Brown-Forman Corporation, Q2 2012, Earnings Call 2011-12-08

Presentation

Operator

Good morning. My name is Tishanta, and I will be your conference operator today. At this time, I would like to welcome everyone to the second quarter fiscal 2012 conference call. — ***Operator Instructions*** — Thank you. Mr. Stegeman, you may begin your conference.

Mark Stegeman

Thank you, Tishanta. Good morning, everyone, and thank you for joining us for Brown-Forman's Fiscal 2012 Second Quarter Earnings Call. This is Mark Stegeman, Brown-Forman's Interim Director of Investor Relations. Joining me today are Paul Varga, our President and Chief Executive Officer; Don Berg, Executive Vice President and Chief Financial Officer; and Jane Morreau, Senior Vice President and Director of Finance Management, Accounting and Technology.

Don will begin our call this morning and will provide some color on results for our second quarter and first half, recent trends and some thoughts on guidance. Paul will provide a few high-level strategic remarks, and then we will open the call for questions.

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

This morning, we issued a press release containing our results for the fiscal 2012 second quarter. This release can be found on our website under the section titled Investor Relations.

In the press release, we have listed a number of the risk factors that you should consider in conjunction with our forward-looking statements. Other significant risk factors are described in our Form 10-K, Form 8-K and Form 10-Q reports filed with the Securities and Exchange Commission.

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

And with that out of the way, I will turn the call over to Don.

Donald Berg

Thanks, Mark. Good morning, everyone. I hope you've all seen the results we announced this morning. I thought I would start my comments acknowledging a particularly nice milestone for Brown-Forman. Our reported net sales for the quarter topped $1 billion, the first time in Brown-Forman's history. In addition to that milestone, let me summarize what we believe are the key takeaways for our first half results.

First, both underlying sales growth and underlying operating income growth accelerated during the first half of the fiscal year. Second, our strong sales growth was driven by a number of factors, including higher volumes; strong growth for the Jack Daniel's Family of Brands; nice results from various marketing and product innovations, such as line extensions, packaging improvements and marketing communications; a continuation of our robust international growth story; and nice trading up to our super-premium priced brands. And third, favorable foreign exchange trends reversed during the second quarter. And looking forward, current exchange rates are significantly affecting our rest-of-the-year outlook. In fact, while we expect continuing strong underlying performance in the second half, slightly stronger than when we set our earnings guidance for the fiscal year back in June, we have adjusted our full-year outlook due to the current exchange rates.

So let me start with more color on our top line growth and delve further into the 10% underlying net sales growth for the quarter. Let's start with the powerful Jack Daniel's trademark and dive a little deeper. On a constant currency basis, net sales for the Jack Daniel's family grew 16%, and all of the trademark's various expressions posted healthy growth. Particularly worth mentioning is the progress with Jack Daniel's Tennessee Honey in the United States. This expression of Jack Daniel's launched in March continued to have strong momentum in the quarter. Looking at the Nielsen data through November 12, on a rolling 3-month basis, Jack Daniel's Tennessee Honey is clearly the leader among the recent flavored whiskeys, outselling all of the entries such as Red Stag and American Honey on a value basis almost 2 to 1. Importantly, Tennessee Honey also seemed to be expanding the Jack Daniel's franchise in a number of ways. Similarly, with what we've seen before when launching Jack Daniel's RTDs in various markets, Honey seemed to have had a bit of a halo effect on Tennessee Whiskey in the United States as takeaway trends for our largest expression continued to improve. In addition, not only have we seen an expansion for Jack Daniel's into new drinking occasions, but we've also seen new consumers coming into the franchise. So we are encouraged by the excitement that Tennessee Honey is generating for the Jack trademark in our largest market.

Let me turn now and talk some more about our international story. Geographically, we continue to make broad-based progress. In our first 6 months, 26 of our top 30 markets grew constant currency net sales, and over half of them grew at double-digit rates. Overall, underlying sales internationally grew double digits, led by the Jack Daniel's family.

Let me cite a few of our international success stories, particularly where we made some recent route-to-consumer changes last year.

First, if you add up all of the various emerging markets for the first half, we had some impressive growth with underlying sales up about 20%. Highlighting a few of these markets where we made route-to-consumer changes, Brazil, Russia and Turkey all grew underlying net sales in very high double digits. While we changed our route-to-consumer in Mexico a few years ago, underlying net sales there grew over 20%. Recall with the Casa Herradura acquisition in 2007, we also gained a Mexican distribution company where we ultimately moved our existing Brown-Forman portfolio. Casa Herradura also had a leading position in Mexico's RTD business with this new mix product line. Basically, el Jimador conveniently prepackaged as margaritas, palomas and with sangrita. Not only has the new mix line continue to grow in Mexico, but we've also introduced it into the United States. And in addition, using this RTD capability, we were able to launch Jack Daniel's RTDs into Mexico over 2 years ago, which sold over 300,000 cases in its first year and continue to grow at very strong double-digit rates in the first half of this fiscal year. As part of our innovation initiatives, we've also used this opportunity to introduce a new Finlandia product, Finlandia Frost, a product that was developed specifically for the Mexican market.

Turning to some developed countries. In spite of Europe's challenges, the U.K. have solid underlying net sales growth in the high single digits. France was up strong double digits, and in Germany, where we also made a change in distribution about a year ago, underlying net sales were also up double digits.

While perhaps not one of our key highlights, let me speak for a moment about one of our most important brands, Southern Comfort. SoCo continue to be challenged with underlying net sales down 7% for the first half. It is under intense competition, particularly in the on-premise and is particularly challenged in the U.S. with a keen interest by consumers in the relatively new flavored whiskey phenomena – a new flavored whiskey phenomena, along with their continued interest in flavored vodkas and spiced rums.

We have continued to pursue a number of initiatives to reinvigorate this brand. For example, SoCo Lime was launched to reintroduce the brand in the shot-shooter occasion and sparked increased trial with SoCo's target demographic. As a follow-on, we just launched SoCo Fiery Pepper in the U.S. in October. We are also investing in the consumer communication strategy that includes digital and TV advertising that started in the U.S. in mid-October to create additional brand awareness. A number of similar initiatives are taking place in these key countries outside the United States.

Let me move on to some highlights from the rest of our results and then speak to our guidance. Our reported gross margin for the first 6 months declined one percentage point versus last year to 49.7%. As I'm sure you recall, we sold the Hopland-based wine business last fiscal year. However, we still have an agency relationship for selling essentially all of these wine brands that, under our agreement with Concha y Toro, continues through the end of December. This agency arrangement delivers a substantially lower gross margin to us than a year ago when we own the brands. This accounts for 0.7 points of the decline. Adjusting for the Hopland-based brands, our gross margin declined 3/10 of a point for the first 6 months. This remainder of the decline in gross margin reflects higher input cost and excise taxes in an environment where at least up to now it has been difficult to take pricing.

In terms of pricing, we believe the environment may have improved somewhat, following the downturn a couple of years ago. It appears the promotional pricing activity seems to have abated somewhat. We always try to look for that sweet spot between volume growth and pricing growth, and given the recent robust volumetric growth we've seen for

Jack Daniel's globally, we expect to be looking more closely at potential price increases for that trademark over the next 6 to 12 months.

Looking at operating expenses for the first half, we intentionally frontloaded our A&P investments in order to support the launch of various brand line extensions, including Jack Daniel's Tennessee Honey and Jack Daniel's RTDs in Japan. SG&A spending for the first half increased partially from the — ***indiscernible*** — consumer investments we made in several markets last year, which won't begin cycling against comparable numbers until the second half of this year. Additionally, we made some further investments in our infrastructure and people in various markets around the world to fuel and support our projected future growth.

Turning now to taxes. The effective tax rate for the first half was 34.1%, and was up about one point versus last year, primarily because of discrete items arising during the period. We expect our effective tax rate to be in the 33% to 33.5% range for the full fiscal year. As we mentioned in the earnings release, our share repurchase program expired at the end of November. During the program, we used $234 million of cash flow to buy 3.4 million shares at an average price of just over $69 a share compared to our recent price of about $80 per share. This program was in addition to the aggregate $513 million worth of shares we purchased in our prior 3 share repurchase programs, which had an average cost of just under $52 per share.

As we look forward to the second half, we expect to see similar growth in our underlying sales as we saw in the first half. However, on a reported basis, in addition to the negative impact of the stronger U.S. dollar, we do not expect the same level of pipeline fill from new product introductions. We also saw a pretty good build in trade inventories through October in advance of a number of activities, including some anticipated price increases in several markets, the timing of some promotional activities, and in a few markets, in advance of some announced excise tax increases, all of which we expect will rebalance in the second half of our year.

For the rest of the year, we expect our underlying A&P spend to continue to grow year-over-year but at a more modest rate as we moderate spending on new brand extensions. We expect underlying SG&A to continue at similar rates for the remainder of the year. So overall, we expect our full year underlying operating income to grow in the high single digits.

As we move into the second half, I'd just like to remind everyone that in addition to the stronger U.S. dollar, assuming the rates today hold for the balance of the year, our reported numbers will be particularly affected by the absence of both the profits associated with the Hopland wines, as well as the gain on the sale of that business in last year's fourth quarter. The Hopland wines provided full year earnings per share of $0.17 to $0.18 last year, and we also recognized $0.26 per share from the gain on that sale.

Turning to some uses of cash. We anticipate capital expenditures to come in between $65 million and $75 million, reflecting continuing expansion of our production facilities to meet the growing demand of our Jack Daniel's franchise. Further, we raised our quarterly dividend by 9.4% and expect that to annualize to about $200 million use of cash flow over the next 12 months.

So looking at our guidance, for the full year, we are adjusting our EPS outlook to a range of $3.45 to $3.70. This range reflects continued high single digit underlying operating income growth, but also continued strengthening of the U.S. dollar. So let me spend a minute on foreign exchange. In June, we had originally forecasted that earnings would be positively impacted by foreign exchange by a few cents. But as the year has unfolded, the U.S. dollar has strengthened, and we are now forecasting a $0.10 to $0.11 decline in earnings year-on-year due to FX. This is included in our updated guidance.

Looking at it further, going forward for the rest of the year and considering our hedge positions, we estimate that if the current rates were to strengthen 10%, our EPS would decline by about $0.06. Conversely, if the current rates were to weaken by 10%, our EPS would increase by about the same.

So in summary, we are pleased by the acceleration of our underlying sales and operating income during the first half. We acknowledge the continued volatility in exchange rates and are cautious surrounding the fragile global economy, particularly in the eurozone. However, we anticipate that our underlying trends will continue for the balance of the fiscal year and we remain confident in our long-term top line growth prospects.

So with that, let me turn the call over to Paul.

Paul Varga
Thanks, Don. Let me add just a few supplementary comments to what Don's already said. And first, I want to say that we're just very pleased with these first half results. While we've incorporated into our guidance this morning the expectations of some unfavorable FX in the second half, the company's underlying growth rates of net sales and operating income, which are both in the high single digits, are a nice acceleration over both last year and the last 3 years so we find this really encouraging. These strong organic growth results combined with the company's healthy ROIC and balance sheet position us well, we believe, for both the second half of this fiscal year and the years that follow it. Reinforcing something Don mentioned, we'll continue to work on improving Southern Comfort's performance. It remains the top priority for the company. And in the year ahead, we'll be giving heightened attention to pricing opportunities for our brands around the world. We believe that our efforts on both of these fronts have the potential to strengthen the company even further.

Something we've been discussing for some time now is the importance of quality new ideas to our company's organic growth story. And examples of these ideas abound to help Brown-Forman today. Jack Daniel's Tennessee Honey, the Lime and Pepper expressions from Southern Comfort, Chambord Vodka and our forthcoming launch of Little Black Dress vodkas are a nice example of recent portfolio innovation. The acceleration we've seen in Herradura Tequila sales is being driven in part by a significant redesign of the brand's primary package, and this represents packaging innovation. Our current holiday advertising for Jack Daniel's, showing our Lynchburg Tennessee community gathering for the lighting of a Christmas tree made of our whiskey barrels, is a wonderfully creative advertising idea, and we refer to this as an example of marketing communications innovation. And finally, our performance in markets such as Germany, Brazil, Russia and Mexico are partially attributable to a variety of route-to-market ideas being implemented by our employees in those markets, and this represents a form of marketplace innovation. Our ability to generate and successfully implement new ideas such as these is an increasingly important and exciting aspect of our work today at Brown-Forman.

And finally, I'd like to highlight an important category trend in our and the industry's largest distilled spirits market in the United States. Referencing the Nielsen data ended November 12, the 12-month growth rate of distilled spirits measured in dollar sales has accelerated from 1.8% one year ago to 3.4% today. This alone is good news, but even more encouraging for Brown-Forman is that the total whiskey category, encompassing all whiskeys including bourbon, Canadian, Scotch, Irish has accelerated even faster, advancing from a 1.1% rate a year ago to a 5.4% rate today.

The fact that the growth rate in whiskey has outpaced distilled spirits by full 2 percentage points over the last year is the departure from the basic trend observed over the last several decades, where whiskey has consistently lagged the performance of distilled spirits as a whole. Even more exciting for our company is the fact that bourbon and American whiskey, the largest U.S. subsegment of total whiskey and the one in which Brown-Forman has the strongest position, has accelerated from 1.8% a year ago to 6.5% today. This momentum is attributable to both general and specific factors. More generally, we believe bourbon is benefiting from the consumers' growing desire for brands with authenticity, heritage and distinctive quality. And more specifically, the category is accelerating due to the explosive growth of flavored whiskeys led in the last 6 months by Jack Daniel's Tennessee Honey, as well as the excellent growth of the super and ultra-premium priced segments where our Gentlemen Jack, Woodford Reserve and Jack Daniel's Single Barrel combine to give Brown-Forman a strong position.

While we still have a lot of room to improve our U.S. business, these favorable category trends and our ability to participate in them are contributing factors to why Brown-Forman in the most recent 3-months Nielsen period is growing its share of the U.S. spirits market for the first time in several years. This really does make it an exciting time to be in American whiskey in America, and the same is increasingly true in countries throughout the world. We expect to continue to be a big part of that excitement.

In closing, let me thank my colleagues across our global beverage business. We are able to report these strong first half results only because of the collective efforts of our people and regional and brand management, marketing, sales, finance, production, IT, legal, HR and corporate services. My congratulations and thanks to each and everyone of you.

That concludes our prepared remarks for the morning, and we're now open for questions.

Question and Answer

Operator

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

Dara Mohsenian

Paul, is the success of the Honey product encouraging you to look at additional flavor extensions going forward for the Jack Daniel's brand or elsewhere in the brand portfolio? And should we expect a significant ramp-up in flavor extensions as we look out over the next couple of years?

Paul Varga

I mean, I think it's certainly causing us to look at it more broadly from a Brown-Forman perspective. As you would imagine, we are really thoughtful and I would say on the cautious side as it relates to extensions on the Jack Daniel's trademarks. So right now, I mean, we really are very focused on the Tennessee Honey expansion within the United States. I think there's still a lot of even distribution and particularly development in the on-premise there, and so we want to make the most of that opportunity. I think as we look across just as we have with Southern Comfort more recently, which in the last 2 years or so, has introduced a couple of flavors into the Southern Comfort trademark into the U.S., and we started to expand some of those into other countries. We'll be looking at all of our whiskey trademarks to see where they can best participate and what is the sort of exciting and growing new segment. But expect us to be more thoughtful, I think, on the Jack Daniel's side. We're going to take it sort of a step at a time, which really means sort of month-to-month and quarter-to-quarter.

Dara Mohsenian

Okay, that makes sense. And can you give us any commentary on the industry pricing environment, both in the U.S. and Western Europe, if you think you'll see a healthier environment here either from a less price perspective or just less promotion? And also, you highlighted some plans to take some additional pricing going forward, but should we expect to see a significant ramp-up from you guys going forward on the price mix line?

Donald Berg

Yes. I think, on the price – this is Don, on the pricing front, certainly in the U.S., it looks better than it did a couple of years ago when we were in the depths of the global recession. As I mentioned, we do think that we're starting to see a healthier pricing environment. We talked quite a bit in the past about looking at pricing at a very targeted way, and I think we're starting to see that there may be some opportunities for more broad-based price increases. As we look at this, I wouldn't anticipate seeing much in the way of any impact in the rest of this fiscal year, but it's certainly something that we'll be looking at over the second half to the extent we take those price increases, you'd be – you should be able to see some impact on that next year.

Dara Mohsenian

Okay. And what was your price mix in Q2?

Jane Morreau

Yes.

Donald Berg

Going down.

Jane Morreau

Yes, actually, it was about flat from a price perspective. Our mix was down a bit. And so as you, I think, has noted most of our – and Don alluded to this in his talk, too, that our growth at the top line was driven volumetrically.

Dara Mohsenian

Okay. And then you mentioned the trends were still strong in a number of your key developed markets around the globe, but given concerns about macros in Western Europe and, to some extent, the U.S., did you see any slowdown in the industry trends at all towards the end of this quarter in either of those regions or – so far in Q3?

Paul Varga

I'm not sure we've had that current of data on them to consumer level to be able to comment on it. I mean, I think we continue to see, I'd say, just generally better results in many – in the troubled parts of Europe, I mean, for a – we think for a variety of reasons. But yes, I think we've both commented on different times. I mean, those are areas you'd definitely pay attention to and remain concerned about just because of the difficulties they're experiencing. But we haven't seen anything that would have – through the end of October, where we would have recent institutional data or something that would be able to validate what you asked.

Operator

Your next question comes from Vivien Azer with Citigroup.

Vivien Azer

My first question has to do with kind of the longer-term trends that we're seeing in the distilled spirits category, particularly in the U.S, and this resumed interest in bourbon. I was wondering if you guys could offer some longer-term historical perspective on consumer shifts within the different categories. Can we look back and say, "Oh, gosh, was it 30 years ago when bourbon had an x percent share of growth versus the 8% today?" Kind of what could that evolved into from here given the clear interest in the category?

Paul Varga

Well, I mean, I'd say it – if that was one thing that I was trying to touch on. I don't have the specific percentage points, and a lot of it depend on how you look at it and when you started that analysis, of course. But I mean, I can definitely talk about directionally that in the time I've been in this industry and at Brown-Forman, I just say there had been, I'm sure, some short-term periods where there have been a burst of activity that was positive for the various aspects of the whiskey category. But I haven't observed over a sort of a 12-month period and as comprehensively as it's influencing every category of whiskey the kind of momentum that has –that we've observed over this last 12 months where each category of within whiskey has accelerated. And then in total, the overall whiskey category relative to distilled spirits is a couple of points ahead on the last 12 months is a real shift versus what I – we would have all experienced over the last 10 or 20, or even 30 years. I mean, the shifting from whiskey to what I would refer as white goods, I mean, in some ways started in the '50s. And back then, there was very little vodka sold in the U.S. And so that had been amazing story in vodka in the U.S. as one of the big contributing factors to this, but – and vodka continues to grow, too. So it's a great time for the U.S. spirts market generally. But some of those comments I made about just the acceleration in the whiskey category maybe attributable, I think, maybe post the 2008 and 2009 periods. Some of the mindshifts of consumers toward products that have that real heritage and authenticities in some ways traditional values. We were seeing, I think, Ben mentioned on his call before, micro distilleries and real interest in the craft of whiskey out there. And so I think that's a contributing factor. But no doubt on the shorter-term, these flavored whiskeys have added real interest to the category, both directly and through halo effect.

Vivien Azer

Got it. In terms of your commentary on the CapEx and the investments in capacity on bourbon, can you guys speak to kind of where you are in terms of inventory and do you have sufficient age inventory on hand to continue to meet this accelerating growth?

Donald Berg

Yes. Vivien, it's Don. We – as we look forward in terms of the forecast that we have for net sales and we feel very comfortable that we've got the supplies that we need to meet kind of what our current plans are. We – as it relates to capacity, you run into different steps in the capacity over time. We've been increasing capacity on a warehouse standpoint for quite a while and that will continue. Part of the capacity increase that we're looking at have to do with the barrels and the barrel manufacturing that we need to do in order to support – continue to support the growth. And then also at the Jack Daniel's distillery itself, we'll be looking at making some investments there over the course of the next probably 6 to 18 months or so.

Paul Varga

Yes, we just opened – announced the opening of a new mill that we're going to construct down in Alabama to help get within our supply chain to help supply the cooperage. And so you get these in various ways, and all of it's a great use of your capital. You're reinvesting back into the business to meet what you hope is that a demand that will be there in several years.

Operator

The next question comes from Judy Hong with Goldman Sachs.

Judy Hong

Paul, could you give us a little bit more color just in terms of in the U.S. market on-premise versus off-premise trends?

Paul Varga

Yes, I mean, I think it all depends on how you're looking at it and what period. But I mean, I'd say looking at data, the one thing we'd say is – I think, say, comfortably, is that versus – certainly versus 2 years ago, the more recent 12 months, you would see I think an important improvement in the overall on-premise trends versus the year ago, maybe a stabilization to slight uptick in these 12 months versus the prior 12. We've said it before. Nothing that we've seen that would indicate that it's booming back. It's – I think, it's more incremental and it probably varies by region of the country. I mean, some of the anecdotal stuff we've started to hear in the last few months is that the major metro markets, the on-premise restaurants are starting to be more crowded, and the bars, therefore, are more crowded. And that's a more anecdotal comment. We don't have any data to support it. And then we would look at the same public data you all would relate it to, things like the casual dining chains and the like. So I mean, I wouldn't say that – I would definitely wouldn't say it had any downturn recently, more say that it's sort of sluggish still, but maybe slightly improving might be a comment about the U.S.

Judy Hong

Okay. And the acceleration – with the outperformance that bourbon and American whiskey are seeing versus the broader spirits category, does that apply to the on-premise channel as well?

Paul Varga

I think so, yes. I mean, particularly on some of these flavored whiskeys where they're having development with, I'd say, the LDA, the 29- and 39-year-old consumer in the on-premise. But also the super-premium whiskeys you're just noticing on the back bars of more and more restaurants and bars a greater selection of high-end bourbons that probably more closely approximate, which you would have observed with maybe these single-malt scotch bars and the high-end selection of vodkas at different times. So that's pretty exciting for companies that are concentrated in bourbon.

Judy Hong

Okay. And then, just in terms of your marketing spending so – and, obviously, in the first half, you've seen a ramp-up in advertising spending. I think you're saying in the second half that slowed down a bit. But just in terms of your broader spending levels, I know a couple of years ago, you were spending a little bit more on the cost of sales line. Now the advertising spending has ramped up. Is this more of a shift in terms of higher allocating marketing dollars or is the total bucket still going up? And how much of the slowdown are we expecting to see in the back half of the year?

Paul Varga

I'll start, and Don, maybe you can supplement. I mean, I think the main thing is that the rate of growth will continue to be above last year that we consider to be an appropriate rate. It's just that as this normal – when you have a pretty significant launch, particularly like we have at Jack Daniel's Tennessee Honey, you really want to – as you're building the distribution rather quickly, you want to build the awareness. And that, in fact, was – it was what we can attribute a lot of the incremental spending in the first half, too. And it's just that you don't need to continue that initial awareness boost at the same rate. So that's one of the big shifts from first half to second half. And as it relates to where in the P&L those investments reside, I think it's – in the last few years, I mean, we made pretty significant investments and changes to almost all our packages. I mean, I'd have to go through and think the ones we almost – that we didn't make changes to. And after you do that, I mean, it's not like you would have a desire to change your package every year. So I mean, that period had a concentrated investment there for many, many quarters where we would have been hitting the cost of sales line, some promotional packaging and special packing increases. And I think appropriately, we've shifted more into the A&P line as the recovery has been more apparent, and we had more opportunity there than we did in the packaging arena.

Judy Hong

Okay. And then just a follow-up on the pricing side. Just in terms of what milestones should we be watching that would give – where you would be watching to give you comfort that you can actually take pricing on Jack in the next 6 to 12 months?

Donald Berg

Well, I mean, again, we'll be starting in on a market-by-market basis. I mean, some of it we'll be looking at just kind of the general environment for pricing as it relates to being able to pass on some of the inflationary costs. We'll be looking at what some of our competitors are doing, and we'll go out there and do some testing and see what some of the impact might be. But we'll look at it pretty closely and make those decisions based upon what we see as we move forward.

Paul Varga

And also, just I think it will relate to – each individual brand will be different. If they have stronger momentum at the consumer level, you feel a little more comfortable and confident about taking some pricing versus brands, particularly if they're highly price-sensitive, you're going to be a little bit more cautious about it. One thing we always look at is that, just a general theme, is the proportion of business and where the growth is in terms of the channels on versus off. And there's no doubt in my mind that a really strong and buoyant on-premise environment is conducive to better pricing. And while it's improved, we haven't yet seen it roar back like it would have been in the mid-2000, so…

Operator

The next question comes from Lauren Torres with HSBC.

Lauren Torres

My question relates to the margin pressure that Paul — ***indiscernible*** — Each of that operating expenses should moderate in the second half. But just curious, first, on the gross margin line, thinking about your input cost pressures that we're seeing short term, how we should think about that? And also, too, on the, I guess, the operating margin line as expenses moderate, should we still expect some pressure in the second half?

Donald Berg

Yes. So when we – I mean, on the gross margin side, I mean, I think you should expect seeing pretty similar to what we saw in the first half. There's nothing out there that we're seeing in the second half that's going to change those trends there. The one thing that could possibly affect it a little bit would be what if there's any kind of mix changes. But in terms of some of the cost pressures that we're seeing and the ability to pass on those pricing, other than the pricing comments we've made before, we don't really necessarily see any significant shifts in the second half. On the overall expenses, I think we pretty much described what you can expect. I think the thing that is the most important thing to gear on is the comments that we've made in terms of our expectations on the overall underlying operating income, which we continue to see growing in kind of the high single digits.

Paul Varga

Yes, and I think it also, just at least it is our anticipation, that at the top line, the sales line, we would continue to have a strong high-single-digit performance as well as we did in the first half.

Lauren Torres

Is there anything on the input cost side, though, that's becoming more or less of a concern as we think about that going forward?

Paul Varga

No, I don't think so. I mean, at part of it is just almost market-by-market and brand-by-brand, how comfortable you feel passing through, whether with the input cost or, in some cases, excise taxes or some of these other things that you may, like I think, that we've made some conscious decisions to hit particular price points correctly, hopefully, around the world. So you're always, I think – it's a hard thing to talk about on a global level. You almost have to get in and look at it country-by-country and brand-by-brand. But I think the main message is that the environment's improving and we continue to see some of these input costs rising that we're going to feel more comfortable trying to pass those through fully.

Lauren Torres

Got it. Okay. And just lastly on your taking that then at top end of your EPS range, Don, I think you said this, but as far is the as the $0.15 reduction on the top end that you talked about, was it a 10% to 11% hit on FX? So it's not – I know I'm kind of splitting hairs here, but it's not all reflective of FX or is it?

Jane Morreau

Or is this all reflective of FX?

Donald Berg

Yes. And I just want to make sure I heard you right because it was $0.10 to $0.11.

Lauren Torres

Right.

Donald Berg

Okay. I understand, yes.

Jane Morreau

And in that outlook that we had initially, Lauren, we had favorable FX, which if you – Don was talking when we started off the year, we had favorable FX of a few cents. Now — ***indiscernible*** — other way unfavorable, so you need to add the numbers together, and it does more than explain it.

Donald Berg

Yes, and we did narrow the range just before halfway through the year, a little bit, too, so…

Operator

Your next question comes from Ian Shackleton with Nomura.

Ian Shackleton

Question really around use of cash, and you've completed the buyback you said in the statement. It doesn't look from what you said today than the buyback that you bought that's going to be started. I wonder whether you could just confirm that? And if not, is that more of a signal that you are more perhaps looking forward to acquisitions now in the spirits space?

Donald Berg

Yes – no. So on the share buyback, we completed the one that has been approved through November 30. At this point in time, there aren't any other share buybacks that either we have announced or that have been approved by the Board. And if we were to do anything going forward, we would have to – it would require Board approval. I would say that at this point in time, as we sit here looking forward, we've talked quite a bit about uses of cash and how we think about the various uses, and I would say that we're pretty much in the same position. I mean, we're – our first goal is to use our cash to invest behind the business. We will be investing a little bit more in the capital expenditure area than what we've historically done just because of some capacity needs. Once we go beyond looking at what the business requirements are, then the dividend is something that's very important to us, and this is the time of the year that we look at that. And in November, we announced the dividend increase. And then from that point going forward, we certainly look at acquisitions as the key component of looking for ways to create shareholder value and to find opportunities that might be out there, particularly brands that might do well in our hands. And to the extent that we can find those kinds of things that create shareholder value, we'll certainly look at acquisitions. If we don't feel that those opportunities are necessarily immediately out there, then we do look at other ways so we can get the cash back to shareholders, and the share repurchase is one of the key ways that we've used that in the past.

Ian Shackleton

Okay, that's very clear. And just a follow-up, we've got, obviously, in France a big duty hike coming in, in January. I just wonder how you saw the outlook for further duty hikes in other markets and, obviously, particularly have you been thinking about the FET in the U.S.?

Donald Berg

Sure. So that duty hike in France was one of the reasons why we actually saw some trade load in the second quarter where we expect that to kind of rebalance by the end of the fiscal year. There, as you probably know, there's a hike coming in the U.K. There's a couple that have been announced in Russia coming forward. We've been dealing with a lot of these individual country-by-country excise tax increases for the last 2 or 3 years. And you generally see similar patterns where you see the buy-in upfront at both at a consumer and a trade level. And then it takes a while, but eventually, it kind of sticks and things level out and get more back to normal. There's nothing that we've seen that would indicate that you wouldn't see some of those normal patterns in these situations. On the U.S. side, at the federal level, every time that Washington is looking for ways to increase their revenues, there's always the concern that federal excise taxes can be on the table. We've been pretty effective at keeping it at bay. One of the things that we have learned as an industry is that it's not only the impact to spirits or to alcohol beverages when we have these, when we see – when we historically have seen these federal excise tax increases, there's a much broader impact to hospitality industry overall, whether you're looking at waiters or bartenders or a whole host of various labor factions that get impacted. And so we've been really pretty effective at building a much broader base of constituents around these issues. Including the hotels and the restaurants and what-have-you to make sure that as these issues come up, people really recognize the full impact that these tax increases could have, not just in terms as it relates to the price of the beverages but the impact that it has on the overall economy. And I think the effectiveness of that has really proven out, given that there really hasn't been any major excise tax increase in quite some time. And so, we'll continue to work that and to do what we can to keep excise taxes at bay the best we can.

Paul Varga

I mean, our plans certainly don't forecast the expectation of anything in the United States at this time.

Donald Berg

In the near term, yes.

Operator

The next question comes from Ann Gurkin with Davenport.

Ann Gurkin

I wonder if you discuss a little bit, dedicated sales force at distributor levels in the U.S. I guess, a competitor has been adding layers into the distribution network? And are you feeling any effect to that or do you need to make any changes to your sales force in the U.S.?

Paul Varga

There's 2 questions there. I mean, in terms of effect, I mean, people have had various dedicated effort now for some time at the distributor level. We actually, in many a markets, we call alliance markets, where we're partnered up with Bacardi and, in many instances, Remy have a dedicated division to the portfolio that would include those 3 companies. And so there are a wide variety of dedicated efforts that you can observe, not only at the distributor level but also within the supplier sales ranks that people, I think, find effective. And so as it relates to how it may be showing up in our results if it – I mean, any impact from that, I mean, you probably heard my comments earlier, in the last 12 months, we've gained share, the U.S. spirits segment for the first time in a while. So it would have – it wouldn't be apparent in that statistic. And I think, the other thing too, is typically when you get that dedication, you tend to have the kind of scale and volumetric – volumes in general to be able to demand at them. Our observation remains about the U.S. market today, which is that it's really not the large and high volume and biggest players that are winning right now in the U.S. distilled spirits market. It's probably more the entrepreneurial smaller companies that are winning with innovation and more entrepreneurial flair if you just look at the numbers. It's a – I mean, company-by-company, a lot of the growth is coming out of maybe more nimble and fast-moving and innovative competitors, and it's one of the things that certainly caught our attention over the last few years.

Ann Gurkin

Okay. And then I appreciate the comments on the bourbon increase. Can you break out – or is there any way to figure out what flavors are contributing to that growth of 6.5%?

Paul Varga

Oh you mean – literally mean flavors? I mean, like – we…

Ann Gurkin

New introduction flavors.

Paul Varga

Oh, yes. Well, we – oh, flavors are generally – I would have to go look at it to see what component of it is. Because we look at it both with and without the flavors. And there's been a nice acceleration in bourbon, even without the flavors. And those are the points

I was making about that premium segment, the super-premium segment, really consistently here now over several years, contributing nicely to the overall growth and not only volumes, of course, then, by dollars as well. But then here, more recently, in the last couple of years and these last 6 months very much attributable to testing those Tennessee Honey. The flavored aspect of it has added even more steam to it. I would just have to go look at it literally by numbers to see what the contributions are. I just don't have it in front of me.

Ann Gurkin

Okay. And then any update on how holiday sales are tracking versus expectations for you?

Paul Varga

I mean, nothing really. We – I mean, we're reading the papers about retail in general like everybody else is, so we don't have anything that we can comment on today.

Operator

Your next question comes from Tim Ramey with D.A. Davidson.

Timothy Ramey

Given the success of flavored whiskey, I wonder if there's any reason why that type of innovation couldn't apply to the tequila category as well? Have you looked at that? Is there any issue in terms of their regulation on what you can do with tequila or...

Paul Varga

No, there's actually a few entrants who I can – can't state that they've had the kind of success that we've seen here more recently. But there have been entrants, particularly in the U.S. market, where we've seen some flavor extensions and they've been more niche. But the appeal of flavor, and just generally, to distilled spirits is just a megatrend over the last 20 years is so evident, and whether you look at it in vodka – and we're just –

we feel so fortunate that the American whiskey base and the bourbon base lends itself so well to mixability. I mean, we found it in mixed drinks for a long time. And so this is a very welcomed trend that we're able to add – the appropriate, they have to be – I think the key thing here is not to think of them as flavor-of-the-month type extensions. I mean, they have to be really high-quality products. And the one thing we've learned about particularly the Jack Daniel's Tennessee Honey is how the response has been to the product in the bottle. I mean, just an excellent product. And people finding all kinds of interesting ways to use it and consume it, enjoy it. And so that's a great lesson that we've learned, and so we think our lab is a real asset in this to help us to create – when we go to a flavor, to create the right formula so that it is appealing as we want it to be.

Operator

— ***Operator Instructions*** — Your next question comes from Kevin Dreyer with GAMCO Asset Management.

Kevin Dreyer

I just had a question on kind of the overall category, and specifically, how you think it's interacting with beer. Obviously, the major beer players have been very aggressive with price in the recent years and continue to – seem to plan to do so going forward. How much of the volume growth resurgence in spirits do you think might be linked to that?

Paul Varga

We have to go tear it apart and study it. I mean, certainly, at the macro level, you can see the trends in beer relative to spirits and you can make some assumptions, of course, that we're getting more of the occasions of the total beverage alcohol market. That would be self-evident. I mean, some of the reasons – I mean, and it'd be interesting to see how some of, for example – using the example of flavored whiskeys relative to what's going on in the high-end craft beer segment and how they're interacting with each other, because there's actually some flavor in that as well. So – but I mean, I've got to believe that for either reasons of they're price-driven or just, I think, this other large trend is that you've – just the consumers' interest in variety as it relates to beverage alcohol. And the inherent mixability and flexibility of spirits relative to beer products may be one of the needs that's being met by spirits. And so, but to give – in order to give you statistics on this, I'd have to probably ask some folks to help us study it more closely.

Operator

— *Operator Instructions* — There are no further questions. I'll turn the call back over to the presenter.

Mark Stegeman

Thank you, Tishanta. We don't have any closing remarks today other than go try Tennessee Honey, if you haven't already done so. Thank you very much.

Paul Varga

Great. Thank you all.

Donald Berg

Thank you.

Operator

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