Upslope Capital Management

Memo: Short - Coca-Cola Consolidated May 14, 2019

"You Can't Beat the Real Thing"

- Coca-Cola slogan (1990)

Coca-Cola Consolidated (Nasdaq: COKE, also the "Company") is one of the more compelling short opportunities that we've seen in some time – and Upslope is currently short. COKE is the largest independent Coca-Cola *bottler* in the U.S. With a market cap of under $4bn, COKE is not to be confused with "Coca-Cola Co." (NYSE: KO), the $240bn enterprise that boasts Berkshire Hathaway as a top shareholder.

The COKE we're discussing doesn't own Coca-Cola brands, but instead "distributes, markets and manufactures" various nonalcoholic beverages across 14 states (mostly Southeast and mid-Atlantic) and D.C. Almost 90% of COKE sales are in fact branded products from *the* Coca-Cola Company (KO). But again, COKE is simply the bottler and distributor of Coca-Cola-branded (and other) products.

While readers might assume we're dealing with a boring consumer staple stock, COKE is anything but. After more than doubling YTD, COKE's current market cap is almost $4bn. There are four key pillars (plus a bonus section at the very end, because why not?) to the short thesis, in our view:

1. **COKE has the financial profile of a mediocre consumer staple stock**
2. **The Company checks all the boxes for poor corporate governance**
3. **Explosive YTD performance driven by questionable, non-fundamental factors**
4. **COKE shares are now egregiously overvalued (>50x 2019E earnings)**
5. **Bonus / Miscellaneous Observations**

We'll dive into each of these section in more detail below and in the coming pages.

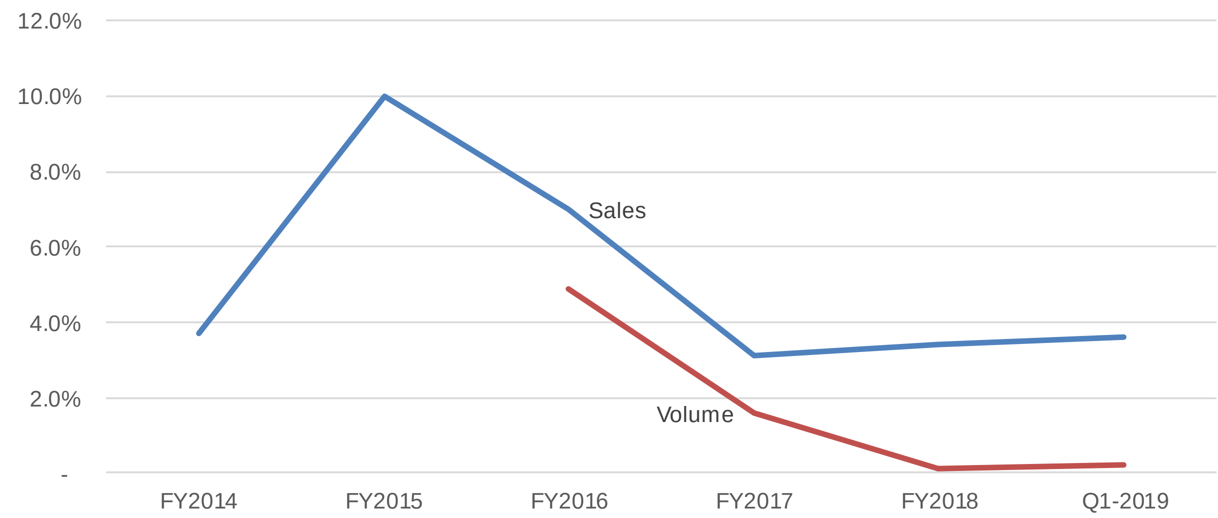
A Mediocre Consumer Staple Stock

In 2013, COKE began a series of inorganic transactions that practically doubled the size of the Company and its footprint. We give management credit for executing well on this front; but it's over. The "Transformation Program," as it was called, concluded at the end of 2017. "Real Coke" (KO) is done refranchising its domestic bottling operations. Today, COKE shareholders are left with a low-quality consumer staple stock. What exactly does this mean?

Qualitatively, we note that COKE has commodity exposure (aluminum, PET resin, and corn price changes create margin volatility), limited organic growth prospects (exclusively focused on domestic sales with heavy exposure to Coca-Cola brands), and significant customer concentration (22% of sales combined go to Wal-Mart and Kroger).

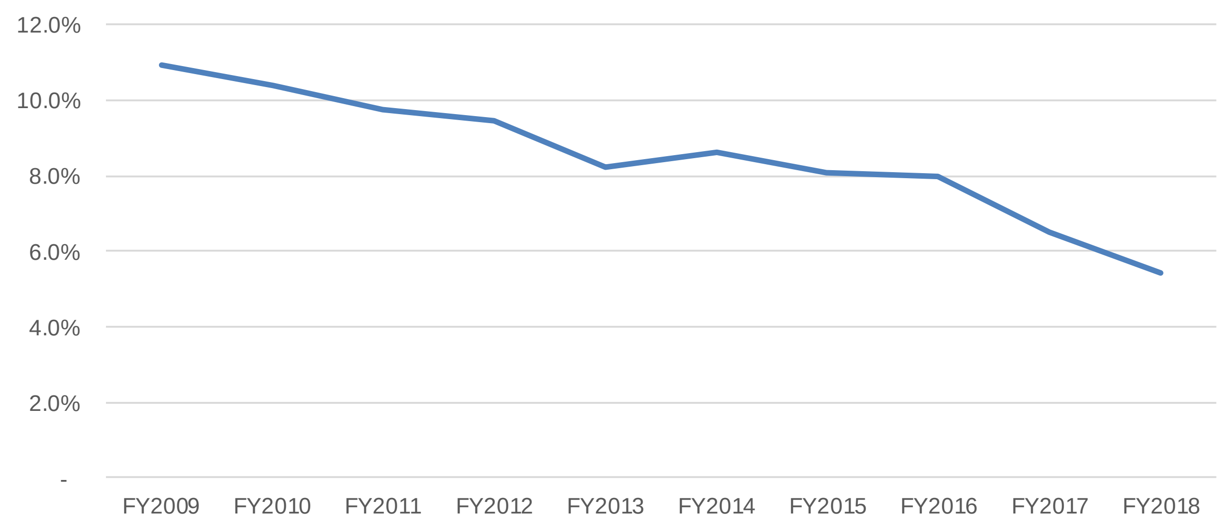
Quantitatively, COKE has (a) modest historic (+ prospective, in our view) organic growth, (b) low margins that have declined over the long-term, (c) low returns on capital, and (d) a full balance sheet (~3.5x net debt/2019E EBITDA).

Exhibit 1: Modest Organic/Comparable Revenue and Volume Growth



Source: Upslope, Canalyst, Sentieo
Note: Organic growth disclosures have been somewhat inconsistent, which is why this chart is limited in its history.

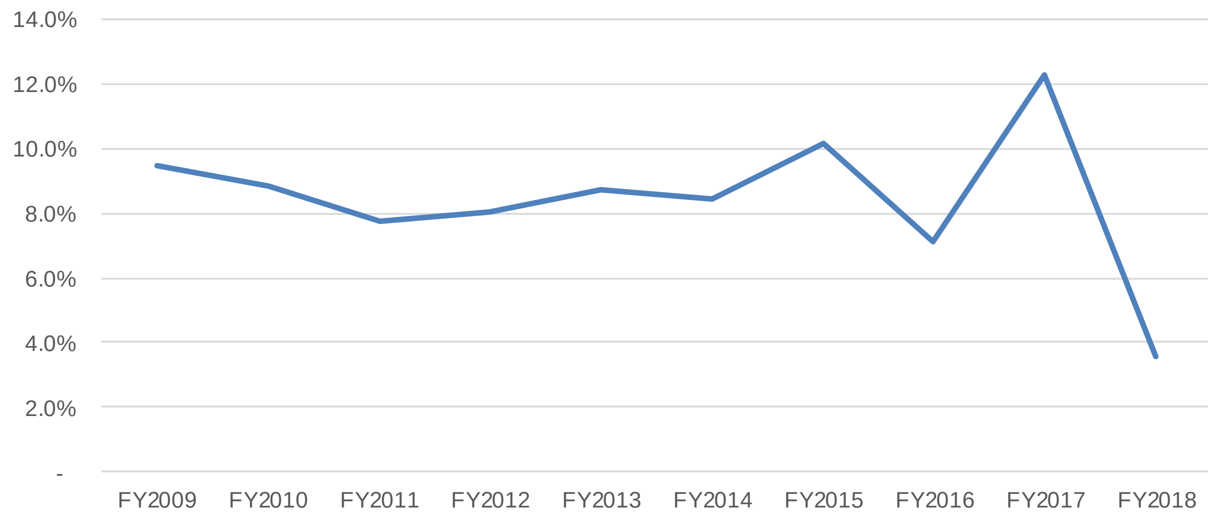
Exhibit 2: Low/Declining EBITDA Margins



Source: Upslope, Canalyst, Sentieo

Note: we do think it's likely for COKE to experience an improvement in margins in 2019 as Transformation Program execution costs finally roll-off. There were $43mm of such direct expenses in 2018 (only some of which should repeat in 2019). For modeling purposes, we assume an EBITDA lift of ~$85mm in 2019 vs. 2018. However, we believe the benefits will be relatively one-time in nature and that margins will remain low in an absolute sense and are unlikely to experience a lasting change in trend.

Exhibit 3: Low Returns on Capital (ex-Goodwill) – Especially for a Consumer Staple



Source: Upslope, Canalyst, Sentieo

Corporate Governance Disaster

Coke's CEO, Frank Harrison, claims COKE's purpose is "to honor God, to serve others, to pursue excellence and to grow profitably." Despite this mantra, which he repeats frequently in interviews and is noted in official SEC filings, Harrison treats the company as his own personal piggy bank. Examples are noted below.

Dual Share Structure

COKE has a dual share class structure. As a result, Harrison controls ~86% of the votes (despite owning ~25% of total shares/economic rights) via his Class B share holdings. While not unusual, such structures have been widely criticized in recent years for entrenching management interests at the expense of shareholders (and we see exactly how that can go wrong below).

Exorbitant Executive Comp

Harrison's compensation level is astronomical by almost any measure. He has earned $11mm/year over the past three years (2016-18) and $50mm total in the last five. And all this, for the CEO of a Company that has historically – until this Spring – had a market cap in the $1-2bn range.

While aggregate data is tough to slice, it appears Harrison's comp is ~2-3x the level of CEOs that run comparably-sized businesses[1]. Out of curiosity, we also took a peek at comp for the CEO of "real Coke" (KO), which has an enterprise value of nearly 50x COKE's. Sure enough, Harrison's compensation was almost dead in-line with the CEO of "real Coke" over the past three years.

[1] Based on Equilar data cited in a Stanford GSB presentation on executive comp.

Big Related Party Deals Boost Comp Even More

On top of his direct comp, Harrison is also an owner of/beneficiary in two properties (including corporate HQ) leased by the Company that receive a combined $8-9mm/year of ongoing rent/lease payments from COKE. While this is disclosed in COKE's SEC filings, these conflicts/transactions are yet another sign of weak corporate governance and executive over-compensation.

Of Course, There's a Jet

Despite COKE being a company of relatively modest size, COKE (a) has a corporate plane and (b) *encourages* Harrison to use it not just for work purposes, but for personal reasons. Harrison has, of course, diligently used the plane for personal travel.

Lack of Openness/Transparency with The Street

Finally, the Company does not conduct quarterly earnings calls – yet another big check-mark in the column for poor transparency and weak corporate governance. This lack of transparency combined with limited sell-side coverage is a key factor making COKE shares vulnerable to becoming mispriced in the extreme.

Questionable Corporate Name Change

Given the above corporate governance weaknesses, it is our view that management (and the board) has not earned the benefit of the doubt when it comes to ethical decision-making. On this front, COKE did something in early 2019 that was quite curious: it changed its corporate name…

From: "Coca-Cola Bottling Co. Consolidated"
To: "Coca-Cola Consolidated, Inc."

Two observations: first, note that COKE mostly just removed the word "Bottling" from the name. Why? It's not clear to us – though we have inquired with the Company. Second, note how similar the new name is to "Coca-Cola Co." (aka the "real Coke"). Given the similarity, you might think COKE's executives would be aware of the risk that people (less-informed investors in particular) might confuse their company with the "real Coke"…

…And, of course you'd be exactly right. From a November 2018 (two months before the name change) interview with *Charlotte Business Journal*, we see that COKE's CEO was well-aware of the fact that people often confused COKE for the "real Coke":

> Sometimes people don't recall that Charlotte-based Coca-Cola Bottling Co. Consolidated in Charlotte is not a part of Atlanta-based giant The Coca-Cola Co. They see the red Coke and Diet Coke logos and, somehow, they believe that the two companies are one big entity, says Coke Consolidated CEO J. Frank Harrison III.
>
> "Coke in Atlanta owns these brands and sells syrup to Coke bottlers throughout the U.S. and the world," Harrison explains. "And we (Coke Consolidated) manufacture it, sell it and deliver it to all of the customers in and around Charlotte and throughout our franchise territory."

MELISSA KEY

Dave Katz, the soon-to-be president and chief operating officer of Coca-Cola Bottling Co. Consolidated (NASDAQ: COKE), and J. Frank Harrison III, CEO of the Charlotte-based company

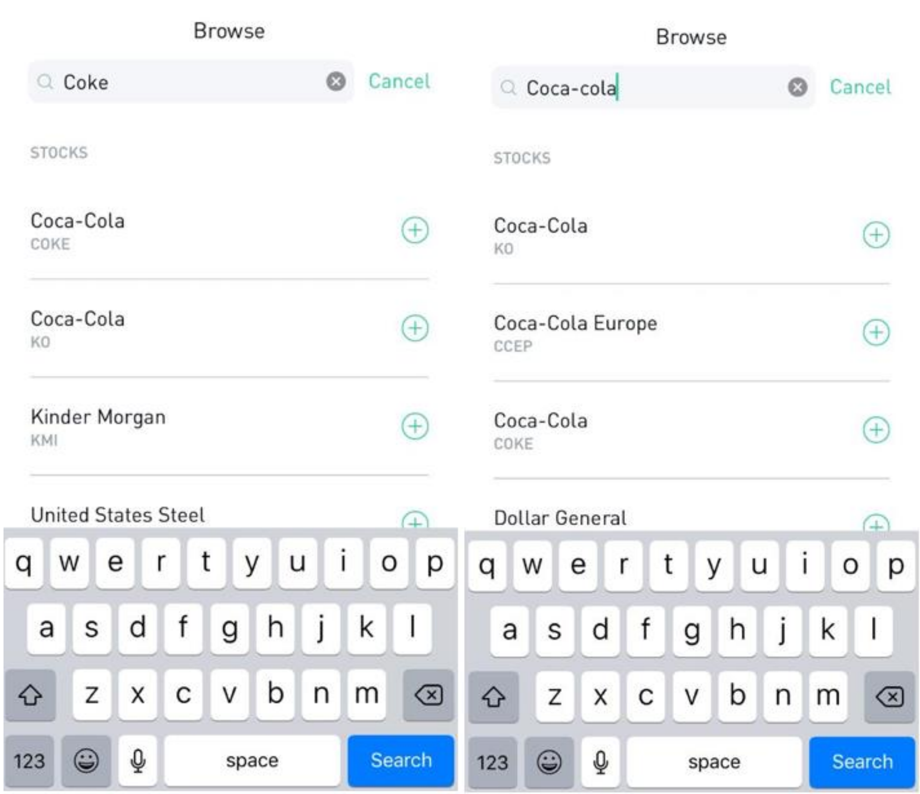
> Just that simple. Harrison doesn't mind reminding those who ask that both companies are independent, publicly traded companies. One is based in Charlotte; the other in Atlanta.

> **Do people ever get your company confused with The Coca-Cola Co. in Atlanta?**
>
> **Harrison:** I can tell the CEOs of major operations how the Coke system works, and they can say, "Totally, I got it. Coke in Atlanta owns these brands and sells syrup to Coke bottlers throughout the U.S. and the world. And we (Coke Consolidated) manufacture it, sell it and deliver it to all of the customers in and around Charlotte and throughout our franchise territory."
>
> That's as simple as it is, and the very next day, it's, "Yea, you know Coke, it's one big company, right, all over the world?"

To summarize: Harrison was well aware that people – even CEOs and sophisticated businesspeople – frequently confuse the Coca-Cola entities. So, what did he do? He *heightened* the confusion – perhaps unintentionally – by changing COKE's name to look even more like "real Coke's."

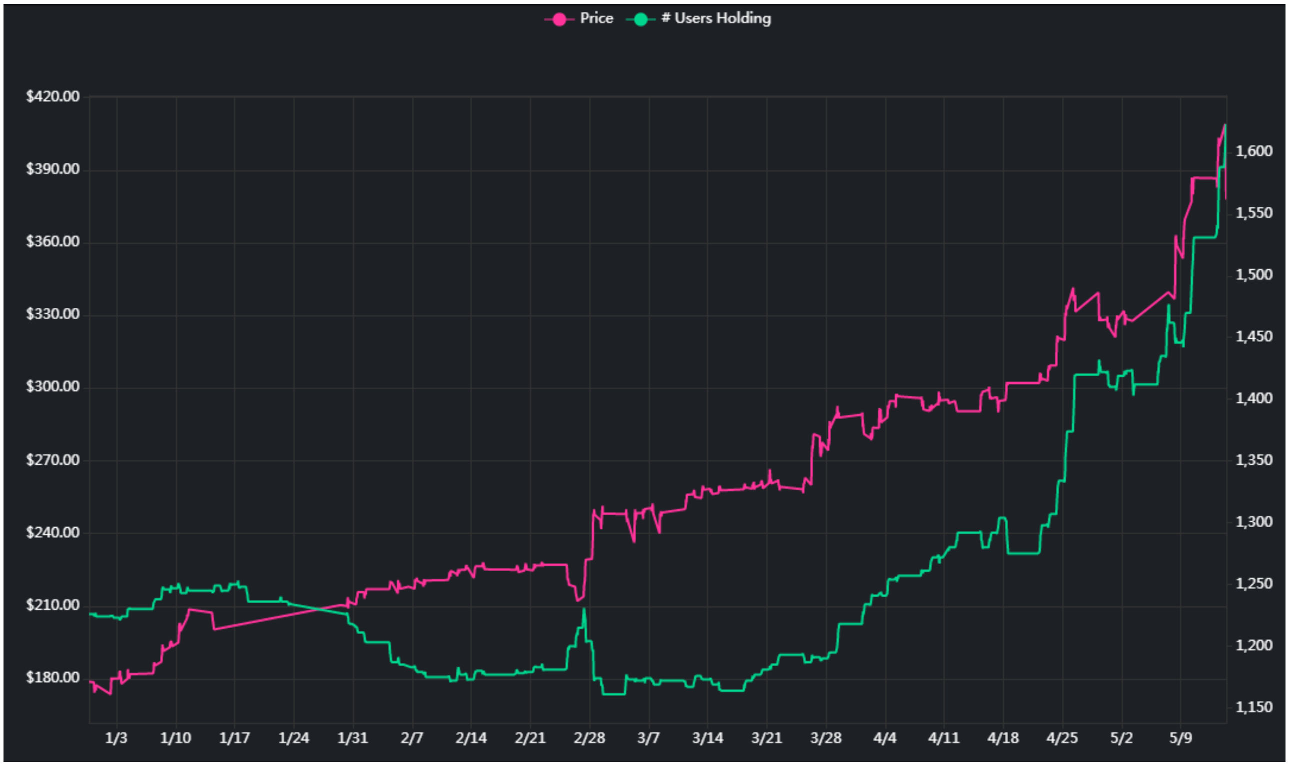
While it doesn't impact the attractiveness of the COKE short today, we (and others) would postulate that a healthy portion of COKE's YTD outperformance has been driven by confusion over the name change. The theory may sound ridiculous, but let's run through a few real-world cases demonstrating how a lesser-informed retail investor (i.e. someone not as financially savvy as the CEOs Harrison often finds himself correcting) could end up owning COKE shares when he/she intended to purchase shares in the Berkshire-backed KO:

Exhibit 4: Robinhood Brokerage App Search for "Coke" and "Coca-Cola"



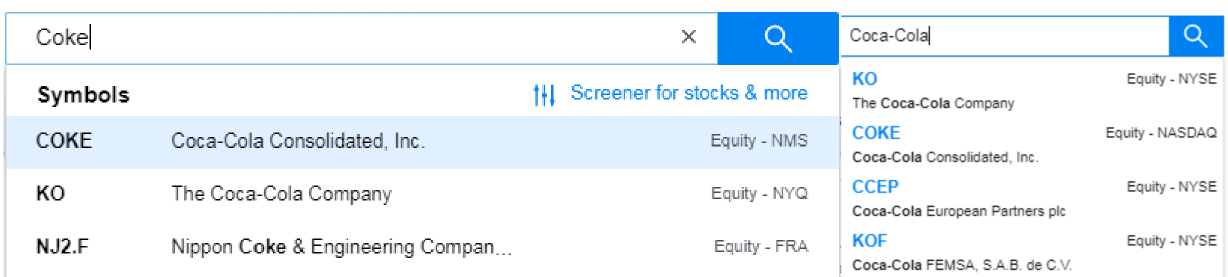
Source: Upslope, Robinhood

Exhibit 5: Robinhood Users Owning COKE Shares vs. Stock Price



Source: Upslope, Robintrack.net

Exhibit 6: Yahoo! Finance Search for "Coke" and "Coca-Cola"



Source: Upslope, Yahoo! Finance

Note: if one didn't take the time to research the difference between the two "Cokes" the COKE ticker might seem to be the logical default choice to buy (instead of KO), in our view.

Exhibit 7: Extreme Outperformance - Ratio of COKE's Stock Price to KO's

Source: StockCharts.com, Upslope

Note the unusual spike on the first day of trading after the name change (highlighted in yellow).

Limited Float Dynamics: Adding Fuel to the Fire

Given the unusual nature of COKE's shareholder base and its equity float, we believe potential confusion over the name change had the ability to drive significant share gains YTD. COKE's shareholder base could roughly be categorized into the following buckets (all amounts approximate for simplicity):

- 25% - Coca-Cola (yes, "real Coke" owns shares in COKE)
- 25% - Frank Harrison (COKE CEO)
- 25% - Passive/index investors
- 25% - Active institutional and retail investors

Given the last bucket is such a small portion of total equity ownership (in a company not particularly large to begin with), it is our view that confused retail investors plus passive index fund buyers were material drivers of COKE's outperformance YTD. **Readers are free to reach their own conclusion about whether this theory holds water. Our goal with this part of the analysis was simply to identify "the why" behind recent outperformance. In our view, it doesn't change the fact that we are left with a very mediocre business that is significantly overvalued.**

COKE Appears Significantly Overvalued, with 40-50% Downside

When thinking through COKE's valuation, we considered a few methods. First, looking at comparable businesses, we could look at either other publicly traded bottlers or the beverage *can* producers. Given far better (if still imperfect) geographic overlap, we actually view the can-makers as the more relevant comp group. They also share a roughly similar volume outlook (given both are reliant on soda and other beverage volume trends) and have fully-levered balance sheets.

That said, we also note some other key differences in comparing COKE vs. Crown (CCK) and Ball (BLL), the two leading global manufacturers of beverage cans:

- More diversified brand exposure at the can-makers vs. COKE (given can-makers serve a variety of soda, beer and other food/beverage customers)
- Contractual pass-throughs for raw material price changes at the can-makers – and therefore more stable, predictable margins (COKE generally eats input cost changes or pushes through pricing changes on a one-off basis)
- Marginally better top-line outlook for can-makers, given emerging markets exposure (arguably this benefit may be offset by FX volatility, but on balance we think it's a win for the can-makers)
- Significantly higher EBITDA margins for the can-makers: ~15-16% vs. COKE's 5%
- Significantly higher returns on capital for the can-makers: roughly mid-teens for the can-makers vs. high-single-digits for COKE
- Far superior conversion of adj EBITDA to Free Cash Flow for the can-makers: ~30-35% in the best years for COKE (and close to 0% in recent years) vs. regularly achieving ~40% for the can-makers
- Significantly better corporate governance for the can-makers: no serious corporate governance concerns/red flags (that we are aware of), as COKE does

Currently, Ball and Crown trade for ~10x and ~14.5x EBITDA (2019E), respectively. COKE trades for ~14.5x EBITDA. So, investors today can buy Ball – considered by many a legendary compounder (yes, I hate that word, but it's true!) – or COKE for about the same price. Based on the above analysis, we would argue COKE is a far lower quality asset than both Ball *and* Crown – and should therefore trade no higher than Crown's 10x EBITDA. **At ~10x EBITDA (which we consider quite generous) COKE shares would trade for $237 – or ~40% lower than where they are today (~$393). At 9x, COKE would trade for $200 per share.**

In addition to the above comparable company analysis, we also ran a simple discounted cash flow model. The results of this analysis yielded a fair value for COKE shares moderately below prices noted above.

Risks to the Short

- Continued squeeze/irrationality/lack of hard catalyst
- Unforeseen improvements in free cash flow and margins
- Unforeseen acquisition/expansion opportunities
- Sale of the Company – valuation + CEO's control/ability to extract value are mitigants

Conclusion

In summary, we view COKE as being a highly attractive short on a number of angles:

- Low growth prospects – both organic and inorganic
- Poor returns on capital
- Full balance sheet
- Challenged free cash flow generation history
- Extreme overvaluation driven by non-fundamental factors
- Highly questionable corporate governance
- Low short interest (2% of float)

What more could you want in a short?

Bonus Items – Miscellaneous Observations

Traditional Free Cash Flow Calculation Appears Over-Stated

As part of consideration paid for its Transformation Program, COKE agreed to make certain ongoing sub-bottling payments to KO. In 2018, those payments appeared to have been ~$25mm. Due to certain accounting practices (which we are not disputing) this cash outflow comes out of the Cash Flow from Financing section. We would argue that investors analyzing COKE's FCF might want to consider incorporating this real cash outflow into free cash flow estimates.

From 2018 10-K: Had to Preserve Cash in 2018 – This Seems at Odds with Stock Performance/Multiple

Capital spending for the fourth quarter of 2018 was $25.1 million, bringing full year 2018 capital investments to $138.2 million. This lower spending level reflects actions taken in 2018 to reduce capital spending in order to preserve cash during a challenging year. We anticipate capital spending in fiscal 2019 to be in the range of $150 million to $180 million as we continue our focus on making prudent, long-term investments to support the growth of the Company. Cash flows from operations for the fourth quarter of 2018 and full year 2018 were $142.9 million and $168.9 million, respectively. Improved cash generation is a key focus area for 2019 as we work to improve our profitability, reduce our financial leverage and further strengthen our balance sheet.

Misc. Executive Turnover

COKE brought in a new CFO in Dec 2018 (had interim CFO from Jan-Dec 2018). The prior CFO (Clifford M Deal III) retired – but, *seems* like he gave two weeks' notice. Despite the notice, COKE named a new CFO (later turned out to be just the interim CFO) immediately. We also note that James Harris – head of COKE's Transformation Program also left recently.

From 2018 10-K: Recently had to Correct an Accounting Error

The Company historically presented consideration paid to customers under certain contractual arrangements for exclusive distribution rights and sponsorship privileges as a marketing expense within SD&A expenses. The Company has now determined such amounts should be presented as a reduction to net sales and has revised the presentation of previously issued financial statements to correct for this error. Management believes the effect on previously reported financial statements is not material. In addition, management believes the revised presentation provides consistency with other companies that operate in the beverage industry. Net sales and SD&A expenses were revised by $36.1 million in 2017 and $26.3 million in 2016. The revision had no impact to net income (loss) or net income (loss) per share.

It's Not Particularly Large, but Coincidentally We Saw the First Insider Sale in Years on May 10, 2019

X	Filing Date	Trade Date	Ticker	Insider Name	Insider Title	Trade Type	Price	Qty	Owned	ΔOwn	Value	1d	1w	1m	6m
	2019-05-10 16:37:04	2019-05-10	COKE	Murrey John W III	Dir	S - Sale	$379.60	-1,000	0	-100%	-$379,604				
	2007-08-22 16:43:33	2007-08-20	COKE	Coca Cola Enterprises Inc	10%	S - Sale	$56.54	-1,000	663,947	0%	-$56,539	0	+1	+6	+1
A	2007-08-21 15:53:02	2007-08-14	COKE	Coca Cola Enterprises Inc	10%	S - Sale	$53.66	-1,000	667,947	0%	-$53,664	0	+4	+7	+5
AM	2007-08-21 15:52:41	2007-08-10	COKE	Coca Cola Enterprises Inc	10%	S - Sale	$53.62	-2,000	668,947	0%	-$107,247	0	+4	+7	+5
M	2007-08-20 13:07:40	2007-08-15	COKE	Coca Cola Enterprises Inc	10%	S - Sale	$54.73	-3,000	664,947	0%	-$164,204	0	+4	+6	+3

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