

Brown-Forman Corporation, Q3 2016, Earnings Call

2016-03-02

Presentation

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the third quarter fiscal 2016 conference call. — ***Operator Instructions*** — I would now like to turn the call over to Jay Koval.

Jason Koval

Thanks, Victoria, and good morning, everyone. I want to thank you for joining us for Brown-Forman's Third Quarter 2016 Earnings Call. Joining me today are Paul Varga, our President and Chief Executive Officer; Jane Morreau, Executive Vice President and Chief Financial Officer; and Brian Fitzgerald, Chief Accounting Officer.

This morning's conference call contains forward-looking statements based on our current expectations. Numerous risks and uncertainties may cause actual results to differ materially from those anticipated or projected in these statements. Many of the factors that will determine future results are beyond the company's ability to control or predict. You should not place undue reliance on any forward-looking statements, and the company undertakes no obligation to update any of these statements whether due to new information, future events or otherwise.

This morning, we issued a press release containing our results for the third quarter of fiscal 2016, and this release can be found on our website under the section titled Investor Relations. In the press release, we have listed a number of the risk factors that you should consider in conjunction with our forward-looking statements. Other significant risk factors are described in our Form 10-K, Form 8-K and Form 10-Q reports filed with

the Securities and Exchange Commission.

During this call, we will be discussing certain non-GAAP financial measures. These measures and the reasons management believes they provide useful information to investors regarding the company's financial conditions and results of operations are contained in the press release.

And with that, I'll turn the call over to Jane for her prepared remarks.

Jane Morreau

Thanks, Jay, and thanks for joining us for our third quarter earnings call. I'll cover 2 topics today, which should leave plenty of time for questions after our prepared remarks. First, I'll review our year-to-date results, and then I'll discuss our revised outlook for fiscal 2016.

So let me start by reviewing our recent results. Against a backdrop of deteriorating economic conditions and foreign exchange moves that negatively impacted our reported results, we delivered solid underlying net sales growth of 4% in the third quarter.

These results reflected 2 different economic realities: on the one hand, we delivered strong and consistent growth in the developed world, where underlying net sales were up 6% year-to-date. On the other hand, we experienced decelerating results in the emerging markets and continued weakness in our Global Travel Retail channel. Third quarter results pulled our year-to-date underlying net sales growth to 5%.

Top line results in the United States maintained their healthy momentum, growing 7% in the third quarter and in line with the 7% we delivered in the first half of the fiscal year. This great performance was led by the leading portfolio of authentic American whiskeys, including the Jack Daniel's family of brands, up 7%, and Old Forester and Woodford Reserve both gaining share in the rapidly growing bourbon category.

Our tequila brands delivered strong growth in the United States, with Herradura and el Jimador up in the teens.

Developed markets outside the United States grew underlying net sales 5% during the first 9 months of our fiscal year. Improving results in Australia were more than offset by Germany's third quarter declines, where our business was negatively impacted by seasonal trading patterns that we expect to reverse in the fourth quarter. Excluding this timing issue in Germany, our nondeveloped U.S. markets – our non-U.S. developed markets are up 6%, in line with first half growth of 6%. The United Kingdom, France, Canada and Spain each delivered solid rates of growth, while Japan was flat.

Takeaway trends in the developed world also remained strong and in some cases, even better than our underlying depletion trends. 3-month blended takeaway for Jack Daniel's Tennessee Whiskey in the United States is steady at around 3% and is currently lapping its toughest comparison from last year. In the United Kingdom and France, takeaway is up almost 10%. Germany's takeaway is up over 10%, and Australia is showing slight growth. These solid takeaway trends for Jack Daniel's give us optimism about our business outlook in the developed markets.

Moving now to the emerging world, where for the first time in several years our emerging markets business underperformed the developed world with year-to-date growth of 5%. Historically, Jack Daniel's Tennessee Whiskey has been growing in the mid to high teens in the emerging markets, fueled by strong market share gains. But the deteriorating economic conditions and worsening spirits trends have temporarily slowed Jack Daniel's underlying net sales growth into the high single digits. This deceleration equates to removing 1 point of incremental net sales growth from our underlying results.

While we don't have large exposure to any one particular emerging economy, the slowdown has been pervasive across most markets and could persist over the near term until

economic and geopolitical pressures lessen. In the meantime, however, we continue to lay the groundwork, seeding these markets so that when economic growth accelerates, we will be well positioned. And in 2 emerging markets where we have visibility on take-away trends, Jack Daniel's Tennessee Whiskey is up mid-teens in Poland and almost 30% in Mexico.

In addition to the slowdown in emerging markets, our Global Travel Retail business remained under pressure in the quarter, resulting in a 13% year-to-date decline. So while our Travel Retail business is still relatively small, this has reduced the company's net sales growth by about 0.5 point. In the aggregate, the slowing emerging markets and declines in the Travel Retail channel pulled 1.5 points of growth off of our year-to-date underlying net sales growth of 5%.

Looking at our results through the brand lens, the Jack Daniel's family of brands led the way with underlying net sales growth of 7%. Core Jack Daniel's Tennessee Whiskey grew 4% in the first 9 months, and brands such as Tennessee Fire, Tennessee Honey and Gentleman Jack all helped drive even higher growth for the family. Jack Daniel's Tennessee Fire contributed over 1 point of year-to-date underlying net sales growth and depleted over 400,000 9-liter cases in its first 12 months, despite the backdrop of intense competition in flavors. This growth has come from bringing in many new-to-whiskey consumers, a group that overindexes to millennial women and Latinos.

Our brands – other brands with standout underlying net sales growth include Woodford Reserve, up 29%; and Old Forester, which grew over 50%. el Jimador and Herradura tequila both delivered impressive global results. And Sonoma-Cutrer and Korbel champagne have grown underlying net sales by mid-single digits so far this year.

Underlying net sales growth was dragged down by declines in Southern Comfort, Finlandia and Canadian Mist. As you know, we closed on the sale of Southern Comfort and

Tuaca yesterday, and I'll discuss that in more detail in a few minutes. Finlandia sales declined due to challenging conditions in 2 of its largest markets, Poland and Russia. And Canadian Mist results were hurt by competitive price pressures and the transition to new price packaging.

Let's move now to a reconciliation of reported to underlying results. The U.S. dollar has continued to appreciate against most currencies, which is weighing heavily on our reported results. Year-to-date, foreign exchange has negatively affected our net sales growth by 8 points. Price/mix was up 4 points year-to-date, driven largely by better mix. The cap – and effects of fast growth in our American whiskey portfolio and declining sales of lower-priced brands have resulted in this favorable mix, helping drive a 40 basis point improvement in gross margins.

Underlying A&P spend increased 1%, while underlying SG&A grew 4%. Both line items were a few points lower on a reported basis as foreign exchange helped our non-U.S. dollar-denominated costs. Putting this all together, we delivered 7% year-to-date growth in underlying operating income. Foreign exchange headwinds hurt our operating income line by 5 points, resulting in reported operating income growth of 2%.

For the first 9 months of the year, earnings per share came in at \$2.65, up 4% over last year. EPS was helped by a slightly lower tax rate and lower share count. Foreign exchange was a \$0.14 drag on reported EPS. So excluding netbacks, year-over-year growth in EPS would have been approximately 10%.

Moving now to my second and final topic, an update on our full year outlook for fiscal 2016. Excluding the estimated gain on the sale of Southern Comfort and Tuaca, we revised our full year outlook down today to incorporate the emerging market slowdown, continued weakness in the Global Travel Retail channel as well as the impact from adverse foreign exchange. While we typically discuss foreign exchange moves and its impact on

our reported results, foreign exchange also negatively impacted our underlying growth. We see this manifest itself in a number of ways, including the decline in the purchasing power of our consumers, most notably in emerging market economies, as well as the negative impact of purchasing patterns of our trade partners.

We now expect our underlying net sales to grow approximately 5% in fiscal 2016, slightly below last year's 6% rate of growth but well ahead of the 2% growth that we estimate of our peer group. While we are disappointed that our growth has moderated slightly due to the deteriorating economic conditions throughout the emerging economies of the world, our view remains unchanged that these economies will become increasingly important growth drivers for the company over the coming years. We believe that we are in the early stages of realizing their long-term growth potential given our low market share today.

We expect modest gross margin expansion for the year, which helps position us for solid operating income growth as we look to continue to leverage some of the investments we have been making over the last few years to build our brands. These investments go far beyond the A&P line and include the people we have added into the marketplace such as the France, Germany and Brazil route-to-market changes, our investments in packaging as well as the significant capital we have been investing in our production operations.

In summary, we expect 7% to 9% underlying growth in operating income for fiscal 2016. This 1 point reduction in operating income growth equates to roughly \$0.03 less of earnings per share. Foreign exchange is now anticipated to be approximately \$0.06 worse than our expectations were at the time of our second quarter earnings call.

And as you know, we closed on the sale of Southern Comfort and Tuaca yesterday. The absence of these brands from our results in March and April will pull an additional \$0.04 off of our full year expectations. These negative items are partially offset by \$0.05 due to a lower tax rate and lower share count. Taking all these puts and takes into consideration

equates to an \$0.08 lowering of our EPS range in fiscal 2016, which we also tightened to \$3.32 to \$3.42. This range excludes the estimated \$483 million gain from the sale of Southern Comfort and Tuaca. Including this gain would adjust our earnings per share range to \$4.97 to \$5.07 in fiscal 2016.

Given the continued volatility in foreign exchange and assuming foreign currency cash flow exposure collectively move 10% in either direction, our EPS over the balance of the year would be impacted by roughly \$0.04.

Just to add a little color on our fourth quarter. This full year outlook incorporates the challenging top line comparisons we expect in the fourth quarter, given last year's launch of Jack Daniel's Tennessee Fire in the United States. Fourth quarter growth should be helped somewhat by normal trading patterns in Germany as well as expanding Jack Daniel's Tennessee Fire in the United Kingdom and Australia, where the brand has been performing well in its limited test phase. We are currently evaluating opportunities for additional expansion beyond these markets.

This year's fourth quarter results should also benefit from favorable comparisons on our tax rate and other operating expense items that pulled down last year's fourth quarter earnings.

Now before I pass the call over to Paul for some brief comments, I thought it would be helpful to discuss our thought process behind selling Southern Comfort. We acquired Southern Comfort for \$90 million in 1979. Despite encountering some cycles over the last 37 years, Southern Comfort has enjoyed a dominant position in the flavored spirits category, given limited direct competition, generating substantial cash flow and return on its investment to the company over that time. But as you know, the competitive landscape in flavored whiskey has heated up over the last few years, including some of our own brand introductions such as Jack Daniel's Tennessee Fire and Honey. And this competition

has been eroding Southern Comfort's leading share, resulting in persistent sales declines since 2008.

So over the last few years, we have allocated additional time, focus and dollars toward reinvigorating the brand, with limited success, and reached the conclusion that we should sell the brand and rededicate resources to brands that we believe have greater long-term growth prospects and can create more value for our shareholders.

So after a thorough sales process, we agreed to sell Southern Comfort and Tuaca for approximately \$542 million. In addition to the increased focus that we will be dedicating to our remaining brands and expectations for faster portfolio growth once we move past the current economic malaise, the proceeds from this sale strengthen an already great balance sheet. Our balance sheet flexibility in turn allows us to invest in our organic growth; consider acquisitions that meet our strategic criteria; and be opportunistic at reducing our share count, including the \$1 billion buyback authorization that we announced in late January that commences on April 1, 2016.

As a point of reference, in fiscal 2015, Southern Comfort and Tuaca generated \$70 million in operating income and \$0.24 of EPS. And our year-to-date underlying net sales growth would have been 6% excluding these brands. This portfolio management has been an ongoing exercise over the past 2 decades as we focus Brown-Forman's portfolio on high-margin, high-return spirits brands with improved long-term growth prospects. Our portfolio of strategies entails not just divesting brands such as Southern Comfort and Tuaca, but also taking the long-term perspective to invest in developing the brands that have the potential to drive the next few decades of growth. This was the case behind launching Woodford Reserve in the depths of the bourbon declines in the 1990s, acquiring Southern Comfort in 1999 and Casa Herradura in 2007, introducing Jack Daniel's Tennessee Honey in 2011 and the reason why we are investing in Slane Irish whiskey today.

So in closing, we continue to deliver industry-leading underlying growth in net sales and operating income. We attribute this top line outperformance to our portfolio focus on Jack Daniel's and our American whiskeys against an excellent global opportunity for them. Our SKU to premium price points allows us to deliver high margins, and with single-point production efficiencies, we have been able to generate great returns on our investments and strong cash flow. We have maintained a consistent long-range perspective to investing this cash flow, focusing first and foremost on investing in our organic growth opportunities. We are doing so today through distillery expansions, adding barrel-making capacity and making homeplace investments.

We have used our growing cash flow to consistently increase the dividend over the last 32 years, making Brown-Forman a member of the prestigious dividend aristocrats. We maintain an active approach to portfolio management, and we generate substantial free cash flow, which allows us to continue returning cash to our shareholders.

And so with that, I'd like to turn the call over to Paul for some of his comments. Paul?

Paul Varga

Thank you, Jane, and good morning, everybody. As a summary, I thought Q3 was a pretty solid underlying quarter for us, given that during the November through January time period, we witnessed the terrorist attacks in Paris, the continued difficulty for emerging market economies and currencies and a very rough start for the calendar year 2016 equity markets in January.

By contributing to a halo of uncertainty, these forces play a role in moderating the consumer and trade's willingness to purchase in the short term. As a result and despite Brown-Forman's favorable geographic diversification, we were not immune to these factors as they weighed somewhat on the quarter's underlying sales growth rate, which was still a very nice 4%.

Our year-to-date underlying growth in sales and operating income now stand at 5% and 7%, respectively, and our 12-month return on invested capital remained very strong at 22%. These growth and return metrics remain ahead of our industry competitive set.

As in past quarters and consistent with other U.S.-based companies, these very nice organic year-to-date results are being offset by a strengthening dollar, and this continued to weigh on reported results. In our case, it had the effect of reducing our year-to-date underlying operating income growth from 7% to 2%.

With these factors present as current headwinds, you might be wondering if we are altering our course in any way. Let me touch on that briefly. Looking back on other challenging macroeconomic environments we've encountered, I feel that we've been very well served by prioritizing 3 things: first, keeping our long-term perspective; second, intensifying and narrowing our focus on the very best growth opportunities we perceive for the company; and third, bringing new ideas that can capitalize on those opportunities. Here are a few examples.

Despite recent emerging market challenges, it is estimated that these countries as a whole still had 4% real GDP growth in 2015. And despite Jack Daniel's excellent progress over the last 20 years in these advancing economies, the brand still has a very low market share. As a result, we remain very bullish on the opportunity that exists for the company across this very large number of countries, where most of the world's population resides. So as these markets grapple with their current local challenges, we intend to be patient by leveraging our company's long-term view. While we do this, we will simultaneously intensify our focus on growing our American whiskey brand priorities in parts of the world that are a bit more conducive to growth just now. To be clear, this does not imply some radical reallocation of resources or exiting of investment positions in emerging markets. It's a more subtle shift in the expectations we will have for where we are likely to derive

our growth in the short term.

For example, we are likely to expect more from the U.S. and developed international markets, where premium American whiskeys are enjoying excellent momentum and consumer appeal. Or as another example, we will also strive to accomplish more on our premium tequila brands at a time when tailwinds are strong for them, particularly outside of their home country. In doing this, we will be leveraging the benefit of our excellent geographic diversification.

This strengthening of our focus will be partially enabled by our recent sale of Southern Comfort and Tuaca, not unlike the focus that was previously enabled by the dispositions of our consumer durables and popular-priced wine businesses. This most recent disposition will permit us to allocate more of our creative time and energy to Jack Daniel's Tennessee Whiskey, Gentleman Jack, Jack Daniel's Tennessee Honey and Tennessee Fire, Woodford Reserve, Old Forester, Herradura and Sonoma-Cutrer, some of our most attractive and immediate growth opportunities. And with this sharpened focus, I expect that we will generate new ideas that can be impactful to the top and bottom line over time. This will be most evident through smart line extensions like Jack Daniel's Tennessee Honey and Tennessee Fire, but as well as an example would be our forthcoming Jack Daniel's Single Barrel Rye, which represents the distillery's first significant effort to date within the exciting U.S. rye category; new product development like our Slane Irish whiskey project; improved packaging like our recent success with el Jimador and forthcoming enhancements on both Woodford Reserve and Finlandia; the strong appeal of the liquid we put in the bottle, like Old Forester Birthday Bourbon and Herradura Ultra.

We'll be emphasizing new formats that might better meet consumer needs like our successful Jack Daniel's and el Jimador RTD businesses. We'll be looking at enhanced marketing communications like Jack Daniel's 150th anniversary and our investment in the Old

Forester homeplace; and well-timed route-to-market investments similar to what – the France example from a couple of years ago and many others before it. I really do feel that this sharpening of our focus and the ideas that will come from it, along with keeping a proper long-term perspective about the business, will serve us well as it has before.

That concludes our prepared remarks for the morning, and we're now happy to take any questions you have.

Question and Answer

Operator

— ***Operator Instructions*** — Your first question comes from the line of Vivien Azer with Cowen and Company.

Vivien Azer

So in light of a very tough macro backdrop, I think the underlying numbers actually look pretty good. But as I think about the outlook, Jane, I know it's very hard to get a read on inventory levels in emerging markets. But as we think about the new outlook for sales growth, can you talk about how you guys are thinking about inventory levels? Do you think that there is more destocking to come? Do you think inventory levels are right in emerging markets? I know it's hard to gauge because FX is going to drive that going forward, but any color you could offer there would be helpful, I think.

Jane Morreau

That's a great question. We actually had this conversation yesterday as it related to our inventory levels in the emerging markets. And we do feel like, and we alluded to this, that foreign exchange has definitely impacted our trade partners' buying patterns and likewise, probably has reduced some of their inventory levels. And we don't – in that part of the world, we don't have a lot of visibility into the trade environment. We do

believe that is a – one of the drivers of the slowdown that you saw and we felt in the emerging markets. Obviously, it's been driven, though, by the economic malaise that's going on there and the foreign exchange devaluation. So we expect more to come. I don't know that I can predict that right now either. I think there are some markets that are – have held up pretty well for us. Brazil, Turkey, places like that are continuing to do very well, Mexico. And we quoted some takeaway numbers in Poland and Mexico on Jack, and they're very strong at this point.

Paul Varga

Yes. I mean, I think the only point I'd add, I mean, it's just so hard for us to get a single metric that can help us, first of all, and then help you all understand what might be underlying the results. I mean, we do think it's a blend of both consumer and trade impact, particularly on the short term. And the reason it's important, of course, is that the trade impact can be onetime and can rebuild with – depending upon what the circumstances are in those countries. I do think it's always – I'm always reminded of the impact that's unique to either our industry and – but in this case, our company, where you have single-point production because it's – the inventory adjustments that occur happen over a little bit longer period of time. I suspect because you have time on the water, you have time going from – because we don't sell as our company in a lot of these countries direct to retail. You go to importers who go to agents who sometimes go to subwholesalers. And so the trail of inventory can be longer for a single-point producer, who has a multiple-tiered distribution system. And so that complicates it even more. I suspect some of this, if I think about weakening emerging market economies, I mean, in some level, if you look at the real GDP growth going back, I mean, they were growing at more like 8% going back 4 or 5 years ago, and now down to 4%. So I suspect some of it has been making its way into our results over time. And then when you have these devaluations of the currency that really impact it, you see it a little bit more dramatically. So those are qualitative comments to a quantitative question I know you asked, but we don't have great visibility into it.

Vivien Azer

No. And I appreciate the challenge there, but maybe if I could ask it a different way. As you think about setting external expectations for the investment community, does the 5% new outlook assume further destocking just out of an abundance caution given the difficulty in the read?

Jane Morreau

It does not.

Paul Varga

I don't think it does, yes. I mean, I think it would reflect – or to the – it would be maybe a continuation of trends. And to the extent that they had some destocking in some consumer, it might be in the same proportion maybe is a way to think about it.

Vivien Azer

Great, perfect. That's helpful. And just my second question. As I think about the composition of sales growth, very heavy to price/mix, less so on volumes. And as I think back to some of our discussions earlier in the fiscal year, it strikes me that perhaps the balance of price/mix to volumes has not played out exactly as anticipated. I recognize some of that has got to be pricing to offset FX. So can you talk a little bit about your pricing strategies in emerging markets and specifically, I think in Russia, where I think one of your competitors has taken pricing in the last few months.

Jane Morreau

Yes. We've actually taken pricing in Russia ourselves, quite a bit. And so we're looking at each market in the emerging markets on a case-by-case basis in terms of how we – whether we should take pricing or not. And we have taken it not just in Russia, a couple other markets. We've taken it in Brazil, some other places as well. So again, our product, Jack Daniel's, was already pretty highly priced for the consumer down there to start off

with. And so with the devaluations of these currencies significantly, of course, it makes, as we were talking about in the earlier question, the affordability of our products a little bit out of – less so than it has been. But as we look forward, again, we'll continue to look at these countries on a market-by-market basis. We'll figure out what's best really market-by-market is what we've been doing.

Paul Varga

We did. Just for historical reference say one thing that would influence our posture about some of these emerging markets, of course, the affordability factor when you have the difficulties they have. But I'm influenced a bit on my posture toward it based on – and it would be hard for everybody to remember this. But back in the FY '12, '13 and even a little bit into '14, in a lot of these emerging markets, we took pretty significant price increases mostly for price positioning and premiumization. We've – there's not as many big global brands in a lot of these countries. I'd cite places like Africa. Even in a country like Mexico, we felt at the time there was an opportunity to go up. But we found that we – it was better for us to do that with sort of large increases versus a bunch of small ones at the time. So in some of these places, we went up 10% or 12%. And so – and those will soften your volumes a little bit. They'll have that impact. But in any event, in those cases, we've been a little more cautious about raising prices today, particularly given the environment we're in.

Operator

Your next question comes from the line of Bill Marshall with Barclays.

William Marshall

So on the last – the second quarter conference call, you guys sounded relatively optimistic. You cited some positive November trends. And also, it sounded like you were a little bit more optimistic on Travel Retail at that point in time. So I'm just curious, first of

all, on that November data point, it sounds like it must have kind of decelerated as you moved through the quarter, so I was wondering if you could give us a cadence of how that has materialized into the fourth quarter. And then on Travel Retail, was that more on the U.S. side that you felt more confident and maybe it just didn't come through the way you had expected? And if you could just unpack kind of what was going on in that channel in particular.

Jane Morreau

Yes. So Global Travel Retail channel, I'll start on that one first. I think we did allude to, we had insights into what our November results were looking like then. And it did say it was a very good November for Global Travel Retail and for the company at large. And what we found, though, was the results did continue to soften in that channel over the remaining 2 months of the quarter. Again, they're not disconnected to the emerging market economies. There's some interplay going on there, too. We know the Global Travel Retail travelers, if you will, come from – the high spenders come from Russia. We know what's going on in Europe overall, and so that definitely continued. Paul alluded to in his talk the Paris attacks. So all that activity going on, the confidence going down, I think it just continued to hit the Global Travel Retail business. And our overall results for the quarter, again, we still think they were very solid against the backdrop of what's going on in the world. And the results in December and January were off a bit, again, so due to the emerging markets and the Global Travel Retail that we've been referring to throughout.

Paul Varga

I think the other thing that I'd add is one of our top countries, and Jane referenced it in her opening comments, Germany, had – I mean, just had a really rough Q3 that we think is seasonal and will – I mean, in terms of the trading patterns and it will come back in Q4. And I do think, look, we were commenting, I mean, all we had at that point were early

indications for November. I mean, I'll remind everybody that the November, December, January period for us is a big one because it includes all our holiday and the gifting, which is seasonally disproportionate for our industry. So I think more than anything, it was the headlines we provided you, that this large group of emerging markets for the quarter saw more of an impact than we would have anticipated either through early reads on November or through the full quarter.

William Marshall

And going – December, January, any early read on how we should be thinking about February?

Paul Varga

I wish we could provide that, yes. I think it's reflected in our guidance.

Jane Morreau

I think, yes.

Paul Varga

That's fair enough.

William Marshall

Yes, fair enough. And then just one quick housekeeping item. I just want to make sure I'm understanding the puts and takes on foreign currency. I know you called out the \$0.06 additional impact. That's all from spot rate movements. Jane, you mentioned the purchasing power impact. I imagine that's on the underlying side of the guidance, and the \$0.06 is just purely on the way spot rates have moved. Is that a fair assessment?

Jane Morreau

Yes, that's correct. You're exactly right.

Operator

Your next question comes from the line of John Faucher with JPMorgan.

John Faucher

Just 2 questions here. First, just to follow up on the last question, which is it sounds like what we should look at is since November, I hate to use this term, but more of a step function down to a lower level, and it seems to have stabilized there as opposed to a continued deceleration and sort of a worsening of the trend. Is that kind of the right way to look at it, where you just had sort of that step function down?

Jane Morreau

Yes. So included in our full year outlook is what we're expecting for the – is embedded in our outlook for the rest of the year, so we're expecting 5% top line net sales growth, which is what we work towards.

Paul Varga

Yes. And that would apply to the sort of remainder of our fiscal year. And this would not reflect, because we have yet not yet looked at it to '17, and we'll provide that when we come out with updated guidance in early June. But that's – certainly, your comment would apply for the balance of this fiscal year.

Jane Morreau

We just building on to what Paul says just so you'll have some thought as you go forward, we did talk about the SoCo sale – the SoCo, Tuaca sale and the impact it had on it in the quarter. We said our results would have been – our year-to-date results would have gone up almost to 6%. So it was 0.5 points or better. So not having that drag on our top line going forward. What will happen in Global Travel Retail and the emerging markets, we've pointed out a 1.5 points drag on our results. Hopefully, those start to stabilize, and then you won't continue to have that as you go forward. And then we did go, therefore, get a

benefit from JD Fire of about a little bit over 1 point. So just some things to think about. And as Paul said, we'll be giving you guidance out for F '17. We're in the midst of our planning process now, and we'll talk to you in June.

Paul Varga

I'd add, too, a bit here. Just because – if you take the 5% sales growth rate through the fiscal year and finish the year at 5%, having to go up against this launch of Fire last year, you could read that as a little bit of optimism despite a – because we have to overcome it, right? So I think that – so I think there's something in that, that you can read a little bit. I know expectations are always high for Brown-Forman. I always feel that way. And so in any event, I don't – and Jane and I's comments reflect it, I don't feel like the results we're talking about here today diminish our optimism in any way about the business. It's some of these temporary circumstances that we feel are out there related very much to the economies where we're doing business so...

John Faucher

Got it. And that actually was my second question, which is sort of thinking about the Fire comps. And earlier in the commentary, you highlighted how Honey – I think you had said this was sort of the peak comp quarter for Honey. You've got Fire now that you have to comp. But again, you do get the benefit from the other brands. So it sounds like you kind of feel like net-net, the puts and takes from a comp standpoint as well as the divestiture should even out pretty nicely as we look through the balance of the year.

Jane Morreau

I think our top line growth for the year is 5% again, so that's where we are year-to-date so...

Paul Varga

Yes. And I'd really go back and look at the focus on the adjustments Jane was talking

about on that – that accounted for that sort of \$0.08 reduction today. I think those give you the best insight to the moving pieces that remain, I think.

Jane Morreau

I think what you're asking about a little bit more, let me – is the – you were talking about the fourth quarter only. So we – our outlook does reflect the challenging comparison to last year's fourth quarter. So in other words, the absence of the national launch of Fire. We did note, though, that we are expanding in a couple of markets overseas, where we've been testing the brand, so in the U.K. market and in...

Paul Varga

Australia.

Jane Morreau

Australia. We also – as Paul just talked about and I've got in my notes, too, that the drag on our top line – one of the drags on our top line in the third quarter was Germany-related, and we expect those trends to reverse themselves in the fourth quarter. So there was a timing trade pattern – buying pattern, so we expect that to come back. And then we have a lot of puts and takes up and down throughout the rest of the P&L. We expect costs to be more favorable as they started to become in the third quarter as we lap the Wood costs that were so high last year are still high, but we don't have the increasing heights of growth of them.

Paul Varga

A known SG&A benefit.

Jane Morreau

Fewer operating expenses. And then, of course, the tax rate is expected to be lower. So all those things combined give us confidence in our underlying operating income forecast

and our EPS forecast for the year that we know today.

John Faucher

Got it, yes. I think – well, my question was really more sort of about the top line and not as much Q4, but sort of looking out sort of next 12 months, right, as you deal with the Fire comps and the divested brands. But you feel like kind of from a net standpoint, you're in a good situation in terms of how those things are going to balance out is what you're sounding like.

Paul Varga

Yes, absolutely. For the – for Q4 and again, we'll update any other new news as it relates to things that would have a positive or drag on the top line when we come out with the full year F' 17 forecast.

Operator

Your next question comes from the line of Judy Hong with Goldman Sachs.

Judy Hong

So one is just – first is just a modeling question, Jane. Just as we think about '17 in terms of the SoCo impact as well as the buybacks. So I think you had said \$0.17 that we're lapping in terms of the divestiture. And then, is the intention with the \$1 billion new buyback sort of to fully offset that dilution? Or is the \$1 billion really more phased kind of throughout the year in '17?

Jane Morreau

So Judy, just to make – both questions. I'll do the SoCo first of all, the impact on this year we noted in our earnings release this morning, you're right. Through January, the results were \$0.17. We'll obviously have the month of February still to be added in there, so that's why we gave you the F '15 full year impact, which was \$0.24. So that you would

have 2 benchmarks, if you will, to understand the absence of the SoCo, Tuaca numbers. So that – just to get that clarity out, first and foremost. The second thing you were asking about was our share repurchase that we announced, the \$1 billion – new \$1 billion one as of January. I just want to take a moment and step back and talk about how we think about share repurchases in the first place. We've considered these really opportunistic investments. If you look over the past history, sometimes we announce these things, we don't always complete them. So we remain flexible with these. We generally do them through open market purchases that allows us the flexibility to start and stop different things. And the reason why I'm explaining that to you is because if other things come up, we'll, of course, invest them heavily behind our organic growth of our business today via distillery expansion, cooperage expansion, homeplace investments, as we've talked about. And of course, our dividends have been increasing for a number of 70 – for 32 years. And we've given them for 70 years. So – and we've done all that side, but we also then want to make sure if there's acquisitions that come about that meet our strategic criteria, we have that flexibility to start and stop things as we go. And then, of course, if we decide to do other returning the cash to shareholders, we can do that, too. So we've got that out there. Just wanted you to know, we aren't forecasting – it will not – as you do a calculation, even if we were to complete it all, it does not offset the dilution from Southern Comfort.

Paul Varga

That specific effort doesn't. And so let me elaborate, too, because I agree with Jane.

Jane Morreau

In line with reality.

Paul Varga

Yes, and I just – here's a way that you – at least if you want insight into how I think about

it. Let me give you an example of how the sale of Southern Comfort that we announced yesterday, I can think of at least 3 pretty direct ways that it will benefit Jack Daniel's. The first is, going forward, is the absence of drag on the corporation's growth rate that, disproportionately, Jack Daniel's over these past few years would have to cover. So that absence of drag is a benefit to Brown-Forman Corporation. It also very much takes some pressure off Jack Daniel's to grow that base of operating income. The second is with the absence of Southern Comfort and Tuaca, our ability to take the time that we were devoting to those brand-building activities and rededicate them to our highest priorities. I made the example in my opening comments, but let's just say in this example, Jack Daniel's Tennessee Whiskey will benefit by us being able to redirect some of our time and attention and creative energies to that particular brand. That becomes, in fact, a multimillion dollar investment behind the Jack Daniel's business. And then the third is, a little more subtle, is that the proceeds from Southern Comfort, which we had a nice gain on the sale, to the extent that you attribute that we would be going and using some of those proceeds to do some of the share repurchasing that is available to us, in effect, the way I like to think about that is for a nonselling shareholder, a shareholder who does not sell into a share repurchase and remains, what ends up happening in effect for them is that they, through Brown-Forman's activities, have sold Southern Comfort and made a reinvestment in Jack Daniel's for them. So I actually feel like this ends up being a multidimensional benefit for the – for our long-term shareholders, people who are very interested in Brown-Forman's progress over generations or a 5- and 10-year period. And in doing so – we've done this several times before with portfolio reshaping. And not always has it had this other dimension of repurchasing shares and the remaining shareholders owning a little bit more of Brown-Forman as a result of it. But in this case, I actually think it's a wonderful use of proceeds or reallocation of our time that benefits that particular brand and the shareholders. So it's a way that you might connect a couple of the dots that are in our news today.

Judy Hong

Okay, that's really helpful. Paul, just maybe you – on the U.S. market, just thinking about Jack over the last 6 months or so, just obviously, the comparisons have been pretty tough. The NABCA data has been a bit choppy. Obviously, the flavored whiskey competition continues to intensify. So can you just give us some sense of – obviously, perhaps there is the reinvestment component that you're looking at to kind of drive more of an acceleration. But just broadly speaking, your view of where kind of Jack is today and the incremental contribution that you're getting from Fire and how much of that you think will sort of be still an incremental to the broader franchise.

Paul Varga

Sure. I mean, you did – you gave a very nice summary of some of the prevailing influences. Here's just a way that you might think about it. I think in the end, with – if I were to summarize this to say that – because your question was specifically about the United States, a lot of this comes down to what do you foresee as possible for the brand development and what are the best ways to achieve it. And I'd start with that thinking about the full trademark Jack Daniel's because, of course, these line extensions do play a role in it. And I want to say something about that as well. But here's something you might think about as it relates to Brown-Forman and this American whiskey momentum that exists. And I actually feel like, because we have a difficulty, even inside our own company or through our trade system, to get our mentality just right on our expectations. And so let me just use this example. Jack Daniel's is roughly 5 million cases in the United States. When it advances in a year, typically, say, 3% on volume, it generates 150,000 cases of incremental growth in the United States. I'll use the example of a 500,000-case brand, which is a pretty sizable brand in the U.S. market. And we've got a couple of them – or just short of that, actually, I mean, Woodford Reserve and Gentleman Jack. And in Woodford Reserve's example, it's growing about 30%. So it's growing 150,000 cases in the U.S. market. And then you'd use the example – I mean, the one that's been the most

resurgent here, and just to show you the scale of us getting what we've considered to be our proportionate growth in this market, even Old Forester, which would get more headlines today, relative to even Jack Daniel's because it's growing at 40%. But it's also off a 100,000-case base, which gives you about a 40,000-case growth per year. So I just used these for scale of magnitude. Now think about Jack Daniel's Tennessee Fire. In its first full year this year, we're anticipating it'll be something like around 400,000 cases. So I mean, if you start to add these up, I really – I mean, it is so hard when you're the leader as Jack Daniel's Black Label Tennessee Whiskey is and Brown-Forman is to expect to grow at 25% or 18% or some of these really superb growth rates that get quoted out there, particularly around some of the upstart brands. But I can, in my own math there, with the examples I gave you, see that if Jack Daniel's grows 3% to 4% in the United States, it gets 150,000 to 200,000 cases of growth, which is about the same amount that our high-flying Woodford Reserve and Old Forester are contributing. So those are ways we think about it. We use a lot of different metrics, not just Brown-Forman's share or Jack Daniel's share of the market. And I think we have realistic expectations about it. You've heard us talk in the past about how to think about these flavors. I think one of the hardest things for the supplier-owner to do is to get the right attitude about these. And it's my view that we will do fewer flavors on Jack Daniel's but try to sell them in more places, so think of global expansion. I think that is a more unique opportunity for Jack Daniel's than it is many of these other trademarks that are participating in flavored whiskey. And having said that, we are going to set ambitions for ourselves that don't just launch and then let sit a new flavor. We intend to treat them as brands and – which they are. I mean, Tennessee Honey today is a one – roughly a 1.4 million case brand, global average price of about \$25 or higher. And that is a very rare accomplishment for any brand in our industry. And so internally, we have to think about it as a very valuable brand and not just sort of a flavor extension from Jack Daniel's. And so it's our intent with the marketing mixes and the investments we make behind those flavors to treat them in the same way you would

expect us to treat a Woodford Reserve or some freestanding brand, okay? Did that help you get a little more color on it? Thanks for the question.

Operator

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

Mark Swartzberg

I guess a couple of questions. One is – and it was helpful hearing your responses to John. Can you give us some sense today about how you’re thinking about the budgeting for fiscal ’17? And by that, I mean, you’ve had a pretty steady trend of high single, even low double-digit operating income growth on an underlying basis. And you’re seeing some issues from a growth perspective. Is it in any way reasonable in your mind to think of fiscal ’17 as kind of an investment year or a transition year, a year where you do need to slow down that rate of organic operating income growth for the sake of organic revenue growth longer term? Or is that not necessary, in your mind?

Paul Varga

I – if I felt that changing the mix of investment for some reason would have a beneficial short-, mid- or even long-term benefit, you would expect us to do it, of course. I mean, I – we’ll sit and really nail down the specifics of this in the next few weeks here. But I will tell you how I’m thinking about it because this is one of the wonderful things for all of you who get to – when you ask these questions, honestly, we have to make decisions about what to make, which literally drives some of our views. And of course, you – we worry about 1-year trends. But in these cases, you’ve got to worry about 4-, 5-, 6-, 7-, 8-year trends as well. And I’ll just tell you, even with what we’re observing out there in terms of difficulties and things like that – and we’ll tighten up what we think for ’17, I have not altered in one way my view of – if I look backwards at Brown-Forman’s sort of 3-, 5-, 7- and 10-year results and then look ahead, I haven’t seen anything that makes me want to

change those viewpoints.

Mark Swartzberg

Got it, okay. That's helpful. And then on the U.S., could you give us a little more color on what you're actually seeing in the way of – in takeaway for Honey, specifically, which I think is down and Fire, which, of course, has gotten this big distribution gain, but kind of in takeaway dynamics. And then – and this is very imperfect, we know. But when we look at the IRI data and back out Honey and Fire and look at the total Brown-Forman portfolio, volumetric year-on-year trends in those tracked markets, we see a slowdown in those – in that large portfolio ex these 2 extensions, which seems like a bit disconcerting, if I'm in your shoes. But it could have a silver lining in the sense that you've been so focused on these innovations that there's opportunity there to simply refocus on these other brands. So I realize it's a fairly involved question, but can you speak to that?

Paul Varga

Yes. I think your – I mean, your insights on that, I think, are correct. And when you start to move pieces in and out, you get different insights. But I mean, I also could do the same thing a little bit on, if we just focused on Woodford Reserve and Old Forester, our growth rates would be exceptional. And I think this whole concept of portfolio management is one that any company that decides to sell more than one brand has to wrestle with. I think a way I would answer yours is the things that would be dragging down our top line in IRI, you couldn't be more correct there, is brands that are of lower priority to us, say, than the new things. But what it isn't reflecting is what's happening at the bottom line. And I actually think that it's important for people to know that even if you get a drag on a Southern Comfort or a Canadian Mist, for example, using the U.S. as an example, its impact at the bottom line will be far less significant than the focus – the increased focus you might provide to a very high gross profit per case item like a Tennessee Fire or a Woodford Reserve. Related to your – but nonetheless, you want to reduce drag

wherever you can, it's either through the improved performance or on the example of Southern Comfort and Tuaca through literally the disposition of the business. I mean, so in those cases, you reduce drag. The stuff we keep, I mean, we absolutely have to put our best foot forward, and so you can expect us to try to do that. I don't think it would be in the best interest of Brown-Forman's long-term value creation to take our eye off of Jack Daniel's Tennessee Whiskey in pursuit of trying to improve Early Times, for example. They're both great brands in their own right, but Jack Daniel's is decidedly more important at Brown-Forman. And so it's something that we would continue to prioritize. I do think on the Honey – the Jack Daniel's Tennessee Honey and Tennessee Fire comments that you opened with there, I do think it's important for you to know that the Tennessee Fire, yes, it has had some both wholesale, which would – inventory build, which would be reflected in our earnings per share and retail during its first full year, but it's also had very nice consumer velocity as well. It hasn't just been a pipeline shove on – and it's just sort of sitting out there. I mean, the data we're looking at tells us it's a very successful brand in its own right because our own internal benchmarks at times were against Tennessee Honey or our most competitive people in the company were actually aiming at Fireball. So depending upon what your frame of reference is, you might be a little more disappointed than others. But brands that achieve in the first full year of national distribution 400,000 cases are sort of runaway successes. And to do it with limited cannibalization, bringing in new consumers, very premium price points and having both defensive and offensive properties, it's a very big success for us. Now that we've got it out in the marketplace, the big challenge for all of us, our sales and marketing teams particularly, is how do we grow it in the United States. We know we can expand it geographically because there's more call for it today than we've supplied. So that will be something that will be interesting for us to explain to you as we get out into June and update you on our expansion plans. But a big thing, just as it was for Honey in its second and third years, are how is it going to grow in the United States? What levers do we pull to ensure that it continues to be treated like

the regular strong consumer brand that we think it should be?

Mark Swartzberg

That's really very helpful, Paul. And if I could just follow up on the specific case of Honey, which is even an obvious success, but with success comes the higher bar. Can you just give us some sense of – I believe it continues to be down year-on-year for now 2 quarters in a row in the U.S., specifically. Can you just talk about how you're thinking about the velocity for that brand and the opportunity for it here in the United States?

Paul Varga

Yes. I think in year, what are we? 4, I guess it is.

Jane Morreau

Five.

Paul Varga

Five. Year 5.

Jane Morreau

Fifth year.

Paul Varga

Yes. So we're in year 5. It – you're accurate on the – I think the 3- and 6-month trends, it's gone slightly low single-digit negative. And I would attribute – I mean, if I were diagnosing, and I don't have the component pieces here, I'd say the contributing factors would be the big halo of competition. And some of that from – within the honey flavor segment within flavored whiskey, there's been an increase of honey competition, but then also just within flavored whiskey, as particularly this apple category took off here in the last year. So those would be some contributing things. I also think that – I mean, it would be silly for us not to say there hadn't been a little bit of cannibalization that can contribute to Tennessee

Honey from Fire's launch, and that could be a little bit consumer. It could also just be focus and attention or sharing displays and some of these other things that go on when you are selling things from the same family. But it still presents the same question. How do we, in year 6 and beyond, in the United States continue to build the brand in a way that competes better versus what the competitive references are out there? So it's the – for our Brown-Forman employees who are listening, that's the question we're focused on. And yes, it really is. I mean, it's very true. And the same things are going to be true with the ensuing – we're already looking at sort of Jack Daniel's Tennessee Fire. Remember, it had some test markets that go back more than 1 year so you can start to learn a little bit more from those markets as well. And with the passage of time, all, I think, new brand entries have this sort of challenge. And I think in my view, the answer isn't to go put 5 more flavors out in the market. It's to really focus on building these brands.

Mark Swartzberg

Well, you can bring your wife in, Paul. And maybe, Jane, you can be part of the consulting team to help kind of restore growth in year 6 here.

Jane Morreau

Yes, we'll do that.

Paul Varga

I've learned a lot over the years listening to my wife about the consumer trends in my business, so thank you for the suggestion.

Jane Morreau

Thanks to my husband.

Paul Varga

Yes, we're all wise men to you, right?

Operator

And your final question comes from the line of Bill Chappell with SunTrust.

Stephanie Benjamin

This is actually Stephanie on for Bill. Just a quick question. I'm just kind of looking at your updated FX guidance. Can you give just a little more color on kind of which countries were the meaningful drivers of kind of your lowered outlook?

Jane Morreau

I could hear – for FX?

Paul Varga

Which countries contributed to the FX lowered outlook?

Stephanie Benjamin

That's right. Kind of which were the main ones that changed materially since your last guidance.

Jane Morreau

The biggest one was the pound.

Paul Varga

Yes.

Jane Morreau

You've seen the dramatic change in the pound over the last month. So we're using the spot rates as of last Friday, so that's the biggest.

Paul Varga

And that's our largest non-U.S. market also, yes.

Jane Morreau

Yes, euro is the largest currency.

Paul Varga

Yes.

Jane Morreau

And the pound is the next largest, yes.

Paul Varga

So that's a big influence. But also – I mean, because we're so geographically spread, you do get little components...

Jane Morreau

Everywhere.

Paul Varga

From just about everywhere, yes.

Thank you all.

Jason Koval

Okay. Thank you, Paul and Jane, and thanks to all of you for joining us today for Brown-Forman's third quarter earnings call. And please feel free to reach out to us if you have any additional questions. Have a great week.

Operator

Again, thank you for your participation. This concludes today's call. You may now disconnect.