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PRESENTATION

Operator

Good morning, and welcome to PepsiCo’s Second Quarter 2017 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  Pepsico, Inc. - SVP of IR

Thank you, operator. 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 second quarter 2017 performance and full year outlook and then we'll move on to Q&A. We've kept our comments brief and intend to conclude the call by 8:30.

Before we begin, please take note of our cautionary statement. This conference call includes forward-looking statements including statements regarding 2017 guidance 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 operating profit growth are on a core constant currency basis. All references to free cash flow exclude certain items. 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 use when discussing PepsiCo’s financial results, you should refer to the glossary and other attachments to this morning’s earnings release and to the Investors section of PepsiCo's website under the Events and Presentations tab.
Now it’s my pleasure to introduce Indra Nooyi.

Indra K. Nooyi - Pepsico, Inc. - Chairman and CEO

Thank you, Jamie, and thank you all for joining us this morning.

I’m pleased report that our second quarter results were very much in line with our expectations and that we remain on track to meet our full year 2017 financial goals.

For the quarter. While our reported results continued to be impacted by macro volatility and weak currencies, organic revenue was up more than 3% globally, a sequential acceleration from our growth rate in the first quarter. We generated organic revenue growth across both developed and developing and emerging markets with developed markets up 2% and D&E markets growing 6%. The portfolio generated strong net price realization, and core constant currency operating profit grew 7%. Core constant currency EPS grew 13%.

Our results reflect the power and durability of our portfolio, its ability to deliver sustainable and well-balanced results despite ongoing pockets of macro and geopolitical challenges in a number of our key markets around the globe and an increasingly dynamic retail and consumer environment.

Let’s briefly review the performance in the quarter across our sectors, starting with North America, where organic revenue grew 2% and core constant currency operating profit was up 4%. Importantly, year-to-date through the second quarter, we’ve also generated more U.S. retail sales growth than all other $5 billion-plus manufacturers combined.

Frito-Lay North America had another very strong quarter. Volume and organic revenue accelerated sequentially from Q1 as we expected and results reflected a very good balance of volume growth, net price realization and margin expansion. We feel very good about the business with innovation, pricing and execution all on target. We are pleased to report that Frito-Lay alone was the #1 contributor to total use food and beverage retail growth by all $5 billion-plus manufacturers to the end of Q2.

Similarly, North America Beverages grew organic revenue and core operating profit, but our growth rates were limited in part by adverse channel and subcategory mix in the quarter as we have seen a lower rate of year-to-date growth in the c-store channel compared to last year and water growth outpaced the balance of our business. We are encouraged by continued strength in our stills portfolio with good growth in Gatorade, our total water portfolio, which benefited from the strong introduction of LIFEWTR, Lipton and our distribution of ROCKSTAR. In fact, in just 5 months of sales since its launch in Q1, LIFEWTR has already reached $70 million in retail sales across measured channels, was the top brand contributing to LRB retail sales growth in the second quarter and is on track to generate approximately $200 million in retail sales on an annualized basis.

On the carbonated side. We’re encouraged by the performance of Pepsi Zero Sugar, but have more work to do on the carbonated portfolio overall. We will also be allocating a bit more marketing behind the big sparkling brand in the second half. We have strong activation for the summer behind Pepsi Fire and our DEW-S-A program followed by strong execution behind the NFL as we get to the fall.

As we execute our second half plans, we will remain very focused on driving better net price realization and letting our marketing and innovation drive the top line.

Quaker Foods North America performance continues to be impacted by broader center-of-store pressures, but is performing well relative to other large breakfast manufacturers. Going forward, we have powerful programming in place aimed to improve the trajectory of the business. So for example, we have activation behind portable breakfast innovation, namely, Breakfast Flats that we launched in 2016 and Breakfast Squares that were launched in the first quarter. And we just launched a new and first-to-market Overnight Oats cup in the second quarter to capitalize on the recent and growing consumer trend of preparing chilled oats using a variety of healthy ingredients.

Turning to our sectors outside North America. In Latin America, we continued to see very challenging macroeconomic conditions, geopolitical instability and high levels of inflation in key markets including Brazil and Argentina, which are dampening consumer spending. Within this context, our businesses are performing well. Our largest market in the region, Mexico, encouragingly has been relatively stable and resilient and is performing...
well and posted double-digit organic revenue growth in the second quarter. While our core profit performance in the first half of the year was impacted by difficult economic conditions, we expect to see an improvement in core profit growth in the second half as we lap incremental investments from last year and we realize productivity from supply chain initiatives.

Similarly, we are experiencing macro challenges in a number of a markets throughout our Asia, Middle East North Africa segment including the significant currency devaluation in Egypt and the economic impact in a number of markets across the Middle East stemming from persistently low oil prices. Related to these, we are experiencing significant cost inflation in Egypt arising from adverse transaction ForEx and we are dealing with the recently imposed carbonated soft drink tax in Saudi Arabia.

So we're adjusting our business to address these challenges: we are pricing to cover the increased cost of doing business, we are going more aggressively after productivity to reduce our overall costs and we continue to transform our beverage portfolio to offer more noncarbonated options and reducing sugar levels across the portfolio.

On the other hand, we are encouraged by a number of bright spots in the region including China where we saw double-digit beverage organic revenue growth and mid-single-digit snack organic revenue growth in markets like Pakistan and Egypt where organic revenue was up double digit.

And finally, turning to Europe and Sub-Sahara Africa. We had very good results across the region with organic revenue growth in each of our major markets and a sequential acceleration overall. Russia, our largest market in the region, had mid-single-digit organic revenue growth and very strong operating margin improvement. As you saw in the release, our results also benefited from our sale of a minority stake in Britvic. Even excluding this gain, core operating profit was up 19%, so we are very encouraged by the performance in the and are optimistic about the outlook for the balance of the year. We continue to manage both in our control and our portfolio of products and geographies is working.

And so with half-year behind us and our performance overall in line with our plans and expectations, we remain very much on track to deliver our full year financial targets of at least 3% organic revenue growth and 8% core constant currency EPS growth.

And we continue to deliver these strong reliable results even as our industry is undergoing some interesting shifts from multiple angles. Consumer habits and behaviors continue to evolve. Some trends like consumers' increasing demand for convenience and variety have been present for decades, but are becoming more pronounced. Consumer shopping habits are rapidly adapting to evolving new retail formats, and their lifestyles are increasingly influenced by pervasive social and digital media and mobile technology. And this, in turn, requires new marketing models that harness the power of digital media and big data in a way that enables us to communicate with consumers on a much more personal and individualized level. Consumers are also seeking more value and benefits from what they purchase and consume. They're also seeking more premium experiences at the same time seeking value.

And across the spectrum, consumers continue to be interested in health and wellness, but with differing definitions, often not science-based of what this means.

Perhaps more pronounced are the changes we are witnessing in retail were the lines are blurring between channels. Brick-and-mortar retailers are building deep e-commerce capability, pure-play e-commerce is moving into brick-and-mortar and virtually every channel is melding aspects of grocery, convenience, foodservice, meal kits, prepared meals and home delivery.

So with all this change occurring and at an accelerated pace, we can look upon this period in our industry with hesitation and pessimism or with a sense of excitement and optimism. We choose to take the optimistic approach because this period offers a once-in-a-lifetime opportunity to strengthen our business and capture new avenues of growth. We believe we are well positioned to win in this environment. In fact, we anticipated and prepared for many of the trends we are witnessing today.

To begin, we participate in growing categories with products that are well suited to consumers' continued desire for convenience, on-the-go portability and snacking in place of structured meals. Many of our brands occupy the #1 and #2 spot in their respective categories, giving them the scale to cut through an increasingly cluttered and fragmented media landscape, especially in the digital realm.
Our product portfolio had the stretch to continue to evolve with consumer needs. We have the ability to innovate to provide new benefits and value to the consumer in ways that are not only consistent with the brand's equity, but in many ways strengthen it.

A few examples come to mind. Lipton Tea. Over the years, we have not only added more variety, but we have strengthened the brand by introducing increasingly premium offerings, first with Pure Leaf and more recently with the Tea House Collection, resulting in the leading share position we enjoy today.

Or Mountain Dew, where over time we've expanded the trademark from traditional green bottle dew and Diet DEW to exciting line extensions like Code Red, White Out and Voltage and our very successful Kickstart lineup.

Or Doritos, where our loyal consumers have embraced flavor extensions of the core product and innovations we have taken to foodservice and quick-serve restaurants.

Or Quaker, where we have provided increasing portability and convenience to a hearty, healthy breakfast through the introduction of Breakfast Squares and Breakfast Flats.

Beyond our product advent advantages, we also have a well-balanced geographic footprint that enables us to weather pockets of macroeconomic volatility. Importantly, we have extremely strong relationships with our retail partners and meaningful presence and scale across all our relevant channels. In each of our 5 largest markets comprising approximately 75% of our total net revenue, we're the largest #2 food and beverage manufacturer based on retail sales.

Regardless of channel, our products and brands possess a number of important characteristics that make them highly appealing to our customers. They're often purchased on impulse, which makes them highly incremental and therefore build basket and box size. On promotion, they drive traffic. They are highly complementary to other food and beverage purchases and they have high velocities, which makes them very productive in whatever shelf they occupy and therefore they are big cash flow generators. These attributes translate to the very foundation of the value we bring to our customers regardless of channel. We deliver sales growth and cash flow for our customers.

And our partnership with customers goes well beyond supplying great products. Our deep capabilities, enabled by our scale and years of extensive investment, allow us to work with a strategic partner delivering value in the areas of supply chain management, consumer and shopper insight, social and digital consumer engagement, research and development, design, data analytics and e-commerce.

In fact, our execution with retailers, leveraging the full breadth of our capabilities, led us to be named the #1 best-in-class manufacturer in the most recent annual Kantar Retail PowerRanking survey in the United States. And this was further reinforced a few weeks ago when I attended the Consumer Goods Forum in Berlin. In meeting after meeting with our retail partners from around the globe, they expressed how much they value the growth we generate for them.

And finally, one of the most compelling reasons for our optimism is our culture. Over decades, we have built and developed a culture that thrives on change. We have the heart of a challenger, a can-do spirit with a must-do resolve. We view the evolution of our business, whether it’s products, supply chains, processes, organizations or business models as our natural state. Our business today is very different than it was 5 years ago, and we expect it to be very different 5 years from now.

Consider our beverage portfolio transformation that began decades ago when we declared that we will become a total beverage company, and over the years, we have built an enviable portfolio of leading brands across virtually every sub-segment of the beverage category including Gatorade, Tropicana, Aquafina, Lipton and Starbucks through organic introductions, joint ventures and acquisitions. And this transformation continues as evidenced by recent introductions of products like LIFEWTR, Lemon Lemon and IZZE FUSIONS and our acquisition of KeVita.

Or how we have continued to evolve our supply chain over the years as the retail landscape has changed and new technologies have come to market. Our supply chain at Frito-Lay today is very different from the one we operated just a few years ago. For example, our deployment of GES...
has enabled us to handle more SKUs, fulfill demand with greater speed and accuracy, improve product quality and freshness and operate more efficiently.

Or our embrace of Performance with Purpose, the journey we embarked on more than 10 years ago that has transformed our business to adapt to the changing world around us. We have reduced added sugars, saturated fat and sodium in many of our products while continuing to expand our lineup of nutritious foods and beverages to meet growing consumer demand. Our product transformation efforts to date have resulted in a portfolio where we now derive approximately 45% of our net revenue from products that we refer to as guilt-free. These products include diet and other beverages that contain 70 calories or less from added sugar per 12-ounce serving and snacks with low levels of sodium and saturated fat as well as what we call Everyday Nutrition product. And a full 28 points of the 45 points is made up of what we refer to as Everyday Nutrition, products with positive nutrients like grains, fruits and vegetables, protein, unsweetened tea and water.

We have steadily improved our operational water use and energy efficiency, reducing our packaging and waste and promoting responsible agricultural practices globally. We have built a workplace that attracts and retains the world’s best and brightest. And we intend to continue to make strides in these areas. We have announced even more aggressive product, planet and people goals that we intend to achieve by 2025.

Net, we feel very good about where we stand.

We have a leading product portfolio, balanced development across channels and geographies, broad capabilities, a robust productivity agenda, a great corporate culture and excellent talent. These factors in combination have enabled us to continue to deliver an attractive balance of top line and bottom line growth. And they give us the confidence to lead into an ever-changing environment with a sense of excitement and cautious optimism.

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

Hugh F. Johnston - Pepsico, Inc. - Vice Chairman, CFO and EVP

Thank you, Indra, and good morning, everyone.

Let's move to our outlook for 2017. Looking ahead and as we set out in the release, we continue to expect organic revenue growth of at least 3%, fueled by successful product innovation and strong marketplace execution, but tempered by a cautious macro outlook. Based on current market consensus rates, foreign exchange is expected to negatively impact full year reported net revenue by approximately 2 percentage points, consistent with our previous guidance and negatively impact core EPS by approximately 2 percentage points, which is a 1 point improvement from our previous guidance. We intend to reinvest the Britvic share sale gain in the balance of the year, so I would encourage you not to flow through the impact of the gain in your full year models. Given the variety of macro issues we are facing around the globe, we think it is prudent to use this upside to strengthen the business.

As a result of the improvement in foreign exchange outlook on earnings, we now expect core earnings of $5.13 per share. This reflects core constant currency EPS growth of 8%, offset by the 2-point Forex impact.

In terms of other key considerations and assumptions embedded in our full year outlook. We continue to expect raw material inflation, driven by both an increase in our basket of commodities and additional pressure from transaction Forex. We continue to expect core operating margin expansion fueled by our productivity programs, and we continue to expect our core effective tax rate to be approximately 24%.

Turning to cash flow, we expect to continue to generate strong cash flow and to exercise discipline over capital allocation with prudent reinvestment into the business and the majority of our free cash flow, excluding certain items, to be returned to shareholders through dividends and share repurchases.

So for 2017, we continue to expect approximately $10 billion in cash flow from operations, net capital spending of approximately $3 billion, approximately $7 billion in free cash flow excluding certain items, cash dividends of approximately $4.5 billion. Recall that we previously announced
a 7% increase in our quarterly dividend beginning with the June payment, this represents the 45th consecutive year in which we have increased our dividend. And share repurchases of approximately $2 billion.

Finally, as you update your models, I'd like to highlight the following 3 items as they relate to the balance of the year. First, please keep in mind that we will be lapping our strongest rate of quarterly organic revenue growth in Q3 with a particularly tough lap in our North America Beverages sector. Second, while we are lapping some incremental investments related to the 53rd week from last year, we do intend to reinvest the Britvic share sale gain this year, hence we expect there may be some variability and volatility in the core operating margin. Third, we expect the negative impact of foreign exchange translation to be similar to what we saw this quarter. And consequently, we expect the balance of our -- balance of year core EPS growth to be weighted toward Q4.

With that, we're ready to take the first question.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from the line of the Dara Mohsenian of Morgan Stanley.

Dara Warren Mohsenian - Morgan Stanley, Research Division - MD

So Indra, I was hoping you could give us some perspective on the U.S. CPG environment. Obviously, it's been weak year-to-date, but also specifically in Q2, we've seen category weakness across-the-board including your segments. So I was hoping for detail on what's driving the softness, in your mind, from a consumer standpoint across CPG? Are you seeing any signs of improvement in Q3? Does Hugh's comment on the tough top line comparison might indicate you're not so far? But any reason to think basically that consumer outlook may improve in the back half of the year? And then specifically on your business, the flat Frito-Lay North America volume result in Q2 are essentially flat. Do you think that'll improve in the back half of the year? And how concerned are you also on the U.S. carbonated soft drink side by the year-over-year market share losses and plans to improve that going forward?

Indra K. Nooyi - Pepsico, Inc. - Chairman and CEO

That was 10 questions, very wonderfully rolled into one, but we're going to try to answer every one of those. Let me start by saying that I think you're beginning to see the limitations of syndicated data because as I mentioned in my script, the channels are beginning to blur between foodservice, retail, home delivery, restaurants, everything, the channels are beginning to blur. And when you have blurring channels, you now have a shopping occasion being replaced by a home delivery or replaced by a meal delivery of kits. So what we have to do is rethink what is the real growth of the marketplace, the food and beverage marketplace, in a much more holistic way. There's no question that the syndicated data showed a slowdown in the overall market, I'd say, in the first half. Rather than talk about quarter-to-quarter, let's just talk about the first half. Slightly south of 2% is what we saw in the first half. But I think if you include a much broader definition of the market, I think you're going to see what the traditional growth is, which is population plus some, more in the range of somewhere between 2% and 2.5%. I think that's what you'll see as an overall growth rate. I think we all as manufacturers have to start to rethink how we serve this multiplicity of channels and how we should retool our business models to serve every one of these fragmenting channels. That's the challenge all of us have and we've been looking at that very, very carefully. Now let's talk a little bit about the category weakness. I think we've -- on salty snacks in particular, let me speak to that. Our belief, and we watch volume, revenue and pricing very, very carefully on a weekly basis. I think where the market is today, when we can take pricing, we should take the pricing. And we've been trying to move the portfolio more to premium products. And the good news is that the syndicated data showed a slowdown in the overall market, I'd say, in the first half. Rather than talk about quarter-to-quarter, let's just talk about the first half. Slightly south of 2% is what we saw in the first half. But I think if you include a much broader definition of the market, I think you're going to see what the traditional growth is, which is population plus some, more in the range of somewhere between 2% and 2.5%. I think that's what you'll see as an overall growth rate. I think we all as manufacturers have to start to rethink how we serve this multiplicity of channels and how we should retool our business models to serve every one of these fragmenting channels. That's the challenge all of us have and we've been looking at that very, very carefully. Now let's talk a little bit about the category weakness. I think we've -- on salty snacks in particular, let me speak to that. Our belief, and we watch volume, revenue and pricing very, very carefully on a weekly basis. I think where the market is today, when we can take pricing, we should take the pricing. And we've been trying to move the portfolio more to premium products. And the good news is that we're actually making progress in Frito-Lay to move the business more to premium products. And so I'd say this thing will right itself, we are gaining share overall in the marketplace. We're gaining value share, which is really what we are focused on. We are managing the mix very carefully, managing channel mix, product mix very carefully. We feel pretty good about the Frito-Lay performance. And where we are moving the portfolio, nudging it towards premium, balancing the value mainstream product portfolio very, very carefully. So we feel good about that. On the beverage side, we've got good
price realizations, I feel good about that. Do I have some concerns about our carbonated soft drink business? Not concerns, but I think they have more opportunity. And I think that as we move towards the second half of the year and we sort of fine-tune our calendar, you'll start us -- you'll seeing more activity from us on carbonated soft drinks. On balance, we have good innovation. And I wouldn't say we're concerned, but we are watching it very, very carefully to make sure that everything that we can control, we do right by this business. Big businesses, very attractive businesses, we just want to make sure we get our fair share of those businesses. But the key thing is we're going to focus on price realization and let marketing drive the top line.

Operator

Your next question comes from the line of Steve Powers of UBS.

Stephen Robert R. Powers - UBS Investment Bank, Research Division - Executive Director and Equity Research Analyst

Actually, I was hoping we could just -- maybe just clean up a little bit on both those 2 topics, Frito-Lay and North American Beverages. On Frito-Lay, the 3.5 points of net pricing this quarter, is there a way to just frame how much of that was rate versus the channel or packaged mix premiumization that you called out, Indra, versus maybe some lingering sober effects? I'm just trying to figure out what's driving the price because to the extent -- I think the concern is that the price gap gets too wide and that becomes problematic on volume. Just like to hear your explanation there. And then on North American Beverages, I was hoping you could also give more color, maybe a quantification on the favorable legal settlement, Hugh, and the promotional spending accruals that helped segment profit there this quarter. I think that's the second quarter in a row where we've had favorable promotional spending accruals and I just love just to better understand the magnitude and the dynamics there?

Hugh F. Johnston - Pepsico, Inc. - Vice Chairman, CFO and EVP

Yes, happy to answer both of those, Steve. In terms of price versus mix in Frito, round numbers it was about 2% price and about 1.5% of mix. Mix, as Indra mentioned, is driven by premium products such as LAY'S Poppables. So when you're selling a potato puff, you're obviously filling the bag with less weight than you would, say, with a bag of Frito. We think that's a good win for the consumer and it's obviously a good win for us as well.

Indra K. Nooyi - Pepsico, Inc. - Chairman and CEO

And it's a great-tasting product.

Hugh F. Johnston - Pepsico, Inc. - Vice Chairman, CFO and EVP

Fantastic-tasting product. In terms of the legal settlement and the other items that you mentioned, it was in the teens in millions. So it was a not small number, but not a gigantic number by any stretch of imagination.

Operator

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

Ali Dibadj - Sanford C. Bernstein & Co., LLC., Research Division - SVP and Senior Analyst

Wanted to touch on 2 topics, if I could, please. One, Indra, your first answer this morning around changes of channels and shift that you mentioned in your prepared remarks as well, have you guys really figured out how to sell impulse online well? How do you get that cold icy package or quick $0.89 or $0.99 bag of Lay's to really resonate online without the immediacy of that channel? It seems to be becoming a bigger and bigger deal given just lower foot traffic in brick-and-mortar, so love to hear your philosophy on that. The second topic I want to dig a little bit deeper on, a few
flems have mentioned early, Steve mentioned a second ago was on operating margins more broadly. So was hoping if you could quantify operating margins, the impact productivity, the impact of commodities, the impact of promotional spending, accrual settlements as well as the marketing spend. Because if I look at 2 of those in particular, on productivity, we've heard from many, many years now, doing all those cost savings on an annual basis, but we don't actually see your SG&A as a percentage of sales particularly low versus peers even with some adjustments, given the bottle or structure, etc. And we're now starting to see operating -- core operating margins have difficulty expanding, in fact they're down 10 basis points this quarter. So is it that the low-hanging fruit is most difficult -- is harder to get now? I mean the lowest-hanging fruit, I guess, is gone and it's hard to show. So love some more detail after quantification on productivity. And on marketing spend, you didn't increase marketing spend in FLNA, QFN, NAB, AMENA this quarter and it looks like in your data as well, and that's where you're seeing volume struggles. And on the one hand, you could say -- one could say, well, that's causality so no ad spend growth leads to challenged volume growth? Or actually is it judicious decision-making because those markets aren't going to grow anyway? So I know there's a lot packed in there, but it's really around on the second part of the topic of operating margins, please?

Indra K. Nooyi - Pepsico, Inc. - Chairman and CEO

Okay. So I'm going to let Hugh get all the answers ready for the 10 questions you asked on operating margin, Ali. Let me talk about the changes in channels. We're all figuring it out as we go along. The good news is our e-commerce business is growing brilliantly. We're doing very, very well. We are not yet ready to talk about it in any significant way. Maybe in the next couple of calls, we will start focusing on that, but it's growing really, really nicely. But it's growing with our traditional products and our traditional packaging, if you want to call it that. There's clearly an opportunity for us to think about innovation for e-commerce, which is what we're all focused on. We want to make sure that our snacks are more shippable, not just in click and collect, but more also for deliveries so that the cube efficiency is there. And on beverages, I think there are 2 issues: one, is the cold delivery of the beverages if consumers so desire ice-cold beverages delivered to them, which I find it hard to believe, but you can never tell. And then how do we make sure that we address this whole delivery of water because beverages is largely water. So we are looking at meaningful innovation, both in snacks and beverages, in order to address the exploding growth of e-commerce. And with our big brands, I think they are well positioned. Now let me come to the impulse nature of our products. I think the whole e-commerce area is going to be impulse as you see it in a brick-and-mortar store, which then translates to e-commerce and it becomes part of a replenishment cycle. But then as people stopped going to brick-and-mortar and start shopping only on e-commerce, which well could be the Gen Z, new iGeneration, if you want to call it that. I think the new digital tools can easily afford you the ability to create the impulse experience online. We've seen so many virtual reality tools right now. You can actually simulate grocery stores or whatever version of a grocery store you want online. And you can easily navigate the aisles, and just with a click, shop for whatever you want. So I think in an interesting way, there's infinite possibilities to create impulse all through technology online. And I think as this market matures and evolves, you're going to see a lot of that happening, and we are focused on developing all of these tools ourselves with our e-commerce partners to make sure that we are responsive to them when they so choose to go that way. So with that, let me turn it to Hugh to give you the treatise on operating margin.

Hugh F. Johnston - Pepsico, Inc. - Vice Chairman, CFO and EVP

Sure, happy to. Ali, a couple of comments on that. First is, as we pointed out at the beginning of the year, we expect to see operating margin improvement strengthen as we go from the front half to the back half, that's what you saw from Q1 going to Q2 and that's what you'll see as we head into the back half of the year as well. So I think things generally are tracking to our expectations. Regarding advertising and marketing spend, we've said many times that we would invest further in A&M to the degree that we saw a return on investing further in A&M. As we move from 5.2% of sales to 5.7%, that was a move to get more competitive as we moved over the past 4 years from 5.7% to about 6.7% of sales, those were all based on good ROI. So I think you'll see the A&M change as we introduce new products or as we see opportunities to earn a good return. We're not going to blindly put money into A&M. Do I think you'll see A&M going backwards? No, I don't expect that to be the case in a meaningful way. It could go forward to the degree that we see good investment opportunities. More broadly on productivity, truthfully, I think we have years of productivity still in front of us. The cost bucket that we evaluate productivity against, what we call OpEx, is about $28 billion. It's got a natural inflation rate of 3% to 4% per year. So as we continue to drive 4%-ish types of productivity, you see that bucket basically staying relatively flat. I do expect that we will, as we've guided in the past, continue to see steady margin improvement while we reinvest in growth. So I think, overall, the margin-versus-growth equation is one that hasn't changed much relative to where we've been in recent years.
Indra K. Nooyi - Pepsico, Inc. - Chairman and CEO

And I think, Hugh, it’s fair to say that with the changing marketplace, with those blurring of retail channels, the consumer preferences changing, the marketing models changing, we have to invest in these new capabilities in order to generate the top line growth we’re generating. So we intend to continue to invest judiciously in these new areas so we can sustain our top line growth globally.

Hugh F. Johnston - Pepsico, Inc. - Vice Chairman, CFO and EVP

Absolutely.

Operator

Your next question comes from the line of Bryan Spillane of Bank of America.

Bryan Douglass Spillane - BofA Merrill Lynch, Research Division - MD of Equity Research

One of the questions that I guess, or themes that have come up this year specifically in North America has been, I think, with all the changes in the retail environment, some concerns about pricing and you’ve seen it especially in the food industry with the food stock and how they performed this year. I think generally the concern is that there’s going to be more sort of deflationary pressure at retail as retailers try to drive some traffic or keep customers. So can you kind of talk to how you’re thinking about that, not so much for this year, but over the next few years? Do you think that there’s going to be maybe a need to just maybe change the way you’ve thought about pricing philosophically just given the changes in the channels?

Indra K. Nooyi - Pepsico, Inc. - Chairman and CEO

We model out different channel shifts, what could be the pricing implications. We look at analogs from Europe and there were lots of retail disruptions. And then we look at what do we need to do to get innovation-driven pricing, mix-driven pricing and then what do we need to offset with productivity, how do we need to go deeper on productivity programs. So Bryan, what we do, do is model these out constantly. We look at multiple scenarios and then we figure out how to get the best blend of top and bottom line growth in a changing retail environment. The good news is that as a retail environment shifts, we just have to retool our model for the retail environment shift. The market’s still growing, that’s the good news, and these are huge categories. So our goal is to capture the growth with the changing environment with our innovation and our big brands. That’s why we focus so much on innovation because we believe innovation can actually create consumer demand and get us a price premium. And then we keep investing in our brands, both at the big brand level and the emerging brands like KeVita and Naked so that we can grow our business on both ends of the spectrum.

Operator

Your next question comes from the line of Mark Swartzberg of Stifel.

Mark D. Swartzberg - Stifel, Nicolaus & Company, Incorporated, Research Division - MD

February, we came to an interesting point in history. It was the 5-year anniversary of your rebasing earnings, and no doubt the environment remains and arguably has become more challenging. But this year, we’re at just shy of 3% organic revenue. If you look at 2012 through ’16, you were at 4s and 5s. So — and we spent time in this Q&A talking about the need to invest. So my question is simply headwinds are always there, they’re always changing, but when you think about your internal capacity to invest, and of course, that relates to the resolve to cut costs and where you put that money, do you think, A, that the need to reinvest is getting greater, that you have to actually pick up the pace of investment because of the
headwinds getting harder? And then, B, if it is getting harder, does -- do you think you have the resources, the ability to even up the productivity targets to address that greater pressure?

**Indra K. Nooyi** - Pepsico, Inc. - Chairman and CEO

I don’t know about harder, I’d say different. I think it’s different buckets, different areas. Some areas that we’re comfortable with, some areas where we have to develop new muscle. But that’s part of life in our food and beverage industry. I’ve been in this PepsiCo for 23 years and every 5 years or so there’s a brand new skill we have to develop. And this place is amazingly resilient. We developed the muscle, we hire from the outside when we have to. We retrain and then we go on. So I wouldn’t say it’s getting harder, I just say that it’s different buckets and we have to put in the work to make sure that we can deliver growth in this new environment. As I said to a response to an earlier question, we are looking at how much productivity we need to deliver to offset any price deflation if it happens because of retail disruption. So we are constantly looking at how we need to balance top line and bottom line growth. And clearly, productivity is a major factor in bottom line growth delivery. So we are looking at that. Hugh, did you want to add anything to that point?

**Hugh F. Johnston** - Pepsico, Inc. - Vice Chairman, CFO and EVP

No, I think you captured it effectively. I do think we’re doing different in new skills, but that’s something to be expected. And as far as having the resources, I think we can continue to drive sufficient productivity to stay ahead of the wave.

**Indra K. Nooyi** - Pepsico, Inc. - Chairman and CEO

Yes, and I think a lot of the new technologies actually allow us to deliver more productivity. We just need to -- I think the key thing people have to take away is that in order to deliver productivity downstream, you have to invest upstream. So you have to deliver -- invest today to get the benefits tomorrow. Benefits don’t come out of thin air and so what we are doing is investing today to get more productivity downstream.

**Operator**

Your next question comes from the line of Pablo Zuanic of SIG.

**Pablo Ernesto Zuanic** - Susquehanna Financial Group, LLLP, Research Division - Senior Analyst

Just a question and maybe it’s going back in time, but 15 years ago, the industry went through significant consolidation with Quaker, Kraft, NABISCO, General Mills, Pillsbury, Kellogg, Keebler, and we are talking about the significant changes taking place in the retail channel. We have seen retail consolidation, consumer changes, e-commerce. Do you think the industry needs to, as you mentioned, develop new muscles and a way to do that, that we should see another consolidation wave in the industry? I mean, I guess, I’m asking do you view that from an industry point of view, but also from a Pepsi point of view, the size being bigger help to adapt to these new changes? Or what happened 15 years ago in hindsight was the wrong answer, the wave of consolidation. And just a quick follow-up. If Unilever were to change hands, I suppose that you could lose the Lipton agreement, right? You would be probably -- there would be a penalty that you will need to be compensated, but I assume that, that contract would be taken away, if you can expand on that?

**Indra K. Nooyi** - Pepsico, Inc. - Chairman and CEO

So first of all, we don’t lose the Lipton business even with change of hands so I would rest assured that we are protected there. On this whole industry outlook, Pablo, I think you guys on the sell-side are much more knowledgeable about industry and industry trends because you’ve been following it for such a long time. We actually read your reports to get insights into where you think the industry is going. So I’d rather depend on your opinion here and we’ll keep our opinions to ourselves on this one.
Your next question comes from the line of Lauren Lieberman of Barclays.

Lauren Rae Lieberman  -  Barclays PLC, Research Division  -  MD and Senior Research Analyst

I just wanted to follow up again on the scanner conversation and just specifically relative to your business on North America Beverages because the scanner data and your results have really been diverging 3, 4, now I think 450 basis points this quarter. So if you could just talk a little bit about where the sort of "untracked data" is coming from? And then the other piece was that at least in the scanner data, both Mountain Dew overall and specifically Kickstart and Gatorade slowed dramatically, both of those down double digit. So if you could just talk a little bit about that, was anything specific, plans you may have where you anticipate most to recover at least again in the tracked channel piece of it?

Indra K. Nooyi  -  Pepsico, Inc.  -  Chairman and CEO

Thanks, Lauren, for the question. First of all, we don’t reconcile our data with the scanner data. We just keep running the business and just we keep selling, we keep making sure that our product is on the shelf. Remember, we have high-velocity products, so we know on a weekly basis exactly what we sell and what’s being pulled by the consumer. So we have good data on what’s happening in the marketplace. I have no idea why the scanner data diverges so much. It’s been happening in many markets and I think it reflects some of the limitation of syndicated data and they need to go back and retool it. But we are very comfortable with where we are and we’re just going to keep running the business this way.

So with that, let me thank you for your questions. And to summarize, we are pleased with our results for the first half. We remain on track to deliver our full year financial targets. And we feel well positioned to continue to perform well even in the midst of change and disruption.

Thank you very much for joining us this morning and for the confidence you’ve placed in us with your investment.

Operator

Thank you. That does conclude today’s PepsiCo’s Second Quarter 2017 Earnings Conference Call. You may now disconnect.