

Brown-Forman Corporation, Q1 2019, Earnings Call

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Presentation

Operator

Good morning. My name is Dorothy, and I will be your conference operator today. At this time, I would like to welcome everyone to the Brown-Forman First Quarter Fiscal 2019 Conference Call. — **Operator Instructions** — Thank you. I would now like to turn the call over to Jay Koval, Vice President and Director of Investor Relations. Sir, you may begin.

Jason Koval

Thanks, Dorothy, and good morning, everyone. I want to thank you for joining us for Brown-Forman's First Quarter 2019 Earnings Call. Joining me today are Paul Varga, our Chairman and Chief Executive Officer; Lawson Whiting, Executive Vice President, Chief Operating Officer and Incoming Chief Executive Officer; and Jane Morreau, Executive Vice President and Chief Financial Officer.

This morning's conference call contains forward-looking statements based on our current expectations. Numerous risks and uncertainties may cause actual results to differ materially from those anticipated or projected in these statements.

Many of the factors that will determine future results are beyond the company's ability to control or predict. You should not place undue reliance on any forward-looking statements, and the company undertakes no obligation to update any of these statements, whether due to new information, future events or otherwise.

This morning, we issued a press release containing our results for the first quarter of fiscal 2019, in addition to posting presentation materials that Jane will walk through momentarily. Both the release and the presentation can be found on our website under the section

titled Investors, Events and Presentations.

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

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

And with that, I'll turn the call over to Paul for some brief comments.

Paul Varga

Hey, good morning, everyone. As you all know, from our late May announcements, at the end of the year, I'm going to be retiring and Lawson's going to be taking over as the company's CEO. And with each passing month, as you can imagine, with these types of transitions, it's normal to be handing things over, and that's actually the case with this particular call today. So I'll be available with Jane and Lawson today for Q&A at the end. But otherwise, Lawson and Jane are going to handle the call. And I'll turn it over to Lawson to take us away.

Lawson Whiting

Yes, great. Well, thank you, Paul. I'm going to open up today, the conversation today and add some color around what was a very good quarter but one that also had several unusual factors impacting the results. But generally, we're encouraged by the strength of the results and how our brands are performing around the world. Jane's going to walk you

through the quarter in a moment to provide you a better understanding of the results, the estimated impact of the tariffs and our current view of how we're approaching the business environment this year.

But putting tariffs aside, we believe our brands remain in great shape and the portfolio's delivering growth that's consistent with what we saw in fiscal 2018. One of the effects of the tariffs though is that we're seeing inventories increase at the retail and wholesale level, particularly in Europe. Jane will get into more of the detail on this in just a minute.

But even after taking into account the increased inventories' impact on our sales growth, the core portfolio, driven by the Jack Daniel's family of brands and sustained double-digit growth on Woodford Reserve, on Old Forester, el Jimador and Herradura all look pretty good.

Our most recent consumer takeaway trends also point to sustained growth. And we believe that our teams around the world are helping us successfully navigate some very unusual times, ensuring that we balance short-term pressures with an eye towards our long-term strategic growth plans.

In a year where we're enjoying favorable bottom line support from tax reform and most of the markets impacted by the tariffs, we decided to invest behind the continued momentum of our brands, absorbing much of the short-term tariff costs through delayed price increases. This helps our consumers maintain the affordability of our products against a competitive set that is not subject to these tariffs.

While this creates some short-term pressure on gross margins, we believe it's the right strategic move to make during a period of uncertainty. Best-case scenario is that these tariffs, or at least those in the EU, are rescinded over the coming months. However, the updated financial outlook in our earnings release does not assume this. Our outlook

assumes that the tariffs remain in place for the remainder of the fiscal year.

Switching to a couple other important topics. We've made a number of refinements to our organization over the past several months. In the United States, we've created an emerging brands group to add incremental focus and help accelerate the development of some of our super-premium and heavy on-premise brands. These brands include Heradura, Old Forester, Sonoma-Cutrer, Slane Irish whiskey, GlenDronach and BenRiach single malt Scotch brands.

Outside of the U.S., we're doing something a little bit similar. We're investing additional resources in several countries to focus on leadership of super-premium whiskey. In particular, we see significant opportunity for Gentleman Jack, Woodford Reserve, GlenDronach and BenRiach in many of our larger markets in Europe. We remain encouraged about the potential for better portfolio development across these developed markets and are making this a bigger priority for the organization.

As we look to invest in other future drivers of growth, we continue to seed our new brands too, such as Jack Daniel's Tennessee Rye, Woodford Reserve Rye whiskeys, Slane Irish whiskey, Coopers' bourbon and a number of other whiskey line extensions. In Q1, we also introduced a new Jack Daniel's Bottled-in-Bond product that is a Global Travel Retail exclusive. So we have lots of innovation that we believe should continue to be an incremental – should be incremental to our overall growth profile.

So fiscal 2019 has certainly had a lot more noise and volatility than normal due to the tariffs, but we believe we're well positioned to maintain our momentum into the holiday season and beyond. Now I'm going to hand it over to Jane and let her walk you through the quarter and give you some color on our updated guidance for fiscal 2019. So Jane?

Jane Morreau

Thank you, Lawson, and good morning, everyone. During my comments today, I will reference the slides we've posted to our website this morning to help you walk you through the 2 main areas of focus that I plan to cover in my prepared remarks.

These 2 areas include first, a review of our first quarter results; and second, our outlook for fiscal 2019, which you saw this morning we revised given the tariffs that were implemented earlier this summer with American whiskey products across a number of markets, including the EU, China, Mexico, Canada and Turkey. So after I complete my prepared remarks, then we'll open it up to Q&A.

So let me start by reminding you that there's always noise when looking at results over short periods of time, and this quarter was no exception. We had normal inventory fluctuations, foreign exchange, customer buying patterns, timing of product innovation. These are just a few examples. Tariffs added yet another lever of complexity. So what I want to do now is spend some time helping you understand our view of the quarter.

So let's begin with Slide 3. It highlights our first quarter results, reflecting strong top and bottom line growth on both a reported and underlying basis. We're very pleased with the start to the fiscal year, particularly in light of last year's 6% underlying net sales growth. So delivering net sales growth of 9% during the first quarter is very encouraging.

As Lawson mentioned, these results were favorably impacted by an increase in retail and wholesale inventory levels related to retaliatory tariffs, particularly in Europe. We estimate that buy-ins added approximately 2 to 3 points to our underlying net sales growth in the quarter. But after we consider these buy-ins, we believe we delivered underlying net sales growth in the quarter similar to last year's underlying rate of growth.

A continuation of the theme we have had over the last 6 years now, we again delivered operating leverage with underlying operating income growth of 10% despite the signif-

icant increase that was partly timing related and operating expenses in the quarter. I'll come back to this topic in a moment as well as our outlook.

So let's move on to Slide 4 and 5 and look at our report – results on a reported basis. You see our reported sales growth was affected by 1 point due to the adoption of a new revenue recognition accounting standard we mentioned on our last call and 2 points due to adverse foreign exchange. These 2 factors were partially offset by a slight increase in distributor inventory levels.

Moving on to Slide 6 and 7, we'll dig into our results by geography. Just starting with our largest and most important market, the U.S. delivered 2% growth in underlying net sales against last year's solid 5% growth. These results were largely in line with our expectations. And as we look at the U.S. business, we believe it is tracking well with blended Nielsen and NABCA value takeaway trends, fairly stable in the 5% range, mostly consistent with the overall market.

Emerging markets delivered very strong 11% underlying net sales growth against last year's first quarter, when underlying net sales grew 19%. You can see this on Slide 8, which highlights the accelerating 2-year stack. We estimate the emerging markets benefited modestly due to tariff-related buy-ins in countries such as Poland and Turkey.

It was really in our international developed markets that tariffs-related buy-ins had the largest impact on our underlying net sales growth rate. These markets were up 16% against tough comparisons from last year's first quarter when results were flat. We estimate that this year's 16% growth rate was roughly double the actual trend in the developed international due to increased purchases to build inventory levels in anticipation of tariff-driven price increases.

On top of the 12% underlying net sales growth that travel retail registered in the first

quarter last year, this channel grew underlying net sales 22% this quarter due in part to timing of trade buys, but also reflecting continuing increase in travelers.

Slide 9 highlights the breadth of stream delivered across our entire brand portfolio, with the Jack Daniel's family of brands underlying net sales up 10%; our premium bourbon, including Old Forester and Woodford Reserve, up 29%; and our tequila brands, including Herradura, el Jimador and New Mix, up 9%.

Slides 10 and 11 examine our margins and other growth rates. Gross margins were flatish for the quarter, resulting in gross profit growth roughly in line with sales, up 9% on an underlying basis. Underlying A&P investment was up 17% in the quarter. So after adjusting for some items, including the timing of the new Woodford Reserve Kentucky Derby sponsorship, which began in early May of this year, and the opening of the Old Forester distillery and homeplace right here in our corporate headquarters, hometown of Louisville, Kentucky in June, A&P is trending up roughly in line with sales.

Underlying SG&A grew 5% against a 1% decline in the prior year. SG&A was negatively impacted by higher personnel costs, including an early retirement program we offered in the first quarter as well as the timing of other benefits. In total, all of this resulted in a very robust underlying operating income growth of 10%. In addition to the overall business growth, a lower tax rate versus last year's Q1 lifted our earnings per share growth to 12% or \$0.41 for the quarter.

So now let's move on to my second topic and share with you our revised outlook for 2019, which are shown on Slides 12 and 13. The key message is we remain confident about our business momentum. This is evidenced by the strong top line start to the year even after considering the impact of tariff-related buy-ins.

Our confidence is supported by our brands' consumer takeaway trends around the world,

which remains strong. For example, the U.S. and Australia value takeaway trends are running up mid-single digits. In Europe, in many markets, our takeaway trends are even stronger, up in the high single digits. And the emerging markets continue to demonstrate improving trends, notwithstanding FX volatility in Turkey and Mexico. As a result, we expect another year of 6% to 7% growth in underlying net sales in fiscal 2019.

Now I thought it would be useful to walk you through the last several months of tariff news flows. Remember that tariffs in most countries, particularly the EU, were not a reality until a few weeks after we reported our fourth quarter earnings in early June.

Given the possibility of tariff, we had already begun our work on mitigation plans earlier in the calendar year, including considering pricing actions and inventory shifts, among many others. To paraphrase what Lawson said just a few moments ago, the goal was to balance what's in the best interest of our business and our brands in the short term, considering the impact on consumers and our momentum, with a careful eye towards achieving our long-term growth ambitions in the affected markets.

We believe news flow around tariffs and retail anticipation of price increases led to some of the buy-ins we experienced during the quarter. But thus far, we've implemented price increases in a handful of markets but have waited in some of the larger markets in the EU following positive development with trade partners.

Further, in a year where we expect tax reform to bolster our bottom line results, as Lawson also said a moment ago, we saw this as an opportunity to invest behind the continued momentum of our business in these highly competitive markets during a very fluid period. As you would expect, we are continuing to monitor and evaluate the situation very closely.

So again, our current expectation, which is a basis of our guidance that we're sharing with you today, assumes trade talks are not successful at rescinding the tariffs and that they

remain in effect throughout the remainder of fiscal 2019.

At this point, given the volatility and uncertainties surrounding tariffs, we intend to take price increases in many of the remaining markets as a result of tariffs and are continuing to assess the timing and amount on a market-by-market basis while considering the impact on our business and our consumers. However, at this point, we do not expect that these price increases will offset the cost of the tariff itself in the interim or the higher cost of goods we had already expected for the full fiscal year.

As such, we now expect gross margins to decline over 2 points for the full fiscal year relative to last year. This gross margin pressure will show up to some degree in the second quarter and more significantly as we move into the second half of the fiscal year. This, along with other puts and takes, including other tariff-related mitigation actions, translates into lowering our full year outlook for underlying operating income growth to a range of 4% to 6%, 3 points below our prior range of 7% to 9%.

Regarding operating costs in fiscal 2019, we still expect solid reinvestment in our brands' development, with A&P up roughly in line with sales growth. And we believe that we can continue to drive and leverage our operating income through SG&A even after incorporating some costs with recent organizational changes. We remain on track to deliver the 3-year \$100 million cost savings initiatives through fiscal 2020.

This revised operating income growth of 4% to 6%, combined with an estimated tax rate in the range of 20% to 21%, drives our reported earnings per share outlook of \$1.65 to \$1.75, representing growth of 11% to 18% over last year's reported EPS of \$1.48. This EPS range incorporates our expectations for additional foreign exchange headwinds and slightly higher interest expense for the year. As a sensitivity, EPS over the balance of the year would be impacted by roughly \$0.05 if foreign exchange rates move 10% in either direction.

In summary, our teams have worked hard over the last 1.5 years to accelerate our top line growth back towards historic rates of growth. And we are confident that we can maintain this momentum despite these trade disputes. We believe that we have the leading portfolio of premium American whiskeys in the world and are very well positioned for additional market share gain.

Our sales growth is high quality, with leading returns and great margins. And given the efficiency of our business model, it leads to strong free cash flow generation. We remain committed to growing our global businesses in a disciplined manner and being judicious allocators of capital back into the business and to our shareholders.

And with that, that wraps up my prepared remarks. So Dorothy, could you please open up the call for some questions?

Question and Answer

Operator

— ***Operator Instructions*** — Your first question comes from the line of Brett Cooper with Consumer Edge Research.

Brett Cooper

I got 2 questions from my side, first on the emerging brands business that you guys are setting up. I'm just wondering if you could kind of give us some color as to where those, I guess, the funds to invest in that business are coming from. And then second, we've seen this in – from other companies in terms of this business becomes a vehicle to invest in smaller brands and take stakes and help them out as they go and then be able to acquire them going forward. So we'd love your perspective on that. And then on the other side, on tariffs, if you could give us a sense of what you're seeing with respect to the pricing environment in the key, I guess, EU markets where you're going to have to take price in

the coming months. Are you talking about coming – or about taking price in the coming months?

Lawson Whiting

I'll take the emerging brands, and then Jane can talk a little bit about the tariffs and sort of pricing that we're seeing around the world. The – yes, I mean, I think you said it largely correctly. We're – a number of our smaller brands need some incremental focus, so we would like to see some incremental focus on there. The cost, most of the investment is being reallocated from other parts of the organization as we have continued to – our SG&A numbers still remain pretty low. So while some of it has been incremental, a lot of – most of it is just a reallocation from other brands or other overhead costs that we've been able to pull out and put into the, call it, a more front-facing part of the organization. So we remain pretty optimistic about it. I think there's another part of the argument too that may not be obvious at first glance, is people that get to focus on these smaller brands then don't have to focus on Jack Daniel's. And the folks that are working on Jack Daniel's don't have to focus on Slane. It's difficult to explain, I'm sorry, just the broader emerging brands portfolio. We have found it challenging, when you've got a brand family as big as the Jack Daniel's family is, to ask a sales guy to go then to focus on a new brand. And that – we don't want that distraction or that lack of focus on what is the biggest part of our portfolio right now. So it goes both ways and we're pretty optimistic. The group is just getting put in place right now. So we'll have to see how the results unfold over the next few months and quarters, but we remain pretty optimistic about it.

Jane Morreau

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Yes, so Brett, your question as it relates to the pricing environment that we see around the world, I would say it remains very intense and very competitively intense. And I think one

of the reasons why we have made the decision we have made thus far, not only because we have some positive news coming out with the trade discussions potentially happening not only [EU], you saw some news earlier this week on Mexico and the U.S., at the EU and U.S. that – in hopes that they will reach successful completion. So we have determined that we're going to not take price increases right away in many of these markets because of this intense competitive pressure. And not only that, our other competitors do not have the same pressures that we have as it relates to this. So we do intend on taking things later in the year, but not at this point in time. And so we've not seen a whole lot of pricing improvements from what we discussed with you in early June.

Operator

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

Vivien Azer

I was hoping that you could touch on the U.S. Clearly, like the comps were tough and we can see that in the NABCA data. But underpinning the 2% underlying sales growth, can you talk about some of the trends by brand, please?

Lawson Whiting

Yes. I'll start it at least. Yes, so I mean, the comps were tough, and that had – that definitely had an impact on – at least on the shorter-term results. I would say overall, as a company, we continue to trend really in the U.S. in that mid-single-digit range, sort of in the 4.5% or 5%. That's what the blended takeaway figures would indicate. And that's been pretty consistent now for – actually probably for a couple of years. So pretty good overall results. And maybe just a notch above TDS on a long-term basis is clearly one of our goals. It's being driven – a lot of it being driven by not – while Jack Daniel's Tennessee Whiskey may be a couple of points below that, the Jack Daniel's family in aggregate is just – is sort of around the 4% range in consumer takeaway, 4% to 5% also. So we feel

pretty good about that. And then we've got the bourbons and tequilas, led by Woodford Reserve as the biggest of them. But the bourbon and tequila business remains very, very strong, well in the double-digit range and clearly lifting the portfolio in aggregate. If you went back 5 years or 10 years, our rest of portfolio was a big drag in the United States, and we were clearly being led by just the Jack Daniel's family – or relying on the Jack Daniel's family for our growth. And thankfully, that has changed over the last few years where the rest of our portfolio is sort of mid- to high single-digit growth rates and lifting the overall profile. So it's a good story there.

Jane Morreau

And just building on, you will also see our tequila is doing very well also and the U.S. are growing in the teens. And so that's another piece of our portfolio that had for a number of years not really hit its stride in the last several years. We think that we're at that point to pinpoint, if you will, for our tequila brands, and they continue to perform very well in the U.S. Further, I would point out, Lawson mentioned this, but I would say we're going into our eighth year of Honey in the marketplace and it's still growing strongly in the U.S., and our fourth year for Fire. And we continue to see new consumers coming into the franchise, both Honey – via Honey and Fire, and they're both continuing to grow very well.

Paul Varga

Vivien, let me add to it, I think sort of just piggybacking on Jane's point about Honey. I think beyond just the quarter results, if you were to think about just what's happening in the U.S., I mean, I consider that the U.S. distilled spirits market continues to progress very much in line with the way it has been performing for many years now. And then when you – when we look at it, I mean, just using sort of the NABCA data, the 2 influences that I think that could help people to understand the dynamics of the market as it relates to us are, particularly if you zone in on the Jack Daniel's Black Label brand, which is continuing,

I think, to hold up pretty good in at least the last 12 months to my eye on the NABCA dollar sales if – 2.5% to 3%, a slightly lower deceleration of the growth versus 12 months ago, but still in that 2.5% to 3% range, and the family is still at about 4% range on value. And all of this at an interesting time where we're seeing some of the key larger brand competitors in the bourbon category. If you just look at their volume trends versus their value trends, there's clearly some negative price/mix going on, which would indicate people are just putting lower prices out in the marketplace sometimes. And those are things that you have to deal with, particularly in a competitive market. And I think the other thing is that last year's elevation of a number of the Jack Daniel's family of brands such as – whether it was Gentleman Jack or Tennessee Fire or Tennessee Honey, the introduction of Rye, all of these in a small way, I think, have to take away on an occasion or 2 from Jack Daniel's Black Label. So one thing is we watch really closely to see how Black Label is holding up in the environment against whether, at least at this time, there could be both a little bit of pressure from cannibalization and a little bit of pressure from some lower prices from competition, and my view is it's holding up very well.

Operator

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

Drew Levine

This is Drew Levine on for Amit. I just wanted to jump back to – you talked about the price/mix maybe under pressure. I know you talked earlier about maybe taking some pricing on tequilas and American whiskey. So can you just talk about the pricing environment in the U.S., if you put any pricing through so far and kind of the outlook for the year in the U.S. in regards to price/mix?

Lawson Whiting

Let me take that.

Jane Morreau

Go ahead.

Lawson Whiting

Yes. Well, Paul largely hit on the Jack Daniel's side of it. We are not going backwards on the way of Jack Daniel's Tennessee pricing while some of our competitors are. And so we're going to hold firm on that. And while I think it will be very low single-digit pricing on the brands, we certainly want to keep it moving in that direction. Tequilas are a little bit of a different story where it's also sort of low to mid-single-digit pricing growth on those brands. We will see how the competition sort of lays out this fiscal year, as you sort of mentioned it, and we have talked about in the past that the cost environment is particularly challenging right now in the world of tequila. And so many of the brands are going up and we consider that a good thing. So bourbons and the rest of the Woodford Reserve and Old Forester on those are largely kind of flattish on the pricing environment, although they're getting help from mix. We continue to do innovation both – on both the Old Forester and Woodford at higher price points, and that helps to lift up the overall portfolio.

Paul Varga

One thing to observe as you continue to look at the U.S. market as it relate – there's the price piece and then there's the mix piece, which I think is enormously important as it definitely applies to our Old Forester and Woodford Reserve lens where the higher-end expressions are growing so rapidly, obviously, in some cases, from very small bases. The other thing that I think is going to affect the marketplace, the U.S. for some time, it's really been interesting given how strongly, for example, a brand like [Tito's] has performed now for many years. It's amazing to see how low the growth of the vodka category is generally. And you can imagine that it's – be very hard to get pricing in vodka right now across the board. And as a result, I mean, my view is that bourbon, in terms of dollars share, relative

to the largest category in the country, which would be vodka, you would expect to see it, from a mix standpoint, to continue to grow, I mean, really continue to grow share over. And I – we've used this statistic quite often over the summer, but we're still a long way from the volumetric high of the American whiskey category, which was reached in 1970. We – our view is we've got many, many years of – consecutive years of growth in order to get back to even that volumetric level. And I wouldn't even touch the per capita consumption level at the time. So there's a lot of excitement still about the U.S. market, even though it does remain competitive, because people are so excited about it.

Operator

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

William Chappell

Just – sorry if I don't fully understand the guidance. But it seems like as you're looking at kind of the slight lowering of operating income guidance this year, that \$0.06 to EPS, that really doesn't have a whole lot to do with tariffs. It has – a lot of that planning being done in place when you put the initial guidance in. This is just a, I guess, an intra-quarter decision to step up SG&A in terms of focusing on international. And so I guess, the first question, is that correct? And then second, why would that be more focused outside the U.S.? It seems like there's – it's certainly, in kind of a media and marketing, bigger, more competitive activity in the U.S., and didn't know if that was needed instead.

Jane Morreau

Bill, let me take the first part of your question. In terms of our guidance that we gave today versus the guidance we gave back in June, they are different. The guidance we gave in June explicitly did not assume any tariffs. Nothing had happened at that time. So the fact that we revised our guidance this time by about \$0.10, we said that about \$0.06 of it were tariff, net tariff related net of some mitigation actions that we have in place

plus the tariff costs themselves and things that we're doing, and then the other \$0.04 is largely foreign exchange. So it is largely tariff. And then of course, the market – the foreign exchange, we always update that each time depending on what's happening in the marketplace.

Paul Varga

And most of the tariffs is in cost absorption versus volumetric declines, yes.

William Chappell

Okay. Yes, I guess I would have thought it would have been a bigger impact on gross margin. It wouldn't have affected SG&A. So I guess, that's what I'm missing.

Jane Morreau

Yes. So SG&A, let me make sure I understand where you're going on the SG&A. What I said on SG&A, I think, early on at year-end, we said it was flattish. Now we're saying slight increase. So again, what – where the tariffs are going to hit, they're going to hit gross margins. And as I alluded to in my talk, in my script here a few moments ago, we did revise and have provided guidance that we expect our gross margins, which we thought were going to be similar to last year's hurt, if you will, or decline in margins, well, we actually expect it to be a little worse if – assuming tariffs remain for the whole year because the cost of the tariffs will go in cost of goods. Yes, it will offset some of the pricing later in the year, at least that's the plan currently. So it's happening in the gross margin line item.

William Chappell

Got it. And then in terms of just the investment in the U.S. versus international?

Jane Morreau

In terms of advertising investment?

William Chappell

Yes. I mean, do you feel like you have enough in the U.S.? Or are you seeing increased competitive pressures there?

Jane Morreau

Yes. I mean, clearly, the first quarter was – I talked about all the investments we're doing in the U.S., whether it was the opening of our new distillery in homeplace, here in town, Old Forester or the Woodford Reserve sponsorship with the derby, those were all incremental new investments for us in the U.S. and in the category of bourbon, which is fast-growing. So I think we feel good that we're investing appropriately in the U.S.

Lawson Whiting

I mean, I think to add a little more color around it, we've been investing heavier in advertising than we have in SG&A now for several years as we've reallocated within our operating expense mix. So we feel pretty good that it's in an appropriate level, I guess. And you should expect increases, I think Jane mentioned it, of – sort of commensurate with sales growth. And that plan has been around for a while, and I think we'll continue that going forward.

Paul Varga

I like the explanation Lawson provides on this, even though it leads with the topic sort of branded as emerging brands. But this heightened focus by dividing and conquering people and brands within our company, I think, can be a benefit. But that initiative comes in the form of an investment. I mean, I call that an investment – well, investment in people and – but the – I feel like the levels are about right. But as you can imagine, we regulate, as you look at the competitive fit, you're always tinkering with everything from what you're supporting and when you support it during the year. I think we're regularly thinking about and trying to improve the creative messaging around our brands, those kinds of things. Those are ongoing exercises. I think they've been sharpened in the last few years. But

I think that therein will be the difference, creating the appeal with what the investment does, much more so than do we have today the right level of investment versus some individual competitor.

Operator

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

Lauren Lieberman

Emerging markets were really strong this quarter, obviously. And I think it's been an area of concern for a lot of investors in general that sort of slowed down in emerging markets, Turkey, possible contagion and so on. So could you just talk a little bit about your overall macros and sort of momentum that you're seeing in your business? And why you believe, if you do, that you have – the momentum you're seeing now can kind of continue, even if the environment continues to be volatile?

Lawson Whiting

Yes, I'll take it or you people can add on to it. I mean, as I know you all realize, our basket of emerging markets is very different than many of the competitors that we have and in fact, many of the broader consumer products companies' sources of growth in emerging markets. So markets like Brazil and Mexico and Poland and even Eastern Europe, which has very low growth in aggregate for many, many companies, continues to be a really nice source of growth for us. And we're delivering overall aggregate emerging markets growth that's pretty consistent with what we've seen over the last year, I think, and we remain pretty optimistic about it. So in particular, I'd highlight a market like Brazil, which is obviously in the media and has all sorts of sort of macro problems there. We continue to absolutely fly in that market, and it's gotten to be quite sizable now. So it is a very strong contributor and somewhere we're pretty optimistic that we've got a long runway in front of us.

Paul Varga

Yes, even though, I mean, the tariffs are the main headline of – and appropriately, the thing we're commenting quite a bit in this particular quarter, I think the underappreciated bit of performance for the first quarter was the emerging markets. I mean, and then particularly against – it was highlighted, I think, in the deck that Jane referenced in her comments about how strong that is compared to last year, which was strong as well. So the 2-year stacks on emerging markets look good. I would take everybody back, those of you who've covered us for a while, you'll remember the meeting we had, investor meeting in New York a couple of years ago, where we highlighted the long runway for growth for the company. And a major part of that, you all, is how much we are at still a relatively early stage of development in these emerging markets. And you would anticipate that we – as long as they're receptive to the types of work we do to build the brand, in this case, it's largely around the Jack Daniel's brand, as long as they're receptive and don't have crippling economies or financial crises, et cetera, we think those markets should be growing double digits. Those are the types of markets to be based on the stage of development and the appeal that we see there for our brands that should give the company a boost on its growth rate for some time to come. So I know because we're a very big U.S. company and Jack Daniel's is so large, a lot of the focus, I think correctly, in some cases, goes to the conversation around Jack Daniel's performance in the United States. It really is an amazing story of where Jack Daniel's has developed around the world, and then within it, how much room that remains for growth in these emerging markets.

Operator

— **Operator Instructions** — Your final question comes from the line of Judy Hong with Goldman Sachs.

Judy Hong

So I guess, I wanted to actually go back to the tariff and your comment about sort of

not taking the full pricing to offset the tariff impacts. Is that more of a function of the developments that could potentially be positive in terms of rescinding the tariffs? Or is it more related to the competitive environment? Because – I ask this because if – to the extent that the tariffs do remain in place, I'm just wondering how much pricing you're expecting to take to offset more of the tariff impacts and how we should think about the price elasticity in the marketplace.

Jane Morreau

Yes. So I think it's more – it is – as I said, I think it's due to 2 things. One, we were thinking about the decision or some of the positive news we've heard over the airwaves, if you will, as it relates to some of the talks that have been had. So that didn't – has influenced us a bit. We also know we're going into the critical O&D period. And if these happen to get resolved during that period of time, we definitely don't want to have our consumers or our partners in the trade, if you will, on a roller coaster ride. And third of all, we are trying to weigh the momentum of our business, our consumers, the affordability, the competitive environment that faces us. So all those things came into play. If you're asking how you should think about it, I think this is – at this point in time, I assume that we have taken, as I said earlier, a handful of price increases in some markets. We are going to continue to look to take price increases in many more markets later this fiscal year. But if we get through the O&D period, clearly, the impact on any elasticities or anything like that would not be that great. But you would probably have some giveback. As we talked about, we had a lot of – 2 to 3 points of top line benefits from buy-ins in the first quarter. And so we would assume that some of that would be given back later in the year. The impact on the consumer will depend upon market by market, what we decided to do, where we decide to do it, what competitors do. You can't imagine all the different scenarios that could come about as a result of that.

Paul Varga

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Yes, Judy. Another way to think about it, if we had very low margins or low returns and these things occurred, I mean, you'd have probably less of an – you would not have as good as an alternative as I think Brown-Forman has to be patient with these with the hopes that they could work themselves out over the fall months. So in some ways, yes, we are buying time to see if these things can be worked out and we – and in some ways, you might view that as an investment in consumer momentum. I mean, there's – consumer momentum takes all kinds of forms in terms of what propels it, so – and because these are so unique, just the one category, and it just so happens that outside the United States, the size of the American whiskey and bourbon category is driven primarily by Jack Daniel's, that a lot of the competitive reference points outside the United States move you immediately into Scotch whiskey. So I just think on balance, we feel like this is the right posture right now. I really do feel like it's the right posture until we can see how things unfold over the next 4, 8, 12 weeks and stay in tune with it and adapt to it and in the meantime, do the work we normally do to build our brands. But I think the updated forecast tries to capture – the impact of that, [AI] captures both of it. And I'm sure we'll have some form of update at midyear because there will be new – some – just the new information surrounding all this.

Judy Hong

Yes. Got it, okay. And then just to follow up on the inventory impact. So the underlying sales growth guidance of 6% to 7% for the year assumes that all of the benefit you got in Q1 does reverse in the back half of the year. So you basically have, in terms of the underlying sales guidance, no benefit from the inventory build that we saw in Q1.

Jane Morreau

Yes, I think we're – at this point in time, we think that's a prudent and reasonable ap-

proach to assume, yes.

Paul Varga

Yes. It will be – just from a quarter to quarter this year, it will be very abnormal for – just because of all this, the trading patterns. And well, we'll do our best to explain to you what we think. I mean, I think it's really interesting. I mean, for – we're one of the few companies that tries to get you down to inventory shift with the precision we do, even between our reported and underlying. And in this case, I thought it was helpful for our teams to go evaluate what they thought, even within the underlying, might be sitting in terms of some temporary inventory build, even at sort of retail. So we'll try to keep track of that. That one's, of course, a harder estimate for us because it's a step away. We will try to keep you all abreast of that as we monitor it ourselves.

Jason Koval

Perfect. All right. Well, thank you, Lawson, Paul, Jane for your comments and Q&A today. And thanks to all of you for joining us for our first quarter call. Just a heads up for those of you who like to plan your travel far in advance, we will be hosting our biannual Investor Day on the afternoon of December 12 in New York. More details to follow in the coming months. But in the meantime, please feel free to reach out to us if you have any additional questions, and have a great Labor Day weekend. Take care.

Operator

Thank you. Ladies and gentlemen, that does conclude today's conference call. You may now disconnect.

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