

DIAGEO PLC (ADR) - (NYSE:DEO)/DIAGEO PLC - (LON:DGE)

Company Description:

Diageo (pronounced dee-AH-zhay-oh) plc was incorporated as Arthur Guinness Son & Company Limited in October, 1886. After a number of mergers, in 1997, the corporation changed its name to Diageo. It is one of the world's largest alcoholic beverage producers and distributors. Popular brands include Johnnie Walker (blended scotch whisky), Jose Cuervo (tequila), Baileys (liqueur), Captain Morgan (rum), Smirnoff (vodka), and Guinness (beer). 43% in emerging markets. It employs roughly 27,400. Chief Executive Officer: Ivan Menezes. Chairman: Dr. Franz Humer. London England. www.diageo.com. 1 DR = 4 ORD

Basic Description:

Net profits have grown slowly, but steadily over time. The stock price has traded in a narrow range with P/Es generally in the high teens regardless of the environment. DEO pays out about 60% of earnings in a dividend with periodic share repurchasing (twice - one with debt). DEO has a good ROC and a superior ROE with a steady ratio of debt to equity to net profits. Revenues grew and then flattened with a steady level in operating profit margins, despite their already high levels and a decrease in tax rates to low levels. Challenges are growth and maintenance of operating and tax margins.

Profitability Description:

DEO has high profitability as indicated by its superior ROEs and operating margins. Yet, the returns on capital are declining, organic growth has been zero for two years and margins appear flat (despite the presentation by VL). The net effect is a "bond-like" company whose large portfolio has winners that seem to be offset by losers. Despite these challenges, DEO continues to pay out a sizeable dividend and retain the remaining funds for making acquisitions. DEO has a different strategy for each geographic zone, highlighting expensive bourbon in the US and cheap spirits and beer in Africa. Despite that breadth, 45% of operating profit comes from the US where bourbon and whiskey gains are barely making up for the declines in scotch. It appears that the India market is increasing in profitability, but large currency swings make income and balance sheet analysis difficult. Excess cash flows from the most recent year appear to reduce debt and post retirement liabilities, despite mark to market confusion.

Core Advantage Description:

DEO has brands which are well recognized and present a wide competitive "moat." In addition, some of the alcohol space, such as wine and whiskey take years to develop, creating more competitive advantages. While consumer tastes may change, they are clearly susceptible to advertising and DEO has proven adept in the past at adapting if necessary. However, the breadth of brands leads to challenges in gaining broader brands, global efficiencies in advertising and supply chains and a lack of conviction as a category or brand loses favor (unlike BFB). In addition, spirits are inherently more complex than beer, soft drinks or still drinks - and this may be a relative advantage in the beverage space.

Investment Thesis:

DEO has a challenge with top line growth, having turned in 0% organic growth for two years. This has contributed to the flattening of revenues for the past two years. However, other issues are at work - notably problems in North and South America. ACM assumes an organic growth (mainly price) of 2% with an inflation rate of 2%, giving 4% growth. In addition, acquisitions (bolt-on due to large size) add another 2%. This 6% top line growth rate is accompanied by a net margin maintenance. However, ACM believe that this profit margin can be expanded in India if volume is "premiumized" and margins are created.

Purchase Description:

ACM considers DEO a buy at \$80 (combo of 15X 2016 earnings, e.g. model, equity bond, low P/E and low P/B and 60% of "fair value") to 4.5% and a buy at 3% at \$88 and a buy to 2% at \$97 and a sell at \$130 (ave of capl charge and 5% sell) as a Tier I purchase. While DEO is a Tier I based on the competitive strengths it has, DEO is not a compounder because it is not exhibiting volume growth.

	FY End			Stock Price		Market Value (in mlns)											
	June			\$102.00		\$70,237.20											
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Net Profit (mln)							2,714	2,975	2,663	2,472	3,051	3,253	3,945	3,871	3,744	3,165	3,150
EPS							\$3.70	\$4.22	\$3.78	\$3.59	\$4.43	\$4.72	\$5.73	\$5.62	\$5.44	\$4.60	\$4.58
Operating EPS							\$3.70	\$4.22	\$3.78	\$3.59	\$4.43	\$4.72	\$5.73	\$5.62	\$5.44	\$4.60	\$4.58
Ave. P/E Ratios							19.2	18.0	13.6	16.3	15.4	18.1	19.3	19.9	19.6	22.9	
Yrly Price Low			37.6	48.2	54.4	58.3	74.5	49.2	40.9	55.9	71.3	84.4	111.9	109.5	100.6	99.0	
Yrly Price High			53.1	58.1	61.6	80.2	93.1	86.4	70.0	76.4	87.5	121.4	134.1	133.0	122.0	117.8	
Dividends Paid							1927.2	1925.9	1671.9	1569.8	1790.1	1907.2	2058.7	2320.4	2354.9	2348.1	2478.6
Dividends PS							\$2.63	\$2.73	\$2.37	\$2.28	\$2.60	\$2.77	\$2.99	\$3.37	\$3.42	\$3.41	\$3.60
Ave. Div. Yld.							3.14%	4.03%	4.27%	3.45%	3.27%	2.69%	2.43%	2.78%	3.07%	3.15%	
Shares Outstdg.							732.8	705.5	705.5	688.5	688.5	688.5	688.5	688.6	688.6	688.6	688.5
Buyback \$ (mln)							2.5	1851.6	0.0	1122.6	(0.8)	(3.1)	(1.2)	(1.2)	(3.3)	(2.2)	0.0
Shr. Equity (mln)							7,984	6,961	5,299	6,011	8,424	8,726	10,700	11,667	12,221	11,451	12,125
Book Value PS							\$10.90	\$9.87	\$7.51	\$8.73	\$12.23	\$12.67	\$15.54	\$16.94	\$17.75	\$16.63	\$17.61
LT Debt (mln)							8,305	11,035	12,642	12,266	10,837	11,554	12,521	13,061	12,450	10,835	10,500
Return On Eq.							33.99%	42.74%	50.27%	41.13%	36.22%	37.28%	36.87%	33.18%	30.64%	27.64%	25.98%
Return On Capl.							16.66%	16.53%	14.85%	13.53%	15.84%	16.04%	16.99%	15.66%	15.18%	14.20%	13.92%
Transl. Rate(\$/ £)							2.01	1.99	1.64	1.50	1.61	1.56	1.52	1.71	1.57	1.34	1.35

Summary:

Investment Characteristics

Earnings Analysis:

Growth Rate %: 2.43%

Quality %: 100.00%

Use Of Earnings Analysis:

Avg Div Payout Rate 62.34%

Avg Stk Buyback Ra 10.74%

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Revenues (mln)								15,037	16,099	15,317
SPS								\$20.52	\$22.82	\$21.71

Sales Analysis:

Growth Rate %: -0.75%

Growth Rate PS %: -0.06%

Sales Analysis (last 5 yrs.):

Growth Rate %: -2.51%

Growth Rate PS %: -2.52%

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Oper. Margin								31.70%	30.40%	29.20%
Tax Rate								32.40%	24.90%	14.50%
Deprec. (mln)								422	464	454
Depreciation %								15.56%	15.59%	17.05%

Summary:

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Description & Analysis of Profits

	2012		2013		2014	
"Gross" Operating Revenues	14,392		15,276		13,980	
Excise Taxes	3,753	26%	3,973	26%	3,722	27%
"Net" Operating Revenues	10,639		11,303		10,258	
NorthAmerican	3,547	33%	3,723	33%	3,444	34%
Europe/Russia/Turkey	2,331	22%	2,203	19%	2,169	21%
Africa	2,048	19%	2,276	20%	2,075	20%
LatAme	1,236	12%	1,453	13%	1,144	11%
AsiaPacific	1,407	13%	1,572	14%	1,347	13%
Corporate	70	1%	76	1%	79	1%
Internal Costs:	7,531		7,923		7,551	
COGS	4,208	40%	4,416	39%	4,029	39%
Marketing	1,671	16%	1,769	16%	1,620	16%
Other Operating	1,652	16%	1,738	15%	1,902	19%
EBITDA:	3,368	32%	3,861	34%	3,196	31%
Depreciation	407		398		629	
Non Operating Items	(147)		83		(140)	
"Free" Cash Flow:	2,930		3,264		2,634	
Capex	438		597		562	
EBIT:	3,108	29%	3,380	30%	2,707	26%
NorthAmerican	1,341	38%	1,478	40%	1,425	41%
Europe/Russia/Turkey	755	32%	619	28%	619	29%
Africa	567	28%	648	28%	531	26%
LatAme	366	30%	468	32%	314	27%
AsiaPacific	299	21%	380	24%	7	1%
Corporate	(180)		(151)		(142)	
External Costs:	1,223		747		583	
Interest Expense, Net	441		457		388	
Income Taxes	1,011		507		447	
Assoc. and JV	(229)		(217)		(252)	
Earnings:	1,885	18%	2,633	23%	2,124	21%
Dividends:	1,036		1,125		1,228	
Share Repurchases:	-5		-2		-2	
Stmnt of CFs					112	
Net Bness Acquisitions:	1,420		644		536	

Summary:	
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Balance Sheet (in millions):

	2013	2014
Assets:	24,991	22,964
Intangible assets	9,013	7,891
Property, plant and equipment	3,425	3,433
Biological assets	36	53
Investments in associates and jc	2,521	3,201
Other non current assets	932	420
Deferred tax assets	242	246
Post employment benefit assets	312	251
Inventories	4,207	4,222
Trade and other receivables	2,437	2,499
Other current assets	116	126
Cash and cash equivalents	1,750	622
Liabilities:	16,903	15,374
Borrowings and bank overdrafts	1,852	1,576
Other financial liabilities	122	146
Trade and other payables	3,212	2,800
Corporate tax payable	224	197
Provisions	109	132
Borrowings	8,217	7,638
Other financial liabilities	473	447
Other payables	118	94
Provisions	256	253
Deferred tax liabilities	1,467	1,365
Post employment benefit liabilities	853	726
Shareholder's Equity:	8,088	7,590
Share capital	797	797
Share premium	1,344	1,345
Other reserves	3,154	2,243
Retained earnings	1,741	2,438
Non-controlling interests	1,052	767
Summary:		

Description & Analysis of Debt Levels (in mlns):

Summary: Debt is a four-letter word. Debt causes the years of repayment of capital to equity shareholders to stretch out into the more distant future. Even worse, debt can cause the best business model to become the property of bondholders in a rough economic environment.

Total Debt-Capital: The measure of total debt to total capital is useful when book value is a good measure of a firm's worth. This is particularly true of traditional businesses where property, plant and equipment are important. Further, it helps to have this ratio in capital intensive businesses with cyclical earnings.

Total Debt:	18,311	Here, deferred income taxes have been excluded.
Total Capital:	28,491	Here, deferred income taxes have been excluded.
Ratio:	64.27%	

Long Term Debt-Cap.: The measure of long term debt to total capital is useful when total debt is distorted by the high presence of current assets being financed by current liabilities. Again, the measure works best within a traditional industry setting. The ratio helps position the equity shareholders.

L. T. Debt:	8,071	Here, the current liabilities have been excluded.
L. T. Capital:	18,251	Here, the current liabilities have been excluded.
Ratio:	44.22%	

Net Income Payback: The measure of how quickly total debt is repaid by net income is a conservative measure, as it includes debt such as current liabilities, that are financed by current assets and excludes some sources of cash, such as noncash amortization numbers.

Total Debt:	18,311
Net Income:	2,406
Years Payback	7.6
L.T. Debt:	8,071
Net Income:	2,406
Years Payback	3.4

Addback Net Inc. Payback: The measure of how quickly debt is repaid by addback net income is a good measure, as it starts with GAAP net income and adds back expenses on an after-tax basis that are clearly discretionary, such as business acquisitions to better analyze the strength of the repayment stream.

L.T. Debt:	8,071	
Net Income:	2,406	
Addback:	0	Merger charges, writedowns above the line, dep. Amort below the line less capex
Years Payback	3.4	

Interpretations: DEO has a good debt situation.

Industry Overview

The beverage industry has high profit margins and better than average financial characteristics. Brands are important in this sector and premium brands continue to have better results as consumers "trade up" globally. This highly competitive sector is characterized by a high level of M&A as bigger distribution systems seek to amortize their costs and deliver a greater variety of product.

Industry Comparisons

Operating Statistics:

Company	Yrs.Paybk	Sales	ROC	Operating Margin
BFB	1.46	\$3,300	23.90%	31.50%
DEO	3.35	\$14,050	14.20%	32.03%
RI	6.92	\$9,414	10.00%	25.88%
RCO	4.00	\$990	7.00%	18.00%

Market Statistics:

Company	P/B	P/E	Divd. Yld.	EV/Sales
BFB	8.41	27.2	1.38%	6.27
DEO	6.13	22.2	3.15%	5.77

Qualitative Characteristics

Positives:

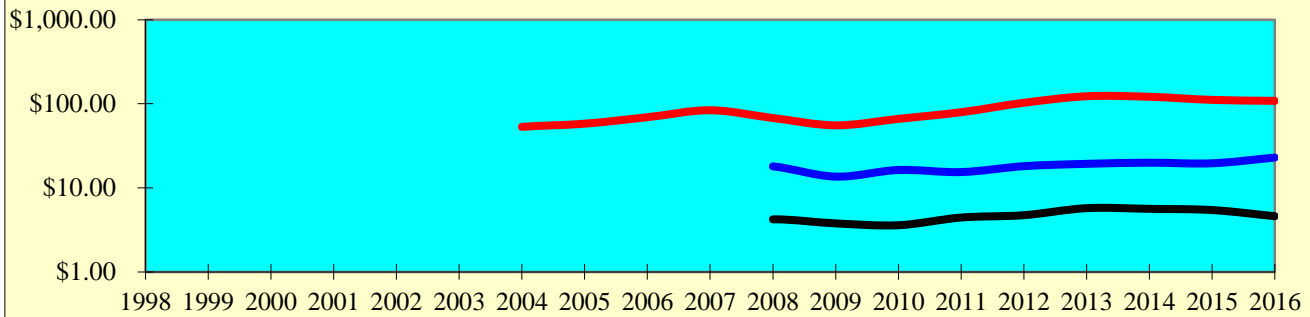
Negatives:

Product/Service:

Pricing Power:	Yes
Management:	
Effective As Public:	Yes
Global Opportunity:	Yes
Business Model:	Portfolio of Brands
Toll Bridge:	Yes
Competition:	Limited
Economic Risk:	
Government Role:	
Business Risk:	Little
Durability:	Yes
Role Of Technology:	Little

Yes, premium brands can trade down
Distribution and Taxation

Average Stock Price vs. Average P/E vs. EPS



	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
EPS	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$3.70	\$4.22
Ave. P/E Ratios	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	19.20	18.00
Ave. Stock Price	0.00	0.00	0.00	0.00	0.00	45.35	53.15	58.00	69.25	83.80	67.80

Price/Earnings Ratio: used - **\$4.60**
 Nine year average low P/E is **17.1**
 Nine year average high P/E is **22.6**
 If we set the purchase at the ave. Nine year low P/E,
 the price implied is: **\$78.68**
 If we set the sell at the ave. Nine year high P/E,
 the price implied is: **\$103.88**

Price/Sales Ratio: used - **\$20.40**
 Nine year average low P/S is **3.45**
 Nine year average high P/S is **4.51**
 If we set the purchase at the ave. Nine year low P/S,
 the price implied is: **\$70.36**
 If we set the sell at the ave. Nine year high P/S,
 the price implied is: **\$92.08**

Price/Book Ratio: used - **\$16.63**
 Nine year average low P/B is **6.14**
 Nine year average high P/B is **8.25**
 If we set the purchase at the ave. Nine year low P/B,
 the price implied is: **\$102.18**
 If we set the sell at the ave. Nine year high P/B,
 the price implied is: **\$137.26**

Price/Cash Flow Ratio: used - **\$5.29**
 Nine year average low P/CF is **13.0**
 Nine year average high P/CF is **18.5**
 If we set the purchase at the ave. Nine year low P/CF,
 the price implied is: **\$68.69**
 If we set the sell at the ave. Nine year high P/CF,
 the price implied is: **\$97.63**

Initial Rate of Investment	
Current Price	\$102.00
Current EPS	\$4.60
Initial ROI	4.51%

Relative Value to Investment In T-Bonds	
Current EPS	\$4.60
T-Bond Rate	6.00%
Relative Value	\$76.60

Capital "charge"

Valuation as an Equity Bond:	
Current BV	\$16.63
Current ROE	27.64%
Retained %	37.66%
Net BV Growth	10.41%
BV in Year 10	\$44.76
EPS in Year 10	\$12.37
Value@Ave.P/E	\$247.44
Total Dividends	\$38.73
Total F. Value	\$286.16
Purchaseat14%	\$77.19

Valuation on Earnings Growth:	
Current EPS	\$4.60
EPS in Year 10	\$9.92
Ave. P/E Ratio	18.23
Value@Ave.P/E	\$237.19
Price Return	6.88%
Dividend Return	3.15%
Total Return	10.03%
Purchaseat14%	\$58.63
Sell@5%	\$145.61

4,153

0.12

0.06

0.8

0.072

57675

8,071

49,604

69445.6

688.6

100.8504211

60.51025269

121.0205054

History of Buys/Sells

Cash Flow (in millions):

	2006	2007	2008	2009	2010	2011	2012
Cash From Operations:							
Net Income	\$320	\$389	\$440	\$435	\$449	\$572	\$513
Depreciation & Amortization	\$42	\$44	\$52	\$55	\$59	\$56	\$49
Stock-based Compensation	\$9	\$8	\$10	\$7	\$8	\$9	\$9
Other	<u>(\$28)</u>	<u>(\$86)</u>	<u>\$32</u>	<u>(\$6)</u>	<u>\$29</u>	<u>(\$110)</u>	<u>(\$55)</u>
Net Cash From Operations	\$343	\$355	\$534	\$491	\$545	\$527	\$516
Cash From Investing:							
Net Acquisitions and Investments	\$204	(\$1,058)	(\$11)	\$17	\$0	\$234	\$0
Net Purchase of PP&E	(\$44)	(\$44)	(\$35)	(\$49)	(\$32)	(\$27)	(\$58)
Other	<u>(\$163)</u>	<u>\$64</u>	<u>\$74</u>	<u>\$5</u>	<u>\$3</u>	<u>(\$4)</u>	<u>(\$10)</u>
Net Cash From Investing	(\$3)	(\$1,038)	\$28	(\$37)	(\$35)	\$203	(\$68)
Cash From Financing:							
Net Issuance of Debt	(\$55)	\$595	(\$172)	(\$6)	(\$302)	\$55	(\$248)
Net Issuance of Stock	\$23	\$35	(\$202)	(\$41)	(\$161)	(\$135)	(\$222)
Dividends	<u>(\$128)</u>	<u>(\$143)</u>	<u>(\$362)</u>	<u>(\$169)</u>	<u>(\$174)</u>	<u>(\$326)</u>	<u>(\$192)</u>
Net Cash From Financing	(\$160)	\$487	(\$736)	(\$216)	(\$637)	(\$406)	(\$662)
Effect of Exchange Rate Changes:	\$0	\$4	\$10	(\$17)	\$19	\$11	(\$15)
Net Increase/Decrease During Year:	\$180	(\$192)	(\$164)	\$221	(\$108)	\$335	(\$229)
Balance at Beg. of Year:	\$295	\$475	\$283	\$119	\$340	\$232	\$567
Balance at End of Year:	\$475	\$283	\$119	\$340	\$232	\$567	\$338

Summary:

Little or no reinvestment needs. Excess cash flow used to fund brand purchases, stock buy-backs and dividends.