Constellation Brands Inc, Q2 2022, Earnings Call 2021-10-06

Presentation

Operator

Welcome to the Constellation Brands Q2 Full Year 2022 Earnings Conference Call. I will now turn the call over to Patty Yahn-Urlaub, Senior Vice President of Investor Relations. Please go ahead.

Patty Yahn-Urlaub

Thanks, Josh. Good morning, and welcome to Constellation's Second Quarter Fiscal '22 Conference Call. I'm here this morning with Bill Newlands, our CEO; and Garth Hankinson, our CFO.

As a reminder, reconciliations between the most directly comparable GAAP 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 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. Thanks in advance, and now here's Bill.

William A. Newlands

Thank you, Patty. Good morning, and welcome to our second quarter call. Let's dive right into a discussion about the quarter. There were a number of puts and takes impacting our results in Q2, and Garth and I will spend time walking through them. However, the fundamentals of our business remain solid, and consumer demand for our brands, particularly our core beer portfolio, remains strong. This gives us confidence to increase our EPS guidance for the year, which we outlined in our press release earlier today and Garth will review in more detail shortly.

In addition, we repurchased a significant number of shares in Q2 at prices that are favorable as we believe Constellation stock is undervalued at current levels. We've received some feedback from investors on this topic in recent weeks, and we'll address key themes that emerge from these discussions in our remarks.

As we walk through our Q2 performance and outlook for the remainder of the year, there are several key takeaways we'd ask you to keep in mind. Number one, the momentum of our core imported beer brands provides a point of competitive strength versus industry peers as we're the leading share gainer in the high end of the U.S. beer market. The majority of our growth continues to be driven by Modelo Especial, supported by strong consumer demand for Corona Extra and Pacifico, and we expect this to continue for the foreseeable future. We continue to believe that Modelo Especial in particular has a long runway for growth, given the steadily increasing household penetration for this brand among non-Hispanic consumers and continued strong velocity.

Now we've admittedly had some supply challenges this fiscal year driven by several external factors, the most relevant being the ongoing robust demand for our beer brands. We expect to return to more normal inventory levels by the end of Q4. Despite these challenges, we continue to be on track to deliver a better-than-expected year for our beer business. In fact, our strong performance to date gives us the confidence to increase guidance for our beer business as we now expect to achieve 9% to 11% net sales growth and 4% to 6% operating income growth for fiscal '22. Our view is reinforced by recent 12-week IRI trends showing the Constellation's beer business is significantly outpacing the high end and total U.S. beer industry.

Point two. As it relates to our hard seltzer business and building off our last point, we're unique in our position versus our competitors in this space as our primary growth is coming from our core beer portfolio, and we're not reliant on the growth of hard seltzers and ABAs to achieve the medium-term growth goals for our beer business. The hard seltzer landscape has shifted considerably in recent months. Therefore, we've lowered our growth expectations for Corona Hard Seltzer, resulting in a sizable obsolescence charge taken for Q2, which includes our view of the total impact for the fiscal year.

So let's be clear, we continue to see the hard seltzer and broader ABA space as a meaningful sector in the beer market, and we continue to believe it's important to participate in and gain our fair share in this segment to complement the growth of our core imported beer portfolio and to maintain our position as a leader in the high end of the U.S. beer market. Going forward, we plan to focus on competing in this space where we offer meaningful points of differentiation and unique value to consumers. I'll have more to say on this topic in a moment.

Number three, while our wine and spirits business was challenged in the quarter by underperformance of several mainstream brands due to tough COVID comparisons, our recent route-to-market transition and supply chain challenges for our imported wine brands, we continue to see the benefits of our premiumization strategy take hold. We're performing well in the high end of the wine segment, which represents the vast majority of expected industry growth over the next several years, and we continue to strengthen our capabilities in emerging growth channels key to long-term success such as e-commerce and DTC.

Number four, we continue to enhance our approach to innovation with a more consistent, strategic, disciplined and consumer-led approach with a focus on high-growth segments aligned with consumer trends. Our innovation agenda is designed to complement our organic growth, and we're developing sustainable products that are incremental to our business while further premiumizing our portfolio into margin-accretive price points.

Over the years, we've been able to extend some of our brands into new spaces, recruiting new drinkers and expanding occasions, and we've achieved a healthy balance between growth from the core and from innovation.

Number five, our capital allocation strategy remains unchanged since I assumed the role of CEO almost 3 years ago. Since then, we've made significant progress in reducing debt and achieving our goal of returning $5 billion in value to shareholders by the end of fiscal year '23 through a combination of dividends and share repurchases. In fact, to date, this fiscal year, we have repurchased 1.4 billion of our shares. And when combined with our dividend, we have achieved nearly 60% of our 5 billion goal.

To be clear, our shareholder value equation is based on outsized growth combined with return of dollars to shareholders. One of the most important capital allocation priorities is to continue reinvesting in our beer business to keep up with robust demand for our products. Despite initial challenges associated with the build-out of a third brewery in Mexico, we have moved on to other capacity alternatives in the country. Our expansions in Nava and Obregon helped ensure we have adequate production capacity for the medium term and will create much needed redundant capacity that better enables us to manage through unexpected events like we've experienced these past 2 years. We continue to work with the Mexican government to solidify plans for a new brewery in Southeastern Mexico with adequate water supply and an available talented workforce.

Now let's move on to a more fulsome discussion about our performance within the quarter. During the quarter, the Modelo brand family posted depletion growth of 17% for the quarter and single-handedly drove total import share gains in IRI channels on a dollar basis. As the #2 beer brand in dollar sales in the entire U.S. beer category, Modelo Especial is the only major beer brand growing household penetration and is leading the way as the #1 share gainer among high-end brands. Modelo Chelada has become the #2 brand family in the Chelada space, posting depletion growth of more than 50% for the second quarter.

Corona Extra continues its growth trajectory as the second fastest share gainer and the #1 loved brand in the import category driven by a return to growth in the on-premise, which currently represents approximately 11% of our beer business volume.

In addition to the comments I made earlier about our hard seltzers, I'd like to discuss industry trends and our refreshed approach to this sector of the beer market going forward. In the short to medium term, we believe that there will be consolidation within the hard seltzer/ABA space primarily due to the chaos of SKU and brand proliferation with too many new entrants that don't have the velocity or consumer demand to warrant shelf space. We also believe this subcategory will evolve beyond low-calorie, low-carb offerings and open up to more distinctive consumer value propositions that include things like more flavor, different alcohol bases and functional benefits.

We've already started to innovate in this way with distinct products like Refresca and Limonada. We've also discovered that consumers are looking for more robust taste and flavor in their seltzers. As a result, we will be altering the flavor and taste profile of our seltzer portfolio to better align with the changing consumer preferences while also introducing single-serve packages to better serve the growing convenience channel, our largest trade channel. And we have a solid lineup of innovation that we have yet to introduce.

We have several great examples of our innovation strategy at work within our wine and spirits portfolio. This business continues to drive growth from recently launched innovations, including Meiomi Cabernet Sauvignon, Kim Crawford Illuminate, the Prisoner Cabernet and Chardonnay, all of which are amongst the top 10 innovations across high-end wine in IRI channels during the quarter. And our wine and spirits innovation pipeline is ready to go with further consumer-led new products as we head into our peak selling period, including the expansion of our SVEDKA ready-to-drink platform and the introduction of Woodbridge wine seltzers and box wines.

In addition to driving growth through innovation, we're making progress with our core wine and spirits portfolio despite the previously mentioned challenges. We continue to take price to further premiumize our mainstream portfolio as these steps are critical to maintain brand equity and to improve profitability, which will serve our brands well over the long term.

We're putting points on the board in a number of areas where we're outperforming the U.S. wine market. Our high-end super premium plus portfolio grew net sales double digits during the quarter. In on-premise channels, our investments are paying off with enhanced wine offerings at major restaurant chains. We're driving in critical emerging channels like 3-tier e-commerce and direct-to-consumer, which continued to drive high-end growth, where we're outpacing category performance at key accounts such as Instacart, Amazon and Albertsons with the resurgence of online shopping due to the COVID pandemic.

For example, Constellation's fine wine share has expanded significantly in the latest 12 weeks due to the robust growth of the Prisoner on Instacart and Robert Mondavi Winery on wine.com. In fact, e-commerce and DTC sales are up nearly 3 to 4x versus 2019, and they comprise roughly 3% to 5% of our business versus 1% pre-pandemic. Going forward, we will continue to focus on becoming a category leader in e-commerce and DTC as we believe these channels will make up a significant portion of our mix over time and will continue to be an opportunity for high-end growth.

I'd also like to provide you an update on our U.S. harvest, which is about 70% complete at this point, while our production facilities, wineries and tasting rooms remain untouched by recent wildfire activity. This quarter, our ventures activities included investments in adaptogen-infused HOP WTR and Aaron Paul and Bryan Cranston's artisanal Dos Hombres Mezcal. HOP

WTR is a nonalcoholic, calorie-free sparkling water, infused with adaptogens and new tropics to provide the perfect balance of function and flavor for health-conscious consumers. The nonalcoholic segment of total beverage alcohol grew almost 40% in 2020 in dollar sales through IRI channels. And according to IWSR research, 60% of consumers are switching between nonalcoholic or low-alcoholic and full strength drinks within the same occasion.

Dos Hombres is an award-winning handcrafted mezcal brand created by Breaking Bad co-stars who have developed an exceptional liquid that receives frequent praise from both the industry and consumers. The overall U.S. mezcal category grew 14% in 2020 according to IWSR, and super premium mezcal priced above $30 per barrel is projected to be the largest and fastest-growing segment within the category.

Moving on to Canopy growth. We're encouraged by the recent introduction of the cannabis opportunity in administration draft bill, which was introduced by Senators Booker, Wyden and Schumer in July. More than 90% of Americans are in favor of cannabis legislation for medical purposes, and 2/3 of those are in favor of legalizing for recreational use as well. In fact, nearly 2 out of 3 Americans already have legal cannabis access as 37 states have legalized for medical use and 18 states for adult use.

While we're optimistic about federal legislation within this congress, Canopy is not waiting for this reality to materialize. Canopy's U.S. business grew 91% year-over-year in their most recent quarter driven by robust consumer demand for their CBD and CPG products, including Martha Stewart-branded products, Quatreau beverages, stores and vape products and BioSteel's new RTDs.

Over the coming years, revenue for Canopy's U.S. business is expected to grow significantly as it benefits from increasing distribution and new product introductions. Once THC permissibility becomes a reality in the U.S., Canopy expects their U.S. business to make a substantially greater contribution to their results.

Canopy has scaled a multistate route-to-market plan ready for legalization and has leveraged Constellation's distributor relationships to fuel their U.S. non-THC business with more opportunities in a world post federal permissibility. Overall, we're comfortable with Canopy's progress, and we're looking forward to the growth and legalization prospects for the business.

In closing, I'd like to reiterate our main takeaways for this quarter. First, continued strong demand for our core imported beer brands provides a point of competitive strength versus industry peers, led by the #1 share gainer in the beer category, Modelo Especial, which we feel has ample runway for growth well into the future, given the steadily increasing household penetration rates among non-Hispanic consumers and continued strong velocity. The short-term supply disruption to our imported beer business does nothing to dampen our long-term prospects as we expect to return to more normal inventory levels by the end of Q4, and we're on track to deliver a better-than-expected year for our beer business.

Second, we continue to see the hard seltzer and broader ABA space as a meaningful sector within the beer market. Going forward, we plan to focus on competing in this space in ways where we can offer meaningful points of differentiation and unique value to consumers, and we have some upcoming innovation in the space that we're optimistic about.

Number three, we continue to see benefits of our wine and spirits premiumization strategy take hold. We're performing well in the higher end of the wine segment, and we continue to strengthen our capabilities in emerging growth channels key to long-term success, such as e-commerce and DTC.

Fourth, we continue to enhance our approach to innovation with a more consistent, disciplined and consumer-led approach focused on high-growth segments aligned with consumer trends to complement our organic growth while developing sustainable products that are incremental to our business at margin-accretive price points.

And fifth, and certainly not least, our shareholder value equation continues to be based on outsized growth combined with the return of dollars to shareholders. And let me reiterate, our capital allocation strategy remains unchanged. We remain committed to our goal of returning $5 billion in value to shareholders by the end of fiscal year '23 through a combination of dividends and share repurchases. Our strong operational performance and cash flow generation allowed us to make significant share repurchases in Q2 aligned with our commitment, which contributed to the increase in our EPS guidance for the year. At the same time, we remain committed to continuing to reinvest in our business with an emphasis on our beer business to keep up with the robust demand for our products.

And with that, I'd like to turn the call over to Garth, who will review our financial results in the quarter. Garth?

Garth Hankinson

Thank you, Bill, and hello, everyone. Q2 certainly reflected yet another strong quarter of marketplace performance for our beer business. Due to continued robust consumer demand for our core beer portfolio, we now expect to exceed our initial top line and operating income targets for our beer business. Additionally, our strong cash flow generation enabled us to continue to repurchase shares during the quarter. And through September, we've repurchased 6.2 million shares of common stock for $1.4 billion. As a result, we've increased our full year fiscal 2022 comparable basis diluted EPS target, and we now expect to be in the range of $10.15 to $10.45. This range excludes Canopy equity and earnings impact and reflects the increase in beer operating income guidance and decrease in the average -- in the weighted average diluted shares outstanding based on shares repurchased through September, partially offset by an increase in the tax rate for fiscal year 2022.

Now let's review Q2 performance and our full year outlook in more detail, where I'll generally focus on comparable basis financial results. Starting with beer. Net sales increased 14% driven by shipment volume growth of nearly 12% and favorable price partially offset by unfavorable mix. Depletion volume growth for the quarter came in above 7%, driven by the continued strength of Modelo Especial and Corona Extra as well as the continued return to growth in the on-premise channel. Depletion trends tempered in Q2 versus Q1 driven by out-of-stocks due to ongoing robust consumer demand as well as lost shipping days for some of our distributors due to severe weather events, including hurricanes and wildfires. We estimate that these factors hampered Q2 growth by approximately 2 to 3 points.

As Bill mentioned, on-premise volume accounted for approximately 11% of the total beer depletions during the quarter and grew strong double digits versus last year. As a reminder, the on-premise accounted for approximately 15% of our beer depletion volume pre-COVID and accounted for only 6% of our depletion volume in Q2 fiscal 2021 as a result of the on-premise shutdowns and restrictions due to COVID-19.

Selling days in the quarter were flat year-over-year and will also be flat in Q3. Wholesaler depletions continued to outpace cases shipped during Q2, resulting in a lower-than-normal distributor inventory on hand at the end of the quarter. To rectify this gap, shipment case volume is expected to exceed depletion case volume throughout the second half of the fiscal year, resulting in a gradual improvement of distributor inventories during Q3 and Q4 as inventories are expected to return to normal levels by the end of the fiscal year.

Moving on to beer margins. Beer operating margin decreased 530 basis points versus prior year to 37.2%. Benefits from favorable pricing, mix and foreign currency were more than offset by unfavorable COGS, increased marketing investments and higher SG&A.

The increase in COGS was driven by several headwinds that include the following: First, a Q2 obsolescence charge of $66 million. As a result of our production constraints earlier in the year, we prebuilt hard seltzer inventory in advance of the key summer selling season based on our best estimates for fiscal year 2022. Due to the overall slowdown in the hard seltzer category in the U.S., some of that growth is not going to materialize in the fiscal year, resulting in excess inventory. Second, increased brewery costs driven by labor inflation in Mexico, increased head count and incremental spend related to capacity expansion. Third, a step-up in depreciation expense, largely due to the incremental 5 million hectoliters at Obregon. And finally, as expected, increased material costs predominantly driven by increased commodity prices and inflationary headwinds on pallets, cartons and aluminum. These COGS headwinds were partially offset by favorable fixed cost absorption.

Marketing as a percent of net sales increased 150 basis points to 9.9 versus prior year as we returned to our typical spending cadence, which is weighted more heavily towards the first half of the fiscal year. As a reminder, marketing spend in the first half of the prior year was significantly muted resulting from COVID-19-related sporting and sponsorship event cancellations and/or postponements. Lastly, the increase in SG&A was primarily driven by an increase of approximately $12 million in legal expenses as well as higher compensation and benefits.

As mentioned earlier, we are increasing full year fiscal 2022 net sales and operating income guidance for our beer business. We are now targeting net sales growth of 9% to 11%, reflecting the strength of our core beer portfolio and pricing actions that are higher than initially planned. Furthermore, we are now targeting operating income growth of 4% to 6%, which implies operating margin in the low to midpoint of our stated 39% to 40% range. Please note that the updated guidance includes all obsolescence charges and legal expenses incurred in the first half of the fiscal year.

We continue to expect our gross margin to be negatively impacted for the fiscal year as benefits from price and our cost savings agenda are expected to be more than offset by several cost headwinds. However, the mix and magnitude of these headwinds have changed from our original assumptions presented at the beginning of our fiscal year.

First, we're still estimating a significant step-up in depreciation expense, which began to accelerate in Q2. However, some of this depreciation started later in the year versus planned. As such, we are now estimating total beer depreciation expense to approximately $250 million, an increase of approximately $55 million versus last year or a $10 million decrease versus our original planned estimate.

Second, we still expect substantial inflationary headwinds across numerous cost components to continue during the second half of our fiscal year as commodity prices continue to rise, specifically across aluminum, diesel and pallets resulting from a rather volatile inflationary market.

And third, due to the growth moderation within the hard seltzer market as well as lower ACV levels across the category on new items, we do not expect our hard seltzer SKUs to meet originally planned volume expectations, which results in a positive mix benefit versus our original estimate.

Conversely, due to the slowdown in the hard seltzer sector, excess inventory resulted in a fiscal year-to-date obsolescence charge of approximately $80 million. Please note that these losses cover our hard seltzer obsolescence exposure. And as such, we do not expect to take any additional obsolete charges in the back half of the fiscal year for hard seltzers. From a marketing perspective, we continue to expect full year spend as a percentage of net sales to land in the 9% to 10% range, which is in line with fiscal 2021 spend of 9.7% of net sales.

Looking ahead to Q3. I'd like to remind everyone of the difficult buying overlaps we will encounter as we're facing a 28% and 12% growth comparison for shipment volume and depletion volume, respectively. Additionally, we expect to perform our normal annual brewery maintenance during Q3, which will result in less throughput versus Q2 as we have to shut down production for a few days. As such, we are estimating low single-digit shipment volume growth for Q3.

Moving to wine and spirits. Q2 fiscal 2022 net sales declined 18% on shipment volume down to 36%. Excluding the impact of the wine and spirits divestitures, organic net sales increased 15% driven by organic shipment volume growth of nearly 6%, favorable mix and price and smoke-tainted bulk wine sales. Robust mix driven by the Prisoner brand family, Meiomi and Kim Crawford accounted for approximately 9 points of the year-over-year organic net sales growth. Shipments were negatively impacted by port delays for our international brands and route-to-market changes, which also impacted depletions. Depletion volume declined 2% during the quarter and was additionally impacted by the challenging overlap to consumer pantry loading behavior, especially for our mainstream brands that experienced robust growth during the beginning of the COVID-19 pandemic. However, as we head into the second half of the fiscal year, we feel as though most of these challenges are behind us and expect shipment volume and depletion volume to generally align in the second half of fiscal 2022.

Moving on to wine and spirits margins. Operating margin decreased 620 basis points to 19.7% as mix benefits from the existing portfolio and divestitures combined with favorable price were more than offset by increased marketing and SG&A spend, higher COGS and margin-dilutive smoke-tainted bulk wine sales. Higher COGS were driven by unfavorable fixed cost absorption and increased transportation costs. The unfavorable fixed cost absorption resulted from decreased production levels in New Zealand due to a frost during their harvest season earlier this year as well as decreased production levels at our wineries in California due to the 2020 U.S. wildfires. These headwinds were partially offset by lower great raw materials and other cost savings initiatives.

Keep in mind that we're lapping lower SG&A spend in Q2 fiscal 2021 due to COVID and heavy smaller business post-divestitures, resulting in significant marketing and SG&A deleveraging, impacting operating margins. For full year fiscal 2022, the wine and spirits business continues to expect net sales and operating income to decline 22% to 24% and 23% to 25%, respectively. This implies operating margin to approximately 24%, which is flattish to prior year on a reported basis, which shows significant margin expansion on an organic basis. Excluding the impact of the wine experience divestitures, organic net sales is expected to grow in the 2% to 4% range.

From a Q3 perspective, keep in mind that we are lapping unfavorable fixed cost absorption of $20 million in the prior year resulting from decreased production levels as a result of the 2020 U.S. wildfires. We expect this favorable overlap to be partially offset by a continued increase in transportation costs and incremental unfavorable fixed cost absorption due to the New Zealand frost. Also, we continue to expect marketing and SG&A deleveraging as a result of the wine and spirits divestitures. As such, we expect marketing and SG&A to continue to be a significant drag to operating margins in Q3 fiscal 2022.

Now let's proceed with the rest of the P&L. Fiscal year-to-date corporate expenses came in at approximately $117 million, up 7% versus last fiscal year. The increase was primarily driven by higher consulting services and compensation and benefits partially offset by a favorable foreign currency impact. We now expect full year corporate expenses to approximate $245 million driven by increase in compensation and benefits.

Comparable basis interest expense for the quarter decreased 4% to approximately $96 million versus prior year primarily due to lower average borrowings. We now expect fiscal 2022 interest expense to be in the range of $355 million to $365 million. The slight decrease versus our previous guidance reflects early redemption of higher interest rate debt as well as $1 billion of senior notes issued in July at attractive rates.

Our Q2 comparable basis effective tax rate, excluding Canopy equity earnings, came in at 21.8% versus 16.9% in Q2 of last year primarily driven by the timing of stock-based compensation benefits and a higher effective tax rate on our foreign businesses. We now expect our full year fiscal 2022 comparable tax rate, excluding Canopy equity and earnings, to approximate 20% versus our previous guidance of 19%. This increase is primarily due to a higher effective tax rate on our foreign earnings than originally estimated. I would also note that we expect stock-based compensation tax benefits to be weighted towards Q4. As a result, we expect our Q3 tax rate to be higher than our full year estimate at approximately 21%. We also now expect our 2022 weighted average diluted shares outstanding to approximate 192 million, reflecting the impact of our September year-to-date share repurchases previously discussed.

Moving to free cash flow, which we define as net cash provided by operating activities less capex. We generated free cash flow of $1.2 billion for the first half of fiscal 2022, which is flat to prior year, reflecting strong operating cash flows offset by an increase in capex. capex totaled $353 million, which included approximately $295 million of beer capex primarily driven by expansion initiatives at our Mexico facilities. Our full year capex guidance of $1 billion to $1.1 billion, which includes approximately $900 million targeted for Mexican beer operation expansions, remains unchanged. Furthermore, we continue to expect fiscal 2022 free cash flow to be in the range of $1.4 billion to $1.5 billion. This reflects operating cash flow in the range of $2.4 billion to $2.6 billion and the capex spend previously outlined.
In closing, I want to iterate that while we had our fair share of challenges during the first half of our fiscal year resulting in several puts and takes impacting our results, the fundamentals of

our business remain strong, and consumer demand for our products, particularly our imported beer portfolio, remains robust, providing us with strong momentum as we head into the second half of our fiscal year. And with that, Bill and I are happy to take your questions.

Question and Answer

Operator

Our first question comes from Dara Mohsenian with Morgan Stanley.

Dara Warren Mohsenian

So on the beer top line front, first, just a detailed question, given the volatility here and the tough comp in Q3, can you give us an update on how September depletions are trending so far? And also for the quarter, are you expecting depletions to still be above that low single-digit shipment rate that you mentioned? Or is that tough with the difficult 12% depletion comp?

And then second, the longer-term question is you raised your revenue guidance for this year. How much of that is underlying demand strength and depletions maybe versus shipments and perhaps getting more supply into the balance of the year versus pricing? And on the pricing front, you've sounded more aggressive in terms of pricing expectations going forward publicly. A, I guess, is that correct? And b, is that more just to combat higher commodity costs? Or is it more confidence in market share gains or that the consumer environment is conducive to taking pricing here?

William A. Newlands

Sure, Dara. Let me take a swing at that. And if I miss anything, Garth can fill in behind. So relative to depletes in September, we expect those to be fairly consistent with year-to-date trends. We're just about all wrapped up for September. Keeping in mind, that's going against 20% increase that we had during September of last year. So that's a pretty powerful start to the quarter. We do expect that depletions are going to continue to be above shipments for the reasons that Garth noted in his remarks. So we would expect the depletions would be above it for that window of time.

The pricing environment remains relatively strong. As we've said, we expect to be slightly ahead of our usual algorithm driven more by taking in pricing on some SKUs that we had not anticipated earlier in the year more than we're doing anything unique to take additional pricing where we -- what we had already planned. Garth, anything you want to add to that?

Garth Hankinson

No, I would just say on the depletions for the quarter, depletion growth will absolutely outpace shipment growth in the quarter. But on an absolute basis, shipments will outpace depletions, which helps us get into a better position from an inventory perspective.

William A. Newlands

Yes. Keep in mind, as we've said, we have our inventory levels at our distributors below what we would like to see and what they would like to see on an ongoing basis. So we would be expecting to fill some of that in as we get our inventory levels back to normal position by the end of the fiscal year.

Operator

Your next question comes from Bonnie Herzog with Goldman Sachs.

Bonnie Lee Herzog

All right. I actually had a question on your guidance as well. I just -- in thinking through it and thinking about the midpoint of your new beer guidance for the full year, this does imply a pretty big step down in the second half. For instance, your new guidance implies around 4%, 4.5% beer shipment volume growth, 3% of income growth and then beer margins of 39% for the second half, and that compares to your beer margins of 40% in the first half, which did include the $80 million obsolescence charge that you called out.

So I guess I'm trying to understand your level of conservatism with your new FY guidance, especially with margins given -- you mentioned there's going to be no more charges in the second half. You highlighted you plan to take incremental pricing, and then there are a few other net positive starts that you called out. So just want to make sure I'm not missing anything or maybe what's changed here.

Garth Hankinson

Thanks, Bonnie. I mean, look, let me try to give you the walk on margins, right? And as you noted, we've got some headwinds and we've got some tailwinds, right? And so just on the tailwinds. Obviously, as we said in my opening remarks, we've got a bit of a benefit on depreciation just starting later than expected in the year, and so that's a net positive. As Bill just articulated, we're taking more -- we're taking increased pricing across more SKUs than we originally planned. So we'll be above our range there. So that's a net positive. We also have the mix benefit of seltzers and, again, a net positive there. And then the increase in core beer outlook is a net positive. So those are all the headwinds.

But we still have -- those are all the tailwinds, but we still have the headwinds that we've been talking about all year long, right? So even though depreciation is coming in less than expected, we still have an uptick in depreciation in the second half of the year. We still are facing increase in commodity prices, including aluminum, diesel, natural gas, wood. Those will continue in the second half of the year. Now we think that the guidance we provided takes into account all of those cost increases. So we feel we have those covered. But again, I mean, we just continue to have these puts and takes, and we feel confident that -- in the margin outlook that we provided.

Keep in mind, too, that even though we're going to have a mixed benefit from seltzers, we still are going to sell seltzers, and those are margin-dilutive as we've noted previously.

Operator

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

Sunil Harshad Modi

So I have 2 questions. One is a real quick one, just on the seltzer reformulation. Bill, I know you probably don't want to provide too many details until it's in the market, but will this change the calorie or the sugar levels? So just curious on that. And then my broader question is, Modelo is clearly doing very well. We see that in the data with non-Hispanic consumers. But as we look at some of the numerator data and we look at different cohorts, what we noticed is that Corona's kind of leveraged to some of these demographics that Modelo's doing much better with. You're seeing some of those numbers deteriorate. So just wanted to get a sense on incrementality of Modelo when you think about Modelo and Corona together. And do you ever think that maybe there's a different merchandising scheme you can use instead of putting both brands right next to one another to kind of reduce some of that cannibalization?

William A. Newlands

Sure. So relative to your first quick point, there won't be a radical change in the current formulation of our seltzer layout. Relative to Modelo and Corona, obviously, there's interaction between those 2 brands as you would expect. However, as we've said before, Nik, and I'm sure you're quite familiar, our household penetration on Modelo is still significantly below where Corona is to say nothing of it's below other brands that are -- that it competes against.

So while it is a true statement that as Modelo grows or as corona grows, it does into some of our brands. We still see it as largely positive as we see that growth profile. And as we've talked before, Modelo, it continues to grow velocity. There's a lot -- still a lot of runway to expand distribution. The household penetration, which I touched on just a second ago remains a massive opportunity for that. And we only started advertising to the non-Hispanic community about 3.5 years ago. So we're really just getting started on Modelo and the opportunity that presents itself there.

So while you continue to see some interaction, and clearly, I think the idea of separating those at retail to some degree has some opportunity, I think, overall, we're still focused on expanding our presence of both of those brands. As you probably saw, Corona Extra had a very good quarter. And it just shows the ongoing strength of the core Corona franchise in addition to exceptional performance by Modelo.

Operator

Our next question comes from Lauren Lieberman with Barclays.

Lauren Rae Lieberman

I wanted to hear a little bit about Corona Extra since you called out the 5% depletion growth for that brand and how that kind of shakes out between on-premise recovery versus tracked channels or -- sorry, I should say, off-premise. And then I was hoping you could also talk a little bit about Nielsen/IRI versus what you guys saw in terms of off-premise trends in total, including untracked outlets. And then finally, just any kind of update on Pacifico. Just continually intrigued to hear about progress you are or aren't making with that brand.

William A. Newlands

Sure. So probably 50%, give or take, of the growth profile that we saw in Corona Extra is the reopening of the on-premise. As we've said in prior calls, we were down as low as 3% of our business a few quarters ago during the sort of the peak of the initial COVID pandemic issue. That's now up to 11%. And clearly, with the Corona being one of the most loved brands that exist in the category, the increase that you would expect to see as on-premise opens has been important. But don't underestimate. Corona Extra has done very well at retail as well.

Relative to Pacifico, we continue to feel like Pacifico is another great opportunity. It's like a baby Modelo. It's developing in a very similar way to what Modelo did, say, 20 years ago with extensive growth profile on the West Coast and as it's starting to filter East. As you know, we're investing more against Pacifico than we have historically. We had a little bit of challenge in this quarter with brown glass, which had some impact on Pacifico during the quarter as it did with Modelo Negra as well. But those are ongoing supply chain challenges that we're working our way through. It does nothing, nothing, just slowed down what we expect to be another superb brand for us as time goes forward in Pacifico.

Operator

Our next question comes from Chris Carey with Wells Fargo Securities.

Christopher Michael Carey

Just on hard seltzers, you had originally planned on investing pretty significantly behind the launch this year. Are you getting any savings from those investment plans now that the category has slowed? Or are those locked? And presumably, that can be a good story going into fiscal '23. In addition, you had mentioned that you plan to double capacity for your ABAs. And so how are you thinking about flexing that capacity toward beer? Obviously, you're looking at building a new brewery in Southeast Mexico. Does this get to delay that new build-out over time because you have the capacity?

Garth Hankinson

Yes. Thanks for the question. So on the capacity piece first, right? As we announced last spring, we were investing in 5 million hectoliters worth of ABA capacity. That is moving forward as planned and should come online earlier in our fiscal year 2023. That's still an important initiative for us because, as Bill outlined in his prepared remarks, while the seltzer category has slowed, the ABA segment within beer continues to be a dynamic and meaningful part of the high end and it's one that we need to compete in. And by having dedicated ABA capacity, that frees up capacity for our core Mexican beer portfolio. So that goes on as planned.

And then furthermore, on the investment that you referenced in the first part of your -- in your question, we did indicate that we were going to spend $60 million this fiscal year behind Corona Hard Seltzer. Most of that spend was slated to be spent in the first half of the year. So that has been spent, and that which wasn't spent is being redirected to invest behind our core Mexican beer portfolio.

William A. Newlands

The only other thing I'd add to that on the last part of your question was about whether or not it causes any delay in what we would do to invest in the Southeast. As I said, we're continuing to work with the Mexican government. We feel the Southeast is highly likely to be where we put our next brewery position. And as we've said, we're -- because of robust demand, we're going to continue to invest to support our business. So we would not expect to see any radical change of what our time frame is all about. Demand has been higher than expected. We need to create some redundancy in our system as we've noted on prior calls. And a brewery in the Southeast will be an integral part of that strategy.

Operator

Our next question comes from Vivien Azer with Cowen.

Vivien Nicole Azer

I was hoping you could comment, please, on intra-quarter trends in on-premise, whether you saw an evolution or a softening there around the Delta variant. And as well, perhaps from an industry perspective, are you observing any changes in consumer alcohol preference across kind of TBA, any cross-category switching as consumers are essentially back out into bars and restaurants?

William A. Newlands

Sure. We saw a lot of variation in on-premise. And at the risk of saying yes, no, yes, no and yes, no, it's largely dependent on where you were geographically and what was going on in particular markets. So while we would sit here and say state X is coming up and we're seeing more on-premise, if you saw a wave of COVID challenges in another market, you saw stuff go the other way. So what that basically -- I think there wasn't an overarching answer to that question. It was really on a localized basis that you saw many of the movements within the quarter.

Again, in the aggregate, on-premise was better than it was in the prior year, and it continues to be increasing as a percentage of our business, but it's still not quite where it was before the pandemic. So hopefully, that helps. It's very hard to give a real aggregate of the thing because it's really made up of a lot of individual answers rather than something being an overarching trend across the marketplace.

I think relative to your question about cross-category, you can -- I think the overarching thing that you see there is the premiumization trends continue. Whether you think about it in ready-to-drink and our ABAs, you continue to see people premiumizing. You see it in the wine business, where the higher end of the wine business continues to outperform the mainstream sector of the business and you continue to see that in spirit. So I think that is an overarching trend that you see.

You also see what we found for many years now, which is consumers are more interested in having an array of beverages depending on the exact occasion in which they are consuming product and are less likely than they used to be to consume only one type of product at any one occasion than what was perhaps the case historically. So I hope that helps.

Operator

Our next question comes from Kevin Grundy with Jefferies.

Kevin Michael Grundy

Great. Bill, just picking up on the last question, but really kind of lasering in, I guess, a little bit on wine and broadly for the industry because there's been some discussion in the marketplace about the recent slowdown, and it's not limited to the on-premise and we've seen the Nielsen data. So your point is extremely well taken. The premiumization trends are still in place, obviously, broad-based across total beverage alcohol. But even on a 2-year average basis, this is -- we're seeing the trend slow down here.

So I'm not sure how much more you can add to your comment previously. Do you view this as transient at this point, some of this deceleration we're seeing in the category? Is there a bigger, maybe a bit more difficult to quantify dynamic going on around ready-to-drink beverages in a way there hasn't been with wine before, if you could comment on that?

And Garth, just sort of a cleanup, but I think important. The 30% operating margin target in the wine segment, is that still the target? And is fiscal '24, so over the next couple of years, is that sort of enough of a time line to take out the stranded overhead? So your comments there would be helpful.

William A. Newlands

I think you got to keep in mind relative to the higher end of the wine business, you're also seeing some, what I'll call, channel evolution and things like 3-tier e-commerce and direct-to-consumer. Those are rough, for us, 3 to 4x what it was in 2019. And you're seeing that as sort of 3% to 5% of our business today, where it was 1% before. So some of what you're seeing in that is a difference in the way the consumer actually acquires, and it may or may not be reflective of some of the IRI/Nielsen data because it's not picked up in those channels. Some of it is with 3-tier e-commerce. But certainly, the direct-to-consumer channel is not.

So you've got some of that dynamic in play. And of course, almost all of that tends to the higher end. That's where that consumer purchasing behavior occurs. So I do think there's ebbs and flows on all of those things. I think you saw probably more consumption behavior at home during COVID. So you're probably seeing a little bit of more challenging comparable versus prior year. So I think as we get hopefully back to a bit more normalcy, I think you'll continue to see what the long-term trend is, which is that the higher end of the business continues to outperform and then it's a strong growth play for that sector. Garth?

Garth Hankinson

Yes. On the wine margins, certainly, the target margin for wine is still 30%. As we've said all along, it was going to take us about 2 years post divestiture of the low end for us to be able to achieve that 30% operating margin. So by the time we get to the end of our fiscal 2023, wine should be in that zip code. Obviously, the progress on that is underway. We're making good progress. As we've said before, in order to get there. There's a number of initiatives that have to -- that we have to make progress on. That's pricing mix, footprint optimization, making smart design-to-value choices. And like I said, I mean, we're making good progress, and we're confident that we can get to 30% by the end of 2023.

Operator

Our next question comes from Robert Ottenstein with Evercore.

Robert Edward Ottenstein

Great. A couple of questions. First, obviously, the low inventories hurt depletions. Can you give us a sense of where you think depletions would have been if you had full inventory levels? And I'm hearing it hurt Corona most. Can you verify that?

William A. Newlands

Obviously, that's a little bit of a tough question to answer because unlike a year ago, where we were very selective of what we produced, this year, we've been producing all SKUs. We've just had trouble keeping up with the demand. Our best estimate would probably be in the 2 to 3 percentage points that we lost in this process. But again, in most instances, if the consumer is looking for our brand, they may have an issue at a particular point in time finding a SKU, but they don't have trouble finding our brand. So I think that's probably the way to think about it.

Robert Edward Ottenstein

Great. And then second question, as you kind of do a diagnostic on what happened with Corona Seltzer, I think I heard you say that you -- that flavor was an issue that the consumer wants more flavor. So as you think about it, was it a question of the taste not being differentiated? Or is there an issue with having a brand that's associated with the beer? Or are there other factors in addition to, obviously, the sector slowing a little bit? Just like to hear a little bit more of your diagnostic on the situation.

William A. Newlands

Well, I would put more emphasis on your very last point, which is the sector changed a lot versus what everybody anticipated. I think we were probably a bit on the conservative end compared to some of the competition as to what they expected going into this year where some of them were predicting in excess of 50% growth. We projected less. But even as it was, we were wrong. So that is the fundamental issue.

When you combine that with the fact that we pre-produced which, again, at the time was about production scheduling and, in our judgment, was the right thing to do at the time, that in hindsight did not work out for us as well either. But you got to keep in mind, despite all that, if it's a relatively small percentage of our overall growth profile, it is additive to our growth. It is not the majority of our growth. The majority of our growth continues to be the robust demand against our core beer portfolio, and that's where we expect it to continue to be.

So now relative to the formulation, we've just -- we obviously do a lot of consumer research, and we track consumer perspectives. And we have found that consumers are desiring a bit more flavor and a bit more differentiation within their sell-through preferences, and we plan to address those consumer needs.

Operator

Our next question comes from Sean King with UBS.

Sean Roberts King

Thinking longer term on the margin front and some of the long-term exposures you have and hedges you have in place, is the second half of fiscal '22 the right way to be thinking about margins for '23?

Garth Hankinson

Look, I think the right way to think about margins over the near and medium term is consistent with our long-term growth algorithm, which is that we're going to achieve margins in the range of 39% to 40%. And as we said in every call, those are best-in-class margins, and we're unapologetic about those. And in any given fiscal year, margins might be slightly higher than that due to tailwinds. And in some years, they might be slightly lower than that, just too many headwinds. But the right way over the medium term is to think about those in the range of 39% to 40%.

Operator

Our next question comes from Nadine Sarwat with Bernstein.

Nadine Sarwat

I want to circle back to Pacifico, and you had called out the brown glass challenges that you faced. So obviously, that brand saw weaker Nielsen off-trade trends this quarter. And I noticed that you didn't call out its depletion figures in the release. So could you provide this and maybe give us some color as to if there were other issues outside of the glass issue you already called out?

William A. Newlands

Sure. We had mid-single-digit depletion growth in that brand during the quarter. And obviously, it was constrained. We would have expected it to be higher without any supply chain issues that revolved around brown glass.

Operator

Our next question comes from Andrea Teixeira with JPMorgan.

Andrea Faria Teixeira

So I wanted to go back to the depletion and shipments commentary. You said depletion should outpace the low single-digit shipments you guided in the 3Q, which would imply a sequential acceleration in 3Q from the 12% on a 2-year stack that you achieved in the second quarter. So given that you're facing tougher comparisons, if you grew depletion the same amount about 12% in the third quarter of last year, is that acceleration on the 2-year coming mostly from on-premise and at-home decelerating but still growing? Is that the way we should be thinking? In other words, should we think about the depletion growing around mid-single digit when you said -- I think you said it emphatically that the third quarter depletions would outpace shipments as well?

And then related to -- and just a clarification on the pricing front, should we think that you will have about 2% price/mix realization already in the 3Q. And what are you seeing elasticities playing out so far?

Garth Hankinson

Sure. So just on Q3 shipments and depletions, what we said in terms of -- from a growth perspective, shipments will grow in the low single digits and depletions will grow higher than that. We furthermore said that on a volume basis, depletions -- shipments would outpace depletions and, therefore, we've made progress in returning inventory to more normal levels by the end of our fiscal year.

On the pricing question, what we said on that was that our typical pricing algorithm has us gaining 1 to 2 percentage points per year. Given the pricing environment that we're in this year, we're able to be a little bit more aggressive on products that we wouldn't otherwise take pricing on. And so we're going to take pricing on those SKUs. And as a result, we'll be slightly above our 2% this year.

Operator

Our next question comes from Laurent Grandet with Guggenheim.

Laurent Daniel Grandet

Yes, thanks for the question. So I'd like to come back on the seltzer category. So first, what is the growth you are envisaging for the category? And really I'm interested in the rationale behind it and thinking about the next, let's say, a year or so.

And then as you mentioned, there will be a consolidation with the elimination of lower velocity SKU. Do you see a risk potentially for the Corona seltzer -- I mean the white can as you -- as that SKU has been significantly underperforming the category? So do you see a risk here that you could lose ACV? And finally, how are you planning to gain the fair share of the seltzer category, especially as Mexican brand, I mean Topo Chico is really becoming more national beginning of next year and also launching a margarita-flavored, more flavor than the SKU? So I'd like to understand how you play that.

William A. Newlands

Sure. If I understood the first part of your question correctly, I mean keep in mind that the beer category has been roughly flat at a time when we are up roughly 8%. So there is a significant delta between what the overall category is performing and what we are performing. We're radically outperforming the category.

Relative to our desire in the seltzer/ABA space, there's a number of things. First of all, we're going to focus our attention on where we think we bring differentiated products that are distinct. Given what we have today, I would use Refresca and Limonada as 2 examples of that, that meet specific needs and are not what I would describe as need-to products.

We also have, as we noted in our scripts, some innovation agenda items that we think are going to be distinctive and will bring unique value to the table as well. So we continue to believe this is going to be an additive portion of our growth but certainly not the largest portion of our growth. That will continue to be our core beer portfolio.

Operator

Our next question comes from Bill Chappell with Truist.

William Bates Chappell

Sorry to belabor the seltzer questions. But I mean, I guess, 2 things, 1 simple, 1 bigger picture. I mean 2 quarters ago, like you said, we have a lot of market research. You and everybody else was very bold up about the market, and it seems like it was a soft summer, but it didn't seem like the category was a fad or it's over. But in kind of redirecting marketing and advertising and moving to kind of focused SKUs, it seems that is what you're kind of seeing. So I guess is that what you're seeing? I mean do you see this as kind of a small niche permanently? Or do you -- and everybody was kind of wrong, that it was going to be a bigger place? Or is this just a pause for the category?

And then the second question is with you redirecting kind of advertising marketing towards your core beer portfolio, does that result in the -- I know it's small but seltzers falling off a cliff over the next 2 quarters and creating kind of headwinds for your growth on beer?

William A. Newlands

Sure. Relative to the category, our view of it is this. We still think that the overall ABA space is going to be a growth category. Whether or not the seltzer subsegment of the beer category is going -- how much of that is going to be driven by the seltzer subsegment remains to be seen. Quite frankly, it clearly is going to be a lot less than what everyone anticipated coming into this year. But again, for us, it's a relatively small percentage of our overall play. So we are not entirely reliant on success in the seltzer category. In fact, we expect to achieve our algorithm through our core beer business.

Relative to the question of will this put a damper on our growth in the beer business if Seltzer is challenging, not really. I mean the fact that we were able to raise our guidance is largely driven by the fact that we're able to make more beer. And we're able to make more beer because we're making a little less seltzer, and that is margin-accretive and it's a very high-growth category.

So I realize there's a bad side and a good side to that answer, but the reality is it's not inconsistent with what we've always seen, which is our core business portfolio of beer from Mexico continues to radically outperform the industry, and we continue to be the leader in the high end and the high-end growth.

So is it going to be any different going forward? I think a little bit remains to be seen. We're going to have a little bit more of a watch-and-see effort than we had before. I think everyone got a little bit excited about seltzer. And frankly, the category has slowed significantly. So I think we will probably do a much better job of being guarded in terms of our expectation around that while continuing to leverage our outstanding portfolio of core beer brands.

Operator

I would now like to turn the call back over to Bill Newlands for any closing remarks.

William A. Newlands

All right. Thanks very much, and thank you all for joining our call today. Despite some challenges impacting our results this quarter, as you can see, we remain very confident in the strength and underlying fundamentals of our business. Our beer business, in particular, continues to be a top growth driver within the industry while we continue to see the benefits of our wine and spirits premiumization take hold. We remain bullish on the future performance of our powerful collection of consumer-connected brands, which provides us with strong momentum as we head into the second half of our fiscal year.

Our next quarterly call is scheduled for early January. So we hopefully wish everyone a safe, happy and holiday season. Please remember to enjoy some of our great products during your celebrations, and please remain safe. Thanks for joining the call.

Operator

Thank you. Thank you for participating. You may now disconnect. That concludes today's conference call.

DISCLAIMER