Diageo

Global & European Conviction Lists Member

Isin / FactSet Code	**GB0002374006 / DGE-GB**	Market cap (in EUR mn)	**68 941**	52-week high	**24.79**	Rating	**BUY**
Sector	**Consumer Staples**	Market cap (in local curr. mn)	**61 654**	52-week low	**19.46**	12-month target price	**26.50**
Industry	**Beverages**	Local currency	**GBP**	YTD return%	**15.62**	Last price (31/07/17)	**24.49**
Benchmark	**MSCI AC World / Consumer Staples -SEC**	Free-float	**98%**	12-month return%	**12.89**	Potential upside	**8%**

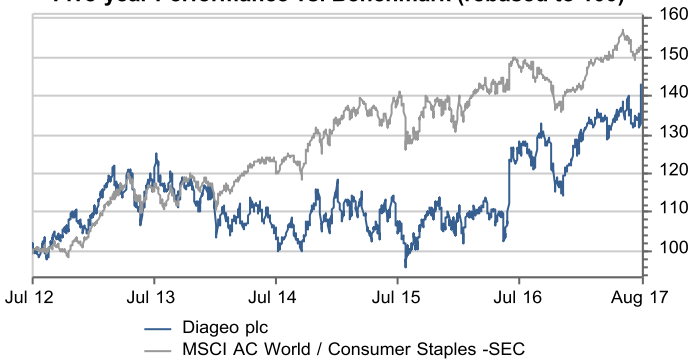
Investment Case:

- Diageo's portfolio of strong and well-known brands in various categories and geographies offers great potential. While Diageo still considers beer (16% of FY17 net sales) as a key priority (bringing scale), the market does not exclude a divestment.
- Two-third of the expected GBP 700 mn savings in FY17–19 will be re-invested in the business to drive top-line growth. The margin should improve by 175 bps.
- In FY18, Diageo continues to focus on improving growth in the US, finding a sound balance between volume growth and an improving price/mix in scotch and developing the high-end market in India.
- Renewed top-line growth, combined with margin expansion, should enhance earnings momentum going forward. We expect the shares to close the valuation gap with the Alcoholic Beverage sector and set our target P/E at 23.0x FY18E EPS of GBP 1.15 to arrive at a target price of GBP 26.50 (increased from GBP 24.50).

Company Description:

London-based Diageo was created in 1997 through the merger of Grand Metropolitan and Guinness. Between 2000 and 2002, it exited the food business and acquired Seagram's spirits and wine business. Today, the group is the world's leading spirits company. It holds 34% of Moët Hennessy, the Wines & Spirits division of LVMH.

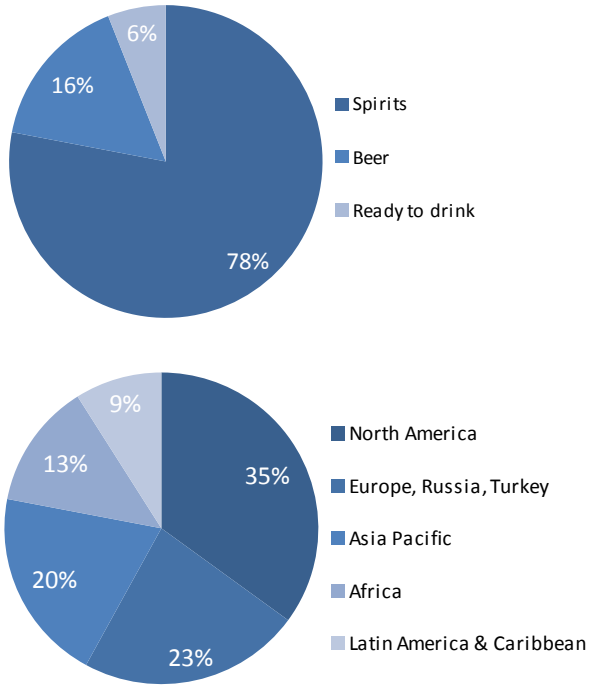
Five-year Performance vs. Benchmark (rebased to 100)



Sources: SGPB, FactSet

Revenue by Key Segments & Geographies: FY17

(FY ending June)



Sources: SGPB, FactSet

Recent Developments Analysis:

- Diageo published FY17 results in line with consensus: net sales of GBP 12.05 bn (+14.9%), recurring EBIT of GBP 3.60 bn (+19.7%) and recurring EPS of GBp 108.5 (+21.4%). The quality of the numbers, however, was better than expected with organic net sales and recurring EBIT growth at +4.3% (volume +1.1%, price/mix +3.2% tilted more towards mix than price) and +5.6% (margin +37 bps), respectively. Moreover, the GBP 2.66 bn FCF implies a 100% conversion rate.
- Diageo confirmed its target for mid-single digit organic net sales growth, but raised its margin improvement objective from 100 bps to 175 bps over the three years ending 30 June 2019 (expected cost savings from GBP 500 mn to GBP 700 mn, remaining expansion to be weighted more towards FY19). To add on, the board approved a share buyback programme of up to GBP 1.5 bn in FY18.
- Organic growth in FY17 was supported by all regions and all categories, except vodka. Vodka (organic net sales -4%) remains challenging, particularly in the US. Demonetisation and the highway ban (no alcohol sales near highways), held back sales growth in India. Both the US and India should perform better in FY18.

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DESCRIPTION			VALUATION					GROWTH				PROFITABILITY			BALANCE SHEET		
FactSet Code	Company	Cap (mn€)	EV/EBITDA (e)		P/E (e)		Div. Yield	Sales Growth		EPS Growth		EBITDA Margin	Net Margin	ROE	Net Debt/ EBITDA		Net Debt/ Equity
			FY1x	FY2x	FY1x	FY2x	FY1%	FY1%	FY2%	FY1%	FY2%	FY1%	FY1%	FY1%	FY0x	FY1x	FY0x
STZ-US	**Constellation Brands, Inc. Class A**	32 019	17.0	15.4	23.7	21.4	1.1	4.1	7.0	20.1	11.3	36.0	21.5	19.8	3.3	3.2	1.31
RI-FR	**Pernod Ricard SA**	30 979	14.7	13.8	20.8	19.3	1.8	3.8	3.6	8.7	7.4	29.4	16.4	10.5	3.6	3.1	0.66
BF.B-US	**Brown-Forman Corporation Class**	16 100	18.9	17.6	26.7	24.4	1.5	4.7	4.3	7.6	8.6	35.6	22.7	44.6	1.9	1.6	1.44
CPR-IT	**Davide Campari-Milano S.p.A.**	7 249	18.2	16.4	27.5	25.2	0.8	8.2	4.1	32.2	8.4	24.0	14.7	12.8	2.9	2.1	0.55
RCO-FR	**Remy Cointreau SA**	4 823	18.9	17.1	31.2	28.0	1.9	4.5	6.6	13.8	9.6	23.5	13.8	11.3	1.7	1.3	0.29
		Average:	**17.5**	**16.1**	**26.0**	**23.7**	**1.4**	**5.1**	**5.1**	**16.5**	**9.1**	**29.7**	**17.8**	**19.8**	**2.7**	**2.3**	**0.85**
DGE-GB	**Diageo plc**	68 941	16.2	15.2	21.2	19.5	2.7	3.6	4.7	7.4	9.2	34.6	23.3	28.7	1.9	2.0	0.75

na=Not available, nm=Not meaningful

Financial terms detailed in glossary

Sources: SGPB, FactSet

Risks To Our Investment Case:

- Diageo's portfolio is heavily tilted towards North America (35% of FY17 net sales, 52% of FY17 recurring operating profit) and scotch (25% of FY17 net sales). Therefore, its share price may slump, if the expected recovery of this region and category (scotch and North American whiskey delivered half Diageo's FY17 net sales growth) does not continue as expected.
- Vodka (12% of FY17 net sales) is weak. Particularly in the US, competition in the segment is fierce and the group's super-premium brands (Ketel One and Cîroc) sales are highly affected. Outside the US, vodka performed poorly in Europe and Brazil. A turnaround in vodka could prove to be very difficult, certainly in the high-end market.
- The shares are trading at a premium to the 10-year historic median (FY1 17.5x; FY2 16.0x), as are the FactSet World and European Alcoholic Beverage Indices. At our target price, the shares would trade in line with these indices, but Diageo's one-year forward P/E would be above the historic upper range of ~22x.

Business Quality Review:

- Diageo ended FY17 with net debt of GBP 7.89 bn, a GBP 743 mn decrease vs. FY16. Net debt/EBITDA of 2.0x was well below the 2.5x–3.0x target.
- Diageo is a high-margin business. For FY17, it reported an EBIT margin of 29.5%. The cost savings and efficiency programme should drive the margin going forward. Consensus sees the EBIT margin gradually improving to 31.7% in FY20.
- S&P rates Diageo's long-term debt A- with a stable outlook.

Dividend Policy:

- Diageo aims to increase the DPS each half year, thereby targeting a full-year dividend cover of 1.8–2.2x, i.e., a payout of 45.5–55.5%.
- The final DPS was recommended at GBp 38.5 (+5%), bringing the FY17 DPS to GBp 62.2 (+5%).
- As Net debt/EBITDA fell below the target range a GBP 1.5 bn share buyback was initiated for FY18.
- The expected FY18–22 average FCF of GBP 2.9 bn should allow for further shareholder returns, in our view.

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Financial Terms And Acronyms

BV (Book Value): is the total value of net assets of a company.

BV/S (Book Value Per Share): is the total value of the net assets of a company divided by the total number of outstanding shares.

C/I (Cost Income Ratio): is used for valuing banks. It shows a company's costs in relation to its income.

CAGR (Compound Annual Growth Rate): is a term used for the geometric progression ratio that provides a constant rate of return over a specific time period.

CAPEX (Capital Expenditure): is the fund used by the company to acquire or upgrade the physical assets such as property, industrial buildings or equipment. The most capital intensive industries include oil, telecom and utilities.

CAR (Capital Adequacy Ratio): is a measure of a bank's capital. It is expressed as a percentage of a bank's risk-weighted credit exposures.

CET I (Common Equity Tier I Ratio) : is a measure of the bank's common equity capital as a percentage of risk-weighted assets. It is generally compared to a defined benchmark stipulated by the regulatory authority to determine whether a bank is sufficiently capitalised.

COMBINED RATIO: It represents the total of acquisition and administrative expenses, and claims and insurance benefits incurred, divided by net premiums earned.

DIVIDEND PER SHARE (DPS): Dividend per share or DPS (total dividend paid out divided by the total number of shares) expressed as a percentage of current stock price.

EBIT (Earnings Before Interest and Taxes): profit before taking into account interest payments and income taxes.

EBIT Margin: Ratio that expresses EBIT as a percentage of total sales (EBIT/Sales*100)

EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortisation): profit before taking into account interest payments, income taxes and non-cash operating expenses (depreciation and amortisation).

EPS (Earnings Per Share): is the division of total net profit by the number of shares.

EQUITY is the difference between the value of the assets and the cost of the liabilities.

EV (Enterprise Value) is a measure of a company's value, often used as an alternative to straightforward market capitalisation. It is calculated as (market cap + debt + minority interest + preferred shares) − total cash − cash equivalents.

FCF (Free Cash Flow): represents the difference between operating cash flow and capital expenditures.

FFO (Funds from Operations): measures a REIT's operating performance. It is net income plus gains (minus losses) from property sale and purchase. FFO per share is often used in place of earnings per share when analysing REITs.

FY0: Realised year, **FY1**: Current unrealised year, **FY2**: next year, **FY17E:** Fiscal year 2017 estimation

GOODWILL: is an intangible asset that arises as a result of the acquisition of one company by another company for a premium value.

GROSS INCOME: gross profit calculated as a company's total sales minus its cost of goods sold (COGS) that corresponds to labour and production costs.

GROSS MARGIN: expresses gross income as a percentage of total sales.

LIKE FOR LIKE (LFL) GROWTH: is a measure of growth in sales, adjusted for new or divested businesses.

Loan-to-deposit (L/D) ratio: Loans/Deposits. This helps in assessing a bank's liquidity, lending capacity and balance sheet quality.

LTV (Loan-To-Value Ratio): is a financial term used to express the ratio of a loan to the value of an asset purchased.

NAV (Net Asset Value): is similar to book value and is also called per investment unit. NAV is the marked-to-market value of the company's property investments less liabilities.

ND (Net Debt): is calculated as a company's total debt minus cash and other similar liquid assets.

NET MARGIN: is a financial ratio which measures the profitability of the net income of a company.

NI (Net Income or Bottom Line): represents a company's total earnings (or profit) which is calculated by adjusting revenues for the costs, depreciation, interest, taxes and other expenses.

NIM: Net Interest Margin

NON-PERFORMING LOANS (NPL) RATIO: NPLs/Loans. This indicates the percentage of the loans that are non-performing or are in stressed segments.

OPERATING MARGIN: See definition of EBIT Margin.

ORGANIC GROWTH: is the growth rate that a company can achieve by increasing its output and enhancing sales, excluding any profits or growth from takeovers or M&A activities.

P/E or PER (Price Earnings Ratio): reflects the trading price of a share in relation to the expected earnings.

P/BV (Price To Book Value): expresses the share price with regard to the accounting value of the company.

PAYOUT RATIO: is the proportion of earnings paid out as dividends to shareholders and typically expressed as a percentage.

PROFIT WARNING: is the announcement made by the company before its earnings release indicating the investors that its earnings would not meet the analysts' expectations.

RWA (Risk Weighted Assets): is a measure of the bank's assets, weighted according to their risk. It involves the risk weighting of both on and off-balance-sheet exposures.

REVENUE GROWTH: Illustrates the growth of sales over a given period.

ROA (Return on assets): a financial ratio that is calculated as net income divided by total assets and shows how profitable a company is relative to its total assets.

ROC (Return on invested capital): a profitability ratio which is calculated as net income minus dividends divided by total invested capital.

ROE (Return On Equity): The amount of net income returned as a percentage of shareholders' equity. Return on equity measures a corporation's profitability by disclosing how much profit a company generates with the money shareholders have invested.

TBV (Tangible Book Value): is the book value excluding intangible assets.

TBV/S (Tangible Book Value Per Share): allows to estimate the accounting value of a company by measuring its stockholders' equity per share. Formula: Re-valued Net Assets/Total Shares of Company.

WACC (Weighted Average Cost of Capital): also referred to as the firm's cost of capital, it is the rate that a company is expected to pay on an average to all its security holders to finance its assets.

WORKING CAPITAL: is the difference between a company's current assets and current liabilities and shows whether the company has sufficient short-term assets to cover its short-term debts.

Appendix

Investment Rating Definitions:

Buy Stock that is expected to outperform its MSCI sector index over a 12-month investment horizon.

Neutral Stock that is expected to perform in line with its MSCI sector index over a 12-month investment horizon.

Sell Stock that is expected to underperform its MSCI sector index over a 12-month investment horizon.

Restricted Covered stock that is not rated or assigned a target price as the Societe Generale group has a capital market transaction with that company.

Termination Stock is subject to be deleted from the SGPB recommended universe and will no longer be followed. In this case, a coverage termination alert is issued.

Recommended Universe Principle:

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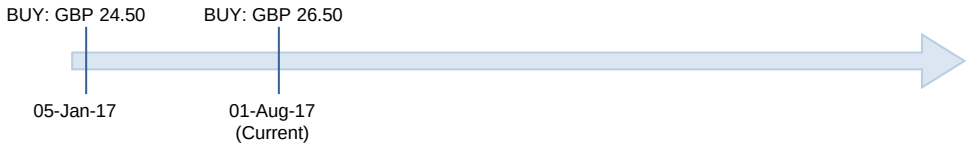
Product Risk Rating:

The product category of single equity, stock, share is rated at '4'.

In order to draw the attention of potential investors to the risk linked to each investment solution, Societe Generale Private Banking has ranked each product according to its own specific risk scale from the lowest risk (class 0) to the highest risk (class 4). The risk classification in 5 levels, is a Societe Generale Private Banking internal risk indicator. These internal indicators are based on the Value at Risk 95% 1 year (VaR). The VaR corresponds to the maximum amount that the portfolio being considered could lose in normal market conditions over a given period with a given probability (past performances and simulations of performance shall not be considered as a reliable indicator of future performance). If the VaR 95% 1 year is y%, this means that there is a 95% probability that the portfolio will not lose more than y% of its value in one year.

Risk Levels	Losses
0 - Lowest Risk	There is a 95% probability that the product will not depreciate in value in one year.
1 - Low Risk	There is a 95% probability that the product will not lose more than 5% of its value in one year.
2 - Medium Risk	There is a 95% probability that the product will not lose more than 15% of its value in one year.
3 - High Risk	There is a 95% probability that the product will not lose more than 30% of its value in one year.
4 - Highest Risk	There is a minimum of 5% probability that the product will lose more than 30% of its value in one year.

1Y Target Price:



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Risk Classification
R0: Lowest Risk
R1: Low Risk
R2: Medium Risk
R3: High Risk
R4: Highest Risk

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