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Research Update:

Keurig Green Mountain Inc. Upgraded To 'BB' From 'BB-'; Outlook Stable; Issue-Level Rating Actions Taken

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Overview

- We have revised our forecast upward for U.S.-based Keurig Green Mountain Inc. given its recent productivity gains. As a result, credit metrics are stronger than our prior forecast.
- We are raising our corporate credit rating on Keurig to 'BB' from 'BB-.
- Concurrently, we are raising our issue-level ratings on the senior secured bank debt by two notches, to 'BBB-' from 'BB'. In addition, we are revising our recovery rating to '1' from '2'.
- The stable outlook on Keurig reflects our expectation that the company will prioritize deleveraging and use internally generated cash to reduce financial leverage to 3.5x in fiscal 2017. Despite our expectation for soft top-line growth, we forecast the company will expand EBITDA margins through cost reductions over the next 12 months, which should enable the company to generate free cash flow of at least $800 million.

Rating Action

On Jan. 26, 2017, S&P Global Ratings raised its corporate credit rating on Keurig Green Mountain Inc. to 'BB' from 'BB-'. The outlook is stable.

At the same time, we raised the issue-level ratings on the company's senior secured credit facilities to 'BBB-' from 'BB'. The debt comprises a $500 million revolver due 2021, $3.175 billion term loan A due 2021, $1.775 billion term loan B due 2023, and a €842 million term loan B due 2023. The company has repaid $750 million in aggregate of funded debt since it was acquired. We also revised the recovery rating to '1" from '2'. The '1' rating indicates our expectation that lenders could expect very high (90% to 100%) recovery in the event of a payment default.

Debt outstanding as of Dec. 24, 2016, was about $5.1 billion.

Rationale

The upgrades reflect our upward revision in our forecast for EBITDA expansion and our expectations that Keurig will trend towards the 3.0x leverage area in fiscal 2018 (ending Sept. 30). Under new management, Keurig's EBITDA margin expanded to 6 points for the 12 months ended Dec. 24, 2016 compared to the

year-ago period. This combined with its debt pay-down has resulted in leverage falling to 3.9x from pro forma 5.4x at the time of the leveraged buyout in January 2016. Operating performance has improved because of new management's manufacturing and procurement initiatives, favorable brewer mix, and lower coffee bean costs. The company also benefitted from disposing its Kold business. We forecast its operating performance will continue to improve as the company streamlines costs and increases its operating efficiencies. In addition, we believe management will focus on deleveraging rather than shareholder distributions. As a result, we expect its credit metrics to strengthen further, including leverage declining to about 3.5x at the end of fiscal 2017 and to 3.0x at the end of fiscal 2018. The revision of the recovery ratings reflects lenders' improved recovery of principal in the event of a payment default given the company's lower debt levels.

The ratings on Keurig reflect the company's moderate leverage, number 1 position in single-serve coffee brewers and portion packs in the U.S. and Canada, participation in the fastest-growing segment of the coffee industry (although growth rates are decelerating), and lack of product and geographic diversity. The ratings also reflect Keurig's good cash flow generation capabilities, its moderating financial policy as demonstrated through the reduction of its dividend compared to when it was a public company, and its use of internally generated cash for debt repayment.

Keurig has a very strong domestic position in its niche segment. The global coffee market is large, at $87 billion (excluding retail coffee shops), and we expect it to grow at 3% annually. Keurig competes predominantly in the attractive U.S. market, which, at $13.5 billion, is the largest coffee market in the world. Single-serve volume per pound share of total coffee is 7% in the U.S., and has been driving the overall coffee market growth, although that growth has been decelerating in recent years. Total coffee volume per pound in the U.S. has been flat while single-serve coffee grew 50% in 2013, 31% in 2014, 14% in 2015, and 11% in 2016. Single-serve share was 39% in 2015 on a dollar basis in the U.S. The significantly higher dollar share is because of the segment's higher price point compared with those of other coffee segments. The single-serve price per cup is 51 cents, compared to premium roast and ground, which is 11 cents; mainstream, at four cents; and instant, at three cents.

Although the coffee sector is highly competitive and fragmented, Keurig should continue to benefit from increasing penetration rates in the U.S. Household penetration of single-serve brewers are low in the U.S. (at 17%) compared to other countries--for example, penetration rates are 65% in Netherlands, 54% in Belgium, 49% in France, 38% in Germany, and 33% in Canada. Keurig's growth is dependent on increasing domestic adoption of single-cup coffee makers, retaining existing households, maintaining stable attachment rates, and maintaining solid relationships with third-party brands. Consumers purchase the brewers for convenience as they are easy to clean and save time compared to roast and grind brewers. Noteworthy is that the brewer base increased 8% year over year in its fiscal first quarter of 2017, which includes its important holiday season.

Keurig competes against large brands with deep financial resources such as Kraft Foods' Maxwell House and The J.M. Smucker Co.'s Folgers, as well as coffee retailers such as Starbucks and Dunkin' Brands. In the single-cup coffee segment, the company competes against companies such as Nestle, which is the category leader with about $12 billion in sales. Keurig also competes against coffees and teas sold through supermarkets, club stores, mass merchants, specialty retailers, and food service accounts. In single-serve, Keurig has a competitive advantage, as it controls innovation on brewers and pods, and has multiyear strategic relationships with Starbucks, Dunkin' Donuts, Eight O' Clock Coffee, and others. The company has 80 brands in its system, which creates a significant competitive advantage because no other single-serve system offers more choices for consumers. We believe Keurig will maintain a very strong share in the U.S. and Canada markets because of its history of success at developing innovative products. Following its patent expiration in 2012, the company increased its mix of private label, which is somewhat lower margin. We do not expect the company will continue to focus on this segment, but will instead focus on its brands.

Keurig lacks product and geographic diversity compared to major competitors such as Kraft, Smucker, and Nestle. The company is highly dependent on the domestic single-serve category with approximately 81% of consolidated net sales to portion packs and 19% to Keurig single-cup brewers and related accessories in fiscal 2016. This leaves the company vulnerable to shifts in consumer tastes and preference. Moreover, it has a narrow geographic footprint, with 87% of its sales in the U.S. and 13% in Canada.

Assumptions supporting our expected ratio ranges for the company in fiscal 2017 and 2018 include the following:

- We forecast economic growth of about 2.4% in 2017 and 2.3% in 2018 supported by continued improvement in labor markets and stronger wage gains. This will be accompanied by consumer spending growth of roughly 2.5%.
- We believe the U.S. single-serve coffee segment will grow faster than the overall coffee market, but that growth will slow because of the single-serve category's increased size and intense competition in the coffee market overall. We expect industry volume to grow 5% over the next two years, down from 11% growth in 2016.
- Keurig revenue decline roughly 2.5% for 2017 and increase about 1.0% in 2018. We believe its revenues will not keep pace with GDP growth because the company is investing in price to gain share.
- The EBITDA margin expands to 300 basis points in fiscal (bps) 2017 compared with fiscal 2016 and increase another 250 bps in fiscal 2018, because of its cost savings initiatives and better operating efficiency.
- Capital expenditures of about modestly below fiscal 2016 levels.
- Dividends similar to fiscal 2016 levels.
- Free cash flow of approximately $800 million in fiscal 2017 and $850 million if fiscal 2018.

Note: the company's financials are private.

Liquidity

We assess Keurig's liquidity as adequate, reflecting our belief that the company's sources of cash will exceed its uses by at least 1.2x over the next 12 months. Even if EBITDA declines by 15% below our base case, the company's liquidity sources will exceed its uses.

Principal liquidity sources:

- Cash in excess of $400 million;
- An undrawn $200 million revolving credit facility due 2021;
- Funds from operations (FFO) of at least $880 million during the next 12 months; and
- Working capital inflow of below fiscal 2016 levels.

Principal liquidity uses:

- Capital expenditures modestly lower than fiscal 2016;
- Debt repayment of more than $175 million annually;
- Peak seasonal working capital needs less than 20% of its revolving credit facility; and
- Dividends in line with fiscal 2016.

Outlook

The stable outlook on Keurig reflects our expectation that the company will prioritize deleveraging and use internally generated cash for debt repayment. We also expect the company to generate volume growth by improving marketing, and expand margins through cost reductions over the next 12 months, which should enable the company to generate FOCF in of $800 million and reduce financial leverage to 3.5x in fiscal 2017.

Downside scenario

We could lower the ratings if Keurig's leverage increases to above 4.0x. This could result from a material reduction in FOCF generation from currently expected levels, possibly from market share losses because of changes in consumer tastes or from a change in the company's financial policies resulting in excess cash applied to dividends versus debt reduction.

Upside scenario

We could consider a higher rating if Keurig sustainably grows the sales of its high-margin portion packs despite strong competition from alternative coffee products, maintains margins at least at current levels, and sustains financial leverage below 3.0x. We would also consider an upgrade if the company geographically diversifies and demonstrates it can gain market share in countries it is currently does not do business in.

Ratings Score Snapshot

Corporate Credit Rating: BB/Stable/--
Business risk: Fair
- Country risk: Very low
- Industry risk: Low
- Competitive position: Fair

Financial risk: Significant
- Cash flow/Leverage: Significant

Anchor: bb
Modifiers
- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: bb
Group credit profile: bbb+ (JAB Holding Co.)
Entity status within group: Nonstrategic

Recovery Analysis

We believe the company would be reorganized rather than liquidated under a default scenario, because of its top market position in single-serve coffee. Therefore, in evaluating the recovery prospects for debt holders, we have valued the company on a going-concern basis using a 7.0x multiple of our projected emergence EBITDA value.

Simulated Default Scenario

Our simulated default scenario contemplates a default in 2022 due to poor product quality or an incident that damages the company's reputation, a spike in the cost of coffee beans that could not be passed along to its immediate clients, changing consumer tastes, or the loss of its major clients. A combination of these factors could result Keurig's cash flows deteriorating substantially, triggering a payment default.

Our default level EBITDA takes into consideration the level of fixed charge obligations assumed at default and consists of $495 million in debt service requirements and $90 million in capital expenditures. This represents about 8x total leverage using the $4,424.0 million in debt outstanding at default. We assume covenants under the revolver would be amended through the path to default up to a threshold before the company defaults.

Simplified recovery waterfall

- Emergence EBITDA: $670 mil.
- Multiple: 7.0x
- Gross recovery value: $4,695 mil.
- Net recovery value for waterfall after admin expenses (5%) [and pensions, if applicable]: $4,460 mil.
- Obligor/non obligor valuation split: 100%/0%
- Estimated priority claims [ABL or other]: $0 mil.
- Remaining recovery value: $4,460 mil.
- Estimated first lien claim: $4,425 mil.
- Value available for first lien claim: $4,460 mil.
- Recovery estimate: 101%

Related Criteria

- Criteria - Corporates - General: Recovery Rating Criteria For Speculative-Grade Corporate Issuers, Dec. 07, 2016
- Criteria - Corporates - Industrials: Key Credit Factors For The Branded Nondurables Industry, May 07, 2015
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Upgraded; Recovery Rating Revised

	To	From
Keurig Green Mountain Inc.		
Corporate Credit Rating	BB/Stable/--	BB-/Stable/--
Senior Secured	BBB-	BB
Recovery Rating	1	2H

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