

Diageo

Price 2,155p

Fine-tuning our estimates

Fair Value 2100p (-3%)

NEUTRAL

On 29th July after Diageo published its full year results, we increased our Fair Value from 1840p to 2100p to take into account the pound devaluation. We now fine-tune our estimates. We expect organic sales and EBIT to grow 3.5% and 4.1% respectively. This compares to previous forecasts of 3.8% and 4.9%. Our Neutral recommendation and Fair Value of 2100p remain unchanged.

ANALYSIS

Diageo's organic sales growth should slightly accelerate next year. Our estimate calls for +3.5% vs +3.8% previously (+2.8% in 2015/16). The group's objective remains to return to a mid single digit growth in the medium term. EBIT margin should increase by only 14 bps organically due to the costs associated with the GBP500m productivity savings. Starting in 2016/17, they will enable a 100bps margin improvement between 2016/17 and 2018/19.

- **Slight acceleration in the United States next year.** We expect organic sales in the US to grow 3.5% in 2016/17, implying a small improvement vs 2015/16 (+2.8%) which should be driven by an increase in marketing expenses and a stronger commercial execution. The trend in H1 is expected to be better than in H2 due to easy comps. Diageo should continue to underperform the market which is running at +4% and should not catch up before 2017/18. Most of the price adjustments have been made on Smirnoff and Captain Morgan and the performance of these two brands is expected to continue to improve.
- **The East penalizing Europe/Russia/Turkey.** Russia should deteriorate due to the weak consumption environment and the lack of price increases that fuelled last year's growth. We think Turkey will be challenging due to the political unrest and the tax hike in January 2016. We expect 2.8% organic sales growth in the region in 2016/17 (+3.9% in 2015/16).
- **Modest growth in Africa.** Sales should increase 4% organically next year. This is a slight improvement vs 2015/16 (+2.6%) but remains well below the historical trend and the group's long term guidance of a high single digit/low double digit growth. The macro environment should remain tough in Nigeria but the country is expected to stabilize by the end of 2017 on the back of easy comps. East Africa should slow down as the Senator Keg brand benefited from a cut in excise duty in 2015/16. Last year, the margin in Africa declined by 740bps. CEO is confident that it will improve in 2016/17 thanks to the increase of local sourcing, cost containment, management of price/mix and the stabilization of Orijin in Nigeria.
- **A better performance in Latin America/Caribbean helped by easy comps.** We expect 4% organic sales growth in 2016/17, implying an acceleration vs last year (+0.6%). This should be driven by a favourable comparison base. In 2015/16 the group had to reclassify Don Julio external sales as intercompany sales following an accounting mistake in 2014/15.
- **China and India driving an improvement in Asia Pacific.** The comparison base should become more favourable in China after a 2% drop in 2015/16. In India, we expect 8% organic sales growth (+5% last year) thanks to the work on local brands and the focus on Diageo's portfolio. Our estimate calls for 4% organic sales growth in the region in 2016/17 after +1.5% in 2015/16.

VALUATION

- Our DCF points to a Fair Value of 2100p. At yesterday's share price, the stock is trading at 17.5x EV/EBIT 2016/17e and 16.2x EV/EBIT 2017/18e, 6% and 4% below the peers' average.

NEXT CATALYSTS

- Pernod Ricard: 2015/16 results (at end-June) on September 1st

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Bloomberg	DGE LN
Reuters	DGE.L
12-month High / Low (p)	2,192 / 1,640
Market Cap (GBP)	54,249
Ev (BG Estimates) (GBP)	61,376
Avg. 6m daily volume (000)	4 354
3y EPS CAGR	9.8%

	1 M	3 M	6 M	31/12/15
Absolute perf.	0.7%	17.4%	15.6%	16.1%
Food & Bev.	-0.7%	4.4%	5.6%	0.3%
DJ Stoxx 600	1.0%	2.1%	4.8%	-6.1%

YEnd Jun. (GBPm)	06/16	06/17e	06/18e	06/19e
Sales	10,485	11,820	12,312	12,911
% change		12.7%	4.2%	4.9%
EBITDA	3,323	3,924	4,225	4,539
EBIT	3,008	3,510	3,733	3,958
% change		16.7%	6.4%	6.0%
Net income	2,242	2,567	2,765	2,972
% change		14.5%	7.7%	7.5%

	06/16	06/17e	06/18e	06/19e
Operating margin	28.7	29.7	30.3	30.7
Net margin	22.5	22.9	23.7	24.2
ROE	22.0	19.6	19.4	19.2
ROCE	12.1	13.5	14.2	14.8
Gearing	16.0	13.2	11.4	9.4

(p)	06/16	06/17e	06/18e	06/19e
EPS	89.04	101.93	109.83	118.01
% change	-	14.5%	7.7%	7.5%
P/E	24.2x	21.1x	19.6x	18.3x
FCF yield (%)	3.9%	4.4%	4.7%	5.0%
Dividends (p)	59.20	62.16	65.27	68.53
Div yield (%)	2.7%	2.9%	3.0%	3.2%
EV/Sales	6.0x	5.2x	4.9x	4.6x
EV/EBITDA	18.9x	15.6x	14.3x	13.1x
EV/EBIT	20.9x	17.5x	16.2x	15.0x



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