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DIAGEO – Cautious Optimism in 2023 and Beyond

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A Project carried out on the Master in Finance Program, under the supervision of:

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Abstract

Forward price target and comprehensive equity research report on the international drink's supplier, Diageo PLC. Company valuation based on five different methodologies to reach twelve-month price target of £4,120.96 representing a 10.44% total shareholder return, including capital gains and expected dividends.

Diageo produce and distribute hundreds of instantly recognizable drinks brands to over 140 countries across the world, with infrastructural facilities in +180 nations. With control over every aspect of their supply chain, Diageo are in a unique position to weather unfavorable external macroeconomic conditions to outperform their competitors in 2023, based on extremely strong economic recovery in the current financial year.

Keywords

Diageo Forward Price Target

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This report is part of the joint report (annexed), developed by Daniel Delaney and Robert O'Leary and should be read as an integral part of it.

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Introduction

Purpose

This joint report aims to provide the fundamental basis and comprehensive reasoning behind our forward price target for our chosen company, Diageo PLC. A significant factor in our selection was related to Diageo's connection to our native country, Ireland. Established in 1997 as part of the merger between the *Guinness Brewing Co.* and the international property conglomerate *Grand Metropolitan*, Diageo PLC has become one of Ireland's finest exports. As a result, we believed that this would be the put our analytical skills on a business, and industry, that we are passionate about.

Conclusions

Although Diageo is already an established market leader in the alcoholic beverages industry, we believe that they are in a unique position to take advantage of uncertain external market conditions to deliver extremely strong financial performance in 2023. Using a number of valuation methodologies, we obtained a twelve-month price target for the company of £4,120.96. This represents a total shareholder return of 10.44%, including capital gains and expected dividends.

Structure

Our report takes the form of three separate parts, the first of which is an overview of Diageo PLC as a whole. In this section we outline the background to our price target based on the most fundamental aspects of the company itself. This includes discussion of their key products, value drivers, management, and other innate factors of the international drink's distributor.

The second section of our report focuses on an analysis of the alcoholic beverages industry as a whole. This was critical to give us a better understanding of the characteristics of the drinks market, allowing us to make more accurate forecasts about Diageo's future prospects. This included examination of the current trends and competitive landscape of the industry, which showed us the potential challenges / opportunities that Diageo may face.

The final section of our research gives a detailed analysis of our forward valuation of Diageo, and how we reached each figure. This includes five valuation techniques and uses sensitivity analysis to forecast a price range for the company based on changes to key variables. We implemented both intrinsic and market valuation methodologies for Diageo, to offer a more comprehensive basis for our investment recommendation.

What We Covered

My role in the joint report focused on the valuation of Diageo, and elements of our internal review of the company. This includes supply chain analysis, a geographical breakdown of value drivers, and revenue stream discussion. Furthermore, I analysed the company's financial statements to make more accurate forecasts for our valuation.

My partner focused mainly on the analysis of the drinks industry as a whole, and how they were likely to impact the outlook of our chosen company. In addition to this, he covered aspects of the company overview such as management strength, ownership structure and examination of Diageo's business model.

Company Overview

Ownership Benefits

Diageo shareholders benefit from a twice-annual dividend payment, with an interim payment in April and a final payment in October. Dividend payments and Dividends Per Share (DPS) have increased from the company year on year since 2016, reflecting the continued strength of financial performance of the group. Although dividend growth slowed during the pandemic, its CAGR of 4.53% shows that the company are committed to creating long-term value for their investors. Owners can even choose to forego their dividend payments in lieu of reinvestment under the company’s share programme.

Furthermore, as part of the company’s attempt to increase their value to investors, they embarked on a significant share repurchase scheme over the previous three financial years. More than 43 million shares were purchased back from the market over this period, for a total of £3.86bn. However, having completed the final share repurchase of their FY20-23 phase, potential investors can no longer expect to benefit from the company’s return on invested capital programme.¹

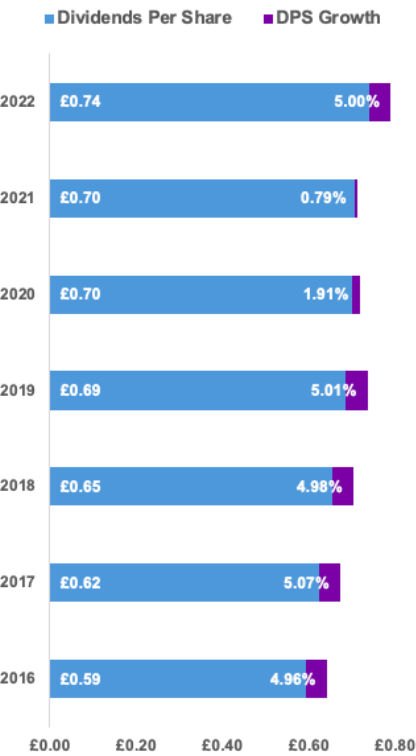


Fig. 1; Diageo PLC Dividends Per Share from 2016-2022

Value Drivers; Geographical Breakdown

Diageo operate in over 180 countries across the globe, with infrastructural and production capabilities in +140 nations. The company segment their main geographical markets into five regions; North America, Asia Pacific, Europe & Turkey, Africa, & Latin America. Additionally, Diageo gain revenue and brand recognition through their corporate stream, which includes aspects such as visitor attractions and user experiences located in all of their five markets. Each of these markets is subject to significantly different market conditions and growth rates, which makes it important to analyse and forecast them individually for our overall company valuation. How these individual growth rates were reflected into the price target for Diageo is further discussed in the Valuation section of the report.

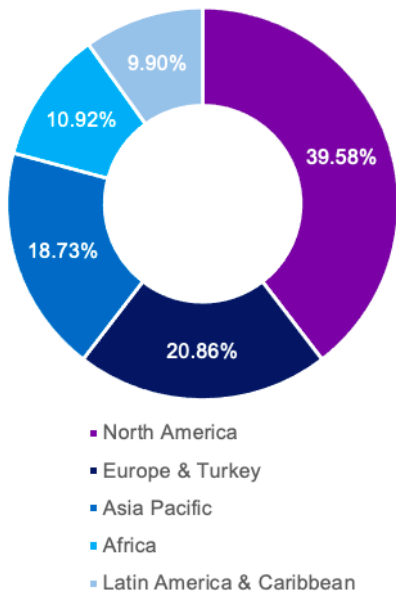


Fig. 2; Diageo PLC Regional Revenue Breakdown 2022

North America

Although North America is Diageo’s largest market in terms of revenue, it is also its fastest growing with a CAGR of 11.11% over the last three years. This is due to a number of factors, including the growth of alternate spirits as new brand favourites for young people in the USA. In fact, for the first time in history “Americans will spend more on mezcal and tequila this year than whiskey.”²

Furthermore, the growth of super-premium brands has contributed significantly Diageo’s increased North American sales over this period. Diageo maintain the largest portfolio of super-premium alcohol products among international drinks companies, which grew by

¹ Diageo PLC (2022) ‘F20-F23 share buy-back programme’

² Kary, T. (2022) ‘Americans Will Spend More on Mezcal and Tequila This Year Than Whiskey’ Bloomberg

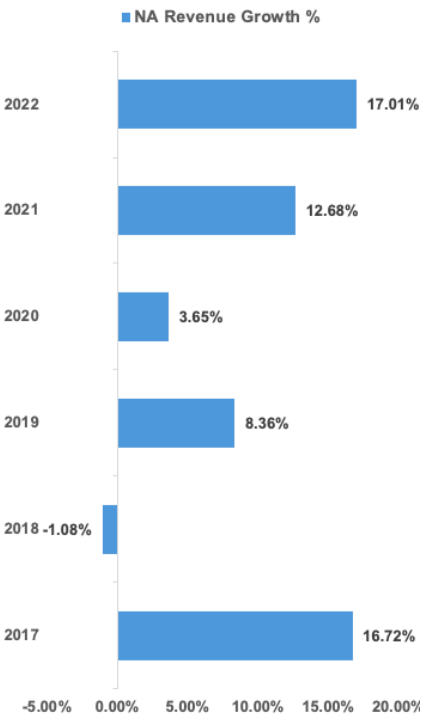


Fig. 3; North American Organic Revenue Growth Year on Year; 2017-2022

31% in the current financial year to account for over a quarter of net sales. This phenomenon has been seen across the drinks industry, where “higher price spirits grew 7x faster than the total spirits category” in the decade from 2011-2021.³

Diageo themselves believe that the North American market will continue to outperform other regions, due to continued trends towards premiumisation of the industry as a whole. As previously discussed, consumers are further seeking quality over quantity and making health-conscious decisions regarding alcohol.⁴ As a result, Diageo are perfectly positioned to take advantage of these changes in consumer behaviour, with an extensive range of premium and ready-to-drink low calorie beverages

Europe & Turkey

Europe & Turkey is Diageo’s second largest market, with over 20% of sales coming from this region. As their most established market, Diageo are subject to growth rates that reflect their mature status as an established industry leader in Europe. Many of their most recognisable brands have their origins across Europe, such as Guinness in Ireland, Johnnie Walker in Scotland, and Smirnoff in Russia. This brand penetration is reflected in their stable CAGR of 4.6% over the last seven financial years. Although Diageo’s European sales were hit hard during the pandemic, decreasing by 12.66% in 2020, their robust recovery of 25.57% in 2022 reflects the reopening of the Western economy.⁵

This market remains critical for the company, as they are headquartered in the United Kingdom. Although Diageo pay regulatory taxes at a country specific level, the consolidated group are liable to pay corporation taxes on their profits in the UK at a level of 25% from 2023 onwards. Furthermore, Diageo began in 1997 as a result of the merger between the Irish-based drinks giant Guinness Brewery and the London property conglomerate Grand Metropolitan PLC. As a result, Diageo maintains a specific relationship to these communities to these days with the groups principal brewing facility based in Dublin.

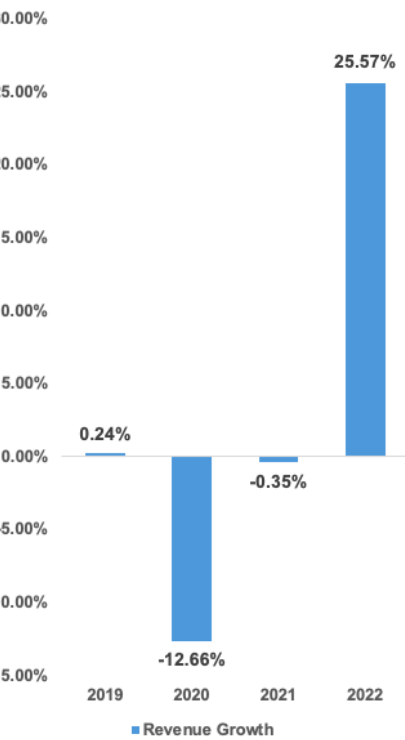


Fig. 4; Europe & Turkey Pandemic Revenue Recovery

Asia Pacific

Although the Asia Pacific is comparable to Europe & Turkey in terms of revenue, it is subject to significantly different conditions and growth prospects. Accounting for 18.67% of sales, the region captures all areas from across continental Asia to the Middle East and down to Australia. As a result, this market can be even further segmented down to its various regions and countries. However, compared to Europe which has grown by almost 5% annually over the last three years, the Asian market has seen its growth rates slashed from 6.23% to 3.32% over the same period. The Asia Pacific market is considered to be the largest in Total Beverage Alcohol (TBA) consumed in the world.⁶ As a result, it is clear

³ IWSR (2021) ‘Global beverage alcohol expected to gain +3% volume in 2021’

⁴ Evans, J. (2022) ‘Diageo sales rise as drinkers celebrate with premium spirits’, Financial Times

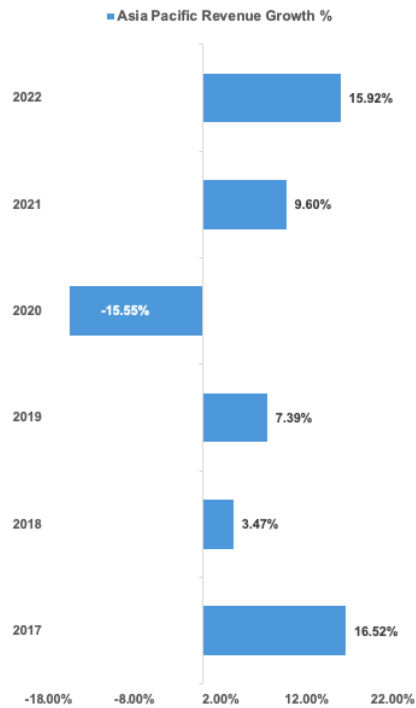
⁵ Gray, A. (2022) ‘Diageo sales pass pre-Covid levels’, Financial Times

⁶ Statista (2022) ‘Alcoholic Drinks’

that Diageo's market penetration and brand recognition is underperforming its potential in this regard.

External fears continue to dampen expectations about Diageo's potential in this market. As the country with the largest population and percentage of geographical revenue in the Asia Pacific region for the company, China has a significant impact on the Diageo's sales. However, the potential and likelihood of increased regulation in China coupled with continued lockdowns due to the Covid-19 pandemic will undoubtedly decrease the company's outlook in the Asian market as a whole.

Unlike other regions, the Asian market has not seen the same trend towards premiumisation and is dominated by sales of domestic spirits and beer in each individual country. Although Diageo maintain an extensive portfolio of recognisable brands, they did not offer an Asia Pacific specific branded alcohol until recently. This year, The Diageo opened a carbon-neutral distillery and visitor centre to produce their first "China-origin, single malt whiskey."⁷ Should the company commit to further investment of domestic brands in these regions, we believe they could turn the Asia Pacific market back into a powerhouse for the company.



Latin America & Caribbean

The Latin American & Caribbean (LAC) market is one of the most exciting prospects for Diageo, and a fundamental basis for their continued overall international growth. Key to this is the exponential growth of tequila and mezcal in the United States and Europe, which are produced in many LAC countries. Although accounting for just under 10% of total revenue, the Latin American market has seen a CAGR of 7.54% over the last seven financial years. This is second only to North America in terms of revenue growth, where the growth of these key spirits and brands in NA has been attributed to their initial rise in popularity in LAC countries such as Mexico.

Diageo own manufacturing facilities in a number of LAC economies, including Mexico, Brazil, and Guatemala. Furthermore, the company have committed to an additional \$500 million investment to increase production levels in Mexico to expand the growth of the tequila category.

Africa

Although similar to the Latin American market in terms of revenue at 10.89%, the African market displays significantly different characteristics. With a growth rate of less than half of Latin America at 2.77% CAGR for the last three years, Diageo are committed more to the development social infrastructure in Africa than increasing revenue at all costs. This is seen by their engagement to benefit the local communities that they service in this market. As part of their strategy to penetrate these markets, Diageo developed existing brands at

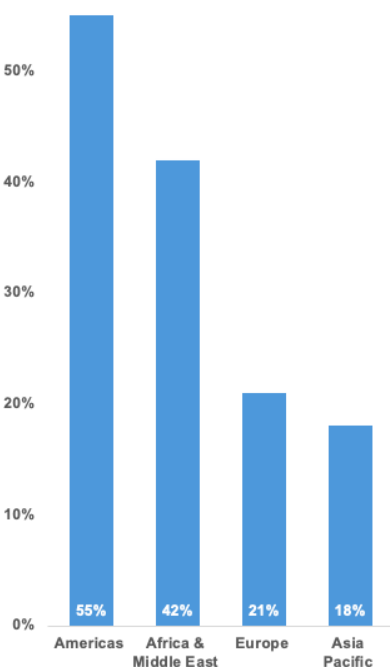


Fig. 6; Premium-Plus Spirits (priced US\$22.50+) Forecast Growth; 2021-26

Source; IWSR

⁷ Ackerman, N. (2021) 'Drinks giant Diageo to create its first Chinese-origin single malt at new \$75m distillery', Evening Standard

lower price points, which includes the introduction of ‘Smirnoff X1’ in Africa.

In 2021, Diageo launched an African specific Guinness marketing campaign, with 1.5 million new consumers trying the stout across Africa in 2022. Furthermore, Diageo maintains and operates several breweries in Africa. With production facilities in Ghana, Nigeria, Uganda, Kenya, Tanzania, Mozambique, South Africa, and the Seychelles,⁸ Diageo is heavily invested in the future of these African economies. The group have also committed to investment in water efficiency for these local communities, with two new water treatment and recovery facilities opened in Nigeria as part of their comprehensive ‘Society 2030: Spirit of Progress’ ESG campaign.



Diageo Production Facilities

- Ghana - Kaase, Achimota
- Nigeria - Lagos
- Uganda - Kampala
- Kenya - East African Maltings, Tusker, Kisumu
- Tanzania - Mwanza, Moshi, Dar es Salaam
- Mozambique - Marracuene
- South Africa - Isipingo
- Seychelles - SeyBrew

Corporate

Although accounting for less than 1% of total revenue for the company, their corporate revenue stream acts as an important aspect of their business to increase brand recognition, loyalty and to attract new customers. The figure includes every user experience that Diageo offer, such as distillery tours, branded pubs, and visitor attraction centres. However, the revenue brought in by the corporate stream is significantly less than it costs to run this side of the business, generating a loss of £238m in 2022.

As part of Diageo’s £185 million investment into whiskey tourism in Scotland, the group opened a Johnnie Walker visitor experience in Edinburgh in 2021, which has already welcomed over 230,000 people. Similarly, Diageo operate the Guinness Storehouse in Dublin, Ireland. This skyline 360° bar experience had welcomed in excess of 20 million tourists by 2019, after opening in 1997. Two new Guinness visitor attractions are scheduled to open in Chicago and London in 2023, which will help the company to increase Guinness sales in existing markets. It is evident that Diageo can see the value in the growth of user attraction experiences to increase sales in all markets. In fact, the company opened up their first Asia Pacific visitor experience in 2022 in the form of an immersive distillery and visitor centre in China.

Although the corporate revenue stream does not contribute significantly to the company’s overall revenue, it is clear how it has become a critical aspect of their operations. Diageo visitor experiences have become a must do for city-break tourists, offering people a chance to learn about the history of their favourite drinks in an unforgettable way.

Revenue Streams

Diageo’s revenue is broken down into three main streams of alcohol sales; spirits, beers, and ready to drink beverages. Spirits account for almost 80% of the group’s total revenue, which can be product down on a product-by-product basis. In total, Diageo’s beer category contributes to 16% of total sales, driven by their powerhouse brand; Guinness. The ready-to-drink category includes products such as pre-mixed premium spirits, that can be consumer without preparation by the customer. Although this category only accounts for



Fig. 8; Diageo PLC Corporate Revenue; 2018-2022

⁸ Diageo (2022) ‘Annual Report’, pp. 208

4% of total revenue for the company, it is critical in the development of their comprehensive product offering to allow consumers to enjoy their drinks in any form.

Diageo get their products to consumers through a variety of methods, including on & off trade sales. On-trade revenue comes from sales to clubs, pubs, restaurants, and bars. While off-trade revenue for Diageo comes from point-of-sale transactions to consumers. Additionally, Diageo distribute their products through a number of channels, such as in retail and wholesale.

With more than 200 brands in their portfolio, Diageo's products have significant brand recognition and loyalty at every price bracket. As the company operate in more than 180 countries across the world, pricing strategy has become a critical element of their operations. This is seen especially in developing countries, where Diageo have introduced cut priced alternatives for their established and recognisable brands. This includes offerings such as "Smirnoff X1 in Africa, McDowell's No.1 in India and Black and White in Latin America."⁹

Furthermore, trends towards premiumisation have also impacted Diageo's portfolio of alcoholic beverages. Premium offerings, such as Don Julio tequila and Tanqueray gin have seen double digit revenue percentage increases over the last decade, due to changes in consumer tastes towards higher quality alcohol. Diageo's portfolio of super-premium drinks has benefitted from this trend, with sales growth of 31% in 2022. These super-premium brands, such as Singleton Malt Whiskey, have been key to the development of another trend in the drinks industry of consumer moments. This trend attempts to pair the perfect drink to each occasion, allowing individuals to personalise their own luxury experiences.¹⁰

Control of Supply Chain

Diageo have control over every aspect of their supply chain, further insulating the company from external macroeconomic factors. Diageo engage in R&D, distillation, maturation, brewing, warehousing, and packaging of their products, meaning that they do not have to rely on third parties for the success of their operations. Development of this critical infrastructure is one of the company's most attractive propositions to potential investors, who can see the value in the stability of their offering. With 132 production facilities across the world, Diageo maintain a footprint in every major market that they service.

Furthermore, with almost 28,000 employees in over 180 countries across the world, it is evident that Diageo are deeply invested in the local communities in which they operate. The company claim to have benefitted in excess of 150,000 people through their community contributions and schemes.¹¹ In Ireland alone, Diageo have contributed more than €1.5 million into community projects to tackle issues such as drug & alcohol abuse,

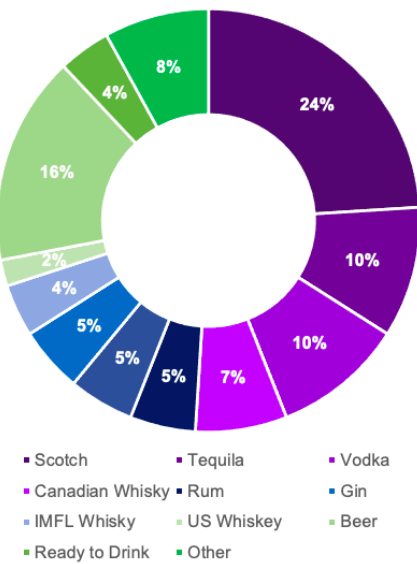


Fig. 9; Diageo PLC Net Sales by Alcohol Category; 2022

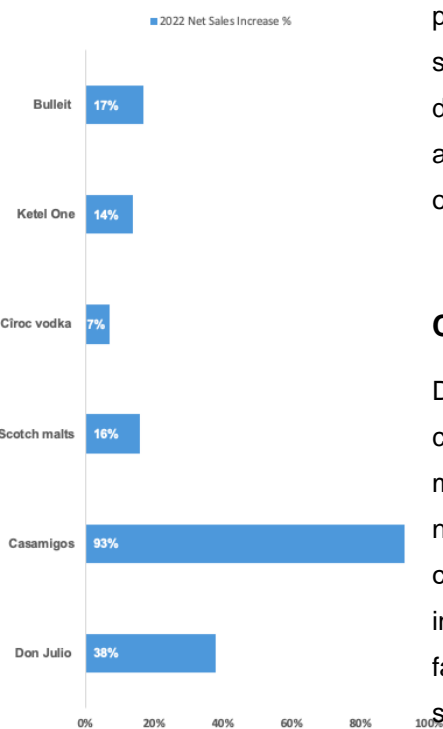


Fig. 10; Diageo PLC Super-Premium Portfolio Products; Organic Net Sales Increase % 2022

⁹ Diageo (2022) 'Annual Report', pp. 13

¹⁰ Maingi, J. & Winfield, T. (2022) 'Alcohol consumption: examining purchase patterns during lockdown', Kantar

¹¹ Diageo (2020) 'Diageo launches new ten-year sustainability action plan'

rehabilitation, and the environmental impact of their operations.

Diageo maintain that their resilient supply chain remains one of their most effective competitive advantages, giving them a “proven ability to respond at pace to in complex and volatile environments.”¹²

Additionally, it is clear from their M&A history that Diageo are committed to investment at every level of their supply chain. Diageo have made in excess of 65 acquisitions since their merger in 1997 to become the firm we know today, with more than half aiming to improve the supply side of their business. This includes purchases of malting companies, distillers, brewers, bottlers, and distributors, to increase their operational efficiency.

Diageo operate in more than 180 countries across the world. As a result, they believe that local production is preferable where possible. They make strategic investments in local infrastructure and production facilities to better service the local communities that they are in. This is further enhanced by the acquisition of brands and products that are tied to certain regions, such as the recent purchase of ‘21Seeds’ flavoured tequila and ‘Mezcal Union’ to increase sales in the North American region.

27,987 People Directly Employed
180+ Countries
200+ Portfolio Brands
132 Production Facilities Globally
456,000,000 Customers Reached

Fig. 11; Scope of Diageo PLC's Worldwide footprint

¹² Diageo (2022) ‘Annual Report’, pp. 9

Valuation

Implied Share Price	
DCF Valuation	£4,606.40
Dividend Discount Model	£3,830.42
Relative Valuation	£2,926.44
EFCF Valuation	£5,120.60
Average Equity Value	£94,568.72
Basic Shares Outstanding	2,295
Share Price Target - GBP	£4,120.96

Our price target for Diageo PLC is based on four equally weighted valuation methodologies. These include; Discounted Cash Flow (DCF), Dividend Discount Model (DDM), Relative Valuation and Free Cash Flow to Equity (FCFE). To be comprehensive in our analysis, we implemented both intrinsic and market valuation approaches.

Additionally, we implemented sensitivity analysis to determine how our price target changes in respect to key figures such as long-term growth rates, and the Weighted Average Cost Capital (WACC). This enables us to forecast a range of values for Diageo based on different market scenarios.

An equal weigh average of these four valuation methods gives us a twelve-month price target of £4,120.96 for Diageo PLC, with a total shareholder return of 10.44%. However, further analysis of these four techniques presents a different picture. Although all three absolute valuation models give Diageo a higher share price target than they currently maintain, comparable analysis of the stock indicates that it may be overvalued in relation to similar companies in the industry.

Growth Forecasts

Diageo operates in five separate geographical markets and generates additional revenue through their corporate department. Revenue from their corporate stream refers to user experiences such as distillery tours and premium bars across Europe, which have become increasingly popular and important for the company to increase their brand recognition and customer loyalty.

To accurately forecast the future revenue of the company, we separated their sales into these different streams, and looked at their growth rates individually. Doing so illustrates that each market is subject to significantly different conditions and potential for growth.

Although North America is the largest market for the company, it is also the fastest growing with a 9.56% CAGR over the last 7 years. Conversely, the African market has grown at an annual rate of just 3.72% over the same period. As a result, we believe that it was important to forecast the revenues of the company based on each geographical regions individual economic outlook.

We split this forecast into both a short- & long-term growth estimate for each region, based on moving averages of the last 7 and 3 years, combined with additional growth potential based on exceptional items (such as the growth of the premium spirits and tequila market in Latin America).

By forecasting expenses in a similar way, we were able to project the outlook for the company over the next eight years, which we used as a terminal period for growth. To estimate figures for depreciation, amortisation, capital expenditures and net working capital, we found that they remained as a relatively steady percentage of revenue over the last ten financial periods.

As Diageo PLC is tax domiciled in the United Kingdom, they are subject to pay corporation

Fig. 12; Summary Valuation of Diageo PLC. Equity Value & Basic Shares Outstanding in Millions

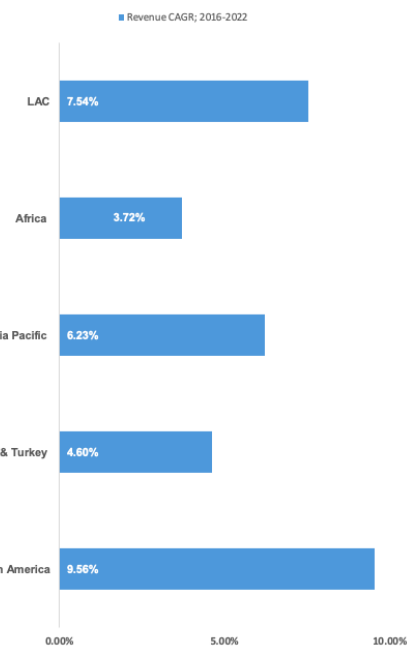


Fig. 13; Diageo PLC Regional Revenue CAGR; 2016-2022

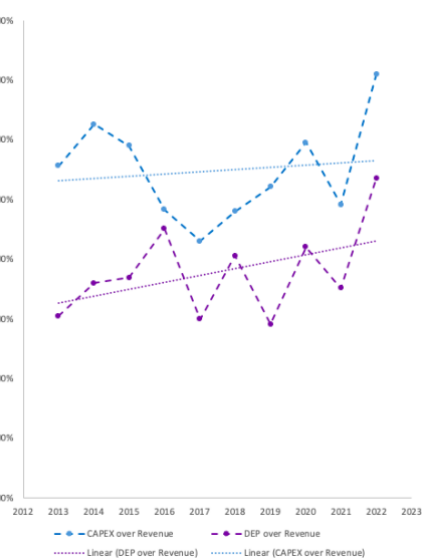
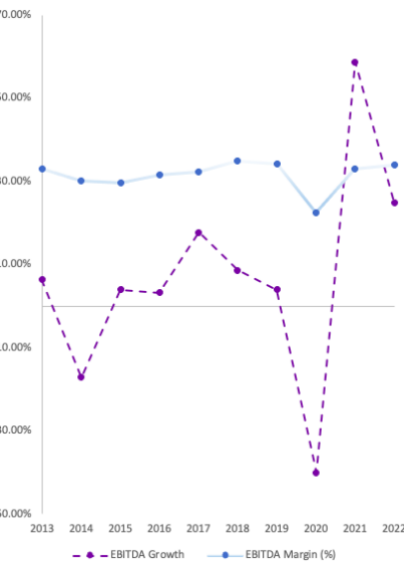


Fig. 14; Diageo PLC Historical CAPEX & Depreciation / Revenue

taxes on the bulk of their group profits in this jurisdiction. Although their effective corporate tax rate has fluctuated over the last decade, it is clear that this would change significantly in 2023. Following the removal of Boris Johnson as prime minister of the UK, Liz Truss and her advisory team introduced sweeping tax changes that would see an increase in the corporation tax rate of the company rise to 25%. This change survived Truss through to the current government, with chancellor Jeremy Hunt announcing that these prospective changes would be made permanent.¹³ This was confirmed by Diageo in their 2022 Annual Report, stating that they would be subject to a flat 25% tax rate on their group profits in future years.



Discounted Cash Flow (DCF)

The DCF method estimates the value of an investment in relation to its expected future cash flows. Although the discounted cash flow approach involves several assumptions related to how the business will perform in the future, it is considered to be the industry standard valuation model for firms in the mature stage of their business life cycle. As a result, we believed that it was important to implement this model into our price target for Diageo.

Using our earlier forecasts, we obtained a figure for the company’s unlevered free cash flows and discounted this back to the present day using the firm’s Weighted Average Cost of Capital (WACC). Forecasting of the company showed an increase in free cash flow growth from 2023 until our terminal period. As a result, we applied a perpetuity growth rate of 3%, which is discussed in greater detail through in sensitivity analysis of our price target. As new firms take advantage of the growing premium spirit’s market Diageo are likely to lose market share, which is reflected in the modest terminal growth rate.

Having calculated a Weighted Average Cost of Capital (WACC), we were in a position to discount the future cash flows of the company back to the present. This WACC estimation involved a significant number of additional calculations, including analysis of the company’s long-term plan to consolidate their position as market leader by their aggressive M&A strategy through debt financing.

We obtained an enterprise value for the company of £121.61bn in 2030 by discounting the free cash flows at the post tax WACC of 5.73%, with a forecasting period of 8 years.

Subtracting the total debt and minority interests from this figure gave us an equity value of £105.69bn, with a twelve month share price target of £4,605.49. This represents a potential 21.01% share price increase from Diageo’s current market value.

Sum dFCF	£23,410.53
Terminal Value	£98,199.92
Enterprise Value	£121,610.45
(+) Cash & Cash Equivalents	£2,513.50
(-) Minority Interest	£1,767.48
(-) Total Debt	£16,668.80
Equity Value	£105,687.67
Basic Shares Outstanding (2023)	2,294.82
Price Target	£4,605.49

Fig. 16; DCF Valuation Summary; figures in £million

D/V Target

An essential element of our valuation for Diageo relies on their modest increase in debt levels from now until our terminal period in 2030. The leverage incentives for the company of increasing their levels of debt as the enter the mature stage of their business life cycle

¹³ James, W. & MacLellan, K. (2022) ‘UK corporation tax to rise to 25% as PM Truss U-turns’ Reuters

D/V	15.37%
Equity Beta	0.37
Debt Beta	0.03
Unlevered Beta	0.32
D/V Target	20%
Beta d	0.03
Beta e	0.39
Rf	4.14%
MRP	5.69%
Tax Rate	25.00%
Cost of Debt	4.31%
Cost of Equity	6.35%
WACC	5.73%
g	3%

are considerable, which is reflected in the strategic priorities of the company in their most recent annual report. Diageo currently operate with a 15.37% Debt/Value ratio (D/V), showing that they are not afraid to take on additional debt to finance significant proportions of their business operations, and aggressive corporate M&A strategy. The company have acquired 66 alcoholic beverages brands, distillers, and distributors over the two decades, mostly through debt financing.

However, it is clear that Diageo are entering an important time in their life cycle. Having reached maturity and market saturation, the company must make alterations to their business plan if they are to maintain their current position as industry leaders in the alcoholic beverages industry. This is referenced in their most recent annual report, where a note from the board of directors directly mentions their renewed strategy of further strategic takeovers over the next decade through both debt and cash financing. As a result, we believe it is important to incorporate this into our valuation of the company, as they attempt to grow their influence and efficiency through consolidation of key competitors and infrastructural firms. Industry analysis of key competitors indicates that many firms operate with a D/C ratio of significantly higher than Diageo. As a result, we believe the company are likely to implement a 20% long term D/V ratio, to reflect the additional debt that they will take on to finance these operations. Although this strategy may make the company more exposed to risks such as rising interest rates, and negative market conditions, we believe that this is justified as they attempt to manoeuvre themselves to the forefront of the industry.

Fig. 17; Key Calculation Figures, including target D/V ratio

Sensitivity Analysis

As the benchmark for most valuation models used by investment banks across the world, we believed it was important to see how our discounted cash flow forecast varied with changes to growth rates and the company's WACC. Sensitivity analysis considers how even minimal changes to a critical independent variable can impact the overall price target for a company, based on different assumptions.

Furthermore, we included this analysis to account for the extremely uncertain market conditions that Diageo are likely to face over the next few years. As a result, we examined the impact of how changes to the company's growth rate and WACC could impact investor confidence in their business. This 'what-if' analysis allowed us to better understand how important factors can influence the price of the company and reduce the uncertainty of our final price target.

	5.00%	5.25%	5.50%	5.73%	6.00%	6.25%	6.50%
2.00%	£4,551.26	£4,151.72	£3,809.26	£3,493.82	£3,252.79	£3,023.66	£2,820.00
2.50%	£5,409.59	£4,860.79	£4,403.46	£3,992.44	£3,684.77	£3,397.28	£3,145.72
2.75%	£5,981.80	£5,321.69	£4,781.58	£4,303.72	£3,950.60	£3,624.12	£3,341.16
3.00%	£6,697.08	£5,885.01	£5,235.33	£4,605.49	£4,260.74	£3,885.86	£3,564.51
3.25%	£7,616.71	£6,589.17	£5,789.92	£5,111.81	£4,627.26	£4,191.22	£3,822.23
3.33%	£7,969.15	£6,853.22	£5,994.37	£5,271.88	£4,759.05	£4,299.98	£4,191.22
3.50%	£8,842.89	£7,494.51	£6,483.15	£5,649.54	£5,067.10	£4,552.10	£4,122.90

Fig. 18; Sensitivity Analysis of DCF Price Target. Changes to WACC result are shown along the X-axis, with changes to the terminal growth rate displayed on the Y-axis.

Terminal Growth Rate

As Diageo is an established player in the alcoholic beverage industry, with a strong history of competitive M&A and successful product launches into the market, we implemented a mature stage growth rate for the company. This assumes that a company's growth increases minimally as it reaches maturity, to defend "its existing market share from emerging competitors in the industry."¹⁴

We calculated a mean of the traditional UK inflation rate, and average GDP growth to reach a terminal growth figure of 3%. This rate indicates that we believe that Diageo will outperform the market over the forecasting period, a sentiment which is echoed by the company through their ambitious strategic priorities of delivering sustainable revenue growth, increasing efficiency, and continued investment.¹⁵

However, industry standards of perpetual growth rates for mature companies indicate an acceptable and common range between 2% - 3.5%. As a result, we believed that it was important to show how our price target was likely to be impacted by changes to this growth rate. Doing so presented a price target with a range of between £3,493.82 and \$5,649.52, assuming no changes to the current WACC. Should the revenue of the company underperform over the next few financial years, they can expect to see their share price decrease significantly as a result

Weighted Average Cost of Capital (WACC)

The WACC measures the cost of financing for a company, by weighing their costs of both debt and equity. This figure is critical in the valuation of a company, as it shows how much they can expect to pay to finance their operations. Furthermore, the WACC represents the discount rate that we used to calculate the price target for our Diageo in our valuation.

A higher cost of capital indicates higher risk for a company, while lower rates imply that a firm can attract investors at lower costs. As a result, we believed that it was important to see how the WACC changes the price target for Diageo at different levels.

To estimate a WACC figure for the company, we applied the CAPM model. To find the beta of our company, we calculated the weekly covariance of DGE with the S&P500 over the last ten years. This figure shows how the price of our company is likely to change in relation to the overall market, which we determined to be 0.37. This illustrates that Diageo is less likely to be impacted by changing market conditions than other firms. This figure makes sense in the circumstances, as the consumer staples and alcoholic beverages industry has traditionally been more shielded from external macroeconomic factors than other markets which exhibit significantly more volatility.

With a debt rating of A3 from Moody's, Diageo's credit risk is considered to be relatively minimal. As a result, we estimated a debt beta of 0.03, which would stay constant throughout our overall valuation as the company implement their long-term D/V target of

¹⁴ Corporate Finance Institute (2022) 'Terminal Growth Rate'

¹⁵ Diageo (2022) 'Annual Report', pp. 19

20%.

We used 10 Year UK Gilt Bonds as a proxy for the risk-free rate of 4.14%. Similarly, we implemented a market risk premium figure of 5.69%.¹⁶ This allowed us to calculate an unlevered beta of 0.32 for Diageo, which measures the risk of the company without its debt obligations. With a new equity beta of 0.40, we calculated the cost of debt and equity to be 4.31% and 6.35% respectively, using the CAPM formula. Doing so allowed us to reach a final WACC figure of 5.77%, which we used as the basis for our valuation.

However, as the WACC figure is so susceptible to change due to fluctuations in the cost of debt and equity, we believed it was important to show how this could impact our price target. Similar to the growth rate in perpetuity, we calculated how our recommendation moves with 0.25% changes to the WACC between 5% and 5.5%. This gives a price range between £3,564.51 and £6,697.08 at the baseline level of perpetual growth, which increases further with proportional increases in the growth rate.

Dividend Discount Model

As Diageo pay dividends on a bi-annual basis, we believed that it was important to incorporate the benefits of these payments into our valuation and price target for the company. The Dividend Discount Model (DDM) assumes that a securities value should consider the expected value of future dividend payments, discounted back to the present by an appropriate rate.

Analysis of the company's accounts over the last seven financial years showed a relatively steady increase in dividend payments of 3.5% per year. Furthermore, Diageo's Dividends Per Share (DPS) has increased by an even greater rate over the same period, from 0.59 in 2016 to 0.74 in 2022. This increase amounts to be a CAGR of 4.53%, which we applied as our perpetual growth figure for dividends in our valuation. The dividend pay-out ratio for the company, of dividends paid over adjusted net income, remained relatively steady at 55% over the same period.

In our model, we implemented the Gordon Growth DDM, which considers that a company's future dividends will grow at a constant rate in perpetuity. This variation is appropriate as Diageo is a mature company with a historically steady increase in revenue and dividends. Under regular circumstances, the Gordon Growth DDM calculation uses the current fair value of an asset. However, as we are forecasting the value of the stock into the future, we implemented the terminal value from our DCF calculation as the basis of the fair value for the stock in twelve months' time. Adding the sum of the present value of the future dividends to this value, we obtained an enterprise value of £103.80bn for Diageo. Having subtracted net debt and minority interests from this figure, we obtained an equity value of £87.88bn with a twelve-month price target of £3,829.52. This represents a modest share price increase of 2.65%, based on the expected future value of dividends of the company.

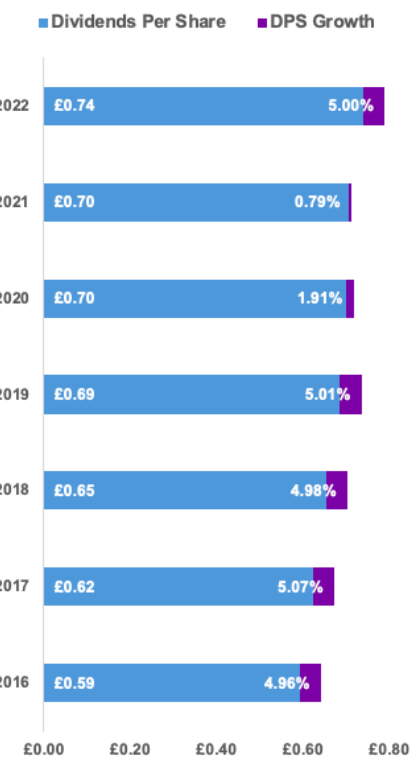


Fig. 19; Diageo PLC Dividends Per Share from 2016-2022

¹⁶ Statista (2022) 'Average Market Risk Premium in the U.S. 2011-2022'

Relative Valuation

Name	Forward P/E
Diageo PLC	19.87x
Anheuser-Busch InBev SA/NV	16.47x
Heineken NV	16.14x
Pernod Ricard SA	18.56x
Davide Campari-Milano NV	24.59x
Remy Cointreau SA	25.59x
Fevertree Drinks PLC	39.25x
Mean	22.92x
Median	19.87x

Relative valuation attempts to express the value of Diageo PLC in relation to similar companies in the alcoholic beverage industry. Analysis of the alcoholic beverage industry illustrates that a small number of large-scale firms dominate the market. As Diageo operates in both the premium spirits and beer market, we believed that it was important to compare the company to key players in both industries. The following six companies were used as the basis for our comparable analysis of Diageo;

Name	Forward EV/EBITDA
Diageo PLC	15.41x
Anheuser-Busch InBev SA/NV	9.32x
Heineken NV	9.39x
Pernod Ricard SA	13.79x
Davide Campari-Milano NV	16.41x
Remy Cointreau SA	16.33x
Fevertree Drinks PLC	22.97x
Mean	14.80x
Median	15.41x

- Anheuser-Busch (ABI BB)
- Heineken (HEIA NA)
- Pernod Ricard (RI FP)
- Davide Campari-Milano (CPR IM)
- Remy Cointreau (RCO FP)
- Fevertree Drinks PLC (FEVR LN)

Name	Forward EV/Rev
Diageo PLC	5.47x
Anheuser-Busch InBev SA/NV	3.17x
Heineken NV	2.13x
Pernod Ricard SA	4.50x
Davide Campari-Milano NV	4.12x
Remy Cointreau SA	5.16x
Fevertree Drinks PLC	2.67x
Mean	3.89x
Median	4.12x

All six competitors operate in the same five geographical markets as Diageo and offer an extensive portfolio of spirits and beers. The average market capitalisation of these six companies was £40.75bn, under half of Diageo at £88.22bn.

We selected relative valuation multiples that best captured the competitive landscape of the drinks industry. All figures are forward ratios, with data taken from Bloomberg in December 2022. For this we chose the forward Price-to-Earnings (P/E) ratio, which divides a firm's stock price by its Earnings Per Share (EPS). Compared to its peer's average of 22.92x, Diageo's P/E ratio of 19.87x was significantly lower. This indicates that Diageo may be undervalued in relation to its competitors, with a P/E price target above its current share price.

However, forward EV/EBITDA and EV/Revenue multiple valuation show the opposite. Both multiples value Diageo at a significant discount to its current share price, as they consider the levels of the company's debt and cash in addition to its stock price. The Enterprise Value (EV) multiples are used to show if an asset is priced correctly in relation to its competitors, with a higher ratio indicating that a company may be overvalued. In both cases, Diageo maintains higher relative multiple figures than its peers, with an EV/EBITDA ratio of 15.41x compared to average of 14.80x, and EV/Revenue ratio of 5.47x in comparison to the mean of 3.89x.

Forward P/E	£3,838.89
Forward EV/EBITDA	£2,964.85
Forward EV/Rev	£2,086.96
Price Per Share	£2,963.57

A weighted average of these three key multiples gives Diageo a twelve-month price target of just £2,963.57, with a negative shareholder return of 22.13%.

Free Cash Flow to Equity

Free Cash Flow to Equity (FCFE) shows how much capital is generated by a company to be distributed to shareholders. This figure is used by prospective investors to see if payments are financed by debt or by free cash flows. Where dividend payments or stock repurchases are financed wholly by a firm's equity free cash flow, investors will have

Fig. 20; Comparable Metrics used in Relative Valuation

Fig. 21; Relative Valuation Price Target Summary

significantly more confidence in the outlook for the company. However, having completed the final share repurchase of their FY20-23 phase, potential investors can no longer expect to benefit from the company's ROIC programme (Diageo, 2022).

Sum dEFCF	£32,879.30
Terminal Value	£100,617.40
Enterprise Value	£133,496.69
(+) Cash & Cash Equivalents	£2,513.50
(-) Minority Interest	£1,767.48
(-) Total Debt	£16,668.80
Equity Value	£117,573.91
Basic Shares Outstanding	2,294.82
Price Target	£5,123.45

This valuation method uses elements from our previous calculations, such as the company's long-term Debt/Value target ratio of 20%. Our FCFE estimation assumes that Diageo will implement their D/V target in 2023, instead of over the coming financial years. With a current equity value of £88.22bn, to implement the 20% D/V target in 2023 requires an increase in net debt of £3.91bn. This results in a larger FCFE figure in 2023 to account for the increased debt levels, followed by modest growth over the following years.

Furthermore, we assume that debt levels grow with revenue from 2023 onwards, to be consistent with the targeting strategy of the firm.

By adding the sum of the discounted FCFE to our terminal value in 2030, we reach an enterprise value of £133.49bn for Diageo. This results in an equity value of £117.57bn, with a twelve month share price target of £5,123.45 for the company, with an upside potential of 34.62%. This represents a significant share price appreciation for the company and showcases the potential benefits of implementing their long-term debt targets over the next year. This further illustrates the benefits of increased debt financing for Diageo, to fund their aggressive M&A strategy.

Conclusion

We believe that Diageo PLC has significant potential to grow over the coming years. It is evident from the company's operations over the last decade that they will continue to be a powerhouse in the alcoholic beverages industry. Although sensitivity analysis of our valuation indicates that investor confidence in the company will fluctuate based on changes to growth rates and costs of capital, we firmly maintain that Diageo are uniquely positioned to take advantage of potentially volatile market conditions.

External factors will have less of an effect on Diageo as they control all aspects of their business operations. This insulates them from instability coming from currency risks, regulation and changing market conditions. Diageo distil, package, transport, and market their own products. This makes them fully independent and not reliant on others to succeed. Furthermore, the firm can benefit from additional synergies created by continuing their aggressive M&A strategy at all levels of their supply chain.

We believe that a twelve-month price target of £4,120.96 is an accurate portrayal of the firm's prospect over the coming year. This represents a total shareholder return of 10.44%, including capital gains and expected dividends.

DIAGEO PLC

ALCOHOLIC BEVERAGES

DANIEL DELANEY & ROBERT O'LEARY

COMPANY REPORT

11 NOVEMBER 2022

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Cautious Optimism in 2023 and Beyond

Consumer staples industry more insulated to volatile market conditions.

- With an extremely strong FY22, we issue a BUY recommendation and forecast a twelve-month price target of £4,120.96 for Diageo PLC, including expected capital gains and dividends. Investors can hope to benefit from a potential 10.44% upside return on their capital, with continued growth in key markets for the company.
- Strong recovery in 2022, with a more than 20% increase in revenue due to the re-opening of the European & Latin American economies, with continued growth in every region. North American market is driven by the sale of premium spirits, which Diageo are uniquely exposed to take advantage of.
- Diageo performs well with regard to most industry valuation techniques. However, relative analysis of the company suggests that it may be overvalued compared to its peers. Valuation of the company may be stretched where global growth slows down due to unavoidable factors.
- The biggest concern for the company relates to external macro-economic factors, such as rising material costs, further inflationary pressures and increasing regulation in the Asia Pacific market. In addition, geo-political instability in the UK where the company primarily operate has led to increased currency risk exposure.

Company Description

Diageo PLC is a global leader in alcoholic beverages, with an extensive portfolio of household name brand spirits and beers. Operating across the globe while headquartered in the UK, Diageo PLC pride themselves on bringing premium brands to consumers, and strong returns to investors.

Recommendation: BUY

Total Shareholder Return; 10.44%

Price Target FY23: £4120.96

Price (as of 15-Dec-22) £3731.50

Bloomberg: DGE

52-week range (£) 3282.50-4110.00

Market Cap (£B) £88.22B

Outstanding Shares 2,337,000



Diageo PLC & FTSE100; 5Y Price Chart

Source: Bloomberg

(Values in GBP Million; £)	2022	2023F	2024F
Revenue	15,452	16,422	17,473
Revenue Growth	21.35%	6.28%	6.40%
EBITDA	5,625	5,672	5,935
EBITDA Margin	36.4%	34.54%	33.99%
NOPLAT	3,649	3,761	3,930
EPS	1.46	1.50	1.57
FCF	3,193	3,737	3,395

THIS REPORT WAS PREPARED EXCLUSIVELY FOR ACADEMIC PURPOSES BY DANIEL DELANEY & ROBERT O'LEARY, MASTER IN FINANCE STUDENTS OF THE NOVA SCHOOL OF BUSINESS AND ECONOMICS. THE REPORT WAS SUPERVISED BY A NOVA SBE FACULTY MEMBER, ACTING IN A MERE ACADEMIC CAPACITY, WHO REVIEWED THE VALUATION METHODOLOGY AND THE FINANCIAL MODEL. (PLEASE REFER TO THE DISCLOSURES AND DISCLAIMERS AT END OF THE DOCUMENT)

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Company Overview

Volume movement

10.3% ↑

2021: 11.2% ↑

Net sales movement

21.4% ↑

2021: 16.0% ↑

Operating profit movement

26.3% ↑

2021: 17.7% ↑

Diageo is a multinational alcoholic beverage company, as a producer, distributor and marketer of spirits and beers. It is a major spirits distributor, operating from 140 sites around the world, across 5 regions: North America, Europe, Asia Pacific, Africa, and Latin America & the Caribbean. The North American market represents over a third of net sales. The product portfolio consists of all major spirit categories, notably scotch, vodka, rum, and beer. It was the world's largest distiller until 2017. Formed in 1997 from a merger of Guinness Brewery and Grand Metropolitan, a leisure, manufacturing, and property conglomerate. At the time, the deal was one of the largest in British history.

St James' Gate Brewery was founded in 1759 in Dublin, Ireland by Arthur Guinness. The company was first floated on the London Stock Exchange in 1886. The main product, Guinness, is one of the most successful alcohol brands worldwide. As is common for the industry, the combined company has grown through a long series of acquisitions. Today, the distiller has the largest market share of spirits in the world, with market leaders across most spirits categories.

Grand Metropolitan was founded as a property company, but subsequently diversified into a range of consumer products and services. Prior to merger, its subsidiaries included hotels, casinos, breweries, dairies, distilleries, and health care services. The company pursued a strategy of rapid growth through acquisitions in profitable fields, led by founder Maxwell Joseph. The diversification was as a result of the company's aim for utmost control and profit of the aforementioned markets.

Post-merger, the newly formed Diageo moved to sell many of its non-drinks-based assets, including selling Burger King and Pillsbury. Instead, the newly formed group sought to focus on their newly found position as the world's largest distiller and vintner. Grand Metropolitan had large market share but little growth in major, developed markets, while Guinness was already a market leader at breaking into fast-growing markets such as Asia and Latin-America. At the time, a Nomura analyst quipped that their shared position was "so much stronger than anyone else, that if they don't make a lot more money as a result of the merger they should be shot."¹

Fig. 1; Diageo PLC Key Metrics; 2022.

Source: Diageo

¹ Ipsen, E., (1997) \$33 Billion Giant Guinness to Unite With Grand Met, *New York Times*, May 13, 1997.

Key Brands

Guinness – World’s #1 Stout

Famous for its Irish heritage and distinctive colour, this stout is brewed in over 50 countries and enjoyed in around 150 worldwide. Guinness is leading the way in terms of quality, sustainable growth. Following on from a period of diminished performance followed by the COVID pandemic shutting pubs and bars, the world-renowned brand is availing of the benefits of a strategy that builds on its legacy of ‘power, goodness and communion’, cementing its place in popular culture and alluring a more varied consumer base, from a premium North American import beer to a local staple in Ireland and Nigeria. The Guinness brand alone is worth approximately \$4bn, making it one of the most valuable and widely recognised beer brands in the world. It is the only non-lager beer in the top 10. Guinness is Diageo’s second biggest brand, with sales growth of 32% this year, representing 16% of Diageo’s net sales along with their other beer brands. In the world’s largest alcohol market, the USA, Guinness account for nearly 2% of the total beer market, rising to 8% for affluent consumers. Africa is the biggest source of sales. Brewed in Ireland and Nigeria, Guinness has a special connection with Africa, with Nigerians even regarding it as their national beer, despite featuring Ireland’s national symbol, the Harp, on the logo. Guinness has embraced their African connection, launching a campaign Black Shines Brightest, celebrating African creativity. The Guinness Experience in Dublin has welcomed over 20 million visitors since it opened in 2000. Two new visitor experiences are due to open in London and Chicago this year.

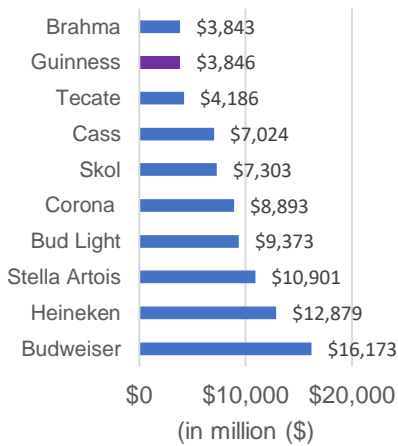


Fig. 2; Largest Worldwide Beer Brands

Source: Statista

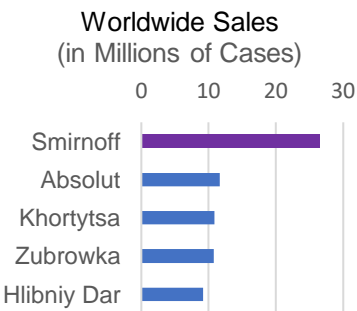


Fig. 3; Largest Worldwide Vodka Brands

Source: Statista

Smirnoff – Worlds #1 Vodka

Established in 1864, Smirnoff is the world’s number one vodka by sales, with more sales than the second and third brands combined. Smirnoff, along with Diageo’s other vodka brands, Ketel One & Cîroc, amounted to 10% of Diageo’s net sales, growing 11%. Smirnoff has long been recognised for its smooth taste and texture, regularly beating out competition in blind taste tests. Smirnoff is the fourth highest selling overall spirit in the world. Other than a pandemic dip, Smirnoff sales have stayed remarkably consistent over the last 10 years. A mark of consistency or a sign to be worried?

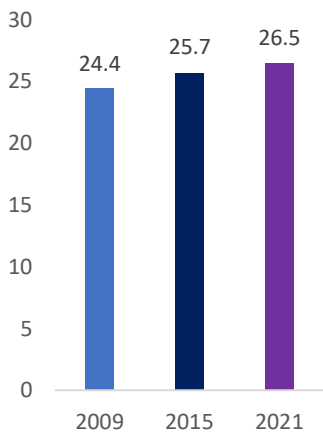


Fig. 4; Smirnoff sales growth from 2009-2021; in millions of units

Source: Statista

Johnnie Walker – World’s #1 Scotch Whisky

Walker first began selling whisky in 1820, the brand has celebrated its 200th birthday in 2020. Along with Smirnoff, Diageo owns two of the world’s four largest international spirits brands by retail sales value. Further, it is the world’s most widely distributed scotch, sold in almost every country on the planet. The brand sells seven different ‘labels’ of their drink across different price points, from the most popular red label to the premium blue label. Net sales grew 34% this year, JW is Diageo’s best-selling spirit. Scotch amounted to 24% of Diageo’s overall sales. The brand has received many awards and accolades at international spirits ratings competitions. Johnnie Walker is the official whisky of the Formula 1. Over 235,000 people have been welcomed to the Johnnie Walker Princess Street visitor experience in Edinburgh.

Other Key Brands

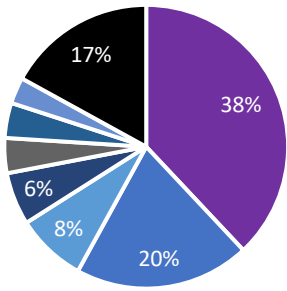
As the global leader in the spirits market, Diageo has a portfolio of world-renowned spirit brands. In addition to the three mentioned, Diageo places Baileys Irish Cream, Captain Morgan Rum, and Tanqueray Gin in their “Global Giants” category. These are major brands sold worldwide. In addition, their “local stars” are spirits with exceptional performance in their respective local market. For example, McDowell’s No. 1 is the largest selling umbrella spirits brand in the world, across whisky, rum and brandy. It is sold primarily in India. Baileys, Crown Royal, Ypioca, Cacique and Bundaberg are all the best-selling brands in their respective categories.

Diageo’s Reserve Section comprises of their premium labels. Customers are increasingly looking to drink better, not more. As a result, Reserve Sales grew 31%, to represent 27% of Diageo’s sales. This trend will be discussed further in the ‘trends’ section of this report. Particularly impressive is the growth of premium tequila. Diageo are well positioned for this, with Don Julio and Casamigos, the latter of which grew 90% this year. The overall matrix of brands at all price points provided by Diageo simplifies the supply chain process to vendors, allowing on-premises customers to complete their stocks all from one top-tier vendor.

Business Model

Consumer Staples

The group operates in the Consumer Staples sector. Consumer Staples refers to essential products used by consumers, including products such as food, drink, household goods and hygiene products. Alcohol & Tobacco are included in this



- Diageo
- Chivas
- William Grant
- Bacardi
- Other

Fig. 5; Whisky Industry Market Share per Company by Volume.
Source: Whisky Invest Direct

Global Giants	Sales Increase
Johnnie Walker	35%
Guinness	30%
Smirnoff	11%
Baileys	8%
Captain Morgan	2%
Tanqueray	20%
McDowell's	5%

Fig. 6; Diageo PLC Organic Brand Growth
Source: Diageo

sector. The description of these products are goods that people are unable, or in some cases unwilling, to give up regardless of their financial state or the current economy. They would be considered to be non-cyclical, that is that sales do not fluctuate or move with the general economy. They are in demand, at a constant level, at all stages. The consumer staples sector has outperformed all but one sector since the early 60s. The sector has even performed better than the benchmark S&P 500 during the last three recessionary periods.² During the Great Recession, total alcohol consumption increased.³ Due to this, coupled with lower volatility, consumer staple stocks are considered to be vital for defensive strategies. This is particularly relevant for Diageo facing into times of economic and geo-political uncertainty.

Consumer Discretionary

Consumer Discretionary refers to goods and services that are considered non-essential but are desirable if disposable income is sufficient to purchase. Examples of these include cars, luxury goods and entertainment. Consumers tend to spend more on consumer discretionary products in high-growth economic periods. In this sense they are cyclical and the inverse of consumer defensive. This may be of concern to Diageo as the group’s ultra-premium spirits sector has seen exponential growth due to the extended period of growth we have experienced. In addition, the group has enjoyed increased growth due to the re-opening of bars and clubs post pandemic. However, nightlife and entertainment spending would be considered a consumer discretionary spend that would be expected to contract during periods of economic slowdown.

Capital Structure

Diageo achieves capital efficiency through effective management of its capital structure. This allows the company to invest consistently during economic cycles and facilitates access to debt markets at attractive costs. The group targets an adjusted net borrowings to adjusted EBITDA leverage of 2.5 – 3x. This range is consistent with a credit rating in the A band. If this ratio was altered due to the financing of an acquisition, the group would seek to return to this level. The debt and equity capital levels are regularly assessed against stated policy. As of 30 June 2022, Diageo’s ratio was 2.5x.⁴

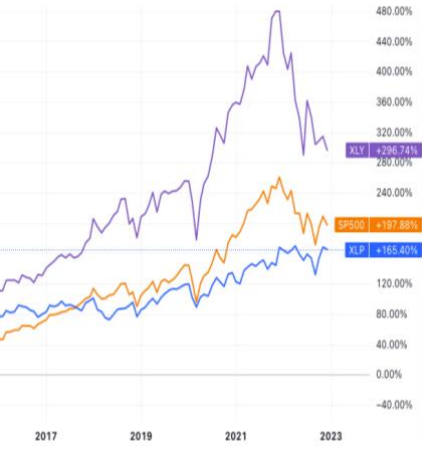


Fig. 7; Consumer Staples Index (blue) and Consumer Discretionary Index (purple) vs S&P500 (orange).
Source: TradingView

Ratings agencies	Moody's	S&P
LT rating	A3	A-
Outlook	Stable	Stable
ST rating	P2	A2
Date	Oct-05	Sep-05

Fig. 8; Diageo PLC Credit Ratings.

² Chen, J., (2021), Consumer Staples: Definition, Role and Examples, *Investopedia*

³ Bor, J., et al., (2013) Alcohol Use During the Great Recession of 2008-2009, *Alcohol and Alcoholism*, Volume 48, Issue 3, p.343 - 348

⁴ Adjusted net borrowings (£14,539) to adjusted EBITDA (£5,703) = 2.55x

Ownership and Shareholder Structure

Diageo PLC, traded primarily on the London Stock Exchange (LSE), under the ticker “DGE.L” has a market capitalisation of £88.2bn as of 12th of December 2022. Institutional investors control 79.7% of the outstanding shares in DGE, while 18.9% is held by the general public and less than 1.5% is held by public companies, individual insiders, and employees. Over the last quarter, management, including Menezes, have acquired 673 shares of company stock. This can imply confidence in future performance. Blackrock Inc is the largest shareholder at 6.6%, implying no single shareholder has a majority interest.

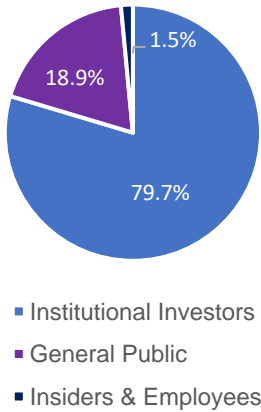


Fig. 9; Diageo PLC Ownership Structure.
Source: Yahoo Finance

Management

Ivan Menezes, Diageo’s CEO since 2013, joined the company in 1997. With over 20 years of experience at operational and leadership level within the consumer products industry, he brings valuable insights to lead the group. In 2021, Menezes was named top of Empowers 100 Ethnic Minority Executive list for his achievements with the company and ensuring diversity and inclusion sits at the heart of Diageo. Commercially, his credibility has been reflected by the strong growth enjoyed by the company in both sales and share price. Critics have argued that he is over compensated, earning over 70 times the salary of the average Diageo employee. 79% of the total remuneration was performance based, reflecting the success of his tenure. Overall, we feel he is the right person to continue leadership.

Lavanya Chandrashekar is in her first year as CFO with the company, which has been a successful one following the re-opening following the pandemic. Diageo’s Board of Directors is composed of 11 members, 7 of whom are non-executive. An additional executive committee comprises of a further 11 members, primarily in regional roles.

Ownership Benefits

Diageo shareholders benefit from a twice-annual dividend payment, with an interim payment in April and a final payment in October. Dividend payments and Dividends Per Share (DPS) have increased from the company year on year since 2016, reflecting the continued strength of financial performance of the group. Although dividend growth slowed during the pandemic, its CAGR of 4.53% shows that the company are committed to creating long-term value for their investors.

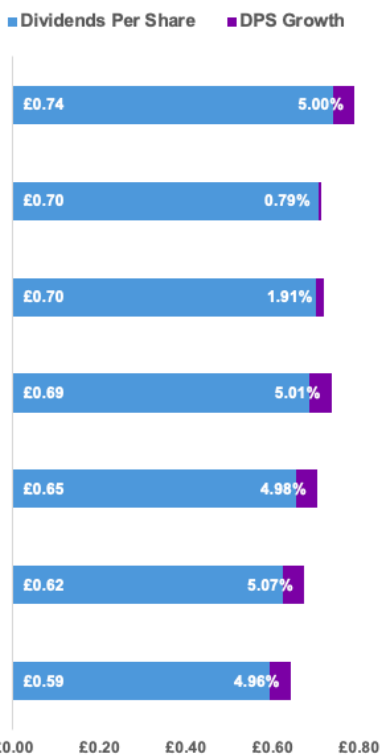


Fig. 10; Diageo PLC Dividends Per Share from 2016-2022

Owners can even choose to forego their dividend payments in lieu of reinvestment under the company’s share programme.

Furthermore, as part of the company’s attempt to increase their value to investors, they embarked on a significant share repurchase scheme over the previous three financial years. More than 43 million shares were purchased back from the market over this period, for a total of £3.86bn. However, having completed the final share repurchase of their FY20-23 phase, potential investors can no longer expect to benefit from the company’s return on invested capital programme.⁵

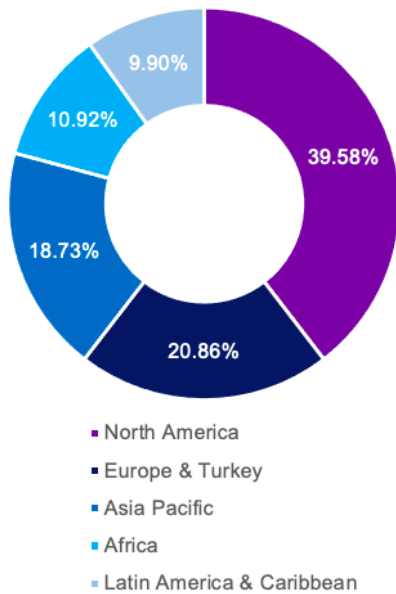


Fig. 11; Diageo PLC Regional Revenue Breakdown 2022

Value Drivers; Geographical Breakdown

Diageo operate in over 180 countries across the globe, with infrastructural and production capabilities in +140 nations. The company segment their main geographical markets into five regions; North America, Asia Pacific, Europe & Turkey, Africa, & Latin America. Additionally, Diageo gain revenue and brand recognition through their corporate stream, which includes aspects such as visitor attractions and user experiences located in all of their five markets. Each of these markets is subject to significantly different market conditions and growth rates, which makes it important to analyse and forecast them individually for our overall company valuation. How these individual growth rates were reflected into the price target for Diageo is further discussed in the Valuation section of the report.

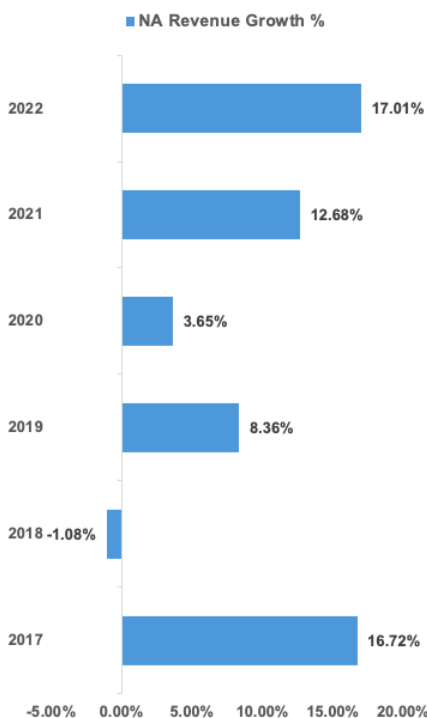


Fig. 12; North American Organic Revenue Growth Year on Year; 2017-2022

North America

Although North America is Diageo’s largest market in terms of revenue, it is also its fastest growing with a CAGR of 11.11% over the last three years. This is due to a number of factors, including the growth of alternate spirits as new brand favourites for young people in the USA. In fact, for the first time in history “Americans will spend more on mezcal and tequila this year than whiskey.”⁶

Furthermore, the growth of super-premium brands has contributed significantly Diageo’s increased North American sales over this period. Diageo maintain the largest portfolio of super-premium alcohol products among international drinks companies, which grew by 31% in the current financial year to account for over a quarter of net sales. This phenomenon has been seen across the drinks industry,

⁵ Diageo PLC (2022) ‘F20-F23 share buy-back programme’

⁶ Kary, T. (2022) ‘Americans Will Spend More on Mezcal and Tequila This Year Than Whiskey’ Bloomberg

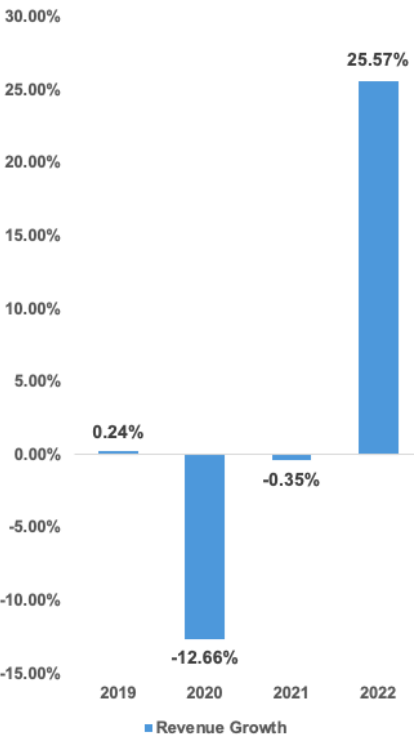


Fig. 13; Europe & Turkey Pandemic Revenue Recovery

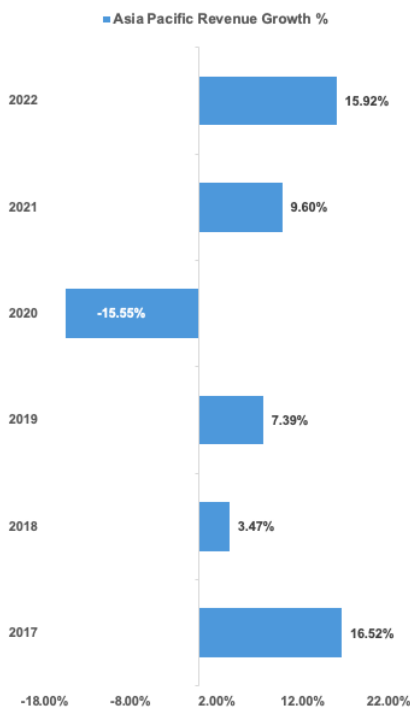


Fig. 14; Asia Pacific Organic Revenue Growth Year on Year; 2017-2022

where “higher price spirits grew 7x faster than the total spirits category” in the decade from 2011-2021.⁷

Diageo themselves believe that the North American market will continue to outperform other regions, due to continued trends towards premiumisation of the industry as a whole. As previously discussed, consumers are further seeking quality over quantity and making health-conscious decisions regarding alcohol.⁸ As a result, Diageo are perfectly positioned to take advantage of these changes in consumer behaviour, with an extensive range of premium and ready-to-drink low calorie beverages

Europe & Turkey

Europe & Turkey is Diageo’s second largest market, with over 20% of sales coming from this region. As their most established market, Diageo are subject to growth rates that reflect their mature status as an established industry leader in Europe. Many of their most recognisable brands have their origins across Europe, such as Guinness in Ireland, Johnnie Walker in Scotland, and Smirnoff in Russia. This brand penetration is reflected in their stable CAGR of 4.6% over the last seven financial years. Although Diageo’s European sales were hit hard during the pandemic, decreasing by 12.66% in 2020, their robust recovery of 25.57% in 2022 reflects the reopening of the Western economy.⁹

This market remains critical for the company, as they are headquartered in the United Kingdom. Although Diageo pay regulatory taxes at a country specific level, the consolidated group are liable to pay corporation taxes on their profits in the UK at a level of 25% from 2023 onwards. Furthermore, Diageo began in 1997 as a result of the merger between the Irish-based drinks giant Guinness Brewery and the London property conglomerate Grand Metropolitan PLC. As a result, Diageo maintains a specific relationship to these communities to these days with the groups principal brewing facility based in Dublin.

Asia Pacific

Although the Asia Pacific is comparable to Europe & Turkey in terms of revenue, it is subject to significantly different conditions and growth prospects. Accounting for 18.67% of sales, the region captures all areas from across continental Asia to

⁷ IWSR (2021) ‘Global beverage alcohol expected to gain +3% volume in 2021’

⁸ Evans, J. (2022) ‘Diageo sales rise as drinkers celebrate with premium spirits’, Financial Times

⁹ Gray, A. (2022) ‘Diageo sales pass pre-Covid levels’, Financial Times

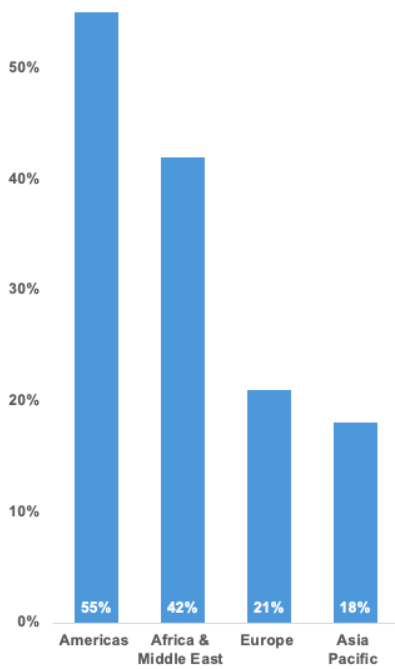


Fig. 15; Premium-Plus Spirits (priced US\$22.50+) Forecast Growth; 2021-26
Source; IWSR

the Middle East and down to Australia. As a result, this market can be even further segmented down to its various regions and countries. However, compared to Europe which has grown by almost 5% annually over the last three years, the Asian market has seen its growth rates slashed from 6.23% to 3.32% over the same period. The Asia Pacific market is considered to be the largest in Total Beverage Alcohol (TBA) consumed in the world.¹⁰ As a result, it is clear that Diageo’s market penetration and brand recognition is underperforming its potential in this regard.

External fears continue to dampen expectations about Diageo’s potential in this market. As the country with the largest population and percentage of geographical revenue in the Asia Pacific region for the company, China has a significant impact on the Diageo’s sales. However, the potential and likelihood of increased regulation in China coupled with continued lockdowns due to the Covid-19 pandemic will undoubtedly decrease the company’s outlook in the Asian market as a whole.

Unlike other regions, the Asian market has not seen the same trend towards premiumisation and is dominated by sales of domestic spirits and beer in each individual country. Although Diageo maintain an extensive portfolio of recognisable brands, they did not offer an Asia Pacific specific branded alcohol until recently. This year, The Diageo opened a carbon-neutral distillery and visitor centre to produce their first “China-origin, single malt whiskey.”¹¹ Should the company commit to further investment of domestic brands in these regions, we believe they could turn the Asia Pacific market back into a powerhouse for the company.

Latin America & Caribbean

The Latin American & Caribbean (LAC) market is one of the most exciting prospects for Diageo, and a fundamental basis for their continued overall international growth. Key to this is the exponential growth of tequila and mezcal in the United States and Europe, which are produced in many LAC countries. Although accounting for just under 10% of total revenue, the Latin American market has seen a CAGR of 7.54% over the last seven financial years. This is second only to North America in terms of revenue growth, where the growth of

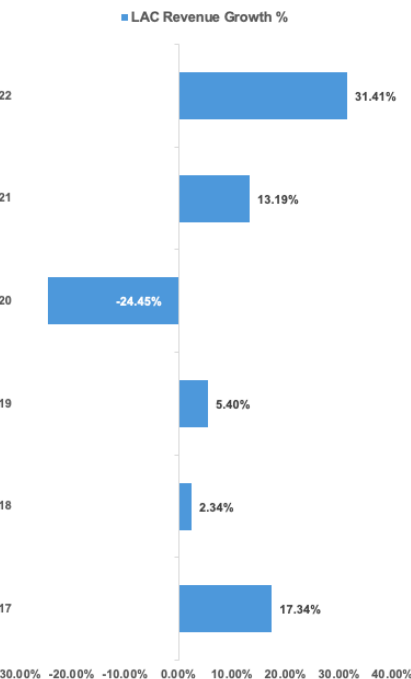


Fig. 16; Latin America & Caribbean Organic Revenue Growth Year on Year; 2017-2022

¹⁰ Statista (2022) ‘Alcoholic Drinks’

¹¹ Ackerman, N. (2021) ‘Drinks giant Diageo to create its first Chinese-origin single malt at new \$75m distillery’, Evening Standard

these key spirits and brands in NA has been attributed to their initial rise in popularity in LAC countries such as Mexico.

Diageo own manufacturing facilities in a number of LAC economies, including Mexico, Brazil, and Guatemala. Furthermore, the company have committed to an additional \$500 million investment to increase production levels in Mexico to expand the growth of the tequila category.

Africa

Although similar to the Latin American market in terms of revenue at 10.89%, the African market displays significantly different characteristics. With a growth rate of less than half of Latin America at 2.77% CAGR for the last three years, Diageo are committed more to the development social infrastructure in Africa than increasing revenue at all costs. This is seen by their engagement to benefit the local communities that they service in this market. As part of their strategy to penetrate these markets, Diageo developed existing brands at lower price points, which includes the introduction of 'Smirnoff X1' in Africa.

In 2021, Diageo launched an African specific Guinness marketing campaign, with 1.5 million new consumers trying the stout across Africa in 2022. Furthermore, Diageo maintains and operates several breweries in Africa. With production facilities in Ghana, Nigeria, Uganda, Kenya, Tanzania, Mozambique, South Africa, and the Seychelles,¹² Diageo is heavily invested in the future of these African economies. The group have also committed to investment in water efficiency for these local communities, with two new water treatment and recovery facilities opened in Nigeria as part of their comprehensive 'Society 2030: Spirit of Progress' ESG campaign.

Corporate

Although accounting for less than 1% of total revenue for the company, their corporate revenue stream acts as an important aspect of their business to increase brand recognition, loyalty and to attract new customers. The figure includes every user experience that Diageo offer, such as distillery tours, branded pubs, and visitor attraction centres. However, the revenue brought in by the corporate stream is significantly less than it costs to run this side of the business, generating a loss of £238m in 2022.



Diageo Production Facilities

- Ghana - Kaase, Achimota
- Nigeria - Lagos
- Uganda - Kampala
- Kenya - East African Maltings, Tusker, Kisumu
- Tanzania - Mwanza, Moshi, Dar es Salaam
- Mozambique - Marracuene
- South Africa - Isipingo
- Seychelles - SeyBrew

Fig. 17; Diageo PLC Production Facilities in Africa; as of December 2022



Fig. 18; Diageo PLC Corporate Revenue; 2018-2022

¹² Diageo (2022) 'Annual Report', pp. 208

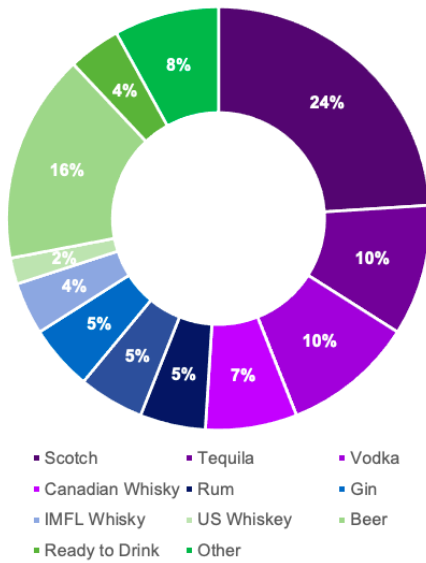


Fig. 19; Diageo PLC Net Sales by Alcohol Category; 2022

As part of Diageo’s £185 million investment into whiskey tourism in Scotland, the group opened a Johnnie Walker visitor experience in Edinburgh in 2021, which has already welcomed over 230,000 people. Similarly, Diageo operate the Guinness Storehouse in Dublin, Ireland. This skyline 360° bar experience had welcomed in excess of 20 million tourists by 2019, after opening in 1997. Two new Guinness visitor attractions are scheduled to open in Chicago and London in 2023, which will help the company to increase Guinness sales in existing markets. It is evident that Diageo can see the value in the growth of user attraction experiences to increase sales in all markets. In fact, the company opened up their first Asia Pacific visitor experience in 2022 in the form of an immersive distillery and visitor centre in China.

Although the corporate revenue stream does not contribute significantly to the company’s overall revenue, it is clear how it has become a critical aspect of their operations. Diageo visitor experiences have become a must do for city-break tourists, offering people a chance to learn about the history of their favourite drinks in an unforgettable way.

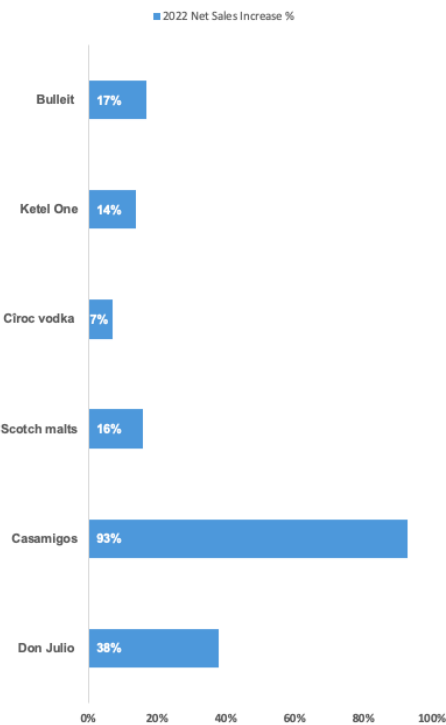


Fig. 20; Diageo PLC Super-Premium Portfolio Products; Organic Net Sales Increase % 2022

Revenue Streams

Diageo’s revenue is broken down into three main streams of alcohol sales; spirits, beers, and ready to drink beverages. Spirits account for almost 80% of the group’s total revenue, which can be product down on a product-by-product basis. In total, Diageo’s beer category contributes to 16% of total sales, driven by their powerhouse brand; Guinness. The ready-to-drink category includes products such as pre-mixed premium spirits, that can be consumer without preparation by the customer. Although this category only accounts for 4% of total revenue for the company, it is critical in the development of their comprehensive product offering to allow consumers to enjoy their drinks in any form.

Diageo get their products to consumers through a variety of methods, including on & off trade sales. On-trade revenue comes from sales to clubs, pubs, restaurants, and bars. While off-trade revenue for Diageo comes from point-of-sale transactions to consumers. Additionally, Diageo distribute their products through a number of channels, such as in retail and wholesale.

With more than 200 brands in their portfolio, Diageo’s products have significant brand recognition and loyalty at every price bracket. As the company operate in more than 180 countries across the world, pricing strategy has become a critical element of their operations. This is seen especially in developing countries, where Diageo have introduced cut priced alternatives for their established and

recognisable brands. This includes offerings such as “Smirnoff X1 in Africa, McDowell’s No.1 in India and Black and White in Latin America.”¹³

Furthermore, trends towards premiumisation have also impacted Diageo’s portfolio of alcoholic beverages. Premium offerings, such as Don Julio tequila and Tanqueray gin have seen double digit revenue percentage increases over the last decade, due to changes in consumer tastes towards higher quality alcohol. Diageo’s portfolio of super-premium drinks has benefitted from this trend, with sales growth of 31% in 2022. These super-premium brands, such as Singleton Malt Whiskey, have been key to the development of another trend in the drinks industry of consumer moments. This trend attempts to pair the perfect drink to each occasion, allowing individuals to personalise their own luxury experiences.¹⁴

Control of Supply Chain

Diageo have control over every aspect of their supply chain, further insulating the company from external macroeconomic factors. Diageo engage in R&D, distillation, maturation, brewing, warehousing, and packaging of their products, meaning that they do not have to rely on third parties for the success of their operations. Development of this critical infrastructure is one of the company’s most attractive propositions to potential investors, who can see the value in the stability of their offering. With 132 production facilities across the world, Diageo maintain a footprint in every major market that they service.

Furthermore, with almost 28,000 employees in over 180 countries across the world, it is evident that Diageo are deeply invested in the local communities in which they operate. The company claim to have benefitted in excess of 150,000 people through their community contributions and schemes.¹⁵ In Ireland alone, Diageo have contributed more than €1.5 million into community projects to tackle issues such as drug & alcohol abuse, rehabilitation, and the environmental impact of their operations.

Diageo maintain that their resilient supply chain remains one of their most effective competitive advantages, giving them a “proven ability to respond at pace to in complex and volatile environments.”¹⁶

<p>27,987 People Directly Employed 180+ Countries 200+ Portfolio Brands 132 Production Facilities Globally 456,000,000 Customers Reached</p>
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Fig. 21; Scope of Diageo PLC’s Worldwide footprint

¹³ Diageo (2022) ‘Annual Report’, pp. 13

¹⁴ Maingi, J. & Winfield, T. (2022) ‘Alcohol consumption: examining purchase patterns during lockdown’, Kantar

¹⁵ Diageo (2020) ‘Diageo launches new ten-year sustainability action plan’

¹⁶ Diageo (2022) ‘Annual Report’, pp. 9

Additionally, it is clear from their M&A history that Diageo are committed to investment at every level of their supply chain. Diageo have made in excess of 65 acquisitions since their merger in 1997 to become the firm we know today, with more than half aiming to improve the supply side of their business. This includes purchases of malting companies, distillers, brewers, bottlers, and distributors, to increase their operational efficiency.

Diageo operate in more than 180 countries across the world. As a result, they believe that local production is preferable where possible. They make strategic investments in local infrastructure and production facilities to better service the local communities that they are in. This is further enhanced by the acquisition of brands and products that are tied to certain regions, such as the recent purchase of '21Seeds' flavoured tequila and 'Mezcal Union' to increase sales in the North American region.

Industry Overview

Diageo PLC operates in the Alcoholic Beverages Industry, a sub-category of the Beverages Industry in the Consumer Staples Sector. We will analyse the major market trends, challenges, and opportunities of this sub-sector. Diageo's key markets are North America, Europe, and Asia Pacific.

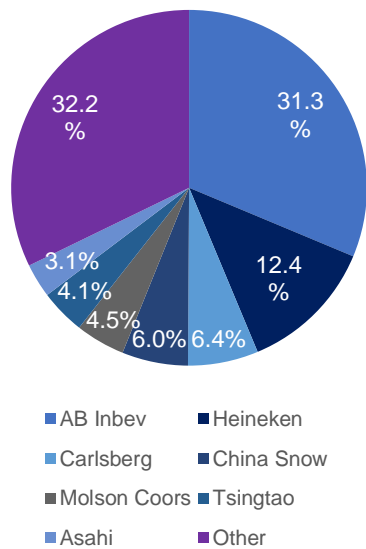


Fig. 22; Market Share of Beer Companies (2022).
Source: Statista

Trends

Industry Growth

Revenue in the Alcoholic Beverages industry amounts to £1,108bn in 2022. This is expected to grow at a compound annual rate of 10.1% between 2022 to 2025. The markets overall largest segment is Beer, with a market volume of £421bn. With the exception of the year 2020, worldwide revenue has continuously grown year-on-year. Diageo's growth is highly correlated with the industry's growth. Total beverage alcohol is resilient, and the long-term trends for the industry are attractive.

Premiumisation

Consumers are increasingly searching for improved quality. The sales data shows that purchasers are choosing brands and categories at premium price points. These brands claim to offer a superior taste experience using higher quality, original ingredients, or distilled using improved methods. This is fuelled

Reserve	Sales Increase
Don Julio	36%
Casamigos	90%
Ciroc	17%
Ketel One	6%
Bulleit	12%
Malt Scotch	16%

Fig. 23; Premium Diageo brand's year on year sales increase in 2022
Source: Diageo

by higher levels of disposable income and prosperity, and a yearning for new experiences. This is particularly evident in the US and Asia. Premium spirit categories grew 700% quicker than the overall spirit's segment. For example, consumer research shows that 39% of urban affluent Chinese alcohol drinkers spent more than the equivalent of approximately £69 on a bottle of spirits to consume at home during the first half of 2021.¹⁷ Expensive, niche categories of spirits associated with status such as tequila, mezcal, Japanese and Irish whisk(e)y all bucked the trend of the overall decline in 2020 to continue growth.¹⁸

Trend Towards No & Low-Alcohol Options

No and low alcohol choices are becoming increasingly normalised lifestyle choices, making the category more accessible and inviting for consumers. The industry has grown from £6.7bn in 2018 to £8.5bn, commanding a 3.5% volume share of the alcohol industry. The industry is forecasted to grow by 8% CAGR. No-alcohol spirits continue to ride the health and wellness trend. Traditionally no-alcohol products used to be about occasions when one can't drink, e.g., designated driver. Today's consumer can drink, they simply choose not to. It has become trendier to choose this option. Products that offer an experience equivalent to their alcoholic counterparts fare best with consumers. For example, low-alcohol wines perform better than no-alcohol wines. No-alcohol beer has even managed to expand into non-traditional occasions, sharing space with soft drinks.

The majority of consumers in this space can be identified as 'substituters' – those who swap alcohol beverages for low or no alcohol choices on certain occasions. 'Blenders' switch between the two during the same occasion. Younger consumers, Gen Z and Millennials, are more likely to be both substituters and blenders than their older, Boomer, counterparts. This would suggest further growth in the category as time passes. In 2019, 65% of US adults reported drinking alcoholic beverages. This has fallen to 60% by 2021. Gen Z in particular is drinking 20% less than other generations did at their age.

E-Commerce and On-Demand Delivery

Forecasts estimate by 2025, eCommerce will represent approx. 6% of all off-trade beverage volumes, a gain of more than 4% from 2018. As ecommerce

¹⁷ IWSR (2022) *Key Trends Driving the Global Beverage Alcohol Industry in 2022.*

¹⁸ Drinks Industry Ireland (2022) *Global Alcohol Beverage Industry – Key 2022 Trends.*

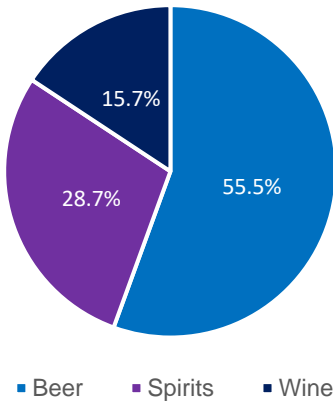


Fig 24; Sales Market Share of General Alcohol Categories in 2000. Source: Statista

sales develop, retailers and their business models are becoming more diverse and nuanced; the distinctions between online sales channels are blurring. Omnichannel retailers are partnering with on-demand services for logistics purposes to offer faster delivery. ‘Dark stores’ are being used to improve delivery times for on demand retailer service providers. More than ever, consumers are shifting between channels and retailers depending on their needs in that moment. There is a clear net-willingness to pay more for delivery within one hour of ordering, particularly among younger generations. McKinsey research shows nearly half of omnichannel buyers will switch retailers if they feel delivery times are too long¹⁹. Beverage companies like Diageo are responding by building strength and presence on prominent distribution platforms such as Amazon in Europe and Drizly in the US. Furthermore, services such as Diageo’s TheBar.com and Malts.com allow direct to consumer digital access. These channels allow companies to deepen their relationship with consumers and help them find the right drink for the occasion. Malts.com is a direct-from-distillery e-commerce platform enabling the relationship with the consumer to be nurtured directly.

Spirits over Beer and Wine

Consumers who drink alcohol are increasingly choosing spirits over beer and wine. This is a long-term trend visible across the globe. Beer’s market share has been consistently diminishing since 2000. It has slumped from upwards of 50% of the market to 42.5% today. Wine has stayed consistent meaning spirits are the direct benefactor. In less mature markets, spirits offer a consistent measure of quality at affordable prices. In mature markets, spirits can offer a premium touch and increased differentiation. This was accelerated during the pandemic. In Diageo’s biggest market, the US, household penetration of spirits has grown ahead of beer and wine. In many emerging markets, spirit penetration is still low, highlighting the potential for future growth. One major area of growth may be a consumer shift from illegal unregulated alcohols to genuine spirits. In the US, vodka is the most popular spirit, with Diageo’s Smirnoff being the most popular brand. This trend is important for Diageo, as they are not present in the wine industry and rely on Guinness in the beer industry.

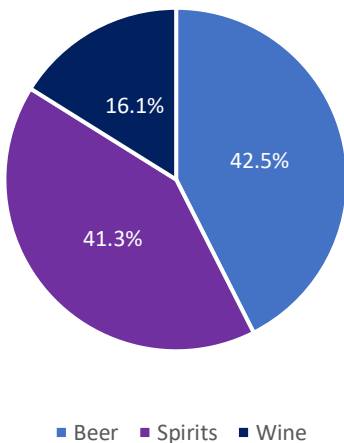


Fig. 25; Sales Market Share of General Alcohol Categories in 2021 Source: Statista

¹⁹ McKinsey (2021) *Retail’s Need for Speed: Unlocking Value in Omnichannel Delivery*

Challenges

Currency Risk

Diageo PLC reports its results in Great British Pounds (£), however the vast majority of its revenues were earned in alternate currencies. Therefore, they are largely dependent on foreign exchange rates. For example, in the year ended 30 June 2022, Diageo reported a £50m loss on the impact of movements on exchange rates, following on from a £290m loss the year prior. This was principally in respect of the strengthening of the pound with respect to the Euro and the Turkish Lira, partially offset by the weakening of the pound against the dollar. However, at the time of the results £1 = \$1.29 or €1.18. At the time of writing, the Sterling has weakened against both of these benchmark currencies, substantially so with respect to the US Dollar. This will have a marked effect on future financial statements and highlights the volatile nature of the markets. These losses are reported as interest charges in the balance sheet. Diageo reports all regional performance in £, not the local currency therefore all regions are subject to currency risk.

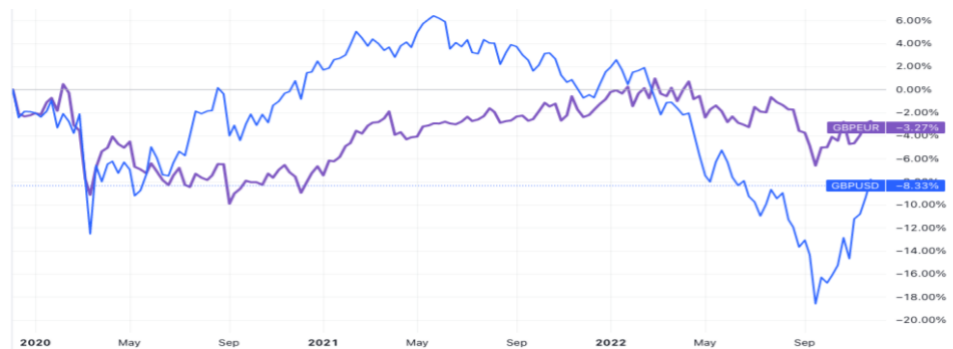


Fig. 26; Visual representation of GBP (£) value vs USD (\$) and EUR (€)
 Source: TradingView

Socio-Economic Landscape

The impact of the pandemic on the economy and on people has led to increases in unemployment and poverty. Consequently, geopolitical instability and steep inflation has worsened these issues. This has led to the sharpest increase in the global wealth gap on record²⁰, further widening social inequality. This could have an effect on the consumer base and their purchasing preferences, and therefore the pricing strategies relevant to the industry. This is particularly relevant in light of the trend towards higher quality spirits, and whether this trend is likely to

²⁰ World Economic Forum (2021) *Income and Wealth Inequalities Significant*

continue. Continued international tension or financial pressures might result in trade barriers or disproportionate tax increases being introduced. Diageo have noted that this risk is increasing, and likely to continue doing so.

The pandemic caused significant disruption to the industry and the possibility of future variants remains. The industry is particularly vulnerable to future restrictions.

Regulation

The beverage alcohol industry is heavily regulated. Regulation varies across the world, often revolving in response to societal changes. Public health concerns may lead to regulators in major markets to restrict or outright ban the advertisement or sale of alcohol. The World Health Organisation noted that sustained action by national governments, the public health community and the WHO has greatly limited the availability and promotion of tobacco products, and as a result are advocating for similar treatment for the alcohol industry (WHO glaring gaps in reg of alcohol mark). For example, countries such as France and Ireland have introduced a total ban on the marketing of alcohol during sporting events. This could have a major impact going forward, as a study showed that there were more than 100 alcohol marketing references per broadcast in each country of every match studied during the Euro 2016 football tournament.²¹ Marketing plays an integral role in the promotion of the industry; this may be hampered in future.

Inflation & Potential Recession

The growing risk of recession and slowing growth has been reported. The Bank of England has raised interest rates to levels not seen since the Great Recession in late 2008. They further warned that the UK may be entering into their longest recession since records began. The upcoming recession is forecasted to last between five to eight quarters, depending on interest rates. Meanwhile, the US has raised interest rates by 0.75 basis points for the fourth period in a row. The European Central Bank has raised interest rates three times this year thus far to the highest rate in over a decade. Japan and China have thus far relented from increasing rates. Although China's existing rates are higher than their Western counter parts.

Total References	1,233
References per Match	123
Average per Minute of Broadcast	0.59
Proportion references in play	66%
Proportion references out of play	34%
Popular locations of references	pitch border, ad break
Popular format for references	static advertising, ad break
Most featured brand	Carlsberg
Median duration of references	4.00
Total duration of references	2.94
Proportion of indirect references	92%

Fig. 27; Irish Alcohol Advertisements during EURO 2016.
Source: Foul Play Study

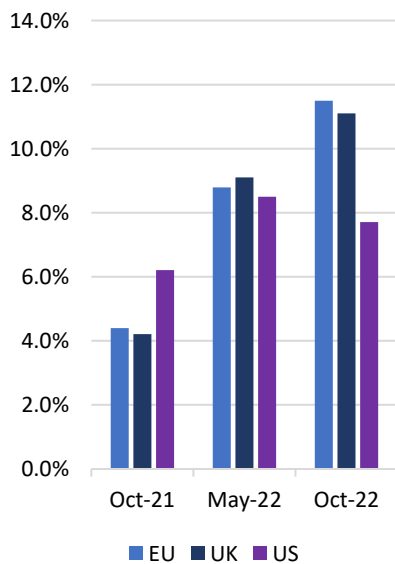


Fig. 28; Annual Inflation Rates from October 21 to October 22
Source: Central Bank Data

²¹ Purves, R., et al., (2017) *Foul Play? Alcohol Marketing During EURO 2016*, April 2017.

UK inflation is expected to peak at 10.9% in Q4 2022. Euro Area inflation is 10.7%. while US inflation is currently at 8.2%. Similarly, Indian inflation is 7.4%. Japan and China are comparatively largely unaffected, at 2.8% and 2.2% respectively. Inflationary pressures are expected to continue in the short term.

Supply chain disruption has been a symptom of the COVID pandemic as well as geopolitical tensions and rising oil & gas prices. The continued presence of these issues can lead to the shortage of essential materials, increased logistical constraints, longer lead times and supplier disruption. This can have a marked impact on commercial and financial performance.

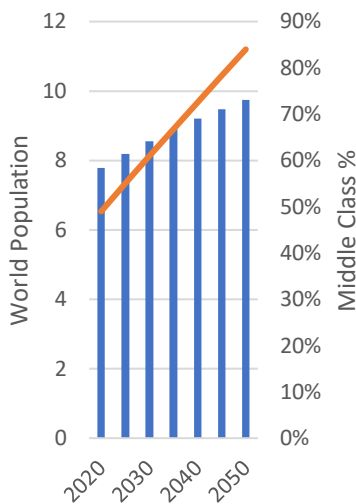


Fig. 29; Expected world population overlaid with % of middle class from 2020 – 2050; (in billions)
Source: Statista

Opportunities

Growth of Population and the Middle Class

World population is growing and expected to reach 10 billion by 2050. Global economic development is driving the emergence of consumers with disposable income. The World Bank estimates 600m consumers will join the ‘middle class and above’ income bracket by 2032. These consumers are seeking new experiences and pushing demand for quality products at different prices. A meta-analysis of studies in the area showed that areas with the highest income had the highest prevalence of alcohol consumption.²² Importantly, they are also purchasing less unregulated, illegal alcohol, which is estimated to amount to 25% of all global alcohol sales. As a result, demand for spirits is rising. As emerging market consumers disposable income rises, so will the demand for lower price point, quality spirits. The demand for alcoholic drinks is growing fastest in emerging countries, like India, China, Indonesia, and Singapore. In developed markets, the trend has been a shift towards lower-tempo, food related consumption occasions. The preference is moving towards drinking better, not more. A study has shown that people with higher incomes are more likely to drink, but also more likely to moderate how much they drink²³. Premium level spirits will benefit from the slow down. Spirits in general will benefit from both developments as they are versatile and adaptable, suitable for occasions of all tempos.

M&A

²² Collins, S., (2016) Associations Between Socioeconomic Factors and Alcohol Outcomes, *Alcohol Res.* 2016; 38(1): 83-94

²³ Hamdi, N., et al., (2015) Socioeconomic Status Moderates... Effects on the Amount of Alcohol Use. *Alcoholism*, Vol 39, issue 4, 603 - 610

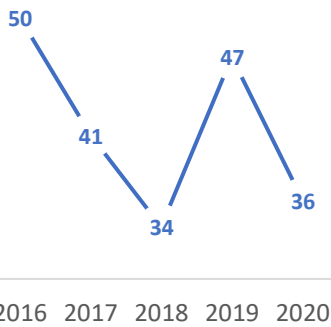


Fig. 30; Total number of Alcoholic Beverage Industry M&A transactions per year. Source: PWC

In today’s challenging environment, the firms that can quickly integrate high-potential businesses and divest those without a profitable future will come out on top. M&A activity in the beverage industry has gained momentum in the last few years but is still off the transaction peak of 2014 and 2015. Many of the larger players have sought to consolidate within their own category and generate synergies by expanding their footprint.

AB InBev’s \$107bn acquisition of SABMiller is by far the largest transaction in recent history. The transaction created the world’s first truly global brewer, with beer operations in every major market. This reenergised stagnating growth enabling AB InBev to conquer emerging markets. The synergies included a reduction of overhead expenses, integration of best practice, combining of source materials and distribution efficiencies through tax savings and economies of scale. The deal allowed the company to become the fourth biggest brewer in Africa, a continent they previously had no presence in.

Despite this, AB InBev has been forced to sell off many of the assets acquired in the deal, either by competition regulators or to reduce debt. All of these deals have been concluded at a diluted multiple to the acquired price. Analysts are conflicted on whether the deal was a success or an overpayment. Revenue has grown consistently since 2005, however has relatively stagnated since the 2015 takeover, peaking in 2017. The merged AB InBev’s market cap (£78bn) is lower than the cost of the acquisition (£87bn).

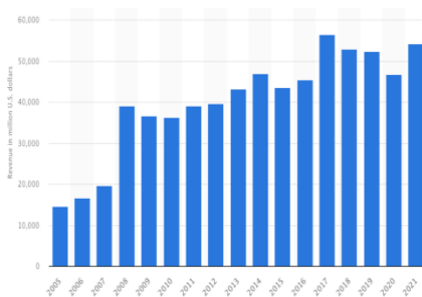


Fig. 31; AB InBev’s global revenue from 2005 to 2021. (in million (\$)) Source: Statista

The never-ending quest to satisfy evolving consumer preferences has brought soft drink and alcohol companies together, resulting in the new category of Hard Seltzer. This category is expected to reach \$16bn by 2025 from just \$7.5bn in 2021 in the US alone. This segment has seen entrants from both soft drink and established alcohol brands, but is still dominated by the original seltzer heavyweight, White Claw.

Spirits companies are well-positioned to manage wine brands. Historically dominated by small, family-owned wine-making dynasties, winemakers are feeling the pressure to scale. Global warming has made harvests more unpredictable; harvests are decreasing in quality. In order to survive, winemakers need to scale and diversify. Spirits companies understand the long-term horizons of wine making. In addition, both industries are heavily fragmented, ripe for consolidation. LVMH, Pernod Ricard and Constellation Brands prove that spirits and wines can be successfully managed under a single parent company.

Competitive Landscape

The industry is largely dominated by a number of MNCs with worldwide influence. There has been a trend towards consolidation, particularly in recent years as these large firms play an increasingly significant role. Industry structure varies substantially between drink categories. The beer market is dominated by a few global businesses, such as AB InBev, while the wine market lacks global players, resulting in a fragmented landscape. The spirit's industry lies somewhere in the middle: Diageo and Pernod Ricard are market leaders, but a long list of smaller distiller's accounts for a large share of the market. A 2019 study placed this share at as high as 76%²⁴. Diageo's primary market is spirits, but also produce beer. Therefore, we will be discussing the major firms of the spirits and beer industries.

By applying Porter's Five Forces Framework we understand that the bargaining power of customers is extremely high as there is a vast plethora of options for consumers due to huge competition. Consumers are searching for new experiences. The brand effect still plays on customer's minds, but they are not bound by switching costs. Despite this, in the beer industry threat of substitutes is not as high as the industry is very consolidated among a few global players. The spirits industry remains ripe for disruption, with 76% of the market share held by smaller independent companies. Given the increasing scale and globalisation of the industry, barriers to entry are increasing, but exceptions such as hard seltzer market leader White Claw have proven successful. As previously mentioned, there is high intensity of competition, particularly in the spirits market where no company has been able to achieve the market share of AB InBev in the beer market. Smaller, local players often gain large market shares in their respective markets or in niche product categories. Bargaining power of suppliers is considered to be low due to the presence of a large number of suppliers. Every firm has trade secrets, and the cost of switching is not high.

Diageo is the world's largest alcohol producer by market cap at £82bn. Dominant beer producer Ab InBev is a close second at £78bn. European beer market leader Heineken is valued at £42bn while wine and spirits behemoth Pernod Ricard's market cap is roughly half of Diageo's at £40bn.

Anheuser-Busch Inbev

Anheuser-Busch InBev is the world's largest brewer and is one of the largest fast-moving consumer goods companies in the world. The company is the product of a long line of mergers, starting with the merger of American brewer

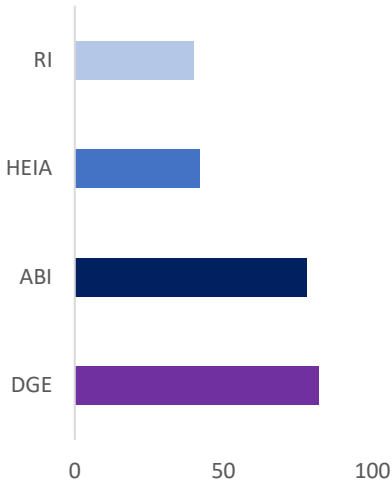


Fig. 32; Respective Market Caps of Discussed Companies. (in billion (£))
Source: Yahoo Finance

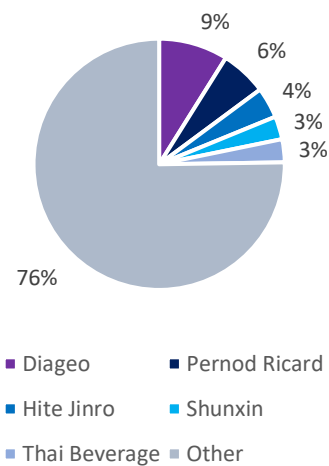


Fig. 33; Market Share of Spirits Companies in 2019.
Source: Euromonitor

²⁴ Institute of Alcohol Studies (2020) *The Alcohol Industry: An Overview*.

Anheuser-Busch and Inbev, the latter formed by the merger of Belgian producer Interbrew and Brazilian producer AmBev. The recent £79bn takeover of SABMiller is largest ever deal in the alcohol sector, and the third largest acquisition in any sector. The Belgian based brewer has a large portfolio of household names including Budweiser, Corona and Stella Artois, the latter being the most sold alcoholic drink in the UK. Further, the brand produces Skol and Jupiler, which are the highest selling beers in Brazil and Ab InBev's native Belgium respectively. Skol has even been named Brazil's most valuable brand for six consecutive years. Overall, the multinational conglomerate operates more than 600 brands in over 150 countries, making it the largest brewer by both volume and revenue.

Unlike Diageo, the vast majority of Ab Inbev's revenue stems from beer, and not spirits. Their CEO has refuted the notion that beer is losing ground vs spirits. This sentiment has not been shared by investors as Ab Inbev's stock has plummeted by 50% since 2017. During this period Diageo's stock has rallied by 33%. Despite this, AB's revenue for 2022 amounted to £47bn, capturing almost a third of global beer sales. For now, they remain the undisputed kings of the alcohol industry.

Heineken

Heineken is the world's second largest brewer, owning over 170 brands in more than 70 countries. The two largest brands are Heineken itself, and Amstel. The portfolio also includes Birra Moretti, Tiger and Bulmer's (Magners). Heineken's revenue for 2021 totalled £23bn, with a 12% global beer market share. Despite a number of peaks and troughs, HEIA is trading at roughly the same level as five years ago, a 1% difference. Heineken are market leaders in Europe. Heineken provides competition to Diageo's flagship brand, Guinness. Heineken produce Beamish, Murphy's, and Island's Edge Stout.

Heineken is synonymous with sports sponsorships. Heineken was the title sponsor of the eponymous Heineken Cup, the European Rugby Cup. The cup was rebranded to the Champions Cup, which Heineken still sponsor. Their support has seen them credited as a founding partner of European Rugby. In addition, Heineken has sponsored the Champions League, Formula 1, ATP Series, EURO 2020 and the 2020 Olympics.

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Pernod Ricard

Pernod Ricard is the world's second largest spirit producer, after Diageo. Pernod Ricard has a comprehensive spirits portfolio comprising of more than 240 premium brands available in over 160 countries. Examples of their more well-known brands include Jameson Whiskey, Havana Club and Absolut Vodka. Sales in FY 2022 broke €10bn (£9.35bn) for the first time, after their fastest growth rate in over 30 years. Despite being the second largest producer, this was only sufficient to claim approximately 6% of the fragmented overall spirit's market. Leveraging on the growth in popularity of spirits, RI.PA value has grown 40% over the five-year period.

Pernod Ricard's organisational structure is based on many different brands based in their respective home countries, under the umbrella PR brand. Each company is responsible for the general strategy of their individual brands. Decentralisation allows overall operations to be flexible, efficient, and effectual. The group headquarters in Paris sets the direction, defined objectives, and oversees the adherence to company strategy. Their portfolio is one of the most comprehensive on the market, with products in all significant categories of spirits and wine, providing the company with an advantage not enjoyed by competitors. This portfolio diversification allows the company to position itself for new trends while reaping the dividends of in their most successful brands.

Bacardi (Private)

Bacardi are the world's largest privately owned spirit's company. Despite this, the seven-generation family-owned company have a portfolio of more than 200 brands and labels, with sales across more than 170 countries. Some of their well-known brands include Martini-Vermouth, Grey Goose Vodka and Bombay Sapphire Gin. As they are privately owned, they do not publish their financial information. Fitch's rating agency have stated they have a "strong market share across several categories", although stated that both Diageo and Pernod Ricard have "stronger business profiles".

Valuation

Implied Share Price	
DCF Valuation	£4,606.40
Dividend Discount Model	£3,830.42
Relative Valuation	£2,926.44
EFCF Valuation	£5,120.60
Average Equity Value	£94,568.72
Basic Shares Outstanding	2,295
Share Price Target - GBP	£4,120.96

Our price target for Diageo PLC is based on four equally weighted valuation methodologies. These include; Discounted Cash Flow (DCF), Dividend Discount Model (DDM), Relative Valuation and Free Cash Flow to Equity (FCFE). To be comprehensive in our analysis, we implemented both intrinsic and market valuation approaches. Additionally, we implemented sensitivity analysis to determine how our price target changes in respect to key figures such as long-term growth rates, and the Weighted Average Cost Capital (WACC). This enables us to forecast a range of values for Diageo based on different market scenarios.

An equal weigh average of these four valuation methods gives us a twelve-month price target of £4,120.96 for Diageo PLC, with a total shareholder return of 10.44%. However, further analysis of these four techniques presents a different picture. Although all three absolute valuation models give Diageo a higher share price target than they currently maintain, comparable analysis of the stock indicates that it may be overvalued in relation to similar companies in the industry.

Growth Forecasts

Diageo operates in five separate geographical markets and generates additional revenue through their corporate department. Revenue from their corporate stream refers to user experiences such as distillery tours and premium bars across Europe, which have become increasingly popular and important for the company to increase their brand recognition and customer loyalty.

To accurately forecast the future revenue of the company, we separated their sales into these different streams, and looked at their growth rates individually. Doing so illustrates that each market is subject to significantly different conditions and potential for growth.

Although North America is the largest market for the company, it is also the fastest growing with a 9.56% CAGR over the last 7 years. Conversely, the African market has grown at an annual rate of just 3.72% over the same period. As a result, we believe that it was important to forecast the revenues of the company based on each geographical regions individual economic outlook.

We split this forecast into both a short- & long-term growth estimate for each region, based on moving averages of the last 7 and 3 years, combined with

Fig. 34; Summary Valuation of Diageo PLC. Equity Value & Basic Shares Outstanding in Millions

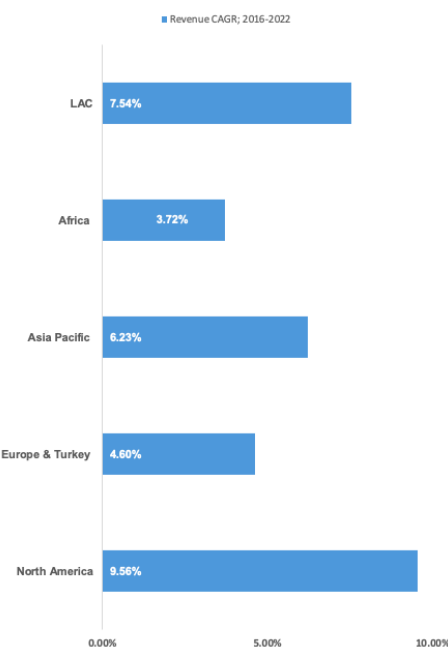


Fig. 35; Diageo PLC Regional Revenue CAGR; 2016-2022

additional growth potential based on exceptional items (such as the growth of the premium spirits and tequila market in Latin America).

By forecasting expenses in a similar way, we were able to project the outlook for the company over the next eight years, which we used as a terminal period for growth. To estimate figures for depreciation, amortisation, capital expenditures and net working capital, we found that they remained as a relatively steady percentage of revenue over the last ten financial periods.

As Diageo PLC is tax domiciled in the United Kingdom, they are subject to pay corporation taxes on the bulk of their group profits in this jurisdiction. Although their effective corporate tax rate has fluctuated over the last decade, it is clear that this would change significantly in 2023. Following the removal of Boris Johnson as prime minister of the UK, Liz Truss and her advisory team introduced sweeping tax changes that would see an increase in the corporation tax rate of the company rise to 25%. This change survived Truss through to the current government, with chancellor Jeremy Hunt announcing that these prospective changes would be made permanent.²⁵ This was confirmed by Diageo in their 2022 Annual Report, stating that they would be subject to a flat 25% tax rate on their group profits in future years.

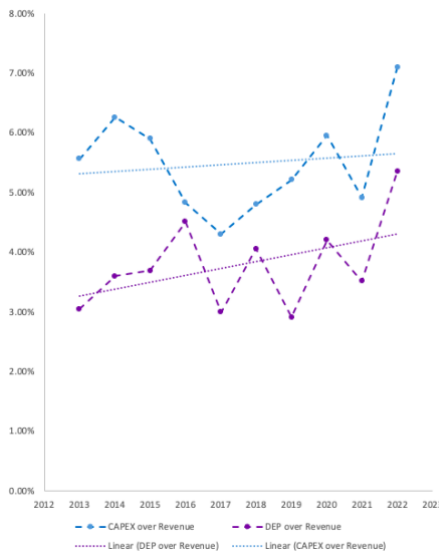


Fig. 36; Diageo PLC Historical CAPEX & Depreciation / Revenue

Discounted Cash Flow (DCF)

The DCF method estimates the value of an investment in relation to its expected future cash flows. Although the discounted cash flow approach involves several assumptions related to how the business will perform in the future, it is considered to be the industry standard valuation model for firms in the mature stage of their business life cycle. As a result, we believed that it was important to implement this model into our price target for Diageo.

Using our earlier forecasts, we obtained a figure for the company’s unlevered free cash flows and discounted this back to the present day using the firm’s Weighted Average Cost of Capital (WACC). Forecasting of the company showed an increase in free cash flow growth from 2023 until our terminal period. As a result, we applied a perpetuity growth rate of 3%, which is discussed in greater detail through in sensitivity analysis of our price target. As new firms take advantage of the growing premium spirit’s market Diageo are likely to lose market share, which is reflected in the modest terminal growth rate.

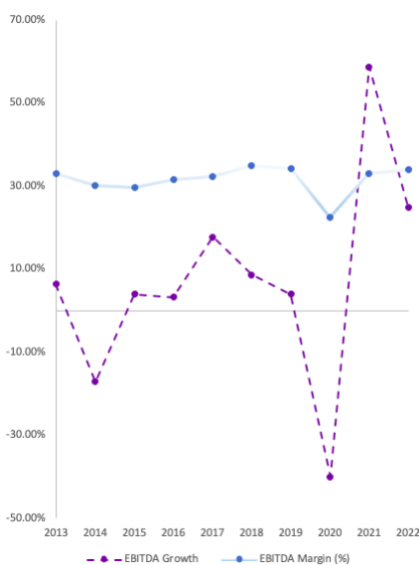


Fig. 37; Diageo PLC Historical EBITDA Margin

²⁵ James, W. & MacLellan, K. (2022) ‘UK corporation tax to rise to 25% as PM Truss U-turns’ Reuters

Having calculated a Weighted Average Cost of Capital (WACC), we were in a position to discount the future cash flows of the company back to the present.

This WACC estimation involved a significant number of additional calculations, including analysis of the company’s long-term plan to consolidate their position as market leader by their aggressive M&A strategy through debt financing.

We obtained an enterprise value for the company of £121.61bn in 2030 by discounting the free cash flows at the post tax WACC of 5.73%, with a forecasting period of 8 years. Subtracting the total debt and minority interests from this figure gave us an equity value of £105.69bn, with a twelve month share price target of £4,605.49. This represents a potential 21.01% share price increase from Diageo’s current market value.

Sum dFCF	£23,410.53
Terminal Value	£98,199.92
Enterprise Value	£121,610.45
(+) Cash & Cash Equivalents	£2,513.50
(-) Minority Interest	£1,767.48
(-) Total Debt	£16,668.80
Equity Value	£105,687.67
Basic Shares Outstanding (2023)	2,294.82
Price Target	£4,605.49

Fig. 38; DCF Valuation Summary; figures in £million

D/V Target

An essential element of our valuation for Diageo relies on their modest increase in debt levels from now until our terminal period in 2030. The leverage incentives for the company of increasing their levels of debt as they enter the mature stage of their business life cycle are considerable, which is reflected in the strategic priorities of the company in their most recent annual report. Diageo currently operate with a 15.37% Debt/Value ratio (D/V), showing that they are not afraid to take on additional debt to finance significant proportions of their business operations, and aggressive corporate M&A strategy. The company have acquired 66 alcoholic beverages brands, distillers, and distributors over the two decades, mostly through debt financing.

However, it is clear that Diageo are entering an important time in their life cycle. Having reached maturity and market saturation, the company must make alterations to their business plan if they are to maintain their current position as industry leaders in the alcoholic beverages industry. This is referenced in their most recent annual report, where a note from the board of directors directly mentions their renewed strategy of further strategic takeovers over the next decade through both debt and cash financing. As a result, we believe it is important to incorporate this into our valuation of the company, as they attempt to grow their influence and efficiency through consolidation of key competitors and infrastructural firms. Industry analysis of key competitors indicates that many firms operate with a D/C ratio of significantly higher than Diageo. As a result, we believe the company are likely to implement a 20% long term D/V ratio, to reflect the additional debt that they will take on to finance these operations. Although this strategy may make the company more exposed to risks such as rising

D/V	15.37%
Equity Beta	0.37
Debt Beta	0.03
Unlevered Beta	0.32
D/V Target	20%
Beta d	0.03
Beta e	0.39
Rf	4.14%
MRP	5.69%
Tax Rate	25.00%
Cost of Debt	4.31%
Cost of Equity	6.35%
WACC	5.73%
g	3%

Fig. 39; Key Calculation Figures, including target D/V ratio

interest rates, and negative market conditions, we believe that this is justified as they attempt to manoeuvre themselves to the forefront of the industry.

Sensitivity Analysis

As the benchmark for most valuation models used by investment banks across the world, we believed it was important to see how our discounted cash flow forecast varied with changes to growth rates and the company's WACC. Sensitivity analysis considers how even minimal changes to a critical independent variable can impact the overall price target for a company, based on different assumptions.

Furthermore, we included this analysis to account for the extremely uncertain market conditions that Diageo are likely to face over the next few years. As a result, we examined the impact of how changes to the company's growth rate and WACC could impact investor confidence in their business. This 'what-if' analysis allowed us to better understand how important factors can influence the price of the company and reduce the uncertainty of our final price target.

\$ 4,605.49	5.00%	5.25%	5.50%	5.73%	6.00%	6.25%	6.50%
2.00%	£4,551.26	£4,151.72	£3,809.26	£3,493.82	£3,252.79	£3,023.66	£2,820.00
2.50%	£5,409.59	£4,860.79	£4,403.46	£3,992.44	£3,684.77	£3,397.28	£3,145.72
2.75%	£5,981.80	£5,321.69	£4,781.58	£4,303.72	£3,950.60	£3,624.12	£3,341.16
3.00%	£6,697.08	£5,885.01	£5,235.33	£4,605.49	£4,260.74	£3,885.86	£3,564.51
3.25%	£7,616.71	£6,589.17	£5,789.92	£5,111.81	£4,627.26	£4,191.22	£3,822.23
3.33%	£7,969.15	£6,853.22	£5,994.37	£5,271.88	£4,759.05	£4,299.98	£4,191.22
3.50%	£8,842.89	£7,494.51	£6,483.15	£5,649.54	£5,067.10	£4,552.10	£4,122.90

Fig. 40; Sensitivity Analysis of DCF Price Target. Changes to WACC result are shown along the X-axis, with changes to the terminal growth rate displayed on the Y-axis.

Terminal Growth Rate

As Diageo is an established player in the alcoholic beverage industry, with a strong history of competitive M&A and successful product launches into the market, we implemented a mature stage growth rate for the company. This assumes that a company's growth increases minimally as it reaches maturity, to defend "its existing market share from emerging competitors in the industry."²⁶

We calculated a mean of the traditional UK inflation rate, and average GDP growth to reach a terminal growth figure of 3%. This rate indicates that we believe that Diageo will outperform the market over the forecasting period, a sentiment which is echoed by the company through their ambitious strategic

²⁶ Corporate Finance Institute (2022) 'Terminal Growth Rate'

priorities of delivering sustainable revenue growth, increasing efficiency, and continued investment.²⁷

However, industry standards of perpetual growth rates for mature companies indicate an acceptable and common range between 2% - 3.5%. As a result, we believed that it was important to show how our price target was likely to be impacted by changes to this growth rate. Doing so presented a price target with a range of between £3,493.82 and \$5,649.52, assuming no changes to the current WACC. Should the revenue of the company underperform over the next few financial years, they can expect to see their share price decrease significantly as a result

Weighted Average Cost of Capital (WACC)

The WACC measures the cost of financing for a company, by weighing their costs of both debt and equity. This figure is critical in the valuation of a company, as it shows how much they can expect to pay to finance their operations. Furthermore, the WACC represents the discount rate that we used to calculate the price target for our Diageo in our valuation.

A higher cost of capital indicates higher risk for a company, while lower rates imply that a firm can attract investors at lower costs. As a result, we believed that it was important to see how the WACC changes the price target for Diageo at different levels.

To estimate a WACC figure for the company, we applied the CAPM model. To find the beta of our company, we calculated the weekly covariance of DGE with the S&P500 over the last ten years. This figure shows how the price of our company is likely to change in relation to the overall market, which we determined to be 0.37. This illustrates that Diageo is less likely to be impacted by changing market conditions than other firms. This figure makes sense in the circumstances, as the consumer staples and alcoholic beverages industry has traditionally been more shielded from external macroeconomic factors than other markets which exhibit significantly more volatility.

With a debt rating of A3 from Moody's, Diageo's credit risk is considered to be relatively minimal. As a result, we estimated a debt beta of 0.03, which would stay constant throughout our overall valuation as the company implement their long-term D/V target of 20%.

²⁷ Diageo (2022) 'Annual Report', pp. 19

We used 10 Year UK Gilt Bonds as a proxy for the risk-free rate of 4.14%. Similarly, we implemented a market risk premium figure of 5.69%.²⁸ This allowed us to calculate an unlevered beta of 0.32 for Diageo, which measures the risk of the company without its debt obligations. With a new equity beta of 0.40, we calculated the cost of debt and equity to be 4.31% and 6.35% respectively, using the CAPM formula. Doing so allowed us to reach a final WACC figure of 5.77%, which we used as the basis for our valuation.

However, as the WACC figure is so susceptible to change due to fluctuations in the cost of debt and equity, we believed it was important to show how this could impact our price target. Similar to the growth rate in perpetuity, we calculated how our recommendation moves with 0.25% changes to the WACC between 5% and 5.5%. This gives a price range between £3,564.51 and £6,697.08 at the baseline level of perpetual growth, which increases further with proportional increases in the growth rate.

Dividend Discount Model

As Diageo pay dividends on a bi-annual basis, we believed that it was important to incorporate the benefits of these payments into our valuation and price target for the company. The Dividend Discount Model (DDM) assumes that a securities value should consider the expected value of future dividend payments, discounted back to the present by an appropriate rate.

Analysis of the company’s accounts over the last seven financial years showed a relatively steady increase in dividend payments of 3.5% per year. Furthermore, Diageo’s Dividends Per Share (DPS) has increased by an even greater rate over the same period, from 0.59 in 2016 to 0.74 in 2022. This increase amounts to be a CAGR of 4.53%, which we applied as our perpetual growth figure for dividends in our valuation. The dividend pay-out ratio for the company, of dividends paid over adjusted net income, remained relatively steady at 55% over the same period.

In our model, we implemented the Gordon Growth DDM, which considers that a company’s future dividends will grow at a constant rate in perpetuity. This variation is appropriate as Diageo is a mature company with a historically steady increase in revenue and dividends. Under regular circumstances, the Gordon Growth DDM calculation uses the current fair value of an asset. However, as we are forecasting the value of the stock into the future, we implemented the

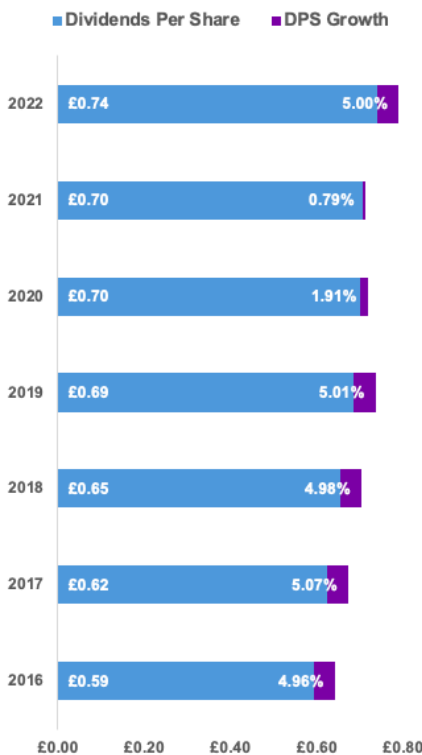


Fig. 41; Diageo PLC Dividends Per Share from 2016-2022

²⁸ Statista (2022) ‘Average Market Risk Premium in the U.S. 2011-2022’

terminal value from our DCF calculation as the basis of the fair value for the stock in twelve months' time. Adding the sum of the present value of the future dividends to this value, we obtained an enterprise value of £103.80bn for Diageo. Having subtracted net debt and minority interests from this figure, we obtained an equity value of £87.88bn with a twelve-month price target of £3,829.52. This represents a modest share price increase of 2.65%, based on the expected future value of dividends of the company.

Relative Valuation

Relative valuation attempts to express the value of Diageo PLC in relation to similar companies in the alcoholic beverage industry. Analysis of the alcoholic beverage industry illustrates that a small number of large-scale firms dominate the market. As Diageo operates in both the premium spirits and beer market, we believed that it was important to compare the company to key players in both industries. The following six companies were used as the basis for our comparable analysis of Diageo;

- Anheuser-Busch (ABI BB)
- Heineken (HEIA NA)
- Pernod Ricard (RI FP)
- Davide Campari-Milano (CPR IM)
- Remy Cointreau (RCO FP)
- Fevertree Drinks PLC (FEVR LN)

All six competitors operate in the same five geographical markets as Diageo and offer an extensive portfolio of spirits and beers. The average market capitalisation of these six companies was £40.75bn, under half of Diageo at £88.22bn.

We selected relative valuation multiples that best captured the competitive landscape of the drinks industry. All figures are forward ratios, with data taken from Bloomberg in December 2022. For this we chose the forward Price-to-Earnings (P/E) ratio, which divides a firm's stock price by its Earnings Per Share (EPS). Compared to its peer's average of 22.92x, Diageo's P/E ratio of 19.87x was significantly lower. This indicates that Diageo may be undervalued in relation to its competitors, with a P/E price target above its current share price.

However, forward EV/EBITDA and EV/Revenue multiple valuation show the opposite. Both multiples value Diageo at a significant discount to its current share price, as they consider the levels of the company's debt and cash in addition to

Name	Forward P/E
Diageo PLC	19.87x
Anheuser-Busch InBev SA/NV	16.47x
Heineken NV	16.14x
Pernod Ricard SA	18.56x
Davide Campari-Milano NV	24.59x
Remy Cointreau SA	25.59x
Fevertree Drinks PLC	39.25x
Mean	22.92x
Median	19.87x

Name	Forward EV/EBITDA
Diageo PLC	15.41x
Anheuser-Busch InBev SA/NV	9.32x
Heineken NV	9.39x
Pernod Ricard SA	13.79x
Davide Campari-Milano NV	16.41x
Remy Cointreau SA	16.33x
Fevertree Drinks PLC	22.97x
Mean	14.80x
Median	15.41x

Name	Forward EV/Rev
Diageo PLC	5.47x
Anheuser-Busch InBev SA/NV	3.17x
Heineken NV	2.13x
Pernod Ricard SA	4.50x
Davide Campari-Milano NV	4.12x
Remy Cointreau SA	5.16x
Fevertree Drinks PLC	2.67x
Mean	3.89x
Median	4.12x

Fig. 42; Comparable Metrics used in Relative Valuation

Forward P/E	£3,838.89
Forward EV/EBITDA	£2,964.85
Forward EV/Rev	£2,086.96
Price Per Share	£2,963.57

Fig. 43; Relative Valuation Price Target Summary

its stock price. The Enterprise Value (EV) multiples are used to show if an asset is priced correctly in relation to its competitors, with a higher ratio indicating that a company may be overvalued. In both cases, Diageo maintains higher relative multiple figures than its peers, with an EV/EBITDA ratio of 15.41x compared to average of 14.80x, and EV/Revenue ratio of 5.47x in comparison to the mean of 3.89x.

A weighted average of these three key multiples gives Diageo a twelve-month price target of just £2,963.57, with a negative shareholder return of 22.13%.

Free Cash Flow to Equity

Sum dEFCF	£32,879.30
Terminal Value	£100,617.40
Enterprise Value	£133,496.69
(+) Cash & Cash Equivalents	£2,513.50
(-) Minority Interest	£1,767.48
(-) Total Debt	£16,668.80
Equity Value	£117,573.91
Basic Shares Outstanding	2,294.82
Price Target	£5,123.45

Free Cash Flow to Equity (FCFE) shows how much capital is generated by a company to be distributed to shareholders. This figure is used by prospective investors to see if payments are financed by debt or by free cash flows. Where dividend payments or stock repurchases are financed wholly by a firm's equity free cash flow, investors will have significantly more confidence in the outlook for the company. However, having completed the final share repurchase of their FY20-23 phase, potential investors can no longer expect to benefit from the company's ROIC programme (Diageo, 2022).

This valuation method uses elements from our previous calculations, such as the company's long-term Debt/Value target ratio of 20%. Our FCFE estimation assumes that Diageo will implement their D/V target in 2023, instead of over the coming financial years.

With a current equity value of £88.22bn, to implement the 20% D/V target in 2023 requires an increase in net debt of £3.91bn. This results in a larger FCFE figure in 2023 to account for the increased debt levels, followed by modest growth over the following years. Furthermore, we assume that debt levels grow with revenue from 2023 onwards, to be consistent with the targeting strategy of the firm.

By adding the sum of the discounted FCFE to our terminal value in 2030, we reach an enterprise value of £133.49bn for Diageo. This results in an equity value of £117.57bn, with a twelve month share price target of £5,123.45 for the company, with an upside potential of 34.62%. This represents a significant share price appreciation for the company and showcases the potential benefits of implementing their long-term debt targets over the next year. This further illustrates the benefits of increased debt financing for Diageo, to fund their aggressive M&A strategy.

Conclusion

We believe that Diageo PLC has significant potential to grow over the coming years. It is evident from the company's operations over the last decade that they will continue to be a powerhouse in the alcoholic beverages industry. Although sensitivity analysis of our valuation indicates that investor confidence in the company will fluctuate based on changes to growth rates and costs of capital, we firmly maintain that Diageo are uniquely positioned to take advantage of potentially volatile market conditions.

External factors will have less of an effect on Diageo as they control all aspects of their business operations. This insulates them from instability coming from currency risks, regulation and changing market conditions. Diageo distil, package, transport, and market their own products. This makes them fully independent and not reliant on others to succeed. Furthermore, the firm can benefit from additional synergies created by continuing their aggressive M&A strategy at all levels of their supply chain.

We believe that a twelve-month price target of £4,120.96 is an accurate portrayal of the firm's prospect over the coming year. This represents a total shareholder return of 10.44%, including capital gains and expected dividends.

Appendix

Reformulated Income Statement

In Millions GBP (£)	2020A	2021A	2022A	2023F	2024F	2025F
Regional Revenue						
North America	4,623	5,209	6,095	6,704	7,375	8,112
Africa	1,346	1,412	1,682	1,724	1,767	1,811
Europe & Turkey	2,567	2,558	3,212	3,340	3,474	3,613
Asia Pacific	2,270	2,488	2,884	2,941	3,000	3,060
Latin America & Caribbean	908	1,046	1,525	1,647	1,778	1,921
Corporate	38	20	54	65	78	93
Total Revenue	11,752	12,733	15,452	16,423	17,473	18,611
Regional Expenses						
North America	2,589	2,972	3,641	4,077	4,568	5,122
Africa	1,245	1,241	1,367	1,389	1,411	1,434
Europe & Turkey	1,810	1,923	2,195	2,294	2,398	2,507
Asia Pacific	1,769	1,880	2,173	2,248	2,326	2,406
Latin America & Caribbean	660	743	987	1,083	1,189	1,305
Corporate	185	228	292	315	341	368
Total Expenses	8,258	8,987	10,655	11,406	12,232	13,142
Operating Profit / EBIT	3,494	3,746	4,797	5,015	5,240	5,469

Balance Sheet

In Millions GBP (£)	2020A	2021A	2022A	2023F	2024F	2025F
Assets						
Current Assets	11,471	11,445	12,934	13,967	15,086	16,293
Non-Current Assets	21,837	20,508	23,582	24,643	25,752	26,911
Total Assets	33,308	31,953	36,516	38,342	40,259	42,272
Liabilities						
Current Liabilities	6,496	7,142	8,442	8,949	9,485	10,055
Non-Current Liabilities	18,372	16,380	18,560	20,416	22,458	24,703
Total Liabilities	24,868	23,522	27,002	28,892	30,915	33,079
Total Shareholders' Equity	8,440	8,431	9,514	9,450	9,344	9,193
Liabilities & Shareholders' Equity	33,308	31,953	36,516	38,342	40,259	42,272

Cash Flow

In Millions GBP (£)	2020A	2021A	2022A	2023F	2024F	2025F
Depreciation & Amortisation	494	447	828	657	699	744
Dividends Received	4	290	190	238	297	371
Share of After-Tax Results	282	334	417	446	477	511
Net Financial Expenses	353	373	422	452	483	517
Cash Generated from Operations	3,529	4,857	5,212	5,629	6,079	6,566
Net Working Capital	4,975	4,303	4,492	4,270	4,543	4,839
Inventories	(366)	(443)	(740)	(888)	(1,066)	(1,279)
Trade Receivables	523	(446)	(378)	(416)	(457)	(503)
Trade Payables	(485)	1,220	939	1,127	1,352	1,623
Cash Flow from Operations	2,320	3,654	3,935	4,289	4,675	5,096
Change in Assets	(686)	(613)	(1,080)	(918)	(780)	(663)
CAPEX	(700)	(626)	(1,097)	(903)	(961)	(1,024)
Cash Flow from Investing	(805)	(1,091)	(1,341)	(1,073)	(858)	(687)
Dividends Paid	(1,646)	(1,646)	(1,718)	(1,770)	(1,823)	(1,877)
Cash from Repayment Debt	4,083	(969)	821	1,026	1,283	1,604
Cash Flow from Financing	1,037	(2,794)	(3,259)	(2,281)	(1,597)	(1,118)

Free Cash Flow

In Millions GBP (£)	2020A	2021A	2022A	2023F	2024F	2025F
Revenue	11,752	12,733	15,452	16,423	17,473	18,612
Less Adjusted Expenses	8,258	8,987	10,655	11,407	12,233	13,142
Operating Profit / EBIT	3,494	3,746	4,797	5,016	5,241	5,470
Depreciation & Amortisation	494	447	828	657	699	744
EBITDA	3,988	4,193	5,625	5,673	5,940	6,214
EBITDA Margin	34%	33%	36%	35%	34%	33%
Tax Rate	29%	24%	24%	25%	25%	25%
Tax Expense	589	907	1,147	1,254	1,310	1,367
NOPLAT	2,905	2,839	3,650	3,762	3,930	4,102
CAPEX	700	626	1,097	903	961	1,024
NWC	4,975	4,303	4,492	4,270	4,543	4,839
Change in NWC	2,605	(672)	189	(222)	273	296
FCF	94	3,332	3,192	3,738	3,395	3,527

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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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