Brown-Forman Corporation, Q1 2018, Earnings Call 2017-08-30

Presentation

Operator

Good morning. My name is Dorothy, and I will be your conference operator today. At this time, I would like to welcome everyone to the Brown-Forman First Quarter Fiscal 2018 Conference Call. — ***Operator Instructions*** — Thank you.

I would now like to turn the call over to Jay Koval, Director of Investor Relations. Sir, you may begin.

Jason Koval

Thanks, Dorothy, and good morning, everyone. I want to thank you for joining us for Brown-Forman's First Quarter 2018 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 first quarter of fiscal 2018 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, Form 8-K and Form 10-Q reports filed with the Securities and Exchange Commission.

During the 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, everyone, for joining us this morning for our first quarter earnings call. During my comments today, I will reference the slides we posted on our website this morning to help you walk through our 2 main areas of focus, which are, first, our first quarter results; and second, our outlook for fiscal 2018. So after I complete my prepared remarks, I'll turn the call over to Paul for a few quick comments. And then we'll open it up to Q&A.

So let me start with our overall highlights shown on Slide 3. First, we experienced our fourth sequential quarterly improvement in underlying net sales, with our first quarter up 6%. Second, our reported results were even stronger, helped by distributor inventories and a lower tax rate, not to mention diminishing foreign exchange headwinds. Third, we invested significantly in our brands with an underlying A&P increase of over 6%, while we continued to deliver meaningful operating leverage through reductions in SG&A. And finally, we reaffirmed our full year outlook for underlying net sales growth of 4% to 5% and underlying operating income growth of 6% to 8%. You will note that we increased our EPS range for fiscal 2018 by $0.05 due to an improved outlook for our tax rate and foreign exchange. I'll come back to our outlook in a few minutes.

So now let's turn to Slide 4 to review our first quarter growth. Underlying net sales grew 6% in the quarter. This represented a continued acceleration from fiscal 2017's growth, which improved throughout the year from last year's first quarter growth of 2%. This 6% growth was essentially in line with our expectation and keeps us on track for our full year outlook of 4% to 5% growth in underlying net sales.

As highlighted on Slide 5, reported net sales increased 9% in the quarter and was helped by 3 points due to the expected year-over-year change in distributor inventories in the United States as well as Russia.

Slides 6 and 7 highlight our net sales growth by geography. So beginning with the United States, underlying net sales grew 5% in the quarter. The growth was driven by our American whiskey portfolio, led by the Jack Daniel's Family of Brands, Woodford Reserve and Old Forester as well as sustained double-digit growth from el Jimador and Herradura. So while we're encouraged to see solid growth in the United States, our results were slightly ahead of takeaway on a value basis, and as a result, we anticipate some giveback in the second quarter.

Turning to our developed markets outside the United States, underlying net sales were flat, impacted heavily by timing and tough comparisons to last year's first quarter. While Australia delivered 17% underlying net sales growth, reflecting buy-ins on RTDs in advance of an August 1 price increase, Japan's underlying net sales declined 14% against last year's price-driven buy-ins. And combined, sales for the United Kingdom and Germany were down 3% against the very strong 11% growth registered during last year's first quarter. We expect to see a nice rebound in the second quarter for these 2 markets as comparisons ease and takeaway trends remain solid. We experienced a strong improvement in underlying net sales growth in the emerging markets in the first quarter, up 19%.

Slide 8 highlights the improvement in our emerging market trends over the last 12 months. While economic conditions in many of these markets remained volatile, we are optimistic that recent declines have passed and we could be entering a more stable period of growth for these geographic areas with large population bases, where our market shares remain well below what we believe are their full potential. That being said, we expect comparisons will get more challenging in the emerging markets as we move through the fiscal year.

Our travel retail channel continued to grow nicely in the quarter, with underlying net sales up 12%, helped by gains from Woodford Reserve and Finlandia in key accounts. Additionally, passenger volumes are growing again in important markets such as Turkey, Russia and Brazil.

Slide 9 breaks out our key brands' underlying net sales growth. Jack Daniel's Family of Brands grew underlying net sales by 6%, an acceleration from the 3% net sales growth for the family in fiscal 2017. Growth was broad-based, including solid gains projecting in Tennessee Whiskey, Tennessee Honey, Tennessee Fire and Gentleman Jack. Jack Daniel's RTDs had a particularly strong start to the year, reflecting the combined effects of the Australia buy-in, new line extensions including Southern Peach Country Cocktails in the United States, Jack Daniel's Tennessee Cider in the U.K. and Lynchburg Lemonade in Germany and expanding consumer demand in Mexico and Western Europe. Our premium and super-premium bourbons such as Woodford Reserve and Old Forester continue to grow underlying net sales well into the double digits, as did our tequila brands, el Jimador, Herradura and New Mix RTDs. Following a modest decline in fiscal 2017, Finlandia grew underlying net sales 6% in the first quarter, fueled by Russia and travel retail.

Now before I move down the P&L, I wanted to share a quick update on our used barrel sales, which were stronger in the first quarter and contributed nearly 0.5 point to our underlying net sales growth. And while this is a positive sign as we enter the negotiating season for calendar 2018, we still anticipate that our used barrel sales will be down this fiscal year. We believe that the growth we experienced over the last 3 months was largely due to the timing of orders against a very easy comparison a year ago, allowing volume gains to offset price declines.

Moving down the P&L and as shown on Slide 10, reported gross margin declined 40 basis points while underlying gross margins were flat. This decline was driven by 100 basis points of adverse foreign exchange, partially offset by the absence of the prior year's A&D-related activity of 60 basis points.

So Slide 11 summarizes our operating performance on both a reported and underlying basis for the first quarter. You'll note our underlying A&P increased 6% as we found ample opportunities to invest in the Jack Daniel's Family of Brands and the continued growth of our bourbon portfolio, while also seeding our new brands including Slane, BenRiach and GlenDronach.

On the SG&A front, we remain committed to a disciplined approach to controlling our costs, including reducing discretionary spending, as we look to continue to reallocate resources toward our brands and consumer-facing activities. First quarter SG&A was consistent with our expectation, with underlying and reported SG&A down 1%. It should be noted that we delivered this decline at the same time we launched our own distribution in Spain on July 1.

In the aggregate, we delivered 12% growth in underlying operating income during the first quarter. Reported operating income grew even faster, up 14%, helped by year-over-year change in distributor inventories. And operating margin expanded by 150 basis points to 33.7%.

We delivered reported earnings per share of $0.46 in the first quarter, up 27% over the same period last year. Earnings per share growth was propelled by the large growth in operating income and helped by $0.03 due to a lower tax rate in the quarter. The reduction in the tax rate in the quarter was due to discrete items, which are expected to help drive down our full year tax rate to about 28% compared to our prior expectations for 29% to 30%.

So let me move on to my second and final topic for this call, a brief update on our fiscal 2018 outlook highlighted on Slide 12. As I previously mentioned, our first quarter results on an underlying basis were essentially in line with our expectations, keeping us on track to deliver an anticipated 4% to 5% growth in underlying net sales for the full year. This will represent a 1- to 2-point acceleration in our top line growth compared to fiscal 2017 results. We expect the top line in our second quarter to be a bit lower than the first quarter's strong start to the year on both a reported and underlying basis. This incorporates our expectations for some giveback in the United States after our strong first quarter, offset somewhat by a better Q2 result expected for our non-U.S. developed markets. This also considers the launch of Jack Daniel's Tennessee Rye, which is expected to benefit our underlying results mainly in the second half of fiscal 2018.

Investing in our business with improved effectiveness, efficiency, cost consciousness and prioritization will remain a focus throughout fiscal 2018 and over the coming years. While we're only 3 months into fiscal '18 plan for resource reallocation, we are already seeing these efforts pay off as we increased investments in our brand while simultaneously realizing cost savings and leveraging the bottom line. We will use our year-end call to update you on our progress.

So back to our current year outlook, we still anticipate that A&P growth will grow at or above our underlying net sales growth. In addition, we anticipate that SG&A will be roughly flat for the year as we continue to seek efficiencies while also making strategic investments such as the Slane route-to-consumer change and startup expenses associated with our new distilleries in homeplaces for Slane Irish whiskey and Old Forester. We believe this cost discipline will drive a nice expansion of our operating margin in fiscal 2018.

So putting it all together, we still expect full year underlying operating income growth of 6% to 8%. Given our revised expectations for a full year tax rate of about 28% and a slight benefit from foreign exchange due to the dollar's recent slide, we have bumped up our EPS outlook by $0.05 to a range of $1.85 to $1.95, equating to a growth of 8% to 14%. As a sensitivity, if foreign currency cash exposures collectively move in – 10% in either direction, we would expect EPS over the balance of the year would be impacted by about $0.04. While distributor inventories will likely fluctuate on a quarterly basis, this full year EPS range incorporates little additional change from inventories.

So in summary, our brands performed well in the first quarter. And we are encouraged to see continued top line momentum and increasingly efficient use of resources delivering profitable sales growth. The global economic backdrop has improved over the last year, and foreign exchange headwinds have diminished. Our employees are executing with a great sense of near-term urgency and commitment to our long-term aspirations. And we remain focused on delivering superior long-term returns for our shareholders.

And with that, let me turn it over to Paul for his comments.

Paul Varga

Thank you, Jane, and good morning, everyone. To start, I was pleased with the very strong start to our fiscal year. And I was really encouraged to see the acceleration in the quarter's underlying growth rate, particularly the underlying growth in net sales. Alongside the favorable developments on our tax rate and FX that Jane referenced, we chose to revise our full year forecast up slightly, which is quite unusual for us with only 1 quarter of the year complete. But it is worth emphasizing that quarter 1 is only 1 quarter's results, but it was a very good quarter nonetheless, and it provides us with some nice momentum as we prepare for the launch of Jack Daniel's Tennessee Rye, the brand that has been many years in the making and for which we have very high hopes.

So why did the first quarter's underlying results accelerate versus what we experienced in FY '17? There was some influence from a few timing-related items such as soft comps from last year or the preprice increase buy-in in Australia that Jane referenced. And these will either be offset or not repeated as the year unfolds. A more significant factor, however, is the way we are executing our plan at Brown-Forman in FY '18, and that is with an even greater sense of competitiveness, prioritization, effectiveness and efficiency.

In Jane's discussion of our results, she highlighted that A&P investment is solidly up. At the same time, we are striving to manage SG&A at a level that is at or below 2 fiscal years ago, all the while absorbing important SG&A investments this fiscal year related to our Spanish route-to-consumer and startup costs associated with our distilleries and hospitality efforts at both Old Forester and Slane. This cannot happen without conscious prioritization and resource reallocation, or said another way, the more active pursuit of efficiency in some parts of Brown-Forman to help fund in incremental investments in other parts of Brown-Forman that we believe are necessary to ensure or improve our competitiveness, effectiveness and ultimately, our ongoing results. And I believe this is particularly well-timed, given the increasingly competitive context for our industry.

Let me give just 2 illustrative examples of this resource reallocation in action this year at Brown-Forman. The first relates to our used barrel sales, which have been very soft over the last several quarters after years of favorable supply-demand circumstances. After those circumstances shifted against us last year, we asked our team if we could be doing anything differently to positively affect our results. They responded by better resourcing our direct selling effort while reaching out to a more expansive used barrel customer base. And while the largest portion of the Q1 improvement we experienced in this area was timing-related, we do believe that this improvement in our outreach is playing and will continue to play a role in helping us in our efforts to arrest the significant decline we experienced last year.

The second example relates to Gentleman Jack, a brand which received stronger media investment in the first quarter behind new creative, which we anticipated would really hit the mark with consumers. The early results would suggest that it did. Globally, the brand grew underlying sales 8% in the first quarter after growing roughly 4% in the full 12 months of FY ’17. Additionally, the U.S. Nielsen’s are indicating an approximate doubling of the Gentleman Jack volume and sales growth rate in the latest 3 months relative to their 12-month run rate.

The incremental sales efforts behind our used barrels and the increased media investment behind Gentleman Jack were in part funded by conscious cost-containment and sacrifices on the SG&A front this year. These came in the form of: less travel, fewer meetings, some reduced training, lower consulting expense and a partial merit increase freeze, to name but a few examples. It can sometimes be difficult to know what management means when we cite improved competitiveness, prioritization, effectiveness and efficiency. So I hope these 2 examples give you an improved understanding of what we mean when we refer to them both today and in future communications.

Let me conclude by saying that these types of trade-offs, as thoughtful as we believe them to be, are not easy for any organization, and Brown-Forman is no exception. So I want to thank my Brown-Forman colleagues, not only for such nice quarter 1 results, but also for the spirit of understanding and cooperation that they have exhibited as we made these trade-offs and carried out these initiatives. All of – as all of you undoubtedly know, an organization with a positive predisposition and attitude is a huge enabler of ongoing success, and we feel fortunate to have such an organization here at Brown-Forman.

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

Question and Answer

Operator

— ***Operator Instructions*** — Your first question comes from the line of Tim Ramey with Pivotal Research Group.

Timothy Ramey

I was struck by the strong growth in Finlandia, which was a nice departure. I know you mentioned Russia, but perhaps you'd have a little bit more color on that?

Jane Morreau

On Finlandia?

Paul Varga

Yes, I think he mentioned it. It's…

Jane Morreau

The question is about retail.

Paul Varga

Yes, travel retail, Russia and Poland, to some extent. I think there's – the brand is so concentrated in Eastern Europe. Any improvements we see out in that part of the world directly helped Finlandia. And that was in fact the case, particularly driven by Russia in Q1.

Jane Morreau

Yes. And we – overall, Tim, we saw improvements in Russia for our Jack Daniel's as well. So I think some of that is just due to some stabilization happening in that the economy, and something that bodes well, we think, as we look forward over the next few months, rest of the year.

Timothy Ramey

Terrific. And just on el Jimador and Herradura, you've had a multiyear trend of raising price and moderating volume. Was – can you elaborate on whether this was back to organic growth in volume? Or are we still sort of continuing that price shift?

Jane Morreau

That's in Mexico.

Paul Varga

Yes. Just clarify, Tim, a lot of which you referred to there was very concentrated on the el Jimador Mexico business, where we were consciously trading pricing for volume in that marketplace. But otherwise, it's been a more volume-led growth trajectory in the United States for both brands and for even Herradura and Herradura Ultra and New Mix down in Mexico. So I would say the continuation here continues to be volume-led on our tequila brands, particularly when you look at the U.S. market.

Operator

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

Nik Modi

Just 2 quick questions. The emerging markets you guys commented, obviously things have looked like they improved. Just wanted to understand what you're seeing to come to that conclusion, because it still looks like it's pretty weak for most other consumer companies. I just wanted to get some thoughts there. And then maybe just an update on what you're seeing on the craft competition. Are you seeing more supply coming into the market? Any update there would be great.

Paul Varga

Yes, I think 2 very different questions there. You want to take the first one?

Jane Morreau

I can take the emerging markets question. Some of the – we may have talked about this at year-end. We were expecting our emerging markets to improve. They actually started to improve in the back half of last year, and we saw a continuation of that happen in the first quarter. Some of it is due, frankly, to some easier comps versus last year where we had some disruption whether it was geopolitical in Turkey as an example, or our own route-to-consumer changes that we did in China. But we are – actually are seeing some stabilization. You actually are seeing some foreign exchange improvement. So we really actually believe that these markets are seeing some stabilizing trends out there. And our brands are seeing the growth and benefiting from this.

Paul Varga

I think the other factor that – because you referenced our competition. It's just always worth remembering that even when you – even look within our emerging markets, our concentration in the BRIC portion of the emerging markets relative to many of our larger competitors is smaller. So our emerging market business will really benefit when, for example in this quarter, it was very prominent where Mexico and Poland were doing very, very well. And they're a larger percentage of our emerging market business than they are for some of our competitors. So I think that could explain us relative to some competitors you may be referencing. The other part was on craft. And yes, I mean, I think the way you asked the question, I think you could have just made it a statement. There is in fact continuing to be increasing competition across the board, most notably in the United States, but also in other key developed markets around the world, where we're seeing just a rise in entrepreneurism, new distilleries coming online, both in white goods and brown goods. And so I just would chalk that up as increased competition for all of us. The more established players have been around for a while, but it is a reality. And it's interesting. It's not – using the United States as an example, I'm trying to think through how significant some of the more recent news around craft has been. And one thing that's so interesting, when you go back and study the performance of the United States, which of course has had such a nice and steady growing distilled spirits market for a very long time, for many years now, the largest players, whether you segment them as the largest 5 or the largest 10 or 12, has been losing share to the smaller players. I mean, it's not some new phenomenon. Now this is only going to create even more competition as you have competition for shelf space, back bar space, et cetera, from all the new craft competition. But one thing I was encouraged about by the first quarters and really the last 12 months' U.S. performance for Brown-Forman, I'll just give you statistics which were fresh from the most recent data, was that of the top 12 largest companies in the U.S., only 4 outperformed the rate of growth of distilled spirits, which means – and by and large, the group as a whole would have continued, as I said, that trend of losing share. But 1 of the 4 companies over both the 12-month and the last 3-month period in Nielsen that would have outperformed total distilled spirits is Brown-Forman. So even though we paid great attention to every single individual category and every brand that we have representative of the categories, but I was encouraged by that continuing trend of Brown-Forman performing at the rate of total distilled spirits. Now what does catch our attention on all this competition is that rate of growth for distilled spirits in the United States has been slowing sort of modestly but steadily over the course of this fiscal year. And what would of course happen, there's – usually, the response to that comes in usually a more competitive effort, particularly from the large and established players. And so what you'll see and this is quite typical. You can see it come in the form of increased investment. But what can really can create some competitive noise in the marketplace are the tried and true increase in line extension activity. So you'll see people particularly in the categories that have flavored extensions. And then the other one is when people get particularly aggressive with lower pricing. And in the first quarter, we did observe, I think, the rate of innovation that seems to me to be about the same. I don't have the data to prove that. But I definitely have been paying attention to the lower prices that some competitors seem to be pursuing as they deal with this more competitive environment in the U.S. So I know it's a long answer to your craft question, but those are some of the dynamics we see for us, particularly using the U.S. as an example. But we continue to be holding up pretty well as a company.

Operator

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

Freda Zhuo

This is actually Freda, on for Judy. Just a follow-up question on pricing, in particular. And the price/mix this quarter was a little bit better than what you've seen in fiscal '17 at 2%. And the geographic mix, it sounds like it was much more heavily tilted to emerging market. So could you talk about the drivers to the price/mix being stronger in this particular quarter? Was it better tequila growth? Was it more mix in certain regions? Any kind of color on that? Then I have a follow-up.

Jane Morreau

Yes, I'll start with this. It was – when you have Jack Daniel's and its Family of Brands growing net sales 6%, you're going to get some nice price and mix benefit from both. And that's what actually happened in the quarter. We had a bit more price – excuse me, mix benefit than we did price, if you actually broke the 2 numbers down a part. And so that, coupled with the continued double-digit growth in our bourbon – super-premium bourbon brands, brands such as Woodford Reserve and then Herradura growing strongly. And there were some pricing in Mexico on that. So all combined, that contributed to our faster or more contribution coming from price/mix than we did last year, but it's mainly mix.

Freda Zhuo

Okay, great. And then just thinking more holistically about the pricing strategy throughout your portfolio in the U.S. I mean, it seems as though, again, the Jack Daniel's pricing has maybe been a little bit more rational. And then, at least sequentially, we've seen a little bit of declines in annual pricing in Gentleman Jack. And so can you talk about how you're thinking in terms of pricing amongst the different brands in your portfolio, especially as you're seeing some of these craft competitors pricing at the lower end?

Paul Varga

Yes, I mean, I think because of the large degree of – just increased number of brands is the best way to say it, and it's really very heavy in the $20 plus per bottle price segments. And of course, that will go up well above $50 a bottle. I mean, last year – I'll give you an example. Last year, I think consciously and implementing this very well market-by-market, taking price on both Old Forester and Woodford Reserve, and in both instances against the backdrop that's out there, there were some volume hits as those prices made their way in. So with each brand, we'll continue to look at what the opportunities are to raise price. I would say it is more difficult today than it would have been 2 years ago. And from time to time, we will continue to raise prices on brands for reasons other than volume, which are about premium price position, et cetera. And that can be as significant an influence as selling the product through to the consumer. And that, for sure, has been the case in the Old Forester price repositioning over several years here. So there'll be a variety of influences. I also think it will depend on the economy, not just the degree of competition that's in there. And for example, if you have – right now we feel like we have a – between category and momentum for bourbon, which should be benefiting us in a nice economy, there will be opportunities for targeted price increases. So – and our people are very well trained to find those. The other form of portfolio management is the one that – it sort of goes back to your first question in the way that Jane answered it. You can't imagine how we'll benefit from introducing line extensions and new brands at higher price points. And you might just go flood the market for that reason, but the example that I would provide – but in spite it is being something that we're very excited about is this forthcoming introduction of Jack Daniel's Rye, which is going to be priced above the Jack Daniel's price point. And it will be a form of portfolio mix that provides benefit in – that's not technically a price increase, but it is being positioned above Jack Daniel's or the more rapid growth of Gentleman Jack that I referenced. Both of those are examples of being able to get portfolio mix benefit to replace some of the pricing that we're not seeing.

Operator

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

William Chappell

Paul, just want to follow up on the rye launch and just to make sure I understand. I mean, if you look over the past couple of years, rye's kind of almost been a market by itself with fast growth in really kind of niche and smaller brands making up most of that growth. I mean, does it make sense? Or kind of as you look at your optimism on the back half and this launch, to have a separate brand kind of similar with what you've done with Woodford Reserve or what you've done on the Irish side? Or do you feel like you can still capture your fair share with just – not just, but with the Jack Daniel's brand?

Paul Varga

Yes. I'm glad you mentioned Woodford because there's a great example of brand that's been in the market for, what, 18 years before we introduced its rye version at a nearly – I think at approximate, almost a $40 price point now and has grown at astronomical rate that's getting incredible product critical acclaim. So that is one of the things this early experience on Woodford Reserve Rye is one of the things that's giving some excitement. Actually, you can see the category's momentum. And remember, this category has largely been built by the bartenders. And in the entrée, they associate it with the resurgence of the classic cocktail. And this particular sort of category that's spicy and bold in flavor is resonating very well. I mean, it's an extremely mixable category. I mean, the product, rye. And there – it's very interesting to taste the various expressions because there's a great range from the 51% ryes to the 100% ryes. And they all make cocktails differently. And one of the things that has us excited is the excellent balance that is in this Jack Daniel's Tennessee Rye product. I really do think it lends itself very well to the cocktails' boon that's going on. It's an extremely well-balanced product. The – we have very good – I'm encouraged. You can never go to the bank on these things. But the preparatory consumer research we did was really encouraging about Jack Daniel's potential in this arena. And I actually think at below a $30 price point, while still super-premium in price, this will, I think, be a value. And we just have had so much experience over so many years just introducing brands to the consuming public from Jack Daniel's and doing it, we hope, the right way. And I just would note that this is the first Jack Daniel's distillery whiskey brand with a different grain recipe. I mean, that in and of itself will encourage all kinds of interest in this legion of Jack Daniel's brand devotees will undoubtedly want to try it. I actually think that Jack Daniel's Tennessee Rye has the ability to expand the category beyond what people might experience, because there's, I'm sure, a lot of Jack Daniel's Tennessee Whiskey drinkers who have not ventures into the rye category yet and experienced cocktails made with rye. And so there's all number of reasons for us to be excited about it. And I would not underestimate the ability of Jack Daniel's Tennessee Rye to play a role in the globalization of the rye category. It's not our primary focus to start. But as we learned with Jack Daniel's Black Label Tennessee Whiskey and then later with even the flavored expressions that we can play a very prominent role in taking the flavors of American whiskey around the world. And so I just know from some of the outreach we've already had from our colleagues around Brown-Forman who are interested in this because the world's already learning about its introduction in the United States. So we got our fingers crossed that it'll be a big success for us. And I'm personally just very excited about it. I think it's a really exciting introduction from the distillery.

William Chappell

Okay. And just a follow up to that. I think, Jane, you said the majority of the benefit comes in the back half. Is that pipeline filled? Because I mean, I think we're seeing the launch is pretty imminent. Or is that just you won't get to full distribution until the third or fourth quarter, and that's why we wouldn't expect as big of a benefit till then?

Jane Morreau

Yes. So we're getting ready to ship it in September, first of all. More or less, first of all, we had laid this down 5 years ago. And so we laid down a certain amount. Some of it's limited by the amount of quantity that we laid down. So shipping is in September for us, means it will start hitting the shelves in our October time frame. We have more coming, obviously, as the year goes on. That's why we're saying it was more the back half, but we are limited by the amount of supply that we laid down 5 years ago. Notwithstanding what Paul said, we're very optimistic about the brand, but we will get into full distribution is our plan.

Paul Varga

Yes, and we would have available – in ensuing years, more quantities available. But I personally – if you go down the list of the leading brands in the U.S. rye category, one of the selling attributes, I believe, that is very compelling for Jack Daniel's Tennessee Rye is the fact that it's actually made by the Jack Daniel's distillery. And there are a number of these competitors out there that really haven't been making their own rye. And it doesn't mean they're bad products per se, but I do think there are some real positive selling attributes associated with our particular entry, because they've been crafted by the distillers themselves at the distillery and not sourced from a third party.

Operator

Your next question comes from the line of Brett Cooper with Consumer Edge Research.

Brett Cooper

I just want to circle back on the message of competition. As a private company, I haven't really heard you speak up about that until your annual meeting and then again today. So is this – I guess, is this something new for the company? Or is that a new message for – kind of for us who's here outside? And then as we think about it, is it competition sort of outwardly focused? Or is there I guess increased competition within Brown-Forman, whether it be across brands and in countries? And then if I can slip one final one in is, this idea of increased competitiveness, is that going to spill over to advertising? You spoke just about it a second ago, but where you can compare yourself, your sourcing versus what else is out there given the new competition?

Paul Varga

Those are good questions. Let me clarify, we've always been in tune with competition. I mean, I would tell you that, for example, years ago, the introduction of Jack Daniel's Tennessee Honey was a direct response to competitive activity in the marketplace, new innovation from competitors that we first saw directly related to the shot businesses on both Southern Comfort, when we owned it, and Jack Daniel's. So I mean, I feel like we're – we regularly talk about what the changing competitive dynamics are. I think a lot of it is, why we're emphasizing it, is to try to sharpen our own perspective and to give you some transparency to how we're thinking about mostly all these new entrants that are forthcoming, particularly the time when – 10 years ago, you would have heard the phrase barriers to entry described around many of the categories, notably the aged categories like whiskey. And today, you just see so because of an available third-party market that can make product, but also the willingness of entrepreneurs to open their own distilleries and get into the business. And so I think here we are, what, 5, 10 years later, and so it's just, I think, normal to talk about what's going on with the competition and also to not let misinterpretation of how the competition is unfolding, either the way you all interpret our business or the way we run it. I mean, I think we have to be very conscious. I mean, like the one example in one of the earlier questions was, is it now a great time to be taking more aggressive price increases while some of our motivated competitors are reducing prices and making their brands more affordable through promotion or one-offs? And there's a lot of new entrants in the market. It's just a little more difficult today that it might have been 3 or 4 years ago. It doesn't mean it's not possible, but it does mean it's a little more difficult. So we go ahead and emphasize that point with you. I think it also is one of the things that compels us then to look at ways that we can be innovative, look at ways that we can participate in some of where the category momentum is or – and there's countless examples of it. And sometimes, we're followers. In other times we can lead some of that. I mean – and that's why I tried to – I mean, it's even as much for our own internal conversations here to try to shed light on what is really happening in the marketplace. There are more SKUs. There are more brands competing for – I actually do think the space is increasing, but it's not increasing at the rate that the number of brands are. But it just makes it inherently a fight for shelf space and market share. Thankfully, the categories themselves are growing. That does enable some of the headspace for new competition, et cetera. But I personally think it – that should sharpen a company. It should make us be very attentive to things such as, are your resources working as hard as they should be? Or do you have them in the right places? And that's why we emphasized in our prepared comments some of the ways we are subtly running Brown-Forman a little differently against the changing competitive context. As to whether there's internal competition, of course, all of our people are regularly lobbying for more resources, and that takes some both art and skill to make sure that we keep everybody focused on the outside and not inside. But as I said in my comments, I've really been pleased by the way that people have adopted such a good attitude about wanting to compete and win. I mean, we're a competitive company. Sometimes we're prone because we're so long term-oriented and we make decisions based on the long term, we're owned by and controlled by a family that has the long-term interest of the company very much at the core of everything. But if you listen to that too much, you can forget to go out and get the weekly market share figures or you can forget to go out and compete in a way that we've tried to turn that up just to notch with our employees but keep it in balance this year. So it's all told. Look, it's very competitive but also exciting arena out there. And I mean, I've been emphasizing a little more than I have in the past this introduction of Jack Daniel's Tennessee Rye, mostly because it's upon us now, but also because we've waited many years. You have to remember, just a small few of us sat around 5 or 6 years ago, and so let's start making some of this so it'll be ready. And so for us, it's been many years in the making, and we're excited about it.

Operator

Your next question comes from the line of Robert Ottenstein with Evercore.

Eric Serotta

It's Eric Serotta, in for Robert. I'm hoping you could give some color in terms of your gross margin outlook. You had some very good operating leverage at the operating income line this quarter, but the gross margin was kind of flattish on an underlying basis and down reported. As we're looking out over the next few quarters, should that FX headwind start to moderate? How should the other moving pieces play out in terms of your gross margin progression for the year?

Jane Morreau

Sure. I'll take that. Yes, you're right. Our reported gross margin was down, as we mentioned, a little bit due to FX noise in the quarter, offset a little bit by A&D activity from last year. So as we look throughout the year, we expect that noise on a reported basis to subside and actually reported gross margin probably be close to flat, flattish. When we look at it on an underlying basis, we were flattish for the quarter. And we would expect our underlying, by the time we get to the end of year, close to flattish, down just a tad, potentially depending though on mix. Just because we've been talking about the competitive pricing environment, we're not able to quite take as much price as we've done in the past, but not marginally down even on an underlying basis. And as it relates to the operating margin, we talked about – you saw in our results this morning, we had 150 basis points of improvement. And that was driven largely by the decrease in SG&A in the quarter. So when we look ahead, we're not forecasting SG&A to be down for the year, but instead flattish. So when we look at the operating margin for the year, we're looking somewhere around 100 basis points of improvement.

Eric Serotta

Okay. And then, Paul, I don't think you guys mentioned Slane much on this call. Just wondering any additional early read on how that launch is going? I know it's fairly limited thus far, but any initial color would be helpful.

Paul Varga

It's off to a good start. It's the way I'd say it, also obviously, very, very small. It's literally, I think, it's in 18 U.S. states and introducing into Ireland, the U.K., in travel retail some. It's a good reception. I mean, people – I mean, some of the things that have been written about the product and what we've heard from trade reaction, a lot of that is anecdotal, has all been good. We just, I think, opened last week to the public. So for distillery visits, as we complete our construction in Dublin, we're actually going to have our board up at Slane next month in September. So it'd be exciting for a number of our board members to see that as well. So – but off to a very good start. I mean, I – everybody's very encouraged by it. Again, it's kind of – it's very staged unlike the amount of product, for example, that we're having – we have available to go with Jack Daniel's Rye, for example. I mean, Slane is not at that level of immediate expectation. It's a new trademark, et cetera. And we're – it's one of those things that is a – from the base that it's in, which is – has a lot of excitement around it, but we will be dabbling with very different selling and marketing techniques in different parts around the world just to learn the best way to introduce it to consumers. But so far, what we've seen in terms of the product – I mean, I really like the package. I think the package and product make a great presentation, I think, so the initial reaction to that has been very good. And then it's up to the good old-fashioned day-to-day brand-building that we have to do. But I know our system is very excited about it.

Operator

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

Laurent Grandet

I had 2 questions. The first one, Jane, I mean, you mentioned down sales. I mean, you provided about 0.5 point of top line gain. What was the contribution of margin expansion? And the second one is, I was a bit cautious entering the quarter for the U.S. market. As gross — ***indiscernible*** — last fiscal year from 5% in the first half to 2% in the second half and then 1% in the last quarter. So now we've – the first quarter in the U.S. began plus 5%. It's a strong inflection. So is the pressure from craft and flavored whiskeys reducing? Or are you just executing better? So I'd like to have more colors on these from you as well.

Paul Varga

I'll take that second question here first. No, I don't think that the impact of craft is distillery. I think it is at the same sort of intense level as it's been, in my view. And I do think there were some execution aspects of it. But the – as I've described in my prepared remarks where our teams are increasingly more competitive and efficient. And then also just the efforts themselves around it. I mean, it's hard to always pinpoint whether it might be a new partnership with the NBA and the media that's related to that or other elements that can contribute to a slight lift in a particular brand sales. But I think we are putting forth a better effort right now against the brands. And this year, I'll also say for – it's the case of Woodford Reserve and, to some extent, Old Forester, they don't have the pressure of higher pricing that we were placing on them a year ago. So that can be a contributor. We continue to see, for us, very good trends that I recited early on the call related to Herradura and el Jimador. So I think these are a number of the contributing factors to why we might see a slight acceleration there. But having said that, I continue to think it's going to be, particularly as we get into the fall and holiday season, continue to be very competitive. So we, too, like you, remain cautious about the marketplace because of that level of competition, but that's just part – that's part of the game.

Laurent Grandet

And then, Jane…

Paul Varga

And then margin? Yes, Jane will address the margin question.

Jane Morreau

Yes. You know what, I don't know if I got all the information in front of me. And so I would be happy to follow up with you after the call. That would be okay?

Laurent Grandet

That's fine.

Jane Morreau

Okay, can we do that? Yes, Thanks.

Operator

Your – we will take our final question from the line of Bryan Spillane with Bank of America.

Bryan Spillane

Jane, just a couple of questions on cash flow. I guess, first, in this quarter, it looked like working capital might have been a little bit more of a drag, at least versus kind of the way we had modeled it. So if it's just simply the timing of the shipments or is there anything that we should think about in terms of working capital in the first quarter or for the year?

Jane Morreau

Yes, yes. Actually, working capital is a funny calculation, as you know. And if you look at this year, I don't think there's anything. I think it's relative to last year that the question may be arising because last year's first quarter and really all of last year, we had the absence of Southern Comfort. So that impacted our AR. So think about that. You had AR the previous year, it went away last year. So that was a source of cash, if you will, last year that came through in our – what we actually settled for. And this year, it's just back to normal. So I don't – I'm not worried about anything. Our sales are up this year. So you see it as being the use of cash this year, if you will. So it's really due to the Southern Comfort.

Bryan Spillane

All right. Yes, that makes sense. And then just in terms of uses of cash. Can you just remind us what the expectations are for capital spending for the year? And then, I guess, you should have a pretty good sort of free cash flow year. There hasn't been any share repurchases the last couple of quarters, so just – and how you're thinking about free cash flow for the balance of the year?

Jane Morreau

Yes, sure. So specifically to your first question as it related to our capital spending or cash for the year, we are projecting up to about $140 million of capital spending. We've got a couple of big projects that we're completing. When Paul just mentioned a moment ago, which was the completion of the Slane homeplace and distillery, which just opened to the public – or is opening to the public this weekend; and then our Old Forester distillery, which is set to open in the springtime. So those are a couple of our big investments behind the up to $140 million of spending. When you look at our free cash flow for the year – well, first of all, I think it's probably worthwhile to take a step back and look at our approach to capital allocation, which we have not changed that approach to capital allocation. We always want to look for ways to deploy cash to create shareholder value, and we always will do that. But this particular year, beyond the up to $140 million of fully investing behind our business, and of course, we'll look to increase continually, deliver ordinary dividends to our shareholders an increase. We do have the $250 million of debt coming through in January, which we plan to pay in cash. So that will make some of our – most of our free cash flow that's left from there. Beyond that though, we have ample debt capacity should acquisitions come available that make sense and fit into our – into what we're doing.

Jason Koval

Well thank you, Paul and Jane, and thanks to all of you for joining us today for Brown-Forman's first quarter earnings call. We hope you all enjoy your Labor Day, and our thoughts are with all the people that have been impacted by the floods. Take care.

Operator

Thank you, ladies and gentlemen. That does conclude today's conference call. You may now disconnect.