



Cornell Hedge Fund Equity Research

Recommendation: BUY

Company Name: Diageo plc

Ticker: DGE (LON) DEO (NYSE; ADR)

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Analyst: Shaun Yan, Nikan Ansari

Esfahani

Date: 11/23/2015

Stock Price: \$29.99 (1 ADR = 4 Shares)

Market Cap: \$73.03B

Dollar Volume: 3.17mm

Industry: Consumer Staples; Beverages
– Wineries, Breweries, and Distillers

1. Company Profile:

Diageo plc is a multinational producer and marketer of spirits, beers, and wines based in London. It is the largest producer of spirits, owning brands such as Johnny Walker, Smirnoff, and Cîroc. It has major business operations in all continents.

Target Price

	Earnings	Price
07/2015	\$1.34 EPS	\$27.33
07/2019	\$2.15 EPS	\$32.73
07/2021	\$2.45 EPS	\$39.72

Stock Chart:



Financial Summary (in millions)

	2013	2014	2015	2016(e)	2017(e)
Sales Revenue	17,179.1	17,545.5	17,004.2	17,490.5	18,035.8
EBITDA	5,723.8	5,824.0	5,283.8	6,859.6	7,735.8
ROA	9.1%	8.1%	7.8%	8.1%	8.5%
P/E	19.87x	18.62x	22.02x	20.03x	19.87x
EV/ EBITA	14.77x	14.25x	16.76x	18.4x	16.4x
Net Debt	13,083.1	15,193.7	15,140.7	15,250.7	15,109.8

2. Investment Thesis

We are recommending to buy Diageo, which we believe is currently undervalued by the market. By our discounted cash flow model, the fair market value would be \$39.72 while the current market price is \$29.99. For more details, please refer to the analysis below.

3. Industry Summary

A growing global market

The global beverage alcohol market is highly regulated, large and diverse, with an estimated six billion equivalent units of alcohol sold each year, generating £300 billion of net sales

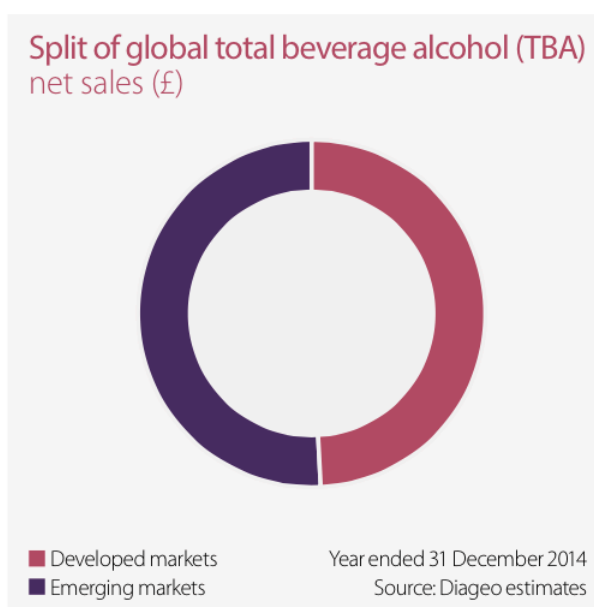
Currently, the global market is split equally between developing and developed markets. Emerging markets are expected to grow at a faster rate. Each individual market presents different consumer dynamics and a different outlook determined by specific local conditions. Diageo's 21-market operating model addresses this perfectly.

Developed markets Opportunities

Overall, wealth is fairly static but is increasingly skewed towards the most affluent. Success depends on offering beer customers other products, particularly spirits, to encourage consumers to trade up within spirits brands.

Developing markets Opportunities

Growth of beverage alcohol consumption in emerging markets is driven by strong, underlying consumer fundamentals. The number of people of legal purchasing age is growing worldwide, and is set to increase by over 450 million over the next decade. Wealth is increasing, with the middle class growing. This means more consumers are buying brands and they have more money to spend on them. There is a good opportunity for growth for spirits, as consumer tastes shift and disposable incomes rise.



Potential hazards of the industry include economic and political instability, increasing expectations of businesses and brands, the need to create a positive role for alcohol in society, climate change and water scarcity and the need to source from local communities and supply chains

4. Business Summary

Management:



Ivan Mendez
CEO

With Diageo since
1997

Prior Position
COO, President of
Diageo North
America
CEO since
July 2013

Total Compensation:
\$6,158,000

Ext. Appointments:
Member of Council
of Scotch Whisky
Association, Non-
Executive Director of
Coach Inc.



Deirdre Mahlan
President – North America

With Diageo since
2000

Prior Position
CFO of Diageo
North America
President since
Nov. 2015

Total Compensation:
\$3,606,000

Ext. Appointments:
Non-Executive
Director of Experian
plc



John O'Keeffe
President – Africa

With Diageo since
1994

Prior Position
CEO Guinness
Nigeria
President since
July 2015



Nick Blazquez
President- Africa, Asia Pacific

With Diageo since
1997

Prior Position
President Africa,
Eurasia & Pacific
President since
September 2014

Key Statistics:

Diageo plc has 33,000 employees across all of its operations. North America represents 45.4% of the company's profits, and 32.2% of the company's sales.

43% of the company's business is coming from emerging markets in Eastern Europe, Latin America, Asia, and Turkey.

Has begun to restructure its North America operations, and increased investment in marketing to recapture market share.

Invests ~\$2500mm on marketing annually. ~\$40mm on R&D.

Investments in sustainability with goals to reduce carbon emissions, conserve water, and combat alcoholism.

Core Brands:



Diageo operates in **21 geographically based markets** in over **180 countries**. The **21 markets** strategy allows the company to tailor its offerings from the lens of a global beverage producer, as well as a local market leader.

Market offerings include **global giants**, such as Johnnie Walker, Smirnoff, and Captain Morgan, as well as beverages **local to the market** as a means to gain market share. **Reserve brands**, such as Ciroc and Johnnie Walker Blue Label, are a core part of the business, as they place Diageo as an industry leader in the luxury segment.

Providing innovative, as well as classic, beverages at every price point is key towards creating a resilient and sustainable brand portfolio for Diageo.

Sustainability:

1. Positive Role of Alcohol

Diageo is committed to the *Five Global Producers Commitments*.

It has contributed to a number of campaigns to tackle harmful drinking.

A positive role of Alcohol is key to the company's success

2. Building Communities

The breweries, distillers, and wineries are at the heart of many communities.

Developing the supply chain requires shared responsibility.

Partnerships with local farmers bolsters supply chain.

3. Environmental Sustainability

Reducing carbon emissions is a key goal across all markets.

Investments in 11 projects for sustainable water sources had aided nearly 60,000 people.

Water stewardship bolsters supply chain.

5. Fundamental Summary

Diageo plc

Discounted Cash Flow Analysis

(\$ in millions, fiscal year ending June 30) (converted from GBP)

Operating Scenario	1			
Mid-Year Convention	N	Historical Period		
		2013	2014	2015
Sales		\$17,179.1	\$17,545.5	\$17,004.2
% growth		NA	2.1%	(3.1%)
Cost of Goods Sold		6,670.7	6,852.0	7,210.3
Gross Profit		\$10,508.4	\$10,693.5	\$9,793.9
% margin		61.2%	60.9%	57.6%
Selling, General & Administrative		2,746.4	2,820.5	2,602.6
EBITDA		\$5,723.8	\$5,824.0	\$5,283.8
% margin		33.3%	33.2%	31.1%
Depreciation & Amortization		494.0	513.1	503.2
EBIT		\$5,229.8	\$5,310.9	\$4,780.6
% margin		30.4%	30.3%	28.1%
Taxes		676.3	771.4	693.5
EBIAT		\$4,553.5	\$4,539.5	\$4,087.1
Plus: Depreciation & Amortization		494.0	513.1	503.2
Less: Capital Expenditures		(966.6)	(1,098.1)	(1,003.3)
Less: Inc./(Dec.) in Net Working Capital				
Unlevered Free Cash Flow				
Terminal Year Free Cash Flow				
WACC		7.1%		
Discount Period				
Discount Factor				

Diageo plc

Working Capital Projections

(\$ in millions, fiscal year ending June 30) (converted from GBP)

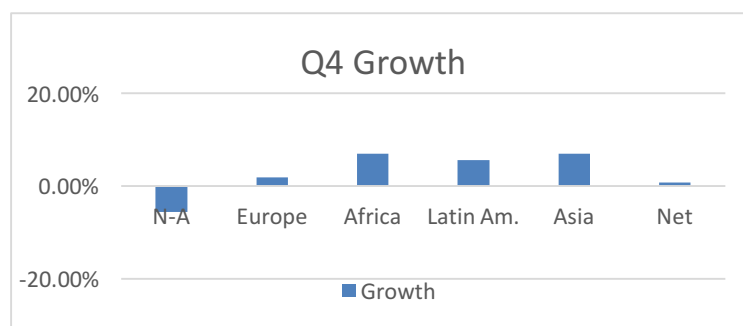
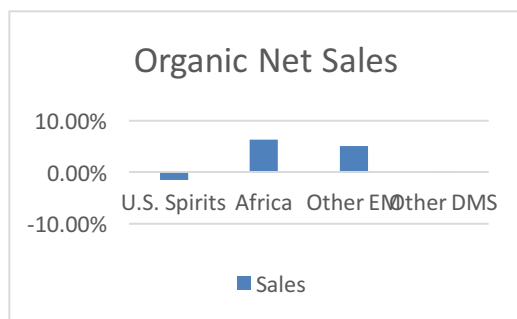
	Historical Period			
	2013	2014	2015	2016
Sales	\$17,179.1	\$17,545.5	\$17,004.2	\$17,490.5
Cost of Goods Sold	6,670.7	6,852.0	7,210.3	7,012.9
Current Assets				
Accounts Receivable	3,071.7	3,427.7	3,039.8	3,126.7
Inventories	6,394.1	7,221.4	7,193.0	7,036.4
Prepaid Expenses and Other	3,468.4	2,126.1	1,828.9	1,881.2
Total Current Assets	\$12,934.2	\$12,775.2	\$12,061.7	\$12,044.3
Current Liabilities				
Accounts Payable	1,652.1	1,544.5	1,388.6	1,350.6
Accrued Liabilities	2,579.2	2,360.4	2,362.0	2,429.6
Other Current Liabilities	4,156.9	4,392.4	4,568.3	4,699.0
Total Current Liabilities	\$8,388.2	\$8,297.3	\$8,318.9	\$8,479.1
Net Working Capital	\$4,546.0	\$4,477.9	\$3,742.8	\$3,565.2
% sales	26.5%	25.5%	22.0%	20.4%
(Increase) / Decrease in NWC		\$68.1	\$735.1	\$177.6

6. Financial Highlights: Latest Quarter

Net Sales: 5% Increase

FY2015 EPS: \$1.34

FY2015 Gross Profit: \$4650mm

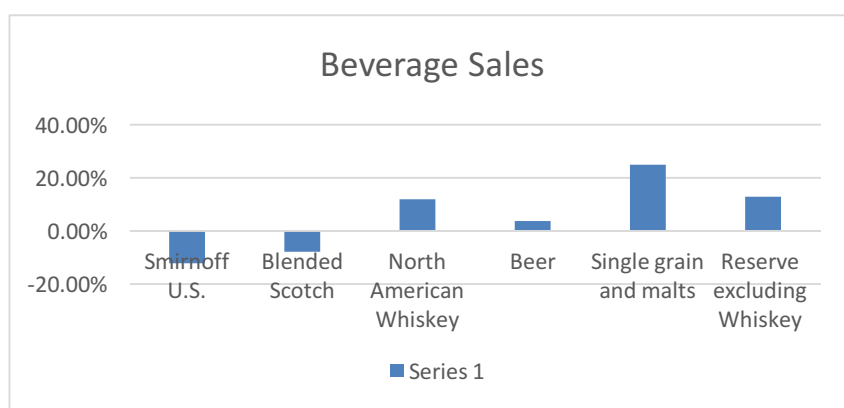


Highlights: Diageo reported lower net sales in North America alongside a decrease in market share. The company has addressed these changes with changes in corporate strategy as well as management.

Overall sales have been consistent, while profits have only suffered lightly due to the contraction in U.S. sales.

Growth in Africa, Latin America, and Asia, show the company's strength in the emerging markets and opportunity to expand market share.

Increases in the Reserves sales are evidence of the company's ability to expand its presence in the luxury sector.



7. Valuation

Diageo plc

Discounted Cash Flow Analysis

(\$ in millions, fiscal year ending June 30) (converted

Operating Scenario		Operating Scenario						Base
Operating Scenario	1							
Mid-Year Convention	N	Projection Period						CAGR
		2016	2017	2018	2019	2020	2021	('16 - '20)
Sales		\$17,490.5	\$18,035.8	\$18,659.9	\$19,396.0	\$20,275.8	\$21,333.6	4.1%
% growth		2.9%	3.1%	3.5%	3.9%	4.5%	5.2%	
Cost of Goods Sold		7,012.9	7,231.5	7,481.7	7,776.9	8,129.7	8,553.8	
Gross Profit		\$10,477.6	\$10,804.3	\$11,178.1	\$11,619.1	\$12,146.2	\$12,779.8	4.1%
% margin		59.9%	59.9%	59.9%	59.9%	59.9%	59.9%	
Selling, General & Administrative		3,618.0	3,068.5	3,174.7	3,299.9	3,449.6	3,629.6	
EBITDA		\$6,859.6	\$7,735.8	\$8,003.5	\$8,319.2	\$8,696.6	\$9,150.3	5.9%
% margin		39.2%	42.9%	42.9%	42.9%	42.9%	42.9%	
Depreciation & Amortization		1,459.0	1,504.5	1,556.5	1,617.9	1,691.3	1,779.6	
EBIT		\$5,400.6	\$6,231.3	\$6,446.9	\$6,701.2	\$7,005.2	\$7,370.7	6.4%
% margin		30.9%	34.5%	34.5%	34.5%	34.5%	34.5%	
Taxes		882.1	1,017.8	1,053.0	1,094.5	1,144.2	1,203.9	
EBIAT		\$4,518.5	\$5,213.5	\$5,393.9	\$5,606.7	\$5,861.0	\$6,166.8	6.4%
Plus: Depreciation & Amortization		1,459.0	1,504.5	1,556.5	1,617.9	1,691.3	1,779.6	
Less: Capital Expenditures		(1,032.0)	(1,080.1)	(1,139.9)	(1,210.9)	(1,284.8)	(1,372.1)	
Less: Inc./(Dec.) in Net Working Capital			(301.1)	11.5	(184.7)	(213.1)	(188.9)	
Unlevered Free Cash Flow			\$5,336.8	\$5,822.1	\$5,829.1	\$6,054.4	\$6,385.4	
Terminal Year Free Cash Flow							\$6,166.8	
WACC								
Discount Period			1.0	2.0	3.0	4.0	5.0	
Discount Factor			0.93	0.87	0.81	0.76	0.71	
Present Value of Free Cash Flow			\$4,983.0	\$5,075.8	\$4,744.9	\$4,601.7	\$4,531.5	

Enterprise Value	
Cumulative Present Value of FCF	\$23,936.9
Terminal Value	
Terminal Year EBITDA (2021E)	\$9,150.3
Exit Multiple	14.3x
Terminal Value	\$130,391.3
Discount Factor	0.71
Present Value of Terminal Value	\$92,534.0
% of Enterprise Value	79.4%
Enterprise Value	\$116,470.9

Implied Equity Value and Share Price	
Enterprise Value	\$116,470.9
Less: Total Debt	(15,344.9)
Less: Preferred Stock	-
Less: Noncontrolling Interest	(2,256.2)
Plus: Cash and Cash Equivalents	717.1
Implied Equity Value	\$99,586.9
Fully Diluted Shares Outstanding	2,507.0
Implied Share Price	\$39.72

		Enterprise Value				
		Exit Multiple				
		13.3x	13.8x	14.3x	14.8x	15.3x
WACC	6.1%	115,121	118,524	121,927	125,330	128,732
	6.6%	112,679	116,003	119,326	122,650	125,974
	7.1%	110,302	113,549	\$116,796	120,042	123,289
	7.6%	107,989	111,161	114,333	117,505	120,677
	8.1%	105,737	108,836	111,936	115,035	118,134

Implied Equity Value Per Share						
		Exit Multiple				
WACC		11.5x	12.0x	14.3x	13.0x	13.5x
	7.5%	\$39.19	\$40.54	\$41.90	\$43.26	\$44.61
	8.0%	\$38.21	\$39.54	\$40.86	\$42.19	\$43.51
	7.1%	\$37.26	\$38.56	\$39.85	\$41.15	\$42.44
	9.0%	\$36.34	\$37.61	\$38.87	\$40.14	\$41.40
	9.5%	\$35.44	\$36.68	\$37.91	\$39.15	\$40.39

Explanations:

Our DCF is projecting the value over five years, ending 07/2021. Our assumptions are based on estimates that Diageo will experience moderate growth in revenue in FY2016, and continue to experience growth in revenue as the company regains market share in North America, and continues its expansion in the emerging markets. Given that the company has 45% of its business in emerging markets, and has seen those very same markets grow between 5%-7% over the past year, it is reasonable to assume as these emerging markets are experiencing an expansion in the number of households in the middle class that Diageo's market share in these economies will grow with it at rates exceeding those of this year. Furthermore, the cost of goods has stayed relatively constant for Diageo over the past decade, showing that Diageo has a relatively consistent supply chain. We are expecting a very slight increase in capital expenditures as the company is going to expand in emerging markets, but not a severe one as it already is well established in most of its markets in regards to the supply chain and manufacturing facilities.

The exit multiple we used was the EV/EBITDA of 14.3x based on the terminal value divided by the LTM EBITDA. Given the fact that capital expenditure is a relatively small percentage of sales and taxes are not very volatile for this industry, it is a reasonable assumption to use this exit multiple.

Our five year valuation makes the most sense in this situation, as it is a large consumer staples company, which relies on slow growth and expansion in emerging markets. It will grow as the markets in Europe recovers, and economies in Asia and Africa begin to see an expansion in the middle class. In Africa alone, the population of drinking age will have grown by around 200 million by 2020. The growth in consumption will be gradual, and will best show over this five year period.

Our WACC was valued using the effective interest rate provided by Diageo in their FY2015 annual report, which was 3.5%. We used the risk free rate of the 10 Year UK Gilt of 1.87%, and the market risk premium of 7.75% found through Bloomberg. We used a beta of .84, a value which we compared to comparable alcoholic beverage companies and found that the value was within .01 of the mean and the media, indicating that Diageo has a similar volatility as the rest of the industry.

8. Growth Opportunities

Developed Markets:

The high disposable income in developed markets presents Diageo with the opportunity to increase its presence in the high-end and ultra-high-end spirits market. Diageo already has 13% of its total net sales come from its Reserve line of liquors, and is expecting this share to increase with further investments in these products.

A further opportunity would be to introduce Diageo's beer customers to its line of premium spirits. The end goal would be to encourage current customers to trade up within the offering of brands to more premium products.

Innovation in core brands is expected to be a major source of growth within developed markets. In 2015, 11% of net sales in the U.K. were innovations of core brands such as Captain Morgan White Rum, and Smirnoff Ice Double Black.

Emerging Markets:

The number of individuals able to purchase alcoholic beverages in emerging markets over the next 10 years is expected to increase by 450 million. Expanding middle classes in emerging markets are also becoming a significant target market. Diageo is already experiencing its highest growths in Africa, Latin America, and Asia, and is not expecting this to slow down.

Acquisitions:

Diageo currently has a 34% stake in the Moët Hennessey drinks, it has also finished the acquisition of tequila brand, Don Julio. Following the recent purchase of SABMiller plc by Anheuser-Busch InBev, there is going to be a strong interest in further consolidation in the industry. Diageo is in a unique position that it can push to gain controlling interest in its partnerships and holdings. It could also purchase brands that will be shaken off following the merger of the two beer giants, allowing it to expand its operations in Africa and other emerging markets.

9. Issues/Risks

Government Restrictions: Increased excise taxes, tariffs, or duties on alcoholic beverages can cause significant harm to the reputation of the company, and decrease the purchase of alcoholic beverages in those markets. However, besides slight restriction on the sale of beer in Indonesia, there are not any immediate threats to any of the major markets.

Changes in Market Volatility: Changes in interest rates can be unfavorable for the company as current low borrowing costs have facilitated increased borrowing that allowed for the consolidation of USL. Volatility in African markets can also pose a challenge to the company as decreased political stability has negative effects on consumer spending.

Emerging markets have seen a slowdown in GDP growth and increase currency volatility, which has been responsible for the slower growth in European and U.S. markets.

Current slowdown in the Chinese economy is bound to have a mentionable impact on the growth and net sales in the short run. Crackdowns on corruption, as seen in Macao, are likely to have a mentionable impact on the sale of Reserve brands in the Chinese markets.

10. Outlook & Recommendation

Based on our valuations and the associated risks and opportunities in the market, we are recommending to go long on Diageo plc. Based on our DCF analysis, the worst case scenario would yield a share price of \$35.44 and a best case scenario of \$44.61, with an implied share price of \$39.72, indicating that the company is heavily undervalued. Diageo is a market leader in the alcoholic beverage industry, as well as the largest producer of spirits. It has instituted management and corporate strategy changes in North America, the company's largest market, to counter a decrease in market share. It is a fundamentally strong company, with competent management, that is willing to exploit the strong portfolio through sustainable innovation and market expansion to allow it to continue to be a leader in the alcoholic beverage industry.