



SABDIAGEO? OR DIAGEABINBEV?

Our pre-closed season meeting with Diageo leads us to see further upside risk to our FY 2010 forecasts, which we upgraded after the strong Q3 sales. We expect Diageo to beat our organic sales growth rate of +2.0% – we now see this coming in closer to +3.0%. We also expect Diageo to beat our FY EPS forecast of 74.0p and consider consensus of 75.0p to be safe. M&A prospects are becoming more interesting. As well as the continued possibility of a Moët-Hennessy acquisition, Diageo seems open to thoughts of a merger with a global brewer, due to the strong revenue synergies available. However, with most brewers' balance sheet constrained, we do not expect this to materialise in the next two years.

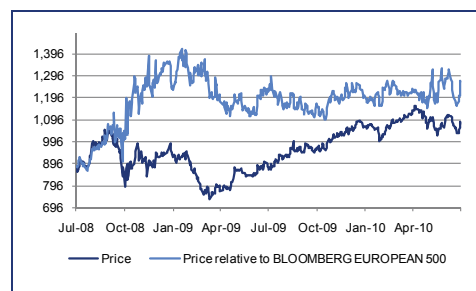
- Following our meeting we see upside risk to our FY forecasts of +2.0% organic sales growth and EPS of 74.0p. We think organic sales growth will be nearer +3.0% and EPS will be at least in line with consensus of 75.0p.
- USA is growing again but at a sluggish +1%. Europe is broadly flat with growth in the UK offsetting declines in Spain. Africa is in solid growth. LatAm is in rapid growth. Asia is seeing strong recoveries in South Korea and Taiwan, markets where Diageo is the #1 player and where margins are strong.
- Diageo reconfirmed its interest in Moët-Hennessy (we value the 66% it does not own at £10.5bn). It would also acquire José Cuervo should it be available.
- Diageo believes strongly in the 'total beverage alcohol' strategy, pointing to the strong revenue synergies achieved between spirits and beer in its South African JV with Heineken. Stretched balance sheets mean that no deal is imminent, but we now expect more JVs like the South Africa business. We also believe the endgame in beer could involve a merger that includes Diageo: this could be SAB and Diageo or ABI and Diageo, or possibly a merger encompassing all three. We do not expect this in the next 2–3 years but we do believe it is a realistic ultimate outcome.

| Rating | BUY |
|-------------------------------------|-------------|
| Target price (p) | 1,300 |
| Share price (p) | 1,085 |
| Upside/downside to target price (%) | 19.8% |
| 52-week range (p) | 857 - 1,176 |
| Projected dividend (p) | 37.91 |
| Total shareholder return (%) | 23.3% |
| Market cap. (£m) | 27,109.33 |
| Absolute performance -1m (%) | (9.00) |
| Absolute performance -3m (%) | (58.00) |
| Absolute performance -12m (%) | 207.00 |
| Relative performance -1m (%) | (1.63) |
| Relative performance -3m (%) | 6.82 |
| Relative performance -12m (%) | 0.29 |
| Enterprise value (£m) | 35,232.34 |
| Bloomberg | DGE LN |

| Year-end Jun (£) | 2009A | 2010E | 2011E |
|------------------------------|-------|-------|--------|
| P/E | 16.9 | 14.7 | 13.2 |
| EV/EBITDA | 11.5 | 10.9 | 10.0 |
| DCF valuation | | 15.23 | |
| ROIC | 21.3% | 20.2% | 20.8% |
| Revenues | 9,311 | 9,737 | 10,274 |
| EBITDA | 2,889 | 3,029 | 3,241 |
| EBITA | 2,613 | 2,796 | 3,000 |
| Adjusted pre-tax profit | 2,185 | 2,485 | 2,759 |
| Underlying earnings | 1,598 | 1,845 | 2,050 |
| EPS pre-exceptionals (basic) | 64.30 | 74.26 | 82.50 |
| EPS pre-exceptionals (fd) | 64.07 | 73.99 | 82.20 |
| Cash flow per share (p) | 52.40 | 69.80 | 79.00 |
| NAV per share (p) | 1.58 | 2.02 | 2.50 |

Research

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SABDIAGEO? OR DIAGEABINBEV?

We had a 1/1 meeting with Diageo this week, which was enlightening in a number of areas. Diageo has just finished its financial year and goes into closed season soon.

Diageo does not expect industry consolidation in the near future, for three reasons:

- In spirits, the second-tier companies (Campari, Rémy Cointreau, William Grants etc.) are mostly performing fairly well. Some are weaker (such as Bacardi, Fortune Brands) but nonetheless this reduces the pressure for cost reduction.
- Also, one of the two obvious consolidators, Pernod Ricard, has a very stretched balance sheet, so vendors are unlikely to put businesses up for sale until they can create an auction between Diageo and Pernod. This could take another 2-3 years.
- Most of the beer consolidators (AB InBev, Heineken, Carlsberg) also have stretched balance sheets. Only SAB could move rapidly.

Moet-Hennessy

Diageo remains keen on Moet-Hennessy – if LVMH were ever willing to sell. We believe our valuation of £10.5bn for the 66% that Diageo does not currently is reasonable. We estimate that Diageo would probably fund 30-50% of this with equity, the rest with debt.

José Cuervo

José Cuervo also remains an attractive target, but the multiple Diageo would pay is not as great as it would have been a few years ago, because most of the growth in tequila is now at the super- and ultra-premium end, whereas Cuervo is the leading mainstream brand.

A beer merger encompassing Diageo

We put to Diageo our theory that AB InBev will continue to consolidate the industry and that its obvious targets are SABMiller (first) and Diageo (second). We also expressed our view that Diageo could try to pre-empt this by merging either with SABMiller or with Heineken.

Diageo's reaction to these comments indicated to us a genuine openness to corporate action. As the primary believer in 'total beverage alcohol' Diageo sees real revenue synergies from merging with a major brewer: merging with ABI or SAB would give its spirits business much more rapid growth in LatAm and certain other markets. Meanwhile it could deliver numerous markets in Europe and Africa that both ABI and SAB lack.

Our impression is that Diageo's door is open to a deal with either company. Following the 1997 creation of Diageo, which was a nil-premium 'merger of equals', Diageo sees this as the best route to creating shareholder value in the industry. It is notable that today Diageo and SABMiller have market capitalisations very similar to those of Guinness and GrandMet in 1997 (DGE £27bn, SAB £31bn).

While a Diageo/SAB combination has the 'merger of equals' attraction, Diageo was much more open to an ABI deal than we had anticipated – although it agreed that the obvious next target for ABI is SAB (selling MillerCoors on to Molson Coors as part of the deal).

Would Diageo merge with Heineken to prevent any of this? The very fact that it sees such merit in a deal with ABI or SAB suggests that it would not. Equally, it is clear to the market from the structure of the FEMSA acquisition that the Heineken family's priority is to maintain control. Diageo added that Heineken still lacks a broad enough emerging market platform from which its spirits brands would benefit if distributed by ABI or SAB – an interesting point. Nonetheless, the premium Heineken brand is clearly a great fit for Diageo, especially in the USA.

Q4 AND FY10 TRADING UPDATE

USA (44% EBIT) remains sluggish. The spirits market is certainly not as weak as it was six months let alone 12 months ago; but overall industry volumes are only growing by 1%, which is less than the Nielsen data suggests, because Nielsen only captures off-trade data and the off-trade is gaining share from the on-trade. Destocking continues but only at 20–30bps of sales. Although unemployment has peaked, the fear of a double-dip is keeping consumer spending very subdued, especially given the flexibility of labour markets. Pricing remains difficult but there is less discounting now than there was a year ago, although pricing in vodka, US whiskey and tequila is still very competitive.

Latin America is growing strongly. The number of people who can afford imported spirits is rapidly accelerating and over the next five years should be double what it was in the last five years. Brazil, Mexico, Colombia and Argentina are all growing strongly. The problem market is Venezuela: consumer spending on spirits is actually strong, but currency controls mean that Diageo is unable to repatriate capital to the UK. So far, Diageo has continued to supply the market, but if currency controls are not normalised Diageo may have to reduce its supply to Venezuela.

Africa is reasonably strong. Diageo is investing in Angola, Southern Sudan and Tanzania, all new markets for Diageo with strong growth potential. The volume weakness felt by the whole drinks industry in Nigeria in the January-March quarter did not recur last quarter, as the new president, the stronger oil price and the recovering stability of the banking industry in the country have all improved consumer confidence. Mix is negative in Nigeria as Guinness is down and Harp is up strongly; nonetheless Diageo is growing volumes and revenues by 20% in that country. In South Africa, the Brandhouse JV with Heineken is performing well with both spirits and beer up in low/mid single digits. It has delivered very strong revenue synergies for both Diageo and Heineken and Diageo would be strongly in favour of replicating the model in other markets.

Europe was recently covered in Diageo's conference call with Andrew Morgan. The UK is strong, driven by market share gains resulting from superior service levels to the retail trade and to a well-executed 'spirit of summer' marketing campaign encouraging consumers to buy spirits for home consumption. Discounting is much more modest in the UK now, due to the government's anti-drinking initiatives of the past two years. Spain, however, remains terrible. No further cost reductions are planned, although Diageo commented that, if the current decline migrates from cyclical to structural, it would totally change its business structure in that market, pulling out a lot of costs.

Asia is performing well. Some of the more established markets, such as Korea and Taiwan, where Diageo is market leader and where margins are high, are back into solid growth (albeit in single digits). In China, Diageo is performing well in the scotch category, gaining significant share from Chivas; however, Diageo agreed that cognac massively dominates the available profit pool, so unless Diageo acquires MH, it will remain a niche player in China. India remains a nascent market in profit terms for the whole industry: the local brands that have driven Pernod's top line make very low profits in dollar terms and both Diageo's and Pernod's imported brands are still small in volume terms. The progress towards tariff reduction in India has been set back by the banking crisis as regulators have more pressing concerns. Australia is in reasonable growth, led by RTD and Johnnie Walker, but the impact of improved Chinese macroeconomic growth is yet to be felt.

Our FY numbers look slightly low. We currently forecast EPS 74.0p for 2010 (consensus 75.0p). Our forecast includes 0% organic sales growth in Q4, and on the back of this meeting we now think 2–3% in Q4 would be more accurate, meaning that our 2% FY organic sales growth should rise closer to 3%. It is not a dramatic upgrade – but at least our numbers and consensus look very safe.

The shares have outperformed the market by 9% since our initiation in January but are still only on a 12.8x Cal 2011E P/E. BUY.

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