

# Brown-Forman Corporation, Q3 2013, Earnings Call

## 2013-03-06

### Presentation

#### Operator

Good morning. My name is Holly, and I'll be your conference operator today. At this time, I'd like to welcome everyone to the Brown-Forman Third Quarter Fiscal 2013 Conference Call. — **Operator Instructions** — I would now like to turn today's conference over to Jay Koval, Director of Investor Relations. Please go ahead.

#### Jason Koval

Thanks, Holly, and good morning, everyone. I want to thank you for joining us today for Brown-Forman's 2013 Third Quarter Earnings Call. Joining me today are Paul Varga, our President and Chief Executive Officer; Don Berg, Executive Vice President and Chief Financial Officer; as well as welcome our new Chief Accounting Officer, Brian Fitzgerald.

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 any 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 2013 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 the 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 will turn the call over to Don for his prepared remarks.

**Donald Berg**

Thanks, Jay. Good morning, everyone. On today's third quarter earnings call, I plan on covering 3 topics: First, I'll start with a review of our year-to-date results; then I'll share a perspective on the 3 main factors that we believe have been fueling our outperformance; and then finally, I'll close with some thoughts on the fourth quarter and the updated fiscal 2013 outlook.

So let me start with my first topic, a review of our results over the first 9 months of fiscal 2013. We are pleased to report year-to-date underlying sales growth of 8%. If you recall, our underlying sales growth in the first quarter came in at 10%, a bit strong as a result of some retail buy-ins in advance of price increases. Then, the second quarter's underlying growth was 6%, a little light as those inventories rebalance. So for the first 6 months, we netted to an 8% underlying growth rate. Results in the third quarter were right in line with this first half trajectory, with underlying sales also up 8%.

Looking at our net sales performance in more detail, let me start with pricing. The overall pricing environment has improved significantly compared to the past couple of years. In our 9 months results, price/mix contributed 3 points of revenue growth, helping deliver strong growth in gross profits. Sales through the holiday period were solid, and we are pleased with the substantial improvement in price/mix that we have seen year-to-date.

We continue to monitor industry trends as we plan for fiscal 2014 and are evaluating future price increases on a market-by-market basis.

Looking at our net sales result through a geographic lens, all of our top 10 largest markets grew constant currency net sales year-to-date. In the U.S., underlying sales grew over 6% thus far in fiscal 2013. Outside of the U.S., underlying sales growth in the developed markets also grew at a 6% rate, driven by Germany, Australia and the U.K. The emerging markets continued on their fast growth trajectory, growing underlying sales 12%, twice the rate of our developed markets. These results were propelled by several markets, including Mexico, Russia, Turkey, Brazil, CIS, Thailand, India and Indonesia.

Shifting from geographies to brands, let's walk through some of our individual brands net sales results, all in constant currency. Our Jack Daniel's trademark registered 10% net sales growth year-to-date. Price increases have made their way through the trade and to consumers, and so far, we're pleased with the marketplace reaction. While industry results have been dragged down by markets within Europe, Jack Daniel's was able to deliver strong and balanced growth there, fueled by market share gains in many of the affected markets.

Jack Daniel's Tennessee Honey's net sales have nearly doubled year-to-date, driven by a focused rollout in non-U.S. markets as well as continued double-digit gains in the U.S. We are particularly pleased by the increased velocity the brand experienced in the off-premise in the U.S., and we believe global growth opportunities remain for Tennessee Honey as the rollout continues and awareness builds.

In the vodka category, Finlandia grew net sales by 5%, driven by premiumization trends in Russia, partially offset by a soft sales environment for premium vodka in Poland. The Casa Herradura family of tequila brands delivered strong global results year-to-date, with net sales growth of approximately 10%. The Herradura brand grew 22% and the el Jimador

family grew 7%, driven by a 15% increase in New Mix and mid-teens growth for el Jimador in the U.S., offset somewhat by declines in Mexico.

Southern Comfort's rate of sales decline improved to a minus 4% year-to-date from a minus 7% last year. Southern Comfort's parent brand's net sales in the U.S. were up 1% year-to-date, driven by the new consumer engagement plan rolled out last summer. International results remain a focus area for us as their declines have more than offset the U.S. improvement. The majority of Southern Comfort's revenues are derived from the brand's top 5 markets: the U.S., the United Kingdom, Australia, Germany and South Africa. So we are approaching these markets in a targeted manner. We launched the new creative campaign in the United Kingdom last fall, and with that, along with the lime flavor extension in the third quarter, saw the trademark return to growth in that market. We plan on rolling out the ad campaign to other key markets as we seek to return the brand to global growth. Brown-Forman super and ultra-premium brands grew net sales at a mid-teens rate. In addition to Herradura noted above, Woodford Reserve was up 22%; Gentleman Jack, up 18%; and Sonoma-Cutrer, up 15%.

Moving down the P&L, underlying gross profit grew 10% year-to-date as reported gross margins increased 2.4 percentage points. Roughly half of the increase was due to the absence of the agency relationship for the lower margin Hopland-based wines. The remainder came from improving price/mix, primarily through selling fewer value-added packages into the market through the holiday period as well as higher retail shelf prices. Underlying A&P spending increased 7% year-to-date, and underlying SG&A grew 10%. Year-to-date operating income grew 13% on both an underlying and a reported basis, and earnings per share were up 18%. So to summarize, we are executing well, delivering top-tier results in an industry that is performing well.

So this leads me to my second topic. Some thoughts on the 3 main factors that we believe

have been helping our company outperform the industry. This includes the underpenetrated position of our brands in the emerging markets, our focus on fast-growing categories, such as North American whiskeys, and our portfolio skew to premium and above price points. In February, the U.S. Distilled Spirits Council explored how the global fascination with American whiskey drove the third year of record spirit exports. And Brown-Forman, with its terrific portfolio of North American whiskey brands led by Jack Daniel's, has benefited from this enormous penetration opportunity.

Given the global interest in Western brands, few spirit brands embody Americana and the Western lifestyle quite as well as Jack Daniel's Tennessee Whiskey. Our revenues in the emerging markets have grown significantly faster than the developed markets for the last decade, and with penetration rates as low as they are, we would expect the emerging markets to be an important source of future growth.

In the U.S., bourbon's a hot category, growing almost twice as fast as total distilled spirits and vodka according to a 12-month Nielsen data. We believe this growth rates are largely being driven by the renewed interest in aged spirits and flavor innovation. Our whiskey portfolio accounts for almost 60% of our cases sold globally, so this portfolio weighting has helped our U.S. growth rates. Value growth is a key metric at Brown-Forman, and we are focused on optimizing the balance between price and volume to both maintain a brands' premium image in the eyes of consumers while also delivering profit growth. So we have built a portfolio of aged spirit brands with a goal of achieving long-term pricing power. This includes actively pushing our prices higher over the last year, led by the Jack Daniel's trademark.

According to a 12-month Nielsen data, among all of the categories, bourbon enjoys the largest year-over-year improvement in price/mix, gaining 2.2 percentage points. This also outperformed total distilled spirits which only showed price/mix gains of 0.6 points. This

has also reported that premiumization trends in the U.S. were alive and well in 2012, with a clear correlation between higher prices and higher rates of growth. The premium price segment grew faster than value, and the super-premium category outgrew premium, with volume growth of 8.9%. We see similar stats in the recent NABCA data, where the higher the price segment, the higher the growth rate. With over 90% of our sales derived in the premium and above categories, we believe our brands are well positioned to benefit from consumers' willingness to pay a premium for brands with heritage and authenticity, not to mention great taste profiles.

In summary, we believe that our small but rapidly growing footprint in the emerging markets, our portfolio weighting to North American whiskey and our premium brand skew has helped us deliver results towards the top of the industry. And we believe these dynamics position us well for future growth.

This brings me to my third and final topic, some thoughts on the fourth quarter and our updated outlook for fiscal 2013. The global economy remains fragile, and it is too early to tell if markets such as Europe have bottomed, but third quarter's underlying topline results were in line with our year-to-date results. And we believe these rates of growth will continue into the fourth quarter, keeping us on track to deliver the high single-digit underlying net sales growth we first shared with you at the beginning of fiscal 2013.

One key difference we expect in the fourth quarter is that reported gross margins will likely be down a bit. However, we expect our full year gross margins to approximate our current year-to-date results. We believe the fourth quarter is impacted by a couple of factors. First, we enjoyed favorable cost variances in the prior year's fourth quarter that we will be lapping this quarter. And we have now completely lapped the positive impact from the expiration of the agency relationship for Hopland-based wines.

Given the sales momentum we have been experiencing, we are taking the opportunity

to make some additional P&L investments, including SG&A costs associated with some recent reorganizations in Europe and Asia. Additionally, we plan to make some additional A&P investments in the fourth quarter that should translate to a mid-teens year-over-year growth rate in A&P. For example, this includes what we view as an opportune time to drive Woodford Reserve's growth and awareness through additional spending on social media and retail activation. We are also planning additional spend on Southern Comfort in the U.K. behind the Whatever's Comfortable ad campaign, which has shown early signs of improvement. These are just 2 examples of targeted investments that we believe can better position us for future growth.

Moving on, there are a couple of items below the operating income line worth mentioning. This updated outlook includes a \$9 million charge associated with the recent redemption of our 2014 notes that will be taken in the fourth quarter. The decision to redeem these bonds in addition to some modest foreign exchange headwinds will negatively impact our fourth quarter earnings per share by about \$0.05. So between the timing of some stepped up investments, the bond redemption and foreign exchange, we anticipate that our fourth quarter earnings per share will be down several cents compared to last year's reported results, but the full year outlook is very much in line with our prior expectations for underlying operating income to be up low double-digits in fiscal 2013. With that in mind, we've also tightened our EPS range to \$2.60 to \$2.68 per share. As we look to the rest of the fiscal year, to help you model the potential impact from any future changes in foreign exchange compared to this outlook, a 10% move in the dollar would impact EPS for the balance of the year by approximately \$0.07 on the upside and \$0.05 on the downside.

So in summary, we believe Brown-Forman has one of the best-positioned brand portfolios in distilled spirits, and this portfolio has been outperforming the industry. This is driven by some of the finest whiskey trademarks in the world, which position us to capitalize

on the resurgence of the category in the U.S. and a substantial penetration opportunity for North American whiskey in the emerging markets. Additionally, we believe premium distilled spirit brands represent affordable luxuries for consumers around the globe, and we are focused on bringing these new consumers into our family of brands. Our top and bottom line performance positions us in the top-tier global spirits companies, and given the efficiency of our business model, we are able to translate our operating cash flow into strong free cash available to fund future growth initiatives, make disciplined acquisitions and return cash to shareholders as we've done in the past to deliver market-leading returns for our stakeholders.

So with that, I'd like to turn the call over to Paul for some brief comments before we open up the call to Q&A.

**Paul Varga**

Thanks, Don, and good morning, everyone. As you can tell from both our release and Don's comments, we feel like the company has continued to perform well. I particularly like the balance observed in these results: geographically, where the breadth of our performance continued to be impressive; within the portfolio, where we've seen improvement; and notably in the P&L, where the volume margin balance we had hoped for is coming to fruition.

Don highlighted all 3 of these in his comments, and I'd like to supplement his comments with a point or 2 about our Jack Daniel's brand and business management. Simply put, we're really pleased with the marketplace reaction to our brand-building efforts on Jack Daniel's over the last couple of years. Obviously, the successful introduction of Jack Daniel's Tennessee Honey is one of the major highlights, and it has continued to be well received in a handful of countries where it is available. We consider it a wonderful accomplishment for it to be as successful as it has been with little to no cannibalization

effect observed thus far. If anything, we think it has provided a positive halo impact on the trademark and reinforced the brand's mixability. This is about the best one can hope for when introducing a line extension, particularly on a trademark like Jack Daniel's.

Just as important as Jack Daniel's Tennessee Honey however, has been our intent to reinforce the premiumness and unique and special nature of Jack Daniel's as it grows and achieves ever-higher levels of global consumer acceptance. Recently, we've aimed to do this with modestly higher prices, as well as through marketing communications, improved primary packaging, the further development of Gentleman Jack and Jack Daniel's Single Barrel and even through the recent introduction of our more limited ultra-premium Sinatra expression. At the same time, we've coupled these efforts with fewer discounts and value-added packs in the off-premise while continuing to promote the brand's easy mixability in that channel via the growth of Jack Daniel's RTDs and RTPs around the world.

Our year-to-date results suggest that all of this is working, as we have essentially maintained the acceptable and impressive rates of underlying sales growth and gross profit growth that we experienced in FY '12 while rebalancing the component parts of our underlying sales and gross profit growth. To illustrate even further, consider that in the last fiscal year, FY '12, the Jack Daniel's trademark grew constant currency net sales by 12% on an identical 12% growth in trademark depletions with no benefit from price/mix. In FY '13 to date, the Jack Daniel's trademark constant currency net sales have advanced by 10% on 6% growth in trademark depletions, suggesting 4 percentage points of sales contribution from price/mix year-to-date.

We believe the slight 2% change between last year's 12% overall trademark net sales growth and this year's to date still very strong 10% growth can be accounted for by the following 3 factors. The first is the reduction of value-added packs that Don mentioned, primarily during the holiday period; a not-expected marketplace reaction to higher prices,

particularly in key markets such as the U.K., France and Australia where the brand's price increases were taken in concert with excise tax increases implemented in those countries; and finally, lower levels of growth in the brand's RTD business.

Even with a small down tick in the trademark's rate of sales growth, the most encouraging results are observed as we move down to the gross profit line. Here, the benefit of the higher prices and the savings from fewer value-added packs have very efficiently contributed to a year-on-year acceleration of the company's underlying gross profit growth. Brown-Forman's FY '13 year-to-date underlying gross profit growth of 10% compares favorably to FY '12's 8% growth rate and FY '11's 7% growth rate. In essence, we've traded lower volume growth and even sacrificed a bit of net sales growth for the benefit of a higher rate of gross profit growth. Our efforts to improve the company's gross margin have been working.

And this higher level of gross profit generation is the source of the incremental investments we plan to make in Q4 to further our position – to further position our company for continued growth in FY '14 and beyond while still expecting to deliver excellent current year operating income growth. We believe these favorable financial results, paired with the reinforcement of Jack Daniel's super-premium positioning and mixability, are a superb outcome for the brand, our company and of course, for our shareholders.

That concludes our prepared remarks, and we're now happy to take any questions that you might have.

## **Question and Answer**

### **Operator**

— **Operator Instructions** — And your first question comes from the line of Kaumil Gajrawala, UBS.

## **Kaumil Gajrawala**

Couple of questions. First on the advertising, looks like you stepped your advertising up a little bit. Don, I think you alluded to some opportunities you saw on Woodford and on SoCo. Was that the entirety of it or could you maybe give some context on what incremental opportunities you're seeing and where those advertising spend is going?

## **Donald Berg**

So through the third quarter, most of the changes that you've seen up till then were mostly timing differences between when we spent our A&P last year versus when we were spending our A&P this year. We've been spending it probably on a more consistent basis throughout the year this year compared to last year. The comments that I made were really on some investments that we plan on making in the fourth quarter. There's several of them. I just kind of cited 2 to give an example of the types of things that we were seeing out there. But there's a handful of them that we're planning to make.

## **Paul Varga**

Yes, I might add that the ones that Don highlighted actually are sort of ones we've been working on over the past couple of years. The Southern Comfort one is just trying to do the best work we can to continue to improve that brand's performance. So there's some incremental investments behind that advertising campaign that Don referenced. The other one, I think he mentioned, Woodford. But it's a general comment. I mean, there was a theme of really the last couple of years where our super-premium spirits have been doing very, very well out there. And they're getting to a point, and probably mentioned Woodford, Herradura, even Gentleman Jack to some extent, are all approaching levels of development where you start to really think about how broadly you go with your awareness building. And so we're in midst of that right now, but some of those fourth quarter investments relate to trying to get a little broader with the messaging on our super-premium brands.

## **Kaumil Gajrawala**

Okay, got it. And then quickly on the value-added products side, I think it's always been the strategy to move the consumer up the value chain. But I'm trying to just sense if incrementally, there was less focus as you moved through the quarter, is that something we should expect to continue? Or is it part of the strategy that's existed for some time that the value-added pack just largely would be flat to down and most of the focus will be elsewhere?

## **Paul Varga**

Well, we had – through this year, we had consciously made the effort to reduce the value-added packs. I mean, I think if I go back 3 or 4 years, we thought they were a really helpful tool for us when the economies suffered, a lot of the traffic was increasing in the off-premise, and the focus was very much on market share and the value that you might bring to it. And then of course, that's a technique you consider alongside everything, from price reductions and everything else. So it had been building over the last couple of years, and this was a year last year when we were looking at some of the – we had actually been seeing our margins go down a bit. And as you looked into it, you found that, that was one of the contributing factors. So we – I've actually personally seen this over the last 20 years several times where it ebbs and flows, and you're a little short on them, so you put them back in the marketplace, and then sometimes you tend to over saturate them and you pull them back. And so I think that's a bit of the contributing factor here, too. And that – a lot of those value-added packs hit in the sort of last 3 to 4 months of the calendar year, often around the holiday selling period.

## **Operator**

Your next question comes from the line of Vivien Azer, Citi Research.

## **Vivien Azer**

The commentary around the pricing environment in the U.S., to be sure, is encouraging. I am curious though if you could offer some thoughts on whether the consumer receptiveness to bourbon pricing in your mind has changed at all after Beam kind of made some announced changes around Maker's Mark and then ended up backing off on those?

### **Paul Varga**

I mean on that particular question, I haven't – I mean, I just wouldn't have any comment whatsoever in terms of any specific reactions to that. I mean, I think – I mean, one of the things I was looking at this morning was the kind of how the bourbon pricing is holding up. Don's cited, I think a couple of price/mix observations as it related to it. But something I was noticing on it is that if you just look at the – I mean using bourbon as the example, a year ago, the – and using Nielsen 12-month data, the distilled spirits business in the U.S. was up in terms of dollar value, up just short of 4 points of growth, so 3.8%. And bourbon was up 6.8%. So even a year ago, there was 3-point spread between bourbon and TDS in the U.S. on value. And you fast-forward to today, and this would be capturing I think what you're asking here is how are those prices holding up? Total distilled spirits still holding in there at 3.5% growth in terms of value, and bourbon finished the last 12 months at 8.4%. So the spread between bourbon and distilled spirits has grown from 3 points to 5 points, and as Don mentioned in his comments, the price/mix component on bourbon has been, I think, more aggressive than TDS overall. So we think you can always respond to sort of 1-month and 2-month things. But I mean I always find the best way is to do rolling 12 months and just see how overall price/mix evolves. And so we're encouraged by what we're seeing. We got great category momentum. I mean, a year ago, we weren't participating in it as much as a company, and encouraging thing for us is we're now participating in it a bit more.

### **Vivien Azer**

Fair enough. My other question has to do with your commentary around the on-premise,

which is encouraging to be sure, but it differs a little bit from what we've heard from other alcoholic beverage companies about holiday. And I'm curious, broadly speaking, has there been a change since you guys closed the fiscal quarter, as the payroll tax goes up, as kind of chatter around sequestration, has ramped up, any change in the on-premise since you closed the quarter?

**Donald Berg**

I'll be honest, Vivien. I haven't really looked at it since we closed the quarter. I mean it's really early when you're talking like, within the last 4 months. The data that we look to, probably the most for that is the NABCA data. And the February NABCA data isn't been out yet. When you look at it in January – actually, when you look at it through kind of November, December, January, it looks as though the on-premise has softened a little bit, but then in January had just ticked up slightly. And based upon what we're seeing, looks like it's growing at something like around 2.5 percentage point growth rate. But certainly, lower than what you're seeing in terms of the off-premise growth rate.

**Paul Varga**

Yes, I've noticed that on an as-reported basis, those NABCA dollar sales for the spirits and the whiskey category, bourbon category, hold up pretty well on a 3-month versus a 12-month. So there, you'd have to split out. I don't have the data in front of me to split out the on- versus off-premise to get at what you're talking about. But otherwise, we'd be commenting more anecdotally, I think.

**Operator**

Your next question comes from the line of Dara Mohsenian, Morgan Stanley.

**Dara Mohsenian**

You detailed the strong pricing environment in the bourbon segment. Can you talk a little bit about pricing outside of bourbon and what you're seeing? And then just in general,

on an overall basis, do you think we're back now to a normal cadence of price increases in the spirits industry going forward, more similar to the environment prior to the downturn, and what your long-term expectations are on the pricing front?

**Donald Berg**

Yes, so generally speaking, I do think that you're seeing differences in strength on pricing. The aged spirits generally have stronger pricing power than the unaged spirits. I think vodka continues to be a category in particular where the pricing environment continues to be more difficult. Outside the United States, I would say it's a little bit of a mixed bag. You've got a number of different factors that are going on, where in different countries, you see different excise taxes going up, and that type of pricing sometimes can get in the way of what you're doing in terms of your own individual brand pricing. So as we've been going through this fiscal year and as we start to think about it for next fiscal year, I think we're definitely thinking about it on a market-by-market basis and looking at where we think that the reception for these price increases have been the strongest versus a little bit tougher. But generally overall, we're pretty pleased by what we've seen on the pricing environment. In terms of is it back to where it was before the downturn, I think it's probably too early to say that yet. I think you're still having to put these things out in the marketplace, see what the reception's like and just kind of be flexible and be able to move based upon what you're seeing in the individual markets.

**Paul Varga**

I might supplement it by saying a year ago, when we talked about why we were interested, as we were observing some of our competition being able to move their prices and as I said I think several times, I felt we were a bit behind on that. And – but in the environment, the thing we were looking to was how was the general momentum in spirits anywhere we were contemplating a price increase, how was the momentum for the categories that we were competing in and then how was the environment for the price

segments in which we were competing. All of course with a reference point to what your competition is doing. Don mentioned the excise taxes which are always a concern out there in terms of how they push prices. And then of course, you look to cost inputs. But on those positive factors I mentioned in terms of category momentum, industry momentum, price segment momentum, I mean we continue to see those holding up very, very well. So that's encouraging, but we'll continue to look at all the other factors that can be offsets to that. But I mean I feel like if you're asking me, how do I feel a year later after having done it just in terms of some of the macro stuff around us, I feel about the same.

### **Dara Mohsenian**

Okay, that's helpful. And then on the gross margin front, I wanted to get more detail on why you're not expecting year-over-year expansion in Q4 given the strong pricing you're experiencing? I understand the Hopland halo's going away, but I think the underlying business would still see some expansion given the strong pricing. So is that just more some individual quarterly variance versus abnormal items last year or is it more related to cost pressure that could linger going forward? And any general thoughts around gross margin expansion potential for next year?

### **Paul Varga**

Yes, in the fourth quarter, it's really mostly in addition to the Hopland. We've got – last year, we ended up having some favorable production variances that came through the fourth quarter that we don't anticipate seeing this year. So we're lapping kind of a tough comp on that. And so when you take those 2 out, we'll continue to see benefit from the price mix that we've taken, but we're also taking that up against kind of the normal inflationary cost increases that you've seen. And so when you kind of net it all out, you don't see the kind of benefit that we've been seeing.

### **Donald Berg**

Happens to be a little less benefit too from value-added packs contributing to gross margin. It's just not a heavy quarter for that type of activity after you've made your way through the holidays.

**Paul Varga**

We're also anticipating on the fourth quarter to see a little bit of a mix change where, I think, some of our premixed items will probably be a little bit stronger. And when you end up with those kinds of swings, it can impact on what you see in your gross margin percentage.

**Dara Mohsenian**

Okay. So it sounds like it's more kind of a quarterly variance as opposed to something that's sustainable in nature.

**Paul Varga**

Yes, that's how I would look at it.

**Donald Berg**

No like permanent increase in cost or any rollback of prices or anything like that.

**Operator**

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

**Judy Hong**

On the Jack Daniel's brand, so first question is on the Honey expansion. It sounds like that continues to go really well, and I'm just curious to hear kind of how that's performing versus your expectation in markets like the U.K. and whether you're thinking about perhaps accelerating the expansion into some of the other markets internationally? And then secondly, as I think about Jack's performance broadly speaking, obviously Honey's continuing to drive bulk of the growth, at least on the volume side. So just curious to

kind of understand your perspective on the core Jack's performance. Obviously, there's been price increases so that has some impact on volume. But just broadly speaking, how you're thinking about the Jack underlying performance outside of Honey?

**Paul Varga**

Okay. On the Jack Daniel's Tennessee Honey portion of your question, the first part, I mean I think we're happy. I mean, I think, and you would have heard Don's comments of roughly 100% or doubling year-to-date, which I think is about what you can expect. So I feel really good about it. I mean, we are, as you can imagine, being measured with how we take that out. We want it to be a very, very successful long-term brand. And we were worried a year ago just because it was successful in the United States and there was demand for it internationally, how might we think about that? And every country's reference point for how that brand might succeed is going to be potentially subtly different. So we want to be thoughtful about that. That's why we did a limited rollout this year, and we're pleased to date on what we're seeing. And we're about to go into the heaviest part of our planning and evaluation for next year. So some of the questions you asked about what we're thinking about for next year, and some of the depth of the things we'll probably comment more on as we get out into our Q4 reporting and providing a look at next year. So I'll pause on doing anything as it relates to that right now, but so far, we're very encouraged it, I mean sort of in my comments, how happy we are with the results. And this piece that is so important when you look at these, particularly for a brand like Jack Daniel's, is to ensure that this type of line extension is incremental, which we largely think it is, and if anything, providing nice additional sort of halo effect. I'll let Don comment a little bit too on Jack, but I'm pleased with Jack Daniel's performance. I mean it is – in my comments, I talked about how we basically reconfigured the components of the growth of that brand this year. And of course, the value packs we referred to are a contributing part to that too because you're taking some of your volumes out. I do think these excise taxes though in major markets, I mean, these are sizable markets for Jack Daniel's when

you reference France, U.K. and Australia. So the fact that all the prices for the entire industry as well as ours went up in those markets, I almost feel like it had to have an impact to volume a bit on Jack Daniel's. But overall, I mean I continue to think the Jack Daniel's Black Label brand is very, very healthy. And everything we read in terms of consumer indices and some of the tracking study work that we do around the world will continue to point to excellent health on it. So we're very encouraged by it. I mean, really the entire Jack Daniel's portfolio's performance in an environment where we're trying to balance a lot of things, I mentioned making sure we reinforce the premium that's the Jack Daniel's. And we think over the last couple years, we've made some contributions to that.

### **Donald Berg**

Yes, the only thing I'd add, I mean for the most part, I would say that Jack Daniel's as we sit here today, is pretty much where we hoped and expect it to be at this juncture. The one thing that I think we're particularly pleased with is seeing the strength of the brand in the U.S. and how it's done there. But otherwise, yes. I think when you think about the whole family and how it's performed and where we are, we're feeling pretty good about it.

### **Paul Varga**

It continued – I think, Don mentioned it through a few metrics on our top 10 markets, I talked about geographic breadth. I mean it continues to be very impressive in terms of how many places around the world it has appeal. And that is one of the rare things for a single trademark and a single expression in this case, to be able to accomplish. It's very, very rare to be able to derive business from over 100 countries like Jack Daniel's does and for it to be able to do it very consistently. And so I mean, that's why we are so enthusiastic about its ongoing opportunity.

### **Judy Hong**

Okay. And then just following up on the pricing commentary. So as you think about the whiskey portfolio, do you think that there's further pricing opportunity more at the high end of the price segment or kind of in the mainstream segment?

**Paul Varga**

I mean I would say at the high-end. I think the higher the price position of a particular brand, you tend to find there's, on a relative basis, a little less price sensitivity, particularly if those rates of growth at those high ends, as we've been seeing in bourbon and American whiskey are what they are. I mean, I think the ability to get price there is quite a bit easier than it is at the popular price and standard price levels.

**Operator**

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

**William Chappell**

Just wanted to follow up on that question on gross margin and maybe I missed it. Was gross margin up for the quarter excluding the Hopland benefit?

**Donald Berg**

Yes, it was.

**William Chappell**

Okay. And then looking forward, I mean looking past kind of the fourth quarter issues, is this something where you think gross margin can continue to improve? Because I'm just trying to balance with the rate of mix or the premixed products bringing that down versus the premiumization bringing it up, and how you see the long-term trends.

**Donald Berg**

Yes, it's a complicated question. As Paul mentioned, we're really just getting started where we're in the midst of our planning for next year, and there's so many things that

impact on the gross margin. When you look at the inflationary cost, when you look at your pricing, when you look at geographic mix, when you look at portfolio mix, there's just a whole host of factors that can move that gross margin number around a little bit. So I would anticipate we're going to be able to give more color around that when we do the fourth quarter call and start talking a little bit more about fiscal 2014, and we've had the chance to kind of get through all of our planning and get a sense of how the different brand – how we expect different brands perform in different markets.

**Paul Varga**

Yes, the only thing for sure that you can – just because it's beginning in the Q4, I think, is we won't have this circumstance where you're having these comps to the Hopland. I think that we've already – I think we cycled that all the way through in these results. And so going forward, we don't have that.

**Donald Berg**

It will be much cleaner. There will be a much cleaner comparison going forward.

**Paul Varga**

Yes. But we'll update you all on everything as it relates to all those critical P&L elements when we get out into the next year thinking about how our pricing will be. And we're just in the midst of all of that now. I mean, I will tell you we're really pleased though with where we are today versus a year ago. I mean we were happy with our results a year ago, we're thinking about – we didn't particularly like in the component parts that none of the contribution to our sales growth was coming from pricing. And we saw that the marketplace was a little more conducive to it. So I mean, if you're asking generally, do we like a better balanced contribution to sales growth between pricing and volume? I think generally, I would say, I do prefer that versus it being all price or all volume. I like it being balanced. That'll vary a bit by brand and stage of development, but as a general sense, I

do prefer that.

### **William Chappell**

Okay. And looking to the smaller brands, just 2 questions. On SoCo you had talked about international being weak. Was it any particular country or was it kind of widespread that's offsetting the U.S. growth? And then on Finlandia and your commentary on the vodkas, is that – I know it's very, very small, but how is Maximus, which I think was the big Polish brand to start with, how is that faring in kind of the increased competition?

### **Paul Varga**

I'll answer Maximus, you want to take Southern Comfort? Maximus is doing okay. I mean I think it's in midst of sort of relaunch plans still, it's small brand and business for Brown-Forman overall, but a little more relevant to the Polish market. But we've revamped it. I think it's growing slightly for the year at the volumetric level, and it's out there in a tough vodka market. I mean, that is the most critical component. But I think it's growing this year, and we'll be looking probably to have a chance to at least check in on that brand a bit here over the next few weeks when we think about the plans for F '14. But I think it's doing okay. And then, Southern Comfort, do you want to talk about it [ph]?

### **Donald Berg**

On Southern Comfort, I mean, the weakness outside the United States, it's lumpy but it's fairly weak across the board. We've seen some real progress in the U.K. and strengthening it, and we've got it moving in the right direction. In Germany and South Africa, which are 2 large markets for Southern Comfort outside the U.S., it has struggled but probably not as much as we've seen in some of the other markets. And so there are different amounts of works that's going to be required in touring the brand around in different countries. We're encouraged by what we've seen in the U.K. and look to take some of those learnings into some of these other markets.

**Paul Varga**

I mean, I'd say the one thing unfortunately for us, I mean Southern Comfort is not in, like Jack Daniel's, 100 countries with a strong base of business, and 2 of its big international markets, Australia and the U.K., had excise tax increases in this last year. So in terms of the concentration of the business internationally in just a few markets and the fact that they had sort of shocks to their distilled spirits system in the last 12 months was not a helpful thing for Southern Comfort. But we're working it hard, you all. I mean I think it's been something we've been talking about for several years. It's a very competitive arena where Southern Comfort is competing right now, and we're encouraged by certainly what's been happening in the United States, and we're seeing which components of the U.S. recipe for recovery will apply in these international markets, and we'll keep our fingers crossed.

**Operator**

The next question comes from the line of Tim Ramey, D.A. Davidson.

**Timothy Ramey**

Paul, you've often had good perspective on the whole alcoholic beverages category, and it strikes me that as you've outlined in spirits, aged products and kind of full flavor things like whiskey and tequila, crafted things are doing extremely well. Same in beer, imported and craft is doing well, and same in wine, with kind of full flavor varietal things doing well. Does this say anything to you about kind of the next 5 years in the category for – I mean, to me, I think, it's bullish, but I'd love to hear your thoughts on it.

**Paul Varga**

Yes, I do. I think that – I mean we're bullish on it, and I think some of where you're hinting there we've commented on before, I do think that these pendulum swing between, I think, out in the consumer world, between absence of flavor and taste and then full flavor. I mean, you really do, it's really interesting to observe. And it changes – it takes – it doesn't

happen overnight, but it will swing back and forth. And I think I've commented before, I think the bolder, more full flavored products as you're referencing, some of the stuff that's happening and you could see it in some food categories as well. But with craft beer and in the more flavorful categories, particularly at the high-end within our industry have been steadily growing. I think there is something underneath here where in some markets where, we haven't studied it closely, where maybe it's demographic where people get through a phase in their life where more mixed strings that are fruity and things like that, they tire of, and they want products that they can taste the core product and enjoy it. And people, we know, as they age, they tend to moderate their consumption. So they spend more on spirits typically and have fewer drinks, so they want to enjoy them more versus the patterns of consumption you see at sometimes earlier stages of their drinking life. So I think all these things can be contributing factors to it. And that's why I think Don has highlighted it quite well in his comments why we think we're positioned so nicely to do it. I mean actually, the thing we felt about, particularly the American whiskey component, for us of course expressed primarily – mostly through Jack Daniel's, is that it kind of has the best of both worlds. That it has a lot of the components, mixability and flavorability, things like that, that you can do with more white spirits like vodka, but also has a lot of the great components that come from the global reference point for whiskey which is scotch. So we feel like we hit sort of the sweet spot, and for those who'd like to mix us, they mix us, and for those who want to enjoy us in a more straight or on the rocks type thing where they can really enjoy the flavor in an unmixed or undiluted way, we're a great product for that, too. So I think we're positioned well from that standpoint.

### **Timothy Ramey**

And just you mentioned something that I wrote down, I thought was powerful, you said the margin – the volume margin balance is coming to fruition. And you've discussed some of this in more detail. But that implies that – I think it implies that there could still continue to be good volume growth for several years, and several of us are concerned about you

kind of running out of whiskey, and I know you're building lots of aging warehouses and so on. Can you speak to kind of the bigger picture curve on supply?

### **Paul Varga**

Yes, I mean, we estimate we're going to have sufficient supplies to meet our plans. I mean I think we've said that in the past. And this balancing act I've talked about as it relates to price-volume is a bit financial. I mean, we just know that if we can get dollar value in pricing, that for people who've long known this in aged spirit business, it's very efficient to your business. I mean, because for every volumetric contribution you're getting, you're building warehouses and doing it and there's all kinds of other consumer aspects that are wonderful about that, too. So these are both wonderful. It was just that a couple years ago, as we saw the dominant component of contribution to sales growth was almost exclusively volume. We just said that's not the healthiest way we felt for us, particularly on Jack Daniel's, to grow the business. And those of us who've been around trying to manage the brand well for a long period of time always look at very, very large trademarks when brands become iconic and try to think about how do you do this to make them very large and successful but also keep them very special? How do you keep them unique and special in the eyes of the people who consume them? And so the entire brand management exercise in a brand like Jack Daniel's has to incorporate things beyond just volumetric growth. You have to think about some of the things I mentioned like continuing to reinforce your premium price position, particularly when there's been an explosion of interest at price points above the Jack Daniel's Black Label price point. So I mean, the last thing we would ever want to happen is for the marketplace to render Jack Daniel's as appearing standard. So again, there's some serious, I think, I'll call price positioning and the desire to position Jack Daniel's super-premium across the world so that it can be successful for a very, very, very long period of time that is behind us as well.

### **Timothy Ramey**

But it sounds like you won't have the volume problem that causes some to water down their whiskey.

**Paul Varga**

I'll let you give a comment on our competition. But hey, look, that balancing act is a known balancing act to anybody who's in the aged spirit. We always joke that we know our forecast from the minute we make them are wrong because they're so far in the future. But you figure out how to balance your business in a really, really well, thoughtful way and a well-grounded way as you go along. And as it relates to Jack Daniel's, we've got a lot of experience at that. So I think we do it pretty well.

**Operator**

Your next question comes from the line of Ann Gurkin, Davenport & Company.

**Ann Gurkin**

To continue a little bit on that conversation, to support growth outside of the U.S. to penetrate all these markets, do you have the needed distribution, either internally or through joint ventures? Or is there going to be a need to step up investment to support expansion into these markets?

**Donald Berg**

I mean I think we're pretty happy with the distribution network that we have. I think when you think about it over the long term, we've been pretty smart and thoughtful about how that's evolved and how it's developed over time. And looking at markets on a market-by-market basis and determining what kind of partners there might be in a local market versus how a market's structured, are we getting the kind of focus that we're looking for in our brands and what have you. When you look at all the major markets, we've announced that we are going to make an RTC change in France in fiscal 2014 and take that one on ourselves in terms of putting together a distribution model there that

was similar to what we did in Germany a couple years ago. But when you look at it across that lens in terms of the largest markets, we've made – I think we probably made just about all of those moves at this juncture. When you look at the emerging market world, there continues to be a lot of different alternatives out there in terms of how you go to market and how you balance where you want to get yourself into a position where you have a fixed cost base versus a variable cost base. We've got quite a nice partnership with Coca-Cola Hellenic in a number of markets, and that's worked really well. And so we continue to talk to them about where they're going and how we're heading. And as you look at it on a market-by-market basis, we'll continue to do the same type of assessment as we've been doing over the course of the last 10, 15 years or so.

### **Paul Varga**

It is a – and I think – we largely think it's part of just what we do as a company now. It's a very organic development. We just – I think some of these references we've made to reorganizations a bit – that have some costs associated with them. I'll give you an example. One of the implications of some of the things we've thought about the last 90 days or so is to try to step up our effort in a group we're calling IMEA which is India, Middle East, Africa, and it's an area we've been having much success in over the last few years but wasn't the #1 focus in terms of our pursuing the emerging world. And so as you go along, you look at it and you see all this opportunities out there. So it does require resources, it requires people, and you have to go in and figure out the best way to approach those marketplaces. So I do think versus having what I would say a fully established sort of fixed SG&A cost that you can now go leverage, I don't think we're near to that. I think we've got a lot of incremental investing still to do to do what we've been doing over the last 10 years or so, which is organically building out. We've made a lot of progress and are a long way down, but this Jack Daniel's business has opportunity we find in so many places that you might have 1 person living in a place that is covering 5 or 6 countries, and as the business gets bigger, sometimes you need 2 people to cover those 6 countries. And it's

that kind of thing that we've been doing as we go along. So you do incrementally reinvest behind the opportunities you see.

**Ann Gurkin**

Right. And then if you think about fiscal '14, I know you're in the early stages of planning, but is there – what would be the biggest challenges or risks for meeting consistent performance as you think about 2014?

**Paul Varga**

Risks? I mean, some we've referenced which are some of these macro influences, industry macro influences too, which are like these excise taxes and things which we're going to have to navigate, I think, are always sort of on our radar screen. You're always thinking about the competition. I mean, any kind of competitive efforts that are going on, whether it's innovation from them or new action in the marketplace. But there's nothing that jumps out at me right now that says this is the key factor you have to be thinking about as it relates to FY '14. And if there's something that comes out of our planning here in the next few months, we'll certainly tell you about it when we get into the Q4 report.

**Operator**

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

**Edward Mundy**

A question on Honey. When you look at the brand, I would be interested in your perspective as to how long you think the brand has to run in the U.S. before it reaches maturity? And secondly, how do you think about the time frame for further innovation for bourbon?

**Paul Varga**

Could you repeat the second part? I just want to make sure I heard it right.

**Edward Mundy**

How do you think about the time frame for further innovation in flavored bourbon?

**Paul Varga**

Oh, in flavored bourbon. Okay. Well, I mean, I'll answer the first one. Just to try to take a stab at it. Don, if you've got some thoughts, add them. I mean I think Tennessee Honey, I mean, it all depends on how the brand continues to develop. I mean as I said, the United States. I mean, who knows what maturity is, this category is doing very well, meaning the flavored brown spirits and flavored whiskeys are doing very well. And then so too is bourbon and American whiskey. So there's certainly some category momentum there. And we're at such an early stage of this, I mean, it's almost really difficult to forecast how far any particular brand or the segment might go. I mean, on one hand, somebody could argue that this year's the very beginnings with what happened with flavored vodkas and that individual brands could be flavored expressions in very much the same way that, I mean I'd make the reference back to rum even where years ago, Bacardi was very much the leader in the U.S. market. And this challenger came along called Captain Morgan, which had a flavor variant to it and then was very successful as you all well know over the last couple of decades in building a really powerful brand in the United States. So these things can go a lot of different ways. And, I mean, we're going to be studying it of course, and with almost the leadership position we've got now, right now, I think a lot of people will be looking to us. So, so far, so good is what I'd say in the United States. As it relates to the innovation cycles, I mean I think that is highly dependent on what the product is you're offering. There's been a lot of innovation, you probably have noticed where people are getting into the market as they see flavored bourbons and whiskeys having success. So some of those innovation cycles appear to be very short. They're just putting flavor into their core whiskey and putting it out in the market. I know our cycle took a little longer because it was on Jack Daniel's, and we were of course thoughtful in our preparations for that, and our rollout would probably take longer than most people because we're going to be very thoughtful about how we enter the global marketplace

as well. But it's certainly easier than just the addition of flavor. It's certainly easier than doing something like totally changing the core whiskey into a new product introduction, because that of course requires years. I mean, it just has to go into a barrel and be aged. So you have a much more rapid cycle in this flavored arena than you do with – so, for example, the one that's been doing well in the United States is the rye category. Anyone who has wanted to enter that rye category would have to make it and age it for several years, you can't just put some flavoring in there. Does that help?

### **Edward Mundy**

Yes, that's very helpful. And then just going back to some of your earlier comments on some of the benefits of or some of the attractions of American whiskey. It's mixable like vodka but it also has premiumization potential of a scotch, for instance. I mean if I look back to 1970s were vodka and bourbon had about an 18% share of U.S. spirits, I mean, vodka's currently 35%, I think bourbon is about 9% or 10%, I mean, how much more headroom do you think there is for American whiskey to gain overall share of total U.S. spirits?

### **Paul Varga**

We hope a lot. I mean we haven't tried to forecast that. I mean, the thing I do know is this U.S. distilled spirits market has now, for a while, continued to grow, and you may not – and you probably don't recall. There was a period of time where the first and core consumption of spirits was not growing, I mean very much losing share to beer and wine. And now, for many, many years, has been gaining share. And then now, to be within that, to be gaining share of spirits, I don't know, maybe we've got so much enthusiasm for the current circumstances because a lot of us lived with the fact that bourbon was not growing as fast as spirits and spirits were declining as a percentage of beverage alcohol, but we welcome it so much. We're just enjoying the now versus forecasting it. But we certainly hope it goes for a long time. There's certainly some demographic things that might

point to it. Some interesting demography as it relates to U.S. population change, I think, could be very interesting as it relates to growing Hispanic populations and the way they consume flavored products in places like Mexico, for example, it bodes well. And then just the aging U.S. population and you start to think about how they might consume. So there could be some positive attributes there that would support the continued growth of bourbon.

**Edward Mundy**

Great. And just going back to Vivien's earlier question. And very short term, but you got a pretty good holiday season in the U.S. but some of your competitors within beer pointed to a slightly slower start to calendar Q1 this year, coming from short-term pressures on consumer disposable income, citing higher payroll taxes, delayed tax refunds and high gas prices. I mean, are you able to comment on whether you're seeing any of that in a limited time frame since the end of your Q3?

**Paul Varga**

I mean we've read the same stuff that you're referring to, but I mean we wouldn't have – our data won't be in until we report our Q4. So I mean I think the smartest thing for us to do is see what actually really happened as it relates to our industry and our business, and then we'll update you all.

**Operator**

And we have reached the end of the allotted time for questions-and-answers. I'd now like to turn the conference back over to management for closing remarks.

**Jason Koval**

Thank you, Holly, and thanks to all of you for joining us today for our third quarter earnings call. Please feel free to reach out to us if you have any additional questions, and we hope you have a great weekend.

**Paul Varga**

Thank you, all.

**Operator**

Thank you for your participation on today's conference call. You may now disconnect.

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