

# **Brown-Forman Corporation, Q3 2015, Earnings Call**

## **2015-03-04**

### **Presentation**

### **Operator**

Ladies and gentlemen, thank you for standing by, and welcome to the Brown-Forman Third Quarter Fiscal 2015 Earnings Call. — ***Operator Instructions*** — I would now like to turn the call over to Jay Koval, Vice President of Investor Relations. You may begin.

### **Jason Koval**

Thanks, Victoria, and good morning, everyone. I want to thank you for joining us today for Brown-Forman's third quarter 2015 earnings call. Joining me today are Paul Varga, our President and Chief Executive Officer; Jane Morreau, Executive Vice President and Chief Financial Officer; and Brian Fitzgerald, Chief Accounting Officer.

This morning's conference call contains forward-looking statements based on our current expectations. Numerous risks and uncertainties may cause actual results to differ materially from those anticipated or projected in these statements. Many of the factors that will determine future results are beyond the company's ability to control or predict. You should not place undue reliance on any forward-looking statements, and the company undertakes no obligation to update any of these statements whether due to new information, future events or otherwise.

This morning, we issued a press release containing our results for the third quarter of fiscal 2015. The release can be found on our website under the section titled Investor Relations.

In the press release, we have listed a number of the risk factors that you should consider in conjunction with our forward-looking statements. Other significant risk factors are

described in our Form 10-K, Form 8-K and Form 10-Q reports filed with the Securities and Exchange Commission.

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

And with that, I'll turn the call over to Jane for her prepared remarks.

**Jane Morreau**

Thanks, Jay, and thanks for joining us for our third quarter earnings call. I'll cover 2 topics today, which should leave plenty of time for questions after our prepared remarks. First, I'll review our year-to-date results, including trends in the third quarter; and second, I'll discuss our updated outlook for 2015.

So let me start by reviewing our recent results. Third quarter underlying net sales growth of over 5% is particularly impressive in light of the strong 8% underlying growth we delivered in the third quarter of last year and against the competitive set that is showing little-to-no growth. Year-to-date underlying sales are also up 5% with price/mix contributing 3 points of sales growth.

Top line results in the United States continued to accelerate in the quarter, up 7% year-to-date compared to 5% through the first half. Market share gains in the U.S. are being driven by the great work our teams and partners are doing to capitalize on the renewed consumer interest in authentic American whiskeys, including the Jack Daniel's family, Woodford Reserve and Old Forester.

Premiumization trends and innovation have played key roles in driving our outperformance over the last few years, and we look to introduce new expressions over time that

we believe can help us deliver sustainable long-term growth.

Developed markets outside the United States grew underlying net sales 4% during the first 9 months. France, the United Kingdom and Canada are all growing quite well, while Germany and Italy were up slightly. These markets helped offset sluggish results in Australia and Japan and in Spain, where results were down double-digits.

And in the emerging markets, Jack Daniel's Tennessee Whiskey continues to grow mid-teens, driven by strength in Turkey, Russia, Ukraine, Brazil, Indonesia, the Philippines and sub-Saharan Africa. Mexico results were flat as the mainstream tequila category remains quite competitive, and we are actively repositioning our el Jimador brand at a higher price point. Additionally, large declines in Poland, driven by Finlandia, pulled down our total emerging market growth to 6% in the first 9 months. Remember, Poland had large buy-ins in advance of last year's January 1 excise tax increase, so comparisons were challenging in calendar 2014. Excluding Poland, our emerging market sales growth would have been 7 points higher.

Furthermore, we estimate that year-to-date underlying net sales growth for the entire company, excluding Poland, would have been a point higher at 6.5%.

Let's now move to the reconciliation of reported to underlying results. In appreciating U.S. dollar continued to weigh heavily on our reported results. Last quarter, I used the euro as an example, stating that it had declined 7% since our first quarter call. These declines continued in our third quarter as the euro dropped another 9%. In total, we experienced additional FX headwinds of approximately \$0.04 in the third quarter, beyond our expectations at the time of our second quarter call.

So while our top line grew 5% on an underlying basis during the first 9 months of fiscal 2015, foreign exchange negatively impacted our reported results by approximately 3

percentage points. In incremental – an increase in estimated net distributor inventories helped reported results by 1 percentage point due to our route-to-consumer change in France.

As a reminder, our former distributor fully depleted inventories of our brands during November and December of last fiscal year, leading to essentially no shipments in the third quarter of 2014 in France, which negatively impacted our reported results last year. The absence of these reductions this year resulted in a favorable onetime comparison. This benefit, combined with the negative effect of foreign exchange, resulted in reported net sales growth of 3% over the 9-month period.

Underlying A&P spend increased 4% while underlying SG&A grew 9%. Both line items were a few points lower on a reported basis as foreign exchange helped our non-U.S. dollar denominated cost. Year-to-date SG&A increases have been driven in part by a route-to-market investment in France, but we expect lower full year SG&A growth.

Putting this all together, we delivered 7% year-to-date growth in underlying operating income. Foreign exchange headwinds hurt our reported operating income growth by 7 points. This was due to transactional impact on net exposures and the revaluation of net current asset denominated in foreign currencies. The revaluations are captured in the \$22 million negative swing in the other income and expense line item on the P&L.

For the first 9 months of the year, earnings per share came in at \$2.54, up 4% year-over-year. Foreign exchange was an \$0.18 drag on reported EPS. So year-over-year growth in EPS would have been approximately 11%, excluding this impact.

Moving now to my second and final topic, an update on our outlook for fiscal 2015. Today, we are reaffirming the ranges we shared with you for our full year outlook for underlying net sales growth of 6% to 8%. Our year-to-date top line results are running slightly below

the low end of this range due largely to comparison issues with the prior year. Our business momentum remains robust, and we will be competing against last year's soft fourth quarter underlying sales growth of 3%, which was negatively impacted by give-back in Poland.

So with 2-year stacks sales growth running 14% in the third quarter and the expectation of easier comparisons, we anticipate strong fourth quarter top line growth to pull our full year sales growth back in the 6% to 8% range.

Regarding the national launch of the Jack Daniel's Tennessee Fire, our teams have been hard at work, and we recently began shipping our first cases to the other 42 states. Our initial read-through from our 8 test states has been very encouraging, with Fire continuing to index quite favorably to Honey's introduction 4 years ago. And we believe that the limited rollout has helped fuel consumer interest in the brand.

Equally important, we believe that Fire is not only complementing Jack Daniel's Tennessee Whiskey, but is showing little sign of slowing the rate of growth for Jack Daniel's Tennessee Honey in the initial test market. From an earnings perspective, we expect a few cents of benefit to fiscal 2015's reported results, reflecting pipeline build.

Year-to-date gross margin expansion of 70 basis points has been stronger than what we expect for the full year given our expectations for higher costs in the fourth quarter related to wood for our barrel-making operation caused by growing an increased interest for bourbon.

Underlying SG&A growth moderated to 6% in the third quarter as we began to lap the route-to-market change in France on January 1. We anticipate additional moderation in the fourth quarter as we lap last year's 14% growth rate. In the aggregate, we expect underlying operating income growth in the fourth quarter in the teens, which should

result in full year underlying operating income growth of 9% to 11%.

Not surprisingly, FX remains a headwind. So given today's spot rates, which, for reference, are roughly 13% weaker than 35-year average versus the dollar, we expect foreign exchange to pull down our reported EPS in the fourth quarter. We anticipate FX will hurt our full year operating income by over \$60 million and EPS by over \$0.20, assuming today's spot rates.

This year, full year FX impact is \$0.05 worse than we expected at the time of our second quarter call and a driver for our revised EPS range of \$3.15 to \$3.25.

As a sensitivity, assuming our foreign exchange cash flow exposures collectively move 10% in either direction, our EPS over the balance of the year would be impacted by approximately \$0.04. And while it's too early in our planning process this year's specific guidance on fiscal 2010 – '16, we remain optimistic about our prospects for a continued growth giving the health of our existing business continued category momentum and our disciplined innovation strategy. We'll share more specifics with you on our fourth quarter call.

So in closing, we continue to deliver strong underlying growth. We attribute this outperformance to our leading portfolio of American whiskey brands, led by the Jack Daniel's trademark, strong and growing geographic diversification and premiumization opportunities for our portfolio of brands. Our business model has been built around premium brands and efficiencies inherent in single point production, leading to high gross margins and strong free cash flow.

We approach our capital deployment with a very long-term view, supported by the health and strength of our balance sheet. This allows us to simultaneously invest in future growth, as we are actively doing today behind Jack Daniel's and our other American

whiskey brands, evaluate potential acquisitions and return cash to our shareholders as we have done to the tune of almost \$0.5 billion so far this fiscal year through ongoing dividend and share buyback programs.

So let me turn the call over now to Paul for his comments. Paul?

**Paul Varga**

Thank you, Jane, and good morning, everyone. First, let me say that I continue to be pleased with the company's results, and I want to publicly thank my Brown-Forman colleagues worldwide for again producing them. I think we had another very good quarter of underlying performance, and I would highlight that our 5% sales growth and 8% operating income growth on an underlying basis came on top of a very strong Q3 last year. So with the expectation that we will finish the year along the lines of what we've guided today, I believe we will have recorded another excellent year of underlying growth and business progress at the company.

One of the things that makes our underlying results stand out in my view is that they compare quite favorably to those we observe across our industry. And this has been a consistent reality over the last many years. One of the reasons for our differential underlying performance, I believe, is that Brown-Forman is uniquely well positioned through our American whiskey leadership and our ownership of the Jack Daniel's brand, which itself gives us superb geographic breadth, diversification and continuing opportunity.

In our communications with you over the years, we've discussed an aspect of American whiskey that I believe is particularly unique. It is simultaneously enjoying the desirable attributes of both mixability and premiumization. Most often in distilled spirit categories, these 2 dimensions are observed as mutually exclusive.

If you consider the 2 largest multi-country categories in the spirits industry by volume, and

that's scotch and vodka, this point is made rather clearly. Within scotch, we frequently see leading trademarks positioned very successfully at many price points, spanning from standard to luxury. In each case, utilizing the same trademark name at each of the price points. Within vodka, the leading trademarks have not exhibited the same vertical agility. The leading brand at each successive price tranche in vodka typically carry a different brand name.

By contrast, however, vodka has shown tremendous horizontal agility, if you will, through flavored vodkas and premixed RTDs, which provide consumers with a broad range of flavor options for the consuming occasion. Scotch, on the other hand, has had little success expanding their trademarks along the same flavor or mixability dimension.

But uniquely within American whiskey, and best evidenced by our own Jack Daniel's, the category's brands have shown the ability to be successful along both of these attractive dimensions within the same trademark. Let me give you an example of this. On the mixability and flavor front, Jack Daniel's has enjoyed today in a more varied fashion than scotch whiskey competition through everyday mixed drinks like Jack and Coke, premium convenience offerings like Jack Daniel's RTDs and propriety flavor whiskey expressions like Jack Daniel's Tennessee Honey and our new Jack Daniel's Tennessee Fire, which is currently rolling out in the United States. At the same time that Jack Daniel's enjoyed this consumption variety through its inherent mixability, the brand's reputation for crafting the finest American whiskey is evidenced through the success of brands like Gentleman Jack and Jack Daniel's Single Barrel, 2 trademark expressions that have become sizable brands in the ultra-premium American whiskey segment. In fact, these 2 brands figure prominently in a milestone Brown-Forman celebrated during our most recent quarter. For the first time, the combined 12-month volumes of Gentleman Jack, Jack Daniel's Single Barrel and Woodford Reserve eclipsed 1 million cases.

Beyond being our company's shining illustration of premiumization within American whiskey, these brands also represent a very valuable ultra-premium whiskey business for Brown-Forman today, given their attractive profitability, returns and growth rates.

Now as nice as this 1 million case milestone is to recognize, just as exciting is the fact that the ultra-premium-plus price segment of American whiskey, is still at a very early stage of development. Contrasting this price segment of American whiskey to the equivalent one in scotch whiskey, we observed that this highest end represents only 2% to 3% of total American whiskey retail dollars, whereas the same price segment accounts for over 30% of total scotch. So on a share of category basis alone, there's a 10 to fifteenfold opportunity for the highest end of American whiskey if it can develop as ultra-premium scotch has.

And to reinforce the point in a different way, in pure retail dollar terms, because scotch is so much larger than American whiskey, the highest end of scotch today represents the segment there's more than 35x the size of the American whiskey equivalent. Any way we view the data, we see this as an enormous long-term opportunity for Brown-Forman within the category that is most important to us and that we know best.

So the brand-building capabilities are people have demonstrated in achieving this first 1 million case milestone will be the enabling factor as we strive for the next 1 million cases. And while my focus today has been on this 1 particular ultra-premium whiskey achievement, we also intend to apply these same capabilities to the significant opportunities we envision for other premium-plus brands such as Herradura, Sonoma-Cutrer and Old Forester to name just a few.

The highest priority for our time and capabilities, however, will remain the responsible globalization and development of the Jack Daniel's Black Label brand as we continue to build its mixability and premiums. Jack Daniel's Black Label is the foundation of the Jack

Daniel's trademark overall as well as Brown-Forman's most meaningful growth opportunity for the foreseeable future.

This concludes our prepared commentary this morning, and we're now happy to take any questions you might have.

## Question and Answer

### Operator

— **Operator Instructions** — Your first question comes from the line of Vivien Azer with Cowen.

### Vivien Azer

So my first question has to do with the depletion trends in the quarter. It looks like they slowed a little bit, but I see that that's on a tough comp. So could you dive in a little bit more in terms of the depletion trends specifically for 3Q, please?

### Jane Morreau

Yes, Vivien. I think the way I would look at that, if you looked at our first quarter trends, I think they're a little bit soft, though, you're right. Q2 was a little bit stronger, and Q3 is a little bit down versus Q2. But I think it's all relative to last year. So really, if you look at where we were through the first half, we're at 2%. We're still at 2%. So I don't really see a slowdown. I think it's really – can't really look at 1 quarter in isolation, if you will. In fact, I see improving trends, particularly in the U.S. we experience some nice acceleration there. So I think a lot of what you're seeing is simply a difficult comp that I was referring to in my script and we also alluded to in our earnings release as it related to some buy-ins last year in Poland. But we don't – we are not seeing it – I don't view it as a slowdown. You're going to see these one-off things happening when you look at quarter-to-quarter.

### Vivien Azer

That's very helpful. Jane, you mentioned in your prepared remarks that Fire continues to track well relative to Tennessee Honey. At your Investor Day, you indicated it was about 1.35x. Can you give us a little bit more detail on how the trajectory has evolved as you've kind of included 5 more states in this comparison?

**Jane Morreau**

Yes, so just to reiterate how encouraged we are about what we are seeing and how excited our people are, the trade is and the consumer are wanting and excited about seeing a super-premium cinnamon brand expression from Jack Daniel's. So you're right, we did talk about the early test market back in – at our investor conference. We are not seeing a slowing. We continue to see somewhere in the 130% to 140% indexing. So we've not seen it slow down, if you will. It's maintained and we're very encouraged by that. With that being said, these are unchartered waters for us a bit, given it is a higher price offering versus what the category price point – that already exists. But nonetheless, we're very excited. We just started shipping our first cases out a couple of weeks ago to the remaining 42 states, as I said earlier. So time will tell, but we're very – I think we're very positioned well for that.

**Paul Varga**

Yes, I mean, the trade reaction so far is – I mean if anything, because there was some pent-up demand. I'd say the national rollout has been received with as much or even more enthusiasm as the original sort of test markets were. And the thing that's so interesting when you go national is you have the ability to use things like media, the ability for social media to help you – I mean this brand – I would give you one sort of I thought – that I thought was an interesting thing I heard in the last month on this that the Jack Daniel's Tennessee Fire Twitter followers have already eclipsed the Jack Daniel's Tennessee Honey followers. And so while it's too early to know how the actual consumer acceptance in terms of real purchases in the marketplace will unfold, what we've seen so far, both at

trade and consumer, on this is really encouraging.

### **Vivien Azer**

That's very good news. My last question just in terms of the acceleration that you're seeing in the United States, can you talk about the balance between on- and off-premise? I think you guys pointed to some improving trends on-premise last quarter, so I'm curious if that's continued.

### **Jane Morreau**

Yes, I can talk a little bit and Paul can chime in. I think the latest NABC information through January indicated that the on-premise trends are continuing to accelerate, both overall spirits is up and Brown-Forman were beating the overall spirits. So Jack Daniel's itself continues to improve as well. I think we're up about 2% in the on-premise. It's up 1 point – about 0.5 point over the prior month. So we continuously, since about last March or April, have seen a continued improvement in overall trends in the on-premise and this has impacted favorably our brands. I will say when I look at our brands, Old Forester is our fastest-growing on-premise brand by a long shot. But we've got a lot of other brands that are growing quite nicely in the on-premise, too, Woodford Reserve, el Jimador. They're growing very, very strongly. Gentleman Jack is doing well. So the trends are improving. We'll see what kind of weather you guys are predicting there today, but we're predicting more snow here today. So remember last year, the winter was quite bad and I know the month of February has been dicey around the states – United States. So – but we think we got a couple more months of soft comps, depending again how the weather goes over the next couple of months.

### **Paul Varga**

And of course U.S. comment – I mean, we don't have as great a visibility and timeliness on international on-premise. But it's been our experience here, as with the places where

these economies have been difficult to be on-premise along with some of the off-premise has continued to show some weakness. But I would say that even though the on-premise - I mean, the strength particularly of this U.S. off-premise environment as spirit brands, and I'll say premium spirit brands, are very much affordable luxuries still. And so if you just compare per drink outlaid by the consumer for either a bottle of Jack Daniel's or Woodford Reserve compared too many other entertainment alternatives stacks up quite nice. I think the off-premise continues to really drive in the U.S. market. And not to diminish the impact of recovering on-premise, but I mean, at least our read of the last 12 months of U.S. distilled spirit sales, driven in great in part by our core category, bourbon and American whiskey, has upticked a little bit.

### **Operator**

Your next question comes from the line of John Faucher with JPMorgan.

### **John Faucher**

I apologize, I got a little confused in terms of the impact in France vis-à-vis the impact in Poland. Were they similar impacts with all of that in the most recent quarter? Is that the way we should look at that? And so that's more of a housekeeping question. And then sort of a longer-term question, Paul, you talked about sort of being single sourced and that's been a huge advantage for you, allows you guys to build scale, what have you. But U.S.-based manufacturing costs could provide a little bit of pressure over the next several years if we continue to see strength in the dollar. So can you talk a little bit about how you guys are looking at that? If we do have a stronger dollar longer-term, what you can do in place to offset some of the transactional FX impacts that you guys are expecting.

### **Paul Varga**

Sure, I'll tackle that, while Jane considers your first question here. Yes, I mean, these are always trade-offs to be a single point producer in the United States at the time of the

strengthening dollar. Yes, I mean, there's all these trends. I would tell you, it's better to be positioned at the very high end of a market versus the low end when that's happening because proportionately, the FX impact is less so – on your profits. And so I feel like net-net, when you balance it all out, the efficiencies – and we've been well served over these years by the single point production and efficiency. And frankly, also that just the importance of that home place and the imported status that's conferred to Jack Daniel's as an imported American whiskey when it leaves the shores of the United States have all been very important to the brand's development over the years. So I think there's both efficiency reasons that you asked questions, also some marketing ones. I do think there are things that are implied, in some ways even more indirectly than directly, as the dollar strengthens. I mean, I think the most significant is that, at least the way I think about it, there might be a big rationalization here. But if you think about why the U.S. dollar has been strengthening, one of the contributing factors is the strength of the U.S. economy and – relative to other countries. And the way I look at it, we happen to have the good fortune of having – as a largest country. It's the most valuable distilled spirits market in the world. It's our home country, which we know very well. And it also happens within our industry to be one of the most exciting times for our core categories. So I know this might be a very simplistic way of thinking, but the way I think about it is, as it relates to things, everything from resource allocation or innovation or the way that we think about developing our business at the time when the U.S. dollar is strong is make sure you're maximizing the opportunities available to you in the United States market is one thing. And so that's one of the ways in this past year we certainly have upped our investment behind Jack Daniel's. You heard us talk about the introduction here of Tennessee Fire, which is an innovative effort. You've – I mean, empathize very strongly here the ultra-premium whiskeys, which have the predominant presence for them. The largest markets in each one of those cases is the United States. So I think it's a reminder to all of us as Brown-Forman's managers to really make sure you're doing the best possible job you

can in the markets to be attractive, it is in some ways causing the dollar to strengthen. So – and that's different than – I mean, it's certainly, sure, a U.S.-based company is a wonderful time to either be making acquisitions in Europe or to be borrowing in European denominations, those kinds of things. But those alone aren't reasons to go do it. They're just – they increased, I think, the benefits of time and as you think about it. But I think the biggest takeaway is for us to make sure we're doing the best possible job in the United States.

**Jane Morreau**

Okay. I'll follow-up on your housekeeping question. Let's see, I see France and Poland as 2 different things. The reason why we illustrated France for you was because it impacted our third quarter only reported results, so when we're providing a reconciliation, understanding between reported and underlying. So it's the reported aspect. Poland, on the other hand, has been something that has hurt us all 2014, following the excessive or huge significant tax increase taken last Jan 1. And as a result of that, it's been a market that has impacted our comparisons all year long. And we do expect easier comps as we go into the fourth quarter. That has impact on our underlying results, and that's why I isolated Poland as it related to our discussion. I hope that helps.

**John Faucher**

That does. But does that mean that the impact – would the impact in Q3 the same – do they offset each other generally? In understanding the differences between the situations, was there a rough offset between the 2 countries in the third quarter specifically?

**Jane Morreau**

No.

**Paul Varga**

No.

**Jane Morreau**

And again, one was on a reported basis and one is underlying. France did not impact the underlying results. It's not reported. Poland...

**Paul Varga**

Yes. And the impact in France that we've highlighted, I think, if I got it right, would be larger than the direct impact that you were citing for the underlying in Poland, don't you think? I think as it relates to – even though one is an underlying, one is in the reported, but there was a significant – it was, what, in terms of estimated net change in distributor inventories is a 6-point quarterly impact on France. And I don't know, did Poland impact 6 points at the underlying?

**Jane Morreau**

Well, it impacted my emerging markets.

**Paul Varga**

Emerging markets, yes, but not the corporation. Yes.

**Operator**

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

**Judy Hong**

Just following up on Poland. I guess I'm curious to hear more about the underlying trends. I think, Jane, you had talked about last quarter where obviously the shipment numbers that you've been reporting has been impacted by the inventory movement, but the underlying trends were starting to improve. So I just wanted to understand if that's continuing in the back half of the year. And then as it relates to the fourth quarter sales guidance, obviously, you're expecting pretty sizable acceleration. The comps are easier. But just in terms of thinking about some of the underlying trends, are you expecting any sizable im-

provement in some of the markets? It sounds like maybe Tennessee Fire is adding about a couple of points to sales in terms of pipe sales. So can you just verify that number? And is there any inventory movement that we should be thinking about as it relates to the fourth quarter?

**Jane Morreau**

A lot there, Judy.

**Paul Varga**

I mean, I'll talk about...

**Jane Morreau**

Let me to talk about Poland.

**Paul Varga**

Yes, are you ready on Poland? Because I could answer the last one if you want me to.

**Jane Morreau**

Yes, I can start on Poland. And what we are seeing there and continue to see, as it relates to the premium whiskey in the Polish market as well as Jack Daniel's from an underlying takeaway trend perspective, we see accelerating results, so another - I'll just give you one example. The premium whiskey is growing 33% in Poland market on a 3-month basis, up from 25% on a 12-month. So similarly, Black Label is growing 13% on a 3-month, up 9% on a 12-month, so you can see the acceleration there. And again, the excise tax or the comparisons impacted the difficult comps that we've been talking about all along impacted both Jack Daniel's Black Label and Finlandia. So neither brand has been growing at the takeaway trend rates that I'm showing here. The takeaway trends for Finlandia are much better than what we're seeing in our current results as well. So 12-month trends are running 3%, and we're down right now year-over-year again. So that gives you a little

bit of flavor that the takeaway trends the consumer has taken is working its way through all the inventory and the adjustments from the excise tax a year ago. So did that help on Poland?

**Judy Hong**

Yes. And are we done with all the inventory destocking that needed to get cleaned out?

**Jane Morreau**

On Poland? Yes, it will be. Yes, that's behind us.

**Paul Varga**

For the purposes of comparison, we hope there's no more excise tax increase. But now, yes, you'll always have the trading pace. But as it relates to what we're guiding today, yes. And Judy, I think the other question you have there was what are the components that give us the confidence, and you cited that all of them - I'll just comment in a general way. The biggest thing are the soft comps that relate to, for example, Poland and in Europe that we feel that are - were in Q4 last year that we do expect and would, as part of our guidance, the United States to continue to accelerate along the lines of what we've been seeing, so the industry and the category but also our business has been accelerating. So it's with that expectation that, that will continue through the fourth quarter. And we think we got the right sort of, I think, investments and programming and system effort around that to accomplish what we want. And then you mentioned the other one, which is Tennessee Fire. And then Tennessee Fire, in addition, which is this a U.S. comment, its introduction to the United States on a national level is the other contributing factor that we would be incorporating into that acceleration. So those are the main 3 components that the soft comp U.S. acceleration with some Tennessee Fire on top of it. Now you also asked would that create any inventory things, and the only inventory things, that I think Jane might have highlighted a little bit, would be on Tennessee Fire pipeline because you

will ship some in a course – at a national launch in advance of the depletions, and so there might be a little there. But otherwise, we're expecting inventories to largely be in balance at the end of the year.

**Jane Morreau**

No different really from where we are.

**Judy Hong**

Okay. So just to clarify on Fire, because you had called out few cents of EPS spend as it related to pipe sale in the fourth quarter, so I guess that implies roughly 1.5 to 2 points of sales impact that potentially would come...

**Jane Morreau**

On a reported basis.

**Judy Hong**

On a reported basis. Okay. But that's not included in your underlying sales growth guidance?

**Jane Morreau**

The impact on our underlying full year impact is less than 1 point – less than 0.5 point as I recall.

**Paul Varga**

We're investing back behind the Fire launch.

**Judy Hong**

Okay. And then, Jane, just lastly on FX. I know we'll get obviously full year guidance for next year when you report next quarter, and FX continues to be a moving target. But if I just sort of take where the spot prices are today, I get to another \$0.15 or so of negative

FX. I just wanted to understand if there's anything missing in terms of hedging exposure or transaction that I'm missing as I calculate the impact as of today.

### **Jane Morreau**

The only thing that I would say is, as I've been trying to explain as we talk the last 2 quarters about transactional and translational FX, so the transactional being attributable to our translating our foreign-denominated net current assets back to the U.S. dollars. Assuming the spot rates stay where they are today, we had a pretty significant impact. I talked about, I think its \$22 million, \$23 million that's showing up in our other income and expense line item, I would consider that onetime in nature, if you will, if the spot rates stay where they are. So that would not repeat itself next year, if you're thinking about hits of FX from this year. So that would come – be a favorable comparison, if you will, next year. That's the only thing right now I would say. It's just in terms of how we hedge, and I think we've discussed that before in our hedging philosophy and how we roll in our hedges actually over time.

### **Operator**

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

### **Bryan Spillane**

Just, Jane, just 2 quick questions relative to the quarter. One, I think you said that underlying SG&A was up 6% in the quarter. Did you give us what underlying advertising was up or down in the quarter?

### **Jane Morreau**

4% in this quarter, I believe. Hold on, let me double check that. I'm sorry. It was up 4% in the quarter.

### **Bryan Spillane**

Up 4%.

**Paul Varga**

3%.

**Jane Morreau**

3%, I'm sorry.

**Paul Varga**

Was up 3% for year-to-date.

**Jane Morreau**

3% for year-to-date, yes.

**Bryan Spillane**

Okay. And then second question, just – I seemed to recall from the last – from the Q2 earnings call that underlying sales growth was 7% and the expectation was that – it had accelerated to 7% and it wouldn't move from that. So I'm just trying to understand was the third quarter a little bit light relative to what you're expecting? Or was that comment about you don't expect to get – you'd expect to hold or get better or more of a comment of what you were thinking over the second half instead of specifically the third quarter.

**Jane Morreau**

Yes, actually, Bryan, that's a great question. And what we were referring – what we said was the back half not – we weren't giving quarterly guidance, so we were saying we were expecting the back half to not – to go down, if you will, or to change. So well, I think the third quarter was largely in line with what we expected. We knew we were going to have difficult top line comparisons the last year where we had a really strong third quarter growing top line 8%. So our comment was more as it related to the back half.

**Paul Varga**

Yes. Overall, I think it sort of met our expectations. I mean, you can always expect a few of the places around the world would have – we would have hoped for more, but actually I think the U.S. actually surprised us on the upside a little bit from my point of view. So – but I think we're sticking to what we basically said back in the Q2 call as it relates to the back half.

**Operator**

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

**Timothy Ramey**

Just skipping from kind of the macro negative of FX to what seemed to me to be a couple of meaningful macro positive, gas prices in Travel Retail. Can you talk about – I mean, I do recall hearing those as negatives on the way up. Are you starting to see benefits in perhaps on-premise or Travel Retail segment?

**Jane Morreau**

Yes. So we have discussed a little bit earlier mainly it was all around the U.S., but we do continue to see on-premise trends for our brands continuing, growing in the low single digits so – overall. We do think there has been, if you look back and when the acceleration began, there seems to be a correlation between when gas prices started going down. So perhaps having a few extra pennies in their pockets to buy this affordable luxury, if you will. As it relates to Travel Retail business, we've actually had mixed results there. I think we're seeing parts of the world doing very well, but places over in Europe, largely around Russia, our European operations because of the disruption going on in that part of the world and the number of consumers from Russia, actually, is a large percentage that actually purchased in the European market has been a little bit lighter than we would have hoped for. And so – but we have seen some good – in certain parts – certain travel

retail markets around the world. And I hope that's due to gas prices and more affordable. But it's hard to say, tell you, with FX and who – where people are coming from and how that may be way more than offsetting gas prices other than the consumers in the U.S., I think is probably a larger trend to pay attention to.

### **Paul Varga**

Yes, as it relates to the U.S. market, I don't – I mean I don't have any specific data on this, but I do know anecdotally that we might even have stronger on-premise U.S. numbers if – particularly European tourism wasn't being hit by the strong dollar. I mean, I feel – we've heard restaurants and we know from hotels and places like that, that they're not as buoyant as they were 6 or 8 months ago. So I mean, those are – all these things have offsets to each other as you go around the world for Brown-Forman. It's one of the benefits that we accrue for having such nice geographic diversity. But I think net-net for our business around the world, the low gas prices are help net-net, and of course they should be help – particularly if they stay down for quite some time, they would be a help to you, you'd expect, like fuel cost and energy and things like that. They will make their way in. And – but on the flip side, what ends up happening is for a company like us, you end up having negative foreign exchange impact with. So – and these things offset each other in some ways partially or not. But I will say this, we do spend some time looking at what foreign exchange rate indices look like. And I mean, I would note that I think that the last time we looked at it, the current index is the dollar is stronger than its sort of 20-year average, and it always fluctuates above and below that average, of course. But this would be a particular time of strength. So for those who are thinking about how much more will this run or how long, if you believe history at all, the U.S. dollar is at a stronger point than its historical index would indicate.

### **Operator**

Your next question comes from the line of Ian Shackleton with Nomura.

**Ian Shackleton**

Two questions. Firstly, within the emerging markets, the commentary on Russia actually, it is more positive. Now I remember you had some specific issues in Russia. Are they all now resolved now? And the second question was around the Investor Day in December, you did talk quite a bit about scotch and Irish whiskey being attractive categories to go into. Is there any update you can provide us on that at this stage?

**Jane Morreau**

I can talk about Russia real quick. We are pleased with Russia in terms of the tone, and doing pretty well there. We had a net sales growth of around 6%, I think, year-to-date through 9 months. Of course it's being hurt by the devaluation of the ruble. But specifically, as it relates to our ability to sell our products and reach the consumers and have things been up there, if you will, we're very encouraged by what we've seen. And so like, we're able to sell our product in the marketplace at this point in time.

**Paul Varga**

Yes, Ian. And I think you are correct in your recall of our interest, particularly I'd say in the – at the ultra-premium, the super-premium-plus segments of those particular categories. I mean, no real news to update you on other to say that we remain as excited about that as we study those marketplaces and the continuing development of them. I mean, it's only been a couple of months since we saw in December so – I would say this, the only thing that might change is for a U.S.-based company if you can find attractive properties, and either one of those, it's even more attractive because of the currency as I mentioned. And you could tell probably from my initial comments that we really think – I highlighted American whiskey, but we really think the premium end of whiskey is a very attractive place to play. I mean amongst the most that you can really kind of – to be quite honest with you, not only within our industry, I just think it's enormously attractive and valuable business when you contrast it to many other industry. So you want to find the

most attractive and advisable investments you can make there. So we are scanning that as we – as you would expect us to.

**Ian Shackleton**

So just going back in Russia because there was some sort of a boycott there by – has it all gone away, if I recall it correctly?

**Jane Morreau**

A boycott on our products? Is that what you're saying?

**Ian Shackleton**

Yes.

**Paul Varga**

We had some administrative labeling things in a particular region of Russia that temporarily disrupted our sales into accounts there on Tennessee Honey. And it was just – so it was a very small part of Brown-Forman's total Russia business. And there's been some, I think, generally positive administrative development on that front. So I would say things as it relates to probably the larger question on Russia for us is just the impact of all of this on their economy more so than what we would declare as any kind of administrative problems or trade restrictions, those kinds of things. Truly right now more the impact on the economy.

**Operator**

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

**Stephanie Benjamin**

This is actually Stephanie, in for Bill. My question has to do with advertising and if you could provide either on a reported or underlying perspective more details on what you expect next quarter, particularly with the launch of Tennessee Fire. And then just kind of

going off of that, what do you expect in terms of kind of – or what you're seeing with your competitive – your competitors in terms of what they're doing for advertising?

**Jane Morreau**

Okay. So we are spending – we're, as you know, we're at 4% year-to-date underlying increase in net sales. We are going to expand to launch the brand quite nicely in the fourth quarter. So I would expect that number to tick up a little bit, up from where we are on a year-to-date basis. So by the end of the year, the number will be more than 4%. I hope that answers that question. And then your other question around competitors and I – we're not – I can't really answer all the questions there in terms of what they're doing. They definitely vary by market, varies by brand.

**Paul Varga**

I looked at a weighted average of our competition. We sometimes do try to study the difference between maybe their sales growth rate and their operating income growth rate as a guide. It looks to me like they – because they're – most of the industry when you look at it is growing a very low organic growth rate. And then when you translate, at least the way they're guiding as an operating income or EBITDA growth rate, it might just be a little bit higher. So that it would appear to me that somewhere, I can't be specific to advertising, but somewhere between advertising and SG&A investment, they might be getting 1 point or maybe 0.2 of leverage from whatever they have reported or whatever they're guiding on sales. So a little bit of leverage, but I can't imagine that people are in very strong investment mode or else it will be showing up with a diminishment to operating income versus an increase. And so if you think about us, I mean, our fiscal year-to-date results, we've got a 5% underlying growth rate and to date, a 7% operating income growth rate, so about 2 points of leverage between sales and operating income, which is a little less than in some years in the past because we've been investing particularly in this brand's rollout of the company over the last year. But I mean that – in the way we're

sort of guiding for the end of the fiscal year, that relationship sort of stays the same as you - even though we got the soft comps and we expect a strong Q4, the relationships stays the same. So we're - it would be my guess that we're investing today at the operating investment line ahead of most of the competition based on what I see from their numbers versus ours.

### **Operator**

Your next question comes from the line of Eric Serotta with Evercore ISI.

### **Eric Serotta**

Two questions. First, last quarter, you highlighted some distributor inventory overhang that was still left from, I guess, going back in the first quarter in the U.S. and Germany. What was the impact of that reduction in the third quarter? And is that all behind us? And then the second question is in terms of how we should think about U.S. pricing going forward. Clearly this year was one of much more constrained pricing in the U.S. following several years of robust pricing. I know you're not giving fiscal '16 guidance yet, but conceptually, should we think about next year looking more like this year? Or more like previous years? Somewhere in between? Any help would be greatly appreciated.

### **Jane Morreau**

Okay. I'll talk to the distributor inventory for Germany as well as the U.S. It is behind us, largely came through in the third quarter. I think we had isolated about a point of impact when we talked about it in the second quarter in terms of what it was impacting our overall results. Tell me how you get to the third quarter because you've got another quarter end, like, it was less than that on the quarter in terms of the overall impact of our growth, okay?

### **Paul Varga**

Yes. And I mean, just on pricing, I mean, we'll guide more specifically what our expec-

tations are by the time we get out to our Q4 release and setting expectations for F '16. But I mean, I think one thing that would certainly be running through all of our minds is in where our core concentration is, which is more of the premium end of a category that has outstanding volume metric momentum right now. And I just really believe that you can be less aggressive with pricing when you're getting the sort of consumer interest and acceptance in bourbon and American whiskey like we're seeing. The high end of this category is growing, I mean, strong double-digit. I mean the overall category is growing in the high single digits in the United States. And so I mean, I think – of course all these will vary by region and country around the world as we go along. But I think it was the right move for the company with the momentum and sort of enthusiasm we were seeing around the category volumetrically to sort of have, as you say, constrained the pricing progress in the way that we did in the last year and they think we're benefiting from it. So we'll be looking at that here over the next 8 weeks or so as we set our plan and give you more information on it specifically when we get into F '16 guidance.

### **Operator**

Your next question comes from the line of Bill Schmitz with Deutsche Bank.

### **William Schmitz**

I'll also try to be quick here. Can we just talk about pricing on 2 fronts? The first is emerging markets. When we have to take pricing in places like Russia and some of the other markets there where currencies has been such a big impact and – do you expect any big pre-buying ahead of those price increases and maybe directionally how high they are? And then I just have a follow-up on how you price Tennessee Fire relative to Fireball.

### **Jane Morreau**

So talk about emerging markets. First off, I want to step back for a moment. Because FX is hurting us, it doesn't necessarily mean that we're going to take the price up to the

consumer and the market. So it's something that we look at on a market-by-market basis. So I wanted to make sure that that was clear. We aren't going to jerk our prices up and down as FX goes up and down.

### **William Schmitz**

So you're not going to offset, even in Russia where you have like a 50% devaluation?

### **Jane Morreau**

Now Russia is an unusual one because it has been so significant for sure. Again, we look at these on a case-by-case basis. And we have already been through a price increase there. And talk about buying some stuff to move our needle, there wasn't. There hasn't been anything to move the needle that would warrant you to put something in your model as to replace the — *indiscernible* —

### **Paul Varga**

Yes, and remember look not only at the – at what the currency is doing in those instances, but you're really are also looking at what your competition is in the marketplace is doing. So as you can imagine, that's a pretty dynamic consideration. But it's rare for us. I mean it's sort of rare for the currency to move like this as rapidly as it has in Russia. But it's unusual for us, as Jane was citing, for us to start to make pricing moves based particularly on more moderate fluctuations in currency. And then your same question related to Tennessee Fire pricing philosophy.

### **William Schmitz**

Yes, like relative to Fireball. I probably should know this, but I don't think Fireball advertises at all. So I mean, when you guys go out, you have roughly 100% share of voice when you launch this thing and kind of what kind of advertising you're going to do and how are you going to build trial.

## **Paul Varga**

Well, it depends on how you define advertising. Yes I would say that they have an enormous presence in social media, and I today consider that very much advertising. So I mean if you're talking about television advertising on cable networks or whatever, I haven't observed any. But to the gist of your question, I think, first and foremost, we price Jack Daniel's Tennessee Fire off of Jack Daniel's Tennessee Whiskey. I mean that is the foremost consideration in our price positioning for that for a variety of what I consider to be very good reasons. No we're not ignorant of where the marketplace falls out in terms of pricing and volume metrics and all that. We really wanted to enter this category as the premium, in this case, super-premium entrant in the cinnamon flavor segment. And I consider that to be a pretty important part of our marketing program and something that I know our people consider very important that they'll stick to. And so far what we've seen and our experience on Tennessee Honey with this, where they are today lower-priced competitors and have been, is that those prices have held up very well. And just to let you know, we have no internal designs or ambitions to do anything volume metrically that would compromise that price. I mean, we're not setting some internal ambition to be the #1 brand by volume or anything else. It's really to build a responsible business that super-premium and of this particular opportunity and to, along the way, be really responsible in the way we manage the Jack Daniel's trademark. So – and actually I just think our people have demonstrated the capacity to do that so well that we really don't worry about it that much. The better thing for us to focus on is these early stages of distribution in creating the awareness. And I would tell you that I don't know we were still sort of refining how we'll communicate on behalf of Jack Daniel's Tennessee Fire over this first year of its national launch. But I would expect social media, just because of the importance of it to the brand's target audience but also just Jack Daniel's prominence as a trademark in social media to be very important to Tennessee Fire as well.

## **Operator**

Your final question comes from the line of Mark Swartzberg with Stifel Financial.

**Mark Swartzberg**

Quick technical one on the quarter and I see one on the revenue outlook. On the quarter, did I hear you, Jane, say – I don't think I heard you right, you're saying FX you think that means EPS will actually be down in the fourth quarter? And then like I said that I have actually revenue questions.

**Jane Morreau**

Yes. Just to clarify, the FX will hurt us in the fourth quarter so it will result in our reported numbers from underlying because we – I said we would be up on an underlying basis in the teens and I'm saying I don't know if it – we won't be up as strongly on a reported basis is what I was implying because of FX.

**Mark Swartzberg**

Right. Okay. You didn't say reported down. Okay. Great. Just needed to clarify that. And then on the revenue outlook, I guess a few things. Just firstly, Paul, with ad spend and its lagging sales year-to-date. Can you just update us on how that relationship you think works for the full year and from a longer-term perspective? And then with the quarter itself, you're looking for pretty healthy acceleration size going to contribute to that, I think 9 as the minimum number that it was for your rate of growth. Can you just talk about how you think about trade inventory in the U.S. specifically, what your attitude towards them potentially increasing it, putting aside the effect of Fire. I guess those are my 2 revenue-related questions.

**Paul Varga**

Okay. I mean, it's just – I guess, I answer the second question first. As we said earlier in the call, we expect our inventory, particularly if you include Fire at retail to be very much in line with our historical basis inventory around the globe. So no excessive building or

diminishment either way. So I think it's a sort of normal course there. I would say on that point, I mean, it's always a swing factor as to how well received in the first sort of 60 days here so of Tennessee Fire's national launch. How much – just the amount of distribution we expect that to be pretty rapid because the trade enthusiasm is so high, but also then it always comes down to how much display activity and promotional activity you'd get around that. So that's – you hope for a nice piece of that and you would expect that the enthusiasm to convert to that. But that's a harder one for us to predict as it relates to what the April 30 retail inventories will be on a really new brand. So I hope that helps you understand how we're approaching it, otherwise, beyond the Tennessee Fire, we expect to be pretty normal course as it relates to days of inventory at retail in there. And your first question related to – I'm just going to repeat it, make sure I got it right because we had a little bit of a broken communication here. I just wanted to see if there's a relationship between the way we think either historically or philosophically on A&P investment as a percentage of sale, is that – I'm reading that right?

### **Mark Swartzberg**

Yes, basically. Like last fiscal year, you grew faster in sales. This fiscal year, it's not sales, slightly, which is how you're thinking about it going forward.

### **Paul Varga**

Going forward, I mean, look, I think – here's the way we've been and we've talked about this over the last couple of years, I mean, I really feel like we've spent a significant level of reinvestment in the business over the last 36 months and it's come in 3 forms really. It's been A&P, what I would consider to be – because our results have warranted it and the A&P in fact had supported it, has been ahead of our competition. And in some instances, you always have pockets where you have an opportunity to invest more, one example being behind Jack Daniel's Black Label this past year in the United States. We helped our investment there. So there's always pockets but – and we were – also at the same time

and I would highlight this last 18 months or so, as it relates to France and the investment in route-to-market and before that, we were investing in Germany and Turkey and all kinds of places we were adding at the SG&A line. And the third area, which didn't show up in the P&L as much right now, is the capital investments we've been making to get the company ready for the growth we foresee out many, many years into the future. So – and those have been investments Woodford, Jack Daniel's, Fire, even the Sonoma-Cutrer. I mean, so we've had a string of capital investments that's been continuing most significantly. Cooperage as well as we are one only billed operator of manufacturers and operators. So there's not a wave here of investment. And still with that, we've been able to get nice leverage across the many years. And so I continue to expect – I really do feel like we're at a point where – particularly some of the SG&A that we can start to leverage some of the investments we've made in particularly the route-to-market around the world, I mean, I, over long periods of time, like to see generally A&P – it doesn't – I don't – I'm not worried about it in 1 particular quarter or year per se to track along with sales. I mean, I just think it's a nice thing. It all depends on the brand-building model. And I do think social media will make it more efficient, not less efficient, to actually invest over time. But I would expect after many, many years of very systematic and continuous investment that the company should still be able, from sales to operating income, to be able to get a little leverage. I mean there were times in our history – I mean, I know way back where there was very little leverage. It was up and down the P&L the same number, and in terms of growth rate. But I really do feel like, this will vary by what time you're operating in, too, and how the economies are and everything else. But as we stand right now, I mean, I think we cited was we're 5% growth right now converted to 7% and investing nicely behind the business. And we see that elevating by year-end because of the soft comps and the things that we cited. But as you go out, I mean, I feel like we would be gaining share of voice with mid-single digit even, a growth rate in A&P compared to our competition right now. I mean, that's my take.

## **Mark Swartzberg**

That's a great comparison to. If I could just one last – on your comments on U.S. pricing I find very interesting because you enjoy premium positioning in your various points versus the nearest competition. And you also enjoy volume momentum. So that seems to favor being more – seeking more rates of price growth not only to strengthen your position of your brands, but to kind of be a – it's a time to do it if your volumes are doing well, yet you're saying you want to have, like, comparatively the higher focus on maintaining volume on that. So could you just talk a little bit about why – does it have to do with the inventory you've already got to sort of ready to come on stream. Can you just talk a little bit about why you have that attitude because it seems you can make the opposite argument for – to be more disciplined on price.

## **Paul Varga**

You absolutely can make the opposite argument, depending upon how you approach it. But I'll give you the example here. And we do know – look, with aged products, a dollar a pricing is more valuable mathematically if you look at it than perhaps a dollar or volume. But in an expanding category where people are fighting for consumption occasions and consumers, you don't want to lose some of these consumers because we have found people who adopt and fall in love with the brand will actually continue some of that consumption. And so it can be a more costly later to try to get it. And – but I give you the example of here we've got a Woodford Reserve, just take that as an example. And let's say you – I mean, the brand's gone 25% or 30%, I guess, we could consider that – just taking your example to a specific thing to consider here is I guess we could take our prices up on Woodford Reserve 10% or 12%. And so over the same dollars through a lower growth rate, I mean, you could do the math on that. But I feel like for brands at an early stage of development, introducing the brand, you're still at relatively low levels of awareness and adoption to introduce the brand to consumers and at lower prices, not that we're lowering price, I mean even at 25% or 30% growth rate, we might be taking 2% or 3%

price increase. So it's not like we're not taking pricing. It's just that you're delivering – the volume metrics are a reflection of the adoption of consumerism around the brand. And if you've already started, in this case with Woodford and ultra-premium price position, I mean, if you had a significant shortage in your stocks or something, sure, you could do a supply-demand trade-off there and you might find yourself in those circumstances if your forecasts weren't particularly accurate. But that's not the case with us. And so I mean, I think introducing 30% more occasions or consumers to the base of Woodford Reserve is today on balance better than asking the current base to pay 15% higher prices and only attracting 10% or 15% people. I mean, that's just a trade-off. You can definitely make the other argument. But at this stage of development with this base of awareness and distribution on a brand like that, I would favor the way we're doing it.

**Jason Koval**

Thanks for that question, Mark, and thanks, Paul and Jane. Thanks to all of you for joining us today for Brown-Forman's third quarter earnings call, and we hope you all have a great week.

**Paul Varga**

Thanks, everyone.

**Jane Morreau**

Thanks.

**Operator**

Again, thank you for your participation. This concludes today's call. You may now disconnect.