Constellation Brands Inc, Q4 2023, Earnings Call 2023-04-06

Presentation

Operator

Greetings, and welcome to the Constellation Brands' Fourth Quarter and Full Year 2023 Earnings Call. — ***Operator Instructions*** — As a reminder, this conference is being recorded. I would now like to turn the call over to Joe Suarez, Vice President of Investor Relations. Thank you. You may begin.

Joseph Suarez

Thank you, Darryl. Good morning, all, and welcome to Constellation Brands' Year-End Fiscal 2023 Conference Call. I'm here this morning with Bill Newlands, our CEO; and Garth Hankinson, our CFO. As a reminder, reconciliations between the most directly comparable GAAP measures and any non-GAAP financial measures discussed on this call are included in our news release or otherwise available on the company's website at www.cbrands.com.

Please refer to the news release and Constellation's SEC filings for risk factors, which may impact forward-looking statements made on this call. Following the call, we will also be making available in the Investors section of our company's website a series of slides with key highlights of the prepared remarks shared by Bill and Garth in today's call.

Before turning the call over to Bill, in line with prior quarters, I would like to ask that we limit everyone to one question per person, which will help us to end our call on time. Thanks in advance. And now here is Bill.

William Newlands

Thank you, Joe, and good morning, everyone. I'm pleased to report that our team delivered another solid year of performance in fiscal '23, driving a 7% increase in net sales and a 3% increase in comparable operating income, despite elevated inflationary headwinds faced throughout the year. We delivered record net sales and comparable operating income of $9.5 billion and $3 billion, respectively. We were recognized as the #1 growth leader among large CPG companies by IRI and Boston Consulting Group in calendar year ’22. And we are the only CPG company of scale in recent times to make their top 10 ranking for 10 consecutive years.

Our performance was pivot by strong execution of our strategy, which centers on continuing to build powerful brands that people love, to introduce consumer-led innovations that address emerging trends and consistently shape our portfolio for profitable growth, to deploy capital with discipline while balancing priorities and operate in a way that is both good for business and good for the world.

Here’s how each of our segments delivered against each of these objectives in fiscal ’23. Our beer business delivered another year of double-digit net sales growth, and its 13th consecutive year of shipment volume growth, while maintaining best-in-class margins. We extended our lead as the #1 high-end beer supplier in the U.S. and as the leading share gainer in IRI channels with a 12% increase in dollar sales. We increased depletions by nearly 27 million cases and delivered net sales and operating income growth, well above the initial top end of our guidance range.

We continue to build momentum for our anchor brands. Modelo Especial maintained its position as the top share gainer and the #1 high-end beer brand in the category, increasing depletions by 9%. Corona Extra was the third largest share gainer and the #3 high-end beer brand in the category, increasing depletions by nearly 4%, and Pacifico gained significant momentum as a top 10 share gainer in tracked channels, delivering depletion growth of over 30%. Several consumer-led innovations within our Modelo Chelada franchise served as growth catalysts in fiscal ’23. Naranja Picosa flavor, a new variety pack added over 1.6 million new cases of depletions to our Chelada brands.

Our new Limón y Sal 12-ounce, 12-pack helped to more than doubled to depletions of that flavor to over 5.6 million cases. And in tracked channels, the Limón y Sal 12-pack was a top 15 new package SKU and the variety pack of top 10 new brands. We continue to invest in our beer business, deploying over $800 million in capital investments in fiscal '23, which supported the ongoing expansions of our growing capacity at Obregon, the continued development of our new ABA alcohol production line in Nava, and the early stage work at our new site in Veracruz.

As part of our commitment to water stewardship, we recently worked with local efficients and water authorities to complete a project that updated water infrastructure in the city of Zaragoza near Nava facility, which improved water accessibility for most of the families in this town that is approximately 13,000 people. This is just one of the number of efforts we have underway in Mexico as part of our water stewardship commitment. As we look to fiscal '24, we will continue to prioritize investments against our core brands in Modelo Especial, Corona Extra and Pacifico.

We believe that the fundamental growth drivers for these brands, including awareness, distribution and demographic upside opportunities, remain as strong as ever. We're excited about several consumer-led innovations that are currently hitting the market, including Modelo Oro, which exceeded both external and internal benchmarks in 3 test markets where we trialed it last fiscal year and Corona non-alcoholic, which addresses the rapidly growing betterment trends. We'll also continue to build momentum for our Chelada franchise with the introduction of a second 12-ounce 12-pack for our best-selling traditional Chelada flavor and with the new spicy watermelon flavor, Sandia Picante, and we'll continue to deploying capital to enhance our growing capacity to meet the anticipated continuing robust demand for our products, both near and long term. Shifting gears. Our Wine & Spirits business has transformed from a U.S. wholesale business, mainly serving the mainstream segment to a global omnichannel competitor with a higher-end focused portfolio. And this strategy is working as the strength of our higher-end brands supported our outperformance against the broader market. While lower demand for our mainstream brands drove a 2.1% volume decline for our Wine & Spirits portfolio and IRI channels, we outperformed the 2.6% volume decline for the combined U.S. Wine & Spirits categories in fiscal '23.

We continue to focus on the growth of our consumer preferred higher-end brands within our portfolio. Our Aspira portfolio, which includes our Fine Wine and Craft Spirits brands, delivered double-digit shipment growth. In addition, it significantly outpaced the Fine Wine and Craft Spirits segment, led by The Prisoner Wine Company, which delivered depletion growth approaching 10% and our Craft Spirits portfolio, which achieved depletions growth approaching 29% in U.S. wholesale.

In addition, these brands delivered exciting consumer-led innovations such as The Prisoner's Blindfold Blanc de Noir, Casa Noble Ultra Premium Marques Tequila and our Mi Campo ready-to-drink cocktails, which are still in early stages of their life cycles, but are contributing to our expanded presence in higher end of the market. Meanwhile, our Ignite portfolio continued to drive the momentum of our premium brands such as Meiomi and Kim Crawford, which delivered depletion growth of 5% and 7%, respectively, both gaining share in their respective segments.

We continue to complement the growth of our core premium products with innovations that broaden the offerings of these consumer preferred brands. As an example, Meiomi's new Red Blend remains the #2 wine SKU since its launch and Kim Crawford's Prosecco was the #2 new wine brand. Within our Ignite portfolio, the performance of our higher-end premium brands was offset by our remaining mainstream Wine & Spirits brands, namely Woodbridge and SVEDKA which experienced declines versus the market in the U.S. We continue to focus on stabilizing and revitalizing these brands. To further support our strategy to reshape our Wine & Spirits portfolio to the higher end, we divested several residual mainstream brands and acquired a smaller, higher-end wine brand and a ready-to-drink cocktail brand.

Of note, our relatively recent acquisition to My Favorite Neighbor portfolio is delivering substantial growth and performing above our initial expectations. So overall, in fiscal '23, while net sales for our Wine & Spirits business declined just under 4%. A large part of that was due to the recent divestiture of primarily mainstream brands that I just referenced. And despite the strong performance of our higher-end brands, on an organic basis, net sales declined by 2%, mainly driven by lower demand for our mainstream brands, reflecting continued consumer-led premiumization trends, which I also noted earlier.

We continue to build momentum for our higher-end brands and continue to accelerate our performance in key channels, such as direct-to-consumer and international markets, which grew net sales by 29% and organic net sales by 4%, respectively. Looking forward, we see an opportunity to continue to grow the DTC and international markets by investing in our Premium Wine, Fine Wine and Craft Spirits brands that tilt their growth toward DTC and international routes to market. Importantly, our Wine & Spirits business delivered operating margin expansion in fiscal '23, further demonstrating the benefits of its strategy and making additional progress towards its medium-term targets.

Overall, we are exiting the year in Wine & Spirits on solid footing, and I remain confident in the pathway of that business. The solid performance driven by our beer and Wine & Spirits teams enabled us to return nearly $2.3 billion to shareholders and share repurchases and dividends in fiscal '23, and we further demonstrated our capacity to conduct opportunistic share buybacks with an additional nearly $300 million of repurchases in the fourth quarter. This means our dividend payments and buybacks since fiscal '20 totaled more than $5.4 billion, well above our $5 billion goal.

Moving forward, we plan to continue to deliver against our capital allocation priorities with our disciplined approach. Our fiscal '24 earnings and cash flow outlook should enable us to move closer to our net leverage ratio target to support dividend payments in line with our payout ratio target to continue to deploy capital to be a growing capacity additions and hospitality investments in Wine & Spirits business and to opportunistically pursue additional share repurchases and small gap — ***indiscernible*** — acquisitions.

Lastly, we remain committed to making meaningful progress against our enterprise ESG goals, which include reducing Scope 1 and 2 greenhouse gas emissions by 15% in fiscal – by fiscal '25 from a fiscal '20 baseline and restoring more than 1 billion gallons of water withdrawals from local watersheds, while also improving accessibility and quality of water for communities where we operate between fiscal '23 and '25. Water stewardship in particular, has been a top priority for our team, and I'm pleased to announce that we have already surpassed our fiscal '25 goal related to water restoration.

We'll look to announce later this year new targets for our water stewardship efforts as well as other important areas that are part of our ongoing commitment to ensuring the long-term viability of our local communities and this environment. We have also significantly enhanced our ESG reporting references aligned to the Sustainability Accounting Standards Board framework and considering recommendations from the Task Force on climate-related financial disclosures.

As we look ahead, we intend to continue to take steps to more fully integrate ESG into our core business planning process, establishing thoughtful, specific, measurable and time-bound targets supported by robust strategies and operating plans that we can map progress against. We believe this approach best serves the interest of our business, shareholders, other stakeholders and our surrounding communities as it seeks to integrate ESG into our business operations and helps ensure that we can clearly deliver on our stated commitments.

So in summary, we delivered another solid year of performance, resulting in record net sales and comparable operating income, despite elevated inflationary headwinds based throughout the year. Our performance was driven by strong execution of our strategy, and we continue to make good progress against all dimensions, building brands that people love, complementing growth of our core products with consumer-led innovation, deploying capital with discipline while balancing priorities against our organization, and continuing to operate in a way that is both good for business and good for the world.

With another strong year of execution against our strategy behind us, we're quite confident in our ability to continue building momentum in fiscal '24. And with that, I will turn the call over to Garth.

Garth Hankinson

Thank you, Bill, and good morning, everyone. Fiscal '23 was another solid year for our company as we continue to relentlessly deliver on our operating plans and strategic initiatives. Despite the inflationary pressures that both our industry and consumers have been facing, we demonstrated yet again the strength of our adaptable businesses, high-end brands and resilient teams. We expect the same focus and dedication to further support our momentum in fiscal '24.

So let's review in more detail our full year fiscal '23 performance and fiscal '24 outlook. As always, I will focus on comparable basis financial results. Starting with the fiscal '23 performance of our beer business. Net sales increased $713 million or 11%, exceeding the upper end of our guidance range. This was primarily driven by solid shipment growth of approximately 7% as strong demand continued across our portfolio, supporting a $464 million uplift in net sales from incremental volumes.

Net sales also benefited from favorable pricing in excess of our unusual 1% to 2% average annual pricing algorithm. As we previously noted, the incremental pricing actions taken in fiscal '23 were in response to cost pressures across the value chain due to inflationary headwinds. We introduced larger pricing increases and made pricing adjustments in certain markets ahead of our regular case. Depletion growth for the year was over 7%, which, as Bill noted, was driven by continued strong growth in our largest brands, Modelo Especial, Corona Extra, Pacifico and Modelo Chelada brands. On-premise depletions grew 15% year-over-year, and on-premise volume accounted for approximately 12% of total depletions in fiscal '23, nearing the mid-teen volume share from prior to the start of pandemic.

As previously guided, our shipments and depletions were closely aligned on an absolute basis. Moving on to the bottom line for our beer business. Operating income increased 6%, also exceeding the upper end of our guidance range. This increase was largely driven by a $492 million benefit from net sales growth and yielded an operating margin of 38.3%, which was in line with our implied guidance range. As expected and noted over fiscal '23, operating margins were negatively affected by inflationary headwinds.

For the import portion of our beer business, which represents nearly the entirety of COGS, we faced an increase of approximately 16% in our raw materials and packaging costs, which was largely driven by inflationary pressures that resulted in an 8% increase on a per case basis. This reflected some benefits from the lapping of the seltzer obsolescence charge in fiscal '22 as excluding any obsolescence impact, the increases in our raw materials and packaging costs would have been 20% on an absolute basis and 12% on a per case basis.

Note that these 2 cost categories, including the obsolescence impact represented just over 55% of the import portions COGS in fiscal ’23. We also saw a 12% year-over-year increase in freight costs, mainly driven by incremental shipment expenses that were offset by efficiency initiatives. Freight costs were 5% up on a per case basis and account for just under 25% of import COGS. and we faced a 14% rise in labor and overhead costs that was mainly driven by our brewery capacity investments. Labor and overhead were up 7% on a per case basis and accounted for just under 15% of import COGS. In addition, operating margins for the beer business were also affected by a $41 million or nearly 22% increase in depreciation, almost entirely associated with our brewery capacity investments. A $55 million or nearly 9% increase in marketing spend related to incremental investments in sport sponsorships and a $48 million or nearly 14% decrease in our – in other SG&A, driven by incremental sales support to align with the momentum of our beer brands. Note, however, that while our marketing investments increased when compared to the prior year, they were still within our 9% to 10% range as a percentage of net sales. All of that said, and it’s important to note that we still delivered best-in-class margins for our beer business in fiscal ’23. Now shifting to our Wine & Spirits business. First, please recall that we divested a collection of primarily mainstream wine brands from our wine portfolio in fiscal ’23.

So during today’s remarks, I will also be discussing top line on an organic basis, which excludes the contributions from the divested brands. As Bill noted, despite the strong performance of our higher-end Wine & Spirits brands on an organic basis, net sales decline of 2%, ultimately landing in our guidance range. The decline in net sales, excluding the impact of the divestiture, was primarily driven by our mainstream brands as they faced challenging market conditions and lapping of prior fiscal year inventory build.

Again, this decline was partially offset by strong growth in our higher-end brands, which outperformed in the U.S. in the higher-end category for both Wine & Spirits and total U.S. wine market. Our higher-end brands also had strong growth in our emerging and rapidly expanding direct-to-consumer channels and international markets. Over time, we expect our portfolio to continue to migrate toward the higher end and for these higher-end brands, channels and markets to support our top line growth acceleration.

Shipments on an organic basis decreased by under 8% and depletions decreased by 3%. As just noted, this volume decline, which reduced organic net sales by $148 million, was driven primarily by our mainstream brands, as mix and price, largely driven by our higher-end brands provided a $111 million uplift to organic net sales.

Wine & Spirits operating income, excluding the gross profit, less marketing of the brands that are no longer part of the business, following their divestiture in fiscal ’23, increased 2%, and operating margin increased 80 basis points to nearly 23%, also reflecting the same exclusion. This margin increase was driven by a $12 million uplift from net sales flow-through as favorable product mix was supported by lower grade costs as well as a strong New Zealand harvest. Benefits from other cost savings actions primarily resulting in lower-grade costs that helped to partially offset higher logistics material costs. And more efficient marketing expense from enhanced investment strategies, which increased focus the highest return opportunities, which supported a $20 million tailwind to operating income.

These benefits were partially offset by $17 million in higher SG&A from increased headcount, as we continue to strategically invest in our growing DTC channels. We remain well positioned to continue to expand margins in our Wine & Spirits business over time with mix improvements and productivity initiatives in the future. Now moving on to the rest of the P&L. In fiscal ’23, our corporate expense included approximately $270 million from SG&A and $20 million from unconsolidated investments related to our ventures portfolio. All-in, landing at the low end of our guidance at $290 million.

Within the SG&A portion of corporate expense, the implementation of our DBA program, which stands for digital business acceleration, accounted for $47 million.

As a reminder, we introduced our multiyear DbA initiative in fiscal ’23 and expect similar investments to carry into fiscal ’24. Interest expense for the year increased 12% to approximately $400 million, coming in at the upper end of our guidance range. This increase was driven primarily by the financing of the stock reclassification, which took place in Q3 of fiscal ’23 as well as the impact of rising interest rates on approximately 15% of our debt with adjustable rates.

Our full year comparable basis effective tax rate, excluding Canopy equity earnings, came in at 19.2% versus 17.5% last year as we lapped favorability in fiscal ’22, primarily driven by higher stock-based compensation activity. Free cash flow for fiscal ’23, which we define as net cash provided by operating activities, less CapEx, was above the upper end of our guidance range at $1.7 billion. CapEx totaled $1 billion, including over $800 million of investment in our beer business.

CapEx came in below our guidance, primarily due to timing shifts in the spend for certain materials and equipment of our Mexico brewery investments at our Nava and Obregon facilities. As of the end of fiscal ’23, our Mexico brewery operations had a total nominal capacity of approximately 42 million hectoliters. This includes 32.5 million hectoliters at our Nava facility and 9.5 million hectoliters at our Obregon facility.

This represents a 1 million hectoliter uplift at our Nava facility relative to the capacity we communicated a few months ago. This uplift is once again the result of our continued productivity initiatives that have unlocked additional production flexibility from the existing footprint of our breweries. As a reminder, earlier this year, we shared that these initiatives had unlocked additional capacity of 1.5 million hectoliters at Nava and 0.5 million hectoliters at Obregon.

In light of the 2.5 million hectoliters of productivity capacity unlocked at Nava in fiscal ’23, we have slightly adjusted the ramp-up plans for our new ABA production line at that facility, which I will discuss shortly. With that, let’s move now to our outlook for fiscal ’24. We expect a comparable basis diluted EPS to be in the range of $11.70 to $12, excluding Canopy equity earnings. For fiscal ’24, our beer business is targeting net sales growth of 7% to 9%. As Bill discussed earlier, we expect to continue strong volume growth momentum to be largely driven by our iconic brands, Modelo Especial and Corona Extra and next wave brands, Pacifico and the Modelo Chelada brands.

We anticipate our full year fiscal ’24 shipments and depletions to track each other closely, both on an absolute basis and in terms of the year-over-year comparison. As a reminder, despite some fluctuations in the last few years in our quarterly shipment cadence and year-over-year growth rates due to severe weather and pandemic-related impacts, we expect the cadence of our shipments in fiscal ’24 to follow a more traditional seasonal pattern. We anticipate approximately 55% of our fiscal ’24 wine to ship in the first half as we meet peak summer demand for our products.

In addition, from a quarterly perspective, particularly when looking at year-over-year growth rates, we also expect shipment and depletion comparisons to still show some variability as they always have, as we manage inventory levels around seasonality throughout the year and our regular brewery maintenance activities in Q3. All of that said, we do not expect to have any incremental lapping variability in our shipment growth rate for Q4 as we did in fiscal ’23.

From a pricing perspective, at this stage, we are planning for average annual pricing within our 1% to 2% algorithm. We are mindful that consumers will likely continue to face challenging macroeconomic conditions for the foreseeable future, and that our pricing increases in the last 2 fiscal years were above this algorithm. As we advance throughout the year, we will continue to monitor inflationary dynamics and potential recessionary risks to ensure our pricing is appropriately balanced to support the momentum of our brands.

We will provide any further update in that regard as part of our future quarterly calls. In terms of operating income growth. Our beer business is targeting 5% to 7%, which implies a fiscal ’24 operating margin of approximately 38%.

As we have discussed, we continue to expect our beer operating margin to be negatively impacted by inflationary COGS headwinds. The majority of these relate to year-over-year adjustments in our packaging and raw material costs, which, on average, represent a high single-digit increase in absolute terms for these inputs in the import portion of our beer business.

While prices for some of these inputs are off their peaks, most are subject to contractual terms that reflect annual adjustments based on trailing pricing data and some still remain significantly elevated relative to pre-pandemic prices. In fiscal ’24, we expect packaging and raw material for imports to account for approximately 55% to 60% of our costs. In addition, we expect freight to be approximately 20% to 25% of costs and reflect a high single-digit year-over-year absolute increase as we continue to face annual volume contractual increases. And labor and overhead to be approximately 15% of costs and reflect a high teens increase in absolute terms, largely driven by increased headcount and training tied to our brewery capacity investments.

For our beer business, we expect incremental depreciation of approximately $35 million to $40 million, as we continue to bring into production incremental growing capacity from our investments, particularly at Obregon, in fiscal ’24. As noted earlier, the incremental capacity unlocked from our existing Nava facility footprint from productivity initiatives has given us additional flexibility on the ramp-up of our new ABA line. We now intend to spend a bit more time optimizing that new additional ABA production to better support the strong growth of our Modelo Chelada brands.

Accordingly, we anticipate the ABA line will be ramping up in Q4 of FY '24. Conversely, we have been able to accelerate the ramp-up of our next 5 million hectoliter investment at Obregon to Q1 of fiscal '24. This is being enabled by the move of brewery and package equipment that we had previously intended for use in Mexico. Now going back to operating margins. We plan to execute a number of productivity initiatives to help offset inflationary pressures. The expectations shared for our beer business COGS in fiscal '24 have operational efficiencies and cost-saving actions embedded into them.

These initiatives include benefits from our ongoing hedging program and contractual negotiation efforts as well as from our fiscal '23 DBA program. To that end, it is relevant to note that only around 25% of our beer business COGS are subject to contractual pricing adjustments within fiscal '24, and then we expect our hedging program to reduce our exposure to those adjustments for about 10% to 15% of COGS.

In addition, we expect to deliver marketing and other SG&A efficiencies, including an even greater focus on optimizing these types of investments toward our iconic and next wave brands. So despite remaining slightly below our medium-term operating margin target we expect our fiscal '24 efforts to still yield best-in-class results for our beer business, and we expect all quarters within fiscal '24 to deliver operating margins above this latest quarter's result.

Moving to the outlook for our Wine & Spirits business. Our fiscal – for fiscal '24, we are targeting organic net sales to be relatively flat within 0.5 percentage point from fiscal '23 net sales, excluding $38.5 million of net sales from the brands divested in fiscal '23. We expect to continue the strong growth of our Premium Wine, Fine Wine and Craft Spirits brands and in our DTC channels and international markets. These segments of our business will help to offset the headwinds we expect to face with our mainstream U.S. wholesale brands, which are facing challenging market conditions due to ongoing consumer-led premiumization.

Conversely to our beer business, we expect our Wine & Spirits business to ship approximately 55% of our fiscal ’24 volumes in the second half, again, in line with seasonal demand for our Wine & Spirits products. More notably, despite continued inflationary pressures, we are targeting operating income growth between 2% to 4%, exclusive of $19.5 million of gross profit, less marketing, related to brands divested in fiscal ’23. This implies an operating margin improvement of at least 40 basis points.

The primary margin improvement drivers for fiscal ’24 include additional mix improvement, particularly with our further optimized portfolio, driven by ongoing growth in our higher-end brands from continued consumer-led premiumization trends, enduring growth momentum in our higher-margin direct-to-consumer channels and targeted international metro areas, primarily through our Aspira portfolio brands, additional innovation with new consumer-led products that help extend our higher-end offerings and stabilize our mainstream brands, reduced marketing spend relative to net sales with optimized investments increasingly focused on high-growth, high-return areas and additional SG&A reductions in cost management initiatives.

Similar to our beer business, we expect approximately 25% of our Wine & Spirits business COGS to be subject to adjustments within fiscal ’24. Now moving to expectations for the rest of the P&L in fiscal ’24. Corporate expense, including just the SG&A portion, is expected to be approximately $270 million. We expect to see favorability from the termination of certain compensation and benefits that will not be payable in fiscal ’24 following the retirement of Rob and Richard Sands from their executive roles for the reclassification agreement approved by shareholders in fiscal ’23, offset by the impact of inflationary pressures and merit-driven salary increases.

Interest expense is expected to be approximately $500 million for the year. This is a 25% increase from fiscal ’23 and is primarily due to the incremental interest expense associated with the financing of the reclassification. The comparable tax rate, excluding Canopy equity and earnings is expected to be around 19%. Rounding up the P&L, we anticipate approximately $40 million in noncontrolling interest benefits and weighted average diluted shares outstanding are targeted at approximately 184 million.

Turning to cash flow. We expect fiscal ’24 free cash flow to be in the range of $1.2 billion to $1.3 billion, which reflects operating cash flow in the range of $2.4 billion to $2.6 billion, and CapEx of $1.2 billion to $1.3 billion. CapEx includes approximately $1 billion to support our Mexico brewery investment and most of the remainder will support our Wine & Spirits hospitality updates.

To wrap up, I would like to reiterate that our refreshed capital allocation priorities that we have introduced and discussed throughout fiscal ’23 and earlier by Bill remain unchanged. We remain committed to a disciplined financial foundation by maintaining an investment-grade rating as we move towards our net leverage ratio target, delivering returns to shareholders via both dividends in line with our payout ratio goal and through incremental share repurchases to at least cover dilution while remaining opportunistic for any additional repurchases, continuing to support the growth of our businesses through deployed capital in our beer brewing emissions and in our Wine & Spirits hospitality investments.

And lastly, through smaller acquisitions that will fill gaps or enhance our existing portfolio.

We believe that this strong disciplined capital allocation strategy, combined with exceptional execution, will empower us to be a premier shareholder return generator for the foreseeable future.

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

Question and Answer

Operator

— ***Operator Instructions*** — Our first question comes from the line of Andrea Teixeira with JPMorgan.

Andrea Teixeira

Can you comment on what you're seeing most recently and that makes you feel confident about the 7% to 9% your sales growth outlook and particularly in light of the broad deceleration in consumption called out by retailers in March? And related to that, are there any dynamics between shipments ahead of the Cinco de Mayo the start of the summer and the depletions as we move into the first quarter and throughout the year?

And if I can squeeze on the pricing front, you mentioned the 1% to 2%, but I understand some of the competitors decided to just pushback. And given the dynamics that you had towards the fall last year, if you're going to be mostly looking to do pricing for the fall?

William Newlands

So thanks for the question. A couple of things that give us the confidence in the 7% to 9% range. First of all, we saw a very strong start to the year in markets like Texas and Florida, which have both seen double-digit increases in the first month of the year. Now acknowledging the state of California has been challenging, but I'll tell you what I'm very excited about California. In Q4, we saw our distribution growth. Our effective distribution grew by 3.6%, Q4 versus the Q4 prior. Our simple distribution, despite a very broad market capability there, saw a simple distribution grow up 2%.

And our draft panels went up over 9%. What this says to me is that we are well prepared when California gets back into their normal weather pattern versus what we saw this year. So we're very comfortable. Obviously, we wouldn't be giving you this guidance that we thought otherwise. But we feel very comfortable that we'll be in that 7% to 9% range that we noted today.

Garth, do you want to touch on the pricing point?

Garth Hankinson

Yes. So I mean as we stated in our prepared remarks, we're comfortable with the pricing at our 1% to 2% algorithm. Obviously, we will continue our approach to pricing gives us the flexibility throughout the year to monitor what's the macroeconomic and the inflationary recession impacts – potential recession impacts are on our consumer. It allows us to monitor competitor behavior and give us the flexibility to act agilely, when we see a reason to move on price.

So that will be something that I said in my prepared remarks that, to the extent we make any changes throughout the year, we will provide updates on our regular quarterly calls.

Operator

Our next question comes from the line of Kevin Grundy with Jefferies.

Kevin Grundy

Just a quick cleanup, Bill, I'm not sure if you can comment on March depletion trends. I mean, presumably, given the importance of California, I suspect it's probably running a bit below what we saw in the fourth quarter. Maybe you could just comment on that. But my broader question is on the Oro launch. And maybe just follow-up there on your expectations, comments on cannibalization risk. And then I think importantly, sort of context around how we should be thinking about this rollout relative to the premier launch several years ago and the degree of incremental spend?

If I'm not mistaken, Garth, you can correct me if I'm wrong, I think that was in the $35 million to $40 million range of incremental spend behind that rollout, but just some context around there would be helpful.

William Newlands

Sure. So that I don't step on myself after I just got done saying I wasn't going to talk about depletions anymore. I won't specifically talk about March depletions other than to say they're pretty much in line with what we expected. As I did note in my prior answer to Andrea, Texas, Florida were up double-digits. Certainly, California was challenged this particular start to the year. But I think it's safe to say that, as we progress in the year, it's extremely unusual to have rain, snow or flooding once you get into May, June, July and August in the state of California. So much like we've seen many other times when there's a dislocation of particular market, we expect that, that would pass over time.

Second, related to your Oro question, we've said we're going to be very sensible about the rollout of Oro. I'm pleased to say that our beer group has done an extremely good job of getting distribution into the marketplace. As you know, we're less than a month in on that particular project. But we were very positive about the cannibalization rates that we saw in the 3 test markets. We saw incrementality above 60% in those markets, which we are very pleased with. And we really think it fills a gap particularly with our core Hispanic consumer, who has been looking for an alternative to some of the other light beer scenarios.

So we're very positive about that, but we're going to do it in a very sensible and approachable way. For those of you who watch March Madness, you would have noted, we had – we started our media campaign during that particular event. And this launch will be supported by significant media over the course of the summer.

Operator

Our next question comes from the line of Dara Mohsenian with Morgan Stanley.

Dara Mohsenian

On the beer depletion side, can you discuss a bit the trends you're seeing on-premise? The gap looked better in terms of on-premise and some of the smaller store on track channels relative to track channels versus Q2 and Q3. So just would love to get an update there. And then also do you think you're seeing any broader macro impacts in your portfolio? Maybe give us a bit of update on trade down in general in beer and what's occurring there and any impacts to your business?

William Newlands

So in terms of on-premise, on-premise continues to grow, as we noted in our prepared remarks. We continue to see acceleration in the on-premise, which we think is very good. We're not quite back to where we were from a normal standpoint that where we sat before the pandemic. But we continue to make progress against that as we are seeing more and more often that consumers are being out in the marketplace and consuming on-premise. So we remain optimistic.

Our growth profile in the on-premise really continues to accelerate. As I think that many on-premise accounts are looking more and more for brands that resonate consistently with consumers. And obviously, we have those and that speaks very well. I used the example of a well saturated market like California seeing draft panels on our business were up 9% in the fourth quarter last year. And I think that's a great reflection of the potential that still exists for us in the on-premise.

Relative to your question about trade down, we have seen very little trade down against our portfolio. Certainly, there has been some it appears, but it tends to occur at lower price points than ours. So there are some consumers that are showing some concern about general inflationary macroeconomic trends. But by and large, that has occurred at lower price points that where our brands compete. And that's fairly consistent with what we've seen relative to the pure loyalty we see against our brands. It's the benefit of having consumer preferred brands in our portfolio.

Operator

Our next question comes from the line of Rob Ottenstein with Evercore.

Robert Ottenstein

Just a follow-up on Garth on some of your guidance comments, and I don't know if I – just maybe I didn't follow you. But I think you were talking about productivity measures that would help get to the margin target. And then you talked kind of very quickly or with some points on hedging programs and the amount hedged or not – and I just – I apologize, I lost you on that. But I was kind of trying to connect what hedging would have to do with productivity and trying to exactly the point you were trying to make.

Garth Hankinson

Yes. So sure, Robert, thanks for the question. And just so as Joe indicated at the beginning of the remarks, we are going to be posting some slides to our website immediately following this call specific to the efficiency – productivity efficiencies and the hedging. The point on that is it's just like in any given year, we have certain productivity goals, efficiency goals, savings to help offset the impact of cost increases related to inflation. So that's no different than any other year.

And the point of the comment was that those increases that I had stated previously, those are net of those efficiencies. And then on the point around hedging is just that we continue to have a fairly robust hedging policy program. Typically, we are only able to hedge around 10% to 15% of what's in our cost of goods. And so we are hedging against those things right now. And as we enter this year, we're at where we would normally be in terms of the percent of commodities that are hedged.

Operator

Our next question comes from the line of Nik Modi with RBC Capital Markets.

Nik Modi

Just a few follow-ups. So just curious on, Bill, you mentioned some of the distribution gains you've seen in California. Just was hoping to get some context on your view on resets, and kind of what you're seeing more broadly, especially in the markets where you're under shared relative to where you are in California? And then the second question is just there's been a lot of discussion in the trade about some of the other brewers perhaps rolling back some pricing or promoting back some of the recent price increases.

Just wanted to get some context on kind of philosophically how you think about if that were to happen, kind of would you need to react or not? And just would love your context and perspective on that.

William Newlands

Yes, you bet, Nik. Thanks for the question. One of the things that relative to resets, we are doing extremely well in reset situations. And I think it's just simple, good business because with our portfolio representing more than 80% of the growth in the total beer category it just makes sense for retailers to increase our shelf positions versus the competition. You see, as we said in our prepared remarks, Modelo being the #1 growth driver and Corona being the #3 growth driver and Pacifico being the top 10 growth driver, these brands demand more space on the shelf. And we're very fortunate that our team is specifically focused on that very topic.

Relative to pricing, as Garth noted, we carefully analyze the elasticities against our brands. And I've said this on many other occasions, we're very mindful that we want to keep our consumer. And our pricing strategies over time have been to be sensible and approachable to ensure that we keep our consumers. We're going to raise within our normal algorithm this year in the 1% to 2%, as Garth noted, but we should and expect no rolling back of any pricing scenarios from us this year because we have been judicious about keeping the consumer engaged with us as we move pricing in the past.

We'll continue to monitor to that carefully as the year goes on, as we always do. On a monthly basis, we analyze elasticities and drivers and drags, which you've all heard from Jim Sabia over time. But we see absolutely no need to be rolling back pricing in any market because we think we were very appropriate in what we have done historically, which should allow us to be right back in our algorithm going forward.

Operator

Our next question comes from the line of Bonnie Herzog with Goldman Sachs.

Bonnie Herzog

I had a question on your free cash flow guidance of $1.2 billion to $1.3 billion this year. It's a fair amount below your historical run rate. So maybe you could highlight the key puts and takes that are going to impact your free cash flow this year? And then you completed your share repurchase goals to date and your $5 billion return to shareholder target, but you didn't necessarily announce a new return goals.

So curious how you're thinking about your capital allocation priorities going forward? And then maybe what's realistic to consider for cash return to shareholders this year and beyond thinking about this in the context of the CapEx needs, your leverage targets, et cetera?

Garth Hankinson

Thanks, Bonnie. So I'll start on free cash flow. I guess to start on free cash flow, we need to start at operating cash flow, right? So operating cash flow is a bit down this year versus last year. And the primary drivers of that are really a couple fold. One is there is the increase in interest that I referenced in my opening remarks pretty much at 25% increase on a year-over-year basis, and that's really reflected primarily of the debt and the interest associated with the collapse. And then to a lesser extent, the remaining floating rate debt that we have on our books.

Additionally, we'll have higher cash paid taxes next year due to the U.S. and some nonrecurring tax benefits that we had in FY '23 and then to a smaller extent, some changes in working capital.

Moving further down the list. We'll continue to have significant investments in CapEx, as you heard. And so that's really – those are the factors that are driving the free cash – the operating cash flow and free cash flow ranges that we outlined earlier. As it relates to the share returns of capital to shareholders through share repurchases, we still have nearly $1 billion left under our existing Board authorization for share repurchases.

As we mentioned in our comments, at the very least, we will buy back dilution throughout the year, but we will continue to be agile and be able to take advantage of market conditions, just like we did in Q4, where, as Bill noted in his remarks, we aggressively bought back almost $300 million worth shares as we saw some – what we consider dislocations in price. So that's going to – that will be how we continue throughout the year. We actually like the ability to have that flexibility. And so it's something that will obviously continue to be a very critical component of our capital allocation strategy.

Operator

Our next question comes from the line of Peter Grom with UBS.

Peter Grom

So I wanted to ask about the pricing cadence and the commentary that you're going to be monitoring the consumer. And you provided a lot of color in the response to both Andrea and Nik's question. But I guess if you don't plan to roll back prices, can you maybe just talk about what actions you would be willing to take if the environment were to deteriorate, would that just be pricing at the lower end?

And I guess what I'm really trying to understand is if the pricing outlook were to really change at all, how would that impact your ability to achieve your margin targets? Could you lean in more elsewhere? Or would it be more difficult to achieve?

William Newlands

Well, there's a lot of negative what-ifs in the question, which, frankly, we don't see coming to pass. If you look historically where our beer business has been able to publish, we have maintained a very consistent approach to pricing over time, 1% to 2% year, after year, after year. The last couple of years, as you know, we've significantly gone beyond that in an effort to hedge against some of the strong inflationary pressures that all consumer companies have faced.

Our belief is we are in a very good position to do our historical 1% to 2% pricing increase. That's based on a lot of analytics and a lot of elasticity assessments that we do on an ongoing basis. We are very comfortable with that, and we feel like that's going to be an appropriate play for the course of this fiscal year, which should allow us to do everything we said. I would also note, just as an adjunct to that, one of the things that I said at CAGNY was how strong the Modelo share was in its 2 strongest markets, which was California and Nevada, where we were double-digit.

I'm pleased to report that at this point that actually is now 4 states, which includes both New Jersey and Texas, which again just continues to show that our growth profile. Outside of the state of California, it remains a tremendous growth opportunity for our business over the long term, and also helps to support what we just talked about relative to our ability to price within our 1% to 2% algorithm.

Operator

Our next question comes from the line of Chris Carey with Wells Fargo.

Christopher Carey

So just 2 quick ones for me. On the — ***indiscernible*** — – on the beer margin outlook, you gave a lot of great detail. I guess you're looking for flat operating margins for the year. Is there any way – or flattish. Is there any way to frame expectations for gross margin relative to operating margin? And I say that in the context of productivity initiatives, which I suppose can play out in both line items. So I was just curious if you have any comment there.

The second observation is Wine & Spirits just delivered what I think is the best operating margin in a few years. And yet the outlook would imply that you're giving a lot of that back. So is that just conservatism? Or is there something just missing in the bridge about some of this nice premiumization, which has really helped the margin structure there. And I sort of asked that in the context of prior margin targets for the Wine & Spirits business in general. So thanks for those 2 ones, beer margins and Wine & Spirits margins.

Garth Hankinson

Yes. So on the Wine & Spirits margins. And so again, I'll reference you to the deck that will be posted to our website after this call. But we're actually forecasting wine margins to increase by at least 40 basis points on a year-over-year basis. And so you'll be able to see that detail on the – on the website. As it relates to operating margin – gross profit margin with beer, I mean, all of the headwinds that we're facing really in beer this coming year will be in gross margin, and not below the line. As we said, we'll continue to – we'll continue to effectively manage our marketing and SG&A spend and focus on the highest return and highest priority initiatives, and we'll manage that effectively.

So the largest drag for us, as we've said for the last several months now, it's going to just be the inflationary impact, and then again, we'll hit through COGS as well as some incremental depreciation throughout the year.

Operator

Our next question comes from the line of Nadine Sarwat with Bernstein.

Nadine Sarwat

So just coming back to the beer margin point, if I take the midpoint up your beer guidance for top line and operating income, it comes a touch below your initial 38% that I think you discussed. Was there anything in particular the change to the downside versus your previous commentary? Or I mean, is this just a situation of rounding here? And then just a follow-up on the margin point, given the margins of last year, what we'll be seeing on the back of your guidance for this fiscal year? Should we still be thinking about 39% to 40% as your medium-term margin for the business? And would it be fair to **— *Technical Difficulty* —** fiscal '25?

Garth Hankinson

So I'm going to apologize because you broke up back there at the end.

William Newlands

I think the back end of that was do we expect to get there in fiscal '25? You broke up, I apologize, but I think that's what she said. So go ahead.

Garth Hankinson

Yes. So I think as you're working with the numbers that we provided, when we said 38% operating – approximately 38% operating margin. So that if you kind of look at the various points within our range, you'll come up with various different outputs as it relates to what the margin will be. So we fully – we have full conviction that we're going to deliver operating margins for our beer business on approximately 38%.

As it relates to the outlook going forward, we've just provided our outlook – our margin outlook for our beer business for FY '24. We're not providing any guidance for future years. We typically don't do that at this point. That's not part of our process. Certainly, the biggest driver again this year that we have for FY '24 is again driven predominantly by inflation, and the inflation that we're seeing, which I in my scripts as well as some incremental depreciation.

Offsetting that, we'll continue to take pricing as we have. And as we've said earlier, we'll be have pricing in our 1% to 2% range. We continue to drive incremental volume, which helps to offset fixed overheads and depreciation as we grow into our expanded footprint. And we'll continue on with the efficiency drivers that I mentioned as well. So that's where we stand for FY '24, and we'll talk about FY '25 as we close to the end of the year.

Operator

Our final question comes from the line of Bryan Spillane with Bank of America.

Bryan Spillane

I wanted to touch just move back to Wine & Spirits. And maybe Garth, could you talk a little bit about how SVEDKA and Woodbridge are affecting margin and maybe margin progression there? And I guess I get – I ask in the context of they're a much larger contributor to volume than they are to revenue. And I guess my assumption is the margins are lower than the average. So just trying to understand, is getting volume stabilization or volume growth in those 2 brands an important component sort of building margins there? Or is that not really a big factor? So really just trying to understand Woodbridge, SVEDKA and kind of the longer-term impact on profitability in Wine & Spirits?

Garth Hankinson

Yes. Well, you're absolutely correct that given the size of those brands that they do have a bit of a drag on our overall margin profile, given the price points in which they compete and therefore, their margin profile, which is below the average profile for the entire business unit. On a positive note, the Wine & Spirits team has pretty aggressive revitalization plans in place for both of those brands so that we can stabilize those brands and continue to outperformed the price segments that they participate in.

And as such, as we continue to make those efficiency improvements, we certainly – and revitalize those brands, we expect that we'll be able to achieve our margin targets as laid out.

Operator

We have reached the end of our question-and-answer session. I would now like to turn the call back over to Bill Newlands for closing remarks.

William Newlands

Thanks very much. Fiscal '23 was a big year for Constellation Brands'. We achieved record net sales and comparable operating income and were recognized for the 10th year as a CPG growth leader, despite some of the most significant inflationary headwinds affecting our company and consumers in recent history. Our beer business outperformed our initial expectations and continue to lead in share gains, growth and margins. Despite some volatility across the year as we lapped distortions in our performance from prior periods and navigating incremental pricing actions beyond our annual algorithm intended to offset cost pressures across the chain. And we delivered many other transformational milestones, including our transition to a single share class structure and other important corporate governance enhancements.

The start of our construction activities at our new brewery site in Veracruz, and some additional refinement of our Wine & Spirits portfolio as well as continued progress against the strategy of that business.

Lastly, the performance of our business, coupled with our disciplined and balanced capital allocation priorities, allowed us to maintain our investment-grade rating, despite the incremental financing associated with the transaction for our transition to a single share price structure to surpass our share repurchases and dividend cash returns goal by over $400 million and continuing to grow our beer production capacity while executing small growth accretive M&A.

As we look forward to fiscal ’24, we remain focused on delivering sustainable growth and value creation for our shareholders through the execution of our annual plan and by continuing to advance our strategic initiatives.

And we are confident in our ability to continue building momentum across our bigger portfolio and strong volume growth and targeted pricing actions. We are bullish on the future performance of our Wine & Spirits business as it continues to advance its strategy, and we are committed to our capital allocation priorities and our ESG orders.

Thanks again, everyone, for joining the call. We hope you will choose to enjoy your Cinco de Mayo and Memorial Day celebrations with some of our great products, and we look forward to speaking with all of you in late June on our next quarterly call. Thank you very much, and have a great day.

Operator

This does conclude today’s teleconference. We appreciate your participation. You may disconnect your lines at this time. Enjoy the rest of your day.