# Brown-Forman Corporation, Q2 2014, Earnings Call 2013-12-04

## Presentation

### Operator

Good morning. My name is Jodie, and I will be your conference operator today. At this time, I would like to welcome everyone to the Brown-Forman Corporation's Second Quarter Fiscal 2014 Conference Call. — ***Operator Instructions*** — I would now like to turn the conference over to Mr. Jay Koval, Director, Investor Relations. Please go ahead.

### Jason Koval

Thanks, Jodie, and good morning, everyone. I want to thank you for joining us today for Brown-Forman's second quarter 2014 earnings call. 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 second quarter of fiscal 2014 and the 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, 8-K, 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. Now, before I turn the call over to Don for his prepared remarks, Paul wanted to share some brief comments with you. Paul?

**Paul Varga**

Thanks, Jay, and good morning, everyone and thanks for joining us for this communication of our Q2 and half-year results. In addition to Jay and myself, we're joined today by 2 of our colleagues who are familiar to most of you and to our investment community at large and who are the principals in the forthcoming transition in Brown-Forman's financial leadership. That is Don Berg, our current CFO, who will be retiring at the end of this fiscal year and Jane Morreau, our incoming CFO, who will assume her new responsibilities on February 1. As is our norm, Don will provide a detailed description of our results released this morning before we take your questions. But before we turn to that, I want to briefly touch on the first half results, give you a little more background on Jane and pay a much deserved tribute to Don and his service to Brown-Forman.

First, with the first half results. I'm very pleased with how the company has continued to perform and be positioned, particularly in light what appears to be a more moderate posture for most of our publicly-traded global competitors. With the well-balanced worldwide growth of the Jack Daniel's trademark leading the way, our company's growth rates in underlying sales, gross profit and operating income remained top-tier within our competitive set. Our return on invested capital continued to be very strong on both an absolute and relative basis. We continued to invest behind our business via both the P&L and through the strongest level of capital reinvestment in recent memory. Our balance sheet remained in excellent shape, giving us the flexibility to invest further as necessary and advisable. And our consistent return of cash to shareholders continued with both share repurchases and our recently announced double-digit increase in the annual dividend.

Alongside the vast opportunity we believe exists for our businesses around the world, these are some of the reasons for our current optimism and they are enabling us today to reaffirm our earnings guidance and our expectations of excellent full-year growth and underlying operating income. Don will give you more color on all of this in just a moment.

Let me now turn to Don and Jane's forthcoming transitions. I'll first start with Jane who has over 30 years of excellent business and finance experience, including 22 years here at Brown-Forman. When Don became CFO in 2008, Jane was already his senior most Director — ***indiscernible*** — and was our Controller and Chief Accounting Officer, and at that time, she joined our executive leadership team. Over the years, she has played a very significant role in the company's business and financial operations. This is included to cite just a few, leading our implementation of and compliance with Sarbanes-Oxley, leading the financial integration of our spirit brand acquisitions, as well as the financial separations related to our dispositions of both consumer durables and wines; offering much of the company's internal and external financial reporting and forecasting; devising and leading the implementation of the company's planning and budgeting; and being the company's go-to corporate analytical resource for most of the last 15 years. Beyond finance in recent years, Jane has worked closely with our branded regional operations, overseeing our information technology function and for the last year, provided excellent leadership to our production operations. She's a proven senior executive and her knowledge of Brown-Forman's business operations is virtually unmatched. Jane has deep experience in our boardroom and while she has not been the face or voice of the company to the financial community to the degree that she will be in her new role, she's very familiar with our approach to Investor Relations and I look forward to her carrying on Don and Brown-Forman's track record of financial excellence. So Jane, welcome back to an environment I know you're quite familiar with. Would you like to add anything?

**Jane Morreau**

Yes. Thanks, Paul, and thanks for the kind introduction. I'll keep this really brief, but I want to convey how excited I am to soon serve as Brown-Forman's CFO. I believe I'll be taking over at a great time when the finance organization and the company are both in very good shape. Our strategy is clearly defined and has been articulated and our organization is aligned around it. And of course, you all saw the earnings release this morning and you see from our first-half results which are very strong, our company is executing well and delivering what we believe to be top-tier performance. I believe that the finance team is a source of strength for our company. I believe it's a testament to the team that Don has created and led over the past 6 years. Finally, I'm really looking forward to getting to know our loyal shareholders better in person and on future earnings calls. Thanks.

**Paul Varga**

So thanks, Jane. You'll all be hearing, of course, a lot from Jane in ensuing months and I'm sure you'll enjoy getting to know her much more closely with us through speakerphone over the last many years. So, let me shift gears now. And of course, I want to publicly thank Don for his superb contributions to Brown-Forman's success over the last quarter century. Think about that: a quarter century. His leadership of the company's financial operations as CFO over the last 6 years really can be measured by just studying our results over that period. And as most of you will already know, they were very strong in both absolute and relative terms.

Alongside the impressive quantity of our results, Don and his team have played the leadership role in ensuring Brown-Forman continued to have an equally high-quality of results. We have long enjoyed a reputation for financial transparency, integrity and responsibility and Don and his finance team have been highly capable stewards of that reputation over the last 6 years. Unlike many traditional CFOs, Don's path to the CFO role encompassed a wide variety of important assignments, ranging from leading the company strategy and corporate development functions to overseeing Brown-Forman's early emerging market operations. The impact of some of this work done earlier in his career can be seen in the results we're announcing today. Along the way, Don served on the company's highest level committees and councils for the better part of the last 15 to 20 years when we witnessed a smart and experienced executive who brought us deep, balanced and often unique insights about our business and our industry. On behalf of everyone at Brown-Forman, I want to simply say thank you to Don for his leadership and congratulations on the success he has enjoyed at Brown-Forman over these last 25 years. Don, I hope Brown-Forman will be a source of fond memories for you for many, many years to come. With that, let me now turn the call over to Don so that he, very appropriately, can discuss our company's excellent first-half results.

**Donald Berg**

Thanks, Paul. This will be my last earnings call at Brown-Forman and I can't help but feel a little nostalgic after hosting with Paul and Jane since early 2008. So before I discuss first half results, let me make a few quick comments. Listening to Paul and thinking about all those great memories, I mean my 25 years at Brown-Forman have been truly great ones. I've had some tremendous opportunities here in a variety of capacities and as I think about it, of course, the company is only as good as its people and I've been very, very fortunate to have worked with many exceptionally talented people here. And I also want to say that during my almost 6 years as CFO, I really enjoyed the time I spent with all of you, the investment community. I'm fortunate to have worked for a company that has been performing very well, delivering some of the best total shareholder returns in any industry, let alone the spirits world. You all have heard me tell the Brown-Forman story countless times and I truly believe that the company is well positioned for the future. Having said that, I'm very much looking forward to the next chapter in my life as I retire from Brown-Forman. While I'll assist with the transition through the end of April, the actual hand-off of the CFO role to Jane will occur on February 1. And as you've heard, with over 20 years of finance experience at Brown-Forman, including almost 5 years working together with her as the Controller and Principal Accounting Officer, I know she's very well prepared to jump into this position. So with that, let me move on to the business at hand and update you on our recent results.

I plan on covering 3 topics today. I'll start with a review of our midyear results, then I'll share our updated outlook for fiscal 2014 and I'll close with a review of our approach to capital allocation, including an update on our capital investments. So let me start with my first topic, a review of first half results. We're pleased to report that our underlying net sales grew 7% in the first half of the year or 4% on a reported basis. Underlying net sales growth in the second quarter was 8%, significantly ahead of the first quarter's 5% growth. As you know, within the first half, we were faced with some timing differences versus last year where our results in the first quarter were negatively impacted by year-over-year comparisons and where the second quarter benefited from easier comps. We believe that virtually all of that is behind us now and our 7% year-to-date net sales growth keeps us on track to achieve the high-single digit full-year outlook we shared with you last quarter. We are particularly encouraged by our ability to deliver such strong rates of growth despite recent announcements from industry competitors discussing how an emerging markets slowdown has negatively impacted their own results and outlooks. We continue to believe that our balanced geographic footprint, our focus on North American whiskey and our premium SKU are all contributing factors to our consistent delivery of industry-leading rates of growth.

So, let's start by looking at our revenue drivers on a geographic basis. Underlying net sales in the emerging markets continued its growth trajectory, up 7%. The business we have is broad-based and fast-growing. Russia remained a standout performer where both Finlandia and Jack Daniel's grew double-digits. Also enjoying impressive double-digit rates of growth from relatively lower bases are China and Brazil. Thailand, Turkey, India and the CIS markets, each also grew well into the double digits. Global travel retail was another bright spot for the company, delivering low-double digit sales growth. Travel retail now represents about 4% of our total revenues and has been a great place for us to innovate, as well as launch premium product offerings such as Sinatra Select. We have seen some softness in 2 of our larger markets, Mexico and Poland, which were down low-single digits. Remember that these markets were impacted by the price increases that we implemented at the start of this fiscal year. For Finlandia in Poland and for New Mix and el Jimador in Mexico which resulted in significant buy-ins at the end of last fiscal year that we've been working through in fiscal 2014. Excluding these countries, our emerging market business would've grown underlying sales by over 20%.

In the United States, underlying sales grew 5%. It appears that the momentum behind distilled spirits continues with market share gains from beer and a healthy price mix contribution, particularly in aged spirits. The off-premise in the United States has been a key driver of our results over the last few years and performed well again in the first half of this year. But, it does appear that declining consumer confidence is negatively impacting on-premise trends which remained weak year-to-date.

In the developed markets outside of the United States, underlying net sales grew 7% in the first half. Our spirits business in Western Europe enjoyed solid market share gains against the backdrop of declining spirits sales for many competitors. We attribute much of this to the strength and focus for our brand portfolio, as well as the flexible approach we take in our route-to-market strategy. The United Kingdom and France each delivered strong growth in the first half. The United Kingdom's results benefited from retailers stocking up for the holiday season earlier than last year, and we believe we are well-positioned for an excellent holiday season there. After a sluggish start to the year, Australia delivered modest underlying growth in the second quarter resulting in low-single digit growth for the first half. Our new distribution arrangement in Japan has helped us drive strong rates of underlying growth, up high teens, although we would expect these growth rates to moderate in the back half of the year as we begin to cycle against the January 2013 distribution change over to Asahi.

While on the topic of route-to-market-changes, we are eagerly anticipating the January 1 launch of our own distribution company in France. We believe that this investment will allow us to leverage our existing scale. Over 600,000 annualized cases today and the 14% compounded annual growth rate in reported net sales that we've achieved over the last 10 years. Naturally, there's an incremental infrastructure cost associated with this investment and that will hit SG&A in the back half of the year. We made similar investments in markets such as Germany, Turkey and the U.K. over the last number of years, and we have seen firsthand that having a dedicated sales force selling a focused portfolio has enabled us to achieve strong rates of growth through market share gains in countries that competitors often describe as mature. We believe France has similar potential. Once France is online, we will own distribution assets or control the sales force in 8 of our top 10 markets. In the 2 exceptions, Japan and Russia, we have very strong partners in Asahi and Coca-Cola Hellenic, coupled with local Brown-Forman folks with strong market knowledge and the brand building know-how that has been helping drive double-digit gains in each of those markets over the last year.

Now, let me look at some of our results through a brand lens beginning with our most important trademark, Jack Daniel's. The Jack Daniel's family registered robust underlying net sales growth, up 10% in the first half of the year. Its global appeal as the premium imported American spirits brand has helped to begin penetrating many of the markets that scotch and white spirits dominated through the 20th century. We continue to believe we are in the early stages of realizing the full long-term potential of this trademark outside of the United States. And inside the United States, we believe that disciplined flavor innovation and brand-enhancing line extensions up the pricing ladder will continue to drive growth. As we think about flavors, Jack Daniel's Tennessee Honey is now one of our largest standalone brands, approaching 1 million cases. Underlying net sales grew 30% in the first half, but we anticipate slower rates of double-digit growth in the back half as we lap major launches outside of the United States and expect more moderate rates of growth in the United States. Combined underlying net sales for Gentleman Jack and Jack Daniel's Single Barrel grew 15% in the first half. Given the success of the superpremium expressions of Jack Daniel's, we launched Sinatra Select last year in duty free and have been pleased with the consumer demand with this $150 limited offering. We also recently launched Jack Daniel's No.27 Gold, a twice mellowed, twice barreled whiskey that will allow us to compete in the ultra-premium whiskey segment. While it is currently sold exclusively in Singapore duty free at about $100 a bottle, early results are encouraging and we anticipate rolling it out to additional travel retail stores soon. Similarly, the success of Winter Jack in Germany led us to test this premium priced ready-to-pour product in the United States last year. And this winter, we're selling Winter Jack in 30 states. We believe that Winter Jack allows us to bring new consumers in drinking occasions and the Jack Daniel's family of brands.

Our other whiskey brands also performed well in the first half. I'll start with our founding brand, Old Forester. Year-to-date, underlying net sales are up 16% as we look for new ways to build brand awareness for this high-quality premium bourbon that was one of the only bourbons legally sold before, during and after Prohibition. Old Forester recently won recognition as one of the best buys in bourbon by Wine Enthusiast and we are repositioning the brand at a more premium price point. The Early Times family of brands grew underlying net sales by 5%, and Canadian Mist grew 1%. And Woodford Reserve continued on its growth trajectory, growing 27%. With only 15% of our Woodford sales derived from outside the U.S., we believe the global growth potential for this brand over time is enormous.

In vodka, Finlandia's family grew underlying net sales by 1%, driven by double-digit growth in Russia. Results in Poland, the brand's largest market, were down slightly as better price mix only slightly offset the volume declines after price increases were taken at the start of this fiscal year.

Moving on to tequilas, Herradura's first half underlying net sales grew 7%, rebounding in the second quarter after a sluggish start to the year. el Jimador sales grew 2% year-to-date as nice growth in the United States was offset somewhat by a stubbornly competitive mainstream tequila marketplace in Mexico. Agave prices continued to decline, but we have yet to see that translate into better pricing discipline in the category.

Southern Comfort's results were mixed in the first half. Results outside of the United States were a bright spot, up low-single digits. Results in the United States were below our expectations, down high-single digits. We believe that while the media campaign helped drive better unaided brand awareness, it wasn't enough to overcome the competitive pressures facing the liqueurs category, as well as weaker on-premise trends. Also facing this environment, not surprisingly, Tuaca and Chambord's underlying sales were both down in the first half as well. Comparing our underlying reported sales results, year-to-date top-line underlying growth of 7% was negatively impacted by 2 points due to reductions in distributor inventories and another point due to the strengthening of the dollar, resulting in 4% reported net sales growth. Underlying gross profit increased 8% year-to-date as reported gross margins increased 1 percentage point. Underlying A&P spend increased 8% and underlying SG&A increased 4%, primarily due to the favorable timing of various expenses. In the aggregate, underlying operating income grew 13% or 9% on a reported basis.

Diluted earnings per share also increased 9% year-to-date from a $1.49 to $1.62. So all in all, we're pleased with our results in the first half and our continued industry outperformance, due in no small parts to the great work of our associates, our diversified geographic footprint and a portfolio focused on aged spirits.

So let me move now to my second topic, an update on our outlook for fiscal 2014. Despite a backdrop of slowing global growth, driven largely by various emerging markets, we believe we are on track to deliver the high-single digit underlying sales growth we shared with you at the beginning of this fiscal year, albeit towards the lower end of this range. In addition to the more challenging comparisons in Japan in the back half, we would also anticipate a difficult comparison in Mexico in the fourth quarter, as we lap last year's price-driven buy-ins. We expect our price increases, improved mix and benign cost inflation will help drive full-year gross margin expansion, although at a slightly slower rate than what we achieved in the first half of the year. A&P has been growing roughly in line with sales and we expect this trend to continue over the course of the full year. But SG&A is running behind full-year expectations due to timing, particularly as it relates to the January 1 transition to owned distribution in France. As such, we expect the first half's operating income growth of 13% will moderate in the back half and result in full-year operating income growth of between 9% and 11%. In an environment where competitors have been tempering expectations, we are pleased to reaffirm the full-year outlook that we shared with you at the beginning of this fiscal year. This should result in an EPS range of between $2.80 and $3 per share. Our full-year outlook includes an expected impact from the French inventory buyback of minus $0.06, largely impacting the third quarter. Foreign exchange is expected to be roughly neutral versus fiscal 2013, a $0.02 improvement from our outlook at the beginning of the year. To help you model the potential impact from changes in foreign exchange, a 10% move in the dollar in either direction would impact the EPS for the balance of the year by approximately $0.06.

So let me now move to my final topic, a review of our long-standing approach to capital allocation and a quick update on the capital investments we've been making as we look to the next generation of consumers of our brands. As you all know, our first priority at Brown-Forman is to find high return investments that can drive long-term sustainable growth and yield multiples of that initial investment. This includes the step-up in capital spend last year to just under $100 million, as well as the $140 million to $160 million that we expect to spend in fiscal 2014. Year-to-date, we've invested about $60 million behind these large-scale expansions of future production. The construction is progressing well, currently on time and on budget. We would expect these capital requirements to moderate in fiscal 2015 and return to more historic levels in 2016 as a new distillery at Jack Daniel's, the cooperage in Alabama and the expansion at Woodford Reserve, all come online.

Given the efficiency and stability of our business model, strong and growing free cash flow permits us to target growing the dividend each year. And we announced our 30th annual increase a few weeks ago, growing the dividend by almost 14%, while maintaining a payout ratio in the mid-to-high 30% range. We've been clear in our M&A strategy and we keep our eyes open for assets and brands that would be complementary to the ones we already own. But with few attractive opportunities available at the right price, we've been able to return substantial amounts of cash back to shareholders through a combination of special dividends and our share buybacks as we did in fiscal 2013 and as we've continued to do in fiscal 2014. Brown-Forman has a great track record of creating value for shareholders through disciplined capital allocation and we don't anticipate changes in approach that has served our company and our shareholders so well.

So to summarize, we feel really good about our results in the second quarter and over the first half of the year. We are delivering solid underlying sales growth and we are driving strong leverage to the operating income line. And we believe that these results keep us on track to deliver on our full-year growth outlook. We are entering the holiday season, cautiously optimistic about the back half of fiscal 2014 and will closely watch the competitive environment and monitor consumer behavior over the coming months.

Looking longer term, we believe Brown-Forman is very well-positioned. The business is highly focused on categories such as North American whiskey, which is enjoying superior growth in volume and price mix. We also have a geographic footprint and portfolio of brands that offers us the long-term upside of growing our business in untapped parts of the world with little of the near-term drag due to the recent slowdown in some of these markets. The Brown family's commitment and engagement continues to provide us with the stability to execute on a strategic plan measured in decades and not quarters as we aim to deliver superior risk-adjusted returns for all of our shareholders. So with that, I'd like to open up the call to any questions anyone might have.

**Question and Answer**

**Operator**

***— Operator Instructions —*** Your first question comes from the line of Vivien Azer from Citi Investment Research.

**Vivien Azer**

Let me be the first, Don, to congratulate you on a wonderful tenure at Brown-Forman and wish you the best of luck in your next endeavors and Jane, congratulations on your new role.

**Vivien Azer**

Just to dive right into the questions then please. Can we drill down a little bit in terms of U.S. spirits category on-premise versus off-premise, brown spirits versus white spirits, please?

**Paul Varga**

What specific question would you have?

**Vivien Azer**

If you could offer some color in terms of the relative growth rates on-premise versus off-premise in U.S. spirits and specifically as that relates to brown spirits versus white spirits?

**Paul Varga**

I mean, I'll do a little. Don, you might take then. I think, I'll start with the brown, white. I mean, I think the most significant thing and it wouldn't be any sort of recent news on this, Vivien, that would be new to the things we've said in the past as it relates to what's happening with the whiskey, particularly American whiskey business in the United States. And where it's taking share, I think within total distilled spirits. And of course, I think, Don mentioned that for total distilled spirits continue to take share within beverage alcohol as well. And so all of those, I think we said in the past that we have – for those of us who have been around long enough at Brown-Forman, endured periods where we were on the receiving end of share – of other companies or other categories' share gains. And so it's really great to have the wind at our back. Now within it specifically, what I would observe is that there has been a real, just, continuation, there's real appeal and it's with this U.S. whiskey business of – really 2 dimensions of it. The ultra-premium, the very premium pieces of it that are beginning to play. I'm going to say, oftentimes, we market it at below or above the Jack Daniel's price point. What I'm talking about here, the price points above the Jack Daniel's price point have been very attractive in the bourbon and the U.S. and North American whiskey business out here for a while, the last several years. And so that seems to be continuing with great excitement. I mean, we can see that in the numbers and anecdotally. Additionally, this flavored piece continues to expand and it's not just – actually, I don't think, it's just a rollout of new flavors either. I think a lot of the brands that have – were the beginning brands in this, have continued to grow organically and of course, we have one of the foremost brands in this segment with Jack Daniel's Tennessee Honey. And so that has been where the excitement is. If you were thinking about it then converting it over to the P&L, those businesses have also been able to get moderate pricing over the last couple of years, more so than they were achieving in the prior years. So, I mean, in terms of being positioned for momentum, you have ultra-premium category in whiskey that's doing very well. You have innovation that seems to be driving the flavored aspect and Don mentioned Winter Jack which we're just now introducing into, I think, 30 states in the United States, which is not as high a proof as, say, Tennessee Honey, but it's still, I think, it's 30 proof. It might be – it's just a lower proof, I think than full strength that sort of mid-proof and – but it's a flavored ready-to-pour, we call it. And so, all of this is creating great excitement around Brown-Forman's traditional business. And vodka is continuing to do well in the United States. We have seen a little bit of softening and we've been hearing about anecdotally in the flavored vodka arena. Maybe some oversaturation with flavors or a little flavor fatigue. I don't know. I don't have any data that tells me that people are shifting from flavored vodkas to flavored whiskeys so much, but we certainly have been hearing some of that more anecdotally. Don, did you have anything on the on-off?

**Donald Berg**

Sure. I mean, I will talk a little bit about that. The key data that we use in just trying to get a sense of what's happening on market, generally comes from our NABCA data and you have to be a little bit careful. The NABCA data, as you know, most of those markets tend to be more in the interior of the country and they don't capture some of the bigger markets like New York and California and Washington, Florida where some of the trends get set. But directionally, it gives you a sense of how the on-premise trends are moving. And when you peel that back, I mean basically, the on-premise has been softening for a while and we've been watching it now probably since about this time last year. And it's now down to a point where it doesn't look like it's growing at all and could even be slightly declining a little bit. And when you step back and you look at it over a long period of time, there can be different things that really kind of drive some of the consumer behavior there. Sometimes it's high gasoline prices. Sometimes it can be little shocks in the market of one nature or another. But this has been trending down for a little while now and it's hard to really say exactly why. As I mentioned in the script, I mean, we had tended to see some hits in consumer confidence of late and there has been a lot that's been going on kind of at the government level in terms of government shutdowns and different things that can affect different people's psyche and how much they want to go out and what have you. But it's been a concerning trend and also, as I mentioned, we have a couple of brands that are skewed somewhat to the on-premise that have been hit disproportionately and as the on-premise has continued to soften, it seems to be an environment where the competition within the on-premise has continued to increase. And so, we think it's one of the areas where Southern Comfort has been hit as well as some of our other liqueur brands. I can't give you much more color than that other than we have been seeing it and you've heard others talk about it as well and hopefully, this will stabilize and start moving back in the right direction soon.

**Paul Varga**

I mean, the one effect – the impact of these channels shifts, I think we've talked about it before is, for a consumer who may be worrying about their purchases and the affordability of spirits, it's just a fact that spirits by the drink in the on-premise are going to be more expensive than their traditional retail purchases. And so, we watch it closely because we're skewed so premium within the business that we want to make sure now, we have not seen an offset – I mean our off-premise business continues to be very, very solid. And so the thing that you would look for in this on-premise, off-premise weaknesses, when you have a difficult on-premise environment, do they not consume you at all is the worry you would have and what we've been seeing over these last couple of years, yes, I mean if you're – if the premium [ph] is, you can have some challenges but I've been pleased that when you shift back over to the off-premise and look at those results, that they're holding up pretty well.

**Donald Berg**

No – just add to that, not only are they holding up well, but the other thing that we continue to see is the return of premiumization. And so, as you look at the different price points, we're pretty close back to what we saw prior to 2008, where the higher the prices, the higher the growth rates. And again, just to Paul's point, when you've got the premium portfolio that we have, we tend to perform better than what you see in the marketplace overall.

**Paul Varga**

Yes. I mean just remember that this is one unique thing about our business, that for a bar to sell a bottle of Woodford Reserve to its completion, depending upon the outlet might cost the consumer in the aggregate $200 to $300. So it's a real value to get Woodford Reserve at $32 a bottle, when you think about it, if you're a loyal Woodford Reserve drinker.

**Vivien Azer**

No doubt, that makes a ton of sense. And thank you for all that color. One quick follow-up on the commentary, Don, please on the on-premise. You mentioned kind of that deceleration in the on-premise over the last few quarters. As you think about the most recent quarter versus the last, was there kind of a step change? Did that deceleration accelerate? Or did the softness in the on-premise accelerate kind of quarter-over-quarter?

**Donald Berg**

I'll tell you the data that I tend to look at more is the 12 months trends, and when you look at the 12 months trends over the last 3 months, you basically saw kind of – where – kind of hit a bottom 3 months ago. It went up slightly last month and then it kind of went back to the bottom this month. And so again, you have to be a little bit careful with that. I mean, I would look at it more broadly in terms of what the trends are telling you than get too much into data on any one month.

**Paul Varga**

It wouldn't surprise me if our business, like a lot of businesses, would've been influenced by the government shutdown, the uncertainty that was created by that. Would people have watched how much they were dining out for a few weeks there perhaps, and that could have shown up in those numbers.

**Operator**

Your next question comes from the line of Nik Modi from RBC Capital Markets.

**Nik Modi**

So a couple of questions from my end and again, congrats to Jane, and Don, on both respective situations. On RTD, it strikes me as those businesses have been kind of struggling, and I'm just curious on is it really a structural fix here or is this just a function of the flavored variants of across different spirits categories, perhaps making those types of products less appealing to the consumer? And then just on travel retail, if you could just provide a little bit of perspective on the trend and how it is in relation to previous quarters and years? I'm just trying to understand if that business is accelerating or decelerating in this quarter?

**Donald Berg**

So I'll start with the RTD business. When you look at our RTD business there are 2 markets, in particular, that are pretty large and drive a lot of what you see in the overall results. One is Australia, and one is Mexico. And there's 2 very different things going on in those 2 different markets right now. In Australia, it has been under quite a bit of macroeconomic pressure for the last several months. And so, you've been seeing that and you've been seeing that hit the RTD market, as well as kind of just broad-based beverages overall. And so, a lot of the performance that you're hearing about in terms of little bit lower trajectory than what you would have hear – heard us talk about a few years ago, just a couple of years ago actually, has a lot to do with just what's happening specifically, macroeconomically, within that market as opposed to there's a consumer problem or there's a brand problem or what have you. It's pretty much across-the-board that everybody's seeing this. In Mexico, it's slightly different. In Mexico, when we bought Casa Herradura in 2007, they already had this very, very strong RTD market, and New Mix and had, if I remember right, something close to 50% share within that market, that we've been able to continue with even through today. It has become such a great growth area and a great consumer area that it has been kind of a natural invite to a lot more competition. And so, earlier this – at the end of last fiscal year, earlier in this fiscal year, there was a bunch of new introductions that were coming out. We took some actions within that market, try to help us competitively. We also took some opportunities to take some price increases. And so you have a bit of a shift of where the volume went in terms of our fiscal year ended. But in terms of the overall RTD market within Mexico, while it's become a lot more competitive, I think, when you look at what's happening at the consumer level and just overall, continues to be a pretty good business for us.

**Paul Varga**

Yes I don't – I would categorize our RTD business, in addition with Don said, as I mean at a very, very low level of its potential development around the world. I mean, there have to be certain ingredients in place in the markets for us to seize the opportunity, most notably the great access to the marketplace through distribution. And that's the big thing. That does exist in Mexico and Australia for us in a great way. So we could actually get these products in distribution and service them. In a way, there has to be a consumer need for single-serve, which there is virtually everywhere. But we'd like to think of this as an opportunity to step into the single-serve with the convenience. Sometimes it's called the beer occasion. Not always. It's not always called that. And so we – if we were take our total sales or our cases and divide it by the denominator of the marketplace size, it wouldn't even register, because our case volumes would be so small on a single-serve basis. So I really feel like it continues to be a great area of exploration and innovation for us. We have to be real careful with it. We have to do it very well, but I think a lot of markets over the next decade for Brown-Forman will see varying forms of what I hope are RTDs or maybe even these RTPs which is slightly different language we use for it, which are ready-to-pours, which would incorporate the Winter Jack. So that's what – I think, the way we'd summarize your question related to RTDs. On travel retail, we've been doing very, very well. I think we've largely been outperforming that market but we needed to. We were really far behind in travel retail, if you go back 5 or 6 years ago. And made a conscious effort to step up our investment in people and in innovation. It so happened that this is a channel that works really, really well for the premium skew of Brown-Forman's portfolio, but we weren't getting as much in terms of results out of it as we thought we could. And so we've had a very nice and steady run, by putting some dedicated effort and being a little more innovative with not only the products that we're bringing into that channel, but also the merchandising we're supporting it with. And so we've been really pleased with our travel retail business.

**Nik Modi**

And just one quick follow-up. Since the government shutdown, just curious if you guys have – all the stuff has ended with the government shutdown? I'm just curious if you've seen any improvement in the consumer's behavior? Any near-term color on kind of any changes in consumer would be helpful.

**Paul Varga**

Nothing we're so – we're a couple of levels from retail and the consumer's actual transaction. So anything in that narrow a period of time we tried – I mean, we just have a hard time making a lot of sense of it. So I can't really add anything. I wish I could for you and it would help us too. So we're prone to more of the anecdotal type of information that gets shared.

**Operator**

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

**Judy Hong**

Good luck to you, Don and look forward to working with you, Jane, going forward. So a few questions from my end. First, maybe just from your perspective, what really explains the difference in terms of how you're performing versus some of the negative commentary coming out of your competitors in your view? Obviously, the category and country exposures are different, but do you think that you're actually outperforming in some of the markets and categories? So just kind of trying to understand your category company – I'm sorry, country exposures versus where you're actually outperforming competitors?

**Paul Varga**

I'll start with it. Actually, I might add even one level below category. For us, to be quite honest, it starts with the brand which is also very much a member of the category, which is Jack Daniel's. And I think Jack Daniel's it's likely – I haven't looked at it recently. It's likely that Jack Daniel's may be more important to Brown-Forman than some of the top brands are for some of our competitors. And so we're very, of course, pleased with the continuing performance of that brand and it's really on a couple of levels. One, how appealing it has proven to be globally. And its ability to travel the world as a trademark and be successful on a multitude of levels. And not only as Jack Daniel's Black Label but the thing that we're very, very proud of, actually over the last decade or more, is how it's become such a nice basis for thoughtful line extensions as well. And often times, when companies will do line extensions, of very powerful trademarks, I mean, their greatest worry is, am I going to cannibalize the parent brand from which I'm extending it and knock on wood, because I think of the way that we've thought about these and the patience we've – the patient approach we've used to introducing them and developing them, we have seen relatively low levels or very limited levels of cannibalization of Jack Daniel's Black Label. If anything, we think any cannibalization we get with the introduction of something like Tennessee Honey is more than compensated for by the positive halo effect to the trademark which is almost 150 years old. So it's nice to keep it contemporary. So I think, if somebody would ask me in 2 words what's differing our performance versus others, it's the great work the company has been doing on Jack Daniel's trademark, and how that has enabled us then as well to do other great things alongside it, with the Woodford Reserves and the Herraduras. And just our confidence that we can take into the marketplace for developing premium plus or ultra-premium brands.

**Donald Berg**

And I do think, just to talk a little bit about the geographic skew, there are some pretty marked differences there. When you think about the larger players in the industry, we would skew more towards the U.S. than what the larger players would. And when you think about the U.S., it's been performing fairly well over the last couple of years. When you think about the European skew, while we've got a sizable part of our business in Europe, we've continued to really buck to trends there. And when you've got the U.K. growing at nice rates, and Germany growing at nice rates, and France growing at nice rates, it does help with our business given the size of our business there. When you look at our emerging markets, I mean today, the emerging markets represent something around 20% of our overall business. And some of our larger competitors are out there, at sizes double that. And so, so there's definitely a geographic skew story here but also, when you look into those markets, I mean we were definitely outcompeting and in many, if not most of those markets and some of them have different reasons than others. I mean, when you think about the emerging markets and you look at, for example, we've been continuing to do really well with Brazil. That happens to be one of the markets where we changed our route-to-market a couple of years ago, and we've been seeing some real benefits from having our dedicated sales force there. When you think about China, we're relatively smaller there than our competitors. We've gone through quite a bit of change there, in terms of really improving the organization and putting different focus on where we're executing against our brands, and we've been seeing the benefit of having made some of those changes. And so a lot of the stories vary from market to market, but there's absolutely no doubt, as Paul said, a lot of what we've seen in terms of our performance is really coming from the work and the efforts of our people that are on the ground there.

**Judy Hong**

Okay. And then just secondly, any early read in terms of the promotional environment as we're heading into the holiday season here in the U.S, and just given the commentary about the soft on-premise channel, does that raise the competitive risk in the near-term?

**Paul Varga**

I think it's going to be very competitive. I mean, I don't know that I've heard anything. Don has said that it's any more competitive than it always is this time of the year. I think we can expect – I mean, you have a very attractive marketplace at the most important time of the year, so I expect it to be very competitive. And to be looking at – sometimes we always think about that as pricing but our folks will be monitoring a full range of items, everything from value-added packaging to innovation to all kinds of things. And we think we're pretty well positioned, I'll say that. Just using the U.S. an example. We would not have had the presence in the marketplace a year ago with this introduction of Winter Jack, which we think is a really nice thing for a seasonal introduction like this. So that's a tool in our arsenal that we didn't have last year. So we'll be monitoring to see how that does.

**Donald Berg**

You always hear kind of the one-off or two-off stories about different things are happening, and on individual brands or in individual markets. And so, I would echo what Paul is saying in terms of what we're hearing in terms of, it's going to be very competitive. But in terms of hearing anything about anybody doing anything crazy across – on some kind of scale across-the-board, no, we really haven't. We haven't heard anything that would be considered to be anything out of the ordinary of a very competitive environment.

**Judy Hong**

Okay, and then just the fact that this year, you've got a shortened holiday season between Thanksgiving and Christmas, would that have any impact on your business or the industry?

**Paul Varga**

You know, we expected it to have a big impact on us last year when we had a longer one. It didn't seem to have much. So I don't, I mean, I'd be hard pressed to forecast anything related to it...

**Donald Berg**

***— indiscernible —***

**Paul Varga**

I mean, it's just we look at it longer than just December. We try to think about sort of a holiday period and for us, because it's in this country and in many parts of the world, a cold weather season, it points very nicely sometimes to our category skew. So we've been pleased by this cold spell, of course, that's been going on – I mean so we keep our fingers crossed that it gets real chilly out. So we can people sipping on our Bourbons.

**Operator**

Your next question comes from the line of Bill Chappell from SunTrust.

**Sarah Miller**

This is Sarah Miller on for Bill. My first question is kind of relates to the U.S. market. Can you kind of talk about maybe an increase in some of the competitive pressures? We've see some of your competitors gaining share. And in light of that, can you talk about any changes to your ad spend maybe behind Winter Jack or behind any other major initiative that would kind of drive the top line in the back half?

**Paul Varga**

Yes, I'll touch on a couple of those. Yes, we are – we always invest – we used to invest to my point of view, far too strongly during this price [ph]. We've spread out the seasonality of our media. I think that's helped us. But we do have nice efforts in the U.S. market, particularly behind Southern Comfort and Gentleman Jack have, these last couple of years, newer efforts and steady support. I don't know that we have a strong media program behind Winter Jack. I think it's more at retail. I think that's the correct case. And but I do think it's going to be competitive, like as we just said here, because it's in a very attractive segment. And I mean, I think that goes across all of beverage alcohol as well. I mean, I think – remember, it's not just the spirit companies that are out there trying to compete for the consumers' dollars this time of year. It's also the beer and wine companies that have some strong seasonality to this period too. So we expect it to be as competitive as ever. If your question related to what might that bode for seasonal spending, I mean, we'd – I think Don referenced in his comments, we continue to think our A&P particularly will travel around the growth rate of sales for the full year. I mean, that's about what we've been targeting. And that can always vary within third quarter and fourth quarter, depending upon where we're spending and what we're spending behind. But we would anticipate it continuing to travel at about the rate of growth sales.

**Sarah Miller**

Okay and then one last question about the gross margin line. I think Don, you might have touched on it, but can you talk about any nuances in the back half of the year? Because I don't think you're lapping the price increase for this year until fourth quarter. So if you could kind of touch on that, that would be really helpful.

**Donald Berg**

It's mostly around pricing. Last year, not this current fiscal year, about last year's fiscal year, we did take slightly higher price increases than what we did this year. And so some of that fell into the – some of the – as you think about year-over-year comparisons, some of that benefit continued to come through in the first few months of this fiscal year, which is why we're seeing a little bit of a higher-margin pop in the first half versus what we would expect in the last half where we won't be getting that kind of benefit.

**Paul Varga**

But it will always depend, as it does, particularly on a quarterly basis to –

**Donald Berg**

Mix.

**Paul Varga**

Mix. I mean we get so many fluctuations, as broadly sold as the Jack Daniel's trademark is, particularly, to geographic and even portfolio mix can hit us during a particular quarter. So those could have as big an influence on variations to the gross margin in a quarter as anything.

**Sarah Miller**

Good luck, Don in your retirement.

**Donald Berg**

Thank you.

**Operator**

Your next question comes from the line of Tim Ramey from Davidson.

**Timothy Ramey**

Davidson. And Don, let me add my congratulations as well and to you, Jane, too. So, a lot of ways you can address growth here, line extensions like Winter Jack or Tennessee Honey, new brand platforms either acquired or created. It's been now – what 16, 17 years since you created Woodford Reserve. Is there any appetite to create new brands or in this period of high innovation with particularly brown spirits, is it just more logical to be thinking about buying them if the prices were not prohibitive?

**Paul Varga**

I mean – I think it's probably a combination of both-and, to be fair. You certainly can control your own destiny more by creating them. They just in the whiskey business, as you would well know, Tim, just take longer to go from inception of an idea to an introduction in the market because of the aging. So you can – the benefit of acquisition, assuming there's sufficient inventories for any of these products, would be that you could fast forward your entry. And so you're looking to do a balancing act, I suspect there, of innovation and acquisition, depending upon what the market segment is. I mean, so far we found that what's happening with Woodford Reserve is really, really exciting for us. It's not just Woodford Reserve base brand. I mean, it is really this Double Oaked has been a great, great addition to the line in the last couple of years. And it actually – the idea for it came out of an original masters collection idea, that was a limited offering years ago and then we decided gosh, that was so well-received, why don't we do something with it more mainstream for later on? And it's been very, very well received at particularly high price points. And so, Woodford Reserve, Jack Daniel's, Old Forester, Early Times, Canadian Mist, they're all great bases for innovations. And I would not rule out the possibility of creating a brand new trademark. Doesn't always have to be a line extension. So those, I think, can be very sound ideas but we do think we're very well-positioned with the production assets we have, having several distilleries from which we could create either line extensions or new products. But there are attractive segments of the whiskey business, both exist in the United States and around the world, that we're observing and watching that – where line extensions, innovation or acquisition can play a role in our entry.

**Operator**

Your next question comes from the line of Ian Shackleton from Nomura.

**Ian Shackleton**

Congratulations, Don. Thinking about Jack Daniel's Honey, you flagged the slow momentum in the second half. And I just wanted to check where we were in terms of new market rollouts and while we're talking about that, what about thoughts about new flavors in the Jack Daniel's range?

**Donald Berg**

Yes, so there's been a number of new markets that we've gone into so far this year. Germany, Mexico there's a whole host of them. The one that's left for this fiscal year to get started on is the introduction of Honey in France. We decided to delay that until we had our own distribution business up and running. So we'll see that coming through once we hit that January 1 target date.

**Paul Varga**

And then in addition to that, I think your question, Ian, was about flavors. And you might, I know it's not technically, might not fit the same mold that you were thinking, but you might think of what we're doing with Winter Jack on a staged rollout is an additional flavor from Jack Daniel's in this space. It's not technically presented exactly like Jack Daniel's Tennessee Honey. But that one might be a hybrid of additional flavors. So we're – and I do think, I've said this before, I think our approach to that will be more on the conservative side. I just – I think what's going on with these whiskeys is really different than what was going on with vodkas. If you think about it, the difference here is that you are beginning to add flavor to a product that's already inherently flavored, which is different than adding flavor to a product that, in its base, is quite neutral. And so, how we do that, I think, has to be very thoughtful. And so far, I think we've done a pretty good job at it. But and then when you're dealing with the Jack Daniel's trademark, you're going to be extra careful. And so, so far, we're getting good feedback for the work we've done in flavors. Obviously, Tennessee Honey and then the early results on Winter Jack has encouraged us to do more. And I suspect we'll have more ideas that we'll treat just as conservatively.

**Ian Shackleton**

And perhaps just a follow-up thing about known distribution. It sounds, the numbers you've given on France, they haven't changed from previous guidance. It sounds like that's very much on track. The fact that you've never aided the top 10 markets in known distribution, you've — ***indiscernible*** — good relationships. Does that really sent the message that's it for now, for the next few years, or are there more markets to move here?

**Donald Berg**

I would say all the big ones. I mean, you're always looking at how markets are evolving and what opportunities that there are out there. So there could be some that could come up. But at least in terms of the big ones, I think we're pretty good set for the time being.

**Paul Varga**

This was a big deal for us 15 years ago. I mean, Don will remember it. I mean, we had lots of conversations about how we enabled and basically the development of Jack Daniel's. But then Jack Daniel's actually helped take Brown-Forman route-to-market around the world because of its appeal. And a lot of companies do it different ways, you can do it through acquisition but we were fortunate to be able to do it largely organically. The Poland and Mexico examples were associated very directly with some acquired businesses, but we're really pleased with the position of our route-to-market around the world and how we've accomplished it. I actually do think, that there was an earlier question about whether or not our results, how might we qualify our results versus others. I mean, one thing that is different a little bit about our business, and it's captured a little bit geographic skews, we just don't have a lot of local mature businesses that we bought along the way in order to enable our route-to-market. We have some, I mean, in particularly, Mexico and Poland. There we have good positions but those are relatively mature categories where we have good positions. And so that can drag on us, as it has a little bit in some of these emerging market figures we referred to today. But compared to other companies who did this – developed their route-to-market through acquisition or have made very, very large acquisitions of local companies as the basis for developing their global brands, we're just not as exposed to that. So if those businesses are soft in a local market, it can be a bit of drag on their growth. And we just don't have that influence as much at our company.

**Operator**

Your next question comes from the line of Bryan Spillane from Bank of America.

**Bryan Spillane**

Just wanted to add my congrats as well to both of you, Jane and Don. Don, I didn't know if Nik Modi and I should take it personally but we want to cover it as you go away.

**Paul Varga**

Made you look good, Bryan.

**Bryan Spillane**

That's ominous for you, Jane, maybe. I have a question about, 2 questions. One, just a quick one, just a clarification on SG&A. SG&A was, I guess, a little lighter than we thought it would be in the second quarter and is there just some timing shift? So did I hear that correctly? You expect to see that kind of kick back up in the second half?

**Donald Berg**

Yes, exactly. I would anticipate by the end of the fiscal year, we'll be somewhere in the mid-single-digit range.

**Paul Varga**

It's France is coming on. That's one of the big contributors.

**Donald Berg**

Heavily influenced by France. There's a couple of other little timing things in there in addition to that, but it's heavily influenced by France.

**Bryan Spillane**

Okay. And then my second question was just on depletions. You had a nice sequential – if you look at it on the equivalent case basis, you had a nice sequential change in depletions from the first quarter to the second quarter, the year-to-date trend improved. So can you talk a little bit about maybe what was happening in market to drive the improvement in depletions? I mean it looks like Jack Daniel's family drove a piece of it, and even El Jimador being less negative was part of it. But if you could just maybe talk a little bit more about that improvement in depletion trends? Is that more or less in line with what you were expecting and just some more color there, please?

**Donald Berg**

Yes, and I would say that a lot of what we talked about in terms of easy comps and tough comps. I mean, it hit us at the depletion line, as well as it hit us at the reported line. So I mean, you saw a lot – 2 years ago, when we took some pretty hefty price increases for the first time in 5 years, you saw some pretty hefty buy-ins at both retail and the distributor level. And so we were going up against those tougher comps when we came out with the second price increase at lower levels where we didn't see quite as large buy-in in either tier. And so, generally speaking, in terms of when you look at the magnitude of that shift that you're looking at, a lot of it was driven mostly by what we've been talking about in terms of this comp difference first quarter, second quarter.

**Bryan Spillane**

Okay, and now, in more at a level now where there's not like trade inventories are – or wholesaler inventories also are at a pretty normal level?

**Donald Berg**

Yes. I would say, here's how I would think about that. Every year, you'll see kind of plus ones, plus twos, minus ones, minus twos. They'll fluctuate a little bit throughout the year. Generally, at this time of the year, where you're really in that early part of the holiday season, that's when you'll start to see some of the inventory buy-ins starting to come in as different distributors and retailers are really loading in for the holiday season. And so, it's not unusual at this time of the year to see our shipments slightly outperforming our depletions because of that effect. And then once we get through the holiday season, you'll tend to see that start to reverse itself in kind of a January, February time frame. And so when you think about it from that standpoint, seasonality, what you're looking at today in terms of this depletion, shipment adjustment, it's pretty much within the norm.

**Paul Varga**

Bryan, the other thing that's in addition to our price increases, the fluctuations, they will influence. Some of these quarter-to-quarters are just the introductions of these line extensions. And it's – we will keep you all apprised as we go along – -we always do – as to when we're introducing something and when we begin to work against that pipeline. We tried our best, particularly – and I'm talking about depletion pipeline - and we had some of that at various times on Tennessee Honey where you begin – you had get the product into distribution. And you only get to do that once and then you're dependent on the velocity. And so innovation plays a role in this in addition to the price increases. Those have been the 2 big things over the last 24 months that would've explained variations from quarter-to-quarter.

**Operator**

Ladies and gentlemen, we have reached the end of the allotted time for questions and answers.  That concludes the call for today.  Thank you for your participation.  You may now disconnect.

**Paul Varga**

Thank you, all.