

Company Name: PepsiCo
Company Ticker: PEP US
Date: 2013-10-16
Event Description: Q3 2013 Earnings Call

Market Cap: 126,169.23
Current PX: 82.27
YTD Change(\$): +13.84
YTD Change(%): +20.225

Bloomberg Estimates - EPS
Current Quarter: 1.012
Current Year: 4.324
Bloomberg Estimates - Sales
Current Quarter: 20138.833
Current Year: 66506.333

Q3 2013 Earnings Call

Company Participants

- Jamie Caulfield
- Indra K. Nooyi
- Hugh F. Johnston
- John A. Faucher

Other Participants

- Bryan D. Spillane
- Ali Dibadj
- Dara W. Mohsenian
- Caroline S. Levy
- Judy E. Hong
- Amit Sharma

MANAGEMENT DISCUSSION SECTION

Operator

Good morning and welcome to PepsiCo's Third Quarter 2013 Earnings Conference Call. [Operator Instructions] Today's call is being recorded and will be archived at www.pepsico.com.

It is now my pleasure to introduce Mr. Jamie Caulfield, Senior Vice President of Investor Relations. Mr. Caulfield, you may begin.

Jamie Caulfield

Thanks, Jackie. With me today are Indra Nooyi, PepsiCo's Chairman and CEO; and Hugh Johnston, PepsiCo's CFO. We'll lead off today's call with a review of our third quarter performance and 2013 outlook and then we'll move on to Q&A. In an effort to get to as many analyst questions as possible within the hour, we've kept our prepared remarks relatively short this morning and we're going to have a one question limit. So we should be able to get through the full queue of analysts when we get to the Q&A.

Before we begin, please take note of our cautionary statement. This conference call includes forward-looking statements, including statements regarding 2013 guidance and our long-term targets, based on currently available information. Forward-looking statements inherently involve risks and uncertainties that could cause our actual results to differ materially from those predicted in such forward-looking statements. Statements made on this conference call should be considered together with cautionary statements and other information contained in today's earnings release and in our most recent periodic reports filed with the SEC. Unless otherwise indicated, all references to EPS and total operating profit growth are on a core basis. In addition, references to organic revenue results in this call exclude the impact of acquisitions and divestitures, structural changes and foreign exchange translation.

To find disclosures and reconciliations of non-GAAP measures that we may use when discussing PepsiCo's financial results, please refer to the Glossary and other attachments to this morning's earnings release and to the Investor section of PepsiCo's website under the Event & Presentations tab. As we discuss our results today, please keep in mind that our

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Q3 reporting period reflects the 12 weeks ended September 7 for our North America businesses and the months of June, July and August for the vast majority of our businesses outside North America.

Now, it's my pleasure to introduce Indra Nooyi.

Indra K. Nooyi

Thank you, Jamie, and good morning, everyone. I'm pleased to report good results for the third quarter, despite significant volatility experienced in a couple of our AMEA region markets. From a top-line perspective, our business largely maintained the top-line momentum we saw in the first half and our year-to-date and expected full year organic revenue growth is right in line with our long-term mid-single-digit growth target.

Our organic revenue growth reflected each of the four business units achieving positive net price realization in the quarter. And we had particularly good organic revenue growth at Frito-Lay North America, which was up mid-single-digits and Latin America Foods, which was up double digits. And this was both in the quarter and year-to-date, as well as in key developing and emerging markets such as: China, where we had strong double-digit organic revenue growth, both in the quarter and year-to-date; Brazil, where we had 9% organic revenue growth, both in the quarter and year-to-date; and Turkey, where we had 7% organic revenue growth in the quarter and 9% organic revenue growth year-to-date.

Snacks volume grew 3%, and our beverage volume grew 1% on an organic basis globally, both in the quarter and year-to-date. Our international beverage volume growth was strong, up 4% on an organic basis in the quarter and 5% year-to-date.

Operating performance was solid. We had good gross profit flow-through, with core gross margins improving 70 basis points in the quarter. We improved core operating margin, even as we continued to invest in A&M, with A&M as a percent of sales up 40 basis points. And we made incremental marketplace investments of almost \$30 million as part of the incremental investment program we announced last quarter.

In addition, our three year productivity program remains on track. We project delivering \$900 million of productivity in 2013 and expect to deliver the full \$3 billion three year target by year-end 2014. Our productivity is funding our growth initiatives and is contributing to our operating margin improvement. We are reaping productivity from across the value chain through the acceleration of global procurement initiatives and coordination of our global supply chain, which, in turn, is enabled by the investments we've made over the , in our SAP platform.

Year-to-date in 2013, PepsiCo organic revenue grew approximately 4%, core gross margins improved by 105 basis points, A&M as a percent of sales increased 50 basis points, and operating margins expanded by 65 basis points. Core constant currency EPS is up low double-digits year-to-date and we continue to manage cash flow exceedingly well. Year-to-date management operating cash flow, excluding certain items, was \$5.5 billion, a 12% increase over the comparable 2012 period.

We have returned \$4.6 billion to shareholders through the first three quarters in the form of dividends and share repurchases, and we're on track to return \$6.4 billion by the end of this year, right in line with the target we set at the beginning of the year.

As you all know, the macroenvironment continues to be challenging. Developed markets remain sluggish and emerging markets are volatile, particularly those experiencing political and civil unrest. In challenging times such as these, it's especially important to stay focused on execution. And that's really what we are doing: focusing on the fundamentals to drive good, sustainable performance. Additionally, we've performed well because our portfolio of brands is extensive and strong, our products are on-trend and relatedly diverse, and we have a broad geographic footprint.

Let me talk to each. Our brand portfolio, as you know, has been well architected. We have a great line-up of iconic brands that cover everything from treats to healthy eats. Our brands worldwide stand for safety, quality, taste and affordability. We are investing appropriately behind our brands and our increased investments have resulted in even

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stronger brand equity scores.

More importantly, the strength of our innovation, design capabilities and revenue management skills, which are all foundational building blocks, are applied across our categories to sustain top-line growth and profitability. Just to give you some examples, in innovation, we had six of the top 25 new food and beverage product introductions across all measured U.S. retail channels year-to-date. And we have seven new products this year that are on pace to achieve \$100 million each in annual retail sales in the United States: Mountain Dew Kickstart; Tostitos Cantina; Quaker Medleys platform, which has been expanded to ready-to-eat cereal and bars; Starbucks Iced Coffee; Lipton Pure Leaf Tea; Muller Quaker Yogurt; and Gatorade Frost – Glacier Cherry.

We continue to see positive results from our investments in innovation. Innovation as a percentage of net revenue is more than 8% year-to-date, a 100 basis point improvement year-over-year. We have recently opened our Innovation Design Center. And we're looking to increase the pace and incrementality of innovation with more re-frame and breakthrough innovation as we move forward.

In addition, our geographic footprint allows us to fully capitalize on the diversity of our portfolio, including the solid top-line performance, high margins, high returns and healthy cash flows of our developed markets, with the high top-line growth, and future margin and return expansion potential of emerging and developing markets, as we drive greater scale by fully capitalizing on the related diversity of the portfolio.

In many markets, including the U.S., Russia, Mexico, we're either the largest or the number two food and beverage supplier. And this [ph] game (8:55) is so important in today's environment, where retailers' competition for share of the shopper's basket and manufacturers' competition for share of retail shelf is intensifying. The scale, ubiquity and related velocity of our categories make us an essential partner for retailers. And consequently, we are relied upon to drive a large share of our retail partners' growth. And our retail partners increasingly seek us out for joint business planning activities to explore mutual, creative ways to drive our respective businesses. So all the benefits of our scale and product, planned and geographic portfolios, enable us to deal with headwinds and capitalize on the tailwinds within categories and across geographies.

So with that as a background, overall, our business is on track and we are pleased with the progress we've made strengthening our competitive position across our key developed, developing and emerging markets.

You know, we manage the business as a portfolio and we've remained highly disciplined in our approach, leveraging our combined scale and capabilities to build sustainable value, rather than over-reacting to short-term pricing pressures or local value brand initiatives. As a result, over the past six quarters, in both salty snacks and beverages, we've seen increases in aggregate market share for our top strategic international markets that account for approximately 80% of our total international business. And year-to-date in the United States, we've grown value share at Frito-Lay and sequentially improved the value share in beverages, even as we've outpaced industry in net price realization at retail.

Let me comment now on our individual operating segments. Each of our businesses performed well financially and in the marketplace in Q3. Just to give you some highlights, at Frito-Lay North America, we generated 3% volume growth and mid-single-digit organic revenue growth, with two points of net price realization. And the performance was very balanced, with volume and revenue performance positive across each major U.S. channel. We gained value, volume and unit share in salty snacks in the quarter and year-to-date. We expanded core operating margins by about 25 basis points in the quarter and 35 basis points year-to-date, even as we increased advertising and marketing expense.

Our advertising initiatives focused on our core brands. For example, Doritos For the Bold integrated marketing campaign was executed across TV, digital and social media and was supported by a new Doritos logo and updated packaging. And our Lay's 75 & Sunny campaign celebrated 75 summers of Lay's. And we continue to capitalize on a highly successful, consumer-driven Do Us a Flavor campaign with the winner, Cheesy Garlic Bread, launched at retail in Q3.

And our innovation continues to perform well, led by Tostitos Cantina, Doritos Jacked Ranch Dipped Hot Wings, Cheetos Mix-Ups and, as I mentioned, Lay's Do Us a Flavor. So that's Frito-Lay North America.

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Now, before I go into the Pepsi Americas Beverage performance, let me give you some perspective on the North American beverage industry, which is much watched and much talked about. First, the beverage category in North America remains the largest category in food and beverages here in the United States, at over \$90 billion at retail and it is very profitable. It's still very relevant to retailers and it's one of the first categories retailers look to when overall growth slows.

As many of you know, the LRB category has slowed and the shift from CSDs to non-carbonated beverages has accelerated. CSDs now comprise approximately 40% of the U.S. LRB category volume versus approximately more than 50% a decade ago.

We have a competitive position in CSDs and we have a very strong leadership position in the faster growing non-carbonated beverages. This advantage enables us to hold or grow overall measured channel LRB value share, as we manage the challenges of the CSD category in a responsible and sustainable way. Our strategy is to compete on the basis of innovation and marketing and to manage the business responsibly and profitably. We are convinced this is the right strategy to increase shareholder value, given category realities. And as we have said in the past, we continue to explore the potential for structural changes in our North American Beverage business to create further value. So we continue to achieve attractive net price realization, as we simultaneously invest in brands and R&D.

So with this as a backdrop, let me now talk about our performance at Pepsi Americas Beverages in the quarter, with a focus on North America. We achieved another quarter of solid net price realization, with net price realization up three points. In the U.S., our LRB value share slightly out-performed our primary competitor in measured channels, led by our advantaged non-carb portfolio, with value share gains in ready-to-drink teas, sports drinks and chilled juice. Our retail pricing in LRB and in CSDs led overall pricing in those categories.

And our key new product launches are performing very well. Mountain Dew Kickstart, a product targeting morning energy needs of Millennials, is expected to significantly exceed \$100 million in the first year retail sales. Capitalizing on the momentum of the morning platform, we will be expanding Kickstart into the evening energy occasion in early 2014.

Lipton Pure Leaf premium tea continues to perform well and has reached a 9% value share in ready-to-drink tea and is also on track to exceed \$100 million in retail sales in its first year. Tropicana Farmstand is a delicious chilled 100% juice, with one serving of fruit plus one serving of vegetables in every glass, and that's doing well. And Starbucks Iced Coffee is performing ahead of expectations. It has reached a 7.5% value share position in ready-to-drink coffee and is on pace to achieve approximately \$100 million in retail sales in its first year.

And across our businesses, we've continued to sharpen how we leverage our scale and capabilities to drive incremental value. As a focused and integrated food and beverage company, we are able to better serve our consumers and retail customers by providing unique value to them through powerful properties like the NFL. Our partnership with the NFL continues to be among PepsiCo's most successful sports sponsorships. This year, we are taking our partnership with the NFL to a new level with NFL activations that include Pepsi, Gatorade, Tostitos, Quaker, Tropicana, Aquafina and Sabra brands.

Let me now move on to developing and emerging markets. Organic revenue grew 9% in the quarter. Most of our developing and emerging markets continue to perform well, as we build our business by driving greater penetration. Organic snacks volume increased 4% in developing and emerging markets in the quarter, led by particularly strong growth in: China, which was up 15%; Pakistan, up 23%; and Turkey, which grew 11%, just to name a few. Year-to-date, organic snacks volume in developing and emerging markets also grew 4%, led by double-digit growth in China and Pakistan and high single-digit growth in Egypt, Turkey, South Africa and India. And again, we are managing the business in a sustainable and responsible way by focusing on profitable growth in segments where brands and quality matter.

Organic beverage volume grew 4.5% in developing and emerging markets, led by double-digit growth in China, Philippines, Pakistan, Poland and South Africa. Year-to-date, organic beverage volume in developing and emerging markets grew 5.5%, led by double-digit growth in China, Philippines, Pakistan and Poland, to name a few.

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We're encouraged by our performance in these important markets and excited by the long-term growth prospects they present. We've built extremely strong businesses across every important developing and emerging market, in large part by leveraging the presence of the beverage business which we established decades ago. So for example, today, we have an integrated food and beverage business in Ukraine with sales approaching \$0.5 billion. We are the number one food and beverage business in the Middle East and, along with our partner Tingyi, have the number one beverage business in China.

As we continue to drive greater consumer penetration and frequency in these markets, we build scale, which makes us more efficient. This allows us to continue to invest in these markets and, at the same time, increase our operating margins. However, as we mentioned in our earnings release, there was a meaningful slowdown in the third quarter in our businesses in Egypt and India, which account for the deceleration of organic revenue in AMEA from the double-digit rate of growth we saw in the first half of the year.

Egypt's performance was impacted by the political turmoil and India reflected unusually aggressive industry pricing. In each case, we are pleased to note early trends in Q4 have improved. The potential for volatility, especially in developing and emerging markets, is, in part, why we provide annual, but not quarterly, targets. The important thing to remember is that we fully expect to achieve a mid-single-digit organic revenue growth goal for full-year 2013. And as we look beyond 2013, we believe we are positioned well to deliver our long-term financial goals, which we believe will translate to top tier, total shareholder return on a sustainable basis.

With that, let me turn the call over to Hugh. Hugh?

Hugh F. Johnston

Great, thanks, Indra. I'll spend just a minute covering the financial results and guidance in a little more detail and then we'll open up the lines to your questions. For Q3, organic volume grew 3% in snacks and 1% in beverages. Organic revenue grew 3.3%. Commodity inflation was up low single-digits. Our core gross margins improved by about 70 basis points and we increased A&M expense by 8%.

Core constant currency operating profit grew 3%. Incremental investments totaled \$28 million pre-tax in the quarter. Excluding the impact of incremental investments, core constant currency operating profit grew 4%.

Our core effective tax rate was 25.5%, approximately 80 basis points below Q3 2012. And core constant currency EPS grew 5% and 6%, excluding the incremental investment.

So between core constant currency division operating profit growth of 3% and core constant currency EPS growth of 5%, we got about: 1.5 points of leverage, including nearly a point of de-leverage from higher net interest expense; one point of leverage from a lower tax rate, which will reverse in the fourth quarter, as we're forecasting the full year core effective tax rate to come in at approximately 27%; and one point from weighted average share count, which was down 1% year-on-year. Overall, the quarter came in largely as expected, with pricing actions, commodity inflation and productivity all in line with our expectations.

On a reported basis, net revenue was up 1.5%, reflecting over a one point drag from foreign exchange and about a half a point negative impact from the Vietnam re-franchising. We generated over \$6.6 billion in cash flow from operations year-to-date, an improvement of \$1.5 billion versus last year. This was driven by lower pension contributions and strong working capital improvements. Year-to-date, management operating cash flow, excluding certain items, was approximately \$5.5 billion, an increase of approximately 12% year-over-year, reflecting the growth in earnings, disciplined capital expenditure investment, and continued improvement in working capital management. And we returned \$4.6 billion to shareholders year-to-date in the form of dividends and share repurchases.

Now, turning to guidance, consistent with what we've said throughout this year, for the full year 2013, we expect core constant currency EPS growth of 7% off of a core 2012 base of \$4.10. And consistent with our previous guidance, we expect mid-single-digit organic revenue growth, core constant currency operating profit growth of approximately 6%, approximately one point of leverage below the operating profit line, driven by share repurchases, and we expect our

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core effective tax rate to be approximately 27% for the full year.

Within these expectations, we assume positive price mix, low single-digit commodity inflation and productivity of \$900 million. Our productivity assumption is completely in line with the three year, \$3 billion program that we launched last year. And the savings will be used to help offset inflation, as well as provide funding for investment back into the business. And as we mentioned on the last conference call, you should also take into account that we intend to incrementally invest the balance of the Vietnam gain in the balance of year, which will impact operating profit growth and margins.

Regarding foreign exchange, based on current market consensus, we anticipate foreign exchange translation to have approximately a two point negative impact on our net revenue and at least a two point negative impact on operating profit and EPS for the full year, including the impact of the Venezuela devaluation. As we anticipate structural changes, driven by China and Vietnam, we'll have a negative impact of approximately one point on our full year net revenue growth.

As a reminder, the world remains a volatile place, as evidenced in our AMEA region this quarter. Despite the volatility, we continue to expect investments in long-term, value-building initiatives, such as advertising, innovation and, in emerging markets, growth capacity.

As you model out the fourth quarter, these are our expectations. Foreign exchange translation should have an approximate three point unfavorable impact on fourth quarter revenue and up to a four point unfavorable impact on fourth quarter EPS, based on current market consensus rates. Revenue in the fourth quarter will have an estimated one-half of a percentage point negative impact from structural changes due to the Vietnam re-franchising. Division operating profit will be impacted by higher sequential commodity cost inflation, as we had expected, incremental investments funded by the Q2 Vietnam gain, increased A&M expense and negative foreign exchange.

Below the division operating profit line, corporate costs in Q4 will be above prior year levels, based on the timing of investments, primarily in R&D. Net interest expense will increase versus last year, primarily reflecting higher rates. And our tax rate will be significantly higher in Q4, as we approach our full year estimated rate of approximately 27%.

From a cash flow perspective, we expect full year core management operating cash flow, excluding certain items, of more than \$7 billion. We'll continue to drive cash flow through an even more efficient working capital management and continued tight controls over capital spending.

And for the full year 2013, we expect to see continued improvement in our key working capital metrics and to manage net capital spending to approximately \$3 billion, which is well within our long-term target of less than or equal to 5% of net revenue. As a result, we'll continue to return strong cash flow to our shareholders. In total, we expect to return approximately \$6.4 billion to shareholders in 2013, \$3.4 billion in dividends and \$3 billion in share repurchases.

Net, our outlook for 2013 is unchanged from our last call and is consistent with our long-term targets for net revenue, operating profit and core constant currency EPS. We expect to drive improved full year margins and net ROIC and disciplined capital allocation, coupled with returning cash to our shareholders remains a top priority for the company.

With that, operator, we'll take the first question.

Q&A

Operator

Thank you. [Operator Instructions] Our first question is coming from Bryan Spillane with Bank of America Merrill Lynch.

<A - Indra K. Nooyi>: Morning, Bryan.

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<Q - Bryan D. Spillane>: Morning. So question about America's Beverages, if you look at the profitability in the quarter, the margins held up pretty consistent with last year, even despite the volume declines. And understanding that there's some price that helped that, could you talk a little bit more about how – the nature of the productivity that's flowing through, try to get a sense for how much productivity is actually helping boost margins? And maybe connected to that, the types of initiatives you're taking and how that might change the structure of that business as we all begin thinking about whether you re-franchise or do something structurally different with the business going forward. Just trying to understand, I guess, what types of changes you're actually making to that business today that might be different than what we would have known before you put it together.

<A - Indra K. Nooyi>: Okay. Bryan, I'm going to answer the second part of the question and then Hugh is going to answer the first part of the question. So when we talked to you about structural options way back in February of 2012, we said we'd look at a range of structural options, JVs, collaborations, any sort of structural separation. We'd look at every option. And at the end of the day, we will do something that makes sense for PepsiCo, for the beverage business globally and for North American Beverage business.

So we want to approach this in a very sensible way because in a buying, spending, buying, spending is not a sustainable way to run any business, especially one that has terrific profitability and generates extraordinary U.S. cash flow and, more importantly, houses some of our most important global beverage brands. So we're approaching this in a very, very sensible way. And we're looking at every structural option possible that will allow us to manage the global beverage business in a sensible way, not jeopardize PepsiCo overall by any sort of loss of the U.S. cash flow and in a way that's long-term shareholder value creating.

So we're looking at fundamental operational improvements in North American Beverage business also. And our strategy has been very simple: focus on innovation; focus on R&D investments to create disruptive innovations, so that we can get incrementality; and think about how to price very, very sensibly in a segment that's going through a lot of volatility. It's still a very big market, very profitable, very important to retailers. But in 2012, second half in 2013, it did go

through a slowdown and was very important that we don't start competing strictly on price.

This category has been competing on price for years. And last couple of years, we've been trying our best to become a lot more disciplined and inch the pricing up and play a very, very disciplined game. And that's really what we've been doing.

So with that, Hugh, let me turn it to you to talk about the mix between pricing and productivity and everything else in between.

<A - Hugh F. Johnston>: Yeah, sure; happy to do that, Indra. Good morning, Bryan. If you look at the margin performance, you really do have to look at it from three perspectives. First is from kind of net pricing in the marketplace. And from that perspective, as we look at a category that doesn't have a lot of growth in it, we do believe the right and responsible way to manage this category is for us to be very consistent in taking net price. We've been consistently articulate about that over the last couple of years. And I think if you look back at our performance, we've consistently led the industry in ensuring that we do take that net price and we take it in an appropriate and responsible way. So that's driver number one.

Driver number two is net revenue management. We have gotten more sophisticated on that over the course of the last couple of years. I think that's been a product of the reintroduction of the bottling businesses back into PepsiCo. And I'd look at it from two perspectives. One is package management, where the array of packages that we have and the opportunity to extract incremental margin from those packages has actually increased substantially compared to where we were three or four years ago, where we were much more heavily focused on just two liters and 12 packs. And then second, from a channel management perspective, I think we have gotten much more granular using technology and much more specific in the way that we price cross channels in a manner that allows us to also drive margin.

The third area, as you mentioned, is productivity. There's little question that the productivity has ramped up in the business and I'd explain it this way. If you think about the way that we historically looked at productivity, it was a very

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manufacturing-centric point of view, in terms of consistent year-over-year productivity. And then episodically, there would be productivity coming out of G&A, primarily through restructurings.

Obviously, we haven't stopped doing any of that, but I think what we've added to it are a couple of components. Number one, value engineering. We've gotten much more sophisticated in terms of our use of materials and, as a result of that, we've really doubled the impact of value engineering, which is essentially two things: number one, using less of a commodity; or, number two, substituting commodities to enable us to get better productivity out of the procured goods that we get. So our value engineering capability has stepped up substantially.

Number two is the distribution system. I think, typically in the past, we hadn't gotten a lot of productivity out of the distribution system. We've clearly gotten a lot sharper on that, both from the standpoint of labor management and, in addition to that, using technology in the warehouse. That's enabled us to lower costs across that. And then the last piece, of course, is tight G&A cost controls and it's something that, as PepsiCo, we're quite good at. So if you put all of those pieces together, that's really what's driving the solid margin improvement in the face of what are obviously a not growing category right now.

<A - **Indra K. Nooyi**>: And, Bryan, I'd just add one last thing for you to keep in mind. As we said in the script, the North American Beverage business is big. It's a \$85 billion category. The velocity of this business is somewhere between 40 and 80 turns a year, so, to the retailer, it generates an enormous amount of cash because they pay out net 30. It's a huge traffic driver. So it's a very important category. It's very profitable. Across the industry, margins range from low to mid-teens. So it's a very profitable business. It generates a ton of U.S. cash. And in today's volatile global environment, we're in the North American Beverage business, which actually is a pretty damn good business today in terms of generating U.S. cash and profitability. So I'd frame that with that context.

Operator

Our next question comes from the line of John Faucher with JPMorgan.

<A - **John A. Faucher**>: Thanks. You highlighted the...

<A - **Indra K. Nooyi**>: Morning, John.

<Q - **John A. Faucher**>: Good morning, Indra. You highlighted the \$30 million of – I believe it was \$30 million of extra spending in Q3 related to the gain. Can you give us a little bit more of an indication, in terms of where those investments are going? Are you still planning on spending the full gain back as we look into the fourth quarter? And what's the timeframe in terms of seeing payback on that incremental spending, kind of given the investments you're making? Thanks.

<A - **Indra K. Nooyi**>: Hugh?

<A - **Hugh F. Johnston**>: Yeah, I'm happy to handle that. John, really the money is being spent in two areas. Number one is where we see a good ROI, we're spending on incremental advertising and marketing. You're going to see that more in the AMEA region than you will anywhere else, although some of it clearly plays back into the developed markets as well.

The second area where we've chosen to make investments is in the growth markets, and it's largely going to be in opportunities to expand distribution, leveraging coolers, leveraging racks, again, to enable us to further accelerate our growth and to create further advantage in those markets, which obviously still have lots of growth potential left in them.

Regarding your question about do we intend to fully spend back the gain, the answer is absolutely yes. We intend to fully spend back the gain. So the investments are really going fundamentally into what we believe are the volume and growth, and ultimately shareholder value-creating drivers for the business. We think they're good investments for shareholders for the long run, and we feel quite comfortable in making them and assuring that we're going to get a good return on them.

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In terms of timing, typically those types of investments have about a one to two year payback.

Operator

Your next question comes from the line of Ali Dibadj with Bernstein.

<A - **Indra K. Nooyi**>: Morning, Ali.

<Q - **Ali Dibadj**>: Hey. How are you guys?

<A - **Indra K. Nooyi**>: Good.

<Q - **Ali Dibadj**>: I do want to focus a little bit more on PAB. So CSD's mid-single-digit decline, okay, you can – there are a lot of reasons for that, potentially one can argue, but the non-carb area declining low single-digits, too, I'm trying to figure out if that is really to your internal plan, given some of the industry dynamics you've described, as a substitution into non-carbs? And in particular, were there any bright spots in non-carbs, given the portfolio that you have? And the last part is, if you step back and you say, okay, look, going forward, sounds like pricing is behind us – pricing aggressiveness is behind us competitively on the CSD front, what should we think about both the non-carb and the CSD business growing going forward for you?

<A - **Hugh F. Johnston**>: Yeah, Ali, why don't I handle that question? Regarding non-carbs, I actually think there were quite a number of bright spots. We've seen year-to-date the Gatorade business continue to perform very well. It's been gaining share. We certainly feel good about where Gatorade is and we, even more importantly, feel good about the fact that we've re-positioned the business very strongly for – in consumers' minds in terms of the brand being really the sports nutrition brand. So that's number one.

Number two, the ready-to-drink tea business is certainly doing quite well. In particular, Lipton Pure Leaf, the innovation that we've had there, both in terms of the smaller and the larger packages is performing extremely well. So we – and that business is now back on track in terms of market share. The chilled juice business as well, both in terms of base Tropicana as well as the innovation that we have with Tropicana Farmstand and Trop50, all continue to perform well.

Now, you're right, as you look at the aggregate non-carb number, the volume number, as we mentioned, was a low single-digit decline. The real challenge there for us is in the packaged water business. We look at that business as something that's a scale enabler, but we also look at it as a business where we're not willing to invest to lose money in order to just hold volume. We just don't think that's a good use of shareholders' money. We don't think it creates value over time. We're obviously going to be in the space with our distribution system. We'll continue to sell packaged water, but it is not a priority for us from an investment perspective.

So as you see the balance of the market, at various times, choose to invest in bottled water, oftentimes to chase volume and to chase share, you're going to see our numbers swing in overall non-carbs because the water category is so big. What it won't do, though, is significantly impact our profitability. So I think we certainly feel good about non-carbs from that perspective.

On the CSD front, I think the biggest thing that we feel very good about right now is Mountain Dew.

The Mountain Dew franchise is performing terrifically well in the United States. We feel good about the base Dew business. The Diet Dew business has been performing extremely well. And I think one of the things we're most heartened by is Mountain Dew really travels well to international markets. Whether you look at India, whether you look at China, the Dew franchise is clearly a global franchise. And we feel terrific about that.

Regarding your question on what the future of CSD growth is, very hard to estimate. Obviously, we've taken a perspective that, by virtue of investing in R&D around package and around products, specifically sweetener, we think that will benefit the category.

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The important thing, I think, from our perspective, is we've got an LRB portfolio that works really well. We think we have an advantaged set of brands. So regardless of where the overall LRB market goes, we do feel like we will be competitively well positioned by virtue of the portfolio that we built over the course of 10 or so years.

<A - **Indra K. Nooyi**>: Well, there's no question that there has been an industry dynamic as we've seen a shift away from CSDs to non-carbs. And we've talked about that many times. It's now at 50%-50% or 60%-40% the other way and it could potentially settle at that number.

Operator

Your next question comes from the line of Dara Mohsenian with Morgan Stanley.

<Q - **Dara W. Mohsenian**>: Good morning.

<A - **Indra K. Nooyi**>: Morning, Dara.

<Q - **Dara W. Mohsenian**>: So looking at the U.S. beverage business, how concerned are you about the volume pressure, specifically on the diet CSD side of the business with the health and wellness concerns? And what are the strategies to combat those issues going forward? You sounded optimistic that innovation could help earlier this year, but we haven't heard much since. So I just wanted to get an update on the innovation side.

And then on the pricing side, appreciating the focus on disciplined pricing, but you did see a mid-single-digit volume decline on the CSD side in North America in the quarter. So do you think that pricing balance has gotten out of whack at all versus competitors? Might you need to make some adjustments going forward? And also, could you give us an update on promotional levels in the industry post the Labor Day discounting and if you're seeing any improvement?

<A - **Indra K. Nooyi**>: Let me speak to the first part of the question, Dara. A couple of years ago, we started to see the decline in full-sugar CSDs, no question about it. Especially in colas, we started to see the decline in full-sugar colas. And diets were holding up. Recently, especially in the last, I'd say, six to nine months, there has been an accelerated decline in diet drinks, as people say they don't even want artificial sweeteners. They want more natural sweeteners. They don't mind some calories, but they want natural sweeteners. They want to go back to sugar in some cases.

So we are seeing a fundamental shift in consumer habits and behaviors. We anticipated some of these. The diet slowdown has been a little more rapid than we expected. The good news is that our overall portfolio, as Hugh mentioned, is very balanced, and our diet – I'm sorry, our Dew consumer likes regular Dew, likes Diet Dew, likes Kickstart, so our Dew consumer is very different than the consumer for colas and consumer for lemon-lime.

We are staying on the path of innovating along natural sweeteners and thinking about flavoring agents to make sugar taste more sugary and so that's all we are focused on. We talked about our products coming to market in 2014. That's really the track we are on. And we are not talking about it now because we haven't yet got a launch date. Once we have a launch date, you'll hear a lot more about it. And our goal is to bring to the market a product that tastes great. We don't want to rush a product to the market and then have to wonder why we launched something that wasn't that great tasting. So that's our focus.

Regarding pricing – and let me add to that. I mentioned this, I think, at one of the conferences, maybe Barclays or something or Bernstein, the category has been declining about 3% a year, CSD category, especially in the last couple of years. And it's important that in the next two to three years, we come up with significant disruptive innovation if you want to hold people in the CSD category, and that's what we are focused on. The best news, of course, is that our portfolio is so diverse, not just within beverages, but also between beverages, snacks and Good-for-You products, that we feel incredibly well insulated against any sort of headwinds in this category.

Let me now turn to pricing. Dara, I'll tell you, we've – the industry, not just PepsiCo, the industry has seen years and years of ridiculous pricing, where for the last tenth of a share, there would be a pricing war which had impacted the whole category, and this went on for almost a decade. And that is not the right way to create shareholder value in this category. It cannot be that one company has almost eight or nine years of problems because of disruptive pricing habits

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and then they take a big reset and then they start coming up and then the other company has to take a reset. This kind of back and forth yo-yo does not work in shareholder value-creating literature.

So what we are trying to do is to say, given the category dynamics, we have to behave in a value-creating way in this category and that's what we're doing. We're going to keep doing that and hope that, at some point in the overall category, there's sensible behavior and all of us are focused on sustainable long-term shareholder value creation. That's what we're going to focus on.

Operator

Our next question comes from the line of Caroline Levy with CLSA.

<Q - Caroline S. Levy>: Good morning. Couple of questions, internationally, I was just wondering if you could talk to us, introduce us a little bit to the new head of international after your very sad loss. And tell us about how the move has been. I believe that he came out of India. And just to give us some confidence in that important market, that your team is strong and I know that Zein also came out of Russia, so your two big important markets have probably new leadership.

And then just secondly, in your U.S. CSD business, do you think the innovation you're working on is such that it could actually stop declines or do you think it just sort of slows declines? Is this something you think will come with some premium pricing? Will it be truly differentiated is really the question.

<A - Indra K. Nooyi>: So let me start with our head of AMEA, it's not international, Caroline, it's just head of Asia, Middle East, Africa. Saad was an amazing leader and we truly miss him, but, as you know, the strength of PepsiCo is that we have very good succession plans for literally every position in the company. Sanjeev Chadha has been in PepsiCo forever, almost 20 years, if I recall. And started his career in PepsiCo India, then went on to Asia Pacific and was a Commercial Director there. From there he came to our Middle East business and was running the Middle East business. So essentially, he's run every aspect of Asia, Middle East, Africa, knows the region very well and is a great successor to Saad.

And so feel very good about Sanjeev's appointment into the head of Asia, Middle East, Africa. He knows snacks. He knows beverages. He knows franchise. He knows company-owned operations, because he's done both in India and [ph] As-Pac (46:50) and the Middle East, which is a big franchise market for beverages, as well as company-owned operations in Jordan and Egypt. And we have a big company-owned snacks business. So Sanjeev is a very seasoned executive, has done turn-arounds, has done big growth, so I think, as all of you get introduced to him, we will certainly bring him around, I think you're going to be very pleased how well the succession has worked. He knows everybody in the region, the bottlers, the employees. They all know him, too. And so I don't think there's going to be any issue in the AMEA region, quite a seamless transition.

In terms of Europe, Zein was a sector head for Europe. The good news is Russia, we have a phenomenal talent base of Russian managers. [ph] Silvia Popovici, who came to us from Wimm-Bill-Dann, Alexi Mekanoshin (47:33), who came to us from a bottling business who was with PepsiCo before. All of these are terrific leaders running our Russian business. And they, in turn, report to Ramon Laguarta, who has been in PepsiCo for decades and Ramon is running the developing markets in Europe. He's got all of Russia, the FSUs, all the way to Turkey, doing very well.

And replacing Zein in Europe is Enderson Guimaraes, who came to us out of Electrolux. Again, an executive who ran a big piece of Electrolux comes to us with a very different perspective and has managed businesses with enormous volatility. As you know, hard goods – white goods, rather, go through bigger volatility in economic downturn than any of our staples businesses. So Enderson is a seasoned executive in that dimension and is adding a lot to our overall management team. And don't forget, Zein hasn't gone anywhere. He's right here down the corridor. So he's always there looking at all these businesses. The good news is that we have a great team at PepsiCo and we take a lot of pain to make sure our succession planning is done well.

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Turning to CSD innovation, especially in North America, because that's really what we are talking about. In most of the international markets, especially in Asia, there's still lots of room for growth. Will our innovation stop the decline? That's anybody's guess, Caroline. I think in today's world, we have to keep betting on innovation, both for creating breakthrough products and also innovation to reduce costs through creative ingredients. And I think in today's world, overall volatility in consumer shopping habits and the way they are spending their money, retail dynamics, et cetera, et cetera, the best insulation is to have a diversified portfolio, relatedly diverse, not too diverse, but relatedly diverse, have a great brand portfolio that covers all eating and drinking occasions, and not be overly dependent on a category like CSDs.

And that's really why we feel very, very good about PepsiCo today and, as we mentioned earlier in the notes in our script, our brand portfolio is diverse, geographic portfolio is diverse, but most importantly, our product portfolio is diverse and CSDs, per se, in North America is not a gigantic driver of our profits. So we feel pretty good about where we stand today.

Operator

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

<Q - **Judy E. Hong**>: Thanks. Good morning.

<A - **Indra K. Nooyi**>: Judy, good morning.

<Q - **Judy E. Hong**>: So first on the emerging markets, Indra, so obviously many companies have talked about the slowdown that they're seeing in the emerging markets and you've talked about the AMEA markets a little bit, but as you think about the next six to 12 months, some of the markets like Russia, China, Brazil -- can you just give us your assessment of how you see those markets playing out and whether the differences that you're seeing in snacks versus beverages is something to really call out here?

And then secondly, I just wanted to clarify the comment you've made about the North American market and how you think about the structural solutions to that market. It sounded to me like on this call, given some of the volatility that you're seeing in markets outside the U.S. and the increased scale that's really needed in North America with a lot of the retailers, perhaps a sense of urgency in terms of making some of the structural solutions may not be there as it was a year or so ago when you made that announcement. So I wanted to just clarify if that assessment is appropriate or we should still be thinking about sometime early next year you're coming up with a decision on that issue.

<A - **Indra K. Nooyi**>: Well, Judy, let me speak to the second one very quickly. You know, as we said, we will tell you in early next year what we're going to do and we've told you all the structural solutions we're looking at and that's what we're doing. We're looking at structural solutions, but I want to underline, sensible, value-creating structural solutions. So keep that in mind.

Let me now come to emerging markets. Emerging markets, emerging and developing markets, by definition, are going to be volatile. In today's world, where you've got turmoil in the developed markets, I think that tends to halo onto emerging markets and that creates more sort of variance around the [ph] vein, (52:11) if you want to call it that.

Very quick walk through, I think because we're in the staples business, the swings in our business are probably going to be less than swings you might see in hard goods or white goods or durables. The thing to be very, very careful about, if you just focus on market share, especially against local competitors' B brands in those markets, and start doing crazy things with pricing, what you'll do is exacerbate the volatility into your business. So again, what we've told -- I've told all of the sector heads, is to make sure that you manage share across a narrow corridor. Don't try to chase pricing down with B brands, local brands. Don't try to hit the pricing so much just to drive volume because in these volatile times, buying volume is like renting volume.

So we've been directing our people to manage the business sensibly, balance volume, pricing, revenue, profitability, and build frequency and penetration deliberately and carefully. Do not rent volume; build it carefully. Build a brand

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equity, build a consumption occasion very, very carefully and that's what we've told everybody to do. Is there volatility? Yes, but I think for companies like PepsiCo, given our broad geographic and product portfolio and brand portfolio, the company becomes a natural hedge against all of these variabilities. So again, we feel pretty good.

Operator

Our final question comes from the line of Amit Sharma with BMO Capital Markets.

<Q - Amit Sharma>: Hi. Good morning, everyone.

<A - Indra K. Nooyi>: Morning, Amit.

<Q - Amit Sharma>: Indra, just wanted to focus on Frito-Lay. I mean, the business is positioned to post the strongest volume growth that we've seen at least last five years and you talked about some of the innovation coming through. Can you provide us a little bit more color of sustainability of the current volume trend and what should we expect in the next six to 12 months?

<A - Indra K. Nooyi>: Frito-Lay North America is a terrific franchise. The business is well run. And I think the incredible way that our snacks business and beverage business work together to really bring solutions to customers is what makes that business so successful. And the virtuous circle of driving top-line growth, focusing on productivity, taking the benefit from that, investing some back into the company to keep the virtuous circle going, putting the rest to the bottom-line is what's kept this Frito-Lay business going.

What Frito-Lay has been known for is, every three or five years, looking at breakthrough productivity to drive another three to five years of profit growth, and that thinking continues at Frito-Lay. But, Amit, I tell you, the most important thing is we have segmented the Frito-Lay business in a very interesting way, where we look more at demand spaces rather than just cohorts or day parts. And looking at demand spaces now, we can see how we can expand the Frito-Lay eating occasions.

So as you look at the overall macro snack environment, we know how to push salty snacks into taking away cookie occasions, cracker occasions, chocolate occasions by looking at various demand spaces and looking to see what consumers consume for each of those demand spaces. So we look at macro snacks as our feeding ground. Salty snacks is just a sub-segment of that. And as long as there's a lot of space with all macro snacks and we have a very strong distribution and great innovation capabilities, we feel good about the fact that we can go after some of those occasions. And that's the growth story of Frito-Lay.

Indra K. Nooyi

Thank you all for your questions. And in closing, our performance to date in 2013 is a good indicator of how a well constructed and developed portfolio, coupled with disciplined execution reinvestment, can drive high quality top and bottom-line results on a sustainable long-term basis, and this is the purpose of PepsiCo. I thank you for your time this morning and for the confidence you've placed in us with your investment. Have a great day.

Operator

This concludes today's conference and may now disconnect.

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