FINAL TRANSCRIPT

Primo Water Corporation

Q1 2023 Results Conference Call

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PRESENTATION

Operator

Good morning, ladies and gentlemen, and welcome to the Primo Water Corporation Q1 2023 Results Conference Call.

Following the presentation, we will conduct a question-and-answer session.

If at any time during this call you require immediate assistance, please press *, 0 for the Operator.

This call is being recorded today, Thursday, May 4, 2023.

I would now like to turn the conference over to Jon Kathol, Vice President of Investor Relations. Please go ahead, sir.

Jon Kathol — Vice President, Investor Relations, Primo Water Corporation

Welcome to Primo Water Corporation's first quarter 2023 earnings conference call.

All participants are currently in listen-only mode. This call will end no later than 11:00 a.m. Eastern Time.

The call is being webcast live on Primo Water's website at primowatercorp.com and will be available for playback there for two weeks.

This conference call contains forward-looking statements, including statements concerning the Company's future financial and operational performance. These statements should be considered in connection with cautionary statements and disclaimers contained in the safe harbor statements in this morning's earnings press release and the Company's annual report on Form 10-K and quarterly reports on Form 10-Q and other filings with securities regulators.

The Company's actual performance could differ materially from these statements, and the Company undertakes no duty to update these forward-looking statements, except as expressly required by applicable law.

A reconciliation of any non-GAAP financial measures discussed during the call with the most comparable measures in accordance with GAAP when the data is capable of being estimated is included in the Company's first quarter earnings announcement released earlier this morning, or on the Investor Relations section of the Company's website at primowatercorp.com.

I am accompanied by Tom Harrington, Primo Water's Chief Executive Officer; and David Hass, Chief Financial Officer.

As part of this conference call, we have included a deck online at primowatercorp.com that was designed to assist you throughout our discussion.

Tom will start today's call by providing a high-level review of the first quarter and our progress on Primo Water's strategic initiative. Then David will review our segment level performance and will discuss our first quarter performance in greater detail and offer our outlook for the full year 2023 before handing the call back to Tom to provide a long-term view ahead of Q&A.

One corporate housekeeping matter before we get started. As you probably saw, our 2023 annual and special meeting of shareowners was rescheduled and will be held on May 31, 2023. The Company will mail a revised proxy statement to all Primo Water shareowners in the coming day.

We encourage you to read these materials carefully. Any previously submitted proxies will be discarded and the shareowners will need to resubmit their votes.

With that, I will now turn the call over to Tom.

Tom Harrington — Chief Executive Officer, Primo Water Corporation

Thank you, Jon, and good morning, everyone. Before I dive into the results for our first quarter, I'd like to take a moment to update you on the proxy contest.

We are pleased to have reached a constructive resolution with Legion. We are excited to welcome to our board Derek Lewis and Lori Marcus, two executives with sales and marketing expertise at leading consumer product and beverage companies. We look forward to benefitting from their insight and perspective.

I also want to welcome Eric Foss who joined our board in March. Eric brings decades of experience as a chairman, CEO, and executive officer of leading route-based businesses and beverage companies with a proven track record of expanding scale, improving margins, and driving consistent earnings growth. Welcome to the team, Eric.

The addition of these new directors to our board complements our Board of Directors' skills and experiences and are in keeping with our commitment to increase the gender and racial diversity of our Board of Directors.

I want to thank Stephen Halperin, whom we announced last year was going to retire at this annual meeting after 32 years of dedicated service. Eric Rosenfeld and Greg Monahan are also retiring from our board after 15 years of dedicated service. We will certainly miss their contributions, valued counsel, guidance, and leadership.

Finally, I want to thank our team of Primo Water associates for a job very well done during the quarter, for avoiding the external distractions, and for remaining focused on our customers. Their ongoing commitment and execution positions the Company for continued success in 2023 and beyond.

Let's move on to the first quarter results. In Q1, we delivered normalized FX neutral revenue growth of 12 percent, adjusted EBITDA growth of 8 percent, increased adjusted EBITDA margin by 70 basis points to 17.4 percent, sell-through of approximately 215,000 water dispensers, and continued distributions of capital to shareholders through our dividend of approximately $13 million.

For Q1 2023, excluding the impact of foreign exchange, normalized revenue increased 12 percent. Normalized revenue excludes the exited North America single-use bottled water retail business and our exited business in Russia.

Reported revenue for the first quarter of 2022 includes $26.6 million of revenue associated with our single-use business and $2.8 million of revenue associated with our Russia business. A schedule is included in our supplemental deck.

Adjusted EBITDA increased $7 million to $95 million, an increase of 8 percent. Excluding the impact of foreign exchange, adjusted EBITDA grew 9 percent.

We continue to deliver increased revenue, adjusted EBITDA growth, and adjusted EBITDA margin expansion.

Consolidated revenue increased 4 percent to $547 million. Revenue growth was driven by resilient consumer demand; increased water dispenser unit sell-through of approximately 215,000; solid revenue growth of Water Direct and Exchange of 11 percent, driven by both pricing and volume; strong revenue growth in water Refill and Filtration of 21 percent; and global Water Direct customer retention of approximately 84 percent, which remained consistent with last quarter.

Adjusted EBITDA in the first quarter increased 8 percent to $95 million supported by higher volume, increased pricing, and effective expense management. We're pleased with the adjusted EBITDA expansion in the face of continuing inflation.

We successfully offset the impact of higher labour, fuel, and freight expense of approximately $15 million in the quarter and expanded the margin percentage to 17.4 percent, up 70 basis points versus prior year. As a reminder, our second and third quarter adjusted EBITDA margins are generally higher because of seasonality in our business.

As you know, we offer a range of products through a razor/razorblade business model where the rental or sales of water dispensers creates high-margin, recurring revenue generated from our water solutions. We saw an increase in the level of sell-through in our water dispenser business to approximately 215,000 units in the quarter.

Higher retail prices reflected the continued impact of tariffs imposed on imports from China. Consumers continued to purchase new Primo Water dispensers and demand remained strong.

Water dispenser sell-through represents the units sold by brick-and-mortar and e-commerce retailers to the end consumer. This is an important metric for the Company because these water dispenser sales drive connectivity to our water solutions, resulting in recurring higher-margin revenue.

The sell-through units are a leading indicator of the future organic growth of our water solutions.

As expected, the sell-in, or what we sold directly to retailers, for Q1 continued to be impacted by efforts to rightsize inventories that were increased during 2022 supply chain challenges.

Our consolidated Water Direct and Exchange business continued to experience strong top-line momentum during the quarter, with 11 percent revenue growth through 9 percent pricing actions, 2 percent volume growth, and 84 percent customer retention in Water Direct and 99 percent retention in Water Exchange.

During Q2, we will expand our mobile app, My Water+, to Poland and Israel and continually update the app based on real-time customer feedback.

Our digital focus in 2023 remains centred on new water customer acquisitions through costcowater.com, as one example; water dispenser sales; and connectivity to our water solutions.

In Q4 of last year, we talked about being awarded a five-year contract to be Costco's exclusive service provider for large-format bottled water delivery services direct to Costco consumer and business members.

We're pleased with the rollout of this program, and we are increasing the number and frequency of in-store activities at Costco locations to capture the full benefit of this relationship. We expect this program to drive increased customer growth as we build out the program across the US.

The growth of our Water Refill and Filtration business continues to accelerate, with an increase in revenue of 21 percent in the quarter driven by price increases primarily on outdoor refill stations and improved refill station uptime and service levels.

Our Water Refill business is one of our Water Your Way platforms where consumers refill their own empty 1 gallon or multi-gallon Primo water bottle at any one of our 23,500+ self-service refill stations. Customers in this business are counted at the retail locations of our refill stations and not the consumers physically using the refill stations.

We maintain high refill station retention, and there is tremendous potential for continued volume growth across the category. Water Refill targets a value-conscious consumer and provides similar margins to our other water offerings.

This is another positive aspect of our business transformation initiated by the acquisition of Legacy Primo that provides a diverse platform of water services for all consumers.

Customer resiliency related to the higher pricing action across our water solutions has been minimal as we track this through a combination of metrics, including call centre activity, customer retention, and customer growth. The balance between our demand and pricing continues to be extremely positive.

It's important that we attract quality customers that will remain with our services long-term. We are highly focused on attracting the right customer, not just to add a customer for the sake of growing customer count.

I would like to talk for a moment about operating efficiency. The ability to serve our customers in the most efficient manner possible is a critical driver of both our short and long-term profitability.

Our automated route optimization tool, or ARO, in North America continues to yield efficiency. We will extend the use of ARO into our Refill and Filtration business later in 2023 to capture efficiencies and improve service levels that this tool can deliver. In addition to capturing cost efficiency, the reduction in mileage supports our commitment to reduction in greenhouse gas emissions.

A key service metric we focus on is on-time, in-full or OTIF. OTIF, simply put, is did we deliver to the customer on the day at the approximate time and with all the products they requested. OTIF in North America in Q1 was 95 percent.

Another tool we use is our predictive staffing model, which continues to be refined and produces outstanding results. During the quarter, we improved our targeted staffing levels to 100 percent of route delivery positions filled.

We continue to believe that our incremental investments in our people and the use of our predictive staffing model will enable us to deliver our 2023 targets and beyond.

Last month, we published a 2021 supplement to our 2020 ESG report. I am pleased with the progress reflected in the latest update.

Some of our notable accomplishments described in our supplemental report include: achieved carbon-neutral certification via the carbon-neutral protocol while advancing clean drinking water infrastructure in vulnerable communities; achieved all stated DEI targets; replaced over 9,000 megawatt hours with energy certificate attributes powering our European operations with 100 percent certified renewable energy certificates; announced the strategic exit of the North America single-use bottled water retail business that produced over 400 million HDPE plastic containers annually, reducing the equivalent of 50,000 metric tons of CO_2; and reduced our global greenhouse emissions by 20 percent over 2020. We expect to publish our 2022 ESG report later this quarter.

As we shared last quarter, for the full year 2023, we expect revenue to be between $2.3 billion and $2.35 billion, with normalized revenue growth in a range of 6 percent to 8 percent. We expect full year 2023 adjusted EBITDA to be between $450 million and $470 million. Both financial guidance items exclude any tuck-ins we might complete throughout 2023.

For the second quarter of 2023, we expect revenue between $575 million and $595 million and adjusted EBITDA of between $113 million and $123 million.

Primo Water is well positioned to achieve our long-term growth targets. We benefit from long-term tailwinds, including a favourable shift in consumer demand toward health and wellness and concerns with aging global water infrastructures.

We continue to invest in our digital platforms to enhance the customer experience and in new innovations for our water dispensers to support connectivity to our water solutions.

We have a compelling financial profile, which we continue to enhance through debt reduction, opportunistic share repurchases, and increases to our quarterly dividends, with continued efficiency improvements that expand our route capacities and increase on-time and in-full delivery. We will continue to drive further adjusted EBITDA margin expansion, leading to increased returns on invested capital.

Finally, I will reiterate that our strategy is working. We’re confident in our ability to deliver our 2023 guidance.

I'll now turn the call over to our CFO, David Hass, to review our first quarter financial results in greater detail.

David?

David Hass — Chief Financial Officer, Primo Water Corporation

Thank you, Tom, and good morning, everyone. Starting with our first quarter results, consolidated revenue increased 4 percent to $547 million compared to $526 million. Excluding the impact of foreign exchange, normalized revenue increased 12 percent for the quarter.

Adjusted EBITDA grew 8 percent to $95 million, which represents 70 basis points of margin expansion. Excluding the impact of foreign exchange, adjusted EBITDA grew 9 percent. The effect of price increases, volume growth, and strong demand increased profitability.

Turning to our segment-level performance for the quarter. North American revenue increased 4 percent to $412 million compared to $397 million. Excluding the impact of foreign exchange, normalized revenue increased 12 percent.

Organic revenue grew by 11 percent in Water Direct and Water Exchange, which included 10 percent price or mix and 1 percent volume growth. Adjusted EBITDA in North America increased 7 percent to $85 million.

In our Europe segment, revenue increased by 8 percent to $69 million. Excluding the impact of foreign exchange, normalized revenue increased 20 percent, with growth in our residential customer base and B2B volume as Europeans continue their return to the office.

Adjusted EBITDA in the Europe segment increased 61 percent to $14 million. Excluding the impact of foreign exchange, adjusted EBITDA increased by 69 percent.

Turning to our Q2 and full year outlook. We expect consolidated revenue from continuing operations for the second quarter to be between $575 million and $595 million and that our second quarter adjusted EBITDA will be in the range of $113 million to $123 million.

For the full year 2023, we are reaffirming our guidance with revenue projected to be between $2.3 billion and $2.35 billion, with normalized revenue growth in the range of 6 percent to 8 percent. We still expect full year 2023 adjusted EBITDA to be between $450 million and $470 million.

Our 2023 CapEx consists of 7 percent of revenue plus an incremental $30 million for a total of approximately $200 million. As a reminder, we determined that during 2023 and 2024, we will invest an incremental $30 million per year as opposed to the $50 million noted in our November 2021 Investor Day.

This decision is based upon our confidence and run rate performance that enables us to reduce the investment dollars and deliver the 2023 and 2024 outlook.

The initiatives to be funded from our CapEx plan include driving digital growth; leading dispenser innovation; building a more environmentally friendly fleet; installing more efficient water production line, which will reduce water usage and increase productivity; and driving growth in Refill and Filtration with refreshed signage and branding of our existing units, the development of our on-the-go units, and new filtration innovations.

We expect to return to our normalized, total CapEx spend of approximately 7 percent of revenue in 2025.

For 2023, we expect interest expense of approximately $70 million to $75 million. We currently expect $20 million to $25 million of cash taxes due to the utilization of net operating losses, or NOLs, in 2022 related to the properties we sold last year. While we are limited in the amount of NOLs we can utilize each year, we do have NOLs available in 2023 and 2024.

Adjusted free cash flow is expected to increase to approximately $130 million in 2023, which includes the assumption that we monetize several properties. This is a significant step up from last year's adjusted free cash flow of $85 million and is primarily driven by increased earnings and reduced supply chain impacts on our working capital.

The $130 million contemplates increased cash taxes for potential property sales and could result in higher free cash flow depending on the timing and outcome of these property transactions. We expect further increases in our free cash flow in 2024.

As we mentioned during our Q4 call, we continued to explore opportunities to monetize properties that have realized significant appreciation in value. We plan to use the net proceeds of these property sales to fund components of our capital allocation plan, including, among other things, debt reduction and our opportunistic share repurchase program.

As part of the opportunistic share repurchase program, during 2022 we repurchased approximately $24 million. During the first quarter, we repurchased another $17 million, bringing the total to $41 million of the one-year $100 million opportunistic share repurchase program, which began last August.

The repurchase program reflects the board's confidence in our future performance and our continued long-term cash flow generation, and demonstrates our ongoing commitment to providing value for our shareholders. We remain focused on achieving our adjusted net leverage ratio target of below 3 times by the end of 2023 and a less than 2.5 times by the end of 2024.

As a reminder, our current debt maturities are in 2028 and 2029 and we, therefore, have no reason or benefit to refinance any of our debt and are pleased with our current debt structure.

Regarding our tuck-in M&A, for 2023, we expect to invest $20 million to $30 million as we focus on our organic growth, as well as take a patient approach due to macroeconomic factors that might weigh more on smaller operators.

Yesterday, our Board of Directors authorized a quarterly dividend of $0.08 per common share, which represents a 14 percent increase over last year's quarterly dividend rate.

Our performance reinforces our confidence in our ability to deliver sustained organic revenue growth supported by recent gains in new points of distribution in our Exchange business; geographic expansion of the Costco in-store events, resulting in an increase in the number of events in North America in our Water Direct business; as well as the improved performance of our Refill business.

These gains are a result of our commitment to improve the customer experience through increased service levels and continuing investment in the digital experience, customer satisfaction, and operating efficiencies.

I am excited about the opportunities that we have in front of us. We continue to execute our strategy and are making solid progress in our transformational journey.

We have the right plan and the right team to win. Our customers, associates, and shareholders can all share in our success as consumers migrate toward healthy hydration solutions.

I will now turn the call back to Tom.

Tom Harrington

Thanks, David. This quarter marked the three-year anniversary of our acquisition of Legacy Primo and the sale of our Coffee and Tea business. And I think it is important to take a moment and reflect on what our team has been able to accomplish during its ongoing transformation from the former Cott and Legacy Primo businesses to the new Primo Water.

We leveraged our highly variable cost structure to rightsize our businesses to adapt to the economic environment and a consumer base that shifted to more in-home consumption.

We increased our revenue and earnings through improved scale, reach, and better execution.

In the last five years, we have expanded adjusted EBITDA margins from Cott’s 13 percent to Primo Water’s 2022 19 percent.

We’ve returned capital to our shareholders through a steadily increasing dividend and opportunistic share repurchases.

We successfully integrated tuck-in acquisitions in our Water Direct businesses and expanded our global footprint.

We increased our understanding, commitment, and capabilities in ESG. We’ve been able to reduce our impact on the environment by becoming carbon-neutral and eliminating single-use plastic from our North American retail operations.

We’ve assembled a strong team and are excited to share our progress as we continue to realize benefits from embracing sustainability as a core strategic pillar of our business.

Prior to the pandemic, approximately half of our customers and even more in Europe were businesses, many of which closed for much of 2020 and 2021. Further hurdles included high inflation, fluctuating foreign currencies, tight labour markets, 25 percent tariffs on water dispensers manufactured in China, and global supply chain constraints.

Our strategy is clearly working, and we’re pleased with our past accomplishments and we’re even more excited about our future. We’re one of the only pure-play water platforms and benefit from a large and growing revenue base.

Our high single-digit, long-term growth targets are driven by the connectivity of water dispensers to our water solutions with supporting consumer tailwinds that include focus on health and wellness and concerns with aging global water infrastructure.

We have a healthy balance sheet, a compelling long-term growth outlook, and an attractive margin profile that we believe will generate adjusted EBITDA approaching $530 million with margins of approximately 21 percent and an adjusted ROIC of 12 percent by the end of 2024.

Once again, I'd like to thank the Primo Water associates across the business for their tireless efforts to serve our customers.

Before we open the call to questions, I just want to remind everyone again that this call is to discuss our Q1 results and outlook. We will not be taking any questions about our settlement with Legion. But I encourage those of you who are interested to visit our website to review our proxy materials.

With that, I'll turn the call back over to Jon for Q&A.

Jon Kathol

Thanks, Tom. During the Q&A, to ensure we can hear from as many of you as possible, we would ask for a limit of one question and one follow-up per person. Thank you.

Operator, please open the line for questions.

Q&A

Operator

Thank you, sir. Ladies and gentlemen, we will now begin the question-and-answer session. If you would like to ask a question, please press *, followed by the number 1 on your telephone keypad.

If your question has been answered and you would like to withdraw from the queue, please press *, followed by the number 2. And if you are using a speakerphone, please lift the handset before pressing any keys.

One moment, please, for your first question.

Your first question will come from Derek Lessard at TD Cowen. Please go ahead.

Derek Lessard — TD Cowen

Yeah. Good morning, everybody, and congratulations on a great quarter.

Tom Harrington

Thanks, Derek. Good morning.

Derek Lessard

And just maybe on that and how this ties into your outlook, you either beat or came in at the high end of your guidance. However, you didn't raise your full year guide. It seems like maybe you're erring on the conservative side, but maybe if you could just add some context and your overall thoughts behind that.

Tom Harrington

Yeah, Derek. Look, we're pleased with the quarter. Right? I would say solid start to the year. We're confident in our current guidance and our ability to deliver on that. But I think it's early.

And I think there's a lot going on in the external market, and it's appropriate for us to be prudent in terms of our forecast and stick to our knitting, accomplish our targets, and deliver the full year guide and see how the next quarter or so develop.

Derek Lessard

Okay. That's fair. And maybe a second one from me is think it's the first time that we're hearing you guys talk in detail about free cash flow. So thanks for that. Just maybe, David, if you could maybe walk us through again how you got to the $130 million and as well as the decision and the importance that you're placing on free cash flow.

David Hass

Yeah. Thanks, Derek. So it's always been an important metric for us. We really think this year, with much of the COVID disruptions behind us and the recovery of the customer base, including the consumption of our European side of the customer base, allows us more clarity for a metric, again, that we've always found important. And it allows us to start to showcase the platform we have as a transformed company.

So in general, as kind of the script suggested, walking down from our midpoint of guidance, removing approximately $200 million for the CapEx, the interest is relatively spoken for on our senior note with, obviously, some of that variability coming in our cash flow alone. Cash taxes would be the most variable, again, affiliated with the properties, as discussed, and how there could be additional upside depending on timing and transaction value there.

And again, on the working capital side, which would've been not necessarily overtly covered, we tend to reserve a few million dollars there as our AR balances tend to grow. While the collection of that doesn't change, the AR balances naturally grow as pricing starts to go into kind of the customer pricing activities.

So I think that would give you a pretty good line of sight of how at this point $130 million is that starting value for our viewpoint of the year.

Tom Harrington

Derek, at this time I also think that, clearly, last year was impacted by supply chain and the Q2/Q3 inventory adjustments that we made. So we thought it important to demystify that and connect the dots on free cash flow post-2022 supply chain challenges.

Hello?

Operator

Your next question will come from Andrea Teixeira at JPMorgan. Please go ahead.

Andrea Teixeira — JPMorgan

Hi. Good morning. Thank you, Operator. So my question is on the cadence of the quarter and the guidance reiterations despite a strong start of the year. Seems like most of consumer names that we cover, January started off strong and then the trends moderated to a softer March. So I was wondering if you can comment on how you progress and then the trends into April?

And then related to that, with the strong performance in the first quarter and above high end—or above—at and above high end of that range, with the second quarter probably a little bit softer than the Street was anticipating and reiterated fiscal year, so can you kind of like let us kind of like think about how you are budgeting. I understand it's the beginning of the year, but just to see how conservative you are.

And then as a follow-up, can you talk about the organic volume and price mix components for the Water Direct business this quarter? I mean, any data on consumer additions, churn, and how we see this progressing for fiscal '23?

Tom Harrington

Okay. Andrea, thank you. That's quite a question, but let me try and dissect that. Let's start with Water Direct price and volume.

So Water Direct and the Company was up on a revenue basis 11 percent; 9 percent from price, 2 percent from volume. So we're pleased with that performance.

You may remember that we have last quarter talked about the cadence of our revenue growth in 2023, and that we anticipated higher revenue growth from price as we lapped the actions that we took in 2022 and that as Costco built and we rolled out that program across the US through the course of the year, that we'd see more volume growth coming from new customer growth and, of course, consumption growth in the installed base on the Costco side. That's the North American side of the story.

We are benefitting from both price and volume in Europe, and as you may recall, we took more aggressive pricing actions later in Europe and we saw some of that manifest in Q4 but, clearly, manifested in Q1. And then we also are enjoying more consistent return to work. It's still a tailwind for us, right, because we're not back to pre-pandemic levels, but we saw good volume growth from our European operations in the first quarter.

In terms of the cadence, we're confident in our 2023 guidance. We think there's a lot going on in the market, and we think it's appropriate for us to be prudent to let the next quarter or so play out for all external inputs on our business.

Andrea Teixeira

Yeah. No, I get that. But I think the two questions that were unanswered, one is the churn. I mean, we all appreciate that you had the volume. But I think as, obviously, investors appreciate in their investment process to see how the churn is progressing and ideally a breakdown on how many additions and how many people got out with the price increase, in particular, in Europe.

And then, I mean, in an environment where your stock is down as much as it is and, obviously, investors are not happy with either the level of conservatism or what you've been willing to disclose or both.

Tom Harrington

Yeah. I'm not going to react to the first hour, hour and a half of the market reaction this morning to the stock price at all. Right? I think we delivered rock-solid numbers that beat what we said it would beat, and we remain confident in our performance in 2023.

Our churn, in the script we articulated Water Direct churn at 84 percent—excuse me, customer retention at 84 percent, which is consistent with prior quarters. And we're not seeing any meaningful changes in the number of customers in or out based on pricing.

And we've shared in the past that we think it's pretty elastic. And I think the best manifestation of the resiliency of our customer base is 11 percent revenue growth from our Water Direct business, which is a combination of largely price, but also with that 2 percent volume performance.

And I can't speak to our markets. Anybody's reaction to are we overly conservative or not, I think there are many others that are, frankly, being prudent in terms of their views of what the next 90, 180 days holds.

Andrea Teixeira

Can you help with just the cadence of what things are happening now in April? Or—

Tom Harrington

Yeah. Because that—

Andrea Teixeira

—because all you said is it's positive, and that's why I think we all puzzled—

Tom Harrington

Yeah. We don't see any material changes to April compared to our first quarter results, which obviously supports our view for the full year performance and is fundamental in our expected performance in the second quarter.

So pretty consistent performance as we move from the third period to the fourth period. So we're pleased with where we are.

Andrea Teixeira

Thank you.

Tom Harrington

Thanks, Andrea.

Operator

Your next question will come from Dan Moore at CJS. Please go ahead.

Pete Lukas — CJS

Hi. Good morning. It's Pete Lukas for Dan. In your prepared remarks, you mentioned that you were pleased with the rollout of the booth program at Costco. And I think in Q&A, you said look for that to increase your volumes. Historically, you've added about a quarter of your customers through that program.

Can you just talk a little bit more about what you expect it to look like in the second half? And how long you would expect any outsized growth to be sustainable there?

Tom Harrington

Yeah. Good morning, Pete. As you think about the booth rollout program, it happened most weekends and it's sequential. So we would expect good growth, more customers, and a volume associated with those customers in Q2. It will expand, obviously, and get larger in Q3 as you build more and more customers as a result of that program.

So it will be much stronger in Q4. And frankly, it's a tailwind as we move into 2024 because we'll benefit in Q1 next year of 100 percent of the benefit of the rollout of the customer program.

It has historically been about 25 percent of the new customers adds, as we've disclosed. We haven't disclosed how much more it will be, but it will be a higher percentage of new customer adds in 2023.

And as I said earlier, what you'll see is our revenue growth will shift as we move through the course of the year as we benefit from more customers as a result of that booth program.

Pete Lukas

Very helpful. Thanks. You talked a bunch about Europe improving pricing and return to work there. Just in the bigger picture, how do you look at Europe now compared to how you did three to four years ago? And do you think it continues to remain a drag on growth for the next several quarters, just given all the macro uncertainty?

Tom Harrington

Yes. Obviously, it was negatively impacted meaningfully during the pandemic. And you may recall, Pete, that customer base was something on the order of 90 percent commercial. So the pandemic and closed offices had a pretty significant impact on that business.

While we're not back to pre-pandemic levels, that's now begun a tailwind as Europeans return to work. So we're pleased with the volume recovery. We're pleased with the customer retention because we have pushed through pricing. And I think the adjusted EBITDA performance for Europe was significantly higher than a year ago.

And I think that's in—I don't have the number at the top of my head. It's a pretty big number. So we're confident that that business will continue to recover and produce meaningfully higher adjusted EBITDA margins for us on a go-forward basis.

Pete Lukas

Very helpful. Thanks. I'll jump back into queue.

Tom Harrington

Thanks, Pete.

Operator

Your next question will come from Derek Dley at Canaccord Genuity. Please go ahead.

Derek Dley — Canaccord Genuity

Yeah. Hi. Good morning, guys.

Tom Harrington

Morning, Derek.

Derek Dley

Just wondering how you guys are—where you're seeing the big buckets of inflation across the business? And are you confident that you can continue to price appropriately for this? Or is the 9 percent pricing growth that you implemented, are you comfortable with that for the next few quarters?

Tom Harrington

Yeah. So our three big components are labour, fuel, and freight. Obviously, ocean freight has mitigated. Right? So that is no longer the headwind that it was last year. And that's associated with all the supply chain and partially, largely, dispensary transportation from China. So that is not a headwind today, thankfully.

Fuel is resistant. Right? And I've shared this in the past. Diesel fuel has been more resistant in terms of price changes than unleaded. So we still face that.

And then labour, the labour cost is really a flopover from last year and the actions that we took. We did manage to cover the $15 million or so of incremental costs in the quarter. And we think we have the pricing actions in place to continue to cover the inflation costs, and if necessary, we'll take further actions based on how things evolve over the next quarter or two.

And I think, Derek, the best way to think about it is we covered the significant changes last year. I think it was $84 million of inflationary cost in '22. And we took the actions in real time to keep pace with that and still managed to increase our EBITDA margins in '22 versus '21.

So I think we have the right rigour and the execution capabilities to cover.

Derek Dley

Yeah. Okay. That's helpful. And then, I guess just given the challenging consumer spending environment that we're in, or that we're entering, are you seeing a shift with consumers shifting perhaps more towards the Refill business? I know it outperformed the Water Direct. Is it a function of consumers kind of trading down? And then can you just give us some colour on the margin differential between Water Direct and Refill, if any?

Tom Harrington

Yeah. I'll take the first part of that and I'll give the second part of that to David. We've been very focused on improving our service execution on Refill. And our uptime number on Refill today, as an example, is higher than 98 percent. That wasn't always that way. We've talked about that in the past.

We also took a price increase on our refill machines and essentially, basically, executed beginning Q3 and Q4 and we're seeing the benefit of that. And we're not seeing any customer resistance at this point. The volumes are recovering. So we're quite pleased. So our growth is from price action in Refill as opposed to any known, to us anyway, migration of consumers down-trading from any of our other services.

And I think what supports that is price and volume growth in the Water Direct business, great performance in our Exchange business, and the continued stickiness of our customer base. So we think it's price and execution on Refill that's driving it.

And then the margin question, David, I don't know if you can help with that one.

David Hass

Yeah. On the margin side, it's fairly agnostic to our other services, the difference, obviously, being that on a percent basis. So on a percent basis, they're agnostic. On a dollar basis, just from sheer difference in what consumers or what revenues we generate on a per unit basis you would get different gross profit dollars.

But on a margin basis we're agnostic and that's exactly why we love the diversity of the services where, as the consumer performs on all three, we are able to sort of generate equivalent profits across the business.

I'd say the one nice distinction about the Refill and Filtration team is compensation differences between our Water Direct RSRs and this side of the house where we're able to keep more of the upside to a performing business there.

Obviously, on the Water Direct side, largely the compensation is commission driven. So I think, again, it's a nice diversity platform for us in terms of consumer choice sort of spreads across all three, and we're able to make equivalent profits.

Derek Dley

Okay. Good. That's helpful. Thank you.

Tom Harrington

Thanks, Derek.

Operator

Your next question comes from John Zamparo at CIBC. Please go ahead.

John Zamparo — CIBC

Thank you. Good morning.

Tom Harrington

Morning, John.

John Zamparo

Wanted to start on maybe Europe plus Rest of World, and I'd like to get a sense of where EBITDA is in dollars from these regions versus 2019, or at least try to get a sense of how much more ground there is to cover to get that business back to where it was.

David Hass

Yeah. So for the Q, EBITDA would have been about $14 million for Europe. And on the other side, we have our corporate costs and other activities in there, and so we'd have to do some work to bridge that back for everyone.

But the continuation there is, again, the resumption of in-office and return to work. And our company is beginning a concerted effort to shift customer acquisition balance into residential to provide more of that diversification that we enjoy in the US today and sort of in our future.

But again, on the balance there, Europe has recovered nicely. It is showing meaningful signs of getting back to sort of pre-'20 levels. And I think that's what we're really pleased with the team and really not seeing any disruption in customer opinion, customer churn.

So again, seems pretty status quo of being able to tolerate sort of the actions we've taken across price.

John Zamparo

Yeah. Okay. And then maybe move to labour expenses. And I wonder if you can quantify the percentage increase in labour costs you saw in Q1 versus some of the past couple quarters. I know this is noisy because of the compensation structure that you just referenced, David, but is there a way you can quantify the inflation you're seeing in labour versus the past year or so?

Tom Harrington

Yeah. I want to say we haven't gone down a path of peeling out labour as a subset. We've shared last year something on the order of 10 percent to 11 percent inflation cost labour, fuel, and freight. And in this quarter, that $84 million was something on the order of 7.5 percent.

So it is lower than prior run rate and, hopefully, the future forecasts of further declines in inflation come true, we will benefit from that as we move through the—potentially benefit from that as that happens in coming quarters.

But we haven't peeled out each sub-piece of that at this point, John.

John Zamparo

Okay. No. That's helpful. Thank you very much.

Tom Harrington

Thanks, John.

Operator

Ladies and gentlemen, once again if you would like to ask a question, please press *, 1 now.

Your next question will come from Kevin Grundy at Jefferies. Please go ahead.

Kevin Grundy — Jefferies

Hey. Good morning, everyone.

Tom Harrington

Morning, Kevin.

Kevin Grundy

Question probably for David, just to come back to free cash flow. So I thought, at least directionally, there was going to be some improvement in inventory days this year, just kind of given where you finished with some of the retailer destocking last year. And that may indeed be the case, but it doesn't sound like it's going to be enough to sort of drive working capital improvement.

If I sort of like tumble through the numbers, it seems like working cap is going to be like a $30 million drag on free cash flow this year. David, maybe just spend a moment on that piece, just the working capital piece, and why it seemingly is going to be a drag this year.

David Hass

Yeah. We would peg that working capital drag closer to probably $20 million, Kevin, and I think the delta there is really conservatism around trying to understand the full tax liabilities of some of the property monetization. So if those come true, understanding sort of the bridge there, that would be the difference of you're trying to use, I think, that full $30-plus million to bridge down to why 130 would be the answer. And again, I think we're saying probably closer to $20 million and we're reserving kind of $10-plus million, et cetera, for excess potential cash tax.

Again, properties have not been monetized to date, they're in our potential future, and we're short of being cautious to not give out a free cash flow guide that we'd have to walk back just as we pay additional or incremental taxes on those properties.

Again, we won't know the exact timing and value until every property sort of in the hopper has been officially and finally monetized with the various jurisdictional sort of cash taxes that come with that.

Kevin Grundy

Okay.

David Hass

So I think that number would be accurate in your head, but we're kind of, again, putting more of that balance after $20 million toward the tax side.

Kevin Grundy

Okay. And then how about longer term with respect to free cash flow? Is it sort of appropriate to ground the Street at any sort of free cash flow conversion number? How are you thinking about that? How do you want to sort of orient the market?

Tom Harrington

I think part of it, Kevin, would be grounded in our previous communications on CapEx. Right? So we've said we'll spend the 7 percent plus $30 million this year, which gets to roughly $200 million. We have a similar 7 percent. Obviously, revenue will be higher, but the same $30 million incremental next year.

And then in 2025, our plan is to eliminate the $30 million, so that $30 million essentially drops. Right? So if you said, how do I think about it, that's a for sure how I think about it narrowly from there.

So hopefully that gives you some context of the next three years. Right?

And I just want to go back and just touch on David's working capital just for a second. The real change in any working capital this year, because we're making progress on the inventory side of your question, is really about growth in AR associated with higher revenue. So that's naturally going to go up. And that really drives the delta in just narrowly working capital.

We're making good progress on the other challenges that we experienced in 2022. Just that point of clarity.

Kevin Grundy

Okay. All right. Very good. I can pass it on. Thanks for the colour, guys. I appreciate it.

Tom Harrington

Thanks, Kevin. Appreciate it.

Operator

There are no further questions, so I will turn the conference back to Jon Kathol for any closing remarks.

Jon Kathol

Thanks, Michelle. This concludes Primo Water's first quarter results call. Thank you, all, for attending.

Operator

Ladies and gentlemen, this does conclude your conference call for this morning. Primo would like to thank you all for participating, and we ask that you please disconnect your lines.