A Work Project, presented as part of the requirements for the Award of a Master Degree in Finance from the NOVA – School of Business and Economics.

Diageo: Dare to Go Premium?

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Abstract
This Work Project analyzes the Alcoholic beverage market, including Diageo Plc past performance, competition and trends that are driving the market growth. Moreover, it includes a valuation on Diageo versus its peers and a DCF to forecast future growth and performance of Diageo Plc.

Keywords: Premiumization, E-commerce, DCF, Alcoholic beverages

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This report is part of the “Dare to Go Premium” report (annexed) and should be read has an integral part of it.

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Global Alcoholic Beverage Market

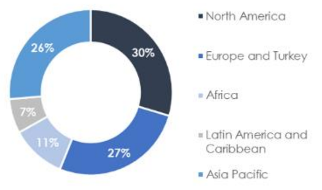

Fig. 1 2020's sales value by region (%). Source: Diageo's Annual Report

Diageo is known today as one of the largest alcoholic beverage producers in the world. The industry is highly competitive and dispersed, with the major 10 players accounting for 35% of the industry's sales value and around 53% of the liters sold in 2019. Diageo is a major player in the industry and operates globally across the five regions: North America, Europe and Turkey, Asia Pacific, Africa and Latin America and Caribbean. An industry estimated at £1 298 billion, equivalent to 257 billion liters sold in the past year, it derives a large part of its value from Asia Pacific, which contributes with 36% of sales, followed by Europe with 29% and North America with 17% (Fig.1).

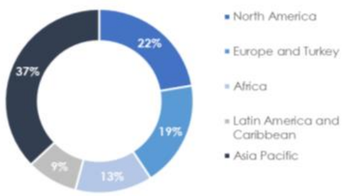

Fig. 2 2020's volume sales by region (%). Source: Diageo's Annual Report

For the past decade, the alcoholic beverage industry has grown consistently in value and proven its resilience in the face of worldwide challenges. It was one of the few markets that was able to grow amid the 2008 Financial Crisis, with a sales increase of 9% in the first year of recession[1] and has overcome the 2014 contraction originated by market saturation and China's economic decline (Fig.3). Trends like the premiumization of the sector emerged with the shift of consumers' preferences to better drinking habits and toward side meal drinking over late-night drinking which have been supporting the growth of the industry in recent years. With an increasing middle and high-income class in developed markets and, especially, in Asia Pacific it is expected that future sales boost will be sustained by the growth of the premium and luxury segments as long-term sales volume grow at lower rates. United Nations estimates there will be around 5.8 billion people above 20 years old (the average minimum legal drinking age), an additional 670 million people until 2030. And as disposable income increases, more people will be able to afford more expensive spirits, an opportunity for Diageo to boost its organic sales and furthermore to maintain the acquisition of new brands that meet new customers' preferences.

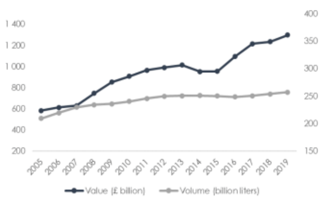

Fig. 4 Alcoholic beverage market. Source: Euromonitor

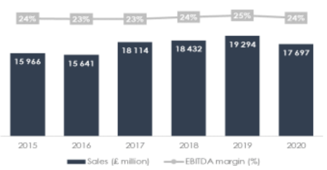

Fig. 3 Diageo's results. Source: Diageo's Annual Report and Analysts estimates

2020 has been a rough year for the industry, as Covid-19 pandemic originated an economic and social crisis. With governments inputting restrictions and forcing the closure of pubs, bars and restaurants, the on-trade channel has taken a big hit. Although people report to be consuming more alcohol during confinement - 14% of Americans[2] report they are consuming more alcohol since mid-March when compared to last year and in Britain sales of alcoholic beverages increased 22%, surpassing groceries' sales growth[3] - it is not enough to offset the losses in the on-trade channel. Diageo was not exception to the rule, with sale shrinking to £17 659 million, a decrease of 8%, and a further negative impact in EBITDA of 50% and free cash flow of 57%. Nevertheless, the diversified portfolio plus consistent and improving performance enabled Diageo to keep a gross margin of 40%, an EBITDA margin of 14% and a ROIC of 8%.

Fig. 6 Alcoholic Beverage Market Value. Source: Euromonitor

Beer is currently the segment which generates the highest sales amount, 41% of total market sales, followed by Spirits 35%, Wine 21%, Ready to Drink[4] 1.8% and lastly, Cider/Perry[5] with 0.8% (Fig.7). Diageo owns a broad portfolio of brands currently present in three of the five segments, where spirits hold the leader crown and the segment that contributes with the highest sales amount, 80% in 2020, followed by beer 13% and ready to drink 5%.

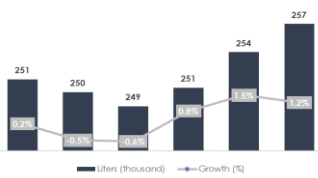

Fig. 5 Alcoholic Beverage Market Volume Source: Euromonitor

Beer is the most consumed drink around the world and the second most significant category for Diageo. Estimated at 534 billion pounds, it is responsible for 41% of alcohol global sales in value

[1] CNN Money, "Alcohol sales thrive in hard times"
[2] Los Angeles Times, What are we drinking during the pandemic?
[3] Euro Care, "Alcohol consumption in times of COVID-19"
[4] Pre-mixed cocktails
[5] Cider is made with apple (e.g. Somersby) and perry is made with pear

and 78% in volume. Beer has a strong established base of consumers being commonly known as the signature drink for casual social gatherings. With volume growth stagnated at 0.3% per year since 2013, it is expected that growth will be more sustained by value.

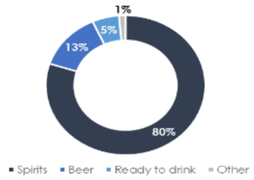

Fig. 7 Market value per category (%). Source: Euromonitor

Spirits segment has been gaining prestige in recent years, as customers actively choose cocktails over a beer after work. In the past 7 years, it has grown at 4.5% CAGR and it is the second biggest segment of the market with 35% of market value . As Diageo's most selling segment, the company has a lot of margin to grow with the segment projected to grow, on average, at 5.5% per year in value until 2024. Although segment sales value is expected to appreciate, volume has hit a stagnation phase – for the past 7 years it grew on average 0.4% per year - and is projected to decrease as the industry adapts to healthier customers that want to drink better. Altogether, although volume sold will be lower, drinks average price will increase in a way that not only offsets the volume decrease, but it also enables Diageo to maintain or even improve its gross margin. A large portion of Diageo's spirits sales come from Scotch (23% of sales), which has been growing at a fast rate in the past few years. Moreover, it has been investing in the fastest growing product segments, gin and tequila, which Diageo has reported a 14% increase in sales when compared to last year.

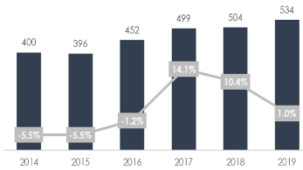

Fig. 9 Beer market value (£ billion). Source: Euromonitor

Fig. 8 Spirits market value (£ billion). Source: Euromonitor

Showing the least attractive results within categories is wine, with zero growth since 2013 in volume and the lowest growth in value. However, it is expected to keep growing, maintaining its second position in volume share and third in value share. Since 2015, Diageo has strategically sold its wine brands to focus on the expansion into RTD's (Fig. 10). Ready-to-drink currently hold the position of fastest growing category in the market. From 2013 it has grown, on average, at 4.9% per year, and it is expected to keep this growing trend by stealing share from beer, spirits, and wine. With only 2.5% of overall market sales, the projected exponential growth has led industry giants, such as Diageo, to invest and acquiring companies operating in this segment.

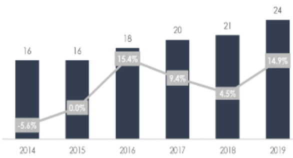

Fig. 10 RTD's market value (£ billion). Source: Euromonitor

Altogether, the growth of each category and the alcoholic beverage market will be dictated by market trends.

Market trends

Better for you is the current trademark of the alcoholic market. As consumers' preferences change towards a healthier lifestyle, industry players adapt their strategies. The increasing access to information also enables individuals to be more acknowledgeable of the impacts of their consumption habits which has ultimately led to a shift on the perception over brands and respective companies.

Fig. 11 Non/Low Alcohol Beer Sales. Source: Euromonitor

Low- to no-alcohol beverages are gaining relevance on the market as health and wellness are on the mind of consumers. The awareness, brought by international health organizations, and industry players on the risks of binge drinking and the health issues arising from heavy alcohol consumption has led, for the past 5 years, alcohol consumption per capita to consistently decline, from an average 52.7 liters, in 2014, to 50.2 liters, in 2019. Alongside the continuous decline of per capita alcohol consumption is the rise of low ABV (alcohol by volume) drinks, especially in beer. As the biggest category within alcoholic beverages, beer is the driver of low- to no-alcohol, reaching in 2019, a total 13 billion units sold (Fig. 11). Between 2014 and 2019 the market grew at a 5-year CAGR of 3.89% and is expected to grow at a 3.61% CAGR until 2024. Heineken, Carlsberg and Anheuser-Busch InBev, as the biggest players in the category worldwide have made the move and are currently leading, with their low calorie, alcohol free products.

Approximately 8% of ABinBev's beer volume, currently come from low-alcohol segment and it is expected to reach 20% by 2025[6], resulting of the company's continuous investment on the segment and its growth prospects. Following the wave is Diageo, that has acquired an alcohol-free gin brand (Seedlip) and launched its zero alcohol Guinness and alcohol-free Gordons gin in 2020. Although spirits are not yet seeing the same growth as beer, the company is already acting ahead as a long-term strategic plan, which will allow the maintenance of its market share, mainly in developed markets, where the trend is more relevant.

Average consumptin per capita in liters						
	2014	**2015**	**2016**	**2017**	**2018**	**2019**
Market	52,67	51,61	50,56	50,23	50,26	50,15
Growth	-1,3%	-2,0%	-2,0%	-0,7%	0,1%	-0,2%

Fig. 12 Alcoholic Beverage Market Value by Channel. Source: Euromonitor

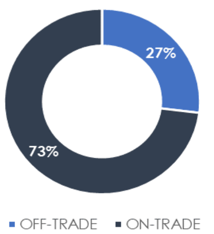

Fig. 13 Alcoholic Beverage Market Volume by Channel. Source: Euromonitor

The increasing awareness of individual environmental footprint and the climate crisis evolution has, in the last years, become a topic under discussion and of relevance in consumption occasions, particularly within younger generations. Consumers are now looking at packaging formats, usage of plastic, agriculture sustainability and an overall eco-friendly process. However, the reduction of environmental impact nowadays is not enough to get the attention of the growing consumer group, social responsibility is also a factor of interest, as consumers privilege companies that promote gender and racial equality within its employees, banning labor abuses across value chain and that positively impact communities where they source and sell its products. As the United Nation sets Sustainable Development Goals, giants such as Pernod Ricard and Brown-Forman are committed to achieve them and lead the industries route to sustainability, being the first awarded 'Lead' status in 2020 by the United Nations Global Compact for the third consecutive year for its work on sustainability[7]. As its peers, Diageo aligns its strategy to achieve sustainability goals which greatly impacts its investments and cost structure. Diageo narrows its suppliers to have their values and ethical professional practices aligned, which increases the base cost of its products. In addition, as one of the company's sustainable milestones is the reduction of wasteful materials on packaging, in 2021 will launch its first 100% paper scotch bottle. These efforts to achieve sustainability targets will ultimately have an impact on operational margins. Lastly, in terms of invested capital, Diageo has been adding assets to its operations that will reduce its production process emissions, such as the carbon free distiller in the US, and the company is committed to continue investing towards this goal. A large base of research has been developed linking consumer satisfaction, loyalty, and trust to company's actions towards more sustainable behaviors. Luo, X. and Bhattacharya, C. B. (2006) show that CSR can even positively affect market value resulting from the company's ability to innovate in sustainability, but ultimately consumers satisfaction will lead to the increase in profitability (i.e. in absolute terms)[8]. Diageo's investments on the improvement of its business towards more sustainable practices will have further impact in on the long-term as it will sustain its organic sales growth and keep customers loyalty.

Convenience is on demand in every industry and alcoholic beverages is no exception. In the digital era, retail found a new way to be closer to consumers, e-commerce. Valued at £1 684 billion in 2019, e-commerce market grew at a 20% CAGR worldwide between 2014 and 2019 and

[6] Beverage Daily, "ABinBev: 8% of beer volumes now come from low and no alcohol"
[7] Harpers Co., "Pernod Ricard recognised for environmental efforts"
[8] Luo, Xueming, and C.B. Bhattacharya. "Corporate Social Responsibility, Customer Satisfaction, and Market Value." Journal of Marketing 70, no. 4 (October 2006): 1–18. https://doi.org/10.1509/jmkg.70.4.001.

is expected to grow at 10% CAGR until 2024 (Fig. 14). Food and beverages account for approximately 7.6% of the global market. Beverages are traditionally distributed through two channels, on-trade (e.g. bars, restaurants, etc.), which accounted for 60% of sales in 2019, being the remaining 40% sold in off-trade premises (e.g. supermarkets, liquor stores, etc) (Fig. 12). The industry has always steered away from e-commerce, however with the pandemic instigating closures of the main sales channels around the world, companies had to find new ways to reach customers. In the past, lack of control of buyers' age and regulations made it difficult to be profitable[9], however 2020's high demand accelerated the digital transformation, which is expected to have an impact of 42% in sales, increasing the online alcoholic drinks market to $24 billion, across major markets, such as Australia, Brazil, China, France, Japan, UK, and the U.S, when compared to the previous year[10]. This fast market adaptation led to the development of exclusively online liquor stores, such as Drizzly, known as the "Amazon of Liquor", that shows e-commerce is an opportunity to be explored. To remain competitive, entering this channel will come naturally to industry leaders as it is an opportunity to reach new consumers, to offset a portion of on-premises losses, but mostly because consumers depend more on digital every day. Diageo, as an industry giant has been developing its partnerships with online retailers and its own digital platforms to capture sales in this high growth market, this way the company will be able to keep competitive and maintain its share. This distribution channel will be one of the company's continuous and potentially growing invested capital targets, mainly in terms of technological development.

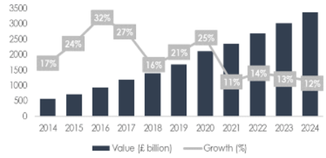

Fig. 16 E-commerce Market Value. Source: Euromonitor

Aligned with the demand for convenience is the growth of ready-to-drink. In the past, characterized as too sweet and with too many artificial ingredients, today the prepared cocktails are known as low-calorie drinks flavored with high quality ingredients that have become a phenomenon within alcoholic drinks[11]. As mentioned, RTD's are currently the category observing highest growth (Fig. 15) in the alcoholic beverage industry and expected to maintain the position in the short-term[12]. The canned cocktails are present in the portfolios of industry giants and are becoming more relevant in sales value as the company develop mixes with it owns brands, such as Pernod's Absolut Vodka Soda and Brown-Forman's Jack Daniels Country Cocktails. Diageo, likewise, has been expanding its portfolio through the development of new drinks that fit the category, such as Gordon's and Smirnoff Martinis, but also keeping its strategy of acquisition of fast rising premium company's operating in the segment.

Fig. 18 RTD's market volume (million liters). Source: Euromonitor

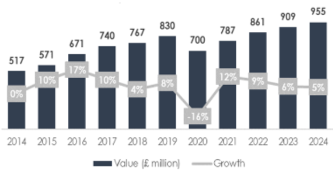

Fig. 17 Luxury Goods Market Value. Source: Euromonitor

Customers are discovering new occasions to drink, most drinking occasions used to happen during social meetings, today, as companies broaden its product portfolio, customers are drinking just for the sake of the enjoying a good drink. Premiumization is therefore the most relevant and impactful trend influencing the alcoholic beverage market. Less but better, underlies consumers choices, leading to a combination of all observed trends, since premium is reflected in prices but more importantly in quality. Around the world, demand for luxury products is growing, with a market valuation of £829 million, it is expected to grow at a 6.41% CAGR until 2024 (Fig. 16). The M&A activity has been mostly towards this trend not only in Diageo but also within its peers, Pernod Ricard, and Brown-Forman. For the past years, Diageo has oriented its strategy to the growth of its premium portfolio, where its acquisitions are mainly premium spirits brands. Rémy Cointreau is a reference to Diageo and its peers due to its high-end super premium spirits

[9] IWSR, "How is alcohol legislation changing in the wake of the ecommerce boom?"
[10] Forbes, "Online Alcohol Sales Surge Amid Coronavirus Pandemic"
[11] Seven Fifty Daily, "The Rise of Ready-to-Drink Cocktails"
[12] IWSR, "How is the RTD Market Evolving?"

portfolio. These acquisitions will mainly impact the company's brand value and net working capital, the latter largely driven by the increase in inventory value. In terms of prices, the average price per liter sold by Diageo and on the market has been consistently growing across regions reflecting the consumer acceptance of premium drink added to the company's portfolio. In 2015, Diageo average price per liter sold was £7.21, and by 2020 it hit £9.06, a 26% growth, which closely followed the market increase.

Average £ spent per liter consumed						
	2015	2016	2017	2018	2019	2020
Market	3,80	4,38	4,89	4,93	5,11	4,21
Growth		15,3%	11,7%	0,7%	3,6%	-17,7%
Diageo	7,21	7,05	8,31	8,52	8,72	9,06
Growth		-2,1%	17,8%	2,5%	2,3%	3,9%

Furthermore, the industry is facing one of the biggest challenges for the past century, as coronavirus pandemic took over the world. How will the overall consumption be affected? What will be the new normality post-coronavirus? How will 2020's social gathering restrictions impact the way of consuming alcoholic beverages? Although slowly, the industry will recover as restriction loose and consumers break resilience to go back to "normality".

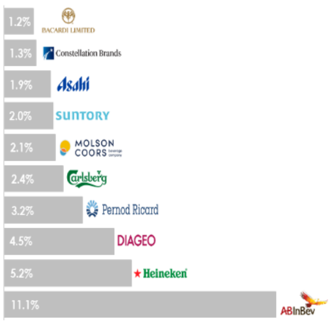

Fig. 19 Overall market share of top 10 players. Source: Euromonitor

Competition

The alcoholic beverage industry is highly competitive, as the top 10 players only account for 35% of the market (Fig. 17). In the past decade, the top 10 has not undergone major changes, with ABinBev holding on to the leader position. With 11% market share and Heineken right behind it with 5% market share, the companies lead in the most popular segment of the industry, beer. This makes them also leaders in sales volume with 30% market share, for the last three years. Right behind them is Diageo, with 4.5% market share, an outstanding accomplishment for a distiller, as it surpasses famous brewers like Carlsberg and Molson Coors, even though Diageo's goal is not to lead in the overall market, but in the spirits' segment only.

	ABinBev	Heineken	Diageo
EBITDA margin	33%	16%	25%
Gross margin	61%	39%	62%
CCC	-287	-70	324

Table 1 Profitability metrics 2019. Source: Company's Annual Reports

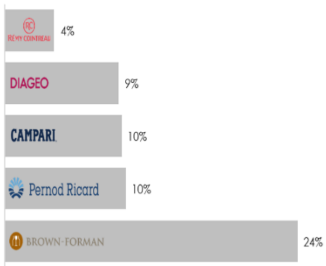

Fig. 20 ROIC. Source: Company's Annual Reports and Analysts estimates

When compared to the brewers, Diageo's 2019 financials stand out. Since 2016, sales have been growing at 5.89% CAGR per year, while ABinBev and Heineken sales have only grown at around 3.5% per year. Regarding gross margin, AbinBev has a 61% margin, while Diageo has 62% and Heineken 39% (Table 1). Regarding EBITDA margin, ABinBev is in the lead with 41% margin, Diageo with 25% and Heineken with 23%, this overwhelming difference is justified by the difference in the inventory holding period, as a distiller has a higher holding period than a brewer, its operating costs will consequently be higher. As for the ability to generate return on its investments, Diageo clearly wins with a 18% ROIC, Heineken 9.6% and ABinBev 8% (Fig. 18). Altogether, even though ABinBev is proven to have higher sales profitability, it is not able to generate as much additional value over invested capital as Diageo.

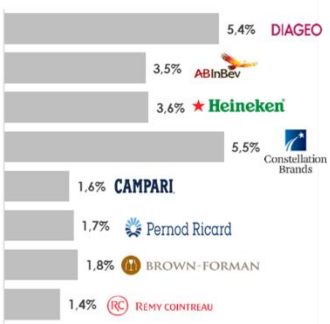

Fig. 21 Average YoY Revenue Growth (2016-2019). Source: Company's report

	Pernod Ricard	Diageo
Revenue growth	-8,0%	-8,3%
EBITDA margin	15%	24%
Gross margin	60%	62%
CCC	564	379

Table 2 Profitability metrics 2020. Source: Company's Annual Reports

Diageo has been holding on to its leader position in the spirits segment, with a market share of 11% and right behind it is its direct competitor, Pernod Ricard, with a 9% market share (Table 2). Both companies have released 2020 results and Diageo clearly outperforms Pernod. While Diageo has grown at an average of 2.5% per year since 2016, Pernod has seen its sales decrease at 0.5% per year. Regarding gross margin, Diageo's margin is higher than Pernod, with 62% and 60% respectively. However, once again Diageo's ROIC outperforms, with 2020 ROIC at 8%, while Pernod's ROIC was practically null, with 0.2% in 2020.

Shareholder Structure

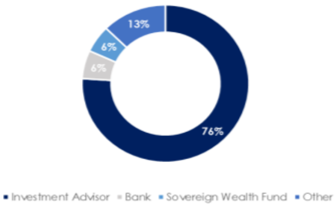

Fig. 22 Ownership type. Source: Bloomberg

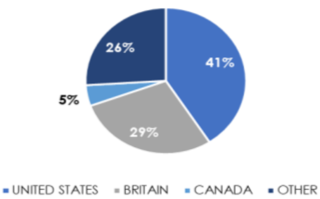

Fig. 23 Ownership by geography (%). Source: Bloomberg

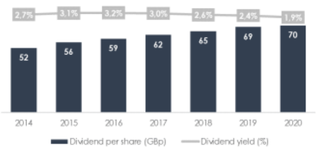

Fig. 24 Dividend per share (pence). Source: Diageo's Annual Reports

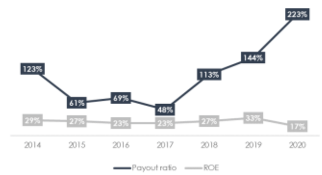

Fig. 25 Payout ratio (%). Source: Analysts estimates

With 2.34 billion shares outstanding, Diageo is traded in two stock exchanges: London Stock Exchange and New York Stock Exchange. The company's shareholders consist mainly of institutional investors (Fig. 60), from which the top shareholders are Vanguard (6.21%), Blackrock (5.72%) and Sun Life Financial (4.81%). The ownership structure has not suffered major changes and is mostly concentrated in the United States, which holds around 41% of the shares outstanding, and in the United Kingdom, with 29% of the shares outstanding (Fig. 61). In recent years, Diageo has rewarded shareholders through dividends and share buybacks, which has contributed, together with good operating results, to the exponential increase of payout ratio.

In July 2019 share buyback program was approved to return £4.5 billion to shareholders over three years, however, in 2020, due to the COVID-19 pandemic, the program was placed on hold until the company regains financial stability. Even so, with operating results negatively impacted, Diageo decided to increase the dividend per share to relieve investor's concerns about the uncertainty we are living these days. Further, in the last three years, the payout ratio has surpassed each year's respective earnings, which is not a sustainable long-term trend, therefore we believe that in the next three to four year, although dividend per share (Fig. 62) will continue its increasing trend, the share buyback program will only return by 2024, when the overall alcoholic market starts to recover, and Diageo's results are sufficiently stable to keep returning additional value to shareholders. Regarding Return on Equity (ROE), it has remained stable in the past 7 years, around 30%, although with the pandemic impact it has hit 17%, it is projected to return to normal levels in the near future (Fig. 63).

Diageo has a highly experienced management team that has led the company's expansion in emerging markets and works consistently to ensure it maintains its leadership in spirits, in every market it is present. Ivan Menezes, Diageo's CEO since 2013, has been with the company since 1997. His long experience in the industry and deep knowledge of the business is a great asset as the company remains focused in emerging markets expansion and to ensure Diageo remains strategically and financially strong, especially during volatile periods.

Valuation

Discounted Cash Flows

The discounted cash flows method was the primary approach to value Diageo's operations. The explicit forecasting period was extended up to 2035, year in which the free cash flows stabilized at 3.5% year-on-year grow. Therefore, the company will have a RONIC of 16% under a 22% reinvestment rate. Overall, in perpetuity, the company will have a ROIC of 14%.

Cost of Capital

Share price	2 878
	28,78
# shares outstanding	2 339
Market capitalization	67 311
Cost of Debt	**1,52%**
Risk Free	0,33%
Market Risk Premium	8,99%
βE	0,58
Cost of Equity	**5,53%**
Tax rate	19%
D/EV	13%
WACC	**5,01%**

Fig. 26 WACC. Source: Analyst estimates

To understand the risk underlying the company's activity, the estimation of the WACC's individual components was made.

The CAPM was computed to estimate the cost of equity. The 10-year UK Government yield bond was considered as risk free rate, since Diageo is a British company reporting its results in GBP's. As a measure of market risk premium, the MSCI World Index (in GBP) gross returns until November 2020, of 9.32%, less the applicable risk-free rate was applied. Lastly, to understand the Diageo's share volatility to the market we regressed the stock's weekly returns to MSCI World (GBP) returns for a period of 3 years, reaching 95% confidence interval of between 0.5784 and 0.3715. Although, the regression narrows the volatility to a short interval, when analyzing peers re-levered beta, it is possible to conclude that fall in similar ranges, from 0.5648 to 0.3396, for Pernod Ricard and from 0.6759 to 0.4653, for Brown-Forman.

Cost of debt was estimated based on the company's issued bonds that, given the relevance of the amount, in this case with face value of £500 million, accounts for a 1.64% yield and with maturity in 2026. Diageo has an A3 credit rating according to Moody's which leads to a probability of default of 1.07% and a loss given default of 31.82%.

Reaching a WACC of 4.88%, it was considered a final cost of equity of 5.53%, a cost of debt of 1.52% and UK's corporate tax rate to remain the constant at 19%. The UK's corporate tax was used as most of Diageo's taxable income is subject to UK's tax law. In terms of capital structure, the current debt-to-enterprise value ratio does not reflect what the company targets, therefore for the next 4 years as the company recovers from pandemic impact will be 19% funded by debt, going forward also as the whole market goes recovers, the company reestablishes its 15% target debt ratio.

Scenarios

In late 2019, a series of events unexpectedly started to roll out as a new virus was identified in Wuhan, China, and rapidly spread all over the world. In March 2020, the world stopped, and companies across all industries faced the challenge of the decade. From the US, to India, South Africa and most European countries started lockdowns with on-trade closures, and even in some countries, such as India, led to the ban of alcohol consumption and commercialization. The alcoholic beverage industry suffered a big hit.

As currently the world faces unprecedent challenges, a scenario analysis was conducted to account for the possible impacts of the pandemic and its economic outcomes. While new advancements arise, the study of the virus itself gets more robust and what was once uncertain becomes clearer. The alcoholic beverage market is therefore projected to recover to 2019 values by 2024[13].

On the first scenario, the most likely outcome, with the vaccine approved by health organization in late 2020, population in most countries will start the first phase of vaccination in early 2021. By mid-2022, around 90% of the worldwide population will reach group immunity as the vaccine shows signs of the 95% effectiveness, as predicted by pharmaceuticals, leading to low reinfection rate[14]. Consumption will start to pick up from that moment onwards, although consumers will be

[13] IWSR, "Global beverage alcohol is not expected to rebound until 2024"
[14] McKinsey, "When will the COVID-19 pandemic end?"

resilient to go back to "normal" on their consumption habits. In the beginning of 2023, on premise market will see growth and consumers in relevant markets will return to restaurants and bars with the same frequency as seen in mid-2019.

The second scenario considers the availability of a vaccine to most of the worldwide population will only occur by mid-2021. The delay could be caused by either a natural catastrophe, man-made disaster, or a slow response from production to the high demand. This would directly impact the mass production of the vaccine and its availability, even the possibility of mis-planning for the rollout for the population by its governments[15]. It was also considered the possibility that the vaccine has a lower efficiency than what was projected by specialists. Thus, and a third wave will take over in the first half of 2021, which will once again oblige countries to apply restrictive measures. Only by the middle of 2023 the population will start reaching immunity. Economic recovery, in particular, the alcoholic beverage market will show signs by 2024.

The least likely scenario is the development of a vaccine that will show low efficiency. The population will reach 90% vaccination late 2022, however with high rate of reinfection. These results will imply continuous lockdowns between early 2021 and 2023, as the new COVID strain spreads. Immunity is therefore, only reached by 2024. The market will mostly struggle between 2020 and 2024, however from that moment onwards it will start to see growth alongside the world's economy.

As the availability of the vaccine is not homogeneous across regions, it was considered different probabilities for each scenario. In developed markets, such as North America, Europe and Asia Pacific the first scenario has 80% probability, as it is already being reflected in the present moment. In less developed regions, such as Africa and Latin America and the Caribbean, the arrival of vaccination program is expected to be delayed. Thus, the first scenario is the most likely one, with a probability of 55% and 65%, respectively. As for the second scenario, Africa has a 40% probability of facing it, while expectations regarding LAC recovery are more favorable, a lower probability of 30% was considered.

The scenario analysis was developed for the alcoholic market in volumes which will have a direct impact on Diageo's revenues and indirectly on costs. In terms of invested capital, it will also have a direct impact since the company will have the need to adapt its investments to the market demand, particularly in terms of PP&E and computer software. Regardless the actual outcome of the pandemic, Diageo will be able to keep its leading position. With more than 200 brands over different price points, even if premiumization is put on hold the company has shown adaptability capacity and has been able to successfully face previous socio-economic challenges.

Even though long-term growth is expected to converge across regions, the impact of each scenario led to different price targets. The most likely scenario will lead to a price of £52.48, the second scenario to £50.86 and lastly, the least likely outcome would lead to a price of £48.16. Considering the probabilities of each scenario it was reached a target price of £51.91.

Sensitivity Analysis

To access the impact small change on estimated indicators would have on Diageo's target share price, a sensitivity analysis was performed. As the discount factor of the estimated free cash flows inputs have direct impact on the estimated enterprise value it was analyzed the market risk premium, the risk-free rate, the equity beta, cost of equity. Ranging from 6.75%, KPMG's

[15] McKinsey, "The COVID-19 vaccines are here: What comes next?"

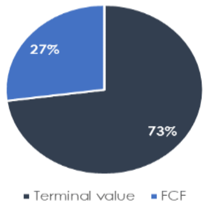

Fig. 27 Portion of terminal on total EV. Source: Analysts estimates

recommended market risk premium for 2020, and MSCI World (GBP) 9.32% market returns until November 2020 (since inception) and considering the risk-free rate of the British government bonds between 8 and 10 years, the range has high impact on the stock final price. It was also observed that all outputs were above the current price. Afterwards its was analyzed the βe impact from the lower to the upper boundaries, the output from regression of the stocks returns against the markets. With a 95% confidence interval with a short interval of values, the share price remained wide, with higher values reflecting higher accuracy. Lastly, the perpetuity growth was analyzed. Ranging from the average long term inflation rate considered (2%) to the expected nominal expected GDP growth (approximately 5%), as well as the sensitivity to RONIC and RR. The share price shows less variation to the latter.

Risk Free \ Market Risk Premium					
	398	217	107	70	51
	330	140	83	58	44
	245	130	79	56	43
	281	121	76	54	42
	245	114	73	53	41

The final price is therefore highly sensible to the inputs on the cost of capital to which it was applied

Multiples

Fig. 28 Cumulative returns. Source: Bloomberg

A relative valuation was performed to evaluate Diageo versus its peers. Three companies were considered as comparable to Diageo, not only regarding regions where they are present, but also in terms of expected growth, risk, and return – Pernod Ricard, Brown-Forman, and Rémy Cointreau.

	P/E	EV/EBITDA	EV/Net Sales	Expected Growth	Payout Ratio	β_E
Rémy Cointreau	71,28	35,68x	7,97x	12,0%	121,2%	0,26
Diageo	18,51	20,98x	7,94x	3,5%	223%	0,58
Brown-Forman	28,92	23,44x	8,08x	5,5%	52,2%	0,56
Pernod Ricard	21,57	17,66x	5,20x	18,6%	38%	0,44
Median	**35,07**	**24,44x**	**7,30x**	**9,9%**		

Starting with companies' market performance since mid-2018 (Fig. 77). Brown-Forman has outperformed its peers for the past 3 years, with a cumulative return of 37.6%. As for the lowest performer position, is Diageo with only 7.43% cumulative return for the past 3 years, severely impacted by the COVID-19 pandemic and Brexit expectations.

Although Diageo's profitability was in line with its peers, in 2019, it was one of the few that was able to maintain it stable in times of crisis, with its gross margin set at 60% and EBITDA margin at 24%. With ROIC highly impacted by the pandemic, it still is the second best in the industry, and in contrast with Pernod, it was able to generate additional value over its investments. It is also important to notice that Brown fiscal year ended in April 2020, which does not reflect the worst phase of the pandemic and subsequent consequences of on-trade closures, which Diageo and Pernod financials already reflect. Regarding leverage, Diageo has a target Net Debt/EBITDA between 2.5x and 3.0x, however the pandemic forced the company to issue more debt than usual, surpassing the leverage target policy. Despite this, Pernod Ricard has become the highest leveraged peer, more than doubling its Net Debt/EBITDA this year (2.5x (2019) vs 6.2x (2020)).

	Diageo	Rémy Cointreau	Brown-Forman	Pernod Ricard
Gross margin	60%	66%	63%	60%
EBITDA margin	24%	22%	34%	15%
ROIC	8%	4%	23%	0%
Net Debt/EBITDA	3,8x	2,1x	2,2x	6,2x

Diageo is the biggest within its peers, with the highest market and most solid track performance, it also has the lowest P/E of the industry, 18.51 while the average P/E of peers is set at 34.62, driven by the high P/E of Rémy Cointreau (35.07). If only Brown-Forman and Pernod Ricard are included as comparable, Diageo P/E is in line with its peers. The higher P/E means investors are expecting the company to have a high growth in its free cash flow, as Remy is more focused in a limited number of products and specifically in the luxury market, which is expected to increase 142% until 2025. By contrast, Diageo's portfolio is present in different price points, from mainstream brands to premium brands and therefore is not expected to benefit in total from this market growth. And with one of the most leveraged capital structures within the industry, 3.8x Net debt/EBITDA vs 3.6x industry's average, it justifies Diageo's low P/E.

As for EV/EBITDA, Diageo is in line with a 20.98x while the industry's average is 24.44x. While EV/Net Sales the industry average is 7.3x, Diageo's is 7.94x. With these metrics we reach three different target prices. The lowest given by the P/E is set at £16, while EV/EBITDA is £31 and EV/Net Sales £29 (Fig. 78).

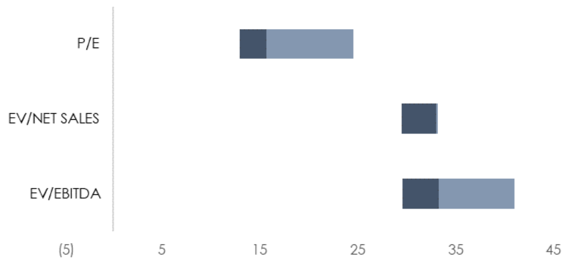

Fig. 29 Target price range. Source: Analysts estimates

DIAGEO

COMPANY REPORT

ALCOHOLIC BEVERAGES

4 JANUARY 2021

STUDENT: MARTA AUGUSTO & JOANA REIS

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Dare to go premium?

Endurance in times of pandemic

▪ Initiating Diageo's coverage with a BUY recommendation. With an annualized total return of 50%, Diageo's price target market value is derived from a DCF valuation discounted at a WACC of 5.01%.

▪ 2020 was defined by unprecedented challenges with COVID-19 pandemic leading to global lockdowns and social gathering restrictions. The consequences of the pandemic had a direct impact on the alcoholic beverage industry, specifically in the on-trade channel.

▪ Diageo's strategy is highly dependent on M&A. Even through the worst economic slowdown since 2008, Diageo increased its M&A activity by acquiring Aviation Gin, Seedlip and Chase Distillery.

▪ Market trends define consumptions patterns across the world. Rising low ABV beverages alongside a shift towards higher quality drinks and online shopping are defining consumer preferences in recent years. Premiumization is the main growth driver of the market.

▪ With the rise middle-income class and accounting for 43% of the global luxury market, Asia Pacific is the most promising region for the alcoholic beverage market.

Company description

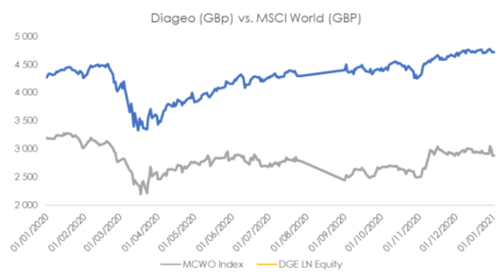
Diageo plc is the world's largest distiller. With headquarters in London, the company was formed by the merger of Grand Metropolitan and Guinness in 1997. The UK based company has a portfolio comprising brands such as Guinness, Tanqueray, Captain Morgan, Baileys and two of ten most valuable spirits brands in the world, Johnnie Walker and Smirnoff.

Recommendation:	**BUY**
Vs Previous Recommendation	-
Price Target FY22:	**51.91 £**
Vs Previous Price Target	- £
Price (as of 4-Jan-21)	**28.78 £**

Reuters: DGE.L, Bloomberg: DGE:LN

52-week range (£)	21.39-32.97
Market Cap (£b)	67.311
Outstanding Shares (b)	2.34

Source: Bloomberg, Analysts estimates



Source: Bloomberg

(Values in £ millions)	2019	2020E	2021F
Revenues	19 294	17 696	17 804
EBITDA	4 872	4 235	3 988
Net Profit	3 624	1 290	2 340
NOPLAT	3 319	1 753	2 675
Core FCF	2 751	2 203	2 414
Gross margin	41%	40%	39%
EBITDA margin	25%	24%	22%
EV/EBITDA	21,0x	20,1x	33,6x
EV/Revenues	7,9x	7,2x	11,4x
P/E	26,4x	47,2x	56,8x
ROIC	19%	8%	13%

Source: Diageo Annual Report and Analyst Estimates

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Global Alcoholic Beverage Market

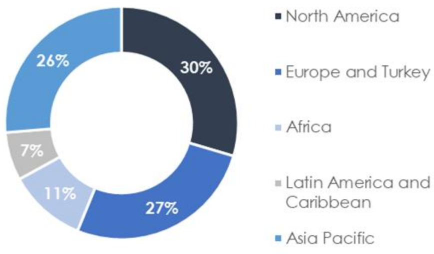

Fig. 1 2020's sales value by region (%). Source: Diageo's Annual Report

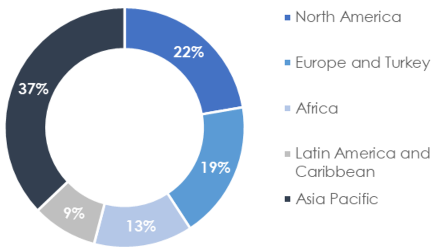

Fig. 2 2020's volume sales by region (%). Source: Diageo's Annual Report

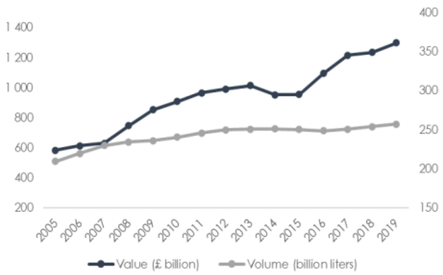

Fig. 3 Alcoholic beverage market. Source: Bloomberg

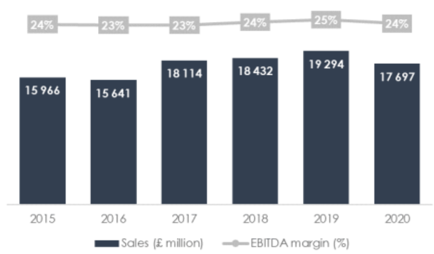

Fig. 4 Diageo's results. Source: Diageo's Annual Report and Analysts estimates

Diageo is known today as one of the largest alcoholic beverage producers in the world. The industry is highly competitive and dispersed, with the major 10 players accounting for 35% of the industry's sales value and around 53% of the liters sold in 2019. Diageo is a major player in the industry and operates globally across the five regions: North America, Europe and Turkey, Asia Pacific, Africa and Latin America and Caribbean. An industry estimated at £1 298 billion, equivalent to 257 billion liters sold in the past year, it derives a large part of its value from Asia Pacific, which contributes with 36% of sales, followed by Europe with 29% and North America with 17% (Fig.1).

For the past decade, the alcoholic beverage industry has grown consistently in value and proven its resilience in the face of worldwide challenges. It was one of the few markets that was able to grow amid the 2008 Financial Crisis, with a sales increase of 9% in the first year of recession[1] and has overcome the 2014 contraction originated by market saturation and China's economic decline (Fig.3). Trends like the premiumization of the sector emerged with the shift of consumers' preferences to better drinking habits and toward side meal drinking over late-night drinking which have been supporting the growth of the industry in recent years. With an increasing middle and high-income class in developed markets and, especially, in Asia Pacific it is expected that future sales boost will be sustained by the growth of the premium and luxury segments as long-term sales volume grow at lower rates. United Nations estimates there will be around 5.8 billion people above 20 years old (the average minimum legal drinking age), an additional 670 million people until 2030. And as disposable income increases, more people will be able to afford more expensive spirits, an opportunity for Diageo to boost its organic sales and furthermore to maintain the acquisition of new brands that meet new customers' preferences.

2020 has been a rough year for the industry, as Covid-19 pandemic originated an economic and social crisis. With governments inputting restrictions and forcing the closure of pubs, bars and restaurants, the on-trade channel has taken a big hit. Although people report to be consuming more alcohol during confinement - 14% of Americans[2] report they are consuming more alcohol since mid-March when compared to last year and in Britain sales of alcoholic beverages increased

[1] CNN Money, "Alcohol sales thrive in hard times"
[2] Los Angeles Times, What are we drinking during the pandemic?

22%, surpassing groceries' sales growth[3] - it is not enough to offset the losses in the on-trade channel. Diageo was not exception to the rule, with sale shrinking to £17 659 million, a decrease of 8%, and a further negative impact in EBITDA of 50% and free cash flow of 57% (Fig. 5). Nevertheless, the diversified portfolio plus consistent and improving performance enabled Diageo to keep a gross margin of 40%, an EBITDA margin of 14% and a ROIC of 8%.

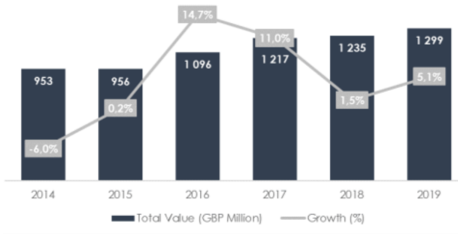

Fig. 5 Alcoholic Beverage Market Value. Source: Euromonitor

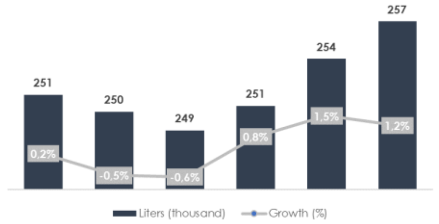

Fig. 6 Alcoholic Beverage Market Volume Source: Euromonitor

Beer is currently the segment which generates the highest sales amount, 41% of total market sales, followed by Spirits 35%, Wine 21%, Ready to Drink[4] 1.8% and lastly, Cider/Perry[5] with 0.8% (Fig.7). Diageo owns a broad portfolio of brands currently present in three of the five segments, where spirits hold the leader crown and the segment that contributes with the highest sales amount, 80% in 2020, followed by beer 13% and ready to drink 5%.

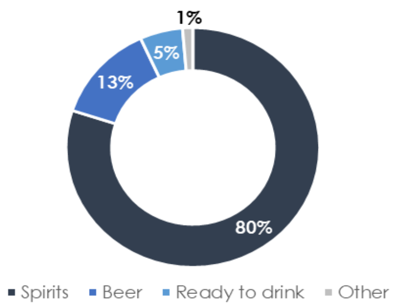

Fig. 7 Diageo's sales value per category (%). Source: Diageo's Annual Report

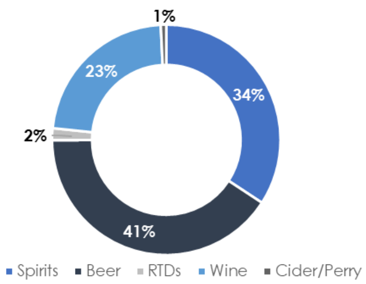

Fig. 8 Market value per category (%). Source: Diageo's Annual Report

Beer is the most consumed drink around the world and the second most significant category for Diageo (Fig 9). Estimated at 534 billion pounds, it is responsible for 41% of alcohol global sales in value and 78% in volume. Beer has a strong established base of consumers being commonly known as the signature drink for casual social gatherings. With volume growth stagnated at 0.3% per year since 2013, it is expected that growth will be more sustained by value.

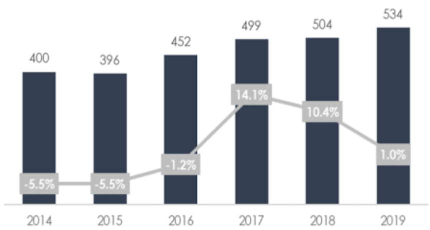

Fig. 9 Beer market value (£ billion). Source: Euromonitor

Spirits segment has been gaining prestige in recent years, as customers actively choose cocktails over a beer after work. In the past 7 years, it has grown at 4.5% CAGR and it is the second biggest segment of the market with 35% of market value (Fig. 10). As Diageo's most selling segment, the company has a lot of margin to grow with the segment projected to grow, on average, at 5.5% per year in value until 2024. Although segment sales value is expected to appreciate, volume has hit a stagnation phase – for the past 7 years it grew on average 0.4% per year - and is projected to decrease as the industry adapts to healthier customers that want to drink better. Altogether, although volume sold will be lower, drinks average price will increase in a way that not only offsets the volume decrease, but it also enables Diageo to maintain or even improve its gross margin. A large portion of Diageo's spirits sales come from Scotch (23% of sales), which has been growing at a fast rate in the past few years. Moreover, it has been investing in the fastest growing product segments, gin and tequila, which Diageo has reported a 14% increase in sales when compared to last year.

Showing the least attractive results within categories is wine, with zero growth since 2013 in volume and the lowest growth in value. However, it is expected to keep growing, maintaining its second position in volume share and third in value

[3] Euro Care, "Alcohol consumption in times of COVID-19"
[4] Pre-mixed cocktails
[5] Cider is made with apple (e.g. Somersby) and perry is made with pear

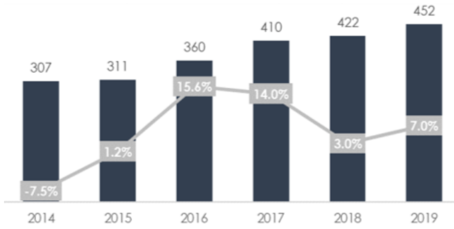

Fig. 10 Spirits market value (£ billion). Source: Euromonitor

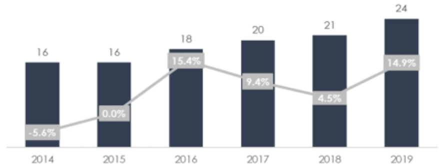

Fig. 11 RTD's market value (£ billion). Source: Euromonitor

share. Since 2015, Diageo has strategically sold its wine brands to focus on the expansion into RTD's (Fig. 11). Ready-to-drink currently hold the position of fastest growing category in the market. From 2013 it has grown, on average, at 4.9% per year, and it is expected to keep this growing trend by stealing share from beer, spirits, and wine. With only 2.5% of overall market sales, the projected exponential growth has led industry giants, such as Diageo, to invest and acquiring companies operating in this segment.

Altogether, the growth of each category and the alcoholic beverage market will be dictated by market trends.

Market trends

Better for you is the current trademark of the alcoholic market. As consumers' preferences change towards a healthier lifestyle, industry players adapt their strategies. The increasing access to information also enables individuals to be more acknowledgeable of the impacts of their consumption habits which has ultimately led to a shift on the perception over brands and respective companies.

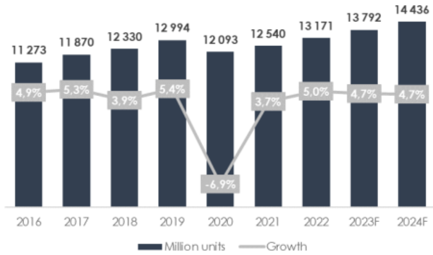

Fig. 12 Non/Low Alcohol Beer Sales. Source: Euromonitor

Low- to no-alcohol beverages are gaining relevance on the market as health and wellness are on the mind of consumers. The awareness, brought by international health organizations, and industry players on the risks of binge drinking and the health issues arising from heavy alcohol consumption has led, for the past 5 years, alcohol consumption per capita to consistently decline, from an average 52.7 liters, in 2014, to 50.2 liters, in 2019. Alongside the continuous decline of per capita alcohol consumption is the rise of low ABV (alcohol by volume) drinks, especially in beer. As the biggest category within alcoholic beverages, beer is the driver of low- to no-alcohol, reaching in 2019, a total 13 billion units sold (Fig. 12). Between 2014 and 2019 the market grew at a 5-year CAGR of 3.89% and is expected to grow at a 3.61% CAGR until 2024. Heineken, Carlsberg and Anheuser-Busch InBev, as the biggest players in the category worldwide have made the move and are currently leading, with their low calorie, alcohol free products. Approximately 8% of ABinBev's beer volume, currently come from low-alcohol segment and it is expected to reach 20% by 2025[6], resulting of the company's continuous investment on the segment and its growth prospects. Following the wave is Diageo, that has acquired an alcohol-free gin brand (Seedlip) and launched its zero alcohol Guinness and alcohol-free Gordons gin in 2020. Although spirits are not yet seeing the same growth as beer, the company is already acting ahead as a long-term strategic plan, which will allow the

[6] Beverage Daily, "ABinBev: 8% of beer volumes now come from low and no alcohol"

maintenance of its market share, mainly in developed markets, where the trend is more relevant.

Average consumptin per capita in liters						
	2014	**2015**	**2016**	**2017**	**2018**	**2019**
Market	52,67	51,61	50,56	50,23	50,26	50,15
Growth	*-1,3%*	*-2,0%*	*-2,0%*	*-0,7%*	*0,1%*	*-0,2%*

The increasing awareness of individual environmental footprint and the climate crisis evolution has, in the last years, become a topic under discussion and of relevance in consumption occasions, particularly within younger generations. Consumers are now looking at packaging formats, usage of plastic, agriculture sustainability and an overall eco-friendly process. However, the reduction of environmental impact nowadays is not enough to get the attention of the growing consumer group, social responsibility is also a factor of interest, as consumers privilege companies that promote gender and racial equality within its employees, banning labor abuses across value chain and that positively impact communities where they source and sell its products. As the United Nation sets Sustainable Development Goals, giants such as Pernod Ricard and Brown-Forman are committed to achieve them and lead the industries route to sustainability, being the first awarded 'Lead' status in 2020 by the United Nations Global Compact for the third consecutive year for its work on sustainability[7]. As its peers, Diageo aligns its strategy to achieve sustainability goals which greatly impacts its investments and cost structure. Diageo narrows its suppliers to have their values and ethical professional practices aligned, which increases the base cost of its products. In addition, as one of the company's sustainable milestones is the reduction of wasteful materials on packaging, in 2021 will launch its first 100% paper scotch bottle. These efforts to achieve sustainability targets will ultimately have an impact on operational margins. Lastly, in terms of invested capital, Diageo has been adding assets to its operations that will reduce its production process emissions, such as the carbon free distiller in the US, and the company is committed to continue investing towards this goal. A large base of research has been developed linking consumer satisfaction, loyalty, and trust to company's actions towards more sustainable behaviors. Luo, X. and Bhattacharya, C. B. (2006) show that CSR can even positively affect market value resulting from the company's ability to innovate in sustainability, but ultimately consumers satisfaction will lead to the increase in profitability (i.e. in absolute terms)[8]. Diageo's investments on the improvement of its business

[7] Harpers Co., "Pernod Ricard recognised for environmental efforts"
[8] Luo, Xueming, and C.B. Bhattacharya. "Corporate Social Responsibility, Customer Satisfaction, and Market Value." Journal of Marketing 70, no. 4 (October 2006): 1–18. https://doi.org/10.1509/jmkg.70.4.001.

towards more sustainable practices will have further impact in on the long-term as it will sustain its organic sales growth and keep customers loyalty.

Fig. 13 Alcoholic Beverage Market Value by Channel. Source: Euromonitor

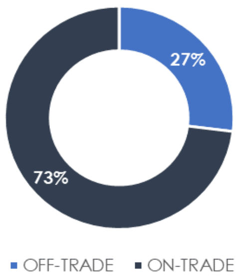

Fig. 14 Alcoholic Beverage Market Volume by Channel. Source: Euromonitor

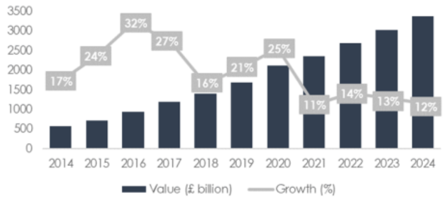

Fig. 15 E-commerce Market Value. Source: Euromonitor

Fig. 16 RTD's market volume (million liters). Source: Euromonitor

Convenience is on demand in every industry and alcoholic beverages is no exception. In the digital era, retail found a new way to be closer to consumers, e-commerce. Valued at £1 684 billion in 2019, e-commerce market grew at a 20% CAGR worldwide between 2014 and 2019 and is expected to grow at 10% CAGR until 2024 (Fig. 15). Food and beverages account for approximately 7.6% of the global market. Beverages are traditionally distributed through two channels, on-trade (e.g. bars, restaurants, etc.), which accounted for 60% of sales in 2019, being the remaining 40% sold in off-trade premises (e.g. supermarkets, liquor stores, etc) (Fig. 13). The industry has always steered away from e-commerce, however with the pandemic instigating closures of the main sales channels around the world, companies had to find new ways to reach customers. In the past, lack of control of buyers' age and regulations made it difficult to be profitable[9], however 2020's high demand accelerated the digital transformation, which is expected to have an impact of 42% in sales, increasing the online alcoholic drinks market to $24 billion, across major markets, such as Australia, Brazil, China, France, Japan, UK, and the U.S, when compared to the previous year[10]. This fast market adaptation led to the development of exclusively online liquor stores, such as Drizzly, known as the "Amazon of Liquor", that shows e-commerce is an opportunity to be explored. To remain competitive, entering this channel will come naturally to industry leaders as it is an opportunity to reach new consumers, to offset a portion of on-premises losses, but mostly because consumers depend more on digital every day. Diageo, as an industry giant has been developing its partnerships with online retailers and its own digital platforms to capture sales in this high growth market, this way the company will be able to keep competitive and maintain its share. This distribution channel will be one of the company's continuous and potentially growing invested capital targets, mainly in terms of technological development.

Aligned with the demand for convenience is the growth of ready-to-drink. In the past, characterized as too sweet and with too many artificial ingredients, today the prepared cocktails are known as low-calorie drinks flavored with high quality ingredients that have become a phenomenon within alcoholic drinks[11]. As mentioned, RTD's are currently the category observing highest growth (Fig. 16) in the alcoholic beverage industry and expected to maintain the position in the short-term[12]. The canned cocktails are present in the portfolios of industry giants

[9] IWSR, "How is alcohol legislation changing in the wake of the ecommerce boom?"
[10] Forbes, "Online Alcohol Sales Surge Amid Coronavirus Pandemic"
[11] Seven Fifty Daily, "The Rise of Ready-to-Drink Cocktails"
[12] IWSR, "How is the RTD Market Evolving?"

and are becoming more relevant in sales value as the company develop mixes with it owns brands, such as Pernod's Absolut Vodka Soda and Brown-Forman's Jack Daniels Country Cocktails. Diageo, likewise, has been expanding its portfolio through the development of new drinks that fit the category, such as Gordon's and Smirnoff Martinis, but also keeping its strategy of acquisition of fast rising premium company's operating in the segment.

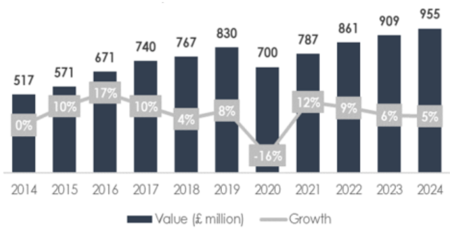

Fig. 17 Luxury Goods Market Value. Source: Euromonitor

Customers are discovering new occasions to drink, most drinking occasions used to happen during social meetings, today, as companies broaden its product portfolio, customers are drinking just for the sake of the enjoying a good drink. Premiumization is therefore the most relevant and impactful trend influencing the alcoholic beverage market. Less but better, underlies consumers choices, leading to a combination of all observed trends, since premium is reflected in prices but more importantly in quality. Around the world, demand for luxury products is growing, with a market valuation of £829 million, it is expected to grow at a 6.41% CAGR until 2024 (Fig. 17). The M&A activity has been mostly towards this trend not only in Diageo but also within its peers, Pernod Ricard, and Brown-Forman. For the past years, Diageo has oriented its strategy to the growth of its premium portfolio, where its acquisitions are mainly premium spirits brands. Rémy Cointreau is a reference to Diageo and its peers due to its high-end super premium spirits portfolio. These acquisitions will mainly impact the company's brand value and net working capital, the latter largely driven by the increase in inventory value. In terms of prices, the average price per liter sold by Diageo and on the market has been consistently growing across regions reflecting the consumer acceptance of premium drink added to the company's portfolio. In 2015, Diageo average price per liter sold was £7.21, and by 2020 it hit £9.06, a 26% growth, which closely followed the market increase.

Average £ spent per liter consumed						
	2015	**2016**	**2017**	**2018**	**2019**	**2020**
Market	3,80	4,38	4,89	4,93	5,11	4,21
Growth		*15,3%*	*11,7%*	*0,7%*	*3,6%*	*-17,7%*
Diageo	7,21	7,05	8,31	8,52	8,72	9,06
Growth		*-2,1%*	*17,8%*	*2,5%*	*2,3%*	*3,9%*

Furthermore, the industry is facing one of the biggest challenges for the past century, as coronavirus pandemic took over the world. How will the overall consumption be affected? What will be the new normality post-coronavirus? How will 2020's social gathering restrictions impact the way of consuming alcoholic beverages? Although slowly, the industry will recover as restriction loose and consumers break resilience to go back to "normality".

Competition

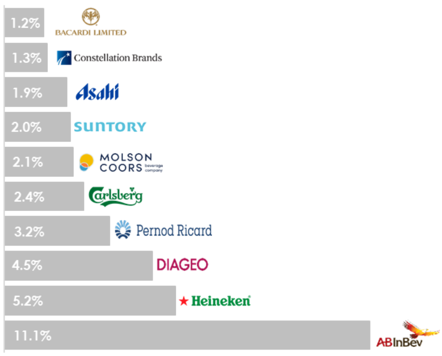

Fig. 18 Overall market share of top 10 players. Source: Euromonitor

	ABinBev	Heineken	Diageo
EBITDA margin	33%	16%	25%
Gross margin	61%	39%	62%
CCC	-287	-70	324

Table 1 Profitability metrics 2019. Source: Company's Annual Reports

	Pernod Ricard	Diageo
Revenue growth	-8,0%	-8,3%
EBITDA margin	15%	24%
Gross margin	60%	62%
CCC	564	379

Table 2 Profitability metrics 2020. Source: Company's Annual Reports

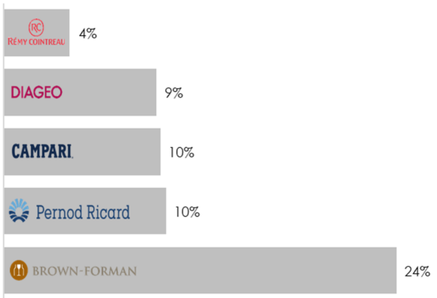

Fig. 3 ROIC. Source: Company's Annual Reports and Analysts estimates

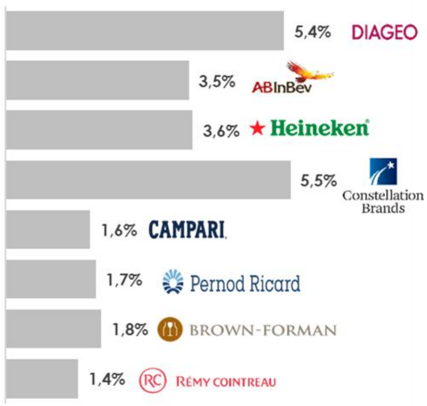

Fig. 4 Average YoY Revenue Growth (2016-2019). Source: Company's report

The alcoholic beverage industry is highly competitive, as the top 10 players only account for 35% of the market (Fig. 18). In the past decade, the top 10 has not undergone major changes, with ABinBev holding on to the leader position. With 11% market share and Heineken right behind it with 5% market share, the companies lead in the most popular segment of the industry, beer. This makes them also leaders in sales volume with 30% market share, for the last three years. Right behind them is Diageo, with 4.5% market share, an outstanding accomplishment for a distiller, as it surpasses famous brewers like Carlsberg and Molson Coors, even though Diageo's goal is not to lead in the overall market, but in the spirits' segment only.

When compared to the brewers, Diageo's 2019 financials stand out. Since 2016, sales have been growing at 5.89% CAGR per year, while ABinBev and Heineken sales have only grown at around 3.5% per year. Regarding gross margin, AbinBev has a 61% margin, while Diageo has 62% and Heineken 39% (Table 1). Regarding EBITDA margin, ABinBev is in the lead with 41% margin, Diageo with 25% and Heineken with 23%, this overwhelming difference is justified by the difference in the inventory holding period, as a distiller has a higher holding period than a brewer, its operating costs will consequently be higher. As for the ability to generate return on its investments, Diageo clearly wins with a 18% ROIC, Heineken 9.6% and ABinBev 8% (Fig. 19). Altogether, even though ABinBev is proven to have higher sales profitability, it is not able to generate as much additional value over invested capital as Diageo.

Diageo has been holding on to its leader position in the spirits segment, with a market share of 11% and right behind it is its direct competitor, Pernod Ricard, with a 9% market share (Table 2). Both companies have released 2020 results and Diageo clearly outperforms Pernod. While Diageo has grown at an average of 2.5% per year since 2016, Pernod has seen its sales decrease at 0.5% per year. Regarding gross margin, Diageo's margin is higher than Pernod, with 62% and 60% respectively. However, once again Diageo's ROIC outperforms, with 2020 ROIC at 8%, while Pernod's ROIC was practically null, with 0.2% in 2020.

Market by geography

North America

North America is the largest and most profitable segment of Diageo. Estimated at £222 billion, it is responsible for 17% of alcoholic beverages worldwide sales, an impressive achievement for a region with only 5% of world population. In 2020,

Fig. 21 Diageo's sales in North America (£ million). Source: Diageo's Annual Reports

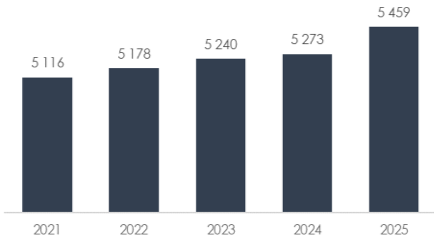

Fig. 22 Diageo's sales forecast in North America. Source: Analysts estimates

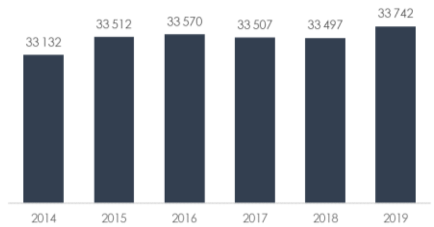

Fig. 23 Market volume in North America (million liters). Source: Euromonitor

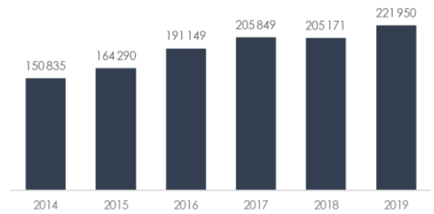

Fig. 24 Market value in North America (£ million). Source: Euromonitor

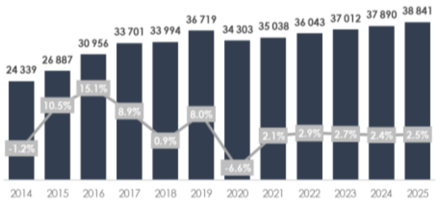

Fig. 25 Disposable Income per Capita in North America (£). Source: Euromonitor

Diageo's sales in the region amounted to £5 222 million, 30% of the company's total sales and a 2% growth compared to the previous year. Diageo has benefited from a steady growth in region sales, of 2.6% per year, on average.

North America has the highest disposable income per capita across all regions. Growing, on average, at 7.1% per year, the pandemic will highly impact the growth expectation of the region that is projected to have a 6.61% decrease of GDP in 2020. Recording £24 339 yearly available income in 2014 to £36 719 in 2019, the latter is only expected to recover until 2023. Although the current crisis will have visible effects in terms of consumption, with the evolution of the premiumization trend observed in the region it is not expected that it will be reflected in high-end consumption, as it has stabilized in recent years.

Alcoholic consumption per capita has recorded constant decrease from 2014, when it was observed an average 91 liter per consumed, to 2019's 86 liters, similar to what was observed over the world. Going forward, although it is expected average consumption per capita slightly increases, it will be driven by RTD's and low to no-alcohol drinks, as customers choose to drink for the enjoyment per se over binge drinking. Regarding average price, it has been increasing on average 6.3% since 2014, from £4.55 spent per liter consumed to £6.58 (in 2019). Likewise, Diageo's average price per liter sold in the region grew from £8.82 in 2014 to £11.41 in 2019, an average growth of 4.38%, and even in a year of general lower consumption, premiumization of the industry does not show signs of regression in the region.

Consumption per capita in North America						
	2014	**2015**	**2016**	**2017**	**2018**	**2019**
	126,0	126,0	124,9	123,4	122,3	122,1
Growth	*0,1%*	*0,0%*	*-0,9%*	*-1,1%*	*-0,9%*	*-0,2%*

Average £ spent in North America						
	2014	**2015**	**2016**	**2017**	**2018**	**2019**
Market	4,55	4,90	5,69	6,14	6,13	6,58
Growth		*7,7%*	*16,2%*	*7,9%*	*-0,3%*	*7,4%*
Diageo	8,82	9,18	9,54	11,08	10,77	11,41
Growth	-	*4,1%*	*3,9%*	*16,1%*	*-2,8%*	*6,0%*

The region most consumed drink is beer, which contributes for 42% of sales, followed by spirits 34%, wine 20%, Ready-to-Drink 3.2% and finally Cider/Perry 0.7%. Overall, sales volume has stagnated, with the global market sales growing, on average, at 0.4% for the past 7 years. With Ready-to-Drink and Cider/Perry as the largest contributors for market growth, since 2013 it has increased at a fast rate of, 7.4% and 7.6% per year, respectively. By contrast, beer sales have been slowly decreasing a t 0.2% per year (on average), while spirits have been steadily growing at 2% per year and wine at 1.4%[13]. Altogether, market value growth has been supported by the increase of average price, not by sales volume.

As bars, pubs and restaurants were forced to close, people found other ways to keep the spirits up. The pandemic has cemented a shift in preferences towards Ready-to-Drink cocktails and spirits. In middle-March, when the US started to go into lockdown, canned cocktails sales increased by 93%, canned wines rose 95%, wine by 66%, and beer by 42%, the segment with lowest growth. Overall, global alcoholic beverages sales increased 55% in the week of March 21st, according to Nielsen. Major players in the market have been making moves towards expanding their portfolios to cover RTDs as well as lower alcoholic drinks, and Diageo is no exception. With the launch of Smirnoff ice zero sugar infusions, it is competing directly with Bacardi new lower-alcohol Plume and Petal and Constellation Brands zero-sugar flavored series Svedka Pure Infusions. More recently, in the end of June, the increasing trend remained, with spirits sales up 40%, led by ready to drink and tequila, which grew by 172% and 82%, respectively. According to Nielsen, since the beginning of the pandemic, off premise beer is up 21.4%[14].

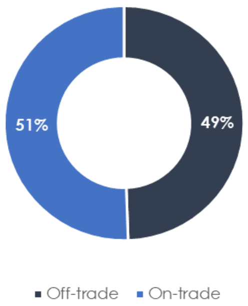

Fig. 5 Market Sales Value per channel. Source: Euromonitor

On-trade is very significant in the region, as before the pandemic it accounted for 51% of sales. With the on-trade closures, customers had to turn to another chann el. Drizzly, one of the largest e-commerce alcohol distributors, has reported a 300% increase in sales, both in the US and Canada. While Nielsen reports a 243% increase in e-commerce sales. This it is a trend that is not expected to disappear after the pandemic. Nowadays, with customers turning to more digital channels, preferring to buy from the comfort of their homes, alcoholic beverages industry would need to adapt in the very near future. As regulations are eased, companies can maintain its gross margin and are willing to invest more in the development of this channel, moreover, companies are already investing in new digital experiences, for example Diageo has invited celebrities to host virtual happy hours while Rémy Cointreau has invited bartenders to hold masterclasses on cocktails[15].

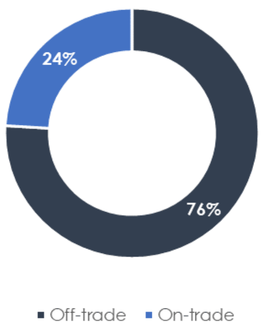

Fig. 6 Market Sales Volume per channel. Source: Euromonitor

The growth rates presented above are astronomic but not surprising. 14% of Americans and 19% of Canadians reported to be drinking more during the pandemic[16]. More importantly, customers are shifting towards pricier drinks. In 2019, 58% of total gross revenues derived from high end (34%) and super premium (24%) drinks, however the pandemic has put this trend into perspective.

[13] Forbes, "How The COVID-19 Pandemic Is Upending the Alcoholic Beverage Industry"
[14] Wine Business, "Nielsen COVID-19 insights and analysis for week ending June 20, 2020"
[15] Bloomberg, "In Lockdown, We're Reaching for Brandy, Not Beer"
[16] CCSA, Mordor Intelligence

With the rise of jobless claims, which in turn will cause a short-term decrease in disposable income, can the trends set in motion last year be sustained? In March, mainstream, and premium spirits surpassed sales of high-end and super premium spirits by twice as much[17]. However, Nielsen reports that high-end spirits sales are higher than super premium in what regards rum, whiskey, cognac, and brandy while vodka sales were concentrated in premium price point, in the end of June. Although it was put on hold in the beginning of the pandemic, pricier drinks demand is recovering, and it is expected to grow in the long-term. It will be one of the main factors of growth of the market.

However, competition is high. Although Diageo is the number one player in the spirits segment in both volume and value, with 16.4% and 16.3% market share respectively, in the overall market is only the 4th biggest player, with 6.4% market share. In spirits clearly leads, however right behind is Suntory Holdings with 9.2%, followed by Diageo most direct competitor, Pernod Ricard, with 9% market share. In the beer segment Diageo is positioned among the top 10 players, with a market share of 1.1%, it is the 8th biggest player. The beer segment is led by ABInBev, with 36% market share, followed by Molson Coors 19.4% and Constellation Brands 21%.

It is expected that Diageo will slightly lose market share in the region, in volume terms, however it will remain the leader of the spirits' segment.

Europe & Turkey

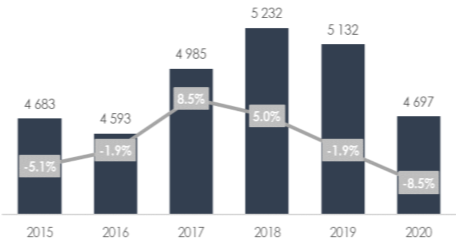

Fig. 28 Diageo's sales in Europe & Turkey (£ million). Source: Diageo's Annual Report

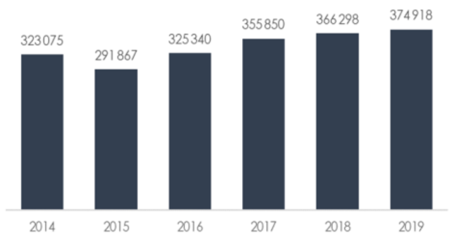

Fig. 7 Market value in Europe (£ million). Source: Euromonitor

Europe, home region of Diageo, is the second most significant for the company accounting for 26.5% of its revenues, £4 697 million in value, recorded in 2020. Europe represents 29% of the market, with a value of £374 billion in 2019, placing it as the second most significant across regions, both in value and volume.

Europe is ranked second with highest disposable income per capita and is expected to maintain this position in the long-term. In 2015, disposable income per capital was £8 976 and grew approximately 29% to £10 633, in 2019. The 2020's economic downturn will have visible impact on available income and consumption, however economic recovery will be reflected and a 2.67% CAGR is expected for the next five years. The impacts of the pandemic are expected to be different in eastern and western Europe with a real GDP growth of -6.13% and -8.92%, respectively, in 2020, due to development stages in which each economy stands.

[17] Forbes, "How The COVID-19 Pandemic Is Upending the Alcoholic Beverage Industry"

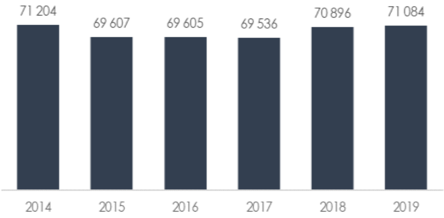

Fig. 30 Market volume in Europe (million liters). Source: Euromonitor

Volume wise, between 2014 and 2017 the alcoholic beverage market consistently decreased, turning to slow growth from that year onwards, this tendency is followed by the average alcohol consumption per capita that keeps Europe the region with highest alcoholic drinks consumption per capita. Average consumption per capita has remained stable between 2014 and 2019, around 121 liters per capita, however it is projected to have a narrowed increase in the long-term that will be led by the same trend as North America, the increased consumption of RTDs and low to non-alcoholic drinks. With the market value consistently increasing, 5-year CAGR of 1.2%, so has the average price. Since 2016, the average price per liter, in the overall alcoholic market, has increased 13%, from £4.67 to £5.27 in 2019.

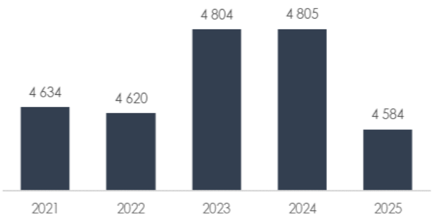

Fig. 31 Diageo's sales forecast in Europe & Turkey. Source: Analysts Estimates

Consumption per capita in Europe						
	2014	2015	2016	2017	2018	2019
	121,5	118,5	118,3	118,1	120,3	120,6
Growth	-2,8%	-2,4%	-0,2%	-0,2%	1,9%	0,2%

Average £ spent in Europe						
	2014	2015	2016	2017	2018	2019
Market	4,54	4,19	4,67	5,12	5,17	5,27
Growth		-7,6%	11,5%	9,5%	1,0%	2,1%
Diageo	16,62	11,80	11,62	12,47	12,56	12,56
Growth	-	-29,0%	-1,5%	7,3%	0,6%	0,0%

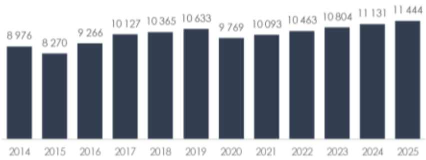

Fig. 8 Disposable Income per Capita in Europe (£). Source: Euromonitor

In what regards to trading channels, off-trade accounts for 72% of volume, however in value has a share of 43%, the segregation has been constant in the last five years. The volume decrease observed in the past has been particularly impacting the off-trade channel, likewise, the growth in value is observed on the on-trade channel. E-commerce has been growing at an exponential rate, with east and western Europe growing at a CAGR 15.6% and 11.3% between 2014 and 2019 and expected to grow at 8.7% and 7.5% between 2020 and 2024, respectively. Two countries are leading the digital channel in Europe, UK and France. In the UK, the rise is mostly motivated by online grocery shopping that led to an increase in sales four times higher online than in physical stores[18]. The lockdowns also pushed alcohol sales in Britain, specially online, with wine, beer and spirits seeing an added £199 million in sales compared with the same period in the previous year, driven by a 50% rise of volume in e-commerce and 20% on the off trade, as reported by IWSR.

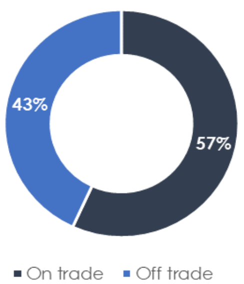

Fig.33 Market Sales Value per channel. Source: Euromonitor

Coronavirus posed many challenges to the industry from the beginning of 2020, with lockdowns on-trade premises saw sales harshly dropping, however alcohol consumption in countries such as the UK, France and Spain observed the other side of crisis with 12%, 10% and 9% of their population consuming more

[18] The Spirits Business, "How will coronavirus affect the e-commerce alcohol sector?"

alcoholic beverages. Diving into an unprecedented reality, alcohol as a well-known nervous system inhibitor, is the first choice for stress and anxiety relief, thus during the lockdown a general increase of consumption was observed. However, the current market trends to live a healthier lifestyle and educational level of the general population on the harms of alcohol consumption strongly limited the possible impacts of heavy at-home drinking.

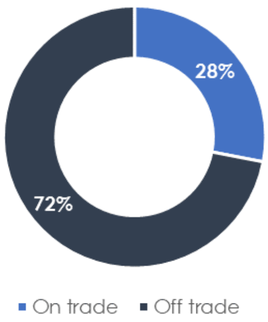

Fig. 10 Market Sales Volume per channel. Source: Euromonitor

Beer is a signature get-together drink for Europeans, thus is the most representative category in value and volume with a share of 71% and 40%, respectively. This market is expected to keep the leading position, mainly driven by the low-alcohol beers, although a shift towards RTD's and Ciders/Perry has been observed, as is the only category growing in volume (1.5% CAGR between 2013 and 2019). Spirits holds its position behind wine, that in volume decreased on average 0.4% vs 1.2% per year, respectively (2013-2019). Standing out in value growth is Cider and Perry accounting with a 4% CAGR (2013-2019).

New trading framework imposed by Brexit as of the start of 2021 is not expected to have great impact on the Diageo's business operations with Europe or the world. Excise duties will not be aggravated as the UK will remain a member of Schengen Agreement. The deal was made with the European Union; thus, it does not pose added risks or volatility to the company itself or to its competitiveness[19]. With 82% of European production capacity in the UK if the no-deal Brexit had happened it would be problematic in logistics terms, as excise duties would be greatly impacted and consequently the price of products would increase. UK's production capacity also accounts for a third of Diageo's total production capacity.

Diageo is a top player in both volume and value in eastern and western Europe. The relevance of the company in western Europe relatively to eastern is evident for its strategy and market positioning. Eastern Europe includes countries with higher consumption rates of the continent, such as Estonia, Lithuania, Czechia and Bulgaria. Although market trends such as the search for quality over quantity and lower ABV drinks are observed in both sides, the adoption will not have the same impact in Eastern Europe. As the overall alcoholic beverage market leaders are Heineken, ABinBev and Carlsberg, that align the current market demands with its product portfolio and the rising categories in the industry, it is expected that Europe maintains its volume share relatively stable in the long term but slightly decreases in the short term. As a highly competitive market, beer companies will keep its top positions gaining market through its already established brands and further low-ABV beverages developments and

[19] Euronews, "Brexit deal: what changed on key issues to get the agreement?

acquisitions. Diageo, on the other hand will maintain its position and mainly grow in value by leveraging from the shift towards quality and higher priced drinks.

Europe's position will remain stable in the long-term within Diageo's revenue; however, its relevance will be surpassed by highly dynamic market of Asia Pacific.

Asia Pacific

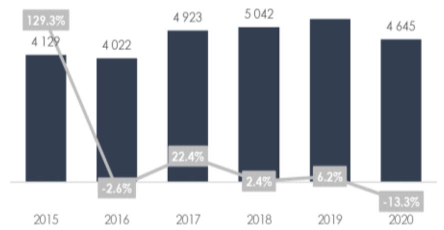

Fig. 11 Diageo's sales in Asia Pacific (£ million). Source: Diageo's Annual Report

Asia Pacific is one of the most promising regions for the alcoholic beverage industry, currently representing 26% of the market's volume and with a value of £472 billion. Diageo has been actively investing in emerging markets, namely in India and China, which makes Asia Pacific one of the most relevant regions for the company. In 2020, Asia Pacific represented 26.4% of sales in value, with a total revenue of £4 645 million, and leading in volume with 37%.

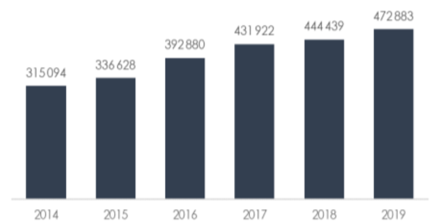

Fig. 12 Market value in Asia Pacific (£ million). Source: Euromonitor

With the rise of middle-income class, Diageo has increased its strategic investment in the region, highly focused in expanding its business in Asia's regions with highest growth prospects. Asia Pacific is currently the region with the highest disposable income, population density and the socio-economic polarization limits disposable income per capita. In 2014, individuals had available, approximately, £2 331, per year, an amount that grew, on average, 7.2% yearly until 2019. Although real GDP is expected to decrease on average 3.39% in 2020, the economic volatility cause by the pandemic is not expected to have long-term effects on available income, as in 2021 it is projected that available income surpasses 2019's values. Until 2024, disposable income per capita is expected to grow at a 5.1% CAGR. Although with values far from the ones observed in North America and Europe, Asia Pacific has some of the fastest growing economies in the world, thus even considering a relatively stable inflation rate, the growth of income will be reflected in terms of purchasing power. According to Nielsen, in 2018, 70% of Asia Pacific population considered that its financial wellbeing had improved, only 12% believed they were worse off[20].

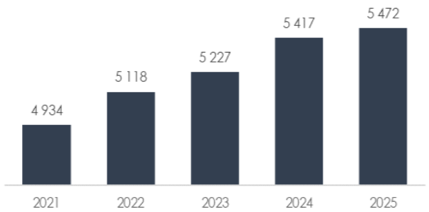

Fig. 13 Diageo's sales forecast in Asia Pacific. Source: Analysts estimates

As consumption per capita keeps decreasing year after year, going from an average of 31.4 liter consumed yearly in 2014 to 29.5 liters in 2019, and average decrease of 1.04% per year. In what regards to price, the opposite is being observed, as the market's average pound spent per liter grew at 6.86% CAGR from 2014 to 2019 and Diageo's, from 2015 to 2019, grew, YoY, on average, 7.85%. The increasing expense per liter consumed reflects the economic development of the region and consumer desire for higher quality products.

Fig. 14 Market volume in Asia Pacific (million liters). Source: Euromonitor

[20] Nielsen, "The impact of the wealth fragmentation on the consumer environment"

Consumption per capita in Asia Pacific						
	2014	2015	2016	2017	2018	2019
	31,4	30,6	29,9	29,8	29,6	29,5
Growth	-1,1%	-2,4%	-2,3%	-0,5%	-0,5%	-0,5%

Fig. 15 Disposable Income per Capita in Asia Pacific (£). Source: Euromonitor

Average £ spent in Asia Pacific						
	2014	2015	2016	2017	2018	2019
Market	3,38	3,65	4,30	4,68	4,78	5,04
Growth		7,9%	17,8%	8,9%	2,0%	5,5%
Diageo	13,52	4,29	4,31	5,63	6,19	6,26
Growth	-	-68,3%	0,6%	30,6%	9,9%	1,1%

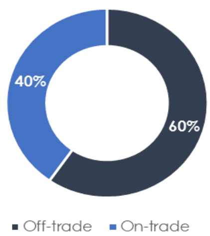

Fig. 16 Market Sales Value per channel. Source: Euromonitor

Distribution channel weights in the region deviate from what is observed in other regions, with an approximate 50/50 split between on-trade and off-trade in terms of volume, by contrast off-trade value outweighs on-trade with 59.7% share. Asia is the leading region in the digitalization of alcohol distribution, with China being the largest e-commerce market, that grew 23% from 2019 to 2020. Currently, online alcohol sales account for 1.7% of e-commerce market in the region, the cut will grow to 3.5% until 2024. The current development stage of this market allows for less growth than other regions, such as the US[21], Asia Pacific currently holds approximately half of global e-commerce sales values, with a share of 50.8%, being China, Taiwan and South Korea the most relevant countries, with share of 24%, 17% and 16%[22], respectively.

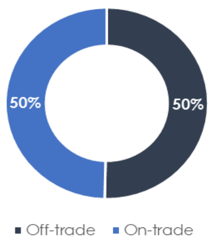

Fig. 17 Market Sales Volume per channel. Source: Euromonitor

Global travel retail is particularly relevant in the region, for Diageo and its peers, however the current pandemic scenario has led to a significant drop of sales in this segment, that is not expected to recover that rapidly[23]. In 2020 the segment was severely hit by the reduction of tourism and business trips, that were replaced by conference calls and general remote communication**Error! Bookmark not defined.**, which will cause a large drop in global travel retail of 68%[24]. This reduction will have an impact across regions, that it is expected to be reflected specially in Diageo's Asia Pacific revenues.

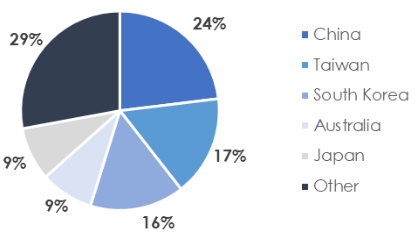

Fig. 18 E-commerce share in Asia Pacific by country (2020). Source: Statista

Category wise, ready-to-drink is the rising star of the Asian alcohol market, although still small in volume and value. With an average yearly growth of 5.5% in value, Asia Pacific is no exception to the health trends observer all over the world. On the other hand, spirits consumption in volume have stagnated in the last 5 years, with a CAGR of 0.2%, however with the opposite trend in terms of value, that has grown has by 5.5% per year, on average, which reflects how consumers are increasingly choosing better quality products, thus shifting to premium brands. Beer is the most consumed product in the region, and like spirits, has been increasing its value at an attractive rate, while in volume a low,

[21] IWSR, "Beverage alcohol ecommerce value grows by 42% in 2020, to reach US$24 billion"
[22] Statista
[23] The Spirits Business, How will travel retail cope with the fallout of Covid-19?
[24] IWSR, "Will Covid-19 disrupt premiumisation trends in the Global Travel Retail channel?"

almost null rate, is observed. Wine consumption has been decreasing in volume, with an average growth of -0.2% in volume, in the past 5-years, alongside the lowest growth rate in terms of value (3.3% CAGR, 2014-2019).

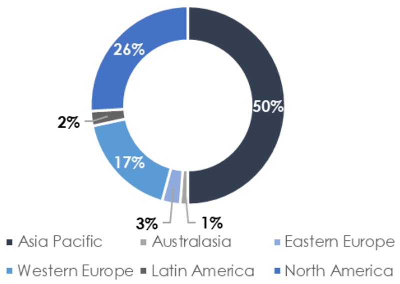

Fig. 19 E-commerce market per region (2019). Source: Euromonitor

Premiumization of the industry is leading the growth of the market in Asia Pacific. The rising middle-income class is directly related to this the growing willingness to pay for higher quality products. This segment is projected to increase, by the Organization for Economic Cooperation and Development, from 1.8 billion to 4.9 billion, between 2019 and 2030, largely driven by emerging market and in particular, Asia[25]. Currently, the region is the largest luxury market accounting for £355 billion in sales during 2019 and is expected to reach £487 billion in 2025. In 2014 Asia Pacific had an overall share of the luxury market of 37% that increased to 42.8% in 2019. By 2025, it is expected to hold almost half of the market value (48.9%), due to the average yearly increase of 7.02% from 2020 to 2025.

Fig. 20 Asia Pacific's Luxury Market. Source: Euromonitor

Baijiu, a Chinese white spirit, a popular drink in China, especially as a higher price tier product, has been gaining attention from other markets. Giant producers of the spirit, such as Kweichow Moutai, are eager to catch the eye of younger, non-chinese, generation to introduce the drink to their recurrent choices[26]. This position is a potential threat to Diageo's long-term market share, since the Baijiu producer already surpasses Pernod Ricard in Asia Pacific, with a spirit's market share in value of 6.1%, in 2019, equivalent to Diageo's the same year. Moutai could become the next M&A target of Diageo, however, as one of the biggest Chinese companies and with its main raw material being a limited resource and highly regulated by China, the acquisition has a low probability of happening. The leading market players in value, however, are ABinBev with 4.6% value share, followed by Asahi Group and Suntory, with 3.4% and 3.2% share, respectively. Diageo holds the fourth place with 3.1% share.

The growth of available in income in the market alongside the high acceptance of the premiumization trend, will be the main drivers leading the industry to become the most relevant to Diageo.

Africa

Fig. 21 Diageo's sales in Africa(£ million). Source: Diageo's Annual Reports

When it comes to beer, Diageo's most relevant segment is Africa. 60% of Diageo's beer sales come from Africa, a region with an estimated market value of 82 billion pounds, equivalent to 6% of global alcohol sales. In 2020, the company's sales amounted to £1 911 million, 12% of Diageo's sales, and it has been growing at an average 0.5% per year.

[25] Nielsen, "Premium Products are in High Demand Around the World"
[26] IWSR, "Baijiu Producers' Eye Global Expansion"

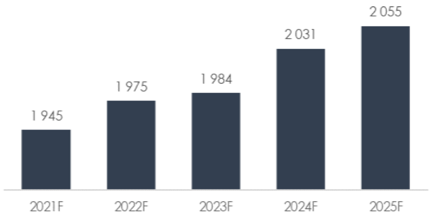

Fig. 22 Diageo's sales forecast in Africa. Source: Analysts estimates

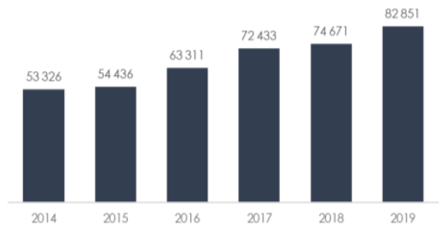

Fig. 25 Market value in Africa (£ million). Source: Euromonitor

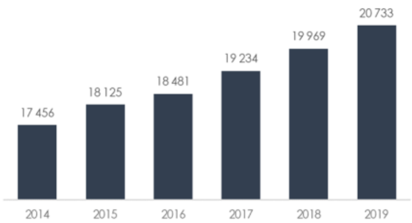

Fig. 23 Market value in Africa(£ million). Source: Euromonitor

As one of the least developed regions in the world, Africa has the smallest economy that is reflected in terms of disposable income per capita. Recording an average £1 178 per year available in 2014, it grew on average 4.22% per year, to £1 509 in 2019. The 3.73% GDP decrease in the region in 2020, is expected to have longer lasting effects than in other regions, with the per capita disposable income per capita recovering 2019's values only by 2024.

Contrasting with the general alcohol consumption trends across the world, per capita consumption in Africa grew on average 0.5% per year, from 31.3 liter in 2014 to 32.2 liters in 2019. Consumption bans observed in South Africa and Nigeria led the reduction of liters consumed in 2020 to 29.2 liters per year. As generally observed, the average price per liter consumed is increasing. With an average growth of 4.58% observed in the market from 2014 until 2019, Diageo's sales in the region have grown at a similar rate, at an average 4.43% per year. The premiumization trend will therefore have far less reaching impact than in developed markets. Moreover, it is projected that average consumption per capita will be in a decreasing trend from 2020 onwards, as harmful drinking will be an issue addressed by governments and companies, namely Diageo who has been investing in programs that help reduce harmful drinking.

Consumption per capita in Africa						
	2014	2015	2016	2017	2018	2019
	31,3	31,6	31,3	31,7	32,0	32,2
Growth	0,8%	0,9%	-0,8%	1,2%	0,9%	0,9%

Average £ spent in Africa						
	2014	2015	2016	2017	2018	2019
Market	3,22	3,05	3,00	3,43	3,77	3,74
Growth		-5,1%	-1,7%	14,1%	9,9%	-0,7%
Diageo	5,70	7,92	6,66	7,36	6,97	7,39
Growth	-	39,0%	-16,0%	10,5%	-5,2%	6,0%

Fig. 26 Disposable Income per Capita in North America(£). Source: Euromonitor

The most consumed drink in Africa is beer, with half of total sales coming from the segment. Followed by spirits which contribute with 29% of sales, wine 17.2%, Ready to drink 1.8% and cider/perry 1.6%. Ready to drink has been growing at an average 13.3% per year, the rest of the segments all grew at around 6% per year. Regard sales volume, the region has not stagnated as developed and the richest countries. With all segments growing around 3% per year, on average, except for RTDs that has been growing at a 10.2% CAGR.

The pandemic has come to put this growth on hold. South Africa, the third largest economy in the region, is projected to have a negative impact of 34% in overall alcoholic beverages market sales[27], harmful drink is a serious issue in the

[27] The spirits business, "Consumers Drinking Less Alcohol During Pandemic"

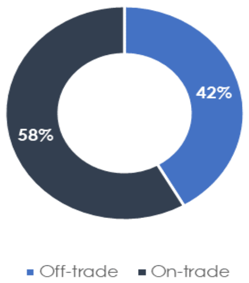

Fig. 27 Market Sales Value per channel. Source: Euromonitor

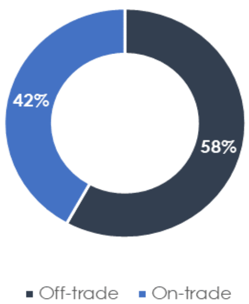

Fig. 28 Market Sales Volume per channel. Source: Euromonitor

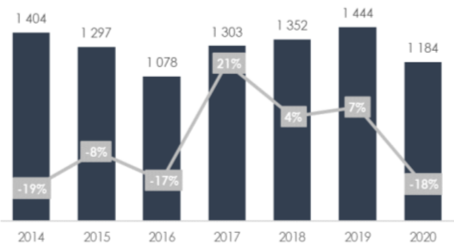

Fig. 29 Diageo's sales in Latin America (£ million). Source: Diageo's Annual Report

country[28], and the pandemic has aggravated it which obliged the government to impose bans on alcohol. The same happened in Nigeria. These two countries represented, in 2019, 45% of sales volume in the continent[29]. However, an IWSR study shows that consumer spending in alcoholic beverages has remained stable, which is a good sign for premium alcoholic beverages. By contrast, in 2018, a Nielsen study showed that only 6% of Africa's population was willing to pay more for drinks, this is encouraging for Diageo as it shows an opportunity to expand its spirits' sales in the region[30]. Moreover, East African Breweries, which is majority-owned by Diageo, reports spirits' sales have grown, since the beginning of the pandemic, in all its markets (Uganda, Tanzania, Rwanda and South Sudan)[31].

With Africa's economy severely hit by the oil prices and COVID-19, jobless claims have risen which in turn will cause a decrease in disposable income. In the biggest economy of the region, 27% of Nigeria's labor force is currently unemployed, which is equivalent to 21 million people[29]. This is worrisome, as this will translate in an even lower disposable income in the short-term. So, although spirits have performed well in the region, there is no reason to believe this will turn into a long-term trend in Africa.

The on-trade channel accounted for 42% of sales of last year, however with the bans imposed during the lockdowns, the market decline will be more serious than in the other regions. Moreover, off-trade sales will not be enough to offset losses from on-trade closures, as some countries, like South Africa, the bans on alcohol were applicable to e-commerce and brick and mortar stores[29]. Despite this, online sales of alcoholic drinks have moderately increased in South Africa and Nigeria, while it has declined in groceries and liquor stores[29].

Going forward, Diageo's market share will not undergo major changes, even though its already a leader in the spirits segment, premiumization will not be a growth driver in the region in the medium to long-term. The company's regional growth will therefore be focused on the beer segment.

Latin America and the Caribbean

Latin America and the Caribbean has the smallest weight in Diageo's operations, with £1 184 million in revenue recorded in 2020, that represents 7% of sales. A market estimated at £145 billion, that corresponds to 11% of global alcohol sales,

[28] BBC, "Coronavirus and South Africa's toxic relationship with alcohol"
[29] IWSR, "How has Covid-19 changed consumer behavior in South Africa and Nigeria?"
[30] Nielsen, "The Impact of Wealth Fragmentation on the Consumer Environment"
[31] The Africa Report, "Kenyans hit the spirits as COVID-19 changes drinking habits"

the region recorded a total of 37 billion liters consumed, which represents 15% of the world's consumption.

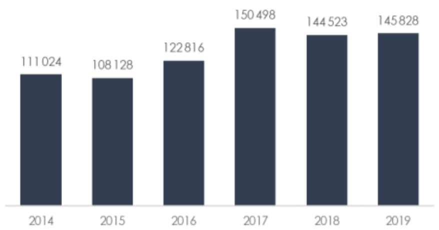

Fig. 30 Market value in Latin America (£ million). Source: Euromonitor

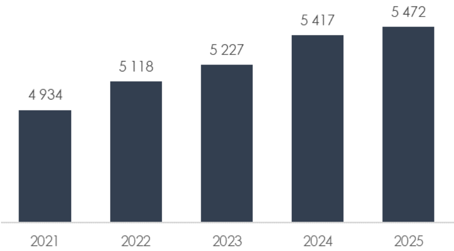

Fig. 31 Diageo's sales forecast in Latin America. Source: Analysts estimates

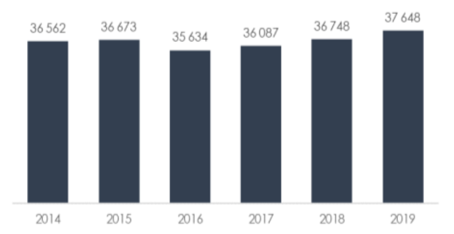

Fig. 32 Market volume in Latin America (million liters). Source: Euromonitor

Fig. 33 Disposable Income per Capita in Latin America (£). Source: Euromonitor

Being a developing market, Latin America's route to premiumization is still far from the trend, as disposable income per capita in 2019 stood at £4 318 per year, which even though is not the lowest is still less than half of those in developed markets. The region is expected to be severely impacted by the crisis coming from the coronavirus pandemic, since in 2020 the GDP is expected to decline 8.7% and grow at an average 3% rate from 2021 onwards. The economic slowdown will be reflected on per capita disposable income, that is only expected to reach 2019 values again by 2027.

For the past 5 years, the market volume growth has been mainly derived from demographics, as above 20 years old population group has been increasing at an average rate of 1.4% YoY. Therefore, per capita consumption, has been constantly decreasing, form 91 liters in 2014 to 86 liters in 2019 consumed yearly, which compounds to an average 0.92% decrease per year. By contrast, the average pound spent per liter consumed has increased at an average 4.14% per year, a trend also observed in Diageo, with average price in the region increasing at 1.43% per year.

Consumption per capita in Latin America and the Caribean						
	2014	2015	2016	2017	2018	2019
	91,0	89,7	85,7	85,3	85,4	86,1
Growth	0,9%	-1,5%	-4,5%	-0,4%	0,2%	0,8%

Average £ spent in Latin America and the Caribean						
	2014	2015	2016	2017	2018	2019
Market	3,04	2,95	3,45	4,17	3,93	3,87
Growth		-2,9%	16,9%	21,0%	-5,7%	-1,5%
Diageo	6,78	6,67	5,81	6,86	6,77	7,16
Growth	-	-1,6%	-12,9%	18,0%	-1,4%	5,9%

Diageo's strategy for the region, due to the limitations in terms of purchasing power and the overall economic conditions, is through mainstream drinks and lower price tier brands. With volume distribution split of on-trade and off-trade, respectively, 38% to 62%, the high relevance of the first will impose, with the pandemic, new challenges to the industry since it expected to have a rather significant decrease in the short term. As commonly observed in other regions, the value split for on-trade outweighs off-trade with 51% share. Shifting to the online channel, Brazil is within the countries observing alcohol online sales growing faster than traditional channels. The pandemic restrictions leveraged online sales, with a 94% increase between February and May, relative to 2019[32].

[32] The Brazilian Report, "Alcohol sales online almost double during pandemic"

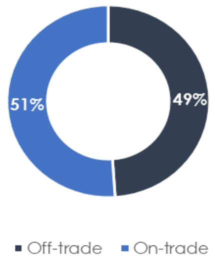

Fig. 34 Market Sales Value per channel. Source: Euromonitor

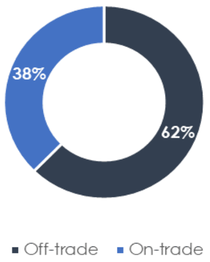

Fig. 35 Market Sales Volume per channel. Source: Euromonitor

Argentina is also observing strong growth in online sales, mainly due to the increase of physical stores online marketplaces, alcohol e-retailers, such as Craftsociety, and the development of home delivery platforms[33].

Ready-to-drink products, as observed in most regions is the category growing more consistently and on the extreme opposite, wine is showing the less attractive values, the categories are growing on average, respectively, 4.5% and -1.1%, yearly. Beer and spirits, that represent 93% of the market volume, have stagnated below 1% CAGR from 2013 to 2019. In terms of value, all categories had a consistent growth trend, however, being the home of internationally known spirits, such as Mexican tequila and Brazilian cachaça, it was observed the most relevant growth, an average, 3.6% per year.

Market players in Latin America are very diversified from local to global companies. ABinBev and Heineken lead the market with a combined 74.4% market share in volume and 47.6% in value. Diageo holds third place in value with 4% share. The economic instability in the region poses many challenges for companies, like Diageo and its peers, to grow. As the UK giant slowly shifts to premium, it also demonstrates no intention to remove its mainstream brands from the portfolio neither its lower priced tier drinks. Therefore, the region is not expected to have an increase relevant for the company.

Shareholder Structure

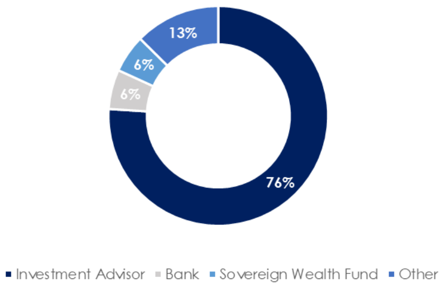

Fig. 36 Ownership type. Source: Bloomberg

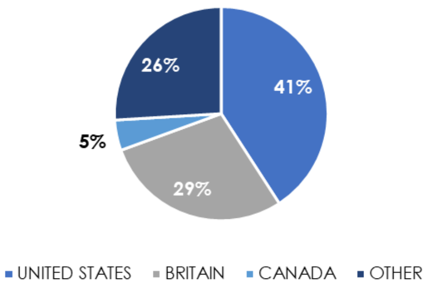

Fig. 37 Ownership by geography (%). Source: Bloomberg

With 2.34 billion shares outstanding, Diageo is traded in two stock exchanges: London Stock Exchange and New York Stock Exchange. The company's shareholders consist mainly of institutional investors (Fig. 58), from which the top shareholders are Vanguard (6.21%), Blackrock (5.72%) and Sun Life Financial (4.81%). The ownership structure has not suffered major changes and is mostly concentrated in the United States, which holds around 41% of the shares outstanding, and in the United Kingdom, with 29% of the shares outstanding (Fig. 59). In recent years, Diageo has rewarded shareholders through dividends and share buybacks, which has contributed, together with good operating results, to the exponential increase of payout ratio.

In July 2019 share buyback program was approved to return £4.5 billion to shareholders over three years, however, in 2020, due to the COVID-19 pandemic, the program was placed on hold until the company regains financial stability. Even so, with operating results negatively impacted, Diageo decided to increase the dividend per share to relieve investor's concerns about the uncertainty we are living these days. Further, in the last three years, the payout

[33] Movendi, Argentina: Growth of Digital Alcohol Retail

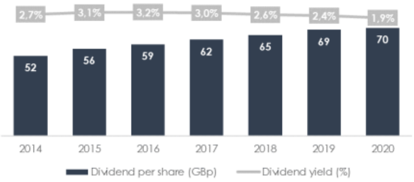

Fig. 38 Dividend per share (pence). Source: Diageo's Annual Reports

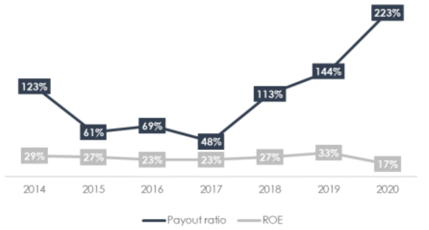

Fig. 39 Payout ratio (%). Source: Analysts estimates

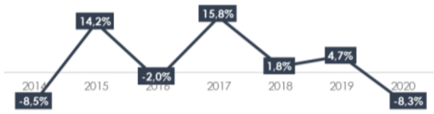

Fig. 40 Diageo's Revenues Growth (%). Source: Diageo's Annual Report

ratio has surpassed each year's respective earnings, which is not a sustainable long-term trend, therefore we believe that in the next three to four year, although dividend per share (Fig. 60) will continue its increasing trend, the share buyback program will only return by 2024, when the overall alcoholic market starts to recover, and Diageo's results are sufficiently stable to keep returning additional value to shareholders. Regarding Return on Equity (ROE), it has remained stable in the past 7 years, around 30%, although with the pandemic impact it has hit 17%, it is projected to return to normal levels in the near future (Fig. 61).

Diageo has a highly experienced management team that has led the company's expansion in emerging markets and works consistently to ensure it maintains its leadership in spirits, in every market it is present. Ivan Menezes, Diageo's CEO since 2013, has been with the company since 1997. His long experience in the industry and deep knowledge of the business is a great asset as the company remains focused in emerging markets expansion and to ensure Diageo remains strategically and financially strong, especially during volatile periods.

Growth drivers

Revenues

On average, Diageo sales have been increasing at the steady rate of 3.43% per year. Highly impacted by the pandemic, Diageo's sales plunged 8.28% (Fig. 62) with North America being the only region to grow until June 2020, by 3%. This sales decrease is in line with its peers, with Rémy Cointreau being the most affected with 9% sales decline. Therefore, sales volume was forecasted in the regions Diageo is present, as well as the average price per liter and the company's market share until 2035.

Across regions the expectation is that the global alcoholic beverage market recovers from 2020's drop by 2024. Although the average consumption per capita has been steadily declining, considering the trends observed in the market, it is expected that this indicator will remain stable with negligible growth. In addition, a general increase of the dollar spent per liter consumed is also being observed on the market, as the search for high quality and premium drinks increases. The average price recorded, in 2014 was £3.79 per liter, while in 2020, although suffering a decline due to the installed crisis, was £4.73, a 24% increase. As a highly competitive market, Diageo is not expected to grow its market share in the future, volume wise, but to maintain it (i.e. volume growth in line with the market) and drive value creation through improved price mix via premiumization.

Consumption per capita (liters)					
2015	2016	2017	2018	2019	2020
51,61	50,56	50,23	50,24	50,12	44,55

Average spent per litter (£)					
2015	2016	2017	2018	2019	2020
3,82	4,41	4,85	4,86	5,05	4,73

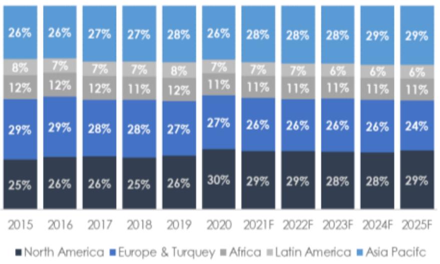

Fig. 41 Sales distribution per region (%). Source: Diageo's Annual Reports

Even though North America is the most relevant geography for the company nowadays, as it is leading the premiumization trend, it is in risk of being outpaced by Asia Pacific, as middle-income class and disposable income of population increases and the luxury market gains relevance in the region (Fig.63).

Alcoholic beverage market growth was forecasted considering GDP growth of each region for the next 5 years, thus, until 2025, and in the long-term it was considered IMF's expected world GDP growth, of 3.5%. As for alcohol consumption per capita, it is on a decreasing trend, and therefore it is not expected that the overall market volume grows at the same rate as the global GDP but, at an average 1.5% growth. In previous years, it already was observed a lower market growth than the respective regional economy growth. Regarding price, it is projected to grow at 2%, which corresponds to the inflation rate. Even though, IMF forecasts a 3.2% inflation for next year, in most regions, the average price per liter has not accompanied the inflation of the respective region, therefore a lower inflation rate was assumed.

Costs

Diageo's operating cost structure is composed mainly by cost of sales, with a weight of 48%, followed by marketing 19%, and staff costs 15% (Fig. 64).

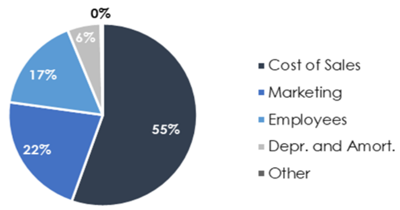

Fig. 42 Diageo's operating costs (2020). Source: Diageo's Annual Report

Costs of goods sold, as the most significant cost on the company's structure, are expected to increase in the long-term, as it is projected that demand for higher quality products will increase, thus, better ingredients. In what regards to gross margin, it has been stable over 62% (Fig. 65), however with volatility triggered by the pan demic, Diageo's cost structure confronted some inefficiencies that led to a slightly decrease, setting the margin on 60%, which is expected to recover at the same rate as sales. Gross margin will remain stable, even as the company turns its portfolio towards more premium brands, since this product have higher flexibility in setting prices which will directly influence the margin.

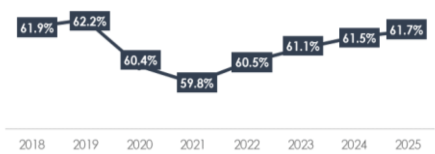

Fig. 43 Diageo's gross margin. Source: Diageo's Annual Report and Analysts estimates

Diageo's staff costs have been following a consistent trend in terms of reduction of the number of employees over the years, alongside a general increase of the average cost per employee. In 2020 the company had 28k people working for the company, while in 2015 were 34k, an approximate 17% decrease. On the cost side, between 2014 and 2020 the average costs increased from a yearly £41k to

£49k. Going forward, the company will continue this trend due to the company's general investment to automate operations, not only on production sites but also administratively wise, this also means that there will be a higher demand for specialized staff that will drive up the average cost per employee.

Staff Costs							
	2019	2020	2021F	2022F	2023F	2024F	2025F
Number of employ	29 402	28 490	28 205	27 782	27 643	27 505	27 367
%growth	*-4,4%*	*-3,1%*	*-1,0%*	*-1,5%*	*-0,5%*	*-0,5%*	*-0,5%*
Average cost per e	53,74	49,28	49,28	49,28	51,08	52,91	54,82
%growth	*9,5%*	*-8,3%*	*0,0%*	*0,0%*	*3,6%*	*3,6%*	*3,6%*

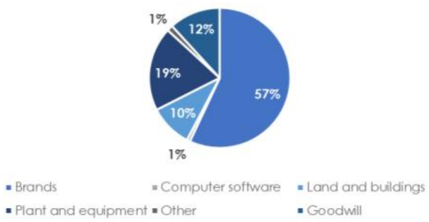

Fig. 44 Diageo's 2020 Invested Capital. Source: Analysts estimates

Marketing, as the second most significant cost on Diageo's operations faces many challenges, due to the high regulation of the alcoholic beverage market and the relevant role it plays in communicating brands to capitalize revenues. To increase efficiency, the company has been investing in data analytics to obtain returns of its campaigns, therefore, even though the company will have an improved approach to its target markets, as the portfolio increases, Diageo will keep the cost over sales in line with what has been previously observed. However, in the next four years the company will increase its spending in marketing, as sales were highly impacted by the pandemic, Diageo will feel the need to leverage sales.

Capital Expenditures

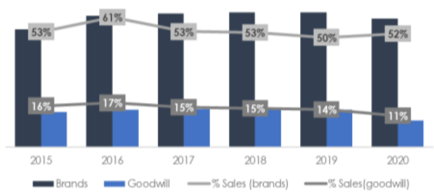

Fig. 45 Brands & Goodwill. Source: Diageo's Annual Report

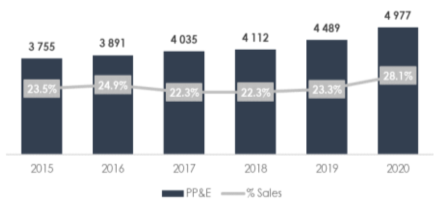

Fig. 46 Property, Plant & Equipment. Source: Diageo's Annual Reports

Fig. 47 Computer Sofware Investment/Sales. Source: Analysts estimates

Diageo's capital expenditures are mainly linked to its strategic acquisitions and the company shows no intentions of slowing its M&A activity, even in such times of uncertainty as the current year. Brand's value have an approximate weight of 57% on the overall Invested Capital (Fig. 66) which is in line with one of the company's strategic pillar, to grow through investment on its own brands, firstly by mergers and acquisitions and secondly with organic growth of the own brands. Computer software investment has been stable over the years, which accounts for a renewal processed, recently the company has been investing in data analytics tools that could improve other areas of investment and support obtaining more target-oriented marketing, therefore the investment in this segment is expected to increase in the short term to leverage for the outputs of the tools in their marketing strategies. Moreover, considering the growth observed of e-commerce in the alcoholic beverage market, on the long-term it is expected that the company continues to invest in online platforms so that it keeps it competitive standing in the market. Property, Plant & Equipment investment has varied over the years. The company has been investing as part of its sustainability landmarks, since it has firmly assumed its role as game changer and responsible party on the industry's environmental footprint reduction, thus investment on the improvement of production sites as been at the core of the company's property and equipment investments. However, as a consequence of the company's frequent acquisitions these assets also increase invested capital. More recently, the company had been focused on the development of consumer experiences through the construction of visitor sites, with the pandemic these were temporarily placed on hold but are expected to provided returns shortly after restrictions start to loosen.

Net Working Capital

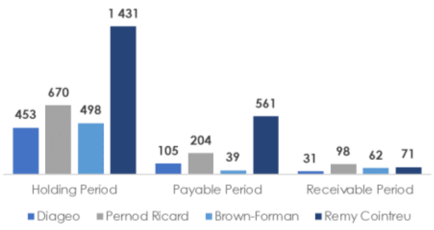

Fig. 48 Activity ratios. Source: Analysts estimates

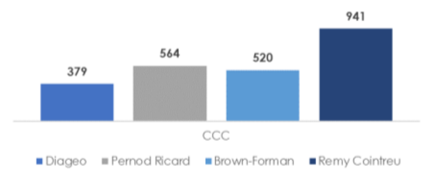

Fig. 49 Cash Conversion cycle. Source: Analysts estimates

Diageo cash conversion cycle is currently the most competitive within peers. Players in the spirits market have long inventory holding periods due to the characteristics of the products, such as maturation, a non-observed indicator in companies selling exclusively beer. As the company keeps growing its premium portfolio, it is expected that holding period increases in the long-term. Rémy Cointreau, as an exclusive premium spirits player, has a holding period of nearly 5 years. However, Diageo is not expected to reach such target, with a holding period of 453 days in 2020 (Fig. 70), since it shows no intentions of excluding its mainstream brands from its portfolio, but also because the beer segment, that accounts for 13% of the business, balances the extremes. In what regards to the receivable period, Diageo's has a competitive position holding the shortest receivable period among peers. On payables, Pernod holds a more competitive position than Diageo, however an increasing trend has been observed, it is expected that it continues to improve although not entirely converging to the peer position, due to the high standards that the company demands from suppliers in terms of product quality and company values.

Borrowings

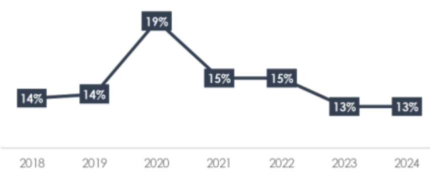

Fig. 50 Diageo's debt/enterprise value. Source: Analysts estimates

Diageo sets clear target debt ratios and has been able to attain them for the past years. However, the pandemic has posed challenges on the company's cash management that led to an increase in debt above the established target range. Therefore, as Diageo's liquidity position remains unstable the debt-to-EV ratio is expected to remain stand at 15% until 2022, as revenue starts to pick-up pre-pandemic values and both the economy and the alcoholic beverage market stabilize the company will be targeting reestablish its target debt-to-EV ratio to 13% (Fig. 72). A mature company as Diageo, with solid presence in the market is not expected to face adversities, remaining financially stable in the long-term. These results also imply the need to return value to shareholders by restarting the share buyback program in 2025, year that the market resets to 2019 values.

Regarding liquidity, Diageo has shown a stable position over the past years, even amidst a pandemic scenario, the company was able to increase its current ratio to 1.77 due to the issue of new bonds. This reflects the company's flexibility to increase its debt to maintain operations solid position. A decision that made it possible to maintain its A3 credit rating (Moody's).

Valuation

Discounted Cash Flows

The discounted cash flows method was the primary approach to value Diageo's operations. The explicit forecasting period was extended up to 2035, year in which the free cash flows stabilized at 3.5% year-on-year grow. Therefore, the company will have a RONIC of 16% under a 22% reinvestment rate. Overall, in perpetuity, the company will have a ROIC of 14%.

Cost of Capital

Share price	2 878
	28,78
# shares outstanding	2 339
Market capitalization	67 311
Cost of Debt	**1,52%**
Risk Free	0,33%
Market Risk Premium	8,99%
βE	0,58
Cost of Equity	**5,53%**
Tax rate	19%
D/EV	13%
WACC	**5,01%**

Fig. 51 WACC. Source: Analyst estimates

To understand the risk underlying the company's activity, the estimation of the WACC's individual components was made.

The CAPM was computed to estimate the cost of equity. The 10-year UK Government yield bond was considered as risk free rate, since Diageo is a British company reporting its results in GBP's. As a measure of market risk premium, the MSCI World Index (in GBP) gross returns until November 2020, of 9.32%, less the applicable risk-free rate was applied. Lastly, to understand the Diageo's share volatility to the market we regressed the stock's weekly returns to MSCI World (GBP) returns for a period of 3 years, reaching 95% confidence interval of between 0.5784 and 0.3715. Although, the regression narrows the volatility to a short interval, when analyzing peers re-levered beta, it is possible to conclude that fall in similar ranges, from 0.5648 to 0.3396, for Pernod Ricard and from 0.6759 to 0.4653, for Brown-Forman.

Cost of debt was estimated based on the company's issued bonds that, given the relevance of the amount, in this case with face value of £500 million, accounts for a 1.64% yield and with maturity in 2026. Diageo has an A3 credit rating according to Moody's which leads to a probability of default of 1.07% and a loss given default of 31.82%.

Reaching a WACC of 4.88%, it was considered a final cost of equity of 5.53%, a cost of debt of 1.52% and UK's corporate tax rate to remain the constant at 19%. The UK's corporate tax was used as most of Diageo's taxable income is subject to UK's tax law. In terms of capital structure, the current debt-to-enterprise value ratio does not reflect what the company targets, therefore for the next 4 years as the company recovers from pandemic impact will be 19% funded by debt, going forward also as the whole market goes recovers, the company reestablishes its 15% target debt ratio.

Scenarios

In late 2019, a series of events unexpectedly started to roll out as a new virus was identified in Wuhan, China, and rapidly spread all over the world. In March 2020, the world stopped, and companies across all industries faced the challenge of the decade. From the US, to India, South Africa and most European countries started lockdowns with on-trade closures, and even in some countries, such as India, led to the ban of alcohol consumption and commercialization. The alcoholic beverage industry suffered a big hit.

As currently the world faces unprecedent challenges, a scenario analysis was conducted to account for the possible impacts of the pandemic and its economic outcomes. While new advancements arise, the study of the virus itself gets more robust and what was once uncertain becomes clearer. The alcoholic beverage market is therefore projected to recover to 2019 values by 2024[34].

On the first scenario, the most likely outcome, with the vaccine approved by health organization in late 2020, population in most countries will start the first phase of vaccination in early 2021. By mid-2022, around 90% of the worldwide population will reach group immunity as the vaccine shows signs of the 95% effectiveness, as predicted by pharmaceuticals, leading to low reinfection rate[35]. Consumption will start to pick up from that moment onwards, although consumers will be resilient to go back to "normal" on their consumption habits. In the beginning of 2023, on premise market will see growth and consumers in relevant markets will return to restaurants and bars with the same frequency as seen in mid-2019.

The second scenario considers the availability of a vaccine to most of the worldwide population will only occur by mid-2021. The delay could be caused by either a natural catastrophe, man-made disaster, or a slow response from production to the high demand. This would directly impact the mass production of the vaccine and its availability, even the possibility of mis-planning for the rollout for the population by its governments[36]. It was also considered the possibility that the vaccine has a lower efficiency than what was projected by specialists. Thus, and a third wave will take over in the first half of 2021, which will once again oblige countries to apply restrictive measures. Only by the middle of 2023 the

[34] IWSR, "Global beverage alcohol is not expected to rebound until 2024"
[35] McKinsey, "When will the COVID-19 pandemic end?"
[36] McKinsey, "The COVID-19 vaccines are here: What comes next?"

population will start reaching immunity. Economic recovery, in particular, the alcoholic beverage market will show signs by 2024.

The least likely scenario is the development of a vaccine that will show low efficiency. The population will reach 90% vaccination late 2022, however with high rate of reinfection. These results will imply continuous lockdowns between early 2021 and 2023, as the new COVID strain spreads. Immunity is therefore, only reached by 2024. The market will mostly struggle between 2020 and 2024, however from that moment onwards it will start to see growth alongside the world's economy.

As the availability of the vaccine is not homogeneous across regions, it was considered different probabilities for each scenario. In developed markets, such as North America, Europe and Asia Pacific the first scenario has 80% probability, as it is already being reflected in the present moment. In less developed regions, such as Africa and Latin America and the Caribbean, the arrival of vaccination program is expected to be delayed. Thus, the first scenario is the most likely one, with a probability of 55% and 65%, respectively. As for the second scenario, Africa has a 40% probability of facing it, while expectations regarding LAC recovery are more favorable, a lower probability of 30% was considered.

The scenario analysis was developed for the alcoholic market in volumes which will have a direct impact on Diageo's revenues and indirectly on costs. In terms of invested capital, it will also have a direct impact since the company will have the need to adapt its investments to the market demand, particularly in terms of PP&E and computer software. Regardless the actual outcome of the pandemic, Diageo will be able to keep its leading position. With more than 200 brands over different price points, even if premiumization is put on hold the company has shown adaptability capacity and has been able to successfully face previous socio-economic challenges.

Even though long-term growth is expected to converge across regions, the impact of each scenario led to different price targets. The most likely scenario will lead to a price of £52.48, the second scenario to £50.86 and lastly, the least likely outcome would lead to a price of £48.16. Considering the probabilities of each scenario it was reached a target price of £51.91.

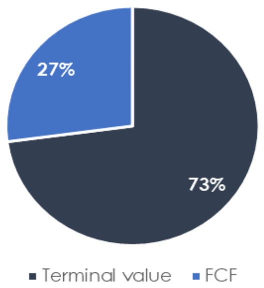

Fig. 52 Portion of terminal on total EV. Source: Analysts estimates

Sensitivity Analysis

To access the impact small change on estimated indicators would have on Diageo's target share price, a sensitivity analysis was performed. As the discount factor of the estimated free cash flows inputs have direct impact on the estimated enterprise value it was analyzed the market risk premium, the risk-free rate, the equity beta, cost of equity. Ranging from 6.75%, KPMG's recommended market risk premium for 2020, and MSCI World (GBP) 9.32% market returns until November 2020 (since inception) and considering the risk-free rate of the British government bonds between 8 and 10 years, the range has high impact on the stock final price. It was also observed that all outputs were above the current price. Afterwards its was analyzed the βe impact from the lower to the upper boundaries, the output from regression of the stocks returns against the markets. With a 95% confidence interval with a short interval of values, the share price remained wide, with higher values reflecting higher accuracy. Lastly, the perpetuity growth was analyzed. Ranging from the average long term inflation rate considered (2%) to the expected nominal expected GDP growth (approximately 5%), as well as the sensitivity to RONIC and RR. The share price shows less variation to the latter.

		Market Risk Premium				
		6,75%	7,50%	8,25%	9,00%	9,75%
Risk Free	0,15%	525	286	141	92	68
	0,20%	435	185	110	77	59
	0,25%	323	172	105	75	57
	0,30%	371	160	101	72	56
	0,35%	323	150	96	70	54

Table 3 Share price sensitivity. Source: Analysts estimates

The final price is therefore highly sensible to the inputs on the cost of capital to which it was applied

Multiples

A relative valuation was performed to evaluate Diageo versus its peers. Three companies were considered as comparable to Diageo, not only regarding regions where they are present, but also in terms of expected growth, risk, and return – Pernod Ricard, Brown-Forman, and Rémy Cointreau.

Fig. 53 Cumulative returns. Source: Bloomberg

	P/E	EV/EBITDA	EV/Net Sales	Expected Growth	Payout Ratio	β_E
Rémy Cointreau	71,28	35,68x	7,97x	12,0%	121,2%	0,26
Diageo	18,51	20,98x	7,94x	3,5%	223%	0,58
Brown-Forman	28,92	23,44x	8,08x	5,5%	52,2%	0,56
Pernod Ricard	21,57	17,66x	5,20x	18,6%	38%	0,44
Median	**35,07**	**24,44x**	**7,30x**	**9,9%**		

Starting with companies' market performance since mid-2018 (Fig. 75). Brown-Forman has outperformed its peers for the past 3 years, with a cumulative return of 37.6%. As for the lowest performer position, is Diageo with only 7.43% cumulative return for the past 3 years, severely impacted by the COVID-19 pandemic and Brexit expectations.

Although Diageo's profitability was in line with its peers, in 2019, it was one of the few that was able to maintain it stable in times of crisis, with its gross margin set at 60% and EBITDA margin at 24%. With ROIC highly impacted by the pandemic, it still is the second best in the industry, and in contrast with Pernod, it was able to generate additional value over its investments. It is also important to notice that Brown fiscal year ended in April 2020, which does not reflect the worst phase of the pandemic and subsequent consequences of on-trade closures, which Diageo and Pernod financials already reflect. Regarding leverage, Diageo has a target Net Debt/EBITDA between 2.5x and 3.0x, however the pandemic forced the company to issue more debt than usual, surpassing the leverage target policy. Despite this, Pernod Ricard has become the highest leveraged peer, more than doubling its Net Debt/EBITDA this year (2.5x (2019) vs 6.2x (2020)).

	Diageo	Rémy Cointreau	Brown-Forman	Pernod Ricard
Gross margin	60%	66%	63%	60%
EBITDA margin	24%	22%	34%	15%
ROIC	8%	4%	23%	0%
Net Debt/EBITDA	3,8x	2,1x	2,2x	6,2x

Diageo is the biggest within its peers, with the highest market and most solid track performance, it also has the lowest P/E of the industry, 18.51 while the average P/E of peers is set at 34.62, driven by the high P/E of Rémy Cointreau (35.07). If only Brown-Forman and Pernod Ricard are included as comparable, Diageo P/E is in line with its peers. The higher P/E means investors are expecting the company to have a high growth in its free cash flow, as Remy is more focused in a limited number of products and specifically in the luxury market, which is expected to increase 142% until 2025. By contrast, Diageo's portfolio is present in different price points, from mainstream brands to premium brands and therefore is not expected to benefit in total from this market growth. And with one of the most leveraged capital structures within the industry, 3.8x Net debt/EBITDA vs 3.6x industry's average, it justifies Diageo's low P/E.

As for EV/EBITDA, Diageo is in line with a 20.98x while the industry's average is 24.44x. While EV/Net Sales the industry average is 7.3x, Diageo's is 7.94x. With these metrics we reach three different target prices. The lowest given by the P/E is set at £16, while EV/EBITDA is £31 and EV/Net Sales £29 (Fig. 76).

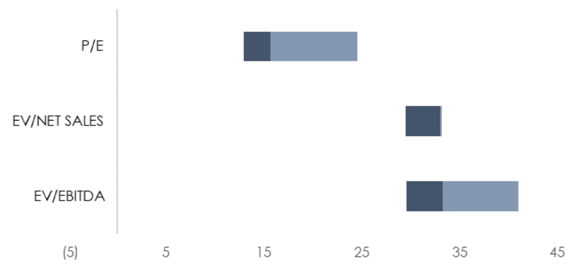

Fig. 54 Target price range. Source: Analysts estimates

Appendix

Financial Statements

REFORMULATED BALANCE SHEET & FORECAST

£ million	2013	2014	2015	2016	2017	2018	2019	2020
CORE BUSINESS								
Intangible assets (excluding Goodwill)	7 636	6 690	8 710	9 671	9 843	9 894	9 875	9 388
Brands	7 412	6 472	8 516	9 483	9 663	9 737	9 736	9 264
Computer software	224	218	194	188	180	157	139	124
Property, plant and equipment	3 461	3 486	3 755	3 891	4 035	4 112	4 489	4 977
Land and buildings	975	995	1 109	1 093	1 201	1 141	1 235	1 595
Plant and equipment	2 242	2 270	2 433	2 580	2 621	2 773	3 044	3 161
Returnable bottles & Fixtures and fittings	244	221	213	218	213	198	210	221
Trade receivables	2 398	2 431	2 304	2 514	2 459	2 418	2 366	1 764
Inventories	4 207	4 222	4 574	4 579	4 788	5 015	5 472	5 772
Operating Cash	452	410	433	419	482	487	515	470
Trade payables	(1 087)	(903)	(883)	(1 088)	(1 365)	(1 514)	(1 694)	(1 333)
Corporate tax	(224)	(197)	(162)	(340)	(294)	(178)	(295)	(56)
Other payables	(1 552)	(1 315)	(1 488)	(1 728)	(1 644)	(1 845)	(1 793)	(1 748)
Tax and social security excluding income tax	(533)	(497)	(551)	(608)	(545)	(640)	(640)	(698)
Accruals	(986)	(785)	(888)	(1 065)	(1 070)	(1 168)	(1 097)	(971)
Deferred income	(33)	(33)	(49)	(55)	(29)	(37)	(56)	(79)
Other receivables	166	175	177	218	191	306	381	393
Interest receivable	19	20	23	20	19	14	25	29
VAT recoverable & Other	-	-	-	-	-	127	146	205
Prepayments	147	155	154	198	172	165	210	159
Deferred Taxes (net)	(164)	(126)	(124)	(126)	(180)	(292)	(349)	(340)
Core Invested Capital before Goodwill	15 293	14 873	17 296	18 010	18 315	18 403	18 967	19 287
Goodwill	1 377	1 201	2 521	2 699	2 723	2 678	2 682	1 912
Total Core Invested Capital	16 670	16 074	19 817	20 709	21 038	21 081	21 649	21 199
NON CORE BUSINESS								
Investments in associates and joint ventures	2 521	3 201	2 076	2 528	2 824	3 009	3 173	3 557
Other investments	412	63	109	31	31	46	49	41
Other financial assets	458	368	338	915	348	217	531	761
Other financial liabilities	(306)	(302)	(337)	(538)	(415)	(287)	(329)	(312)
Other payables	(513)	(575)	(564)	(545)	(503)	(696)	(810)	(625)
Assets/Liabilities held for sale	51	8	140	3	-	24	33	-
Assets held for sale	51	8	143	3	-	24	65	-
Liabilities held for sale	-	-	(3)	-	-	-	(32)	-
Provisions	(365)	(385)	(343)	(390)	(415)	(397)	(416)	(476)
Thalidomide	*(164)*	*(200)*	*(191)*	*(190)*	*(223)*	*(217)*	*(209)*	*(199)*
Restructuring	*(71)*	*(88)*	*(49)*	-	-	-	-	-
Other	*(130)*	*(97)*	*(103)*	*(200)*	*(192)*	*(180)*	*(207)*	*(277)*
Deferred taxes (net)	(1 061)	(993)	(1 583)	(1 558)	(1 798)	(1 573)	(1 545)	(1 513)
Intangible assets	(1 526)	(1 361)	(1 898)	(2 201)	(2 277)	(1 812)	(1 795)	(1 736)
Post employment plans	109	100	81	240	112	(27)	(38)	(72)
Tax losses	108	113	103	60	43	32	24	61
Other temporary differences	248	155	131	343	324	234	264	234
Post employment benefits	(541)	(475)	(259)	(1 193)	(491)	63	214	362
Non Core Invested Capital	656	910	(423)	(747)	(419)	406	900	1 795
FINANCING								
Excess Cash	1 298	212	39	670	709	387	417	2 853
Interest Payable	(178)	(101)	(77)	(81)	(75)	(104)	(127)	(152)
Finance leases	(289)	(291)	(262)	(242)	(183)	(155)	(128)	(470)
Borrowings	(10 069)	(9 214)	(9 838)	(10 129)	(9 042)	(9 902)	(12 555)	(16 785)
Non-controlling interests	(1 052)	(767)	(1 485)	(1 650)	(1 715)	(1 765)	(1 795)	(1 668)
Financing	(10 290)	(10 161)	(11 623)	(11 432)	(10 306)	(11 539)	(14 188)	(16 222)
Equity	**7 036**	**6 823**	**7 771**	**8 530**	**10 313**	**9 948**	**8 361**	**6 772**

£ million	2021F	2022F	2023F	2024F	2025F	2026F	2027F	2028F	2029F	2030F	2031F	2032F	2033F	2034F	2035F
CORE BUSINESS															
Intangible assets (excluding Goodwill)	9 572	9 904	10 006	10 074	10 120	10 476	10 845	11 227	11 623	12 033	12 457	12 897	13 352	13 823	14 311
Brands	9 436	9 761	9 860	9 920	9 965	10 317	10 681	11 058	11 448	11 852	12 270	12 703	13 152	13 616	14 096
Computer software	136	142	146	154	155	159	164	169	175	181	187	193	200	207	214
Property, plant and equipment	5 277	5 428	5 539	5 702	5 916	6 175	6 382	6 597	6 821	7 052	7 293	7 543	7 802	8 070	8 349
Land and buildings	1 798	1 938	1 960	1 985	2 007	2 072	2 139	2 210	2 282	2 358	2 437	2 518	2 603	2 691	2 783
Plant and equipment	3 270	3 290	3 376	3 505	3 688	3 875	4 006	4 143	4 285	4 433	4 585	4 744	4 908	5 078	5 255
Returnable bottles & Fixtures and fittings	208	200	203	213	220	228	236	244	253	262	271	281	291	301	311
Trade receivables	1 707	1 733	1 803	1 867	1 913	1 981	2 051	2 123	2 198	2 276	2 356	2 439	2 525	2 614	2 706
Inventories	5 883	5 875	5 920	5 959	6 008	6 097	6 312	6 535	6 765	7 004	7 251	7 507	7 772	8 046	8 330
Operating Cash	469	475	483	489	494	511	529	548	568	588	608	630	652	675	699
Trade payables	(1 422)	(1 529)	(1 610)	(1 644)	(1 683)	(1 708)	(1 768)	(1 830)	(1 895)	(1 962)	(2 031)	(2 103)	(2 177)	(2 254)	(2 333)
Corporate tax	(129)	(136)	(178)	(183)	(187)	(198)	(202)	(210)	(217)	(225)	(233)	(241)	(250)	(258)	(268)
Other payables	(1 848)	(1 821)	(1 819)	(1 817)	(1 831)	(1 873)	(1 939)	(2 008)	(2 079)	(2 152)	(2 228)	(2 307)	(2 388)	(2 472)	(2 559)
Tax and social security excluding income tax	(691)	(684)	(684)	(684)	(694)	(719)	(744)	(770)	(798)	(826)	(855)	(885)	(916)	(949)	(982)
Accruals	(1 086)	(1 073)	(1 071)	(1 067)	(1 071)	(1 086)	(1 125)	(1 164)	(1 205)	(1 248)	(1 292)	(1 338)	(1 385)	(1 434)	(1 484)
Deferred income	(71)	(63)	(65)	(66)	(66)	(68)	(71)	(73)	(76)	(78)	(81)	(84)	(87)	(90)	(93)
Other receivables	365	311	280	247	239	247	256	265	274	284	294	304	315	326	338
Interest receivable	27	22	22	22	23	23	24	25	26	27	28	29	30	31	32
VAT recoverable & Other	178	127	92	56	47	49	50	52	54	56	58	60	62	64	66
Prepayments	160	163	166	168	169	175	181	188	194	201	208	216	223	231	239
Deferred Taxes (net)	(326)	(303)	(278)	(243)	(214)	(190)	(197)	(203)	(210)	(217)	(225)	(232)	(240)	(249)	(257)
Core Invested Capital before Goodwill	19 548	19 938	20 146	20 451	20 775	21 517	22 268	23 044	23 848	24 680	25 543	26 437	27 363	28 322	29 315
Goodwill	1 912	1 912	1 912	1 912	1 912	1 912	1 912	1 912	1 912	1 912	1 912	1 912	1 912	1 912	1 912
Total Core Invested Capital	21 460	21 850	22 058	22 363	22 687	23 429	24 180	24 956	25 760	26 592	27 455	28 349	29 275	30 234	31 227
NON CORE BUSINESS															
Investments in associates and joint ventures	3 557	3 557	3 557	3 557	3 557	3 557	3 557	3 557	3 557	3 557	3 557	3 557	3 557	3 557	3 557
Other investments	41	41	41	41	41	41	41	41	41	41	41	41	41	41	41
Other financial assets	761	761	761	761	761	761	761	761	761	761	761	761	761	761	761
Other financial liabilities	(312)	(312)	(312)	(312)	(312)	(312)	(312)	(312)	(312)	(312)	(312)	(312)	(312)	(312)	(312)
Other payables	(625)	(625)	(625)	(625)	(625)	(625)	(625)	(625)	(625)	(625)	(625)	(625)	(625)	(625)	(625)
Assets/Liabilities held for sale	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Assets held for sale	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Liabilities held for sale	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Provisions	(446)	(432)	(422)	(411)	(400)	(398)	(397)	(399)	(401)	(405)	(410)	(416)	(423)	(431)	(41)
Thalidomide	(179)	(161)	(145)	(131)	(118)	(106)	(95)	(86)	(77)	(69)	(62)	(56)	(51)	(46)	(41)
Restructuring	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Other	(267)	(271)	(276)	(281)	(282)	(292)	(302)	(313)	(324)	(335)	(347)	(360)	(372)	(385)	-
Deferred taxes (net)	(1 362)	(1 226)	(1 103)	(993)	(908)	(675)	(502)	(373)	(276)	(210)	(159)	(120)	(91)	(69)	(52)
Intangible assets	(1 562)	(1 406)	(1 266)	(1 139)	(1 025)	(769)	(577)	(432)	(324)	(243)	(182)	(137)	(103)	(77)	(58)
Post employment plans	(65)	(58)	(52)	(47)	(38)	(30)	(24)	(19)	(15)	(11)	(8)	(5)	(4)	(3)	(2)
Tax losses	55	49	44	40	32	26	20	16	13	9	6	4	3	2	2
Other temporary differences	211	190	171	154	123	98	79	63	50	35	25	17	12	8	6
Post employment benefits	362	362	362	362	362	362	362	362	362	362	362	362	362	362	362
Non Core Invested Capital	2 601	2 751	2 884	3 005	3 101	3 336	3 510	3 638	3 731	3 794	3 840	3 873	3 895	3 909	4 316
FINANCING															
Excess Cash	2 109	2 412	2 072	1 850	1 526	1 180	1 219	1 049	1 084	1 120	1 158	1 196	1 236	1 276	1 319
Interest Payable	(159)	(195)	(200)	(173)	(178)	(181)	(183)	(189)	(194)	(201)	(208)	(216)	(224)	(231)	(240)
Finance leases	(486)	(489)	(502)	(521)	(548)	(576)	(596)	(616)	(637)	(659)	(682)	(705)	(730)	(755)	(781)
Borrowings	(19 897)	(20 785)	(18 204)	(18 558)	(18 794)	(19 068)	(19 762)	(20 264)	(20 993)	(21 744)	(22 518)	(23 318)	(24 143)	(24 994)	(25 872)
Non-controlling interests	(1 668)	(1 668)	(1 668)	(1 668)	(1 668)	(1 668)	(1 668)	(1 668)	(1 668)	(1 668)	(1 668)	(1 668)	(1 668)	(1 668)	(1 668)
Financing	(20 102)	(20 725)	(18 501)	(19 070)	(19 662)	(20 314)	(20 990)	(21 688)	(22 408)	(23 152)	(23 919)	(24 711)	(25 528)	(26 372)	(27 242)
Equity	**3 959**	**3 876**	**6 441**	**6 298**	**6 126**	**6 452**	**6 700**	**6 906**	**7 083**	**7 235**	**7 377**	**7 511**	**7 642**	**7 771**	**8 301**

FREE CASH FLOW MAP

£ million	2014	2015	2016	2017	2018	2019	2020	2021F	2022F
NOPLAT	2 297	2 333	2 434	2 870	3 233	3 319	1 753	2 675	2 829
Depreciation, Amortisation & Impairments	629	440	473	361	493	374	1 839	443	457
Gross Free Cash Flow	2 926	2 773	2 907	3 231	3 726	3 693	3 592	3 118	3 287
Δ Net CAPEX	468	-4 049	-1 748	-701	-576	-736	-1 070	-927	-940
Δ Net Working Capital	-190	-267	3	60	-42	-253	-14	36	82
Δ Other Operating Invested Capital	-311	134	379	-49	82	47	-305	187	11
Unlevered Free Cash Flows	2 893	-1 409	1 541	2 541	3 191	2 751	2 203	2 414	2 440
Non Core Result	-1 017	496	404	915	-45	693	-38	282	291
Δ Non-Core Invested Capital	-254	1 333	324	-328	-825	-494	-895	-806	-150
Non Operating Free Cash Flow	-1 271	1 829	728	587	-870	199	-933	-524	141
Free cash flows available to investors	1 621	420	2 270	3 128	2 321	2 949	1 270	1 890	2 581
Finance charges	-455	-528	-459	-451	-395	-478	-525	-762	-895
Tax shields	102	110	92	89	75	91	100	145	170
Δ Financial Debt	156	743	-355	-1 191	1 183	2 619	2 161	3 880	623
Δ Equity	-1 425	-744	-1 547	-1 575	-3 183	-5 181	-3 006	-5 153	-2 479
Free cash flows from investors	-1 621	-420	-2 270	-3 128	-2 321	-2 949	-1 270	-1 890	-2 581

£ million	2023F	2024F	2025F	2026F	2027F	2028F	2029F	2030F	2031F	2032F	2033F	2034F	2035F
NOPLAT	2 968	3 053	3 110	3 303	3 369	3 489	3 613	3 741	3 873	4 011	4 153	4 299	4 452
Depreciation, Amortisation & Impairments	419	417	406	418	493	510	527	545	563	583	603	624	645
Gross Free Cash Flow	3 388	3 470	3 517	3 721	3 863	3 999	4 140	4 286	4 437	4 593	4 755	4 923	5 097
Δ Net CAPEX	-633	-648	-666	-1 033	-1 069	-1 107	-1 146	-1 187	-1 229	-1 272	-1 317	-1 363	-1 411
Δ Net Working Capital	-41	-75	-62	-149	-243	-251	-260	-269	-279	-289	-299	-310	-320
Δ Other Operating Invested Capital	47	0	-3	22	68	73	76	79	81	84	87	90	93
Unlevered Free Cash Flows	2 760	2 748	2 786	2 561	2 618	2 714	2 809	2 908	3 011	3 117	3 227	3 341	3 458
Non Core Result	291	297	311	311	311	311	311	311	311	311	311	311	311
Δ Non-Core Invested Capital	-133	-121	-96	-235	-174	-128	-94	-63	-46	-33	-22	-14	-407
Non Operating Free Cash Flow	158	176	215	77	137	183	218	248	265	279	289	297	-96
Free cash flows available to investors	2 918	2 924	3 001	2 638	2 756	2 897	3 027	3 156	3 276	3 395	3 516	3 638	3 363
Finance charges	-935	-827	-831	-850	-863	-894	-917	-949	-984	-1 019	-1 055	-1 092	-1 130
Tax shields	178	157	158	162	164	170	174	180	187	194	200	207	215
Δ Financial Debt	-2 223	569	592	651	676	698	720	743	767	792	817	843	870
Δ Equity	62	-2 823	-2 920	-2 600	-2 733	-2 870	-3 004	-3 131	-3 246	-3 362	-3 479	-3 597	-3 318
Free cash flows from investors	-2 918	-2 924	-3 001	-2 638	-2 756	-2 897	-3 027	-3 156	-3 276	-3 395	-3 516	-3 638	-3 363

REFORMULATED INCOME STATEMENT & FORECAST

£ million	2013	2014	2015	2016	2017	2018	2019	2020
CORE BUSINESS								
Sales	15 276	13 980	15 966	15 641	18 114	18 432	19 294	17 697
North America	4 283	3 937	3 929	4 046	4 737	4 684	5 088	5 233
Europe and Turkey	5 099	4 963	4 707	4 604	4 998	5 247	5 146	4 707
Africa	2 024	1 856	1 877	1 879	2 137	2 089	2 241	1 915
Latin America and Caribbean	1 750	1 412	1 304	1 080	1 306	1 356	1 448	1 187
Asia Pacific	2 120	1 811	4 150	4 031	4 936	5 056	5 371	4 655
Excise duties	(3 973)	(3 722)	(5 153)	(5 156)	(6 064)	(6 269)	(6 427)	(5 945)
North America	(535)	(467)	(448)	(469)	(560)	(551)	(610)	(595)
Europe and Turkey	(2 881)	(2 127)	(2 070)	(2 051)	(2 163)	(2 302)	(2 195)	(2 132)
Africa	267	(415)	(452)	(473)	(575)	(591)	(638)	(565)
Latin America and Caribbean	(287)	(259)	(263)	(215)	(258)	(282)	(313)	(276)
Asia Pacific	(537)	(454)	(1 920)	(1 948)	(2 507)	(2 543)	(2 672)	(2 378)
Cost of Sales	(4 416)	(4 029)	(4 610)	(4 251)	(4 680)	(4 634)	(4 866)	(4 654)
Marketing	(1 769)	(1 620)	(1 629)	(1 562)	(1 798)	(1 882)	(2 042)	(1 841)
Depreciation	(287)	(297)	(316)	(299)	(305)	(310)	(311)	(417)
Amortisation	(38)	(47)	(60)	(56)	(56)	(58)	(63)	(63)
Impairments	(50)	(260)	(41)	(104)	-	(125)	-	(1 219)
Staff costs	(1 403)	(1 479)	(1 433)	(1 475)	(1 583)	(1 509)	(1 580)	(1 404)
Other operating income/expenses	42	194	86	141	(46)	49	49	(30)
Core Result (before taxes)	3 382	2 720	2 810	2 879	3 582	3 694	4 054	2 124
Core Taxes	(803)	(612)	(583)	(576)	(707)	(702)	(770)	(404)
Tax Adjustments	(33)	189	106	131	(5)	241	35	33
Differences in overseas tax rates	5	(33)	(64)	(50)	(162)	(134)	(106)	(53)
Effect of intra-group financing	-	106	81	97	64	61	34	13
Other tax rate and tax base differences	-	105	95	87	100	109	132	84
Changes in tax rates	(7)	(4)	1	(7)	9	371	54	(45)
Adjustments in respect of prior years	(31)	15	(7)	4	(16)	(166)	(79)	34
NOPLAT	2 546	2 297	2 333	2 434	2 870	3 233	3 319	1 753
NON-CORE BUSINESS								
Non-operating items	(83)	140	373	123	20	-	144	(23)
Interest income	99	109	162	153	148	155	232	192
Share of after tax results of associates and joint ventures	217	252	175	221	309	309	312	282
Other finance income	5	17	21	21	11	27	55	51
Other financial charges	(63)	(57)	(73)	(39)	(46)	(46)	(70)	(71)
Fair value gain on financial instruments	155	115	61	88	76	61	155	123
Fair value loss on financial instruments	(151)	(117)	(55)	(91)	(67)	(62)	(157)	(123)
Gains on disposable of properties	(1)	(25)	(26)	(39)	(7)	(9)	(5)	(2)
Net foreign exchange (gains)/losses	(1)	12	13	1	(16)	6	(7)	15
Non-Core Result (before taxes)	177	446	651	438	428	441	659	444
Non-Core Taxes	(42)	(100)	(135)	(88)	(85)	(84)	(125)	(84)
Tax Adjustments	252	(26)	37	(55)	(24)	(126)	(128)	(234)
Discontinued operations	-	(83)	-	-	(55)	-	-	-
Other Comprehensive Income	131	(1 254)	(57)	109	651	(276)	287	(164)
Non-Core Result	518	(1 017)	496	404	915	(45)	693	(38)
FINANCING								
Finance charges	(502)	(455)	(528)	(459)	(451)	(395)	(478)	(525)
Finance lease interests	(20)	(20)	(17)	(13)	(11)	(9)	(7)	(6)
Borrowings and overdrafts interest	(482)	(435)	(511)	(446)	(440)	(386)	(471)	(519)
Tax Shields	119	102	110	92	89	75	91	100
Financing Result	(383)	(353)	(418)	(367)	(362)	(320)	(387)	(425)
Total comprehensive income for the year	**2 681**	**927**	**2 410**	**2 471**	**3 423**	**2 868**	**3 624**	**1 290**

£ million	2021F	2022F	2023F	2024F	2025F	2026F	2027F	2028F	2029F	2030F	2031F	2032F	2033F	2034F	2035F
CORE BUSINESS															
Sales	17 804	18 076	18 430	18 717	18 802	19 466	20 153	20 864	21 600	22 362	23 152	23 969	24 814	25 690	26 597
North America	5 116	5 178	5 240	5 273	5 459	5 652	5 851	6 058	6 272	6 493	6 722	6 960	7 205	7 460	7 723
Europe and Turkey	4 638	4 625	4 811	4 815	4 594	4 756	4 924	5 097	5 277	5 463	5 656	5 855	6 061	6 275	6 496
Africa	1 945	1 975	1 984	2 031	2 055	2 128	2 203	2 281	2 361	2 445	2 531	2 620	2 713	2 809	2 908
Latin America and Caribbean	1 172	1 179	1 168	1 180	1 222	1 265	1 310	1 356	1 404	1 454	1 505	1 558	1 613	1 670	1 729
Asia Pacific	4 934	5 118	5 227	5 417	5 472	5 665	5 865	6 072	6 286	6 508	6 738	6 976	7 222	7 477	7 741
Excise duties	(6 078)	(6 195)	(6 352)	(6 484)	(6 452)	(6 680)	(6 916)	(7 160)	(7 412)	(7 674)	(7 945)	(8 225)	(8 515)	(8 816)	(9 127)
North America	(585)	(595)	(605)	(612)	(633)	(656)	(679)	(703)	(728)	(753)	(780)	(808)	(836)	(866)	(896)
Europe and Turkey	(2 111)	(2 095)	(2 168)	(2 159)	(2 060)	(2 132)	(2 208)	(2 285)	(2 366)	(2 449)	(2 536)	(2 625)	(2 718)	(2 813)	(2 913)
Africa	(576)	(588)	(594)	(611)	(618)	(640)	(663)	(686)	(710)	(735)	(761)	(788)	(816)	(845)	(875)
Latin America and Caribbean	(274)	(277)	(275)	(280)	(290)	(300)	(310)	(321)	(333)	(344)	(357)	(369)	(382)	(396)	(410)
Asia Pacific	(2 533)	(2 640)	(2 710)	(2 823)	(2 851)	(2 952)	(3 056)	(3 164)	(3 275)	(3 391)	(3 511)	(3 635)	(3 763)	(3 896)	(4 033)
Cost of Sales	(4 720)	(4 690)	(4 703)	(4 710)	(4 725)	(4 795)	(4 964)	(5 139)	(5 320)	(5 508)	(5 703)	(5 904)	(6 112)	(6 328)	(6 551)
Marketing	(1 993)	(2 000)	(2 012)	(2 018)	(2 017)	(2 088)	(2 162)	(2 238)	(2 317)	(2 399)	(2 483)	(2 571)	(2 662)	(2 756)	(2 853)
Depreciation	(394)	(403)	(363)	(364)	(351)	(364)	(438)	(452)	(468)	(484)	(500)	(517)	(535)	(554)	(573)
Amortisation	(48)	(54)	(57)	(52)	(55)	(54)	(56)	(57)	(59)	(61)	(63)	(65)	(68)	(70)	(73)
Impairments	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Staff costs	(1 390)	(1 369)	(1 412)	(1 455)	(1 500)	(1 553)	(1 608)	(1 665)	(1 724)	(1 784)	(1 847)	(1 913)	(1 980)	(2 050)	(2 122)
Other operating income/expenses	35	35	36	36	37	38	39	41	42	44	45	47	49	50	52
Core Result (before taxes)	3 215	3 401	3 568	3 670	3 738	3 970	4 050	4 194	4 342	4 496	4 656	4 820	4 991	5 168	5 350
Core Taxes	(611)	(646)	(678)	(697)	(710)	(754)	(769)	(797)	(825)	(854)	(885)	(916)	(948)	(982)	(1 017)
Tax Adjustments	71	75	79	81	82	87	89	92	96	99	102	106	110	114	118
Differences in overseas tax rates	(107)	(113)	(118)	(122)	(124)	(132)	(134)	(139)	(144)	(149)	(154)	(160)	(165)	(171)	(177)
Effect of intra-group financing	39	42	44	45	46	49	49	51	53	55	57	59	61	63	65
Other tax rate and tax base differences	104	110	116	119	121	129	131	136	141	146	151	156	162	167	173
Changes in tax rates	76	81	85	87	89	94	96	100	103	107	111	115	119	123	127
Adjustments in respect of prior years	(43)	(45)	(47)	(49)	(49)	(52)	(54)	(55)	(57)	(59)	(62)	(64)	(66)	(68)	(71)
NOPLAT	2 675	2 829	2 968	3 053	3 110	3 303	3 369	3 489	3 613	3 741	3 873	4 011	4 153	4 299	4 452
NON-CORE BUSINESS															
Non-operating items	53	53	53	53	53	53	53	53	53	53	53	53	53	53	53
Interest income	18	18	18	18	18	18	18	18	18	18	18	18	18	18	18
Share of after tax results of associates and joint ventures	285	295	295	302	320	320	320	320	320	320	320	320	320	320	320
Other finance income	51	51	51	51	51	51	51	51	51	51	51	51	51	51	51
Other financial charges	(71)	(71)	(71)	(71)	(71)	(71)	(71)	(71)	(71)	(71)	(71)	(71)	(71)	(71)	(71)
Fair value gain on financial instruments	123	123	123	123	123	123	123	123	123	123	123	123	123	123	123
Fair value loss on financial instruments	(123)	(123)	(123)	(123)	(123)	(123)	(123)	(123)	(123)	(123)	(123)	(123)	(123)	(123)	(123)
Gains on disposable of properties	(2)	(2)	(2)	(2)	(2)	(2)	(2)	(2)	(2)	(2)	(2)	(2)	(2)	(2)	(2)
Net foreign exchange (gains)/losses	15	15	15	15	15	15	15	15	15	15	15	15	15	15	15
Non-Core Result (before taxes)	349	359	359	366	384	384	384	384	384	384	384	384	384	384	384
Non-Core Taxes	(66)	(68)	(68)	(70)	(73)	(73)	(73)	(73)	(73)	(73)	(73)	(73)	(73)	(73)	(73)
Tax Adjustments	(70)	(85)	(85)	(79)	(80)	(82)	(81)	(81)	(81)	(81)	(81)	(81)	(81)	(81)	(81)
Discontinued operations	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Other Comprehensive Income	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Non-Core Result	282	291	291	297	311	311	311	311	311	311	311	311	311	311	311
FINANCING															
Finance charges	(762)	(895)	(935)	(827)	(831)	(850)	(863)	(894)	(917)	(949)	(984)	(1 019)	(1 055)	(1 092)	(1 130)
Finance lease interests	(22)	(23)	(23)	(23)	(24)	(26)	(27)	(28)	(29)	(30)	(31)	(32)	(33)	(34)	(35)
Borrowings and overdrafts interest	(740)	(872)	(912)	(804)	(806)	(825)	(836)	(866)	(888)	(919)	(953)	(987)	(1 022)	(1 058)	(1 095)
Tax Shields	145	170	178	157	158	162	164	170	174	180	187	194	200	207	215
Financing Result	(617)	(725)	(757)	(670)	(673)	(689)	(699)	(724)	(743)	(768)	(797)	(825)	(854)	(884)	(915)
Total comprehensive income for the year	**2 340**	**2 396**	**2 502**	**2 680**	**2 749**	**2 926**	**2 982**	**3 076**	**3 181**	**3 284**	**3 388**	**3 497**	**3 609**	**3 726**	**3 847**

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Buy	Expected total return (including expected capital gains and expected dividend yield) of more than 10% over a 12-month period.
Hold	Expected total return (including expected capital gains and expected dividend yield) between 0% and 10% over a 12-month period.
Sell	Expected negative total return (including expected capital gains and expected dividend yield) over a 12-month period.

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