Constellation Brands Inc, Q1 2019, Earnings Call 2018-06-29

Presentation

Operator

Welcome to the Constellation Brands' First Quarter 2019 Earnings Conference Call. — ***Operator Instructions*** —

I will now turn the call over to Patty Yahn-Urlaub, Senior Vice President of Investor Relations. Please go ahead.

Patty Yahn-Urlaub

Thanks, Laurie. Good morning, and welcome to Constellation's First Quarter Fiscal 2019 Conference Call. I'm here this morning with Rob Sands, our President and Chief Executive Officer; and David Klein, our Chief Financial Officer.

As a reminder, reconciliations between the most directly comparable GAAP measure and any non-GAAP financial measures discussed on this call are included in our news release, or otherwise available on the company's website at www.cbrands.com.

Please refer to the news release and Constellation's SEC filings for risk factors, which may impact forward-looking statements we make on this call. — ***Operator Instructions*** —

Thanks in advance, and now here's Rob.

Robert Sands

Thank you, Patty. Good morning, and welcome to our discussion of Constellation's first quarter sales and earnings results. These results were in line with our expectations and reflect significant investment across the business, designed to ensure that we maintain our growth momentum well into the future as well as other timing issues.

We’ve maintained our earnings guidance as the top line is responding to these investments, including digital enablement for our e-commerce initiatives and our new ERP platform as part of our Fit For Growth initiative.

We continue to work with Canopy Growth to develop and build cannabis brands. Our investment in Canopy is certainly paying off as we’ve recognized gains of more than $700 million in our reported results, since we made this investment last year.

Now most importantly, we continue to invest in brand building to our innovation and new product development initiatives across the country. Our most significant investment includes an increase in beer marketing to support our newly introduced products, which are exceeding our expectations and fueling sales momentum. The successful launches of Corona Premier and Corona Familiar are the first 2 major Corona initiatives in more than 25 years.

Premier has achieved record speed, record speed to shelf with velocities increasing each month since launch, and Familiar has already achieved a healthy share of the category and its regional expansion with velocities outpacing our expectations.

Now these innovations help drive industry-leading depletion growth of 9% for our beer business during the first quarter, despite unfavorable weather-related impacts early in the quarter in some of our largest markets.

As a matter of fact, this quarter marks 32 consecutive quarters of growth as the winning streak continues for the Constellation beer business. We remain the leader in the high-end of the U.S. beer market, contributing more growth than any other supplier during the first quarter. Constellation also won the Cinco de Mayo and Memorial Day holidays, driven by strong execution and sales increases across the Modelo Especial, Corona Premier and Corona Familiar brands, all of which were top 5 share gainers in IRI channels during the quarter.

We are well-positioned throughout the remainder of fiscal 2019 with a great lineup of marketing and promotional activities to support the ongoing growth momentum of our portfolio. I'd like to take a minute to highlight some of the activities we have underway for this summer-selling season.

The Corona Extra summer campaign is currently in full drive, leveraging new, strategic partnerships and increased media activities. Corona Premier launched new English and Spanish language TV campaigns during the first quarter, which will continue throughout the summer and into the fall to drive broad brand awareness. New Premier programming has been developed and is relevant for live sports including golf, major league baseball and the NHL.

Earlier this year, Modelo became the official beer for the Ultimate Fighting Championship, which is one of the fastest-growing sports in America. Throughout the year, Modelo will celebrate UFCs 25 years of fighting spirit through 5 sponsorships and national retail activation. In this summer, Casa Modelo will celebrate soccer as the beautiful game through a national retail promotion as well as Spanish language broadcast of the World Cup.

During the first quarter, we executed a nationwide launch of the Pacifico 12-pack can to build on the success of the 24-ounce SKU. In support of Pacifico's national expansion, the brand aired its first-ever national TV ad campaign and is poised to be a top 10 national TV beer advertiser this summer.

In addition to the Corona Premier and Familiar rollouts, we recently launched new brand entrance into test market within the alternative beverage alcohol space, which is a growing market opportunity that has been incremental to the beer category. The new Svedka spiked premium seltzer is targeted at the female consumer, who is looking for better for you light options that fit an active lifestyle, 3 new flavors made from natural ingredients have been introduced in select Northeast test markets.

We recently introduced Corona Refresca in 3 test markets. This premium spiked refresher in 2 tropical flavors is being supported by English and Spanish language TV as well as sampling events at targeted digital and social media activities.

Western Standard, a high-end barrel-finished easy-drinking lager will be available in test markets beginning in August. We are leveraging the equity and authenticity of our high-end small-batch high-west whiskey brand and building up trends of craft spirits and barrel-aged beverages.

From an operational perspective, during the quarter, we began the new expansion of our Obregon brewery, while continuing to make progress at our Mexicali and Nava sites.

The final phase of the 30 million hectoliter expansion project at Nava is on track as we add capacity for production, fermentation and filtration. And furnace number 4 at our Nava glass plant is now fully optimized and running at capacity.

Construction continues at Mexicali with brewhouse tank fabrication nearly completed. We are also progressing well on the packaging hall and site utility installation.

Overall, I am very excited about the ongoing growth prospects for our beer business. We remain committed to delivering our fiscal 2019 targets for this business with net sales and operating income growth in the 9% to 11% range.

Moving to wine and spirits. Our wine and spirits business delivered first quarter results that were consistent with the guidance we provided last quarter. As previously discussed, we experienced the Meiomi supply shortage, which caused the timing overlap versus last year's first quarter.

In addition, this year's first quarter completion trends were muted, following a better-than-expected finish to 2018.

However, we continue to see strong consumer takeaway trends for our wine brands in the U.S. marketplace during the quarter as we gain share in IRI channels.

And we continue to make progress in executing a steady evolution to the high-end of the U.S. line of spirits category, by capturing growth at higher price points to achieve mix and margin benefits, particularly at the greater-than-$11 price point at retail.

A good example of our success in this area includes key Focus Brands at these price points that posted double-digit depletion growth during the quarter, including Franciscan, High West, Robert Mondavi and The Prisoner portfolio.

Currently, Constellation's wine business at the greater-than-$11 retail price point is growing 12% versus market growth of 10%. Overall, our Focus Brands continue to drive growth of our wine and spirits portfolio and have consistently delivered growth at the 3x to 4x U.S. market rate.

From an innovation perspective, we are well-positioned with a strong pipeline of new brands, including Black Box Spirits, Robert Mondavi Selection Rum Barrel-Aged Merlot and Spoken Barrel, a Washington state red blend.

In addition, we've expanded our Rosé offerings to include Kim Crawford, Meiomi, Black Box, Band of Roses, a Charles Smith brand, to capitalize on this hot-growing category within the U.S. wine industry.

We will continue to support these innovation and brand building efforts throughout the remainder of the year with impactful marketing campaigns to strengthen and build the portfolio. During the quarter

— Technical Difficulty —

Operator

Ladies and gentlemen, this is the operator. I apologize that there will be a slight delay in today's conference call. Please hold and the conference will resume momentarily.

— Technical Difficulty —

Operator

Ladies and gentlemen, this is the operator. Please hold and the conference will resume momentarily.

Robert Sands

Indicate that our total beverage-alcohol strategy is working as we achieved the most retail sales growth by a wide margin among our U.S. beverage alcohol peers. As such, we remain one of the best growth stories within the U.S. CPG space.

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

Patty Yahn-Urlaub

Operator, this is Patty Yahn-Urlaub, are we back online?

Operator

Yes, ma'am, please go ahead.

Patty Yahn-Urlaub

Okay, thank you.

David Klein

Thanks, Rob, and good morning, everyone. Q1 results were in line with our expectations and we're on track to achieve our full year comparable basis diluted EPS goal of $9.40 to $9.70.

Now let's review Q1 performance in more detail, where I'll generally focus on comparable basis financial results.

Starting with beer. Net sales increased 11% on volume growth of 9%, favorable pricing and a $10 million federal excise tax reduction related to tax reform. This benefit will not recur in the remaining months of calendar 2018, as we've reached the maximum barrelage level allowed for this excise tax reduction.

Depletion growth came in strong at 9% with excellent portfolio performance during the key Cinco and Memorial Day holidays. This growth is even more impressive considering the 12% depletion growth we are overlapping from Q1 last year and weather-related softness experienced throughout the industry in March and April.

Beer operating margin decreased 230 basis points to 37.8% as the benefit of favorable pricing was more than offset by marketing investments, higher COGS and unfavorable foreign currency. The higher COGS reflects increases in transportation costs and depreciation.

Beer segment depreciation increased $10 million to $49 million for Q1. Marketing, as a percent of revenue, increased 110 basis points to 11% of net sales, driven by the upfront marketing investments supporting the successful Corona Premier and Familiar introductions.

For fiscal '19, we continue to expect net sales and operating income growth of 9% to 11%. This includes 1% to 2% of pricing within our Mexican portfolio. As a reminder, we're facing a 12% shipment growth comparison for Q2 and 6% shipment growth comparison for Q3. We continue to expect operating margin improvement for fiscal '19, although benefits from product pricing, glass sourcing and operational efficiencies are expected to be mostly offset by marketing investments, increased transportation costs and higher depreciation.

We continue to target fiscal '19 marketing as a percent of revenue in the range of 9.5% to 10.5% versus 9% for fiscal '18. This increase primarily reflects investment supporting our innovation activities and is weighted towards the first half of the year in an effort to generate strong marketplace performance throughout the key summer selling season.

As a result, Q2 marketing as a percent of revenue is expected to be in the range of 10% to 11% versus Q2 fiscal '18, which came in at 8.4%.

This marketing investment and the overlap of the strong Q2 fiscal '18 shipment volume is expected to move our Q2 fiscal '19 operating margin into the 39.5% to 40% range, versus our record 41.2% operating margin result achieved in Q2 last year.

Q1 fiscal '19 wine and spirits net sales and EBIT decreased 3% and 15%, respectively. This was in line with our expectations, as we overlapped strong Q1 fiscal '18 wine and spirits financial results, where EBIT grew approximately 20% and U.S. shipment volume significantly outpaced depletions.

Net sales were impacted by the overlap of strong shipment volume in Q1 fiscal '18, driven by replenishment of Meiomi supply, which was constrained coming out of Q4 fiscal '17. U.S. depletions were down 4%, as overall depletion performance was muted following strong Q4 fiscal '18 results.

Wine and spirits operating margin decreased 430 basis points to 25%, primarily driven by higher COGS, mostly reflecting increased grape and transportation costs and marketing investments for key Focus Brands and innovation initiatives.

We recognized approximately $5 million of income from our Opus One investment during Q1 due to a first-time spring release of certain older vintages. The 2015 Opus One vintage to be released this fall is expected to be smaller than the previous year. As a result, fiscal ’19 investment earnings from Opus are expected to be similar to our fiscal ’18 earnings, but Q3 fiscal ’19 investment earnings will be below Q3 last year.

In Q2, we expect to see ongoing cost pressures and marketing investments impact wine EBIT performance. However, we expect financial performance to improve in the back half of the year, which includes the key holiday selling season. As a result, we continue to expect wine and spirits net sales and operating income growth of 2% to 4% for fiscal ’19.

For wine and spirits sales, we continue to target low single-digit volume growth and mixed benefits from our premiumization efforts. We continue to realize benefits from the increased marketing spend on brands like Meiomi and Kim Crawford over the next several quarters.

As Rob mentioned, the wine business gained IRI market share in the first quarter and has a strong innovation pipeline and solid programming in place for the remainder of the year. We continue to expect mixed benefits and COGS productivity enhancements, which are targeted for the back half of the year, to be mostly offset by higher grape and transportation cost and marketing investments.

Even with some of the cost pressures I just noted, we expect full year operating margin expansion for both business segments. However, we expect the deltas between sales and operating income growth to be contained within the guidance range provided.

The increase in corporate expenses primarily reflects investments in people and consulting services in support of our growth organization, cannabis investments and our digital enablement and Fit For Growth initiatives. These investments will continue in Q2, when corporate expenses as a percent of sales is expected to be similar to that of Q1.

Interest expense for the quarter increased 7%, primarily due to higher average borrowings. Fiscal '19 interest expense is still expected to be in the range of $355 million to $365 million. When factoring in cash on hand, our net debt total $10 billion, a decrease of $199 million since the end of fiscal 2018.

Our net debt to comparable basis EBITDA leverage ratio came in at 3.5x at the end of May versus 3.6x at the end of fiscal '18, while we continue to invest in our Mexican operations and return cash to shareholders with $141 million of dividends paid and $100 million of share repurchases for the quarter.

Our comparable basis effective tax rate for the quarter came in at 21.4% versus 19.2% for last year. Our rate benefited from the new 21% U.S. federal statutory rate, but was more than offset by higher tax on foreign earnings and the lower benefits from stock-based compensation activity, due primarily to timing.

We anticipate that our Q2 fiscal '19 effective tax rate will be similar to the Q1 rate, in the 22% range. However, we continue to forecast our full year fiscal '19 effective tax rate to approximate 19%, with stock-based compensation benefits expected to be weighted towards the back half of the year.

Moving to free cash flow, which we define as net cash provided by operating activities less CapEx. For Q1, we generated $336 million of free cash flow compared to $165 million for Q1 last year. This improvement primarily reflects lower CapEx and strong operating cash flow growth. While CapEx was down for the quarter, we still have significant spending plan for the balance of the year as our full year CapEx guidance of $1.15 billion to $1.25 billion remains unchanged.

This guidance includes approximately $900 million targeted for our Mexico beer operations expansion. We expect fiscal '19 free cash flow to be in the range of $1.2 billion to $1.3 billion. This reflects operating cash flow in the range of $2.35 billion to $2.55 billion and the CapEx spend that I just outlined.

In Q1, we recognized an additional $258 million pretax unrealized gain from the change in fair value of the Canopy Growth investment and warrants, bringing the total pretax gain on this investment to over $700 million. Earlier this month, we acquired CAD 200 million worth of convertible debt securities issued by Canopy in support of their growth initiatives. We also recognized a $101 million net gain on the sale of our Accolade Wine Investment. The gains I just noted were excluded from our comparable basis financial results.

As mentioned earlier, we continue to project our comparable basis diluted EPS to be in the range of $9.40 to $9.70. Our comparable basis guidance excludes comparable adjustments, which are detailed in the release.

Before closing, I'd like to note we adopted new accounting standard guidance for revenue recognition at the beginning of the year. Under this guidance, we are recognizing certain sales incentives earlier than we have historically. We've provided restated income statement information for fiscal '17, fiscal '18 and fiscal '18 quarters in the Investor Overview section of our website.

As a result of this activity, our fiscal '18 comparable basis diluted EPS was restated from $8.72 to $8.70 per share.

In closing, we're executing against our plans and on track to achieve our financial performance goals for fiscal '19. While our first half financial results are being impacted by the investments behind the marketing, innovation and growth initiatives I noted earlier, we're confident that we'll produce top-tier financial performance versus CPG for fiscal

’19.

We also believe the investments we are making in support of growth opportunities today, position us to generate industry-leading sustainable and profitable growth in FY ’20 and beyond, while we deliver on our FY ’19 commitments.

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

Question and Answer

Operator

— ***Operator Instructions*** — Your first question comes from the line of Bonnie Herzog of Wells Fargo.

Bonnie Herzog

I was hoping, you could help us understand your conviction level for the rest of the year, given the weak Q1 results and your ability to hit your guidance ranges for the full year, specifically for beer. When you look at the midpoint of your guidance, it implies that beer margins for the balance of the year need to expand 80 bps. So could you drill down just a little bit more on the key drivers of that? And then I guess, I am just concerned that this might be tough given the spending and strong commodity and transportation cost inflation you touched on. And then does your guidance assume a price increase, for instance?

Robert Sands

Yes, Bonnie, I’ll start out and then I’ll let David address some of your points, but our conviction level is very high. I think that as I said in my comments, the first quarter was very much in line with our own internal expectations. We have planned to invest behind, in particular, the new products and the beer portfolio as well as some other investments in a big way during the first half of this year, and in particular the first quarter. And we did make those investments and we see the top line coming through. And that's what I would say is the most important thing that everybody should be looking at is, is the top line coming through? And in that regard, the top line is probably a little bit above our own internal expectations and our new products are performing, I would say, a little bit above our own internal expectations. So our confidence level on the year and the guidance, I would say, is very strong. David?

David Klein

Yes, so Bonnie, let me start out with GP margins in beer. So GP margins in beer benefited from robust pricing and then that was offset by incremental depreciation, which we'd planned on as well as about a 70 basis points drag from incremental freight and logistics cost as a result of a tighter trucking market in the U.S. It also was impacted by a headwind on FX, meaning the peso. Now that may seem a little counterintuitive, but the weakening of the peso really happened at the very end of May. And our production cycle is such that transactional FX benefits or headwinds actually don't flow through for about 30 days. So we didn't get any benefits from the weakening peso at the GP line in Q1. We expect the remainder of the year to have – to experience a tailwind from FX. We also have had several COGS improvement initiatives underway that we believe will offset the transportation headwinds that we're facing. We fully expect to expand GP margins in FY '19 versus FY '18.

Now I'll also go on and talk about overall operating margin. So in Q1, we had about 110 basis point headwind versus last year from the marketing investments that we made behind our brands, in particular Premier and Familiar.

We expect in Q2 that we'll spend about 10% to 11% of net sales on marketing, primarily because the brands are getting real good traction in the marketplace. As Rob outlined, the distribution performance has been astounding and we now want to make sure that we continue to drive increasing velocity on the shelf. However, we're still committed to being in that 9.5% to 10% marketing load for the full year. So when you kind of do all of that math, you get to the place where with confidence in the top line, understanding that we have a path to expanding GP margins and getting the timing right on our marketing investment that we are very confident that we'll deliver both our top line and our bottom line guidance in the beer business.

Operator

Your next question comes from Dara Mohsenian of Morgan Stanley.

Dara Mohsenian

So first just a couple of follow-ups. The drag from freight that you mentioned in the quarter, is that fairly consistent in the guidance in the balance of the year in terms of the year-over-year drag you're expecting in the balance of the year? And then on the beer pricing front, are you guys looking to perhaps be more aggressive with pricing, given the rise you're seeing in transportation costs? Or do you look at it really more from a competitive standpoint and consumer demand elasticity than being tied to cost spikes? And then just the last one on the innovation front. Can you just talk about Premier repeat rates at the consumer level so far? Obviously, you mentioned the distribution was strong. But what are you seeing in terms of repeat rates and cannibalization across the rest of your portfolio?

David Klein

So I'll start out and I'll leave Rob to talk about the cannibalization. So yes, there – we've – in our thinking about the rest of the year, we've fully internalized the effects of the transportation drag and expect to be able to cover it. From a pricing standpoint, we typically talk about being able to take price of 1% to 2% a year across the portfolio. We're seeing a fairly robust pricing environment in high-end. I wouldn't expect that we'll go outside of our pricing range, that 1% to 2% range. Although, that work is going on literally this month, as our teams are working through pricing.

Robert Sands

And then I'd say, as to consumer takeaway and repeat on Premier in particular, which is what you asked about. As I said, Premier is responding probably a bit above our expectations. We were very – we were able to gain distribution of the product at a pretty rapid rate. You see velocities at rates, which we think, are very strong. So I'd say, all good for Premier, we don't see any chinks in that armor. We think it is going to be a very, very successful brand launch, plus we put a lot of investment behind the marketing of the brand and I think that we're seeing the response to that.

And then to your question on cannibalization, we're not seeing cannibalization at a rate greater than what we expected in the first place, period.

So pretty much – and that's the bottom line. So I'd say, as it relates to the new products, I put that above expectation, I'd say as it relates to the entire Mexican portfolio, I have to say that that's also slightly above expectations as well. That business, our Mexican beer business is performing very strongly as we go through this fiscal year. So we see no issues whatsoever there.

Operator

Your next question comes from the line of Caroline Levy of Macquarie.

Caroline Levy

Just a couple of quick ones. Could you just discuss the level of beer inventories with distributors? At the end of the quarter, how that looked versus where you're comfortable, is it a little high, or little low? And are there any other stock issues, were there any other stock issues as a result of the new product being managed? The second thing really is, just I've never, in the past decade, I don't think I heard you call out grape costs. So it sounds like those are creeping up, if you could explain why?

David Klein

Yes, so in terms of inventory levels at distributors, they are in line with where we typically are at this point of the year, perhaps a bit on the low side. So I don't think there are any – there aren't distributor load issues clearly. And there weren't significant out-of-stocks to the best of my knowledge. From a grape cost standpoint, the callout is really based upon the flow-through of a tight Napa harvest year 2016, which is starting to come through our P&L. Also, there was issues in Italy as well in terms of the grapes that are coming through that are driving increased costs. Now that said, the operations team in the wine business has some overhead initiatives and some blend management initiatives that we put in place that will start to see flow through the P&L over the remainder of the year. So I don't think there is anything that's worrisome there. It's just a callout in terms of our margins in wine.

Operator

Your next question comes from the line of Andrea Teixeira of JP Morgan.

Andrea Teixeira

So I want to just, perhaps, go back to the kind of depletions trends and how you see it evolving for the rest of the summer? And on the price – in the pricing commentary that you gave, in terms of timing, do you still – is it the timing around October, which is the typical historical trend for the industry? Or given the cost pressures you may anticipate this price increase, or perhaps reduce the promotional levels, as we go? And then related to that, just to – as a clarification, so you are saying the second quarter pressures on gross margin for the beer business would be slightly less than what we saw and then compounded in the cadence through the rest of the fiscal year, given that the FX has been more favorable now that the beers are depreciating? Or should we still see some sort of the same magnitude of pressure on the second quarter?

David Klein

So let me start with the last one first. So in terms of gross margin in Q2, we expect that some of – we'll still have some transportation headwinds. We actually expect, instead of having an FX headwind we'll have a bit of an FX tailwind and we'll get some of the operational benefits that I touched on earlier. So any operating margin pressure in Q2 will really come from the incremental spend behind our brands that I talked about from a marketing standpoint being in that 10% to 11% range of net sales. We are working through our price increase process, our revenue consults have been meeting working with our salespeople to try to arrive at our pricing increase, which will take place in October. It will be announced before then, so we see no changes on that front. And depletions, I would say, that 9% were quite strong especially given the weather effects that we're seeing across the company, but in particular for us, in California, which is our largest market. So we're very happy with those depletion trends and we're feeling pretty bullish on the performance of that business throughout the remainder of the year.

Andrea Teixeira

And on depletion, can you give us like now much was each quarter, so that we can see the cadence?

David Klein

No, we don't really give depletion guidance.

Andrea Teixeira

Okay. No, I'm saying within the months – sorry, within the months of the fiscal – the first quarter fiscal '19?

David Klein

Yes, again, we don't break it out to that level. But again, we – just generally and you can assume that March was soft in California, April was soft elsewhere in the country and May looked pretty strong, so.

Operator

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

Vivien Azer

So I wanted to touch on Premier and Familiar as well, please. So two questions. In terms of the distribution gains, can you contextualize how your kind of ACV like has changed and perhaps like, kind of the size of your shelf set has changed with this incremental innovation, one? And number two, any callouts in terms of competitive responses?

Robert Sands

Yes, Vivien, ACV is a great story. We built ACV in Premier thus far to 63% and Familiar, without it being introduced everywhere, to 37%. So we are pretty excited about that and as I sort of indicated, I'd place that in the category of excellent results and even potentially above our own expectations. And then, I'd say, in terms of the shelf, we are fundamentally getting incremental shelf space for these products, which is great and makes a lot of sense for the retailers. I mean, I would say that retail is getting it, okay? Retail understands and they are getting that they can increase their own sales and profitability by getting behind this portfolio – Constellation's portfolio. So we continue to be, by a factor of manifold, the largest provider of growth at retail of any beverage alcohol company period in the United States. So we are pretty pleased with these results, which is one of the reasons, I would say, why we have the stomach, okay, to invest behind the portfolio the way that we have invested behind the portfolio. So we're pretty confident as we sit here right now that, that this is going to work out well.

Operator

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

Judy Hong

So one is just a quick follow-up on gross margins on beer, David. Just – was there any impact on Q1 related to any of the trade spend linked to the Premier and the Familiar expansion? And then secondly, the broader question, just really on the Corona brand family. So obviously, the new innovations are lifting the growth rate of the entire family, which is positive, but you are seeing slowdown in terms of the Corona Extra and the Corona Light declining. And I know Rob, you talked about cannibalization actually being pretty close to your expectations. So what do you think is happening to those particular brands? And is there any concern that even though the family is accelerating, that particularly those brands are a little bit soft as you think about the growth rate into, maybe, next year as you lap the innovation-driven growth this year?

Robert Sands

Yes, I guess, I'll comment on the last point. As I said, cannibalization is well within what we expected and predicted. We don't see cannibalization really being a huge factor except perhaps against Corona Light, which I would say, is what we expected. Any impacts on Corona, which – Corona Extra, which is performing very well, is probably mostly weather-related in March, in the first month. And frankly, I don't really like to bring the weather up, because it doesn't really matter and I think that we fully expect the portfolio and the base portfolio to respond or to perform as we expected. If you take a look at the whole Corona family, for instance, we were tracking, I don't know, 200 or 300 basis points or 200 basis points behind where we were for the first quarter. So it definitely appears to us that 1 plus 1 meaning the base portfolio plus the new products is adding up to 3, not just 2 or even below 2. So I think we are at, what, 14.7% IRI?

Patty Yahn-Urlaub

Yes, about even higher than that — ***indiscernible*** — for the latest.

Robert Sands

So – and higher than that for the latest, so consumer takeaway is very, very strong across the entire portfolio. As I said, Corona Light, we expected some cannibalization there.

David Klein

And Judy, there was no real meaningful effect on – drag on margins as a result of the new product launches. Those were quite smooth based upon some really good work out of our production folks.

Operator

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

Robert Ottenstein

Rob, I was wondering if you could perhaps reflect on how you're looking at the cannabis opportunity, touching on what roughly kind of your investment level in cannabis-related projects this year? Do you see that being more or less than what you thought it would be 6 months ago? And in addition, can you address the potential of doing something in California, Lagunitas is coming out of a product in 1 to 2 months, is there any way, in which you can create a separate subsidiary or something that would give you regulatory comfort that you could enter that market at some point in the future, even if we don't get full federal legalization, is it even a remote possibility?

Robert Sands

So first of all, Robert, our investment in cannabis is completely in line with what we expected, but that said, we are making a significant investment in cannabis from an operating point of view. We all know of our investment in Canopy and of course, that's working out quite well, but we didn't do it, specifically to speculate on Canopy stock, because that's not what we do. We did it to, in essence, have a stake in Canopy and to create what's almost a joint venture between ourselves and Canopy to develop product for the world market, okay, including the U.S. So we have a team and a significant team of people that both came out of Constellation as well as new hires sort of the full accouterment that's necessary to really develop products. They're headquartered – we call them GreenStar, they're headquartered in Toronto, and they are working diligently with many of the major, both advertising firms and marketing firms and consulting firms for that matter. We also have been engaged on the – on that topic meaning cannabis, so that we are ensuring that we are covering all fronts on that. I think that, as to your question about the United States, the answer is that we are not going to do anything that is violative of federal law. But that said, we are looking closely at, precisely that issue, and making sure that we understand what we can do and what we can't do. And sort of, as you implied, there may be things that we can do and we will do them if we can do them, if it's, as I said, it's not violative of federal laws. And we'd like to. So yes, so we are aware of the Lagunitas, what they are saying, let me put it that way, I don't have any really true inside knowledge of exactly what they are doing and how they are doing it, but we are pretty interested in what they're doing and how they are doing it. And we don't intend to get caught and be coming from behind. So I suppose, therefore, the answer to your question is, yes, we are looking at it pretty carefully, and if we see that opportunity within the confines of what we can legally do, we will do it.

Operator

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

Timothy Ramey

I think Rob probably continued talking in the couple of minutes that you weren't on the call and it – if it was true to former previous calls, it might've been when you're discussing some of the brand performance in beer, Modelo Especial, we didn't hear any commentary on that if there was some. So that would be one question to maybe repeat some of that. And second on the wine grapes, based on my data, looks like 2017 would have been flat to down from '16, so understanding your FIFO structure, should we expect some easing of that as we roll forward?

Robert Sands

I'll let David address that. Yes, I think we had some technical difficulties in the call and I believe, I was talking about wine and spirits and perhaps what the part that was deleted was the fact that I said that we would reiterate – we wanted to reiterate that we are committed to growing net sales and operating income for our wine and spirits business in the 2% to 4% range in fiscal 2019, which is what our original guidance was. So – and then I think, I was talking a little bit about appointing Jim Sabia, who is our beer marketing guy historically, to the position of Chief Marketing Officer for the whole company. So I think that that's what was – was cut out. And then on the Modelo Especial, I think that I was saying that we had double-digit depletions in Q1, and so we see everything to be all good with Modelo Especial. Like some other brands, March was a bit dicey in the beer industry, it's a general proposition, especially in California, in our largest market, but I think the good news there is that we outperformed everybody else, probably to the same extent that we have in the past and we saw everything bounce back. And if you look at a Modelo Especial's latest IRI, it's up 20%. So we just don't see anything there that's indicative that our Mexican beer portfolio won't perform in accordance with our guidance and in fact, we think it's performing above – a bit above our expectations at the current time. So we are very optimistic in general about hitting both the beer guidance and the wine and spirits guidance. I'll just talk a moment about the wine side of the business, which – first quarter was weaker than we would have liked on the depletion front and that was largely due to a couple of factors – really 2 factors: number one, strong finish to last year, so I think that there was some timing there and some borrowing, perhaps at retail from the first quarter. But nothing untoward and I think that we'll see that made up as we go forward here. I think, we'll see depletions fundamentally performing at sort of the historical levels and you've been looking sort of the 12-week or the 52-week and sort of see what that is. And then last year, we had – we ran ourselves out of Meiomi, and I say, ran ourselves out of it, was really due to fact that the sales were so stellar that we ran out of Meiomi and then we refilled that pipeline in the first quarter. As you recall, we had like this wildly good first quarter last year in wine and spirits and so we were overlapping that fill, which also accounted for some of the performance below expectations on wine and spirits for the first quarter. But we don't really see that necessarily impacting the whole year and we see the wine and spirits business performing in line with the market as we've been saying for quite a long time now. And we don't see any real chinks in that armor. There is nothing happening with our brands that is contrary to what's been happening in the past. And in fact we've got a lot of really strong marketing programs, that we're were hitting strong promotional programs, that we're hitting our innovation pipeline on the wine and spirits side, I think it's the strongest that it's ever been. So we are optimistic on wine and spirits as well.

David Klein

And on the COGS question, Tim, so last year, we finished with gross margins in the wine business kind of just sub-45% and then coming out of Q1, where we were just above 43%. We expect to grow our gross margins year-over-year in the wine business. So yes that implies a combination of mix improvements, some work we've done from an overhead and operational standpoint as well as a blend improvements, which are inclusive of grape costs.

Timothy Ramey

Is it a fair statement that '17 was flat to down versus '16 in terms of grape costs?

David Klein

Yes, I'm not sure as it relates across – as it ties out across our portfolio, but we can get back to you on that.

Operator

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

William Chappell

Just following back up on Premier and Familiar. You'd given out the ACV numbers, can you just kind of give us some color where you thought they were going to be this quarter? Because you last reported 3 months ago and something happened, obviously in the 3-month time frame to pull forward the marketing, was it a big customer added more? Was it just across the board? There was much more ACV than you had expected kind of going into the planning process? Just trying to understand how? I mean, it seems like it was a pretty quick shift and meaningful shift in a very short amount of time. So maybe even just on the ACV where you thought it would be?

Robert Sands

So Bill, we don't really plan ACV, quite that specifically in terms of the numbers – so all I can really say is I think that the numbers that I quoted were above what we expected, which basically means that we had more, even better retail take-up than we expected. I mean, it's sort of as simple as that. I can't tell you like whether it's 300 basis points or 400 basis points or whatever and I think it would be sort of sophistry to start talking about those numbers in hindsight. And then on the marketing, in fact, we did not pull it forward. We planned it. We planned to do what we've done. And in actuality, we thought that we had communicated that pretty specifically that we were going to be making significant investments behind the introduction of these new products in the first half of this year. We thought we had communicated that. And the only reason I'd say, I thought we communicated that is, I think that there – people seemed a little surprised about it. But to be clear, we didn't pull anything forward at all. We did exactly as we planned to do and yes, there is no way around. We have some significant investment spending in the first quarter against these new products. The good news is, this is not a plan to invest money for some long term – and some long-term basis that is immeasurable. We do think it's a very, very good investment for the long term, but in terms of seeing our return on this investment, we expect to see the return on this investment this year. So that's why – and we are seeing it and that's why we are confident in the guidance and that's why we were able to give the guidance that we gave in the first place, which we think is pretty robust performance for our company and for our consumer goods company. I mean, it still puts us I mean in a percentile that can hardly be measured. So that's basically the story. So we didn't pull anything forward.

William Chappell

That helps. So it's – just reading it and I understand what you're saying. You're – the comments at a conference, maybe a few weeks ago, was more of, we said this before, we on The Street just didn't hear it clearly, and so we are trying to reemphasize that, is that the right way to think about that?

Robert Sands

Yes, I would say that. And again, I just reemphasize one thing, in particular, which is, we didn't do anything. Our explanation is not that we did something this quarter that we weren't fully planning to do. We did what we planned to do and based on our own internal expectations, things performed as well as we expected, if not better. So we are on track for our guidance for the full year.

I mean, I guess, in the end, you can wait and see how the year turns out, we're only in the first quarter. Which is fine.

Operator

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

Bryan Spillane

Two quick ones. One, David, on the FX effect on beer gross margins, just how much of a headwind was it in the first quarter? And how much of a, like tailwind, given where the exchange rate is now, do you expect it to be in the balance of the year?

David Klein

Yes, so there are a really 2 components. So FX was the small headwind to GP in Q1, but it was a larger headwind through operating income, because we have – as the peso weakened in the quarter and we have to reval our peso receivables with the biggest one being our VAT receivable, there was a reasonably sized SG&A drag on our beer business.

So again, at the operating income line, it was a larger drag than it was at the GP line and then going forward, we were about just over 80% hedged for the year, had reasonably favorable rates and so actually the peso has been a little bit volatile leading into the elections this weekend. So I would say, it's probably too early to say, but we know, we had a headwind in the first quarter and we're pretty confident it's a tailwind for the rest of the year and I guess, the size will be determined on what happens, maybe even in the election over the weekend.

Bryan Spillane

Okay, great. And then just one second one on Corona Premier, can you give us a sense of where it's sourcing its share from? So is it coming from domestic Premium Lights? Is it coming from above Premium or even outside the sector? Is it coming from spirits? Just any sort of color or early indication you have of where it's pulling its consumers from?

Robert Sands

I would say it's pretty much pulling its consumers from across domestic Premium as the general proposition. So I think that your characterization of it is probably correct, meaning it's – I think it's probably pulling its consumers from domestic Premium Lights. And that kind of makes sense when you think about it, because it's a low-calorie, low-carbohydrate beer. I would say that its primary competition Michelob Ultra, continues to perform well. So yes, I don't think that it's evident that it's pulling necessarily from there. But Mic Ultra and I think Corona Premier is pulling from the Premium Lights. It's probably the bottom line. People aren't going to drink the light beer in the first place, aren't all of a sudden switching from non-light beer to light. They already made the decision that they weren't going to drink light. So I think that it's – the simple logic would suggest that this is the premium choice for the already health-conscious and Light consumer, that's what I would believe.

Operator

Your next question comes from the line of Lauren Lieberman of Barclays.

Lauren Lieberman

Two quick things. One was just one brand we haven't mentioned, which is Pacifico, outside of your prepared remarks, and I know I get Nielsen data, which doesn't seem to be all that representative, IRI seem to do a better job for you guys. But Pacifico, even as the weather improved, looks to not be performing terribly well again in the scanner data. I was just surprised to see that, as you're kicking off the national launch of the 12-pack on the TV. So I would just be curious to hear any commentary on Pacifico performance and what the scanner might be missing? And then also just on the distribution footprint, so there's – the trade press, the gossipy stuff, there's been a lot of chatter about some changes you guys have been making in your distributor footprint. So any color you could offer there on what's been driving decision-making process? And if there's any record to be set straight versus what's kind of being reported in the – again, in the trade press, it'd be great.

Robert Sands

Sure. So first of all, on Pacifico, Pacifico is, almost in the vast, vast majority of it, is very regional and largely Southern California, so it was probably affected by the weather in Southern California in the earlier part of the quarter to a greater extent than others. If you look at the performance outside of Southern California, it continues to perform double digits and in general, it's a looking very good. We see no real issue with Pacifico other than that, that market had – has been – was pretty weak in the first quarter and Pacifico was affected by it. But it continues to be a very strong brand that I think that we have very high hopes for and we don't see anything dashing those off. Now on the distributor question, number one I would say that we have the best distribution network in the country. We call it the Gold Network, we call it the Globe Network for a reason, because it's like making gold. It's as simple as that. The one change that we made in Southern California was only one change. So I think that characterizing it as some kind of change in our distributor footprint in general, or some kind of change in our philosophy of how we deal with or treat our distributor partners is simply incorrect. I think that it was kind of interesting news and there's a lot of pundits that have a lot to say about it. But the fact of the matter is that it was one change in a market and the change made a lot of sense, because we were able in that particular market to give that territory to another one of our very important distributor partners. So that change, as I said, made a lot of sense to us. Interestingly, I think the trade press glossed over another change that we made, which I think, is very significant and probably more significant, which is the fact that we gave our entire wine and spirits business in the Pacific Northwest, i.e. Washington and Oregon to our longtime beer distributor up there, Columbia, which I think, is an interesting thing, because it is aligned with our total beverage alcohol strategy. Not that that's necessarily something that we intend to do either on a broader basis. So in either case, it's just simply not appropriate to extrapolate what we did in either one of those cases necessarily to any broader, I'll say, point about the network other than what we did in those specific instances.

So we have a great relationship with our wholesalers. We're the company that's really providing 100% of their growth in many cases now, especially as you see craft having slowed down a bit. And I have to say that the results that we have achieved in our beer business and that we continue to achieve in our beer business, is in a large part due to the efforts and the investment and really the skill of what we call our Gold Network and those distributors. So the only thing I would say is, you can't take one move and extrapolate it to mean anything whatsoever in a distributor – in a network that has 500 or 600 distributors across the entire United States. There is always something going on in soft market relative to the network and I would say, we have better relationships than anybody, I would say, we will have better relationships than anybody, and I would say that the network is completely intact and a very, very strong network. We may change the name of it from the Gold Network to the Platinum Network, in fact. It's always getting better.

Operator

Your final question comes from the line of Amit Sharma from BMO Capital Markets. Amit, your line is open, please state your question.

Robert Sands

Well, that's an easy question to answer, Amit.

Operator

There is no response from that line, I'll now return the call to Rob Sands for any additional or closing remarks.

Robert Sands

Okay. Well, I want to thank everybody for joining our call today. Let me just reiterate that our business prospects remain very strong, and I'd like to reiterate that we're confident in achieving our full year goals, as we're expecting a strong back half to the fiscal year. As the July 4 holiday approaches, I hope that everybody gets to enjoy some of our fine beer, wine and spirits products at your celebrations with family and friends. So thanks everybody, and have a fantastic rest of your summer.

Operator

Thank you for participating in the Constellation Brands First Quarter 2019 Earnings Conference Call. You may now disconnect your lines and have a wonderful day.