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Has Coke lost its fizz?

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[Headnote]
Trouble at home and a less-than-refreshing outlook abroad make the soda giant's prospects look flat.

Over the summer in Japan, Coca-Cola launched a low-calorie beverage containing six minerals, named Tarumi. Translation? "To sag." It's intention, of course, is to prevent soda drinkers from doing just that. But the irony can't be lost on Coke executives.

The soda giant's stock (KO, $45) is down 45% from its 1998 high and lags the S&P 500. Investors who relished strong double-digit earnings growth in the 1980s and early 1990s have seen the numbers fizzle: Operating income has grown an average of just 4% in the past five years, while sales growth has averaged a mere 3%. Furthermore, the company suffered through an embarrassing episode this summer when it owned up to rigging a marketing test in Burger King restaurants in 2000. Eventually it agreed to pay the burger chain up to $21 million. It also settled for $540,000 with a former Coke auditor who claimed he was wrongfully terminated after exposing the scheme and warning higher-ups about accounting problems. Coke says an independent investigation found that most of his claims were invalid. The SEC and Justice Department are still looking into these matters.

Lately even good news comes with an asterisk. Coke's most recent quarterly results-it turned in a 6.5% rise in ongoing operating profit-don't provide evidence that a true turnaround is at hand. Sure, Europeans baking in a historic heat wave this summer consumed plenty of Coke. But let's face it, that's a one-time event. A big chunk of Coke's gains came from the weakened dollar, which boosts overseas sales when converted back to the U.S. currency. In fact, if the currency benefit is stripped from quarterly results, Coke's operating income rose only 4.3%. "We were not overall impressed with Coke's third-quarter results given that earnings per share appear to be driven more by a lower tax rate and currency," summed up Smith Barney analyst Bonnie Herzog, who has a hold on the stock. By comparison, archrival Pepsico wowed analysts with a 10% rise in operating profits in its beverage and snack-food business.

No doubt, Coke has a strong foundation. It's one of the most recognized brands in the world and is a topnotch bluechip company with a reputable board that includes longtime shareholder (and Coke drinker) Warren Buffett. That's a big reason Coke still trades at a 20% premium to the market on a price/earnings basis. Still, it faces plenty of challenges on its home turf, where consumers have become bloated with colas. Volumes of carbonated soft drinks are growing at less than 1% in North America, according to Beverage Digest. That's nothing compared with the 26% growth rates for bottled water or the 15% growth pace in sports drinks.

And Pepsi has established a solid beachhead in those faster-growing segments. When Coke pulled out A of the bidding for Quaker Oats in 2000, Pepsi stepped in and bought the company-including the sports drink Gatorade-for $14 billion. Today Gatorade has 81% of that expand- ing market, dominating Coke's Powerade brand. Pepsi also has the bestselling orange juice, Tropicana. And Pepsi's bottled water, Aquafina, outsells Coke's Dasani.

Pepsi also has excelled in the hot youth sports market by offering summer-only products like Mountain Dew Live-Wire. "Pepsi does an awfully good job of marketing," says Todd Slender, an analyst at Los Angeles brokerage Crowell Weedon & Co. "It is driving volumes higher in the critical convenience-store channels by get- ting a young crowd into the corner 7-Eleven to buy 20-ounce bottles of Mountain Dew."

Coke has had its share of wins. Sprite still dominates the lemon-lime market. And last year's launch of Vanilla Coke was a bona fide success. Unfortunately, as is often the case with hot product launches, volumes at supermarkets have fallen off by nearly 60% since Vanilla Coke's introduction.

In searching for faster growth, Coke has clearly staked out the international markets. There's good logic for doing so. While annual consumption per capita of soft drinks in the U.S. is about 840 servings, the rate in countries like China and India remains below 25 servings per person. However, it can be tricky navigating the political, economic, and social waters overseas. While sales in Europe have rebounded since the 1999 tainted-soda nightmare in Belgium, Coke faced a similar scare this year in India. There, rumors that Coke (and Pepsi) products contained high levels of pesticide sent sales into a tailspin.

By far, Coke's biggest challenge over the next few years is Japan. While that market accounts for only 5% of Coke's global volume, it generates a whopping 20% of the company's worldwide operating profits. Until now Japan's love affair with the high-margin vending machine has helped Coke's profits tremendously. But an aging Japanese population and a move toward buying Coke in the lower-margin supermarket segment has stunted growth. Analysts predict profit growth in Japan could slow to 5% annually, about half of what it was a decade ago. Coke says it's experimenting with new vending-machine technology and working with its bottlers to cut costs. "A lot of the bad news from Japan is built into the stock," notes John Faucher, an analyst at J.P. Morgan, who recently upgraded Coke. "But longer term, Japan is the biggest risk."

Of course, it's up to Coke's CEO, Douglas Daft, and president, Steven Heyer, to deal with the company's array of woes-and many analysts credit the pair for taking the right steps. The execs are reining in costs and improving margins in a restructuring effort. "Part of the problem with Coke has been that expectations have been so high," says Faucher. "People used to think of Coke as a company with 18% earnings growth. Now they look at it as a company with a 10% growth rate. That's a big help." The company has also made great strides in improving Coke's longtime bitter relationship with its network of bottlers. That's important in driving retail pricing growth in local markets.

Wall Street is expecting Coke's operating profits to improve dramatically next year. But it has nothing to do with a new product offering or a marketing campaign. Instead, after a rough 2003 the financial hurdles for Coke will simply be easier to leap. And then there's the weak dollar. Coke's chief financial officer told analysts in October that its earnings next year would get another lift if the euro and yen continued to rise. That may be enough to prop up Coke's shares in the near future. But then, investors who want to make a currency bet are better off avoiding Coke shares in favor of another strategy: Go long the euro.

[Sidebar]
With soda consumption maxing out in the United states, Coke now gets 75% of its profits in fickle foreign markets.