DIAGEO

BEVERAGES

TOUGH COMP WILL RESTRAIN H1 BUT Q3 WILL LOOK MUCH BETTER

Diageo will report H1 results tomorrow (11 Feb). We firmly believe that it will beat consensus for the full year (our EPS forecast is 2.6% above consensus – a material number for Diageo) – but that H1 is likely to look bleak, with sales down and profits no more than flat in constant currency. The trigger for share price outperformance will be stronger organic sales growth and the possibility of rising consensus forecasts. Do not expect FY guidance to change this week: it is not Diageo's style to raise guidance just seven months into the year. However, guidance might rise at the end of the financial year (in June) and a nearer-term trigger will arise in April with publication of strong Q3 sales (against an easy -7% comp). A strongly defensive stock, we see Diageo as a top pick for 2010.

- **Our H1 forecast is close to consensus:** We forecast H1 net sales of £5,059m (consensus £5,092m); EBITA of £1,694m (consensus £1,690m); pre-tax profit of £1,598m (consensus £1,562m); net profit of £1,177m (consensus £1,081m); and EPS of 47.2p (consensus 47.0p).
- **Diageo's FY guidance is clear: low single-digit organic EBIT growth**, including £120m of cost savings. This implies around a 1.5% sales decline in the full year (assuming margins are flat pre-cost savings).
- **Our own forecasts are more bullish.** With a far easier sales comp in H2 (especially Q3), we expect FY sales to be down -0.5% organic. Our FY EPS forecast is 2.6% above consensus. We see the trigger for this in Q3 when Diageo reported -7% a year ago. However, the drop was all accounted for by destocking: consumer off-take was actually flat in that quarter. Therefore, if consumer off-take is flat in Q3 this year, and there is no further destock, organic sales growth in Q3 would be +7%. Our forecast is more prudent: we assume a little more destocking and a slight reduction in consumer off-take, so we forecast Q3 organic sales growth of +5%. The implication of this is that our FY forecast, already above consensus, looks conservative, in our view.
- **H1 sales and earnings drags:** Tomorrow the focus is likely to be weak H1 performances in the US, Eastern Europe, Ireland and Spain. Also, H2 will see a drag on earnings of around 1% following the Venezuelan devaluation. As such, recent share price weakness might persist; but if it does, we would see that as a buying opportunity ahead of the expected Q3 bounce-back.
- **Recent newsflow from Coke Hellenic and from SABMiller also changes our view:** Given recent excise tax hikes on beer and higher input costs that affect beer more than spirits, we warm to spirits as a more defensive play.

Rating	BUY
Target price (p)	**1,300p**
Current price (p)	1,014p
Market cap (£m)	25,394
EV/EBITDA	10.1
Reuters/Bloomberg	DGE.L / DGE LN
52-wk range	727p-1098p

Year-end June (£m)	2009	2010E	2011E
Revenue	9,311	9,415	9,831
EBITDA	2,889	3,006	3,188
EBITA	2,613	2,780	2,953
PBET	2,185	2,509	2,713
Net profit	1,598	1,177	1,843
Net (debt)/cash	(7,563)	(6,747)	(5,823)
Net assets/(def)	3,936	5,016	6,170
Dil EPS (p)	64.1	73.9	79.9
DPS (p)	36.10	37.91	39.80
FCF (p)	52.2	72.3	78.5
P/E (x)	14.7	13.2	12.3
EV/EBITDA (x)	10.8	10.1	9.4
Net debt:EBITDA (x)	2.48	2.15	1.75
Interest cover (x)	4.7	7.2	8.1
ROIC (%)	21.3	20.1	20.6

Research

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MATRIX

10 FEBRUARY 2010

CORPORATE CAPITAL

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This report was first released on 10 February 2010.

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Company	Disclosure
Diageo (DGE)	None

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