29th January 2016

Food & Beverages

Diageo

Price 1,842p

Bloomberg	DGE LN
Reuters	DGE.L
12-month High / Low (p)	2,023 / 1,640
Market Cap (GBP)	46,333
Ev (BG Estimates) (GBP)	54,756
Avg. 6m daily volume (000)	4,150
3y EPS CAGR	2.1%

	1 M	3 M	6 M	31/12/15
Absolute perf.	-0.8%	-1.5%	1.2%	-0.8%
Food & Bev.	-2.8%	-3.2%	0.5%	-3.2%
DJ Stoxx 600	-8.1%	-10.9%	-14.1%	-8.5%

YEnd Jun. (GBPm)	06/15	06/16e	06/17e	06/18e
Sales	10,813	10,585	10,735	11,178
% change		*-2.1%*	*1.4%*	*4.1%*
EBITDA	3,390	3,282	3,422	3,653
EBIT	3,066	2,964	3,046	3,205
% change		*-3.3%*	*2.8%*	*5.2%*
Net income	2,225	2,143	2,219	2,371
% change		*-3.7%*	*3.6%*	*6.8%*

	06/15	06/16e	06/17e	06/18e
Operating margin	28.4	28.0	28.4	28.7
Net margin	23.8	22.8	22.8	22.5
ROE	24.0	20.4	20.0	20.0
ROCE	12.3	12.5	12.6	13.1
Gearing	102.9	80.3	72.2	63.3

(p)	06/15	06/16e	06/17e	06/18e
EPS	88.40	85.10	88.14	94.16
% change	*-*	*-3.7%*	*3.6%*	*6.8%*
P/E	20.8x	21.6x	20.9x	19.6x
FCF yield (%)	4.2%	3.4%	4.1%	4.6%
Dividends (p)	56.40	59.22	62.77	67.17
Div yield (%)	3.1%	3.2%	3.4%	3.6%
EV/Sales	5.2x	5.2x	5.1x	4.8x
EV/EBITDA	16.5x	16.7x	15.9x	14.7x
EV/EBIT	18.2x	18.5x	17.8x	16.8x

Improving fundamentals well factored into the share price

Fair Value 1790p vs. 1830p (-3%) **NEUTRAL**

Although Diageo's H1 2015/16 results came out below market expectations, this was mainly related to FX/perimeter effects. Organic sales growth accelerated vs last year (+1.8% in H1) and confirmed the group's improved trajectory. Nevertheless, we have cut our EPS estimates by 2% on average for the next three years, not only to reflect yesterday's miss but also the unexpected increase in minority interests. We have reduced our Fair Value to 1790p (upside of 2%) and are maintaining our Neutral recommendation. We think that an improvement in the group's organic performance is already factored into the share price. At 18.5x EV/EBIT 2015/16e and 17.8x EV/EBIT 2016/17e, the stock is trading 8% and 11% above peer-group average.

ANALYSIS

- **The organic performance should continue to improve over the second half of the year. North America was particularly weak in H1, with organic sales down 2% due to some innovation pipeline effects. However, the region should improve materially in H2 on the back of a favourable comparison base (-3.1% in H2 2014/15) and the launch of innovations (especially Ciroc Apple).** The underlying trend (even for Smirnoff and Captain Morgan) in the US was better during the period but the group continued to lose market shares. Despite some softness in Global Travel Retail and the Middle East, **Asia Pacific should accelerate in H2 thanks to the end of destocking in the South Eastern part and the renovation of the Mc Dowell's brand,** which is owned by USL. Notwithstanding a slowdown in Turkey related to an excise duty hike at the beginning of January**, the good trend in Europe should continue in H2 thanks to easy comps in Russia and an acceleration in the western spirits markets**. **The H2 performance in Africa should be broadly similar to H1. In the region, the business environment has deteriorated in a number of key markets (notably Angola…) and the group is now facing tough comps related to the launch of Orijin** in Nigeria. LAC should moderate over the remaining of the year in the absence of a positive technical effect in Brazil (excise duty hike), while Mexico and Colombia are expected to remain solid.
- **Estimates. We are forecasting organic sales growth of 2.8% in 2015/16 (+4.1% in H2)**, implying +2% in North America, +2.5% in Europe, +2.5% in Africa, +5.5% in LAC and +3.5% in Asia Pacific. **Diageo has reiterated its guidance for a slight organic increase in the full year EBIT margin but said that in H2 the EBIT margin should be broadly flat due to the intensification of marketing investments. Our estimate is for a 3.1% organic growth in EBIT in 2015/16 (+4.1% in H2).** This muted margin expansion in 2015/16 stems from the tough pricing environment, a negative market mix with the ramp-up in profitability in India, the necessary investments behind low end brands in the US and mainstream brands in Africa, and few savings (GBP59m expected in 2015/16 after GBP127m in 2014/15). We anticipate 2015/16 sales and EBIT of GBP10,585m and GBP2,964m, respectively, down 2.1% and 3.3%, as the FX and perimeter effects should remain penalising in H2. **We have adjusted our EPS estimates by 2% on average over the next three years to reflect yesterday's miss and higher than expected minority interests (EBIT growth at USL).**

VALUATION

- **We think that the improvement in the group's operating performance is already reflected into the share price. At 18.5x EV/EBIT 2015/16e and 17.8x EV/EBIT 2016/17e, the stock is trading 8% and 11% above the peers' average.** We maintain our Neutral recommendation. **Our DCF-derived Fair value is revised downwards to 1790p**

NEXT CATALYSTS

- Africa call on 3rd March
- LAC call on 12th May

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