Primo Water Corporation

Third Quarter 2020 Earnings Conference Call

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Welcome to Primo Water Corporation's third quarter 2020 earnings conference call. All participants are currently in listen-only mode.

This call will end no later than 11:00 a.m. Eastern Standard Time.

The call is being webcast live on Primo's website at www.primowatercorp.com and will be available for a 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 the 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 estimable is included in the Company's third quarter earnings announcement released earlier this morning, or on the Investor Relations section of the Company's website at www.primowatercorp.com.

I am virtually accompanied by Tom Harrington, Primo's Chief Executive Officer, and Jay Wells, Primo's Chief Financial Officer.

As a 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 with an update on the business impact of the ongoing pandemic and the actions we are taking in response. Then Jay will discuss our third quarter financial performance, liquidity, ongoing cost containment and synergy work as well as fourth quarter outlook before handing the call back to Tom to provide a long-term view ahead of Q&A.

Within the prepared remarks, Tom and Jay will be discussing continuing operations, which will incorporate the legacy Primo business and exclude the S&D business, which was sold in February.

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

Tom Harrington — Chief Executive Officer, Primo Water Corporation

Thank you, Ryan, and good morning, everyone. I hope all of you have remained safe and healthy since our last update. Earlier this morning, we reported strong third quarter results that exceeded expectations and continue to demonstrate the resilience of our business. It remains clear to us that our pure-play water model is well positioned for the current environment and beyond as consumers continue to place a premium on access to high-quality drinking water provided whenever, wherever, and however they want it.

Revenue of $518 million increased 10 percent, 9 percent excluding the impact of foreign exchange, and was roughly 6 percent better than the midpoint of the guidance we provided. Throughout the quarter, we experienced steady improvement from our commercial customer base in our Water Direct channel in both North America and the rest of the world as consumers showed increased mobility and more people returned to the workplace. Performance at our Water Direct residential customer base and other at-home consumption channels remained strong.

In the third quarter, on a pro forma basis, our residential Water Direct and Exchange business in North America grew about 23 percent, and dispensary sales are up roughly 57 percent. We continue to be encouraged by the growth of these at-home channels and believe it is indicative of a consumer trend that will persist beyond the pandemic.

As there's been a spike in cases in some countries and new precautions are being implemented in these markets, we would expect that our residential and at-home channels distribution and penetration along with our online capabilities will help to insulate us from potential future impacts from the coronavirus.

Adjusted EBITDA grew 28 percent in the quarter to $111 million and was roughly 8 percent better than the midpoint of our guidance. In fact, on a pro forma basis, we returned to adjusted EBITDA growth during the quarter, something we had anticipated achieving sometime in the fourth quarter. We're quite pleased to have returned to adjusted EBITDA growth versus prior year despite the challenges presented by the coronavirus.

We were able to return to adjusted EBITDA growth before returning to revenue growth largely due to the aggressive cost reductions we implemented early in the second quarter. We took advantage of our highly variable cost structure to remove 18 percent and 19 percent of our SG&A, and some of these cost reductions are permanent.

We are now operating more efficiently and delivering more bottles per truck per day than we were before the pandemic. We have streamlined company operations and are capturing good operating leverage with our rightsized route structure. As a result, our adjusted EBITDA margin in the third quarter was 21.4 percent, an increase of 310 basis points compared to last year.

After the cost actions we have taken, combined with our solid performance over the past few quarters, we're currently ahead of schedule of our forecasted adjusted EBITDA margin percentage by roughly two years. We expect Primo to be a structurally more profitable company going forward, and we are therefore raising our targeted annualized adjusted EBITDA margin from approximately 16 percent to no less than 18 percent.

We generated $35 million of adjusted free cash flow in the quarter. This was lower than prior year mainly due to the timing of interest payments and growing accounts receivable as our commercial Water Direct business gradually returns.

We continue to outpace the timing of the synergy capture work we've been executing. Our team has done a great job, and we've captured roughly 10 million in synergies year to date, which Jay will elaborate on in a moment.

Overall, I am very pleased with our third quarter financial results and the work our team continues to do on a daily basis in such a dynamic environment and want to thank all of the associates across Primo for their continued commitment to delivering superior customer service during the pandemic.

The pandemic continues to present both opportunities and challenges to the way companies operate. We are guided by our strategic initiatives and are focused on executing in the areas that are within our control. The initial work behind many of these efforts was in motion for some time before the crisis hit, and we are making good progress in these key focus areas.

We believe that changing consumer behaviour is creating opportunities for our business. For example, consumers are spending more time at home and dining in is becoming the new dining out. Staying home is taking on new meaning and assuming elevated levels of work-from-home and cocooning

through and after the pandemic, we would anticipate further growth from our residential customer base and at-home consumers who use our Water Direct and Exchange or our Water Refill and filtration services.

Another example is consumers purchasing more of their products online and having more of the things they buy delivered directly to their door in a safe, no-contact way.

These are two areas where we are well positioned to benefit. Our mobile app was rolled out across the US during the second quarter, and we're seeing solid adoption trends of the app from our customers. Through the end of the quarter, the app has been downloaded nearly 150,000 times, which represents roughly 10 percent of our customer base in the US. The feedback from customers has been very positive, and we will continue to enhance this customer-friendly solution.

We continue to make improvements to our website, including water.com, to simplify the ordering process. With all of our investments in the customer experience, we're confident that we can retain the new customers we have added in recent months through and beyond the pandemic. These investments are clearly working, as our net promoter score continues to trend above 2019.

Our churn rate in our US operations during Q3 was 23.4 percent, an increase of 100 basis points compared to last year. While we are pleased with the churn rate over the past few quarters, as we have discussed, we do realize it will be several quarters before we understand the impact of the pandemic on the commercial customer base and whether customers, who have not purchased since the pandemic began, are permanently lost.

Along with our initiatives around existing customers, we're working to generate new customer adds in this new environment. Our partnership with a large E-commerce retailer is also growing with terrific customer feedback. Our service currently has an average customer rating of 4.6 stars on this retailer's website.

We expanded this program to Southern California during the second quarter and rolled it out to dozens of new markets in the third quarter as well. The service is now available in 80 cities, and we expect to extend the program across our entire US footprint before the end of Q4.

No-contact home delivery and E-commerce capabilities will continue to be highly desired by consumers, and the expansion of our online retailer program is a great way to ensure we participate in this trend. Fortunately, we have the capabilities to execute both from an online perspective, as well as at the customer doorstep.

In our Rest of World segment, we’re focused on establishing our European residential base by expanding our 4R model. We are one of the leaders in water solutions in Europe and have the footprint and expertise for a low-cost rollout of our legacy Primo solutions. Our team is currently developing the plans to begin implementation in 2021 in select markets where we have identified greater demand for our at-home products and services.

We’ve also introduced a new transactional website in 11 countries, up from six at the end of Q2, in Europe for residential customers to sign up for the service. This is the first time that European consumers can sign up online with us, and we’re pleased with the early performance in terms of the number of new customers and the low cost to acquire these new customers. We believe we’ll begin to see the benefits of these actions in 2021, and they will provide us with profitable growth and better balance within our customer mix across our European business.

Finally, as we focus on the future, we continue to focus our efforts on improving our sustainability position. We take our role as a steward of the planet’s natural resources very seriously, and we’re finding ways to better serve our customers in an environmentally sustainable way. For example,

one of our 5-gallon bottles can be sanitized and reused up to 50 times before being recycled, which saves about 1,500 plastic half-litre water bottles.

In North America, we've shifted new route truck purchasing to propane-powered trucks to reduce carbon emissions. We've greatly improved energy efficiency at our plants to ensure lower energy usage per finished product. We proudly achieved carbon neutrality in our US operations during the third quarter. And we're continuing to pursue the Alliance for Water Stewardship certification for the first two of our springs.

In Europe, we've been carbon neutral for eight consecutive years. Our offices are entirely powered by renewable energy sources, and we introduced biodegradable water cups. Overall, our results are solid, and we're very pleased with the way our team has navigated the crisis.

We continue to execute in our key focus areas to ensure that we are well positioned to capitalize on opportunities, and we still see the long-term growth drivers of our business intact and growing.

Before we discuss our fourth quarter outlook and take your questions, I'd like to turn the call over to Jay to review our third quarter financial performance.

Jay Wells — Chief Financial Officer, Primo Water Corporation

Thank you, Tom. And good morning, everyone. Starting with consolidated results, revenue increased 10 percent to $518 million compared to $472 million in the prior year. Excluding the impact of foreign exchange, revenue increased 9 percent. The increase was primarily driven by the benefit from the legacy Primo acquisition, as well as increased revenue from our Water Direct and Exchange residential customer base in North America. This was partially offset by lower revenue from our Water Direct commercial customer base and coffee services in both North America and Rest of World segments. On a pro forma basis, revenue was down 5 percent, better than our initial forecast of down 8 to 12 percent.

Third quarter adjusted EBITDA increased 28 percent to $111 million compared to $87 million in 2019. Adjusted EBITDA margin increased by 310 basis points to 21.4 percent. The increase was primarily driven by the benefit of the legacy Primo acquisition, growth in revenues from increased water products and services sold to residential customers within the US, synergy realization, and improved operating leverage resulting from cost reductions. On a pro forma basis, adjusted EBITDA increased 8 percent versus prior year.

Third quarter SG&A expense increased 5 percent to $257 million compared to $244 million. The increase was due to the addition of the legacy Primo business, largely offset by lower SG&A resulting from cost reductions. Costs in the quarter related to COVID-19, such as severance, were approximately $2 million.

As we have discussed, we remain very diligent with our cost structure, given the state of the world. We have brought back a small amount of cost in headcount, approximately 100 associates, as we have seen slow but steady improvement from the April lows. We will continue to take advantage of our highly variable cost structure which allows us to flex our route structure and labour force with changing conditions, and we will remain judicious with our cost structure.

Turning to our segment-level performance. Starting with North America segment, where we generate approximately 75 percent of our total company’s revenue, revenue increased 16 percent to $393 million. The increase was driven by the benefit of the legacy Primo acquisition, as well as growth within our residential Water Direct and Exchange business. This was partially offset by lower revenue from our Water Direct commercial customer base and coffee services business. On a pro forma basis, third quarter revenue in this segment was lower by 4 percent.

Adjusted EBITDA increased 38 percent to $91 million. The increase is the result of the legacy Primo acquisition, growth within residential Water Direct and Exchange, synergy realization, as well as improved operating leverage. On a pro forma basis, third quarter adjusted EBITDA increased by 12 percent.

Turning to our Rest of World segment. Third quarter revenue decreased 8 percent to $124 million, driven by decreased volume in our Water Direct commercial customer base, as well as in our coffee services business. Adjusted EBITDA was flat at $28 million as decreased volume in our Water Direct commercial customer base and coffee services business was offset by improved operating leverage resulting from cost reductions.

Turning to our liquidity position and balance sheet. We ended the third quarter with a cash balance of $162 million and available net borrowing capacity on our cash flow revolver of $171 million for a combined total liquidity position of $333 million. We remain comfortable with our AR balances, as well as our overall working capital position.

We ended the third quarter with a net leverage ratio of 3.4 times and continue to target a post-synergized net leverage ratio of 3.0 times. As we've previously announced, we closed the private placement offering of €450 million senior notes due 2028. The proceeds of that issuance were used to redeem our outstanding 2024 notes. The new notes carry an interest of 3 and 7/8 percent per year, and the transaction is expected to result in annual interest savings of roughly $8 million.

Regarding synergies, we remain confident that we will obtain the full $35 million in synergies over three years. We continue to make good progress and remain ahead of the initial schedule we laid out at the time of the legacy Primo acquisition. We originally forecasted $7.5 million in synergies achieved in 2020. Through the end of the third quarter, that figure is already approximately $10 million. This

accelerated rate of synergy realization is the result of the aggressive cost actions we took in response to the pandemic. So we are pulling forward some actions we originally expected to achieve in 2021.

Our team is diligently working on this front, and we expect additional synergy capture in the fourth quarter as well. This performance is a direct result of the Company's long history of M&A and the efforts of our teams who have M&A in their DNA.

Overall, we are happy with our third quarter financial results and the consistent improvement we saw throughout the quarter from our commercial customer base. As Tom said, the sustained strength in our at-home channels is also very encouraging. We are well aware that conditions can change quickly, but the resilience of our pure-play water model and variable cost structure leaves us confident that we can react accordingly while also executing our strategic priorities.

As we look to the fourth quarter, based on the information we have available to us today, we currently expect consolidated revenue from continuing operations to be between $470 million and $500 million. We also believe our fourth quarter adjusted EBITDA will be in the range of $85 million to $95 million, thanks to growth in our residential Water Direct and Exchange business, synergy capture, our operating expense reductions, as well as the benefit of a 53rd week as fiscal 2020 is a 53-week fiscal year.

As we look to next year and beyond, we've taken aggressive cost actions targeted around G&A, improved the efficiencies of our routes and drivers, accelerated synergy realization, and materially lowered our expected annual interest expense with the euro debt refinancing. These actions will improve some components of our growth algorithm such as raising our targeted annualized adjusted EBITDA margin to no less than 18 percent.

We expect to provide an update to our short-term and long-term targets during our fourth quarter results call as we would like to complete this fiscal year and continue to monitor the impact of COVID-19 through the winter months.

I will now turn the call back to Tom.

Tom Harrington

Thanks, Jay. As you heard Jay cover, we're pleased with where we stand today and how the business has performed over the past quarters. Our financial results continue to meet or exceed our expectations, and we continue to make great progress on the key priorities we have identified. We're endlessly looking for ways to improve the customer experience, and we'll continue to invest in the process from water placement to final delivery.

In North America, we will continue to invest in our Water Direct and Exchange, Water Refill and filtration, and Water Dispenser channels, as these channels are seeing sustained growth.

In Europe, we plan to accelerate our Water Refill, Water Exchange, and Water Dispenser businesses to diversify our customer base and capture growing demand in the residential market. Our team is focused on capturing the identified synergies, and we will continue to take appropriate action on that front. We will continue to emphasize efficiency and remain judicious with our cost structure. And we will seek new ways to further improve our standing as an ESG and sustainability leader.

As Jay noted, we expect our consolidated fourth quarter revenue to be between $470 million to $500 million. And for adjusted EBITDA to be between $85 million and $95 million. We expect to see sustained strength from our Water Direct residential customer base and in other at-home channels, and we're closely monitoring the condition of our Water Direct commercial customer base.

As we've all seen, during the month of October, there's been an increase in case counts in both North America and Europe as well as a return on some more restrictive containment efforts by local governments, particularly in Europe. We're keeping in mind the potential for increased regional lockdowns as we enter colder seasons in the Northern Hemisphere. We do not expect to return to the peak levels of global lockdown, but we are prepared for setbacks due to local spikes in cases and targeted restrictions and closures and would expect to see acceleration in our residential at-home channel if there is a meaningful spike in coronavirus cases.

The result is that forecasting remains more difficult than usual, but we're focusing on the things we can control to ensure we are well positioned to withstand the crisis and capitalize on strategic opportunities. And we're improving our long-term growth algorithm as we maintain our conviction in Primo's future and our pure-play water model.

Again, I would like to thank the full Primo team and all of our associates for their commitment to Primo and to our customers during this crisis.

I'll now turn the call back to Ryan and move us to Q&A.

Ryan Coleman

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 up the line for questions.

Q&A

Operator

To ask a question, simply press *, 1 on your telephone keypad. Again, that's *, 1 to ask a question. And we'll pause for a moment to compile the roster.

Your first question comes from Nik Modi with RBC Capital Markets.

Tom Harrington

Good morning, Nik.

Jay Wells

Good morning, Nik.

Nik Modi — RBC Capital Markets

Good morning, everyone. So just two quick ones from me. So the low end of the guidance assumes a 7 percent decline for the upcoming quarter versus 5 percent this quarter. So just wanted to understand the mix, how you're thinking about commercial versus residential. And then maybe just Jay or Tom, if you guys could just provide some context on how October is doing relative to kind of what we saw in the September quarter?

Tom Harrington

Yeah, Nik, good morning.

Nik Modi

Good morning.

Tom Harrington

If you think about the guidance we've provided, we've obviously factored in what we currently see in terms of new lockdowns. So as an example, Israel shut down for three weeks. It was during October, end of September into October. The UK is starting, I think, tomorrow in terms of more aggressive

lockdowns. So we've tried to anticipate a range of results based on the unknown of what that means to us.

We do believe the simplicity of a transactional water site in Europe will help buffer some of this because when we entered this in Q2, we didn't have that, and we're pleased with those results thus far. So we think that'll help us a little bit against our commercial revenue performance in Europe but have fully factored in what we currently see, based on October results.

Jay, do you want to give a comparison of October and September if you can?

Jay Wells

Hey, Nik. Good morning.

Nik Modi

Good morning.

Jay Wells

You looked at how we left the quarter. Overall, and Tom hit on some of these numbers, residential Water Direct, Exchange revenue for Q3 was up 23 percent. And commercial was down only high teens in Q3, with overall global commercial revenue being down around 20 percent. So that's what we saw in the quarter.

Now you look at as we go into October, and I'm going to talk volume numbers now. I don't have good revenue numbers because I haven't closed my books yet, but we do watch volume every day. And keep in mind, our volume is always lower than our revenue because it excludes rent on coolers and things like that. So we still were seeing residential Water Direct up 26 percent in volume, which means even better in revenue. And Direct on the commercial side was down roughly 30 percent. And it was really, I

would say, North America has stayed pretty consistent. But as Tom said, that's softened over in Europe a little bit. And we factored that into the forecast we provided.

Nik Modi

Super helpful. Thanks, guys.

Tom Harrington

Thanks, Nik.

Operator

Your next question is from Derek Lessard with TD Securities.

Derek Lessard — TD Securities

Yeah. Good morning, everybody. And congratulations on another great quarter.

Tom Harrington

Thanks, Derek. Good morning.

Derek Lessard

You did speak about raising your annualized adjusted EBITDA margin target to 18 percent. I was just wondering, I guess, what's driving the increased confidence there in that new guidance?

Tom Harrington

Yeah. If you think about the actions we took in Q2 that we have communicated, we would expect some improvements in the overall EBITDA margin and that a number of those changes would be permanent. And we're now running at levels that, because we've been judicious about what we had cost back, we're operating at an infrastructure that frankly existed in Q2. And we're going to maintain lower levels and maintain this EBITDA margin such that we're confident that it will be no less than 18 on a go-forward basis.

And that's the rightsizing of the route. It's G&A actions we've taken. It's the combination of all of that, offset, frankly, to some degree, as we're making investments in residential and those at-home channels, which are all in the opposite side. But that gets to the opportunistic, take advantage of these strategic opportunities as the residential, online, at-home, no-contact delivery business. That's our sweet spot.

Derek Lessard

Okay.

Tom Harrington

So we need to invest in that.

Derek Lessard

Has your partnership with your E-commerce partner, has it benefitted you on the route side or your margin position?

Tom Harrington

It's small today. We rolled out through Southern California at the end of Q2. The end of Q3, we are in something on the order of 80 cities across the US. We're beginning to see some acceleration in the number of customers that are hitting online.

It's small. We would expect to be across our entire footprint before the year is out. And then it really is, if you think about online marketing, it's consistent communication by our partner. We get 4.6 stars, I think, from that partner, so we're meeting and exceeding SLA. So we think it'll help us. But today, it's not a meaningful impact because it's so small. We're hopeful, in the years to come, that it becomes a bigger piece of the algorithm when more customers always leverages our operating structure.

Derek Lessard

Okay. Thanks, guys. Great job. Thank you.

Tom Harrington

Thanks, Derek, appreciate you.

Operator

Your next question is from Peter Grom with JPMorgan.

Jay Wells

Good morning, Peter.

Tom Harrington

Hello, Peter.

Peter Grom — JPMorgan

Hey. Good morning, guys. Congrats on a great result. So just a couple for me. First, and maybe I missed this, but did you quantify the impact of the extra week on both your revenue and EBITDA guidance?

Jay Wells

No. Good question, Peter. For the 53rd week, it's worth about $10 million of revenue and $2 million of EBITDA. Now the question I always get, for a week, that seems pretty low. But keep in mind this only applies to our North America business to start off with. It doesn't apply to Europe. And it's the week that New Year's lands on. So it isn't a full week of deliveries that we do because it is a holiday week. So that's the answer to the question of $10 million of revenue, $2 million EBITDA does seem low, but that's why it's lower than you would expect.

Peter Grom

Okay. Thank you for that. And then I kind of wanted to ask around the margin work you've done, but maybe direct it more towards 2021 and how we should think about the bridge to next year as we cycle

a very unique 2020. I guess is the underlying growth of $12 million to $15 million with still in line with kind of how we should be thinking about it? Or given the tough comps, could it be at the lower end? And then, given the strong synergy realization year to date, what is the right way to think about the phasing of synergies next year? Is the $25 million spread over this year and next kind of the right number with more being pulled forward into this year? Or could we see some of the benefit that was expected to come in 2022 pulled forward into next? Thanks.

Tom Harrington

I'll give you, Peter, the high level, and then I'll ask Jay to share any details that we can. Clearly, next year is going to be quite lumpy, and we plan to wait until we get through the full year to provide clarity about how we think about it. But we know that the first quarter last year was a super performance. It was positively impacted at the end of the quarter as a result of the pandemic. And then Q2 was Armageddon the other way.

So we expect lumpy performance and really want to get through the next two months, frankly, to see what's the next impact of any of these incremental cases to make sure that whatever we provide in terms of guidance is our best view at the most relevant time from my seat.

Jay Wells

Yeah. On next year, when you're looking at EBITDA growth, first off, keep in mind, we are lapping two months of Primo that wasn't in our results for this year, and that's worth $6 million, $7 million. We will be lapping also the 53rd week I called out. So there'd be $2 million in the other direction at the end of the year.

But it really is, as Tom said, it's Q1 is the difficult period to lap. Once we get past Q1, we start lapping the European performance, which really saw a big hit to EBITDA in Q2 of last year. So Q2 is a really

good quarter to lap. We should see very good growth in Q2. And then I would say once we get into Q3 and Q4, it should more normalize.

So those are the factors when I look at EBITDA for next year that I would consider, but we will continue to provide organic growth on top of lapping these comps. So we see that we should be able to generate the growth next year. It'll just be a little lumpy between Q1 and Q2.

Tom Harrington

And then his other question about how are we thinking about the Primo synergies?

Jay Wells

Oh, thank you. Primo synergies. Now being that we're already up to 10 this year, we are definitely going to over deliver because I have one more quarter of synergies. So will we get another $6 million, give or take, in the fourth quarter if you look at what we did this quarter and trend. So we're over delivering this year, and we still view for the two years in total to generate $25 million. So it really is shifting synergy benefits from next year into this year with the remaining 10 hitting in 2022.

Peter Grom

Great. Thanks. Appreciate it, and congrats again.

Tom Harrington

Thanks. Peter.

Jay Wells

Thanks, Peter.

Operator

Your next question is from Kevin Grundy with Jefferies. Please go ahead.

Kevin Grundy — Jefferies

Hey. Good morning, guys, and congrats on the continued progress here with the business and particularly in this environment. Not to belabour the margin question, but I just wanted to come back to it. It looks like just sort of like a quick back of the napkin here, just taking your guidance for the fourth quarter what you've done for the year, the Company's kind of already in this north of 18 percent EBITDA margin range. So can you just build on this a little bit? I'm still a little bit confused as to why there would not be greater upside, understanding maybe some of the synergy pulled forward. But just synergies alone are going to give you some benefit. How much in terms of fixed cost are going to be coming back into the P&L? Why isn't there, I guess, some sort of even something baked in operating leverage alone, notwithstanding the opportunity to take out further costs from the business as you continue to work through that?

So just a little bit of clarity on the longer-term margin guidance relative to where you expect to land for '20. And then I have a follow-up.

Jay Wells

Yeah. I'll give you some colour about how we think about the margins. In both Q2 and Q3, we pulled the cord on lots of expenses, so particularly if you think around sales and marketing, right? And we've very slowly put those back in. But if you think about the growth opportunity in out years, we'll spend more money on marketing and more sales because we'll need, obviously, to take advantage of the market and return to organic growth. So you have to consider that that's principally not quite zeroed out, but a pretty significant cut in those areas around the business and that we'll put those reinvestments back in.

The synergies, we said 35 by the end of three years. We're ahead of schedule, and that's certainly a part of the margin enhancement, but we're two years ahead of where we thought we would be when

we talked about that. And then it becomes what's our normal algorithmic growth of EBITDA margin expansion. What we used to say, and we haven't said it, is the 20 to 30 basis points is work that we need to finalize and analyze as we get through this quarter because there's a fair bit of unknowns. And then we can determine that, yes, the normal model should have X amount of growth in it.

Tom Harrington

I mean, Kevin, our goal is to drive increasing organic growth. And to do that we're going to put the sales and marketing costs back in next year. So the key is not to forget that because we think we can drive significant organic growths for this company, but you've got to spend to do that. And that's why it's a little bit lower than you would think because, as Tom said, this year we have cut a significant amount of sales and marketing because there has been nobody on the commercial side to market to. Our Costco booth programs were closed for a quarter. They're reopened now, but so those are costs we want to spend because we really feel we can drive organic growth in this company.

Kevin Grundy

And just to stick with that, just a quick follow-up, more of a broader strategic question. Is that what is driving the step-down in the fourth quarter guidance? Because your guidance implies about 18 percent to 19 percent EBITDA margins down from something north of 21 percent. Are you guys leaning in? I know there's some operating leverage. I know there's some seasonality to it. I understand that. Is it just the seasonality? Or are you investing?

Tom Harrington

Seasonality, plus I would love to reinvest in Europe sooner, right, to help 2021. But UK's shut down, so that makes sales and marketing—UK and others, frankly—makes that tougher, so.

Jay Wells

But I mean, Kevin, if you look historically, our shoulder seasons versus our busy summer months, there's about 200 bips difference

Kevin Grundy

Yeah.

Jay Wells

And even margin historically. That's just the leverage we get during the summer months we really see the benefit in our EBITDA margin. But the fourth quarter is probably our lowest quarter when it comes to that. So just look at us historically. It's about a 200 bip movement between second and third quarter and first and fourth quarter.

Kevin Grundy

Okay. Understood. The broader question, then I'll pass it on, just with respect to larger-scale M&A. Can you talk about some of the governors around capital structure, specifically debt leverage and maybe even some broader commentary around hurdle rates when you think about broader strategic M&A versus smaller tuck-in M&A? And then just from a portfolio assessment, just given the work that you guys have done to get the portfolio where it is today, is it fair to say that there's little appetite to increase the Company's exposure to areas outside the core? And specifically now lower-end branded water sold in traditional retail channels, more of a commoditized business, lower margin than your business, is it fair to say that there's little appetite outside of the core? And then I'll pass it on. Thanks.

Tom Harrington

I'm going to try and unpack that and take a piece of that, Kevin. Handful of questions here. Look, our company is brand-new, right? This pure-play water company, frankly, was created in March of 2020.

It's clear to us that our pure-play water strategy works. It's clear to us that the acquisition of the legacy Primo business fits into our model.

So we like the direct-to-consumer delivery model. We like that we have alternative quality drinking water solutions whenever, wherever, and however you want it. So we have to complete the synergy work. We have to stick to our knitting, and our knitting is what we do today. Would we go into an adjacency which is a different category that has water? Maybe. But we haven't been in the—retail business is a small percentage of our business, which is your question, and that's not what we do.

Jay Wells

And we like the sustainability of our package. We reuse our bottles up to 50 times. We sanitize them, reuse them. That equates to about 1,500 half-litre bottles in a landfill. That's not what we want to do. I mean, we're a very ESG-focused company, and we want to continue to focus on that. Should I handle a couple of the other—

Tom Harrington

The others, yeah.

Jay Wells

—others? When you look at larger strategic deals, and I think we've showed it in the past, we will always use the appropriate balance of debt and equity to fund any deal in order to not dilute our stock too much, nor put too much leverage on our balance sheet. Especially where you look at macroeconomic events are right now, we will be very, I'll use the word judicious again, on the amount of leverage we put on to our balance sheet, so. And even after that, then we have a very big focus on leveraging after transactions. So that model would not change going forward.

You look at hurdle rates, cash-on-cash IRR has always been a key hurdle rate that we've got to get a better return than our cost of equity, else it's better to send the money back to our investors for them to use it. And we're changing our overall long-term incentive metrics to return on invested capital. So that's going to be a key part of any future investments, a key focus on us increasing our overall company's return on invested capital.

Kevin Grundy

Very good. Thanks for all the colour, guys. I appreciate it. Good luck.

Tom Harrington

Thanks, Kevin.

Operator

Your next question is from Daniel Moore with CJS Securities.

Tom Harrington

Morning, Dan.

Jay Wells

Hello, Dan.

Daniel Moore — CJS Securities

Good morning, Tom and Jay. Thank you very much. Just one or two. Looking at the balance sheet, receivables ticked up a bit, probably a function of timing. And any sense for a range of expectations for free cash flow in Q4?

Jay Wells

On the AR, two things happened. One, we are getting our commercial customers back. Their payment terms are a little bit longer. So it's a combination of the return of our commercial customers

affecting our AR. And two, Tom mentioned our dispenser sales were up 57 percent in the quarter as there was some early loading for Black Friday. And just how those work, the AR was still on our balance sheet. We had to do the AP beforehand. So it was just more the significant dispenser sales in the quarter.

And on Q4 on free cash flow, haven't provided any. The good news is, we had talked about an extra interest at the end of that quarter, which now is a refi of the euro debt, we won't have. But other than that, would expect to see AR to continue to go up a little bit as our business recovers. But again, in the current environment, I'm hesitant to give too much guidance on working capital at this time.

Daniel Moore

Understood. Appreciate it. And then, you gave pretty good colour, but one more just in terms of the E-commerce channel. Has your thinking changed at all as to the magnitude of the opportunity as that's accelerated and gained traction?

Tom Harrington

Yeah. Look, I remain cautiously optimistic. I'm pleased. As we roll out, you would expect we'd get more customers. So there's some building traction. So we're pleased with the progress. And remember. We've communicated we've got to make sure we have our execution right. So this is about when that customer, that order, gets to us, that we execute against our SLAs. And you looked at the 4.6 stars. It's about how many negatives you don't have. Right? And there's like two or three in the whole scheme of things. So that's an important part for us.

And then, as we build that capability, we get it rolled around the entirety of the US, then it'll build as we move into the coming years.

Jay Wells

Yeah. I will tell you, and Tom talked about a little bit in his prepared remarks, I mean, the concept of E-commerce picking up customers via the web and no-contact delivery, we are seeing more and more adds by our water.com and our website. And another form of E-commerce acquisition of customers is important. And we've been doing no-contact delivery for decades and decades. So between the two, we think we're in the sweet spot of consumer trends right now.

Daniel Moore

All right. Very helpful. Thanks for the colour again.

Tom Harrington

Thanks, Dan.

Jay Wells

Thanks, Dan.

Operator

Your next question is from Derek Dley with Canaccord Genuity.

Derek Dley — Canaccord Genuity

Yeah. Hi guys.

Jay Wells

Morning, Derek.

Derek Dley

Hey. How are you?

Tom Harrington

Hey, Derek.

Derek Dley

Thanks. Just on the cost-cutting, just wondering if you could give us just a bit more colour in terms of how much of the cost-cutting that you've been able to achieve throughout this period is really variable cost. And how much of that is actual fixed costs coming out of the business?

Jay Wells

You want me to try?

Tom Harrington

Yeah.

Jay Wells

That's an interesting, Derek. The key is we're able to take the cost out. So one thing I've said, the nature of our business is much higher variable than you would think. So key costs that we've taken out has been people. And we talked about it. We started off about 20 percent of our workforce we took out, which were routes. Now routes are variable, up and down on demand. That is definitely variable. But we've also—those routes are performing as well as they ever have where are we delivering 8 percent, 9 percent, 10 percent more bottles per day, per route? Yes. So we're seeing more efficiency.

Other costs we've reduced is on the marketing side. We reduced the traditional door-knockers who call on small commercial businesses because there's nobody there to answer the door. I would more view that as a fixed cost because we want to invest behind growth all the time, but in this type of environment they're more than variable to take out.

And then the last thing we did, we have removed some G&A cost. So those, I would say, are more fixed, but we have reduced our organizational structure to be a more lean organization I would say. That's a smaller part of the overall costs we've taken out, but that's certainly fixed.

Derek Dley

Okay. No. That's helpful. That's really helpful. And just one follow-up on the M&A environment, and this is probably a bit different than the last question. But just when we think about the smaller bolt-on opportunities—I'm not talking about anything larger that may be out there—has there been any change in your viewpoint on that, or in multiples that are sort of being expected in those private sales, just given some of the challenges that you've seen in the market?

Tom Harrington

Yeah. It's a good question. We executed two, I believe, in Q3, and we're quite pleased with those. We have a pipeline on both sides, and there has been no uptick in the cost to acquire; maybe a flattening. So it's kind of standard fare in terms of where we're at. And it's going to depend on the businesses that we circle around, and it's about selecting through our pipeline as we enter '21 and beyond.

Jay Wells

Yeah. I mean, I would say, Derek, I mean, a lot of people ask are the distressed assets out there, and we're not seeing that at this point in time. The main thing is for the ones that we're looking at right now, since we're in the middle of a pandemic we might have a little bit more of an escrow, hold back a purchase price until we confirm that the customers we're buying are customers that are there. But other than a little bit more of a holdback of the purchase price to ensure we're buying the customers we think we are, really nothing's changed.

Derek Dley

Okay. Perfect. Thank you very much.

Tom Harrington

Thanks, Derek.

Operator

And your next question is from Pavel Molchanov with Raymond James.

Tom Harrington

Morning.

Pavel Molchanov — Raymond James

Thanks for taking the question, and nice to be on your call for the first time. I thought I'd ask about the M&A landscape. So in the context of the pandemic, the recession, and the lockdowns, as you've watched multiples on M&A opportunities in 2020 versus 2019 or previous years, have you noticed any reductions or any changes just in the broader M&A landscape?

Tom Harrington

Yeah. If you think about our I'll call it tuck-in pipeline, the multiples are about the same for the deals that we've executed. What's different is a much higher percentage of the purchase price in a hold-back. And so the price may ultimately come down, but we'll have to wait and see how that turns out. And that's really driven by how many customers did you represent as to be sold and how many did we wind up keeping, which is a direct relationship to the revenue and, obviously, EBITDA.

Jay Wells

Yeah. I mean, the tuck-ins that we do are really we've talked about a multiple of revenue, not really a multiple of EBITDA, and with the US being is it 1 to 1.2 times, Europe a little bit higher, maybe 1.5 or higher times. And so that's why we're doing more of a holdback because it really is a customer list acquisition. So it's just making sure we're buying the revenue we believe we are because once we get it on our routes and the US synergizes quickly down to around 3.5 times.

Pavel Molchanov

That’s helpful. One more question about M&A, and this is specifically in relation to Europe. I think you’re currently, correct me if I’m wrong, in 16 countries in the EU and a few members like Switzerland that are not in the Union. Is that pretty much the footprint that you are happy to have for the long run? Or are you looking at adding any additional geographies to your footprint there?

Tom Harrington

Yeah. So we’re in 18 what I’ll call Eastern and Western European countries, right? Twenty-one total. US, Canada, Israel, the other 18 are there. There’s a couple adjacent markets that we would have interest in that we’d look at over time, but I don’t think of it as a country. I think about where there happens to be a number of large cities on the border of businesses we already have. So we’d look at those opportunistically in the future when they become available.

Jay Wells

Mm-hmm.

Pavel Molchanov

Thanks very much, guys.

Tom Harrington

No worries. Thanks.

Jay Wells

Thank you.

Tom Harrington

Nice to meet you.

Operator

Your next question is from Faiza Alwy with Deutsche Bank.

Faiza Alwy — Deutsche Bank

Yes. Hi. Good morning.

Tom Harrington

Good morning.

Jay Wells

Morning.

Faiza Alwy

I wanted to talk about gross margins. And we've seen a significant expansion this year. I believe when you did your Investor Day back in March, you had talked about a long-term guide of 53 percent to 54 percent. So I think a lot of this is the mix driven by the increase in residential and the decline in commercial customers. But I just wanted to see if you could provide more colour on that. And how should we think about gross margins next year and maybe on a longer-term basis? Sort of has your thinking changed? And I guess, is gross margin really even a—

Jay Wells

I think you got to our answer right at the end there, Faiza. Especially with the legacy Primo acquisition, they recorded a lot of things up in COGS that we record down in SG&A. So there's even a lot of movement between if you try and do something pro forma. So even just trying to get a combined pro forma gross margin is difficult because it was treated so differently by legacy Primo. And you really look at our plants that we have. Our COGS are—there's no significant commodity exposure. Our plants are a lot of capacity.

So there's not really a lot within our COGS line that moves up and down one way or the other. It's really when you get into SG&A and you look at our routes, and that's what we're leveraging with our

growth that we can get a lot more efficiency on our routes. So it's really the SG&A line that we focus more on on a cost side and maximizing our overall efficiency.

So that's why we talk a lot more about EBITDA margin because it's the SG&A line that we feel that there's opportunity to attack and to get more efficiency on. So that's why we're much more of an EBITDA margin-focused organization than gross margin.

Faiza Alwy

Okay. But I know you've talked about this before, but the residential business is much more profitable than the commercial business, I think, on an EBITDA basis. But is there a mix impact on the gross margin line? Or not really?

Tom Harrington

Not meaningfully there. If you look at our overall gross margin, one place that is lower, so there is a mix impact, is the meaningful declines in our OCS business.

Jay Wells

Coffee services.

Tom Harrington

Coffee services.

Faiza Alwy

Yeah.

Tom Harrington

So that's the wild card in the overall growth because that business it's lower margin. It is also down upwards up 50 percent, right, so. And frankly, in our forecast we expect that rate of decline to

continue in Q4, as an example. So we've modelled that in. But that's one of the bigger wild cards in how you look at gross profit.

Jay Wells

Mm-hmm. And now the other parts of our business. Dispensers, it's the razor we sell at a very low margin. So as in the quarter, we saw very good growth in dispensers. So that would be a mix that detrimentally affects it. And my hope is we're still working on getting our books and records where we need to be on a pro forma basis, like I said, to add gross margin to our exhibits. I was hoping to do it this quarter. Was not able to really work through the pro forma numbers to get comfortable with disclosing, but we will work on getting disclosure on a segment level of gross margin because we know it's important to you who are trying to do modelling.

Faiza Alwy

All right. Great. Thank you so much.

Tom Harrington

Thank you.

Jay Wells

Thank you.

Operator

And we have no further questions at this time. I'd now like to hand the call back over to Ryan Coleman for closing remarks.

Ryan Coleman

This concludes Primo's third quarter call. Thank you, everyone, for attending.

Operator

Thank you again for joining us today. This does conclude today’s presentation. You may now disconnect.