Constellation Brands Inc, Q3 2022, Earnings Call 2022-01-06

Presentation

Operator

Welcome to the Constellation Brands Q3 FY '22 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, Valerie. Good morning, and welcome to Constellation's Third 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 measures and any non-GAAP financial measures discussed on this call are included in our news release or otherwise available on the company's website at www.cbrands.com. Please refer to the news release and Constellation's SEC filings for risk factors, which may impact forward-looking statements we make on the call.

And now here's Bill.

William A. Newlands

Thanks you, Patty, and Happy New Year to everyone on the call. I sincerely hope you were able to enjoy a safe and happy holiday season with family and friends.

Calendar year 2021 was another challenging year given the continued effects of the pandemic, a host of global supply chain issues impacting nearly every industry, inflationary pressures and severe weather events. That said, I'm incredibly proud of the determination shown by our team at Constellation throughout the year. They worked relentlessly, navigating a myriad of evolving dynamics to deliver a very solid performance year-to-date and in Q3, putting us on pace for another strong year of financial performance and shareholder value creation in fiscal '22.

That said, I'd like to highlight a few key takeaways from the quarter. First, our beer business delivered a very strong performance in Q3, while lapping tough comps in fiscal '21. We continue to see robust consumer demand, yielding high single-digit depletion growth. We extended our leadership position as the top share gainer in the high end of the U.S. beer market behind the strength of our Modelo and Corona brand families, while improving our inventory position. Our strong performance to date gives us confidence to increase top and bottom line guidance for our beer business in fiscal '22.

Second, we continue to see significant runway for growth for our core imported beer portfolio in the years ahead, and we're investing in the next increment of capacity additions required to sustain our momentum as this represents one of the most compelling value-creating opportunities for our company and our shareholders.

Third, our Wine & Spirits business has made solid progress in transforming both its brand portfolio and financial profile. Q3 marked another step along our journey as we continue to shift to a higher-end Wine & Spirits business focused on delivering increased revenue growth and margin expansion.

While our Wine & Spirits business continues to navigate through a series of headwinds impacting its year-to-date performance, our increased focus and investments behind our fine wine and craft spirits portfolio, margin accretion innovation and e-commerce initiatives continue to gain traction and are enabling an increase in our net sales guidance for the business in fiscal '22.

And finally, our strong overall total company performance in Q3 gives us confidence to increase our comparable basis EPS guidance for the fiscal year. Garth will provide additional details relative to our financial performance and fiscal year guidance in just a few minutes.

Today, we are also excited about our announcement of a new agreement with The Coca-Cola Company in the United States to bring FRESCA brand into beverage alcohol through manufacturing and distributing a new line of FRESCA mixed cocktails.

FRESCA is currently the fastest-growing diet soft drink in Coca-Cola's portfolio, and over half of FRESCA consumers already use it as a mixer with spirits. Building on this great foundation and in alignment with emerging consumer preferences around convenience, flavor and a preference for high-quality products, we plan to launch FRESCA Mixed later this year, starting with cocktails using real spirits and inspired by recipes created by FRESCA fans from around the globe.

With that, let's talk in more detail about our performance in the most recent quarter. Our beer business posted depletion growth of more than 80% in the third quarter, outpacing the high end of the U.S. beer category. Modelo Especial continues to be our most significant growth driver, with depletions increasing over 13%. That is more than 5 million cases relative to the same quarter last year. It remains the brightest star in our portfolio as the top share gainer across the entire U.S. beer category in IRI channels, while maintaining its position as the #1 high-end beer brand.

Our Modelo Chelada brand family has become an important growth contributor to our portfolio as the #1 chelada in the U.S. beer market and maintained its explosive growth, posting 35% depletion growth in the third quarter. We continue to build on this extremely successful innovation platform with a new entrant, Modelo Chelada Pina Picante, which was launched in August and is already a top share gainer among important brands.

Corona Extra sustained its reinvigorated growth trajectory and position as the second-fastest import share gainer and the #3 high-end brand in IRI channels with 11% depletion growth versus prior year. Similarly, Corona Premier continued its strong performance with 8% depletion growth, which accelerated through distribution gains as supply conditions improved.

From an innovation perspective within the Corona brand family, Refresca and Refresca Mas are back in production and contributing nicely to growth in our ABA portfolio. Meanwhile, Corona Hard Seltzer remains a top seltzer brand in IRI, following the dramatic slowdown in the seltzer category. We're making good progress to enhance our flavor profiles, and we're on track to roll out the restaging of our variety packs, tropical mixed pack and berry mixed pack in the first quarter of fiscal '23. And we are diligently working to address the brown glass shortage that is acting a big headwind this year, especially for our Pacifico brand, which continues to see strong demand and has a long runway for growth ahead.

Overall, our outstanding performance gives us confidence to increase guidance for our beer business as we now expect to achieve 10% to 11% net sales growth and 6% to 7% operating income growth in fiscal '22.

To fuel the continued growth of our imported beer portfolio, we plan to deploy an increased level of investment over the next 4 fiscal years to support construction of a new brewery in

Southeast Mexico in the state of Veracruz as well as to expand and optimize capacity at our existing Nava and Obregon operations. Garth will give you additional details on that momentarily.

Now moving on to our Wine & Spirits business. We remain committed to our vision to become a bold and innovative, high-end wine and spirits business with distinctive brands and products, delivering exceptional consumer experiences. In an effort to make this vision a reality, we recently reorganized into 2 distinct commercial teams within the business, one focused on our fine wine and craft spirits brands and the other focus on our mainstream and premium brands.

While each team has their own distinct strategy, both remain aligned to our goal of accelerating performance by increasing revenue growth and expanding margins. Our fine wine and craft spirits business is delivering solid growth this year, driven by brands like The Prisoner Unshackled, Roberto Mondavi Winery and High West as well as strong gains in our direct-to-consumer, e-commerce, hospitality and international businesses.

Our mainstream and premium business is focused on maintaining share in the mainstream wine segment, while delivering and continuing to deliver growth through premium segment brands such as Meiomi and Kim Crawford, in line with our consumer-driven premiumization strategy.

While we've experienced recent headwinds on mainstream brands like Woodbridge, Robert Mondavi Private Selection and SVEDKA, IRI trends for these brands have improved since overlapping the peak of the pandemic, supported by an increased focus on more relevant branding, strategic pricing and innovation.

Throughout our buying experience portfolio, we've launched several innovations that are creating momentum and driving growth, including Kim Crawford Illuminate and The Prisoner Unshackled, both of which were among the top 5 share gainers in their respective price points and IRI channels this quarter.

During the quarter, we also launched multiple initiatives. First, the editor's collection, an exciting collaboration between our SIMI Winery and the Hello Sunshine Book Club, the book club community founded by media mogul and innovator Reese Witherspoon. Second, SVEDKA ready-to-drink, soda mixed pack; and third, our new Woodbridge 3-liter box.

We've also experienced successful market expansion for our Woodbridge and Robert Mondavi private selection spirit barrel aged wines. Within our DTC portfolio, we launched exclusive SKUs from the Robert Mondavi Winery and The Prisoner Saldo Red Blends as well as High West Midwinter Night Dram and the ready-to-serve Manhattan and old-fashioned cocktails.

Within the 3-tier e-commerce landscape, Constellation continues to outpace total U.S. wine market growth by double digits. In fact, Meiomi sales in the 3-tier e-commerce channels increased 27% versus the prior year. Currently, about 10% of Meiomi's sales come from 3-tier e-commerce, which is the highest level among leading U.S. line brands in IRI e-commerce channels.

While we advance our strategic agenda in Wine & Spirits, we continue to address a number of headwinds that have impacted our year-to-date performance. We continued to lap last year's COVID pantry-driven loading, where we experienced outsized growth. However, upcoming comparable growth rates are less challenging.

Throughout the year, we've experienced out of stocks and other operational challenges related to our SAP implementation, a difficult domestic and international logistics environment and our route-to-market transition of 70% of our distribution to Southern Glazer's Wine & Spirits. The encouraging news: These issues are all stabilizing. We are rebalancing our inventories and expect more standard service levels for the balance of the year. Based on our year-to-date performance, we are raising organic net sales guidance from 2% to 4% to 4% to 6% for fiscal '22.

And before I close, just a couple of quick notes on Canopy growth. Clearly, recent results have been disappointing and there are meaningful near-term challenges facing Canopy and the overall cannabis market in Canada. The store openings have been slower than previously anticipated due to the pandemic.

However, we continue to believe that the cannabis market represents a significant growth opportunity in the CPG space over the next decade given the predicted U.S. market size of roughly 100 billion post-legalization, which is double the size of the spirits market and approaching the size of the beer category. We're encouraged by Canopy's innovation agenda with more than 40 new SKUs launched globally during their recently reported second quarter.

In addition, Canopy purchased the right to acquire Wana Brands upon a U.S. triggering event, which includes U.S. federal legalization of cannabis. Wana Brands has the #1 share of the gummy market in Canada, with more than 40% market share and the largest multi-market presence in the U.S. gummy market. The gummies category is one of the fastest growing segments in both the U.S. and Canadian cannabis markets, accounting for over 70% of all edibles purchased. Wana's asset-light licensing model approach will allow them to scale quickly in the U.S. and provide Canopy a highly distributed brand upon U.S. legalization.

In closing, I would like to reiterate our main takeaways from this quarter. Our beer business continues to deliver impressive performance. Its growth remains ahead of the high end of the U.S. beer market in IRI channels, and we now expect to achieve 10% to 11% net sales growth and 6% to 7% operating income growth for fiscal '22. We remain confident in the robust longer-term growth prospects of our beer business, and we're securing our ability to capture the significant value creation opportunity by expanding and optimizing our production capacity over the next 4 years.

Our Wine & Spirits business continues to move towards its long-term revenue growth and margin expansion vision, which is further enabled by the clearer strategic focus of its newly configured fine wine and craft spirits and mainstream and premium teams. And in spite of an ongoing challenging environment, our strong overall total company performance gives us the confidence to increase our comparable basis EPS guidance for the year.

We look forward to continuing to build a portfolio of products that consumers love and delivering another strong year of financial performance and shareholder value creation in fiscal '22.

And with that, I will now turn the call over to Garth.

Garth Hankinson

Thank you, Bill, and hello, everyone. Q3 was another quarter of strong execution by our beer business. This continued strength, coupled with tax favorability, enabled us to deliver 8% comparable basis diluted EPS growth for the quarter, excluding Canopy. As a result, we have increased and narrowed our full year fiscal 2022 comparable basis diluted EPS target to a range of $10.50 to $10.65 versus our previous guidance of $10.15 to $10.45. This range excludes Canopy equity earnings, includes an increase in beer operating income guidance and reflects a decrease in the tax rate for fiscal 2022.

Now let's review our Q3 performance and full year outlook in more detail, where I'll generally focus on comparable basis financial results.

Starting with beer. Net sales increased 4% driven by shipment growth of 3% and favorable price, partially offset by unfavorable mix. As a reminder, we are lapping a significant inventory rebuild in Q3 of the prior year, which generated 28% shipment growth.

Depletion growth for the quarter came in above 8% driven by the continued strength of Modelo Especial and explosive growth of Corona Extra as well as the continued return to growth in the on-premise channel. Again, keep in mind the difficult volume overlap we encountered during the quarter as we faced a 12% depletion growth comparison driven by robust inventory replenishment at the retailer in the prior year. On-premise volumes account for approximately 12% 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 was only 8% of our depletion volume in Q3 fiscal 2021 as a result of on-premise shutdowns and restrictions due to COVID-19.

Selling days in the quarter were flat year-over-year, and please note that in Q4, there is one additional selling day. Cases shipped exceeded cases depleted as distributor inventory levels began to rebuild during the quarter. Inventories are expected to return to normal levels by the end of the fiscal year as shipment volume is expected to continue to exceed cases depleted for the remainder of the fiscal year.

Moving on to beer margins. Beer operating margin decreased 130 basis points versus prior year to 41.3%. Benefits from favorable pricing and marketing timing were more than offset by unfavorable costs. The expected increase in COGS was driven by several headwinds that included the following: First, increased material costs due to rising commodity prices and inflationary headwinds that on average are in the mid to high single-digit range, predominantly driven by wood pallets, aluminum, steel and carpets. Please note that this range includes the impact of hedging more positive.

Second, increased brewery costs driven by labor inflation in Mexico, increased head count, incremental spend related to capacity expansion and annual brewery maintenance that was performed during the quarter. As a reminder, the annual brewery maintenance took place during the fourth quarter last fiscal year.

And third, a step-up in depreciation expense, largely due to the incremental 5 million hectoliters at Obregon completed earlier this fiscal year.

These COGS headwinds were partially offset by favorable fixed cost absorption driven by increased production levels.

Marketing as a percent of net sales decreased 130 basis points to 8% versus prior year as we have returned to our typical spending cadence, which is weighted more heavily towards the first half of the fiscal year. In the prior year, a significant amount of marketing spend was shifted from the first half to the second half of the fiscal year due to COVID-19-related sporting and sponsorship event cancellations and/or postponements. Additionally, we continue to expect full year spend as a percent 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.

For full year fiscal 2022, we now expect net sales growth to land in the 10% to 11% range and operating income growth to land in the 6% to 7% range, reflecting the continued strength of our core beer portfolio. As previously communicated, we expect price increases within our beer portfolio to land slightly above our typical 1% to 2% range. However, we anticipate this incremental pricing favorability to be partially offset by unfavorable net sales mix, primarily driven by a shift in package types and return of on-premise draft SKUs.

We continue to expect our gross margin to be negatively impacted for the fiscal year as benefits from price and cost savings agenda are expected to be more than offset by cost headwinds, predominantly driven by a significant step-up in depreciation and increased inflation across numerous cost components as the inflationary environment resulting from economic supply chain and other byproducts of the pandemic continues to be dynamic and variable.

We now anticipate these elevated inflationary pressures to persist well into fiscal year 2023 and expect inflation on the commodity spend component of direct materials to land on average in the high single-digit to low double-digit range next fiscal year. We will continue to maintain our disciplined approach to address these evolving conditions through our commodity hedging program, cost saving initiatives and balanced price adjustments. However, due to a persistent and tough inflationary environment and incremental depreciation driven by our capital expansion plans, operating margins could land below our stated 39% to 40% range in fiscal 2023. Let me reiterate that these are still best-in-class operating margins within our industry, which reflects the strength of our core beer portfolio and efficiencies of our operations. We will continue to refine our outlook for fiscal year 2023 and will provide more details and official guidance during our Q4 earnings call in April.

Moving to Wine & Spirits. Q3 fiscal 2022 net sales declined 25% as shipments declined approximately 39%. Excluding the impact of the Wine & Spirits divestitures, organic net sales increased 3%, driven by shipment growth of approximately 3%, favorable price, incremental sales to Opus One and smoke-tainted bulk wine sales, all partially offset by unfavorable mix.

Depletions declined approximately 7% during the quarter and continue to be challenged by port delays for our international brands and distributor route-to-market changes in transition markets. Additionally, depletions faced a difficult overlap, especially for our premium and luxury brands, which experienced robust growth during Q3 of the prior year. However, we expect depletion growth to accelerate during the fourth quarter driven by the continued strength of our higher-end brands, led by the Prisoner brand family, Meiomi and Kim Crawford, a robust innovation agenda and an easier buying overlap versus a year ago. From a shipment perspective, we expect shipment growth for the fourth quarter to decelerate versus Q3 as we continue to rightsize distributor inventory levels for our mainstream brands.

Moving on to wine and spirits margins. Operating margin increased 140 basis points to 25.4% as decreased COGS, mix benefits from divestitures and favorable price were partially offset by increased marketing and SG&A as a percent of net sales and unfavorable mix from the existing portfolio. As expected, lower COGS were driven by net favorable fixed cost absorption, lower grade raw materials and cost savings initiatives, partially offset by increased transportation costs. The net favorable fixed cost absorption resulted from lapping the unfavorable impact of $20 million in the prior year, which was a result of decreased production levels due to the 2020 U.S. wildfires. This benefit for the quarter was partially offset by unfavorable fixed cost absorption, resulting from decreased production levels in New Zealand due to a late frost during their harvest season earlier this year.

Marketing and SG&A as a percent of net sales increased versus the prior year due to a loss of top line leverage resulting from the divestitures. In the prior year, a significant amount of marketing spend was shifted from the first half to the second half of the fiscal year due to COVID-19-related cancellations and/or postponements. As a result, marketing as a percent of net sales for Q4 is expected to be lower than the prior year. For the full year, we expect marketing as a percent of net sales to be in the 10% range.

For full year fiscal 2022, we now expect net sales and operating income to decline 21% to 22% and 23% to 25%, respectively. Excluding the impact of the Wine & Spirits divestitures, organic net sales is now expected to grow in the 4% to 6% range versus our previous guidance of 2% to 4%.

It is important to note that the increase in our top line guidance is mainly due to incremental shipments to support our route-to-market transition earlier this fiscal year and revenues associated with sales of smoke-tainted bulk wine. Both are onetime in nature, and thus, we do not expect them to be repeated in future years. As such, going forward, we remain confident in our medium-term top line growth algorithm for the Wine & Spirits business 2% to 4%.

Looking ahead to fiscal year 2023, we expect significant cost increases for the business, including supply chain disruptions and inflationary cost pressures on product, freight and warehousing costs. However, in order to mitigate some of these cost headwinds, we intend to take incremental price that will be staggered throughout the first half of calendar year 2022. We will continue to work through the puts and takes of our fiscal -- of our full year fiscal 2023 outlook, and we'll provide more details and official guidance during our Q4 earnings call in April.

Now let's proceed with the rest of the P&L. Fiscal year-to-date corporate expenses came in at approximately $162 million, down 6% versus Q3 year-to-date last fiscal year. The decrease was predominantly driven by compensation and benefits, due to the reversal of an accrual for performance share units, which will not be earned due to not achieving the threshold level of earnings performance from our Canopy investment and a favorable foreign currency impact. These tailwinds were partially offset by increase in consulting services and T&E spend. We now expect full year corporate expenses to approximate $230 million, reflecting the year-to-date compensation and benefits favorability.

Comparable basis interest expense for the quarter decreased 8% to $88 million versus prior year primarily due to lower average borrowings. We expect fiscal 2022 interest expenses to land towards the midpoint of our previous guidance range of $355 million to $365 million.

Our Q3 comparable basis effective tax rate, excluding Canopy equity earnings, came in at 14% versus 17.7% in Q3 last year, primarily driven by the timing and magnitude of stock-based compensation benefits, partially offset by higher effective tax rates on our foreign businesses. We now expect our full year fiscal 2022 comparable tax rate, excluding Canopy equity earnings, to approximate 19.5% versus our previous guidance of 20%. This 0.5 point decrease primarily reflects the impact of increased stock-based compensation tax benefits received during the quarter.

Additionally, stock-based compensation tax benefits were weighted towards Q3 versus our previous expectation of Q4, resulting in a sequential rate increase to our implied Q4 tax rate, which is now expected to approximate 23%.

Moving to free cash flow, which we define as net cash provided by operating activities less capex. We generated free cash flow of $1.8 billion for the first 9 months of fiscal 2022, reflecting a 3% increase in operating cash flow, offset by an increase in capex spend. capex spend totaled approximately $600 million, which included approximately $500 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 Mexico beer operations 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 indiscernible.

As Bill mentioned, our beer business continues to significantly outperform the U.S. beer industry driven by robust consumer demand, and it is essential that we invest appropriately to support the expected ongoing growth momentum for our exceptional beer brands. As such, we have updated and increased our brewery expansion investment plans in Mexico.

Total capital expenditures for the beer business are now expected to be $5 billion to $5.5 billion over the fiscal 2023 to fiscal 2026 time frame with the majority of spend expected to occur in the first 3 years. In total, this investment will support an incremental 25 million to 30 million hectoliters of additional capacity and includes construction of a new brewery in Southeast Mexico in the state of Veracruz as well as continued expansion and optimization of our existing sites in Nava and Obregon. Please note that this investment includes the previously disclosed beer capex guidance of $700 million to $900 million annually during the fiscal 2023 to fiscal 2025 time line to support a 15 million hectoliter build-out between our Nava and Obregon facilities. As a reminder, our existing brewery footprint currently supports 39 million hectoliters between Nava and Obregon.

In closing, I'd like to reiterate our medium-term growth expectations for our beer business. As Bill and I outlined, we expect continued momentum, and thus, continue to target top line growth in the 7% to 9% range over the next 3 to 5 years, which includes 1 to 2 points of price and implied volume growth in the mid to high single-digit range. This expectation provides us with the conviction to support incremental capital investments in Mexico.

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

Question and Answer

Operator

Our first question comes from Dara Mohsenian of Morgan Stanley.

Dara Warren Mohsenian

So on beer depletions, another strong result. It was the best 2-year average we've seen in recent history. So in regards to Q3, can you discuss the underlying strength behind the business and maybe specifically the market share performance, which we saw improved in tracked channels? And then also on a go-forward basis on depletions, how sustainable do you think those trends are? Perhaps give us an update on December. You sounded bullish on fiscal

Q4, but an update specifically on December. And any thoughts around Omicron variant impact and if that could pose any risk to your business as we look at the on-premise channel or overall to the business?

William A. Newlands

Sure. We'll try and unpack that, Dara. Obviously, we had a very, very strong Q3. As you saw, we saw acceleration during -- in IRI channels during the quarter as both -- a couple of things happened. First of all, the acceleration of our brands. Modelo was up 13% depletions and the IRI takeout was up in the high teens in the most recent 4-week trends. Corona Extra has just been tremendous for us. It's been great to watch and see that iconic brand do as well as it has. So we're very excited about both of those.

To your question about December, our year-to-date is up almost 9% depletions. And I'm very pleased to say December was ahead of that trend. And certainly, it puts us in a position to deliver the fourth quarter and the year that we had anticipated.

Certainly, the COVID scenario was different. You do see more consumers consuming more meals at home than what we probably saw before the start of the pandemic. And you do see a lot of variations depending on the individual market. Clearly, the on-premise is the one that gets nailed in these type of instances. And again, there's a lot of variability there.

But consumers are going out more than they did certainly a year ago, and we're all very hopeful that this particular variant of the virus comes and goes more quickly. It certainly appears that those who are heavily vaccinated have had less overall experience and concerns around that, which ultimately should help the entire country and our business as well as people continue to go out in the marketplace.

As you know, we have a Chief Medical Officer who continues to guide us on these important topics so that we make sure we not only keep our people safe, but do everything we can to meet consumer needs while we're at it. So all in, we think that -- we hope we're progressing against that, but we're very excited about the position we currently hold across our business and certainly are bullish about how the rest of the year and the close of the fiscal is going to go.

Operator

Our next question comes from Vivien Azer of Cowen.

Vivien Nicole Azer

Happy New Year. In your prepared remarks, Garth, you noted that beer pricing is going to be, I think you said, specifically slightly ahead of your historical average. But as we observe the broader pricing backdrop across beverage alcohol as well as packaged food and beverage, it seems like the consumer is able to absorb a fair bit more pricing than we've seen broadly historically. So can you just kind of comment on your appetite to take incremental pricing and perhaps your views around your brands price elasticity, specifically given your premium pricing?

Garth Hankinson

Yes. Thanks, Vivien. And as you know, our typical range for price increases in any given year is kind of in that 1% to 2%. So what we do as we go through the year, we're looking at our portfolio, we're looking at the competitive set and we're looking at individual markets. We take our price increases on a brand-by-brand and on a market-by-market basis. And so we do this and as I say in a very disciplined approach.

Given the current economic environment, this year, we've determined that we can take more pricing than we typically have, and that's what's driving us to say really slightly above the 2%.

Keep in mind, we have to make sure that we're balancing the right level of price increases with what's going on with our consumer.

As you know, we have a consumer set that skews a bit more Hispanic than some of our competitors. And in times of economic downturn, if you will, or weakness, they tend to get hit a little bit harder and they recover a little bit slower. So we want to make sure that we're not leaving any pricing on the table. We want to take as much as we can, but we also don't want to take so much pricing that we impair the performance of our brands or impair the growth of our brands.

Operator

Our next question comes from Kaumil Gajrawala of Credit Suisse.

Kaumil S. Gajrawala

If I could just follow up, Garth, on that. I think you explained how you take pricing market by market, those sorts of things. But it seems pretty clear from everything that we're seeing as it relates to inflation that pricing you have in place now is covering it. But can you maybe just talk a little bit further out? Is that -- it feels like that's also likely to be the case for next year. So just some context on pricing for next year.

Garth Hankinson

Sure, and thanks for the question. Like, look, we're in the middle of our annual planning process. And so we're taking a look at what we think we can cover next year. As you heard in my prepared remarks, we continue to think that inflation is going to be a big factor for us next year, and we still intend to take a significant amount of pricing.

Where that falls within our range, that remains to be seen. But that pricing that we do get, as I said in my script, it's likely not to cover all of our inflationary headwinds next year. But just like we did this year, we're going to look at this on a market-by-market basis, brand-by-brand basis, and we'll take as much pricing as we think the consumer can absorb.

Operator

Our next question comes from Bonnie Herzog of Goldman Sachs.

Bonnie Lee Herzog

I actually just wanted to make sure I understand the different puts and takes for beer operating margins next year. You did mention you expect beer op margins to likely be below 39% to 40%. So just maybe wanted to make sure we understand the key drivers of this.

First, I think you mentioned the higher cost pressures including depreciation expense. So could you guys maybe quantify a few of these buckets further for us? And then should we assume you'll be able to generate your typical high single digit, your top line growth next year with maybe possibly better-than-planned pricing that you just mentioned, possibly offset by negative mix?

Garth Hankinson

Yes. So in general -- or not in general, but we are sticking to our long-term growth -- or our midterm growth, that is. So as I said in my script, we continue to target over the next 3 to 5 years in beer to have top line growth in that high single-digit range. And as we've said historically, we think the right way to think about our margins is between 39% and 40%.

However, we've also said that in any given year, depending on market dynamics or what's going on in the business, that we could fall above or below that range. So I think my comments are -- is pretty consistent with what we said previously.

We're still -- as I said, we're still in the process of going through our annual planning process. So we'll give more update on margins as we close out the year and move into next year. But it is a tough inflationary environment. As I mentioned, we're seeing inflationary and commodity pressures that are in the high single digits to double-digit range.

And again, we'll absorb as much as that we can with pricing and with robust cost savings initiatives that we have in both wine and spirits and beer. And we'll alter our hedging strategy to take care -- or to take advantage of weakness in commodity prices as we see some weakness as we recently have in aluminum and in heating oil.

So those are all things we'll do to try to offset inflationary pressures, but we'll have more details on the actual margins and outlook for margins at our Q4 earnings call.

Operator

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

Bryan Douglass Spillane

I guess my question is around the new brewery in Veracruz. And maybe just tying, Garth, back to the 39% to 40% margins over time for beer. I guess given that it's -- the distance that, that brewery will sit relative to the border, is there any negative mix implication, I guess, to margins over time as you begin to produce more beer there? Or are there other offsetting factors that would sort of mitigate that?

Garth Hankinson

Yes. Thanks, Bryan. Yes. So we're still going through the planning process there, but we do think that there are some offsets. So you're right, it's further away from the border than, say, Obregon or Nava. However, it does open up some really interesting shipping lanes for the eastern half of the U.S. going across the Gulf of Mexico. So we're looking at those now to see what the impact is.

We also, as we're thinking about building the brewery up, what products we're going to put into that category, what's the level of complexity, what brands we'll put in there. Can it be highly efficient so that it offsets any margin impact? So still a lot of work to be done on that. I would expect that we have more details on that in our Q4 earnings call as well.

Operator

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

Christopher Michael Carey

Can you just expand on the FRESCA partnership, how it came about, envision the time line of the rollout? I know you said this year, but pace of rollout and how distributed do you think this can get? And whether you envision doing more partnerships with The Coca-Cola Company? Can you go outside of the U.S.? So just a little bit more perspective.

William A. Newlands

Sure, Chris. This particular partnership around the FRESCA brand was one that was very exciting to us. FRESCA hits on a number of key consumer attributes, everything from convenience to flavor and is the hottest diet soda in their portfolio. So the idea -- when you consider that more than 50% of FRESCA consumers already mix it with spirits, it seemed like a natural one for us. And certainly, they felt the same way. So we're very excited about the potential for this.

Obviously, it starts in the United States. We're still putting a lot of finishing touches on exactly how and what this will be as we get later in the year. And certainly, we'll give you a lot more information about that as we get closer to the time where we will launch this product. But certainly, this opens a very interesting door and one that's exciting, I think, for both companies.

Operator

Our next question comes from Lauren Lieberman of Barclays.

Lauren Rae Lieberman

Great. I will cover a lot. I wanted to ask about Corona depletions because that brand has had building momentum, getting up to double-digit depletions this quarter. So I think when I asked it previously, you didn't have a great sense for how much of this was driven by on-premise recovery versus the brand performing better in take-home channels. And if it's the latter, kind of what's really been driving that change in momentum for the brand? So I'd love any additional color on that you can offer.

William A. Newlands

Sure, Lauren. We've noted a number of things as it relates specifically to Corona Extra. First of all, as retailers have begun to address their shelving opportunity, we've taken advantage of that and improved our distribution profile versus what had been previously been.

Second, our marketing effort is doing extremely well and it has been very, very well received, and that's driving consumer demand. So we're very excited about that particular element. And we've said this many, many times before, but that remains as true as it ever has been. Corona is one of the most loved brands in the beer landscape.

So I think one of the things that you've seen a little bit of in this particular time frame is that the consumer is returning to many of those iconic brands that they love and trust, and Corona is really at the top of the list. We still saw in off-premise continued growth, as you've seen in the IRI channels that, that continues to develop. On-premise has not gotten itself all the way back to where it was before the pandemic. But as we've always said, on-premise was a little bit smaller in the total profile of the Corona brand than it is for some other industry players.

So overall, we couldn't be more excited about it. And certainly, we're going to continue the great work in the advertising sector. We have a very robust planned for advertising in the fourth quarter, and we're sure that's going to continue to bear excellent results for our brands.

Operator

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

Sunil Harshad Modi

Happy New Year. So just a quick follow-up, and then my question. Just if you can give some perspective around the double-digit inflation, just kind of some of the builds there and what's driving that. And then the question is ABI recently announced they're going to be launching a Corona non-alc beer. And I was curious if you guys have access to that innovation here in the U.S. given how quickly that segment has been growing.

Garth Hankinson

Yes. Thanks, Nik. I'll take the first part, and then Bill can respond to the second. So just on the inflationary front. As I mentioned, we're seeing sort of a wide range of increases year-over-year from kind of low to mid-single-digit for things like corn and hops and glass, which obviously is a big driver of our cost buildup.

But then you're seeing some really large increases on things like cartons, which is up in kind of the mid-teens; and wood pallets, which is up sort of over 30%. And then there's a number of other line items that range sort of in between those 2 bookends. So all of that is driving what we expect to be high single-digit inflation overall across the -- for the beer portfolio.

William A. Newlands

And Nik, relative to your question about the particular launch, the IP would certainly be available to us in the United States. But keep in mind that the regulatory environment of what you can put in as additives in the United States is very different than it is in Canada, and it would remain to be seen whether or not that would fly in the United States. So it's sort of a guess and a who knows on that particular answer.

Operator

Our next question comes from Rob Ottenstein of Evercore.

Robert Edward Ottenstein

So wondering if you could give us your updated view on the hard seltzer market and particularly the interaction between hard seltzers and beer and corona specifically and maybe further thoughts in terms of where you look to take that business going forward.

William A. Newlands

Obviously, Robert, there was a lot of change in the seltzer business over the course of the last calendar year. And certainly, the growth profile slowed substantially.

We still think that there's going to be some growth in that particular segment. As you know, we have both reformulated and repackaged some of our variety packs, which we'll be bringing out in the first quarter of '23. We still think that that's going to be an important part of the overall beer sector, and we're going to participate in it.

So we are optimistic that, that's going to continue to see growth, albeit it's probably significantly lower than what everybody anticipated, say, a year ago. And so a little bit remains to be seen. And most predictions have proven to be challenging. So we'll not over-predict the question. What we will say is we think we're putting the right products in the market that have the right flavor profiles that are going to attract consumers going forward.

Operator

Our next question comes from Sean King of UBS.

Sean Roberts King

Sort of related to Bryan's question, but how should we think about the capacity expansion CAGR to 2026 with the long-term beer algorithm? Is it safe to say that the capacity will be exceeding the utilization based on the 9 -- the 7% to 9% growth model? And I guess is incremental capacity typically more flexible or automated, I mean, as part of your success, the company has been -- the high utilization or the capacity that you have in place? So I was curious of your thoughts on that.

William A. Newlands

Yes, certainly. I mean one of the challenges that we've also identified in the prior calls and it remains true today, as we've said, we want to create some redundant capacity. Some of the challenges that we've had is we've had some one-off events that had caused us some inventory challenges. We think it would be highly beneficial to have some redundancy in the system. And part of our expansion plan not only gets after, as Garth pointed out, high single-digit growth profiles for our business for the foreseeable near-term future but also gives us some redundancy.

So in the event that there are any external factors that are in play, it should have less impact on us going forward. We continue to maintain the 7% to 9% growth profile going forward that we've consistently said. And certainly, we believe that our brands are going to continue to grow significant for the foreseeable future. So this is about investing in growth, and it's one of the very best value creation opportunities for our shareholders in our judgment.

Operator

Our next question comes from Kevin Grundy of Jefferies.

Kevin Michael Grundy

Bill, I was hoping you could spend a moment on your decision to split the Wine & Spirits segments into fine wine and spirits from mainstream premium brands. Just the factors driving that decision, how you expect it to drive improved results? And then more broadly, taking a step back, your openness to further divestitures through this reorganization not drive the results you're looking for in the segment?

William A. Newlands

So our thinking around that was, in many instances, it's very different approaches to how the consumer buys and engages with the fine wine and craft spirit sector. That area tends to be higher DTC. It tends to be higher on-premise. And in many cases, it's a little bit of a different skill set. And we realized by segregating those 2 things, it would give us a chance to both maximize the potential in the mainstream and premium sector as well as maximizing our potential at the very high end where some of those different and evolving channels are becoming more and more important to us.

I think this both understand our strategy, which is we want to grow our business. We want to improve our margin position to best-of-class margin structures, and we're well on our way to doing that. But our view was this was an opportunity to maximize the potential to do that. It also matches up very nicely with how many of our distributors go to market, where they separate their portfolio and their sales organizations in fine wine and craft sectors and mainstream and premium. So it also matches our organization with the route-to-market approach that many of our distributors did.

Operator

Our next question comes from Steve Powers of Deutsche Bank.

Stephen Robert R. Powers

Maybe circling back on Bonnie and Bryan's earlier line of questioning on beer margins just -- and just round it out, if I could. As depreciation presumably ramps further alongside the capex build over the next few years, do you think you can get back to that consistent 39% to 40% range beyond fiscal '23 as you catch up on the current inflation dynamics? Or is there risk that the depreciation build could keep you at least toward the lower end of that range for the next couple of years? That's just kind of a follow-up cleanup.

And then I guess relatedly, as the incremental capex commitment just runs through the cash flow statement, just any commentary you have on how you think about capital allocation in terms of how it may impact M&A or for the return to shareholders over the next couple of years alongside that ramp?

William A. Newlands

You bet, Steve. Garth and I have been very consistent about this now for years, quite frankly, of saying 39% to 40% is what we expect to do on a consistent basis. There will be individual years and times where we exceed that when things go in our favor, and there may be occasions where, based on certain headwinds, it falls slightly below that.

But as Garth, in fact, pointed out earlier today, these remain best-of-class margins. And we very strongly believe 39% to 40% is a very appropriate long-term algorithm for this business.

Garth Hankinson

Yes. And just a final point on that. As I said, you're right, depreciation will ramp up. But we're going through the process right now. We're looking at the impacts of what's the right sort of capacity to have or capabilities to have in our breweries and optimizing that. We're looking at optimizing our transportation. So to the extent we have any news on that, then we'll share with you at our Q4 earnings call.

As it relates to capital allocation, with this increased investment, nothing changes. We continue to have the best portfolio in terms of growth and in terms of margins. That growth in that margin generates a significant amount of cash flow. That cash flow allows us to continue to prioritize investment-grade rating, return capital to shareholders and to invest in the growth of our business. So our capital allocation strategy hasn't changed. And then the last piece of that is acquisitions, and we continue to say that acquisitions will be used as a portfolio gap filler. And in large part, we're going to use our venture fund to fill those gaps.

Operator

Our next question comes from Nadine Sarwat of Bernstein.

Nadine Sarwat

Two quick follow-ups, if I may. First, regarding the FRESCA agreement. Could you give us a sense of the economics of the agreement? What would the impact on margins be? And what edge do you think you and Coke can bring in to win in an already crowded space?

And then the second one on Pacifico, I know you mentioned brown glass bottles. What sort of initiatives do you have in place to mitigate this negative impact? And when can we expect Pacifico to return to its previous growth profile?

William A. Newlands

Sure. Relative to the brand, we will be buying concentrate from The Coca-Cola Company and manufacturing, marketing and selling their -- that brand through our network. We're very excited about it, frankly, because of the strength of the FRESCA brand.

As I said earlier, it's a growing brand, it's a brand that's already used -- more than 50% of the users use it and it has some mix with alcohol beverage. We think it's a natural play, while also recognizing the local and great flavor characteristics of that individual brand. So we're very excited about that.

We are making progress on brown glass. I think it remains to be seen when we will be back to full proposition. And obviously, it had some bearing on our ability to deliver in the quarter. As we said, brown glass has been a drag against otherwise outstanding results. We expect, as we get into the new fiscal year that, that will balance out quite a bit and that we will see Pacifico get back to the double-digit growth profile that we've enjoyed for the last several years.

Operator

Our next question comes from Andrea Teixeira of JPMorgan.

Andrea Faria Teixeira

I just want to ask the margin question slightly differently, if I may. Given the new capex and depreciation, why aren't you giving guidance on an EBITDA basis? And related to that, can you please unpack the operating margin assumption for next year landing below 39%? If you're assuming no additional, no seasonal pricing, which you normally take, I believe, October, November, and it only would impact the fourth quarter of 2023? And then if there is any nonrecurring impact on the maximum appreciation on that -- on any of the hedges?

And another follow-up on the guidance for fiscal fourth quarter. I don't think you're implying any impact of the new variant above and beyond what you were expecting. So -- but if you can give us some comfort on what you're seeing on the trade and the ability for the distributors to get the beer on shelf and also on-premise, appreciate those commentaries.

William A. Newlands

Let me answer the second part first, and I'll have Garth answer the first. As we said, we have had a very strong start to our fourth quarter. Our depletions in the beer business are up ahead of our year-to-date trends in the month of December, and we feel very comfortable and confident in our ability to deliver what we've said around the fourth quarter and the overall fiscal year. Garth, can you take the first one?

Garth Hankinson

Yes. So just on the EBITDA point. So first of all, that's a good point. It's actually something that we think about. Do we want to provide that level of detail kind of very much in an upfront way? Again, as we go through sort of the planning process here, and we look at the effects of inflation, we look at the effects of depreciation, we look at the effects of our capacity expansion, to the extent that we think that that's a meaningful way to show our financial results, then we will add.

Operator

Our next question comes from Laurent Grandet of Guggenheim.

Laurent Daniel Grandet

I'd like to come back on FRESCA. I mean, first, will that be reported that brand will be reported into the spirit or Wine & Spirit segment or beer segment? And what level of margin should we think of? Should we be concerned about the level of marketing you would have to spend to launch the brand? I remember, I mean, you said that launch Corona Hard Seltzer, which was a much more known brand, I mean you have to spend about $40 million. So I'd like to understand a bit more about the margin we should seek out for that brand.

William A. Newlands

Well, relative to the whole FRESCA story, we will bring that to you in our next earnings scenario when we are much further along, I mean, that launch planning and launch timing, and we'll give you a more fulsome view of what we plan to do.

What we would say, as we said in our release today, this will be going through our distribution network, which will largely be driven by the Gold Network on the beer side. And in some states, it will go through the Wine & Spirits network depending on the regulatory environment of the particular state.

Operator

This does conclude today's conference. I'd like to turn the call over to Bill Newlands for any closing remarks.

William A. Newlands

Thank you, everyone. I appreciate you joining our call today.

Despite the challenges faced thus far driven by the continued effects of the pandemic, global supply chain issues and a volatile and dynamic inflationary environment, combined with severe weather events, we're on track to deliver again another strong year of financial performance. Our beer business continues to remain extremely solid as consumer demand for our core beer brands continues to be robust, while our incremental capacity investments in Mexico will position us to capture the ongoing growth opportunities we see within the higher end of the U.S. beer market well into the future.

Additionally, our Wine & Spirits business continues to move toward its long-term revenue growth and margin expansion vision. Overall, 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 fourth quarter. As a reminder, during our next quarterly call, we'll be providing our guidance for the upcoming fiscal year.

So thanks, again, everyone, for joining the call, and I wish you all a safe, happy and prosperous new year. Thank you.

Operator

Thank you. Ladies and gentlemen, this does conclude today's conference. Thank you all for participating. You may now disconnect. Have a great day.

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