Constellation Brands Inc, Q3 2016, Earnings Call 2016-01-07

Presentation

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the Constellation Brands Third Quarter FY ’16 Earnings Conference Call. — ***Operator Instructions*** —

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

Patty Yahn-Urlaub

Thank you, Lori. Good morning, everyone, and welcome to Constellation’s conference call. In addition to our third quarter fiscal ’16 results and outlook, we will also discuss our Mexicali and Nava Brewery projects and their related outlook.

I’m here this morning with Rob Sands, our President and Chief Executive Officer; and David Klein, our Chief Financial Officer. This call complements our news release, which has also been furnished to the SEC.

During this call, we may discuss financial information on a GAAP, comparable, organic and constant-currency basis. However, discussions will generally focus on comparable financial results. Reconciliations between the most directly comparable GAAP measure and these and other non-GAAP financial measures are included in the news releases or otherwise available on the company’s website at www.cbrands.com.

Please also be aware that we may make forward-looking statements during this call. While those statements represent our best estimates and expectations, actual results could differ materially from our estimates and expectations. For a detailed list of risk factors that may impact the company's estimates, please refer to the news releases and Constellation's SEC filings.

— ***Operator Instructions*** — Thanks in advance, and now here's Rob.

Robert Sands

Thanks, Patty, and good morning and happy new year to everybody. I hope you enjoyed the holidays and had the opportunity to include some of our fine Constellation products in your celebrations with family and friends.

Welcome to our discussion of Constellation's third quarter fiscal 2016 sales and earnings results. Before we get started with a review of the quarter, I am pleased to report that we posted another year of exceptional stock price performance, with Constellation's stock increasing more than 45% for calendar year 2015 versus the S&P 500, which declined 1% for the year. This is the fourth consecutive year that Constellation was one of the best-performing stocks in the S&P 500 Consumer Staples Index. I believe this excellent stock price performance is being driven by our strong financial results, led by our beer business, which has incredible momentum and strong prospects for future growth. It is because of this tremendous growth opportunity that we are making smart investments now to ensure that we have the capacity, quality, control and flexibility to help us meet expected demand for our iconic beer brands well into the future.

These investments include the construction of a new state-of-the-art brewery in Mexicali, Mexico. Details of our plans were announced earlier this morning. Initially, this brewery will be built to operate at 10 million hectoliters of production capacity, with future scalability to 20 million hectoliters. The Mexicali location is ideal given its close proximity to the State of California, Constellation's largest beer market. The new brewery is being built with similar technology and operational advancements as our Nava Brewery, and is designed to ensure consistency in brewing and production processes with the highest level of product quality expected between the 2 facilities.

Let's take a moment to discuss the progress at our Nava facility, which had production capacity of 10 million hectoliters with the ability to expand at the time we acquired it. As previously discussed, we currently have work underway to expand Nava to 25 million hectoliters by the summer of calendar 2017 via 3 incremental 5-million-hectoliter expansions.

In addition to our plans to build the Mexicali brewery, we also announced today that we have plans to further expand Nava with a 2.5 million hectoliter capacity expansion that will bring production from 25 million to 27.5 million hectoliters when completed in early calendar year 2018. Now I'm pleased to report that, as expected, our first incremental 5 million hectoliters of Nava production capacity recently became operational and is in the process of ramping to optimal capacity utilization levels. We now have 15 million hectoliters of functioning brewing capacity at Nava. Two packaging lines have been running to support this new brewing capacity, and ramp-up to full utilization is expected shortly for these lines, which will provide additional capacity for premium-class products like Modelo Especial and Coronitas.

The second incremental 5 million hectoliters of new brewing capacity at Nava is underway, with this piece of the expansion to be expected to be completed by June of this year. And work continues on the third expansion phase, as we increase Nava production capacity from 20 million to 25 million hectoliters and continue to expand the rail and logistics capability around the site, with completion expected by the summer of calendar 2017.

As these expansion activities continue, we have worked with ABI to extend the Interim Supply Agreement we currently have in place for finished goods in order to support our robust growth and enable a smooth transition as we increase capacity. This agreement is expected to remain in place through June of 2017 for a select number of products that are expected to represent about 15% to 20% of the company's needs for the U.S. marketplace. Overall, we remain on track with all expansion activities, but I'm excited to be in a position to continue investing in Mexico and enhancing our operational platform to support the industry-leading growth levels of our incredible beer business.

Our additional investments in production capacity are designed to ensure that we are well positioned to capture the continued momentum and growth opportunities we see in the high-end segment of the U.S. beer market, which has consistently grown in the mid- to high single-digit range and is expected to grow at these levels into the foreseeable future.

Our third quarter beer results are a testament to this momentum. As we achieved depletion growth of more than 16%, leading volume gains amongst all U.S. brewers and outperforming the U.S. beer industry, key competitors and all other imports with double-digit growth achieved by nearly every brand, every brand in our Mexican beer portfolio.

Corona Extra posted accelerating depletion and consumer takeaway trends during the quarter by gaining distribution for key packages, accelerating velocities behind investments in media and merchandising and continuing to grow the can format, which represented nearly 25% of the growth of the Corona Extra brand during the quarter.

Marketing initiatives for the brand included Corona Football with Jon Gruden, 2 major boxing matches, general market and Hispanic TV advertising throughout the fall football tailgating season and the airing of the O' Tannenpalm holiday spot for the 25th consecutive year.

Modelo Especial also delivered accelerating depletion growth of more than 20% during the third quarter, with all core Especial packages growing double digits. This brand's media investments included the continuation of Modelo Especial's national English-language TV and video campaign, with the addition of sports programming during the start of the

NFL season across CBS, Fox, ESPN and ESPN2. And national Hispanic media continued throughout the quarter with weekly TV exposure to Spanish-language consumers.

Now given some of these marketing highlights, it's important to note that the beer team was recently recognized by earning a top spot on Ad Age's 2015 Marketers' A-List. Constellation is the only beer, wine and spirits company to make the list, and I am very, very proud of this accomplishment.

Collectively, these activities resulted in Modelo Especial becoming the #1 dollar-share gainer amongst established U.S. beer brands in the IRI channels during the third quarter, followed by Corona Extra as the #2 share gainer. Overall, the strong results that the beer business achieved in the third quarter are the primary driver of the upward revision to Constellation's EPS guidance for fiscal 2016. David will have more to say about this in a few moments.

When you put all of these pieces together, the exceptional growth of strong consumer demand for our Mexican beer brands, the exciting opportunity to invest in Mexico to expand our brewery operations and the on-schedule progress we are making to meet our expansion goals, it is clearly an exciting time at Constellation, where the opportunities to build upon our growth as a leader in the high end of the U.S. beer segment keep getting better and better.

As you know, we acted upon another such opportunity for the future growth when we entered the U.S. craft beer market with the acquisition of Ballast Point, one of the most awarded major craft breweries in the industry. Ballast Point provides a high-growth premium platform that will enable Constellation to compete in the fast-growing craft beer segment, further strengthening our position in the high end of the U.S. beer market.

Now Ballast Point is currently growing at more than 125% in IRI channels, and remains on track to sell nearly 4 million cases and generate approximately $115 million in net sales for calendar 2015, representing growth of more than 100% versus the prior calendar year. I am pleased to welcome the Ballast Point founder, Jack White, and the entire Ballast Point team to Constellation.

And now I would like to discuss the business results for our wine and spirits business. In our wine and spirits business during the third quarter, we achieved earnings growth and strong margin expansion, driven primarily by the Meiomi wine acquisition as well as favorable mix and COGS trends. As I mentioned last quarter, we have successfully integrated into – our new Meiomi wine brand into our existing wine portfolio and our efforts to expand distribution are working to drive incremental growth for the brand. As a matter of fact, the most recent IRI trends corresponding with our quarterly results show that the Meiomi Pinot Noir is growing more than 80% in IRI channels, a trend which has accelerated since we first acquired the brand this past summer.

Third quarter depletions for the brand were also strong across all channels, growing more than 50%. Meiomi Pinot Noir is one of the hottest wines of the year, listed as #20 in the Wine Spectator's Top 100 Wines for 2015 and #1 on wine.com's Top 100 List, which is based entirely on consumer preferences. We believe the brand has plenty of room to continue driving healthy growth for our business. Just this quarter, we began shipping the 2414 vintage – 2014 vintage of Meiomi Chardonnay, following the success of the 2013 Chardonnay in the marketplace.

Our Mark West brand is also known as a leader in the premium Pinot Noir category, and we are pleased to announce that the new line extension, Mark West Black, is now shipping. This higher-priced tier of the Mark West brand welcomes consumers to the dark side of Pinot Noir, with a more full-bodied and rich taste profile.

Now one of our newer brands, Tom Gore Vineyards, has been gaining consumer acceptance for its high quality and authentic second-generation grape farmer brand story. It has also been featured in publications like Wine Enthusiast, celebrating wine around the world, and the Wall Street Journal's My Ride Series. Our Focus Brands are gaining, again driving positive results for the quarter in our wine and spirits portfolio, led by brands like Woodbridge by Robert Mondavi, which is America's favorite Cabernet, holding the #1 Cabernet Sauvignon position with the highest dollar and volume sales.

Other Focus Brand leaders include Kim Crawford, which was named #1 – or #11, I'm sorry, on wine.com's Top 100 Wines of 2015; and The Dreaming Tree, which launched its Pinot Noir varietal earlier this year.

Our luxury brand and tiers continue to maintain their reputation for excellence among the critics, with outstanding reviews, rankings and 90-plus scores for our brands like Robert Mondavi Winery, Simi and Mount Veeder, from publications like the Wine Spectator, Wine Enthusiast and Wine & Spirits. During the quarter, our spirits portfolio posted net sales growth of 2%, driven by Paul Masson Grande Amber peach flavor as well as SVEDKA Vodka Mango, Pineapple and Strawberry Lemonade flavors.

Casa Noble Tequila is exceeding our expectations so far this year with continuing share gains, and was recently awarded a 94-point score in the Wine Enthusiast and a Top 10 Best Tequila designation by liquor.com.

In closing, it is certainly shaping up to be yet another eventful year at Constellation. With the year quickly drawing to a close, I am very pleased with our progress to date. Our efforts have produced a year of strong financial performance, notable business and brand milestones, industry accolades and healthy growth within several areas of the business. I am particularly pleased that we have finalized our investment plans in Mexicali, Mexico, to support the future growth we see within our beer business. And we are working diligently on the Nava Brewery and glass plant expansions while maintaining the strong momentum of the commercial side of the beer business.

In calendar 2015, amid all of our hard work and accomplishments achieved throughout the year, we also celebrated the 70th anniversary of our company founding. While we are proud of our most recent accomplishments, taking a longer view of our 70-year heritage gives us perspective of how far we have come, and even greater resolve to continue challenging our own expectations as we look forward to the next 70 years.

With that, I would now like to turn the call over to David Klein for a financial discussion of our third quarter results.

David Klein

Thank you, Rob, and good morning, everyone. Let's start with some Q3 highlights. Comparable-basis diluted EPS was up 15%. Stellar execution by the beer business drove strong marketplace and financial results for the quarter. The strong beer performance, along with some slight favorability in our tax rate and better-than-expected Meiomi results, are driving our full year fiscal '16 comparable-basis diluted EPS projection up to a range of $5.30 to $5.40 versus our previous guidance range of $5 to $5.20.

Operational activities related to bringing new capacity online at Nava continue to progress as planned. And the beer business performance, timing of capital expenditures related to the Nava expansion and lower-than-planned income tax payments are helping to increase our fiscal '16 free cash flow projection to a range of $475 million to $525 million versus our previous range of $200 million to $300 million.

In addition to our quarterly results, we recently completed the Ballast Point craft beer acquisition. And this morning, we outlined our plans to build a new 10-million-hectoliter brewery in Mexicali, Mexico, and further expand our Nava Brewery.

Let's take a closer look at all of this activity, starting with our Q3 results, where my comments will generally focus on comparable-basis financial results.

Consolidated net sales on an organic constant-currency basis grew 6% for the quarter. We continue to see robust marketplace momentum for our beer business with depletion growth coming in over 16%. Beer net sales increased 8% on volume growth that came in a little under 7%. Beer net sales growth for the quarter was impacted by the overlap of a shift of approximately 2 million cases and $37 million of net sales from Q2 fiscal '15 into Q3 fiscal '15 related to the beer product recall. In addition to that activity, wholesalers also increased their inventory position during the third quarter of fiscal '15 to bring inventory more in line with historical levels.

Given the Q3 fiscal '15 overlaps just mentioned, it is worth noting that beer net sales growth for the first 9 months of fiscal '16 totaled 11%, and we now expect full year fiscal '16 beer net sales growth to be in the range of 12% to 14%.

Wine and spirits net sales on an organic constant-currency basis increased 3%. This primarily reflects favorable mix across the business. As mentioned by Rob, Meiomi continues to demonstrate excellent marketplace momentum, as the brand generated approximately $35 million of incremental sales during the quarter.

For the quarter, consolidated gross profit increased $89 million, up 13%, with gross margin increasing 280 basis points. Beer gross profit increased $58 million, primarily due to volume growth, favorable pricing and lower COGS. Our beer gross profit margin increased 360 basis points to 48.9%.

Wine and spirits gross profit was up $31 million. This primarily reflects the benefit from the Meiomi acquisition, favorable mix and lower COGS. Wine and spirits gross profit margin increased 190 basis points to 43.6%.

Consolidated SG&A for the quarter increased $29 million. This reflects marketing investments made by the beer and wine and spirits businesses. Corporate expense was up due primarily to an increase in payroll-related taxes associated with employee stock option exercises, higher incentive compensation expense and investments to support the growth of the business, including the establishment of our Chief Growth Officer function.

We continue to expand margins across the business, as consolidated operating income increased $61 million and consolidated operating margin improved 210 basis points. Beer operating margin increased 360 basis points to 35.1%, and wine and spirits operating margin improved 170 basis points to 27.5%. Equity earnings increased $6 million due to strong results for Opus One.

Interest expense for the quarter was $76 million, down 12%. The decrease was primarily due to lower average interest rates. At the end of November, our debt totaled $7.4 billion. When factoring in cash on hand, our net debt totaled $6.9 billion, a decrease of $326 million since the end of fiscal 2015. This primarily reflects our free cash flow generation, partially offset by the funding for the Meiomi acquisition.

Our net debt to comparable-basis EBITDA leverage ratio came in at 3.5x at the end of Q3. Even with the funding of the Ballast Point acquisition, we expect to end fiscal ’16 below the 4x level. Additionally, we continue to expect fiscal ’16 interest expense to be in the range of $310 million to $320 million.

Our effective tax rate for the quarter came in at 32.3% compared to 29.2% last year, which reflected the benefit of certain tax credits. We now expect our full year tax rate to approximate 30%.

Now let’s review free cash flow, which we define as net cash provided by operating activities less CapEx. For the first 9 months of fiscal ’16, we generated $578 million of free cash flow compared to $209 million for the same period last year. Operating cash flow totaled

$1.1 billion versus $750 million for the prior-year period. This increase was primarily generated by the beer business. Given higher projected earnings for the beer business and lower projected income tax payments, we now expect to generate operating cash flow in the range of $1.35 billion to $1.45 billion for fiscal ’16. CapEx for the first 9 months of fiscal ’16 totaled $514 million and was slightly below our CapEx spending from the same time frame last year.

While our initial 10-million-hectoliter expansion at Nava continues to progress as planned, payment timing for some of the capital expenditures associated with this activity has shifted into fiscal 2017. In a few moments, I will outline the CapEx requirements we are targeting for the new Mexicali brewery and the additional 2.5-million-hectoliter expansion at Nava.

Even with the incremental capital expenditures projected from these initiatives, we are decreasing our total capital expenditure estimate for 2016 to a range of $875 million to $925 million versus our previous guidance of $1.05 billion to $1.15 billion for fiscal ’16. Due to the factors just mentioned, we now expect fiscal ’16 free cash flow to be in the range of $475 million to $525 million.

Now let’s move to our full year fiscal ’16 P&L outlook. As discussed earlier, we are increasing our comparable-basis diluted EPS projection to $5.30 to $5.40. Our fiscal ’16 comparable-basis guidance excludes comparable adjustments, which are detailed in the release.

For the wine and spirits business, we continue to expect organic net sales and operating income growth to be in the low to mid-single-digit range. Meiomi’s volume performance has exceeded our initial expectations, and we now expect fiscal ’16 diluted EPS accretion from this acquisition to be around $0.07 to $0.08 versus our previous $0.03 to $0.04 accretion projection. The beer business is the primary driver of our diluted EPS guidance increase. We now expect volume growth of 10% to 12%, net sales growth of 12% to 14% and operating income growth in the range of 22% to 24% before any benefit from the Ballast Point acquisition.

We closed the Ballast Point acquisition in December. We funded the $1 billion purchase price with a combination of net proceeds from the issuance of $400 million of 4.75% senior notes due in 2025, borrowings under our accounts receivable securitization facilities and cash on hand. For calendar 2015, Ballast Point is expected to sell nearly 4 million cases and generate approximately $115 million in sales. On a comparable basis, the acquisition is expected to be neutral to diluted EPS for fiscal '16 and $0.05 to $0.06 accretive for fiscal '17.

Our current beer segment guidance has us targeting a beer operating margin of approximately 34% to 35% for fiscal '16. The improvement versus our previous 34% target primarily relates to Q3 benefiting from lower depreciation as well as lower line commissioning and optimization costs than originally anticipated. Now that this incremental capacity has become operational, we expect these costs to ramp up in the fourth quarter.

We are pleased that we have already achieved our mid-30% operating margin goal for our beer business. We expect the beer operating margin to continue to run in the mid-30% range over the next 1 to 2 years, as we still have much to accomplish at Nava, and expect some margin volatility as we bring online and optimize new capacity. As Rob mentioned earlier, we have extended the Interim Supply Agreement with ABI to ensure a smooth transition as we increase capacity. This could temper operating margin expansion in fiscal '17, as utilization at Nava will likely run below the utilization targeted before the extension of the supply agreement.

Speaking of capacity, Rob also outlined our plans to build a new 10-million-hectoliter brewery in Mexicali and further expand capacity at our Nava Brewery. In the press release we issued this morning, we included a table summarizing the collective investments we are making in our Mexican operating platform. Let me provide a few highlights around the capital expenditures associated with this activity, starting with Nava.

The additional 2.5 million hectoliters we are adding to Nava is estimated to cost approximately $250 million. This, combined with our previously announced Nava Brewery and glass plant expansion projects, puts our total targeted Nava capital expenditures at $2.5 billion. After fiscal ’16, we expect to spend $1.1 billion over the fiscal ’17 and ’18 time frame, with most of that occurring in fiscal ’17.

The new 10-million-hectoliter Mexicali brewery is expected to cost $1.5 billion. And the associated land, water rights and infrastructure and other site requirements to accommodate scalability to 20 million hectoliters is estimated at $500 million. For this total $2 billion investment, we expect some initial spend to occur in fiscal ’16, a little over half of this spend to come in fiscal ’17 and ’18, and the remaining spend to happen in the fiscal ’19 to fiscal ’21 time frame.

Given the strong demand we see for our beer portfolio and our best-in-class margin profile, the investments I just outlined are expected to generate high returns with a fast payback. Even with the capital requirements associated with these initiatives, our strong projected earnings and operating cash flow will allow us to operate below our targeted 4x leverage range and continue to provide us with significant capital allocation flexibility.

With that, we are happy to take your questions.

Question and Answer

Operator

— ***Operator Instructions*** — Your first question comes from the line of Dara Mohsenian of Morgan Stanley.

Dara Mohsenian

So it's obviously been a great couple of years here on the beer business with steady acceleration. I was hoping maybe you could take a step back on the Modelo Especial brand, which has driven a lot of the growth, and peel back how much of that growth has been driven by distribution expansion in the last couple of years versus organic sales growth per distribution point. And then more importantly, how sustainable is that as you look going forward over the next few years in both buckets, and particularly in terms of how much distribution expansion is left for the brand?

Robert Sands

Yes, Dara. Clearly, it's been both. It's been both distribution expansion as Modelo Especial has, I would say, migrated to the general market and as, of course, we have begun our general market advertising for the brand, and velocity has also increased. So I think that there's plenty of room left for Modelo Especial distribution expansion. It does not have the ACV of, say, Corona Extra. Right now, the ACV on Modelo Especial is about 65%. So we see lots of room for continued expansion in both distribution, and we see opportunity for expansion of velocity, i.e., sales per point of distribution, as the brand continues to gain momentum with general market consumers. So this is a real growth story for beer, in general, not only just for Constellation Brands. I mean it's a phenomenon.

Dara Mohsenian

Okay. And then on the Corona brand, that's obviously accelerated nicely this year – or last year, I should say now. Cans are driving a big piece of that, but it looks like glass is also doing very well, and even more so, probably, if you assume some can cannibalization on it. So I was just hoping for an update on what's driving the overall brand acceleration in your mind over the last few quarters here. Is it mainly cans? Or do you think there are other factors behind it, and the sustainability of those factors going forward?

Robert Sands

Well, cans only, I think, represented about 25% of the growth of Corona Extra. So I shouldn't say only, it did represent a significant portion of the growth. But clearly, cans has been very important, but probably more importantly is our continued increased investment in the brand behind our marketing activities as well as investments in SG&A, basically our sales organization as well. So we're investing, I would say, even ahead of the growth on Corona Extra. And we're investing very effectively, probably more importantly in the brand. I've talked about the consistency of our advertising. Clearly, that advertising and marketing is – it works. And therefore, when we do invest more, we see the results of those investments. So it's a very strong brand with a very strong marketing campaign behind it.

Operator

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

Judy Hong

So a couple of questions. First, just on the brewery capacity expansion. So if I think about the expansion you're doing for the next few years, by end of calendar '19, it looks like you'll be getting to about 32.5 million hectoliters, which implies a CAGR of around sort of mid-teens level. So I was just hoping to sort of get your color just in terms of how this jives with your volume outlook over the next few years. And to the extent that if you see some changes in terms of that trajectory, how much flexibility do you have to either expand more quickly or scale back on that expansion?

Robert Sands

Yes, so the only thing I would say about that, and I'll let David comment in more detail on it, is that that's maximum capacity, okay? No one runs breweries flat out 24/7, so I don't think that you can take those numbers and just assume that we're going to utilize

100% of the capacity. In fact, an important element of our brewery expansion is to make sure that we have the total capacity, okay, to run these breweries at, I would say, more normalized production levels as opposed to absolutely flat out, which isn't the best way to run a brewery. So David, did you want to comment more on that?

David Klein

Yes, I would say from a growth rate perspective, Judy, we're still focused on the high single-digit kind of growth rate that we're seeing in the high-end beer business as being applicable to our business, right? So that's point one. So we're not expecting outsized growth beyond the high end of the beer business in order to support the capacity we're putting in. And I would say the second thing is that having the capacity in a redundant facility on the West Coast closest to our biggest market is actually very important to us and, in and of itself, generates a return.

Judy Hong

Okay. And then the second question is just on your Ballast acquisition and just broadly your craft beer strategy. So on the craft – on the Ballast acquisition, I think some people have looked at the $1 billion price tag in the context of the current volume size and thought it was the high end of some of the recent deals. So if you can sort of give us your view of why that price tag was appropriate and the growth opportunities, perhaps beyond maybe even distribution expansion, that you see with Ballast. And then more broadly, if you think about your ambition to really get bigger in the craft beer industry, do you think that you would have to have more collection of some of the more regional brands and expand distribution or more of a large-scale kind of brand like Ballast and just getting more scale with that brand?

Robert Sands

Yes, so purchase price and size of the brand. First of all, the purchase price is not related to the size of the brand. It's related to the growth percentage and the size of the brand, okay? So obviously, the multiple that we paid for it in relationship to the growth is actually a pretty reasonable purchase price, right? As you recall from my initial comments, the brand grew over 100% this year and 125% in IRI. So when you look at purchase price and multiple as a function of growth rate, it's pretty reasonable. And we don't see that growth rate changing much in the short term, so we expect another pretty robust year with Ballast Point. Also, you've got to realize that Ballast Point has the highest average retail selling price basically of any significantly sized craft, right? If you go buy some Ballast Point, you're going to see that Ballast Point sells for around $15, $16 a six-pack, okay, versus competitors that you'll see at under $10 or just a bit over $10 a six-pack. So it's a very, very high-growth, high-margin product. Now our strategy with Ballast Point is actually pretty simple, and it's why we were so particularly interested in the brand, which is our strategy is we don't really have to do too much other than what they're doing right now. The key to Ballast Point is maintaining the growth, and I think the maintenance of the growth is going to be a function of maintenance of sort of the award-winning stature and high quality of the brand. It's a very sought-after product. All of the people that had been involved in making Ballast Point what it is today continue. That's Jack White, the founder; it's Jim Buechler, the CEO. All of these people are brewmasters. The incredible group of people that we have there, continue to be 100% behind the brand and have continued very enthusiastically with Constellation. Part of the motivation for them wanting to sell the business to Constellation was, of all the buyers, they saw Constellation as the best fit because of our incredibly strong position in the beer industry and the fact that we are only a high-end beer manufacturer and seller as well as being in the high end of the wine business, which makes us a completely different animal, okay? We're not big beer, okay, in the sense of one of – being one of the 2 U.S. premium domestic producers. So the strategy with Ballast Point is all about continuing to do what the company has been doing and, I would say, bringing incrementally to that some of the areas where I think that Constellation can be a help – of help. And that would be with major key accounts and, I would say, other places where a smaller company wouldn't necessarily have the ability to play right off the bat.

Judy Hong

Okay. It's $18.99 per six-pack in Manhattan, but I hear you on the pricing point.

Operator

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

Mark Swartzberg

Congratulations. And also to the Crown team, very impressive trends here. I guess, 2 questions.

Robert Sands

Thanks, Mark.

Mark Swartzberg

Rob, 2 questions. One is just as you think about the third quarter depletion number of plus 16% and change, obviously a great number. Is there anything in that number that you think is unique to the quarter, either weather or some particular practice you engaged in that would cause the depletion trend to take down – I really don't mean to get at like whether it's going to be 12% or 10% or 15% in the fourth quarter. I'm just trying to get at like what's underlying that kind of performance that might go away as we all try to update our models and think about sustainable growth. And then I had a Ballast Point question after that.

David Klein

Yes, Mark. We try not to factor in weather all that much. But clearly, a warmer fourth quarter was beneficial, I think, for our beer business. I would also say that we continued some of the activity that we had been working throughout the first 2 quarters related to marketing spend along with the NFL and within other venues to continue to drive the brands, but I don't think it's anything outside of those items.

Mark Swartzberg

That's great. Okay. And then on Ballast Point, I want to try to probe a little bit more on the consumer proposition, and we've all seen the multiple. I still want to press here. It's clear on the – what the distribution opportunity you present for a brand that already has some pretty clear distribution opportunities because of its award-winning qualities. But I'm kind of still stuck on the consumer proposition from a longer-term perspective. When I hear you emphasize growth in a multiple, I'm reminded of wine deals in the past, going back far enough where growth was a rationale. And then when I look at the craft beer segment, I think the segment's been around for a long time, and we probably all argue over whether there's more than really one brand, Sam Adams, that's become a national brand and really has that sessionability associated with it, so – and then the price point and the IPA. It's like these are not brands that you see people kind of having in – you get a group of 5 people together, one is going to be having Sculpin, one is going to be having another craft beer. So it just doesn't seem to lend itself to being a big brand the way your imported beer portfolio does. So could you just speak about that consumer proposition and how you're thinking about that?

Robert Sands

Yes. I think that the – I think that there is opportunity, okay, for Ballast Point to become a big brand. And when we say big, okay, I think that, that may be a relative kind of a number. I mean, we're not talking volumetrically, Bud Light big, okay? But versus where it is right now, okay, it can be a lot bigger. And if you look at sort of the competitors in the marketplace and where they are volumetrically, okay, that implies a huge amount of growth for Ballast Point. And obviously, at the kind of price point and margins that we're talking about, big is a relative term. So you look at some of the other competitors, and we clearly see plenty of craft brands in the 10-million to 30-plus-million case ranges, right? And we started out at 4 million cases, right now, as we end the year with over 100% growth rate, so – and incredible margin. So things are relative. I mean, I think that what we're really talking here financially is about the kind of contribution, right, economically and financially, that a Ballast Point can make to our bottom line. With all that said, maintaining the quality and the award-winning position of the brand with craft consumers is going to be key to that, and I am 100% sure that the team that's running Ballast Point will do that. We have some unbelievable great new products that are coming out like a Watermelon Dorado, which is a double IPA. These are very sort of breakthrough products that I think are going to potentially set the craft world vis-à-vis the consumers on fire, so that's why it's been so successful. We've got a totally award-winning team producing these products and incredible innovation behind it.

Mark Swartzberg

That's helpful. That watermelon actually sounds like it will bring in women.

Operator

Your next question comes from the line of Vivien Azer of Cowen and Company.

Vivien Azer

So I wanted to follow up on Ballast Point as well, and then I've got a follow-up question on beer. So on Ballast, I mean the growth is clearly remarkable. But as I understand it, the company did enter some new markets. So I'm curious, as you guys think about fiscal '17, sustaining that growth, like how much of your accretion expectations and top line expectations are dependent on new distribution opportunities?

Robert Sands

Well, you're talking about this year?

Vivien Azer

Yes, for calendar ’16. Yes.

Robert Sands

Well, we obviously aren’t giving guidance for our next fiscal year, but we don’t see anything impeding our Ballast Point performance in general. There will continue to be expanded distribution. And Ballast Point continues to increase its velocity per point of distribution, even in its major markets where it’s already a big brand, like its old [ph] market in San Diego. So we don’t see any real catalyst for change in that regard. The company will continue to expand its distribution, and I think it will be very successful in doing so.

Vivien Azer

Fair enough. That’s perfect. And then on beer, David, I appreciate the 2 call-outs in terms of kind of the disconnect between shipments and depletions being the bottler recall and the wholesaler inventory true-up, but I’m still having a hard time kind of getting comfortable with the delta given how large it was. Is there anything else that was driving that disconnect?

David Klein

Yes. I think – we brought – because depletions accelerated the way they did in Q3, our wholesale inventories dropped a little bit kind of on a year-over-year basis, and we’re comfortable in getting those back in line by year-end. So I think that may be the other component, if you feel there’s a disconnect there, Vivien. But yes, we – that’s why we took our guidance up for the year basically across all of our P&L line items.

Operator

Your next question comes from the line of Rob Ottenstein of Evercore.

Robert Ottenstein

Great. I'd like to switch over a little bit to the wine business. Two questions on wine, one big picture in terms of the industry. Can you talk a little bit – there – I guess there's some data that there was a slowing of the wine industry in 2015, so perhaps you can address that and trends in pricing. And then second, more specifically, on Meiomi, perhaps give us a little bit of color in terms of what you're doing differently with the brand and why it's beating your expectations.

Robert Sands

Yes, I think it's the opposite, Robert. The wine industry has actually accelerated quite considerably, and is probably, as we sit here right now, at one of the most robust points that it's ever been. I mean, you look at the IRI dollars for the last 12 weeks, the wine industry has accelerated to over 6% growth. And probably even more importantly, if you look at the premium plus segment, which is a segment of $8-plus, okay, which is what we would be primarily interested in, okay, the industry has accelerated to double-digit growth in dollar terms over the last 12 weeks, 11.2%. That's the industry, okay? And then as it relates to Meiomi, okay, number one, basically, the brand has a tremendous amount of momentum in and of itself, okay? We bring a lot to that party. Obviously, we bring distribution strength. We bring strength where we're major players, #1 players, for that matter, with key customers. If you look at our position today in beverage alcohol, total beverage alcohol, okay, which is really important, and you look at major, major customers like the mass merchandisers, like the big grocery chains, when you combine our beverage alcohol portfolio, okay, we tend to be a #1 supplier, certainly in terms of the kind of profit that we're providing these key customers. So that's been helpful in driving the Meiomi results as well. And also I think that, like everything, okay, whether we're talking Corona, whether we're talking Model Especial, whether we're talking Meiomi, it's all about the consumer voting with their feet, all right? Meiomi has just a tremendous, tremendous amount of consumer acceptance, and that's building. So it's a very, very strong brand. It's a – I've talked about this before, somewhat of a unique taste profile for Pinot Noir. And it's sort of fitting squarely into what the consumer is looking for, for that kind of product; and price point, everything. I mean, it's just a tremendous "wine by the glass" opportunity in higher-end, on-premise venues. So it just meets every kind of criterion for success.

Robert Ottenstein

In terms of your expectations, you're saying it's looking like it's going to be a good bit more accretive than you thought. Is that because the distribution is going faster? There's an acceleration velocity? Or how to think about that?

Robert Sands

All of the above.

Operator

Your next question comes from the line of Tim Ramey of Pivotal Research.

Timothy Ramey

I think those are the best wine margins I've ever seen, and I've been hanging around this company for a long time. Any further commentary that you would give us on that? Was there any significant contribution from spirits? It doesn't look like spirits was really the driver in the quarter.

Robert Sands

Yes, it's really premiumization of the portfolio, Tim, and you know the wine industry. I mean, right now, the high end of the wine industry is growing probably better than it's ever grown before, and Meiomi fits right into that. I mean, it's part of our premiumization strategy. And as we continue to drive sort of product now in the, call it, $15 to $20 range, you're going to see margin expansion because those products have higher margins, okay, than the lower end of the business. And there continues to be a premiumization shift in the wine industry in general, which Meiomi fits full square into, and our increase in margins is directly related to that. But right now, the sweet spot of the industry has basically moved up into, as I said, that sort of $15 to $20 or even above range, and margins are significantly better in that range. So we're operating under some pretty good external conditions.

Timothy Ramey

Sounds good. Well, we have some good 2015 bulk pinots, so have your people call my people for the Meiomi.

Robert Sands

We'll give you a call, Tim.

Operator

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

John Faucher

Yes, wanted to talk a little bit about sort of the – sort of following up on Tim's question here in terms of the mix impact as we look at the wine business going forward, and the potential for, let's say, pricing on top of that. Or is it just going to continue to be the consumer trading up? And how do they – how do you really sort of track the value that they're getting as they trade up? Do you get better brand differentiation as they trade up? And how are consumers really sort of understanding that value equation as you get that mix trade-up?

Robert Sands

Yes. So yes, I would say that you do get higher quality definitely, and perhaps more brand differentiation, for sure, as you trade up. I mean, wine is a very unique product, and there's a lot of differentiation between products. And as you move up in price, you're definitely moving up in quality in terms of the type of grapes that are used to make the wine, i.e., where do they come from? Do they come from the best places? They certainly come from – have to come from better places, okay, as you move up the price scale, and then how the wine is made. In particular, things that add quite a bit of cost to wine: like how much oak is used; if it's white, how much of the product is fermented on oak; and age of barrels, quality of barrels; where the wood came from; et cetera. So those things both contribute to the quality of the product as well as contribute to the cost and the pricing of the product. What was your other question, John?

John Faucher

That basically covers it. And I guess, is it a similar consumer dynamic on the beer side, on the wine side – as we see on the wine side, right? Because obviously consumers have traded up on wine for years, but it seems as though the overall impact on the pricing and the huge price different – the pricing differential as they trade up on beer seems even greater than the pricing differential on wine. And so I'm wondering if we could see something that pushes that wine differential even further from a mix standpoint. Does that make sense?

Robert Sands

Well, I think so. I mean, I think you'll see – trading up on wine is accelerating, and I think that you'll continue to see it be extremely robust. And I think that you'll continue to see us benefit from that trading up. And yes, you asked about pricing on wine. We are taking – we're doing both. We both have significant trading up going on within the portfolio, and therefore, our sales growth is running considerably ahead of our volume growth, which is representative of that positive mix shift. And we're taking pricing where we think that it's applicable, and that would be in sort of the lower end of our portfolio. For instance, products like Vendange, where we're not so focused on, I would say, share and volume. And there's opportunities to enhance profitability nominally, and they're not the most strategic areas of the business. So we're now into an environment where we're sort of getting the best of both worlds in that regard. Beer, okay. Beer is a – yes, beer is becoming like wine. There is – the high end of the beer business is a very exciting part of the business because there's huge trading up going on in beer, okay? The consumer is definitely premiumizing. It's premiumizing into our import – they're premiumizing into our import brands and craft. You see the high end of the beer business be very robust. You can see it coming right out of the sort of the premium part of the beer. We definitely think that that's going to continue. And although the price differential seems big in beer, okay, that's really in percentage terms, okay? Yes, you're still talking about like a super affordable luxury. I mean way, way even more affordable than wine, right? It's a big deal for the consumer to go to a grocery store and buy 2 $25 bottles of wine. That's $50, okay? But the trade-up to Corona at $1 a bottle versus whatever else they were purchasing at $0.50 or less a can, big percentage increase, but fundamentally not something that takes the product outside of the realm of an affordable luxury. So I don't think the consumer – the consumer is proving to be pretty insensitive to those kind of changes at those sort of nominal prices.

Operator

Your next question comes from the line of Megan Cody of UBS.

Megan Cody

So obviously, your guy's pace of growth has been great. But my question is, as you try to deliver against that growth in the marketplace while also taking on 2 large-scale manufacturing initiatives, while also trying to expand Ballast, how are you guys thinking about execution risk, for example, managing out of stock, service delivery, et cetera?

David Klein

We have a very – we have a lot of confidence in our supply chain in our Mexican beer business, right? We've been doing this a long time, so we have no concerns about our ability to continue to supply in the U.S. market over the foreseeable future. Thus far, our Nava expansion has gone according to plan. We are on schedule, and we continue to actually run a little bit ahead of schedule in certain areas in our production build-out. And then lastly on Ballast Point, we are keeping those businesses operating separately. We're allowing Jim and Jack and the team at Ballast Point to continue to run Ballast Point, working with our beer teams. But we're not integrating the sales teams in such a way that would cause us to lose focus either at Ballast Point or in our import beer business.

Megan Cody

Okay. All right. And then actually, I had a follow up, an unrelated follow up. Just from a free cash flow perspective, on one hand, you guys are clearly delivering better-than-expected P&L results. But on the other, you're also increasing CapEx to fund that growth. So kind of looking from a long-term perspective, how do those dynamics impact your free cash flow outlook for the next few years net of this CapEx, and then how do you see that being deployed?

David Klein

We believe that we can do the Nava – complete the Nava expansion, complete the Mexicali expansion, stay well within our 4x leverage ratio range and still have the flexibility to continue to grow our dividend and do share repurchases, and we will remain opportunistic around M&A.

Operator

Your next question comes from the line of Pablo Zuanic of SIG.

Svetozar Stefanovic

This is actually Svety Stefanovic on behalf of Pablo. We actually have 2 questions, please. First, you disclosed beer depletions of 16%, but this canner [ph] data is pointing to a 20% growth. We realize this difference has been there in recent quarters also. So does this mean that given that your on-premise business is about 15% of sales, that your on-premise business is down by about 6%? And if this is the case, why would there be such a big gap between your on-premise performance and your off-premise performance?

David Klein

Yes, so there's not that big of a gap between our on-premise and off-premise performance. Our – the IRI measures you're looking at measure a portion of the off-premise channel, not the entirety of it. And then when you look at on-premise, we are up in mid- to high single digits in the on-premise, even though the on-premise channel itself is flat to slightly down. So yes, there's a disconnect between the IRI and depletions, but I would hypothesize that, in particular, in our beer business, that depletions are the best measure of the performance of our business.

Svetozar Stefanovic

Got it. And the second question is, we have been doing a lot of work looking at your beer market share by state. And we realized that in border states, like New Mexico, Arizona, Texas, you're below your average national share. And given the demographics, we would expect you to have higher share there. So the question is, should we assume that those states represent a significant distribution expansion opportunity for you? Or is there something structural that explains the lower shares?

Robert Sands

Yes, I think that it depends on the state. I mean, California, we're – which is obviously a border state, right, we have some of our highest shares, right? Southern California, our shares are over 20% versus our national share and, therefore, twice as much. In other places, yes, there's plenty of opportunity. But traditionally, our business has been focused on those places, and we have tremendous share in the largest population area in the country bordering Mexico, which is Southern California. Is there opportunity in Texas and Arizona, as you have suggested? Yes, sure, big opportunity.

Operator

Your final question comes from the line of Carla Casella of JPMorgan.

Carla Casella

I'm wondering on the financing side, do you contemplate coming back to the market this year or next to pre-fund some of the expansions you've got planned?

David Klein

No. So Carla, we feel comfortable that we will be able to fund the expansion out of operating cash flows. What I would say is that we will likely, at least, consider our options in coming to the market so that we can continue to layer in a nice maturity ladder of 10-year notes as it makes sense to us. In particular, we have a note coming due next September that we would – that we'll possibly look to come to the market to refinance.

Operator

At this time, there are no further questions. I'll now return the call to Rob Sands for any additional or closing remarks.

Robert Sands

Okay. Well, thanks, everybody, for joining our call today. Needless to say, we are incredibly pleased with our fiscal 2016 year-to-date results. Our beer business has tremendous, tremendous momentum and continues to gain market share. And our high-return investments in beer production capacity position us to support the significant growth in this business. We are growing EBIT and have significantly improved margins in our wine and spirits business.

During our next quarterly call, which is scheduled for early April, we will provide guidance for our upcoming fiscal year. In the interim, we will be working diligently to continue to execute our strategy and deliver excellent results for the remainder of the year.

Thank you again, everybody, for your participation.

Operator

Thank you. That does conclude the Constellation Brands' Third Quarter FY '16 Earnings Conference Call. You may now disconnect.