

## Diageo

Price 2,192p

## Entering 2016/17 in a better position

Fair Value 2100p vs. 1840p (-4%)

NEUTRAL

Diageo thinks momentum will improve next year. We still expect organic sales and EBIT to grow respectively 3.8% and 4.9%. The company reiterated its medium term guidance for mid single digit sales growth and a 100bp margin improvement between 2016/17 and 2018/19. We have revised our EBIT estimates upwards by 10% on average over the next three years to take into account the decrease in the GBP following Brexit. Our Fair Value is adjusted from 1840p to 2100p. Neutral recommendation maintained.

## ANALYSIS

- Growing the scotch business is one of Diageo's point of emphasis.** In 2015/16, scotch showed an improvement that should continue in 2016/17. Last year, Buchanan's grew double digit and Johnnie Walker was back in growth led by the reserve offerings up 10%. In the US, the strong multi-cultural dynamic should support scotch growth as Hispanic and Asian consumers have an affinity with the category.
- Strengthening the US spirits business is also a priority.** In 2015/16, Diageo's fastest growing brands in the country were Buchanan's, Crown Royal, Don Julio and Bulleit. Sales of Smirnoff rose 2% against a decline of 4% in 2014/15. Captain Morgan was also back in growth (+2%). More price adjustments should be made on Smirnoff and Captain Morgan next year. The group will also 1/ increase marketing effectiveness by building an integrated approach across digital and traditional platforms, 2/ be more disciplined in how it measures and evaluates the brand spend, 3/ use time limited innovations to meet specific consumer opportunities and 4/ focus on productivity.
- Diageo will also focus on continuing to expand the Indian business.** The country accounts for 10% of the group's sales. Organic sales in India grew 5% in 2015/16, helped by the relaunches in the prestige segment of Royal Challenge, McDowell's No. 1 and Signature. Diageo said that USL is now a business in good shape to grow share. The indian company is well placed to capture growth in the market given its brand range across categories and price points.
- The group's objective remains mid single digit organic sales growth and a 100bp margin improvement between 2016/17 and 2018/19.** Diageo thinks momentum will improve next year. We maintain our estimate of 3.8% organic sales growth, accelerating vs last year (+2.8%). EBIT should grow 4.9% organically, implying a 30bp margin improvement. The company indicated that the exchange rate movement in 2016/17 should positively impact net sales by around GBP11bn and operating profit by GBP370m. This is the result of the weakness of GBP following the Brexit. We revise upwards our EBIT estimates by 10% on average over the next three years.

## VALUATION

- Our DCF now points to a Fair Value of 2100p. At yesterday's share price, the stock is trading at 18.1x EV/EBIT 2016/17e, 9% above the peer average.

## NEXT CATALYSTS

- Campari is due to release H1 2016 results on 2nd August

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Bloomberg	DGE LN
Reuters	DGE.L
12-month High / Low (p)	2,192 / 1,640
Market Cap (GBP)	55,182
Ev (BG Estimates) (GBP)	63,817
Avg. 6m daily volume (000)	4 588
3y EPS CAGR	7.2%

	1 M	3 M	6 M	31/12/15
Absolute perf.	13.3%	16.8%	19.0%	18.1%
Food & Bev.	4.8%	3.0%	3.4%	0.0%
DJ Stoxx 600	7.2%	-2.7%	1.4%	-7.2%

YEnd Jun. (GBPm)	06/15	06/16	06/17e	06/18e
Sales	10,813	10,485	11,718	12,261
% change		-3.0%	11.8%	4.6%
EBITDA	3,390	3,323	3,893	4,181
EBIT	3,066	3,008	3,483	3,691
% change		-1.9%	15.8%	6.0%
Net income	2,225	2,304	2,549	2,743
% change		3.6%	10.6%	7.6%

	06/15	06/16	06/17e	06/18e
Operating margin	28.4	28.7	29.7	30.1
Net margin	22.8	22.0	23.5	23.4
ROE	24.0	19.0	14.5	14.6
ROCE	12.3	12.7	11.4	11.8
Gearing	17.7	16.0	13.4	11.9

(p)	06/15	06/16	06/17e	06/18e
EPS	88.40	91.50	101.24	108.95
% change	-	3.5%	10.6%	7.6%
P/E	24.8x	24.0x	21.7x	20.1x
FCF yield (%)	3.6%	3.8%	4.0%	4.3%
Dividends (p)	56.40	59.22	62.77	67.17
Div yield (%)	2.6%	2.7%	2.9%	3.1%
EV/Sales	6.0x	6.1x	5.4x	5.1x
EV/EBITDA	19.1x	19.2x	16.2x	14.9x
EV/EBIT	21.1x	21.2x	18.1x	16.9x

## Analyst :

Virginie Roumage  
33(0) 1.56.68.75.22  
vroumage@bryangarnier.com



## Sector Team :

Nikolaas Faes  
Loïc Morvan  
Antoine Parison  
Cédric Rossi

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15 St. Botolph Street	75008 Paris	New York, NY 10022	80538 Munich	New Delhi 110 001
London EC3A 7BB	Tel: +33 (0) 1 56 68 75 00	Tel: +1 (0) 212 337 7000	Germany	Tel +91 11 4132 6062
Tel: +44 (0) 207 332 2500	Fax: +33 (0) 1 56 68 75 01	Fax: +1 (0) 212 337 7002	+49 89 2422 62 11	+91 98 1111 5119
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