Silverman Sachs

City University of Hong Kong

EF4312 Mergers and Acquisitions

Silverman Sachs (Group 6)

Merger Proposal:

Diageo Inc.'s acquisition proposal for Anhui Kouzi Distillery Co., Ltd.

Group Number

Name	SID
LI Ruopan	57126351
CHAN Yau Yung	57156539
LAI Oi Ching	57137722
ZHAO Wanchao	56644513
HU Ziyan	56644261
CHIN Ming Kai Michael	56582820

Link to PPT: Presentation Sildes

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Part 1: Executive Summary

Diageo Inc is a leading company in the global spirits industry, owning world-renowned high-end brands such as Johnnie Walker, Smirnoff, Baileys, and Guinness. Within the industry, Diageo is uniquely positioned as the world's most famous alcoholic beverages manufacturer by offering integrated services, from distillation production and procession to sales.

In the global market, Chinese spirits (liquor) has exhibited the fastest growth rate worldwide. Hence, this acquisition aims to meet Diageo's expansion willingness in the Chinese market and further solidify its competitive position globally. Previously, Diageo had experienced challenges with the Chinese liquor brand Sichuan Swellfun Co., Ltd. However, Swellfun specializes in strong aroma (Nong Xiang) liquor, whereas in the Chinese spirits (baijiu) market, sauce aroma (Jiang Xiang) liquor is more popular and demonstrates higher growth rates and sales. Acquiring Anhui Kouzi Distillery Co., Ltd., a sauce aroma (Jiang Xiang) liquor brand, will help Diageo enhance its strategic positioning in the Chinese market. Compared to other companies, Kouzi Distillery boasts a long history and renowned brand, along with stable and sound financial performance. Meanwhile, Diageo's previous acquisition, Swellfun, had its influence primarily in western China. Kouzi Distillery, originating from the east, can assist Diageo in swiftly penetrating the eastern market.

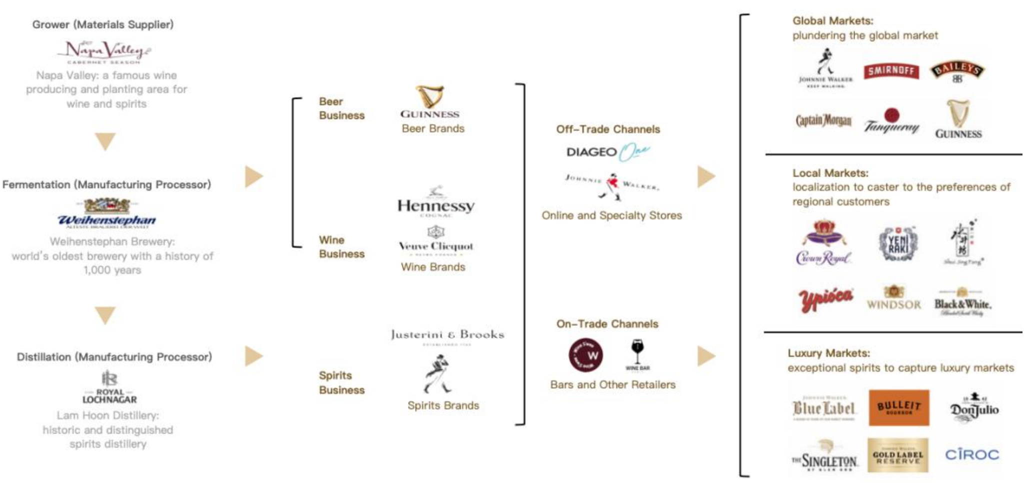
Silverman Sachs' analysts will provide a detailed assessment of the proposal, including synergies, competitor analysis, DCF and synergy valuation, payment structure, and potential risks. Analyzing business synergies, financial performance, and the post-merger synergies in revenue and costs will ensure Diageo in fulfilling its commitment to increasing investment in the Chinese market. This also reflects our income growth in optimistic, conservative, and worst-case scenarios in DCF calculations. Providing synergy valuation and sensitivity tests to support analysis and payment structure. The proposal considers Diageo's precedent transactions when making assumptions about the acquisition offer. Based on the analysis of DCF, Comparable (multiples), and precedent transactions, we propose a tentative offer price for Diageo's acquisition of Kouzi Distillery at ¥41.12 billion, with ¥16.21 billion in cash offer and the remaining ¥24.91 billion in stock offered (90 million shares of Diageo with an R ratio of 15%). With vigilance towards potential risks and due diligence, if the transaction succeeds, Kouzi Distillery could become another formidable entity under Diageo, both companies successfully achieving their long-term and short-term goals.

Part 2: Strategic Analysis and Background

2.1 Spirits Industry Analysis

The spirits industry may be separated into different sections which are sourcing and manufacturing, business categories, sales channels and eventually different target markets. For the manufacturing part, it concludes grower, fermentation and distillation. Without distillation, it mainly produces beer and wine, but spirits need to be distilled at the final step. Our customer, Diageo China Limited, also owns fermentation plants and distilleries in several countries to process raw materials. Although Diageo produces various champagne, wine and spirits, its main growth driver is the spirits business, accounting for 80% of its revenue. For the sales channels, it is divided into off-trade channels which contain online and specialty stores and on-trade channels which contain bars and restaurants. The main sales channel of Diageo spirits is off trade. Different spirits brands have clear target markets. They may target the global markets, local markets to cater to the preferences of regional customers, or luxury markets by launching exceptional flavors.

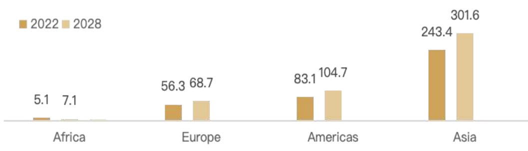
Chart 1: Spirits Industrial Chain



Source: Public Equity Research Report, Public Information

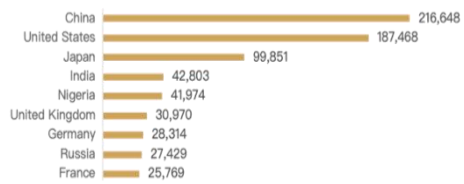
Diageo has a dominant position in both net income and spirits' market. However, there are various companies with similar genres based in different countries and cities, and the competition within the industry is still fierce. As a result, Diageo requires mergers and acquisitions to adapt to market changes and maintain its dominant position (see Appendix 1).

Chart 2: Market Size Prediction and CAGR



Source: Statista Spirits Industry Insights

Chart 3: Market Size Prediction by Region



Source: Statista Spirits Industry Insights

The spirit's market is experiencing significant growth and development, driven by changing customer preferences, emerging trends, special local circumstances, and underlying macroeconomic factors. The spirits' market revenue was estimated at USD

408.8 billion in 2023 and is expected to reach USD 779.5 billion by 2028, growing at a CAGR of 4% during the forecast period (2023-2028). With a revenue of USD 243.4 billion, Asia is the biggest market among selected regions in 2022, and China is the region with the highest revenue. As a result, Diageo decided to acquire Anhui Kouzi Distillery Co., Ltd.

2.2 Company Overview of Diageo

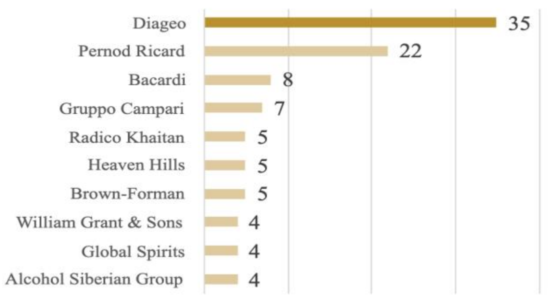
2.2.1 Company Review

Chart 4: Ownership Structure

Name	Ownership	Shares	Current Value
BlackRock, Inc.	7.76%	173,388,255	UK£4.8b
Massachusetts Financial Services Company	5.06%	113,119,662	UK£3.2b
The Vanguard Group, Inc.	4.39%	98,158,572	UK£2.7b
Norges Bank Investment Management	2.54%	56,750,819	UK£1.6b
FMR LLC	2.53%	56,485,642	UK£1.6b
Lindsell Train Limited	1.88%	41,906,980	UK£1.2b
Legal & General Investment Management Limited	1.71%	38,207,003	UK£1.1b

Source: Statista Spirits Industry Insights

Chart 5: Industry Competitive Situation



Source: Statista Spirits Industry Insights

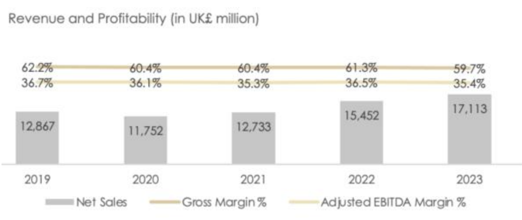
The largest shareholders in Diageo include institutional investors, one of them is BlackRock, Inc, which is also the largest institutional shareholder in Diageo, holding 7.76% and 173,388,255 shares that are worth CNY43.92 billion. Followed by Massachusetts Financial Service Company as the second largest shareholders, with 5.06% ownership and 113,119,662 shares which worth CNY29.28 billion. The third largest shareholder is The Vanguard Group, Inc, with 4.39% and 98,158,572 shares that are worth CNY24.7 billion. The fourth and fifth largest shareholders are Norges Bank Investment Management and FMR LLC, which hold 2.54% and 2.53% ownership respectively, with 56,750,819 and 56,485,642 shares. The sixth and seventh largest shareholders are Lindsell Train Limited and Legal & General Investment Management Limited, holding 1.88% and 1.71%, with 41,906,980 shares and 38,207,003 shares, worth CNY10.98 billion and CNY10.07 billion respectively.

Diageo is a leading player in the global alcoholic beverages industry, especially in net income and market, but still, it is facing fierce competition from other competitors. Merger and acquisition are a good way to adopt market changes and maintain its dominant position in the industry.

According to the market share of spirits company in 2020, Diageo holds 19% of the market share, which is the largest spirits company in the market, followed by Bacardi with 9%, also Beam Suntory and Pernod Richard with 8% in the market. It reflects that it is a highly concentrated market and the top 4 players accounted for about 45% of the market share.

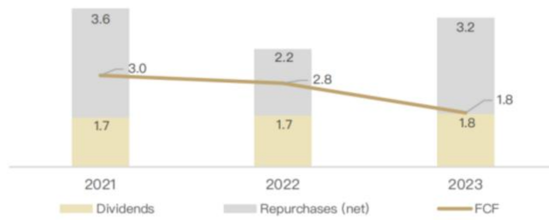
2.2.2 Financial Review

Chart 6: Revenue and Profitability



Source: Annual Report

Chart 7: FCF and Returns to Shareholders



Source: Annual Report

The positive financial performance of Diageo is resulted by robust revenue growth, increased gross profit, and growing EBITDA. However, it was offset by declining free cash flow, lower ROIC due to increased expenses, and drop in TSR driven by the reduced share price.

The EBITDA was in line with the revenue growth, and it was adjusted with lease interest and non-operating items to reflect the continuous profitability. The adjusted EBITDA margin percentage has fluctuated from 2019 to 2023 yet remains in 35-37%. It indicates that the company is generating a substantial operating profit relative to its revenue and suggests that the company is efficiently managing its costs and operating expenses. Achieving such a margin suggests that the company has efficient operations and is effectively managing its resources, including labor, materials, and overhead costs.

2.3 Company Overview of Kouzi Distillery

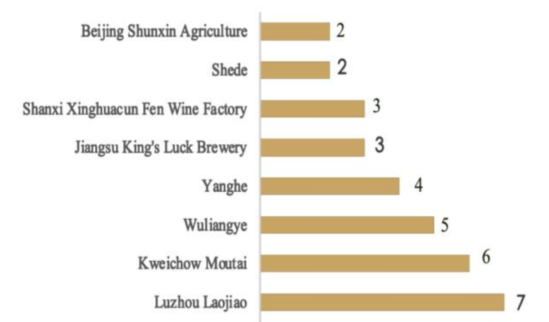
2.3.1 Company Review

Chart 8: Ownership Structure

Name	Ownership	Shares	Current Value
Jin Xu	18.4%	109,568,568	CNY4.6b
An Sheng Liu	11.7%	69,973,529	CNY2.9b
China Merchants Fund Management Company Limited	3.97%	23,708,002	CNY991m
Dajia Asset Management Co., Ltd.	2.09%	12,483,471	CNY521.8m
Shao Gang Huang	2.08%	12,411,743	CNY518.8m
China Asset Management Co., Ltd	2.04%	12,151,900	CNY507.9m
Bo Fan	1.71%	10,965,476	CNY458.4m

Source: Wind, East Money, Annual Report

Chart 9: Industry Competitive Situation



Source: Wind, East Money

The major shareholders of the company are individual insiders, which take 43.3% ownership and 258,439,821 shares. The second largest shareholder is the general public, with 39.6% ownership and 236,569,377 shares. The rest would be held by institutions, with 17.1% ownership and 101,856,588 shares. The top 25 shareholders own 57.78% of the company, which the CEO Jin Xu holds the most shares, which is around 18.4% ownership. He holds 69,973,529 shares and are worth CNY4.6 billion. An Sheng Liu, ranked second, holds 11.7% ownership and 69,973,529 shares that are worth CNY2.9 billion. The third largest shareholder is China Merchants Fund Management Company Ltd, with 3.97% ownership and 23,308,002 shares that worth CNY991.0 million.

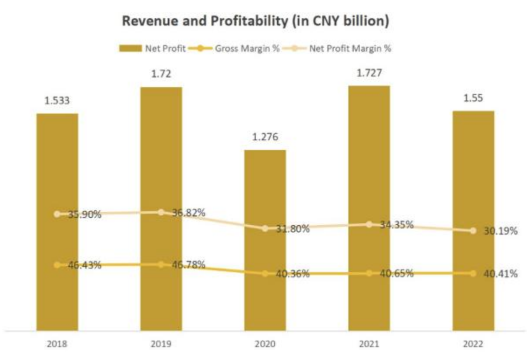
Anhui Kouzi Distillery Co., Ltd. is known as one of the prominent producers of baijiu, a traditional Chinese distilled liquor. The company likely holds a notable market position within this segment. Which baijiu continues to rule the Chinese spirits industry with 98% market share. As a result, the major competitors of Anhui Kouzi Distillery Co., Ltd are mainly baiju producers, large-scale companies and smaller regional distilleries. The current market share of high-end and mid-range segments domestically is approximately 16.9% and 20.8%, respectively.

According to the market share of baijiu company in 2022, Kweichow-Moutai Co Ltd holds 18.68% of the spirits market share in China, followed by Wuliangye Yibin Co., Ltd., accounting for 10.20%. Jiangsu Yanghe Brewery Joint-Stock Co Ltd ranked third, which takes 4.43%. Shanxi Xinghuacun Fen Wine Factory Co Ltd holds 3.93% and Luzhou Laojiao holds 3.74%. The top 5 players accounted for about 41% of the market share.

Although the overall supply and demand of Chinese liquor continue to decline, this decline is primarily concentrated in the mid-to-low-end products. Meanwhile, the proportion of demand for mid-to-high-end products continues to increase, driving the sustained growth of the Chinese liquor market. In terms of the current operational status of Chinese liquor companies, as competition in the domestic market continues to intensify, small and medium-sized enterprises are continuously exiting the market.

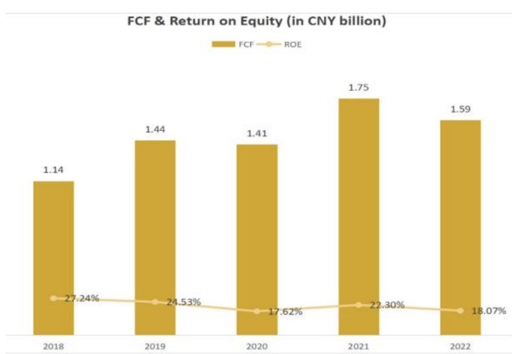
2.3.2 Financial Review

Chart 10: Revenue and Profitability



Source: Company Annual Reports

Chart 11: FCF and Returns to Shareholders



Source: Company Annual Reports, TradingView

From 2018 to 2022, the net profit of Anhui Kouzi Distillery Co., Ltd. followed a recurring trend. In 2020, it decreased to the lowest level probably because of the pandemic. After that, it went back to 1.55 billion which was similar to the net profit level in 2018. Overall, the gross margin and net profit margin slightly decreased to 40% and 30% respectively. It shows that Anhui Kouzi Distillery Co., Ltd. did not perform well in the last five years and the acquisition could stimulate Anhui Kouzi Distillery Co., Ltd. to perform better in the following years. Although the free cash flow increased from 1.14 billion to 1.59 billion from 2018 to 2022, the ROE decreased almost 10%. The declining ROE may show that Anhui Kouzi Distillery Co., Ltd. did not make good investment decisions and became less efficient at creating profits and increasing shareholder value.

2.4 Rationale of the Deal

Previous Acquisition Experience and Market Knowledge

Diageo's prior acquisition of Sichuan Swellfun Co., Ltd. (Shui Jing Fang), a renowned strong aroma baijiu (Liquor) brand, has provided it with deep insights into the Chinese market. This experience is critical, as it has given Diageo a nuanced understanding of the complexities of market dynamics, consumer preferences, and the regulatory environment in China. Successfully integrating and growing Sichuan Swellfun under Diageo’s umbrella demonstrates the company's ability to manage and scale local brands on an international stage.

Dedication to Increased Investment in the Chinese Market

Highlighted in Diageo's 2023 director meeting was a strategic focus on escalating investments within the Chinese market, signaling the company's dedication to enlarging its market presence in one of the globe's largest and most rapidly expanding spirits markets. This strategy indicates Diageo’s commitment to seizing emerging market opportunities and underscores its long-term vision for growth in Asia.

Growth and Market Share of Sauce Aroma (Jiang Xiang) Baijiu (Liquor)

The sauce aroma (Jiang Xiang) baijiu segment, in which Anhui Kouzi Distillery Co., Ltd. operates, is growing faster and commands a larger market share than the strong aroma (Nong Xiang) baijiu and other aroma categories. This growth signifies a shift in consumer tastes and presents an opportunity for Diageo to assume leadership in this premium segment. By acquiring Anhui Kouzi Distillery Co., Ltd., Diageo would tap into a thriving category, thereby diversifying its product range and securing a significant market share in a lucrative sector.

Geographical and Brand Diversification

Anhui Kouzi Distillery Co., Ltd.’s robust presence in Eastern China complements Sichuan Swellfun’s (Nong Xiang) influence in the West (which are different from the flavors), offering Diageo comprehensive coverage across China’s vast market. Anhui Kouzi Distillery Co., Ltd. 's standing as a distinguished sauce aroma baijiu brand and its reputation as one of the few renowned private baijiu entities add considerable brand equity and consumer allegiance to Diageo’s portfolio, enhancing its market position in China’s competitive spirits arena.

Financial Valuation and Acquisition Opportunity

Currently, Diageo's market valuation is perceived to be on the lower end, and an acquisition could serve as a significant boost to its stock price. At the close of 2023, Diageo's board was actively exploring acquisition opportunities, indicating a strategy to leverage its market stature and financial robustness to drive growth through strategic acquisitions. The purchase of Anhui Kouzi Distillery Co., Ltd., particularly given its appealing valuation and earnings multiple, represents a strategic investment to enhance shareholder value.

Strategic Positioning in China

The acquisition of Anhui Kouzi Distillery Co., Ltd. would substantially enhance Diageo's strategic positioning within China by providing a diversified portfolio across both the sauce and strong aroma baijiu segments, as well as achieving a balanced geographical presence. This strategic move would fortify Diageo's capacity to cater to a wider array of consumer preferences and exploit regional growth opportunities throughout China.

Synergies and Operational Efficiency

The merger is anticipated to yield considerable synergies, including operational efficiencies, cost reductions, and an expanded distribution network. Merging Anhui Kouzi Distillery Co., Ltd.’s local expertise with Diageo’s global supply chain and marketing prowess could lead to improved product development, branding, and market penetration efforts. These synergies would not only boost the combined entity's competitive edge but also lead to increased profitability and long-term value generation.

2.5 Alternative Analysis

2.5.1 Peer comparison

Anhui Kouzi Distillery Co., Ltd. has a strong presence in the baijiu market, particularly within Anhui Province and potentially in other regions of China. It is positioned in the alcoholic beverages industry. The company has a significant presence within Anhui Province, China, where it is headquartered. The company may also have distribution networks extending to other regions within China, although its primary focus could be on serving local and regional markets.

Hebei Hengshui Laobaigan Liquor Co., Ltd has a similar business model to Anhui Kouzi Distillery Co., Ltd., and they both belong to the second tier (according to revenue). However, Anhui Kouzi Distillery Co., Ltd reformed to achieve the construction of the brand core. The company also focuses on cultivating strategic flagship products. With a revenue scale of 5 billion CNY, it indicates that the company has at least one super core market. While at the same time, Hebei Hengshui Laobaigan Liquor Co., Ltd was facing fierce competition and the risk of being squeezed out of the market by high-end Baijiu due to several reasons, including continuous strengthening of public health consciousness and the upgrading of consumption. Despite Hebei Hengshui Laobaigan Liquor Co., Ltd spent a significant amount on marketing expenses, the progress in achieving high-end and nationwide expansion has not been very smooth.

2.5.2 Financial Comparison

Anhui Kouzi Distillery Co., Ltd's current and quick ratios are 2.8621 and 0.8938 respectively. which is better than the current and quick ratios of Hebei Hengshui Laobaigan Liquor Co., Ltd. It implies its ability to pay the short-term debt is strong. Having high liquid assets also provides benefits for Diageo China to acquire Anhui Kouzi Distillery Co., Ltd to proceed with the deal. Anhui Kouzi Distillery Co., Ltd shows higher net working capital over total asset ratio compared to the competitors, showing that Anhui Kouzi Distillery Co., Ltd has lower liquidity risk in the future.

Anhui Kouzi Distillery Co., Ltd demonstrates lower financial risk by holding the lowest debt to equity ratio. Anhui Kouzi Distillery Co., Ltd's growing net income and OCF to debt ratio shows a healthy business. The net profit margin reached 29.16%, which is a satisfactory performance. It indicates that Anhui Kouzi Distillery Co., Ltd does not rely on issuing debt to finance their business. The gross margin is 66.91% and suggests that the company is effectively managing its production costs and generating a healthy profit on each unit sold.

Anhui Kouzi Distillery Co., Ltd's net margin has the largest growth, which has increased 35.61% compared to last year, while Hebei Hengshui Laobaigan Liquor Co., Ltd has 21.46%. It indicates that the company is generating a larger profit relative to its total revenue. This reflects the fact that Anhui Kouzi Distillery Co., Ltd is more profitable compared to its competitors of the same level. Given the data of operating margin, Anhui Kouzi Distillery Co., Ltd performs the best, which has 46.7% growth, which is higher than Hebei Hengshui Laobaigan Liquor Co., Ltd (18.64%).

Yet the company may perform less outstanding in efficiency, as its receivables turnover and total asset turnover are lower, with 9.06 and 0.39 respectively. Hebei Hengshui Laobaigan Liquor Co., Ltd has 13.54 receivables turnover and 0.4 total asset turnover.

In terms of total debt to EBITDA, Anhui Kouzi Distillery Co., Ltd is 0.18, which has a better performance. Hebei Hengshui Laobaigan Liquor Co., Ltd is with 0.3. It indicates that the company has a lower level of debt relative to its earnings and with a lower debt burden, hence reducing its financial risk.

Briefly conclude that Anhui Kouzi Distillery Co., Ltd performs well in liquidity and profitability, proving that its strong financial performance and growth potential could benefit Diageo from entering the China market while comparing with other competitors (Shede, Jiuguijiu, JKL).

Part 3: Valuation

3.1 Future Financial Performance Projection

3.1.1 Revenue Projection

Extracted from Kouzi Distillery Co., Ltd's annual report from 2018 to 2022, we have the year-on-year growth rate of the company's revenue. From 2017 to 2019, Kouzi distillery's revenue saw a stable growth, with 18.50% and 9.44% respectively. However, with the impact of Covid-19, the company suffers a decline in earnings in 2020. After 2021 there is a resilience in the company's business. The 5-year CAGR from 2017 to 2022 is calculated as 7.35%. Based on Bloomberg consensus prediction, we assume the revenue is CNY 6060.6 million and 7043.9 million respectively in 2023 and 2024, with the growth rate of 18.02% and 16.22%.

Chart 12: Revenue and Operating Margin Consensus Prediction

(in Million CNY)	2017Y	2018Y	2019Y	2020Y	2021Y	2022Y	2023E	2024E
Revenue	3602.6	4269.0	4672.1	4011.1	5028.6	5135.1	6060.6	7043.9
yoy%		18.50%	9.44%	-14.15%	25.37%	2.12%	18.02%	16.22%

Source: Bloomberg

Therefore, in the conservative case, we take Bloomberg forecasting sales as the 2023 and 2024 estimated revenue, which are 6060.6 and 7043.9. Meanwhile, we assume the revenue maintains strong in 2025 being 12.25%, and then decline to 7.35% in 2026 and 2027, with the perpetuity of 3.00%. Besides,

3.1.2 EBITDA Projection

For the operating margin, it was 39.97%, 40.37%, 39.63%, 39.88% and 40.46% respectively in the recent 5 five years according to Bloomberg, therefore we assume it will be 40% in the next years and in perpetuity. According to relevant polices, the tax rate is projected to be 25%. As found in the annual report of Kouzi Distillery, the account receivable, payable and inventory of the last reporting period are CNY 343.38, 805.92 and 4210.83 million. As we have the total revenue in 2022 to be 5135.1, we can calculate the working capital ratio as 0.73.

For the depreciation, we assume the capital expenditure will increase by CNY 25 million annually for every situation. For the capital expenditure CAPX, based on the company's capital expenditure record over the past five years, we assume the capital expenditure will increase by CNY 90 million annually for every situation, as the company is significantly increasing CAPX amounts post-pandemic. The depreciation at the ending balance of year 2022 is CNY 208.28 million, and we assume the depreciation will increase by 25 million each year. After that, we can project the net cash flow for the future years.

3.1.3 Ratios

Firstly, we computed the five-year return of Kouzi Distillery Co., Ltd to be 8.47%. And we adopted the five-year Chinese treasury bond return as the risk-free return, which is 2.20%. By referring to Wind, we obtained the recent five years' Beta of Chinese spirits market to be 0.65. Then we quoted the size premium as 3.12% from IDC industrial research report for further calculations. In the annual report, we extracted the company's financial data, and computed the equity cost and debt cost to be 8.30% and 3.70% respectively. Also, in the balance sheet, we calculated the equity weight and debt weight to be 77.20% and 22.80%.

3.2 DCF Analysis

3.2.1 DCF Valuation in Conservative Situation

Chart 13: DCF Analysis in Conservative Situation

Unit: Million CNY							
	2022	2023E	2024E	2025E	2026E	2027E	Perp
Sales	5,135.10	5,752.60	6,342.24	6,849.62	7,260.60	7,551.02	7,626.53
Sales Growth	0.02	0.12	0.10	0.08	0.06	0.04	0.01
EBIT	2,034.98	2,416.70	2,849.90	2,739.85	2,904.24	3,020.41	3,050.61
Operating Margin	0.40	0.42	0.45	0.40	0.40	0.40	0.40
acc NOPAT	1,526.23	1,812.53	2,137.43	2,054.89	2,178.18	2,265.31	2,287.96
Inc WC - 73%	77.74	450.73	430.40	370.35	299.99	211.99	55.12
Cash NOPAT	1,448.49	1,361.79	1,707.03	1,684.53	1,878.19	2,053.32	2,232.84
CAPX -	90.36	180.36	270.36	360.36	450.36	540.36	
Depreciation +	208.28	228.28	248.28	268.28	288.28	308.28	
NCF	1,566.41	1,409.71	1,684.95	1,592.45	1,716.11	1,821.24	1,897.92
Disc factor	1.00	0.93	0.87	0.81	0.76	0.70	
PV NCF	1,566.41	1,314.37	1,464.74	1,290.71	1,296.87	1,283.23	
SUM PV NCFs	6,649.93						
Terminal Value						36,125.47	
PV Term Value	25,453.80						
PV All Cash Fls	32,103.73						
Cash +	1,588.79						
LT Debt -	178.34						
Legal Liability -	–						
Total Equity	33,514.18						
Number of shares	600.00						
Stock Price	55.86						

Source: Bloomberg, Wind, Silverman Sachs's Valuation

According to the estimation by Bloomberg, we set the sales to be 5,752.60 million CNY and 6,342.24 million CNY in 2023 and 2024, indicating YOY growth rates of 12% and 10%, respectively. China's liquor industry will gradually enter a cooling-off period after its complete recovery in 2024, with projection growth rates of 8%, 6%, 4%, and perpetuity of 1% in conservative situation. In this scenario, the intrinsic price of Kouzi Distillery is ¥55.86 per share, compared to the current market price of ¥41.82 per share.

3.2.2 DCF Valuation in Optimistic Situation

In the most optimistic situation, the estimated sales growth in 2023 is projected to be 18%, which is the same as one of the highest sales growth companies in the industry. As the expectation of the popularity of the liquor market after 2024 weakens, the growth rate will gradually reduce to around 5% till 2027, and perpetuity growth will finally come to around 2%. In this scenario, the intrinsic price of Kouzi Distillery is ¥62.86 per share (see Appendix 1).

3.2.3 DCF Valuation in Pessimistic Situation

However, if the sales fall unexpectedly, the worst case that we estimated is the sales growth in 2023 will drop to 8%, referring to a sales growth rate of 18% indicated in the fiscal report of Q3, followed by decreasing growth rates of 6%, 5%, 4% 3% and projected perpetuity of 1%. In this scenario, the intrinsic price of Kouzi Distillery is ¥50.61 per share (see Appendix 2).

3.3 Multiples Analysis

3.3.1 Comparable Companies Selection

We select a list of companies for conducting a multiples valuation analysis including Kouzi Distillery, Kweichow Moutai, Wuliangye, Shanxi Xinghuacun Fenjiu, Sichuan Swellfun as well as the Industry Average. The companies have shared characteristics:

1.Similar Product Type and Business Model: all selected companies mainly manufacture sauce-flavor Chinese spirits, thereby sharing similar product market and business model, and subject to similar market risks and environment.
2.Market Capitalization: the selected companies have a substantial market capitalization and share similar operation scales and financial resources.
3.Market Positioning: the selected companies are premium brands in the markets, sharing similar market positioning strategy and segment of target consumers.
4.Reginal Enterprises: while Diageo is a global company, the selected companies are private enterprises (except Kweichow Moutai) from China and have significant presence in the East Asian market. This offers great referential value for analyzing Diageo's performance in this region if it acquires Kouzi Distillery.

3.3.2 Multiples Valuation Analysis

Chart 14: Multiples Analysis

		PE		EV/EBITDA (multiples)
Stock Short Name	TTM	23E	24E	
Kouzi Distillery	14.62	13.90	11.84	11.06
Kweichow Moutai	30.24	29.10	24.48	24.44
Wuliangye	20.44	19.95	17.63	16.75
Shanxi Xinghuacun Fenjiu	29.78	29.52	23.70	28.96
Sichuan Swellfun	19.97	18.75	15.76	13.91
Industry Average	33.23	179.89	22.40	26.28

Source: Bloomberg

Using the expected P/E ratio, the estimated intrinsic value of a stock = Earnings per share (EPS) × (1 + r) × P/E ratio = 2.82*1.38*13.9 = 54.09. Compared with the DCF valuation ranging from 50.61 to 62.86, the estimated intrinsic value of a stock is within the DCF valuation range, yet the estimated enterprise value per share is valued relatively much lower than the DCF valuation range. From Chart 17, it can also be seen that the valuation of Kouzi Distillery would be much lower than the other selected companies and the industry average. It is therefore submitted that it is a good chance now for Diageo to acquire Kouzi Distillery.

3.4 Synergy and Sensitive Analysis

3.4.1 Synergies

The merger is anticipated to yield approximately ¥21859.05 million synergies in a conservative scenario. Our assessment encompasses three types of synergies. Initially, cost synergies are expected to enhance Kouzi Distillery's leverage in negotiations with suppliers, potentially reducing purchasing costs by 50% over the next five years and 5% indefinitely. Another synergy arises from the correction of Kouzi Distillery's valuation, manifesting primarily in the initial year post-merger. This is computed by comparing the current stock price with the implied valuation derived from discounted cash flow analysis, multiplied by the total shares outstanding, to ascertain the total misevaluation synergy. Additionally, revenue synergy is foreseen, with the merger facilitating an annual sales growth of 60% and 1% in perpetuity, attributed to Diageo's expanded customer base. By summing these synergies over five years, incorporating perpetuity, and factoring in merger costs for the initial year, the present value is estimated at approximately ¥23036.75 million when the discount rate and growth rate are projected to be 6% and 4%, respectively. Analogously, optimistic and pessimistic scenarios yield synergies of ¥31440.87 million and ¥16722.47 million (see Appendix 4 and 5).

Chart 15: Synergy in Conservative Scenario (r = 6%, g = 4%)

(in Million CNY)	2024	2025	2026	2027	2028	Perp
Revenue Synergy	3451.56	3805.34	4109.77	4356.36	4530.61	76.27
Cost Synergy	38.87	225.37	215.20	185.18	150.00	10.60
Misvaluation	842.40	0.00	0.00	0.00	0.00	0.00
Sum of Synergies	4332.83	4030.71	4324.97	4541.54	4680.61	86.86
Discount Factor	0.96	0.92	0.89	0.85	0.82	
PV Synergy	4166.18	3726.62	3844.88	3882.12	3847.12	
Sum PV	19466.93					
TV					4343.24	
Present Valua of TV	3569.83					
Total PV Synergy	**23036.75**					

3.4.2 Synergy Sensitivity Analysis Matrix

Chart 16: Sensitivity Analysis

Conservative		Discount Rate							
	23036.75	0.06	0.07	0.08	0.09	0.1	0.11	0.12	0.13
Growth Rate	0	23358.40	23151.58	22996.46	22875.82	22779.30	22700.33	22634.53	22578.84
	0.01	22909.73	22634.24	22437.46	22289.87	22175.08	22083.25	22008.11	21945.50
	0.02	22599.53	22206.15	21943.90	21756.57	21616.08	21506.81	21419.39	21347.87
	0.03	22534.23	21909.81	21535.16	21285.39	21106.98	20973.18	20869.11	20785.85
	0.04	23036.75	21846.81	21251.84	20894.86	20656.87	20486.88	20359.38	20260.22
	0.05	25728.34	22325.30	21190.96	20623.78	20283.48	20056.61	19894.56	19773.02

Optimistic		Discount Rate							
	31440.87	0.06	0.07	0.08	0.09	0.1	0.11	0.12	0.13
Growth Rate	0	29118.34	28611.70	28231.72	27936.18	27699.75	27506.30	27345.10	27208.69
	0.01	28851.36	28176.49	27694.44	27332.90	27051.70	26826.74	26642.69	26489.31
	0.02	28885.82	27922.17	27279.74	26820.86	26476.70	26209.02	25994.87	25819.66
	0.03	29484.63	27955.01	27037.24	26425.39	25988.36	25660.59	25405.65	25201.70
	0.04	31440.87	28525.91	27068.43	26193.95	25610.95	25194.53	24882.22	24639.30
	0.05	38727.93	30391.62	27612.85	26223.47	25389.84	24834.09	24437.12	24139.39

Pessimistic		Discount Rate							
	16722.47	0.06	0.07	0.08	0.09	0.1	0.11	0.12	0.13
Growth Rate	0	16764.17	16599.42	16475.86	16379.75	16302.87	16239.97	16187.55	16143.19
	0.01	16464.25	16244.79	16088.04	15970.47	15879.03	15805.88	15746.03	15696.15
	0.02	16271.96	15958.60	15749.69	15600.47	15488.56	15401.51	15331.88	15274.90
	0.03	16272.24	15774.84	15476.39	15277.43	15135.32	15028.73	14945.83	14879.51
	0.04	16722.47	15774.59	15300.64	15016.27	14826.70	14691.28	14589.72	14510.73
	0.05	18914.26	16203.45	15299.84	14848.04	14576.96	14396.24	14267.16	14170.34

Recognizing the significant impact that both the Weighted Average Cost of Capital (WACC) and the growth rate have on the calculated present value of synergies—due to their roles as the denominator in discounting future cash flows—we proceeded to perform a sensitivity analysis. This analysis explored a range of discount and growth rates, varying from 6% to 13% and 0% to 5%, respectively.

After we gave the different projections of the probabilities of each level of rates under the three situations, the present value of synergies across conservative, optimistic, and pessimistic scenarios are calculated to be ¥21859.05 million, ¥28502.70 million, and ¥15632.08 million CNY, respectively. It is also noted that by holding the growth rate constant, the present value of synergy decreases as the WACC increases. Consequently, a smaller gap between the WACC and the growth rate leads to a higher present value of the generated synergy.

Part 4: Deal Design and Risk Management

4.1 Deal Structure, Pricing and Payment

4.1.1 MVBS Analysis

We obtained Diageo's recent cash, EV, debt and equity from its last corporate report. We used the financial data published by Diageo on the London Stock Exchange. To unify calculations, we converted currency units into CNY. The exchange rate is the real-time exchange rate between GBP and CNY, which is 9.15. At the same time, to maintain time consistency, we obtain Kouzi Distillery's 2023 financial data based on the Wind consensus forecast.

Chart 17: MVBS Analysis – Diageo (in Billion CNY)

Shares Outstanding (N)	*2,230,000,000*	*Current Price*	*274.4 CNY (30.0 GBP)*
MVA		MVL	
Cash (C)	23.74	Debt (D)	155.10
Enterprise Value (EV)	743.25	Equity (E)	611.89

Source: Yahoo Finance (DEG.LSE)

Chart 18: MVBS Analysis – Kouzi Distillery (in Billion CNY)

Shares Outstanding (N)	*600,000,000*	*Current Price*	*41.82 CNY*
MVA		MVL	
Cash (C)	0.96	Debt (D)	5.60
Enterprise Value (EV)	29.31	Equity (E)	24.67

Source: East Money (603589.SH)

According to our DCF valuation, Kouzi Distillery's intrinsic value is approximately from 33.51 to 44.42 billion CNY. Therefore, Diageo would need to offer a total deal consideration of above that amount to acquire Kouzi Distillery. As Kouzi Distillery may look for a near-term sale, Diageo needs to pay a control premium to fend off outside interest. However, Diageo only has 23.74 billion on account at present. Consequently, we will assume that Diageo will also proposal a mixed offer to acquire Kouzi Distillery.

4.1.2 Payment Structure

Besides, we analyzed Diageo's precedent transaction of acquiring Sichuan Swellfun Co., Ltd. Diageo acquired Swellfun in 2013 with all cash payments, a tender offer to acquire 295 million shares of Swellfun at CNY 21.45 per share, bringing the total price to CNY 6.318 billion, and synergy around 3%. Therefore, the projection of merging Kouzi Distillery at a synergy of 2.83% is reasonable. A total deal consideration worth 41.12 billion CNY would be put forward by Diageo (calculated using the allocated synergy % to each firm), and the deal structure would be a cash-stock mixed method that consists of the following:

1.Total Deal Consideration: ¥41.12 billion
2.Cash offered: ¥16.21 billion
3.Stock Offered: 90 million shares of Diageo worthing ¥24.91 billion, with R ratio 15%

Chart 19: MVBS Analysis – New-Co (in Billion CNY)

Shares Outstanding (N)	*2,320,000,000*	*Current Price*	*276.82 CNY*
MVA		MVL	
Cash (C)	8.49	Debt (D)	160.7
Enterprise Value (EV)	794.42	Equity (E)	642.21

Source: Silverman Sachs

The table above shows the balance sheet of the new company after the merger using the indicated strategy. The new company still has enough cash (i.e. Around 8.5 billion) to finance its operations.

Since no debt is raised to finance the acquisition, the total debt remains unchanged. Enterprise value is calculated by adding the EVs of two companies to the synergy value.

The merger activity will be an obvious accretion since:

1. The control premium is 11.81 billion CNY, smaller than the total synergy, which is 21.86 billion, indicating a net gain of 10.05 billion to the bidder company.
2. The stock price of the new company is 276.82 CNY, higher than the bidder company's stock price, which is 274.4 CNY, meaning a potential increase in market value after a merger.

4.2 Financing Plan and Credit Impact

There is no financing plan needed as the merger plan does not involve new issuance of debt to finance the deal. The deal is fully funded by cash and stock of Diageo. Kouzi Distillery has a debt to EBITDA ratio of 0.18, indicating that its debt burden in relation to its earnings is at a relatively low and healthy level that would not materially affect the financial health of the merged entity. However, an area of concern might be that the cash level of the merged entity is 10.02 billion CNY, which is less than half of the cash held by Diageo pre-merger, raising some concerns whether the cash is enough to meet short-term liabilities by Diageo and as reserves for any unexpected scenarios. As such, the credit impact of the deal to the merged entity is minimal but there may be concerns for the low level of cash.

4.3 Diligence Issue and Risk Management

Legal Due Diligence

In Diageo's acquisition of Kouzi Distillery, legal due diligence is paramount, especially given the rigorous regulatory environment in China. Diageo must conduct a thorough review of Kouzi's compliance with the complexities of Chinese laws, including the Foreign Investment Law of the People's Republic of China and applicable local statutes. It's imperative to scrutinize Kouzi's contractual obligations for any liabilities or restrictions that may affect future operations.

Litigation risks should also be assessed to preclude unforeseen legal complications post-acquisition. When foreign companies aim to acquire A-share listed Chinese companies, obtaining approval from the Ministry of Commerce is mandatory, in accordance with the "Provisions on the Merger and Acquisition of Domestic Enterprises by Foreign Investors." This process involves an evaluation of the transaction from various angles, including its economic impact and potential issues related to national security.

Considering Kouzi's size and the competitive landscape of the baijiu market, regulatory resistance is not anticipated. The precedent of Diageo's prior approval for acquiring a stake in Shui Jing Fang suggests a positive outlook for the deal's authorization, provided it passes the review of anti-competitive effects by the competition authorities.

Financial Due Diligence

The financial health of Kouzi Distillery is a critical concern for Diageo. A meticulous audit of the financial statements over the past several years will provide insight into the company's profitability, cash flow stability, and overall financial resilience. Tax compliance is another area of focus. Diageo must ensure that Kouzi has been compliant with all tax obligations to prevent future liabilities from arising post-acquisition. The valuation process also demands attention; it is paramount that Diageo arrives at a fair market value for Kouzi Distillery, which involves ensuring that the assumptions and data involved in the various methodologies such as discounted cash flow analysis, comparable company analysis, or precedent transactions are accurate and applicable. In addition to outsourcing financial due diligence to a firm, we and Diageo should also conduct a detailed investigation of the company to eliminate the possibility of hidden debts and financial fraud.

Operational Due Diligence

Operational due diligence delves into the very heart of Kouzi Distillery's day-to-day functioning. Diageo must evaluate the robustness of the supply chain and the efficiency of production facilities. Understanding the operational workflow, from raw material procurement to product distribution, is essential to anticipate any integration challenges. Additionally, the state of Kouzi's current technology and infrastructure must be assessed to ensure it aligns with Diageo's standards (ie. Hygiene, Safety, ESG etc.) and strategic direction.

Antitrust

The Anti-Monopoly Law of the People's Republic of China provides the legal framework for the regulation of mergers and acquisitions. Any concentrations (which are defined as including the acquiring of control of other undertakings) which meet the threshold requirement must be notified to the Anti-Monopoly Bureau ('AMB') and approved before taking effect. The threshold requirements are i) the aggregate global turnover of all the undertakings to the concentration exceeds RMB10 billion and each of at least two of the undertakings to the concentration has a Chinese turnover of at least RMB400 million; or ii) The aggregate Chinese turnover of all the undertakings to the concentration exceeds RMB2 billion and each of at least two of the undertakings to the concentration has a Chinese turnover of at least RMB400 million.

As Diageo has a global turnover over RMB10 billion and both Diageo and Kouzi Distillery has a Chinese turnover of over RMB400 million, this acquisition is a transaction that has to be notified to the AMB. Diageo has to submit a written declaration, explanation of the effect of the concentration on the relevant market, and the audited financial statements of the entities involved in the concentration.

Shareholder Approval from Both Buyer and Target

For the Buyer, Diageo, the stakes are multifaceted. Having previously acquired Sichuan Shujingfang, another player in the Chinese baijiu market, Diageo has already cultivated a substantial understanding of the local industry landscape. Shareholders must weigh the potential benefits of further insight against the possibility of diminishing returns in terms of new market knowledge. There is also the consideration of how this acquisition may overlap with the previous one, potentially leading to reduced synergies. Furthermore, the financial aspect of the deal is of paramount importance, with shareholders scrutinizing the cost implications and the expected return on investment.

On the Seller's side, the primary concern for Kouzi Distillery's shareholders is the proposed price of the deal and ensuring it reflects the true value of their investment.

Additionally, should the transaction include a share transfer, they must consider the inherent risks, such as the long-term prospects of the acquiring company's stock and the impact on shareholder value.

Integration Issues

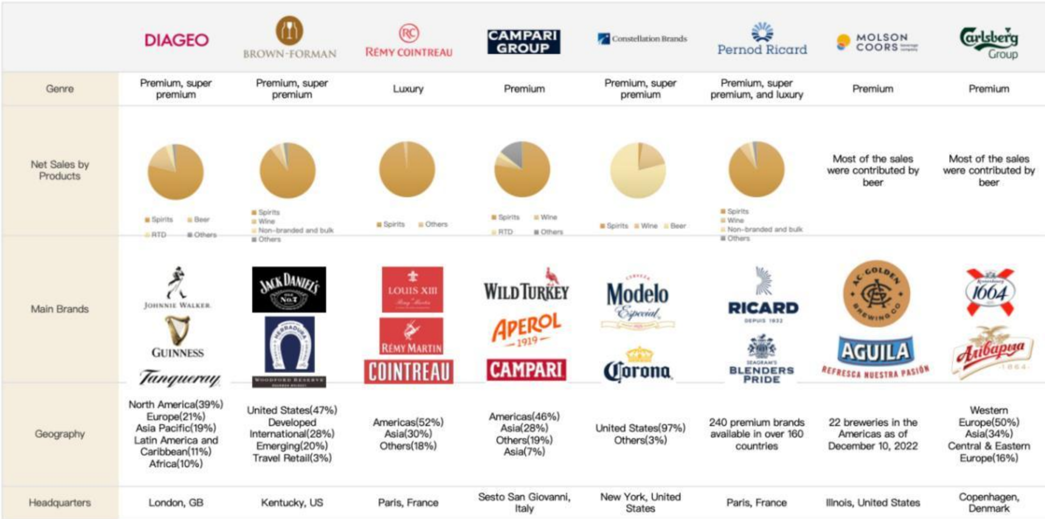
Kouzi Distillery is a mainland brand of baijiu. This is hugely dissimilar to Diageo which operates internationally selling multitudes of varieties of Spirit. The integration of the two entities brings its own set of risks. Differences in corporate culture, business processes, and systems can hinder the seamless merger of operations. Developing a detailed integration plan, with clearly defined milestones and responsibilities, is crucial for managing this risk. Cultural compatibility is often a neglected factor in the success of mergers and acquisitions. Diageo must consider the management styles, employee relations, and organizational cultures of both companies. The integration of Kouzi Distillery into Diageo's corporate structure should not undermine the intrinsic value that Kouzi's brand identity holds in its home market.

Intellectual Property

Due diligence on Kouzi Distillery's purchase should prioritize verifying its intellectual property (IP) ownership regarding its baijiu products. This step is crucial to safeguard the acquisition's primary asset—the baijiu recipe. It's essential to confirm the type of IP protection (patents, trade secrets, copyrights) Kouzi uses and ensure it's enforceable in China. The process must assess measures to keep the recipe confidential, such as employee agreements and security protocols. If the recipe isn't formally IP protected, these internal controls' effectiveness against unauthorized disclosure is paramount. The inquiry should also cover trademarks and proprietary production technologies. Ensuring trademarks and patents are valid and unchallenged is necessary to maintain brand value and production post-purchase. Lastly, checking Kouzi's IP litigation history can highlight potential vulnerabilities in their IP strategy, influencing future IP management. Addressing any IP protection gaps is vital for the distillery's value and the baijiu recipe's long-term security.

5. Appendix

Appendix 1: Competitive Landscape



	DIAGEO	BROWN-FORMAN	RÉMY COINTREAU	CAMPARI GROUP	Constellation Brands	Pernod Ricard	MOLSON COORS	Carlsberg Group
Genre	Premium, super premium	Premium, super premium	Luxury	Premium	Premium, super premium	Premium, super premium, and luxury	Premium	Premium
Net Sales by Products	Spirits, Beer, RTD, Others	Spirits, Wine, Non-branded and bulk, Others	Spirits, Others	Spirits, Wine, RTD, Others	Spirits, Wine, Beer	Spirits, Wine, Non-branded and bulk, Others	Most of the sales were contributed by beer	Most of the sales were contributed by beer
Main Brands	Johnnie Walker, Guinness, Tanqueray	Jack Daniel's, Herradura, Woodford Reserve	Louis XIII, Rémy Martin, Cointreau	Wild Turkey, Aperol, Campari	Modelo Especial, Corona	Ricard, Blenders Pride	AC Golden, Aguila	1664, Алівария
Geography	North America(39%) Europe(21%) Asia Pacific(19%) Latin America and Caribbean(11%) Africa(10%)	United States(47%) Developed International(28%) Emerging(20%) Travel Retail(3%)	Americas(52%) Asia(30%) Others(18%)	Americas(46%) Asia(28%) Others(19%) Asia(7%)	United States(97%) Others(3%)	240 premium brands available in over 160 countries	22 breweries in the Americas as of December 10, 2022	Western Europe(50%) Asia(34%) Central & Eastern Europe(16%)
Headquarters	London, GB	Kentucky, US	Paris, France	Sesto San Giovanni, Italy	New York, United States	Paris, France	Illnois, United States	Copenhagen, Denmark

Source: Public Information Organizing

Appendix 2: DCF Analysis in Optimistic Situation

Unit: Million CNY	2022	2023E	2024E	2025E	2026E	2027E	Perp
Sales	5,135.10	6,060.60	7,043.90	7,906.78	8,487.93	8,912.32	9,090.57
Sales Growth	0.02	0.18	0.16	0.12	0.07	0.05	0.02
EBIT	2,034.98	2,416.70	2,849.90	3,162.71	3,395.17	3,564.93	3,636.23
Operating Margin	0.40	0.40	0.40	0.40	0.40	0.40	0.40
acc NOPAT	1,526.23	1,812.53	2,137.43	2,372.03	2,546.38	2,673.70	2,727.17
Inc WC - 73%	77.74	675.55	717.74	629.84	424.20	309.78	130.11
Cash NOPAT	1,448.49	1,136.97	1,419.68	1,742.19	2,122.18	2,363.92	2,597.06
CAPX -	90.36	180.36	270.36	360.36	450.36	540.36	
Depreciation +	208.28	233.28	258.28	283.28	308.28	333.28	
NCF	1,566.41	1,189.89	1,407.60	1,665.11	1,980.10	2,156.84	2,207.50
Disc factor	1.00	0.93	0.87	0.81	0.76	0.70	
PV NCF	1,566.41	1,109.42	1,223.64	1,349.60	1,496.37	1,519.69	
SUM PV NCFs	6,698.73						
Terminal Value						42,018.25	
PV Term Value	29,605.81						
PV All Cash Fls	36,304.54						
Cash +	1,588.79						
LT Debt -	178.34						
Legal Liability -	–						
Total Equity	37,714.99						
Number of shares	600.00						
Stock Price	62.86						

Source: Bloomberg, Wind, Silverman Sachs's Valuation

Appendix 3: DCF Analysis in Pessimistic Situation

Unit: Million CNY							
	2022	2023E	2024E	2025E	2026E	2027E	Perp
Sales	5,135.10	5,545.91	5,878.67	6,172.60	6,419.50	6,612.09	6,678.2
Sales Growth	0.02	0.08	0.06	0.05	0.04	0.03	0.01
EBIT	2,034.98	2,416.70	2,849.90	2,469.04	2,567.80	2,644.84	2,671.2
Operating Margin	0.40	0.44	0.48	0.40	0.40	0.40	0.40
acc NOPAT	1,526.23	1,812.53	2,137.43	1,851.78	1,925.85	1,983.63	2,003.4
Inc WC - 73%	77.74	299.86	242.89	214.55	180.22	140.57	48.26
Cash NOPAT	1,448.49	1,512.66	1,894.54	1,637.23	1,745.63	1,843.05	1,955.2
CAPX -	90.36	180.36	270.36	360.36	450.36	540.36	
Depreciation +	208.28	228.28	248.28	268.28	288.28	308.28	
NCF	1,566.41	1,560.58	1,872.46	1,545.15	1,583.55	1,610.97	1,661.9
Disc factor	1.00	0.93	0.87	0.81	0.76	0.70	
PV NCF	1,566.41	1,455.04	1,627.75	1,252.37	1,196.69	1,135.08	
SUM PV NCFs	6,666.93						
Terminal Value						31,633.45	
PV Term Value	22,288.74						
PV All Cash Fls	28,955.67						
Cash +	1,588.79						
LT Debt -	178.34						
Legal Liability -	-						
Total Equity	30,366.12						
Number of shares	600.00						
Stock Price	**50.61**						

Source: Bloomberg, Wind, Silverman Sachs's Valuation

Appendix 4: Synergy in Optimistic Scenario (r = 6%, g = 4%)

(in Million CNY)						
	2024	**2025**	**2026**	**2027**	**2028**	**Perp**
Revenue Synergy	3636.36	4226.34	4744.07	5092.76	5347.39	181.81
Cost Synergy	38.87	337.78	358.87	314.92	212.10	30.98
Misvaluation	1262.40	0.00	0.00	0.00	0.00	0.00
Sum of Synergies	4937.63	4564.12	5102.94	5407.68	5559.49	212.79
Discount Factor	0.96	0.92	0.89	0.85	0.82	
PV Synergy	4747.72	4219.78	4536.49	4622.51	4569.50	
Sum PV	22696.00					
TV					10639.47	
Present Valua of TV	8744.87					
Total PV Synergy	**31440.87**					

Appendix 5: Synergy in Pessimistic Scenario (r = 6%, g = 4%)

(in Million CNY)						
	2024	**2025**	**2026**	**2027**	**2028**	**Perp**
Revenue Synergy	2567.55	2772.96	2939.34	3086.30	3209.75	66.78
Cost Synergy	38.87	149.93	121.45	107.28	90.11	2.41
Misvaluation	527.40					
Sum of Synergies	3133.82	2922.89	3060.78	3193.58	3299.86	69.20
Discount Factor	0.96	0.92	0.89	0.85	0.82	
PV Synergy	3013.29	2702.37	2721.02	2729.88	2712.24	
Sum PV	13878.81					
TV					3459.76	
Present Valua of TV	2843.67					
Total PV Synergy	**16722.47**					