# Constellation Brands Inc, Q3 2020, Earnings Call 2020-01-08

## Presentation

### Operator

Welcome to the Constellation Brands Third Quarter Fiscal Year 2020 Earnings Conference Call. — ***Operator Instructions*** —

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

### Patty Yahn-Urlaub

Thanks, Liz. Good morning, and welcome to Constellation's third quarter 2020 conference call. I'm here this morning with Bill Newlands, our CEO; and David Klein, our CFO.

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

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

### William Newlands

Thank you, Patty. Good morning, and happy New Year to everyone. I certainly hope you enjoyed the holidays and had the opportunity to include some of our awesome Constellation products in your celebrations with your family and friends.

The end of every year is a time of reflection for me, and this year is no exception. As I reflect on 2019, I'm reminded that we're not only ending a certain fiscal year, but a dynamic decade at Constellation Brands. Since 2010, Constellation has been on an incredible journey, marked by strong financial performance and notable business milestones. Over the last 10 years, we've significantly increased the value of our stock and produced double-digit growth in sales, operating income and operating cash flow. As a matter of fact, the closing price of Constellation stock on December 31, 2009, was just more than $15. Fast forward to December 31, 2019, we closed at almost $190. This incredible increase of more than 1,000% over the last 10 years made Constellation the best-performing stock in the S&P 500 Consumer Staples index during this time frame.

One of the biggest drivers of our success with a game-changing beer acquisition that was executed almost half way through the last decade. It enabled Constellation to buy the Grupo Modelo brands in the United States where we successfully built these brands for many years, while positioning ourselves for this transformational opportunity. At that time, this deal allowed us to double the sales of our company, diversify our profit stream, significantly enhanced our margin, earnings and free cash flow while providing new avenues for growth.

Since then, our beer business has made significant contribution to the overall sales, profit and cash flow results for our business and continues to be a powerhouse for growth as the #1 brewer and seller of imported beer in the U.S. market.

Calendar 2019 marked the 10th consecutive year of volume growth for Constellation beer business, and solidified our position as the leader in the high end of the U.S. beer business. These trends were driven by Corona Extra, Modelo Especial's explosive growth and our successful innovation initiatives. In 2010, the Modelo Especial brand depleted approximately 35 million cases and then went on to achieve double-digit growth in every single year of the past decade, finishing 2019 at more than 140 million cases, and there's more to come.

In our most recent third quarter, this powerhouse brand posted depletion growth of almost 15% with double-digit growth in 46 of the 50 states, while solidifying its position as the #4 beer brand in the U.S. market. Corona Extra, which is the #7 beer brand in the U.S. beer category, grew from approximately 90 million cases in 2010 to more than 110 million cases in 2019, and is one of the few top-selling brands in the U.S. to grow this past decade.

From a quarterly perspective, the Corona brand family grew nearly 7% in IRI channels, driven by the continued strength of our Corona Premier and Corona Refresca innovations as well as the renewed growth of Corona Extra. Corona Premier continues to gain distribution, especially in the on-premise and delivered double-digit depletion growth in 35 of the 50 states during the quarter. Corona Refresca was a top 10 growth contributor to the U.S. high-end beer category during the third quarter.

And finally, let's not forget Pacifico, which achieved double-digit depletion growth of nearly 16% and remained a top share gainer within the U.S. import segment. We're excited also about our plans for the launch of Corona Hard Seltzer this spring, which will help to further strengthen our position as the leader in the high-end of the U.S. beer segment.

Our launch strategy includes the largest ever single brand investment for our portfolio of more than 100 – excuse me, more than $40 million in marketing to support this intro. We've already started to take orders from distributors and have received incredibly positive feedback from retailers who are excited about the prospects of Corona Seltzer and have already incorporated our newest portfolio addition into their shelf set programming plans for the spring selling season.

As we've discussed, Corona Hard Seltzer will be introduced in 4 flavors, including tropical lime, mango, cherry and blackberry lime. Corona carries unbelievably strong brand equity as the #1 most loved brand among both Hispanic and total population drinkers aged 21 to 54, and that's why we've decided to put the Corona brand name on our new Seltzer. And of course, the refreshment characteristics of Seltzer perfectly matches with Corona's refreshment DNA.

There's been a lot of debate about the Seltzer trend and where Seltzers are sourcing their growth within the total beverage alcohol category. Our research shows that Seltzer is taking share across the board from beer, wine and spirits. While a significant amount of this growth is sourced from the beer category, it is primarily coming from domestic premiums, crafts, and FMBs with minimal interaction of Seltzer consumption with imported brands. In addition, we're seeing increased overall consumption from those Seltzer drinkers and new consumers who are entering the TBA space through their interaction with Seltzers.

As an aside, the trends that you've seen for Constellation's beer business in this week's 4-week IRI data covering the month of December are related to our recent annual price increase, specifically in the California market, which briefly decreases features and promotions. The impact of these price increases are normal and frankly short term in nature. Overall, we closed out the month of December with depletion growth of our beer business in the high single-digit range of our year-to-date trends.

Moving now to Wine & Spirits. I'm pleased that we've been able to execute a revised agreement with Gallo, which paves the way for accelerated growth and margin performance for our Wine & Spirit business going forward. In addition, we believe it addresses the FTC concerns by excluding the sparkling wine, brandy, dessert wines and concentrate categories from the original transaction.

We're already actively pursuing other opportunities to divest most, if not all brands, in these categories as we believe this is the best path to optimize our portfolio going forward.

To be clear, the FTC needs to provide final approval of our revised agreement with Gallo once we have finalized all transactions, including the proposed divestitures, which we expect to occur by our fiscal year-end.

We have also entered into a separate but related agreement with Gallo to divest our Nobilo Wine brand. This fits with Gallo's portfolio strategy and allows them to expand in the New Zealand wine category without affecting our long-term goals and strategy for our opportunity in the New Zealand wine category in the U.S. at the greater than $11 price point. This transaction is expected to close in the first half of fiscal '21.

Despite the delay in timing and revisions to the transaction, I'd like to remind everyone that we have benefited from almost an entire year of additional cash flow from a divested brands by the time the transaction closes, which has contributed to our debt reduction and share buyback activities. During the last decade, our team has created significant value by transforming and simplifying our Wine & Spirits portfolio through the rationalization and divestiture of assets in an effort to premiumize the business, which is the right strategy to enhance our Wine & Spirit growth and financial profile going forward. This premiumization strategy is taking hold in the marketplace as our power brands continue to outpace our competitors and take market share at the price points that matter in the higher end. In fact, our power brands at the greater than $11 retail price point grew nearly 9% in IRI channels during the third quarter, including brands like Meiomi, which has more than doubled its volume with a CAGR of nearly 30% since its acquisition in 2015.

Kim Crawford, which is another gem within our power brand portfolio, was the #1 selling wine on wine.com this past year and has consistently outperformed its competitors, posting a 20% volume CAGR in IRI channels over the last decade.

As we progress through fiscal ’20, we continue to show steady upward progression in revenue trends for our power brands and expect mid-single-digit sales growth to this collection of brands in the fourth quarter. Innovation and new product development are also critical to our success for the remainder of the year, and we feel we are well positioned to drive these initiatives to the finish line.

We’ve already had great success with the launch of Robert Mondavi Private Selection Buttery Chardonnay and Woodbridge ready-to-drink packs, which, while gaining traction across all channels, is doing especially well in the convenience channel, a channel growing at 2x the rate of the total U.S. wine market.

Both Woodbridge and Robert Mondavi Private Selection, which represent the most significant volume within the Robert Mondavi brand franchise are outperforming in their respective price segments, driven by marketing investments that we’ve recently made.

We recently extended our highly successful Bourbon Barrel-Aged program with the introduction of RMPS, Rye Barrel Aged Red Blend. As a reminder, we’ve sold more than 1 million cases of Barrel-Aged products since the inception of this program nearly 2 years ago, which helped to revive the Robert Mondavi Private Selection brand while also becoming the foundation for some of our other successful Barrel-Aged innovations like Cooper & Thief.

We’re also building on success of wine in a can, where consumers are seeking products that are convenient, ready-to-drink and sold in an environmentally friendly packaging. These trends have helped to fuel the growth of Crafters Union, which is the #1 growth driver in canned wine over the last 12 weeks. We plan to build on the momentum of this brand with the launch of Crafters Union Bubbles during the fourth quarter.

Later this month, we will be releasing The Prisoner

Unshackled, the newest addition to the Prisoner collection of brands in Cabernet, Red Blend and RosÃ©. We expect these brands to strengthen our ability to compete at the fast-growing $25 retail price point.

On the spirits front, SVEDKA Vodka continues to significantly outpace the vodka category in IRI channels, driven by increased distribution within our core portfolio as well as the more recent introduction of the Rose flavor. During the quarter, one of our most successful venture investments, Nelson's Green Brier, launched its first Tennessee whiskey product. This Tennessee whiskey is based on Charles Nelson's original recipe dating back to 1860, and it's the first time it's been bottled since Prohibition shutdown of distillery in 1909. This is another milestone for Nelson's Green Brier as they continue to innovate and leverage the success they've already achieved.

Overall, our U.S. Wine & Spirits business has executed changes that have resulted in a sharpened focus on consumer-preferred trends related to premiumization, innovation and brand building. As a result, we have benefited from ongoing consumer trade-up trends, positive mix and great consumer response to our new product introductions in the marketplace.

Before moving on to Canopy Growth, I'd like to remind everyone that the core business activities I just highlighted are driving an increase in our EPS guidance for fiscal '20.

Now a few comments about our investment in Canopy Growth, which continues to have the leading market share in Canada and today the leader in global cannabis sales. We remain bullish on the Canadian cannabis market as the conversion of the illicit market to the legal market continues to strengthen. Per statistics Canada, in 2018, 23% of cannabis consumers obtained cannabis from the legal market. While in 2019, that number significantly improved to almost 50%. In addition, retail store sales have increased significantly in every province during the last 12 months. We expect further retail sales increases as products like vape, edibles and beverages flow through the retail stores in Canada, now Direct 2.0 products have been released. We couldn't be more excited to see these products in the marketplace as Canopy now will have the ability to showcase their best-in-class brands and intellectual property.

We are also excited to see the progress the Ontario government has made to satisfy the demand of consumers by agreeing to allow more retail store openings beginning in early March.

During Canopy's second quarter, they established leading recreational market share across Canada, including a noteworthy share of over 35% in Alberta, Canada's most developed provincial recreational market.

In the U.S. in early December, the Canopy team introduced First and Free, a line of branded hemp-derived CBD products. These products are offered in a variety of formats, including softgels, oil drops and creams, and are currently available for sale via e-commerce on the First and Free website. Overall, we're pleased with the progress of the Canopy team and what they've accomplished in the last few months.

As most of you know, in less than a week, my colleague, David Klein, will assume the role of CEO at Canopy Growth, where I believe he will bring more focus and discipline to that business in executing their strategic priorities.

We have also appointed Garth Hankinson as Constellation's new CFO, who will help lead our company through its next phase of growth. David has been a significant contributor to our organization during his time here. His accomplishments at Constellation are numerous, and I wish him great success at Canopy, where I will continue to collaborate with him through our Canopy Board interactions. During his time at Constellation, David built an incredibly talented finance organization, which is why we're expecting a seamless transition to Garth as he assumes his new role.

Garth brings a wealth of experience to this critical leadership position, most recently serving as Senior Vice President for our corporate development activities, where he's led the company's efforts in financial planning, reporting and analysis as well as mergers, acquisitions and our venture initiatives. Many of you will have the opportunity to meet Garth in the coming weeks, and I would like to publicly congratulate him and welcome him to our executive management team.

In closing, we've accomplished a great deal on this exciting journey through the last decade. But I'm equally excited and optimistic about the next 10 years as well. We have a great product portfolio in a terrific industry. We have the right strategy and an energized management team in place to execute our vision for the future.

I'd like to reiterate 2 key takeaways from today's discussion: number one, with every step we take, we are positioning Constellation for sustained long-term success as we continue to premiumize the portfolio, a strategy which has paid huge dividends over the years. I'm confident in continuation of strong results for our beer business and the excellent prospects for our Wine & Spirits business going forward. Number two, our powerful cash generation capability and our desire to quickly delever and return $4.5 billion in cash to shareholders makes Constellation a compelling investment for the future. We remain steadfast in this commitment, and I believe our significant debt reduction to date coupled with our second quarter share repurchases are a testament to this commitment.

We have a relentless consumer-obsessed focus on brands and categories that are high growth, high margin, and we're working continuously to build a solid and sustainable foundation of operational excellence, financial strength and innovation. We plan to execute in these areas throughout the remainder of the year and well into the coming decade.

With that, I'd like to turn the call over to my colleague, David, who will review the financial results of our third quarter. David?

**David Klein;Chief Financial Officer**

Good morning, everyone. Thank you, Bill. It's truly been our pleasure working with you and all of the wonderful people at Constellation. My time as CFO has been exciting as well as personally and professionally fulfilling.

I'm leaving the company in good hands with Garth as the new CFO. Throughout his 18 years at Constellation, Garth has been a significant contributor to our premiumization and growth efforts, while developing an in-depth understanding of the company's business operations and finance activities. Going forward, we'll continue to collaborate on key initiatives as they relate to Constellation's investment in Canopy Growth. I'll certainly miss my interactions with our investors and the sell-side analysts who cover Constellation. Over the years, I valued your ideas, suggestions and feedback, and I thank you for your ongoing support. I look forward to continuing to interact with many of you in my new role at Canopy Growth.

Now moving to the financials. In Q3, we continued to produce strong beer operating performance and cash flow results. Our Wine & Spirits power brand strategy is gaining momentum as marketplace performance for these brands continues to outpace the overall category. We also recently closed the Black Velvet transaction, revised the original Wine & Spirits deal with Gallo, including a separate but related agreement to divest the Nobilo Wine brand and signed an agreement with Kings & Convicts Brewing to divest Ballast Point.

Before we jump into the financial results, I'd like to provide an update on guidance. We've increased and narrowed our full year comparable basis diluted EPS range to $9.45 to $9.55. Our increased guidance range primarily reflects the updated Gallo transactions and related timing as well as strong beer operating performance. This range excludes Canopy equity earnings, which better reflects the underlying performance of our core business. We strongly urge investors to focus on this metric as the Canopy equity earnings impact is noncash.

Our increased FY ’20 guidance now assumes the revised Wine & Spirits transaction and the Ballast Point transaction to close by the end of fiscal ’20. We expect the Nobilo transaction to close in the first half of fiscal ’21.

As Bill mentioned, we believe efforts to divest remaining brands from the original transaction, along with incremental cash flow generated from the delay in timing of the transaction will get us relatively close to the value outlined in our original divestiture agreement with Gallo. This assumes we realize the full value of the earn-out. After completing these transformation activities, we believe the Wine & Spirits business will be positioned to produce mid-single-digit top line growth, while migrating to an operating margin of 30% over time.

Now let’s review Q3 performance and our full year outlook in more detail, where I’ll generally focus on comparable basis financial results. Starting with beer. Net sales increased 8% on shipment volume growth of nearly 7%. The reversal of the year-end fiscal 2019 over-shipment was minimal in Q3 and came in lower than previously anticipated. We expect the remainder of the shipment timing benefit from fiscal ’19 to reverse in Q4.

Depletion volume growth for our import portfolio showed continued strength growing nearly 8%. As Bill mentioned, this was mostly driven by continued strong performance of Modelo Especial. When including an unfavorable impact from Ballast Point, total beer depletions were up 7.3%. In Q4, we pick up the additional selling day that we lost in Q2, which will help us achieve high single-digit depletion growth in Q4.

Beer operating margins increased 200 basis points to 39.3%. Benefits from pricing and COGS were partially offset by higher marketing and SG&A. COGS benefits were largely driven by FX, a onetime contractor cost reimbursement and an inventory build ahead of our SAP S/4HANA implementation. The contractor cost recovery and the inventory build helped us outperform our margin expectations for the quarter.

I'm pleased to report that the first phase of our SAP S/4HANA implementation for our beer operations in Mexico was completed ahead of schedule and with excellent execution by the team. This is an important milestone after more than a year of planning, designing and training for this important initiative. We'll continue to update you on upcoming milestones of our S/4HANA implementation.

Marketing as a percent of net sales increased 30 basis points to 11%. Marketing spend for the quarter was slightly below expectations. We expect fiscal '20 marketing as a percent of net sales to be in the 9.5% to 10% range.

For fiscal '20, we now expect net sales growth of 7% to 8%. This includes 1% to 2% of pricing within our Mexican portfolio. As a result of the planned reversal of fiscal '19 shipment timing benefit, we expect full year fiscal '20 depletion volume growth to land about 1 percentage point ahead of shipment volume growth. We also expect fiscal '20 operating income growth of 8% to 9% and our full year operating margin to be in the range of 39.5% to 40%, which is an improvement compared to the previous year and prior FY '20 guidance of 39.3%.

As we move toward next year, we're excited about our plans to launch Corona Hard Seltzer at the beginning of fiscal '21. There will be some investment in production costs as we ramp up production for this major innovation in addition to the significant marketing investment Bill mentioned earlier.

Moving to Wine & Spirits. Net sales declined 10% on shipments that were down 14%. Depletions declined 6%. Q3 results outperformed our previously communicated expectations, primarily due to a shipment timing benefit. Our third quarter Wine & Spirits results were somewhat impacted by a shift in Thanksgiving holiday timing with retailer and distributor replenishment shifting to the fourth quarter. Last year, there was 1 full week post Thanksgiving to fully replenish. In addition to the shift of the Thanksgiving holiday, we continue to be impacted by transition activities with distributors and lapped some lower quality sales incentives and pricing activities that we've decided not to repeat in order to better align with our strategy for the business going forward.

Wine & Spirits operating margin decreased 80 basis points to 26.2%, as mix benefits were more than offset by higher COGS and higher SG&A as a percent of net sales. Higher COGS mostly reflect freight cost headwinds. The higher SG&A as a percent of net sales, included marketing investments, driven by the continued support of the Power Brand, including new product development initiatives and Meiomi advertising in the quarter. We now expect fiscal '20 Wine & Spirits net sales and operating income to decline 8% to 10%. Our updated guidance reflects the revised transaction close assumptions discussed earlier.

As part of the Wine & Spirits transactions, we remain committed to our $130 million stranded cost reduction plan, which we now expect to be realized over the fiscal '21 to fiscal '22 time frame. I remain confident that the Wine & Spirits transformation strategy is working. Power Brand performance continues to benefit from our increased focus and marketing investments. In fiscal '20, we're running a bit short of our mid-single-digit power brand depletion growth target, largely due to the activities I mentioned earlier. However, power brands are driving mix benefits and gaining share in IRI channels, and you should expect to see a sequential improvement in depletion trends in Q4.

When you include these mix benefits, we believe our portfolio post divestitures is on track to achieve our longer-term targets, including mid-single-digit net sales growth, while migrating to an operating margin of 30%. Fiscal year-to-date corporate expenses came in at $149 million, up slightly versus Q3 year-to-date last year. We now expect full year corporate expenses to approximate $230 million, reflecting an increase for insurance-related costs, higher incentive compensation and a ramp in IT spend, which includes our S/4HANA implementation and other digital enablement activities. We expect our SG&A was to decrease by the end of fiscal '22 once our digital enablement activities are fully implemented when we can eliminate redundant IT costs and realize the benefits of the new platforms.

In Q3, comparable basis interest expense increased 11%. This primarily reflects additional interest expense related to the funding of our incremental Canopy Growth investment in fiscal – in November of 2018. Fiscal '20 interest expense is now expected to approximate $430 million.

Our Q3 comparable basis effective tax rate excluding Canopy equity earnings came in at 17.5% versus 14.1% last year. This increase primarily reflects lower stock-based compensation benefits. We now expect our full year fiscal '20 comparable effective tax rate, excluding Canopy equity earnings to approximate 18%. The 1 percentage point rate increase versus our guidance is primarily due to the impact of lower stock-based compensation benefits and higher expense for miscellaneous tax items than we previously forecasted. I'd like to note that we expect our full year cash tax rate to be in the mid- to high single-digit range.

Let's move to free cash flow, which we define as net cash provided by operating activities less CapEx. We generated free cash flow of $1.5 billion for the first 9 months of fiscal '20. This represents an impressive 14% increase. Free cash flow improvement primarily reflects strong operating cash flow and lower CapEx. We now expect full year CapEx spend of $700 million to $800 million versus our original guidance of $800 million to $900 million. This includes approximately $560 million of CapEx for our Mexico beer operations expansion, including investments in the Obregon and Mexicali breweries as well as the fifth glass furnace at the Nava Glass Plant. We expect fiscal '20 operating cash flow to be in the range of $2.2 billion to $2.4 billion, and free cash flow to be in the range of $1.5 billion to $1.6 billion.

Now let's discuss several impacts that were excluded from Q3 comparable basis results. Last quarter, we noted that we expected to recognize a loss in Q3 on the write-down of assets held for sale related to our transaction with Gallo. The actual write-down of $340 million was largely driven by the $250 million of contingent consideration associated with the revised transaction price. Accounting rules govern our election to record the contingent consideration when it's determined to be realizable.

We also recognized $547 million of net income tax benefit resulting from the remeasurement of our deferred tax assets in connection with tax reform in Switzerland.

Moving to Canopy. The total pretax net gain recognized since our initial Canopy investment in November 2017 is $223 million. In Q3, we recognized the $534 million decrease in the fair value of the Canopy investment. As a reminder, Constellation's original warrants with Canopy have an exercise price of CAD 12.98 per share and will expire on May 1, 2020, and represent less than $200 million in consideration. In addition, the Tranche A warrants expire on November 1, 2023. The company will evaluate exercise of each of these warrants immediately prior to expiration and does not plan to make additional cash contributions to Canopy beyond the potential exercise of these warrants.

I'd like to close with some comments on capital allocation. First and foremost, as Bill mentioned, Constellation remains committed to its goal of returning $4.5 billion to shareholders in dividends and share repurchases over the fiscal '20 to fiscal '22 time frame. I am pleased to report that in Q3, we returned to our targeted leverage ratio range. This was at the early end of the 12- to 18-month time frame we committed to when we closed on the Canopy investment. It excludes noncash Canopy related equity earnings. Continued deleveraging driven by the company's strong cash flow generation capabilities should provide the flexibility to be opportunistic and increased share repurchases as we move into fiscal '21 and '22.

As I reflect on my time as CFO of Constellation, I'm proud to have been in this role during a time of significant value creation. I remain bullish about Constellation's prospects and believe the company has the right strategy in place to produce top-tier performance for many years to come. I look forward to creating value for Canopy shareholders, including Constellation in my new role at Canopy Growth.

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

**Question and Answer**

**Operator**
— ***Operator Instructions*** — Our first question comes from the line of Kaumil Gajrawala with Credit Suisse.

**Kaumil Gajrawala**
David, congratulations. I guess a question on question on Seltzer. It's obviously going to be an incredibly competitive category for calendar 2020. What's going to make your proposition different? And how are you thinking about marketing spend and investment, given that it seems like it's really building up to be a pretty significantly competitive category this summer? And then second, separately, on your deleverage comments, are you happy to keep the levels at where they are now and everything incremental from here is a buyback to manage to those levels? Or should we be thinking about it differently?

**William Newlands**

Sure. Well, I'll take the first half of that. We're very excited about Corona Hard Seltzer, in part just because of the refreshment DNA that's attached to the Corona brand. We obviously have done a lot of product testing, a lot of product research to make sure that we have a product that meets or exceeds the other key players in the marketplace. So we are quite comfortable with the sheer quality of the product that we're going to bring to the table. And as usual, our crack marketing department will bring outstanding consumer communications as they always do around our critical brands.

The last thing I would say is, we still believe that there's a lot of upside in the total size of the Seltzer business. It was roughly 60 million cases in 2019, and we believe there could be a 2 to 3x opportunity going forward, and we expect to take a significant share of that opportunity. Dave, you want to…

**David Klein;Chief Financial Officer**

Yes. Kaumil, on the buybacks, our targeted range is 3 to 4x. Our preference would be at the midpoint of the range. But now that we're back in the range, we'll definitely look to be opportunistic as we move forward.

**Operator**

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

**Nik Modi**

David, let me second the congratulations on your new opportunity. So the question is really around – if I can go back to capital allocations. Bill, obviously, a lot of investors for years have been concerned about Constellation's capital allocation decision. And the last few months have been tough, right, with Ballast Point, with Canopy value declines. So maybe just kind of give us a state of the union from your perspective, kind of what you've learned as an organization from Ballast Point in particular? And how you think about just capital deployment outside of, obviously, the buyback stuff that you guys have already committed to? Just to give people a sense of kind of how you're thinking about it philosophically as you kind of go into year 2 of being CEO of the company?

**William Newlands**

Sure. I think one of the things, and David just pointed it out. We remain as committed as we always have to getting ourselves into the range. And as he said, we're pleased that we have gotten into the top end of our range earlier than we had anticipated. We have a tremendous amount of opportunity with our core existing franchises. You have seen, and you will continue to see a relentless focus on the critical categories and brands that we see as high-margin, high-growth opportunities. And we will invest to take significant share within those. Where we see issues and problems, much like you point out with Ballast Point or the low end of our wine business, we are prepared to take action to make sure we are focused on where the consumer is going rather than where they have been, and those are 2 examples of that. I think what that will do? Well, that will allow us to continue to focus all of our attention on the premiumization play, both in the beer business and the Wine & Spirits business so that we continue to be the leader. And when someone sits in this chair 10 years from now, they'll be able to tell the same story that I just told, which is a great decade of tremendous growth for our company and for our shareholders.

**Operator**

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

**Vivien Azer**

I'd also echo my congrats to you, David. I really look forward to working with you as part of my coverage of Canopy. So Bill, I just wanted to follow-up on your commentary around the dislocation that you think Hard Seltzer is driving based on the consumer insights you offered. Do you think it's kind of broad-based and it's underindexing to imported beer?

How are you, say, not asking for guidance for fiscal '21, but are you expecting that dynamic to shift given the introduction of Corona Hard Seltzer? And perhaps put it more specifically, how much cannibalization might you guys be expecting in terms of the interaction between your core Corona offerings and that Hard Seltzer proposition?

**William Newlands**

Well, the thing that excites us, Viv, about the Corona Seltzer introduction is that, first of all, the category appears to continue to have real strength. And that there's a lot of growth potential in it. As I said a moment ago, I think there's probably 2 to 3x where it sits today, which creates tremendous opportunity for those of us who are going to play in the category. I think our expectation would be that we would have a similar type of cannibalization profile that we saw around Premier, which is, as you might recall, is in the 70% to 75% range incremental. So this – we think this is a great opportunity for us. But I would also urge all of you on the call to keep in mind. As big and as exciting as this launch will be, Modelo Especial is likely to be our single biggest grower next year. This continues to be a brand that is absolutely on fire. It grew 15% in the most recent period, and it had 30-plus consecutive years of double-digit growth. This is a brand that's going to be and remain a significant foundational play for this company for many, many years to come.

**Operator**

Our next question comes from the line of Kevin Grundy with Jefferies.

**Kevin Grundy**

David, I wanted to extend my congratulations as well. I wanted to pick up on the beer guidance. So Bill, you sounded pretty positive despite some of the slowing that we saw in the Nielsen data. I think you attribute it to pricing. But as I look at the midpoint, if my math is right, it implies about 7.5% organic sales growth. The year-over-year comp is easier if you do get an additional selling day. Can you talk about maybe what you're seeing in the business? Corona looks a little bit light, Premier looks like it's decelerated a bit. Is there anything that gives you cause – a bit of pause here with the base portfolio in terms of some deceleration? And then given that, as we look at the 7% to 9% longer-term growth that you've expressed confidence in over the intermediate term and the fact that we had to tweak it modestly lower this year, should that be at all concerning for investors looking out to next year?

**William Newlands**

Sure. No, I think you should be very positive about our expectations around our core business. We were particularly excited that the Corona Extra business returned and renewed in growth in the third quarter. As I stated, certainly, the price increases that we took, particularly in the state of California, gave us a very brief factor that you saw in the most recent IRI data. But we do not expect that to have any impact on our longer-term trends and the fact, as I alluded to earlier, our December depletion growth profile overall was in the high single-digit range, which is ahead of our year-to-date trends. So we remain very, very bullish. And when you think about things like Modelo and Pacifico and the addition of our Seltzer business, I think you're going to see a continued strong delivery against our business in the range that we had said we would do, and that we will deliver this year.

**Operator**

Our next question comes from the line of Dara Mohsenian with Morgan Stanley.

**Dara Mohsenian**

Also wanted to extend my congrats to David. Just 2 quick clarifications on the beer business. Bill, you mentioned that high single-digit depletion growth in December. I think that included an extra day, though. So ex the extra day, what type of rate are you trending at? And then, David, you mentioned the contractor and inventory timing benefited margins in the quarter. Can you give us a sense of how much that was? And those are more clarifications. So if you give me the benefit of an additional question, you guys did comment on the fabulous track record of beer volume growth over the last decade and kudos for that. Obviously, an amazing track record. But if you do look at the year-to-date depletion growth of 7%, it's below that 9% to 10% pace from the prior few years. I know it's close to what you guys originally expected. But just at a high level, taking a step back, just curious for your perspective on if the slowdown this fiscal year, that's just more of a natural maturation as you move to larger case volumes, if we should expect sort of a gradual slowdown in depletion over time on larger numbers? Or if there were more discrete issues driving the sequential slowdown this year? And this is not sort of the start of a moderation trend as you look out longer term?

**William Newlands**

So relative to the depletion trends for the fourth quarter, we expect – fully expect that our depletion trends for the fourth quarter are going to be in the high single-digit range, much like December presented itself. Look, we remain extremely bullish about the long-range prospects for our beer business. We are significantly, significantly outperforming the overall category as well as the high end of the category as well. And that's before we introduced Hard Seltzer product, which will compete in an area that admittedly has gotten very big very fast. So this will provide us with, I think, renewed opportunity for growth, and we're very excited about the prospects for that going into the new fiscal year. Obviously, as a reminder, we will give fiscal guidance during our next call. So we'll refrain from doing that at this point in time. But certainly, we're very excited not only about the fourth quarter and finishing our year very strongly, but for next year as well.

**David Klein;Chief Financial Officer**

Yes. Dara, on the contractor settlement and even in the S/4HANA kind of production build that we did in Q3 that gave us a benefit, these are all a few to several million dollars each. And if you think about last year, as you rewind to last year, I think in Q3, we had an issue with glass production in the quarter. So we get these impacts every single quarter that are, call it, $3 million to $7 million each. And sometimes they kind of aggregate in our favor, sometimes they go against us. But if you look at our total operating margins in, say, FY ’18, we’re at 39.5%; FY ’19, we’re at 39.3%. And this year, we’re saying we’re going to be between 39.5% to 40%. I think by the time you get to the end of the year, all these little timing nits go away, and we end up in a pretty consistent margin range in this business, which I’ll point out maybe for the last time is, by far, best-in-class in North American brewing.

**Operator**

Our next question comes from the line of Amit Sharma with BMO Capital Markets.

**Amit Sharma**

Just a couple of questions. One on beer. Bill, you talked about the long-term outlook, and it looks like you’re still confident of high single digit. Can you talk about Modelo in particular, like still growing double digit, but some people are a little bit concerned about the decel that we saw recently. Can you talk about what is in the pipeline from a Modelo perspective, as you look to continue this momentum?

And then on wine, David, good to hear, 30% operating margin outlook still intact for that business. Can you talk about the time line of the stranded costs as they come out post the divestiture of the lower price brands?

**William Newlands**

Sure. I’d say, and I’ve said this many times, I think Modelo remains the single largest opportunity for this company. It is just beginning to crack into the general market. It has had a very, very strong run with its core Hispanic base and continues to grow with that audience. And as many of you know, we do have a great tailwind with the growth of the Hispanic consumer in the United States, which will continue to give us a tailwind for a fair amount of time. But as you know, our advertising and our marketing activities around Modelo have been expanded to a broader audience and the growth profile within the non-Hispanic consumer is tremendous. So we see a remaining tremendous upside in Modelo.

Going to your question then about what else? We will be introducing the Modelito product. So a different size. We have size opportunities. And as you all know, we have done nothing truly to innovate around Modelo outside of the Chelada business, which has done extremely well for us. So we think Modelo is going to continue to be a juggernaut well into the next decade and will likely be the single largest growth product and brand for us going forward.

**David Klein;Chief Financial Officer**

Yes. And on the topic of stranded costs, it's a bit of the story we told at the beginning of this year, almost on a 1-year delay, where we're saying it's $130 million stranded cost without getting into specifics that will be included when we provide guidance next quarter. You can assume that 1/4 to 1/3 of those costs come out in FY '21, the rest in FY '22 because we have the flow-through through COGS to hit before it hits our P&L. So like FY '23 will be the first real clean year where we can take a look at that, seeing all the stranded costs coming up or being out.

**Operator**

Our next question comes from the line of Lauren Lieberman with Barclays.

**Lauren Lieberman**

Great. So I was hoping to talk a little bit about the increased marketing spend on Corona, because last quarter, right, you took the opportunity to say, look, beer profitability is coming in a bit ahead of plan. We'll put some extra money behind Corona. And clearly, there's been some reaction. But at the same time, the marketing spends on beer came in a little bit light of plan. So if you can just give us some color on why the spend was a little bit lighter, kind of plans looking forward? And what in that marketing mix is particularly – had a particularly attractive return would be interesting?

**David Klein;Chief Financial Officer**

Sure. Yes, I'll comment on the kind of timing of spend. It really is – it's a timing issue. We expect that we will finish the year, as I said, in the 9.5% to 10% range of net sales. At the same time, we expect that we will see an uptick in our marketing spend in Q4 this year versus Q4 last year. Some of that having to do with incremental investment behind our core brands, but also some of it having to do with basically production costs around the Seltzer marketing campaign that Bill outlined earlier. So I think for marketing for us, it really is just a function of timing as we still are focused on that 9.5% to 10% range.

**Operator**

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

**Robert Ottenstein**

A couple of just kind of follow-up clarifications. First, it looks to us that the price mix was about 1.6%. Can you give us a sense of what that would have been without Ballast Point?

And then second, following up on some of the comments on Corona Seltzer. You made some comments that it's being well received by retailers. Can you give us a sense of how you see the shelf sets coming out next year, where Corona Seltzer is going to be positioned on the shelf versus beer versus other White Claw? And then if you look at the White Claw trends, they've been unbelievable, right? I mean they're actually increasing share. I think the latest share is something like 67%, up from 60%. What gives you the confidence that this is actually a Hard Seltzer segment as opposed to a White Claw segment and that there's room for a lot of new competitors?

**William Newlands**

Sure. So let's talk about the sense and where we expect to see Seltzer. Seltzer is in all likelihood not going to take space from our core beer franchise. The consumer views it as something different. The retailers viewing it as something different, whether it's on the shelf or in the cold box. So we think there will be a distinct differentiation of product location versus just cannibalizing existing shelf space. That's the way it's been so far, and we believe that will continue.

This – the answer to your question regarding whether this is a category or a brand, I think we've solved that answer for ourselves with research. Our consumer and the Seltzer consumer is very interested in the idea of Corona Hard Seltzer, in part because of what I said earlier, which is the whole refreshment DNA around the core Corona brand. The strength of Corona in that whole refreshment, relaxation, beach experience is perfect for this. As we said earlier that the Seltzer consumer has generally been increasing their overall consumption of the total alcoholic beverage category, which I think speaks well for the overall category of Seltzers going forward. And the strength of the Corona brand name, together with the investment that we're going to make against it, we're quite bullish on.

**David Klein;Chief Financial Officer**

And Robert, on the price mix question, it might be as if we were just looking at imports, it might be 10, 15 basis points, but not – additional to that, but not much more.

**Operator**

Our next question comes from the line of Steve Powers with Deutsche Bank.

**Stephen Robert Powers**

Congratulations from me too, David. Maybe coming at the beer outlook from another direction. Just coming back and coming into calendar '19 at the beer event in Chicago, you guys were pretty adamant that beer margins would trend flattish, more or less in line with where you finished last year, call it, 39.5%, as you said. But now we're 3 quarters into fiscal '20, beer margins have exceeded expectations, 3 quarters in a row, raising the full year outlook. And arguably, 4Q would seem to have potential upside embedded in it as well, acknowledging some of the 3Q benefits that could reverse. I guess, as you step back, does any of that change or go forward-thinking as to where beer margins could ultimately aspire to, especially without the recent drag from Ballast? I mean is there – I guess, is there a structural upside to your prior outlook? Or do you attribute the recent strength just to some of those timing nits that you'd mentioned earlier, David?

**William Newlands**

So I'll start with that, and David can add as he would like. During that discussion, one of the things we were quite clear about relative to our guidance, is there will be some years where things go our way. Costs are better. FX is better. Certain things just simply are favorable to what we would view as sustainable long-term proposition around our margin structure. This year has been one of those. And we're certainly happy to take it. But it's also realistic to recognize that those things can go either way. As I said, this year, it has gone in our favor, and we continue to work, as you would expect, on our operational footprint to make sure we are extracting every ounce of opportunity as it relates to cost. But this year, we're on our way, and we're quite pleased that it has. David, do you want to add anything to that?

**David Klein;Chief Financial Officer**

Yes. Steve, I would say that we are pleased. I'm convinced we have some of the best operations people on the planet in order to produce the results that we do on a consistent basis. A note of caution, though, is that – and I think we've been clear about this is that when we are in the launch year from a Seltzer standpoint, we know that we're going to be driving towards the high-end of our marketing spend as a percent of SG&A range. We also know, as I said in my script, that there are going to be some drag on gross margins as we come out of the gate on Seltzers. However, we've also said that we believe, over time, Seltzers don't have to be a drag, and we don't expect them to be a drag over time, right? So I think you're going to see puts and takes in our business, as Bill outlined, but I'm actually pretty pleased with the consistency of margins in that – as I said, 39.5-ish percent range for 3 years in a row.

**William Newlands**

And I would just add on to David's comments that much like our beer margin structure is best-in-class, I think you would expect that our Seltzer margin structure as we get to critical mass will also be best-in-class versus the competition.

**Operator**

Our next question comes from the line of Andrea Teixeira with JPMorgan.

**Andrea Teixeira**

David, congratulations also on your promotion, and thank you for your work as a CFO of Constellation. So my question is a follow-up on the comment about increased investment on the Seltzer marketing. Should we budget part of it already in the fourth quarter and also increasing early first quarter in fiscal 2021, because I understand the launch is early fiscal year in March – early March, so relative to the typical launches or the typical innovation that happens around Cinco de Mayo?

And a clarification, if I will, and shifting gears a little bit for Wine & Spirits. So the implied fourth quarter Wine & Spirits profit guidance, it's down – so far, it's down 13% year-to-date. So the full year is down 8% to 10%, which implies that you have an improved performance in the fourth quarter. So if you can elaborate on that as well?

**David Klein;Chief Financial Officer**

Yes. So on marketing spend, yes, we expect that our spend will be up on a year-over-year basis in Q4. And that's the – you can kind of calculate back to get into that 9.5% to 10% range. As I said, that's most likely to be a Seltzer production – marketing production costs. And then we think that the spend will be a little bit weighted to the first quarter and certainly the first half of the year, while we're just getting the product on the shelf, we want to make sure that we're driving a lot of consumer activity at that point in time.

**Operator**

Our next question comes from the line of Bill Kirk with MKM Partners.

**William Kirk**

So I have a quick question on cannabis. Obviously, you worked with Canopy on the beverage launch up in Canada and as I understand it, Acreage can bring Canopy's IP technology, including that beverage technology to the U.S. So I guess my question is, would you want Acreage in the U.S. to start making the products that you developed with Canopy?

**William Newlands**

Yes. I think the best thing that – so it's not our decision. Let me just be clear about that, it's Acreage's decision, but to the extent that we develop outstanding products for use in the Canadian market. If Acreage can bring those to the U.S. and they're comfortable to do so, we think that, that's a home run all around like throughout our cannabis ecosystem, if you will, that's a benefit to Canopy, that's a benefit to Acreage and some of our Constellation team has been helpful in making sure that the products are meeting the expectations of the consumer and the marketplace.

**Operator**

Our next question comes from the line of Sean King with UBS.

**Sean King**

You called out Refresca as a growth driver, but it still looks pretty small in the track channels. Where do you stand in terms of, I guess, a national rollout strategy? And how do you expect Seltzer to interact with Refresca, I guess, on the shelf?

**William Newlands**

Yes. We're very pleased with Refresca. It has outperformed what our expectations were. And we're going to continue to invest behind it to make sure it continues to grow. As I said a little earlier, we don't expect the shelf interaction to get in the way between our Seltzer and our Refresca businesses. We think they serve different needs, although admittedly, there is some interaction between an FMB consumer and a Seltzer consumer. But we think there is room for both of those products in the market, and we're looking forward to seeing continued acceleration of both the Refresca franchise as well as the Hard Seltzer when it comes out.

**Operator**

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

**William Chappell**

David, congratulations. Two quick ones. Any kind of guidance on what the peso versus the dollar impacted beer margins this quarter? Or is that more to come in future quarters? And then also, in terms of kind of what you talked about marketing spend and following Andrea's question, is this similar when we look at the first quarter of 2021 to what we saw 18 months ago with the rollout of Premier in terms of kind of pulling forward marketing, more spending very front-end loaded? Or is it more balanced throughout the year?

**William Newlands**

Yes. So on FX, and again, we get some volatility in FX. And our team, I think, does a nice job of trying to lock in bumps in the peso, which gives us a little tailwind on – especially given the volatility between the USD and the peso over the last couple of years, right? So we think that, in the quarter, that was about 60 basis points of impact on margins.

And then – yes, I think you can think about it a lot like Premier. So kind of the spread throughout the quarters of the year should look just like the Premier launch.

**Operator**

Our next question comes from the line of Laurent Grandet with Guggenheim.

**Laurent Grandet**

Like to have a question on Corona Premier and Familiar, specifically regarding Familiar, when looking at the Nielsen data over the last few periods, we are seeing an accelerated decline. So is it deliberate choice as it seems, you keep mentioning it, and you're anchoring Corona in the refreshment space, that Familiar may not fit and to provide pretty more space for Modelo to grow? And then on Corona Premier, growth is plateauing. It seems like it's getting to the size of Corona Light. So is there any sense you can revamp that brand and reaccelerate the growth? Or are you satisfied with the current performance of Corona Premier? So those 2 ones.

**William Newlands**

So relative to Familiar, Familiar continues to do very well, particularly in the core Hispanic community, which is where it was originally targeted. So we continue to think that Familiar is going to be an important part, particularly with the Hispanic consumer and very specific demographics and very specific geographic regional opportunities.

Relative to Premier, Premier continues to do very nicely and we're excited about it. Obviously, there has been some impact. The cannibalization that has occurred has been impacting Light, as you would expect to some degree. But Premier also opens up a bunch of new consumers to our franchise as well who are looking more for that low carb positioning that Premier presents. So we remain very bullish on the future for Premier, and we're going to continue to invest against that franchise going forward. And again, it goes right back to, we are always pleased when more and more consumers spend more and more dollars against the overall Corona franchise. People believe in this franchise. It is the #1, as I said before, #1 most trusted brand, with both Hispanic and non-Hispanic consumers, 21 to 54. And that gives us the chance to continue to leverage new introductions like Refresca, Premier and Hard Seltzer, which is obviously coming in this coming fiscal year. So we remain very bullish on the overall Corona franchise. And I think the fact that, that franchise was one of the few growth brand franchises over the course of the last decade shows the real longevity for that brand.

**Operator**

I'm showing no further questions in queue at this time. I'd like to turn the call back to Bill Newlands for closing remarks.

**William Newlands**

Well, thanks very much. And I guess I'd be remiss, David, if I didn't say that all the congratulations you just received are well-deserved. We're certainly going to miss you on this side, but we'll be happy to get our 37% value-add going forward. Thank you, everyone, for joining our call today.

Before closing, I'd like to reiterate what a powerful decade this has been for Constellation. Our results over the past 10 years are a testament to the dynamic, strategic efforts made by our strong management team. Through our current initiatives and priorities, we are positioning this company for sustained long-term success. And therefore, we are just as excited and optimistic that the next 10 years will continue the momentum into the fourth quarter as well as a strong finish to this fiscal year. As a reminder, during our next quarterly call, as I said earlier, we will be providing guidance for the upcoming fiscal year. So thanks, again, everyone, for joining the call. I wish you all a safe, happy and prosperous New Year and new decade. Thanks, everyone.

**Operator**

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