Brown-Forman Corporation, Q3 2017, Earnings Call 2017-03-07

Presentation

Operator

Good morning. My name is Kayla, and I will be your conference operator today. At this time, I would like to welcome everyone to the third quarter fiscal 2017 conference call. — ***Operator Instructions*** — Thank you.

Mr. Jay Koval, Director of Investor Relations, you may begin, sir.

Jason Koval

Thanks, Kayla, and good morning, everyone. I want to thank you for joining us for Brown-Forman's Third Quarter 2017 Earnings Call. Joining me today are Paul Varga, our Chairman and Chief Executive Officer; Jane Morreau, Executive Vice President and Chief Financial Officer; and Brian Fitzgerald, Chief Accounting Officer.

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

This morning, we issued a press release containing our results for the third quarter fiscal 2017 in addition to posting presentation materials that Jane will walk though momentarily. Both the release and the presentation can be found on our website under the section titled Investors, Events & Presentations.

In the press release, we have listed a number of the risk factors that you should consider in conjunction with our forward-looking statements. Other significant risk factors are described in our Form 10-K, 8-K and 10-Q reports filed with the Securities and Exchange Commission.

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

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

Jane Morreau

Thanks, Jay, and thanks for joining us for our third quarter earnings call. Similar to last quarter, we have posted slides to our website that I will reference in my comments to help you walk through our 2 main areas of focus today, including first, our year-to-date results; and second, our revised full year outlook for fiscal 2017. After I complete my remarks, I'll turn the call over to Paul for his comments, and then we'll open it up to Q&A.

So let me start with Slide 3, a summary of recent highlights. First, as expected, our reported results through January continued to be negatively impacted by acquisition and divestiture activity as well as FX headwinds. It's worth noting that we recently lapped last year's March 1 sale of Southern Comfort and Tuaca. So those headwinds on our reported results will abate in Q4, notwithstanding last year Q4 gain on sale.

Second, we experienced another quarter of sequential improvement in our underlying top line results. The U.S. continued to deliver good results, while the sales growth accelerated in many markets outside of the United States, including developed and emerging as well as Global Travel Retail. Third, we continued to deliver operating leverage through reductions in SG&A.

And finally, we revised our full year outlook. Despite the sequential improvement in our underlying net sales growth, a challenging global backdrop has slowed the rate of acceleration compared to what we had been anticipating. We now expect full year underlying net sales growth of 3% to 4% and underlying operating income growth of 5% to 7%. Given this 1-point reduction and where we are in the fiscal year, we tightened our fiscal 2017 EPS to a range of $1.71 to $1.76. I'll come back to our outlook in a little bit more detail in a minute.

So let's now turn to Slide 4, a review of our year-to-date growth. We grew underlying net sales by 4% in the third quarter. This represented a continued acceleration from the first quarter's 2% growth and the second quarter's 3% growth. This led us to 3% underlying net sales growth during the first 9 months of our fiscal year, roughly 1 point below where we had anticipated we would be at this time. Reported net sales over the same period declined 3%, pulled down by 3 points of A&D impact and 2 points due to adverse foreign exchange, both highlighted on Slide 5.

Breaking down our underlying net sales performance by geography shown on Slide 6. The United States grew 3% in the quarter and 4% year-to-date. We believe that the deceleration during the quarter was due in part to the modest softening in the TDS trends we have seen over the last few months.

The developed markets outside of the U.S. grew underlying net sales by 4%, pulling up our year-to-date growth in these markets to 3% versus 2% in the first half. Results were bolstered by the reversal of some timing-related items in the United Kingdom and Germany that had negatively impacted the second quarter's rate of growth.

In emerging markets, we experienced another sequential improvement during the third quarter, with underlying net sales up 5%. This drove our year-to-date results in the emerging markets back into the black. While many emerging markets remained volatile, we are encouraged to see them return to growth as we believe they represent a substantial potential driver of our top line over the coming decade as we develop our brands in the largest population centers in the world.

Global Travel Retail, which had been a drag on our results during fiscal 2016, grew underlying net sales by 13% in the third quarter. This drove a 7% underlying net sales increase during the first 9 months of our fiscal year, with growth helped by distribution gains on several brands in our portfolio, including Woodford Reserve.

Slide 7 highlights the year-to-date sales growth for our top 10 markets. We delivered 4% underlying net sales growth in the United States, United Kingdom and Germany. Mexico grew 14%. France grew 9% and Poland grew 8%, while Australia and Canada were roughly flat. Russia and Turkey were down 4% and 11%, respectively, but both markets experienced improving demand during the third quarter. Several other emerging markets, including Southeast Asia, Africa and Latin America, remained challenging due to weak economic conditions, but we expect easier comparisons beginning in the fourth quarter.

Slide 8 breaks out our brands' contributions to year-to-date underlying net sales growth. Jack Daniel's family of brands grew underlying net sales by 3%, a slight improvement from the 2% in the first half. Growth was driven by gains for Jack Daniel's Tennessee Whiskey, Tennessee Honey, Tennessee Fire, Gentleman Jack and Jack Daniel's RTD. Our premium bourbons, including Woodford Reserve and Old Forester, are growing nicely, up 21%, despite the anticipated slowdown in volume growth after taking price increases earlier this fiscal year on both brands. Our tequila brands, el Jimador, Herradura and New Mix RTDs, grew underlying net sales by 13%.

The rest of our portfolio include several other brands, including Finlandia, where underlying net sales dropped 1% in the first 9 months. Sonoma-Cutrer and Korbel champagne grew mid-single digits, and Canadian Mist's rate of decline moderated to 7% in the third quarter.

Our used barrel business remained a top line drag in the quarter, resulting in a 22% year-to-date decline in our other – unbranded net sales. This reduction was due to lower prices and volumes as a result of weaker demand for blended Scotch industry buyers and pricing pressures due to increased supply of used barrels in the market. As we look ahead, we don't anticipate a near-term improvement in this business.

Moving down the P&L and as shown on Slide 9, reported gross margin declined 210 basis points year-to-date. This decline includes 120 basis point of impact from A&D activity and 90 basis points from foreign exchange.

Slide 10 summarizes our operating performance on both a reported and underlying basis for the third quarter and first 9 months. You'll note our underlying A&P increased 10% in Q3, driving a 4% increase in year-to-date A&P. While we invested behind Jack Daniel's 150th anniversary during the quarter, some timing was also responsible for the big uptick in the quarter spend.

On the SG&A front, we remain committed to a disciplined approach to controlling our costs. This, combined with lower compensation-related expenses, has allowed us to drive down year-to-date underlying SG&A by 2% or minus 4% on a reported basis.

In the aggregate, we delivered 5% growth in underlying operating income during the first 9 months of the year or over 6% after normalizing the anticipated back-half A&P spend. Year-to-date reported operating income declined 4%, largely due to divested brands and foreign exchange headwinds.

We reported earnings per share of $0.47 in the third quarter, up 1% over the prior year period and $1.34 during the first 9 months of fiscal 2017, also up 1%. Earnings per share growth was helped by a lower tax rate and the net effect of our share repurchase program.

Let me now move on to my second and final topic for this morning, an update on our outlook for fiscal 2017, which is shown on Slide 11. At a high level, I would characterize fiscal 2017 as a tale of 2 halves. Remember the first half of the year got off to a sluggish start, given the emerging market woes, tough comparisons against the prior year's launch of Jack Daniel's Tennessee Fire in the U.S. and a decline in our used barrel business. Our rate of underlying net sales growth accelerated to 4% in the third quarter. Despite a sluggish start to this calendar year in January and February, we expect the fourth quarter to deliver similar rates of growth to the third quarter, resulting in back-half underlying net sales growth of approximately 0.4%, roughly double the rate we delivered in the first half of the fiscal year.

This should result in a full year rate of growth of 3% to 4% on an underlying basis. While this is still a healthy rate of growth when compared to other consumer staple companies, it is below what we aim to deliver over longer-term horizon and a point below prior expectations. But we believe that this is a temporary slowdown rather than a permanent change in our demand for our brands, in part due to the reduced purchasing power of non-U.S. consumers due to the strong dollar against a weak macro backdrop.

Specific to the fourth quarter, takeaway trends in our major markets remain solid and, in many cases, ahead of depletion growth. We are seeing improved results from many of our historically fast-growing emerging markets against easier comparisons, as highlighted by Slide 12. We believe that the worst of the gross margin pressures in fiscal 2017 caused by A&D activity are behind us, but the combined headwinds from foreign exchange, higher content costs and challenging pricing environment could continue over the near term.

On operating costs, we expect A&P to grow roughly in line with sales for the full year, implying a substantial deceleration in the rate of growth in the fourth quarter compared to the third quarter's 10% increase. Conversely, SG&A is going up against some challenging fourth quarter comparisons last year, and we will begin layering in some additional costs related to this summer's transition to own distribution in Spain. So we expect fourth quarter SG&A to be up modestly, but still result in a decline in underlying spend for the year.

In the aggregate, we now expect full year operating income growth of 5% to 7%, also 1 point below our prior expectations, but still a very solid growth for the year. Assuming current spot rates, we now expect foreign exchange headwinds of $0.06 in the fiscal year. As a sensitivity, assuming our foreign currency cash flow exposures collectively move 10% in either direction, EPS over the balance of the fiscal year would be impacted by roughly $0.02.

After considering recent growth rates, larger expected FX headwinds and the benefit of our share repurchase program and with only a quarter to go in the year, we have tightened our EPS range to $1.71 to $1.76.

So in summary, our core brand portfolio continues to deliver healthy, sustained underlying net sales growth, and we are translating that top line performance into solid bottom line results. For example, if we deliver the midpoint of our underlying operating income guidance this year, it will be the eighth straight year of at least 6% growth in underlying operating income for our company. This is indicative of solid execution of a great business model and a performance that we strive to replicate over the coming decade. Our team is experienced and focused on accelerating our business back towards our historic rates of growth, but we are also cognizant of the current market dynamics that may limit near-term attainment of these ambitions.

In the meantime, we have been able to effectively contain costs during this period of slower growth and are at the beginning of our planning process for fiscal 2018. We will share our preliminary fiscal 2018 outlook with you in June. Thoughtful reinvestment in the business with cost discipline will remain among our top priorities at the company.

As you know, calendar 2016 was a significant year of transition for Brown-Forman, including reshaping the portfolio. And while these changes coincided with the slowdown in our business trends, we believe we will emerge from this period [ph] well positioned to capitalize on the long run rate that we believe so many of our brands have. We also believe our superior capital allocation remains a hallmark of our company. We are nearing the completion of 0.5 decade of ramped up capital spend and investments in working capital to support organic growth opportunities and were able to return $4.2 billion to our shareholders over the same period. Despite this shareholder-friendly approach, our net debt-to-EBITDA stands at only 1.8x, one of the strongest leverage ratios across consumer staples and the best among our competitive set, providing us with ample capacity for future endeavors.

And so with that, let me turn the call over to Paul for his comments.

Paul Varga

Thank you, and good morning to everyone. To supplement Jane's remarks, we were pleased to see that our growth rate and underlying net sales accelerated again in the third quarter. The underlying sales growth was just a touch below what we might have hoped for back in November, but I thought it was still an encouraging acceleration and pretty solid growth considering 2 items: one is the deceleration that we've observed of late in the growth rates for spirits in the U.S., and the second one is the negative impact we've had this year from used barrel sales. When I add this to the observable quarterly uptick from our international business, most notably in emerging markets and Global Travel Retail, I conclude that we made nice progress during our most important quarter of the fiscal year.

As Jane stated, we expect Q4 to build a little further on Q3's progress and are hopeful to achieve a very solid 5% to 7% growth in underlying operating income when the year concludes. And while we are still amidst our internal planning for fiscal year '18, our current bias is toward a continuation of the steady progress that we've been seeing in underlying sales growth rates. Assuming that the environment does not deteriorate in a manner that would change our minds, we would envision F '18 underlying sales growth expectations to be more like the back half of FY '17 than the first half, and that is prior to considering any impact from Jack Daniel's Rye, which launches this coming September. We will update you more fully on all of this when we discuss our full year FY '17 results in early June.

Importantly though, the long-term growth ambitions that we have for the company and which we discussed publicly at our December Investor Conference remain intact. And those ambitions are supported, in my view, by our continued belief in the global opportunity for Jack Daniel's and American whiskey, our recent and forthcoming portfolio additions, our multiyear expansion of production capacity, our increasing supply of mature whiskey and tequila, strong and growing A&P investment and the reallocation of organizational focus away from the brands that we divested and toward today's portfolio priorities, most notably the Jack Daniel's and Woodford Reserve trademarks.

So that concludes Jane and I's prepared remarks for the morning, and we're now happy to take any questions that you have.

Question and Answer

Operator

— ***Operator Instructions*** — Our first question comes from the line of Brett Cooper from

Consumer Edge Research.

Brett Cooper

Two questions for me, I guess both on competition. First, I was just wondering if you guys are seeing any of the Scotch producers using advantageous exchange rates to be more competitive in the marketplace? And the second one is some of the larger competitors are seeing improving growth rates in sales, matching that with increasing rates of brand support or A&P. How does that inform kind of what you guys need to do going forward? And how do you fund those higher levels of investment, if that's in fact the case?

Paul Varga

We missed just the very first part of your question. So if for some reason you had asked something that we didn't pick up, just repeat it again. But I thought the first question was around have we observed anything in the U.S. marketplace related to using currency to their – the Scotch producers' advantage. And I haven't seen anything in terms of reduced prices. I mean I know the category for particularly the higher-end expressions of single malt, et cetera, continues to be pretty good in the U.S., but I haven't noticed that at the consumer level – I mean it would make sense that because the products aren't perishable that if the U.S. wholesalers were to stock more of those inventories, that would – you could envision that occurring, but we wouldn't have any visibility into that. I think the second question related to just investments in line with increasing growth rates for our competitors. And we're observing some of it. I don't have as much insight into their A&P investment as we do to the improving rates over the last 1.5 years or 2 years. In some of those instances, they've been seeing that, from what we can tell, in emerging markets, as they – from what we recall, those – a number of our larger competitors had experienced pretty deep drops in that business for them going back a few years. So their recoveries, we believe, were ahead of where we might have seen. And most of the reason for that is because we don't have large local businesses there. I mean we are, almost exclusively in many of these emerging markets, a Jack Daniel's-led portfolio. And so the dynamics around the portfolio development for our competitors in those markets are so different. So it's hard for us to know what they are supporting and how it might be driving in the improved performance for them. I can say for us that our A&P has been tracking in line this year with the underlying sales growth rates of the company, in some cases, even a touch ahead of it. Some of that is attributable to the investments we're making much longer term behind some of these newer portfolio additions.

Brett Cooper

So Paul, if I can just follow up, I guess the Scotch question wasn't just U.S. I mean, are you seeing it anywhere globally?

Paul Varga

No.

Jane Morreau

No.

Paul Varga

Not that we've seen anything. There may have been a part we missed, sorry.

Jane Morreau

Yes.

Operator

Our next question comes from the line of Vivien Azer from Cowen.

Vivien Azer

So I was hoping that you could expand, please, on your commentary towards the end of your prepared remarks around the deceleration in the U.S., and if you could speak to some of the factors that you think are driving that. And then as a follow-up to that, how does that dovetail with your commentary around preliminary expectations for 2018?

Paul Varga

Yes, we've seen, I mean as recently as even this week, some top lines that expanded into the February for Nielsen. I haven't seen anything for the NABCA markets in the United States. And yes, I mean this has sort of been a steady sort of reporting observation going back to the sort of the fall from Nielsen. And at this stage, I mean, we really don't have a strong sense for what's going on. The one thing that I would observe, of course, you have the postelection uncertainties in the world, et cetera, as policies are being contemplated to change and everything. So maybe that's having an impact. But I think one of the things that we noted is that when you see departures and the trends between NABCA and Nielsen, it catches your attention. And that has in fact been the case for of late that the Nielsen markets have trailed off a little bit here in the more recent 4 or 5 months, whereas the NABCA markets have held pretty good. And then that enforces you to consider is there something in the channel dynamics? Because the NABCA markets actually pick up on-premise. They pick up all of the off-premise volume. So – whereas many of the Nielsen markets aren't picking up a lot of independent liquor stores that don't scan. And so it makes you wonder whether there's something going on. Now I mean I haven't seen anything or even heard anything anecdotally that the U.S. distilled spirits business has been making any shifts between off to on. I mean, of course, the trend in this country for the last several years has been the opposite of that as people have moved more of their consumption off-premise. It does make you wonder a little bit, Vivien, whether the just changing competitive dynamics but – that so many of the new competitors that are in the world of craft may not have their distribution skewed toward the large chains and they may be more distributed in independent off-premise or in the on-premise. And I just wonder if maybe that's a contributing factor. But at this stage, they're all sort of hypotheses. I mean the other natural thing that's worth observing, which usually there's some delay in the data on this as whether or not spirits is observing any loss of share to beer or wine. And in that case, it might – in the event that say imported beers were doing well in this country because of the favorable FX right now, that could be a factor. But at this stage, we're kind of hypothesizing, but we certainly have observed it. As it relates to FY '18, we'll want to see some additional data to see if the current trends persist. If they do, I mean we would try to reflect that of course in our guidance when we get to June. Longer term, I mean there's nothing I've seen that makes me want to change what we discussed with so many of you in December related to our ambitions out to 2025. So we're reacting to some of the short-term observable data in the same way that you are.

Vivien Azer

That's really helpful. And if could just follow up on that on. Some of the commentary that you offered in terms of the decel, in particular Nielsen, makes an awful lot of sense to me. But kind of with that backdrop, I mean your business slowed, right, and that's not a channel issue per se. So how does that inform your thinking about pricing, in particular as you look across the aisle to what's happening in vodka? Because looking at Diageo and Pernod's reported results, it looked like price/mix was negative for a lot of your key vodka competitors.

Paul Varga

Yes, I mean our U.S. business, I mean actually the U.S. had, had a very solid first half. And it was just a touch below it in the holiday period for Q3, but I mean, to me, it didn't travel in direct correlation to TDS. And then of course more broadly, our third quarter business, as Jane commented, was up 4% on an underlying basis, which compared really favorable, we feel, to the 2% in the first half. So – And part – but to your point about the pricing is I think real. With all the increased competition, particularly in the U.S. market from new entries, I just find that pricing right now, with all of this competitive supply and all of this competitive distribution, is a little more challenging for brands to get. And so – but that has been the case frankly for about the last year. I don't know that it's increased in any significant way in the last quarter or so, but I know at our company, we're a little bit more cautious. And even in instances where we took pricing this past year with Woodford Reserve and Old Forester, in the short term, they felt the impact on the shelf once the prices got in there. And I think it's a reflection of the fact that there are alternatives out there. I mean there's just a lot of competition in this U.S. bourbon and spirits market. And when there's a lot of choice, it makes pricing a little bit more difficult.

Operator

Our next question comes from the line of Laurent Grandet from Crédit Suisse.

Laurent Grandet

Yes. I do have 2 quick questions, one on innovations. Could you please update us on recent and upcoming innovations? I'm thinking more specifically about BenRiach and Slane Castle, but also if you can give us some quantitative or qualitative, I mean, first results of your Coopers' Craft regional launch. My second question is about China. I know it's not part of your top 10 countries, but I was surprised by the double digit of negative numbers there, as your major competitors seems to be enjoying some growth again. So if you can help me understand what's going on there.

Jane Morreau

Okay. I'll start off and Paul sure will chime in here. On Slane, which is our Irish whiskey getting ready to go to market here, I think that we're excited about it. Just as a reminder, let me tell you what we did here. We actually bought Irish whiskey that we took and we've refinished ourselves using our R&D folks here and our expertise in our barrel making and finished it into very nice product. It's going to be hitting the shelf first in duty-free. So we're going to start in Ireland duty-free, starting in April. That's when we'll first launch it. And then this summer, we'll be launching it in Australia, the U.S. and the U.K So we're very excited about that. In terms of the actual facility and so forth, as you know, we've been investing roughly $15 million behind this facility, which will have its own home place bottling facility and distillery. And we're about ready to have that commissioned. I think in the springtime, it will be commissioned. What I mean by that is we'll be producing our whiskey. So it will go to – be ready to go to the market in 3 or 4 years from now. So we're excited about that. We're on track, and stay tuned, you'll be seeing it soon. In terms of Coopers' Craft, we introduced it just as a limited introduction in 8 states in the U.S., and it still is in just in 8 states. We're pretty optimistic about it. Right now, it's still very early in the process. And as Paul noted, there's a lot of competition out there. There's some things we're adjusting and tweaking with it in terms of how it's positioned, pricing and so forth like that, but we're optimistic. Still early, as I said. I thought I might just touch on one other of our new things to our portfolio this year, which is the BenRiach or the single-malt Scotch, which is GlenDronach, Glenglassaugh and BenRiach itself. And we, in the third quarter, actually launched them in the United States. Our own field employees and sales force are very excited about it as is the trade. So we're excited to have those products in the U.S. and under our control now.

Paul Varga

Yes, and I think just to – if you're sitting and thinking about expectations for the range there of Coopers' and Slane and the single malts, I mean I think they could be modestly helpful to sales going forward, but we're going to be investing pretty significantly behind them. So I wouldn't expect them to be dramatically impactful to the bottom line, like we saw in some prior years with Jack Daniel's Tennessee Fire, Jack Daniel's Tennessee Honey. They're going to be much more slow build, we think. And it's just a reality that anything that is launched from the Jack Daniel's distillery has such initial interest from its large consumer franchise, and it's what – why we sort of have mentioned Jack Daniel's Rye's prospects out into FY '18. I would expect that particular expression to have as much or more impact going forward, just because we've been waiting for the product to mature.

And now we've got an ample supply to be able to take our in particularly the U.S. market here, and we're kind of latecomers to the rye phenomenon that's been occurring, but we expect it to be a very nice positive impact under the umbrella of innovation. And as you know, I mean FY '17 was, in some ways, a bit of a transition year for us for all the positive introductory work we're doing on Coopers' and BenRiach Distillery brands, et cetera. Going up against the Jack Daniel's Tennessee Fire launch, net-net, it was – we just had less impact from innovation and this past fiscal year than we've had in some prior years, even though Jack Daniel's Tennessee Fire has launched very nicely into some of the international markets. So – but we'll be updating you further on the plans around innovation when we get out to June.

Jane Morreau

Just a follow-up on one of your questions. You were asking about the double-digit decline in China. So first, I would just let you know China is not a large market for us. It's less then – significantly less, I should say, than 1% of our sales. What we have been experiencing there, we had a route to consumer change. So we had some disruptions there. We think we were stabilizing now. So we think, as we look forward, we'll look for some more stabilization out of that market. There was a route to consumer change. We had some new product introductions that were – from an RTD perspective, that had some disruption, too. So it was more a disruption than anything just on our part as we transition.

Paul Varga

I think the other thing too that our competitors would have noted, I mean they are – I don't know which exact competitors you're talking about. But to the extent that they're in the cognac business and have seen some of the recovery in that particular category, of course, we're not in that business. And the example at least one of our competitors, they also have a presence in the local baiju business. So I mean I think category skew, in that case, has an impact on relative performance. So that might explain what you're seeing from some of our competitors relative to us.

Operator

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

Judy Hong

So I guess I had a couple of questions on the margin side. And Jane, I'm not sure if I missed this. But just in terms of the modest gross margin pressure that you saw, can you just remind us the drivers? And then I think you talked about just the sort of the peak in terms of the gross margin degradation. So what sort of gets better going forward from a gross margin standpoint? And then I guess in terms of FY '18, I know it's early days, but if we think that price/mix is sort of challenging in this environment, are there any other levers in terms of the gross margin drivers? And how do we think about the margins in '18?

Jane Morreau

Okay, yes, I'll take it, Judy. Just again reiterate what I said in my script today, I said that we do think that the worst is behind us in terms of the gross margin pressures. And we're looking at it on a reported basis, so let's make sure that we're all in sync there. So we did see our margins, on a reported year-to-date basis, decline 210 basis points. The biggest piece of that is M&A related, and we talked about the M&A last quarter. Just to remind you what the pieces of the M&A are, first of all, it was the Southern Comfort, Tuaca margins from last year. They were high-margin brands at a gross profit level; second piece being our transition arrangement that we had where the buyer for the brands, which was a low-margin agreement, if you will. And the third piece being the acquisition of BenRiach, without getting into the technical aspects of things. But there was a technical expense that came through from an accounting perspective write-off of inventory, if you will. So those things have all taken place. They're behind us, except for 1 month of the Southern

Comfort, Tuaca profits, if you will, of their business for the month of February, and that will be behind – essentially behind us. So what I'm saying is the M&A impact becomes – is essentially over. And then the other big piece that had hurt us in the quarter – year-to-date has been the FX headwinds. Just to remind you the – because we're single-sourced and our products are made in the U.S., essentially what happens at the revenue line item when you sell it in overseas in foreign currency, you don't have a buffer or an offset to that. It goes straight down. So that, of course. And as we roll into our hedges at that – we're going to have FX around for a period of time. So – but as I pull back and look at the full year or what I'm expecting to happen in the fourth quarter, I'm forecasting our margins to essentially be unchanged from last year in the fourth quarter. So that's why I'm saying that worst is behind us. As we're looking ahead, we'll be providing that information. We're still early in our planning process. And so I prefer to give you more robust information in June. It's pretty early in that process. So we can wait for then.

Paul Varga

Yes, and as with the case here in FY 17, if you've stopped at the gross margin line, you would have the explanations that Jane talked about but we also, particularly during this period of investment we've been making, have also just taken that – taken the visibility all the way down to the operating income margins, which has for us become important. And that's where I think Jane has mentioned the continued focus on discretionary costs, and it had been reflected in SG&A. So we're trying to get some offset to some higher costs in other parts of the P&L as well.

Judy Hong

Got it, okay. And then just in terms of looking at emerging markets and maybe Global Travel Retail, obviously the first half has been pretty challenging. And it seems like trends are getting better, but it's a little bit hard to sort of, I guess, to discern whether the improving trends are just more from a comparison standpoint? Or are they really – or you really seeing kind of the underlying momentum building in those markets? And in Global Travel Retail specifically, how much of the improvement is also restocking of inventory versus some of the underlying trends that you're seeing from an improvement standpoint?

Jane Morreau

Yes, versus – I'll take the Global Travel Retail. Versus last year where we were declining and versus where we are today, which is the 7% increase in underlying net sales growth, some of that, as I said in my script, is due to just new distribution. So getting some of our products out there that weren't out there before, such as Woodford Reserve. So we know some of that, but we also have seen the actual underlying trend turn positive, too. So we are back into the low single-digit growth in Global Travel Retail. As it relates to the emerging markets, we've talked about this in the past. This is kind of a mixed basket, if you will. so some markets are doing very well, continue to do well. the – Poland and Mexico, of course, Mexico there's a lot of uncertainty down there around – with all the geopolitical stuff going on. But they are growing nicely. This is up in double digits. We've seen – so they are growing. There's other markets where there's nice growth going on. And then there are some that are just soft comps. And you can see that when we showed on Slide 12 where you see the declines last year in the third quarter, even more declines in the fourth quarter, which also was one reason why when we look at our fourth quarter this year versus last year on decelerations, we expected some continue easy comps in the emerging markets. So it's a mixed story there, Judy, but – so some are continuing to grow, some have turned back into growth, and some are still tough.

Paul Varga

Yes. Judy, I'll add to that. Just like for right now, the example of the earlier question related to China, our portfolio doesn't match up some – where the recovery is. In the example of Global Travel Retail, I think our portfolio matches up very, very well with that channel's recovery. Because we are – amongst our competition, we are so premium skewed, and that channel tends to be a great showcase for the premium brands. I think that's a benefit for us. And then differentially just as you go along, you just really have to look at the portfolios for the various companies and you almost have to pare back the emerging markets where maybe some of our competition are doing well. They have very large local businesses. And the local businesses, the local spirits are doing particularly well. That's something we, I mean for the most part, don't particularly participate in, those sort of, I'd say, value level or slightly lower pricing than the premium level where we are. We just – we have not tended to be in those. So for us, recoveries in emerging markets would be most directly related to any momentum built around premium whiskey. And in our case, it will be led by Jack Daniel's.

Operator

Our next question comes from the line of Tim Ramey from Pivotal Research Group.

Timothy Ramey

Paul, you mentioned you're going to have an increasing supply of mature whiskey and tequila. And I was just trying to better understand how you think about that. Is that a new product development opportunity? Is it a distribution opportunity? I hope it's not a pricing opportunity. But as more supply becomes available at the high end, the – how do you think about pushing that out?

Paul Varga

Yes, I mean I think that comment directly related to these forthcoming supplies in rye whiskey that can support the Jack Daniel's trademark at a – what I'll call a premium level. We've already been out there with Jack Daniel's Single Barrel Rye, but it's been up at a very elevated price points, done pretty well. I like that product a lot.

Timothy Ramey

I do, too. Yes, it's really good.

Paul Varga

I mean, it really is. I mean, and the other one – Woodford Reserve for us has done very, very well. It's another one that, that has received great critical acclaim. I actually like that product a lot too. And so rye has been so helpful to the sort of classic cocktail trend that's been going on in the United States. And so I just feel like with the Jack Daniel's name and at the most – more affordable premium price point, it's an exciting time for the trademark to be able to enter. We would have loved to have some of the supplies available a couple or 3 years ago, but we just didn't. And so these maturation and the available stocks that I was referring to relate very directly to that. But it's also you have to remember every day, we are making the product and laying it aside. And it's also a reflection that we're planning for growth in the future. And part of what we did in December with our investor conference, we looked out, I think, to 2025. And for the most part, the ambitions we'll have there, we will have pretty much by the time you get out to 2019, 2021, you're going to have to have that product in the barrel or in the case of tequila, in the ground with the agave plant. So I actually just always – and just to remind everybody who covers this industry, I mean you have to make those forecasts in advance and those plans building the warehouses, putting the barreled inventory become part of your – they have to sync up with the ambitions you're expressing. So part of why I said that is that, we continue to be pretty bullish about what we see for the opportunity for Jack Daniel's and American whiskey and our premium tequilas, some of these new products we bought out of that time frame, despite the fact that you have – might have challenging circumstances around any 90- or 180-day period.

Timothy Ramey

Great. And one more for Jane, if I could have a second. I know it's early. You haven't got your '18 forecast yet. But should we think about advertising and product support likely accelerating or maintaining from current levels?

Jane Morreau

Yes. Tim, again, as I said in the script today, I think we'll continue to invest thoughtfully behind our brands. I think if you wanted to do something, I would not assume it is – it will grow in line with our sales growth.

Operator

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

Bryan Spillane

Two quick ones for me. First, just a clarification in terms of the sales not accelerating completely to the levels where you were expecting at the beginning of the year. That's really just barrel sales and the U.S., right? Those are the 2 main drivers of the acceleration not being as high as you thought it was going to be?

Jane Morreau

It's mainly the U.S. The barrel sales, we had fairly anticipated. So we had a little bit of slowdown in the U.S. in the third quarter and a little bit in a couple of other markets. Australia was a little bit softer, so – but it's mainly the U.S., in terms of – you're talking about versus our second quarter, just let me clarify, not versus the first part, our plan is the first of the year because it's is same versus the first of the year with emerging markets.

Bryan Spillane

Yes, no, no, no. This is just versus the guidance that you gave at Q2.

Jane Morreau

Okay, yes. — ***indiscernible*** —

Bryan Spillane

All right. And then the second one, and this is I think just a follow-up maybe to some of the comments you just made, Paul, about inventory. Inventory levels are, on the balance sheet, are much higher today than they were at the end of last year. And so could you just maybe explain a little bit the dynamics there? How much of that is you're laying more product down for future growth? Or is there – are there any other dynamics that have affected it? And I guess as we're looking forward with inventory as we look into '18 or '19, the inventory maybe a percentage of sales go up from here? Or is this sort of a good base to use?

Paul Varga

I mean, I think, generally, we would anticipate these – barring any significant changes in your route to consumer or something that might have an impact. I mean we generally see the inventories grow in line with your sales expectation. So it's general what it is, the something Jane, in the...

Jane Morreau

There's 2 things that, Bryan, I just want to make sure that when you're looking at the numbers or pulling out BenRiach, the impact of BenRiach, which is the $140 million, $150 million out of that number. We also have some Slane whiskey in there, the 5-or-better million in there. So then when you just look at the raw numbers, you're seeing 2 pieces, one being volume, which is what Paul was saying in terms of what we are forecasting what we anticipate our growth to be in the out years. But we also have talked about this in prior calls that our costs have gone up somewhat, too. We talked about the front end with the barrels of those costs. The cost of wood, if you will, to make our barrels has gone up. And so that's what are 2 pieces when I look at the increase once you strip out the BenRiach and Slane impact. So the volumetric impacts is about half and half is what it is.

Paul Varga

Is it half and half? Okay. That gets you what you need? Okay.

Operator

Our next question comes from the line of Mark Swartzberg from Stifel Nicholas.

Mark Swartzberg

The dollar, you touched on this, Jane, in your prepared remarks and how the strength of the dollar's impinging, at least a little bit, on purchasing power in some of the emerging markets. A few questions, one is, is it right to think that your planning assumption for the dollar has shifted when you look at these multiyear plans you're making towards a comparatively higher, comparatively stronger dollar than what you might've had prior to November? That's one question. And then if that is the right assumption, and it might be the wrong assumption. But if it this the right assumption, can you give us some sense of how that's affecting the way you think about the emphasis you place on the United States, for example, where you don't have that issue, or emphasis you placed on a particular market, whether it's in emerging markets or developed market? And then my final question is to what extent does dollar strength and your history dealing with dollar strength and strength from here kind of give you some insight into how to deal with this?

Paul Varga

Yes, well, I think there's 3 in there. So that's why – I think the first one is that I – Jane, you add to this. I – my view of – we just reflect the current rates in our planning. I mean we try not – I mean while we will do the hedging programs in order to defer the impact, which we continue to think us smart, I mean we're trying not to play the currency market with our plans is the way I'd say it. And so occasionally particularly on very significant devaluations or changes in local currency, you'll see us enact some pricing activity. But for the most part, we just try in our plans to reflect what we know at that time. And then going forward as it relates to what have we learned over the years from the dollar, I mean it has been now for a couple of years outside the band of what we historically would have experienced here at the company. And on the same vein, Jack Daniel's over the last 30 years has become even more important to Brown-Forman. So the impact on foreign – and as our export markets have increased in – as part of the Jack Daniel’s business, that exposure increased. So as far as we’re concerned, I mean, we are operating today outside the historical band that one would have expected. And now whether that is some kind of cyclical event or secular remains to be seen. As it relates to investing, I mean, I think there’s 2 offsetting factors. I mean, one is yes, I mean the more you can drive your U.S. business right now, the more you minimize that currency exposure. I do think the U.S. is such a competitive environment right now because of all of the – particularly at the premium level plus with all craft that it requires investment, but it also – you just got to make sure you don’t get ahead of yourself on your expectations there, particularly going in making the product. And it – even in the results of, say, Woodford Reserve and Old Forester, which have been growing so fast and benefiting from all of this, both of those brands continued to experience new competitors each and every day because of what’s happening in this country with the craft spirits. So I think there are offsetting factors there a bit. And I will say, I’ll just remind you that go back and glance at the December investor presentation we gave. We love geographic diversification at Brown-Forman. We like to try to build, particularly in the Jack Daniel’s brand, this business in as many places as we can. But as we go out to 2025 and beyond, we really do expect to see the emerging markets piece be a growing and increasing part of the Jack Daniel’s business. So we would make whiskey on that basis. We would invest on that basis. And even though it’s been sluggish in a few of these markets of late, they continue to be – what we consider to be the best markets for percentage growth rate going forward.

Mark Swartzberg

Right. Very helpful, and then just one more on the U.S. It’s been helpful to hear your take on the industry overall. And I think we’re all trying to figure out why we’re seeing this comparative slowdown. But when you look at your own share performance, and you’re dealing with all channel data that I think the rest of us don’t have. When you look at your own share performance – and I'm really interested in JD specifically. Could you give us a little bit more color on the share performance of that label? And then the role specifically of innovation and its impact on the label? Of course, Fire, Honey, just looking for a little more detail on the U.S. and of course, Rye will help, but just trying to get a sense of where we are in that innovation evolution here in the U.S. against that brand.

Paul Varga

Yes, I've been reasonably pleased with the I'll call it multiquarter, even multiyear Jack Daniel's Black Label share performance in the United States. I mean, we've been getting a little less pricing these last couple of years. I think it would be unrealistic to expect that Jack Daniel's would today grow at the rate of premium whiskey, premium bourbon just because it's so big. I mean, so it's hard. I don't have that expectation. We have all oftentimes tracked ourselves against total distilled spirits which Jack Daniel's has held up pretty good at various times. I think the thing that's so remarkable about the Jack Daniel's share performance in the United States when you isolate the Black Label brand is how well it's done when you consider the additions of Jack Daniel's Tennessee Honey and Jack Daniel's Tennessee Fire as well as Gentleman Jack as they continued to grow in the United States and Jack Daniel's continued to grow as well. I mean, so many trademarks would have experienced very direct cannibalization of a magnitude that we have not seen. So this balancing act of developing Jack Daniel's along with the portfolio additions we've had is a really encouraging sign, in my view. And so we don't often go out and declare some specific share ambition for a particular trademark in a country. We monitor all of them. People here are used to looking at 5 to 6 different competitive sets for the Jack Daniel's Black Label. We look at share of the top 10 brands in the United States by volume. We look at share of whiskey. We look at share of premium whiskey. And then we even look at occasion, share of shock brands or share of the – and Coke occasion. There are all kinds of different ways we look at it. And I feel like we've done, in my view over these last few years, particularly with the innovation that Jack Daniel's brand has held up extremely well. And you have to consider the booming American whiskey market in this country, while a help as well to American whiskey brands to the established – most established brand and the leader like Jack Daniel's, it's also a source of competition.

Mark Swartzberg

That's great. So what I'm hearing you say, and I want to be sure if it is what you are saying is that the U.S. disappointment in the third quarter is something you put more on the category than on your own share performance?

Paul Varga

Oh yes. I mean, I feel like the – I mean we're probably getting some impact from the slower TDS growth in the United States. I mean, we tend to travel – I mean brand like Jack Daniel's tends to travel with a lot of macroeconomic factors as well as significant category trends. But there was nothing that I saw in terms of execution. I thought the communications and media we had behind the Jack Daniel's brand during the holiday period was particularly good. And so this tick down that we're seeing, I mean, as we said from the very beginning of this call, we're trying to get our hands around it more at the macro level, but I don't think that we've seen anything from the standpoint of that's very specific to the Jack Daniel's brand that causes us to be alarmed.

Operator

And our final question comes from the line of Eric Serotta from Evercore.

Eric Serotta

A quick question in terms of your used barrel business. You guys gave the – or I think Jane gave the comment that you aren't expecting an improvement in the near term. The comps there certainly get a lot easier as you get into early fiscal '18. I know that business tends to go in terms of annual contracting. Should we still expect to see some steep declines in that business as we enter fiscal '18? Or do you expect to see more of a leveling off at the low levels that you're at right now?

Jane Morreau

Yes, you hit it. It's a cyclical business, but we also have, as you know, that we have insights already into what we can do over the next 12 months or the calendar 2017. And we know we're going to continue to have pressure on pricing. And so we are anticipating to still have a drag, if you will, declines on the business. Will they be as drastic or as heavy on the top line as they were this year? It may be a slight bit less, but again, what we were pointing to was not seeing this business stabilize or growing. It's going to continue to decline over the near term.

Eric Serotta

Okay. And could you remind us where you expect that business to end fiscal '17, or where it was in terms of fiscal '16 in terms of size relative to the rest of your portfolio?

Jane Morreau

Yes, I don't have that information in front of me. It's less than 2% of revenues, as I recall, but if you want, we can always do this offline, but it's less than 2% of our revenue.

Eric Serotta

Great. My other questions have been asked and answered.

Jason Koval

Well, thanks, Eric. And thanks, Jane and Paul and to all of you for joining us today for Brown-Forman's third quarter earnings call. And please feel free to reach out to us if you have any additional questions. Take care.

Operator

This is the end of today's call. You may now disconnect. Have a great day.