customers that are up and down every high street or strip mall in the U.S. Not the massive national accounts, but the individual sole trading commercial customers like a tire shop or a hairdresser or a local attorney firm. What we're doing is we're adding back into our business 50 targeted salespeople designed to call on these small commercial stores in order to grow our single kind of sole trading commercial customer base.

Last year, we had down-weighted our focus there because we just had more customers, especially residential ones, through our booth program than we could cope with and we didn't want to pressure service more by adding in this area. But as we've adjusted our marketing programs as explained in our three-point plan, we've down-weighted the focus on residential customers and we're adding back in these 50 salespeople to focus on commercial customers only and their performance-based pay paid for commercial customer wins only. We believe that will have a cumulative effect because we look out not just over the next two to three quarters, but the next couple of years in re-shifting the mix of our commercial versus residential customer base.

Tom?

**Thomas J. Harrington - Chief Executive Officer, DS Services, Cott Corporation**



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If you stay with the 50 salespeople and as we onboard them in the first quarter, I really only have costs associated with them because I have to onboard them, I have to train them before they get productivity, so it's one of the reasons you would see our revenue weighted on the back half so that they have time to get in place, begin to generate the customers, and then give us the forward benefit of that revenue on the sales guys.

On the routes we've added, it's a difficult number because we had the friction cost from last year, but we have incremental routes and associates going in, so it's two parts to that story. Those routes are less efficient than others, but offset by efficiency in the other routes.

So it again becomes a phasing issue that there's more sunk costs early because if you can imagine those routes start with no customers, and by the time we get to the second quarter and the third quarter, we'll do what we said in the comments, is those routes will be full, and then we'll integrate them and get the benefit from that greater in Q3 and Q4.

**Amit Sharma - Analyst, BMO Capital Markets**

Tom, that's really helpful. Just one more. That $15 million represent what percent increase in your total sales force for DS? Sorry, 50 persons, I think, 50 people here.

**Jerry Fowden - Chief Executive Officer, Cott Corporation**

Yes. It's 50 people, not $15 million....



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**Amit Sharma - Analyst, BMO Capital Markets**

Right, right, right. Yes, okay. That would be—yes, okay.

**Thomas J. Harrington - Chief Executive Officer, DS Services, Cott Corporation**

Yes. So if you looked at all of the salespeople, it's something on the order of 8 percent to 10 percent.

**Amit Sharma - Analyst, BMO Capital Markets**

Okay.

**Thomas J. Harrington - Chief Executive Officer, DS Services, Cott Corporation**

But again, this is specific to commercial, so that work is 100 percent new versus what we did a year ago, and it's just incremental to what we do with the retail booth program and some of our...

**Jay Wells - Chief Financial Officer, Cott Corporation**

You've got to keep in mind, each one of our RSR is also a salesperson. They generate new customers.

**Thomas J. Harrington - Chief Executive Officer, DS Services, Cott Corporation**

Yes.



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**Jay Wells - Chief Financial Officer, Cott Corporation**

So when you count all them in, it's the overall small percentage.

**Thomas J. Harrington - Chief Executive Officer, DS Services, Cott Corporation**

Yes.

**Jerry Fowden - Chief Executive Officer, Cott Corporation**

The focus here, Amit, was as I referenced in that deep dive. We looked the lifetime of each customer in five different customer groups. We looked at the margin. We looked at the IRR, and out of all of that work we identified the kind of strip mall, single, sole proprietor commercial business as the most attractive when you put cost to acquire versus price, margin, the length of their retention all together, it gave us the best IRR, and hence, be adding the incremental sales force back targeted against that specific customer group. But I hope that kind of works well and four questions was enough, Amit.

**Amit Sharma - Analyst, BMO Capital Markets**

Absolutely. Thank you so much.

**Jerry Fowden - Chief Executive Officer, Cott Corporation**

Thank you.



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**Operator**

Your next question comes from the line of Mark Petrie with CIBC. Your line is open.

**Jay Wells - Chief Financial Officer, Cott Corporation**

Good morning, Mark.

**Jerry Fowden - Chief Executive Officer, Cott Corporation**

Good morning, Mark.

**Thomas J. Harrington - Chief Executive Officer, DS Services, Cott Corporation**

Good morning.

**Jerry Fowden - Chief Executive Officer, Cott Corporation**

Hello?

**Operator**

Mark Petrie, if you're on mute, please unmute. Your line is open.

**Mark Petrie - Analyst, CIBC World Markets**

Sorry about that. Good morning.

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**Jerry Fowden - Chief Executive Officer, Cott Corporation**

Good morning, Mark. Let's try again.

**Mark Petrie - Analyst, CIBC World Markets**

Yes. So my first question is just related to obviously you've shifted to more of a focus on the commercial customer, but for the residential customers that you added through the course of 2016, are you on track in terms of the payback period that you had articulated before of sort of under a year and a half?

**Jay Wells - Chief Financial Officer, Cott Corporation**

Yes. So if you look at the actions at one of our three-point plan, that customer profitability and pricing is an action to ensure that we get the returns that we would have expected. So discrete actions in the first two quarters, another action that will benefit from the third and fourth directed, frankly, at that segment. So we would expect to get to our historical return rates on that customer base.

**Mark Petrie - Analyst, CIBC World Markets**

Okay. That's helpful. And what was the absolute number of net customer adds for Q1?

**Jay Wells - Chief Financial Officer, Cott Corporation**



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Thirteen thousand-ish.

**Mark Petrie - Analyst, CIBC World Markets**

Okay. Thanks. Then just switching gears a little bit, on the traditional North America business, could you just give us a sense of sort of the competitive environment today coming into summer? I've seen some comments about price mix being beneficial. Are you seeing that, and how do you feel about that business coming into summertime?

**Jerry Fowden - Chief Executive Officer, Cott Corporation**

We don't really see a lot of change, Mark, in the kind of, let's call it, on-shelf pricing for the key categories that we're in. That is being put against the context of large-format or big-box retail stores, 12 packs of cans, 2-litre PET, where we have seen common promotional prices from the national brands being around $1 or $3.30, $3.40 on the 12 packs versus our pricing that's kind of mid $0.80 on the 2-litre and kind of upper end $2.65, $2.85 on the 12 packs. So, we've seen that pricing landscape stay pretty much the same.

Our strategy remains that growing our contract manufacturing business, which does have lower revenue but similar cash contribution per case versus our private label, and continuing to grow our sparking waters and mixes.



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It might have been missed, but Jay did comment that we had 5 percent growth in sparkling waters and mixes in the quarter, but we still do anticipate on a go-forward basis that category growing much closer to the 10 percent sort of level, just below or just above. It's really because if you remember, quarter one last year, we were doing the pipeline fill and big rollout and it had us scrambling on capacity for a major launch of a value-added and sparkling water that we're lapping in this quarter.

So, in the quarter, 9 percent growth contract manufacturing, 5 percent sparkling water, allowing us to keep case volume flat, and as we go forward, case volume being flat still the goal, but we're likely to see the mix be a little bit more leaning towards sparkling waters and value-added waters.

**Mark Petrie - Analyst, CIBC World Markets**

Okay. That's really helpful. Thank you very much.

**Jerry Fowden - Chief Executive Officer, Cott Corporation**

Thank you, Mark.

**Operator**

Your next question comes from the line of Judy Hong with Goldman Sachs. Your line is open.

**Freda Zhuo - Analyst, Goldman Sachs**



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Hi, guys. This is actually Freda on for Judy. Thanks for taking my question.

**Jerry Fowden - Chief Executive Officer, Cott Corporation**

You're welcome, Freda.

**Freda Zhuo - Analyst, Goldman Sachs**

Hi. So wanted to ask a question on the U.K. and U.K. profitability in particular. I think we were expecting a sizable impact from FX and the loss of the larger retail customers, but the underlying profitability still seemed to come in quite a bit below what we were expecting. Any kind of colour as to maybe what the underlying portion of the U.K. business was doing from a profitability perspective, how Aimia Foods is progressing? Any kind of colour on that would be helpful.

**Jerry Fowden - Chief Executive Officer, Cott Corporation**

Yes. And our U.K. business is a combination of what we might call our traditional business, so private label and value brands, also our cold fill lines, as well as our Aimia Foods powdered business. I think one point worth highlighting, just from some conversations we've had where some people might have missed it, is given the devaluation of sterling is nearly just as much versus the euro as it is versus the U.S. dollar, but this foreign exchange impact impacts all of our U.K. operating segment. It impacts the Aimia business as well as the traditional business.



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Aimia's commodities—predominantly sugar, cocoa, various powdered ingredients—are largely bought in euros, and our traditional business—sugar bought in euros, aluminium, PET resin—predominately dollar-denominated. So it's more than just an impact on the traditional private label business, and it's against that backdrop that we've set out, and I can say we have now agreed with all customers, changes to their pricing, which will progressively go into effect this month, next couple of months, such that by the second half of the year we believe that foreign exchange impact from the embedded cost of currency, both euro and dollar, will be fully covered by pricing. What that means is actually, when you get to the first quarter of next year and you compare it back to Q1 this year, we'll go into 2018 with favourability and overall margins that when you compare back to this first quarter that's been pressured that are up. So, that's one comment. It's the whole business and it's about euros as well as dollars.

Then on the underlying volume part of the business, we did highlight a year ago that we'd lost some business with one major customer and that that would be about 10 percent of our business. That business loss phases out by the end of Q2, so that by Q3, we will no longer have that comparative pressure of volume loss versus the prior year.

I guess the last point I'd say is we did say on our first quarter call that we expected about a $10 million overall—fourth quarter call, sorry—about a $10 million impact from this, and I think if you look



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at the results, it's pretty much in line with what we've said. Now, we know that wasn't universally picked up by everyone in their reports, but I would like to remind people that we did state it very clearly.

**Freda Zhuo - Analyst, Goldman Sachs**

Okay. Got it. Then I mean if we turn back to DSS Services, clearly a better underlying profitability performance with operating income up 37 percent in the quarter, you're also lapping kind of like the $3 million to $4 million, I guess, as additional customer costs from this time last year. Are there any other kind of additional kind of customer signup costs that you would call out for the balance of the year? I understand that the customer adds are lower this quarter, but any kind of abnormal cost that you would call out?

**Thomas J. Harrington - Chief Executive Officer, DS Services, Cott Corporation**

Well, Freda, this is Tom. Certainly, in the first quarter and a bit, it's about the investment we're making to enable the future growth. So year-over-year, we're still investing and ensuring that we can onboard them, albeit less, as you point out, but to do this in an orderly fashion that will give us the future benefit of revenues at a more normalized cost as we progress through the year.

So that three-point plan, really think about it as a very highly disciplined approach to execution to make sure we stabilize the performance, obviously improve the performance, deliver the $20 million we committed to over the course of the year.



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**Freda Zhuo - Analyst, Goldman Sachs**

Okay. Got it, and just one more in terms of the customer adds. Was there any change in terms of the underlying demand that you saw? I know last year you called out some of the municipal water issues really boosting demand in that segment. Are you still seeing that trend continue this year even if you're being more disciplined in terms of the additional customer sign-ons?

**Thomas J. Harrington - Chief Executive Officer, DS Services, Cott Corporation**

Yes, Freda. I think in our fourth quarter call and late last year, we talked about somewhere between zero growth and 60,000 of growth lies the right answer and we've built a business that is neither of those in terms of the model, so we're frankly managing a bit of the growth. The demand for water continues and we just don't want to outgrow our ability to properly execute and avoid the friction cost that we incurred last year.

**Jerry Fowden - Chief Executive Officer, Cott Corporation**

I think, Freda, I remember we had a conversation last year that we would be trying to calibrate and set where our overall desire was for net new customer growth this year, and we targeted somewhere between 15,000 and 25,000 net new customers versus the 55,000 that swamped us a bit last year, so we have planned for fewer customers.



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Part of that plan has been a lower number of retail booth events in the first quarter of this year, which we will increase because the payback and the demand is stronger in the summer, and then we will add these new 50 commercially-targeted salespeople for the summer.

So we have built a different shape, a different phasing, and a different target number of new customers, all designed to provide better service, improved profitability, and we think so far that's running pretty much to plan.

**Freda Zhuo - Analyst, Goldman Sachs**

Great, thanks.

**Jerry Fowden - Chief Executive Officer, Cott Corporation**

Thank you, Freda.

**Operator**

Your final question comes from the line of Carla Casella with JPMorgan. Your line is open.

**Carla Casella - Analyst, JPMorgan Securities**

Hi. I was wondering if you could talk a little bit more about just the private label environment in the U.S. and if you're seeing a lot of other, I guess, proposals from retailers or retailers putting out bids



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for private label suppliers. If you're seeing any of the branded players get into this and if it varies dramatically between juices and carbonated soft drinks or even the water business.

**Jerry Fowden - Chief Executive Officer, Cott Corporation**

Yes. Overall, I think as we've tried to highlight and explain, our focus for the last three years now has been keeping our kind of North American traditional business volumes stable. It's an area where our desire is not to invest new capital to grow that business, because when we look at investing new capital we believe there are higher returns for our shareholders, investing that capital in growth for water, coffee, tea and filtration solutions.

So for three years on the trough now we've kept our case volumes flat within that area. We've just done it again this quarter, and we see that flat top line volume—it can be plus or minus a couple of percent in any quarter, but broadly flat, continuing as we look out over the next several years, and we have a very high free cash flow yield from that traditional business, which has been our focus and has been what we've been communicating to our investors.

But back to the kind of trading environment, albeit our strategy, let's say, is slightly different to that generic trading environment, we have not seen any meaningful step change in behavior or approach this last quarter or the quarter before compared to where we were this time last year. It's a competitive market, yes, but if your customer service is good, your lines are efficient and well invested



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in and you listen to your customers' preferences, then that's the way to be successful in this business, and despite the declines in the overall categories, our strategy has allowed our volume to stay flat.

**Carla Casella - Analyst, JPMorgan Securities**

Okay, great. I guess have you seen anything on the online side? We've seen a lot more of these retailers going direct with Amazon and other—Jet—replenishment-type services. Do you interact with them as well or is your private label still focused mostly on the retail side?

**Jerry Fowden - Chief Executive Officer, Cott Corporation**

We do have some interaction with them, but let's try and be clear. A case of soda is about $4. At 24 cans, it weighs quite a lot. It's pretty low down the pecking order of where any of these online businesses are really focusing. So, we do have involvement and we do have relationships with those people, but our category is not their priority.

I think what's more interesting and more important on our DS Services side of the business, where we've got 2,100 routes that cover over 90 percent of U.S. roads and streets and populations, we do act as the fulfillment agent and as the distributor for other premium brands as well. One good example of that would be we took on the rights to both fulfill their orders and distribute and sell ourselves for VOSS water, which is a nice, over $35 a case water product that very much means we're



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just as comfortable selling that because of the margin opportunity as we are our traditional 5-gallon jugs of water for the water coolers.

So I think having a 2,100 fleet of trucks that call on small offices, home offices and residences actually puts us in a good position when it comes to fulfillment requirements for home delivery. We just want to make sure we pick the products that fit our business model and allow us to make a nice margin in that process.

**Carla Casella - Analyst, JPMorgan Securities**

Great, that's helpful. Thank you.

**Operator**

That concludes today's Q&A session. I'll now turn the call back over to Jarrod Langhans for our closing remarks.

**Jarrod Langhans - Head of Investor Relations, Cott Corporation**

Thank you very much for joining our call today. This will conclude Cott Corporation's first quarter 2017 call. Thanks for attending.

**Operator**



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This concludes today's conference call. You may now disconnect.



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