# Brown-Forman Corporation, Q3 2012, Earnings Call 2012-03-07

## Presentation

### Operator

Good morning. My name is Kathy, and I will be your conference operator today. At this time, I would like to welcome everyone to the Third Quarter Fiscal 2012 Conference Call. — ***Operator Instructions*** — I would now like to turn the call over to Mr. Mark Stegeman, Interim Director of Investor Relations. Sir, you may begin.

### Mark Stegeman

Thank you, Kathy. Good morning, everyone, and thank you for joining us for Brown-Forman's Fiscal 2012 Third Quarter Earnings Call. This is Mark Stegeman, Brown-Forman's Interim Director of Investor Relations. Joining me today on the call are Paul Varga, our President and Chief Executive Officer; Don Berg, Executive Vice President and Chief Financial Officer; and Jane Morreau, Senior Vice President and Director of Finance Management, Accounting and Technology.

Don will begin our call this morning with some thoughts on our performance and a few other topics of interest. Paul will then provide some additional remarks, and then we will open the call up for your questions.

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 fiscal 2012 third quarter. 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 Don.

**Donald Berg**

Thanks, Mark. Good morning, everyone. With our third quarter earnings release this morning, I thought I'd spend some time addressing a number of topics. Let me start with a 30,000 foot summary of our third quarter and year-to-date results. Then I'll talk some about our gross margin and the pricing environment. Following that, I'll highlight some of our portfolio and geographic performances, and then lastly, I'll talk a bit about how we are thinking about the balance of our fiscal year.

So starting with our third quarter results. We are pleased with the quarter's continuation of year-to-date high single-digit underlying growth in net sales and operating income and the acceleration compared to last year. So far, this fiscal year, underlying net sales has grown 8% compared to 4% last year, and underlying operating income has also grown 8% compared to 4% during the same time period in fiscal '11.

Furthermore, we are also pleased that our year-to-date performance has essentially met our expectations and has continued to play out as we had outlined with our guidance at the beginning of this fiscal year.

Now let me talk for a bit about our gross margins and the slight erosion to margin that we have experienced in the last couple of quarters. Historically, our top line growth has come from a balance of price increases and volume gains. There have been times when price was the dominant driver of our net sales growth, improving our gross margin. But in the recent few years, during and following the global recession, a number of factors skewed our top line performance towards being essentially all volume driven.

First, as you'll recall, the consumer shifted their consumption to the off-premise, which is typically a more price-sensitive channel. Further, we were concerned about our consumers' ability to buy premium brands. And finally, price competition intensified. Given the overall economic environment, we took very little price increase, absorbing higher input costs and at times, excise tax increases.

Today, the global economy, while a bit firmer, continues to experience a very fragmented recovery, and in some economies, continues to struggle. However, in some markets, the competitive pricing environment seems to have abated somewhat, and we have seen some return to trading up to premium and super premium brands.

So as we think about pricing, there are really 3 key components we are thinking about: first, recapture a portion of the increase in the input costs of grain, glass and fuel costs; second, we believe for the positioning of a premium brand, price is a key component; and lastly, there is the delicate act of using price to help balance supply and demand, particularly as it relates to aged products.

Considering all of these factors, last quarter, we mentioned that we think the timing is becoming more favorable to reinstate price increases more in line with historical levels. During the third quarter, we initiated a frontline price increase in France in conjunction with an excise tax increase. And we are in the process of taking a price increase in the important U.K. market on top of a tax increase there.

Looking forward, we will proactively look for opportunities to take price increases in most markets over the coming fiscal year and across most of our brands. While we don't anticipate a lot of pricing improvement for the rest of this fiscal year, we are optimistic about the potential opportunity in fiscal '13. We plan to talk about this more with our year end conference call in early June, when we lay out in greater detail our expectations for fiscal '13.

Moving along to our portfolio and geographic performances, let me start with a few comments about our A&P spending. As we have spoken about in the past, a few years ago, we shifted some of our brand investments outside of what gets traditionally reported as A&P, to things like packaging, promotional activities, value-added products, raw to consumer changes, as well as product development expenses related to ready-to-pour products, RTDs, new in-line extensions and new product innovations.

All to capture consumers with convenience and great tasting products where they were buying in the off-premise. Our investment has continued to be reflected in other lines in the P&L besides A&P, but this fiscal year-to-date, we have also invested more in our brands, resulting in a higher increase in our underlying A&P as we reallocated some funds to more traditional media and to capitalize on trends with social media.

We also saw a significant increase in spend levels in support of a number of product introductions, including Tennessee Honey. So through January, our underlying growth in A&P spend year-to-date is almost triple last year's. Given the sizable upfront investment in A&P to launch Jack Daniel's Tennessee Honey, both at the end of last fiscal year and during the beginning of this fiscal year, we expect full year underlying A&P to moderate significantly over the balance of the fiscal year, with the fourth quarter expected to be essentially flat compared to the same period last year.

Continuing the discussion of our portfolio. Both Jack Daniel's family of brands and Finlandia's family experienced double-digit net sales increases on a constant currency basis for the 9 months, while the Southern Comfort family declined in mid-single digits, a slight improvement compared to the first half.

In many ways, Southern Comfort was the first flavored American whiskey and it remains a very important brand for us. According to recent U.S. Nielsen results, on a 3-month basis through February 4, Southern Comfort commands about 1/2 of the value in volume when combining all of the top flavored whiskeys. We are progressing in reinvigorating this brand with new communications, along with flavor extensions, including SoCo Lime and SoCo Fiery Pepper, and we are now introducing Cherry in the U.K. in the fourth quarter.

The good news is that flavored whiskeys continue to explode in the U.S., fueled by Jack Daniel's Tennessee Honey. We are firming up our plans to expand Tennessee Honey into several international markets in fiscal '13, including the U.K., South Africa and Australia.

While we will be cycling against the U.S. brand launch and pipeline fill in this year's fourth quarter and at the beginning of next fiscal year, we believe opportunities still remain to build Jack Daniel's Tennessee Honey velocity in both the off-premise and on-premise markets in the U.S.

Our super premium brands also continue to perform very well globally, with Gentleman Jack, Herradura, Woodford Reserve and Jack Daniel's Single Barrel all increasing, year-to-date, constant currency net sales at double-digit rates. In the U.S., our super premium wine brand, Sonoma-Cutrer, also continued to expand.

New brand and marketing innovation investments continued this quarter as we launched the product line of Little Black Dress vodkas. We retained the Little Black Dress trademark for spirits when we sold the Hopland-based wine brands last year. Little Black Dress vodkas were developed by women for women and deliver several flavorful products, primarily targeted to calorie-conscious consumers.

A couple of other examples of recently launched innovative brand extensions include, in Germany, Jack Daniel's introduced Winter Jack, a Tennessee Apple whiskey punch, a seasonal ready-to-pour Jack Daniel's with the taste of apple, cinnamon and cloves. In addition, building on the brand equity that Finlandia Vodka has built in Poland, we recently launched a new line extension, Finlandia Spice, to play in the spice vodka arena, where we previously did not participate.

Shifting gears to our international markets, where we continue to make broad-based progress. Looking at the 9-month constant currency net sales for our top 30 markets, once again, over 1/2 of them grew at double-digit rates. The brands that have been resonating internationally and also grew constant currency net sales double digits for the 9 months, were Jack Daniel's Tennessee Whiskey, Finlandia, Herradura, Gentleman Jack, Jack Daniel's Single Barrel, Early Times and Woodford Reserve.

Now let's spend a minute talking about Europe and our larger markets there in terms of fiscal year-to-date constant currency net sales. Unlike many of our competitors, particularly with respect to Jack Daniel's, we have been seeing positive results in Northern Europe. For both the quarter and year-to-date, the U.K. was up mid to high single-digits, with Germany and France both up double digits. Some of our super premium brands also grew in these markets, although on a small base. We have continued to invest in European markets, which have remained a growth vehicle for our brands.

With respect to what we refer to as the emerging markets, which for us is a broad array of countries, we continue to record double-digit growth in year-to-date constant currency net sales through January in the majority of the emerging market countries where we do business. This would include France – I'm sorry, this would include Russia, Brazil, Turkey, Mexico and the Ukraine, just to name a few. All combined, emerging market countries grew year-to-date constant currency net sales, 16%.

Lastly, in the U.S., net sales on a constant currency basis for the year through January increased mid-single digits, led by the Jack Daniel's family of brands.

Finally, looking at our guidance for the full year, we confirmed our guidance and narrowed our EPS range to $3.50 to $3.65. As we look forward to our fourth quarter, we expect to see similar growth in the high single digits in our underlying net sales and operating income.

As a reminder, the fourth quarter reported numbers will be noticeably affected by the impact of last year's sale of Hopland-based wine brands. Last June, we pointed out that the reduction in profit from this business in fiscal '12 would reduce our EPS about $0.16 for the full fiscal year. We now expect this full year impact to be closer to $0.18 due to less-than-expected agency income on these brands for the transition. $0.14 of that $0.18 was in the first 3 quarters, and we anticipate there is around a $0.04 impact remaining to go for the balance of the fiscal year. In addition to this, last year's reported fourth quarter benefited from a gain on the sale of that business of about $0.26 per share.

In terms of our foreign exchange exposure, considering our hedged positions and recent spot rates, we estimate that a 10% strengthening of the U.S. dollar would penalize EPS by about $0.01. On the other hand, if the dollar weakens by 10%, we expect it would benefit EPS also by about same $0.01.

Turning to some uses of cash. We intend to use some of our available cash balances to fully pay off the 5.2%, $250 million bond when it matures on April 1. In addition, we still anticipate capital expenditures to come in between $60 million to $70 million in the year, slightly lower than we thought last quarter due to some timing differences.

So to summarize, we are pleased with our consistent story of accelerating underlying sales led by Jack Daniel's. We've invested in new products and line extensions, made investments in A&P across the portfolio of brands and made progress in growing our international distribution. All of these factors are expected to help drive continued high single-digit underlying operating income growth, in line with our plan, our guidance for this fiscal year.

So with that, let me turn the call over to Paul.

**Paul Varga**

Hi, everyone. And I'll just add a couple of comments to what Don has already said. The first point relates to the significance of the Jack Daniel's Tennessee Honey performance. It's of course exciting to have a brand extension accomplished what it has in the market-place in less than one year.

In addition to that, however, it has played the very important role of being the impetus to Brown-Forman's improved performance in the United States, which is our most important country, and today, the industry's most valuable distilled spirits market.

Just one year ago, Brown-Forman and its 2 most important trademarks, Jack Daniel's and Southern Comfort, were all losing share and struggling to grow in the United States. To-day, the company and the Jack Daniel's trademark are both growing nicely and gaining share of their relevant competitive segments.

These gains have been driven by the Jack Daniel's Tennessee Honey introduction and success, but importantly, the Tennessee Honey's success has not come at the expense of either Jack Daniel’s or Southern Comfort. In fact, from what we’ve observed, thus far, the parent Jack Daniel’s brand has performed slightly better in the United States since the introduction of Honey, as we believe this line extension has provided what we sometimes call a positive halo effect for the trademark.

And while Southern Comfort has not yet returned to growth, we believe this trademark’s performance has also improved in the U.S. since the introduction of the Jack Daniel’s Tennessee Honey brand. This is noteworthy as we were naturally anxious to see if Honey’s success would come at the direct expense of Southern Comfort, which has long been one of the leading brands in this category referred to as either flavored brown spirits or flavored whiskey.

To date, this has not been the case, as the parent Southern Comfort performance in the U.S. has been essentially unchanged since Honey’s introduction and the trademark’s overall performance is, in fact, improved due to the introductions of Lime and Fiery Pepper.

As a result of all of this, our company has grown and gained share in the U.S. over the last year, and today, we have a strong leadership position with 2 trademarks in one of the most exciting growth segments of the world’s most valuable distilled spirits market. This is important progress, and I’d like to publicly congratulate the many people of Brown-Forman who have led and contributed to it.

In addition to the successful launch of Tennessee Honey in the U.S., the accelerated and impressive global growth of Jack Daniel’s, in both developed and emerging international markets, has been the driver of this year’s accelerated growth and underlying net sales, gross profit and operating income versus what we experienced for the full-fiscal year 2011.

Importantly, our company’s year-to-date growth and underlying operating income of 8% approximates our historical high single-digit, long-term growth rate on the same measure. We find the return of the company's underlying growth rate to this level to be very encouraging for the future.

And looking ahead a bit, we will remain focused on further improving Southern Comfort's performance and continuing the company momentum we've created this fiscal year, which includes the continued growth of our super premium brands and the recent improved trajectory of Finlandia's performance.

And as Don mentioned, the planned further expansion of Jack Daniel's Tennessee Honey, both within the U.S. and into new international markets, and the improving pricing posture across our company, are additional encouraging signs as we finish up fiscal year '12 and finalize our plans for FY '13 and beyond.

Thanks. That's all for our prepared commentary, and now we're happy to take any questions.

**Question and Answer**

**Operator**

— ***Operator Instructions*** — Your first question comes from the line of Kaumil Gajrawala with UBS.

**Kaumil Gajrawala**

Just on the splits for advertising, Don, that you spoke about, should we then assume that you're happy with how you report the numbers on advertising as a percentage of sales? That number, going from $13 million to about $11 million over the last few years. Is $11 million the right number given the reclassifications that we should be thinking about over the long run?

**Donald Berg**

I think – one thing. What we talked about, quite a bit, over the last couple of years, is just how much we really want it to stay flexible in how we use our A&P and to make sure that we're being responsive to what's going on in the environment. I think as we move towards taking more price increases, one of the things that we think about and all of that is, as we think about our A&P and supporting our brands and supporting those price increases, oftentimes, you'll look at shifting your mix more towards pull-type marketing efforts rather than push. And the more you get into the pull type, the more you're driving more expense through kind of what goes through that traditional A&P line. And so, yes, I mean, I would expect that we'll probably be seeing more – some more increases going in that way. But all in all, I think we feel pretty comfortable about the balance that we've got right now in terms of the investment behind our brands generally. What you might just see is a little bit more mix shifting going on more towards kind of the pull versus the push. And Paul if you want to add…?

**Paul Varga**

Yes, I think we're still firming up a lot of our F'13 spending priorities, which will have an influence on that. But I think Don is directionally correct on it that we frequently will move, depending upon what we see the best opportunities, between, monies between things that reside in cost of sales or in discounts to A&P and back if we think it can be impactful. So the – probably the prevailing theme that Don mentioned in his comments about the pricing environment, we could see advertising – the advertising as percentage of sales fluctuate a little bit based on what – where we allocate our investment.

**Kaumil Gajrawala**

Got it. And then also on pricing, you've now taken pricing in a variety of markets. In some markets, you've – I guess, the price to consumers gone up significantly more than you in your price increases because of excise taxes. Could you give us a read on how well it's sticking, what the consumer response has been so far? And I guess you may need to go region by region on that, but overall, maybe for the United States, then maybe for Western Europe?

**Donald Berg**

Yes, I mean, in the U.S., I mean, pricing, for the most part, has been fairly flat in the U.S. We've seen some – we've seen some occasional mix improvements here and there. But for the most part, on average, our pricing has been pretty flat. In the 2 markets that I identified today, both with France and the U.K., it's really just too early to tell yet. With the buy-ins and everything, it usually takes about a month or 2 for everything to kind of make its way through the marketplace before you can really get a good, strong read on kind of what's happening. I mean, I would say, generally, to the extent that we've seen excise tax increases, which we've been seeing in a number of markets for the last couple of years, and in some markets, like Australia, for example, I mean, they automatically take excise tax increases every year. In fact, there they take it twice a year. We've generally seen not that large of an impact in terms of the health of our industry and our business overall. And so to that extent, it would appear that consumers have been able to absorb it. There have been some markets where we haven't been able to pass them on because it wouldn't stick. It ends up being kind of a market to market situation, but overall, when you kind of look at how the industry is doing generally, it continues to grow and do pretty well on a global basis.

**Paul Varga**

There's a real difference, too, between tax-related increases and prices where the whole market goes up. And it has a real different effect, we've observed. And I think that will vary from market to market, which is different a little bit than just the conscious decision to take your prices up based on a desire for a premium price position or the input costs that you've been absorbing. So they're very different in those circumstances, in terms of the impact. I would say it varies – with the caveat that it varies brand by brand and market by market, our experience as a company is that it's been typically, on a historical – looking at our history, a very positive financial decision when Brown-Forman has implemented price increases in an appropriate manner. I mean, implemented well, thought through in terms of all the components of size by size and market by market, and then typically supported well as well. So we don't anticipate they'd be any different this time, although you're still going to – I think we're going to be – need to be even more sharp than we historically have because of all the changing global economic conditions that exist out there and how they are prone to varying pretty quickly. So did that help you?

**Kaumil Gajrawala**

Yes, that's helpful. And then just a last very quick one. You gave us some guidance on distributor inventories and the expectations into this quarter. Are you happy with where they are now or is there potentially some further drawdown in 4Q?

**Donald Berg**

Yes. I mean, if you look at the earnings release that we put out there, we've provided a Schedule A which kind of gives a reconciliation between the reported and the underlying. And when you look there on a year-to-date basis, I mean, it basically shows that our distributor inventories are to date, pretty much in line with where we started out the fiscal year, which we're comfortable with at this juncture. And then when you look forward, these things have the tendency to vary a little bit, up or down, and a lot of it just depends upon what's happening in individual market places, and it's always kind of hard to sit here and to guess in advance what might happen. So there could be some fluctuations on this as we get into the fourth quarter. But at this juncture, we think that our inventories are pretty much in balance with where we started the year.

**Kaumil Gajrawala**

Yes. So you've worked off the pre-buy-in from last quarter? It sounds like it's generally been worked off, correct?

**Donald Berg**

Yes.

**Paul Varga**

Yes. I mean, we – there's nothing that we see at the end here at Q3 like we did see at Q2 that we've talked about, so certainly, better in balance. But that remains to be seen, of course, right?

**Operator**

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

**Judy Hong**

So just in terms of the Tennessee Honey, obviously, you guys, had a pretty successful launch. So as you're sort of lapping that into next year, can you give us some perspective on the opportunities within U.S. in terms of the increase in velocity that you're planning to have both on the on-premise and off-premise? And then maybe you can give us a little bit more color, just internationally, how you size up the opportunity for a product like Honey? And then over time, do you have a sense of how big sort of the flavor portion of the whiskey could get? Is it something that we could see getting as big as some of the other categories like vodka or rum or just the flavor portion is pretty sizable?

**Paul Varga**

Okay, let's see. I guess, I'll start with…

**Donald Berg**

Opportunities in the U.S.

**Paul Varga**

Yes.  The first one was sort of opportunities in the United States.  And I think that the main comment there is, while it has been a wonderful success, we believe, particularly because of things like the distribution in the marketplace doesn't occur overnight. It takes a while to phase that in, typically where you have to get authorization with whether it's chains or with control states, some of that, it doesn't just happen overnight. So we think that there was a more phased pipeline that we've built going in at the early stages of the fiscal year.  So – and then what we observed in terms of really the most dramatic difference in performance for our particular brand relative to what we're seeing from some of our competitors, is that we are skewed more to the off-premise and really have only scratched the surface, thus far, in the on-premise. So we think there's an opportunity both on on-premise distribution and velocity, and we think that there continues to be interest.  I mean, the one thing I would observe about not only – in our introduction, I commented a little bit about the impact it's having on other Brown-Forman brands, but we observed that this segment, in addition to what the volume we're contributing continues to grow, that a number of the competitors who were enjoying success before our entry are continuing to grow nicely.  And I just think those are indicative of a real significant growing interest by the trade and consumers for those offerings, of which we happen to be in a wonderful leadership position with our 2 trademarks. So that also tips a little bit to your last question, which is, where could this go? We frankly don't know. I mean, it's one of those things that we know that the interest in distilled spirits are very much so in the United States, but increasingly globally, whether it's on vodka and here, more recently, in this example with whiskeys, is skewing better very much to the variety that comes from flavors. People like them for their – I mean, just very interesting flavors and different flavors, but also the convenience oftentimes that comes in preparation of their drinks.  So we think there's a lot of growth here.  And if you just look at the long running success of flavors, as it related to, most notably, vodka, if it reflects any of the opportunity that might be there for the whiskey trademarks, it would be a real exciting thing for the industry. And Don, do you want to talk about the international piece, I think, that Judy was asking?

**Donald Berg**

Sure. On the international side, I mean, we've identified some of the markets that we're looking at for next year. We're continuing to look at where we think the best opportunities lie. I mean, part of it – part of what you look to is where – kind of where – what Paul was alluding to, those markets where consumers seeming to be interested in flavors and where you've been able to establish the brand fairly well. And so we've seen some interest in markets like Australia and Germany and South Africa and a lot of places where you see the RTD market working tends to give you some sense as to where flavors are kind of hitting a sweet spot with consumers. And so that's pretty much how we're looking at it. And we'll continue to look to see where we think opportunities – where there might be opportunities along those lines, continue to look for ways to go after them.

**Paul Varga**

Judy, I would add to that, that – I mean, one real fact, since the introduction of Tennessee Honey in the United States, the global demand for it or call for it has been ahead of our willingness and actual desire, to be honest, to fulfill that, simply because it's a Jack Daniel's trademark expression. And we really wanted to understand and learn how it's performing in the United States. As you can imagine, before we thought about any expansion plans. And as we sit here and prepare for FY '13, we're in a better position to sit and consolidate those ideas and plans, but it's been our experience throughout the course of this year that many international markets have had a demand for this ahead of our willingness to supply.

**Judy Hong**

So as you think about fiscal '13, obviously, you still have one more quarter to go, but given the improving trends than you'd see in Finlandia and maybe even SoCo and potential for pricing to accelerate in 2012, can we see sort of this high single digits underlying sales growth accelerate even further? Or is sort of the Tennessee Honey launch in fiscal '12 somewhat of a hurdle just in terms of the lapping?

**Paul Varga**

We'll confirm all of the guidance that's related to – I think you called it – I think you're referring to calendar year '12 with some of your comments there, but we'll be updating our FY '13 forecast and look when we speak with you all, I think, in early June when we report our Q4 and full year results. But what you mentioned there and what we've mentioned here this morning, certainly, our influence is to – as confirming our guidance and narrowing it here this morning. And so we're pretty much focused on that right now, the development of plans into the next fiscal year. And we're aware of the reality of introductory pipeline associated with Tennessee Honey. And we'll be – that will very much be considered as we've developed our plans for F'13. And it's just premature for us to be, I think, commenting on any of that because, frankly, we haven't finished up all our plans yet.

**Operator**

Your next question comes from the line of Lauren Torres with HSBC.

**Lauren Torres**

Just to follow up on some of your pricing comments. I'm just curious about timing. Why is next year the right time? I mean, is it because some of your cost pressures are getting tougher? Or is it because your competitors are taking pricing? And then with that said, just thinking about how consumers may react, just curious if you think some behavior is firming up, that you do think it's the right time just based on how the consumer is doing?

**Paul Varga**

Sure. I mean, it's a really a good question and one I suspect a lot of people are thinking about. I think there's 3 areas that we might think about: there's some general environmental things; there's some influences and considerations that, I think, are more specific to the industry in which we operate and then a few others, of course, that are more specific to our company and the brands that we own. On the general side, I mean, just using the U.S. as one surrogate for the environment, I mean, we think there's just a little bit better environment, whether it's the consumer confidence numbers you look at, or the job reports that come out. Also – there's always something that's a counter to that, whether it's higher fuel prices, but you're constantly looking at the macro environment to try to observe what is this changing nature and how does that prepare you, so we study that. We would, I think, in general, even though it varies all over the world, we would generally say it's a little better today than it would have been in the prior couple of years. Probably more importantly, are these things that are specific to our industry and our company. I mean, last call we talked a lot about the improving momentum in the United States and increasingly worldwide, for bourbon and the whiskey segment, generally. And given that we have a strong and leadership position in that, I think that bodes well for the industry or the company's, frankly in this case, ability to think about our improved pricing because the momentum happens to be there in a segment or category that's very important to us. We've observed, over the course of the time here, that the growth rates for premium and super premium price segments have continued to improve versus a couple of years ago, where they were much reduced growth rates compared to what we're seeing today, particularly in this U.S. market where the super premium segment is doing extremely well. And then something I think you noted that you always are looking at the competitive behavior to see if they are pricing down or up in some directional way that – and how that might influence you. And I think Don mentioned that we basically feel that, that environment is a little bit better today as well. And then I think, probably, the most important thing is those factors related to Brown-Forman. We noted in here, the strong momentum for Jack Daniel's in our super premium brands, the momentum the company has today versus a year ago. We have noted the higher costs, which are grain driven, but also, thinking something that helps us is that those also incorporate higher investments in packaging, which actually help you – help support some of the pricing plans you might have out in the marketplace. And then I think Don mentioned this, and it's just so important for a company like us, which is that you're always thinking, with these products that are aged, the balance of your – the value generation between volume and margin. And when you're laying down inventories for many years into the future, $1 of revenue generated from pricing is more valuable than that of volume, so you're always looking at the recipe for delivering value. And when it gets skewed one way or the other, I mean, you should take note. And sometimes that's appropriate. But in this case, we think that because of the environment, because of some of the margin pinch we've observed, we just think we're in a much better position today in the opportunities there to go out and get improved pricing. So that's probably the summary of all of it.

**Lauren Torres**

Yes. So taking all that in, I guess we should assume that looking into fiscal '13, we should see margin improvement as a result of this falling through?

**Paul Varga**

I mean, we'll be guiding that when we come out with F'13. But just as we said last quarter, we'll say it now, it certainly is our aim to shore up and improve our margins.

**Lauren Torres**

Okay, great. And just one follow-up too, you mentioned where we are with the inventories. Where are you with respect to promotional activity? Is that pretty much played through or we'll see more of that in the next quarter?

**Paul Varga**

Do you mean as it relates to – give me a little more information so I can help you with the answer to that.

**Lauren Torres**

Yes. I mean in the quarter, the third quarter, you mentioned the impact of the distributor level and also the promotional activity that was flowing through, the timing of promotional activity. I was curious, is that still flowing through your business or that was something that was more in your, maybe, second and third quarters of this year?

**Donald Berg**

Yes. Those comments, Lauren, were really more directed towards the promotional – the timing of promotional activities that we were seeing through the holiday period.

**Lauren Torres**

Okay. So that's done?

**Donald Berg**

Yes.

**Operator**

Your next question comes from the line of Tim Ramey with D.A. Davidson.

**Timothy Ramey**

As we think about the whiskey category, I'm winging it, but maybe it was growing 2%, 3%, 4% over the last couple of decades, and then seeing this tremendous acceleration. I guess the obvious question is supply and how well prepared do you believe you are as well as the category, and I know Beam takes a point of view that well, if we start running out, pricing will be the break. Do you have a comment on that?

**Paul Varga**

I mean, that's the – I mean, the comment that you referenced from Beam is anybody who's been in the aged business – the business as they're aged over any prolonged period of time, have always had both that challenge, but also that tool of trying to balance the pricing and volume. I mean, I think most – I think most companies – I can't speak for them specifically, but it's been my experience that if you're operating in a good industry, and particularly, with the brands that we have positioned at the premium price points, the economics of selling more of your product are so attractive that you always try to plan for that success. And so we always try to build that in as it relates – and of course, the only thing we know about this forecasting process is that it's always wrong. I mean, you can't, with precision, predict it. So you have to develop forecasting and cushion tools and all kinds of other things that help you, as a manufacturer and a brand builder, plan this. Yes, ultimately, pricing is one of the tools that can be deployed to help you with that. But I mean, if your question was about whether or not we anticipate the industry to be challenged on this front or our company, I mean, our plans right now don't anticipate it being a problem for Brown-Forman. I mean, we are sitting – more than anything, particularly with this report, we're excited about the kind of progress we're seeing. The additional actual sort of recent success through innovation has been a real help for the company. And then the other thing that we've got, which I think is a real help as being a company that has a portfolio of brands is to be able to go and where you are – have products that aren't in the aged business, which we always – oftentimes, refer to as our sort of rest of portfolio at Brown-Forman beyond Jack Daniel's. It's really exciting to go and have the opportunity to develop the vodkas or the liqueurs and try to accelerate those growth rates in tandem with the whiskeys. So – but I think we're – at least in our planning, we feel pretty good about where we are, and I just, more than anything, consider it one of the most exciting developments for the company and the industry just to see what's happening with this category overall.

**Timothy Ramey**

And if I could just ask a granular question about the fourth quarter. Should we assume any discontinuity on executive compensation or bonus accruals in the fourth quarter, given a flattish kind of year or sort of hold the course on that?

**Donald Berg**

Yes. I'd tell you, too, the way I think about that I mean, to the – based upon our performance through this third quarter, all those accruals have been made. I mean, it depends on how the fourth quarter ends up coming out, that will determine kind of what the final accruals end up being.

**Paul Varga**

We hope we have to surprise you positively with that.

**Timothy Ramey**

To the upside, you're saying?

**Paul Varga**

Yes, sure.

**Timothy Ramey**

Okay. And then just – if you said this and I missed it, I apologize. But is there – are you seeing a halo effect from Tennessee on the core business? I assume you are, to some degree, but it'd be nice to know kind of if the growth is more broad based then.

**Paul Varga**

Yes. I mean, that's what I tried to reference in a couple of my comments. I mean, of course, the first thing you look for are the signs of cannibalization, and you study that close, and in fact, then you see that it's the opposite of that, that you actually get little boosts of momentum. And of course, you can never attribute this stuff so directly to one brand's introduction, and how much of a halo effect it's contributing to any improvement you might note in the parent brand. There's a fair amount of guesswork in that. But at a minimum, you start with the prospect that these always have the potential to cannibalize or to actually take something away from the brand. And I can say with confidence that Tennessee Honey has largely, not only on its own merits, but also very much helped the trademark. And if anything, we see an improved position to the Jack Daniel's brand, parent brand, in the U.S. market today. And I also mentioned that we were concerned that it would directly impact Southern Comfort, just given the size and position Southern Comfort has in the U.S. market. And to date, that's holding up really well, too.

**Operator**

Your next question comes from the line of Ann Gurkin with Davenport.

**Ann Gurkin**

I wanted to start with your comments about expanding overseas and how you see expanding that distribution, is it through joint ventures, internally developed networks? Can you just give me an update as to where we are with that distribution plan?

**Paul Varga**

Are you talking about in the expansion overseas just generally, not necessarily for Tennessee Honey?

**Ann Gurkin**

In general, yes.

**Paul Varga**

Yes, okay. I mean, we are in the process this year – I mean, it's a little bit in our results, but most of the major route to consumer and distribution changes in recent years here, we had a handful of them that occurred last year. And because they were staged at different times of the year and the transitions take a little bit longer, they will affect your year-over-year comps. Russia is one that comes to mind in that regard this year. But in terms of activity, there's a few, but there are – that we would call them more ongoing regular things that are just good improvements that – probably, the most significant one was the January launch of our own company in Turkey that we talked about, I think, a couple of times prior. That was probably the biggest singular change this year. But last year, we had Germany and Russia, Brazil, I think, Canada phased at a certain point. So there's less activity this year on that front. But they've continued a long-term trend and – that we think is important. Where we just can be appropriately influential over our business for the plans we have developed. Sometimes, that's in partnerships, sometimes, we have the opportunity to go out and work on our own and capture some of the full margins and actually the costs associated with that. But it continues to be a hybrid model all over the world, and we're always looking at that.

**Ann Gurkin**

Right. And then Paul, be interested in your comments or opinion on, do you think the global spirits industry is ready for another round of consolidation, kind of what do you think could happen there?

**Paul Varga**

Well, I just – In general, since I don't know what the last sort of round was. It's oftentimes – I mean, there's periodically acquisitions and mergers in this industry. It's a very attractive industry. But I don't see it as buoyant in our industry as when you compare it to a bunch of other industries where this stuff is very, very frequent. And – but I mean, it'd be hard for me to predict where the industry on that particular front is going to hit. To be quite honest, we'd pretty much got our heads down, building the business organically and have the benefit of an ownership structure that really has a long-term view on this business. And we try to put that to use each and every day in the marketplace. So…

**Ann Gurkin**

Great. And then finally on – may I just get an update on your outlook for the tequila category and your plans there for this year – calendar year?

**Paul Varga**

Yes, it's a bit of a mixed picture through the first 9 months. I mean, actually, the Herradura brand has seen some nice sales improvement going back almost a year now or so. And well, in el Jimador, it's a bit mixed by country because it's been much more competitive in the U.S. market. There's been a lot of competitive activities, that 100% agave level at lower price points, so it's made it competitive. And that's impacted some of our depletion trends. El Jimador continues to be in, I think, a good position in the United States and have a lot of growth opportunity, but there's just been a lot of competition there. The Mexico el Jimador business is always in a competitive arena. And it's sort of flattish. And particularly, we've stabilized, over the last couple of years, I'd say, some of the takeaway trends that we were observing, which were a little more negative going back toward the 2008, 2009 period, so we've been enthused about that. But the news in Mexico, as it relates to our tequilas, are really Herradura's improvement over the last year or so and the continuing progress of our New Mix ready-to-drink brand down there.

**Operator**

Your next question comes from the line of Edward Mundy with Nomura.

**Edward Mundy**

A couple of questions from me. Back to A&P. As you move back towards traditional forms of advertising, could you remind us what proportion of your marketing spend is in digital? And do you see digital becoming a greater piece – a greater part of the piece?

**Paul Varga**

I don't have off-hand what percentage is in that. It – like almost every company, I'm sure it's a growing – it certainly is a growing percentage. What I've been impressed with on our work in the digital arena, particularly around the Jack Daniel's brand, is not so much that the – it's required massive amounts of investment as much as it has leveraged the ability to directly communicate with consumers through things such as Facebook. And the launch of Tennessee Honey in the United States would be example number one in the way that it brought new friendships to the Jack Daniel's brand, it could – where you could communicate with them in far more efficient and direct ways that, oftentimes, that's available to mass communicators. And I think that's the gold in this. It's not only that you're communicating directly through the new technological formats, it's just so efficient in your ability to talk to people who are predisposed to you. So we're fortunate that Jack Daniel's is a type of brand that people really want to interact with, and that's an advantage in the world that we call social media.

**Edward Mundy**

Great. Second, on China. I know it's a small part of the overall group, but can you just provide some color on the decline of net sales in the quarter? And how you look at the longer-term opportunity for American whiskey in the Chinese market, in particular? I mean, trading consumers up to more premium variants of it?

**Donald Berg**

Yes. We've talked about China for a little bit now, where we've actually struggled there a bit of late. We continue to see China as being a very big opportunity. They certainly have an interest in whiskey. We're taking a real look at that market in terms of what we've got there as far as an organization, and how we're approaching it. We've been seeing – I would say, when you look at kind of our emerging market world, we've been seeing a lot earlier opportunities for Jack Daniel's in a number of other places than what we've seen for China up to this point in time. But it's certainly one that continues to be on our radar screen and one that we're trying to figure out.

**Paul Varga**

We still think we're – even though we're struggling there, we do think we're one of the – there's not a lot of brands at the volume levels the Jack Daniel's and above. So we sometimes refer to that as acceptable brands in that still relatively small international spirit market there. But we are in, definitely in the transition period right now, where everything from strategy to implementation to organization, we're having a fresh look at it to make sure that we can approach that market so that it can be growing in the way that we experienced through most of the 2000s. And – but it's a competitive market. And getting all aspects of it lined up well, the strategy, everything all the way down to your pricing and promotional spending plans and implementation, the media support you put behind it. We'd have to think our way through it and maybe, in some different ways, than we have in the last couple of years.

**Edward Mundy**

Got it. And just final question from me. We're hearing quite a lot about innovation in U.S. beer this year from new flavors and new pack sizes, et cetera. I mean, do you see this threatening the current trend of spirits getting share away from beer in the U.S.?

**Paul Varga**

We certainly understand the response. To date, we haven't seen anything, and I didn't actually check some of the more recent figures in advance of this call. But no, you totally expect people to fight for share of the beverage alcohol market and same from wine at various price points. But none of it will surprise me in terms of – particularly in the formats that beer is typically served. And they've actually obviously observed the appeal of the variety that comes from spirits consumption are trying to tap into that in some ways. So – but also, I think, the innovation – the beer companies have long been innovative in pack size and in many of those. I think innovation to the spirits industry these last 5 or 6 years is relatively new, and consumers seem to enjoy it. I mean, they seem to be responding to it and – a measure we keep an eye on is what percentage of the incremental growth is coming from new products in the industry. And it remains at a very high level.

**Operator**

At this time, there are no questions.

**Paul Varga**

Okay. Well, then, thanks, everybody.

**Donald Berg**

Thank you, thank you.

**Operator**

This concludes today's conference call. You may now disconnect your line.