Brown-Forman Corporation, Q4 2016, Earnings Call 2016-06-08

Presentation

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the Fourth Quarter Fiscal 2016 Year-end Conference Call. — ***Operator Instructions*** — Thank you. I would now like to turn the conference over to Mr. Jay Koval, Director of Investor Relations. Please go ahead, sir.

Jason Koval

Thanks, Paula, and good morning, everyone. I want to thank you for joining us for Brown-Forman's Fourth Quarter 2016 Earnings Call.

Joining me today are Paul Varga, our President and Chief Executive Officer; Jane Morreau, Executive Vice President and Chief Financial Officer; and Brian Fitzgerald, Chief Accounting Officer.

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

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

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

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

Jane Morreau

Thanks, Jay, and thanks for joining us for our fiscal 2016 earnings call. I plan on covering 3 topics today, which should leave plenty of time for questions after our prepared remarks. First, I'll review our full year results, including a brief overview of the fourth quarter. Second, I'll discuss our earnings outlook for fiscal 2017. And finally, I'll share some additional color on the changes we have made to our portfolio over the past year, including the BenRiach acquisition.

So let me start by reviewing our results. Despite a very challenging comparison against last year's fourth quarter 10% increase in underlying net sales, which you will recall, benefited from the launch of Jack Daniel's Tennessee Fire in the United States, we delivered solid 4% growth and underlying net sales during this year's fourth quarter. Underlying A&P spend increased 8% while a 3% reduction in underlying SG&A boosted our underlying operating income growth to 15% for the quarter.

For the full year, underlying net sales grew 5% and underlying income increased 8%, in line with the guidance we shared with you on our third quarter call and well ahead of our estimate for the industry's rate of growth. Our net sales growth in the year was driven by volume gains from our premium price brands, driving 4 points of mixed benefit and 10 basis points of gross margin expansion.

Looking at our business results by geography. The developed world delivered growth consistent with last year, helping offset a slowdown in emerging markets and declines in our travel retail channels. We grew underlying sales in each of the top 10 markets with the exception of Russia and believe that our balanced geographic approach in building our portfolio is one of the reasons why we consistently deliver top-tier results.

The United States grew underlying net sales by 6%, led by the Jack Daniel's family of brands, a remarkable achievement for a trademark that is celebrating 150 years in the market. The U.S. launch of Jack Daniel's Tennessee Fire contributed almost 1 point of underlying net sales growth to our corporate results in fiscal 2016. Combined, Tennessee Honey and Tennessee Fire depleted over 1 million cases in the United States in fiscal 2016, strengthening the brand equity of the Jack Daniel's family by appealing to new consumers and accelerating the brand's reach across ethnicity and gender.

We believe we are uniquely positioned to benefit from consumer interest in premium American whiskey. Our leadership position in this category is, of course, driven by the Jack Daniel's family of brands but is also aided by our bourbon brands such as Woodford Reserve and Old Forester, both of which enjoyed rapid rates of growth in fiscal 2016. And we believe that our whiskey expertise, including our vertically integrated supply chain from barrels to homeplace experiences position us well to grow our brand in the coming years.

Woodford's family of brands reached 500,000 cases in fiscal 2016. While this impressive milestone might seem like an overnight sensation, it required a strategy built on patience and consistent investment behind the creation of a new brand in the mid-1990s that leveraged heritage and our whiskey-making expertise. We are replicating this proven business model with Slane Irish whiskey, which we believe can become the next Woodford-like driver of our company's result as we see the next 20 years of growth.

Developed markets outside the United States also delivered solid underlying net sales growth, up 6%. This rate of growth marks a 2-point acceleration from fiscal 2015 with particularly strong results in Western Europe, up high single digits, as well as solid gains in Canada and New Zealand. Australia, Japan and Spain each returned to growth during the year while results in Italy declined.

The Jack Daniel's trademark is continuing to gain share from blended Scotch among other categories, and our market shares remain low compared to what we have achieved in the United States. So we are optimistic that the best is yet to come as the Jack Daniel's benefit from its brand positioning around confidence and independence, strong heritage and authenticity, not to mention its prominent and pop culture.

Moving now to our emerging markets business. Underlying net sales grew 4% in the year, a marked [ph] deceleration from what we have delivered over the last decade. Mexico and Poland, our largest – 2 largest emerging markets, grew underlying net sales by 6% and 1%, respectively. Turkey grew 17% while Russia declined 17%. Brazil, South Africa and Ukraine each grew underlying net sales double digits, but this growth was offset by the slowdown in many of our other small emerging markets, including Southeast Asia, where regulatory changes in Indonesia led to significant disruption in the beginning of fiscal 2016.

Our business has not been immune to the weaker economic condition and currency devaluations that have negatively impacted consumer demand. In our other markets, which represented 15% of total sales per the table in our earnings release this morning, underlying net sales growth accelerated from 11% in fiscal 2015 to flat in 2016, effectively removing 1.5 points from top line growth. As we look ahead, we think the challenges in many emerging markets will persist in the short term. But that does not diminish our long-term expectations for emerging markets, given how early we are in developing our brand outside of the United States.

Travel retail had a challenging start to fiscal 2016 with underlying net sales declines of almost 20%. The rate of decline has moderated over the last 3 quarters. So while business fundamentals remain soft compared to this historic levels of growth, we believe the worst is behind us. Travel retail's 12% underlying net sales decline in the year removed about 0.5 point from fiscal 2016 net sales growth rate.

Let's move now to a reconciliation of reported to underlying results. An appreciating U.S. dollar negatively impacted our reported net sales in fiscal 2016 by 6 percentage points. While inventories were roughly flat year-over-year, reported sales were also hit by 1 percentage point due to the 2 months' absence of Southern Comfort and Tuaca revenue while under disposition during the fourth quarter. Our underlying operating costs increased nearly 3% in the year but declined approximately 3% on a reported basis.

Tight cost management helped us deliver SG&A growth of only 2%, and we remain focused on leveraging prior SG&A investments. It's worth noting that excluding Southern Comfort and Tuaca, our A&P increased over 5% for the portfolio of brands we have today, in line with our underlying sales growth. Putting this all together, we delivered 8% growth in underlying operating income for the fourth year. Reported operating income increased 49%, including the impact of the sale of Southern Comfort and Tuaca and 3% excluding. Earnings per share increased 63% to $5.22. Excluding the $1.76 impact as a result of the sale, our earnings per share would have been roughly $3.46, an increase of 8% from the prior year.

So now turning to my second topic for today, our outlook for fiscal 2017. Notwithstanding the emerging market slowdown we experienced during fiscal 2016, we expect our portfolio SKU to premium American whiskey will allow us to capitalize on favorable trends as consumers continue to shift from white to brand spirits, driven by a desire for heritage, authenticity and craftsmanship.

In fiscal 2017, we will be activating a global campaign to celebrate Jack Daniel's 150th anniversary as America's oldest registered distillery. This activation consists of a focused campaign here in the United States called Jack Attack, including additional media spend and programming behind the trademark that we believe will accelerate our growth in the United States. It also entails large-scale events in Lynchburg and pop-up distillery experiences in several major metro markets. And we'll introduce special edition products, including an 86-proof Jack Daniel's 150th anniversary bottle.

This intense consumer campaign extends far beyond the United States, including a global Jack Daniel's barrel hunt in over 50 countries and incremental media support. Our global teams and partners will focus on the premiumization of this trademark through additional support behind Gentleman Jack as well as the continued growth and rollout of Tennessee Honey and Tennessee Fire outside the United States.

In fiscal 2017, we expect underlying net sales growth of 4% to 6%, driven by sustained growth of our portfolio of brands in the developed world. We intend to launch Jack Daniel's Tennessee Fire in a few markets outside the United States, including the United Kingdom, France and Germany. We are innovating with high-quality expression, including rolling out Woodford Reserve Rye and Jack Daniel's Single Barrel Rye as well as introducing Coopers' Craft, our first new bourbon in 2 decades.

Furthermore, underlying net sales should benefit from global consumer demand from our premium bourbon and tequila brands. We expect to benefit from both the easier comparison and travel retail this coming year as well as the absence of the 15 basis point drag that Southern Comfort had on last year's results.

On the negative front, we anticipate moderate pricing for used barrels as the global slowdown in blended Scotch is negatively impacting barrel demand. Fiscal 2017 should be another year of volume gains and improved mix but with minimal pricing beyond a few select markets given the overall economic environment. This should result in flat gross margins compared to fiscal 2016.

We are investing behind our brands' growth and development and are reallocating our human capital in dollars towards the brand market combination that we believe have the greatest opportunities to create value. We are forecasting another year of low single-digit growth in SG&A. And so while we are tightly controlling our core SG&A growth, we will invest where the opportunities exist such as plan to switch to own distribution in Spain next summer, which will result in some modest cost later this fiscal year.

In total, we anticipate underlying operating income growth of 7% to 9%. At today's spot rates, we expect the stronger dollar will negatively impact reported earnings per share by $0.07. The benefits from a lower share count will be offset somewhat by reductions in distributor inventories. The effective tax rate will be in the 29% to 30% range.

In aggregate, we expect earnings per share of $3.42 to $3.62. This represents 5% to 11% growth from our fiscal 2016 baseline EPS of $3.26, which excludes $0.26 – $0.20 of earnings contribution from Southern Comfort and Tuaca in fiscal 2016. You'll find additional details in a table in our earnings release that we released this morning. As with sensitivity on FX, a 10% move in the dollar in either direction would impact our full year EPS by approximately $0.15.

Just a quick comment on seasonality. We expect our first quarter to be the most challenging comparison against 7% underlying growth in the first quarter of fiscal 2016, which was also helped by the U.S. launch of Tennessee Fire. Regarding our capital spending programs, CapEx came in at $108 million for the year, well below our original estimate, driven largely by timing as our long-term capital expansion plan remain unchanged. Timing of spend for Slane Castle and the Old Forester distillery in homeplace, for example, will be weighted more to fiscal 2017 than we expected at this time last year. We are over halfway through our stepped up investments to increase total capacity and continue to deliver an industry-leading 23% return on invested capital after adjusting for the gain on the sale of Southern Comfort and Tuaca, the highest ROIC in a decade for our company.

Now let me move now to my final topic, an update on portfolio changes, including the acquisition of the BenRiach Distillery Company. We made some important changes to our portfolio of brands over the last 12 months, including the disposition of Southern Comfort and Tuaca as well as our reentry into the single malt Scotch category with the BenRiach acquisition.

These portfolio changes mark the continuation of a decade of portfolio evolution at Brown-Forman, following the sale of Lenox China and Hartmann luggage, the acquisition of Casa Herradura tequila portfolio and the sale of our mid-priced wines, Fetzer and Bonterra. In addition to this M&A activity, we have introduced significant innovation into the market-place, including the launch of Jack Daniel's Tennessee Honey and Fire, Woodford Reserve Double Oaked and Rye and our entry into Irish whiskey with Slane.

So let me share a bit more color on our rationale for our most recent addition to our port-folio, the acquisitions of the BenRiach distillery company and 3 great single malt Scotch brands GlenDronach, BenRiach and Glenglassaugh. The single malt Scotch category is one of the fastest-growing categories, along with American whiskey and Irish whiskey. Outside of the 4 largest single malt brands, GlenDronach, BenRiach and Glenglassaugh represent the largest collective production capacity in the industry, giving us a great plan – platform for which to build our – over time.

We believe that our whiskey-making knowledge, barrel technology know-how and long-term perspective will continue to serve us well. Combined, these single malt Scotch brands are relatively small today under 100,000 cases in calendar 2015. But we believe they have significant global potential as our primary markets today are focused on the United States, Duty Free, U.K., France, Taiwan and Germany. There is also a small blended Scotch business today.

Given the purchase price of just over USD 400 million, we paid a similar multiple on trailing EBITDA to where Brown-Forman trades today. We believe that we acquired high-quality brands and assets, including the current homeplaces, distilleries, warehouses and the bottling facility, not to mention valuable inventory. Equally important is the potential for these brands in a rapidly growing category. So we are hard at work at developing the long-term business plan of how we can maximize the value of these brands.

As is typical with any acquisition, we expect some transition and integration costs this year somewhere in the $5 million to $10 million range. But even after including these costs, we expect the acquisition to be roughly neutral to earnings in fiscal 2017, given only 11 months of ownership, and then will be accretive in the following years.

Let me remind you that our last acquisition of size was when we acquired Casa Herradura in 2007. After several years of methodical investment, these brands have enjoyed solid growth over the last few years as we believe they have reached an inflection point in consumer awareness. Herradura's underlying net sales jumped 13% globally in fiscal 2016, while Herradura's U.S. underlying net sales increased 19%. And New Mix, our Mexican RTD business, experienced a 23% jump. So all in all, a stellar year for our tequila brands, but one that was years in the making. We expect that these single malt Scotch brands will also receive time – require time and patience to best position them to help fuel our growth over the long term.

So in summary, fiscal 2016 was another great year for Brown-Forman. We delivered solid top and bottom line growth, notwithstanding foreign exchange pressure from an appreciating U.S. dollar. We invested significantly in the long-term opportunities that we believe will fuel our growth over the coming decades, including our entry into Irish whiskey with Slane and the launch of Coopers' Craft. We made several enhancements to our portfolio of brands, including the disposal of Southern Comfort and Tuaca and the acquisition of BenRiach, and we invested over $100 million in capital investments behind our organic growth prospects.

We did all of this while returning a record $1.4 billion of capital to our shareholders in fiscal 2016. Steady dividend growth is a hallmark of Brown-Forman, and we increased ours by 8% this past year. We repurchased over 11 million shares, bringing our diluted share count to half of where it was in the mid-1980s, and we recently proposed a 2-for-1 stock split, our seventh split in 35 years. Our ability to simultaneously grow our business, invest in the future and return capital are reasons why we believe we can continue to generate top-tier returns for our shareholders.

Our TSRs have outperformed the competitive fit, [ph] the Consumer Staples Index and the S&P 500 over the past 3-, 5-, 10-year periods by a healthy margin. We believe that we will remain an industry leader through thoughtful allocation of resources and categories focused on our core competency, whiskey. We operate in a business with aged products in multi-generational brands, and we benefit from having a long-term focus and engaged shareholder base through family control. And with our strong cash flow generation and inherent capital efficiency, we will continue to pursue a well-balanced capital agreement strategy aimed at perpetuating Brown-Forman's strength and independence.

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

Paul Varga

Thank you, Jane, and good morning, everyone. My take on FY '16 and our guidance for

FY ’17 is that they are both illustrative to Brown-Forman’s strong and continuing organic growth story once you consider the effect of last year’s dispositions and account for the impact of FX and inventory, which we customarily do. Something a little less customary is the disproportionate amount of work we’ve been doing of late to position Brown-Forman for enduring growth in the distant years ahead. And for sake of defining distant years ahead, I mean 2020 at the earliest and more like 2025 and beyond.

While we always strive to take a long view of our business, somewhat by necessity, given the aging horizons for most of our products, this last 18 months, in my view, has been even more exemplary of Brown-Forman’s long-term orientation. The current time reminds me in some ways of similarly strategic times in our recent history when we made changes to benefit our long-term future. Examples would be the early 1990s when we began a more aggressive geographic expansion, which included our initial work in emerging markets and our first experiences with international distribution ventures; the mid-2000s when we followed our disposal of Lenox and Hartmann with the acquisitions of Casa Herradura and Chambord; and more recently, in 2011 when we sold the vast majority of our wine business to enable us to better focus on our premium American whiskey trademarks at a time when consumer interest in the category had begun to surge.

In the last 5 years, this shift of focus, alongside further investments in our organization and global route-to-market, contributed to successes such as: Jack Daniel’s Black Label’s ascent to one of the industry’s most valuable brands; the creation of both Jack Daniel’s Tennessee Honey and Jack Daniel’s Tennessee Fire, 2 of the company’s most successful line extensions ever; the accelerated development for super premium brands, Woodford Reserve and Gentleman Jack, as both brands achieved the difficult super premium volumetric milestone of 500,000 cases; and the resurgence of Brown-Forman’s founding brand, Old Forester.

So now in mid-2016, we have our recent portfolio changes and capital deployment actions as examples of significant actions and investments from which we believe shareholders are likely to benefit in the years ahead. The investments we've made in Scotch and Irish whiskey over the last year are intended to give us brand and production platforms for what I'd like to call Woodford Reserve-like brand development over the next generation and exciting premium whiskey categories adjacent to the American whiskey category that we know so well.

Our patient brand building success on Woodford is certainly a source of confidence as we begin our work behind brands like GlenDronach and Slane. And our initial investment behind Coopers' Craft bourbon will enable us to tell our story of our coopers, the people who make our whiskey barrels and in doing so, convey the importance of wood and barrels in crafting the highest quality bourbons. The brand will leverage our distinctive know-how in its very old and truly unique trade of barrel making. We will undoubtedly seek to apply some of this cooperage expertise to our new endeavors in both Ireland and Scotland.

For these new trademarks and products to find commercial success, they need the focus of an organization that has the skill, the scale and the time to develop them. Brown-Forman's global route to market platform is a strong asset in this regard, and with the sale of Southern Comfort and Tuaca in FY '16, we have enabled our sales team to shift their focus to existing brands with greater growth prospects as well as the newer brands that I've just mentioned.

Since we are not reducing overhead cost dollar for dollar to cover the lost profitability of the brands we recently disposed, I consider this an incremental organizational investment against big ideas like Jack Daniel's 150th distillery anniversary this year and Coopers' Craft and BenRiach in the years ahead. We made a similar type of hidden investment behind our American whiskeys after the sale of our wine brands in 2011 and has served them very well in the years that ensued.

Beyond these portfolio and organizational investments, quality capital deployment, long a hallmark at Brown-Forman, will continue to be important to the next 10 years and beyond. We are fortunate to have a very capital-efficient business model as evidenced by the 23% return on invested capital that Jane mentioned in her comments as well as excellent financial flexibility.

Beyond the acquisitions I've mentioned, we are continuing to make significant investments in production expansion and homeplace marketing at Jack Daniel's, Woodford Reserve, Old Forester and Slane. In the years – and in the years ahead, we will incur depreciation costs associated with this additional capacity. These investments are intended to enable us to grow going forward in a manner similar to our last 10 years. Considering the margins, returns, track record of growth and the potential we see ahead, I believe these capital expenditures are excellent investments by the company.

And finally, through our more ambitious share repurchase program of late, shareholders are essentially given the options of liquidity for those who choose to sell their shares or a slightly increased percentage ownership of Brown-Forman for those to choose to hold their shares. For nonselling shareholders, your decision means the repurchase program, therefore, represents a long-term investment the company makes on your behalf in the future of Brown-Forman. And that is something that we believe in, and I hope today's results and next year's outlook as well as our discussion of the investments we are making to enable our continued success give you a similar belief in the company's prospects for continued value creation.

That concludes our remarks. Thank you for listening. And we're now happy to take any questions you have.

Question and Answer

Operator

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

Dara Mohsenian

All right. So just wanted to get a bit more detail on the interplay between volume and price. It looked like total company volume declined on a year-over-year basis in the back half of the year x price and mix, which is the first time I can remember that in recent history. It sounds like you're expecting volume growth next year. But can you give us a little bit more specifics on the balance between volume and price mix. And on the price mix side, it sounds like you're looking at more mix than pricing. Is that fair?

Jane Morreau

Yes. Let me talk about this year. I think what you're seeing in the back half of this year are a couple of things had happened. One, we're cycling against the Fire launch in the United States. So that – what happened – if you recall last year's fourth quarter, so we didn't repeat that big buy-in. It sold all the way through to the retailers, last year's fourth quarter. And probably, I think, that's one of the things that's driving it. The second thing is we continue to have declines in Finlandia. It's a low-priced brand, so a little margin brand. So it really hit your top line, not so much your bottom line. It continues to be heard in markets like Russia and the CIS, so some of the markets where the economic conditions have just continued to be very, very poor. And so you can – we saw some acceleration in the back half of the year on that brand and then again, the other piece being the absence of the launch in the U.S. on the Fire. So you did see a slowdown because of those 2 factors, if you will. They netted again – the gains that we had on the rest of the portfolio that continue to grow nicely. Our premium bourbon brands continue to grow nicely, our tequilas did and Jack Daniel's did as well. In terms of – as we look to next year, we're expecting really, very little, if any, pricing just in a few select markets, so it'll be more mix. But what's coming along next year is – Paul alluded to this a little bit. We've been making investments for a number of years – last several years behind our production facilities' sustained capacities, so we can meet demand that we think we'll be there in the not-so-distant future. So we're going to have some a bit higher cost than our price. Price will come through so that higher costs will also offset the mix benefit that we've been – that saw this year. So most of it will be coming from pricing – excuse me, volumes next year, most of our growth.

Paul Varga

Yes. And the benefit on mix, it's just – it would be evident in this past year's results, but you'd expect – it's continued – well, you get more mix benefit than pricing. And if you just think about Jack Daniel's and Woodford Reserve growing and brands like Finlandia and Canadian Mist and the absence of Southern Comfort declining, just the mix of profitability improves for Brown-Forman overall.

Jane Morreau

There's one other thing I just thought of too. It's – our table is somewhat misleading in the volume. So I think this is where you're looking at is the table. We've got SoCo volume – so SoCo is in the table, and we did not adjust for the 2 months of last year's volume. We adjusted for the 2 months of the revenue, but it's not out there for the volumes. That's probably the biggest piece than Fire and than Finlandia. So we need to figure those numbers out.

Dara Mohsenian

That's helpful. And then on the flavored whiskey side, Paul, I guess, can you discuss, as you look out over the next few years – you've obviously had a lot of success with Fire and

Honey. Are you planning to launch additional flavors in that category? And as you look out over the next few years, given we're seeing such strong growth there and a lot of competition ramping up, how's your portfolio kind of positioned to compete versus that expanding category?

Paul Varga

Well, the 2 that you – that we discussed in our results today, we continued to have very high hopes for. And I mean, I think I've mentioned this a few times, that we have no plans at this time on the – particularly on the Jack Daniel's brand, to be bringing on any additional flavors. And what we think is the best approach for our company is – and we have been encouraged so far. But what we've seen from the success of Jack Daniel's Tennessee Honey globally, but also the early and limited tests we've done on Jack Daniel's Tennessee Fire outside the United States, that, for us, we think global expansion versus additional flavors is the more effective tool for us in expanding our flavored whiskey business. So that – I think we're going to stick to that. And actually, I think some of that is incorporated in this year's plan for Jack Daniel's Tennessee Fire that enters— ***indiscernible*** — either more full distribution in the markets where it was tested or some additional countries as well.

Dara Mohsenian

Okay. And then last, in emerging markets, I mean, what we've seen in your business recently is a pretty rapid slowdown. And also, your business didn't really slow as much early on than some of the competition. So I'm just kind of curious why you think your business is seeing a more rapid slowdown recently in emerging markets given if we go back over the last 2 years, it looks like macros have really been consistently slowing in emerging markets over time? And can you talk a little bit about the pace of improvement next year and when that plays out in terms of emerging markets' organic sales growth.

Paul Varga

I mean, we'll maybe hit on a couple of those. I think part of it was the early part of the slowdown. So much of it was associated for some of our competition in China where we – just our presence is relative on a percentage basis smaller than many of our competitors. So maybe that and particularly the cognac players, they were impacted by that going back a few years. I think more recently for us, we've seen that in places – a lot is – Jack Daniel's is so geographically diversified and spread. And for many, many years, it has been developing its business and for example, in the emerging markets, we never singularly focused on BRIC. We looked to all kinds of smaller markets that were also emerging and we just felt that those were, I think, more appropriate developmental efforts on behalf of the brand, even going back 10 years ago. So like in – for example, Eastern Europe has slowed down in some markets. Some of the smaller markets, those related to oil, it is – their economies and their currencies have been so difficult. And so it just – this round of emerging market difficulty because there's always – it seems to me that there's some markets going up and down, and that's why we like the geographic diversification we have this particular year, with emphasis on Russia and then some of the smaller markets, other markets tied to – particularly tied to oil, seem to hit us in more than they had in past years. And it doesn't really take away over a longer period of time our viewpoint that these will be important markets for Brown-Forman. It's just that you have to be patient while those economies wrestle with what's happening locally.

Jane Morreau

So just building up on what Paul said. So you're asking about – also asking about what we talked about in F '17 as it relates to – we really don't expect much improvement in the short term. So we're not expecting big bumps, big increases from the emerging markets. We still, as Paul said, believe in the long term of these brands – or of these countries. The one thing I would say, just to add on to what Paul said, he talked about the oil and all of these, well, that had a big impact on currency. And so we found that currency hit us in many different ways in the emerging markets. So whether it was that the consumer –

that the price – that the valuation of the currency had gone down so much, making our products so much higher, and so maybe the purchasing power in the situation called that to happen or some of our trade partners, margins were screwed. It was pretty widespread and I would say, a lot of the currency stuff hit like starting the last summer when the big devaluation in the Brazil real and some of those other currencies and just kept going everywhere. And so I think that is…

Paul Varga

Yes. I think the thing too, if you're looking for something unique to our company, because we play relative to our competition at – since our confidence is in terms of sales and profitability at higher price points and impact like what we're seeing in the emerging markets might hit us. For them, we don't own a lot of local brands in these emerging markets, so they might have a hedge or something against the devaluations and purchase power that you see. So that could be a point to help to explain it as well.

Operator

Your next question comes from Judy Hong of Goldman Sachs.

Judy Hong

Wanted to get a little bit more color on how you're thinking about the U.S. outlook for fiscal '17 in terms of the underlying sales growth. So obviously, you're lapping the Fire launch, which will be pretty challenging in certainly the first part of the year. I think you talked about some of the competitive dynamics in the marketplace. It sounds like you have a lot of the consumer campaigns planned for this year. So I'm just curious. As you think about what you did in terms of fiscal '16, the 6% underlying sales growth, how sustainable is that kind of growth lapping Fire? And all – and are all – a lot of these consumer campaigns that you have planned really aimed at driving growth kind of more the near term or more really building the equity in the longer term and enduring growth on the

Jack?

Paul Varga

I'll touch on it, just the second question you've got there. I mean, I feel like what we're planning for the U.S. is sustainable. I mean, I really do. And I would segregate the – my answer to your question. There's some investments we'll be making, for example, this year, in Woodford and Old Forester packaging, for example, which, I think, could benefit those brands. There's easily some initial interest in it. But I think those things tend to benefit brands in the years ahead. Clearly, the most significant thing that will have a timely impact that I think is probably the most significant thing we're doing this year is the promotion and marketing and selling around the Jack Daniel's 150th anniversary. So I think that is pointed toward – a lot of it is already underway. But also, we'll have really here, in the second half of the year, we think, a pretty significant consumer impact. So that is one of our bigger ideas for ways to sustain the growth, both in the U.S. and at Brown-Forman.

Jane Morreau

And just building on what Paul said and just to emphasize that Woodford Reserve, Old Forester and our tequilas are doing very, very well and they continue to grow nicely, and we expect them to continue to grow nicely next year. We've alluded to some of the double-digit growth on all those categories, so we're somewhere at an inflection point and good consumer awareness is happening. So we're continuing to see nice gains and nice contributions out of those. So those will continue with our expectations on the...

Paul Varga

And one of the offsets – just to repeat something I said just a few minutes ago, one of the offsets to cycling the initial interest and trial on Jack Daniel's Tennessee Fire in the United States is the fact that we'll be introducing it to new countries. And so that is clearly a partial offset. And it's not diminishing the fact that the U.S. market for this category is really competitive. And in this particular year, in year 2 of Jack Daniel's Tennessee Fire, reminds me in some ways of prior years where there was such interest in the prior year on the launch of something where there was pent-up demand, which I felt last year, when – in spring particularly after we've done that stage rollout. And there was a huge surge and interest in trial associated with this product. And as you can imagine, I mean, I just feel like – and it – just composition as a product, it's not going to be for every straight whiskey drinker because it's, in fact, a flavored whiskey. And so I really do. It doesn't surprise us that there are tough quarters following a launch like that in a particular country. But I do feel we have the benefit of expanding it geographically to partially offset that.

Judy Hong

Okay. And if I can just follow-up on that, Paul. So as you – when you compare the Honey geographic expansion to sort of the Fire expansion, how should we kind of think about the impact? And maybe also, you can also remind us how big Honey is in some of the markets that Fire is getting launched this year, the U.K. then France.

Paul Varga

Well, I think on a global level, the volumes are about half-half, I think, for Jack Daniel's Tennessee Honey, and that…

Jane Morreau

A little bit more outside the U.S.?

Paul Varga

A little bit more outside the United States, if it gives you any indication. And we're in no hurry, I mean, to go get as – I think Jack Daniel's Tennessee Honey, we – it took us the better part of 4 years plus to get to, I think, where – I mean, rough [ph] this number, we're something like in 80 countries where we're doing most of the business for Tennessee

Honey today. And I don't anticipate us getting that fast next – this fiscal year, even in the next 2 fiscal years on Jack Daniel's Tennessee Fire. We're playing it a market at a time to see where there seems to be appeal. As we go along, we know that the – one of the differences between Jack Daniel's Honey and Fire are that – there's – the way that they're used. And so going into it, we knew that Tennessee Fire would skew more towards shot or straight consumption whereas Honey, a lot – some of that is also used in mix format equally. So I think we're just going to learn as we go and try to promote as we've been encouraged. I'll tell you from what we've seen, not only in the United States, I just feel like we had a great first year there against the pretty tough competitive environment. And what we've seen, where the competition is not the same in these international markets as it is in the United States, that Jack Daniel's Tennessee Fire is doing very well and sufficiently enough that we would either expand it within those countries or introduce it into new countries.

Judy Hong

Okay. Then my last question is obviously, you've made significant changes in terms of the portfolio over the last few years. If I look at your brand performance, certainly, Finlandia and Canadian Mist sort of screen [ph] is continuing to be a drag in terms of your growth. So not asking what your intentions with these brands are. But I mean, are you investing behind these brands at this point? Is it just more of macro dynamics that sort of are pressuring these brands? And are there other strategic considerations as you think about brand like Finlandia where given its size and the Russian market, that you kind of need a sizable brand like this if you are going to be in that market?

Paul Varga

Yes. I mean, you kind of answered your question. There are – I agree with you. I think there are always strategic considerations. But we don't have the largest portfolio by any means. And so as a general bias, we are brand builders versus brand sellers. And I really do feel like that almost any brand in our portfolio, we're going to try to do the best job we can with it and oftentimes, they do play strategic roles. And Finlandia has been very important to particularly Jack Daniel's' development in Eastern Europe over the last decade. And Finlandia has been, on its own merit, a very successful brand in that part of the world. It's just a very difficult time for the vodka segments in those Eastern European countries right now. And we've seen this before with categories where they go through some rough times, but it doesn't mean we don't put our best foot forward. And actually, we're – right now, we've continued to work on Finlandia. We've got – I don't know if it will hit this year, but it – maybe into the next fiscal year as it takes a lot to make those changes. But we're sort of enthusiastic about some packaging changes there. And this – we have the latitude of being patient here because it's really – in the grand scheme of things, the brands you mentioned are not that significant a drag on Brown-Forman. I mean, they're relatively small when you get down to the bottom line as it relates to their – the degree of their impact on our performance. I mean, yes, they might pull you up a quarter or 2 on the sales line or even on the operating income line, a little bit from time to time. But I mean, the story of our company, because of the – just development that I mentioned over the last decade or more around Jack Daniel's and our American whiskeys is really where we're placing our emphasis today. But having said that, it doesn't mean that we're not going to develop brands in the tequila space, which we're very excited about what's been going on within the last 18 months or so, but also do the best job we can to shore up brands that are having difficult performances like Finlandia and Canadian Mist.

Operator

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

Bryan Spillane

Just a couple of quick ones. First, I think when you went through the components to the revenue build for '17, you've referenced barrel pricing not being as good as it was last year and also some reduction in distributor inventory. Can you just give us a sense for how much of a drag you expect that to be in '17?

Jane Morreau

Yes. I'll take the distributor inventory one specifically. We've estimated somewhere in the $0.05 for it to be a drag on our reported top line growth. So that's the answer to that. What I would say with the other pieces of the sales growth, focus on the things that were dragged this year. So there won't be drags next year. For instance, the Southern Comfort, Tuaca dragged on our top line, which was about 0.5 point. Global travel retail, which we think the worse was behind us, that was about 1 point. So both of those things, we don't expect to repeat again. And so in terms of the barrel sales, it's not material to our top line sales number.

Bryan Spillane

Okay. So the message there is that those things are generally washing themselves out. Is that the way we should look at it?

Jane Morreau

You could get there.

Paul Varga

Yes.

Jane Morreau

You could get there, yes.

Bryan Spillane

Okay. And then there was also the mention about, I think, in the out year, changing over to self-distribution in Spain. Did I catch that?

Jane Morreau

Yes, you did. Definitely 2018. So we'll have some costs that will start to incur in the latter part of next year. But the actual transition to it will not happen until next summer.

Bryan Spillane

In terms of order of magnitude – I'm sorry. I was going to say, just in terms of order of magnitude, I remember when you did this transition in France, it caused a lot of noise kind of around the fourth quarter, if I'm remembering this correctly, of the year before and in the year that you actually made the transition. So this order of magnitude, do you think it will have that similar types of effect on sort of the flow of things?

Jane Morreau

No. It's definitely not in F '17 for sure. And it's – the size of the market is not as large as France either. So we don't expect, even when we do transition, that it will have that kind of magnitude. We will have a transition and it will have some small impact, but not as significant as what we had in France.

Paul Varga

We'll make that more visible as we get closer to it. But yes, it's intended to have similar long run impact as it relates to bringing focus to our priority brands in that market. It's an excellent whiskey market. It seems, from at least a view of our vantage point, to be turning the corner as it relates to their economy and their disposable income relative to what they've been experiencing in the prior few years. So we think it could be well timed to go and make this move, which is familiar terrain for us. And in each instance, they've been differently scaled investments and operations. And as we get closer, we'll give you all visibility to that.

Bryan Spillane

Okay. And then just one last quick one. Does the EPS guidance range for '17 include or

– include any share repurchases? Or would that be, if you did any B— ***indiscernible*** —, above and beyond?

Jane Morreau

It only would include what's been done thus far.

Operator

Your next question comes from Bill Schmitz of Deutsche Bank.

William Schmitz

Can you just talk about the gross margin outlook for next year? Because it seems like your commodities are still relatively favorable. The currency environment's a little more tamed. And it looks like there's going to be a ton of positive mix. Is that a fair assessment?

Jane Morreau

I'm sorry. Can you repeat that question?

William Schmitz

I was just asking about the gross margin outlook for next year because it seems like there's a lot of favorability going into '17.

Jane Morreau

Yes. So we aren't expecting – and we actually expect our margins – gross margins to be flat next year. And the reason why that is we're not expecting much in the way of pricing, and our costs are going to up modestly. They'll more than offset pricing investment and offsets in the mix. So we're not expecting margin expansion. So some of our cost increases, I mentioned this earlier, are starting to come through as we've made these investments behind our stepped up capital spending to expand our capacity.

William Schmitz

In the moderate – the moderation of currency is not going to help?

Jane Morreau

You're talking about on a reported basis then?

William Schmitz

Yes, yes, exactly.

Jane Morreau

Right now, what we have forecasted in there, no.

William Schmitz

Okay, all right. And then if I look at some of the flavored brands in the U.S., and this is obviously just in the scanned [ph] channels, it seems like some of the sales trends are declining pretty rapidly. I mean, is that kind of what you're seeing as well and maybe what's driving that? And is there a plan to kind of get that moving in the right direction again?

Paul Varga

Well, I think there's – it's just been such a dynamic category. When you look at any short-term period, whether it's a month or a quarter, there could be all kinds of explanations for why they might be showing big gains or big losses. I think we have the number of entries that are going in there. I know and as we sort of explained for our business, we're currently, on the Jack Daniel's Tennessee Fire, up against some, I think, some significant introductory promotion and trial from last year. So for us, that would be the case. I can't speak to every single competitor, but I suspect that – remember, this category is still relatively new. So there's been a lot of new introductions just in the last 2 years. I mean, I remember, thinking about it, I guess, as we turn the calendar year, this year, how much did it change, just even since we began with the launch of Tennessee Honey and then how we had sort of methodically been testing Jack Daniel's Tennessee Fire and how rapidly the category kind of changed just from the test markets on Jack Daniel's Tennessee Fire to the national launch. And so it's the nature of these categories that rapidly develop. We think we're smart to be in it in the way that we're in it. It's been very, very nice business success for us to date but also plays, just as we were referencing on the roles brands can play in portfolio, it plays a very strategic role in some ways defensively but also very offensively as it relates to giving people an opportunity to try whiskey in a way that they might not have before. The straight whiskey can be an acquired taste. And we find that this category, particularly for our brands, has been bringing in new consumers, and it generates an interest in our other whiskeys, most notably Jack Daniel's Black Label. And so it plays – it can play a strategic role as well as being a bona fide business in some right.

William Schmitz

I got you. That's helpful. So do you think it'll start inflecting positive in the sell-through data as we kind of see the data come out, bounce out of it? [ph]

Paul Varga

These are not – the category or for our brands or what?

William Schmitz

The category under your brands.

Paul Varga

I think the category is continuing to grow just because there's been – I mean, it's really concentrated right now around 3 predominant flavors. But I think the category will continue to grow. But then within the category, you'll see trademarks and certain flavors be more volatile than you would say a normal bourbon or gin or vodka category, but just because the category is so dynamic right now. As it relates to Jack Daniel's Tennessee Fire, I think once we cycle through some of these comparisons, the impact won't be as large. But I still expect that it will – I really do feel like that first year with particularly a brand that's participating in a category where the flavor is cinnamon, I really do expect that they're in the first sort of half of its national launch. There were absolutely – just think of it this way. There were – I know there were a bunch of Jack Daniel's drinkers who were straight whiskey drinkers and were not participants for say, in the cinnamon whiskey business, who tried it and just decided it wasn't for them, right? I mean, they prefer straight whiskey. I think there were also a fair amount of fireball, which was the – obviously, the large volume, lower priced brand. They tried it and then maybe didn't see fit that they could afford it on every single occasion when they were consuming cinnamon-flavored whiskey. And so I think those things, they end up being what I call trial influences in those early days of a brand's existence in a marketplace that just don't get repeated. So until [ph] you work through some of that and then also begin the marketing and selling process to introduce the brands to new consumers, which – the most encouraging thing we're seeing in our numbers which don't really reported a lot in the syndicated data is the – are the results to the on premise, which kind of started okay, I felt. I thought it was going along pretty well. But with the expanded distribution and the momentum that sort of happened out in the marketplace, the Jack Daniel's Tennessee Fire brand is doing very, very well right now in the on premise, which – it might surprise you because the off premise is not doing as well against that introductory launch. So in any event, the thing that gives us encouragement and tells us we can either continue to sell it and market it and promote it in a way that can make it the choice for more consumer locations. I mean, it just comes down to that and in knowing it full well that it's going to be a competitive environment in which you are attempting to do that.

Operator

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

Mark Swartzberg

A couple of operating income questions. The first is when I look at fiscal ’16, Jane, you’ve had this nice reverse where you’ve gone from another expense item in fiscal ’15 to another income item. And I think it’s about a 3-point benefit to your total operating income growth. So it’s pretty significant and I don’t quite understand what’s going on there. So is my math right? And if it is, can you give us some understanding on what is going on there.

Jane Morreau

And just to – you’re talking about – you’re talking in the fourth quarter, correct?

Mark Swartzberg

No. Well, it’s clear that it’s more of an impact in the latter part of this fiscal year than in the earlier part of the fiscal year. But I’m really looking at the full year and just saying you guys are incentivized on operating income performance. You got to your 8, [ph] but 3 of those points came from this reversal from an other expense in fiscal ’15, so an other income in fiscal ’16.

Jane Morreau

Yes. So the largest component of it is FX related. So we had some fairly sizable loss this last year that we had talked about throughout the year that wouldn’t repeat itself this year, coupled with – as the year went on, particularly in the fourth quarter of this year. When we got to April, we had a nice gain. And these are on cash and other current assets and liabilities that aren’t denominated in U.S. currency. So that’s FX related, the big piece of that is, probably 2 – probably about half of it actually is due to that. Some – more than half of it is actually due to that. About 2/3 of it is due to that. Then we also had an asset that we wrote off last year’s fourth quarter that was a low-value vodka brand. So it was a write-off that we had in last year that didn’t repeat itself, and that’s about the other piece of it. Those are the 2 pieces.

Mark Swartzberg

Got it. And that FX component, how much discretion do you and your team have with that? And to what extent is it just what the market deals you? [ph]

Jane Morreau

What the market feels generally – I mean, we do hedging, but that – our hedging is largely against another line item on our P&L, more again— ***indiscernible*** — or sales or revenue.

Mark Swartzberg

Got it. Got it, okay. And then as I think about fiscal '17, the 7% to 9%, you talked about SG&A. I'm still not quite there because you're talking about a volume-driven revenue performance. You're also going to get this distributor drawdown effect. You're also saying gross margin's going to be flat. So it all really comes back to SG&A and perhaps if you have some optimism about this other income line as well. So can you just help me better understand how you think you get 7% to 9% given what's going on from the revenue down to the GM percentage line?

Jane Morreau

Let's just step back for a moment on the distributor inventory number. That's a reported number, not an underlying number. So that's not going to affect the 7% to 9%, so — ***indiscernible*** —

Mark Swartzberg

Fair enough. Yes, good point, yes.

Jane Morreau

That's probably your biggest piece. But let's talk about SG&A as I alluded to. We had, what, a couple percentage point increase in underlying SG&A this year. We expect about the same next year. So if we're going to really leverage our prior investments that we've made — ***indiscernible*** — to consumers, Paul alluded to this in his comments as well, the reallocation of resources as I did too, from the folks that were spending time on Southern Comfort and Tuaca, that we're reallocating that time and energy to some of the value – to the new brands that we brought into our portfolio as well as other opportunities for value creation – that or [ph] value creation. So you get leverage from the SG&A.

Mark Swartzberg

And do you have a view about what will happen with this other income line or do you just kind of see what happens with that line?

Jane Morreau

I mean, the other income line, we don't forecast FX per se in that line. So we won't – whatever was in there that was related to FX this year won't repeat itself, other than whatever happens at the top rate that's in [ph] – as you asked, you said, "Are you at the mercy and we are at the mercy.

Paul Varga

And we do think, just based on where currency rates are today versus last year, we know that currency is net-net and our EPS forecast is a bit of a drag on the overall. I mean, so we do forecast that, but we sort of just do our plans in a consistent rate and then we report to you all as the year goes on and as fluctuations occur.

Mark Swartzberg

And what's – you can probably tell, I mean, I – what's driving my questions is the rate of operating income growth for a lot of companies is coming down because of the nature of the marketplace. But you have this incentive comp structure that changed a few years ago, and 8% is the magic number. And you got there in fiscal '16, and fiscal '17 has got incremental challenges on the top line. So I'm just trying to understand how you're thinking about the cost flexibility you have as a result. Okay. And then just when you think about the distributor intention, how are you thinking about your own promotion rate vis-à-vis either your more expensive brands or some of your lower tier brands? I would think there's an incremental incentive to promote a little more given that you do want to improve volumetric performance. So am I thinking about that right? Or can you help us – and that's a U.S. question. I'm just trying to better understand how you're thinking about that.

Jane Morreau

I don't have a higher level of discounting or promotional activity plan for next **— *indiscernible* —**

Paul Varga

Yes, I think it's – I think we…

Jane Morreau

Well, when they do it, and it depends on how they do it.

Paul Varga

Yes. So I think it would be consistent from year to year. I actually think the thing that will drive more promotion this year that will assist, and it might help you with your answer, is the Jack Daniel's 150th anniversary. I mean, it just – I mean, it is significant news for our trade system, and we just happen to have a very – and we're fortunate to have such a loyal and affiliated Jack Daniel's consumer base around the world and that we can already tell, from their early reaction, to some of the initial PR, that they're very enthusiastic about the things that we are planning and we'll be undertaking, which include new to the marketplace special offerings and packages in the latter half of the year to which – from which we should benefit. So it – but I also think you'll just see more Jack Daniel's Black Label on displays. And because of the event itself that – we sometimes call this a gift from the calendar that we've lasted this long. And we think that there is just the energy and emotion around it we had a bunch of the U.S. distributors in here about 3 weeks ago. And I can tell you the reaction to what's forthcoming and the expectations that we're placing on our U.S. system, they didn't balk at them at all.

Operator

Your final question comes from Tim Remy of Pivotal Group.

Timothy Ramey

My question was really a about sort of triangulating how impactful the 150th anniversary might be. I can see this being quite a gift from the calendar. But I don't know how, and you probably are not ready to tell us how big your promotional plans are. But will the average consumer be aware that this is going on? Or is this sort of an insider cult anniversary?

Paul Varga

No. It'll be – I mean, look, we are – our advertising and promotional budgets aren't of the scale as some industries. But no, they'll be quite a bit. It'll be targeted through our social media means so realize— ***indiscernible*** — to be efficient, but there will also be mass media. The public relations piece of this, which is more significant than in past years, will also expose it to larger populations of people. The special packaging, of course, will be more devoted to the retail environment where that's offered. But there's a couple of offerings. There's one that's a little bit above the price of Jack Daniel's Black Label in every day. [ph] And then there's one that's going to be more limited. It's, I think, $100 a bottle. And so yes, I mean, these are unusual events for us because we – you don't come along them that much. And so they – well, you treat them like a milestone. And I actually expect, the – when I sit and look at it, can you get another point of growth out of the Jack Daniel's Black Label franchise over a year because of an event such as this? I sure think so. I'd like to hope so. So we'll keep you updated as we go. And some of it will become more visible as the marketing and selling makes its way out into the environment. But I mean, we wouldn't put forward a forecast that we didn't have some level of confidence in. We obviously do a range because we can't predict what the world is going to do out there. But as I said in my comments, I really do feel like what we're considering – even though the puts and takes are a little bit different, what we are forecasting in our outlook is really a continuation of the good year that we think we reported this morning.

Timothy Ramey

Right. Is the $100 offering you mentioned a special product or a special package?

Paul Varga

Both. It'll be hard to get. I know you're going to want one, aren't you?

Timothy Ramey

I will. Put me down.

Paul Varga

I'll put you down? I don't even know if I can get one. We've actually – those will be much more limited as the market for them is. But nonetheless, we think it's something that honors the 150th anniversary of the distillery. And actually, I think, I'll tell you, it's really important that – not only just an important thing for Brown-Forman. Earnings is what we're discussing here today, but it's also a really important opportunity for Jack Daniel's against a competitive backdrop where there's everything from craft whiskeys and bourbons out there to some of these waves of – and trends where big is bad and small is cool and all of that. I just feel like this is a really important opportunity for Jack Daniel's to tell its authentic story in really, really compelling ways, which will go way beyond calendar year 2016. I mean, I think that it is an inflection point for the brand to remind everybody that it's one of the most special brands of any kind in this industry. And I think across a lot of categories of consumer goods. And as you all observed across a lot of companies and a lot of categories, it's hard out there right now for established brands. And we've largely been – continue to be successful against that backdrop. But this gives us a really unique opportunity to – what I'd like to say, just to tell our story. And it's a story that should fit beautifully with why people are choosing American whiskeys today and drinking whiskey generally. And so it's just a great opportunity for us to get out and tell that.

Jason Koval

Well, thank you, Paul and Jane, and thanks to all of you for joining us today for Brown-Forman's fourth quarter earnings call. Please feel free to reach out to us if you have any additional questions. And we hope you all have a great week. Take care.

Operator

Thank you. This concludes your conference. You may now disconnect.