



BAD NEWS IS OVER – TIME TO BUY

The next 3 months present a strong buying opportunity for Diageo. Most importantly, the tough quarters are now behind Diageo: easy comps lie ahead. H1 numbers were undeniably weak but much of the H1 EBIT shortfall was due to £49m higher central costs: these were one-offs and will not recur in H2. Sales declined 6% in Q1 so to have been down just 2% in H1 they must have grown by around 4% in Q2. We expect this solid growth to continue in H2, especially in Q3 (reporting 6 May), comping against the -7% "destock quarter" a year ago. We disagree with the notion that Diageo has under-invested in AMP on its brands. We cut EPS 2% but we reiterate our Buy rating.

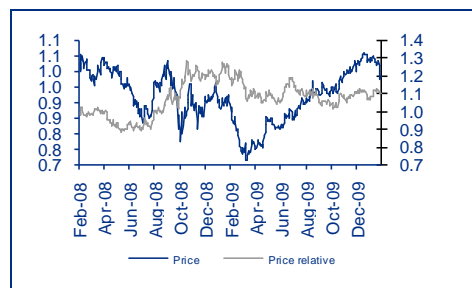
- **We cut our F10 EPS** 2% from 73.9p to 72.4p, F11 by 2.5% from 79.9p to 77.9p
- **Trading is improving.** There are signs of improvement in the USA with vols up 4% in Dec. Jan has been weaker again but it's a very small month. The destocking is largely over. No doubt some risk remains here (after all we've heard them say that before!) - but clearly the worst is over. Elsewhere in the world, Diageo recorded very strong performances (and share gains) in Britain, Russia, LatAm (including Venezuela), Africa and even in China.
- **Costs are falling.** COGS will only rise 2% in the FY, not 4-5% as previously guided. And, as we've been saying since the start of the new year, with media rates down 10-12%, Diageo has not cut its AMP any more than media deflation, so the brands are not "under invested". It has also cut out a lot of non-working dollars from the AMP budget. It is also perfectly reasonable in our view to cut AMP in markets such as Spain and Ireland which are structurally challenged. The AMP rebuild begins right now, but to restore peak levels of AMP, it needs to rise by 2%-pts of sales. History suggests this will happen in a phased manner over 2+ years, so we see it as only a modest drag to earnings (essentially the first 1% of sales growth will be profitless for 2 years).
- **Price/mix was weak in H1** but in fairness to Diageo there has been a lot of downtrading in the USA and many of Diageo's brands are at very premium or even super-premium price points (eg Crown Royal, Tanqueray, Baileys, Johnnie Walker Black). Diageo's view is that we are now at the bottom of the price promotion cycle in the USA so price/mix should be stronger hereafter.
- **We are less bearish than the market on AMP:** We refute the notion that Diageo has under-invested in AMP on its brands and we see the rebuild of AMP as a modest drag on earnings, not a major drag. With media rate cards down 10-12%, we contend that there has been no underinvestment in AMP on the brands. We demonstrated in our January note that to restore AMP to peak levels as a % of sales, AMP investment will grow by 1%-of-sales per year for 2 years, which is only a modest earnings drag.

Research

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Rating	BUY
Target price (p)	1300p
Current Price (p)	1018p
Market Cap (£m)	25,494
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	9,435	9,804
EBITA	2,613	2,760	2,916
PBET	2,185	2,449	2,635
Net profit	1,598	1,797	1,933
Net (debt)/cash	(7,563)	(6,736)	(5,796)
Net assets/(def)	3,936	5,033	6,190
Dil EPS (p)	64.1	72.4	77.9
DPS (p)	36.10	37.91	39.80
P/E (x)	14.9	13.5	12.4
EV/EBITDA (x)	10.8	10.1	9.4
Net debt:EBITDA (x)	2.48	2.14	1.75
Interest cover (x)	4.7	6.5	7.3
ROIC (%)	21.3	20.2	20.7



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Company	Disclosure
Diageo (DGE)	None

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