

Constellation Brands Inc, Morgan Stanley Global Consumer & Retail Conference

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Presentation

Dara Mohsenian

All right. Welcome, everyone. I'm Dara Mohsenian, Morgan Stanley's beverage and household products analyst. Just before we get started, I'll give you the research disclosures, which are, please see Morgan Stanley's research website at www.morganstanley.com.

With that, I'm very pleased to welcome Constellation Brands here today and Garth Hankinson, Constellation's CFO.

Constellations had a great track record of growth over the last, really, decade driven by their beer business and Modelo Especial has become the #1 beer in the U.S. in off-premise retail sales this year.

So very pleased to have Garth here with us. Thank you for being here.

Garth Hankinson

Thank you, Dara.

Question and Answer

Dara Mohsenian

So first, I thought, clearly, Constellation has been through a period of very pronounced change over the last couple of years. You've had a collapse of the dual share structure, board changes, shift away from the Sands family, emergence of an activist investor with the stake. And really, a lot of those changes were frankly underway, sort of internally, before the external announcements or manifestation of some of them.

But I'm curious, sort of taking a look back and thinking about the last couple of years, what do you think has changed during that time frame? How is the way you manage the business may be different today than it was a couple of years ago? Maybe what hasn't changed? How do you sort of think through all those changes?

Garth Hankinson

Well, thanks for the question, Dara. before I get started answering that question, let me start my disclaimer of my own, as is every year with your conference given the timing of it, we just ended our fiscal Q3. So during today's discussion, I won't be providing any information related to the fiscal – or to the financial or operational performance of the company, again, for our fiscal Q3.

So let's start with what has been what we think is the most significant change. And you kind of alluded to it, I believe, which was the changes in governance, which have been multiyear in nature as you suggested.

Certainly, as we sit here today, a big change has been that we now have a one share structure, so that all shareholders have the same economic and voting rights, if you will. So it's the same governance for all shareholders.

In many ways, that was the first of changes as it relates to governance since we made that – since that was approved by shareholders back in November of last year, we've had 2 of our longest tenured Board members resigned from the Board. We've added 2 additional Board members with strong financial backgrounds as well as backgrounds in retail and CPG. So again, good additions to the Board from an experience standpoint.

And there's been a change in the chairmanship of the Board. Certainly, we're in a period right now where we have an interim, a Board, chair, but we're looking for – we're in the process of identifying a permanent replacement, and that process is going well. And

there'll be more news on that, hopefully, in short order, but that's continuing to evolve.

And then more broadly, our Board continues to assess itself around the capabilities and diversity to ensure that we've got a Board that really is the best board that we can possibly have.

Certainly, all of those changes, again, as you indicated, we're multiyear in nature, and we heard from all of our investors around the importance of having a more modern governance structure. And so we appreciate the feedback that we got from all of our investors, and we appreciate the support that we've gotten from all our investors in making these changes happen.

What hasn't changed? What's remained consistent really is the strategy and the capital allocation priorities of this current management team, and this management team has been in place for roughly 5 years, give or take, depending on who it is on the executive team.

Over the course of this period of time, we've delivered on our capital allocation priorities of strengthening our balance sheet, of returning capital to shareholders, of investing in our core business or the organic growth of our business and then layering in incremental smaller scale tuck-in acquisitions.

And what you heard at Investor Day a month ago is that we remain committed to the disciplined approach into being very principal and we remain committed to getting our leverage ratio to 3.0 target, which we expect to be in our fiscal year 2025.

We remain committed to a 30% dividend payout. We remain committed to delivering capital or returning capital to shareholders through share repurchases, and we now have \$2.8 billion of authorization at our disposal to use. And we will continue to assess bolt-on acquisitions as opportunities arise.

Dara Mohsenian

Okay. Great. And turning to the Beer business. You reiterated the 7% to 9% midterm top line growth algorithm for beer at Analyst Day. Obviously, you guys went into a ton of detail there. But for the benefit of those who missed it, 40% to 50% of volume growth from distribution, 20% to 30% from demographics, 20% to 40% from innovation. I think I got those right.

Just give us your sense of the level of confidence in each of those buckets as you look at the business and as you think about volume growth going out over the next couple of years, you've delivered upside over time, where might that come in terms of those specific buckets if that were to emerge over time in your mind or what's most likely?

Garth Hankinson

Yes. Well, I'll go through each of those one by one, but let me start by saying we've got good confidence, good conviction in really all 3 of them. And let's just start with distribution. And over the last 5 years, we've consistently delivered against our aggressive distribution initiatives.

Over this period of time, if you look at our – if you look at the top 25 retailers, we've increased our category captaincy positions from 2 to 11. We've executed, again, you've heard us talk about our Shopper First Shelf initiative on many instances. But in FY '19, we executed against about 1,500 Shopper First Shelf resets. In this fiscal year, we're anticipating the end of fiscal year, executing against 21,000 Shopper First Shelf resets.

And again, at Investor Day, you heard us articulate the opportunities and the target – the opportunities we have on the targeted 500,000 incremental points of distribution over the next 5 years, really against just our core product offering.

And as it relates to demographics, I think it's important to note that about 50% of our

net sales comes from the Hispanic consumer as it relates to our Beer portfolio. And while the total legal drinking age population growth is expected to grow about 1%, 60% of total population growth is expected to come from the Hispanic segment. That's an important segment for us. Obviously, just given, as I said, about 50% of our performance is due to the Hispanic consumer. This is a consumer that controls about \$2 trillion of spend. And it's the largest affluent subgroup amongst Gen Z. So a real opportunity for us.

And it's a group that tends to over skew towards beverage alcohol and has a real preference for an affinity for our brands. And so given the expected growth and given the resonance that our brands have with the Hispanic consumer, we expect that this to continue to be a very favorable tailwind for us as we go forward.

And then the last component there is innovation. And I think it's important, again, for everyone to note that when we talk about innovation, innovation includes both liquid, if you will, as well as packaging innovation or price pack architecture initiatives.

And as you noted, this is the category, if you will, the driver, if you will, that has the widest range. That has the widest range, really, that's reflective of sort of the approach we take on test and learning in the marketplace. And certainly, based on what we learned in the marketplace, we'll be more or less aggressive. But we feel like this is the appropriate range for us because if you look at the last 5 years, we've really operated at about the midpoint in terms of the impact on our overall growth rate coming from innovation.

Dara Mohsenian

Great. And then on the distribution side, obviously, we've had some major changes in the Beer category over the last few quarters here. In theory, you always had this shelf space argument of growth and velocity relative to the peer set. But with the struggles on Bud Light and some of the ABI brands, obviously, that argument has been strengthened.

How much of that was sort of realized as you think about the ability for shelf space gains from that in fall resets, which usually aren't as significant in the beer category versus maybe upcoming this spring, where traditionally it's a larger percentage of your mix that's reset. Just help us think through the benefits from that and sort of when it's fully felt by your organization and compare and contrast upcoming spring versus last fall?

Garth Hankinson

Yes. So this is probably a good opportunity for me to sort of just reiterate what our full year expectations are for our business, right? And we continue to expect to achieve top line growth of about 8% to 9%. And as is typical of our algorithm, we're expecting 1% to 2% of that to come from pricing initiatives.

Just to give a little bit of context in terms of shelf resets. Our last fiscal year, fiscal 2023 was our best year to date as it relates to gaining shelf space. We gained about 2% or 2 share points of the cold box, and we executed again on about – or against about 17,000 shelf resets.

So compare that to FY '24 year-to-date, we've already picked up an incremental 3 share points of the cold box, and we've already executed it on 18,000 shelf resets, on our way to what we expect to be 21,000 shelf resets on the full year, as I indicated earlier.

In terms of a little bit of the cadence between fall and spring, about 20% of shelf resets are done in the fall. And that results for us in a high single-digit growth rate in terms of distribution on a year-over-year basis. But we still expect that the vast majority of shelf resets are done in the spring. Obviously, the balance of that is 80-ish percent, 80%, which will result in sort of low double-digit distribution gains for us.

Dara Mohsenian

Okay. That's very helpful. And part of that beer top line target is 1% to 2% pricing. Give

us a sense of how consistent that will be looking forward over the next couple of years. We are coming off a period of – well, we're in a period of theoretically greater consumer stress, greater inflation in beer, but in broader CPG even more.

And in theory, ABI maybe isn't pushing the needle as much on pricing as they have previously. So should we expect pretty consistent 1% to 2% pricing from you guys going forward? How do you sort of think through that strategically, given all those factors that I mentioned?

Garth Hankinson

Yes. I think that for those of you that follow us closely, which looking across this room is quite a few, you'll hear a similar response to this question, which is we take a very, very methodical approach and disciplined approach to pricing. And on this 1% to 2% pricing algorithm, we don't take necessarily a pricing action across the entire country, right? So it's never that we're experiencing 1% to 2%, again, across the broad swath of the country. Rather, what we do is we look at markets on a market-by-market basis, we look at brands and we look at SKUs.

And so in any one given year, you might see that in a particular region or particular brand, there's a higher than 1% to 2% pricing increase, and then there's another area where we have something less than that. And again, across the portfolio that averages out to that 1% to 2%.

In some markets, we won't take more – we won't take pricing multiple times a year nor will we take pricing in back-to-back years in order to make sure that we're managing the impact that any pricing has on our consumers, as you've heard us say before, we always have the consumer front of mind when we're making pricing decisions because what we don't want to do is ever price our consumers out and we don't want to do anything that slows the momentum of the brands.

We'll continue on with that very, very methodical and disciplined approach. That approach does give us a lot of flexibility, obviously, Dara. And you saw in both FY '22 and FY '23, given the economic conditions, given the inflationary environment, we were able to take incremental pricing over and above that 1% to 2%. Again, I think that, that shows the strength of the disciplined approach. And when we did that, we very much took into account elasticities.

Again, always making sure that we have a good sense for what the impact is going to be on our consumer and overall for the portfolio. So it's a discipline, it's served us well over the past and one that we think we can rely on going forward.

Dara Mohsenian

Okay. And then maybe some near-term perspective, since that February quarter low, we've seen your business really come back pretty strongly in terms of market share performance over the last 9 months. We've also seen some periods of sort of beer industry malaise from a volume standpoint.

So just curious for your perspective on both those areas. How sustainable they are as you think going forward? Is there anything sort of occurring from a beer industry standpoint that you think is depressing trends here? Or is it more just the numbers per ounce around month-to-month? And then your own market share performance and that strengthening we've seen, can you talk about what's behind that sequential improvement? And how sustainable that might be?

Garth Hankinson

Yes, broadly speaking, and we've kind of gone through the drivers for our business going forward in terms of distribution, innovation and demographics. So we feel good about our ability to continue to deliver the growth that we've outlined.

Now as it relates to the broader category, if you will, and there has been a little bit of volatility in the broader beer category. But if you look at various segments, if you look at the high end, for instance, the high end continues to be quite healthy. If you look at Circana data, for instance, in any given period, really, you're seeing the high end growing quite nicely.

Certainly, the overall beer category is a bit weighted down by the declines you're seeing at the more value priced, if you will, or sub-premium price segments. But overall, the high end remains to be, again, pretty healthy.

We also look at – as it relates to the high end, one of the key metrics we look at, you've heard us mentioned this before, is buy rate. And buy rate has actually gone slightly up year-over-year. So we think that, that's an indication that the premiumization trends at the high-end demand remains fairly stable.

Looking at – you asked about our ability to continue to deliver on the growth profile, and again, over and above what we talked about in terms of the drivers that we're counting on. If you look at some of the opportunity we have from a share perspective, and I'm going to try to get these numbers roughly right for you.

But you look at our brand, for instance, like Modelo Especial overall across the whole country, that brand has about a 9.2% share. But if you look at that in a state like California, that share is closer to 20%. So obviously, there's a good opportunity there to increase the share of that across the rest of the country, if you can close that gap even somewhat with what you see in California.

And then similarly across the broader portfolio, the broader portfolio has a share of about 19.4% I think, is what the number is. But if you compare that to California, our largest market, the total portfolio has a share of about 34.9%. So again, I mean, that's a real

opportunity for us, to be able to replicate that type of performance. And then again, we've touched upon the innovation and the demographic opportunities for us to continue to deliver outsized growth.

Dara Mohsenian

Okay. And you touched on the high-end strength. Maybe put that in context to the macro environment we're in across broader CPG, we've started to see package and channel shifts be pretty pronounced, which is occurring in the beer category. We've also started to see some brand trade down, which we really haven't seen in beer.

So just as you think about your business in beer and then maybe you can also touch a little bit on Wine & Spirits, what are your thoughts around the threat from the macro environment, consumer trade down, why you're not seeing it? And how much of a risk point that is in the current consumer environment we're in?

Garth Hankinson

Yes. I mean we – again, and it's a little bit similar to the last answer, which is we remain confident in the high end, just given the performance of the high end and the period after period growth that we see in the high end. And again, the strength that we see in buy rate, which gets us to believe that the high end is relatively stable overall.

And while there is some concern around the macroeconomic condition, consumer sentiment seems to be rather positive relative to where it was last year in terms of where – in terms of both how the consumer is feeling and the relative strength, if you will.

And certainly, specifically to beverage alcohol, we see a little bit of an opportunity for us or a benefit for us or if you will, or maybe a little bit less of a headwind, because if you look at something like food, broader food price increases are kind of 4% to 5% over sort of norms, meanwhile beverage alcohol's only up, kind of 1% to 2%. So the impact that

the consumer is feeling on beverage alcohol is lower relative to something like the food category, if you will.

And you've heard us reference a couple of these stats before as well. But certainly, beverage alcohol, as a percentage of the total basket, if you will, for consumers, is still relatively low. It's less than 2%. So this is not a big drain on a consumer's overall budget. So when consumers are going to look at ways to make trade-offs to save dollars, this is not a big driver of their cost, so probably not a place where they're going to compromise, if you will.

Additionally, you've heard us say before that beverage alcohol tends to be a bit of an affordable luxury. So even during times of a little bit of economic tightness, if you will, consumers still will purchase beverage alcohol. They might change where they – the channel at which they purchase it, they might change where they purchase it, meaning, is it – are you going out for dinner and having drinks or you buying that bottle of wine and having it at home. But they still tend to drink.

Now there are some things that we've seen. As you mentioned, some channel shift. Certainly, we've seen that specific to the beer category. That shift, as you've seen that there's been a shift towards convenience for more immediate consumption and with single serves. Fortunately, we're quite strong in the convenience channel. We have a full offering of single-serve SKUs. So not necessarily something we're seeing as a significant risk to us.

And then one of the other things that we're seeing a bit of a change in is just in the larger pack sizes consumers are looking for more value per ounce, if you will. Again, this is why we've had a bit of a focus and why we'll continue to have a focus on our price pack architecture initiatives to ensure that we've got a product at every price point in which a consumer is shopping at.

Dara Mohsenian

Okay. And that thinking that channel shift, package shift, we saw sort of a mid-single-digit gap open up between Circana, standard data growth and your beer business last quarter, that's a bit above where it's been historically. Is your view that's a more sustained type of level going forward just because there has been these macro impacts? Could it ramp up even more from here as you think about macros going forward and consumer shift. Using your crystal ball, where do you see that sort of going, going forward versus what happened last quarter?

Garth Hankinson

Specific to Circana data?

Dara Mohsenian

Yes, sure. We have to use something as a reference.

Garth Hankinson

Sure. As we – I think we talked about this at the end of our Q2 earnings, and this was a point that we talked about at Investor Day as well, right there. There has been a widening in that gap between Circana and depletions for sure. Historically, that's been more in the low single-digit range. And then over recent quarters, that's been more in the mid-single-digit range.

That seems to be tied to the fact that Circana data doesn't have as much exposure to independents, convenience retailers. So it's over representing the impact of the shift towards the convenience channel. So that's why you're seeing that bit of a skewing, if you will.

We expect that you're going to continue to see this sort of mid-single-digit gap between Circana data and our depletion data until the second quarter of our FY 2025. That's when

kind of the lap will occur.

Specific to our Q3, you will see that, that gap has been closer to the higher end of that range than it was even in Q2. So we are expecting that, that will continue.

It is important, I think, for folks to remember that Circana really only captures about 50% of our overall performance, which is why we always say that to really - if you're really looking to track our business, you got to look at both our shipments and depletions information to get a sense for how we're performing.

Certainly, for us, when we look at syndicated data, in this case, Circana, we're doing that so that we can measure our relative performance against the categories in which we compete or the competitor set in which we compete against as well as longer-term trends.

So you need to try to look at our depletion and shipment data in a combination when you're looking at our performance.

Dara Mohsenian

Right. Okay. And speaking of shipments, it's been a few abnormal years here during the COVID period, right? And a lot of the summers, you've had specific supply constraints and then sort of ramped up shipments post the summer.

Just as we think about the quarterly cadence of shipments going forward in the back half of this year, next year, should we sort of be using shipments as a percent of the full year looking at a pre-COVID level? Is that sort of - are we back to normal or coming up against the last year or 2 is reasonable? How do you sort of think about that from a shipment standpoint, just given there's been so much volatility year-over-year in the last few years?

Garth Hankinson

Yes. And as another question, I'll touch on both shipments and depletions a little bit, and

we'll start with shipments. And as I indicated, we continue to feel good about how we're performing against our full year guidance as well as the quarterly cadence against our plan for the year.

Now as it relates specifically to shipments, as we said at the outset of the year, we were anticipating or expecting about 45% of our shipments to occur in the second half of the year, and that continues to be true. That continues to be our expectation.

Specific to Q3, if you take out fiscal years '21 and '22, which, as you noted, we had some disruption in there, if you will, due to first, COVID, and then some weather-related disruptions to our business.

If you take those 2 years out, Q3 has typically accounted for about 23% to 25% of our overall shipments in any given fiscal year. And that range is impacted by the number of weekend days in a particular quarter. Obviously, the more weekend days you have, the fewer shipping days you have.

And so Q4 or Q3 rather, of FY '24 has more weekend days than, say, Q3 of last year has. So for this year, if you think about that 23% to 25% range, we're expecting to be somewhere in the midpoint of that range, around 24%, versus last year, we were closer to the high end of that range of around 25%.

Now as it relates to depletions, depletions, the second half of the year, we typically see about 46% of our depletions occur in the second half of the year. And in Q3, there's less of an impact on weekend days, right? So you have a little bit more sort of consistency, if you will. And so the range for depletions for Q3 is more in the 24% to 25%. So it's – again, it's a bit of a tighter range. And this year, we're expecting to, again, kind of come in some place in the midpoint from a depletion perspective.

Dara Mohsenian

Okay. That's helpful. Then maybe shifting to Wine & Spirits, at Investor Day, you did adjust your longer-term targets. What gives you confidence in delivering these new targets, particularly with some of the struggles on the lower end from a category standpoint in Wine.

And after the portfolio shift you've seen in recent years, do you feel like you now have visibility that this business can deliver consistently going forward on your goals and talk about your level of visibility.

Garth Hankinson

Yes. I mean like, look, I do think that we feel confident in our ability to deliver against the new revised goals. Certainly, you've seen that over the last several years, the transformation of the portfolio that we've been underway has really taken root and shown some positive results.

5 years ago, about 68% of the net sales of the Wine & Spirits division came from brands in the mainstream price segment. And today, about 63% of our net sales comes from brands that are premium priced and above. So that shift is underway. And what's underpinned that shift is that the impact or the benefit of some of the M&A activity that we did as well as divesting the majority, almost all of our mainstream brands.

As we think about the impact of those M&A transactions have had, you look at brands like Meiomi and the Prisoner for instance, and since we've acquired those, they've had a compound annual growth rate in the mid- to high 20% range. So we've got obviously good performance from those brands. And we expect that performance to continue into the future as the consumer-led premiumization in Wine & Spirits, really across all beverage alcohol and consumer packaged goods continues.

And so we expect over the medium term that the amount of – or the percentage of net

sales derived from the higher end will be 70%, 70-plus percent.

Obviously, we've talked about the renovations that we have underway with brands like Woodbridge and SVEDKA. And certainly, we're where we feel good about the path that they're on and the ability to stabilize those brands. That being said, they are large volume brands and given some of the near-term challenges, they have weighed down our overall growth.

Beyond the changes that we've made and are making to the portfolio, Wine & Spirits has continued to invest in higher growth opportunities outside of the U.S. wholesale market, and U.S. wholesale is really where we've been participating almost exclusively, almost, I'd say, exclusively in the recent past. And we've invested in, like I say, higher growth opportunities in DTC and international.

In FY '19 DTC and international only comprised about 10% of our overall performance. That was about 14% in FY '23, and we expect that to be around 30% over the next several years, FY '28. Again, that's taking advantage of some of the consumer-led premiumization that's going on.

That being said, we did reduce guidance at our Investor Day, giving some of the near-term headwinds we're facing, and we lowered guidance to being down 1% to down 2% this year, but we maintained our operating margin target of plus 2%, our operating margin of plus 2% to plus 4%.

Some of the near-term challenges that we're facing are primarily, but not exclusively in the mainstream price segments. Certainly, we've seen the weakness that we've been experiencing in U.S. wholesale, start to expand in some of the more mature international markets like Canada, in New Zealand and Australia and Italy.

We've also seen some increased pricing competitiveness. We've tried to be very disci-

plined or we are being very disciplined from a pricing perspective, taking some targeted pricing actions on brands that we feel can hold that pricing. And once we take that pricing, we're looking to maintain that pricing, but we've seen a number of our competitors get more and more competitive on price in order to drive volumes.

And then we've recently – kind of back to some of the international headwinds we faced is we've seen in a market like Canada, where given some of the softness there, liquor control boards in an effort to manage their inventory levels have started to destock a little bit.

So those are all headwinds that we're facing in the near term and what drove our reduction in guidance for this year.

Dara Mohsenian

Okay. And from here, the macro impact on the Wine & Spirits business, any thoughts there? How much risk that might pose? Or is that sort of reflected in the revised guidance in your mind?

Garth Hankinson

Look, I think that, that's reflected in the revised guidance for sure. Obviously, we're seeing – we talked about the resiliency we're seeing in beer, but the premiumization trends in Wine & Spirits continue. And again, we now have a portfolio that's better oriented towards these consumer trends. And so we feel good about the revised guidance.

Dara Mohsenian

Okay. And as I mentioned the introduction that Modelo has become the #1 off-premise brand in sales this year. Can you talk about growth opportunities for that brand going forward? What are the biggest growth opportunities, whether it be geographic, demographic, channel expansion, how you think about the biggest growth opportunities from

here?

And also maybe give us a bit of a review in some of the areas where it's highly penetrated in those areas? How is the brand performing, that can sort of inform where longer-term share can go for the brand?

Garth Hankinson

Yes. So we touched a little bit about this, but obviously, the same drivers we have for the broader portfolio are there for Modelo Especial as well. We talked about the 500,000 points of incremental distribution. Roughly half of those, slightly less than half of that, I should say, will be for Modelo Especial.

Again, there certainly continue to be opportunities for us to expand that brand in terms of Texas, the mid-South and the Southeast from a distribution perspective. Obviously, a bit less of an opportunity out West for that brand. While it's a smaller overall market for us, but the Northeast is an opportunity for Modelo Especial. So again, distribution will be a big driver for Modelo Especial.

The demographic trends that we touched on, that's a brand that's still about 55% of the overall performance of that brand is tied to Hispanic consumers, so the demographic trends we outlined earlier will continue to be a driver of growth.

As we look to grow that brand, the 45% of that brand that is with the general consumer is another opportunity because that's still under-indexed relative to, say, Corona, where Corona does about 70% in the general market. So we're able to hit the general market as well as continue to take – to grow with a span of consumer.

And then if we look at things like household penetration or brand awareness, while this brand has become the #1 brand in the U.S. on a dollar sales basis, it's still under indexes against Corona and some of its larger non-CBI beer competitors.

So again, opportunity there. And then we've talked about innovation, building up the broad shoulders of Modelo is an opportunity for us.

Dara Mohsenian

Great. Well, we really appreciate you being here again. Thanks very much. It was very informative.

Garth Hankinson

Thank you, Dara. Thank you. Thanks, everyone.

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