

INDEPENDENT RESEARCH
UPDATE

23rd November 2016

Food & Beverages

Bloomberg	DGE LN
Reuters	DGE.L
12-month High / Low (p)	2,268 / 1,745
Market capitalisation (GBPm)	50,448
Enterprise Value (BG estimates GBPm)	58,168
Avg. 6m daily volume ('000 shares)	4 948
Free Float	99.9%
3y EPS CAGR	11.0%
Gearing (06/16)	17%
Dividend yield (06/17e)	3.10%

YE June	06/16	06/17e	06/18e	06/19e
Revenue (GBPm)	10,485	11,969	12,564	13,177
EBIT (GBPm)	3,008	3,590	3,848	4,080
Basic EPS (p)	89.39	103.98	113.90	122.34
Diluted EPS (p)	89.04	103.57	113.45	121.86
EV/Sales	5.63x	4.86x	4.58x	4.30x
EV/EBITDA	17.8x	14.5x	13.2x	12.1x
EV/EBIT	19.6x	16.2x	14.9x	13.9x
P/E	22.5x	19.4x	17.7x	16.5x
ROCE	12.1	13.8	14.5	15.2



Diageo

An improvement in trajectory

Fair Value 2150p vs. 2200p (price 2,005p)

NEUTRAL

In our view, the gradual improvement in operating performance is already priced in. We maintain our Neutral recommendation but we adjust downwards our Fair Value to 2,150p due to FX.

■ **A gradual acceleration in growth.** Diageo's sales are expected to increase by 3.5% on an organic basis this year after +2.8% in 2015/16. This reflects a pick-up in the group's main markets excluding the Europe/Russia/Turkey region which is expected to be up by only 2.8%, last year's good performance (+3.9% in 2015/16) having been driven by significant price rises in Russia. The group is expected to continue to under-perform in the United States with our forecasts looking for US sales growth of 3.5% in a market up by 4%. The trading environment also remains difficult in the emerging countries. Africa, Latin America & Caribbean and Asia Pacific are expected to post respective increases of 4%, 3.8% and 4% this year, well below their historic trends.

■ **A limited improvement in the EBIT margin.** In 2016/17, the EBIT margin should increase by 120bps at reported level thanks to currency effects but by only 14bps in organic. This should be due to the expenses linked to the GBP500m cost-saving programme to be realised via the implementation of zero-based budgeting, revenue management and efficiency gains at the level of overheads and advertising. The first half should see a 14bp organic decline in the EBIT margin.

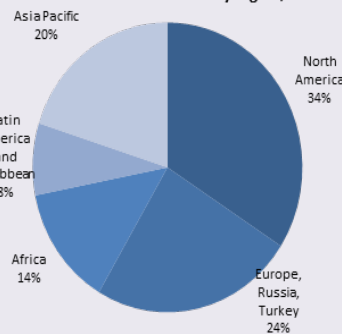
Neutral, Fair Value: 2,150p. In our view, the improvement in the trajectory is priced in. At the day before yesterday's close, the stock is trading at 16.2x 2016/17e EV/EBIT, a 9% premium to its closest peer Pernod Ricard. We maintain our Neutral recommendation but we adjust downwards our Fair Value to 2,150p due to FX.



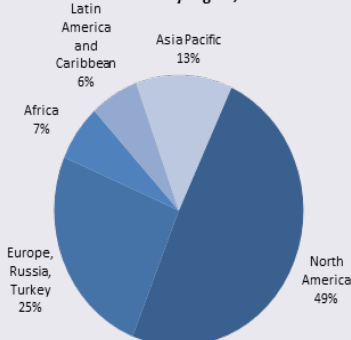
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Net sales breakdown by region, 2015-16



EBIT breakdown by region, 2015-16



Company description

Formed in 1997, following the merger of GrandMet and Guinness, Diageo is a global leader in beverage alcohol with an outstanding collection of brands across spirits, beer and wine categories. Headquartered in London, the company is listed on both the London Stock Exchange and the New York Stock Exchange.

Simplified Profit & Loss Account (GBPm)	30/06/14	30/06/15	30/06/16	30/06/17e	30/06/18e	30/06/19e
Net sales	10,258	10,813	10,485	11,969	12,564	13,177
Change (%)	-9.2%	5.4%	-3.0%	14.2%	5.0%	4.9%
Organic change (%)	0.4%	0.0%	2.8%	3.5%	4.2%	4.9%
Gross profit	6,252	6,228	6,234	7,229	7,614	8,011
Adjusted EBITDA	3,478	3,437	3,323	4,009	4,351	4,673
Marketing expenses	(1,769)	(1,620)	(1,629)	(1,562)	(1,759)	(1,847)
Adjusted EBIT	3,134	3,066	3,008	3,590	3,848	4,080
Change (%)	-9.9%	-2.2%	-1.9%	19.3%	7.2%	6.0%
Financial results	(388)	(412)	(327)	(343)	(280)	(240)
Pre-Tax profits	2,711	2,933	2,858	3,472	3,803	4,085
Tax	(447)	(466)	(496)	(729)	(799)	(858)
Profits from associates	252	175	221	225	235	245
Minority interests	(67.0)	86.0	118	135	148	159
Net profit	2,181	2,467	2,362	2,743	3,005	3,227
Restated net profit	2,394	2,225	2,242	2,608	2,857	3,068
Change (%)	-7.2%	-7.1%	0.8%	16.3%	9.5%	7.4%

Cash Flow Statement (GBPm)

Operating cash flows	2,707	2,797	2,841	3,590	3,848	4,080
Change in working capital	(597)	117	(53.0)	(204)	(204)	(210)
Capex, net	(562)	(586)	(449)	(600)	(628)	(659)
Financial investments, net	(673)	(722)	(639)	(899)	(906)	(925)
Dividends	(1,228)	(1,341)	(1,443)	(1,491)	(1,565)	(1,643)
Net debt	8,850	9,527	8,635	7,720	7,071	6,235
Free Cash flow	1,235	1,963	2,097	1,906	2,213	2,480

Balance Sheet (GBPm)

Tangible fixed assets	3,433	3,690	3,881	3,850	3,733	3,513
Intangibles assets	7,891	11,231	12,370	12,617	12,870	13,127
Cash & equivalents	622	472	1,089	(454)	(217)	(341)
current assets	7,469	7,670	8,852	7,987	8,619	8,902
Other assets	6,982	6,431	6,180	7,693	7,340	7,245
Total assets	22,964	25,804	28,491	27,844	28,611	28,932
L & ST Debt	9,214	9,838	10,129	6,505	6,093	5,133
Others liabilities	6,160	6,710	8,182	8,778	9,091	9,413
Shareholders' funds	7,590	9,256	10,180	12,561	13,426	14,386
Total Liabilities	15,374	16,548	18,311	15,283	15,184	14,546
Capital employed	15,245	18,987	20,144	20,564	20,903	21,150

Ratios

Gross margin	60.95	57.60	60.20	60.40	60.60	60.80
Marketing expenses as % of sales	15.79	15.07	14.90	14.70	14.70	14.70
Operating margin	30.55	28.35	28.69	29.99	30.63	30.97
Effective tax rate	16.49	15.89	17.35	21.00	21.00	21.00
Net margin	21.26	22.82	22.53	22.92	23.91	24.49
ROE (after tax)	31.54	24.04	22.02	20.76	21.28	21.33
ROCE (after tax)	13.70	12.30	12.10	13.79	14.54	15.24
Gearing	17.33	18.65	16.90	15.11	13.84	12.20
Pay out ratio	54.36	63.80	66.49	60.02	57.53	56.24
Number of shares, diluted	2,517	2,517	2,518	2,518	2,518	2,518

Data per Share (GBP)

Basic EPS	95.53	88.82	89.39	104	114	122
Diluted EPS	95.11	88.40	89.04	104	113	122
% change	-7.2%	-7.1%	0.7%	16.3%	9.5%	7.4%
BVPS	302	368	404	499	533	571
Operating cash flows	107	137	133	158	164	176
FCF	49.07	77.99	83.28	75.70	87.90	98.49
Net dividend	51.70	56.40	59.20	62.16	65.27	68.53

Source: Company Data; Bryan, Garnier & Co ests.

1. A gradual acceleration in growth

Diageo's sales should increase by 3.5% on an organic basis this year after +2.8% in 2015/16.

This reflects a pick-up in the group's main markets excluding the Europe/Russia/Turkey region where sales are expected to be up by only 2.8%, last year's good performance (+3.9% in 2015/16) having been driven by significant price increases in Russia. The group should continue to underperform in the United States where our forecasts look for sales growth of 3.5% in a market up by 4%. The trading environment also remains difficult in the emerging countries. Africa, Latin America & Caribbean and Asia Pacific are expected to post respective sales increases of 4%, 3.8% and 4% this year, well below the historic trends.

Fig. 1: Sales forecasts

<i>GBPm</i>	2015/16	2016/17e	2017/18e	2018/19e
GROUP				
Sales	10 485	11 969	12 564	13 177
Reported variation	-3.0%	14.2%	5.0%	4.9%
Organic variation	2.8%	3.5%	4.2%	4.9%
FX variation	-1.6%	13.3%	0.8%	0.0%
Perimeter variation	-3.0%	-2.7%	0.0%	0.0%
NORTH AMERICA				
Sales	3 565	4 152	4 385	4 582
Reported variation	3.2%	16.5%	5.6%	4.5%
Organic variation	2.8%	3.5%	4.0%	4.5%
EUROPE				
Sales	2 544	2 813	2 888	2 990
Reported variation	-2.8%	10.6%	2.7%	3.5%
Organic variation	3.9%	2.8%	3.0%	3.5%
AFRICA				
Sales	1 401	1 518	1 612	1 709
Reported variation	-0.8%	8.3%	6.2%	6.0%
Organic variation	2.6%	4.0%	5.0%	6.0%
LATAM				
Sales	863	966	1 014	1 074
Reported variation	-16.3%	11.9%	4.9%	6.0%
Organic variation	0.6%	3.8%	5.0%	6.0%
ASIA-PACIFIC				
Sales	2 076	2 485	2 629	2 787
Reported variation	-6.2%	19.7%	5.8%	6.0%
Organic variation	1.5%	4.0%	5.0%	6.0%
CORPORATE				
Sales	36	36	36	36

Source: Diageo, Bryan, Garnier & Co

2. A limited progression in the current operating margin

In 2016/17, the EBIT margin is expected to increase by a reported 120bps but by only 14bps on an organic basis. This should be due to the expenses linked to the GBP500m cost-saving programme to be realised via the implementation of zero-based budgeting, revenue management and efficiency gains at the level of overheads and advertising. The first half is expected to post a 14bp organic decline in the EBIT margin.

Fig. 2: EBIT forecasts

GBPm	2015/16	2016/17e	2017/18e	2018/19e
GROUP				
EBIT	3008	3590	3848	4080
Reported variation	-1.6%	19.3%	7.2%	6.0%
Margin	28.7%	30.0%	30.6%	31.0%
Reported variation in bp	33	130	64	34
Organic variation in bps	19	14	58	34
NORTH AMERICA				
EBIT	1551	1880	2005	2116
Reported variation	7.1%	21.2%	6.6%	5.5%
Margin	43.5%	45.3%	45.7%	46.2%
Reported variation in bp	160	179	44	44
EUROPE, RUSSIA, TURKEY				
EBIT	801	937	985	1030
Reported variation	-0.4%	14.3%	3.7%	4.5%
Margin	31.5%	32.6%	32.9%	33.2%
Reported variation in bp	76	108	32	32
AFRICA				
EBIT	212	233	250	267
Reported variation	-33.3%	9.8%	7.3%	7.0%
Margin	15.1%	15.3%	15.5%	15.6%
Variation in bp	-734	20	15	15
LAC				
EBIT	199	220	231	246
Reported variation	-24.3%	10.5%	4.9%	6.5%
Margin	23.1%	22.8%	22.8%	22.9%
Variation in bp	-240	-29	0	11
ASIA-PACIFIC				
EBIT	395	513	559	604
Reported variation	11.0%	29.9%	9.0%	8.0%
Margin	19.0%	20.7%	21.3%	21.7%
Variation in bp	294	163	63	40
CORPORATE				
EBIT	-150	-173	-147	-147

Source: Diageo, Bryan, Garnier & Co

3. Valuation

Fig. 3: DCF (1/2)

GBPm	2016/17e	2017/18e	2018/19e	2019/20e	2020/21e	2021/22e	2022/23e	2023/24e	2024/25e	2025/26e
Sales	11 969	12 564	13 177	13 858	14 617	15 315	15 939	16 477	16 917	17 251
% reported	14.2%	5.0%	4.9%	5.2%	5.5%	4.8%	4.1%	3.4%	2.7%	2.0%
EBIT	3 590	3 848	4 080	4 305	4 556	4 773	4 967	5 135	5 272	5 376
EBIT margin	30.0%	30.6%	31.0%	31.1%	31.2%	31.2%	31.2%	31.2%	31.2%	31.2%
-Income taxes	-729	-799	-858	-904	-957	-1002	-1043	-1078	-1107	-1129
+Depreciation	419	503	593	643	699	753	807	857	903	863
as % of sales	3.5%	4.0%	4.5%	4.6%	4.8%	4.9%	5.1%	5.2%	5.3%	5.0%
+change in WC	-204	-204	-210	-220	-233	-244	-254	-262	-269	-274
as % of sales	1.7%	1.6%	1.6%	1.6%	1.6%	1.6%	1.6%	1.6%	1.6%	1.6%
Operating cash flows	3 076	3 349	3 606	3 824	4 065	4 281	4 477	4 651	4 799	4 836
-Capex	-600	-628	-659	-693	-731	-766	-797	-824	-846	-863
as % of sales	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%
Free cash flows	2 476	2 720	2 947	3 131	3 334	3 515	3 680	3 828	3 954	3 973
Discount coefficient	0.93	0.87	0.81	0.76	0.70	0.66	0.61	0.57	0.53	0.50
Discounted FCF	2 309	2 365	2 389	2 366	2 349	2 309	2 254	2 186	2 105	1 973

Fig. 4: DCF (2/2)

Sum of discounted cash flows	22 605
+Terminal Value	38 728
+Financial assets	3 443
-Net debt	-8 635
-Minorities	-1 650
-Provisions	-390
Equity Value	54 101
Number of shares	2518
Fair Value	2150

Source of all tabs: Diageo, Bryan, Garnier & Co

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