Research Update:

Keurig Dr Pepper Inc. 'BBB' Rating Affirmed On Revised Financial Policy; Outlook Stable

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Rating Action Overview

- Beverage and coffee pod maker Keurig Dr Pepper Inc. (KDP) recently revised its capital allocation priorities and financial policy, including a lower debt to EBITDA target of 2.0x-2.5x and expectation for more modest merger & acquisition (M&A) activity.
- However, S&P Global Ratings-adjusted leverage (including our debt adjustment for the company's supply chain financing program) totaled 3.9x for the fiscal year ended Dec. 31, 2022 (fiscal 2022), well above the company's target. Additionally, it has not demonstrated a track record of deleveraging since announcing its new financial policy and has only modest annual S&P Global Ratings-adjusted EBITDA growth over the past couple of years.
- Therefore, we affirmed all ratings on KDP, including the 'BBB' issuer credit rating.
- The stable outlook reflects our expectation that the company will steadily reduce leverage over the next two years toward 3x while growing through organic sales expansion and modest-sized bolt-on M&A or partnership investments. We could revise the outlook to positive over the next few quarters if the company demonstrates clear progress in its deleveraging.

Rating Action Rationale

Although KDP has a more conservative financial policy, deleveraging to levels that support a higher rating may take time. The company's S&P Global Ratings-adjusted debt to EBITDA was 3.9x as of fiscal year-end 2022, largely unchanged from 3.8x a year earlier. This was higher than our previous expectation of 3.5x, primarily because of the $871 million Nutrabolt acquisition. Leverage was also higher because of higher adjusted debt balances for leases after the company pursued sale leasebacks of its facilities and further increased the balances of payables under its supply chain financing programs, which we consider debt like. Our supply chain financing debt adjustment totaled $1.8 billion in fiscal 2022, compared with $1.4 billion the prior year. Still, we expect net debt balances to decline over the next several years as the company reduces leverage closer to its stated targets. We project S&P Global Ratings-adjusted debt to EBITDA will decline to about 3.5x in fiscal 2023 and approach 3x in 2024. Although we view this deleveraging outlook favorably, the company has not yet demonstrated a track record of reducing leverage since it revised its financial policy. Moreover, we project working capital outflows will hamper leverage reduction for the current fiscal year. We expect fiscal 2023 discretionary cash flow (DCF) will decline closer to $500 million, compared with just under $1 billion in 2022, due to working capital outflows of about $500 million. Thereafter, DCF will rebound to historical levels and support faster deleveraging.

KDP has adopted a measured approach to M&A and share repurchases. The company's revised capital allocation priorities also support deleveraging. Management has indicated it will not pursue large, transformational M&A and instead will invest in more modest-sized bolt-on and partner investments to complement its organic growth. We expect its future investment outlays will likely be similar in size to its recent $871 million investment in Nutrabolt, which will strengthen the company's foothold in the fast-growing energy drink category and further increase volumes in the convenience store channel. In addition, we expect the company will adopt a measured approach toward its discretionary share repurchases, primarily repurchasing shares to offset stock compensation dilution. Assuming the company will successfully execute these strategies, we forecast it can reduce net debt by over $1 billion over the next two years. This combined with a partial rebound in EBITDA margins should enable the company to reduce leverage below 3x, but only beyond fiscal 2024.

Its operating performance has largely met our expectations, but inflation and recession risk could keep EBITDA growth subdued. KDP continues to generate heathy organic growth, with year-over-year net sales growth of 10.8% in fiscal 2022. Although its growth primarily reflected pricing, volumes grew across the company's three core beverage product offerings: coffee pods, carbonated soft drinks (CSDs), and noncarbonated beverages. Coffee brewer volumes declined about 5% in 2022 compared with strong volumes in 2021 due to increased at-home consumption from the pandemic. We expect the company to generate 4%-6% organic sales growth due to pricing, improved mix to more premium offerings (particularly after supply chain constraints prevented the company from prioritizing its higher margin branded pods last year) and 1%-2% volume growth across its core beverage categories. We also expect EBITDA margins to rebound more than 100 basis points (bps) in 2023 from a continued product mix shift to higher-margin new products, as well as pricing and cost management. However, continued high wage inflation and increased costs to expand Nutrabolt's distribution will keep its margins from fully rebounding to historical levels of 29%-30%. Based on these assumptions, we expect the company will continue expanding EBITDA by 5%-7% annually over the next several years, albeit with a fair degree of downside risk over the next 12 months given the elevated risk of a recession.

Outlook

The stable rating outlook on KDP reflects our expectation that the company will generate 4%-6% organic sales growth over the next several years, slowly restore margins closer to historical levels as inflation eases, and reduce leverage closer to 3x by fiscal year-end 2024.

Downside scenario

Although unlikely given the company's more conservative financial policy, we could lower the ratings if its leverage increases above 4x. This could occur if the company:

- Adopts a more aggressive financial policy, including a willingness to undertake debt-financed share repurchases; or

- Pursues much larger M&A compared with the past two years, when M&A remained well below $1 billion.

Upside scenario

We could consider revising the outlook to positive over the next few quarters or raising the company's ratings if we project it will sustain leverage below 3x in 12-18 months. This could occur if the company:

- Maintains its current leverage target of 2x-2.5x;
- Exercises share repurchases primarily to offset stock compensation dilution and limits M&A opportunities to bolt-on acquisitions and other modest-sized partnership investments consistent with the past several years; and
- Maintains organic revenue growth and EBITDA margins well above 25%.

Company Description

KDP is a major nonalcoholic beverage company in North America with a diverse portfolio of flavored (noncola) CSDs, specialty coffee and noncarbonated beverages, and the leading single-serve coffee brewing system in North America. KDP's national distribution system provides its portfolio of more than 125 owned, licensed, and partner brands to consumers. Its coffee business is modestly more profitable than its cold beverage business.

Our Base-Case Scenario

- Sales growth of 5%-6% in fiscal 2023, reflecting continued pricing benefits and 1%-2% volume growth.
- Sales to continue expanding 4%-5% in fiscal 2024 as its volume recovers and it increases its innovation offerings.
- Gross margin increases 110 bps as pricing offsets input costs and freight inflation and it shifts to a higher-margin product mix shift of company-branded coffee pods and new product innovations.
- General and administrative expenses increase 2% year over year as cost savings only partially offset labor inflation and higher distribution costs
- Capital expenditure (capex) totals about $350 million annually in 2023 and beyond.
- Dividends total about 45% of net income.
- Its share repurchases largely offset stock compensation dilution, and M&A activity remains muted in fiscal 2023.
- The company executes possible bolt-on M&A or other minority partner investments beyond 2023.

Liquidity

We assess KDP's liquidity as adequate, reflecting our expectation that its sources will cover uses by more than 2.2x over the next 12 months. We expect sources will exceed uses even if forecast EBITDA declines 50%. We believe KDP has a strong standing in the credit markets, strong relationships with its banks, and an EBITDA cushion of more than 60% on its minimum interest covenant.

Principal liquidity sources

- Cash totaling $535 million;
- Full availability on its $4 billion revolving credit facility maturing 2027; and
- Funds from operations (FFO) exceeds $2.5 billion.

Principal liquidity uses

- Debt maturities of $1 billion over the next 12 months;
- Seasonal working capital outflows of $100 million consistent with our base case assumptions;
- Net working capital reduces $500 million in 2023 consistent with our base case assumptions;
- Capex of $350 million consistent with our base case assumptions; and
- Dividends of $1.2 billion.

Issue Ratings - Subordination Risk Analysis

Capital structure

KDP's capital structure consists of senior unsecured debt, all of which is issued at the holding company. The company has no secured debt or priority subsidiary debt.

Analytical conclusions

We rate KDP's unsecured debt 'BBB', the same as the issuer credit rating, because we believe that any subordination risk that may exist is not significant enough to warrant a notch down.

Ratings Score Snapshot

Issuer credit rating: BBB/Stable/A-2

Business risk: Strong

- Country risk: Very low
- Industry risk: Low

- Competitive position: Strong

Financial risk: Significant

- Cash flow/leverage: Significant

Anchor: bbb

Modifiers

- Diversification/portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: bbb

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012

Ratings List

Ratings Affirmed	
Keurig Dr Pepper Inc.	
Issuer Credit Rating	BBB/Stable/A-2
Senior Unsecured	BBB

Ratings Affirmed

Commercial Paper	A-2

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.