Constellation Brands Inc, Q2 2016, Earnings Call 2015-10-07

Presentation

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the Constellation Brands Second Quarter Fiscal Year 2016 Earnings Conference Call. — ***Operator Instructions*** — Thank you.

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

Patty Yahn-Urlaub

Thank you, Jackie. Good morning, everyone, and welcome to Constellation's Second Quarter Fiscal 2016 Conference Call.

I'm here this morning with Rob Sands, our President and Chief Executive Officer; and David Klein, our Chief Financial Officer.

This call complements our news release, which has also been furnished to the SEC.

During this call, we may discuss financial information on a GAAP, comparable, organic and constant currency basis. However, discussions will generally focus on comparable financial results.

Reconciliations between the most directly comparable GAAP measure and these and other non-GAAP financial measures are included in the news release or otherwise available on the company's website at www.cbrands.com.

Please also be aware that we may make forward-looking statements during this call.

While those statements represent our best estimates and expectations, actual results could differ materially from our estimates and expectations.

For a detailed list of risk factors that may impact the company's estimates, please refer to the news releases and Constellation's SEC filings.

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

Robert Sands

Thank you, Patty, and good morning, and welcome to our discussion of Constellation's second quarter 2016 sales and earnings results. I am very pleased with our excellent quarterly results. Our beer business continues to deliver industry-leading results. Our wine and spirits business is on track to meet its goals for the year, and we continue to progress as planned with our Nava Brewery and glass plant expansions.

Let's drag right into the commercial and operational results we saw this quarter for our beer business. During the second quarter, the beer business generated double-digit depletion growth, driven by exceptional consumer demand for our products across the beer portfolio. In fact, the second quarter marks the 22nd consecutive quarter of volume market share growth for our beer portfolio. Constellation beers represented 45% of total U.S. beer industry volume growth during the quarter, as all of our beer brands grew across most channels and package sizes.

Excellent execution by the beer team during the peak summer selling season with the 120 Days of Summer marketing campaign drove market share gains during the Fourth of July, which continued throughout the heart of the summer and into the Labor Day holiday. This performance was led by Corona Extra and Modelo Especial.

Corona Extra posted accelerating depletion and consumer takeaway trends during the summer months, driven by continuing velocity, growth and distribution gains, including the can launch and ongoing investments in media and merchandising with the new Always Summer marketing campaign.

The new Corona cans continued to expand consumption occasions for the brand and are a hit with consumers. Cans represented more than 40% of the growth of the Corona Extra brand during the quarter.

Throughout the summer, we dedicated significant media support behind the can launch with English- and Spanish-language TV and digital advertising, especially during the July 4th and Labor Day holidays.

We see great opportunity with this format as it currently represents only about 5% of total Corona Extra volume.

Modelo Especial delivered depletion growth of nearly 20% during the second quarter, driven by continuing velocity and distribution gains.

The brands increased media investments, including the continuation of Modelo Especial's national English-language TV and video campaign, continued throughout the summer months, reaching the general market and bicultural Hispanic beer drinkers through targeted entertainment and sports programming.

National Hispanic media included the Gold Cup broadcast sponsorship on Univision throughout the month of July, including in-game advertising and sponsorships.

Corona Light continued to gain share with all core Corona Light packages posting growth during the quarter. 3 new brand TV spots were showcased on national TV throughout the summer and the brand sponsored Kenny Chesney tour continued with 29 tour dates from June through August.

For the remainder of the year, we have solid marketing programs in place in order to maintain the excellent brand momentum we are experiencing across the portfolio.

For Corona Extra, the football season continues to grow in importance through our returning partnership with Coach Jon Gruden and maintenance of key investments with the NFL, the #1 program on TV.

Boxing also remains a priority with Corona Extra through an integrated marketing plan to support highly anticipated fights.

The momentum of the Corona can format will be supported through general market and Hispanic TV support into the fall football tailgating season. And you should expect to see our iconic Corona Feliz TV spot leading into Thanksgiving holiday, which will be accompanied by robust on and off-premise promotional programs designed to drive brand affinity for Corona during the holiday season.

For Modelo Especial, we have added 6 weeks of live TV sports program on national English-language TV during the start of the NFL season across CBS, FOX, ESPN and ESPN2.

National Hispanic media will also continue for Modelo Especial with the weekly TV exposure to Spanish-language consumers.

Before moving on to a discussion of our beer operations, I am pleased to announce today that we are launching our new Tocayo Hominy White Ale, a craft Belgium-style wheat beer inspired by the culture and flavors of Mexico. The idea for this new beer brand was developed by our beer team working in conjunction with Chef Rick Bayless. It will be available beginning next week at several of the Rick Bayless' Chicago Frontera restaurants and other key Chicago area on premise accounts.

Our beer operations continue to run smoothly. The brewery and glass plant expansions are proceeding as planned. All key performance metrics related to cost, quality, capacity utilization and service are better than target this quarter.

New bottling lines are currently being commissioned and will become fully operational by year-end. Support for the expansion such as cogeneration, wastewater, engine room and fire protection are all on schedule. Work continues on the next expansion phase as we increase production capability from 20 million to 25 million hectoliters and continue to expand the rail and logistics capabilities around the site.

Overall, the strong results that the beer business achieved in the second quarter are the primary driver of the upward revision to Constellation's EPS guidance for 2016.

We are now targeting EBIT growth for the beer business in the 15% to 18% range, which is expected to drive an enhanced operating margin of approximately 34% for the segment in fiscal 2016 versus our previous margin estimate of 33%.

While we are currently experiencing favorable commodity and foreign currency benefits, which combined are the most significant drivers of the revised beer margin for fiscal 2016. We have also experienced better-than-planned operational results driven by our glass plant performance.

We are on track to bring the first 5 million hectoliters of capacity online at Nava by calendar year-end. Once this capacity is operational, we will be positioned to bring the next 5 million hectoliters into service by next summer.

Upon completion of these 10 million hectoliter expansion, the Interim Supply Agreement with ABI for finished goods will no longer be required as we will be fully self sufficient from a supply perspective to fulfill our needs for the U.S. market.

We expect to receive the full benefits of our targeted mid-30% operating margin goal on a more sustainable basis once we are fully operational at 20 million hectoliters at Nava.

Longer-term margin target, we will still have much to accomplish. I would like to remind everybody that the 5 million hectoliters of capacity that will increase Nava capacity from 20 million to 25 million hectoliters is expected to be completed by calendar 2017.

Finally, given the continued strength of our beer business, we continue to make progress in evaluating plans for our future capacity needs beyond 25 million hectoliters. And we will have more to say as we finalize our plans in coming months.

And now I would like to discuss the business results for our wine and spirits business. In the wine and spirits business during the second quarter, we achieved earnings growth and solid margin expansion while delivering strong spirits performance and excellent overall results for our Canadian business.

In the U.S., our net sales are benefiting from positive mix trends, and we are maintaining IRI volume share in the U.S. wine market.

We have successfully integrated our new Meiomi wine brand into our existing wine portfolio and are working to expand distribution to drive incremental growth for this brand.

The most recent 4-week IRI trends show that Meiomi is growing more than 80% in multi-outlet and convenience channels, which is contributing to the fact that our premium plus dollar growth improved in recent periods.

Throughout the quarter, our focused investments within wine and spirits could be seen in the marketplace.

As a reminder, we are concentrating our investments and our resources on a key subset of our focus brands because we believe they have the right combination of scale, higher margins and growth potential to drive our overall business results.

Let's talk about a few examples of these programs. Our TV advertising for Woodbridge aired over the summer and helped to drive strong IRI growth for this brand during this time frame. This program will rev up again in advance of our winter holiday selling season.

Our Kim Crawford brand is the unrivaled leader of the New Zealand category with its distinct flavor profile and undue [ph] ordinary marketing platform.

This summer, it kicked off its exclusive national campaign with Cirque du Soleil and executed promotional programs with co-branded advertising offer, sweepstakes and sampling events.

Kim Crawford posted dollar growth of more than 30% in the recent IRI periods.

Mark West, America's #1 pinot noir and 5-time consecutive winner of Impact's Hot Brand Award, is harnessing the power of its unique majority male shopper base with targeted digital Facebook ads and expanded print media in conjunction with its Healthy Grilling campaign.

And this month's – month, we're launching Mark West Black to take further advantage of the pinot noir craze.

Overall, we experienced depletion trends of more than 6% for our focus brands during the second quarter, which demonstrates that this strategy is paying off.

We've also taken some exciting steps towards our goal of developing new brands that have potential to win big with consumers.

The newest wine brand in the portfolio, Tom Gore, is named for Tom, a second generation grape farmer, who has a passion for cultivating fruit with exceptional flavor and quality from his vines. This brand resonates with consumer's search for authenticity of the origin ingredients and people involved in what they eat and drink, and we are very pleased with its preliminary results.

During the quarter, our spirits portfolio experienced excellent net sales growth of 19% and solid depletion growth across the portfolio, driven by Paul Masson Grande Amber Brandy and the success of its peach flavor offering as well as SVEDKA Vodka, led by its hit flavors, mango pineapple, strawberry lemonade and grapefruit jalapeño.

Casa Noble Tequila is exceeding our expectations so far this year with continuing share gains after particularly strong depletion growth during Cinco de Mayo. And we continue to make focused Casa Noble marketing investments in 4 key local markets: LA, New York, Chicago and Texas where activation programs include tasting, cocktail features and collaboration with our beer portfolio for local events.

Print ads targeting millennial consumers are also running in regional publications. This quarter, we launched the national rollout of SERPENT'S BITE, a bold whiskey infused with apple cider flavors. This product targets the intersection of 3 of the hottest trends in alcoholic beverages: Flavored whiskey, hard cider and the shot occasion. Though it is too early to comment on long-term expectations for this brand, our retailer and consumer feedback has been very positive, and we are pleased with what has been a fantastic start to the development of this brand.

As we head into the key holiday seasons for our wine and spirits business, we will be executing programming designed to ensure that we continue to drive growth, especially for our focus brands. Our expectation is that you should see improving depletion trends as we progress throughout the remainder of the year.

As is typical at this point in the year, I would like to provide an update relative to the California grape harvest, which is currently more than 80% complete and is expected to be completely finished by mid-October.

The current California industry estimate is for a total harvest yield of 3.6 million to 3.8

million tons versus approximately 4 million tons last year. While the crop is down this year versus last, quality looks to be very good with excellent color and flavors and our winemakers are smiling.

From a pricing perspective, we continue to expect grape pricing to be flat to down slightly versus last year, depending on the variety, location and demand with the exception of Cabernet, which continues to be in high demand.

In closing, we are at the halfway point in the year, and I am very gratified with our impressive results so far this year.

We are working diligently on the Nava Brewery and glass plant expansions while maintaining the strong momentum of the beer commercial business.

And within our wine and spirits business, we are making good progress overall, and I believe we are well positioned to drive our great portfolio of brands during the upcoming holiday selling season.

This December marks the 70th anniversary of our company's founding. We are proud of our heritage and look forward to positioning our company for the next 70 years of living our vision to elevate life with every glass raised.

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

David Klein

Thank you, Rob, and good morning, everyone.

Let's start with some Q2 highlights. Comparable basis diluted EPS was up 41%. Stellar execution by the beer business drove strong marketplace and financial results during the key summer selling season.

The strong beer performance along with some favorability in our interest expense are driving our full year comparable basis diluted EPS projection up $0.20 to a range of $5 to $5.20 per share for fiscal ’16.

The beer performance, along with lower than previously expected payments for taxes and interests, are also helping to push our fiscal ’16 free cash flow projection up $100 million to a range of $200 million to $300 million.

And our glass plant and brewery expansion activities continue to progress as planned as we are positioned to bring the first 5 million hectoliters of additional capacity online during the second half of fiscal ’16.

Let’s take a closer look at our Q2 results where my comments will generally focus on comparable basis financial results.

Consolidated net sales on an organic constant currency basis grew 9% for the quarter. We continue to see robust marketplace momentum for our beer business with depletion growth of 10%. Beer net sales increased 14% on volume growth of 13%.

As a reminder, during Q2 fiscal ’15, we estimated that beer recall activities resulted in the reversal of approximately 2 million case shipments to wholesalers and a $37 million reduction in net sales.

If you adjust last year’s second quarter for the impact of this activity, volume growth in this year’s second quarter would have been closer to 9% and net sales growth closer to 10%.

We replenished the Q2 fiscal ’15 recall volume with shipments to wholesalers during the third quarter of fiscal ’15.

In addition to that activity, wholesalers also increased their inventory position during the third quarter of last year to bring inventory more in line with historical levels.

As a result of these activities, we will be facing a difficult beer sales and EBIT growth comparison for Q3 fiscal ’16.

Beer sales growth for the first half of fiscal 2016 totaled 13%. However, the difficult third quarter comparison is a primary driver of why we continue to expect full year fiscal ’16 beer net sales growth to approximate 10%. We continue to expect solid third quarter depletion growth.

Wine and spirits net sales on an organic constant currency basis increased 3%. This primarily reflects higher spirits shipment volume.

For the quarter, consolidated gross profit increased $93 million, up 13%, with gross margin increasing 220 basis points.

Beer gross profit increased $89 million, primarily due to volume growth, lower COGS and favorable pricing, and our beer gross profit margin increased 310 basis points to 48.4%.

Wine and spirits gross profit was up slightly as volume and COGS benefits were partially offset by unfavorable foreign currency translation.

Gross margin increased 60 basis points to 41.6%. Consolidated SG&A for the quarter increased $5 million.

Due to the factors just mentioned, consolidated operating income increased $88 million and consolidated operating margin improved 320 basis points. Beer operating margin increased 450 basis points.

This improvement reflects the gross profit benefits that I just highlighted, plus favorability in marketing spend on a per case basis for the quarter.

The marketing spend benefit is timing related as we expect to see higher marketing spend during Q3 and for the full year.

Wine and spirits operating margin improved 90 basis points, primarily due to the gross profit benefits discussed earlier.

Interest expense for the quarter was $77 million, down 9%. The decrease was primarily due to lower average interest rates.

At the end of August, our total debt was $7.4 billion. When factoring in cash on hand, our net debt totaled $7.1 billion, a decrease of $144 million since the end of fiscal 2015.

This activity primarily reflects our free cash flow generation, partially offset by the funding for the Meiomi acquisition.

We now expect interest expense for fiscal 2016 to be in the range of $310 million to $320 million.

The improvement in this target reflects favorability in short term interest rates and timing of our CapEx spend versus our original plan.

Our effective tax rate for the quarter came in at 24.6% and compares to a 32.3% rate last year. The decrease was primarily driven by the favorable outcome of various tax items that were effectively settled in connection with IRS examinations.

We still expect our full year tax rate to approximate 30.5%.

As a result, we expect our tax rate for the second half of the year to run above our projected full year rate.

Now let's review free cash flow, which we define as net cash provided by operating activities less capital expenditures.

For the first half of fiscal ’16, we generated $508 million of free cash flow compared to $360 million for the same period last year.

Operating cash flow totaled $803 million versus $668 million for the prior year period.

This increase was primarily due to the higher earnings generated by the beer business.

Given higher projected earnings for the beer business and lower projected tax and interest payments, we now expect to generate operating cash flow in the range of $1.25 billion to $1.45 billion for fiscal ’16.

CapEx for the first half of fiscal ’16 totaled $295 million and was slightly below our CapEx spending during the same time frame last year.

Our brewery expansion activities continue to progress as planned, but we have seen some shifting in the timing of our CapEx with a higher level of spending expected to come in the second half of the year.

Overall, we are still targeting CapEx of $1.05 billion to $1.15 billion for fiscal ’16, which includes $950 million to $1.05 billion for beer.

Due to the factors just mentioned, we now expect fiscal ’16 free cash flow to be in the range of $200 million to $300 million.

Now let’s move to our full year fiscal ’16 P&L outlook.

As discussed earlier, due to continued strong results for our beer business and lower-than-expected interest expense, we are increasing our comparable basis diluted EPS projection to $5 to $5.20 per share versus our previous $4.80 to $5 range.

The beer business continues to target mid- to high single-digit volume growth and net sales growth of approximately 10%.

As a reminder, fiscal ’15 beer shipments ran ahead of depletions as distributors brought inventories back to historical levels.

As a result, we expect our fiscal ’16 depletion growth rate to be in the high single-digit range and above the shipment growth rate of mid- to high single digits.

We’re currently experiencing favorable commodity and foreign currency benefits along with better than expected glass plant performance that are helping to drive improved operational results. Therefore we now expect the beer business to generate 15% to 18% operating income growth. This guidance has us targeting a beer operating margin of approximately 34% for fiscal ’16.

For the wine and spirits business, we continue to expect net sales and operating income growth to be in the low to mid-single-digit range before any benefit from the Meiomi acquisition.

While we anticipate improving depletion trends in the second half of fiscal ’16, we expect to see most of the wine and spirits sales growth to be driven in Q4 versus Q3 due to shipment timing and comparisons versus the second half of fiscal ’15.

Our fiscal ’16 comparable basis guidance excludes comparable adjustments, which are detailed in the release.

Overall, we’re very pleased with our results for the first half of the year and our projected sales, earnings and operating cash flow growth for the full year of fiscal ’16.

And with that, we’re happy to take your questions.

Question and Answer

Operator

— ***Operator Instructions*** — Our first question comes from that line of Dara Mohsenian with Morgan Stanley.

Dara Mohsenian

The fiscal 2016 beer guidance implies near 34% margins already with the FX and cost favorability. So you're really at the mid-30s long-term target rate. So I guess, why haven't you raised the long-term guidance and when can we expect more clarity on that guidance?

David Klein

So we don't typically provide the long-term guidance. We provided the medium-term guidance, if you will, so we could give people a sense of our beer business. I would say that we still intend to have beer margins that are in line with the industry leaders in North America. And in fact, we would likely be the benchmark if we achieve our mid-30s guidance in the midterm. I would also say that it's – we're early on in the process of bringing our capacity online with Nava, and so to really answer your question specifically, once we get that production capacity in place, we'll be in a better position to make an adjustment, if any, to our medium-term guidance.

Dara Mohsenian

Okay, that makes sense. And then I was hoping you could discuss the level of cannibalization you're seeing on Corona with the can business doing so well, it doesn't look like it's had much impact and also maybe conceptually, can you discuss where you think can mix for Corona can move over time versus the 5% level you had highlighted earlier?

David Klein

Yes. So we do know there's cannibalization between the can and the bottle. When we pick apart our business and we look at the drivers and drags of our business, we see a little cannibalization but you have to look at our numbers year-to-date and you see that our bottle depletions are up mid-single digits, while our cans have expanded from 3% of our mix last year to 6% of our mix this year. So we are seeing some cannibalization but we're not seeing it affected the overall brand of Corona. In terms of where we think the mix can get to, you know our Modelo brand is more of a can centric brand. We don't really see Corona becoming a can centric brand. The purpose of the can is to just provide incremental consumption occasions for our consumers.

Operator

Our next question comes from that line of Nik Modi of RBC Capital Markets.

Nik Modi

Two questions from my side. Just a quick update on the Corona draft test that you've been running, just any early thoughts on that. And then I guess, the bigger picture question is on wine. Just tell me if I have this right in terms of thinking about the long-term strategy. Effectively, given you still have a big chunk of your portfolio in the low end of the wine category, it's more about harvesting those brands for profit and reinvesting in the premium end of the portfolio so you can rebalance the portfolio over time. Am I thinking about that in the right way?

Robert Sands

Yes, Nik. So I guess, I'll start with the wine question first. In volumetric terms, it's a large chunk of our portfolio that's sort of subpremium, but in actuality in terms of what's really generating our profits and the bulk of our sales, it's our focus brands. And that's all largely premium. And then to your question, the answer is basically yes, as to what you have described the strategy is definitely about not worrying too much about the nonstrategic part of the portfolio, which is the subpremium. And we are – we did take some pricing very successfully this year in that part of the portfolio. And we are reinvesting against, as I mentioned in my script, a smaller subset of our focus brands. And we think that sort of that mix of activity will drive stronger overall results, which I believe that it is and I believe that it will. So we're pretty optimistic about the wine and spirits business in general this year. It's going to be a good year. And then what is your question on beer?

Nik Modi

Oh yes, the Corona draft test.

Robert Sands

Yes, I think we continue to test Corona draft in a number of places. And I would say that the Corona draft test is proving to be very successful. And I guess you could ask what do we mean by that? Okay. And what we do mean by that is we see it thus far as being additive as opposed to just sort of a pure swap out on premise. And then where we do have it, we see some positive effects in the marketplace around it, meaning in the off-premise. There seems to be a positive effect when we have Corona on draft on the on premise and then our off-premise sales in the area. So the test is positive but at the same time, Corona is our, by far, most important brand and we're going to be very thoughtful about how we proceed basically with anything new with that brand. So good news is the brand's performing better than ever right now or at least, as it relates to shorter term history. So again, beer business is extremely strong.

Operator

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

Judy Hong

So first, on the beer depletion. The second quarter performance, 10%, a pretty healthy number, but I guess it's a little bit softer than what the Nielsen or some of the measure channel data has shown. So first, can you talk about maybe what the disconnect is there. And then your full year guidance also implies some slowdown in the back half, which also seems to be at odds with very strong acceleration that we're seeing in the measure channel data. So just wanted to get a little bit more color just in terms of the depletion trend in the second quarter and then the growth in the back half.

Robert Sands

Yes. Well, Judy, we basically – our guidance has called out a high single digit for beer depletion performance and obviously, we're outperforming that at 10%. So I would say that our beer depletion performance exceeds our expectation,s, but realizing that we have some – continue to have tough overlaps in terms of strong growth last year, too. I mean, we can only be relatively cautious as to the kind of growth that we're willing to predict. So hey, I hope we far exceed those numbers, but I think that high single digit remains – depletion growth remains a good estimate. We do have some pricing that we're taking right now in the marketplace, in the 1% to 2% range liked we've talked about historically. While we feel that the brand is in an extremely strong position to take that pricing, it's not as if it will have 0 impact on depletion growth. And then in terms of IRI and the disconnect, I think that IRI only measures about half of the business, the half that it doesn't measure is the half that's not necessarily industry-wide performing very well, like the on premise for instance and liquor stores, as an example, that are the more sluggish part of the industry. That said, we're performing, of course, better than anybody else in those channels. But those channels are not the highest performing channels, whereas, the IRI channels, being grocery and convenience, are some of the strongest channels at the current time. So I'd say that's where the disconnect is.

Judy Hong

Okay. And then David, just in terms of the glass cost, I think in your prepared comment, you had called out gross margins on beer benefiting from better glass plant performance.

So number one, I just wanted to get clarification on what that means. Secondly, just in terms of your mix of what you're now sourcing from the OI JV as well as the Vitro arrangement. If you can just get a mix of where the sourcing of glass comes from as of the second quarter. And then the OI's proposed acquisition of Vitro, does that have any impact on your glass sourcing arrangement going forward?

David Klein

Okay, Judy. So yes, when I have referenced the glass joint venture performance, what I'm really talking about, and you'll see this in our Q, which we intend to file today, which is a first for us to file our Q on the same day as our earnings call, you'll see that we have a profit at the glass joint venture level, which was not in our expectations for the year because there were a fair number of startup costs. So we – the joint venture team on the ground in Nava as well as our partners at Owens-Illinois have done an outstanding job of smoothly getting our furnace at Nava functioning well. So as a result of that, we're seeing better profit performance from the joint venture. And that allows us to shift our mix just a little bit, and I don't have the exact numbers, Judy, but to shift our mix a little bit toward our own glass plant as opposed to third-party providers, which gives us near-term, in particular freight benefits as it relates to the glass plant. And we have – to get on to the Vitro acquisition question, we have a very strong relationship with Owens-Illinois. We have the separation, if you will, that comes from owing the joint venture with O-I, and so we're not concerned at all about O-I taking – or acquiring Vitro because, again, we control our own destiny along with O-I at our own joint venture.

Operator

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

Bryan Spillane

I just wanted to ask one question or one topic, just capital allocation. And maybe, David, if you could sort of remind us or update us on your current thinking in terms of share repurchases, kind of where you're comfortable in terms of leverage on the balance sheet. And I guess, as you're contemplating additional brewing capacity, just how we should think about kind of where cash is going to go, whether it's dividends, repurchases or CapEx over the next couple of years.

David Klein

Yes, so as we position this business for total shareholder return for the medium term, the most important thing that we can do is ensure that we have enough capacity to service our high margin beer business. And so when we think about capital allocation, number 1 in line is that capital expenditure required to build out Nava and to build out a second site at some point in the future. So that's really number 1. I would say then beyond that, we – our capital allocation strategy hasn't changed. We remain committed to our dividend as well as share repurchases and tuck-in acquisitions. I would also say we're pretty happy coming out of the quarter with a net debt leverage ratio of about 3.7x, which is in our range of 3x to 4x. And I guess, where I would just caution on that leverage ratio range, provide a little bit of caution in that we have a lot of spend to complete the Nava buildout in the second half of the year. And so we're just going to be very careful with our capital decisions as we go through the build out.

Bryan Spillane

Just – would that imply, just 2 follow-ups to that. One is, in terms of a potential buildout, could you remind us just rough idea how much the cost per hectoliter is to build out brewery expansion? And then I guess based on that scenario or the potential to have to – to allocate more to CapEx, should we be thinking about share repurchases as more just covering stock options at this point and – as opposed to real sort of share count reduction as a P&L lever?

David Klein

Yes, so as it relates to a new greenfield facility, what we've stated in the past is that we haven't made a decision on specific location, although we are planning for Western Mexico. We haven't made a decision on size of the buildout. And then we've provided a really large range of $100 to $150 a hectoliter, recognizing that a greenfield will be completely starting from scratch with no basic infrastructure, which we benefited from at the Nava facility. So we will come back to you within the next several months with definitive plans around our buildout. And I would say based upon our volume growth numbers that we demonstrated this quarter and for the last while, we will be spending the capital on a greenfield sooner than later because it's going to take 4 years to build out another brewery. And with these kind of growth rates, we will need it to keep up with capacity. I think to then answer your question on share repurchases, again, we're going to evaluate our circumstances as we go forward, and depending upon the capital requirements and our leverage ratio and understanding the requirements from our dividend, we'll then consider share repurchases. I don't see anything in the very near-term, though, and we've said this publicly as well, around a large accelerated kind of program. It's likely to be methodical, and it's likely to start out with absorbing dilution.

Operator

Our next question comes from the line of Caroline Levy with CLSA.

Caroline Levy

I just want to check that the delay in the capital spending that you talked about is not in any way a reflection that there's a delay in when the plant might open.

David Klein

None whatsoever. We're actually pretty happy with the progress we've made in the buildout at Nava. In fact, we've now run beer down our premium glass line. So for the first time, we've put labels and foil on bottles because our previous production had been Corona – primarily Corona Extra and Corona Light using the applied ceramic label bottles. And so now our premium glass line, which is Modelo Especial is – has run beer down the line, which is a little bit ahead of where we thought we would be at this moment. So we're very pleased with our progress on the brewery buildout.

Caroline Levy

That's great. And on the wine side, we never really discuss CapEx there, but do you see any significant needs in the next couple of years?

David Klein

I think you'll continue to see our wine CapEx in the range it has been for the past several years. We don't expect a big change in that regard.

Caroline Levy

Okay. Then the peso benefit, any way you could call that out and tell us what you think it will do in the back half of the year?

David Klein

Yes. See, that's the problem with the FX in commodity-related items. You know there's a fair amount of variability when you're trying to predict it, but what I will say about our peso exposure, it's about 15% or so of our COGS and from that, you have to exclude the COGS that are attributable to ABI. And we generally, we run a 3-year layered hedging program across our currency and commodities. And so for the remainder of this year, we are roughly 80% hedged on FX.

Caroline Levy

Okay. And one of the big drivers of your business has clearly been the big incremental advertising spend behind your brands. And I mean, you mentioned in the second quarter that, as a percent of sales, it wasn't up a lot, but I think it was down a bit. But basically, do you see keeping that pressure on the brands? Because I think that's going to be critical to the ongoing momentum. Do you have budgets to go up significantly on ad spend going forward?

David Klein

Yes, so we expect in our beer business for our marketing expense to be somewhere between 8.5% to 9% of net sales, which implies we will continue spending at kind of the second quarter rate as a percent of net sales. Our case rate, I think, goes up a little bit in Q3. I will also say that, that's going to be Q3-weighted as we take advantage of the fall sports season, which we found to be a successful platform for driving our brands. But we measure and are very pleased with the returns we get from our marketing investment in our beer brands, and we will continue to keep that pressure on.

Caroline Levy

Right. Because yes, I mean, I think that's going to be critical. So your returns have obviously been incredible. Would you see going to the higher end then, the 9%?

Patty Yahn-Urlaub

Caroline, I think we'll be – that's the longest 2 questions, I think, we've ever get [ph].

Caroline Levy

Sorry.

Patty Yahn-Urlaub

That's okay. No worries. I guess we'll take the next question, operator.

Operator

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

Mark Swartzberg

A couple here, both beer-related. One is, this year has been about the – has been called the year of the can. And I'm trying to understand – it's clear you have a lot of opportunities for share within your portfolio. But what might be the priority from here? I heard you, David, just mention premium glass for Modelo Especial and putting an SKU of – into an existing account is easier than trying to add accounts, which is part of the job with Especial. But what might be your next priority, if you will, after the year of the can for Corona?

David Klein

I would say that you're right on in calling out distribution, so we know, for example, that Modelo Especial roughly has – is it 65 ACV across the market, but we also know that we have packs like our 12-pack bottle, which is more like for a 45, right? So we have a lot of ground that we can cover from a distribution standpoint. I do want to come back on the year of the can, however. We've seen a lot of growth in Corona Extra from our year of the can program. We've also seen a lot of growth on Corona Light, which was a bit of an ancillary benefit that came from our focus on cans in Corona. So yes, I think there are a lot of opportunities for future growth in our brands.

Mark Swartzberg

And I'm trying to – we're all looking at these 10 numbers and wondering is next year going to be an 8? Is it going to be at a 12? I'm just trying to – I'm not asking for a crystal ball – I know you – we all are, but I'm just trying to get a sense of like where's the real shoulder going to be from here? Is it going to remain against the can? Is it going to be – I think Especial has actually slowed this year in terms of rate of growth, which, of course, large numbers, but again, I'm just trying to understand where you guys are deciding to make that next priority, if you will, after the can for Corona?

David Klein

Yes, I think around Modelo Especial and on your particular point, we have year-to-date depletions that are in the high 20% on the bottle itself. So that's a package that's growing really, really well for us. And so the momentum behind the brand continues. I see us continuing our strategy of focusing on our – building out our strong distributor network, gaining more distribution at retail, getting our brewery completed and continuing to execute across the entire portfolio of beers that we have.

Mark Swartzberg

Okay. And I know I'm pressing here, but I do want to understand the brand Modelo overall, Especial that is, has – rate of growth has slowed overall, of all packages. Is that right? And you're saying that glass is a priority there?

David Klein

No, in the recent 12-week IRI, Modelo Especial is up 30%.

Robert Sands

It has not slowed. Where did you – where are you getting that idea?

Mark Swartzberg

Okay, great. I'm just referring to some of the materials you put out back in early September, 16% at fiscal '15 and accelerating this year. Got it. Okay. And then the brewery expansion or the added brewery you're saying in the next several months, can you be more specific? Should we think about that as third quarter?

David Klein

In terms of spend?

Mark Swartzberg

When you would give us detail on that plan?

David Klein

By – I would say by – roughly by the end of the calendar year, likely on our third quarter earnings call.

Operator

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

Vivien Azer

David, one question on wine and spirits, please. Given the diverging trends that we continue to see between those 2 sub-segments, can you offer a little color around the margin profile of those 2 independent businesses?

David Klein

Yes, I think when we look at our wine and spirits business, I think it's important to – that we – are focused on the U.S. business. But then when you break down – which amounts to 80% of our net sales, by the way, overall. But then when you break down our wine versus spirits margins, they're roughly in line across the portfolio.

Vivien Azer

Okay, that's helpful. And David…

Robert Sands

Yes, that's likely – it's likely because our spirits business is really sort of mid-premium as opposed to higher premium. So the margins are roughly the same as the wine business.

Vivien Azer

Terrific. My second question has to do with the outlook for the tax rate. David, if I think back a couple of years ago, we've seen these tax benefits before and then over time, the step-up in the tax rate doesn't actually happen, and so your overall tax rate ends up coming in lower than previously expected. So I am just curious kind of what gives you kind of confidence that the step-up in the back half?

David Klein

Yes, in the back half, the further you get in the year obviously, you know what sorts of settlement opportunities you might be working on. And I would say that we're pretty confident in our outlook for the full year rate, and I'll also say that our initial 30.5% guidance for the year actually included the benefits that we realized in the second quarter. What we didn't provide and we didn't have clear line of sight into was the timing at which we would receive those benefits.

Operator

Our next question comes from the line of Robert Ottenstein with Evercore.

Robert Ottenstein

I'm wondering if you could give us a little bit of your thinking on pricing strategy for beer. I think you talked about you're in the market now for 1% to 2%. And I'm wondering, given your success, tremendous success in the market, have you changed your strategy? And I'm asking that also because it appears that you lead price increases in California and Texas at a minimum and that may be a little bit of a divergence from in the past when – again, correct me if I'm wrong, where you were perhaps more of a follower. So is there a change in strategy? Is there the potential, given again, the strong demand for your product for perhaps more aggressive pricing to really further your premium image and get back to some of the price gaps of 10 years or so ago? And how are you thinking about your overall pricing architecture between the brands?

Robert Sands

Yes, so first of all, as it relates to pricing, it is pretty much what we have said all along throughout the year, which is that we've expected to take in the 1% to 2% pricing range. And that's what we're doing. So the strategy really hasn't changed. I mean, like every other business, we've got costs to cover, and our brands are strong enough to bear that kind of pricing. If there's any change in our strategy, I would say that the marketplace is changing somewhat in terms of sort of the makeup of the types of products that are out there. The market – I mean, the industry is definitively premium-izing while volume remains sort of flat so that there's a shift internally towards more premium products. And I would say that, that probably has given us the opportunity to be less focused on what's going on with competitive products and to be more focused on what do we think is good for our brand and what do we think will work and won't work. So we continue to be very strategic in our pricing. We're doing it on a market-by-market, brand-by-brand basis. Our guidance, nevertheless, hasn't changed. We're still looking at the 1% to 2% range. And you can call it leading or not leading. We're sort of, I'll say, marching to our own beat as opposed to too worried about what some of our competitors are doing overall. And that's sort of up to them. And we'll do what we think the market will bear for our brands and what's good for the health of our brands. So in some cases that will mean that we will lead pricing. But as I said, the market's changed. It's premium-izing. 10% of the industry now is craft, selling at very high prices, right? And the other 10% of the market is basically us. And those are the 2 segments, that 20% is, obviously, taking share from the other 80%. So things are a little different out there than they have been in the past.

Robert Ottenstein

Right. I mean, it's interesting. If you look at the Corona brand outside of U.S. and Mexico, ABI is taking a very strong strategy of really making this super, super premium brand, generally priced significantly higher than Heineken, for instance, in most areas. Obviously, the reference point in Mexico is paramount. But do you think perhaps there is a way to kind of increase the gap with premium, with U.S. mainstream brands, with Corona and just develop a little bit longer kind of pricing architecture for your brands, a little more differentiated than it is now?

Robert Sands

Yes, I would say in general, we're not overly focused on the pricing gap with the domestic premiums. I mean, the domestic premiums have sort of taken on a life of their own. I am not sure how relevant it is at this stage.

Robert Ottenstein

All right. So that definitely sounds like a departure in strategy than what you would have said a few years ago.

Robert Sands

Yes.

Robert Ottenstein

Great, great. And just…

Robert Sands

I would say that you've identified that nuance correctly, — ***indiscernible*** — We're less concerned about that gap today than we were several years ago.

Operator

And our next question comes from the line of Tim Ramey with Pivotal Research Group.

Timothy Ramey

Rob, your family must be incredibly proud, too. In 70 years, you've built a $26-billion company. That's amazing.

Robert Sands

Well, thank you.

Timothy Ramey

David, just a clarification on the ending point of the TSA was – I think I heard you say, is it end of calendar 2016 that you expect that to be largely wound down?

David Klein

So we have in terms of supply chain procurement, not finished good procurement, we have largely separated ourselves from reliance on ABI. And then separately, we'll continue to procure finished goods from ABI's breweries until June of next year, of 2016.

Timothy Ramey

Great. And then Rob, on the wine outlook, you cited the overall harvest, but Ultra premium was a little bit short in Napa and Sonoma. And I'm just wondering if you think that might provide somewhat of a pricing umbrella for mid-tier premium-priced products and any challenges you foresee in terms of Pinot Noir sourcing or some of the grapes that are more…

Robert Sands

Yes. So I don't think we see any issues with Pinot Noir sourcing, which we're doing quite a bit of it between Mark West, Robert Mondavi, the various tiers and Meiomi, but I would say that our supply chain is very well nailed down. And then I think to your question on the pricing in the marketplace, I think that pricing – I mean, I think the answer to your question is maybe yes. Yes, I think that even in the higher end, I certainly don't see pricing going the other way. It hasn't been a very robust market over a number of years in terms of pricing. But if you sort of listen to the talk out there in industry-type circles, I think everybody's sort of – meaning, the market in general is probably more favorable to some pricing than it has been in quite a number of years so — ***indiscernible*** — as well.

Operator

Our next question comes from the line of Bill Chappell with SunTrust.

William Chappell

Just a clarification on the 34% margins. Did you quantify just how much FX and commodities benefited that number? And then am I right in what you said with the hedges, we wont see any incremental benefit in the back half? I mean, this is probably the watermark for the rest of the year.

David Klein

Yes, so clearly implied in guidance that brings us back into the 34% range, margins will compress a little bit in the back half of the year as a result of several headwinds, if you will, those being bringing on – bringing assets into service, so our depreciation number will go up. Line commissioning costs, incremental employees for training as well as throughput lowering as we go into the back half of the year at Nava, just based on the seasonality of our production. So I would say that built into the 34% is our current estimate of FX and commodity rates for the rest of the year.

William Chappell

Okay, but just trying to understand that – especially on the commodity front, would you expect as we move past the hedges that you would see an incremental benefit as we move into next year? Or is it less on – is it more on productivity benefits than it is straight commodities?

David Klein

Both – it's a little bit of both. And so from a hedging perspective, we run a 3-year layering program and so we kind of stabilized our returns a little bit, which means you leave some money on the table when commodity prices and FX values are falling, and you gain on the other side. So I would say that there – that we will get, assuming commodity rates were to stay where they are today and primarily for us, we're talking about benefiting from diesel rates as well as aluminum. But assuming those rates were to stay as they are today, there would be some benefit that we would experience next year. It's just far too early to call what that is at this point.

Operator

Our next question comes from the line of Pablo Zuanic with SIG.

Pablo Zuanic

Okay, I have a couple of questions on Modelo Especial. The first point is that to me, the brand, the bottle and the can are really totally different products. It's a different demographic, it's a different price point and obviously, it's a different packaging. And I'm just trying to understand how can that work in the long term? The person buying the cheap Modelo Especial can is very different from the one that you're advertising in True Detective [ph] for the bottle. And the second question, which is related to this also. Obviously, Modelo Especial is driving the growth, and you provided ACVs for cans and bottles. Can you give some color in terms of what's the growth in bottles, what's the growth in cans? I understand the bottles are starting from a lower base. But the reason why I ask the question is that when you say 65% ACV for Modelo Especial, I'm not so sure there's a big market for Modelo Especial in states like Alabama or South Carolina. So perhaps your ACV has already capped on Modelo Especial on the cans or maybe not. I mean, obviously, given the growth rate, it hasn't. But just give some color there. I find the brand is a fascinating brand worth a business full case study, but it has its own challenges because of the way the cans and the bottles are marketed.

David Klein

Well, the first thing I would say that from a consumer-experience standpoint, our research and the feedback that we receive is that as more people in the U.S. become exposed to Modelo Especial, they tend to continue to drink it, so it's a very high-quality, well-respected, authentic brand from Mexico. To address your – the can versus bottle component, we had depletions year-to-date on cans that are 12-ish percent on the can part of the portfolio, and then bottles, it's – we were in the high 20% growth rate from a depletion standpoint. So we're seeing growth coming across the spectrum of offerings on Modelo Especial.

Robert Sands

Yes, and I would say that as far as the consumer goes, I'm not sure that we agree with you, though, that it's 2 completely different consumer bases. I think that we've seen a shift somewhat at least in the growth from cans to bottles. The can is only slightly priced less than the bottle. It's really almost irrelevant, the pricing difference. Interestingly enough, cans have, in general, taken on a very premium image, since it's becoming the package of choice in the crafted segment of the market so the whole view towards cans in general, I would say, is shifting quite significantly from a consumer perspective. So we don't see any difficulties in marketing the cans and the bottles together, like everybody else does markets cans and bottles. So that's not a particularly unique aspect of our Modelo Especial business, which as we said earlier, is actually growing more than it ever has on an incredibly large base. So the strength of that brand is phenomenal at this stage without it really having fully transitioned to a general market product. And it is transitioning to a general market product. Again, with our own help as we've turned on general market TV advertising, which has been very successful. And we know that there is huge room for distribution growth in that brand and you will see it. You will see it as we continue to move forward and execute with that brand. You'll see the ACV continue to go up. That's simply going to be the case as we believe quite strongly at the current time. So the cans are strong, the bottles are strong. It's following the same pattern as many brands that have become major brands, and Corona is probably the best example of that.

Pablo Zuanic

That's very helpful color. Can I just ask a quick follow-up? With all this talk about the Anheuser-Busch InBev/SABMiller transaction, if it happens. If I recall, about 65% of your volumes in the U.S. go through MillerCoors wholesalers. Obviously, they are independent, the balance mostly Anheuser-Busch InBev. I know it's very hypothetical and speculative, but if Heineken were to be involved in any way in the future with MillerCoors and/or Molsen Coors, there could be some changes there at the wholesaler level, right? I will assume that they would want the MillerCoors wholesalers to carry their portfolio of Mexican brands. Of course, the wholesalers will have their own say and your business is much larger. But is there a risk there, #1. And the second question would be, in terms of your volume in the U.S., at the wholesaler level, what percentage would overlap with the Femsa brands? Or pretty much wholesalers that carry your brands don't carry the Femsa brands. And sorry about the detail there.

Robert Sands

Yes, so there is some overlap of wholesalers that carry the Femsa brands or the Heineken/Femsa brands and ourselves, quite a bit of overlap in fact. I would say that, that is totally irrelevant to us. The Femsa brands are small, okay? And in terms of growth, they have some growth in their Dos Equis brand, which is less than half the size for instance of Modelo Especial and the growth has slowed down. And Tecate, I think, is in negative territory, and they've had some growth in Tecate Light which basically sells at the domestic premium price point. So we don't really view that as particularly strong competition. And we don't really care whether they're in MillerCoors or ABI or frankly where they go because we don't focus on that portfolio very much. And Heineken's a whole different animal, obviously, that I think is competing with a different consumer base in general than our Mexican portfolio. So again, it's not something that we really focus on. And in general, our modus operandi is to worry more about our portfolio and the opportunities there, and execution is going to be the key on our portfolio in the future, which is going to be about taking advantage of distribution opportunities and basically increasing the number of SKUs per account. I mean, that's really what we – where the opportunity lies for us because we actually generate a huge amount of growth for ourselves and our retailers with a relatively small amount of shelf presence, and we're under skewed given our velocity and our dollar volume at retail. So there's just a big opportunity there for us and our retailers. Our retailers are – and should be interested in increasing their sales and margin per unit space of shelf space. That's what they're all about, and probably their biggest opportunity to do that and to get dollar sales, turns and even more importantly, margin, is through increased SKU and shelf space for our portfolio. So – and when we talk to retailers about that, I think they realize it because the statistics are just overwhelming for them as a way to increase their profitability. So building our SKU count per retail account is going to be one of our primary focuses going forward.

Operator

Our final question comes from the line of Brett Cooper with Consumer Edge Research.

Brett Cooper

Two questions on the beer business. Can you talk about what your volume assumption is for capacity planning for the beer business going forward? And then we've seen the cans come in and if memory serves, the ACV has gotten pretty stable over the last few months. But where you see the potential for distribution on Corona cans in the medium term?

Robert Sands

Yes, I think in terms of capacity, it's sort of like high single digits is what we have said in the past. Or you can infer that, right, from sort of a – our comments about doubling the business over a long period of time, 10 years, that's just sort of simple math. Our real guidance for the year continues to be high single digits for the beer business in general. And then your second question was?

Brett Cooper

How much more room is there for distribution on Corona cans?

Robert Sands

Oh, a lot. We've just introduced it, really, and made it a priority over the last relatively short period of time. So I think that there's a big opportunity for more distribution on that, right? It's only about 5% of our volume at the current time. And we should be growing that to more like 15% or 20%. So that will be achieved through continuing to build distribution and doing what I said, focusing on SKUs per account.

Operator

That was our final question. I'd now like to turn the floor back over to Rob Sands for any additional or closing remarks.

Robert Sands

Okay. Well thanks, everybody, for joining our call today. As we close the discussion of our second quarter results for fiscal 2016, I am very, very pleased with what our business has achieved so far. Though the year is far from complete, our new guidance reflects the confidence we have in our ability to execute in the second half and achieve our goals for the full year.

We look forward to the next time we speak with you in early January when we will share the results of our third quarter. Until then, we wish you a safe and happy holiday season. This time of the year is a great opportunity to share our fine beer, wine and spirits products with friends and family, and we encourage you to make Constellation Brands a part of your celebrations this holiday.

So thanks again, everybody, and have a great day.

Operator

Thank you. This concludes today's conference call. You may now disconnect.