Why we like Diageo – February 2018

Walk into any bar or pub, and there's a good chance you'll order something produced by Diageo, the global drinks company created by the 1997 merger of Guinness and GrandMet. Today, the company generates annual net sales of $12bn from a unique portfolio of iconic brands including Johnnie Walker, Smirnoff, Captain Morgan, Baileys, Tanqueray and Guinness. The group is an integrated operator, producing and supplying drinks at a variety of price points with strong distribution routes globally.

Product innovation is a key driver of growth. Brands, such as Haig Club, have been developed in-house, while *Distill Ventures* is an incubator unit which supports spirits entrepreneurs. Innovation also encompasses marketing, with 'big data' used to more accurately determine future trends and launch 'relevant' consumer products.

We believe the outlook for the industry is very positive, with Diageo targeting sales growth in the mid-single-digits. In the developed world, the company is well placed to benefit from the trend towards 'premiumisation' – as people become wealthier, they consume less alcohol, but the quality of what they drink goes up. This is important for the bottom line – according to a study by Bernstein, although premium spirits only make up a third of market volume, they represent around 90% of the industry's profit pool.

Diageo has a strong heritage in the so-called emerging markets, which currently account for more than 40% of the group's net revenue. In these countries, the number of people of legal purchasing age is growing rapidly, and is set to increase by over 450m over the next decade. Penetration of spirits in emerging markets is lower than that of other consumer product categories, and as wealth increases and the middle class expands, consumers are shifting from local products to premium global spirits brands. Diageo predicts around 730m more consumers will be able to afford international style spirits over the next decade, with 85% of this growth coming from emerging markets. In this regard, we believe Japan provides a great precedent.

Margins are higher than for the overall consumer goods market, with Diageo currently generating a 30% return on sales. However, there is more to come – following a reinvigoration of the company by the new Chairman and CFO, margin growth of 1.75 percentage points is targeted for the three years ended June 2019. The new team has also sought to remove some of the cyclicality from the business by reducing levels of stock in the supply chain.

Diageo has a robust balance sheet and strong free cash flow characteristics which provide the flexibility to reinvest in the business, make bolt-on acquisitions, and return capital to shareholders. In a fragmented industry – Diageo only has around a 10% global market share – part of the strategy is to supplement organic growth with acquisitions of local brands that can be rolled out across the group's global distribution infrastructure. The most recent purchase was Casamigos, the super-premium tequila brand. The group has a long-term record of dividend growth and looking forward, the payout is expected to grow in the mid-single-digits, providing investors with a generous income in addition to the prospect for further capital growth. Cheers!

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