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FEATURE

## Coke's Fortunes Are Set to Pop

By CHRISTOPHER C. WILLIAMS |

*The world's leading beverage maker has lost some of its fizz. But it's likely to pop again, as it flexes its muscles in the overseas markets. Video: Coke's Looks Overseas to Boost Sales*

**AFTER BESTING PEPSICO IN THE COLA WARS OF** the 1990s to become the King of Pop, Coca-Cola has encountered a more formidable opponent -- the recession. A struggling economy, together with health concerns, has contributed to a further decline in soda consumption in the U.S., and depressed Coke's profits and shares. Earnings are expected to slip 3% this year, while Coke's stock has fallen 13% in the past 12 months, to a recent 48.



Coca-Cola

From Dayton to Dubai, who doesn't recognize this logotype?

But this could be the pause that refreshes for the world's leading beverage maker, which commands a 10% share of the global market in all non-alcoholic beverages. As in prior economic downturns, Atlanta-based [Coca-Cola](#) (ticker: KO) is using its copious cash, marketing muscle and unmatched global distribution system to take market share from rivals and strengthen its core business. Among other things, it is cutting costs and launching new products. Coke also is expanding aggressively overseas, to offset sluggish domestic volume. Volume in the \$73 billion U.S. carbonated-soft-drink market fell 3%

in 2008, continuing a protracted slide.

Significantly, Coke management is working to bolster the company's sometimes-rocky relationship with Coca-Cola bottlers, who buy concentrate from the company and transform it into bottled soft drinks and juices. In a dramatic shift, the company is inking multi-year concentrate-price agreements with bottlers in the U.S., moving away from annual negotiations. Under these deals, Coke will charge bottlers a percentage of revenue generated, rather than a fixed rate per gallon bottled. Analysts say such agreements will give bottlers greater visibility and encourage them to make longer-term investments in growing the brand. "With these deals, the franchise model in the U.S. can be put on steroids," says Credit Suisse analyst Carlos Laboy.

Yet, for all its formidable strengths, including what may be the best brand name in the world, Coke sells for just 15 times analysts' 2009 earnings estimates and 15 times 2010 forecasts -- near its lowest valuation in 20 years. Given the company's significant exposure to fast-growing emerging markets, its strong balance sheet, a gold-plated brand and savvy management, Coke arguably deserves to trade at a multiple of at least 17 times forward earnings, which would imply a stock price of 56. Add a 3.4% dividend yield, and that's a potential total return of 20% based on today's stock price.

Steven Roge of the Roge Partners Fund says he went looking for "top-notch franchises selling for once-in-a-lifetime valuations" -- and reached for Coke in January. Using his discounted cash flow model, Roge estimates the company is worth 72.50 a share.

Roge is in good company. Coca-Cola is one of the largest equity holdings of Warren Buffett's [Berkshire Hathaway](#) (BRKA), and Cherry Coke is Buffett's favorite drink. Buffett holds 200 million of Coke's 2.3 billion shares.

Citing declining soft-drink sales in the U.S., some critics say Coke's business is fizzling. But that ignores the company's aggressive move into markets such as China, where volume is growing by double digits. Today Coca-Cola, first served at soda fountains in 1886 for five cents a bottle, is a staple in more than 200 countries. Coke, the company, gets 80% of its sales, and more than 95% of operating profits, from abroad, and is a blue-chip play on the growth in emerging markets.

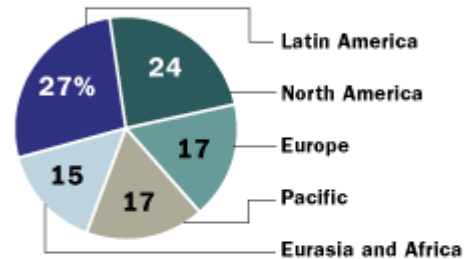
Still, the critics have a point: The growth rate of carbonated-soft-drink, or CSD, sales peaked in 1994, according to Beverage Digest. In the years since, consumers have embraced alternatives such as bottled water and sports and performance drinks. Last year, for instance, the energy drink Red Bull saw a 5% uptick in average case volume, while volume at Coke and Pepsi fell more than 3%. Coke has added numerous soda alternatives to its beverage line-up, including Dasani water, VitaminWater and Nestea. Carbonated soft drinks today account for 78% of unit volume, down from 90% ten years ago.

**THIS YEAR'S SECOND QUARTER** marked the eighth consecutive quarter in which Coke posted volume and market-share gains in non-alcoholic, ready-to-drink beverages. The company earned a better-than-expected 92 cents a share for the latest period, on a 9% drop in revenue to \$8.3 billion, as currency translation punished reported results. Coke benefited from strong income from its bottling investments and a 4% uptick in its worldwide beverage volume, led by gains of 33% in India and 14% in China. North-American volume slipped 1% but improved from the first quarter.

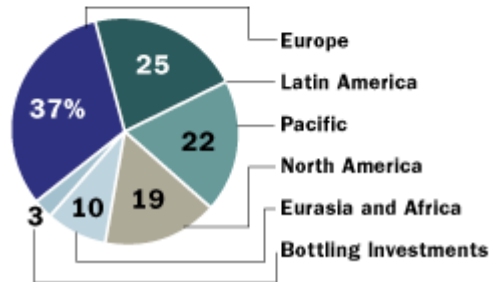
## Thirst Quencher

Carbonated beverages may be going a little flat in the U.S., but there's oceans of room for growth in emerging markets, where Coke is the leader.

### Geographic Breakdown: 2008 Volume



### 2008 Operating Income\*



\*Excluding corporate expenses.

Source: Company reports

The latest results support analysts' expectations for a rebound in earnings next year. The Street estimates 2010 net income of \$7.6 billion, or \$3.30 a share, on revenue of \$32 billion, versus this year's projected profits of \$7 billion, or \$3.04, on sales of \$31 billion. Coca-Cola earned \$7.4 billion, or \$3.15 a share, in 2008, on revenue of \$32 billion.

Although it won't disclose exact figures, Coke is benefiting from price increases, in some markets, especially in Latin America, as well as volume growth and cost cutting. Management hopes to save an annualized \$500 million by 2011, mainly in administrative costs. Share-buyback also will boost growth in earnings per share; the company is buying back \$1 billion of stock this year. Long-term, Coke is looking to grow annual volume by 3% to 4%, revenue by 4% to 5%, operating income by 6% to 8% and earnings per share by high single digits.

**IN AN INTERVIEW** with *Barron's*, Chief Financial Officer Gary Fayard said year-to-date results are generally in line with management's long-term goals. "If we can hit guidance in this economic environment, that's the biggest reason why we think we'll be stronger," he said.

**Table:** [Soda on Sale](#)

Coca-Cola and PepsiCo generally are linked in investors' minds, although Pepsi is a dominant snack-food player and generates more revenue, at \$43 billion. It also has a smaller presence overseas. One big difference between the two is the approach each is taking with bottlers. PepsiCo paid \$8 billion earlier this month to buy two of its largest bottlers, promising cost savings and growth. But Coke seems glued to its franchise model, in which it owns stakes in Coca-Cola bottlers. Chief Executive Muhtar Kent, a former bottler who joined the company in 1978, was named CEO in 2008. He is working closely with bottlers, especially Coke's largest, [Coca-Cola Enterprises](#) (CCE), on ways to strengthen the brands and leverage marketing and distribution investments. Coke owns 35% of CCE.

Some analysts and investors seem confident Coke's approach will pay off but note management could change course if Pepsi's strategy is more successful. "The franchise model is better from a return-on-capital and profitability standpoint," says Stephen Boland, an analyst at Odium Brown. "I would prefer to see them stick with that model."

With its stock depressed on two years of domestic downtrends, Coca-Cola, may be worth 50% more than its current share price.

Having bottlers who are motivated is critical for Coca-Cola, since bottlers account for 89% of worldwide sales volume. The multi-year pricing deals, begun in Latin America, were instrumental in making that region a leading growth engine for Coke, says Credit Suisse's Laboy. He expects the company to sign more 50/50 profit agreements with bottlers for noncarbonated beverages, and thinks they will help Coke deliver "EPS growth rates of 12% to 14% over the next few years." Laboy has an Outperform rating on the stock and a price target of 57.

Coke reported better-than-expected equity income of \$310 million in the second quarter from its bottling investments, including CCE and Femsas, or [Fomento Economico Mexicano](#) (FMX), in Latin America.

The beverage business isn't immune to a downturn, and a collapse in the nascent recovery could pinch Coca-Cola's growth. And even with a truce in the cola price wars, competition from PepsiCo, which has 31% of the U.S. carbonated-soft-drink market versus 43% for Coke, remains intense. Companies like Austria's Red Bull also are keeping the beverage giants on their toes.

### **The Bottom Line**

With its stock depressed on two years of domestic downtrends, Coca-Cola, one analyst says, may be worth 50% more than its current share price.

"[Coke is] a China, India, Latin America story that had better work," says Joseph Tatusko of Westport Resources." Otherwise, the stock will likely be range-bound for years."

CFO Fayard says the biggest risk is in currency translations, as revenue from foreign operations is translated into dollars. Coke doesn't hedge in emerging markets, which hurt in recent quarters. Revenue in the latest quarter took a 9% hit from currency translation, and operating income was squeezed by 14%. Management is bracing for a 12% to 14% hit in the third quarter.

Yet, making soda isn't rocket science. If Kent & Co. can keep the three critical elements of Coke's organization -- products, bottlers and retailers -- working smoothly to satisfy consumers' shifting tastes, management will have gotten the formula for the company, and its shares, just right.

<http://online.barrons.com/article/SB125029831086233597.html?page=sp>