Constellation Brands Inc, Q1 2021, Earnings Call 2020-07-01

Presentation

Operator

Welcome to the Constellation Brands First Quarter Fiscal Year 2021 Earnings Conference Call. — ***Operator Instructions*** —

I will now turn the call over to Patty Yahn-Urlaub, Senior Vice President of Investor Relations. Please go ahead.

Patty Yahn-Urlaub

Thanks, Shannon. Good morning, and welcome to Constellation's First Quarter 2021 Conference Call. I'm here this morning with Bill Newlands, our CEO; and Garth Hankinson, our CFO.

As a reminder, reconciliations between the most directly comparable GAAP measure and any non-GAAP financial measures discussed on this call are included in our news release or otherwise available on the company's website at www.cbrands.com. Please refer to the news release and Constellation's SEC filings for risk factors which may impact forward-looking statements we make on this call.

Before turning the call over to Bill, similar to prior quarters, I would like to ask that we limit everyone to 1 question per person, which will help us to end our call on time. Thanks in advance, and now here's Bill.

William Newlands

Thank you, Patty. Good morning, and welcome to our first quarter call, everyone. Before getting into a discussion of our quarterly results, I'd like to address 2 topics that have become extremely relevant to our business and our society in large. First, our thoughts and prayers go out to all those who have been impacted by racial injustice and associated acts of violence in both this most recent time period and throughout the years. We stand in solidarity with the black community, and our belief that black lives do, in fact, and have always mattered. We categorically denounce bigotry, racism, social injustice and acts of senseless violence in all forms. They are clearly inconsistent with our company values and our commitment to embracing diversity and creating an inclusive environment where all employees feel safe, respected and valued.

Earlier this week, we announced our commitment to invest $100 million to support African-American black and minority-owned startups in the beverage alcohol space and related categories over the next 10 years. These small businesses serve as the fabric of their respective communities. And we must make it more equitable for them to access the capital needed to have a fighting chance at success. In addition, we've made a $1 million commitment over 5 years to the Equal Justice Initiative and their efforts to educate the public about the history of racial injustice in this country and to support their quest for equity in the criminal justice system.

Furthermore, we have made a commitment within our company to enhance representation and access to opportunity for black team members at Constellation by strengthening our recruiting, hiring and development programs. The conditions that have allowed systemic racial injustice to persist have existed far too long. We all have a role to play in creating a more equitable experience for African-Americans in this country, and we are committed to doing our part to make this happen.

Switching gears. Our organization has responded and adapted to the challenges of the COVID-19 operating environment in an incredible and agile manner, which is reflected in our results for the first quarter. I'm especially proud of the efforts of the Constellation team members, of our distributors and our retail partners who worked together to ensure our customers' needs were met under very challenging circumstances.

As I've said before, the health and well-being of our employees is our #1 priority, and we've taken a number of preventative measures to keep them safe in our operations and out at retail to ensure our continued ability to meet the needs of the market. We've provided support and relief to our customers and our channel partners by donating more than $4 million in COVID-19 relief efforts and by donating PPE, hand sanitizer produced in our own facilities.

Bottom line, I'm extremely proud of the way our team and industry partners have risen to the occasion, and I remain confident our business and our brands will emerge even stronger on the other side.

Now let's transition to a discussion of our performance in the quarter. As Garth and I run through the highlights, there are 3 key points I'd like you to take away. Number one, despite various headwinds, we delivered solid first quarter business performance and strong cash flow generation. We are winning in sales channels that are open. Beer depletions remain strong and consistent with long-term trends despite the lost selling day in the quarter and the virtual shutdown of on-premise sales. And our wine and spirit power brands continued to gain traction.

Number two, the slowdown of our beer production in Mexico due to COVID impacted shipments and net sales in Q1, and this impact will extend into Q2 as well. We will make up some of that impact in the back half of the year as our beer production in Mexico has returned to normal levels.

Number three, this short-term disruption to our import beer business does nothing to dampen our long-term prospects. Consumer demand and takeaway for our brands remains extremely strong, and our outlook for the year and over the long term remains extremely bright.

Now let's talk more specifically about our performance in the first quarter, starting with our beer business. Imports continue to be one of the primary growth contributors in the high end and total U.S. beer market, with Constellation delivering more than 80% of that import growth, driven by the Modelo Especial and Corona brand families. Solid first quarter depletion trends of 7% adjusted for 1 less selling day were driven by strong off-premise growth of almost 20% due to the grocery and C-store channels, offset by a drag from the closure of the on-premise channel, which was down about 75% year-over-year. This is excellent performance considering that the country really began to feel the impact of COVID-19 pandemic in earnest in early March, which coincided with the beginning of our fiscal year and our brands over-index to densely populated states, such as New York and California that have been significantly impacted for a prolonged period of time.

One of the highlights of the quarter was the successful launch of Corona Hard Seltzer. As expected, the brand name Corona drove extremely good trial of Corona Hard Seltzer, and the great taste profile is driving a repeat purchase intent of almost 80%, which exceeded our expectations. Corona Hard Seltzer is already the #4 hard seltzer brand and recently achieved IRI market share of almost 6% of the U.S. seltzer market.

Ongoing distribution gains have led to IRI ACV distribution approaching 65 since product launch in March, with early results for Corona Hard Seltzer incrementality trending at around 90%, also exceeding our original expectations. We're also seeing high Hispanic penetration rates for the brand versus other hard seltzers, which we believe will be a key growth driver going forward and a major point of differentiation within the fast-growing demographic in this country.

We believe the refreshment attributes of seltzer, combined with the halo effect of the

Corona brand, which remains one of the most loved beer brands, provides an opportunity to build one of the strongest hard seltzer brands in our industry. During the quarter, we kicked off the summer selling season and gained share during the Memorial Day and Cinco de Mayo holidays. Cinco is a great example of changing consumer behavior during the pandemic when people enjoyed our great brands in Cinco celebrations at home. As a result, our Cinco performance increased 2 to 3x what we would normally see in the off-premise.

Our beer portfolio contributed nearly 20% to total U.S. beer category growth during Cinco and claimed 4 of the top 20 share gaining brands in IRI channels, driven by Modelo Especial as the top share gaining nonseltzer beer brand, Corona Hard Seltzer, Pacifico and Modelo Chelada Limón y Sal. As previously mentioned, we have returned to normal production levels at our breweries in Mexico.

During the mandated production slowdown in the quarter due to COVID-19, our focus on prioritizing production of our top-selling SKUs, which represent about 75% of total volume helped minimize disruption at retail, while supporting our efforts to ensure consumers could find our brands on the shelf and in the cold box. While supply will continue to be tight on select slower moving SKUs throughout the remainder of the summer due to continued strong consumer demand for our brands in the off-premise, we expect to return to normal inventory levels in the third quarter.

Let's now move to quarterly results for our wine and spirits business, which experienced the same market dynamics as our beer business during the quarter, with strong demand in the off-premise, offset by a decline in the on-premise of almost 80%. We continue to see staying power of the premiumization trend with premium price segments continuing to outpace value price segments, further reinforcing our wine and spirits business strategy. In fact, we saw excellent consumer takeaway trends up over 25% for our Power

Brands in the IRI off-premise channels during the quarter.

Our power brands are winning in the high end and across the majority of price segments in the U.S. wine category with strong velocity and distribution gains that are outpacing the market. First quarter depletions for our collection of Power Brands grew 5%, driven by Kim Crawford, Meiomi, SVEDKA, The Prisoner brand family and Woodbridge by Robert Mondavi.

We continue to invest in additional ways to fuel portfolio growth through innovation, capitalizing on priority consumer trends with successful product introductions like The Prisoner Unshackled, Ruffino Organic Prosecco and Robert Mondavi Private Selection Buttery Chardonnay, all of which are performing well in the marketplace.

As you know, some of our biggest success stories in innovation have come from the spirit barrel aged category, where we currently enjoy a 40% market share. The newest addition to this portfolio comes from the Woodbridge family, where we're seeing early success from the Bourbon Barrel-Aged Cabernet and Red Blend as well as the rum barrel-aged Chardonnay. You should expect to see continuing premium category-leading innovation from us as we emerge from the COVID environment, including line extensions for Meiomi in the cabernet space and from The Prisoner brand family with the addition of Cabernet and Chardonnay varietals.

In the spirits category, you'll see SVEDKA Pure Infusions as well as High West and SVEDKA premixed cocktails in the RTD space. We continue to invest in capabilities that position our wine and spirits business for long-term success. As a result of shelter-in-place restrictions and the shutdown of on-premise accounts due to COVID-19, e-commerce for beverage alcohol has exploded, increasing 3 to 7x in volume versus prior year, depending on the channel.

Consumer awareness for e-commerce and beverage alcohol has significantly increased and accelerated change in consumer behaviors by several years. With 2/3 of consumers saying they are planning to continue their e-commerce habits post-COVID, e-commerce is gaining share through platforms like Instacart, Drizly and other retailer online sites as consumers seek the convenience of these channels.

In line with this accelerated trend, we acquired Empathy Wines in June. This acquisition fits in nicely with our broader premiumization strategy and strengthens our position in the direct-to-consumer and 3-tier eCommerce channel, where we'll utilize Empathy's digitally native platform to reach new as well as thousands of existing loyal consumers.

In addition, Empathy focused on producing high-quality, sustainably made wines sold direct-to-consumer from its winery via its e-commerce platform at the $20 price point in 3 variants: white blend, red blend and Rosé. Launched in 2019, the brand has sold approximately 15,000 cases and acquired more than 2,000 subscription customers.

We are already a leading player in 3-tier eCommerce and have seen growth in this channel of more than 500% in the last 3 months. We plan to leverage this acquisition as an opportunity to strengthen our position and outpace the market.

As you know, we recently revised the Gallo transaction to exclude our Mission Bell facility as the FTC wanted to ensure that we had adequate production capability for our J. Roget and Cooks brands, which we decided to retain once they were excluded from the original transaction.

We're also one step closer to the finish line on this transaction with the signing of separate agreements to sell Nobilo New Zealand Sauvignon Blanc and Paul Masson Grande Amber Brandy. As you will recall, last December, we entered into a separate but related agreement with Gallo to divest our Nobilo brand for $130 million. This fits with Gallo's portfolio strategy and allows them to expand in the New Zealand wine category without affecting our long-term goals nor our opportunity in this category at the greater than $11 price point.

In addition, we've signed an agreement to sell Paul Masson Grande Amber Brandy to Sazerac for $255 million. As a reminder, last December, we announced that Paul Masson had been excluded from the original transaction due to FTC concerns, and we indicated that we were pursuing opportunities to divest this brand at that time. These transactions are subject to final FTC review, and they are expected to close in the second quarter, concurrent with or closely following the close of the Gallo transaction. All proceeds will primarily be used to reduce debt.

Finally, we continue to be encouraged by steps David Klein and the Canopy team are taking to position the company to win in key markets and product categories over the long term. The business continues to work through its transformational strategy with a leaner approach that will allow Canopy to be more flexible and adapt more quickly to changes in this dynamic cannabis market. Canopy has seen early success from its Rec 2.0 products in the Canadian cannabis market, including beverages, which we are very excited about.

The company's Tweed and Houndstooth brand has been one of the most raved about cannabis beverages in the market with overwhelmingly positive consumer feedback. We believe that beverages and other Rec 2.0 products will attract new consumers to the market and further drive conversation – excuse me, conversion from the illicit market. We continue to believe that Canopy remains best positioned to win long term in the emerging cannabis space and is well capitalized to face the challenges associated with this current economic environment.

As I close, let me again reiterate the 3 main takeaways from this quarter. First, despite various headwinds, we delivered a solid first quarter business performance and strong cash flow generation. We are winning in the sales channels that are open. Beer depletions remain strong and consistent with our growth outlook for the future despite the lost selling day in the quarter and the virtual shutdown of on-premise sales. And our wine and spirits power brands continued to gain traction.

Number two, the slowdown of our beer production in Mexico due to COVID impacted shipments and net sales in Q1 and this impact will extend into Q2 as well. We will make up some of that impact beginning in the third quarter as our beer production in Mexico has returned to normal levels.

And number three, this short-term disruption to our import beer business does nothing to dampen our long-term prospects. Consumer demand and takeaway for our brand remains extremely strong, and I remain optimistic about our outlook for this year.

With that, I would like to turn the call over to Garth, who will review our financial results for the first quarter.

Garth Hankinson

Thank you, Bill, and hello, everyone. While the start of our fiscal year marked the beginning of a global pandemic resulting in rapidly changing market conditions, Constellation Brands delivered solid performance in Q1, driven by our ability to remain agile and prudently navigate through these uncertain and volatile times.

During Q1, we improved margins in both our beer and wine and spirits segments, delivered solid beer and wine and spirits power brand depletion volume trends due to strong brand performance despite closures in the on-premise channel and shelter-in-place guidelines that impacted a majority of the quarter and increased operating cash flow and free cash flow by 16% and 24%, respectively. These strong cash flow results provide us with the financial flexibility needed to continue to focus on debt paydown and liquidity.

During the quarter, we were able to issue debt at very favorable rates and use the proceeds to satisfy $700 million of debt coming due in November and pay down other near-term maturities.

Now let's review Q1 performance in more detail, where I'll generally focus on comparable basis financial results. Starting with beer. Net sales declined 6%. Excluding the impact of the Ballast Point divestiture, organic net sales declined 4% and organic shipment volume down 6%, partially offset by favorable pricing. Q1 shipment volume was negatively impacted by reduced production levels at our breweries in Mexico as part of COVID-19 safety measures.

Depletion volume growth for the quarter came in at 5.6%, driven by Modelo Especial and the successful launch of Corona Hard Seltzer, a strong performance in the off-premise channel more than offset the impact of the reduction in the on-premise channel due to COVID-19-related shutdowns. When adjusted for 1 less selling day in the quarter, the beer business generated nearly 7% of depletion volume growth, an impressive result in this operating environment.

The large gap between shipment and depletion volume trends for Q1 was driven by the reduced production levels for roughly 2/3 of the quarter and robust consumer demand. This resulted in lower-than-normal distributor inventory on hand at the end of the quarter. I'm happy to report and reiterate that beer production in Mexico returned to normal levels in June, and we expect distributor inventory levels to return to more normal levels during the third quarter of our fiscal year as some shipment volume shifts from Q1 and Q2 into Q3.

Beer gross margin of 55.6% was flat to prior year as favorable pricing and the benefit of the Ballast Point divestiture was offset by increased operational cost, driven primarily by higher material cost and reduced throughput at our breweries, resulting in unfavorable fixed cost absorption.

Marketing as a percent of net sales decreased 220 basis points to 8.8% as marketing spend decreased due to the implications of COVID-19, essentially canceling and/or post-poning most sporting and sponsorship events. With most sports programming on hold during Q1 and big events such as the NCAA basketball tournament canceled, in the short term, we are reallocating marketing dollars to lower cost digital marketing efforts and TV programming that consumers are engaging with in this current environment.

We are recalibrating our marketing spend and strategy for the remainder of the fiscal year. However, currently, we still expect to spend in the range of 9.5% to 10% of net sales on a full year basis. As such, the marketing-related margin benefit in Q1 is mostly related to timing. As a result of the above-mentioned factors, beer operating margins increased 240 basis points to 41.7%.

Looking ahead to Q2. We expect shipment volume to be negatively impacted as we ramped back to normal production levels in June. Keep in mind that we expect to see some residual margin compression in Q2 as the reduced production levels in Q1 and the start of Q2 will create unfavorable fixed cost absorption, which is expected to continue to work its way through the beer business results during Q2.

Moving to wine and spirits. Power Brand depletion volume accelerated and achieved 5% growth as these brands continue to win in the higher end and across the majority of price segments in the U.S. wine category. Overall depletion volume declined 1%, reflecting the impact of the brands to be divested. Net sales declined 7% on shipment volume down 13%. The decline in net sales was driven by the following: Lower volume and unfavorable comparison to Q1 prior year due to a very strong quarter last year for the brands to be divested; on-premise and retail tasting room closures throughout most of the quarter as a result of COVID-19; and net sales of the Black Velvet brands are not included in this year's Q1 as a result of its divestiture late last year.

The decline in net sales is an improvement from our Q1 pre-COVID targets we provided for the wine and spirits business during our last sales and earnings call, driven by the strength of some of our fast-moving Power Brands such as Kim Crawford, Meiomi and SVEDKA, and an improvement in some of the brands to be divested such as Black Box and Paul Masson, which saw accelerated and robust consumer takeaway trends during Q1.

Excluding the impact of the Black Velvet divestiture, organic net sales declined at 4%, reflecting shipment volume decline of 9%, partially offset by strong price and mix benefits in the quarter. Operating margin increased 240 basis points to 28.3% as benefits from price and mix, along with favorable SG&A, were partially offset by the Black Velvet divestiture and higher COGS.

In Q1, we saw the benefits of shipment volume mix, driven by Meiomi and Kim Crawford and favorable pricing for Woodbridge and SVEDKA. In addition, we saw lower promotion expense as scheduled incentive programming activities did not occur due to the current operating environment and COVID-19-related closures for the on-premise.

While we expect to continue to see positive price and mix benefits the remainder of our fiscal year, they should temper versus the very strong price and mix results we saw in Q1. Depletion in shipment volume for our Power Brands is expected to temper in Q2 as we do not plan to replicate some lower return incentive programs that ran during our Q2 fiscal '20. However, we plan to shift some programming resources for these brands to the back half of the year to better align with timing for our key selling season for our wine and spirits business.

In addition, we are assuming a Q2 close for the Gallo and other divestiture transactions, which will negatively impact the quarter. Therefore, we're expecting a decline of 25% to 30% in reported wine and spirits sales and operating income for Q2.

Q1 corporate expenses came in at approximately $51 million, up 16% versus last fiscal year. The increase was primarily driven by unfavorable foreign currency losses and an increase in charitable contributions primarily driven by COVID-19 support efforts.

Comparable basis interest expense for the quarter decreased approximately 13% to $100 million primarily due to lower average borrowings. Our comparable basis effective tax rate, excluding Canopy equity earnings, came in at 19.3% versus 18.6% last year, primarily driven by lower level of stock-based compensation benefits this year.

Moving to free cash flow, which we define as net cash provided by operating activities less CapEx. We generated free cash flow of $542 million for the first quarter of fiscal '21. This represents an impressive 24% increase. Cash flow improvements reflect strong operating cash flow and lower CapEx.

CapEx totaled $144 million or 7% below last year's spend. This included approximately $110 million of beer CapEx, primarily driven by the 5 million hectoliter expansion project at our Obregon brewery. While COVID-19 safety precautions slowed expansion activities at our Obregon brewery during Q1, construction activities are ramping back up, and we expect the 5 million hectoliter addition to be completed by the end of fiscal 2021. Let me remind you that with the completion of the Obregon capacity expansion, we believe we will have ample capacity at Nava and Obregon to meet consumer needs over the medium term.

Moving to Canopy. In Q1, we recognized a $197 million decrease in the fair value of Canopy investments. These impacts were excluded from our comparable basis results. The total pretax net gain recognized since our initial Canopy investment in November of 2017 is $112 million. On May 1, we exercised the original warrants with Canopy for $174 million and increased our ownership position by approximately 3% to 38.6%. The warrants were in the money and the amount was manageable from a liquidity and leverage standpoint. We continue to believe in the long term and substantial opportunity in the emerging cannabis market, and we remain confident that Canopy is best positioned to win in this space.

As a reminder, the expiration of future and much larger warrant tranches were extended to calendar years 2023 and 2026. We will evaluate the exercise of each of these warrants prior to expiration as we continue to see how the cannabis industry unfolds in both Canada and the U.S. Furthermore, we do not plan to make any additional cash contributions to Canopy beyond the potential exercise of these warrants.

Now let's shift the discussion to outlook and guidance. Given the unprecedented COVID-19 events that began to abruptly and dramatically impact consumers and the marketplace almost concurrently with the start of our fiscal year, and given the related uncertainty, volatility and fast-moving developments that have evolved during the first quarter of our fiscal year, we still do not believe it is prudent or appropriate to provide formal financial guidance for fiscal '21 at this time. However, let me take a moment to reiterate that in a normalized environment, our medium-term growth algorithm remains unchanged for both our beer and wine and spirits segments.

This is a good spot to discuss our capital allocation strategy. While we remain focused on our goal of returning $4.5 billion to shareholders, in the short term, given the uncertainty of the current environment, we will be focusing on maximizing free cash flow and utilizing that free cash to reduce debt and leverage, creating the flexibility needed to fulfill our $4.5 million (sic) [billion] commitment longer term. As a result, we are moving this goal out to cover the fiscal ’20 to ’23 time frame and the total cash return in the form of dividends and share repurchases to approximately $5 billion as we add another year of dividends into the mix.

In closing, I want to reiterate that our cash generation profile remains strong, our quarterly dividend rate has been maintained, and we remain focused on actively and prudently navigating through the challenging environment presented by COVID-19, and we look to provide updates as more factors become known.

With that, Bill and I are happy to take your questions.

Question and Answer

Operator

— ***Operator Instructions*** — Our first question comes from Bryan Spillane with Bank of America.

Bryan Spillane

So I guess, a question on the wine business and maybe just 2 related. One was – I think you took some price increases earlier this year on Woodbridge and maybe some other brands. So I just wanted to see how the market reacted to that. Whether you feel like you were able to successfully get those price increases through?

And then maybe related, there were some repositioning that you were planning to do in the wine business this year from a brand positioning and marketing increases. And just want to understand if that’s actually happening, if you can still do that in this current environment.

William Newlands

Sure. You bet. So we did, in fact, take price increase on Woodbridge. And I must say, one of the things that has been a benefit of COVID is that – if there are any, is that consumers have continued to buy tried-and-true brands, of which Woodbridge is one. And it was certainly helpful that we put our price increase through concurrently with that. And Woodbridge has actually been outperforming our expectations around the pricing increase throughout the first quarter. So so far, so good. We're going to continue to watch that, as you would expect. But so far, that's gone very well.

I would also say that some of the new product introductions that we have put into Woodbridge have performed, and we're expecting to continue to perform very well. That's a very important brand for us. A lot of the work that we're doing more broadly around our brands is continuing. We've seen a tremendous increase in direct-to-consumer and 3-tier eCommerce, which goes very well to strong brands like The Prisoner and Meiomi and brands of that ilk.

So we're going to continue to put focus on those brands. We think they're very well positioned and those brands are tried-and-true brands in the mind of the consumer, which at the moment, is where the consumer is spending their dollars.

Operator

Our next question comes from Bonnie Herzog with Goldman Sachs.

Bonnie Herzog

I had a question on out of stocks. It's a key summer holiday this week with the Fourth. So hoping you guys could share with us how you feel specifically about the holiday and your supply. Also, maybe love to hear some more color on what you're doing to minimize the disruption for out of stocks. For instance, I've heard from some of the distributors that you're doing drop loads. So I guess I'm trying to get a sense from you how flexible you can be on the production side with all of this.

And then maybe finally, can you touch on how big of a drag some of these shortages and maybe any initiatives you might be taking to minimize the situation? How big of a drag it might be on your margins, if at all?

William Newlands

Sure. Let's start with – our belief is that our operations team is best-in-class. And we are doing everything we can do at the moment to expedite shipments from our breweries through our distribution facilities and out through our distributors to consumers. Certainly, because of the reduced production that occurred during about 70-plus days, mostly in the first quarter, it certainly reduced our ability to ship to normal levels. But let's keep in mind, the demand for our brands, for Modelo and Corona, have never been stronger. We were up almost 20% in the off-premise channel during the quarter. And we're seeing consistent depletion levels as we start Q2 as well. So we are in a very strong position.

Keep also in mind that during the mandated COVID-19 reduction in production, we produced the SKUs primarily that led to 75% of our sales. So while a consumer may or may not be able to buy a particular SKU, in all likelihood, we would expect that a person who wants to buy Modelo or Corona and the brand families associated with those will be able to buy those during the holidays.

Operator

Our next question comes from Nik Modi with RBC.

Nik Modi

So Bill, I know that, obviously, there's a lot of noise in the numbers. And the question – I think the top question most investors have is how long – or what the growth curve for the beer business will look like not only next 6 months, but the next 2, 3 years? So I was hoping maybe you can provide some context on the following 3 points, right? One is number of new households or trial surge that you've seen and repeat rates on those new trials that you've seen since this whole pandemic started. The second point would be, I understand the out-of-stock situation you were able to actually provide products and maybe some packages weren't found, but I'm sure that out of stocks did cost you some sales. So I'm just curious, maybe you can help provide some context on how much the business would have grown on depletions had there been no issue in out of stocks at all.

And then the third point is, obviously, retailers are thinking – rethinking how they think about the shelf, something you guys have been doing for the last 2 to 3 years now. And so how you think this environment might shape or accelerate some of your shopper-first initiatives and more spacing for your brands in retail longer term?

William Newlands

Sure. So let's take it in reverse order. Relative to the shelf, obviously, the one thing that's occurred during this particular time frame is some of the resets that would normally occur have been pushed back as many retailers are focusing their attention on throughput from their existing shelf sets. We think that as they come into the fall season and do fall resets, that this will continue to increase the probability of shopper first. Because I think it's become more and more clear that brands that have strong demand behind them, and ours are 2 great examples with the Modelo and Corona franchises, are demanding more space, and they're demanding more space because the takeout is there against them.

It's kind of difficult to give you a specific example about what we could have grown because you had so many different factors involved in the quarter. Our quarter, of course, started almost concurrent with the pandemic, which was a little different than if you were on a calendar quarter, admittedly. But when you look at the fact that on-premise was effectively closed, but off-premise was up almost 20%, you've got a lot of different dynamics in play there.

As I said earlier, we sincerely believe that the consumer wanting to buy our brands will be able to buy Corona and Modelo. And certainly, the start of Corona Hard Seltzer has also been a real success. We have already shipped in excess of 3 million cases of Corona Hard Seltzer. And as I said in my prepared remarks, the takeaway and repeat has been exceptional.

So one of the things we are seeing relative to your first question in terms of consumer purchasing, about 30-some-odd percent of consumers are actually increasing their consumption of those brands that they are traditionally using. And given the strong representation of our brands, Corona, Modelo, in particular, it's not surprising that you've seen an increase in the takeout demand during this time frame. It goes back to what I said earlier about tried-and-true brands. The same would apply to many of our wine and spirits brands as well. But certainly, the consumer's interest in buying brands in which they have a lot of faith and comfort is working to our advantage.

Operator

Our next question comes from Vivien Azer with Cowen.

Vivien Azer

Garth, I was wondering – thanks for the color in terms of the marketing spend outlook. I was wondering if you could offer any color on how you're thinking about phasing that and whether we might expect something different as you kind of lean into a post-COVID recovery perhaps.

And then a quick follow-up. Bill, I really appreciate your comments at the top of the call, and I'm curious whether you guys are assessing any change to your social media advertising spend.

Garth Hankinson

Yes. Vivien, thanks for the question. As it relates to marketing spend and the phasing of that, I'd say it's still too early to tell exactly what that will be, as we sort of come out of COVID-19, and we don't know exactly when some of these sponsorships and sporting events might get rescheduled. So other than we still believe that we're going to spend in that 9.5% to 10% of net sales for the full year, the phasing is still a little bit up in the air.

William Newlands

So Viv, relative to social media, there's obviously been a lot of discussion around social media. I would say – and let me reiterate what I said earlier. We think it's very important to protect users from misinformation and hate speech. Those things run directly counter to our commitment to social justice and to racial equality. We have decided that we are going to do a comprehensive review of our social media work. And along with that, for the month of July, we are pausing our Facebook engagement until we are able to do a thorough review and to make sure that all of our social media efforts match up with what I just said, which is the commitment to social justice and racial equality.

Operator

Our next question comes from Robert Ottenstein with Evercore.

Robert Ottenstein

Great. Just one point of clarification and then my question. Just can you just break out the price/mix in the quarter and maybe separate out headline pricing from promos? And then my main question really is unbelievable growth, right, in the seltzer category? You're now in the mix, big time with Corona seltzer, which I think you said is 90% incremental. What have you learned about the category now year-to-date? And how big do you think it can be as a percentage of overall beer sales? And what is your latest thought in terms of incrementality to the entire beer category at this point?

William Newlands

So relative to those 2 or 3 questions in there, we continue to have our long-term algorithm, particularly as it relates to beer, of expecting the price will grow 1% to 2% annually. We've done that consistently over time, and we expect that, that algorithm is going to continue.

Relative to seltzer, earlier this year, we said we thought the category, which was roughly 60 million cases last year, could double and probably triple in the long run. If anything, that's starting to look conservative. The consumer certainly enjoys the refreshment characteristics of this particular category. And I think our introduction of Corona Hard Seltzer is a great example of leveraging a tremendously strong brand into a new category.

I think it would be important to not simply lump seltzer in with beer. Given the incrementality that we've seen at roughly 90%, which again, is more than we, frankly, expected, suggest to us that it is not necessarily a direct trade-off with beer. And I think that it has category dynamics that are free and understanding of the run. So our view is that this continues to have a lot of longevity, and we are certainly planning to be a critical part of it. As you know, we've already gotten to #4 in the category with a roughly 6% share. And as you also know, we're just warming up.

Operator

Our next question comes from Lauren Lieberman with Barclays.

Lauren Lieberman

I was hoping you guys could give us a little bit of help on the gross margin bridge this quarter, particularly in beer, then curious across those businesses. I know you mentioned that you'll see some of that going into Q2, the lower production volumes. But I think maybe just a little bit of visibility on the drivers of gross margin this quarter and thinking about how that developed into Q2 would obviously be very helpful?

Garth Hankinson

Yes. So gross margins for beer, we had some drags there as it relates to materials and to fixed overhead absorption. That drag was offset by the Ballast Point divestiture as well as by pricing. Going forward into Q2, we expect that there will be further downward margin pressure as it relates to fixed overhead absorption as we work through the inventory or the slowdown that we had in Q1 at the very beginning of Q2.

At gross margin, we were flattish in gross margin in beer. That resulted in about 240 basis points of improvement at the operating line because of primarily the timing of the marketing spend that we talked about earlier.

Operator

Our next question comes from Sean King with UBS.

Sean King

I apologize if I missed this. But did you provide any update on Mexicali and I guess, the potential options you're exploring there?

William Newlands

We continue to be in discussions with the Mexican government about what our long-range plans are for Mexico. As you know and as we've stated, based on the expansions that we already have in play, our medium term is already set. We believe there's going to be plenty of opportunity. We've spent more than 30 years working very well with the Mexican governments, both local and federally. And we expect that to continue, and we expect to have a strong long-range solution for our continuing supply for the long run. So I don't have anything new to report on Mexicali, other than to say, we fully expect to be able to service our needs for the long run.

Operator

Our next question comes from Dara Mohsenian with Morgan Stanley.

Dara Mohsenian

So first, just a clarification. You mentioned depletion levels in Q2 in beer so far consistent with Q1. Is that versus the reported 5.6% depletion result? Or is that more 7% on a days adjusted basis?

And then just on Corona Hard Seltzer. With the strong repeat rates you mentioned, can you give us a sense for what share level you think that brand can ultimately reach within the hard seltzer category? And also what distribution level would be reasonable to expect that brand to get to?

William Newlands

Sure. Let's start with the hard seltzer question. We already are seeing ACV distribution and IRI channels of approximately 65, which is very strong, especially given the fact that, as I said earlier, many retailers are not doing the resets that they had planned for the earlier part of this year. It remains to be seen what our long-term scenario looks like. We're already about 6%. As you know, we've only introduced so far in variety pack. We would expect to extend beyond just variety pack later this year and into the following years. So we're very optimistic that we're going to have an important part of the seltzer category and certainly would expect to be in the top 3 overall within that category going forward.

Operator

Next question comes from Kevin Grundy with Jefferies.

Kevin Grundy

Congrats on the strong quarter. Just to follow-up on the last question. Bill, I'm not sure there's clarity on where depletions were running for Q2, if it was closer to 7% on a selling day adjusted basis. So some clarity there, I think, would be helpful for folks.

And then more broadly, maybe you can just comment on the biggest variables impacting your decision to withhold guidance and the context being particularly strong start to the year, it sounds like June is off to a good start. Bill, you commented the portfolio has never been stronger. We're seeing that in really strong Nielsen data. Production is ramping at breweries. You've had the strong start to the second quarter. Commodity is still relatively benign, enough confidence to deploy some cash for a small wine deal, kind of putting this all together. And then in addition, the company is obviously very adeptly managing through this very sharp and unprecedented channel shift. So with all of that said, comment on the biggest swing factors here that leave the company a little bit reluctant to provide guidance at this point.

William Newlands

Okay. Thank you. I might quote some of you. Some of those things that you just said, that was quite nice. And first of all, I need to apologize to Dara. I did not answer the same question a minute ago, and I apologize for that. Relative to depletions, our view is, is that the second quarter, specifically starting in June, is looking fairly consistent with what the nonadjusted amount would be. And if the takeout continues to be strong, all you have to do is look at IRI and Nielsen every week, and you see that the takeout is strong.

Look, here's the issue around guidance. If anybody would have said in February that we would have gone through what we just went through over the course of a quarter, you wouldn't have believed us. And while – excuse me, on-premise was off 75% in the first quarter, a little more actually in wine and spirits. You started to see some openings, which saw a decrease to an off sort of 40% plus for a brief period of time. Now we're turning around and we're seeing closures, again, in Arizona, in Texas and Florida. So it is very difficult in this particular environment to be able to predict. What we are anxiously looking for, and I would suggest that all of you would want to look for is, how are brands performing given there are going to be spits and spurts in the marketplace. And our brands continue to perform extremely well. There's going to be a lot of volatility this year, and ability to predict is very challenging admittedly. But I think those brands that are tried and true, that have strong consumer pull-in demand, as I stated earlier, we are seeing a significant portion of our existing consumer base buying more than they had done historically. That speaks to strong brands.

And I think that when we are through this pandemic scenario that has been very hard to predict, we believe we will be right back on our longer-term beer sales trends of 7% to 9% growth, which is what I'm sure many of you are interested in. And certainly, every – all signs point to the fact that our long-term algorithm is unchanged.

Operator

Our next question comes from Andrea Teixeira with JPMorgan.

Andrea Teixeira

I have a question and a clarification. On the question, can you give us an idea of the cadence of the beer depletions for the quarter, especially [as you exited] May and now in June. I think you – Bill, you said kind of the 5% to 6% would be the nonadjusted number for June. But I was wondering what happened in the previous quarters. And then that situation in June is probably because you went out and the stock-outs that you mentioned before.

And if you can give us an idea of the 75% decline in terms of the cadence that you had. I'm assuming that would be much worse in May than it was in the beginning of the quarter, that will be helpful.

And the clarification on the wine guidance for the second quarter. You said sales and EBIT down – Garth had said down 25% on a year-over-year basis. Is that an organic number or you incorporate some of the impact of the divestitures closing during the quarter?

William Newlands

Yes. So I'll take the second part.

Garth Hankinson

I'll take the wine [experience one first]. So the down 25% to 30% really does take into account largely the wine divestiture. We didn't expect – since we're now anticipating or expecting to close that in our Q2, we're not expecting to ship much of the divested brands during our Q2.

And then furthermore, we are expecting on our Power Brands to have depletions slightly down as we don't replicate some promotional and shipping activity that really was non-productive.

William Newlands

And going back to your question about how we think about the month. I think your question is a perfect example of why we have not given guidance because it is very, very difficult to predict. I mean in the beginning of March, on-premise looked fairly normal. By the time we got to the end of the quarter, the first quarter, it was off 75%. I mean as good as Garth is in predicting, he couldn't have predicted that answer. So – and now we are seeing some marketplaces going back to closure or to significantly reduce volume in restaurant and pub scenarios.

So it is just very challenging for us to put an exact number on how it's going to flow. If you could tell me how the pandemic would play out, we could give you a much better answer. But as we see, on almost daily basis on the news, it's impossible to predict exactly what the pandemic is going to do, which is why we continue to go back to the scenario that says we have extremely strong brands, and our brands are outperforming in the marketplace and in the channels that are open to us, and that's how we will continue to judge our success.

Operator

Next question comes from Bill Chappell with SunTrust.

William Chappell

Just a follow up on the marketing spend. I'm trying to understand how you're looking at it. As you said, some events like the NCAA tournament have been canceled. There could be a case where you're advertising at the World Series and the NBA Championship at the same time. So how do you look at the spend for the back half of the year, especially around sports spending when a lot of it's going to concur? And it seems like it would be very duplicative to advertise all over the place.

William Newlands

Well, you're right. It's more challenging than it would usually be. And as Garth pointed out in his remarks, the first quarter was a great example as there weren't a lot of live events and many of the things on which we normally advertise, like using the NBA as an example, just didn't exist. So we are going to be focused in real-time on where we can implement our marketing spend.

What I think is most important overall, as Garth noted, we still expect to spend between 9% and 10% on our marketing of our brands. When you look at historical results of companies that continue to spend in recessions, and admittedly, we're in one, or we're about to be in one, those companies that continued to support their brands came out the back end even stronger. We believe in that, and we're going to continue to spend. As you point out, that will mean some real-time adjustments as we go because admittedly, it's been very tough to predict what will, in fact, occur and when it will occur as you're seeing with things like the baseball schedule, which has moved all over the place in terms of number of games and how they're actually going to exercise those. Same is true in basketball, same is true in many of the live activity.

So the reality is we will be doing this in real time. But it doesn't change our intent, which is we are going to spend against our brands to make sure they are top of mind in the consumer's view.

Operator

Our next question comes from Steve Powers with Deutsche Bank.

Stephen Robert Powers

Actually, I want to pick up on that train of thought in terms of just an update on how you're assessing any implications of recessionary economic conditions on your categories and brands. I mean, so far, as you highlighted, the premiumization trends have continued and nicely so, but do you see any risk coming – of that coming under pressure, even if temporary, whether in beer or wine and spirits? And just what are you watching most closely to keep tabs on that as conditions develop?

William Newlands

Certainly. As you would expect, we watch things like unemployment rates. We are overdeveloped, as you know, with the Hispanic community. And the unemployment rates in the Hispanic community have been significantly higher than the average unemployment rate in the marketplace today, although all of it's in double digits. So that's something that we watch very carefully.

Again, at the same point, the brand awareness, brand loyalty of our brands within those communities are very strong. But we watch those things very, very carefully. Certainly, one of the other things that you see – and I think it's been exacerbated in the pandemic because of people sheltering, as people look for those small moments of joy in their lives, and fortunately, our brands can often offer those to people.

So we think that the strength of our brands, in conjunction with people engaging more at home than they would naturally and normally do, will be important to the continued success of our business, albeit, we're watching a lot of those characteristics like unemployment very carefully.

Operator

Our next question comes from Laurent Grandet with Guggenheim.

Laurent Grandet

So I'd like to come back to the wine divestiture to Gallo. It looks like, I mean, the $250 million earnout is based on volume depletion performance in fiscal year '20 and '21 versus fiscal year '19. And if I read it correctly, in depletion orders between minus 10% for the payment to minus 2% for 100% payments. So could you please tell us, as we're kind of almost in the middle of it, the current volume depletion performance of the portfolio brands you're planning to divest to Gallo?

Garth Hankinson

Yes. Thanks for the question. And what I would tell you is that the earn-out portion of that transaction is really based on the 24 months after we closed the transaction. So we'll measure how those brands are performing at the end of year 1, and then again, at the end of year 2. Those brands have benefited recently by what Bill has described is the change in consumer behavior or the shift in consumer behavior toward these tried-and-true brands or back to tried-and-true brands.

And so some of the brands that we're divesting to Gallo has actually recovered quite nicely and that portfolio of brands is performing much better than it was a year ago at this time.

So we feel is that, as we transition that portfolio of brands to Gallo, that they're in a very good position and they're in good state of health that we've got a very good chance of getting into that or not in a meaningful way.

Operator

Our next question comes from the line of — ***indiscernible*** — with MKM Partners.

Analyst

And then you'll have to forgive me, I'm still a bit confused. Did you say June beer shipments are roughly minus 7%? Or are you saying June is down a bit more than minus 7% and July and August will help make up for it to get the total quarter beer shipments to minus 7%?

William Newlands

We didn't comment on shipments at all. We talked about depletions. As we've said, we have ramped up our production during June to normal levels, which will allow us as subsequent quarters. My personal suggestion would be that many of you think about the first quarter and the second and the third as – in combination. Because as our production has ramped up, you will see some continuing stress on the shipment side of our business during Q2, but – and then we would expect depletes to outperform ships during the quarter with a lot of that flipping as you go to the latter part of the year. Again, it still goes back to our long-range algorithm around beer being up 7% to 9% is very consistent. We expect that in the long run. And we feel this short-term pandemic blip as being just that, a blip in our long-term success.

Operator

Thank you. And I'm showing no further questions at this time. I'd like to turn the call back over to Bill Newlands for closing remarks.

William Newlands

Great. Thank you. Thanks, everybody, for joining our call today. Despite the challenges and an extremely volatile environment that we're concurrent with the start of our fiscal year, we delivered solid performance and strong cash flow generation during Q1, which provides us with great momentum as we head into our key summer selling season.

Let me reiterate that the short-term production disruption to our import beer business that we experienced during Q1 does not hinder our long-term outlook as consumer demand and takeaway for our brands remains extremely robust in the channels that remain open. And we remain optimistic about our outlook for the remainder of the fiscal year.

In closing, I'd like to wish everyone a happy Fourth of July, and hope that your celebrations with your family and friends includes our fantastic beers, our wines and our spirit products. Thanks, again, everyone. And please have a healthy and safe summer season.

Operator

Ladies and gentlemen, this concludes today's conference call. Thank you for participating. You may now disconnect.