



## OUTSTANDING Q3: 2.2% EPS UPGRADE WITH FURTHER UPSIDE RISK

Our Buy case on Diageo has been that the bad news is behind it, and that coming quarters would see strong growth against easy comps. Q3 strongly underpinned this view with +12% organic sales growth (vs. consensus +7.1% and Matrix +8.5%). It means that Diageo's 2-year growth rate versus Q3 2008 is +5%, compared with Pernod Ricard +4% and Moët-Hennessy -2%. We upgrade our FY organic sales growth forecast from 0% to +2%, but this is still prudent and could become 2.5% or 3% as we look ahead. Even the current 2% sales upgrade gives an EPS upgrade to 74p. The industry is performing well and Diageo's performance within it is far stronger than the market had expected. We maintain our BUY rating.

- **We raise our F10 EPS by 2.2% from 72.4p to 74.0p, F11 by 5.5% from 77.9p to 82.2p.** These forecasts now exceed the modest EPS cut we put through after the H1 figures in February. More importantly, we see real further upside risk to these upgraded numbers.
- **Our upgrade is driven by stronger FY organic sales growth.** We had forecast 8–9% organic sales growth in Q3 and 0% in Q4. Overall we were forecasting 0% organic growth in FY 2010. With the massive Q3 beat we now raise our FY 2010 organic sales growth estimate from 0% to 2%. This delivers £189m of additional sales and, on our estimates, £110m of additional gross profit (Diageo has confirmed to us that costs guidance has not changed since February – in fact commodity costs are slightly lower than expected then).
- **We expect the £110m extra gross profit to be shared partly between increased AMP investment and higher EBITA.** Official guidance is for AMP in F10 to stay flat at 12.8% of net sales (implying an increase in H2 after a decrease in H1). However Diageo openly talks about raising AMP as a % of sales as economies improve and sales grow. We forecast an AMP increase to 13.0% of sales in F10, delivering our new EBITA forecast of £2,796m. (For F11 we forecast AMP at 13.8% of net sales; for F12 we forecast 14.4%).
- **Upgrade today – more upgrade risk ahead.** Organic sales growth in Q1 was -6%; in Q2 it was +2%; in Q3 it was +12%. The Q3 figure was cycling a -7% figure a year ago, so the 2-year growth rate was +5%. In Q4 the comp is -1%, far tougher than the Q3 comp, so we do not expect a similar growth rate in Q4. We currently project zero growth in Q4, but even this prudent estimate would lead to the 2% FY organic sales growth that we now project. There is further upside risk to our Q4 and FY estimate.

### Research

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<b>Rating</b>	<b>BUY</b>
Target price (p)	1,300
Current price (p)	1,084
Market cap (£m)	26,937
Reuters/Bloomberg	DGE.L / DGE LN
52-wk range (p)	829-1176

Year-end June (£m)	2009	2010E	2011E
Revenue	9,311	9,737	10,274
COGS	(3,883)	(4,111)	(4,226)
Gross profit	5,428	5,626	6,047
Operating costs	(2,539)	(2,597)	(2,806)
EBITDA	2,889	3,029	3,241
EBITA	2,613	2,796	3,000
Associates	164	134	141
Finance charges	(592)	(445)	(381)
PBET	2,185	2,485	2,759
Tax	(485)	(547)	(607)
Minorities/other	(104)	(103)	(102)
Net profit	1,598	1,845	2,050

Net (debt)/cash	(7,563)	(6,815)	(5,885)
Net assets/(def)	3,936	5,036	6,227

Dil EPS (p)	64.1	74.0	82.2
DPS (p)	36.10	37.91	39.80

P/E (x)	16.9	14.6	13.2
EV/EBITDA (x)	11.5	10.9	10.0

Net debt:EBITDA (x)	2.62	2.25	1.82
Interest cover (x)	4.7	6.6	8.2
ROIC (%)	21.3	20.2	20.8



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Company	Disclosure
Diageo (DGE)	None

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