RISK FACTORS

Diageo faces competition that may reduce its market share and margins.

Diageo faces competition from several international companies as well as local and regional companies in the countries in which it operates. Diageo competes with drinks companies across a wide range of consumer drinking occasions. Within a number of categories, consolidation or realignment is taking place. Consolidation is also taking place amongst Diageo’s customers in many countries. Increased competition and unanticipated actions by competitors or customers could lead to downward pressure on prices and/or a decline in Diageo’s market share in any of these categories, which would adversely affect Diageo’s results and hinder its growth potential.

Diageo may not be able to derive the expected benefits from its restructuring programme.

On 17 July 2000, Diageo announced the integration of its spirits, wine and beer businesses to create a premium drinks business as part of an integrated strategy to be a focused premium drinks company. In line with this strategy, Diageo acquired on 21 December 2001 certain of the Seagram spirits and wine businesses. However, there can be no assurance that Diageo will be able to derive all anticipated operating synergy and cost savings from the integration of a portion of Seagram’s spirits and wine businesses into Diageo’s.

Following the acquisition of the Seagram spirits and wine businesses, Diageo is consolidating the Diageo and Seagram brands acquired by Diageo into a single distributor in each US state. This consolidation has given rise and is likely to continue to give rise to legal actions by some distributors and regulatory bodies at the state level, and could lead to disruption to distribution. See ‘Item 4. Information on the Company — Business Overview — Premium drinks — Marketing and distribution — North America’.

There can also be no assurance that Diageo’s strategic focus on premium drinks will result in better opportunities for growth and improved margins.

Regulatory decisions and changes in the legal and regulatory environment could increase Diageo’s costs and liabilities or limit its business activities.

Diageo’s operations are subject to extensive regulatory requirements regarding production, product liability, distribution, marketing, labelling, advertising and labour and environmental issues. Changes in laws, regulations or governmental policy, could cause Diageo to incur material additional costs or liabilities that could adversely affect its business. In particular, governmental bodies in countries where Diageo operates may impose new labelling or production requirements, limitations on the advertising activities used to market beverage alcohol, restrictions on retail outlets or other restrictions on marketing and distribution. Regulatory authorities under whose laws Diageo operates may also have enforcement power that can subject the group to actions such as product recall, seizure of products or other sanctions, which could have an adverse effect on its sales or damage its reputation.

In addition, alcoholic beverages are the subject of national import and excise duties in many countries around the world. An increase in import or excise duties could have a significant adverse effect on Diageo’s sales revenue or margin, both through reducing overall consumption and by encouraging consumers to switch to lower-taxed categories of beverage alcohol.

Companies in the beverage alcohol industry may also be exposed to class action or other litigation relating to alcohol abuse problems or health consequences from the misuse of alcohol. If the industry were to be involved in such litigation, Diageo’s business could be materially adversely affected.

US regulatory authorities are considering possible changes to the regulation of flavored malt beverages. Discussions are taking place in respect of possible rule changes related to the alcohol content in flavored malt beverages. Revised rules could result in changes in the methods by which Diageo currently produces flavored malt beverages and therefore increase the costs of production and/or distribution of these products. In addition, possible regulatory changes could impose adverse federal tax consequences on the import and sale of flavored malt beverages. Flavored malt beverages form a component of Diageo’s growth strategy within the United States and it is possible that the implementation of any regulatory changes by the US authorities could have an adverse effect on Diageo’s future profitability.

Diageo’s reported after tax income is calculated based on extensive tax and accounting requirements in each of its relevant jurisdictions of operation. Changes in tax law (including tax rates), accounting policies and accounting standards could materially reduce Diageo’s reported after tax income.

Demand for Diageo’s products may be adversely affected by changes in consumer preferences and tastes.

Diageo’s portfolio includes certain of the world’s leading beverage alcohol brands as well as brands of local prominence. Maintaining Diageo’s competitive position depends on its continued ability to offer products that have a strong appeal to consumers. Consumer preferences may shift due to a variety of factors, including changes in demographic and social trends, changes in travel, vacation or leisure activity patterns and a downturn in economic conditions, which may reduce consumers’ willingness to purchase premium branded products. In addition, concerns about health effects due to negative publicity regarding alcohol consumption, regulatory action or any litigation or customer complaints against companies in the industry may have an adverse effect on Diageo’s profitability. In addition, the launch of new products is inherently uncertain especially as to their appeal to consumers; the failure to launch a new product successfully can give rise to inventory write offs and other costs and can affect consumer perception of an existing brand. Any significant changes in consumer preferences and failure to anticipate and react to such changes could result in reduced demand for Diageo’s products and erosion of its competitive and financial position.

If the social acceptability of Diageo’s products declines, or if litigation is directed at the beverage alcohol industry, Diageo’s sales volume could decrease and the business could be materially adversely affected.

In recent years, there has been increased social and political attention directed to the beverage alcohol industry. Diageo believes that this attention is the result of public concern over problems related to alcohol abuse, including drink driving, underage drinking and health consequences from the misuse of alcohol. If the social acceptability of beverage alcohol were to decline significantly, sales of Diageo’s products could materially decrease. Similarly, recent litigation against the tobacco industry has directed increased attention to other industries, including the beverage alcohol industry. If the drinks industry were to become involved in litigation of the type brought against other industries, such as tobacco, Diageo’s business could be materially adversely affected. See ‘Item 8. Financial Information — Legal proceedings’ for further detail.

Diageo’s operating results may be adversely affected by increased costs, shortages of raw materials, or labour or disruption to production facilities.

The raw materials which Diageo uses for the production of its food and beverage products are largely commodities that are subject to price volatility caused by changes in global supply and demand, weather conditions, agricultural uncertainty or governmental controls. If commodity price changes result in unexpected increases in raw materials cost or the cost of packaging materials, Diageo may not be able to increase its prices to offset these increased costs without suffering reduced volume, revenue and operating income. Diageo may be adversely affected by shortages of such raw materials or packaging materials. For example, in recent years, volume for Cuervo tequila was adversely affected by the shortage of agave, a key ingredient in the production of tequila.

Similarly, Diageo’s operating results could be adversely affected by labour or skill shortages or increased labour costs due to increased competition for employees, higher employee turnover or increased employee benefit costs.

Diageo would be affected if there were a catastrophic failure of its major production facilities. See ‘Item 4. Information on the Company — Business Overview — Premium drinks — Production’ for a listing of Diageo’s principal production sites. In addition, the maintenance and development of information systems may result in systems failures which may adversely affect business operations.

Diageo has a substantial inventory of aged product categories, principally Scotch whisky and Canadian whiskey, which mature over periods of up to 30 years. As at 30 June 2002, the historical cost of Diageo's maturing inventory amounted to £1,474 million. The maturing inventory is stored primarily in Scotland, and the loss through contamination, fire or other natural disaster of all or a portion of the stock of any one of those aged product categories could result in a significant reduction in supply of those products, and consequently, Diageo would not be able to meet consumer demand for these products as it arises. In addition, there can be no assurance that insurance proceeds would cover the full replacement value of Diageo's maturing inventory or other assets were the entirety of such assets to be lost due to contamination, fire or natural disasters or destruction resulting from negligence or the acts of third parties.

Diageo's business may be adversely impacted by unfavourable economic conditions or other developments and risks in the countries in which it operates.

Diageo's business is dependent on general economic conditions in the United States, Great Britain and other important markets. A significant deterioration in these conditions, including a reduction in consumer spending levels, could have a material adverse effect on Diageo's business and results of operations. In addition, Diageo may be adversely affected by political and economic developments in any of the countries where Diageo has distribution networks, production facilities or marketing companies. Diageo's operations are also subject to a variety of other risks and uncertainties related to trading in numerous foreign countries, including political or economic upheaval and the imposition of any import or investment restrictions, including tariffs and import quotas or any restrictions on the repatriation of earnings and capital. Diageo may also be adversely affected by movements in the valuation of, and returns from, the investments held by its pension funds.

Diageo may be adversely affected by fluctuations in exchange rates. The results of operations of Diageo are accounted for in pounds sterling. Approximately 37% of sales in the year ended 30 June 2002 were in US dollars, approximately 21% were in sterling and approximately 20% were in euros. Movements in exchange rates used to translate foreign currencies into pounds sterling may have a significant impact on Diageo's reported results of operations from year to year.

Diageo may also be adversely impacted by fluctuations in interest rates, mainly through an increased interest expense. To partly delay any adverse impact from interest rate movements, Diageo maintains approximately 50% of its debt at fixed interest rates. See 'Item 11. Quantitative and Qualitative Disclosures about Market Risk — Interest rate risk'.

Diageo's premium drinks operations may be adversely affected by failure to renegotiate distribution and manufacturing rights on favourable terms.

Diageo's premium drinks business has a number of distribution agreements for brands owned by it or by other companies. These agreements vary depending on the particular brand, but tend to be for a fixed number of years. There can be no assurance that Diageo will be able to renegotiate distribution rights on favourable terms when they expire or that agreements will not be terminated. Failure to renew distribution agreements on favourable terms could have an adverse impact on its revenues and operating income. See 'Item 4. Information on the Company — Business Overview — Premium drinks — Acquisitions' and disposals of businesses and acquisitions and terminations of distribution rights' for information about the renegotiation of distribution rights of the Cuervo tequila brands in the United States, termination of Brown-Forman rights in the United Kingdom and termination of Bass Ale distribution rights in the United States. In addition, Diageo's sales may be adversely affected by any disputes with distributors or Burger King franchisees.

Diageo may not be able to protect its intellectual property rights.

Given the importance of brand recognition to its business, Diageo has invested considerable effort in protecting its intellectual property rights, including trademark registration and domain names. Diageo's patents cover some of its process technology, including some aspects of its bottle marking technology. Diageo also uses security measures and agreements to protect its confidential information. However, Diageo cannot be certain that the steps it has taken will be sufficient or that third parties will not infringe on or misappropriate its intellectual property rights. Moreover, some of the countries in which Diageo operates offer less intellectual property protection than Europe or North America. If Diageo is unable to protect its intellectual property rights against infringement or misappropriation, this could materially harm its future financial results and ability to develop its business.

Diageo remains exposed to factors affecting the US food industry.

While Diageo's strategy is to focus on premium drinks, it remains exposed to factors affecting the US food industry through Burger King and its equity interest in General Mills. Following the disposal of Pillsbury to General Mills and the exercise of its option to sell back to General Mills 55 million General Mills' shares, Diageo holds approximately 22% of General Mills' outstanding share capital. The market valuation of this interest may be affected adversely by a variety of factors, including the performance of General Mills and the extent to which that performance meets investors' expectations, economic conditions in the United States, including the US financial markets, and factors affecting the food industry generally, including increased competition and changes in consumer preferences. Any of these factors could also affect Diageo's ability over time to reduce its equity interest in, or affect the price it receives for, General Mills shares. In addition, Diageo's ability to complete the disposal of Burger King is subject to a number of conditions. See 'Item 5. Operating and Financial Review and Prospects — Trend Information' and 'Item 10. Additional Information — Material Contracts — Agreement for the sale of Burger King Corporation'.

It may be difficult to effect service of process and enforce legal process against the directors of Diageo outside of the United States.

Diageo is a public limited company incorporated under the laws of England and Wales. Substantially all of Diageo's directors and officers, and some of the experts named in this document, reside outside of the United States, principally in the United Kingdom. A substantial portion of Diageo's assets, and the assets of such persons are located outside of the United States. Therefore, it may not be possible to effect service of process within the United States upon Diageo or these persons in order to enforce judgements of US courts against Diageo or these persons based on the civil liability provisions of the US Federal Securities laws. There is doubt as to the enforceability in England and Wales, in original actions or in actions for enforcement of judgements of US courts, of civil liabilities solely based on the US Federal Securities laws.

Forward-looking statements

This report contains statements with respect to the financial condition, results of operations and business of Diageo and certain of the plans and objectives of Diageo with respect to these items. These forward-looking statements are made pursuant to the 'Safe Harbor' provisions of the US Private Securities Litigation Reform Act of 1995. In particular, all statements that express forecasts, expectations and projections with respect to future matters, including trends in results of operations, margins, growth rates, overall market trends, the impact of interest or exchange rates, the availability of financing to Diageo and parties or consortia seeking to buy its assets, actions of parties or consortia planning to buy Diageo's assets, anticipated cost savings or synergy and the completion of Diageo's strategic transactions, are forward-looking statements. By their nature, forward-looking statements involve risk and uncertainty because they relate to events and depend on circumstances that will occur in the future. There are a number of factors that could cause actual results and developments to differ materially from those expressed or implied by these forward-looking statements, including factors that are outside Diageo's control.

These factors include, but are not limited to:

- Increased competitive product and pricing pressures and unanticipated actions by competitors that could impact Diageo's market share, increase expenses and hinder growth potential;
- The effects of future business combinations, acquisitions or disposals and the ability to realise expected synergy and/or costs savings;
- Diageo's ability to complete future acquisitions and disposals;

- Legal and regulatory developments, including changes in regulations regarding consumption of, or advertising for, beverage alcohol, changes in accounting standards, taxation requirements, such as the impact of excise tax increases with respect to the premium drinks business, and environmental laws;
- Changes in consumer preferences and tastes, demographic trends or perception about health related issues;
- Changes in the cost of raw materials and labour costs;
- Changes in economic conditions in countries in which Diageo operates, including changes in levels of consumer spending;
- Levels of marketing and promotional expenditure by Diageo and its competitors;
- Renewal of distribution rights on favourable terms when they expire;
- Termination of existing distribution rights on agency brands;
- Technological developments that may affect the distribution of products or impede Diageo's ability to protect its intellectual property rights; and
- Changes in financial and equity markets, including significant interest rate and foreign currency rate fluctuations which may affect Diageo's access to or increase the cost of financing.

Past performance cannot be relied upon as a guide to future performance.

ITEM 4. INFORMATION ON THE COMPANY

HISTORY AND DEVELOPMENT OF THE COMPANY

Diageo is one of the world's leading beverage alcohol businesses with a portfolio of international brands. Diageo was the eleventh largest publicly quoted company in the United Kingdom in terms of market capitalisation on 8 November 2002, with a market capitalisation of approximately £22.6 billion.

Diageo was formed by the Merger of GrandMet PLC and Guinness PLC that became effective on 17 December 1997. As a result of the Merger, GrandMet PLC became a wholly owned subsidiary of Guinness PLC, and Guinness PLC was renamed Diageo plc.

Diageo is incorporated as a public limited company in England and Wales. Diageo's principal executive office is located at 8 Henrietta Place, London W1G 0NB and its telephone number is +44 (0) 20 7927 5200.

Diageo is a major participant in the branded beverage alcohol industry and operates on an international scale. It brings together world-class drinks brands and a management team committed to the maximisation of shareholder value. The management team expects to invest in global brands, expand internationally and launch innovative new products and brands.

Diageo's principal business activities are as follows:

Premium drinks. Diageo's premium drinks business is the world's leading branded premium spirits business by volume, sales revenue and operating profit. Diageo also brews and markets beer and produces and sells wine. It produces and distributes a wide range of premium brands, including Smirnoff vodka, Johnnie Walker Scotch whiskies, Guinness stout, Baileys Original Irish Cream liqueur, J&B Scotch whisky, Captain Morgan rum and Tanqueray gin.

Diageo also has exclusive distribution rights for the Cuervo tequila brand in the United States until 2013 and, in addition, Diageo owns 34% of Moët Hennessy SA (Moët Hennessy). Moët Hennessy is based in France and is a leading producer and exporter of champagne and cognac. Diageo and Moët Hennessy have established a number of joint distribution arrangements in the United States, Asia and France.

On 17 July 2000, Diageo announced the integration of its spirits, wine and beer businesses to create premium drinks. It is anticipated that the integration will cost approximately £170 million of which £122 million has been charged as an exceptional operating cost in the two years ended 30 June 2002.