Constellation Brands Inc, Q3 2017, Earnings Call 2017-01-05

Presentation

Operator

Welcome to the Constellation Brands Third Quarter 2017 Earnings Conference Call. — ***Operator Instructions*** —

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

Patty Yahn-Urlaub

Thank you, Laurice. Good morning, everyone. Happy New Year, and welcome to Constellation's Third Quarter Fiscal 2017 Conference Call. I'm here this morning with Rob Sands, our President and Chief Executive Officer; and David Klein, our Chief Financial Officer. This call complements our news release, which also has been furnished to the SEC.

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

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

Please also be aware that we may make forward-looking statements during this call. While those statements represent our best estimates and expectations, actual results could differ materially from our estimates and expectations.

For a detailed list of risk factors that may impact the company's estimates, please refer to the news release and Constellation's SEC filings. — ***Operator Instructions*** — Thanks in advance. And now here's Rob.

Robert Sands

Thanks, Patty, and good morning and Happy New Year. I hope you enjoyed the holiday and had the opportunity to include some of our great Constellation products in your celebrations with family and friends.

Now before we get started with our discussion of third quarter results, I'd like to thank those of you who participated in our recent New York Investor Meeting. I hope one of your key takeaways from that meeting is that Constellation is better positioned today than it has ever been to generate growth and build value.

Our business has never been stronger and the prospects across our beer, wine and spirits portfolio are compelling. We sell a diversified portfolio of fast-growing, premium brands from the U.S. as well as other parts of the world.

Our business continues to produce very impressive results. We are gaining share, improving margins and making smart investments to fuel growth. Consumer demand for our iconic brands remains very strong, and we have no reason to expect this to abate.

We are so confident about our future business prospects that we recently repurchased more than $800 million worth of our outstanding shares because we believe our stock is undervalued at current levels. I believe it's the changing political and legislative landscape in the U.S. that has recently impacted our stock price, particularly as it relates to potential changes to tax structure, tariffs and trade policies. But I'll address this topic in a few moments.

With that said, let's focus our discussion on some of the industry-leading results we delivered for the third quarter. Our beer business continues to be a powerhouse for growth, delivering third quarter depletion trends of almost 11%, while contributing 60% of total U.S. beer industry IRI dollar growth and significantly outperforming the high end of the U.S. beer category.

Constellation beers was the clear market winner for Labor Day, outperforming the category in all major competitors while gaining both IRI dollar and volume share, with all core import brands driving these gains.

In addition to Labor Day, which marked the official close of our "120 Days of Summer" selling season, Constellation was the U.S. beer market growth leader during all key summer holidays, including Cinco de Mayo, Memorial Day and July 4th.

During the quarter, Corona Extra aired TV campaigns during NFL games while continuing to invest in boxing and the Corona Extra can format and was the #3 share gainer overall among high-end U.S. brands.

Casa Modelo was recently established to include all Modelo brands under a master branding strategy and portfolio approach. During the quarter, this brand family launched new packaging and initiatives for more effective cross promotion and awareness building, while setting the stage for enhanced product innovation and line extensions.

Casa Modelo continued TV advertising via both national Spanish language TV and national general market TV for Modelo Especial, with a strong presence in the high-profile NFL games. These initiatives helped to solidify Modelo Especial as the #2 share gainer almost all beer brands as well as high-end brands in the U.S. market and drove depletion growth of almost 20% during the third quarter.

Pacifico continues to be on fire, with nearly 20% depletion growth during the quarter. All core packages are growing, with 24-ounce single-serve can driving acceleration of the growth for this brand.

Ballast Point continues to be the fastest-growing major craft brand in the U.S. and achieved a solid double-digit depletion growth during the quarter. Operationally, our Nava Brewery currently operating at 20 million hectoliters as well as our complete supply chain continues to perform at exceptional levels to support our sales growth through the first 3 quarters of our fiscal year with planned future expansions at Nava on or ahead of plan.

The Obregon brewery in Mexico remains fully operational as we transition the 400 highly skilled employees who have joined Constellation. They have hit the ground running now that this transaction is closed.

This acquisition allows immediate access to functioning brewery capacity to support our fast-growing, high-end Mexican beer portfolio and provides flexibility for future innovation opportunities. We have also become fully independent from our interim supply agreement with ABI, which was terminated with the acquisition.

Our Mexicali brewery project has been initially re-scoped to 5 million hectoliters of production capacity as a result of the Obregon brewery acquisition. The Mexicali construction is picking up momentum, and we expect the first module to commission in late calendar year 2019.

And now I'd like to discuss the results for our wine and spirits business. During the quarter, we advanced our premiumization strategy with the acquisition of Charles Smith Wines and High West Whiskey and Distillery. Both of these portfolio additions are off to exceptional starts and place us in categories with excellent potential and upside.

Our innovation efforts are also taking hold, with brands like Robert Mondavi Private Selection, Bourbon Barrel-Aged Cabernet, which has become one of the fastest-growing superpremium SKUs and IRI.

The recently introduced Cooper & Thief, a bourbon barrel-aged red blend at the superluxury price point, has been a hit with consumers, and Ravage Cabernet continues to ravage the competition.

And Casa Noble Alta Belleza, which is the first edition of a new line of limited release luxury tequilas that retails for $1,200, began selling recently and has received rave reviews from the media.

Our higher-margin Focus Brands drove positive results for the quarter, posting depletion growth of almost 9%, driven by excellent trends for most of these brands, including Meiomi and The Prisoner, which continue to outperform our initial expectations. Many of these Focus Brands continue to maintain their reputation for excellence among critics with outstanding reviews, rankings and 90-plus scores.

The 2013 Robert Mondavi Cabernet Sauvignon reserve was named among the year's best U.S. cabernets and blends in Wine & Spirits magazine and received 95-plus points from Robert Parker in The Wine Advocate.

Following a banner year of growth and recognition, including IRI's #1 New Zealand wine and #1 Sauvignon Blanc in the U.S., Kim Crawford has been named New World Winery of the Year by Wine Enthusiast magazine.

Our newly acquired Charles Smith Kung Fu Girl Riesling scored 90 points in both the Wine Spectator and Wine Advocate and was named to the Wine Spectator Top 100 Wines 3 times in the past 4 years. Meiomi pinot noir achieved the #5 slot on wine.com's 2016 top 100 list.

And finally, High West Distillery recently received the distiller of the year award from Whisky Advocate, America's leading whiskey publication. This award represents recognition of excellence, innovation and great-tasting whiskey, and it credits High West with pioneering a successful new paradigm for craft distilling.

We recently sold our Canadian wine business as part of our strategy to focus on premium margin-accretive growth opportunities. This strategic action was also the result of our ongoing efforts to identify value-enhancing opportunities to strengthen the financial portfolio of our overall wine and spirits business.

I'm also pleased to report that Constellation Ventures has been busy investing in 2 new minority interests, the newest, which is Catoctin Creek Distilling Company, a producer of premium rye whiskey and gin from organic sources.

Earlier in the quarter, we also announced Bardstown Bourbon, the largest new whiskey distillery in the U.S. Both of these investments provide us with the opportunity to further explore innovation in the brown spirits category.

Now before I turn the call over to David, I think it's worth taking a moment to address some of the more frequent investor inquiries we've received since election day, including what potential changes under our new administration could mean for Constellation going forward. One specific aspect of a proposed Republican tax reform plan called border adjustability could potentially disallow a deduction for foreign-sourced COGS or cost of goods sold. As you know, our imported Mexican brands can only be authentically produced in Mexico and sold in the U.S.

In order to understand how different tax reform proposals could impact our business, we have modeled several different potential scenarios that include border adjustability as well as some of the positive facets of a corporate tax reform plan based on what we know today.

Overall, there are many unknowns related to future legislation and it's still too early to make a definitive call on final outcomes and timing because legislation has not been written.

As more details develop on these policies and legislation materialize, you can be assured we are prepared to respond accordingly. As you would expect, we are closely monitoring this situation, and we have significant resources dedicated to this effort.

We have been working directly with our legislators to safeguard our ability to continue to cost effectively produce and sell our imported beer, wine and spirits products in the U.S.

Under every scenario of proposed tax reform, we remain confident in our ability to achieve the strategic goals we outlined during our recent New York Investor Meeting.

To reiterate these goals, we believe we can achieve EPS growth at a rate greater than 10% over the next 3 years, and we think Constellation is a very compelling investment, which can produce significant value for our shareholders.

Our team is committed to delivering industry-leading returns. We think we have the right brands, the right leadership and the right strategies to do so. The fundamental of our business have never been stronger, and we believe that Constellation provides the best-in-class combination of sustainable top line growth and profitability in the consumer space.

We continue to build shareholder value commercially, operationally and through significant share repurchases under our $1 billion stock buyback program while remaining committed to our leverage target. I am also proud of the fact that we recently achieved investment-grade status for the first time of the history in the company.

Now with all that said, I would now like to turn the call over to David, who will review our third quarter financial results. David?

David Klein

Thank you, Rob, and good morning, everyone. We're pleased with our impressive financial results for Q3 and our recent business accomplishments as we continue to grow share and outperform the competition.

Our continued strong top line and operating results were accompanied by a favorable tax rate benefit related to APB 23 accounting as we determine that a portion of our foreign earnings will be indefinitely reinvested. This assertion allows the company to record income taxes on certain foreign earnings using the applicable foreign jurisdiction tax rates rather than the higher U.S. tax rate.

The fiscal 2017 year-to-date impact of this change was recorded in the third quarter of fiscal ’17 and helped drive comparable basis diluted EPS growth of 38%. As a result, we’re now projecting a lower tax rate for the year and this is driving an increase in our full year comparable basis diluted EPS target to a range of $6.55 to $6.65 versus our previous guidance of $6.30 to $6.45.

Looking at our Q3 fiscal ’17 performance in more detail, where I’ll generally focus on comparable basis financial results, you can see beer net sales grew 16%, organic beer net sales increased 12%, primarily due to volume growth of 10% in favorable pricing.

Beer depletion growth for the quarter came in at 11%. Wine and spirits net sales increased 5%. This reflects the acquisition benefit from The Prisoner wine brands and favorable mix, partially offset by lower volume due to timing, as U.S. depletion volume outpaced shipment volume during the quarter. Our U.S. depletions grew a little over 3% in Q3.

Beer operating margin decreased 30 basis points to 34.8%. The impact of planned marketing investments and consolidation of the Ballast Point business were mostly offset by benefits from pricing and foreign currency.

For the Q3 year-to-date period, beer operating margin was 35.8%, up almost a full percentage point versus the same period last year.

Looking more closely at beer SG&A, about half of the year-over-year increase in beer SG&A for the quarter was due to an increase in marketing spend. A majority of the remaining increase was driven by the overlap of a reclass from SG&A into COGS during Q3 of FY '16.

Wine and spirits operating margin decreased 20 basis points to 27.3%. Investments in SG&A and marketing were mostly offset by favorable COGS benefit from the addition of The Prisoner wine brands and favorable mix.

On a year-to-date basis, wine operating margin increased 80 basis points to 25.6%. Interest expense for the quarter increased $2 million as higher average borrowings were mostly offset by a lower average interest rate. Equity earnings totaled $28 million and were generated primarily by Opus One.

Our comparable basis effective tax rate for the quarter came in at 16.4% versus 32.3% for Q3 last year. This reflects the benefit of APB 23, which I highlighted earlier, as the fiscal 2017 year-to-date impact of this change was recorded in the third quarter. We now expect our full year fiscal '17 comparable basis effective tax rate to approximate 27%.

Let me spend a few moments discussing our debt leverage ratio in recent business and capital allocation activities. When factoring in cash on hand, our net debt at the end of Q3 totaled $8.4 billion, an increase of $436 million since the end of fiscal '16. Our net debt-to-comparable basis EBITDA leverage ratio came in at 3.5x at the end of Q3 versus 3.8x at the end of fiscal '16.

Our leverage ratio at the end of Q3 does not reflect the full year of EBITDA benefit from our premium wine and spirits brand acquisitions, including The Prisoner acquisition, which was funded during Q1, and Charles Smith and High West acquisitions, which were funded during Q3.

During the quarter, our credit rating was upgraded by Fitch and Standard & Poor's to an investment-grade designation. We're proud of this achievement, and are committed to maintaining this status moving forward.

We saw the benefit of this upgrade in early December when we completed a $600 million senior notes offering. These notes are due in 2026 and carry an attractive interest rate of 3.7%.

In December, as part of our efforts to increase focus on higher margin, higher-growth premium brands, we completed the sale of our Canadian wine business in a transaction valued at CAD 1.04 billion. We received cash proceeds net of outstanding debt of CAD 775 million or USD 581 million.

We received the proceeds from the outstanding debt prior to the sale.

In the fourth quarter, we expect to recognize a net gain on the transaction, which is preliminarily estimated to be $255 million. In addition, we expect to pay income tax of approximately $70 million in connection with the divestiture, with most of that payment expected to occur in fiscal '17.

At the end of December, we acquired the Obregon brewery operation from ABI for $583 million, net of cash acquired. This provides us with immediate functioning brewing capacity to support our growth, supply independence from ABI and flexibility for future innovation. We're committed to delivering shareholder value using every tool at our disposal.

During the quarter, we carefully reviewed the growth targets which were presented at our Investor Day in November in the context of tax reform. After diligent review, we determined that all of the targets remain appropriate as stated. This work provided us with confidence that the purchase of our shares would create value for our shareholders.

Therefore, we purchased 2.4 million shares of common stock at a cost of $367 million during Q3 and in December, purchased an additional 3 million shares at a cost of $450 million.

All of the activity I just highlight demonstrates management's ability to respond quickly and effectively to changing business conditions, the strength of our financial profile, the capital allocation flexibility we have as we operate at our leverage target and the confidence we have in our ability to execute our premiumization strategy, drive profitable growth and build shareholder value over the long term.

Now let's review free cash flow, which we define as net cash provided by operating activities less CapEx. For the first 9 months of fiscal '17, we generated $824 million of free cash flow compared to $578 million for the same period last year.

Operating cash flow totaled $1.4 billion, up 30%, primarily driven by our earnings growth. CapEx for the first 9 months of the year was $592 million compared to $514 million for the prior year period.

We are lowering our full year CapEx guidance by $100 million to a range of $825 million to $925 million. This primarily reflects some shift in the timing of Mexicali Brewery capital-related payments to next year. We are also lowering our full year operating cash flow guidance by $100 million to a range of $1.4 billion to $1.6 billion. This is being driven primarily by anticipated tax payments associated with the Canadian wine business divestiture and the loss of Canadian wine business operating cash flow during the fourth quarter.

Given these offsetting factors, we continue to expect fiscal '17 free cash flow to be in the range of $575 million to $675 million.

Moving to our full year fiscal '17 P&L outlook, I shared earlier that we now expect our comparable basis diluted EPS to be in the range of $6.55 to $6.65 and the increase is being driven primarily by our lower projected tax rate.

Our beer business continues to target net sales growth in the range of 16% to 17% and operating income growth in the high teens.

This guidance continues to target beer operating margins in the 35% to 36% range. For the wine and spirits business, we continue to expect net sales growth in the mid-single-digit range and operating income growth in the mid- to high single-digit range.

Interest expense is now expected to be in the range of $335 million to $345 million and weighted average shares are now targeted at 204.5 million. These updates reflect the share repurchase activity I noted earlier.

I would also note before closing that our comparable basis guidance excludes comparable adjustments which are detailed in the release.

In closing, our results for the first 9 months of fiscal ’17 have us on track to achieve another phenomenal year of growth and financial performance. Our focus on strong marketplace execution and making smart investments to support our business continues to strengthen our business and financial model, providing us confidence in our ability to drive sustainable profitable growth and build shareholder value over the long term.

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

Question and Answer

Operator

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

Dara Mohsenian

So first, on the SG&A side, clearly, you posted a high increase year-over-year as a percent of sales at the corporate level in the quarter that was driven by both beer and wine; and the beer comments were helpful. But I was hoping on wine, you could also give us a sense of how much of the increase in SG&A was due to marketing moving up as a percent of sales versus maybe other factors and what those other factors are and how long they might last?

David Klein

So Dara, as a dollar amount delta, year-over-year, the wine increase, similar to the beer increase, was about half marketing spend, as we invest more in our brands on the wine side; and the other half was just investments primarily in people to drive our execution and NPD capabilities.

Dara Mohsenian

Okay. And is that – those people costs and those execution capabilities, is that something you lap over in a couple more quarters and cycle or is it something that's just beginning at this point? Last quarter, you had some spending in those areas, too, so I'm just wondering when you cycle over that.

David Klein

Yes, I would expect fundamentally that our SG&A range really in both of our business will remain in line with where it's been historically over time as a percentage of sales.

Dara Mohsenian

Okay. Okay, and then on border adjustability, the comments were helpful. I'm curious if you did need to take a large price increase to offset any changes in taxes, could you clarify if you think distributors and retailers would more just pass on the dollar profit impact of any price increases from Constellation? Or do you think they might look to

– more to maintain margins not just offsetting the profit dollar impact? And then also, you've shown a willingness to price to offset cost historically in beer. Conceptually, if a tax change was large in nature, would you be willing to consider a mid- to high-single digit price increase if needed to offset taxes? Is that kind of in the range of scenarios you run when thinking about the tax changes that you mentioned earlier?

David Klein

So Dara, when we looked at the tax changes – and I just really want to caution everybody because we're talking to people in Congress on this topic, and the border adjustability provision haven't even been written, right? So it's hypothetical and, of course, we're trying to understand the effects that could take place, but it's hard to get into a lot of specifics when answering. But I would say that we still would suspect that our pricing algorithm would remain consistent where it's been in the past in the range of 1% to 2% a year. And that in order to mitigate any sort of border tax, we would be more inclined to address elements of the supply chain that we would make – put into the deductible category. So for example, if you look at elements of our cost inputs that currently come from the U.S. that we could make deductible, I would put, say, the energy cost of producing glass in Mexico. That's just one example of things we can do in our supply chain. So we turn that into a U.S. cost instead of a Mexican cost, and we then have a deductible expense for U.S. tax purposes. We think that, combined with the lower U.S. tax rate and a reasonable phase-in period for any border adjustment tax, would be a more appropriate and value-creating approach than to really just jump on the price lever.

Operator

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

Vivien Azer

So just in thinking about the beer trends, I think there's been a little bit of anxiety from some of the investors that we've talked to this morning around the 3Q print and beer results coming in a little bit below expectations and I think that's being exacerbated by some of the press reports about the preliminary Nielsen numbers through December. So a two-part question for me, please. Number one, can you walk us through the phasing of your beer trends through the quarter to help kind of put the December numbers that we're seeing from Nielsen in context? Number two, can you offer any perspective on why you thought December might have been soft, and in particular what's going on with craft beer in that context?

Robert Sands

Yes, so, Vivien, number one, we don't think that the quarter was soft at all. And if you look at IRI trends, for instance, consumer takeaway, this quarter, our growth was up to the most recent reporting period, 16%, whereas, last quarter, right, it was below that at approximately 14%. So we're actually seeing an acceleration at retail on consumer takeaway. And then if you look at our depletion results, for the quarter, we were at 10.7% depletion growth. But this quarter, we were overlapping 16.2% depletion growth for the same quarter last year. And if you look at last quarter, we had 13.8% growth, which was higher than the same quarter or second quarter last year, which was 10.2%. Now the fundamental point is that these kind of fluctuations quarter-by-quarter in depletions are not indicative of much of anything as long as they're in a range, right, of the kind of growth we've been experiencing, which is double-digit growth in the low teens. You're going to continue to see fluctuations of this nature quarter-to-quarter in depletions based on what's happening with inventories at retail, shipments into our retail customers, et cetera. So you can't go by changes of, say, 100 basis points to judge whether the business is soft or not. The simple fact is that the consumer takeaway for our products is accelerating, okay, sequentially, as we look at our results. So I don't think that we believe or see any softness whatsoever in the business and in fact, I would say it's the opposite, okay? At the consumer level, to the extent that it can be measured, we are actually seeing acceleration, and I'm sure that, that'll shake out from a depletion point of view over the medium term, meaning throughout the year and into next year. So very, very, very strong results. We are the leader in growth in beer in every possible respect and contributing most of the growth to the entire industry. So we think our results are, in actuality, outstanding. To have double-digit growth following a 16.2% overlap is actually almost unbelievable.

Vivien Azer

Understood. That's helpful. And can you comment at all please on December, if you had a chance to take a look at that data and your view on some of the softness in the scanner data for December. And then if you could comment please on the broader slowdown that we're seeing in craft beer.

Robert Sands

I think that, number one, December continues to be strong. We don't really see, I mean, we don't pay that much attention to month-over-month fluctuations. But December continues to be strong results. Yes, we were up, what, 13% in IRI in December. So actually, it continues to be very strong trends. And as far as craft goes, look, I mean, craft is a tale of two cities, right? You can't look at the craft number as the total number. I mean, what continues to go out in craft is the major brands, Sam, Sierra Nevada, Blue Moon, which are all in the craft numbers. Those continued to be down big time, right, like in the, I don't know, about 8% range. And then you have sort of everything else, which continues to be up significantly and is not being dragged down by those numbers. And you've also got the, what I'll call, the local effect, which is a lot of the smaller local craft players eating up many of those various – those larger, older brands, which are now 25 years old. So as I said, it's really a tale of two cities. But most importantly, Ballast Point's IRI trends were up 54%, okay, for the quarter. And it continues to be the fastest-growing major craft brand in the category, and it is certainly the most premium significantly sized brand in the category. So while you're seeing a lot of stuff kind of going on in craft, it's really not something that you can think of, I think, in terms of like a total category because it's almost a meaningless term. It's a brand-by-brand phenomenon and so you really have to look at the specific brands that – and companies that you're concerned about as to how they're performing.

Operator

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

Judy Hong

So a couple of follow-ups on the border adjustability comment. First, just in terms of – and I completely understand it's not even written as part of the legislation, but what are you hearing in terms of the potential carve-out if indeed the border adjustability is included as a part of the tax reform? And then, David, you've talked about some portion of your beer COGS already U.S. – classified as U.S. COGS, but can you give us the number today and potentially what that can get to?

David Klein

Yes, so – thank you for caveating that it hasn't been written because I think I'm going to say that every time anyone asks about border adjustability, right, so we're in the field of concepts here. Our understanding is that U.S.-based COGS will be deductible and right now, our U.S.-based component of our beer COGS, inclusive of freight, is about 40%, meaning 60% of the COGS is from Mexico. Now we have ways – things that we can do within our supply chain over time. But we're talking about long-term supply agreements, we would have to take into account changes in freight and, of course, any changes in – or fluctuations in currency between the countries before you would make final plans like that. So I would say when we do our modeling, we're looking at kind of staying in the range of foreign COGS that we have today and then picking up the benefits that are included in the rest of the tax package and assuming a reasonable phase-in period, which is how we come back to having a great deal of comfort in saying that we can grow EPS greater than 10%, as we described in November.

Judy Hong

Okay. And then just any color just you're hearing in terms of the carve-out prospects?

Robert Sands

What do you mean by a carve-out prospect, Judy?

Judy Hong

So if border adjustability is included, could Mexican beer be exempt from that adjustability?

Robert Sands

Sure, it's possible that Mexican beer could be exempt because it's an inherently Mexican product in that it's not the kind of thing that, perhaps, is being targeted, i.e. the movement of production from the U.S. to Mexico. In fact, in our particular case, it's the complete opposite, which you have a U.S. company that bought an inherently Mexican company and actually resulted in the creation of jobs in the U.S. as opposed to the opposite. Now – so of course, we're making that point with our legislators, and I would say they fully understand and comprehend that point. So yes, there could be a carve-out. But I think, more importantly, I would reiterate what David said, number one, we're not necessarily relying upon a carve-out. Number two, what we have been told, if you believe that border adjustability will in fact occur, which is a big maybe in the first place, if it does, there will be a relatively lengthy phase-in period. That's what our legislators and the people on Ways and Means, et cetera, are saying. And then furthermore, as David pointed out, we would have significant ability to mitigate the effect of it by moving COGS, right, costs from Mexico to the U.S. So David gave a good example of it, energy, which is a very large component in the manufacture of glass, glass being the largest component of COGS, we buy it at Mexico right now. We could shift our purchase of natural gas from Mexico to the U.S. and increase our cost of goods sold component that's U.S.-based and, therefore, mitigate the impact of the lack of deductibility of foreign cuts. So it's those kind of things that we are looking at planning on if this comes to pass so that we can maintain, as David said, our current pricing algorithm, which is sort of in the 1% to 2% and, therefore, we don't expect consumer demand for our product to be affected by border adjustability in any time frame that's probably relevant to our investors.

Judy Hong

Got it. That's helpful. And then just a quick follow-up on Ballast Point…

Robert Sands

And Judy, I'd also point out that the other benefits of tax reform that's being suggested in the Better Way plan being put forth by the House, right, has very significant other benefits, which will also offset any negative from border adjustability. So I think it could be a net positive when all is said and done, but it remains to be seen, as David has said. We – the only details we get are from talking to the legislators who are involved right now in – I'll say contemplating the details of these proposals. And that's the best anybody can know and I would say we probably know more about this than anybody, any corporation.

Judy Hong

Yes, that's really helpful. Just if I can ask a quick question on Ballast Point. So just in terms of the contribution to your sales, it looks like it slowed pretty meaningfully versus first half and then maybe even implying a down year-over-year. So just wondering if there is any kind of a destocking going on just from a shipment perspective for Ballast? And then just in terms of . . .

Robert Sands

No, there's nothing going on with Ballast. The business is up double digits. The IRI is up

54%. There's nothing going on with it at all, and it's a very small contributor to the results. I mean, it's a very small business, right? So it's not meaningfully contributing to any of the numbers that we're talking about. But it will in one of these days because it is a very fast grower and it continues to grow well. So it's part of our strategy to continue to drive the portfolio towards growth brands. And that strategy is working very well, by the way.

Operator

Your next question comes from the line of Bonnie Herzog of Wells Fargo.

Bonnie Herzog

I just have a couple of quick follow-on questions. First, on your total beer business, could you drill down on how your on-premise business has been performing versus off-premise? And then curious to hear how your beer business has been performing in the untracked channels off-premise. And then could you touch on where you're at with national distribution for Ballast Point, please?

David Klein

Yes, so in terms of on-premise and off-premise, our beer business is up high single digits in the on-premise, and we think the market's down low to mid-single-digits in the on-premise. So we're gaining share and feeling very comfortable there. And on your last question as it relates to, I have it here somewhere, as it relates to Ballast Point's distribution, I think, Ballast Point is about 25. Yes, so it is about 25 and we're in about 45 states, but what I want to caution when we talk about expanding into incremental states is that if we sell a case in a state, we say that we're in that state. We really need to continue to drive the sales execution and broadening of the base in each state that we go into with Ballast Point. So there's a lot of runway in front of us as it relates to Ballast Point.

Bonnie Herzog

So you expect that continued push on distribution to continue well into next year before you feel like you've gained international?

Robert Sands

We'll continue way beyond next year. It's hardly in distribution outside of California, right?

Bonnie Herzog

Okay. And then just circling back on maybe the untracked channels off-premise, just trying to get a sense of how your business is performing there just since we're all looking at scanner data.

Robert Sands

I would say that our business is performing similar to what you're seeing in the tracked off-premise channel in the untracked off-premise channel. So that's about the best we can tell you, but we have no reason to believe otherwise, so I suppose taking a look at – well, we have no reason to believe otherwise, let me put it that way. Based on our shift with distributors and their reported depletions, business is, as I have said, very, very strong.

Operator

Your next question comes from the line of Mark Swartzberg of Stifel.

Mark Swartzberg

So a few questions. I'll try to leave Mexico for the moment, but I will come back there. You're doing very well with your balance sheet, you've been very aggressive recently buying your shares. You picked up further in terms of monthly pace in December. You've got this new authorization that – in a sense you're close to being done with, if you take the pace you're already acted out in December. So the simple question is you – the 2 of you as people advising the board and saying hey, we want to do this or that, how interested are you in presenting to the board another $1 billion authorization?

David Klein

Well, I would – first of all, Mark, we have $800 million approximately remaining on the recent authorization. And just for clarity, we – I think that we have $600 million or $700 million remaining on our previous authorization that we spent as part of these repurchases and then we went into the new authorization by about $200 million.

Mark Swartzberg

Right. And so my question is, the pace you're going at implies you're going to be done with that new authorization rather quickly. So what's your appetite for asking for an additional authorization?

Robert Sands

The board would be completely amenable to giving us any authorization that we ask for because of the fact that David mentioned, which we think that our shares are, especially today, significantly undervalued. That said, we have $800 million left on our authorization, so it's really not much of an issue at the moment. We'll continue to make share repurchases opportunistically as we have in the past, and the only caveat on that is that we do desire to stay within our debt target of approximately 3.5, which is also important and to therefore maintain our investment-grade rating. So that's probably the only real caveat on making stock repurchases, but hey, we're going home on stock repurchases. So no one needs to convince us of that strategy.

Mark Swartzberg

All right. And your balance sheet is much more suited. Okay, fair enough. And then on the beer business, on the front, so to speak, you mentioned, how we should think about the increase in SG&A and part of it is just an accounting change. But the portion that you referred to as half, the portion that you said half of the increase is attributable to increase in marketing spend, and I think one of the things that we're all trying to understand is how much should we think that, that already shown up in a sense in the quarter and the way the depletion's already performed? And how much of that is kind of yet to come benefit? And I realize no one has a crystal ball, but can you give us a sense of like how much of that was trade-related? How much of that increase was consumer-related? Or because we're just trying to get a sense of, we already see the benefits or rather some benefits yet to come and maybe trade versus consumer is one way to think about that?

David Klein

So the increase in marketing spend was mostly at the consumer level. And when we talked about – when I talked about increase, I am really talking about the dollar increase. We haven't really changed our overall strategy in terms of marketing expense as a percent of net sales. And so we still expect that to be in the 8.5% to 9% range, and we track that very diligently to make sure that we are getting a return for it, and we continue to see the returns as we invest in our brands and the best example I can give is that this year we started investing from a marketing standpoint in Pacifico, and we're seeing Pacifico, for example, in the last 12 weeks is up 27% in IRI. So you can expect us to continue to do that, but I think, as a percentage of sales, we really haven't changed our strategy.

Mark Swartzberg

That's great. Okay. And then specifically in the case of border adjustability and sort of an immediate benefit that's come with Donald Trump being elected President is the peso has depreciated. So with the peso depreciating, you've talked to us historically about the portion of your COGS that are in, denominated in pesos. Is there any benefit above simply that depreciation benefit we should be thinking about? Is there something that's affecting your peso-denominated inputs themselves or the hiring dynamics? I realize we're only kind of 2 months since November 8. But I'm just trying to get a sense of how Mexico's economy so to speak is affecting your costs in Mexico?

David Klein

Yes, so about 25% of our costs are peso-denominated, which disconnects a little bit from the percentage that I said earlier. So 60% of our COGS being Mexican and the difference is dollar-denominated contracts for goods that we purchase in Mexico. Those contracts themselves really have an underlying FX component to them. They just – they're denominated in dollars and it may take longer for any benefit from that to flow through. And as it relates to the Mexican economy, we're really – we're not seeing any issues from a hiring or a labor standpoint or cost within Mexico. So we're seeing no problem. We're also not seeing any significant benefits.

Mark Swartzberg

Great. And then final question. I don't know if you touched on this or not, but you've drawn our attention again to the fact that 60% of your COGS for the beer business are relating to the operations in Mexico. And your openness to moving glass or some other element to a location north of the border. But can you tell us, if we take a long view, a 3-year view, a 5-year review, a 10-year view, what portion of that 60% in your mind is eligible for movement north of the border?

David Klein

Yes, that's harder to get to, and I think you have to take into account, any discussion of this, we could really only have after we know the specifics of any sort of border tax, because I think you'd have to look at the actual cost of purchase, of changing moving supply chain components to the U.S. You'd have to take into account freight and then, of course, you'd have to take into account the currency delta. And maybe there's a scenario where the currency delta makes moving the supply chain irrelevant, right? So I think we'd have to play that through when we actually know the conditions on the ground and we don't, we can't really know that today.

Robert Sands

But I think to your question, okay, if you're really talking about the longer term, it could be the majority of it because although the beer has to be made in Mexico, a lot of the components could be shifted if it was really determined to be advantageous and labor, which is required to make and bottle the beer, is a very small percentage of the total COGS. So it's only 15% of the COGS. So you can get the vast majority of it in one way or another U.S.-based.

Mark Swartzberg

If the currency supports that, got it. Okay. Very helpful.

David Klein

And you also...

Robert Sands

And the details of everything else, and all of the puts and takes with everything else. I mean, we wouldn't just totally disrupt the supply chain over the long run if it's not necessary. But we do have quite a bit of flexibility in what we can do. So hence our optimism, obviously, relative to this whole matter. And as also evidenced by our view on our own stocks value and our buyback activity.

Mark Swartzberg

Could I – I wanted to ask one last legislative thing. This isn't so much a constellation question but your point, Rob, about having better insight into what's happening to Washington and the many companies is simply the Senate. So we know what Kevin Brady and the House have put out there, we know what Donald Trump thinks, we know what Paul Ryan thinks. But do you have any sense of either timing or leadership in the Senate, when we're going to actually hear someone from the Senate speaking with some clarity about how they're thinking about this matter?

Robert Sands

Well, I think that Hatch made some comments yesterday saying that he doesn't know yet what their view or opinion is on any of this. I've talked to Schumer myself personally and I would say that on the Senate side, everybody is pretty reserved as to where this whole thing is going. So I would say that there is a lot less clarity on the Senate side than there is on the House side. And I'd say we know a lot more about it than anybody else only in that we're told that other companies that should be concerned about this are just waking up to the whole matter, whereas we've been focused on it from the very beginning, having met ourselves with Ryan several months ago so really over last summer. So we've been quite aware of this and thinking about it, hence, as David has pointed out, we've been thinking well in advance of strategically all of the things that we can do and will do if necessary to mitigate the impacts of this. So I think we're totally ahead of the game and – which is good because I think that our comfort level now is indicative of that fact, which is that we have been so far ahead of the game that we sort of know how – know what we're going to do, and we're not sort of relying upon, oh, hopefully this won't happen or what the probabilities are because it's like nobody can predict any of that stuff. So all we can do is sit around and determine what our action items will be if something occurs and how we're going to do it. So as I said, we're pretty far advanced in that thinking.

Operator

Your next question comes from the line of Tim Ramey of Pivotal Research Group.

Timothy Ramey

Just going back to your commentary on wanting to stay within the investment-grade bounds, sort of a more liberal interpretation of debt ceilings has really served Constellation well over the couple of decades and certainly over the last 5 or 6 years. What is it that makes you more comfortable in that 3.5x or below range? And is this a change in the rating agencies viewing 3.5x as investment-grade, which maybe wasn't true in the past, or is this comfort on your level that you don't need to lever beyond that?

Robert Sands

I think, David will answer this as well. I'll just give you my quick view on this, which is that it's really a size and scale thing, right? Our EBIT and margins and the cash flow that this company is and will be generating, especially as we complete over the next couple of years our capital, our large capital projects, pretty much give us, I would say, the flexibility to do everything that we could possibly want to do without really having to deviate from sort of that mid-3 range. That could deviate a little bit from time to time, but I don't really see that it's important – I mean, we just – I mean, we're going to have so much cash generation that I think that we feel pretty comfortable that we can pretty much internally fund just about anything that you could conceivably do in the alcoholic beverage business, right? So that's my view on it. David?

David Klein

Yes, I would just reiterate that, yes, $2.5 billion of EBITDA generated every year. You can stay at the 3.5x, and you have a fair amount of capital to allocate to other activities. And I would say that we're focused on saying that we will stay at the 3.5x. We're not looking to be levered below 3.5x. And if we go above 3.5x, we would then want to get back to that number, but we're really thinking about it, Tim, as a target.

Operator

Your next question comes from the line of Rob Ottenstein of Evercore.

Robert Ottenstein

Congratulations on the investment-grade rating and the continued tremendous business momentum. On that point, you mentioned very interestingly that you had actually seen on a sequential basis an acceleration in the beer business. And I'm wondering if you could be perhaps a little bit more specific in terms of what you think those that the potential triggers of that acceleration are? Is it particular new SKUs? Is it Corona cans? Is it your c-store initiatives? Increased marketing? Probably a little bit all of the above, but I'd love to get your thoughts on that.

Robert Sands

Yes. Well, I think first of all, you gave a pretty good litany of all of the things that are driving our marketing, our advertising, cans, SKUs, those are all things that continued to drive our consumer takeaway. And then there's some – increased distribution is another big focus of ours and getting the right distribution in the right places. I mean, it's not just increased distribution by the numbers, it's quality of distribution. So that all relates to sales execution. So that's kind of motherhood and apple pie, and we're doing a great job with it. I think also if you sort of look at what's going on at retail with even the craft segment, there's definitely now a movement to reduce the number of SKUs. That is causing some regained focus at retail, which we always thought that this ought to happen, on the really fast-growing, high-margin bread-and-butter items that they have, which happens to be our portfolio. And therefore, more attention, more space, more distribution is being given to what they know is working versus what hasn't worked. I think that sort of takes us back to a Ballast Point point of okay, which is as you see some slowdown in the older, more established craft-type brands, a brand like Ballast Point, which will be supported, has strong sales execution behind it. These are the types of brands that will be sort of a beneficiary as things shake out a little more in the craft segment, as will our import portfolio because it's clear cut that, that's what's driving all of the growth in the beer business at retail. So I think that we'll see our sort of total portfolio be the beneficiary of sort of the constant or anticipated changes that will occur over time as has always occurred. I mean, there's always been these kind of changes in the business. On the one hand, it's a slow business to change; on the other hand, there's constant change going on with all 3 categories. So...

Robert Ottenstein

And in terms of that retailer respacing or kind of relooking at their SKUs and we certainly heard about that from Walmart, about when do you think that started? I mean, has that been going on kind of throughout 2016, calendar 2016? Did you see that really pick up in the second half of the year?

Robert Sands

I think it's just – I think that it's actually in its infancy. I think it's just starting. But you take Walmart, for instance. I mean, they love our products because they're trying to – they want higher margin, fast moving, glowing products on their shelf because they don't have that much space devoted to the category. So they want all the best stuff.

Robert Ottenstein

Terrific. And...

Robert Sands

So I think, it's just starting and I think that you'll see us – I think you'll, as I said, there's always changes that are going on in the industry across all 3 categories and the key strategically is to make sure that you're positioned to be the positive beneficiary of those changes, and that's why we make some of the comments that we do about being better positioned as a company than we ever have been because it's pretty clear to us that sort of given our whole portfolio and our strategy and our premiumization strategy and our focus towards high-margin, high-growth brands that that's going to really, that really positions us to be the key, not one of, but the key beneficiary of all of the changes that are going on. And you see that in our results versus every other beverage alcohol company, right? Frankly, versus almost any other company in consumer goods, period. There's no companies in consumer goods in general that are performing like we are that I am aware of.

Robert Ottenstein

No, no, no. It's tremendous.

Robert Sands

Even some of the ones that are outside of our industry and category in non-alc have not consistently performed as we have. So we're a bit of an outlier in that regard and will continue to be so.

Robert Ottenstein

Absolutely. And then just on the cost side, I just want to – I believe in the last quarter, you mentioned that you thought advertising spend, as a percent of sales, would be flattish in the second half with the kind of the big chunk in the third quarter as we just saw versus the fourth quarter. Do you still stand by that?

David Klein

Yes. I would say that on an absolute dollar basis, once again, we'll see some of the year-over-year growth in marketing spend. But from a model perspective, our marketing spend will end up in that 8.5% to 9% range for the full year.

Operator

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

William Chappell

So just a quick question on the taxes. I think you had talked about a lower tax rate for 2018. I assume there's no change in kind of the outlook there.

David Klein

No. So we talked about having a mid-20 sort of EPR as the target over the next 3 years. And we're not really giving guidance for FY '18, but there's no reason to expect that we'd be outside of that.

William Chappell

Okay. And then also just to make sure I understood, the net leverage at the end of the quarter, that includes the cash used for share repurchase, or just trying to understand kind of where we stand as of today.

David Klein

Yes. So that was – so that 3.5x was at the end of the quarter. I would say we're – if the year were to end today, we're probably more in the 3.6, 3.7 range given the repurchases that took place in December.

William Chappell

And in terms of future share repurchases, comfortable going above 4x?

David Klein

I would say, again, we're – we would – we're focused on the 3.5x range. And if appropriate opportunities present themselves from a capital allocation standpoint, we'll go above the 3.5x. But our objective is to always be able to quickly get back to that level. So again, we would think on the 3.5x versus trying to – if that's how high we could actually go.

Operator

Your next question comes from the line of Laurent Grandet of Crédit Suisse.

Laurent Grandet

So I'd like to come back to this SG&A point. SG&A went up to 19.5% in the quarter from about 17%, 17.5% in the previous quarters. And you mentioned at the same time that the marketing spend was roughly 8.5% to 9% of sales, roughly similar to the previous quarters. So really would like to understand, where did you spend this – the balance of the SG&A? And is it something we should see in the future quarters? Is it some kind of initiative, I mean, to support new brand introductions? Or I mean to go after the on-premise channel? So I'd like to – have more color about this SG&A and how we should think about it going forward.

David Klein

Yes. So again, from a – holding aside quarter-to-quarter volatility in total SG&A spend, I would say that for – just focused solely on the beer business, our SG&A – our marketing spend will be somewhere between 8.5% to 9% of net sales. In terms of the SG&A spend in our beer business, we expect that it stays in the historical range that's really in the 5.5% to 6% range, specifically in our beer business. And the incremental growth in SG&A in both businesses really, any incremental spend there is put in place to really drive innovation and better sales execution. But again, I don't – our SG&A algorithm is not changing. They're just – these are just quarter-over-quarter anomalies.

Laurent Grandet

Okay. And in term of focus, I'd like to come back on this sort of question on Ballast Point. I understand, I mean we do have this on the sales shore, I mean, at 45%. So ballpark, it's similar read to IRI. I'd like to – but we – if we did more into the numbers, I mean, we see that this version now has been plateauing at about 23% for the last 6 periods. And since all sales seems to be now at minus 25%, I mean, that's for the last few quarters, so what's the plan here to kind of push even further Ballast Point? I understand it's still a small part of your algorithm, but out here, it's important for the future of the growth of the beer segment of your business.

Robert Sands

We've got all kinds of programs to drive distribution of the product. And throughout the United States, we've taken the brand national. We have very strong relationships with our distributors. We're increasing our support levels behind the brand and doing all of the standard things that one would do in this particular category, and that's an important caveat to drive the business. So it's all about doing things like driving national accounts. These kinds of brands require a lot of grass-roots types efforts. We continue to develop new products. We continue to develop our retail model. We continue to win awards, which is important in the craft segment because it's a lot like wine, and ratings. And I think we're on the forefront of that in actuality so it's all good. There's just nothing to be concerned about or to complain about.

Operator

Your next question comes from the line of Stephen Powers of UBS.

Stephen Powers

Back to taxes, I guess, really 2 questions, if I could. First, your comments on border adjustability have been very helpful, but I'm wondering if you could comment also on what discussions you may have had around interest expense deductibility and how that aspect of potential tax reform has factored into the scenarios you've talked about? And then second, I just wanted to test whether your confidence in the 10% growth algorithm through 2020 under potential tax reform depends on the phase-in assumptions that you mentioned? Or if you've modeled scenarios where sort of the adverse aspects may take effect more quickly and you can still hit the 10% number.

David Klein

Yes. So in terms of interest deductibility, I think the general assumption is, under the better way plan, is that it wouldn't be deductible on a go-forward basis. Our assumption there is that existing interest would remain deductible. And then in terms of phase-in, the last time there was tax reform, I think the phase-in period was 4 years. But this sort of tax reform really isn't about just setting up back office accounting departments to manage tax – the new tax code. This kind of tax reform would require a time horizon that would allow companies to change their entire supply chain. So our expectation is that it would at least be 4 years, and our objective would be to advocate to make that as long as possible so that we could actually get to open supply agreements and so forth. And so I would say that when we start looking at the 3-year numbers, I think there are a couple of things that play into it, and one is the phase-in period, of course. And we're not assuming that it's just an immediate phase-in. And then I think the other component that you have to keep in mind is if you look at, in particular, peso rates historically, for us versus the current peso rates, so not incremental currency movement, but the current peso rate actually provides some benefits to us that would be somewhat offsetting as we sit here today.

Robert Sands

But I think that it's not just phase-in, right? When you think that the actual tax reform legislation will be enacted, I mean, it's probably a year off at best, right?

Stephen Powers

Yes, yes. No, okay, that's all fair. That's all fair. I just wanted to clarify.

Robert Sands

We can only tell you what our legislators have been telling us, right? But the first thing that's going to happen in Congress, which you're seeing right now, is Obamacare. So Congress has a lot on its plate right now. And to work through all of the details and get legislation like that passed, well, Congress is telling us it's going to be a while in any event. And it is clear-cut. And again, this is literally what we have been told by the leaders that Obamacare is the first thing on their plate. And that's going to take a while.

Stephen Powers

So okay, and I don't want to get too far into the weeds here, but I just want to make sure I'm thinking about this correctly from what you're currently doing. It looks to me like today, what you're doing in terms of – you're essentially leveraging some pretty high transfer prices from Mexico to the U.S. to keep profits today outside the U.S. I think 60%

of your pretax income effectively is booked outside the U.S. today. So I'm assuming in the future you would theoretically be able to reduce those transfer prices, shift dollars, shift profits back to the U.S., hopefully at a lower tax rate, and that's part of the – that's part of your – the leverage you can pull? Could you just talk to me through the transfer pricing algorithm there?

David Klein

Yes. You shouldn't even think about that, right? So the transfer prices are set at kind of market rates. You just have to think about the deductible component of COGS, which really doesn't change. It – what matters is where you incur the cost, not necessarily where you've put the revenue.

Stephen Powers

Okay. So you've put the revenue wherever the tax rate was most advantaged?

David Klein

Yes. So it's a shift in **—** ***indiscernible*** **—** adjustability. It's really all about the COG sourcing.

Stephen Powers

Okay, okay. The last thing, not on tax. I just wanted to see if you could add some comments on Corona Premier. There's been some, I guess from my perspective, some degree of apprehension amongst – from the marketplace in terms of maybe pushing that too far to the detriment of mainline Corona. I just want to get a sense for how – what your rollout plan was there and kind of how big, how small, how fast, how slow, that kind of thing.

Robert Sands

We're going to test market it in 3 or 4 different markets of different types, meaning more mature and less mature markets to get a good handle on how it interacts with our other products, and then make a decision as to whether we will continue with the product and roll it out or not. I don't see any big issue with it. Our distributors are excited about it. The category is a good category. Mich Ultra is one of the leading growth drivers in the industry right now. The product's differentiated from our other products. I'd say that we continue to believe that it's got a high probability of success. It's priced at Corona, right? So we're not worried necessarily about a cannibalization factor. We're – we would be only worried about the product if fundamentally they're not being successful or – well, that's really it because otherwise, it's going to be 1 plus 1 equals 3. So there aren't any margin concerns relative to cannibalization. So I guess it's only whether it's additive and successful. And that'll be determined pretty easily in the test market scenario. So it's real straightforward low-risk stuff.

Operator

Your next question comes from the line of Brett Cooper of Consumer Edge Research.

Brett Cooper

And it's 2. I just want to confirm on the comments. When you're saying that you're able to grow earnings 10%, that's off of the guided basis $655 million to $665 million, and that you'll be able to exceed $1 billion in free cash flow in '19? That's my first one.

David Klein

Yes. We stand by the targets we've put out there in November.

Brett Cooper

Okay, perfect. And then can you guys talk about the retailer receptivity? I've been thinking about...

David Klein

Hang on. The only thing that – just when we look at the targets for the individual businesses, you do have to remove Canada. But our EPS targets remains.

Brett Cooper

Okay, perfect. And then can you talk about retailer receptivity to taking on some of your smaller brands? I mean, I guess they're not all that small, but things like Pacifico and Negro relative to their willingness to do some of the craft brands. And then talk about your expectations for incremental placements in smaller brands and/or packages into the coming year?

Robert Sands

Yes. I'd say that they're dying for them, especially Pacifico. I mean what we're going – the only thing that's held us back on Pacifico is not retailer demand. I mean, retailers are dying to get the product. Up until now, we've been sort of production-constrained, just trying to feed the growth that we've had now that we've got our – we've got Nava up to speed, and we'll see the addition of another 5 million hectoliters of Nava in the next few months. And we bought Obregon. That sort of cleared up, and now we are beginning to drive those brands like Pacifico. I mean, look, I don't want to necessarily predict the future but Pacifico has got a good chance of being the next Modelo Especial, while Modelo Especial still continues to have a huge runaway and grow 20%. So I think the good news is we've got Pacifico coming right behind Modelo Especial with huge retail demand and excitement about the product. I mean, there's all kind of anecdotes about Pacifico and what consumers are thinking relative to the product. I mean, probably the most interesting anecdote being that it is the fashionable choice of craft drinkers, meaning for after – when they can't – when they get sick of drinking double IPAs, their beer of choice is Pacifico.

Operator

Your final question comes from the line of Caroline Levy of CLSA.

Caroline Levy

Just wondering what your people in Mexico are saying about what the Mexican government's reaction might be to Trumpenomics, border taxes, et cetera, whether there is any risk or opportunity there for you? And then also just given that you've invested in these glass plants, does that put at risk your investments, be it the glass plants or your big production capacity? Would any change in where you source goods lead some of that capacity to be unnecessary?

David Klein

So I'll answer the second point and then Rob can maybe comment on the Mexican point. But what I would say, Caroline, is that I don't see a scenario where our glass joint venture wouldn't be, by far and away, the cheapest source of glass even in the new tax regime just simply because of the freight benefit of having that plant and a highly efficient plant sitting next door to our brewery. And so about half of our glass needs will ultimately come from that joint venture facility. And I would say that if we needed to move our other packaging sourcing elsewhere, we could do that given enough time because we're sitting under quite long-term contracts with our packaging vendors.

Robert Sands

And I guess my comment on the Mexicans, and of course, we do talk to the Mexican politicians, as well as Peña Nieto, et cetera, et cetera, I think they're taking a measured view of the whole thing, not necessarily being overly aggressive in their comments about what they will do other than they're prepared to engage in reasonable negotiations. And they do not believe that the U.S in the end will enter into – will take actions that would violate WTO principles and other principles of that nature. So I would say that the Mexicans are being measured in their comments, but on the other hand, if pushed, they're certainly prepared to say that they'll act accordingly if the U.S. violates their agreements.

Caroline Levy

Got it. My last question, if you don't mind, would just be to understand the margin expansion, the gross margin expansion in beer, the key drivers like how much have eroded the peso play? How much of a drag was Ballast?

David Klein

Yes. So I don't have the exact components of each of the products. I would say the first thing is that when we talk about the SG&A reclass last year, that gave us a year-over-year comparable benefit on COGS on GP versus the negative hit on the SG&A. And then in the current year, even though the peso has weakened substantially, in the current year, we're probably 75% hedged on the peso, right? So that effect is mitigated to a certain extent. And then our – we just continue to see improvements in overall performance at our Nava facility. So I think it's just the biggest jump may be the year-over-year reclass. And then beyond that, we're just seeing some kind of expected improvements in total GP.

Caroline Levy

And just safe to say then that the benefit of the weak peso will continue to be felt next year because of hedging?

David Klein

Yes. So we – yes, we talk about – so we use the 3-year hedging program for currency. As I said, we're 70% to 75% hedged on the peso for this fiscal year. Next fiscal year, we need to go into the fiscal year about 50% of our exposure hedged. And then in – as we roll forward into the 24- and 36-month time horizon, it's a lower number, so yes. So assuming the peso stays where it is, we'll continue to see benefits coming into our P&L.

Operator

Thank you. I will now return the call over to Rob Sands for any additional or closing remarks.

Robert Sands

Okay. Well, thank you, everybody, for joining our call today. As we've delivered fantastic results for the first 9 months of fiscal '17, we've never been very confident in our future prospects of our business. We look to capitalize on our businesses' tremendous momentum as we execute our strategy and continue to build shareholder value.

Just as a reminder, during our next quarterly call, which is scheduled for April, we will be providing our guidance for the upcoming fiscal year. So thanks again, everybody, for joining our call, and have a great rest of your day.

Operator

Thank you for participating in the Constellation Brands Third Quarter 2017 Earnings Conference Call. You may now disconnect.