

Constellation Brands Inc, Q2 2019, Earnings Call

2018-10-04

Presentation

Operator

Welcome to the Constellation Brands' Second 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, Shannon. Good morning, and welcome to Constellation's Second 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 are 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 second quarter sales and earnings results. I'd like to kick off the call with a reminder that Constellation has an outstanding core business that constant – consistently delivers top-tier growth within the consumers' product space, as reinforced by our second quarter double-digit organic net sales and comparable EPS results.

These results were driven by the Constellation beer business, which delivered exceptional performance with industry-leading depletion growth of 10%, record operating margin results.

During the quarter, our beer business was the #1 share gainer in the U.S. beer industry, driven by accelerating Corona brand family dollar trends and Modelo Especial's position as the top share gainer in the market.

Corona brand family trends accelerated from 4% depletion growth in fiscal 2018 to 8% for this year's first half, driven by the successful launches of the Corona Premier and Corona Familiar product introductions, both of which have significantly exceeded our expectations.

Corona Premier has achieved record speed-to-shelf and has become the 10th largest brand in the high end and the #1 high end share gainer in very, very short order.

The incrementality rate for Corona Premier is best-in-class for the launch of a new consumer product, with almost 75% of Corona Premier volume being sourced outside the Constellation beer portfolio, mostly from domestic light beers. The Corona Premier English and Spanish language TV campaigns that aired throughout the first half of the year will continue into the fall to drive broad brand awareness during Major League Baseball as well as the NFL and NHL seasons.

Corona Familiar also achieved a healthy share of the U.S. beer category and its regionally expansion at a rate of about 50% incrementality for the brand with velocities outpacing our plans.

Corona Extra continues to provide the strong foundation needed for the portfolio to grow, with strong brand equity as the #1 most loved brand among Hispanic and total population drinkers aged 21 to 54. There continues to be plenty of runway for future Corona Extra

growth, with incremental contributions from draft and canned formats as well as the Coronita product. And we continue to see growing household penetration with Hispanic and non-Hispanic consumers.

The Casa Modelo family of brands has been the #1 growth driver in the U.S. beer category, with a CAGR of almost 20% for the last 5 years.

The Modelo Especial power brand, with volume of 100 million cases last year, continues to be on firing – on fire, capturing not only the top spot as the #1 growth brand but also the #1 share gainer in the total U.S. beer industry during the second quarter.

To sustain this incredible momentum, we are increasing the media investment for Modelo Especial in the second half to drive additional demand, especially during the football season and the holidays.

During the quarter, we purchased Four Corner (sic) [Corners] Brewing, a local Dallas craft brewery whose bicultural brand, inspired flavors capitalize on one of the hottest trends in beer, Hispanic-influenced products. This high-performing brand has grown sales 5x since 2014. Our new brand entrants in test markets within the alternative beverage alcohol space are doing exceptionally well as a growing market opportunity that has been incremental to the beer category.

Corona Refresca is exceeding our expectations in current test markets, with early indicators suggesting that this product is at least 80% incremental to our portfolio. As a result, we are planning a phased national rollout beginning next spring with a focus on retail chain space. And the new SVEDKA Spiked Premium Seltzer, which is also seeing excellent results in Northeast test markets, has planned an expanded rollout next spring in select markets.

From an operational perspective, during the quarter, we continued the new expansion

phase at our Obregon brewery, with detailed design and site work in various phases of completion. The phase – the final phase of the 30 million hectoliter expansion project at Nava is on track, as we add capacity for production, fermentation and filtration with completion planned for the end of fiscal 2019.

Our Nava glass plant, which we are already underway with work on, the batch house and furnace foundation in anticipation of the buildout of furnace #5, which we expect to complete by the end of calendar 2019. And construction continues at Mexicali, with warehouse and packaging buildings nearly complete.

Overall, I'm excited about the existing momentum and the ongoing growth prospects for our beer business. We remain committed to delivering industry-leading targets for this business, with net sales and operating income growth in the 9% to 11% range for fiscal 2019.

Moving to wine and spirits. Our wine and spirits business benefited from strong shipment volume growth in the second quarter to ensure that the portfolio is well positioned for a head start to our peak selling period, when we believe that freight lanes may be in short supply.

We are performing particularly well in the greater-than-\$11 price point at retail, a level that is driving much of the over growth – overall growth in the U.S. wine industry. Our attention to this higher retail price point is paying off, as we posted depletion growth of more than 6% for this price segment during the second quarter, with Meiomi, Kim Crawford, Simi and Prisoner Focus brands all posting solid growth trends.

I'd like to remind everyone that our total Focus Brands portfolio currently represents more than 70% of the net sales and profitability for the wine and spirits business. This collection of brands has also consistently grown at a rate of 3 to 4x the U.S. market rate. Our

high end spirits brands like High West, which is also included in our Focus brands, delivered accelerating depletion growth of almost 35% for the quarter, driven by American Prairie Reserve and Double Rye!, with Casa Noble Tequila posting second quarter depletion growth of almost 15%.

Current initiatives are also driving growth, with successes like Clos du Bois Lightly Bubbled Chardonnay, Black Box Sangria and our collection of newly introduced Rosé brands, including Meiomi, Kim Crawford and Band of Roses.

Our innovation pipeline is already primed for the upcoming holiday selling season with new brands like Meiomi Sparkling, Cooper & Thief Rye Barrel Aged Cabernet, The Snitch, a new Prisoner brand Chardonnay as well as Black Box Spirits, which will continue to expand in a phased rollout.

While our fiscal 2019 wine and spirits guidance of net sales and operating income growth of 2% to 4% range remains intact, we are facing some challenges with the low end of our portfolio that make our targets challenging to achieve. The U.S. wine market has slowed, particularly at the less than 11% retail price point, and our non-Focus brands are in decline. Therefore, while we continue to focus on initiatives to drive growth at the higher end, we are also developing plans and considering options to optimize value at the low end of the portfolio so that we can direct our innovation and investment dollars to Focus brands, particularly those at the greater-than-\$11 price point.

We have plans in place for the remainder of the year to improve our COGS management capabilities, with planned initiatives for yield improvement, production efficiencies, blend optimization and procurement savings. We expect these initiatives to offset some of the headwinds we continue to face, including higher transportation and grape cost.

In addition, we will continue to support our innovation plans and brand building efforts

throughout the remainder of the year, especially during the key holiday selling season with impactful marketing campaigns to strengthen and build the portfolio.

Now before turning the call over to David, I'd like to take a few minutes to walk you through the strategic rationale and highlights of Constellation's pending investment in Canopy Growth, and why we believe that Canopy is the best partner to align with in the cannabis space. With our focus on continuous growth, we've recognized the significant opportunity that the emerging cannabis space presents as potentially one of the most significant global growth opportunities of the next decade. Our incremental \$4 billion investment increases our interest in Canopy to approximately 35% and include warrants that provide us with the option to take our ownership position to greater than 50% over time. This will be the largest investment to date in the cannabis space, a market which is expected to reach more than \$200 billion in retail sales globally within the next 15 years, and one that is opening up much more rapidly than originally anticipated.

So why Canopy Growth? Canopy is the largest publicly traded cannabis supplier in the world and the leader in the medical cannabis market in Canada. We've worked closely with Canopy throughout the last year to better understand the cannabis market. The unbelievable opportunity it presents and Canopy's market-leading capabilities in this space. With world-class expertise in R&D, innovation, product development, scaled production and international expansion, Canopy is poised to capitalize on the emerging global cannabis opportunity. They have already established a global presence via numerous joint ventures and partnerships.

Canopy Growth has the largest legal cannabis production footprint in the world and in Canada, and they are the only producer currently participating in all Canadian provinces. They also have been awarded approximately 35% of the supply contracts announced throughout all Canadian provinces to date that are dedicated to recreational cannabis,

a market that will become legal in Canada later this month. Going forward, we will be working exclusively with Canopy, as we believe that having a single platform to address all markets and formats globally is essential to winning in this space.

Canopy plans to use the investment proceeds to bolster their global leadership position in the Canopy – cannabis industry by building or acquiring key assets needed to establish global scale. Strategic priorities beyond Canada include the U.S. and the nearly 30 countries presently pursuing a federally permissible medical cannabis program. In addition, Canopy plans to focus on intellectual property development across medical and recreational opportunities, while also preparing and creating brands and products for new recreational cannabis markets.

Canopy has a portfolio of the most recognized cannabis brands in Canada and they're building a suite of new offerings across various product formats that will be sold through new and existing channels.

A strong online platform currently supports Canopy's ongoing direct-to-patient medical business and they're building a network of brick and mortar stores across Canada as they ramp up for participation in the legalized recreational market.

Canopy shareholders recently approved our pending transaction, and I look forward to working with Bruce Linton and his Canopy team who have built a phenomenal business.

As the growth leader in total beverage alcohol space, we expect to reap the benefits of our cannabis investment, which we see as being incremental to our core beer, wine and spirits portfolio. I am very excited about the excellent prospects for this business as the global cannabis space emerges.

In summary, I'm pleased that we have been able to increase our EPS guidance range for the year based on our year-to-date results and the plans we have in place for the re-

mainder of the year. Given Constellation's leadership position in the high end U.S. beer market, further runway for margin expansion throughout the business, unique leverage to the emerging cannabis space and an attractive valuation, I believe Constellation will continue to be a multiyear double-digit EPS compounder.

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

David Klein

Thanks, Rob. And good morning, everyone. For Q2, we generated 16% comparable basis diluted EPS growth. This reflects particularly strong operational and marketplace performance by our beer business during the key summer selling season. These results, along with favorability in our tax rate and interest expense, have allowed us to narrow and increase our full year comparable basis diluted EPS projection to a range of \$9.60 to \$9.75 versus our previous guidance of \$9.40 to \$9.70. This excludes the impact of the additional \$4 billion investment in Canopy Growth, which is expected to close at the end of October. We plan to finance the Canopy investment primarily with term loans and senior notes, and estimate the interest expense associated with this transaction to approximate \$60 million, with an approximate \$0.25 to \$0.30 impact on fiscal '19 comparable basis EPS results.

Our Q2 reported basis results reflect a \$692 million unrealized gain for the increase in fair value of our current investments in Canopy growth during the quarter, which was excluded from our comparable basis results. The cumulative unrealized gain since our November 2017 investment is \$1.3 billion.

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 11% on volume growth of 9%. Depletion growth showed continued strength at 10%, as

we won the key summer selling season with excellent execution across all channels. Beer operating margin increased 10 basis points to a record 41.3%, as benefits from pricing and strong operational performance were offset by higher transportation costs and marketing investments.

Marketing, as a percent of revenue, increased to almost 9% for Q2 and to nearly 10% for the first half of fiscal '19. This compares to 8.4% and 9% for Q2 and first half of fiscal '18. The increases are primarily due to the upfront marketing investments for the Corona Premier and Corona Familiar introductions as well as ongoing investments to sustain the growth momentum within the portfolio. Marketing spend came in lower for Q2 than our previous estimate, as we decided to shift some planned spend into Q3. We continue to target fiscal '19 marketing as a percent of net sales in the range of 9.5% to 10%.

Back half marketing spend is expected to be weighted toward Q3 and approximate 11% to 12% of revenue as part of our brand building efforts during the important fall sports season.

I would also note that beer segment depreciation for the first half of fiscal '19 increased \$21 million to \$100 million. For fiscal '19, we continue to expect net sales and operating income growth in the 9% to 11% range. This includes 1% to 2% of pricing targeted for our Mexican portfolio.

Full year beer operating margin is expected to be similar to the prior year's 39.5% result. For the year, we continue to expect to increase gross margin, even with the headwinds from higher transportation costs.

From a quarter perspective, Q3 operating margin is expected to be below the prior year third quarter and Q4 above the prior year fourth quarter, primarily due to the timing of marketing spend that I just outlined.

Moving to wine and spirits. We saw strong Q2 U.S. shipment volume drive net sales growth of 9%. The U.S. shipment volume outpaced U.S. depletion volume primarily due to timing, as we positioned ourselves for success ahead of the key holiday selling season, as we expect freight lanes and carriers to remain in tight supply. We expect most of the shipment timing benefit experienced during the second quarter to reverse in the third quarter, and as a result, we expect our third quarter wine and spirits net sales and operating income to be down low single digits.

Wine and spirits operating margin decreased 20 basis points to 26.1%. This decline primarily reflects higher COGS, mostly due to increased grape and transportation costs and marketing investments for key Focus Brands and innovation initiatives, which was mostly offset by favorable pricing in SG&A.

As a reminder, the 2015 Opus One vintage to be released this fall is expected to be smaller than the previous year. Therefore, Q3 fiscal '19 equity earnings from Opus will be below Q3 last year. Even though the lower end of the wine and spirits market and our depletion performance has been challenging during the first half of fiscal '19, we're still expecting fiscal '19 wine and spirits net sales and operating income growth of 2.4% – or 2% to 4%, driven by continued focus on our portfolio premiumization efforts and productivity enhancements across the business.

The increase in corporate expenses primarily reflects investments in people to support our growth organization and our digital enablement in Fit for Growth initiatives.

Interest expense increased 8%, primarily due to higher average debt balances. Excluding the projected impact of additional debt to fund our pending Canopy Growth investment, we now expect fiscal '19 interest expense to be in the range of \$335 million to \$345 million. The decrease in our interest expense guidance of approximately \$20 million primarily reflects interest favorability at our glass joint venture, partially offset by an increase in

the net income attributable to the noncontrolling interest line of our income statement, which we now expect to be approximately \$20 million to \$25 million for fiscal '19.

As mentioned earlier, we expect incremental interest expense related to the funding of the Canopy Growth investment to be in the \$60 million range for fiscal '19.

When factoring in cash on hand, our net debt at the end of August totaled \$9.7 billion, a \$379 million decrease from our net debt balance at the end of fiscal '18.

Our net debt to comparable basis EBITDA leverage ratio moved down to 3.4x at the end of August from 3.6x at the end of fiscal '18, while we continued to invest in our Mexican operations and return cash to shareholders with \$504 million of stock repurchases and \$279 million of dividends paid during the first half of the year.

Our comparable basis effective tax rate came in at 18.4% versus 20.6% last year. The decrease reflects benefits from tax reform and lower taxes on our foreign earnings, partially offset by a lower stock-based compensation tax benefit.

For fiscal '19, we now expect the effective tax rate to approximate 18% versus our previous guidance of 19%. The lower tax rate for Q2 and the lower rate projected for the full year is primarily the result of lower taxes on our foreign earnings. This is being driven largely by a structure change in the foreign legal entities that reduced certain tax accruals. Most of this decrease will not be recurring.

I would also note that we expect stock-based compensation tax benefits to be weighted toward Q4. As a result, we expect our Q3 tax rate to be higher than our full year rate at around 21% to 22%. We also now expect fiscal '19 weighted average diluted shares outstanding to approximate \$196 million. This reflects the estimated impact of our year-to-date share repurchases. We don't plan to make additional share repurchases during the remainder of fiscal '19, as we will focus on delevering after completing the additional

investment in Canopy.

As a result of the aforementioned factors, we now expect our full year comparable basis diluted EPS to be in the range of \$9.60 to \$9.75. Our comparable basis adjustment excludes comparable adjustments which are detailed in the release. It also excludes any impact related to the pending additional Canopy Growth investment.

After completion of the transaction, we expect to account for our investment in the original and new shares of Canopy under the equity accounting method.

At the date of the transaction close, the equity investment, original and new shares, will be reflected on our balance sheet. Accordingly, this portion of our Canopy investments will not change in subsequent periods due to the fluctuations in the value of Canopy's stock price. And the equity earnings for our share of Canopy earnings will be reported on a 2-month lag.

In addition, our Canopy warrants, original and new, will be recorded at fair value, and we'll continue to exclude changes in the fair value of the warrants from our comparable basis earnings.

We continue to evaluate potential comparable adjustments related to the transaction and the impact on equity earnings to fiscal '19 results.

Moving to free cash flow, which we define as net cash provided by operating activities less CapEx. We generated strong free cash flow of \$968 million for the first half of fiscal '19 compared to \$598 million for the same period last year. This improvement primarily reflects strong operating cash flow growth and the lower CapEx.

The lower CapEx is primarily due to timing, as we still have significant spending planned for the balance of the year. Our full year CapEx guidance of \$1.15 billion to \$1.25 billion

remains unchanged, and we continue to expect fiscal '19 free cash flow to be in the range of \$1.2 billion to \$1.3 billion.

In closing, we are focused on our portfolio premiumization and innovation activities, while working to drive productivity enhancements across our wine and spirits business.

Our beer business continues to deliver impressive operational, marketplace and financial performance. These efforts have positioned us to continue generating top-tier sales and profit growth for this year and beyond.

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

Question and Answer

Operator

— ***Operator Instructions*** — Our first question comes from Bonnie Herzog with Wells Fargo.

Bonnie Herzog

I was hoping to ask you guys a little bit more about your beer margins in the quarter, which were strong, and quite a bit above what you were guiding. So could you drill down just a little bit more on some of the drivers there? And then, just want to get a sense on your expectations for the full year. Is it fair to assume that beer margins will in fact be higher now, given some of the strength we're seeing?

David Klein

Yes, Bonnie. So the actual margin performance of 41.3%, which is a record operating margin for us, was mostly in line with our expectations, with the primary difference being, we had expected to have our marketing spend run more like 11% versus the – it came in just under 9%, that accounts for virtually all of the difference from where we kind of

suggested the quarter may land from an operating margin standpoint. And that was really just based upon timing between Q2 and Q3 of the marketing spend. As we outlined in our scripts, we intend to invest behind some of the major sports venues over the fall – in the fall season. I guess, the point I don't want lost, though is that we also generated a record gross margin, as the – some of the initiatives from our operations teams really started to provide benefits for us and helped us to offset the headwinds that we thought we would be facing from a freight standpoint. So I would say, in general, the quarter came in as we expected, with that shift of marketing spend from Q2 to Q3. And that really keeps us on track to achieve the operating margins that we set out in our guidance, where we suggested kind of flattish operating margin versus last year, which, again, is just slightly less than 40%.

Operator

And our next question comes from Caroline Levy with Macquarie.

Caroline Levy

Beer looked pretty spectacular, and I do note that you didn't spend as much as you expected on marketing and yet you got really strong depletion growth. So I'm wondering if you can look out for us a little further and just talk about what sort of legs you think Premier has. And the incrementality seems to be even higher than we originally thought, at 75% not 70%. Has there been any supply shortage on Premier? Do you think you can sell significantly more over time? And how is Familiar playing out? And again, just a little more detail in the other new initiatives you have in beer would be great.

Robert Sands

Yes, Caroline. I think that we can say at this stage that all of our NPD in beer and in particular Premier and Familiar, has been performing extremely well. And as you noted, the incrementality on Premier and Familiar has outpaced our expectations. So we did

front-load some of our spending on marketing this year, as you probably recall in the first quarter, which we had highlighted even prior to the first quarter. And that marketing spend I think has really paid off for all of our initiatives, as you can see, in that the Corona brand family and the Modelo – Casa Modelo family have been performing extremely well, both as reflected by our depletions and as reflected in IRI. I would say that we don't really see any reason why that momentum should not continue throughout the remainder of the year, enabling us to make the guidance which we put forth of roughly 9% to 11%. So generally, I would say that the beer business is hitting on all cylinders. Strong consumer takeaway, our marketing is working really well, incrementality on our new products is higher than expected. We've been able to achieve distribution on those products to a greater extent than we even believed that we would be able to achieve. So there's really nothing in the horizon that would suggest that the beer business won't do anything other than to achieve the guidance that we've put forth.

Operator

Our next question comes from Kevin Grundy with Jefferies.

Kevin Grundy

I wanted to come back to Canopy, Rob, if we could. Can you talk about what you've learned, I guess, in recent months since you announced the larger stake, anything that makes you bullish or bearish? There's naturally a lot of questions out there among investors. Can you also talk about potential timing and other considerations around the decision to exercise the warrants at some point in the future? And last, understanding you may be limited, given that Canopy is obviously publicly traded, is there anything you can provide with respect to near to intermediate-term impact from equity earnings from the investment?

Robert Sands

Yes. So I would say that if anything, we continue to be extremely bullish, if not more bullish, since we've announced the deal. I mean, we're right on the cusp, in the next couple of weeks, of recreational marijuana becoming legal in Canada on October 17. I'd say that the overall market projections on that haven't really changed. I think some – it's pretty widespread, but I think that most people are predicting somewhere in the \$5 billion – market-wise in Canada, \$5 billion to \$6 billion or \$7 billion range for legal recreational cannabis. As I noted in my script, Canopy has secured approximately 35% of the supply contract. So we expect to take a significant share of that business as it develops over the next, call it, 12 to 18 to 24 months. So I think we're feeling pretty good about Canopy's position and their results – or how that position will be reflected in the results. No, we don't – we really haven't given any guidance on the equity earnings as of yet. I think that we really need to take a little bit more of a wait-and-see approach to that element of our guidance in the future. So once I think that we get – recreational becomes legal, and we get a little history under our belt, we'll be able to address that better as time goes on. I think that another thing that shouldn't be lost on anybody is that Canopy has significant positions outside of Canada. And that – those markets are developing very quickly, and Canopy is extremely well positioned to take leading positions in major markets where medical, in particular, is going to become legal. And the history of a lot of markets, which is a little different than the United States, is that first medical becomes legal, which is why we want to participate in that category and the governments then are able to establish the regulatory bodies, the regulatory frameworks, sort of settle in with that reality and then recreational follows after the governments have, as I said, established their oversight mechanisms. We see that happening largely all over the world in very large countries like Germany and the U.K. and Western Europe in general. And we're poised through Canopy to participate in all of that. That said, I think something that David has said all along, we premised our investment really solely on Canada and the countries that Canopy already had a strong foothold in, and we see nothing to suggest that our returns on those

investments won't be as we expected. United States, we pretty much count as nothing, but things are moving very quickly in the United States on the legal front. It looks like perhaps after the election, we'll see the Farm Bill enacted. The Farm Bill legalizes CBD, and that will be an interesting market to see how that develops in the U.S, which we'll be poised to participate in. And there's certainly a lot of talk that eventually there'll be some form of decriminalization of marijuana at the federal level, meaning the taking of it off the Schedule 1 list and therefore really leaving it to the states to determine the legality. And of course, that's moving quickly too, with 2 states having the recreational legality on the ballot this November and 8 states already having made it recreationally legal. And a large – those states are big states, so a large percentage of the population in the United States already in states where it's recreationally legal. So we think that we're by far the best company in the world or in the best position in the world of any company to capitalize on what is absolutely without a doubt going to be a huge market over the next 10 years, hundreds of billions of dollars. So we're addressing our position on every front, meaning that we need to be a key player in the development of the science. That's really important. Branding, we've got top people and top agencies and firms working on branding because like all businesses of this nature in consumer products, branding is going to be the key to success of the future. And we're leaving no stones unturned in any of those areas through our Canopy investment and also, with regard to our Constellation folks, who are dedicated to that element of our business. So we're excited. We see very positive future in that regard.

Operator

Our next question comes from Lauren Lieberman with Barclays.

Lauren Lieberman

I was hoping we could talk a little bit more about the wine business. And so just any color you can offer. I know you definitely specified kind of the below \$11 price point, above

\$11 price point performance of your Focus Brands. But I was curious on overall category performance and then also difference between high end and low end. The Nielsen data or IRI data seems to show no correlation to your business at all. So if you could just comment it on why you think that is, if it's a mix of what's available in those channels. And my final question was, just the price/mix in that business year-to-date is less than 1%? And I would have thought that mix alone should be driving that line to be pretty positive. So if you could talk about anything that might be a downdraft in terms of actual pricing in the business or promotional activity, that would be great.

Robert Sands

Yes. So I'd say that the – if you look at the wine business in the U.S. over the long run, it's been consistently growing. It's sort of the low or – to mid-single-digit range. And although it's off a bit from that or at least the near-term historical performance, we don't really see anything that suggests that as an entire category over the long run, it's going to grow at any rate different from what it has historically, which is significantly above almost all other consumer product categories. So I think it remains a very strong category to participate in. There continues to be a significant premiumization in the business with the low end becoming softer as time goes on. And it's a very large segment. And the high end continues to perform well, certainly above \$11, with growth in the high single-digit range and sometimes in the lower double-digit range. And obviously, we continue to position our portfolio to take advantage of that. At the same time, our lower end portfolio also continues to, I'd say, deteriorate consistent with the market. And we certainly, in terms of how we are running the business, are focusing all of our efforts on our Focus Brands and on the high end. We have all of our NPD against the high end. And we're certainly taking our results in the low end and, I'd say, reinvesting that in the high end to accelerate the mix change. So I'd say, the first half of the year for us on a depletion basis was kind of lackluster, but we have a lot of plans and programs in place for the holiday season and the remainder of the year. So we are expecting to see significantly better depletion growth in

the second half of the year based on how we've timed our programming. We do expect to see better leverage as a result of the premiumization, meaning we expect to see our premium brands outpace our popular price brands, which should drive some positive mix. So generally, we're favorable about the business going into the second half. Hence, we've maintained our guidance of 2% to 4% on the top line and the bottom line, which, I think, will be a pretty good result. I would say that the wine business in general, the wine and spirits business, is a strong business. As I said, both the category – the category outpaces consumer products in general. If you look at margins, our margins in the wine business, if it stood alone, everybody would think it was a great business. It only looks like an ugly stepchild in comparison to the beer business, which – there's basically no company in the world of any size that's performing like our beer business across the top line and with the kind of margins that we have in that business. I mean, it's really a unique business in terms of the kind of totally outstanding performance it's generating. So it is a little – there is a little bit of relativity involved in that. People are very focused, as they should be, on the beer business and it tends to, perhaps, overshadow the wine business, which continues to be a very good business. So our Focus Brands constitute about 70% of the business. We've got good growth in the Focus Brands. The above \$11 segment continues to grow in the high single digits, and our business is actually outpacing that in IRI, the high single-digit growth. We've gained share, in other words, in the above \$11 segment. And that's really where all of our focus is. We've got strong operating ROIC in the wine business, another – high double digits. And in general, I'd say that the business is performing well, plus, our TBA, total beverage alcohol platform, I think, is really paying off. Some of the things that, I think, have been lost in terms of what the press and – has been reporting are things like the entire Pacific Northwest, where we consolidated our wine, beer and spirits business in 1 distributor, Columbia, millions and millions of cases. And that consolidation has actually gone extremely well. Columbia has done a fantastic job on the wine side, and we've seen accelerating results through Columbia in particular.

So we've also done a lot of interesting things in that, for instance, our SVEDKA seltzers, SVEDKA being a spirits brand, which historically – and continues to go through the wine and spirits distribution network. We've created the seltzer product, which is malt-based, which we therefore have put through our beer network. So we're finding all kinds of ways that we can use our very, very strong position in both networks to drive our business. And then at retail, most retailers have a single organization that deals entirely with – or deals with all beverage alcohol. They may split it up below the top people, but they're looking at their beverage alcohol category. It continues to be the most important category at retail because it's the most profitable and has the most growth of the other large categories. And Constellation continues to be the #1 growth provider by a factor of probably 3:1 at retail with our beverage alcohol portfolio. So we're the ones who are driving all of the growth, or a large percentage of the growth at retail for the retailers. That puts us in a very strong position. And as I often like to say about our sales guys or I say to our sales guys, when they're going in and talking to retailers, that's a story you can't make up, okay? It doesn't get any better than that when you have those kind of facts at hand when you're going in and talking to our retail customers. And we can say straight out that we're their #1 growth provider by far and therefore, the squeaky wheel ought to get the grease. That is a great story, versus going in hat in hand and having to – not generating any growth, in fact having to deal with how you're going to explain the declines and the continuing declines and trying to figure out how to make a silk purse out of a sow's ear. So I think we're in very good shape across the board.

Operator

Our next question comes from Vivien Azer with Cowen and Company.

Vivien Azer

So, Rob and David, I was wondering, is your working with Canopy Growth and presumably helping them with some of their forecasting exercises, which is, admittedly, a tough

exercise, trying to size an illicit market transition. But as part of that exercise, is there any discussion around alcohol cannibalization? Is that part of the calculus at all?

Robert Sands

No. I would say straight out, the answer is no. We see no evidence whatsoever, especially in the United States and the legal states, of alcohol cannibalization. So I'd say, as we sit here right now and we think about the cannabis business and our position in the cannabis business, it's probably going to be close to 100% incremental for us, talking about incrementality. So this conversation comes up a lot. Two things, okay. Number one is, is it a defensive move? The answer is, no. We're not playing offense – defense, we're playing offense. This is an offensive move, period. We've got a fantastic core business, and as you can see from these results and our projected results on our core business for the remainder of the year, we're very positive and have a lot of confidence in that business, and we see nothing in the horizon that suggests that it's going to be anything other than great, as it's continued to be. We're playing offense on this and that we think that this is another very aligned category that's going to develop very fast and very large. And it simply presents another opportunity for growth for Constellation in addition to our core business. Why did we do this, okay? We did it because first of all, we got involved with Canopy in a joint venture to develop beverages, okay? As that progressed, it became evident to us that the whole market, all channels, all forms, is going to be explosive. And therefore, there was really no reason why we should only participate in a relatively small segment of that market, which is beverages, when other channels, i.e. medical, for instance, and other forms are going to develop very quickly around the world, and we have – and we had a platform, which we had a minority interest in, that we could take advantage of. So as I said, we're completely optimistic. It's completely offensive on our part. We didn't do it because we have any concern whatsoever about the core business. I've heard that suggestion made. I can tell you that our core business is stronger than ever and that had no bearing on why we did this. Totally offensive, totally incremental. An-

other leg of the stool that Constellation can add to continue as probably the #1 growth company in consumer products in the Fortune 500. So that's really the bottom line.

Operator

Our next question comes from Andrea Teixeira with JPMorgan.

Andrea Teixeira

I do appreciate the color on the beer margin and the cadence going forward. So my question is on the beer pricing. I understand that negotiations are taking place now. So is your guidance embedding the typical low single-digit pricing? And what are you hearing from the trade in terms of passing on aluminum and transportation cost pressures? So if you can – and if you can also offer, there's a lot of news, I mean, press releases about, or press comments about hearing some noise in terms of beer distributors consolidation along with the wine distributors as well. So I think, Rob, you mentioned that has been productive on the wine side. So I wonder if you can offer us some comfort on the beer as well.

David Klein

So I'll take the pricing and I'll leave the second question to Rob. But – so from a pricing standpoint, yes, the letters are in the market. We're not seeing any pushback. It seems – the market seems fairly conducive to price increases this year, especially maybe compared to over the last several years. And our full year guidance includes the benefits that we expect to receive from the price increases that we're putting out at this point.

Robert Sands

Yes. And I would – I'd parrot what David said in that regard. Our pricing continues to be, as it has been in the past, completely normal in that 1% to 2% range. The environment for that pricing is probably – I'd put it as better as opposed to worse. If you were just saying, how's the market absorbing price increases? I'd say, we're on the better end of that scale

this year than we have even been in the past, where it hasn't been a significant issue. On the distributor consolidations and my comments on wine, in the Northwest, we consolidated wine, beer and spirits, and while I was focusing on wine – that whole consolidation across wine, beer and spirits and for beer as well has worked very well, as we are a major, major player with that distributor. As to some of our moves in really Southern California that have been in the press, it's really about very specific instances and examples in some of our most core markets where we have the highest market shares, where consolidation provides an opportunity to create significant efficiencies, especially in distribution. Otherwise, that will directly benefit our brands in those areas where we've consolidated by taking some of those efficiencies that have been created and being able to apply those against our brands in terms of manpower on the street, in terms of marketing dollars that can be available at local levels against those brands. So these were moves really intended to accelerate what is already a good performance. And I'd say, one of the hallmarks about Constellation, and what I'm about to say even relates to the Canopy transaction is, we're not a company that's sitting around waiting for some element of our business to turn down or get bad before we jump in and we take action to improve our results. We're really quite the opposite of that. We have a fantastic business. It's performing better than it's ever performed in the past. And we're really applying all of our thought and effort against actually accelerating the great position that we're in as opposed to sitting around, waiting for it to turn bad and then we're all going to jump in with some kind of fix-it attitude, because that's too late in a business. When it turns bad, turning something around is 900x harder than it is to play offense from an already very strong position. So that's a lot of our mentality and a lot of the things that we're doing, both in our core business, something like our distributor consolidation moves in Southern Cal. It's truly about playing offense and accelerating an already strong business platform.

Operator

Our next question comes from Judy Hong with Goldman Sachs.

Judy Hong

So on beer sales guidance, 9% to 11% not changing despite the fact that you have 11% year-to-date, I don't think the second half comparisons are that different than the first half. So I guess, I'm just curious sort of the decision not to raise at least the low end of it. Is it just conservatism? Is there anything that we should be mindful of? And then a little bit of more of a longer-term question, as you're lapping some of the innovation benefit this year, particularly on Premier and Familiar, just given the success of those products, how do you think about sort of the lapping that innovation into 2019 or fiscal '20? Is it your expectation that we will see continued growth of those innovations really being still a big contributor or do you think that other innovations like the Refresca and others have to kind of carry the load going forward, just from a contribution standpoint?

David Klein

Yes, so, Judy, from a guidance standpoint, the 9% to 11% range for our top line, which we just feel comfortable with where the business is performing. We think it will continue to perform there. We all – and then it kind of builds into your second question around the lapping of innovation, because we remain committed to the numbers that we've shown as our kind of medium-term guidance, where we expect this business to continue to deliver high single-digit kind of volume growth, even as we lap innovation. We think Premier is going to be a big brand. So it's not – a lot of times innovation will go out in the market and there'll be a big splash in one year and then it decelerates going into the next year. We actually think Premier will continue to do very well. And we remain very bullish on the other core parts of our portfolio like Modelo Especial and Pacifico and Modelo Negra, so – now that said, are we going to continue to do innovation work around things like Refresca, as Rob talked about in his script? Yes. And we expect that we'll see some growth from those areas as well. But I think we remain committed to our algorithm, which is distribution and consumer demographics will continue to drive a majority of our growth. And then there will be a growing role for innovation. But again, we just believe we're

going to continue to run the same play and deliver the results that we've committed to you guys.

Robert Sands

Yes. And I guess, I would add, your questions, Judy, almost presume the answers. We will be overlapping the distribution gains on some of the new products. On the other hand, we're going to turn our attention then to building velocity on those new products. And as we build velocity on those new products, that will provide some incremental performance that will help offset the overlap question that you answered – asked. Refresca is looking like it's going to be a huge opportunity for us. I think you all know that the alternative category is really one of the stellar performers in the beer category overall, with numerous brands now performing extremely well. So we think that that's a big opportunity in that we think that Corona Refresca, certainly based on our test markets and given the strength of the Corona franchise and the Corona name and the continued demographic tailwinds that we have in the business, I think that Refresca is a huge opportunity. And then, let's not forget about some of the secondary brands like Pacifico, which continues to be a huge opportunity, like even Victoria. Take a look at IRI on Victoria, okay? Victoria is growing now high double digits. So I think that in the beer business in general, not only do we have the opportunity to drive velocity on some of our NPD that's already in the marketplace, we have new NPD that's going to go national, i.e. Refresca, which is going to give us more growth opportunities. And then, we have the smaller secondary brands that we can jump to as well to continue to provide strong growth against the whole portfolio. And then, you've got Modelo Especial, which is a huge brand already and continues to grow high double digits. So it's – we really see opportunity across that whole portfolio. On the wine and spirits side, we have brands like High West that are growing wildly. Spirits brands like Casa Noble Tequila and wine brands that are really unparalleled in terms of their potential for growth, like the Prisoner, like Kim Crawford, which is already a very large and profitable brand, just to name a couple. I could name many more. But I would

say that therefore the opportunities across the whole portfolio remain very strong.

Operator

Our next question comes from Amit Sharma with BMO Capital Markets.

Amit Sharma

Dave, a quick question for you and one for Rob. Dave, so as pricing rolls through, as you're saying, pricing that is in the marketplace already, your gross margins are already tracking around a year ago level, maybe a little bit higher. Why shouldn't we expect a little bit more contribution on gross margin as pricing comes through, right? And then, Rob, you talked about CBD and how the Farm Bill could accelerate legalization of at least that aspect of the cannabis. Can you give us a little bit of understanding of – if you are planning on bringing a product based on CBD, is that going to be in partnership with Canopy, so you only derive equity income, or could that come directly under Constellation?

David Klein

Yes. So on the gross margin question, I think you're hearing this from everybody else in the industry with the headwinds on freight and a little bit of headwinds in some of the commodity areas. And so we think that our operations team is doing an outstanding job to be able to deliver a quarter where we have best-ever gross margins in that kind of headwind environment. And we expect that environment will continue for the rest of the year. But as we said, we also believe that our gross margins in our beer business will expand, albeit slightly, but will expand over the full year. And then, any – and then we have the incremental marketing spend to continue to drive our brands, which brings us back to the place where our operating margins are roughly in line with the prior year. We think – by the way, that's the best way to grow the business because we're focused on driving that top line growth at – in a business that has almost 40% operating margins. We want to keep as much growth coming in as we possibly can.

Robert Sands

Yes. And to your next question, the answer is, both. It could be reflected in the Canopy equity earnings as well as directly in Constellation. So number one, just to be clear, Canopy is one of the largest CBD producers in the world. So it's very possible that – depending on how – exactly how the law works and whether imports are permissible, the CBD could well come from Canopy. And then, assuming that we produce CBD beverages and they can be sold through the normal retail channels, obviously, maybe not to everyone, but to us, the product would be distributed through our wine, beer and spirits network to retailers. So obviously that element of it would be reflected in Constellation's business. So the answer is really both, that it has the potential to be reflected in the equity earnings, with Canopy already being one of the biggest CBD producers in the world and in Constellation's earnings as we potentially introduce CBD beverage, which doesn't necessarily mean it's alcoholic, probably not, through our wine, beer and spirits networks.

Amit Sharma

Rob, can you just give us a little bit of color on the potential size of that market, of the CBD?

Robert Sands

I can't really speculate on that at this point. I don't think that there is a lot of prognostication on exactly what the size of that market is in the United States. I'd say, given the chatter about companies like Coca-Cola looking at it as well, I would say that it couldn't be immaterial or tiny if other major beverage companies are looking at it as well. So I think it's got a lot of potential. CBD is the non – one of the non-cycle active components in cannabis. Although that said, I would say that there's a lot of science as well as general belief that CBD as an organic compound has many positive and curative, in fact, health benefits. I think you may be aware that FDA just recently approved the first CBD drug in the United States to treat childhood epilepsy or seizure disorder. And then, CBD has other

qualities potentially that people are seeking in organic, inorganic products. So the market could be very big. As we said, it's not a psychoactive component but it has properties that, I think, the consumer would be interested in.

Operator

Our next question comes from Bryan Spillane with Bank of America.

Bryan Spillane

I just had one question. If – I think in the prepared remarks, Rob, you talked a little bit about part of the motivation to ship ahead in this quarter in wine and spirits was to get ahead of maybe some potential freight shortages. So could you just add a little bit of color to that? Is that sort of freight coming out of California? And also, just as we're looking forward, is that a potential sort of variable or factor that we'd have to think about over the next couple of quarters?

Robert Sands

Sure. So little is a good word in that we always have shipped more during the first half than we deplete, as we always want to build inventory prior to the OND holiday season, October, November, December. I'd say little is a good word because we probably shipped a little more than normal versus depletions in that there is some tightness in terms of shipping. But that said, I think to directly answer your question, I don't think that we see that as any kind of material problematic matter for really wine, beer or spirits. It's just something that we have to keep in mind and we have to take into account so that our products are well positioned in the marketplace. I know David's talked a little bit about higher shipping costs as it relates to beer, but these are things that we've otherwise offset through the creation of other operational efficiencies, and it's not huge dollars for us. So the fundamental answer, especially on the wine and spirits side, is, no, we don't see it. There is really nothing like totally something to be concerned about. It's really sort of just

a more minor business matter where shipping lanes, it is tough to get shipping lanes. But that said, we expect to – we've got everything well under – well in hand, and we don't expect it to be particularly impactful on the wine business. And on the beer business, as David has said, we've largely offset any cost increases that we've seen. So we're in pretty good shape on shipping and shipping costs and availability throughout the whole business on the remainder of the year.

Operator

Our next question comes from Robert Ottenstein with Evercore ISI.

Robert Ottenstein

You have over the various quarters done a nice job keeping expectations down on beer margins on the one hand. On the other hand, you highlight record margins this quarter, and we understand, I think, the timing on the marketing side. But even and regardless of that, you had a very nice progression on the gross margin. Also, in your opening comments, there was talk about further runway for margin expansion in the beer business. So I'm just wondering if you could give us your latest assessment of the medium-term outlook on margins for the beer business, please.

Robert Sands

Yes, I'll let David address that. But I'll just say that our expectations are in that 39% to 40% range, sort of as simple as that. You already cited some of the factors that have contributed to the slightly outside margins in the second quarter, but we're expecting margins to be relatively flat for the whole year. There are some headwinds, which we talked about. We've offset those headwinds. So I think that we're going to maintain approximately the same margins. David?

David Klein

Yes. So, Robert, first of all, and I think I've said this to you before, but the – we, being our

team, comes in every day trying to make our margins as high as we possibly can. So when we talk about holding the line on margins, it's – we are trying to expand them as much as we can. But I would say this is playing out kind of the way we had anticipated over the last few years, as there was a lot of, I'd say, exuberance around where our margins could get to. And we've had a view that we had existed in a benign commodity pricing environment for a long period of time and a pretty favorable peso environment for us for a long period of time. And that we know we have a lot of potential things that we can do, from an operation standpoint, to continue to enhance our margins and maybe even possibly from a pricing standpoint to enhance our margins over time. But we just want to be prudent about where that can get us to because we know we have these headwinds. And it seems unrealistic to just talk about the positives without being really clear about what the potential drags could be. And I would say that this year is kind of playing out that way. We're seeing some really good things happening from an operations perspective that are helping to be a bit of a driver for improved margins. But we're also seeing drags on margin like the freight topic that we and everyone else is talking about at this point.

Robert Ottenstein

Will your distributor consolidation, presumably that can help on the margin side?

David Klein

I – we don't – we're not expecting that we get margin enhancement from that sort of activity. Again, we're – everything we do is built around driving growth in our business. Again, we'd be really happy to have a business that for the next several years grew at this rate, at 40% margins.

Robert Sands

I would say, however, that to the extent that our distributor consolidations create effi-

ciencies, and therefore, improve distributor margin on our business, that creates an environment where the distributors are more willing to invest behind our brands than the opposite. So that is part of the thinking behind this. And then, the distributor's actual investment behind our brand should drive continued strong results, if not better results, for our business, which will translate back to us on even better sales and growth than otherwise would be the case, everything remaining equal.

Operator

And our last question comes from Brett Cooper with Consumer Edge Research.

Brett Cooper

Two questions, if I can slip them in. First, I was just wondering if you could offer your views on what you're seeing in terms of fall shelf resets and what you would expect from spring, I guess, specifically looking at beer. And then, on the cannabis front, when you're talking to regulatory authorities, do you guys have a particular view in which you're trying to get to in terms of what the retail format and distribution format looks like in the future?

Robert Sands

On the first question, as I've said historically a lot, retailers should be giving Constellation and our beer business more space in general because we're their largest growth provider and probably their most profitable supplier. And I think that, that is resonating, and therefore, we do continue to make distribution gains, and therefore, acquire more space for our portfolio, which as I said, is the #1 growth portfolio and profit provider to many retailers. So I think that that's all going well. And that's part of what we call our Shoppers First programs, probably historically referred to as category management. But now Shoppers First is what we call it. And then, on your second question, the answer is, is that, I think you sort of phrased it in terms of talking to regulatory bodies and this and that. In the United States, it's really more about talking to politicians. We've got to get over the

hump of decriminalization first and then in the States, the – our legal – we're really not talking to anybody because we're not participating in that because of the federal illegality. In Canada, we're definitely talking to regulatory bodies and the government about how the product is going to be sold and through what channels. I mean, Ontario is probably a good example of that, where initially, it was planning to go through the LCBO, the Ontario Liquor Control Board and then very recently, the Ontario government changed direction and decided to allow it to be sold through private retailers. As you may know or may not know, Canopy bought a company of private retailers called Hiku, and their brand for their stores is called Tokyo Smoke. And that's one of the formats that we're developing our stores in. But one of the things that Canopy has done, and I think with a lot of forethought, is already gone out and secured prime retail locations, even in Ontario to put our Tokyo Smoke branded stores and Tweed branded stores in anticipation of being able to have private stores and outlets in Ontario and of course, in the other provinces. Originally, Hiku and Tokyo Smoke came from head stores in British Columbia and is developing stores in British Columbia. So we're well positioned from a branding point of view to control, so to speak, the whole ecosystem around the brands that we're developing, in particular in Canada, and the vertical integration, which will be very profitable as well in Canada.

Operator

And I'd now like to turn the call back over to Rob Sands for closing remarks.

Robert Sands

Well, thank you, everyone. And let me say, as we close out the discussion of our quarterly results, I'd like to reiterate the confidence that we have in our ability to drive the future growth of our business, while generating very strong cash flows that allow us the flexibility to make strategic investments in long-term growth opportunities with significant upside. Our next quarterly call is scheduled for early January. So please be sure to have a safe and

happy holiday season. And remember to enjoy some of our great products during your celebrations with friends and family. So thank you again for joining our call, and have a great day.

Operator

Ladies and gentlemen, this concludes today's conference. Thanks for your participation, and have a wonderful day.

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