

## Diageo

Price 2,159p

## Positive outlook for Europe

Fair Value 2100p (-3%)

NEUTRAL

Bloomberg	DGE LN
Reuters	DGE.L
12-month High / Low (p)	2,192 / 1,714
Market Cap (GBPm)	54,369
Ev (BG Estimates) (GBPm)	61,497
Avg. 6m daily volume (000)	4 337
3y EPS CAGR	9.8%

	1 M	3 M	6 M	31/12/15
Absolute perf.	-0.9%	21.9%	15.5%	16.3%
Food & Bev.	-1.5%	5.2%	2.6%	-1.0%
DJ Stoxx 600	0.3%	4.8%	-0.1%	-6.7%

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	21.2x	19.7x	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	19.0x	15.7x	14.3x	13.1x
EV/EBIT	20.9x	17.5x	16.2x	15.0x

Yesterday, Diageo held a conference call on Europe/Russia/Turkey, which account for 24% of its sales. Management gave a globally positive outlook for the European activities, excluding Russia and Turkey, which are set to remain challenging but represent only 16% of the region's sales. The remaining 84% is expected to grow low single-digit this year according to the group. We are making no change to our estimate for 2.8% organic sales growth in Europe/Russia/Turkey. Our Neutral recommendation and Fair Value of 2100p are maintained. The group's strong exposure to emerging markets (an estimated 48% of total sales) is challenging in the current environment, while its underperformance in its first market, the US (32% of total sales), makes high investments necessary, thereby limiting operating leverage.

## ANALYSIS

- Management gave a globally positive outlook for the European activities. This excludes Russia and Turkey, which should remain challenging, but account for only 16% of the region's sales. The remaining 84% is expected to grow low single-digit this year according to the group. We are making no change to our estimate for 2.8% organic sales growth in Europe/Russia/Turkey. This is a slight deceleration vs last year due to the lack of price increases in Russia, political tension in Turkey and some uncertainty in the UK with Brexit. We think this performance is respectable in view of economic conditions, the tough retail environment and structurally unfavourable demographics.
- Europe, excluding Russia and Turkey, is dynamic, with sales up 3% last year. The group has taken a number of initiatives that should drive the region's performance in coming years:
  - ✓ **Enhancement of the route-to-market.** The group has increased its salesforce by 200 people. It has also improved its effectiveness through training programmes and automation tools. E-commerce is becoming a priority. Diageo generates 3% of its sales in this channel, which was reported to grow in high double digits over the past two years.
  - ✓ **Investments behind premium core brands.** Guinness, Bailey's, Captain Morgan, Smirnoff, Johnnie Walker, J&B and Tanqueray are benefiting from more marketing expenses.
  - ✓ **Innovation.** Diageo derives 10% of its sales from Europe from innovations vs 6% three years ago. Innovations refer to products introduced within the last five years. They are currently growing by 30% a year. The group has innovated in formats by extending some of its brands into premixes.
  - ✓ **Investments in Reserve.** These higher-priced products now represent 18% of the group's spirits sales in Europe and posted double-digit sales growth 2015/16. Half of these consist of malt whiskeys which grew 7% last year.
  - ✓ **Increase in productivity.** The group is implementing zero-based budgeting which should reduce indirect spend by 13% this year and is also improving marketing efficiency through procurement benefits.

## VALUATION

- At yesterday's share price, the stock is trading at 17.5x EV/EBIT 2016/17e. This is 3% below the peer average.

## NEXT CATALYST

- Pernod Ricard will release its Q1 sales on 20th October.

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