Deutsche Bank
Markets Research

Rating
Buy

Europe
United Kingdom

Consumer Staples

Company
Diageo

Reuters	Bloomberg	Exchange	Ticker
DGE.L	DGE LN	LSE	DGE

ADR Ticker	ISIN
DEO	US25243Q2057

Date
16 December 2014

Company Update

Price at 15 Dec 2014 (GBP)	1,805.00
Price Target (GBP)	2,000.00
52-week range (GBP)	2,003.50 - 1,709.50

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MUCH aDO about the MUST DOs

The MUST DOs don't work for equity investors

In our view Diageo's MUST DOs do not work for equity investors: they are inputs not outputs. Their introduction (or perhaps the abandonment of August 2011's targets) has seen Diageo revert to type: an underperformer against the UK peer group. There is really only one MUST DO for Diageo in our view: grow EPS at least in line with peer group. Though we have sympathy with no targets, on balance we believe Diageo needs to reinstate tangible targets (executive remuneration provides a steer). Diageo is one of the most geared plays into a US consumer recovery. Despite our reservations as to the lack of targets and the MUST DOs, valuations still warrant a 2000p price target. BUY.

Re-introduce targets

We believe Diageo was right to abandon the August 2011 targets; they were too excessive in our view. We do not consider the MUST DOs an adequate replacement: they are inputs not outputs/targets and have a major failing; no metrics by which they are measured. We note the shares have underperformed since the MUST DOs were introduced in November 2013. We have sympathy with no targets at all. However, on balance we believe, less excessive targets than August 2011's should be reinstated with one addition: a cash target.

Medium-term targets

In our view Diageo should employ the following targets: mid-single digit sales growth (4-6%); annual increase in margins; mid-high single digits EPS growth (7-9%); annual cash targets set by the Board (not satisfactory but realistic).

MUST DOs

Though reflective of group strategy, the MUST DOs have not resonated with investors because they are intangible; are inputs rather than outputs and have no specific measures. Alongside reinstating targets (outputs) as outlined above, we advocate the following five alternative MUST DOs: increase gross margins annually; grow premium core (and reserve) brands ahead of the group average; 'fix' beer/Guinness within three years; grow North America revenues at least 4% pa; grow emerging markets sales ahead of the group average.

Valuation and Recommendation

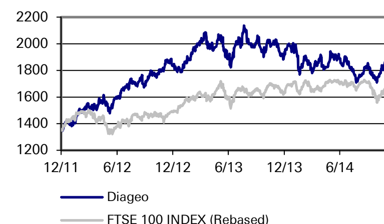
We value Diageo via a DCF using a WACC of 7.4%, years 6-10 cash flow growth of 4.7% and perpetuity of +1.5% as with other spirits companies. Risks include global growth, competitor activity and M&A.

Key changes

Target Price	2,050.00 to 2,000.00	↓	-2.4%
2015E EPS	97.0p to 93.5p	↓	-3.7%
2016E EPS	104.3p to 99.1p	↓	-5.0%
2017E EPS	114.5p to 106.5p	↓	-7.0%

Source: Deutsche Bank

Price/price relative



Performance (%)	1m	3m	12m
Absolute	-4.3	-2.6	-4.2
FTSE 100 INDEX	-7.1	-9.1	-4.0

Source: Deutsche Bank

Forecasts And Ratios

Year End Jun 30	2013A	2014A	2015E	2016E	2017E
Revenue (GBPm)	11,303	10,258	10,953	11,416	11,955
EBITDA (GBPm)	3,877	3,763	3,975	4,063	4,275
DB EPS (GBP)	102.38	100.07	93.45	99.13	106.50
P/E (DB EPS) (x)	18.1	19.3	19.3	18.2	16.9
EV/EBITDA (x)	13.8	14.7	13.4	12.9	12.0
Yield (%)	2.6	2.7	3.0	3.2	3.4

Source: Deutsche Bank estimates, company data

Deutsche Bank AG/London

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Model updated:16 December 2014

Running the numbers

Europe

United Kingdom

Beverage

Diageo

Reuters: DGE.L Bloomberg: DGE LN

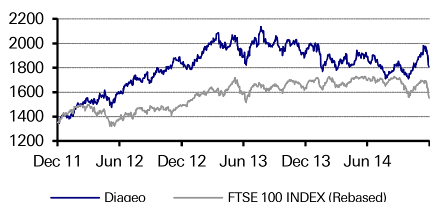
Buy

Price (15 Dec 14)	GBP 1,805.00
Target Price	GBP 2,000.00
52 Week range	GBP 1,709.50 - 2,003.50
Market Cap (m)	GBPm 45,233
	USDm 70,627

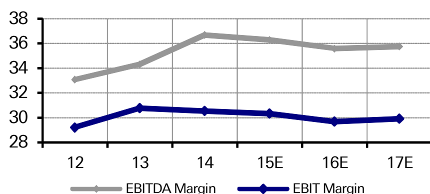
Company Profile

Diageo is a global leader in beverage alcohol with an extensive collection of brands across spirits, beer and wine. These brands include Johnnie Walker, Crown Royal, J&B, Windsor, and Buchanan's whiskies, Smirnoff, Ciroc and Ketel One vodkas, Baileys liqueur, Captain Morgan rum, Tanqueray and Gordon's gin, Don Julio tequila, Guinness stout and Red Stripe lager. Diageo owns 34% of Moët Hennessy, the spirits and wine subsidiary of LVMH Moët Hennessy - Louis Vuitton SA (LVMH).

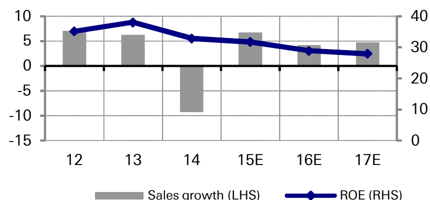
Price Performance



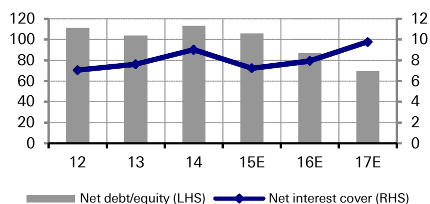
Margin Trends



Growth & Profitability



Solvency



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Fiscal year end 30-Jun	2012	2013	2014	2015E	2016E	2017E
Financial Summary						
DB EPS (GBP)	92.56	102.38	100.07	93.45	99.13	106.50
Reported EPS (GBP)	76.17	95.16	90.33	91.47	93.05	100.42
DPS (GBP)	43.50	47.35	51.70	54.29	57.00	60.99
BVPS (GBP)	224.0	281.2	272.3	306.8	341.8	380.3
Weighted average shares (m)	2,495	2,502	2,506	2,506	2,506	2,506
Average market cap (GBPm)	34,729	46,252	48,454	45,233	45,233	45,233
Enterprise value (GBPm)	42,334	53,638	55,275	53,153	52,298	51,354
Valuation Metrics						
P/E (DB) (x)	15.0	18.1	19.3	19.3	18.2	16.9
P/E (Reported) (x)	18.3	19.4	21.4	19.7	19.4	18.0
P/BV (x)	7.33	6.69	6.85	5.88	5.28	4.75
FCF Yield (%)	4.4	2.9	2.4	4.8	5.1	5.5
Dividend Yield (%)	3.1	2.6	2.7	3.0	3.2	3.4
EV/Sales (x)	4.0	4.7	5.4	4.9	4.6	4.3
EV/EBITDA (x)	12.0	13.8	14.7	13.4	12.9	12.0
EV/EBIT (x)	13.6	15.4	17.6	16.0	15.4	14.4
Income Statement (GBPm)						
Sales revenue	10,639	11,303	10,258	10,953	11,416	11,955
Gross profit	6,429	6,884	6,252	6,697	7,015	7,381
EBITDA	3,519	3,877	3,763	3,975	4,063	4,275
Depreciation	411	398	629	651	674	697
Amortisation	0	0	0	0	0	0
EBIT	3,108	3,479	3,134	3,324	3,389	3,577
Net interest income(expense)	-441	-457	-348	-460	-427	-367
Associates/affiliates	229	217	252	244	262	282
Exceptionals/extraordinaries	147	-83	140	0	0	0
Other pre-tax income/(expense)	0	-99	-467	-173	-173	-173
Profit before tax	3,043	3,057	2,711	2,935	3,052	3,320
Income tax expense	1,011	507	447	537	601	677
Minorities	120	98	-67	95	108	114
Other post-tax income/(expense)	-11	0	-83	0	0	0
Net profit	1,901	2,452	2,248	2,303	2,342	2,528
DB adjustments (including dilution)	409	127	271	50	153	153
DB Net profit	2,310	2,579	2,519	2,353	2,495	2,681
Cash Flow (GBPm)						
Cash flow from operations	1,975	1,933	1,702	2,806	2,949	3,149
Net Capex	-445	-597	-562	-642	-650	-663
Free cash flow	1,530	1,336	1,140	2,164	2,299	2,486
Equity raised/(bought back)	1	-11	-112	-35	-35	-35
Dividends paid	-1,036	-1,125	-1,228	-1,360	-1,428	-1,528
Net inc/(dec) in borrowings	512	1,238	-157	349	-835	-923
Other investing/financing cash flows	-1,541	-808	-756	-1,118	0	0
Net cash flow	-534	630	-1,113	0	0	0
Change in working capital	*-529*	*-552*	*-597*	*-208*	*-138*	*-156*
Balance Sheet (GBPm)						
Cash and other liquid assets	1,076	1,750	622	622	622	622
Tangible fixed assets	3,006	3,461	3,486	5,098	5,075	5,040
Goodwill/intangible assets	8,821	9,013	7,891	8,115	8,115	8,115
Associates/investments	2,295	2,933	3,264	2,586	2,638	2,695
Other assets	7,152	7,834	7,701	7,985	8,172	8,376
Total assets	22,350	24,991	22,964	24,406	24,622	24,848
Interest bearing debt	8,646	10,153	9,214	9,606	8,771	7,849
Other liabilities	6,893	6,750	6,160	6,317	6,456	6,606
Total liabilities	15,539	16,903	15,374	15,923	15,227	14,455
Shareholders' equity	5,588	7,036	6,823	7,687	8,566	9,531
Minorities	1,223	1,052	767	796	828	862
Total shareholders' equity	6,811	8,088	7,590	8,483	9,394	10,393
Net debt	*7,570*	*8,403*	*8,592*	*8,984*	*8,149*	*7,227*
Key Company Metrics						
Sales growth (%)	7.1	6.2	-9.2	6.8	4.2	4.7
DB EPS growth (%)	10.7	10.6	-2.3	-6.6	6.1	7.4
EBITDA Margin (%)	33.1	34.3	36.7	36.3	35.6	35.8
EBIT Margin (%)	29.2	30.8	30.6	30.3	29.7	29.9
Payout ratio (%)	57.1	48.3	57.6	59.1	61.0	60.5
ROE (%)	35.1	38.0	32.8	31.7	28.8	27.9
Capex/sales (%)	4.5	5.6	6.3	5.9	5.7	5.5
Capex/depreciation (x)	1.2	1.6	1.0	1.0	1.0	1.0
Net debt/equity (%)	111.1	103.9	113.2	105.9	86.7	69.5
Net interest cover (x)	7.0	7.6	9.0	7.2	7.9	9.8

Source: Company data, Deutsche Bank estimates

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Executive summary

MUST DOs

MUST DOs established November 2013

Figure 1 provides the MUST DOs[1] as set by Diageo in November 2013.

Figure 1: MUST DOs

1. Strengthen and accelerate our premium core brands
2. Win in reserve in every market
3. Innovate at scale to meet new consumer needs
4. Build and then constantly extend our advantage in route to consumer
5. Drive out costs to invest in growth
6. Ensure we have the talent to deliver our performance ambition

Source: Diageo

History

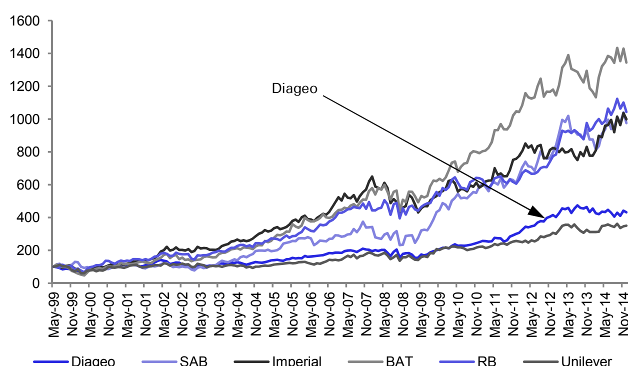
UK investors underweight

It is critical to understand the immediate history before the MUST DOs were established in order to have a real understanding of why/how they emerged.

We believe there has been a long-standing frustration within Diageo as to the UK investor base being underweight the stock (22% vs. 33% for the peer group, see Figure 13 and Figure 14, page 15) with various iterations of management seeking to address the relative imbalance.

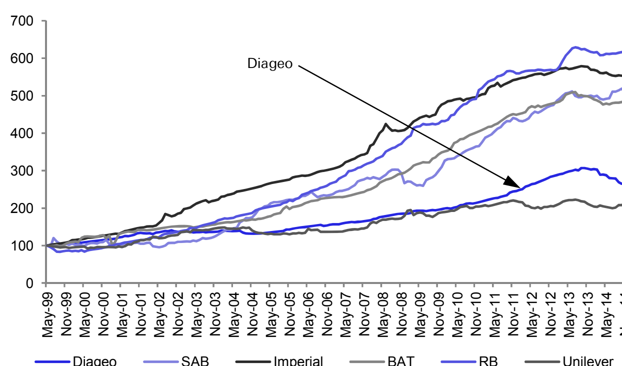
Since SAB listed, Diageo (with Unilever) has been a significant underperformer relative to the peer group. That underperformance has coincided with Diageo and Unilever's EPS growth materially underperforming the same peer group.

Figure 2: TSR since April 1999



Source: Datastream; monthly data

Figure 3: 12 month forward EPS since April 1999



Source: Datastream; monthly data

[1] Shown in capital letters to reflect how Diageo referred to the MUST DOs in their November 2013 presentation

UK investors have been right to be underweight Diageo.

One clear MUST DO

Too simplistic, but in order to rectify the relative imbalance of the UK investor weighting Diageo needs to do only one thing: grow its EPS in line with, or ahead of the peer group. Execute that MUST DO (in a sustainable way) and the 'issue' of the UK investor base will likely disappear over the long-term.

August 2011 targets

In August 2011, then CEO Walsh established a set of what we consider excessive targets. Expecting any large FMCG business to grow EPS at double digits over a sustained period is too aggressive in our view as it likely ultimately undermines sustainability; 'even' PMI gave up its double digit target in 2014.

Figure 4: August 2011 targets

P&L variable	Aim
Faster organic net sales growth	6% CAGR in the medium term
Organic operating margin improvement	The first 200bps by FY14
EPS growth	Double digit growth in core EPS ex FX

Source: Diageo, August 2011

Despite CFO Mahlan making it clear the August 2011 targets were medium term and Diageo being on track after two years (see Figure 20, page 20) the then new CEO Menezes (appointed July 2013) abandoned them in November 2013 with the comment:

"… we need to make changes, quite simply we need to change the culture and step up execution."[2]

A very interesting statement given it was made after two years of 5.5% pa top line growth and 11% pa EPS growth. Our interest is heightened by CEO Menezes saying, less than four months earlier, in July 2013:

"…we believe our performance this year leaves us on track to deliver our medium term guidance"

Noting our concerns as to communication, abandonment of the inherited targets was nevertheless the right thing to do in our view: our issue is what has replaced them.

Inputs not outputs

Six MUST DOs

Replacing the targets of August 2011 as the headline focus of the business is six MUST DOs, first provided to the market in November 2013.

[2] All quotes in this note taken from transcripts available at www.diageo.com

Figure 5: MUST DOs

1. Strengthen and accelerate our premium core brands
2. Win in reserve in every market
3. Innovate at scale to meet new consumer needs
4. Build and then constantly extend our advantage in route to consumer
5. Drive out costs to invest in growth
6. Ensure we have the talent to deliver our performance ambition

Source: Diageo November 2013

To coincide with the MUST DOs CFO Mahlan established the end aim of the business as:

"… both top tier net sales growth and consistent margin improvement."[3]

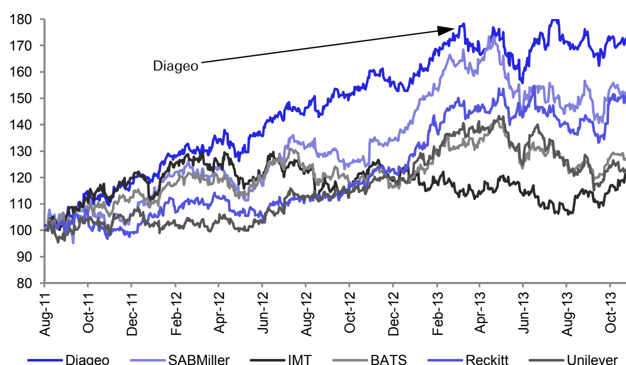
In our view, the MUST DOs are intangible and very difficult to measure externally. Noting they reflect group strategy, they nevertheless appear to be set as much for the internal audience as the external. We view them as a set of inputs, not outputs by which Diageo's performance can reasonably be measured by shareholders.

The original targets set in August 2011 (very much outputs) were too excessive; the new MUST DOs not specific enough, even with the over-riding aim of top tier net sales growth and consistent margin improvement.

The current MUST DOs may be characterised as inputs with the aim of meeting P&L and cash outputs; outputs Diageo have now avoided.

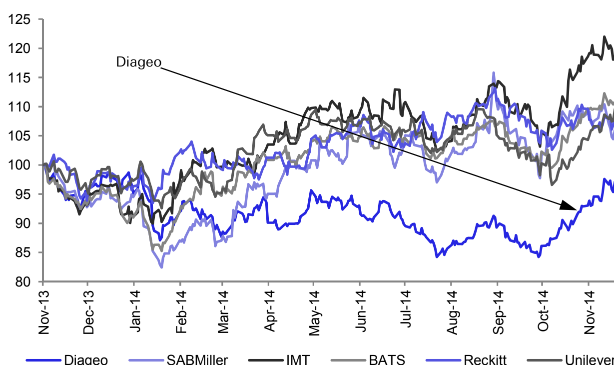
The shares were a strong performer post the announcement of the August 2011 targets but since have returned to reflect the relative performance of Figure 2. Noting the impact of a subdued FY14 operational performance, we are nevertheless not surprised.

Figure 6: Share price 15 August '11 to 18 November '13



Source: Datastream

Figure 7: Share price post 18 November 2013



Source: Datastream

[3] Top tier subsequently clarified to mean top quartile.

In our view the MUST DOs suffer from:

- Input not output focussed (at least from a shareholder perspective)
- No reference to cash, never mind a reference that can be measured
- No tangible metrics
- No definable margin targets
- 1-4 being all revenue inputs
  - providing detail with no metrics or big picture target
- Rather harshly some may consider MUST DOs #4 and #6 'the day job'
- No specific mention of underperforming operations such as beer and Guinness

DB alternatives

Targets and MUST DOs

While we recognise the new over-riding aim of Diageo as top tier [top quartile] net sales growth and consistent margin improvement we consider it not sufficiently specific.

In our view the chastening experience of abandoning the 2011 targets after two years has led Diageo to avoid the issue of targets. We believe Diageo is headlining the second derivative of the MUST DOs (what is needed to achieve the required targets) and is ignoring the tangible targets themselves.

As Figure 7 shows, the market appears to have worked this out.

Tangible targets need to be reinstated in our view with a variation of the MUST DOs (with tangible metrics) sitting underneath them.

In practice, if more tangible targets with measurable metrics are adopted the detail of the MUST DOs to achieve those targets can remain just that: detail to be discussed when assessing performance against the targets and articulating the group strategy, as they are used in the 2014 Annual Report where they are termed 'performance drivers'.

Targets

We set four potential targets for Diageo in Figure 8: three aligned to, but less onerous, than those of 2011, and one to correct what we consider glaring omission to the August 2011 targets: a cash based target.

In establishing the targets as set out in Figure 8 we would envisage Diageo stressing that these are targets are to be achieved in aggregate over the medium term (3-5 years) making it clear that some years are very likely to miss one or more of the four.

Figure 8: Diageo targets per DB

Mid single digit top line growth (4-6%)
Steadily increasing margins (some years better than others)
High single digit EPS growth (7-9%)
Cash based target set by the Board with the target and performance against it to be communicated at the end of the year[4]

Source: Deutsche Bank; top line and EPS targets organic

Having been critical of Diageo for not employing a cash based target in 2011, we note we have applied a less than ideal cash target in Figure 8.

We are more than conscious of this.

However, we also recognise the need to consider the impact of 'spirit specific' variables on cash flow: 'laying down' brown spirits and the volatility created by spirits not being particularly 'FM' (fast moving) in the world of FMCG resulting in trade inventories being relatively unpredictable and impacted more by the economic cycle than most other FMCG categories.

No targets

We have sympathy with companies having no external targets (Unilever abandoned targets with the appointment of Paul Polman as CEO in 2009). That said, and with clear reservations, on balance we consider the complete abandonment of targets as unrealistic for Diageo given original targets were only adopted in August 2011 with the current CEO then running the group's largest division (North America) and the then CFO, the CFO today.

The adoption of MUST DOs may have been seen as an acceptable alternative to targets. The subsequent share price performance would suggest not[5].

MUST DOs

Assuming targets aligned to our suggestion are reinstated (perhaps a major assumption now they have been abandoned) we do not believe Diageo needs to subsequently articulate MUST DOs in the headline fashion of November 2013, notwithstanding they are a means of articulating the group's strategy (not least of which in the Annual Report each year).

If Diageo persists with the MUST DOs either because they sit alongside targets as an articulation of the strategy (as performance drivers per the 2014 Annual Report), or because they are retained in the absence of targets (not ideal), we believe they need to be more tangible with a wider scope than the revenue focused MUST DOs as per Diageo's alternatives.

Our MUST DOs are formulated on the basis targets are reinstated, if they are not we would revise our MUST DOs to be output as opposed to input orientated.

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[4] We recognise this is far from ideal but given the 'unique' nature of spirits within FMCG in that brown spirits have to be laid down for many years ahead of sale we nevertheless reluctantly concede it is most appropriate and at least ensures a focus on cash by executives.

[5] That said, walking away from the MUST DOs with no alternative will prove very difficult: the MUST DOs now form a central element of the group strategy (Performance Ambition) as discussed in the 2014 Annual Report (pages 14-15) with the MUST DOs referred to as Performance Drivers. In addition the MUST DO's comprised a material element of the FY14 results investor presentation of 31 July 2014.

Figure 9: DB alternative MUST DOs

1. Increase gross margins annually
2. Grow premium core (and reserve) ahead of the group average
3. Fix beer/Guinness in three years or abandon Total Beverage alcohol
4. Grow North America at least 4% pa
5. Grow EM sales ahead of the group average

Source: Deutsche Bank

Forecasts, Valuation and Recommendation

Forecasts

We trim our forecasts by a combination of reduced organic growth expectations, currency and the corporate tax rate.

Notwithstanding some renewed confidence as to the prospects for the US consumer, for FY15E we cut our organic growth forecast to 1.4% from 2.4% and in FY16E to 3.9% from 4.8%.

Albeit still impacted by Senator in Kenya and de-stock in WestLac and South East Asia, Q1 was relatively weak at -1.5%. To generate organic sales of +1.4% for FY15 requires the following three quarters to average +2.4%. With a subdued volume and pricing dynamic in Europe, subdued pricing in the USA (not just vodka), further de-stocking to come in South East Asia and recent global macro turbulence we consider +2.4% for the next three quarters as sufficiently taxing.

As a counter we have potential support from a resurgence of middle income America on the back of lower oil feeding into petrol prices. In their S&P500 outlook of 15 December or US strategists said that over the past year, about 7% of US household spending was on energy, including gasoline, home heating and electricity. Gasoline was c3% of spending, but is now expected to fall to c2% at c$65/bbl oil. This should put nearly $100bn in household pockets or about $1,000 per household. Though some of this fuel saving might be saved, DB economists expect it to boost real GDP principally through household spending, which is near 70% of GDP. Our strategists believe this additional US household spending will boost sales for consumer discretionary and consumer staples companies, such as Diageo.

Recognising the added complication of Chinese cognac, we model Pernod organic growth of 2.8%. Q1 for Pernod was +2.3%.

For FY16E we take our organic growth forecast to 3.9%, at the bottom of what we consider a viable long-term top-line objective of 4% to 6% pa organic growth for Diageo.

With USL consolidated we model margins of 29.4% in FY15E climbing 20-30bps pa thereafter.

At Q1 with £=$1.61 and £=€1.27 Diageo estimated the impact operating profit by £95m. We are running with the £=$1.57 and £=€1.27 and have accordingly adjusted our forecasts down marginally for the US$ and other currencies including the Rouble. We now model negative currency of £115m impacting operating profits in FY15E.

We model the tax rate climbing steadily to over 20% in FY18E.

We cut our FY15E EPS forecast 3.7% to 93.5p and our FY16E forecast 5.0% to 99.1p in part due to these changes in our tax assumptions.

We model capex climbing marginally each year from FY14's £642m (we see the risk to the downside) and for working capital we model continuing outflows based on sales growth. We are aware working capital is a major focus for the business and again see the risk to the downside.

Valuation

Incorporating the shorter term P&L, capex and working capital parameters as above, we value Diageo via a DCF using a WACC of 7.4%, with medium term (years 6-10) cash flow growth of 4.7% per annum post our forecast horizon and perpetuity cash flow growth of +1.5% as per all spirits companies we cover. With HY15E on our doorstep (though still to be reported) we have rolled forward our DCF to commence in FY16E (discounted appropriately back to today). The end result: 1997p.

Recommendation and risks

Re-appraising our forecasts to derive a revised 2000p price target means we retain our Buy recommendation. To be clear, the recent market (and Diageo) sell-off in the last few days has clearly aided retention of our Buy recommendation. Issuing this note earlier in the month with the shares approaching 2000p (they traded at 2001p intra-day on 1 December) would likely have seen a different outcome.

Major risks include the outlook for global growth, competitor activity, FX rates (in particular the US$ and Euro) and M&A.

The shares had a very strong November which we attribute to the market re-appraising the growth potential of Diageo's US business in the light of falling oil prices feeding into lower petrol prices and therefore higher disposable US consumer incomes, particularly in 'middle-America'. Should the market alter its view as to the outlook for oil prices, or the impact of lower oil prices on the US consumer, this could have a negative impact on Diageo's share price.

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Historical context

Summary

Six MUST DOs

In November 2013 Diageo established the MUST DOs as shown in Figure 10. In order to assess whether they resonate with investors we must first understand their history.

Figure 10: Six MUST DOs

1. Strengthen and accelerate our premium core brands
2. Win in reserve in every market
3. Innovate at scale to meet new consumer needs
4. Build and then constantly extend our advantage in route to consumer
5. Drive out costs to invest in growth
6. Ensure we have the talent to deliver our performance ambition

Source: Diageo

UK investors underweight

UK investors are underweight Diageo stock relative to other UK FMCG companies and have been for very many years. We sense a high degree of frustration within senior Diageo ranks as to the issue, which has survived much iteration of Diageo's senior management.

Over the long-term UK investors have been right to be underweight Diageo; the share price (and TSR) performance has followed that of the EPS: it has significantly underperformed the peer group.

Too simplistic, but we may regard our discussion of Diageo's MUST DOs in many ways misplaced. There is really only one MUST DO for Diageo: unlike the past, grow EPS at least in line with the peer group.

August 2011 targets

In August 2011, perhaps because of

- frustration with the relative share price performance
- the rating (P/E)
- the underweight UK investor base and
- a relatively high degree of visibility for FY12 and FY13

Diageo set what we consider as very onerous targets for the medium term.

Figure 11: August 2011 targets

P&L variable	Aim
Faster organic net sales growth	6% CAGR in the medium term
Organic operating margin improvement	The first 200bps by FY14
EPS growth	Double digit growth in core EPS ex FX

Source: Diageo, August 2011

DB targets

In our view all targets should have been set over the medium to long-term with no promise to deliver in every single year and should have comprised (organically):

- a top line target of mid-single digit growth (4-6%)
- a target of "steadily improve margins"
- high single digit EPS growth
- with the addition of one glaring omission: a cash target based target.

Six MUST DOs

The August 2011 targets were abandoned in November 2013, in our view because they were too excessive. Out of them emerged the six MUST DOs:

In the subsequent Six MUST DOs section we discuss the value of the MUST DOs within this historical context which helps understand their emergence and in our view, their failure to match the expectations of shareholders.

But first we consider the history.

Shareholder register

Six MUST DOs

In November 2013 Diageo outlined its six MUST DOs. In order to critique them we must first understand the background to their formulation.

Figure 12: Six MUST DOs

1. Strengthen and accelerate our premium core brands
2. Win in reserve in every market
3. Innovate at scale to meet new consumer needs
4. Build and then constantly extend our advantage in route to consumer
5. Drive out costs to invest in growth
6. Ensure we have the talent to deliver our performance ambition

Source: Diageo

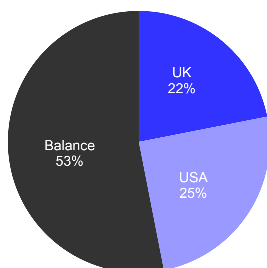
A sense of frustration?

Perhaps somewhat surprisingly we start with Diageo's shareholder register: in our view there has been a long-standing frustration within senior Diageo ranks as to the make-up of the investor register.

To be clear, we sense no fundamental issue with the register, rather there has been a long running frustration with the UK investor base being deemed 'underweight' relative to other UK listed FMCG companies: an 'opportunity' from a Diageo perspective that numerous iterations of senior management have failed to exploit[6].

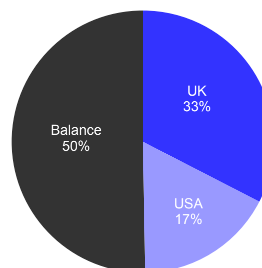
[6] An opportunity in the sense that creating investor demand in the UK would potentially lead to an increase in valuation (and therefore share price) as the additional demand is filled by the market.

Figure 13: Diageo shareholder base



Source: Reuters, November 2014

Figure 14: FMCG peer group shareholder base

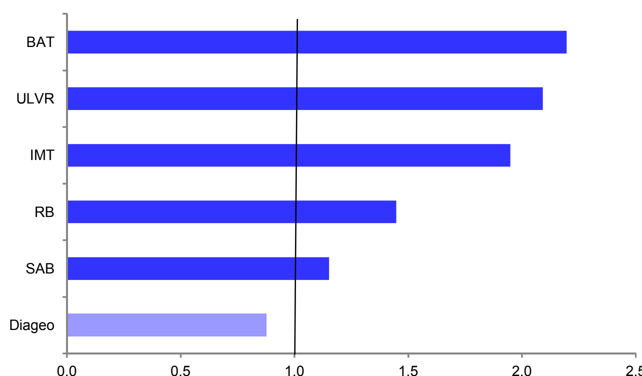


Source: Reuters, November 2014; .

In Figure 13 and Figure 14 we see UK investors represent 22% of Diageo's investor base against an average of 33% for BAT, IMT, RB and Unilever (and this with Unilever's significant European base given the former dual structure).

The lowest UK shareholder base of the four comparators per Reuters is RB at 26.1%. SAB is excluded from Figure 14 given its legacy South African shareholders and EM fund bias (relative to other UK FMCG companies). SAB has a 14% UK investor base (adjusted for Altria (Miller) and the Columbian shareholders (Bavaria) versus Diageo's 22%.

Figure 15: UK investor base relative to US



Source: Reuters November 2014

Figure 15 addresses the 'issue' in another way by comparing the size of the UK investor base relative to the typically second largest geographical investor base, that of the USA.

We see that, unlike each of BAT, Imperial, RB, SAB and Unilever, Diageo's UK investor base is smaller than the US.

A positive

All major UK based FMCG companies spend significant time and effort marketing to US institutions with the aim of establishing a major foothold with the largest institutions within one of the world's most sophisticated equity investor bases.

Nothing wrong with that.

Further, (despite Diageo's mindset as to their investor base) we can turn the argument around and see the large US investor base as a major success and one which the many listed companies around the world wish they could replicate.

Clearly there is no general rule as to why Diageo 'over-indexes' as regards US investors. That said, we suspect one or more of the following are contributory factors for the majority of US shareholders (the list is far from exhaustive):

- Spirits a long-term growth category standalone and relative to other staples categories
- Limited alternatives within the domestic universe and none with the global reach or brand diversity of Diageo
- Domestic alternatives either relatively expensive and/or not pure spirits plays historically
- Global leadership
- High quality brands
- Third of group sales in North America
- Significant emerging market exposure
- Hard currency reporting (and dividend payment).

We could end the debate there and conclude Diageo has done an excellent job with US investors culminating in US investors over-indexing on the Diageo register when compared with other listed UK FMCG companies.

Except, we believe it is much more complicated than that.

We need to turn the argument back and return to focusing on why the UK investor base is underweight Diageo.

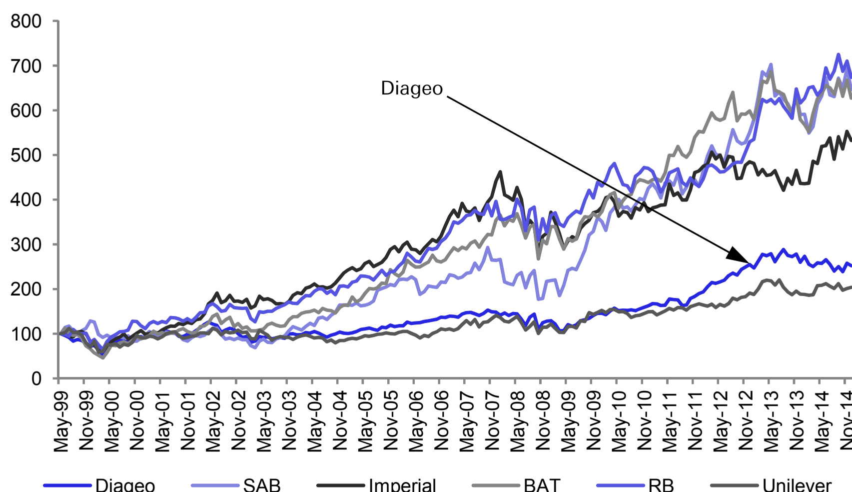
Track record

Share price

Figure 16, Figure 17 and Figure 18 consider various aspects of Diageo's performance over the long-term when compared to the UK FMCG peer group.

We commence our analysis from April 1999 when SAB listed on the UK market.

Figure 16: Share price since April 1999



Source: Datastream; April 1999 chosen as when SAB listed on UK market

Figure 16 looks at the share price of each of Diageo, BAT, Imperial, RB, SAB and Unilever. Alongside Unilever, Diageo has been a significant laggard.

Total shareholder returns (TSR)

Figure 16 is flawed. Dividends matter; reinvested dividends matter even more; reinvested dividends in highly cash generative growing businesses (i.e. FMCG) with relatively high pay-out ratios and growing dividends matter even more than that.

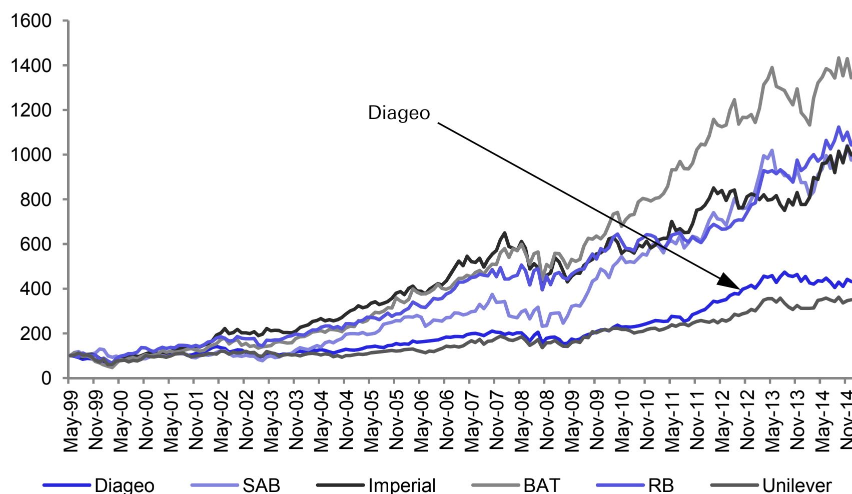
Figure 17 considers the performance of each of the stocks on a TSR basis (dividend reinvested). We concede the period from April 1999 is firmly 'long-term' but so too has been the 'issue' of Diageo's shareholder base. More importantly, staples are long duration businesses that reinvest in A&P to support their key assets: their brands.[7]

Alongside Unilever, Diageo has significantly underperformed SAB, RB, Imperial and finally BAT. SAB has outperformed Diageo by 108%, RB outperformed Diageo by 141%, Imperial outperformed Diageo 154% and BAT outperformed Diageo by a (staggering) 234%.

True, April 1999 catches Imperial and BAT at low points (during the malaise of tobacco litigation concerns) but we did not catch either of them at the absolute bottom, far from it:

- BAT fell 35% April 1999 to February 2000
- Imperial fell 22% over the same period
- close inspection of Figure 17 illustrates the point for both companies.

Figure 17: TSR since April 1999



Source: Datastream; April 1999 chosen as when SAB listed on UK market

[7] Many commentators focus on quarterly numbers in staples (at times the author is guilty) but quarterly numbers very rarely give a real insight to the business: in our view staples should be analysed in the context of their long duration assets; i.e. over the (very) long-term.

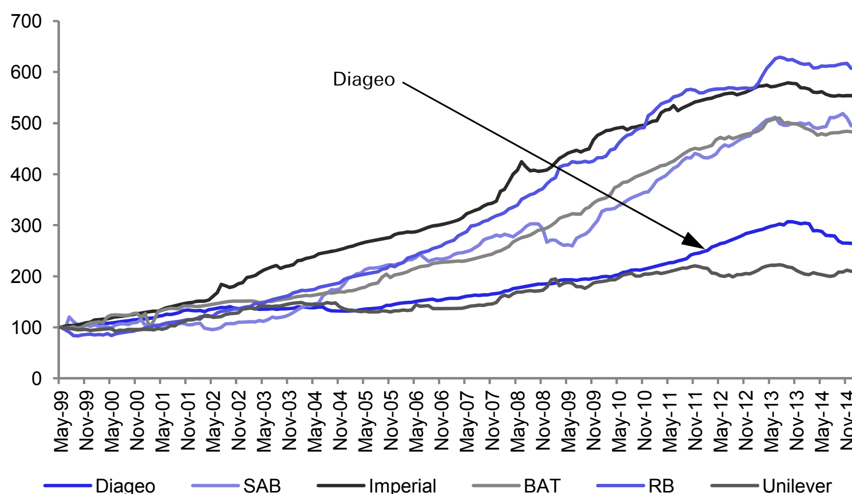
Relatively poor performer

So, we ask ourselves the question why has Diageo been a relatively poor performer.

We could write hundreds of pages on the subject.

Figure 18 answers the question in one fell swoop: Diageo and Unilever's earnings growth has been relatively poor when compared to BAT, SAB, Imperial and RB.

Figure 18: 12 month forward EPS since April 1999



Source: Datastream; April 1999 chosen as when SAB listed on UK market

UK shareholder perspective

The UK shareholder base has been right to be relatively underweight Diageo: SAB, RB, Imperial and BAT have all significantly outperformed Diageo through their superior earnings growth.

Somewhat aggressively, assuming each of SAB, RB, Imperial and BAT have been alternatives for US investors, US investors have been wrong to choose Diageo.

What MUST Diageo DO?

What must Diageo do to 'solve the issue' of an underweight UK investor base?

Grow earnings at least in-line with, or ahead of, the peer group.

That's it. Done.

Somewhat simplistic but nevertheless critical: Diageo's MUST DOs must be tangible and aligned with this objective... and be seen to be so in our view.

A combination of investors being dismissive and the company concerned then deemed to have failed to deliver ('even' against the dismissed objectives) is a powerful negative influence on valuation in our view.

This last point is critical in our view.

August 2011 targets

Understanding the context

In order to understand the context of Diageo's MUST DOs we first need to go back to August 2011.

Sales, margin and EPS targets

In August 2011, on release of the FY11 results, then CEO Paul Walsh and Deidre Mahlan CFO, set medium term goals for Diageo's sales, margins and EPS.

Figure 19: August 2011 targets

P&L variable	Aim
Faster organic net sales growth	6% CAGR in the medium term
Organic operating margin improvement	The first 200bps by FY14
EPS growth	Double digit growth in core EPS ex FX

Source: Diageo, August 2011

In setting out the targets CEO Walsh said:

"We have confidence in what Diageo, its brands, its route to market and its people can achieve, although we are very well aware of the challenges we will face in these volatile economic times.

"This morning, we articulated our aims. 6% top line growth, operating margin improvement, with the first 200 basis points in 3 years, and double digit EPS growth to underpin faster dividend growth. <u>These are not annual goals. It is a description of the progress we aim to deliver over the medium term.</u>"[8] (DB emphasis).

In response to a question during the results call CEO Walsh also said:

"…<u>we don't know what the global economy is going to throw at us. What I do know is that we have the brands, we have the routes to market, we have the people whereby we will navigate through whatever seas we have to.</u> And I would remind everyone that even in the teeth of the downturn in 2008, 2009 we continued to grow this business..." (DB emphasis).

A somewhat categorical statement from the then CEO.

New York November 2011

At a subsequent Diageo investor conference (Nov. 2011), CFO Mahlan said:

"...the key message is that we have now reached an inflection point in our emerging market business after a number of years of investment which has built scale."

"It is by continuing to deliver double digit growth in the emerging markets modest improvement in our performance in Western Europe and driving growth from our leading position in North America that we will deliver our top line guidance."

[8] All quotes in this note taken from transcripts available at www.diageo.com

FY13 results, July 2013

Moving forward a couple of years, during the FY13 results call of 31 July 2013, CFO Mahlan said:

"…we believe our performance this year leaves us on track to deliver our medium term guidance".

And in response to a question, new CEO Menezes[9] said:

"Our confidence in the organic growth of 6% medium term takes into account the world we're operating in, the current economic condition."

"If it continues at this 5-ish-% rate in the emerging market GDP growth, we feel the diversity of Diageo, and the fact that we operate across all these markets, really gives us resilience… and that's what gives us the confidence to hold to the medium-term guidance of organic growth of 6%." (DB emphasis)

Confidence

For over two years Diageo appeared very confident of delivery of its targets and we note was keen to stress that their targets (margin aside) were medium term (as they should be) as opposed to rigid year-in, year-out objectives.

Figure 20: Targets – position after two years

	2012	2013	Cumulative	2yr CAGR	Comment
6% top line growth	6%	5%		5.5%	Behind, but only marginally and Diageo made it clear that top line and EPS targets where medium term
Operating margin 200bps over three years (organic)	60bps	80bps	140bps		On track
Double digits EPS growth	13%	11%		12%	On track

Source: Deutsche Bank estimates; Diageo

Noting the reiteration of medium term guidance was given (very categorically) as late as July 2013, everything changed in November 2013 at a subsequent Diageo investor event in London.

November 2013

Where did that come from?

In his opening remarks at the November 2013 London investor event CEO Menezes said:

"...we need to make changes, quite simply we need to change the culture and step up execution".

In light of the proceeding two years' commentary from senior management and the business delivering against the August 2011 targets the audience was left asking, *"Where did that come from?"*

[9] Ivan Menezes was appointed CEO of Diageo effective 1 July 2013. Mr. Menezes was appointed to the Board in July 2012 in his capacity at that time as COO, a role he was appointed to in March 2012.

The comment was followed by a discussion of the businesses strengths by CEO Menezes (brands, geographic reach, market leading positions etc.) culminating in the observation that to meet its challenges (widespread in the global economy both in developed and emerging markets) and despite the confidence emanating from comments made in July 2013, Diageo was going to address two key issues: execution and culture.

Six MUST DOs

Out of the 'execution' imperative came the Six MUST DOs.

Figure 21: Diageo six "MUST DOs"

Source: Diageo; November 2013 Investor conference, London; replicated in the form presented by Diageo

We discuss the merits or otherwise of the MUST DOs in the following section.

Cultural changes

In terms of the cultural changes CEO Menezes wanted to engender in the business is summarised by two comments from his presentation:

- *"We want owners not tenants"* and
- *"...everyone in Diageo sells or helps to sell".*

The inference of the latter clear and the former requiring greater ownership of decisions and their consequences, implementation times, costs etc.

Following a series of presentations from a various senior managers CFO Mahlan gave the final presentation of the event entitled *Bringing it all together*.

August 2011 targets abandoned

At the end of her presentation CFO Mahlan said:

"In 2011 we gave explicit medium-term guidance especially in respect of the three year outlook for margin expansion. At that point Diageo was making a change to focus on efficient growth after a number of years of investment in innovation, in building capabilities and in building the presence in our emerging markets… We remain committed to delivering efficient growth… We are confident that delivering our ambition will achieve both top tier net sales growth and consistent margin improvement." DB emphasis added.

And with that last statement the guidance of August 2011 was abandoned to be replaced by the underlined sentence above[10].

The subsequent Q&A unsurprisingly spent considerable time discussing the abandonment of medium term targets. In response to the first question, CEO Menezes said:

"What you should read is after the first three years of guidance we are no longer giving specific quantitative guidance. Deirdre's last chart said it all right? We will be a top tier top line performer and deliver consistent operating margin expansion. That is how we would characterize the performance profile of this business going forward…" [Emphasis added]

CFO Mahlan augmented CEO Menezes answer with:

"...overall, our commitment, our ambition is to perform at the top tier of consumer goods companies. And that would of course then take into account all of the macro factors such as the things we're describing today rather than trying to articulate some specific number that may or may not be meaningful in the context of the broader economic environment." (See later comments.)

This stock is going nowhere

A combination of the last comment from CFO Mahlan and the answer to the first question was a real bolt from the blue. The author heard a member of the audience turn to the person to their right and say after the answer to the first question *"This stock is going nowhere"*.

The question

If that statement was reflective of the view in the room those views were generally whispered between colleagues or past unmentioned, unlike a long-standing, highly respected and very experienced peer, who later in the Q & A asked:

"... before these targets were set in 2011... the shares used to trade at a fairly meaningful discount to the consumer staples sector. Explain why that shouldn't be the same again please."

There was an immediate audible reaction: all in the room may have been thinking it, but only one member of the audience asked the question.[11]

---

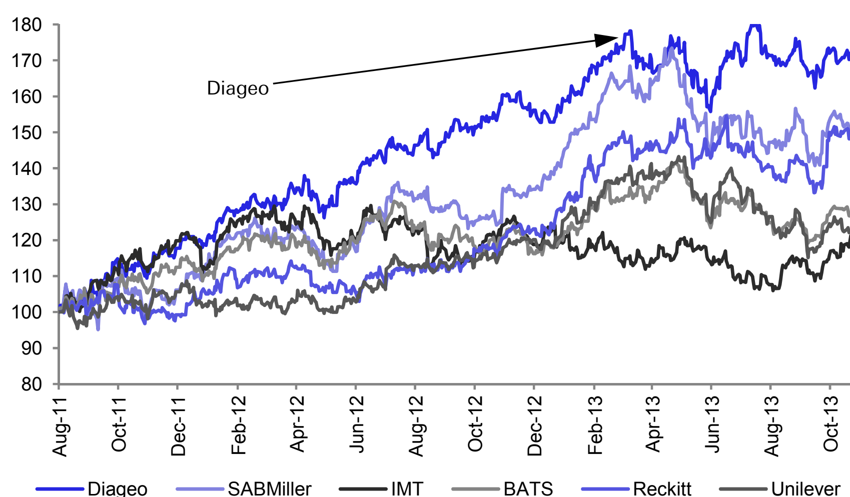
[10] Top tier net sales growth subsequently clarified to mean top quartile net sales growth.

It is extremely rare for any analyst (never mind one as experienced as the individual who asked the question) to be as forthright/aggressive and cross the unwritten rule: 'the company runs the business, the market values the stock'.

Whether it should have been asked or not, what the question did do, in our view, was reflect the mood in the room: one of resounding negativity[12].

In addition, the question indirectly, though somewhat aggressively, highlighted the historical misgivings surrounding Diageo, as manifest in Figure 17 and Figure 18. The room sensed a return to the Diageo of old after a brief, but very profitable, divergence from the past following the setting of the medium term targets in August 2011 (Figure 22).

Figure 22: Share price 25 August 2011 – 18 November 2013



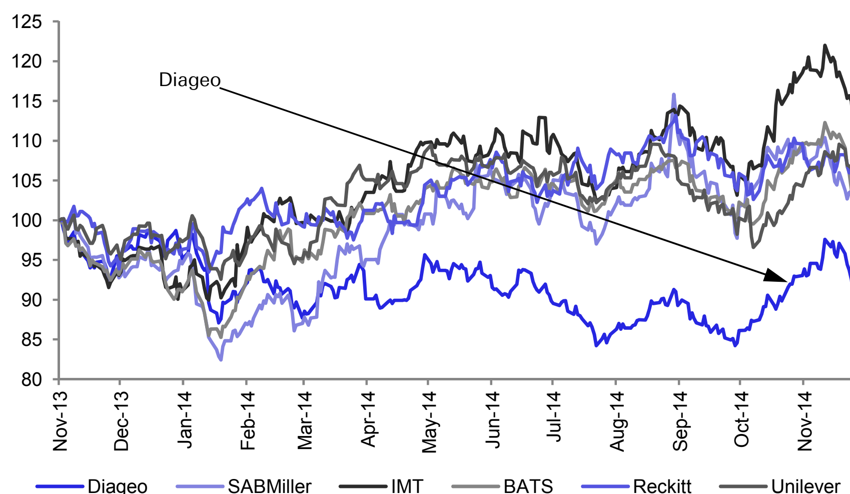
Source: Deutsche Bank; Datastream

And so Diageo did return to the Diageo of the past: the short period of relative share price performance has not survived the post November fall-out, as shown in Figure 23.

[11] The answer to the question, from CEO Menezes was: *"...I would hope if we perform at the top of consumer products, we don't get dinged on our rating. So you know what our ambition is. It's measurable. We're setting the goal and the yardstick pretty aggressively."*

[12] We believe the subsequent negative reaction to the abandonment of targets was compounded by the timing of the announcement within the day. In our view, Diageo should have announced the change in the first presentation possibly with an accompanying RNS (shareholder statement) at 7am that morning fully explaining the changes. Rather than leaving the comments of CFO Mahlan (and the change in guidance) to the end of the day, CFO Mahlan could have followed the initial comments of CEO Menezes a Q&A session at that point. Following this Q&A session Diageo could have moved to the agenda for the day and having established the logic of the removed guidance potentially ended the event on a high note focusing on the positives. As it was people left the room after the final Q&A session with the abandonment of targets (and the subsequent relatively negative Q&A) front and centre in their minds. The abandonment of targets was always going to leave a negative sense from the event, but a change in the order of presentations and messages may have made it less so.

Figure 23: Share price post 18 November 2013



Source: Deutsche Bank; Datastream

August 2011 targets: the results

Appraisal

Before proceeding with an appraisal of Diageo's MUST DOs and establishing a link with them and Figure 23, we first consider the final out-turn of the August 2011 targets noting their abandonment after only two years in November 2013.

Sales

Easy to say now, but 6% was always an aggressive sales target in our view.

Nestlé is an extremely well managed business with an enviable track record of top line growth (5.8% CAGR over 22 years). In aggregate we would not regard its categories as strong as spirits over the long-term (despite exposure to some very high growth markets) but the track-record speaks for itself: yet 'even' Nestlé only targets 5-6% long-term organic growth.

5.5% CAGR for the two years to FY13 was a good performance in our view.

0.4% in FY14 was not (and it was overstated by Argentina and Venezuela).

On the same basis (i.e. including the benefit of high inflation in Argentina and Venezuela) we model organic growth of 4.5% for Nestlé for FY14 (December year end).

Spirits is 'different' in that in the world of FMCG, spirits is very often not particularly 'FM', i.e. fast moving (relatively high priced) with trade inventory levels being a constant distortion both to the up and down-side.

Diageo know that better than anyone yet they set the guidance: a harsh lesson learned.

While hindsight (and we would suggest a modicum of realism) suggests a 6% target was too high, the final out-turn of 3.8% (skewed to two years followed by a very weak third year) is not what a business with geographic breadth and brand strength of Diageo should be aiming to achieve (even over the reasonably short-time frame in the context of staples of three years[13]).

Is there a bail-out for the macro/inventory issue? Maybe, but if so, why did then CEO Walsh say in August 2011:

"…we have the brands, we have the routes to market, we have the people whereby we will navigate through whatever seas we have to."

In this regard we note recent comments from Nestlé CEO Bulcke who, when quizzed on the retention of 5-6% organic growth targets in the current economic environment, took the view that amending targets to outperform a benchmark rather than retention of an absolute figure gave people an excuse to miss targets.

In addition, Bulcke noted benchmark targets for a global leader as per Nestlé (and Diageo) are somewhat meaningless: as global leader you are (and you set) the benchmark.

Excellent point.

In Bulcke's view, better to retain absolute targets, drive to meet them (without undermining sustainability) and even if they are missed, the end result will be better than amending targets to a lower benchmark. Not unreasonable, as long as the messaging is fine-tuned.

Margins

Margin delivery has been nothing other than a success. Not only did Diageo exceed the organic 200bps target it did so despite FY14 organic revenue growth of only 0.4%, still delivering margin growth of 80bps in the year.

EPS

Diageo's EPS guidance was set almost by default, i.e. it was a function of the revenue and margin guidance coupled with the value of debt pay-down. Lower initial revenue targets would have facilitated a lower EPS target.

In our view, no staples business needs to (or should) guide to double digit EPS growth. Of the more highly regarded European staples stocks we note the following:

- Nestlé does not guide EPS growth
- RB does not guide EPS growth
- L'Oreal does not guide EPS growth

In the US, PMI has in the past guided to 10-12% EPS growth but now guides to 8-10%.

---

[13] We recognise three years may be considered the very long-term by a number of readers. Staples are very very long duration assets: three years is not a long-time in the context of brands that last generations.

The cynical (or realistic (?)) analyst would argue Diageo should have guided to high single digit EPS growth (with 8% in mind) and worked back from there to derive a revenue growth target via a less onerous margin target.

Scorecard

We appreciate guidance was abandoned in November 2013 but the fact remains a highly experienced management team set guidance with a fanfare of:

"…we have the brands, we have the routes to market, we have the people whereby we will navigate through whatever seas we have to"

… and missed.

In summary we score the August 2011 guidance as follows:

- Top line growth: Fail
- Operating margin: Pass
- EPS growth: Fail

Figure 24: August 2011 targets – out-turn

Target	FY12	FY13	Cumulative	2yr CAGR		FY14	Cumulative	3yr CAGR
6% top line growth	6%	5%		5.5%	Guidance abandoned Nov 13	0.4%		3.8%
Operating margin 200bps over three years (organic)	60	80	140		Guidance abandoned Nov 13	80	220	
Double digits EPS growth	13%	11%		12.0%	Guidance abandoned Nov 13	2.3%		8.7%

Source: Deutsche Bank; Diageo; FY end is June; Diageo abandoned guidance after two years at London investor day November 2013.

August 2011 targets: too aggressive

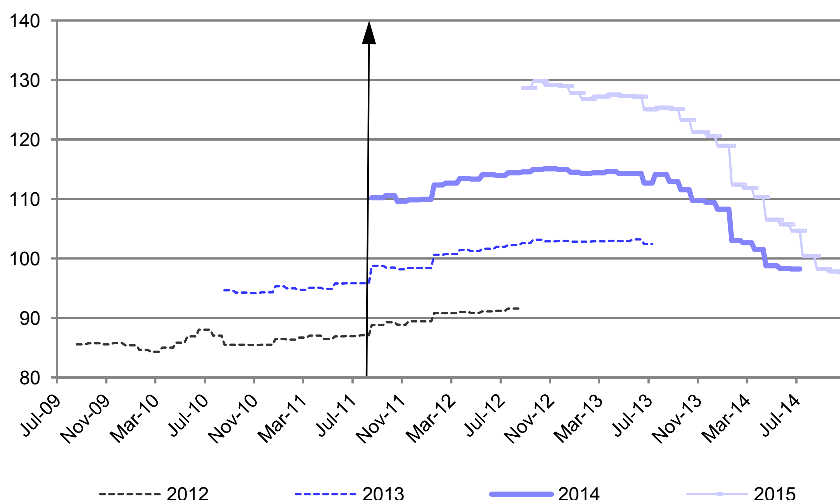
High single digit EPS growth would have sufficed

We discuss the August 2011 targets in further detail in Addendum 1.

Figure 25 shows the EPS revisions of Diageo for FY12, FY13 and FY14. At 24 August 2011 (the day before Diageo released its medium term guidance) the shares closed at 1118p.

On 25 August 2011, the day after the guidance was released the shares closed at 1170p (+4.7%) with the EPS forecasts for FY12E and FY13E seeing an uptick after the results.

Figure 25: Consensus EPS revisions



Source: Deutsche Bank; Datastream, monthly data points are end of month

From Figure 25 and Figure 26 we see that as at 24 August DBe FY11E, FY12E and FY14E forecasts were in line with consensus.

What stands out to us (by some distance) is that prior to the announcement of the FY11 results Diageo was trading on less than 13x FY12E and less than 12x FY13E.

No company, ever, in our view should set targets to justify their current rating, or the rating they want to trade on: companies should categorically strive to run the business to its sustainable maximum and let the share price/rating look after itself.

At any one point the market can misinterpret the value of business but over the long-term, generally the market attributes an appropriate value to most businesses: those companies that try to manage the rating and/or share price invariably come unstuck.

To the extent Diageo felt pressured because of the rating (we don't think it did) it shouldn't have: less than 13x one-year forward was not pricing excessive expectations in our view.

With reference to Figure 26, FY11A EPS was 5.5% ahead of expectations but was largely a function of a 17.4% tax rate against DB's 22.3% estimate. Post results and immediately before publication of H1'12 the shares had risen 27%.

Figure 26: EPS forecasts and ratings at time of August 2011 guidance

		FY11E	FY12E	FY13E	Growth
At 24-Aug-11	Consensus EPS forecast (p)	79.2	87.1	95.9	10.1%
	DBe EPS (p)	78.6	86.6	96.0	10.9%
	DBe vs. Consensus	-0.8%	-0.6%	0.2%	
	Share price (p)	1118	1118		
	P/E (consensus) (x)	12.8	11.7		
		FY11A			
	EPS (p)	83.6			
	Beat vs consensus	5.5%			
			FY12E	FY13E	Growth
At 27-Jan-12	Consensus EPS forecast (p)		89.4	98.5	10.1%
	DBe EPS (p)		91.7	103.3	12.6%
	DBe vs. Consensus		2.6%	4.9%	
	Increase in consensus		2.7%	2.7%	
	Share price 27 Jan 2012		1411	1411	
	Change in share price		27%	27%	
	P/E (consensus)		15.8	14.3	
Increase in P/E			22.9%	22.9%	

Source: Deutsche Bank estimates; Diageo; Datastream

There were upgrades to estimates as shown by the estimates as at 27 January 2012 but these were curtailed by estimates assuming the FY12E and FY13E tax rate would climb to 19.0% (per DBe) from FY11's 17.4%.

We note from Figure 22, page 23 that Diageo outperformed the peer group after announcing FY11 results and establishing the medium term double digit EPS guidance. Within six months of establishing this guidance the P/E had climbed 23% (we recognise from a low base). Critically the outperformance stemmed from an increase in the P/E, driven in our view, to a significant degree, by the setting of aggressive targets in August 2011.

In our view, given Diageo probably had high visibility as to the outlook for FY12 (and probably FY13) and the rating was relatively low, why issue the guidance at all? Never mind at the unsustainably high level of double digit EPS growth which set expectations too high as evidenced by the climbing P/E[14].

With a nod to hindsight, why not issue either no guidance or guidance of high single digit EPS growth over the medium to long-term and then exceed expectations (within the confines of all legal requirements)?

[14] We recognise the P/E has since climbed higher thereby potentially undermining our argument. We disagree. We believe the recent increase in the P/E has been driven by ever lower bond yields, which have seen the majority of staples P/Es climb: the further increase in Diageo's P/E is not a Diageo specific event.

As per Addendum 1, exceed expectations, but not to the extent of 13% and 11% EPS growth as reported in FY12 and FY13: take the higher profit pool and reinvest part back in the business through higher A&P, thereby improving sustainability and ultimately the P/E. Invest today for tomorrow's longer-term upside. The longer term EPS may be lower because of the heightened A&P but:

- the quality the EPS will be higher by function of the A&P spend
- the P/E therefore higher in our view
- the share price at least as high in our view and
- the management of the EPS progression by function of a stronger business through the heightened A&P supporting the top line that much easier.

On the back of 13% EPS growth followed by 11% (two very strong years) all Diageo managed to achieve was matching very high expectations they themselves had set.

In addition, and critical in our view, Diageo ultimately lost control of the shareholder/equity market agenda by function of the excessive targets (as confirmed by their abandonment).

If expectations had been set at high single digit EPS growth we contend:

- From a prospective P/E of less than 13x this would have been deemed 'good enough' by the market
- Diageo would have exceeded expectations in FY12 and FY13 even with additional A&P spend (with EPS growth therefore probably slightly below 13% and 11% respectively in FY12 and FY13)
- Diageo would have retained greater control of their own agenda by
    - Exceeding expectations in FY12 and FY13 (rather than 'just' matching them) and
    - Maintaining caution throughout FY12 and FY13 to set expectations (as best as possible) at an appropriate level for FY14; we recognise FY14 would have still been a (very) difficult year for Diageo to manage expectations.

We move on with one very firm conclusion: double digit EPS guidance was:

- unnecessarily high
- unsustainable over the medium term
- needed to be revised.

CEO Menezes: moved as soon as he could?

CEO Menezes appointed July 2013

Turning to the time line around abandonment of the guidance, though Ivan Menezes became CEO on 1 July, Paul Walsh remained on the Diageo board until end September 2013, leaving the company on 30 June 2014.

Noting companies are required to inform the market of material changes in the business as and when they arise (we regard Diageo as fully compliant) we nevertheless note that with Mr Walsh was on the board when the FY13 results were announced: we suspect amending guidance at that point would have been difficult.

In addition, when announcing FY13 on 31 July 2013, CEO Menezes said in the press release:

"This year we have again made a strong business stronger and we remain on track to deliver our medium term guidance."

IMS'

At Q1 in any year Diageo only comments on organic sales. At Q1'14 Diageo reported 3.1% organic net sales growth against a comp of 5% Q1'13 and 9% Q1'12. In his quoted comments issued with the IMS CEO Menezes said:

"We continue to make this strong business stronger and we remain committed to delivery of our medium term guidance." (DB emphasis)

Working within the confines of the requirement to keep the market informed and 3.1% organic net sales against a two prior years of strong comparatives, we understand why Diageo made no comment on the medium term outlook with the Q1 IMS.

November 2103 Investor Conference

The November investor conference was the ideal and best opportunity to amend what we consider the inflated inherited medium-term guidance of August 2011; the issues surrounding which were compounded by the strong performances of FY12 and FY13, adding to inflated expectations.

To their credit in our view, Diageo took the opportunity, painful though it was; given what CEO Menezes inherited we believe he had little choice.

Termination of the August 2011 guidance only two years post introduction was never going to be elegant. The subsequent fall-out was almost inevitable as epitomised by the valuation discount question referred to above, and the share price performance of Figure 23, page 24.

All-in-all we may conclude CEO Menezes should never have been in the position of inheriting the guidance he did[15]: having inherited it, he exited it as soon as he could.

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[15] At the time guidance was provided CEO Menezes was President, Diageo North America (see later comments)

And so, out of the 'failure' of the medium term targets emerged the six MUST DOs.

The extent to which Diageo should be applauded for exiting the August 2011 targets (targets that should never have been set so high), the success or otherwise of the Six MUST DOs is another matter.

Conclusions

Grow the earnings

At a very high level, based on an analysis of TSRs across UK FMCG companies and their EPS growth there is only one MUST DO for Diageo: unlike the last 15 years grow the EPS at least in line with, and preferably ahead of, the peer group.

2011 targets too onerous

In our view the 2011 targets set by the business, partly out of frustration with the relative share price performance we believe (and relatively high visibility as to FY12 and FY13), were unnecessarily onerous and unsustainable over the long-term.

They subsequently proved to be too onerous over the shorter-term.

CEO Menezes right to abandon targets

We believe Diageo was right to abandon the 2011 targets.

We proceed to now discuss the six MUST DOs noting what we consider as the over-riding MUST DO: grow EPS in line with peer group or better.

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The Six MUST DOs

Summary

MUST DOs

In our view the MUST DOs are the second derivative of what is ultimately of interest to investors: targets aligned to those of August 2011 albeit less onerous and with the addition of a cash metric.

Figure 27: MUST DOs

1. Strengthen and accelerate our premium core brands
2. Win in reserve in every market
3. Innovate at scale to meet new consumer needs
4. Build and then constantly extend our advantage in route to consumer
5. Drive out costs to invest in growth
6. Ensure we have the talent to deliver our performance ambition

Source: Diageo

The MUST DOs represent an articulation of Diageo's strategy (as 'performance drivers') exemplifying how Diageo will deliver its ambition to 'create one of the best performing, most trusted and respected consumer products companies in the world' (2014 Annual Report, page 8).

While the MUST DOs may be very valid from a high level strategic perspective, we see a number of failings in them acting as headline messaging for shareholders:

- Too input focussed; not enough focus on outputs
- No reference to cash: the singularly most important metric in our view
- No tangible metrics assigned to any MUST DO
- No margin targets
- MUST DOs 1-4 all variations on revenue without landing on a metric
- MUST DOs 4 and 6: the day job? Perhaps a harsh assessment, but maybe not an unreasonable one
- No specific mention of underperforming assets such as beer and Guinness.

Abandoning targets altogether following the ultimate malaise of the August 2011 targets may have been the ideal solution for Diageo but given they were originally set only two years before, that was not a realistic option in our view in November 2013: Diageo probably had to maintain targets in some form.

In our view Diageo has fallen between two stools: in attempting to maintain targets they have failed; replacing a set of excessively onerous targets with a set of MUST DOs that are inputs to target outputs, target outputs we no longer have.

Senior management is remunerated on the basis of set targets; it is not unreasonable for the business to set itself targets aligned with senior management objectives.

To be clear, we would be very worried if the two were not aligned.

Meaningful, measurable targets need to be reinstated in our view. We believe these targets (on an organic basis) should be:

- mid single digit top line growth (4-6%)
- steadily increasing margins (some years better than others)
- high single digit EPS growth (7-9%)
- an annual cash metric set by the Board (we recognise this is far from ideal).

MUST DOs

Articulated 19 November 2013

As discussed above, Diageo articulated their six MUST DOs at an investor conference in November 2013. They emerged out of the ashes of the failed medium-term targets; abandoned after just two years. The subsequent share price performance (Figure 23, page 24) has mirrored the bulk of the previous 15 years: underperforming the peer group (Figure 17, page 17).

MUST DOs

Figure 21 page 21 outlines the MUST DOs in the form Diageo presented to shareholders in November 2011, which we show in tabular form in Figure 28.

Figure 28: MUST DOs

1. Strengthen and accelerate our premium core brands
2. Win in reserve in every market
3. Innovate at scale to meet new consumer needs
4. Build and then constantly extend our advantage in route to consumer
5. Drive out costs to invest in growth
6. Ensure we have the talent to deliver our performance ambition

Source: Diageo

Some observations

7 observations

We commence our discussion by considering a number of observations regarding the MUST DOs.

We should preface our observations with the over-riding view that we do not believe the MUST DO's fulfil the requirements of investors.

The August 2011 targets were too aggressive in our view but were at least very tangible, albeit with the glaring omission of a cash based metric. Their replacement MUST DOs too intangible in our view.

We may argue, the (chastening (?)) experience of the August 2011 targets has led Diageo (whether subconsciously or not) to avoid the issue of tangible targets altogether.

1. Inputs; investors want outputs

In our view all the MUST DOs are inputs. From an investor perspective these represent the building blocks by which the outputs of a company are measured: revenue, margins, profits, cash flow over the long-term.

What the MUST DOs do achieve is a sense of Diageo seeking long-term sustainability of the business (as they should given they are an articulation of strategy per the 2014 Annual Report) but all businesses should be doing that as a matter of course.

In our view the MUST DOs are building blocks; the detail. The market wants outputs it can measure and from those, combined with the detail of the inputs, establish a view as to sustainability.

2. Where's the cash

The value of any business is the cash flow it will generate in the future discounted back to today at an appropriate rate.

That's it.

There is one critical over-riding statement in this regard: we assume the cash generated is handed back or reinvested to generate returns above an appropriate cost of capital depending on the investment.

Everything we associate with a business should be driven to that one ultimate aim. If not, something is very wrong.

There is no cash metric in the MUST DOs: we struggle with that omission – a lot.

3. No tangible metrics

While the metrics of the 2011 targets were too excessive we have flipped too far the other way in our view; to now having no targets other than the broad statement of targeting top quartile net sales growth.

When presenting the MUST DO's CEO Menezes gave some additional colour as to metrics in some instances, but nothing we consider sufficiently tangible for the equity investor (see Figure 29).

Figure 29: MUST DO's – additional details

MUST DO	'Metric'
1. Strengthen and accelerate our premium core brands	In every market: grow brand equity; grow value market share; raise prices
2. Win in reserve in every market	No specific additional detail
3. Innovate at scale to meet new consumer needs	The number of sustainable significant innovations
4. Build and then constantly extend our advantage in route to consumer	Increase sales forces, optimise outlet coverage, improve growth driver activation and drive efficiencies in distributor and wholesale returns and in logistics
5. Drive out costs to invest in growth	No specific additional detail
6. Ensure we have the talent to deliver our performance ambition	No specific additional detail

Source: Deutsche Bank; Diageo, 19 November 2013

4. No margin targets

Ironically, the one August 2011 target Diageo met is now replaced with MUST DO #5, and what we consider a weak statement: 'drive out costs to invest in growth'.

The author's 16 year-old son (pre-occupied with Saracens RFC, Arsenal FC, the prospect of the pub in two years time and girls (not necessarily in that order)), has little regard for the ins and outs of global business but would nevertheless likely respond to the desire of a business to drive out costs and invest in growth with the comment: no kidding dad[16]. Quite.

5. 1-4 are all revenue ambitions

MUST DOs 1-4 replace August 2011's one tangible revenue target with a series of more detailed imperatives with no metrics.

6. The day job

At the risk of undermining the importance of both to any business (not our intention) we struggle with route to consumer (#4) and talent (#6) as MUST DOs: we see them as part of the 'day job' for any global consumer goods business of the stature of Diageo.

Many would take their inclusion as MUST DOs a negative in that they will be seen as a 'matter of course' for any major business: requiring them to be MUST DOs perhaps suggests some failing in these areas on Diageo's part.

7. No specific mention of beer/Guinness

While the requirement to grow in beer and, in particular, Guinness falls under the catch all MUST DO of strengthening and accelerating premium core brands we nevertheless believe the performance of the beer business warrants a specific MUST DO. We discuss this in more detail later.

Is there a need for targets?

No targets: too simplistic

We have a relatively high degree of sympathy with the view that no business should be bound by targets (even medium/long-term) and to the extent targets exist they should be relatively broad (Nestlé springs to mind) and we note Unilever abandoned targets with the appointment of Paul Polman as CEO in 2009.

Problem is that statement is too simplistic; if not naive.

With reservations, on balance we consider the complete abandonment of targets as unrealistic for Diageo:

- Targets were only originally set in August 2011: they may have been too onerous but by abandoning them after two years, especially when they had been delivered, was poor in our view.

[16] In reality his vernacular would be somewhat more 'Anglo-Saxon' in nature (blame his mother; we're still married – 19 years - maybe not for much longer if is she reads this.)

By setting the targets as recently as August 2011 it would have been very reasonable for the investor in November 2013 to assume they would be retained. The targets may have been inherited by CEO Menezes but on 31 July 2013 he said:

"This year [FY13] *we have again made a strong business stronger and we remain on track to deliver our medium term guidance."* [Emphasis added]

- At the time of setting the targets, CEO Menezes may not have been CEO but he was President, Diageo North America, chairman Diageo Asia Pacific, chairman Diageo Latin America and Caribbean and a member of the Executive committee. CFO Mahlan was CFO at the time and on the Board as she is today. In our view, while neither occupied the role of CEO, we find it difficult to envisage a situation where both were not aligned to the adoption of targets in August 2011
- While spirits may be the most macro exposed of all staples categories, we nevertheless believe the relative stability of spirits warrants targets, noting all targets will be assessed on a medium to long-term basis with no commitment to any one year hitting the targets.
- The majority of staples companies employ some form of targets, though we concede not all and to varying detail
- Albeit coinciding with a weak performance in 2014, the abandonment of targets has hardly coincided with a particularly strong share price performance relative to the peer group (see Figure 23, page 24)
- Finally.... what's good for the goose is good for the gander...

What's good for the goose

Management remuneration

Management is remunerated in relation to targets so why not articulate a form of those as targets for the business as a whole and present them to the shareholders as a means by which the performance of the business may be assessed?

We struggle to argue against that.

Long Term Incentive Plan

In the remuneration report of the 2014 Annual Report the 2015 Long Term Incentive Plan (LTIP) for senior management (vesting over three years) is as outlined in Figure 30.

Figure 30: LTIP year ending 30 June 2015

		Performance shares		Share options	
	TSR (25%)	Organic net sales (GAGR) (25%)	Organic operating margin improvement (25%)	Adjusted EPS growth (CAGR) (25%)	Vesting profile
Threshold	Median ranking (ninth)	4%	125bps	6%	20%
Mid-point	-	5.5%	175bps	-	60%
Maximum	Upper quintile (third or above)	7%	225bps	11%	100%

Source: Diageo

We note net sales CAGR (threshold to maximum) is 4-7% and adjusted EPS 6-11%: much more reasonable and with a greater recognition of sustainability than the August 2011 targets in our view.

In addition, we also note the 2014 Annual Report states these targets were defined *"in the light of shareholder feedback"* (2014 Annual Report, page 75) and they resonate with our independently derived later conclusions as to what Diageo's targets should be.

No comment

As an aside, and with reference to Figure 17, page 17, we note the inclusion of RB, SABMiller and Unilever as peers for the TSR component of the LTIP. Two other UK FMCG companies, BAT and Imperial, are not included. Again with reference to Figure 17, page 17: no comment.

Annual Incentive Plan

The details of the targets of the 2015 annual incentive plan (AIP) are not disclosed on the 2014 Annual Report for commercial reasons; but the out-turn for 2014 was disclosed.

We note the use of a cash metric in the AIP and its glaring omission either in the August 2011 targets or November 2013 MUST DOs.

The omission should be addressed in our view.

Figure 31: FY14 AIP outcome

Measures	Weight	Target set	Result achieved	% of maximum bonus paid (weighted)
Net sales (% growth)	30%	6.0%	0.80%	0.0%
Profit before exceptional items and tax (% growth)	30%	11.7%	8.30%	7.6%
Free cash flow	10%	£1,840m	£1,640m	0.0%
Average working capital as a percentage of sales	10%	4.7%	6.8%	0.0%
Individual business objectives	20%	A range of objectives linked to individual contribution and medium term strategic goals, delivery of M&A integration performance and compliance	partially met	1.3%
				8.9%

Source: Diageo

We note the application of cash targets on annual basis in the AIP but no cash targets in the LTIP.

We struggle with that; a lot.

We note the variability of cash on annual basis given the working capital requirements of the business. That said, the value of any business is the cash it generates with cash required to pay the dividend, invest in capex, and in the case of spirits companies, potentially high levels of working capital.

Cash metrics should be applied to the LTIP in our view.

Diageo could not abandon targets; but MUST DOs not fill the void

We take the view, from a position of relative weakness, Diageo was in no position to totally abandon targets.

Diageo will undoubtedly insist it hasn't abandoned targets given the MUST DOs, which are aligned to the group's strategy (see pages 8-15 of the 2014 Annual Report).

While that may be the case, we nevertheless argue the lack of associated metrics and the MUST DOs being inputs rather than outputs, leaves them less than helpful from an investor perspective.

Again we refer to the valuation discount question at the November 2013 investor event in London, which, in our view, neatly sums up the market reaction to the abandonment of targets.

Internal vs. External?

Talking to the internal as much as the external audience

We note with some interest CEO Menezes comment when announcing the MUST DOs in November 2013:

"...we need to make changes; quite simply we need to change the culture and step up execution."

We believe the market underestimates the extent to which companies, when ostensibly presenting to investors, are as much talking to the internal as external audience. When we see comments such as the above from CEO Menezes, we are all but convinced this is the case.

One very valid conclusion as to the reason why the MUST DOs have fallen between two stools is the desire of Diageo to externalise internal priorities with the aim of providing them with (an even greater) degree of import, credibility and focus internally.

We get that; but not the coincidental consequence of no tangible external targets. In our view, the over-riding aim of achieving external measurable, deliverable targets has been lost.[17]

[17] The main reason why internal targets often differ from external is they have to be tailored to outcomes that are deliverable at the 'micro' internal level. External metrics (as we advocate) are typically too 'macro' for a manager (even at a relatively senior operational level) to have a material individual influence upon. As a result, external metrics are taken to the second, third or even fourth derivative as a means to measure internal performance. We believe the MUST DOs have landed the market with the second derivative, not the higher level 'macro' external targets required of shareholders.

Targets: the DB version

Four tangible, deliverable, measurable targets

In our view Diageo's medium to long term organic targets should comprise:

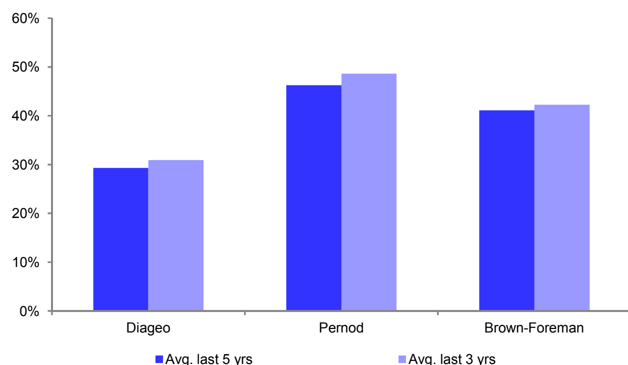
- mid single digit top line growth (4-6%)
- steadily increasing margins (some years better than others)
- high single digit EPS growth (7-9%)
- free cash flow and average working capital metrics set annually by the Board, performance against which to be reported at the end of the financial year.

Cash metrics

We totally understand the cash metric outlined above is less than ideal.

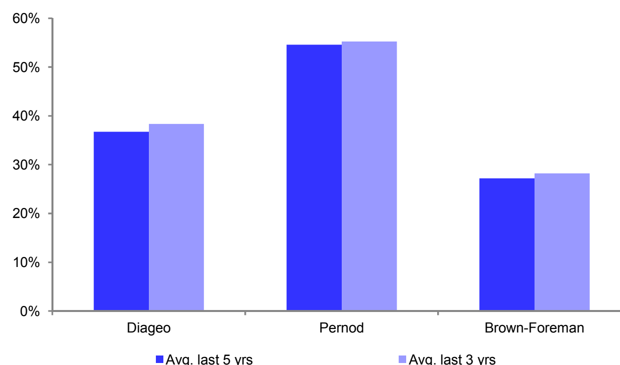
The position is compounded (and explained) by the relatively weak cash metrics endemic in the spirits industry, not restricted to Diageo, as outlined in Figure 32, Figure 33 and Figure 34.

Figure 32: Operating working capital:sales



Source: Diageo; Pernod; Brown Forman; Deutsche Bank estimates

Figure 33: Inventory:sales



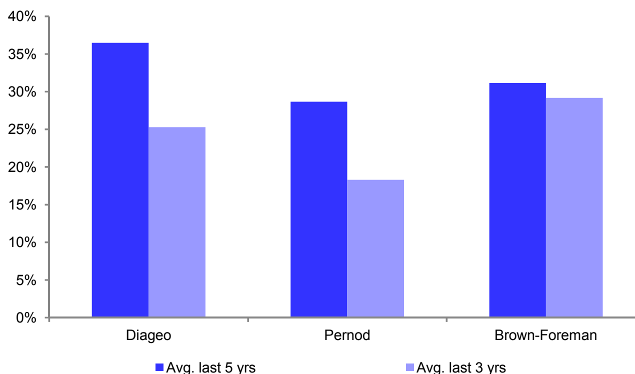
Source: Diageo; Pernod; Brown Forman; Deutsche Bank estimates

Brown spirits are different to the vast majority of other staples categories: they need to be 'laid down' for multi-year periods in many instances, with companies having to assess long-term demand and plan accordingly (clearly all brown spirits exposed companies believe in long-term growth hence the inherent laying down).

While there is an underlying belief in growth, growth expectations fluctuate: as a consequence already high working capital demands are complicated by continually changing.

We note that in setting the 2015 annual targets for management (including cash) Diageo's said in the 2014 Annual Report:

Figure 34: Cash conversion



Source: Diageo; Pernod; Brown Forman; Deutsche Bank estimates

"Details of the targets for this performance period will be disclosed retrospectively in next year's annual report on remuneration, as soon as they are no longer deemed commercially sensitive by the Board."

Not ideal but we understand the point.

Given the variable nature of working capital and the changes that can take place year to year we are prepared to accept (surprising ourselves somewhat) that annual cash metrics should be set by the Board, the performance against which is reported after the event.

Compounding

Predictable compounders

Staples are relatively predictable businesses, which can leverage

- growing populations,
- growth in global GDP,
- innovations to drive improved mix and
- inflation

to grow the top-line by mid-single digit percentages sustainably year-on-year.

Coupled with:

- margin improvements (in part through mix and heightened scale)
- leverage of the balance sheet (perhaps coupled with a buy-back depending on leverage) and
- bolt-on M&A

top line growth should convert to sustainable EPS growth of high single digits per annum.

Clearly running a global business is more complex (as Diageo will testify) but the broad principle holds as a starting point for how most staples categories can perform.

Is 8% EPS growth enough? Coupled with a 3% dividend yield (reinvested) and a stable P/E (and therefore dividend yield) this simplistic model compounds at 11.2% pa.

Exciting? Some may think not.

Well, it compounds to grow the value of the investors stake by c70% over five years.

Will some other stocks provide more? Some probably will.

Will those same stocks do so the over the following five years?

That is where the value of the staples compounding model comes into play and does so with likely considerably less volatility than many other sectors that manage to match staples over the long-term.

Figure 35: Compounding and TSR

	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5	CAGR
Earnings per share (p)	10	10.8	11.7	12.6	13.6	14.7	
P/E (x)	20	20	20	20	20	20	
Share price (p)	200	216	233	252	272	294	
EPS growth		8%	8%	8%	8%	8%	
Dividend growth		8%	8%	8%	8%	8%	
Dividend yield	3%	3%	3%	3%	3%	3%	
Shares owned	50,000	51,500	53,045	54,636	56,275	57,964	
Dividend per share (p)	6.0	6.5	7.0	7.6	8.2	8.8	
Dividends (£)	3,000	3,337	3,712	4,130	4,594	5,110	
Shares bought from reinvested dividend	1,500	1,545	1,591	1,639	1,688	1,739	
Value of stake (£)	100,000	111,240	123,743	137,652	153,124	170,335	11.2%
5 year growth						70.3%	

Source: Deutsche Bank

Conclusions

In summary, Diageo had the option in August 2011 to not adopt specific targets; but it did... and they were too aggressive.

While we believe Diageo was right to abandon these targets we nevertheless think it was wrong to replace them with a set of inputs and not outputs as the means by which shareholders can assess performance.

We note the use of metrics for executive remuneration based on sales, margins, EPS and, for the AIP, cash.

In our view external targets for the business should be aligned with the basis of executive remuneration (noting the input from shareholders to executive remuneration).

We note the 2015 LTIP targets are less aggressive than the August 2011 targets and therefore better support sustainability: we believe they should form the base of long-term externalised targets for the business.

In our view Diageo’s medium to long term organic targets should comprise:

- mid single digit top line growth (4-6%)
- steadily increasing margins (some years better than others)
- high single digit EPS growth (7-9%)
- an annual cash metric set by the Board.

Staples work as investments over the long-term because of their compounding characteristics. Compounding EPS at 8% and reinvesting a dividend of 3% (Diageo’s yield) provides a more than adequate long-term return in our view.

Five MUST DO alternatives

Summary

Subservient to targets

Assuming targets aligned to our suggestion are reinstated (perhaps a major assumption now they have been abandoned) we do not believe Diageo needs to subsequently articulate MUST DOs as a key external measure. We recognise their importance from a strategic perspective (notwithstanding we have alternatives). Given their strategic importance we believe they should be used as part of consistent messaging by Diageo rather than centric to the story: reinstated targets become the centre piece of the story.

If Diageo persists with the MUST DOs either because they sit alongside targets or because they are retained in the absence of targets, we believe they need to be more tangible.

Figure 36 summarises our alternative MUST DOs.

Figure 36: DB alternative MUST DOs for Diageo

Source: Deutsche Bank

Increase gross margins annually

In 2011 CFO Mahlan rightly emphasised the importance of gross margins and the need for them to progress after a number of years with no growth. Progression in FY12 and FY13 coincided with superior EPS growth. In our view Diageo needs to retain its focus on gross margins.

Grow premium core (and reserve) ahead of the group average

Growing premium core (and reserve brands) will help facilitate growth in gross margins. As premium core and reserve improved their performance in FY12 and FY13 so did gross margins.

Aligned with the emerging market MUST DO we have some concerns as to the relative growth profile of brands such as Johnnie Walker when compared to the peer group. Johnnie Walker appears to have been supported by Diageo's reach in emerging markets. In developed markets it has materially underperformed Jack Daniels: Diageo needs to address the developed market performance of Johnnie Walker in our view.

Fix beer/Guinness in three years

Beer is c20% of group revenues (including Guinness); Guinness is c10% of group revenues. Both beer and Guinness have been consistent relative underperformers within Diageo in recent years.

We accept the argument of superimposing 100% spirits businesses on the majority owned distribution network of beer in emerging markets. That said, ultimately as markets mature we see the value of combined distribution as open to debate.

Notwithstanding the value of superimposing a 100% owned spirits operation on a majority owned beer business in emerging markets that does not alleviate the need for the beer businesses to perform standalone. Diageo's beer and Guinness businesses haven't in our view... that needs to change.

Grow North America at least 4% pa

North America is over a third of Diageo's sales. While relatively mature with some difficult aspects (Guinness, vodka pricing) long term demographic trends are very favourable and margins are materially above the group average. In order to meet our targets and noting potentially long-term subdued growth in Europe, Diageo needs to grow revenues at least at the bottom of our 4-6% pa target range in North America.

In addition, as recent macro events have highlighted, the value of growing hard currency earnings should not be underestimated.

Grow EM sales ahead of the group average

We estimate emerging market sales are c40% of Diageo's business. We see significant long-term upside in spirits in emerging markets (see our pan-staples note, *Emerging Exposure,* March 2014 highlighting the potential of whisk(e)y and vodka). Emerging markets remain a core long-term growth driver for all staples: spirits and Diageo are no exception.

From targets to MUST DOs

MUST DOs the drivers behind the targets

In our view it is important not to confuse the MUST DOs with targets; at least when communicating with shareholders.

In order to provide goals that are credible with investors we believe they need to take the *form* of the August 2011 targets with the addition of a cash metric.

As we have previously argued in this note, we see the targets as the main criteria by which Diageo will be measured by investors with the MUST DOs a derivative of those targets, serving as drivers to ensure delivery... aligned with the group strategy as the current MUST DOs are, albeit we believe the MUST DOs should change.

We understand the desire of Diageo to abandon targets (we have a degree of sympathy); but in our view reinstated targets will form the basis by which Diageo is measured, not the relatively intangible inputs which currently form the MUST DOs.

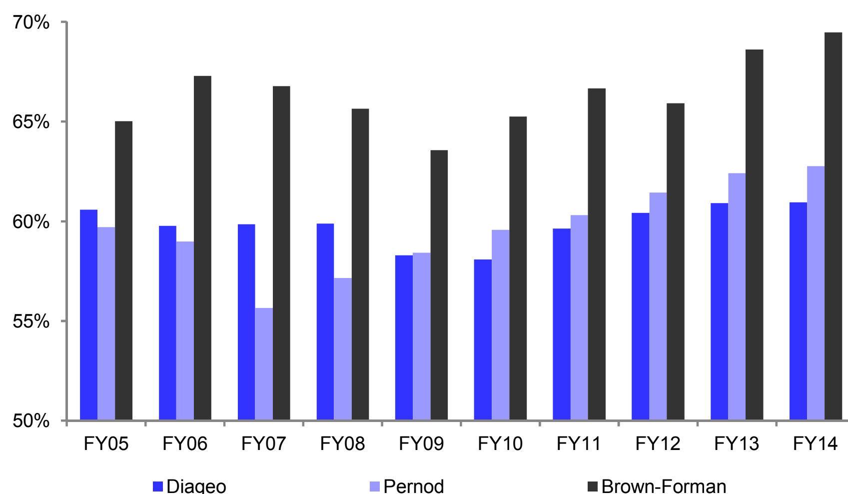
That said, were Diageo to maintain external MUST DOs (perhaps to reinforce their internal importance) we believe they should be amended as we outline below.

DB MUST DO #1: Increase gross margins annually

Limited gross margin progression

Figure 37 shows the gross margins of Diageo, Pernod and Brown-Forman since FY05. Figure 38 shows the change in each year and the aggregate change over the period.

Figure 37: Gross margins FY05-FY14

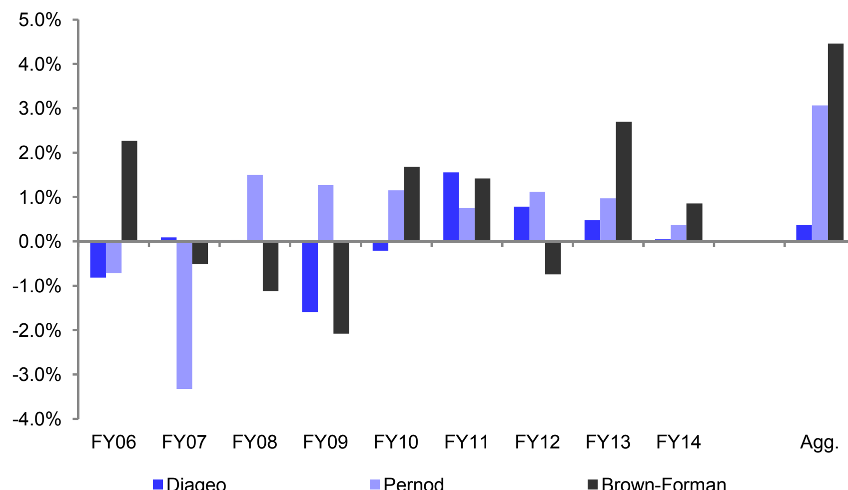


Source: Diageo; Pernod; Brown Forman; Deutsche Bank estimates; Diageo & Pernod June YE, Brown-Forman April YE

Recognising the changes in business over time (e.g. Pernod acquiring Absolut in July 2008, the growth of Chinese cognac) and differing models (beer being a major component of Diageo's business) Diageo's gross margins have nevertheless only increased by 40bps over nine years. Pernod's have climbed 310bps and Brown-Forman's 450bps.

From a low in FY07 of 55.7% Pernod's gross margins have climbed 710bps. Brown-Forman's gross margin low over the period was 63.6%, from which gross margins have climbed 590bps. Diageo's gross margin low was 58.1% in 2010, since when gross margins have climbed 290bps.

Figure 38: Change in gross margin



Source: Diageo; Pernod; Brown Forman; Deutsche Bank estimates; Diageo & Pernod June YE, Brown-Forman April YE

We favour Diageo over Pernod given

- Pernod's exposure to Chinese cognac
- Pernod's greater exposure to the high inflation markets of Argentina and Venezuela
- Pernod's relatively weak cash generation (though as we have seen, Diageo's is far from strong).

That said, we have to recognise that on the key metric of gross margins (despite the slow-down in China in 2014) Pernod has materially outperformed Diageo over an extended period and did so 'even' in 2014 despite Chinese cognac (as did Brown-Forman).

Figure 39: Change in gross margin 2014

	2014
Diageo	0.0%
Pernod	0.4%
Brown-Forman	0.9%

Source: Diageo; Pernod; Brown Forman; Deutsche Bank estimates; Diageo & Pernod June YE, Brown-Forman April YE

At the November 2011 Investor Conference CFO Mahlan noted that gross margin had increased in spirits and declined in beer as the beer business moved from Europe to Africa meaning margins had been broadly flat FY06-FY11 (+10bps over the period).

The decline in gross margins in FY09 and FY10 (see Figure 37) was attributed to consumers trading down and heightened promotional and competitive activity. CFO Mahlan noted a gross margin improvement in emerging markets over time with the key message of the presentation being:

"... we have now reached an inflection point in our merging market business after a number of years of investment which has built scale".

Post FY11, gross margins have improved but 'only' by 130bps. Over the same period Pernod has improved gross margins by 250bps and Brown-Forman by 280bps.

Figure 40: Gross Margins FY11-FY14

	FY11	FY12	FY13	FY14	Change
Diageo	59.6%	60.4%	60.9%	60.9%	1.3%
Pernod	60.3%	61.4%	62.4%	62.8%	2.5%
Brown-Forman	66.7%	65.9%	68.6%	69.5%	2.8%

Source: Diageo; Pernod; Brown Forman; Deutsche Bank estimates; Diageo & Pernod June YE, Brown-Forman April

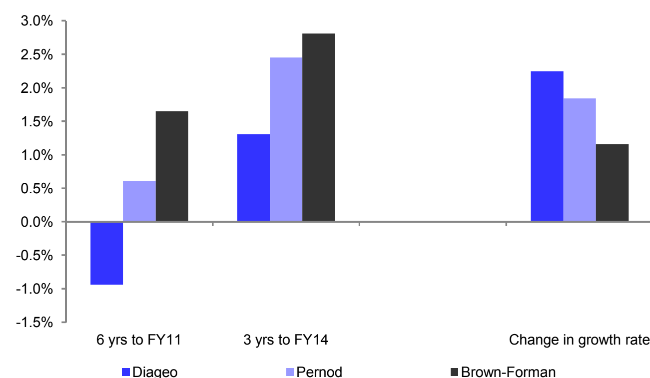
August 2011 an inflection point?

Though Diageo's rate of gross margin progression has been below that of Pernod and Brown-Forman's (and was flat FY14 vs. FY13) we can point to some progress.

In the six years to FY11 Diageo's gross margins fell 90bps (from 60.6% to 59.6%). Despite solid top-line growth the then 'Global Priority Brands' underperformed the non-priority brands with the non-priority brands accounting for the majority of growth; therefore undermining gross margins.

Diageo's gross margins increased 130bps following CFO Mahlan's comments in November 2011. Against the previous six years decline of 90bps in gross margins that is an improvement in the growth rate of 220bps.

Figure 41: Gross margin progression



Source: Diageo; Pernod; Brown Forman; Deutsche Bank estimates; Diageo & Pernod June YE, Brown-Forman April

The gross margin improvement for Pernod and Brown-Forman over the same period has been 180bps and 120bps respectively.

Recognising stable margins in FY14, we do believe Diageo is heading in the right direction with a focus on brands that provide incremental improvements to gross margins, i.e. what are now called Premium Core and Reserve brands. Diageo should continue along the same path in our view.

Accordingly, we move on to DB MUST DO #2.

DB MUST DO #2: Grow premium core (and reserve) ahead of the group

Pre FY14

Prior to FY14 Diageo focussed on a group of 'strategic brands'. These brands contributed 57% of FY13 volume and net sales.[18] The brands listed as Strategic were: Johnnie Walker, Crown Royal, J&B, Buchanan's, Windsor, Bushmills, Smirnoff, Ketel One, Ciroc, Captain Morgan, Baileys, Tanqueray and Guinness.

Premium Core/Reserve

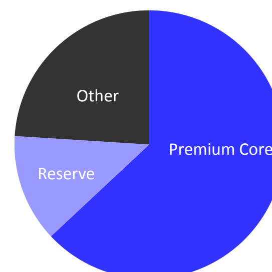
Diageo now splits the business into Premium Core, Reserve and 'Other' brands.

[18] FY13 Annual Report & Accounts

The 2014 Annual Report state Johnnie Walker, Crown Royal, J&B, Buchanan's, Windsor, Bushmills (sold as part of the deal to buy the balance of Don Julio), Captain Morgan, Smirnoff, Ciroc, Ketel One, Baileys, Don Julio, Tanqueray and Guinness comprise approximately two-thirds of net sales, which we subsequently understand is closer to 60%.

Ciroc, Ketel One and Don Julio are classified as Reserve brands. The remainder (Johnnie Walker, Crown Royal, J&B, Buchanan's, Windsor, Captain Morgan, Smirnoff, Baileys, Tanqueray and Guinness) comprise the bulk of the Premium Core brands.

Figure 42: Diageo 2014 sales by brand classification



Source: Deutsche Bank estimates; Diageo

Even with the sale of Bushmills, we estimate these remaining Premium Core and Reserve brands listed above still comprise the same proportion of sales (c60%). When announcing the sale of Bushmills as part of the Don Julio transaction Diageo stated Bushmills sales were £57m, being 0.6% of group FY14 sales replaced by an additional £39m of sales (from previously non-accounted Don Julio sales by Diageo and the return of Mexican Smirnoff sales).

We estimate total Premium Core and Reserve brands (i.e. including those listed above with the addition of others not listed above, such as Singleton, Talisker, Bulleit and Zacapa in reserve) represent c75% of group sales per Figure 42.

All about the gross margin

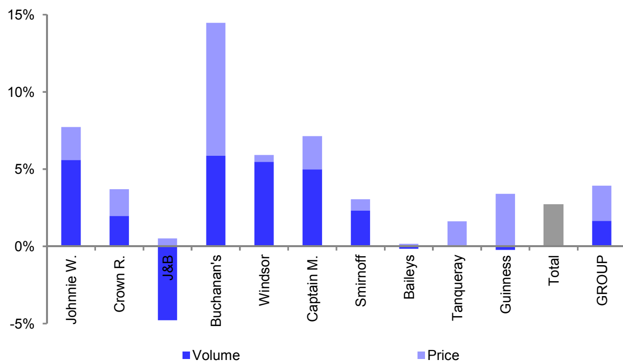
Aiming to grow c75% of the business (all Premium Core and all Reserve brands) faster than c25% of the business may be an obvious target for any business.

But it is only an obvious target if the c75% is at a sustainably superior gross margin than the c25%.

As noted above, in November 2011 CFO Mahlan said there would be an inflection in gross margins (i.e. post the end of the FY11 year in June 2011). In Figure 43 we show that 10 brands now classified as Premium Core (and therefore attaining high gross margins) grew 2.7% on a weighted basis over the five years to 2011 and the group at 3.9% implying brands beyond those shown in Figure 43 grew in excess of 5% per annum, and, in aggregate, at a lower gross margin.

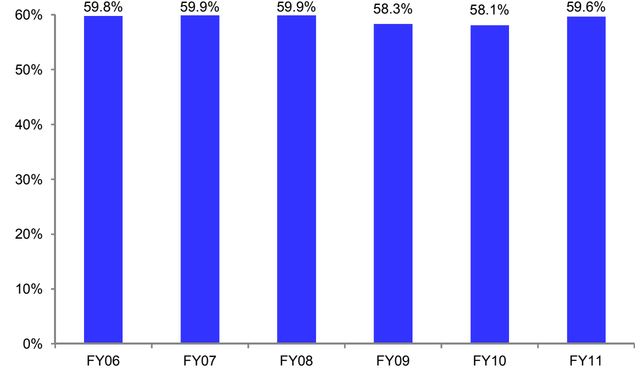
Based on Figure 44 our relative gross margin assertion appears very reasonable: while the then termed Strategic Brands were growing below the group average the group gross margin fell 20bps. As we have seen above, over this period Diageo's gross margin performance materially underperformed Pernod's and Brown-Forman's.

Figure 43: Premium core revenue (5 year CAGR to 2011)



Source: Diageo; Deutsche Bank estimates; Total is weighted and is total growth for the brands shown (not split volume and price); growth is organic

Figure 44: Diageo gross margins



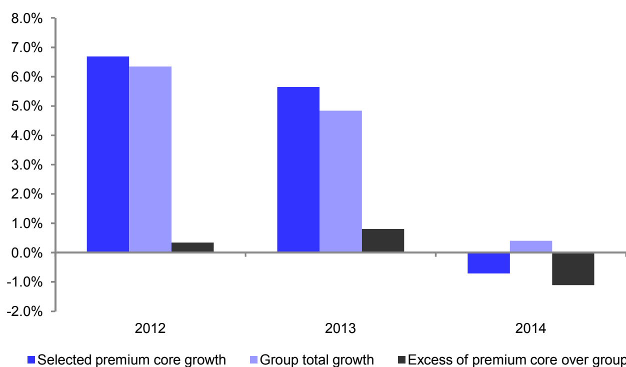
Source: Diageo; Deutsche Bank estimates; selected premium core growth is as per brands in Figure 43; growth is organic

What has happened since 2011 with CFO Mahlan's assertion that group margins had reached an inflection point?

Figure 45 shows the 10 Premium Core brands of Figure 43 have grown faster than the group with the exception of FY14.

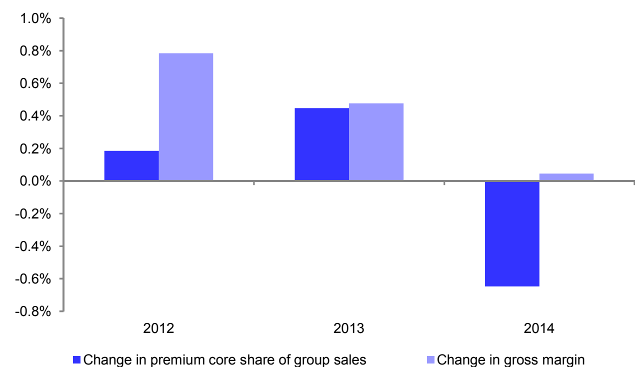
We then see in Figure 46, as the 10 Premium Core brands climb as a proportion of the group in FY12 and FY13 that the group gross margin climbs higher. In FY14 when the proportion of the group from the 10 Premium Core brands declines we see the group gross margin reverts to the themes of Figure 43 and Figure 44: inferior growth from higher gross margin brands impacting group gross margin progression.

Figure 45: Premium core and group revenue growth



Source: Diageo; Deutsche Bank estimates; selected premium core growth is as per brands in Figure 43; growth is organic

Figure 46: Premium Core revenue and gross margins



Source: Deutsche Bank

Reserve

Reserve brands in total comprise 13% of total sales in 2014 with Ciroc, Ketel One and Don Julio sales disclosed as part of the brands comprising around two-thirds of group sales noted above.

Figure 47: Selected Reserve brands organic revenue growth

	2012	2013	2014
Ciroc	62%	8%	2%
Ketel One	9%	8%	6%
Don Julio	26%	13%	27%
Group organic growth	6.3%	4.8%	0.4%

Source: Diageo

Alongside Premium Core brands beginning to take a greater share of the overall group, Figure 47 shows these key brands are also growing ahead of the group average thereby supporting long-term gross margin progression.

It appears clear that with the August 2011 commitment to focus on gross margins CFO Mahlan identified one of the key reasons why Diageo had underperformed the peer group historically.

Higher gross margins in FY12 and FY13 coincided with superior sales, operating margin and EPS growth.

To state the obvious: gross margins are critical and Diageo, notwithstanding FY14, is now highly focused on the issue. An existing focus on gross margins does not make them any less of a MUST DO in our view, rather it means having gotten the focus it may be easier to retain it: it isn't (and will be in our view) any less important to focus on gross margins.

Not all plain sailing

While the performance of premium core has been strong recently we note Diageo has not had it all its own way.

Figure 48 shows the growth of Johnnie Walker compared to Jack Daniels. Johnnie Walker has outgrown Jack Daniels but the growth of Johnnie Walker has been driven by emerging markets.

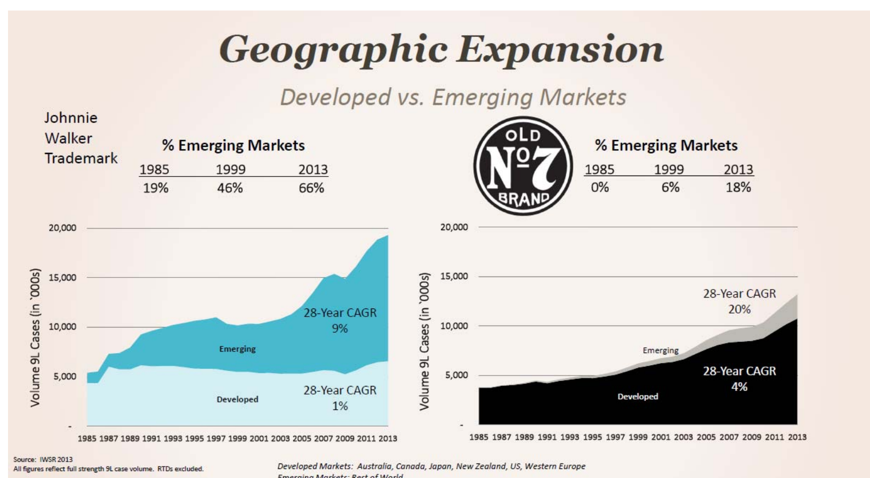
That of itself is fine but we note the relative performance in developed markets. Noting the y-axis is the same for both companies Figure 48 shows that Brown-Forman has significantly grown Jack Daniels in developed markets, materially outperforming Johnnie Walker in these markets, and has only just begun to expand the brand in emerging markets.

Given the geographic profile of Diageo we may conclude that existing distribution in emerging markets has been key to its success and maybe, the brand and marketing of it less so.

We will monitor the relative performance of Johnnie Walker and Jack Daniels in developed and emerging markets with interest: Figure 48 would suggest Diageo and the Johnnie Walker team have some work to do to when compared to Brown-Forman and Jack Daniels.

We now turn to DB MUST DO #3.

Figure 48: Brown-Forman investor day December 2014



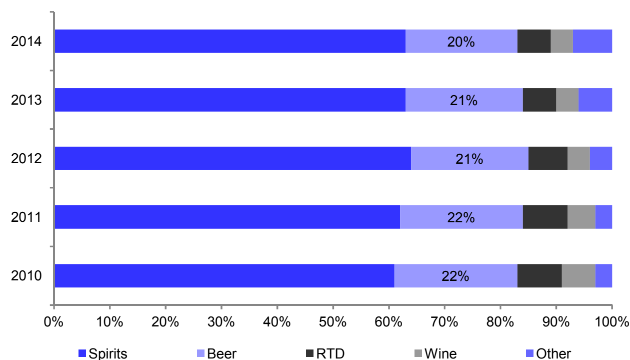
Source: Brown-Forman

DB MUST DO #3: Fix beer/Guinness in 3yrs

Beer: c20% of the business; Guinness c10%

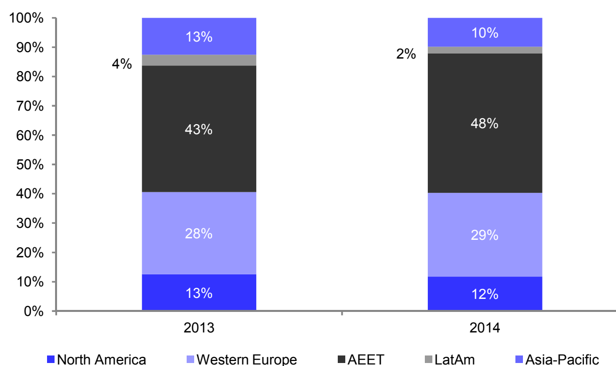
Beer represents c20% of group sales in 2014 with Guinness approximately half those sales. Western Europe and Africa are the key regions.

Figure 49: Diageo split of business by sales



Source: Diageo; Deutsche Bank estimates

Figure 50: Beer sales split by region



Source: Diageo; Deutsche Bank estimates

The UK and Ireland dominates Western Europe and in Africa the major markets include Nigeria, Kenya, Cameroon and South Africa.[19] In Figure 51 we show the proportion of each region's sales from beer. Africa, Eastern Europe and Turkey are most reliant on beer with Africa is the most reliant on beer (by some distance) within AEET.

[19] Regional disclosure on former basis as detailed breakdown of beer under the new regional disclosure is unavailable.

Figure 51: Beer as a proportion of each regions sales (£)

	2013	2014
North America	8%	7%
Western Europe	30%	27%
AEET	45%	47%
LatAm	6%	4%
Asia-Pacific	18%	15%

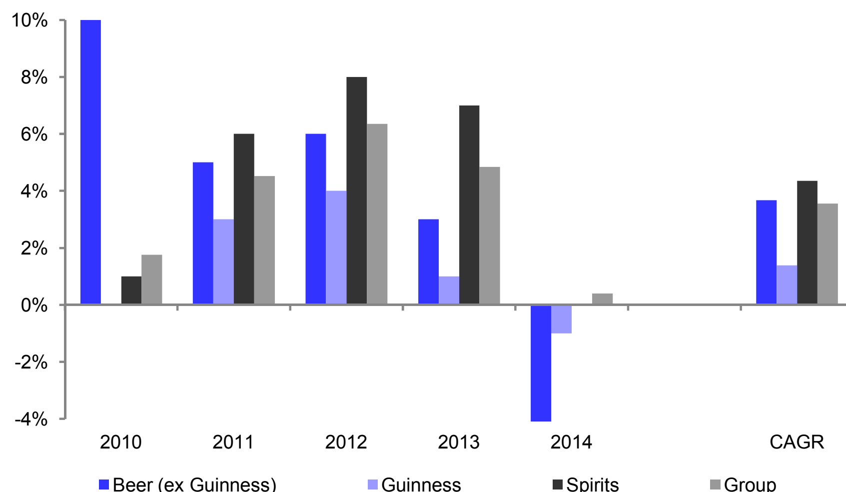
Source: Diageo; AEET is Africa, Eastern Europe and Turkey

Organic growth

Figure 52 shows the organic growth for the group split between beer (ex Guinness), Guinness, spirits and the group. We can make a few observations:

- Beer (ex Guinness) growth has been on a steady decline since 2010
- With the exception of 2010, beer (ex Guinness) has lagged spirits in each of the last five years
- Guinness has lagged spirits growth in every year
- Guinness has lagged beer (ex Guinness) in all years ex 2014
- Guinness growth rate has declined in the last two year
- Beer (ex Guinness) and Guinness delivered negative growth in 2014
- Despite a high exposure to Africa Guinness five-year CAGR is only 1.4%, significantly lagging beer (ex Guinness) and spirits

Figure 52: Organic growth by category FY10-FY14



Source: Deutsche Bank estimates (beer ex Guinness); Diageo

Reflective of the trends in Figure 52, Figure 53 shows that beer (incl. Guinness) and Guinness have underperformed spirits in AEET/Africa and Western Europe/Europe over the last four years.

Figure 53: Organic growth in Europe/Western Europe/AEET/Africa

		2011	2012		2013	2014
Beer (incl. Guinness)	Africa	NA	9%	AEET	5%	-5%
Guinness		NA	7%		2%	1%
Spirits		NA	20%		13%	3%
Region total		10%	11%		10%	1%
Beer (incl. Guinness)	Europe	-4%	0%	Western Europe	-5%	-3%
Guinness		-4%	-2%		-6%	-3%
Spirits		-4%	1%		-3%	-1%
Region total		-3%	-1%		-4%	0%

Source: Diageo; 2011 details unavailable other than region total as details included within the former International division and not broken out

Shorter term weak performance in beer has been a function of a number of factors including:

- Guinness pricing being too aggressive in Nigeria
- Inconsistent pricing of Harp in Nigeria
- Excise changes very significantly impacting Senator Keg in Kenya.

Beer and Guinness are not working for Diageo.

Spirits and beer: high value, low volume with low value, high volume

Though there is some opportunity to leverage corporate skills especially in emerging markets, a combination of beer and spirits on the same platform is difficult to execute in our view, with arguably limited benefits.

Beer is a low value, high volume business requiring deep penetration into the trade. Premium spirits is a high value, low volume business requiring a diverse and wide top end focus.

The lack of synergies between the two businesses is apparent through the value chain:

- Procurement needs differ, especially in packaging and quality of grains
- Production needs and infrastructure differs, particularly in packaging
- Warehouse management and distribution most visibly demonstrates the difference between high and low value items
- Efficiencies of spirits alongside beer are impacted by the relatively low volume throughput of spirits
- Working capital management differs: stock management for beer is counted in days, with best practice focusing on low to mid single digits. Brown spirits can stay in situ for years
- Sales model is inherently different: one bottle of spirits can last weeks (if not months even in the on-trade) versus moving multiple beer crates and returnable packaging formats

Premium spirits is a value orientated business requiring time and care from production to the sales call. The focus is weighted towards effectiveness.

Beer is a volume business requiring speed and depth from production to the outlet. The focus is weighted towards efficiency.

Diageo maintains its beer operations in Africa primarily as a long-term spirits distribution platform. Because Diageo only owns part of the beer businesses in Nigeria and Kenya and other markets, but 100% of the spirits businesses that sits on the beer cost base, the corporate structure works very much in Diageo's favour.

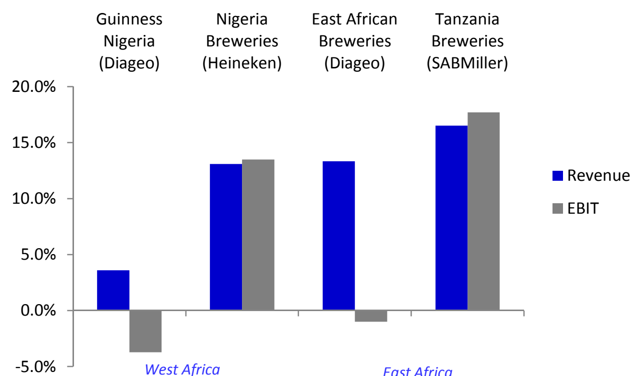
To the extent beer and spirits work together for Diageo we contend it is because of the often 100% ownership of spirits leveraging less than 100% ownership of the beer cost base; arguably the corporate structure of the business creates value for Diageo, not the day-to-day combination of beer and spirits.

Diageo's mediocre beer track record

Reviewing the beer operations in Africa in Figure 54 and Figure 55, Diageo has underperformed in the region.

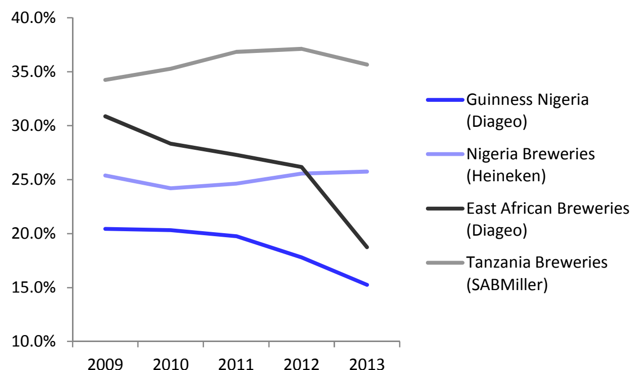
In Nigeria, Diageo's 53% owned Guinness Nigeria, has seen a negative profit performance in the last five years to December 2103. Heineken has delivered double digit growth in the same market. Diageo margins have declined 500bps over the period.

Figure 54: 5 year CAGR Africa performance (local)



Companies calendarised to full year 2013. Results in Local currency. Guinness Nigeria and Nigerian Breweries in Nigerian Naira. East African Breweries in Kenyan Shillings. Tanzanian Breweries in Tanzanian Shillings.
Source: Deutsche Bank, Bloomberg, Datastream, Company reports.

Figure 55: Africa subsidiaries margin performance

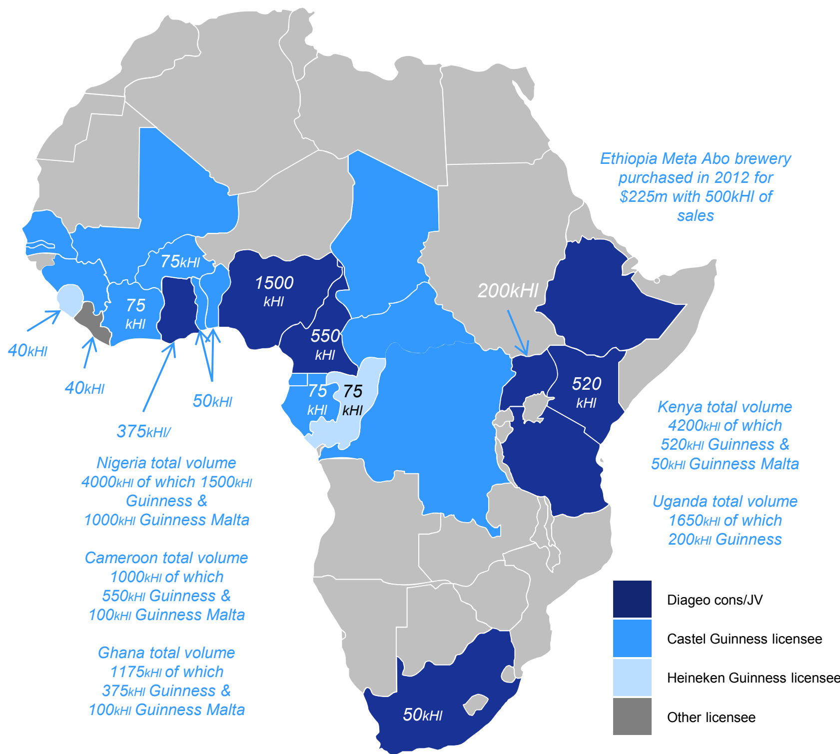


Companies calendarised to full year 2013. Results in Local currency. Guinness Nigeria and Nigerian Breweries in Nigerian Naira. East African Breweries in Kenyan Shillings. Tanzanian Breweries in Tanzanian Shillings.
Source: Deutsche Bank, Bloomberg, Datastream, Company reports.

In East Africa, 50.03% Diageo owned East African Breweries (EABL) has also delivered a negative EBIT growth, while Tanzania Breweries has delivered results in the mid-teens. Margins for EABL have dropped 2200bps.

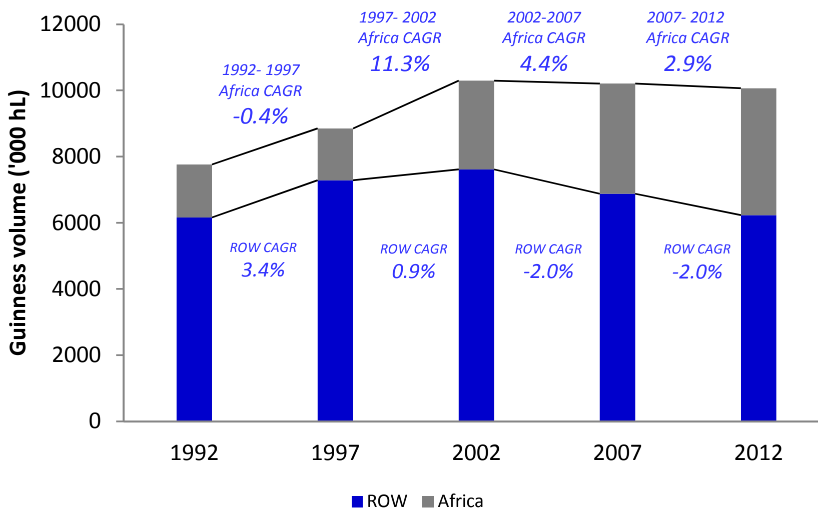
Guinness Ghana has seen a similar weak performance with margins in 2013 hitting 6.6%: Diageo has lost almost 25% market share in the past three years.

Figure 56: Diageo Africa beer footprint



Source: Deutsche Bank estimates, company reports, Euromonitor, Plato Logic

Figure 57: Guinness brand global growth



Source: Deutsche Bank estimates, Euromonitor, Plato Logic, company reports

$5 to 6bn for Diageo's Africa beer business

We view the beer production assets of Diageo as an attractive investment for any of the global brewers, both as a means of consolidating their position or as an entry into Africa.

The Guinness brand will have a sizeable premium but we believe Diageo will be very reluctant to part with it. The brand already has a very profitable licensing model with the extract being supplied inclusive of sizable tax benefits from Ireland: a model that could be replicated around the world.

Since South African Breweries in 1964 was granted the first license to brew Guinness outside Ireland, there are now 66 active licensees. This group includes Heineken managing the brand in 15 markets and Castel in ten African markets.

We estimate a potential sum of the parts value based on the EV of the listed entities in Nigeria, Ghana, and Kenya, the purchase price of Ambo in Ethiopia and our estimates in Cameroon, we value the consolidated beer operational footprint of Diageo to be worth between $5 and $6 billion. For a further discussion see our recent note, *Tapping into growth,* 29 July 2014.

Despite a relatively weak recent performance Guinness remains a highly attractive asset in the region in our view. While a sale of the brand is unlikely, we believe Diageo may be better served by selling its production assets while maintaining the very profitable license business out of Africa, thereby retaining a profit stream from which to leverage the tax advantage of Ireland.

The problem with that argument is Diageo loses the reason why it owns the beer business unless some complex (and potentially difficult to manage) deals are put in place.

While we have concerns with model 'spirits on beer platform' we also recognise emerging markets are less sophisticated and therefore beer and spirits together is more logical.

We end up concluding Diageo needs to fix beer but that statement cannot run forever, at some point the fix has to be delivered or an alternative course of action sought.

While splitting sprits and beer in emerging markets may be less than optimal while markets are relatively immature, the upside from realising the value of the beer assets may offset the lower growth profile (and higher cost base) of the remaining spirits business.

Even if that proves the case on paper, arguing it and getting the Diageo management/Board to see value in splitting the beer business from the group is an entirely different matter in our view.

We now turn to MUST DO #4.

DB MUST DO #4: Grow North America at least 4% pa

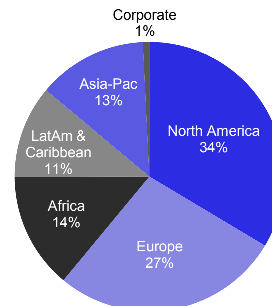
Delivering in North America necessary to meet DB targets

Figure 58 shows North America is 34% of group sales, closely followed by Europe representing 27% of sales.

North America is probably the most sophisticated spirits market in the world and certainly the largest for western spirits. In addition, the current macro backdrop appears much stronger than Europe[20]: if North America does not deliver neither does Diageo. While Europe in aggregate is of similar size, North America appears to be in a much stronger economic position.

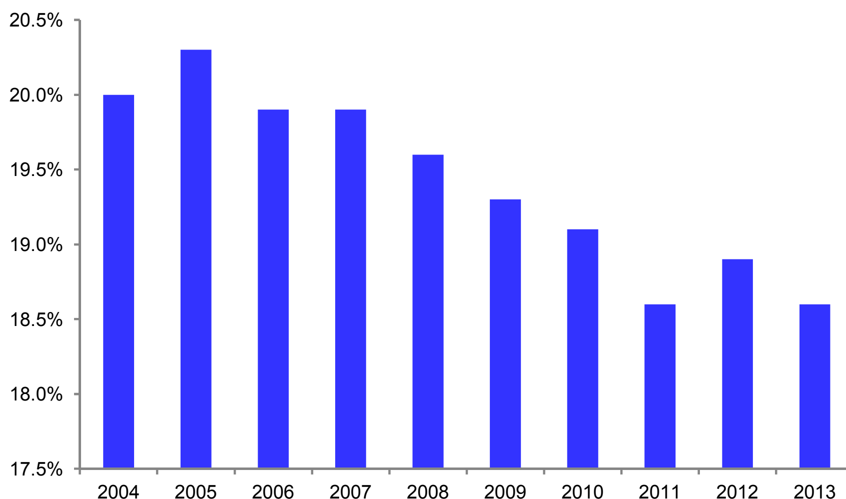
While we are loath to place excessive reliance on volumes (*sustainable* growth of the market by value is significantly more valuable) we nevertheless note Diageo's share of the US market by volume has been declining (Figure 59) and has done so consistently since 2007 (with the exception of 2012).

Figure 58: Diageo 2014 sales



Source: Diageo

Figure 59: Volume share of US market



Source: Euromonitor

Figure 60 shows North American sales have compound at 3.7% over the last nine-years, 2.8% over the last five years and 4.6% over the last three years.

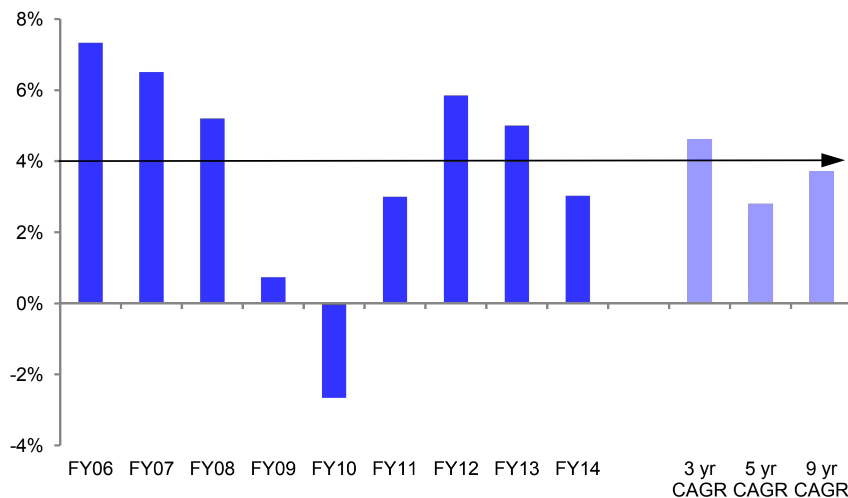
We task the North American business to grow at least 4% p.a. With price in vodka appearing non-existent, increased competition from niche brands (particularly in whiskey) and ongoing issues with Guinness, 4% organic growth will be a sufficiently stretching target in our view. That said, there are a number of longer term positives as regard North America, including:

[20] One of the main reasons Diageo's share price has risen from its lows of mid-October 2014 is the expectation of lower oil (petrol) prices feeding into US consumer pockets and into products such as Diageo's (see comments on page 8.

- African American and Hispanic's are a growing proportion of the population with alcohol preferences skewed to spirits and
- Reserve already representing c25% of sales.

In order to deliver high single digit EPS growth the US needs to grow at least in line with the bottom end of the group target (4-6%) given its superior margins (>40%) predicated on the US distribution model.

Figure 60: North American organic growth



Source: Diageo; Deutsche Bank estimates

Figure 61: Operating margins

	FY14	FY15E	FY16E	FY17E
North America	42.4%	42.3%	42.4%	42.6%
Europe	30.3%	30.4%	30.4%	30.5%
Africa	23.8%	23.4%	23.8%	24.3%
LatAm	28.7%	27.8%	27.9%	28.2%
Asia Pacific	21.0%	18.2%	18.7%	19.3%
Group	30.6%	29.4%	29.7%	29.9%

Source: Deutsche Bank estimates; Diageo

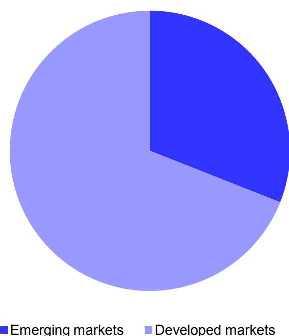
Finally, we move to MUST DO #5.

DB MUST DO #5: Grow EM sales ahead of group average

Not a particularly onerous target

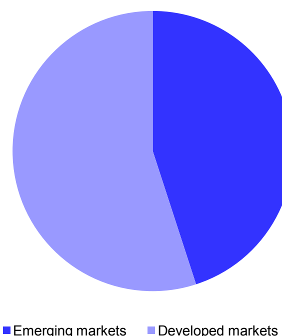
Diageo estimates the global beverage alcohol market at £300bn per annum comprising 6 billion equivalent units[21]. The type of beverage alcohol consumed varies widely depending on local incomes, cultures and attitudes.

Figure 62: Global TBA volume (equivalent units)



Source: Diageo estimates; year to 31 December 2013; TBA is total beverage alcohol; equivalent unit is equal to one nine-litre case of spirits/45 litres of wine/90 litres of beer

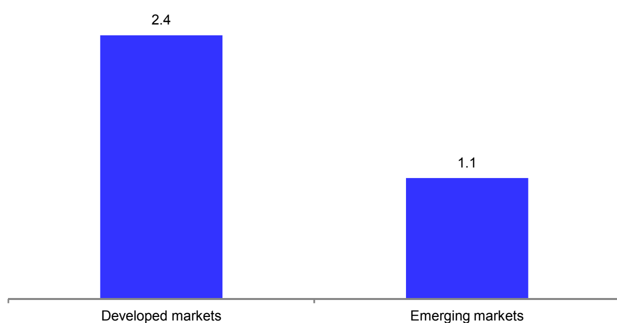
Figure 63: Global TBA sales (£)



Source: Diageo estimates; year to 31 December 2013; TBA is total beverage alcohol

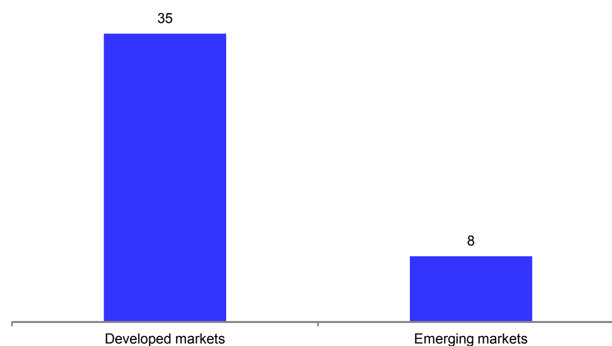
On average, per capita consumption is higher in developed markets at 2.4 equivalent units of alcohol per year versus 1.1 in emerging markets, driven in part by differences in averages levels of disposable income but also variables such as religion and culture. The shape of the market differs from region to region with Asia more focused on spirits and Africa, beer.

Figure 64: Per capita consumption (LDA) (equiv. units)



Source: Diageo estimates; year to 31 December 2013; equivalent unit is equal to one nine-litre case of spirits/45 litres of wine/90 litres of beer; LDA is legal drinking age

Figure 65: GDP/capita £'000 (LDA)



Source: Diageo estimates; year to 31 December 2013; LDA is legal drinking age

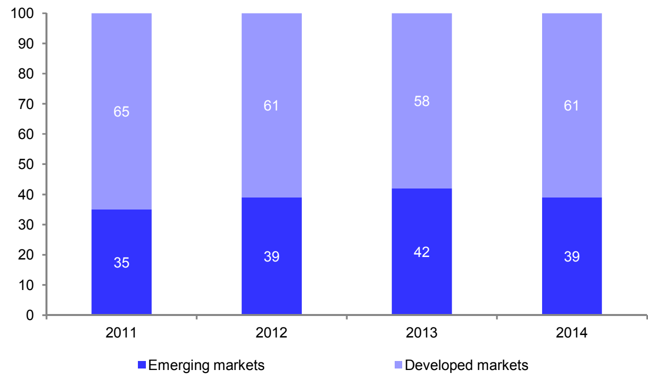
In their 2014 annual report and accounts, Diageo said:

[21] An equivalent unit is equal to one nine-litre case of spirits; 24 litres of wine; 90 litres of beer

"Our business is increasingly balanced across developed and emerging markets and we are able to capture share across a wide variety of consumer occasions... Developed markets are large and profitable, but with lower growth rates. Emerging markets, also large, are less profitable with faster growth rates. Overall, the global beverage alcohol market is supported by the strong consumer fundamentals of growing legal drinking age population and increasing wealth, driving both consumer penetration and premiumisation."

While none of that is particularly new it does serve to underline the potential in EMs as compared to DMs and we note Diageo's sales split per Figure 66 is similar to the market (Figure 63).

Figure 66: EM/DM sales split



Source: Diageo

In addition, work we have previously undertaken across all consumer categories (*Emerging Exposure*, March 2014) highlighted spirits alongside personal care as potentially the fasted growing staples category over the medium to long-term in emerging markets.

Whisk(e)y

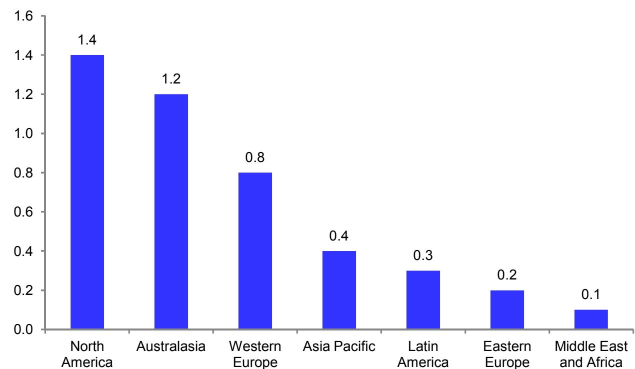
We estimate Scotch whisky is over 20% of Diageo's sales. In our view, the outlook for scotch whisky and American whiskey in emerging markets appears strong.

Per cap consumption in EMs for whisk(e)y has grown consistently since 1998 at a CAGR of 6.5% pa to reach a position where consumption is still only c17% of that per capita in DMs (Figure 69).

Over the period from 1998 per cap consumption in DMs has declined at a CAGR of -0.6% pa but this hides growth of 1.1% CAGR since 2007 (Figure 69).

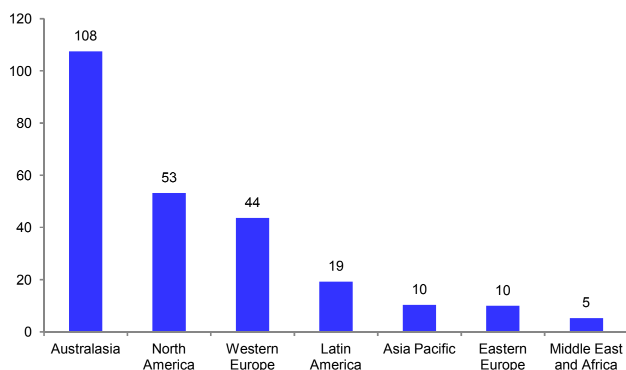
Therefore, not only is EM growth strong (and consistent) EMs have plenty of growth potential against where DM per cap rates currently sit and DM per cap rates have been improving over the last five years.

Figure 67: Whisk(e)y per cap volume by region (litres)



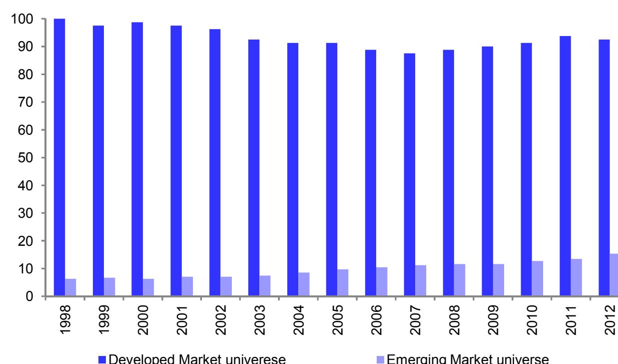
Source: Deutsche Bank estimates; Euromonitor; 2012 data

Figure 68: Whisk(e)y per cap value (US$) by region



Source: Deutsche Bank estimates; Euromonitor; 2012 data; the aggregation of single malt scotch whisky, blended scotch whisky, Bourbon/other US whiskey, Canadian whisky, Irish whiskey, Japanese whisky and Other whiskey.

Figure 69: Whisk(e)y per cap. consumption indexed



Source: Deutsche Bank estimates; Euromonitor; 2012 data; the aggregation of single malt scotch whisky, blended scotch whisky, Bourbon/other US whiskey, Canadian whisky, Irish whiskey, Japanese whisky and Other whiskey.

EM retail values are relatively high when compared to the staples peer group categories; in 2012 they were 66% of DM prices. We assume price/mix of +1.7% in EMs over the medium term implying relative pricing in EMs will fall from the currently relatively high level of 66% of DMs (assuming DM price/mix of +2.1%). This is feasible over the medium term, but over the long term either DM pricing falls, or, more likely +1.7% in EMs is too conservative.

Figure 70: Whisk(e)y medium term EM per cap revenue growth estimates

Per cap volume growth	6.5%
Price/mix	1.7%
Per cap revenue growth	8.3%

Source: Deutsche Bank estimates

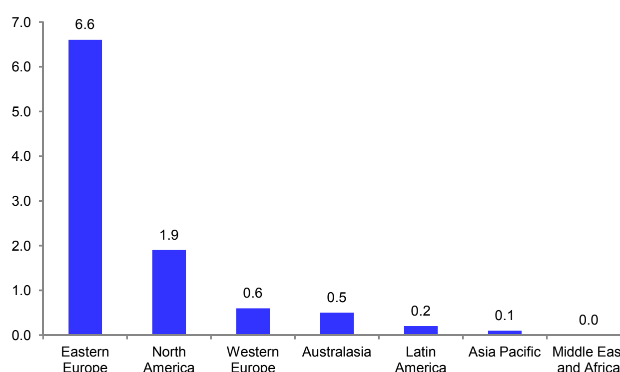
Vodka

We have broken EM vodka down between EM's and EMs ex Russia, Poland and Ukraine given the preponderance of relatively low priced product in those markets. Diageo's exposure to these three markets is immaterial to our conclusions.

We believe Vodka volumes have the potential to grow significantly over the medium to long-term: the ongoing growth of vodka in DMs suggesting high consumer acceptance of the category; steady growth in EMs; still very low penetration of EMs.

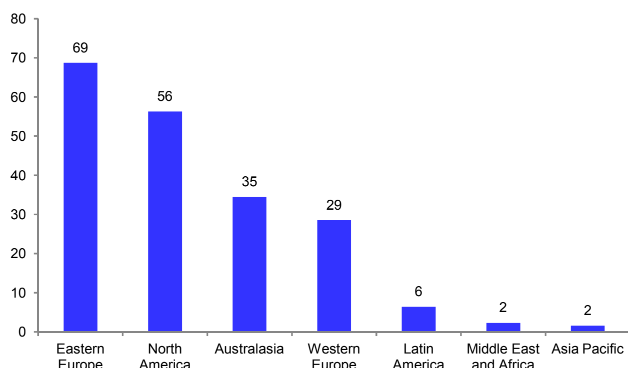
Discounting Eastern Europe, the category, in terms of per caps, is dominated by North America with Europe c30% of North American levels. LatAm, Asia-Pacific and Middle East & Africa hardly registering support the long-term potential of the category.

Figure 71: Vodka per cap volume by region (litres)



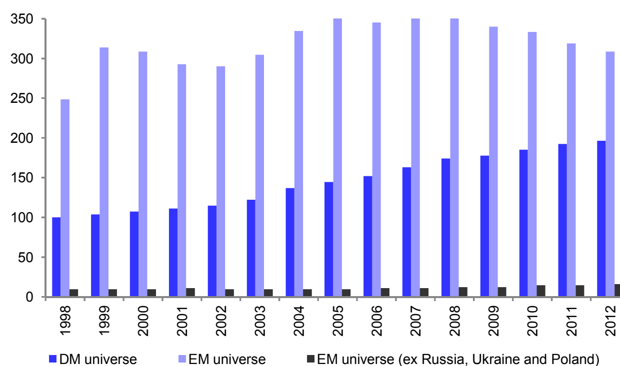
Source: Deutsche Bank Euromonitor; 2012 data; Eastern Europe includes Russia, Poland and Ukraine

Figure 72: Vodka per cap value (US$) by region



Source: Deutsche Bank estimates Euromonitor; 2012 data;

Figure 73: Vodka per cap. consumption indexed



Source: Deutsche Bank estimates Euromonitor; index takes DM in 1998 as the base at 100.

Ex Russia, Ukraine and Poland EM per cap volumes have grown 3.5% pa since 1998. However, unlike most categories the rate of growth is accelerating. For the period 2002-07 volumes increased 2.4%; for 2007-2012 they grew 7.6%. Ex Russia, Poland and Ukraine EM per cap volumes relative to DMs are only 8%; the volume growth potential in EMs for vodka is extremely high. Rather than extend the volume trajectory 2002-2012 even further we have assumed EM per cap volume growth in vodka of 7% (below that seen 2007-2012).

We have to be aware that local white spirit alternatives exist in most markets thereby potentially capping this growth. With that in mind we note (Figure 75) the recent cachaca acquisition in Brazil. Note also we model relatively low price/mix growth for vodka reflecting already relatively high price points in EMs and ongoing difficult pricing in the category (particularly in mature markets such as USA).

Figure 74: Vodka medium term EM per cap revenue growth estimates

Per cap volume growth	7.0%
Price/mix	1.0%
Per cap revenue growth	8.1%

Source: Deutsche Bank estimates;

Recent acquisitions

While a number of recent acquisitions have been less than successful (Shui Jing Fang, Mey Icki and the recent USL minority shareholder vote spring to mind) Diageo is nevertheless increasing its exposure to EMs through its acquisition policy.

Noting the acquisition process of USL has been less than smooth (and expensive) we see USL as filling the last gap in Diageo's international growth profile.

While a number of the acquisitions have been in beer (our least favoured staples category) and therefore increasing the bet on total beverage alcohol, these acquisitions have been in Africa where we see relatively strong potential for the beer category and the ability to leverage spirit sales on the back of beer in emerging markets.

Figure 75: Recent acquisitions

Date	Company	Category	Brand	Key market	Cost	Holding	Strategy
October 2010	Serengeti Breweries	Beer	Serengeti	Tanzinia	£48m	51%	Growing economy; #2 player; platform for Diageo brands
July 2011	Zacapa	Rum	Zacapa	LatAm; North America; Western Europe; Global Travel	£125m	50%	Unique brand to grow through Diageo network
August 2011	Mey Icki	Raki; Vodka	Multi-brand	Turkey	£1,256m	100%	Scale precence in Turkey through leading local player
January 2012	Meta	Beer	Meta	Ethiopia	£149m	100%	#2 player in fast growing market
June 2012	SJF Holdco	Baijiu	Shui Jing Fang	China	£265m	40%	Largest spirits categroy in the world; access Chinese meal occasion
June 2012	Halico	Vodka	Vodka Hanoi	Vietnam	£62m	45%	Access to EM consumers
August 2012	Ypioca	Cachaca	Ypioca	Brazil	£284m	100%	Largest category in Brazil; Ypioca the leading brand
Various	USL	Multi-spirit categories	Multi-brand	India	£1,842m	55%	Market leader; attractive long-term TBA market; synergies for Diageo brands
November 2014		Tequila	Don Julio	Mexico	Sold Bushmills and also received $408m	100%	Premium Tequila brand; leverage into Mexican growth

Source: Deutsche Bank

Conclusions

Reinstate targets as the key outputs

We believe Diageo should reinstate targets aligned to the key outputs of the business: revenues, margins, EPS and cash with associated metrics.

MUST DOs subservient

We see the adoption of external MUST DOs as a secondary to reinstated targets: we consider them inputs to drive results, ultimately measured by the outputs, manifest as group targets.

Figure 76: DB alternative MUST DOs

1. Increase gross margins annually
2. Grow premium core (and reserve) ahead of the group average
3. Fix beer/Guinness in three years or abandon Total Beverage alcohol
4. Grow North America at least 4% pa
5. Grow EM sales ahead of the group average

Source: Deutsche Bank

Recognising they are aligned with the group strategy we consider the MUST DOs as much for internal as external consumption. Should they be retained for external consumption we believe they need to be more focused and with tangible metrics by which they can be measured.

In addition, we think five MUST DOs is enough: six is at least one too many in our view. Our alternative five MUST DOs are set out in Figure 76

Assuming the adoption of revised targets, were the MUST DOs dropped for external consumption (to form part of general massaging rather than specifics by which the company were measured) we would have no issue.

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Forecasts and DCF

EPS revisions

EPS forecasts cut 3% FY15E, c4.5% FY16E

We trim our forecasts by a combination of reduced organic growth expectations, currency and the corporate tax rate. Notwithstanding some renewed confidence as to the prospects for the US consumer, for FY15E we cut our organic growth forecast to 1.4% from 2.4% and in FY16E to 3.9% from 4.8%.

Albeit still impacted by Senator in Kenya and de-stock in WestLac and South East Asia, Q1 was relatively weak at -1.5%. To generate organic sales of +1.4% for FY15 requires the following three quarters to average +2.4%. With a subdued volume and pricing dynamic in Europe, subdued pricing in the USA (not just vodka), further de-stocking to come in South East Asia and recent global macro turbulence we consider +2.4% for the next three quarters as sufficiently taxing.

As a counter we have potential support from a resurgence of middle income America on the back of lower oil feeding into petrol prices. In their S&P500 outlook of 15 December or US strategists said that over the past year, c7% of US household spending was on energy, including gasoline, home heating and electricity. Gasoline was c3% of spending, but is now expected to fall to c2% at c$65/bbl oil. This should put nearly $100bn in household pockets or about $1000 per household. Though some of this fuel saving might be saved, DB economists expect it to boost real GDP principally through household spending, which is near 70% of GDP. Our strategists believe this additional US household spending will boost sales for Consumer Discretionary and Consumer Staples companies, such as Diageo.

Recognising the added complication of Chinese cognac, we model Pernod organic growth of 2.8%. Q1 for Pernod was +2.3%. For FY16E we take our organic growth forecast to 3.9%, at the bottom of what we consider a viable long-term top-line objective of 4% to 6% pa organic growth for Diageo. With USL consolidated we model margins of 29.4% in FY15E climbing 20-30bps pa thereafter.

At Q1 with £=$1.61 and £=€1.27 Diageo estimated the impact operating profit by £95m. We are running with the £=$1.57 and £=€1.27 and have accordingly adjusted our forecasts down marginally for the US$ and other currencies including the Rouble. We now model negative currency of £115m impacting operating profits in FY15E.

We model the tax rate climbing steadily to over 20% in FY18E. We cut our FY15E EPS forecast 3.7% to 93.5p and our FY16E forecast 5.0% to 99.1p in part due to these changes in our tax assumptions.

We model capex climbing each year from FY14's £642m (we see the risk to the downside). For working capital we model continuing outflows based on sales growth. We are aware working capital is a major focus for the business and again see the risk to the downside.

Diageo P&L and other key forecasts

Figure 77: Diageo P&L and other key forecasts (£m)

		FY14	FY15E	FY16E	FY17E
Net sales	North America	3,444	3,538	3,728	3,867
	Europe	2,814	2,752	2,781	2,832
	Africa	1,430	1,393	1,506	1,641
	LatAm	1,144	992	997	1,047
	Asia Pacific	1,347	2,200	2,326	2,489
	Corporate	79	79	79	79
	Total	10,258	10,953	11,416	11,955
	Reported growth	-9.2%	6.8%	4.2%	4.7%
	Organic growth	0.4%	1.4%	3.9%	4.7%
Operating profit	North America	1,460	1,497	1,579	1,649
	Europe	853	836	846	864
	Africa	340	326	359	399
	LatAm	328	276	278	295
	Asia Pacific	283	400	435	481
	Corporate	(130)	(114)	(108)	(111)
	Total	3,134	3,221	3,389	3,577
	Reported growth	-11.2%	2.8%	5.2%	5.6%
	Organic growth	3.5%	4.3%	5.4%	5.6%
Margins	North America	42.4%	42.3%	42.4%	42.6%
	Europe	30.3%	30.4%	30.4%	30.5%
	Africa	23.8%	23.4%	23.8%	24.3%
	LatAm	28.7%	27.8%	27.9%	28.2%
	Asia Pacific	21.0%	18.2%	18.7%	19.3%
	Total	30.6%	29.4%	29.7%	29.9%
Net interest and other		(388)	(480)	(447)	(387)
Exceptionals		(287)	103	0	0
Associates		252	244	262	282
Pre-tax		2,998	2,985	3,205	3,473
Tax		(546)	(537)	(601)	(677)
Underlying tax rate		18.2%	18.0%	18.8%	19.5%
Discontinued		(83)			
Minorities		67	(95)	(108)	(114)
Attributable		2,436	2,506	2,648	2,834
DB attributable		2,519	2,506	2,648	2,834
DB EPS (p)		100.1	93.5	99.1	106.5
Growth		-3.5%	-6.6%	6.1%	7.4%
DPS (p)		51.7	54.3	57.0	61.0
Growth		9.2%	5.0%	5.0%	7.0%
EBITDA		3,763	3,872	4,063	4,275
Net Debt		8,403	8,592	8,984	8,149
Net debt/EBITDA (x)		2.3	2.3	2.0	1.7

Source: Deutsche Bank

Diageo DCF

Figure 78: Diageo DCF (£m)

	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	Perp.
EBITA	3,389	3,577	3,800	4,055	4,337						
Growth rate	4.8%	5.6%	6.3%	6.7%	7.0%						
Adjusted tax	(661)	(698)	(741)	(791)	(846)						
Depreciation	674	697	722	747	773						
Working capital	(138)	(156)	(182)	(208)	(230)						
Capex	(650)	(663)	(676)	(690)	(704)						
Other	(100)	(100)	(100)	(100)	(100)						
FCF	2,514	2,658	2,822	3,013	3,231	3,489	3,711	3,888	4,009	4,069	4,130
FCF growth		5.7%	6.2%	6.8%	7.2%	8.0%	6.4%	4.8%	3.1%	1.5%	1.5%
Time coefficient	1.54	2.54	3.54	4.54	5.55	6.55	7.55	8.55	9.55	10.55	
WACC	7.4%	7.4%	7.4%	7.4%	7.4%	7.4%	7.4%	7.4%	7.4%	7.4%	
PV factor	0.896	0.834	0.776	0.723	0.673	0.626	0.583	0.543	0.505	0.470	
PV of cash flows	2,252	2,217	2,191	2,178	2,174	2,186	2,165	2,111	2,026	1,915	
PV of FCF years 1-10	11,012										
PV of terminal value	10,402										
Less net debt	8.984										
Less pension	726										
Less minorities	2,851										
Add associates	8,533										
Equity value	50,269										
Shares at end 2015	2,517										
Per share	1997p										
Price 15 Dec. 2014	1805p										
Upside	+11%										
WACC											
Current price	1986p										
Market Cap	45,438										
Debt & pension	9,710										
Total EV	55,149										
% equity	82%										
% debt	18%										
Cost of equity											
Risk free rate	4.0%										
Risk premium	4.3%										
Beta	0.98										
Cost of equity	8.23%										
Cost of debt											
Debt pre-tax	4.0%										
Tax	19.5%										
Post tax cost of debt	3.22%										
WACC	7.4%										

Source: Deutsche Bank estimates; market cap uses share price at close 15 December 2014. Share price as shown in Table is as at 15 December 2014

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Addendum 1

August 2011: an alternative scenario

The benefit of hindsight?

Perhaps we are guilty of applying hindsight too easily but we start with the premise that the EPS growth target did not have to be double digit; high single digits would have sufficed[22]. Why? Diageo yields c3% and may reasonably be expected to grow the dividend at the rate of EPS growth over the long-term. A total return of c11% (c8% EPS growth coupled with 3% yield) would be enough to maintain the rating in our view; a stock returning c11% is a (very) powerful serial compounding machine.

In addition, over the medium term we would take the view that Diageo would be capable of marginally exceeding the 8% in numerous years (see A&P comment below) thereby, over time, potentially facilitating an increase in the rating.

There is little need to do any more than high single digits in our view. As Paul Adams, former CEO of BAT was keen to stress: *"bad stuff"* can and does happen… all the time; it is just a question of whether it is significant enough to make a difference.

The extent to which a business can materially exceed high single digit EPS growth we would advocate a significant element of the excess above guidance be reinvested back into A&P to underpin sustainability of the model over the long term.

Taking the actual out-turn of Figure 24 we create the following scenario:

- In August 2011, rather than guiding as it did, Diageo instead guided to:
  - mid-digit revenue growth
  - steadily rising margins
  - high single digit EPS growth
  - critically, all variables medium term: some years may be above the target, some below – make that very clear to investors
- When announcing FY12 and FY13 results (as reported, not with our potentially higher A&P scenario) Diageo made it clear:
  - it was performing significantly ahead of expectations
  - this level of outperformance was very unlikely to last
  - the macro back drop remained unpredictable

[22] Against a double digit EPS target and FY12 growing 13% and FY13 11% we may conclude that Diageo had a relatively high degree of short-term visibility which perhaps led to a degree of excessive optimism; hence we ended up at double digit. No large-cap staple needs to commit to double digit EPS growth in our view: PMI also recently walked away from such guidance

    - history shows the nature of spirits (relatively high price points; inventory variables) means the category is more volatile than other staples whilst retaining one of the strongest long-term growth outlooks[23] [24]
- Heading into FY14 do not abandon guidance
    - remind the market targets are medium term
    - highlight the significant outperformance of FY12 and FY13
    - given the macro backdrop state that you expect FY14 to be a significantly more difficult year citing Paul Adams' "bad stuff"

When communicating FY14 through IMSs and the interims reinforce the messaging: 'tell it how it is' (footnote 24).

On announcing the FY14 results recognise it was a tough year *"as we flagged at the outset"* but the quality of the model has come through on a three-year basis with EPS compounding at c8%; at the top of the medium term target range.

We are not naive enough to suggest FY14 would have otherwise been an easy ride for Diageo; clearly not... but less excessive objectives at the outset may have resulted in them being retained today and nota abandoned: Diageo could have made it much easier for themselves in our view.

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[23] For detail see *Emerging Exposure*, March 2014

[24] We are continually frustrated with companies continually having a positive outlook: in our view the best companies have no issue in telling investors 'how it is'. Next, a UK retailer and Richemont (luxury goods) spring to mind in this regard.

Appendix 1

Important Disclosures

Additional information available upon request

Disclosure checklist

Company	Ticker	Recent price*	Disclosure
Diageo	DGE.L	1,842.24 (GBp) 15 Dec 14	14,15

*Prices are current as of the end of the previous trading session unless otherwise indicated and are sourced from local exchanges via Reuters, Bloomberg and other vendors . Data is sourced from Deutsche Bank and subject companies.

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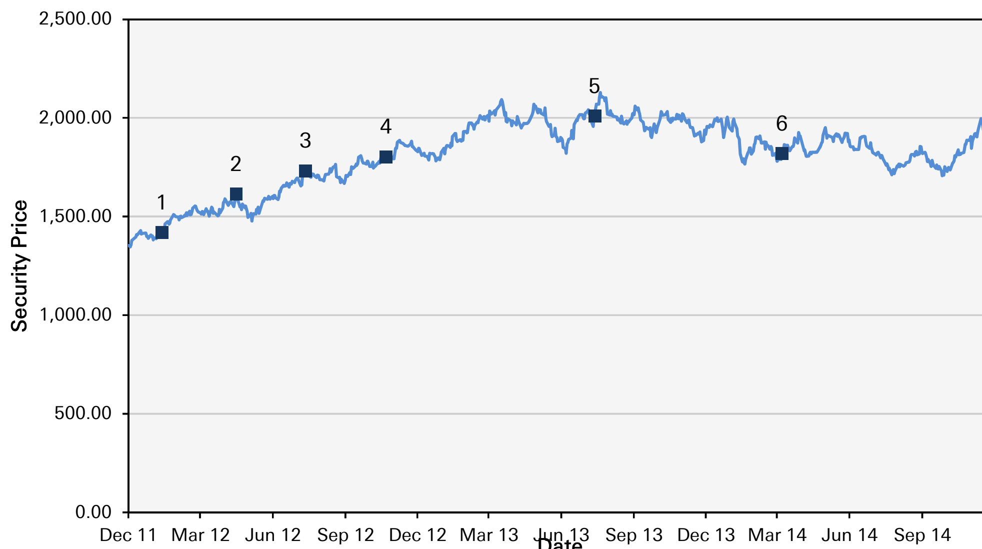
Historical recommendations and target price: Diageo (DGE.L)

(as of 12/15/2014)



Previous Recommendations

Strong Buy
Buy
Market Perform
Underperform
Not Rated
Suspended Rating

Current Recommendations

Buy
Hold
Sell
Not Rated
Suspended Rating

*New Recommendation Structure as of September 9,2002

1.	30/01/2012:	Buy, Target Price Change GBP1,600.00	4.	09/11/2012:	Buy, Target Price Change GBP2,000.00
2.	03/05/2012:	Buy, Target Price Change GBP1,750.00	5.	31/07/2013:	Buy, Target Price Change GBP2,200.00
3.	30/07/2012:	Buy, Target Price Change GBP1,900.00	6.	25/03/2014:	Buy, Target Price Change GBP2,050.00

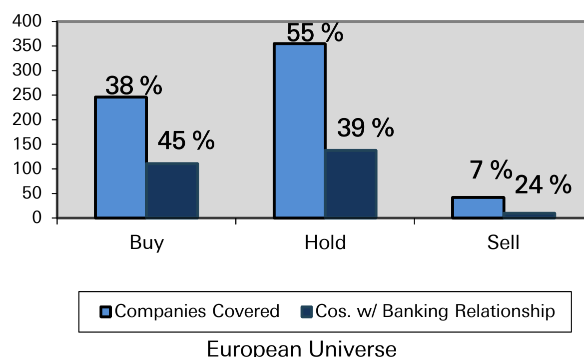
Equity rating key

Buy: Based on a current 12- month view of total share-holder return (TSR = percentage change in share price from current price to projected target price plus pro-jected dividend yield) , we recommend that investors buy the stock.
Sell: Based on a current 12-month view of total share-holder return, we recommend that investors sell the stock
Hold: We take a neutral view on the stock 12-months out and, based on this time horizon, do not recommend either a Buy or Sell.
Notes:

1. Newly issued research recommendations and target prices always supersede previously published research.
2. Ratings definitions prior to 27 January, 2007 were:

   Buy: Expected total return (including dividends) of 10% or more over a 12-month period
   Hold: Expected total return (including dividends) between -10% and 10% over a 12-month period
   Sell: Expected total return (including dividends) of -10% or worse over a 12-month period

Equity rating dispersion and banking relationships



European Universe

Regulatory Disclosures

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