Constellation Brands Inc, Q3 2019, Earnings Call 2019-01-09

Presentation

Operator

Welcome to the Constellation Brands Third Quarter 2019 Earnings Conference Call. — ***Operator Instructions*** — I will now turn the call over to Patty Yahn-Urlaub, Senior Vice President of Investor Relations. Please go ahead.

Patty Yahn-Urlaub

Thanks, Brian. Good morning, and welcome to Constellation's Third Quarter Fiscal 2019 Conference Call. I'm here this morning with Rob Sands, our CEO; Bill Newlands, our President and COO; and David Klein, our CFO.

As a reminder, reconciliations between the most directly comparable GAAP measure 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 that we make on this call. — ***Operator Instructions*** —

Thanks in advance, and now here's Rob.

Robert Sands

Thank you, Patty. Good morning, and happy New Year to everyone. I hope you enjoyed the holidays, and got the chance to enjoy some of our fine products during the holiday season.

As I reflect on 2018, I am reminded that I am very fortunate to be part of the exciting dynamic at ever-changing beverage alcohol industry. I am also proud of the fact that

Constellation continues to be one of the best growth stories in the industry, led by our remarkable high-end beer business, which is generating double-digit top and bottom line growth. Overall, our business is strong and has excellent prospects for the future and for future growth, and that's why I believe it's the right time to hand over my CEO responsibilities to Bill Newlands, while I assume the role of executive chair at the beginning of our next fiscal year on March 1. Bill has an excellent understanding and appreciation for the values and strategy that have made Constellation Brands one of the top-performing S&P 500 companies over the last decade.

Since joining Constellation in 2015, Bill has made a significant impact on our company as he has assumed increasing levels of responsibility, finding ways to leverage our unique capabilities as a leader in total beverage alcohol and reinvigorating our innovation engine. The company is in good hands with Bill at the helm, and I look forward to continuing to collaborate on key strategic initiatives as I transition to my position as executive chair. As such, Bill will be taking the lead with David and the IR team on all future investment calls – investor calls and meetings.

Over the years, I valued and appreciated the ideas, suggestions and feedbacks I received from the investment community, and I'd like to thank you for your ongoing support. I'd like to mention that my brother, Richard, and I, recently acquired in excess of 1 million shares to take advantage of the tremendous value that Constellation's stock currently represents. With that said and as a precursor to my transition to executive chair, I believe it's the appropriate time to turn the call over to Bill, who will review our business results for the quarter. Bill?

William Newlands

Thank you, Rob. I'm honored to be selected as Constellation's next CEO, and I couldn't be more excited about the opportunity to lead one of the best growth stories in the CPG category.

As many of you are aware, in Rob's tenure as CEO, Constellation has delivered an incredible total shareholder return of almost 800%. Rob, that's quite a legacy and certainly a tough act to follow, so congratulations to you.

Let's now turn to the business. I have 5 key takeaways that I would like to emphasize on this morning's call. Number one, Constellation's beer business continues to outperform the U.S. beer market by a wide double-digit margin. Number two, we have plenty of beer capacity in Mexico to meet the incredible demand for our products well into the future. Number three, we're disappointed with the performance of our wine and spirits business as we're facing challenges with the low end of the portfolio. As a result we've changed our guidance for the year and have taken action by pursuing strategic alternatives to optimize the value of that business. I personally have assumed short-term responsibility for the business to accelerate this effort, and we expect to have more to say in the coming months as a final outcome is determined. Number four, Canopy Growth is committed to achieving their CAD 1 billion revenue run rate target within the next 18 months. Number five, we plan to provide $4.5 billion in cash returns to shareholders within the next 3 years in the form of share repurchases and dividends.

So let's take a moment to discuss each of these points in the order that I outlined them, starting with beer. High-end beer is driving virtually all the U.S. beer category growth, and Constellation, as the leader in the high-end beer, is driving a significant portion of that growth. As a matter of fact, in the month of December, which is the largest month of our fourth quarter, beer depletions accelerated to a rate that was ahead of our fiscal year-to-date growth rate of 9%. Our beer business marked the highlight of our third quarter, driven by Corona and Modelo brand families, which continued to be fueled by strong velocities, excellent distribution gains and highly incremental innovation. Corona Premier, Corona Familiar and Modelo Especial achieved winning spots as the top 3 high-end U.S. beer industry share gainers for the quarter, while Constellation's overall beer business was the most significant share gainer in the U.S. beer market during this time frame.

Modelo Especial continues to have incredible momentum as the #1 growth driver in U.S. beer, and it is now the #1 beer overall in the state of California. Strong NFL media support during the quarter for this brand provided the reach to expand market share with general market consumers, while maintaining its leading position with the growing Hispanic consumer base.

The Corona brand family's depletion growth has roughly doubled to 8% this fiscal year, fueled by better-than-expected performance from our fiscal year '19 innovation initiatives, Corona Premier and Familiar. And we continue to see growing household penetration with Hispanic and non-Hispanic consumers for our Corona brands. I am extremely pleased with Premiers' best-in-class incrementality, which is driving value for distributors and retailers as a trade-up option for consumers in the growing better-for-you space. Corona Premier has already become one of the top growth contributors in the high-end, and we believe Premier continues to have ample runway for growth as it's sourcing much of its volume from the more than 1 billion cases of declining domestic lights. Corona Extra continues to provide the strong foundation needed for the portfolio to grow, with strong brand equity as the #1 most-loved brand among Hispanic and total population drinkers aged 21 to 54.

There also continues to be plenty of runway for future Corona Extra growth, with incremental contributions from draft and canned format as well as the Coronita product. We also have a very strong beer innovation pipeline now and for the future, with ample opportunities to increase distribution and space across our portfolio. Corona Refresca is one of these opportunities, and based on our consumer research, is more than 80% incremental to our growth. It's our strategy to complement our import portfolio and lay the foundation for future success with domestic sessionable and alternative beverage alcohol products that appeal to general market and Hispanic consumers.

Now turning to the operations side of our business. We are currently putting the finishing touches on the final Nava capacity expansion, which we expect to be complete by this fiscal year-end. This marks an incredible feat of expanding capacity to 30 million hectoliters over the last 5 years, on time and on budget, while providing ample supply to meet the growing demand for our beer portfolio. We also continued the new expansion phase at our Obregon brewery with design, site work and utility installations in various phases of completion.

Based on our progress to date, we now believe the new 5 million hectoliter expansion at Obregon will be completed ahead of schedule by the end of fiscal '21, which is about 1 year ahead of the original time line for this project.

Construction also continues at Mexicali with brewhouse tanks in place and warehouse and packaging buildings near completion. While the political environment in Mexicali has been challenging, Constellation has adhered to all regulatory obligations in accordance with Mexican law, which has been verified by the Secretary of the Interior in Mexico. In any event, upon completion of our planned 5 million hectoliter expansion project, Mexicali will only represent 10% of Constellation's total beer capacity in Mexico. The capacity we have built in Nava, plus Obregon when completed, will provide more than 400 million cases of beer, which is ample supply for several years to come.

Shifting now to wine and spirits. We are currently taking advantage of the premiumization trends that have accelerated in the U.S. wine market, with virtually all the growth being driven at the greater than $11 retail price point, and that's where we're focused. In the last 52 weeks, we outperformed the U.S. wine market at the greater than $11 level, with several of our focus brands growing double digits in IRI channels during this time frame. We believe we have unique and ownable positions with powerhouse brands like the Prisoner, Kim Crawford, Meiomi, Robert Mondavi and Schrader to name just a few. Not only do we have powerful brands at these price points, but our innovation engine is focused on premiumizing the portfolio with mix and margin-accretive brands. Our innovation efforts are paying off with successes like Meiomi Rosé, SVEDKA Blue Raspberry and Cooper & Thief rye barrel-aged Cabernet, all of which are exceeding our expectations.

Another great example of innovation success and a turnaround story as well is Robert Mondavi Private Selection, which is currently the second-most significant growth contributor to the Cabernet Sauvignon category, driven by the Robert Mondavi Bourbon Barrel-Aged Cabernet, a brand that equally has exceeded our expectations. My goal for the wine and spirits business is really quite simple, it's to drive a powerful portfolio of high-end wine brands that consistently deliver growth, exceeding the trends in the U.S. market, with an operating margin profile in the 30% range.

Now turning to our leading position in the cannabis market through our investment in Canopy Growth. We are seeing strong consumer demand in the Canadian recreational cannabis market. According to the Canadian government, as of the third quarter of calendar 2018, Canadians spent at a run rate of almost $6 billion on cannabis products, the majority of which were purchased illegally for nonmedical use. As we've discussed, we believe the emerging cannabis space represents one of the most significant global growth opportunities of the next decade, and frankly, our lifetime. An opportunity that is opening up much more rapidly than originally anticipated.

And on that point, the 2018 U.S. Farm Bill was recently passed, with one of the key components of the legislation, legalizing production of industrial hemp, including CBD, a nonpsychoactive cannabis compound that is believed to have significant medical benefits. It also amends the U.S. Controlled Substances Act, by removing hemp-derived CBD products from Schedule 1 and allow states to regulate the production and sale of hemp. Canopy Growth provides a single platform for Constellation to address all global markets and product formats, including both CBD and THC. They announced in a press release earlier this week, their position and advantages relating to the U.S. market entry for CBD products, and they are currently awaiting FDA guidelines pertaining to the sale of these products in the United States.

Since our investment in August, Canopy has used the proceeds to bolster their global leadership position in the cannabis industry, with strategic partnerships and acquisitions, including ebbu, a leading hemp research and innovation firm; Storz & Bickel, a profitable global leader in vaporizer design and manufacturing; and Battelle, who is the world's largest nonprofit R&D organization. Canopy and Battelle will work together to advance cannabis medical research and product development. In addition, Canopy continues to focus on intellectual property development across medical and recreational opportunities, while also preparing and creating brands and products for new, legal recreational cannabis markets across various product formats that will be sold through new and existing channels. It is these initiatives that give me confidence that Canopy can and will achieve their CAD 1 billion revenue run rate target within the next 18 months.

In closing, as the growth leader in the total U.S. beverage alcohol space, Constellation has a stable, core consumer franchise market with growth prospects that exceed those of our competitors in this sector. And our investment in Canopy Growth provides an even greater long-duration growth play, which we believe is being valued as a free call option today with significant value in the future. Combine this with our powerful cash generation capability and our desire to quickly delever and return $4.5 billion in cash to shareholders through a combination of share repurchases and dividends, those in combination make Constellation a compelling investment for the future.

And with that, I would like to turn the call over to David, who will review our financial results for this quarter.

David Klein

Thanks, Bill, and good morning, everyone. With a lot of volatility in the equity markets and knowing that our investors must continue to assess where they can get the best returns, I want to offer to you why we believe that Constellation provides the best combination of growth and cash returns to shareholders within the CPG space.

We've grown comparable basis diluted EPS at almost a 20% CAGR over the past 3 years, using the midpoint of our updated FY '19 guidance. We remain committed to our algorithm of a 10% comparable basis EPS growth CAGR on a mid- to high-single digit net sales growth CAGR over the medium term. This may not be straight-line performance given changing consumer preferences and economic volatility, but we're confident we'll deliver on this commitment.

In addition to our growth prospects, we believe Constellation is also a cash return story. We plan to return approximately $4.5 billion to our investors over the next 3 fiscal years in the form of dividends and share repurchases. This goal is supported by our historically strong cash flow generation and the ramping down of the CapEx needs in our beer business. It assumes we quickly delever back into and operate within our 3.5x targeted leverage ratio range as we remain committed to maintaining our investment grade rating. It also assumes we exercise the Canopy warrants that expire in November of 2021.

Our Canopy investment is like a ventures investment, which positions us to use our capabilities in building brands in a regulated industry to take advantage of the legitimization of an emerging $200 billion global industry. The impact of Canopy on our income statement will be reflected as noncash equity and earnings from an unconsolidated investment. This will not limit our ability to return cash to our shareholders.

In terms of noncash performance to date, we've recognized $1.2 billion of unrealized net gains on our investment through the end of Q3.

As Bill said, we fully expect Canopy to achieve a CAD 1 billion net sales run rate within 18 months, and we continue to expect to receive outsized returns on our total investment in Canopy.

Now let's look at our Q3 performance, where I'll generally focus on comparable basis financial results. Q3 represents another quarter of strong execution by our beer business, which generated double-digit net sales and operating income growth. These strong results, coupled with tax favorability, helped us to deliver 18% comparable basis diluted EPS growth for the quarter. For beer, we continue to outpace the rest of the beer category by a consistently wide double-digit margin. Net sales increased 16% on volume growth of 14%.

In addition to strong demand, shipment volume also benefited from timing as fiscal year-to-date shipment and depletion volume are now fairly aligned. Year-to-date depletions grew 9%.

Beer operating margin decreased 60 basis points to 37.3%. This reflects higher marketing as a percent of net sales, which increased 70 basis points to almost 11%. Favorability in pricing, FX and SG&A were offset by higher COGS primarily related to increased transportation. In addition, we experienced higher glass cost in the quarter due to a nonrecurring raw material supply issue that impacted glass production at the Nava glass plant. This supply issue has been rectified. Gross margin for the quarter would've been flat when excluding this impact.

Depreciation expense increased $10 million to $52 million for Q3, and $30 million to $152 million for the fiscal year-to-date period.

For wine and spirits, shipment volumes and net sales were flat. Operating margin increased 70 basis points to 27% as SG&A favorability and pricing benefits were partially offset by unfavorable mix.

Our comparable basis interest expense increased 14% for the quarter and our net debt to comparable basis EBITDA leverage ratio moved up to 4.6x at the end of November from 3.6x at the end of fiscal '18, primarily due to the additional Canopy investment financing.

Our cash generation profile is strong as we expect our business to produce over $2 billion of operating cash flow annually. This positions us to quickly delever back into our targeted leverage range and return cash to our shareholders, as I outlined earlier.

Our comparable basis effective tax rate came in at 14.1% versus 19% last year. The decrease primarily reflects benefits from tax reform and increased stock-based compensation benefits. This rate came in lower than our previous guidance due to higher-than-forecasted stock-based compensation benefits and a lower-than-expected effective tax rate on our foreign business.

Now I'd like to provide an update on fiscal '19 guidance. For beer, we expect fiscal '19 net sales growth to be at the high end of the 9% to 11% range, including 1% to 2% pricing benefit on our Mexican portfolio.

This guidance implies depletion growth above the 9% year-to-date depletion rate. Volume growth will lag depletion growth in Q4 due to timing and a tough compare. We also expect operating margin for beer to approximate 39%. This would represent a 50 basis point decrease versus last year's 39.5% operating margin in our previous guidance, which implied a relatively flat operating margin result in fiscal '19.

Forecasted transportation costs are driving gross margins to be fairly flat compared to our previous goal of gross margin improvement for the year, as the benefit from pricing is being largely offset by the higher transportation costs as well as higher depreciation expense. We believe holding gross margin for the year is an impressive result given the unfavorable gross margin impact we've experienced from transportation cost for the first 3 quarters of the year.

We've been able to accomplish this result in part from the operational costs and efficiency initiatives that we have underway and which we expect to continue into next year. These efforts are important as we continue to expect some transportation cost headwinds as we move into fiscal '20 as drivers in freight lanes are expected to remain in short supply.

We expect fiscal '19 marketing as a percent of net sales to be at the low end of our targeted range of 9.5% to 10%. This compares to last year's 9% result.

This year's incremental marketing investments are primarily in support of our very successful Corona Premier and Corona Familiar product introductions, along with Modelo Especial – which along with Modelo Especial were top share gainers this quarter. Going forward, we expect our marketing as a percent of net sales to fluctuate within the 9% to 10% range and may move toward the higher end of that range depending on the magnitude of our innovation.

Moving to wine and spirits. Year-to-date, U.S. shipment volume has outpaced depletion volume primarily due to timing. This timing benefit is expected to reverse in Q4. As a result, we now expect fiscal '19 wine and spirits net sales and operating income to decrease low single digits compared to our previous guidance of 2% to 4% net sales and operating income growth.

In addition, we've updated our interest expense projection to a range of $380 million to $390 million. This now includes $55 million in additional interest expense related to the financing of our $4 billion Canopy Growth investment. This has an approximate $0.25

impact on our fiscal '19 comparable basis diluted EPS. We continue to expect our fiscal '19 comparable basis effective tax rate to approximate 18%, which implies a Q4 rate of approximately 19%. This higher Q4 rate is primarily due to lower-than-expected benefits from stock-based compensation.

Finally, I'd like to note for fiscal '19, we expect weighted average diluted shares outstanding to approximate 196 million shares, corporate segment expense as a percentage of net sales to approximate 2.5% and net income attributable to noncontrolling interest to approximately $20 million to $25 million. Due to the factors I just outlined, we now expect comparable basis diluted EPS to be in the range of $9.20 to $9.30 per share. Excluding the impact of the incremental Canopy-related interest expense, comparable basis diluted EPS for our core business will grow almost 10% for fiscal '19.

We remain on track to generate over $2.3 billion of operating cash flow and $1.2 billion to $1.3 billion of free cash flow.

And now a few additional words about our Canopy investment. We will be accounting for our November '17 – our November 2017 initial common share investment and the additional common share investment which closed on November 1 of 2018 under the equity method of accounting. As of November 1, our Canopy ownership totaled 123 million shares. This represented approximately 37% of the outstanding common shares of Canopy Growth. This portion of our Canopy investment will not change in subsequent periods due to the fluctuation in Canopy's stock price. Instead, we'll see fluctuations based upon our share of Canopy earnings.

The equity and earnings for our share of Canopy earnings will be reported on a 2-month lag. Therefore, Canopy's earnings for November and December, which is included in their Q3 results, will be recognized in Constellation's Q4 results.

Our Canopy warrants are recorded at fair value. Market fluctuations will therefore flow through our reported earnings. We'll continue to exclude changes in the fair value of these warrants from our comparable basis earnings.

I'd like to emphasize that the recognition of our share of Canopy earnings in our income statement will not impact Constellation's cash flow. To reiterate, Canopy's equity and earnings are a noncash flow item for Constellation. We continue to evaluate the potential equity and earnings impact to fiscal '19 and fiscal '20 results from the Canopy investment, including any comparable – any potential comparable adjustments related to the transaction. As a result, Canopy's equity and earnings impact is not factored in to our updated '19 comparable basis diluted EPS guidance range of $9.20 to $9.30. When we begin recognizing our share of Canopy earnings, we will adjust Canopy's reported IFRS results to U.S. GAAP. As such, the fair value accounting impacts related to Canopy's biological assets and inventory will not be reflected in our GAAP or comparable basis results. However, our GAAP and comparable basis results will reflect amortization expense related to the fair value allocated to Canopy's intangible assets.

In addition, I would also note we currently expect stock-based expense related to Canopy's acquisition milestone payments as well as other certain fair value changes to be excluded from our comparable basis results. When we provide guidance for fiscal '20 in early April, we'll continue to provide net sales and operating income growth targets for our beer and wine and spirits businesses in order to highlight the underlying earnings power of our core business.

Separately, we expect to provide guidance related to Canopy's noncash equity and earnings and the estimated interest expense associated with the Canopy investment and how these items will impact Constellation's P&L. This approach will highlight the strong financial growth and cash generation capability of our core business, which we believe is not currently reflected in our valuation.

With that, we're now happy to take your questions.

Question and Answer

Operator

— ***Operator Instructions*** — And our first question will come from the line of Dara Mohsenian with Morgan Stanley.

Dara Mohsenian

So my question is around the trajectory of beer depletions going forward. Fiscal Q3 was a bit softer than we've seen from you guys historically at 8%, but it sounds like you're off to good start so far in fiscal Q4. So help me understand that slowdown in Q3. Was it more just industry softness is dissipating a bit now? And just any thoughts around if your forward beer depletion growth can hold up if the industry trends remain softer would help? And then specifically on the innovation front going forward, can you give us some detail on if you think Premier can grow next year, year 2, post the launch? And the reasons why? And just any frame of reference for how big you think Refresca can be next year?

William Newlands

Sure. Dara, a couple of things on the depletion trends. As I mentioned during my prepared remarks, our depletion trends in December were actually up higher than our year-to-date rate, which was at 9%. So we're still very comfortable with the growth profile of our business. What's also important to note is that our share gaining performance during that quarter remained consistent with our share gaining performance over the course of the year. So our delta to the market remained very, very strong, and we're confident that this is going to be a continuing trend. Relative to innovation, we think there's a lot of runway yet to go in Premier. We continued to see accelerating velocities in that business, and we expect that that's going to be an important part of our overall mix for our Corona brand family going forward. Lastly, Refresca. Well, it's a little early to tell. We're extremely excited about this. Our research and our testing that we've done on Refresca suggests this will be over 80% incremental to our core franchise and will bring new customers into our business. So we think this is going to be a tremendous launch that will occur during the early part of our next fiscal year.

Operator

And our next question will come from the line of Bonnie Herzog with Wells Fargo.

Bonnie Herzog

I had a question on beer gross margins. I guess, I am still trying to reconcile, like you guys said during your last quarterly call in terms of cost and things being more transitory, especially transportation. And then you also talked about several COGS improvement initiatives that were underway to help offset some of the cost headwinds. So could you give us an update on those initiatives? Did something change with timing since they didn't really help to offset some of the gross margin headwinds that you faced in the quarter? And I guess, I'm still trying to reconcile maybe what went wrong in the quarter? And then how we should think about gross margins for the full year? You did mention they'd be flat instead of improving, but just want to make sure they're not worse than flat.

David Klein

Yes. No, we're still comfortable with flat, Bonnie. And if we kind of breakdown the gross – the Q3 gross margin, the transportation and logistics headwind accelerated a little bit for us in Q3. But we still – because of the productivity initiatives, we still were well on track to at least maintain our margins in the quarter. And then we had an issue with some raw material inputs into our glass facility in Nava, which caused us to have to slow down the furnaces and lower throughput for the plant in Q3. That's a onetime issue. But it created a headwind that the other – that in addition to the freight headwinds, we weren't able to overcome. But other – again, other than a slight acceleration in our transportation and logistics cost headwinds and the glass issue, we remain on track with where we thought we would be with gross margins.

Operator

And our next question will come from Nik Modi with RBC Capital Markets.

Nik Modi

So the – I guess, the question is on the wine business and you're talking about some of the strategic alternatives. I know it's probably too early for you to give us some finite viewpoints. But maybe just help us understand some of the options you might have available to you? I think there were some discussions in prior meetings about perhaps regionalizing some brands or even making some of the brands private label at certain retailers. Maybe you could just help us understand kind of how we should think about it.

William Newlands

Sure. I think, Nik, the way we're thinking about the wine business is this, we have an entire stable of brands that generate outstanding gross margins and have high-growth profiles at the high end of our business. You know, as you've heard me say before, something like Kim Crawford has a 68% gross margin. It's a terrific business as is Meiomi and many of our other brands and the Prisoner and things of that nature. We have been challenged by the lower end of our business, which in totality has been flat to down, and we continue to be slightly overweighted into that sector of the business. So we, as we've said before, are taking a strategic look at what our portfolio should look like going forward, which could include disposition of some of the lower end of our portfolio. Our long-term view is that the high end of the business, which is the – in our judgment, primarily driven by over $11 price point, is where we're going to get the kind of margin structure and growth profile that we think we would like to see for our wine business going forward.

Operator

And our next question will come from the line of Steve Powers with Deutsche Bank.

Stephen Robert Powers

I really want to just pick on the $4.5 billion in cash return and just some clarifications around that. Is that – I'm assuming that's a fiscal '20 to '22 statement, just want to get that out of there. And then any color you could provide on sort of the cadence of that cash return? And as you think about the cash return alongside maintaining the targeted leverage ratio, I know, you said you want to delever to 3.5x and then exercise the warrants, which presumably puts you back up above 3.5x. So as we think about the capital structure over that – alongside that $4.5 billion in cash return at the end of it, are you anticipating to be at 3.5x? Or be above that as you think about the next 3 years?

David Klein

So Steve, when we think about that – first of all, this isn't necessarily new news, in that our company generates a lot of cash and we know that we're going to have CapEx ramping down over the next few years, the CapEx related to our beer business. And so we look at – we have a targeted leverage ratio of 3.5x, although, we're willing to operate in that 3x to 4x range. And we're really confident that we'll be able to both return $4.5 billion worth of cash, stay within our targeted leverage ratio range and exercise the Canopy warrants. And I think that's a pretty powerful view of the ability of our business to generate cash. And we don't expect that there would be any share repurchases in the remainder of FY '19 just given where our leverage ratio is. So clearly, your point about it being an FY '20 through FY '22 statement is accurate.

Operator

And our next question will come from the line of Vivien Azer with Cowen.

Vivien Azer

I wanted to touch on wine as well. A 2-part question please. Number one, could you comment anything specific that drove the magnitude of the deterioration over the last 3 months in the low end. Bill, I heard you loud and clear, that the low end has been a problem, but given the magnitude of the guide down it seems like something changed and changed pretty recently. And then the follow-up to that is, how do you think about the impact of potential asset sales in wine impacting your ability to be a category captain or category leader in that category? So I think historically, one of the cases for having a broad wine portfolio was that scale gave you a lot of influence at retail?

William Newlands

Well, certainly, the growth profile of the wine business, I think, is going to continue to be in that $11 and up. Now we've seen premiumization be an ongoing play for years and years and years, and I don't see that changing any. Therefore, I wouldn't see that there would be a lot of difference in the whole question of being able for category captaincy. People look for organizations that have growth profiles and for people that have deep consumer understanding of where the market is going and why. Relative to the decline in our low-end business, which is reflective in the earnings position, we've certainly seen that – and we said this last quarter, our shipments have been ahead of our depletions, partially driven by our desire to make sure we had adequate inventory levels heading into the holiday season. And frankly, that needs to correct in Q4. The low end of the business, which we've said we are looking at strategic alternatives, has suffered the most, and that's not surprising when you make a statement of that ilk.

Operator

And our next question will come from the line of Lauren Lieberman with Barclays.

Lauren Lieberman

I think you've been pretty clear on the Canopy impact on the P&L and delineating cash versus noncash impacts to net income. But I do think that there is a lot of concern out there on the degree to which you will see dilution to your earnings base in fiscal '20 and beyond from Canopy. So you've talked about the CAD 1 billion in revenue. Anything that you can add in terms of the current outlook for Canopy's earnings? My understanding from them is that they intend to report Canada separately. So even if they reinvest profit dollars to establish U.S., or whatever it may be, that we'll see they are executing in Canada. But anything you can offer, I think, would be really helpful, because people are struggling with the '20 kind of number that we should be playing with here.

David Klein

Yes, so Lauren, the – so we expect – and we've said this, this isn't Canopy now, this is really Constellation's view. We expect the Canadian business to be at that CAD 1 billion run rate. We expect them to have very attractive CPG-like operating margins within their business. We – and that's focused on Canada. And we also know, as you pointed out, that there'll be drags on their business from investment in R&D and the cost of opening additional markets. So we've said that we expect that this transaction will be accretive to us by FY '21, and we expect that to be the case or we continue to expect that to be the case. In terms of actual guidance in the near term for Canopy, we're not in a position to provide that, primarily because they've just closed their recent quarter. They'll produce results in mid-February. And shortly after that mid-February results come out from Canopy, we'll then provide a bit of a walkthrough for the market on how those actual results will flow through our P&L, and that'll be the first time we do it. And then clearly, when we provide guidance, we'll provide more specificity around the Canopy equity and earnings number. But – and I know you said we've been clear on this, but it's a noncash measure. We're viewing this as a ventures investment. We've already made that investment. That was the $4 billion investment that we closed in November, and we expect to get an outsized return on that investment, understanding there's going to be some volatility in our P&L,

however, that volatility will be noncash in nature.

Operator

And our next question will come from the line of Amit Sharma with BMO Capital Markets.

Amit Sharma

Bill, a quick clarification on wine and then the beer business. So you said over shipment will clear in fourth quarter. Should we expect that impact to drag into fiscal '20? Or by the end of 4Q, you would have achieved right inventory level for wine? And I have a beer business question.

William Newlands

Sure. No, we expect – the way we have traditionally run is no matter what our situation is coming into the fourth quarter, we get our depletions and our shipments to balance during the course of the fourth quarter. So we would not expect that this would have impact on next fiscal year.

Operator

And our next question will come from the line of Andrea Teixeira with JP Morgan.

Andrea Teixeira

So in terms of the capital allocation for the strategic alternatives for the wine brands, would an outright sale be doable in that view? And if so, what is the plan of use of cash, as you said before in the prepared remarks, but could you please rank if that would be pay down the debt first, buybacks and leaving the warrants for Canopy for after when you see your own cash flow generation?

David Klein

Yes. So in terms of any proceeds of any asset dispositions that may come up over a period of time, we would first make sure that we're comfortably within our targeted leverage ratio range. And then beyond that, as we've committed today, we'd be focused on returning cash to our shareholders. With respect to the Canopy warrants, and I want to be really clear about this, we're going to return $4.5 billion to our investors, and we can fund the Canopy warrants. However, we'll only fund the Canopy warrants if it makes sense and the business is unfolding as we expect when we get into November of 2021. So if that business is going well, we think our investors will be happy for us to exercise those warrants. And if the business isn't going well, we'll have a lot more cash to return to our investors.

Operator

And our next question will come from the line of Judy Hong with Goldman Sachs.

Judy Hong

So I guess my question is around the Corona brand family performance. And recognizing that obviously this year, you had a very good performance on Premier and Familiar. Bill, I'm just wondering what do you think is going on with the Extra in terms of velocity being down this year? And then as you think about next year, do you think that the broader Corona franchise can continue to grow at this 7%, 8%, even if Corona Extra is down a bit next year?

William Newlands

Yes. One of the things that you see going on with Corona Extra is a good news – what I would call a good news, bad news situation. Premier has done so well. And even though the incrementality is over 70%, which is phenomenal, the better it does, the more it has some impact on our other franchises from which it does take some cannibalization. So – and obviously, as you have all seen, Corona Premier has virtually done twice what we expected it to do heading into this fiscal year. So it's been a phenomenal success. What I do believe is that the Corona franchise continues to have significant upside across the entire brand family. And my – just as a marketing belief, I think that the more Corona brand family we can provide to the consumer and that the consumer buys is outstanding for the long-term equity of the Corona brand family. So we're very optimistic. You then in turn add Corona Refresca, which brings a whole different consumer profile to the table. As I said during my prepared remarks, it appears that, that will be in – at the high end of the incrementality that we saw with Premier, which was best in class. So again, this will help to enhance the number of times that consumers in this country are picking up a Corona brand family product, and I think that speaks very well to the long-term franchise of Corona.

Operator

And our next question will come from the line of Robert Ottenstein with Evercore ISI.

Robert Ottenstein

So a lot of questions came into us on the gross margin for beer. And you addressed some of it, but I just want to kind of touch on a couple of points. One, shipments really strong. All things equal, you would think the shipments would've been a benefit for the gross margin in the quarter, however, there could have been additional transportation costs related to that. Can you address that? Second on gross margin. Looks like you've got about 2% pricing for beer. Is that right? And then finally, roughly what quarter do you think the transportation costs will start to ease?

David Klein

Yes. So Robert, the pricing – so if I do kind of a bridge out of our gross margin numbers, we got about 110 basis point benefit from pricing. We got a little bit of benefit from FX. We had about 160 basis point drag from transportation and logistics, which is larger than it's been on a year-to-date basis. That's the acceleration that we were talking about. And then as I said, we had some drag from the glass issue, which was, in aggregate – that and maybe some depreciation amounted to about 80 basis points. So a couple of things happened when we get into Q3, and that's that even though we're shipping more, we're actually – we are slowing down our production because it's our lowest, kind of, production quarter of the year. And so I think taken altogether, the gross margin worked out as we expected, but for the glass plant – the glass production issue, which is behind us.

Operator

And our next question will come from the line of Kevin Grundy with Jefferies.

Kevin Grundy

I wanted to come back to Canopy, just given the importance here and the focus in the investment community. Can you drill down a little bit on the Canada rec rollout. I think you said you're seeing strong demand. I'm not sure if there's anything you can add to that, relative market share, 30% to 40%. Another question, beverage rollout expectations. I think your – the discussion has been around calendar Q4. Maybe if you can sort of frame the opportunity and what you're expecting there? And then just last, in the long-term guidance, what gives you confidence at this point on the CAD 1 billion within 18 months? And then David, maybe you could just confirm the 30% to 40% operating margins as well for Canopy. I think you said CPG-like margins. Just want to confirm that you're still confident that 30% to 40% is operating margin is the right number?

William Newlands

Sure. Why don't I take the first piece of that, and I think David will take the last piece of that. Let me just remind everyone upfront that we are in a quiet period, they are in a quiet period at this point in time. So we will be reflecting things that have been in the public domain. Yes, Canopy has been progressing with the kind of market share, which we have said before, is in the 30-plus-percent range of the total cannabis business in Canada. We also, if you recall, projected that the Canadian market as part of our total global projections of where we thought the market would go, would be in the $5 billion to $7 billion range. And just this past week, the Canadian government has estimated that the consumption of cannabis by Canadians in the third quarter was at a run rate of $5.9 billion, which of course, is right smack in the middle of what the initial projections were. I'll remind everyone, beverages are not currently available in Canada. We expect and Canopy expects that, that will change later this calendar year, but an exact date of that has not been defined yet. But I can assure you, when and if that eventuality occurs, and we certainly expect that it will, that Canopy will be in a position to take advantage of that opportunity.

David Klein

And only thing I might add to that, Bill, is the $5.9 billion number quoted by the Canadian government includes – a majority of that is illegal sales. So really, the build to CAD 1 billion is dependent upon the channel shift, if you will, from illegal markets to legal markets, of which we're comfortable with the market share that we've outlined before for Canopy. And I would say that after Canopy's results are released in mid-February, we'll – they will have a lot more to say about their margins as will we.

Operator

And our next question will come from the line of Pablo Zuanic with SIG.

Pablo Zuanic

Just a quick question. I want to go back to what Judy was discussing. I'm trying to understand better the cannibalization or the opportunity for Premier and Familiar in terms of further distribution gains. The numbers we're looking at, Corona Extra, a core brand, is down about 10%; Corona Light, down about 20%; Modelo Especial, which I think has been cannibalized from Familiar, has decelerated from the 19% range to 10%, 11%. So there is an impact. And according to our data, 80% of your growth in the fourth quarter, November, was really Premier and Familiar. Yes, the 2 brands have done great. So the simple question is, as you rolled out those brands, did you have to take space, existing space from your current portfolio? Or did you gain new space? Or is that – are you in the process of converting that and expanding space? What are the opportunities for Premier and Familiar or even Refresca eventually if it does well in on-premise, restaurants, in draft? If you can expand on that. Because I think there's a question mark here, depletions up 10% the last 2 years, this year, running 9%, what happens next year when you're so dependent on these line extensions? And I want to stick to one question, but if I can just at the very end, as you have more extensions and you have more complexity to your portfolio, does that, in any way, affect your profit margins in beer?

William Newlands

Sure. So let me answer the last one first. Any of the products that we have discussed, meaning Familiar and Premier and so forth, we are agnostic as to which product actually gets sold, the margin and profit profile of those individual products are virtually the same. Relative – so let's go back for just a minute to the question of cannibalization. As we – we have seen the cannibalization exactly as we expected, in fact, if anything it's been slightly less, meaning more incremental than we had expected with Premier and Familiar. One of the things that we have done extensively and we are continuing to do, and I think your point's a good one, is we have had the Shopper First initiative, where our emphasis has been, based on in-store research, as to what an appropriate shelf should look like that focuses on the right set of brands for retailers to maximize their benefit in the beer section. Of course, the beauty of that is we actually come out pretty well on that issue. And that opens up significant opportunities for us to expand distribution and shelf space. And frankly, we need that shelf space because our portfolio with its share-gaining performance really demands that kind of shelf placement improvement. I would also mention that Refresca, what you asked a question about, we'll probably not be sitting in the middle of the beer section. This is an alternative beverage alcohol product, that will place – be placed in the different door of the cold box and will compete with other brands not necessarily directly within our franchise, and we think this is great because it opens up another window coming from the great equity that Corona has and has had for many years.

Operator

And our next question will come from the line of Tim Ramey with Pivotal Research Group.

Timothy Ramey

I understand your commentary on the sub-$11 wine business, but is there enough, other than Woodbridge, in the portfolio that would really make a difference there? Is this a Woodbridge problem? Can you speak directly to the performance of Woodbridge?

William Newlands

Sure. We're actually very happy with Woodbridge. Woodbridge is in a category that's actually in decline, but Woodbridge is gaining share within that category. And obviously, it benefits from the Mondavi franchise halo. As you know, we have Mondavi's franchise covered at a number of price points. And so Woodbridge will continue to be an important part of our portfolio. And yes, we have a substantial amount of assets in the under $11 price point outside of Woodbridge. And that gives us significant options of what to do going forward and as we said earlier, in fairly recent time, we'll be able to talk about that more extensively.

David Klein

Tim, we've also said in the past that about 30% of our volume comes at the greater than $11 price point. And then if you look at Woodbridge, Woodbridge by itself is about 20% of our volume. And of course, when we're looking the greater than $11 price point, we get a lot more dollars out of that volume. But that gives you a sense for what else is in the portfolio.

Operator

And our next question will come from the line of Bill Chappell with SunTrust.

Grant O'Brien

This is actually Grant on for Bill. We just had a question on the spirit side of the wine and spirits business, we haven't talked about that much this morning. So hoping to get some comments may be on the SVEDKA national marketing program and any other more kind of commentary on the general portfolio?

William Newlands

Sure. It's early days on the new creative that we have put out in the marketplace, but I can assure you, from our initial testing, this is one of the stronger campaigns certainly that this organization has put out in the recent past. So we're very excited of how that campaign could work for us. And I think it's a great example of some of the work that Jim Sabia has done to bring some of his outstanding marketing efforts in beer in to our wine and spirit efforts as well. So we're very optimistic about it. SVEDKA has already been performing in a positive manner versus the vodka category and we think this can only help it. I'm sure you've also seen we have very good results as it relates to High West and Casa Noble and the continue to see the more premium aspects of our spirits portfolio as important going forward as well.

Operator

And our next question will come from the line of Laurent Grandet with Guggenheim.

Laurent Grandet

I like to discuss about the Mexicali and the water issue. I mean there are more and more, I mean, reports in the Mexican press that there are potentially some risks associated to water rights at the Mexicali brewery and impact it has on the local community. So could you please give us some more color about that issue? And let us understand how you are planning to mitigate those risks?

William Newlands

Sure. As I said in my prepared remarks, our efforts in Mexicali have been totally in compliance with all Mexican law and has been done with a deep understanding of water usage. We do not believe this is a major issue. And we believe that all is going to proceed as planned with our Mexicali site. I will say, and I said this also, with the completion of our Nava facility as well as our expansion at Obregon, that after the 5 million hectoliters of Mexicali comes online, that facility will only represent 10%, roughly, of our total capacity in Mexico, one way or the other.

David Klein

And said in other way is, more from an investor's standpoint, I would say that, we can – with Obregon and Nava, Bill said this in his script, we have the ability to produce 400 million cases of beer from Obregon and Nava.

Operator

And our next question will come from the line of Bryan Spillane with Bank of America.

Bryan Spillane

David, I just wanted to follow-up, you had referenced, I think in your prepared remarks, just the medium-term growth targets. And I just had a couple of follow-ups on that. One is, the diluted EPS expectation – the EPS growth of around 10%. Does that now include share repurchases, given what you've said about capital allocation? And I think the second, you kind of referenced that it's not linear. So I guess, as we're kind of looking into fiscal '20, it's kind of sounding like beer margins may be under pressure for a little while longer, not sure what the path to low – mid-single-digit growth on operating income in wine and spirits is. Is it kind of meant to infer that next year may – could potentially be an off-algorithm year?

David Klein

Look, Bryan, we haven't even finished rolling up our estimates for next year. What we do know is when we look out over the medium term with our beer business, we still expect that high single-digit net sales growth. We still expect to have very robust margins. And then Bill talked about the wine and spirits view, which is kind of mid-single-digit growth and 30% operating margins. So we think that, along with our ability to make investments in the business and buy back our stock as well as getting – working our way through the early years and the choppiness in the equity and earnings in the Canopy investment, we expect that we'll continue to see that 10% EPS growth target that we put out before.

Operator

There are no further questions in the queue. So now, I'd like to hand the conference back over to Mr. Bill Newlands for any closing comments or remarks.

William Newlands

Thank you, everyone, for joining our call today. I want to take this opportunity to wish all of you a safe and happy and prosperous new year. And as Rob said at the beginning, hopefully, you'll do that while enjoying some of our fine products.

I'm honored to assume the role of Constellation's CEO in just a few short months, and I look forward to capturing the great opportunities that lie ahead of us for our company. We look forward, David and I, to seeing many of you at the CAGNY conference in late February, where we'll be providing an update on our strategic business initiatives. As a reminder, during our next quarterly call, we will provide our guidance for the upcoming fiscal year. So thanks, again, to everyone for joining the call and have a great day.

Operator

Ladies and gentlemen, thank you for your participation on today's conference. This does conclude our program, and we may all disconnect. Everybody, have a wonderful day.