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Cott Corporation

Second Quarter 2017 Earnings Conference Call

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CORPORATE PARTICIPANTS

Jarrod Langhans
Cott Corporation — Head, Investor Relations

Jerry Fowden
Cott Corporation — Chief Executive Officer

Jay Wells
Cott Corporation — Chief Financial Officer

Thomas Harrington
Cott Corporation — Chief Executive Officer DS

CONFERENCE CALL PARTICIPANTS

Nik Modi
RBC — Analyst

Derek Dley
Canaccord — Analyst

Amit Sharma
BMO — Analyst

Mark Petrie
CIBC — Analyst

Judy Hong
Goldman Sachs — Analyst

PRESENTATION

Operator

Welcome to Cott Corporation's second quarter 2017 earnings conference call.

All participants are currently in listen-only mode.

This call will end no later than 11:00 a.m.

This call is being broadcast live on Cott's website at www.cott.com, and will be available for playback there until August 17, 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 US 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 in this call with the most comparable measures in accordance with GAAP is available in the company's second quarter 2017 earnings announcement released earlier this morning, or on the Investor Relations section of the company's website at www.cott.com.

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

Jarrod Langhans — Head, Investor Relations, Cott Corporation

Good morning, and thank you for joining our call. 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 recently announced transaction, as well as our operations thus far in 2017 relative to expectations before turning the call over to Jay for a discussion of our second quarter consolidated financial performance and an overview of our traditional business.

Tom will them cover our water and coffee solutions segment before handing the call back to Jerry to provide some additional comments on our recent transaction, as well as this thoughts on our go-forward business. 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, everyone. As most of you know, we have a lot to talk about this morning, not just with our Q2 results, but also with the announcement just last week that we'd entered into a definitive agreement to sell our traditional beverage manufacturing business to Refresco for US$1.25 billion in cash.

This transaction excludes the RCI International division and its associated concentrate facility in Columbus, Georgia, as well as Aimia Foods in the UK. Following the close of this transaction, Cott, or shall I say New Cott, would be a focused water, coffee, tea, and filtration business, with approximately $2.2 billion in revenue, just under $300 million of EBITDA, and around 110 million to $115 million in free cash flow.

While we will expand more on New Cott's pro forma profile later during this call, it's important to note that New Cott will be well-positioned to grow its top- and bottom-line performance over the coming years.

We envisage New Cott growing revenues in the 2 to 3 percent per annum range while also benefitting from continued small tuck-in acquisitions, such that 2019 free cash flow should be around $150 million.

We will expand further on this topic later, but for now I'll turn my attention to our Q2 results.

As I look at our second quarter's performance, I think the best way to describe it is a quarter with a stronger top line than we expected and continued strong free cash flow generation, but limited by certain factors such as adverse foreign exchange and some nonrecurring costs within our traditional business during the quarter that impacted our EBITDA.

I believe key highlights of the quarter can be summed up as follows: around 4 percent revenue growth for our water and coffee solutions segment, with DS Services delivering on its improvement plan; good performances from both S&D Coffee & Tea, as well as Eden Springs, where

S&D's coffee volume increased 13 percent and Eden Springs's organic customer growth improved significantly with 6,000 net new customers in the quarter; 1 percent actual case volume growth across our total traditional beverage business with an earlier-than-expected return to volume and revenue growth in the UK; continued adverse foreign exchange that should subside as we go through the back of the year; and the presence of certain nonrecurring costs limiting EBITDA in our traditional business during the quarter that Jay will expand on later.

All this alongside continued improvements in gross margin and free cash flow contributed to our results this quarter.

On that note, I'll turn the call over to Jay to cover our financial results in more detail and the performance of our traditional business.

Jay Wells — Chief Financial Officer, Cott Corporation

Thank you, Jerry, and good morning, everyone. As Jerry noted, this quarter's consolidated results saw a stronger top-line performance, especially within our traditional business, as well as good free cash flow generation.

Against this backdrop, consolidated revenue increased by 33 percent to just over $1 billion, 35 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, offset in part by the adverse impact of FX, predominantly as a result of the devaluation of pounds sterling versus the US dollar.

Gross profit increased 36 percent to $342 million, driven by the additions of Eden and S&D, offset in part by adverse foreign exchange rates and certain nonrecurring costs within our traditional business.

Adjusted EBITDA increased 13 percent to $122 million, due primarily to contributions from all of the businesses that make up our water and coffee solutions segment, offset in part by $6 million of adverse foreign exchange and certain nonrecurring expenses within our traditional business.

As Jerry noted, free cash flow saw good growth in the quarter at 29 percent, and subject to a required change in our accounting treatment as a result of the Refresco transaction, we continue to be confident in delivering 155 million to $175 million of adjusted free cash flow in 2017.

That said, our traditional business will need to be accounted for as an asset held for sale going forward, and this will make the reporting and tracking of this target somewhat more difficult because the free cash flow generated by our traditional business will no longer be included in our free cash flow from operations.

So looking to the back half of 2017, we will only report free cash flow from operations of our retained businesses, which may include interest expense associated with debt we intend to redeem with proceeds from the sale of our traditional manufacturing business.

While this is all rather technical and complex, the most important thing to note is that our free cash flow performance year to date has been strong, and if not for this required accounting treatment, we are and would be comfortably on track to meet our 155 million to $175 million of adjusted free cash goal for the year.

One other point to note during the quarter was our refinancing activity. As you know, we issued $750 million of senior notes at 5.5 percent in Q1 of this year, but due to the timing of the issuance and the subsequent payoff of the entire $625 million of our 6.75 senior notes, as well as redeeming $100 million of our 10 percent senior secured notes, we had some restricted cash on our balance sheet at the end of Q1. This cash was then used to fully pay off the $625 million of our 6.75 notes, as well as the $100 million redemption of our 10 percent notes, resulting in approximately $19 million of net expenses during the second quarter.

So with that said, let me 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 strong growth and value added in sparkling water of 12 percent, as well as contract manufacturing growth of 33 percent, allowing the overall business unit to grow actual case volume by 2 percent despite continued market declines in carbonated soft drinks and shelf stable juices.

We continued to anticipate that growth in value added and sparkling water, as well as contract manufacturing, will offset declines in other areas. Cott North America's revenue was down 1 percent at $345 million due to the ongoing mix shift towards contract manufacturing within the business. Albeit with the volume growth we saw in the quarter, this mix shift was largely offset versus the impact this mix shift had on prior quarters.

Our gross profit saw pressures of around 5 million to $6 million during the quarter, driven by a couple of key items. First, in order to maintain our best-in-class service and accommodate new contract manufacturing wins, we worked diligently to make sure all of our facilities and manufacturing lines received the appropriate upgrades and maintenance that's needed.

As a result, we took a number of lines down during the quarter to accommodate this work, leading to higher freight and production costs per case, and inventory levels were significantly reduced during this period, resulting in higher overhead per case.

Although this activity puts some pressure on our quarterly results, the investment will allow for new customer wins to be better accommodated, and we will have a more effective production system. We'd expect to recapture a portion of these costs in the coming months as we rebuild inventory across our network.

Second, on commodities we have mentioned over the last few quarters that we were beginning to see some pressure on a net basis as small declines in certain categories were projected to more than offset—be offset by increases in other categories. We began to see some commodity inflation in Q2, which may subside over the coming months as oil has retreated, that slightly squeeze margins in our Cott North America operations.

We will monitor these areas closely, and if commodity pressures return or continue, we will implement pricing initiatives to offset its impact in a similar manner that was just completed in the UK.

And looking to SG&A, we reached a legal settlement of around $2 million during the quarter that will not reoccur in the future. Excluding this settlement, SG&A was roughly in line with the prior year.

All in all, we were very pleased with the top-line progress that our Cott North America business unit made during the quarter, and we believe the business is well set up for the back half of the year.

Now turning to the UK. On our last earnings call we stated that we expected to see continued adverse foreign exchange within our UK operations in addition to lower volumes. However, our UK operations top line performed much better than expected, with volumes increasingly slightly and 6 percent growth in local currency revenues.

On a more disappointing note, our UK operations undertook some voluntary product withdrawals during the second quarter in order to uphold our exacting quality standards, and these actions drove increased cost in areas such as product retrieval, product write-offs, and product rework. With that said, we have worked through these issues, and these nonrecurring costs should not impact the balance of the year.

With the UK volume pressure now largely behind us and the appropriate pricing actions to offset sterling's devaluation have been fully implemented, we are now well set to see progressive improvements in our UK's operations top and bottom lines as we go through the second half of the year, and we expect to be in a position of both EBITDA and revenue growth by Q4.

I will now hand the call over to Tom to cover our water and coffee solutions segment.

Thomas Harrington — Chief Executive Officer DS, Cott Corporation

Thank you, Jay, and good morning, everyone. Let's start with DS Services, where we saw the business continue to track in line with our 2017 improvement plan.

Revenue was up over 2 percent at $281 million. If you exclude a $2 million noncash true-up entry for a change in the way we calculate our bottle deposits then we would have seen revenue growth of around 3 percent in the quarter.

Our EBITDA was up during Q2, in line with expectations, and again if you exclude the true-up entry I just mentioned, it would have been up even further. This brings first-half EBITDA growth in line with our 2017 improvement plan, where we anticipated about one-third of the benefit coming in the first half, with the remaining two-thirds coming through in the second half.

From a customer perspective, we ended the quarter with 19,000 net new customer additions comprised of 4,000 organic additions, with the balance coming from tuck-in acquisitions completed prior to the end of the quarter. We believe this puts the business in good position as we move to the back half of the year.

We continue to work on and improve the phasing and execution of our marketing efforts within both our retail booth program and our drive to improve commercial customer sign-ups via the recruitment of additional commercial-only focused salespeople. All in all, I believe we are well on track with our recovery program, and we will see further improvement as the year progresses.

As an update to the status of our three-point improvement plan, you'll remember first, customer profitability and pricing. Our more controlled customer growth plan for 2017 is on track.

We are not seeing the inefficiencies that came through in 2016. In addition to the regular customer anniversary pricing that we take, we have fully implemented the other pricing actions we identified as part of our improvement plan, and we continue to bring on new sales associates. We've recruited 45 thus far to focus on commercial customer growth in key high-density areas, with a focus on customer service, route density, and profitability.

Second, sales, marketing, and logistics. With our pre-mapped targeted sales and marketing initiatives, we now have new routes and route sales representatives in place in advance of our marketing efforts in each region.

This has enabled our current routes in these areas to not be negatively impacted as the new customers come on board. In addition, we are focusing our efforts in the periods and channels where we see the highest return and success rates in order to maximize our marketing expenditures. The results thus far have been in line with expectations, and we believe that we are firming up on a program that can be utilized on a go-forward basis.

And third, further executing Cott's four Cs. We've 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 profit growth target for this year.

As we look out over the next two quarters, we remain confident in delivering on 2017's 3 percent revenue growth goal, which you recall come roughly 2 to 3 percent in the first half of the year, followed by 3 to 4 percent growth in the back half of the year based upon the phasing of our marketing activity, the timing of our pricing actions, and the optimal sourcing of our water inventory to avoid certain case-back water inventory issues we had in the back half of last year.

Now before I move on to Eden and S&D, I'd like to spend a few minutes on an acquisition completed in the quarter, Remington Pure. In line with DS's strategy of expanding on water filtration, we acquired a small filtration company during the quarter called Remington Pure.

While Remington is a relatively small filtration business with approximately 12,000 filtration customers, it owns an impressive range of intellectual property that cover patent-protected technologically advanced water purification systems.

These multiple intellectual property patents mainly cover long-life, environmentally friendly water filtration devices and associated technologies for use in the water filtration market. This technology, which offers the potential for attractive synergies across much of our existing filtration customer base, will be rolled out over the next three to four quarters after we have expanded the manufacturing and availability of the technology.

Now turning to Eden and S&D. We were again pleased with the results both at Eden and S&D, and we remain excited about the platforms that we're building in HOD water, coffee, tea, and filtration.

Both businesses are either tracking in line with or ahead of our acquisition models. During the quarter, Eden delivered revenues of 104 million and saw 6,000 net new organic customer growth, up from 600 last year. This organic customer growth, plus a couple of very small tuck-ins completed prior to the quarter's end, saw our total customer numbers approximately 2 percent higher than the prior year.

In addition, Eden continues to track ahead of plan in relation to integration and synergy capture, as noted in our investor presentation last week. During the quarter, our senior management team was able to see this integration and synergy capture in action, as we visited with Eden's leadership team for the opening of our new Barcelona corporate facility, which replaces one in Switzerland and will both lower SG&A costs and drive faster decision-making.

We also continue to see many opportunities whereby our HOD water and coffee business can work together to drive future growth.

Turning to S&D, it delivered strong revenues of $153 million during the quarter and continues to make good progress on its integration and synergy capture targets. The strong revenue performance at S&D reflects 13 percent growth in pounds of coffee sold during the quarter, and continued excellent performance within ingredients and extracts sales.

In addition, as many of you know, we hosted a number of analyst investors at our S&D conference facility in June, and were able to showcase the great depth, knowledge, and skill level of the S&D management team, as well as the planned capacity expansion scheduled for late 2017 to support further business growth.

And looking out for the remainder of the year, we continue to believe that both S&D and Eden are on track to meet or exceed their top-line and bottom-line acquisition model growth targets.

I will now turn the call back to Jerry.

Jerry Fowden

Thank you, Tom. Your Q2 update clearly shows the good performance and outlook for our water and coffee solutions segment.

So now on that note, let’s go back to review in a little more detail the transaction to sell our traditional beverage manufacturing business, why it’s a great example of 1 plus 1 equals 3 that benefits all parties, what the conditions to closing are, what the profile of New Cott after the transaction is, who might appropriate peers be for this new-look company, and how New Cott should be viewed or valued as we look to the future.

First, the transaction. We announced on July 25 that we had entered into a definitive agreement to sell our traditional beverage manufacturing business, known as Cott Beverages, to Refresco, who trade on the Euronex under the ticker RFRG for US$1.25 billion in cash.

This transaction is structured to include our Cott North America, UK, and Mexico businesses, which represent about $1.7 billion in revenue, and excludes RCI International and our RC brand rights and its associated concentrate manufacturing plant in Columbus, Georgia, as well as the Aimia Foods business in the UK, which is extremely complementary to our Eden operations in the UK.

I believe this is a very attractive transaction for all stakeholders, including the traditional business customers who will benefit from better customer service, an improved manufacturing footprint, reduced freight lanes, and an expanded product and packaging portfolio. It really is a good example of 1 plus 1 equals 3.

As Hans Roelofs, Refresco's CEO has stated, this transaction is a significant enhancement to their buy-and-build strategy that adds 29 manufacturing facilities and over 4 billion litres to their system, reinforcing their position as a leading independent bottler for retailers and A-brands.

The transaction not only strengthens and builds their existing operations via an expanded manufacturing footprint and their large product and packaging portfolio alongside enhanced customer relationships, but it also offers significant synergies to underwrite their investment and enhance shareholder returns, an area where their management team has a successful track record of delivery.

With that said, a number of steps are required prior to closing, including Refresco's shareholder approval on September the 5th, and customary regulatory approval. We would anticipate the transaction closing towards the end of the second half of 2017.

Once closed, or let's say on a pro forma basis, the profile of New Cott will be as follows: a company with approximately 2.2 billion in revenue, just under $300 million in adjusted EBITDA, and around 110 million to 115 million of free cash flow; a company with an attractive corporate structure, retained tax assets, and low cash taxes alongside strong free cash flow growth profile; a focused water, coffee, tea, and filtration services company; a company that is positioned in growth markets with just under 50 percent of revenue in water, around 40 percent in coffee and tea, and around 10 percent in filtration and other products and services; a company with a 2 to 3 percent top-line growth per annum, and one that is predominantly a route-based services company—over 70 percent of New Cott revenues being route-based; a company with very low customer concentration—in fact, over 2.3 million individual customers; a higher-margin company, with gross margins around 50 percent and EBITDA margins above 13 percent; and a company with significant opportunities to continue with further accretive, small tuck-in customer acquisitions and other complementary overlapping transactions.

All in all, the transaction is expected to improve top-line growth and predictability, enhance gross profit and EBITDA margins, significantly reduce net leverage, reduce customer concentration, reduce commodity exposure, and increase the company's valuation.

So let's look at this topic of valuation for New Cott in a little more detail, especially as we look to the future when it will be appropriate to look at New Cott as a route-based services company with an attractive corporate structure. This business portfolio and its structure is best valued via a free cash flow yield methodology, as that methodology best recognizes the benefits of our corporate structure and favourable tax assets and cash tax outlook.

Also, as a route-based services company after the transaction, we will in effect have a new group of route-based services peers. Companies such as Aramark, Fintesk (phon), Service Master, and several others that if you look at them collectively tend to be valued on free cash flow yields in the 3 to 5 percent range.

In fact, if you look at the data we supplied in our recent investor presentation still on our website, it showed the average route-based services free cash flow yield for valuation purposes is around 3.2 percent. But let's not use that figure for now, as we have a way to go and it takes time for significant change to settle in and be fully recognized by the market. So let's use a 5 percent free cash flow yield for now in an attempt at valuing New Cott.

If you consider our 2019 $150 million estimate of free cash flow, the 5 percent free cash flow yield just mentioned and the fact that we have approximately 140 million shares, you have a valuation outlook for New Cott comfortably above $20 per share.

Whatever free cash flow metric you use, you can see the potential for value creation is significant once the market fully recognizes the profile and characteristics of New Cott as a much more focused, growth-oriented business with attractive free cash flow characteristics.

However, I know we first have to close the transaction, deliver on our 2 to 3 percent top-line growth, and the $150 million of 2019 free cash flow. But these calculations do in a very simple manner lay out the prospects for New Cott.

What's more, I am personally committed and have been for many years now to getting Cott, or New Cott, on a long-term attractive and sustainable path for all our shareholders who have invested in and supported our transformation from a private label soda pop company to an international route-based services leader in water, coffee, tea, and filtration.

With that, I'll now pass the call back to Jarrod for Q&As.

Jarrod Langhans

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 per person. Thank you for your time.

Operator, please open up the line for questions.

Q&A

Operator

Certainly. As a reminder, if you would like to ask a question, press *, then the number 1 on your telephone keypad.

And your first question comes from Nik Modi from RBC. Please go ahead.

Nik Modi — RBC

Yeah. Thanks. Good morning, everyone.

Jerry Fowden

Good morning, Nik.

Nik Modi

Good morning. Couple questions; one for you, Jay, on the cost of capital. Can you just give us some thoughts on how you think your cost of capital on the debt side is going to look now that the company's obviously going to be a lot less levered and you're obviously taking out a lot of expensive debt? So that's just the first question.

And then the second question really comes down to the cross-sell and just kind of where we are in that process. Maybe, Jerry, if you can give us an update on that? Thank you.

Jay Wells

On the cost of capital, I mean you really look at post this transaction we're going to have two long-term tranches of debt, senior notes unsecured with fixed interest rates, and it's the €450 million we issued as part of the Eden acquisition at 5.5 percent. And that is a good long-term fixed debt which also provides us with a little bit of an FX hedge on that.

And then you look at the 750 million we just issued to the refinancing at, again, 5.5 percent long term. And those are two tranches of debt we're not looking to take out, so you could really look at cost of debt being about 5.5 percent. Now for anything future-type offerings, one would think as we're deleveraging and become a more predictable business, overall our ratings should improve and our cost of debt should go down.

Jerry Fowden

And picking up on the second part, Nik, as you know, we did launch a range of sparkling unsweetened waters manufactured in Cott's traditional facilities and sold through the DS Services fleet within the US. And those sales will have continued after this transaction as we will continue to buy those products under a TSA from Refresco.

In addition, and I think we might have mentioned this in the past, we took on the distribution rights for Voss last year, and that's also been added to and been a successful addition to our portfolio.

As we look forward, we have now agreed the transfer of all our coffee program from S&D supplying the coffee to DS Services instead of an outside third-party supplier. And that will go live in Q4 of this year and not only lower costs and provide those internal benefits from vertical integration, but improve the profile range and quality of coffee that DS Services can offer its customers.

In addition to that, we now have several thousand of our AquaCafé R, the smaller $200-odd combined bottom-loading water cooler within integrated single-service Keurig coffee machine within it placed within the marketplace. About two-thirds of those machines placed are incremental new placements, but obviously with a customer where we are supplying both water and coffee. And we have an additional 10,000-plus of those machines scheduled to arrive within the US before the end of the year.

So if you think we used to carry around 25,000 combined water and coffee customers, the placing of several AquaCafé Rs in just the last quarter, 10,000 more to go in as we look towards the end of the year, that will be a significant improvement, and we see is a key strategy in increasing this cross-sell opportunity.

So we have the various plans. I think we have to accept the AquaCafé for a number of a technical reasons took longer to get off the ground than we all would have liked, but it's also very pleasing to see that it's now going well, and that two-thirds of the placements are incremental brand-new customers to both water and coffee.

Nik Modi

Excellent. Thank you, gentlemen. I'll pass it on.

Jerry Fowden

Thank you.

Operator

Your next question comes from the line of Derek Dley from Canaccord Genuity. Please go ahead.

Derek Dley — Canaccord

Hi, guys.

Jerry Fowden

Good morning, Derek.

Derek Dley

Good morning. Just a question on S&D, and this is has been the second quarter in a row we've had really robust volume growth on the coffee side. Can you just speak to some colour on this. Is it mostly organic? Is it new accounts? A combination of the both?

Jerry Fowden

I would say there's two key areas that contribute to it, Derek. One, as you know, we had in the pipeline a number of new customer wins, incremental business in 2017 over 2016. And they have and are coming on board, and that's benefitted the coffee volume in particular.

But I think as you and a number of people saw on our S&D Analyst and Investor day in early June, we'd also had a very, very attractive track record in our liquid extracts area of the business. And I'm very pleased to say that those very significant high-double digit growth rates within ingredients and extracts have continued.

And in fact just as a little aside, Derek, we were up there just earlier this week and we tasted a craft beer that was using S&D's extract within it that was named on the label of the can. And we have two or three other projects that are in that space in the pipeline. So the ingredients and extract business continues to also grow well, and that grows across a whole spectrum of customers, both quick service restaurants, as well as food processors that wish to use them within the production of new items for themselves in addition to the whole growth in cold brew and other uses for ingredients and extracts.

So strong new customer growth in bean and ground coffee, and very high growth rates within ingredients and extracts.

Derek Dley

Okay. Great. At DS in terms of your three-point plan, I think the cadence you kind of mentioned earlier in the year was a third of that 20 million in incremental EBITDA in the front of the half of the year and the remainder in the back half. Are you still on track for this? And can you comment on just some of the initiatives, whether it be pricing, that have helped contribute?

Thomas Harrington

Yeah. Derek, this is Tom. Good morning. We put the three-point plan had three components: customer profitability and pricing, sales marketing and routing, and then further execution of four Cs, which was a real focus on operating efficiency, both on the route side and in production. And I'm happy to report we've made the progress we expected against each of those initiatives. We delivered the roughly one-third improvement we expected in the first half. We said 2 to 3 percent revenue growth in the first half, we expect 3 to 4 in the back half, and then we'd expect two-thirds of the EBITDA to come in the next two quarters.

The pricing is in place, our ability to better service customers is in place, and now it's just continued execution of the plan that we laid out some six to eight months ago.

Jay Wells

And, Derek, Tom referred to it a little bit—and since I'm over the accounting for things, I will take this one—is that we did have a change in estimate for how we accounted for the customer deposits, which did give Tom's top line and bottom line some additional headwinds, and we still delivered within that plan. If it wasn't for that change in accounting, we would have delivered well above that plan in the quarter.

Derek Dley

Okay. That's good to know. And then just one last one, if I can, and since I've got Jerry and Tom already, maybe this one'll go to you, Jay. Just on FX; it's been a major headwind for the last three years. I think you guys commented on your last call you'd expected the bulk of the FX challenge this year to happen Q1 and Q2. So heading into Q3 and Q4, I mean should we start to see that really start to disappear and become immaterial?

Jay Wells

Yeah. Since you directed it to me, I will start, but Jerry always has a lot to say on Brexit and the effect on FX, as you know. So if you can really recall, there were two different drops. One was the initial drop in July of last year, and the second drop, Jerry, was ...

Jerry Fowden

Late September when it went from the kind of low 130s to the low 120s.

Jay Wells

Right. So we have lapped the first significant drop, but it really isn't until that point in time that we will have fully lapped it. Now on that—and that will really still continue to affect a little bit of the translation of results.

The good news on the transactional side, we have implemented all the pricing to offset the increased cost of commodities because of that. So the overall impact of transactional and on local currency, profitability, and revenue, that basically has been offset with pricing. But we'll still in third quarter see a little bit of effect on translating the UK results from pound to dollars.

Jerry Fowden

Yeah. And I think the only thing I'd add, because I think Jay's covered that very well, is about two-thirds of the FX impact comes through in that kind of hidden commodity cost when commodities are bought in one currency and sold in another. There we feel pretty good that the implemented pricing in the UK that you really already saw starting to come through, but it will be fully in place for Q3, has made a difference there. Because volume was up 1 percent within the UK and local currency revenue was up 6 percent, so you can start to see the real benefits of that pricing action come through in the reported results. And that will be even clearer in the third quarter.

So the two-thirds of that foreign exchange sterling impact we can now say is taken care of and will not be present in Q3 and Q4. And it leaves us this little bit of year-over-year translation of earnings, which will be still present in Q3, but should be by the time we get to Q4 looking at current exchange rates about the 130, 131 mark, that should no longer be present in Q4.

So I think the whole landscape there is starting to look much better. When you consider we've had a three-year foreign exchange drag of $47-odd million, it's just nice to think what this business could do going forward if we no longer have any foreign exchange drag.

Derek Dley

Okay. Thank you very much.

Jarrod Langhans

Thanks, Derek.

Operator

Your next question comes from the line of Amit Sharma from BMO. Please go ahead.

Amit Sharma — BMO

Hi. Good morning, everyone.

Jarrod Langhans

Good morning.

Jerry Fowden

Good morning, Amit.

Amit Sharma

Jerry, forgive me if you addressed this in your prepared comments. Just talking about the Refresco deal and the breakup fee for that deal is relatively light, and especially if you think about Refresco was approached by a private equity buyer a few months ago. Can you talk about that? And then just perhaps what plan B is if that player reemerges? And how does it impact their intention or appetite to still go with this deal?

Jerry Fowden

Yeah. And I think the first thing, Amit, is when you talk about breakup fees is which end of the telescope are you looking through? And what do I mean by that? I think in your write-up you mentioned 1.6 percent that would increase by a percent if there was any subsequent change of control at Refresco if the deal didn't go through, and you compared it to a market average of 2.8 percent.

From all of the data we have, 1 to 1.5 percent is about the range of breakup fees for European companies, and the situation is more like 3 to 4 percent with US companies. So if you're looking at this from a European perspective, then 1.6 percent is higher than the average, and of course that has to be justified to all the European investors of Refresco. And if you're looking at it from a US perspective, that's where I think you're right, it could be seen as a little bit light.

I think you have got to remember that we have commitment from Refresco management to vote in favour. We have pre-irrevocable commitments from a proportion of the shareholders to vote in favour. I think the market sees the strategic benefits of this, and obviously there were a few shareholders in there that were linked to short-term investors against the PAI transaction that are probably largely out by now. And that's perhaps reflective in the Refresco stock price creeping up over the last few days, and holding some nearly €3 above the pre-PAI price, but now based on fundamentals of the long-term outlook for that business rather than speculative transaction.

So back to the start of the question, against a European perspective it's a pretty reasonable and at the upper end of things break fee.

Jay Wells

Yeah. And, Amit, you look at Refresco's strategy, this transaction is square right in their strategy. I mean, we've been talking for them for over ten years, give or take, on all different options because this makes so much logical sense for these two businesses to combine. And we were in talks with them before anything on PAI came up. Management's 100 percent behind it, and really sees this as the future of the company.

Amit Sharma

So you believe, Jerry, that—I mean maybe it's speculation entirely, but even if PAI were to come in, the strategic or attractiveness of this deal is still—could still be—

Jerry Fowden

Yeah.

Amit Sharma

Still be? Okay.

Jerry Fowden

I think strategically financially it's very attractive. There's substantial synergies for them. But I think—look, it's not quite right for me to put words in Hans's mouth, but on the other hand I don't need to because he was very clear on this on his investor call. This transaction had nothing to do with defence against PAI. They saw it as a very attractive transaction that fits their well-declared strategy of buy and build, and it's significantly value enhancing for all parties.

As I said earlier on, and I can't put it any simpler—and I like to keep things simple—this is a real 1 plus 1 equals 3. Customers benefit, both companies benefit, and you have an enhanced overall larger manufacturing platform that if you just think of freight lanes on average has more plants closer to end-using customers, so the retailers and the end consumers benefit from this transaction from lower freight lanes.

Amit Sharma

Got it. And just one more for me on S&D; again, double-digit real growth gain, but as we look into '18, can you just remind—and Tom mentioned—can you remind us what percent of new capacity is being added? What's the pipeline for customers to absorb that excess capacity? And then where margin structure is today for S&D? And where could it be once you have fully absorbed the excess—or non-excess of new capacity?

Thomas Harrington

Yeah. Amit, this is Tom. Good morning.

Amit Sharma

Good morning.

Thomas Harrington

I'll take the first part of that. Work is in process to put additional capacity on in 2017, and it will give us the ability to roast another 20 million pounds once that is finally put in place later this year.

Jay Wells

And as you saw in the tour, there's structures, there are footprint, there's an ability to add another three roasters very easily in the new facility that they set up a couple years ago. So they have plenty of room for even further expansion above the current roaster that they're installing.

Amit Sharma

And, Jay, any idea of—

Jerry Fowden

And—

Amit Sharma

Sorry, go ahead.

Jerry Fowden

Not to pile on, Amit, but when I was up there on Monday, Tuesday, I think you might remember we sat in an attractive control room where there was the multicoloured manufacturing chart, and right next to it there were a load of canopies up. Well, those canopies were hiding where the new line was going in.

Those canopies are now down. All the vessels for holding the coffee beans are in place. It's all coming along, and we would expect that line to be in production by Q4 of this year. So there's a kind of update from Monday, Tuesday this week.

Sorry, Jay.

Jay Wells

You want to hit on margin?

Jerry Fowden

Our margin. As you know, this business was about a 7 percent EBITDA margin that we saw growing to 9 percent as we executed the various synergies. The S&D part of the synergies rather than the Eden part we're in for 2 million this year. They're tracking slightly above that. It's the Eden part with the new Barcelona headquarters and some other initiatives there that's allowed us to increase that overall synergy target for this year from the 4 million to the 7 million that we mentioned last week.

But we see the EBITDA margins moving to that 9 percent sort of level in line with the plans we had for that business. With the top-line growth will we get there a little bit earlier? That's always possible, but I'd say everything's tracking very well indeed.

Amit Sharma

And the 9 percent margin, Jerry, already included this 20 million excess capacity that's coming on line later this year?

Jay Wells

Yeah. I mean, Amit, I think you're asking if we're going to get more—additional leverage above and beyond. And I think going from where we are now to the 9 percent Jerry is talking about really does include all-in, so I wouldn't expect any additional leverage on top of that.

Amit Sharma

Got it. Thank you so much.

Jerry Fowden

That said, 9 percent is on revenue, and as you've pointed out at the start of this, Amit, we've had our second good revenue quarter now, so that looks good. Let's just hope it keeps going.

Jay Wells

Thanks, Amit.

Amit Sharma

Indeed. Thank you.

Operator

Your next question comes from Mark Petrie from CIBC. Please go ahead.

Jarrod Langhans

Morning, Mark.

Mark Petrie — CIBC

Good morning, guys. Just wanted to follow up on the acquisitions; 39 million in the quarter. How much of that was Remington? And how much was other tuck-ins?

Jerry Fowden

Yeah. We had about 39 out and we had 14 or 15 coming in on other disposals within the quarter, but Remington was about $20 million, Mark. Has just under 4 million of revenue; a relatively high EBITDA kind of proportion at over $2 million of EBITDA. But I think while it's a relatively small business on those kind of figures I've just described, the attractiveness is here more long term in the use of the technology that I'll ask Tom to expand on.

Thomas Harrington

Yeah. We think—we know we can extend the filter technology into the DS customer base, which is obviously significantly larger than the 12,000 we acquired at Remington. And it's not just DS. This technology and the patents and all of the benefits we get from this platform can also be extended into Canada and into Europe over the next, frankly, three to four years.

Jerry Fowden

And the first thing we need to do is expand the manufacturing capability of this patented technology such that we have a greater supply of these to use within the US where it's already approved. As we look around the rest of the world we will need to submit this technology to various regulators for approval, but basically it provides a much more environmentally friendly, longer-life filtration and filter to equipment that's placed within customers, thereby meaning less cost in calling out technical representatives to replace the filter and less frequent need to replace the filter.

So that's the kind of basis behind the patented technology.

Mark Petrie

Okay. That's helpful. You sort of answered a couple of my follow-ups, but just to clarify, does Remington manufacture itself or does it have external manufacturing?

Jerry Fowden

It has—

Thomas Harrington

Yeah. Uses a third party; it obviously owns the things like the molds, but it's a third party that produces it. And to Jerry's comment, because of our scale we're currently looking through alternatives to source the kind of volume that we would need, and that work is in process as we speak.

Mark Petrie

Okay. Thanks. And then you talked about the potential to expand this technology into Europe over time where obviously filtration is a bigger part of the market. So this product or something like it does not exist in Europe today?

Thomas Harrington

Not with these patents and this type of technology. That was one of the reasons—that is the reason that we were enamoured with and acquired Remington is it's scalable because of what it can bring to the market.

Mark Petrie

Okay. Thanks. And then sort of, I guess, maybe a broader question around M&A. I mean do you guys have a time line in terms of how long you feel like you need to or want to sort of continue to execute on the existing businesses before you do something more substantial than a tuck-in or something small like Remington?

Jerry Fowden

I think that's a very good question, Mark, and the shape of New Cott as we look at it is a shape where we feel very comfortable that we have top line, bottom line, and free cash flow growth, more predictably of that growth, and the continued multiple ability to do these small customer list or small tuck-in type acquisitions that have this highly complementary overlapping nature that drive synergies and value creation.

So as we look forward we have a business that I think in its present structure has a very attractive outlook for investors, even if we only just get the synergies and carry on with the small tuck-ins; that anything larger than that as we look out one, two, three, or four years would be a true additional overlay on top of that attractive base structure. So simply put: I don't think we feel pressured to do anything other than run the business well, get these synergies, and carry on with our organic growth and tuck-ins. That doesn't mean that we won't continue in our strategic planning exercise to look at a handful of opportunities where we believe in a desktop basis that there is good value to be had for the owners of our business.

But you can look at it on a desktop. Unless someone else wants to do something at the right time at a value that we think is enhancing for our shareholders, we won't do it and we don't need to do it because of the attractive outlook for the base business.

Mark Petrie

That's very helpful. Thank you very much.

Jerry Fowden

Thanks, Mark.

Operator

Your next question comes from the line of Judy Hong from Goldman Sachs. Go ahead.

Judy Hong — Goldman Sachs

Thank you. Good morning, everyone.

Jay Wells

Good morning.

Jerry Fowden

Good morning.

Judy Hong

So first is just clarification on your free cash flow guidance. So I think last week you had given 110 million for 2018 or 110 million to 115 million as the pro forma ’18 number. Now you’re looking at 150 million in ’19, so it seems like a pretty big step-up from ’18 to ’19 also in the context of your 10 percent three-year free cash flow CAGR target. So maybe just a little bit more colour on what’s driving that big jump from ’18 to ’19? And then would you also be able to give us a ’17 pro forma number for New Cott?

Jay Wells

I mean—it’s Jay. Good morning. A couple things; let me answer the first question second—or second question first. So right now with—and I talked about it a little bit on the call—with actually doing the carve-out, doing the separation, discontinued ops, certain debt not being paid down, but the interest being attributed, there is a lot of noise in our numbers this year and will continue through this year and maybe even into a little bit of next year, with next year really being finalizing the carve-out, getting the costs in the right place. Let me tell you, this has been a very complex process to work through.

So the reason why we came out with the 2019 guidance, first we had given previous guidance on 2019 and had a need to update it, but truly that’s going to be the first year that our numbers are really going to be clean of noise. The separation is going to be fully complete, the debt will be paid off, and that’s why we came out as part of this earnings release because it really is the best, cleanest number to come out with.

On the incremental growth, a couple of drivers. One is, first off, we do have synergy capture that is going to continue. We have the organic growth that we've talked about. We have the tuck-ins that we've talked about that really gives us additional incremental growth going to 2019. And then after '19, once we get through the synergies from Eden and S&D, you're looking at the organic growth that we've talked about plus tuck-ins giving us more the 10 percent CAGR that we've talked about.

Judy Hong

Got it. Got it. So basically the '18 110 million let's forget about that and just really look at the 150 million of '19 as a clean base, and then off of that you're planning to grow that on a 10 percent through organic, as well as a little bit of tuck-ins?

Jay Wells

You've got it.

Jerry Fowden

Very well put. Probably better than we've put it over the last few days. Well done.

Jay Wells

You're trying to work me out of a job, I think.

Judy Hong

All right. Just going back to the synergy and integration capture for Eden and S&D, so it sounds like Eden's ahead of plan, but S&D's sort of in line. So what's sort of gone right for Eden from at least a synergy and integration capture perspective versus S&D, which sounds like it's more in line with your initial guidance?

Jerry Fowden

Yeah. And let's start off with a kind of philosophical comment. We saw 4 million for this year, roughly 2 million at S&D and 2 million at Eden growing to $23 million of synergy in four years' time. That was the path. And I think the increments of that are shown in a bar chart that we put out just last week.

Within S&D, I think I've mentioned on calls in the past I have said to them that if all of the work necessary to keep up with the growth in the top line where things have been very strong meant that they needed to down weight any focus on synergies, they certainly had my and Jay's permission to do that because we can always come back and get the synergies one or two years later if need be; they wouldn't have gone away. Whereas if you don't capitalize on the top line opportunities when they're there you might lose them.

So with that as a backdrop where we have provided that guidance that synergies can always wait, if needed, it's pleasing to see that they are marginally ahead of the 2 million goal that was in for S&D this year, and the top line, as we've discussed, has gone very well indeed.

As we look at Eden Springs, they were in for 2 million, like S&D. We've upped our total target to 7 million instead of 4 million. The vast majority of that increase is at Eden and that reflects, one, the very successful implementation of the new Barcelona headquarters and the closure of the much more expensive, both whether you're looking at SG&A, headcount cost, local taxes, rent. Switzerland is absolutely gorgeous and very nice and I used to live there, but we all know it's not a cheap place.

So the opening of the Barcelona headquarters has gone well, we've seen the cost reduction that we expected from that, and we feel very confident of that as we forecast it forward. That, coupled with some other procurement initiatives that are looking attractive; we've just struck a global cup supply for our global water business. DS and Eden Springs together really has given us the confidence to say we'll do better than expected on Eden Springs.

Judy Hong

Got it. Okay. That makes sense. Thank you.

Jerry Fowden

Thank you.

Jay Wells

Thank you.

Operator

That concludes our question-and-answer session. I'll now turn the call back over to Jarrod Langhans for closing remarks.

Jarrod Langhans

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

Thanks again for attending.

Operator

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

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