Soaring costs, sinking market chill Cott results

Bottler hedging bets on material prices, slashing costs, raising prices, and unveiling new products to stem the bleeding

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The perilous North American soft drink market has forced **Cott Corp.** to become a commodity trader in addition to its role as a bottler of private label pop.

The Toronto-based company is now hedging its purchases of three big components in its products - aluminum for the cans, sweeteners for the pop itself, and plastic for bottles - because prices of those materials have leaped recently.

But dealing with high input prices is only one of the problems facing Cott's business. The overall market for carbonated soft drinks is down sharply in North America as consumers move to other beverages.

The storm of troubles was reflected in Cott's poor second-quarter financial results, unveiled yesterday. The report disappointed analysts and pushed down the stock price by 6.7 per cent on the Toronto Stock Exchange.

Chief executive officer Brent Willis acknowledged it was a "very disappointing" quarter, but promised analysts on a conference call the firm is taking action on several fronts to ensure it meets growth targets for revenue and operating income over the balance of 2007.

Cott has started a short-term hedging program to lock in the price of aluminum purchases this year. And it is also hedging sweetener purchases for 2008, along with the polyethylene terephthalate (PET) plastic it uses in pop bottles.

At the same time, Cott has been cutting costs (it closed two of its plants late last year) and trimming its staff (40 salaried jobs were cut in recent months).

The company has also recently put in place a price increase on its products, a move that Mr. Willis said caused a short-term dip in sales but will boost margins for the balance of the year.

While North American pop consumption is falling and that is reflected in Cott's 5.3-per-cent revenue decline in that region, Mr. Willis said Cott has been quickly moving to introduce new, non-carbonated products.

Energy drinks, teas, and sports drinks are key growth areas, and generate much higher profit margins than pop, he said.

Cott's international operations have also been going like gangbusters compared with its North American arm. Revenue in that group was up 14.3 per cent in the second quarter.

Analysts are divided on Cott's ability to adapt to the new market conditions. David Hartley of BMO Nesbitt Burns in Toronto is one of the believers, saying in an interview yesterday that Cott management is "doing all the right things to answer the challenges" by changing its cost structure and reorganizing for growth.

Mr. Willis has overhauled the company significantly since he took the helm a year ago, Mr. Hartley said, and is doing a good job in tough conditions. Now what Cott needs, he said, is for that effort "to show up in the earnings."

By contrast, ***Peter Holden*** of ***Veritas Investment Research*** is much less enthusiastic. "Their existing business is in decline," he said, and the new products still represent a small proportion of revenue.

Private label pop "is a troubled industry whose volumes overall are declining, and whose competitors are big, well organized and fierce," he said.

Price increases likely aren't the answer either, he said, because they will be hard to enforce. "Their biggest customer [Wal-Mart Stores Inc.] is the most relentless cost-cutter in the history of retail, so that is a huge problem."

Mr. Holden said a stock price in the $8-$12 (U.S.) range is more reasonable for Cott, and suggested the current level is mainly a result of takeover speculation.

Cott has been in talks with other industry players about consolidation, and rumours have centred on a possible link with Cadbury Schweppes PLC's soft drink division, being spun off from the parent's candy division.

Mr. Willis said yesterday that Cott managers "continue to engage in these developing discussions," but are focusing on growing the company as a standalone entity.

Cott's commodity hedges

To reduce the volatility of the input costs for its private label soft drinks, Cott Corp. is adopting hedging strategies on these materials:

Aluminum

The cost of pop can metal has jumped sharply in recent months, and Cott has adopted short-term hedging programs to lock in aluminum prices for the balance of 2007.

Sweeteners

Corn-based sweeteners have increased in price as more of the commodity is used to produce ethanol, and the prices are expected to keep going up. Cott is using hedging to lock in prices for 2008.

PET (Polyethylene terephthalate)

This plastic, used in pop bottles, has been slipping in price, but Cott is hedging so it can plan for the price it will have to pay in 2008.

Cott earnings

Q2,$U.S.	2007	2006
Profit	$4.7-million	$7.6-million
Revenue	$498.4-million	$502-million
Earnings per share	7 cents	11 Cents