

Diageo plc (DEO)

\$166.41 (As of 01/03/20)

Price Target (6-12 Months): **\$175.00**

Long Term: 6-12 Months

Zacks Recommendation:

Neutral

(Since: 04/01/19)

Prior Recommendation: Outperform

Short Term: 1-3 Months

Zacks Rank: (1-5)

3-Hold

Zacks Style Scores:

VGM:B

Value: D

Growth: A

Momentum: A

Summary

Diageo has surpassed the industry in the past year, driven by its expansion and innovation strategy. This also aided sales and earnings growth of the company in fiscal 2019. Earnings and sales also improved from robust organic growth, backed by broad-based gain across regions and categories. The company's focus on achieving growth via acquisitions is also yielding results. Diageo remains focused on expanding the fastest-growing premium spirits brands by resource optimization, which should drive growth and boost shareholder value. The company reiterated its medium-term sales and operating margin growth targets. However, cost inflation and higher marketing expenses partly offset margins, which should continue in fiscal 2020. It expects a slowdown in sales growth in fiscal 2020 due to the lapping of several innovation launches in fiscal 2019.

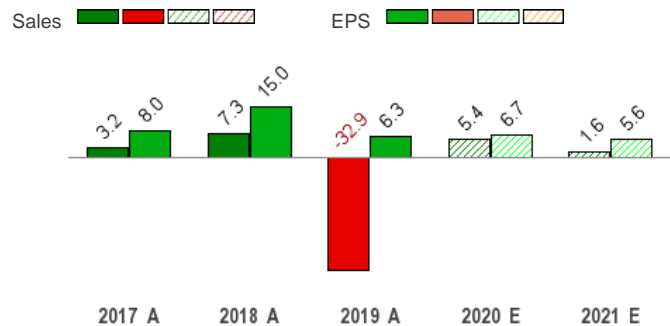
Price, Consensus & Surprise



Data Overview

52 Week High-Low	\$176.22 - \$138.20
20 Day Average Volume (sh)	271,531
Market Cap	\$108.2 B
YTD Price Change	-1.2%
Beta	0.43
Dividend / Div Yld	\$4.16 / 2.5%
Industry	Beverages - Alcohol
Zacks Industry Rank	Bottom 8% (231 out of 252)

Sales and EPS Growth Rates (Y/Y %)



Last EPS Surprise	NA
Last Sales Surprise	NA
EPS F1 Est- 4 week change	1.2%
Expected Report Date	NA
Earnings ESP	0.0%
P/E TTM	NA
P/E F1	23.1
PEG F1	2.8
P/S TTM	NA

Sales Estimates (millions of \$)

	Q1	Q2	Q3	Q4	Annual*
2021					17,841 E
2020					17,554 E
2019					16,653 A

EPS Estimates

	Q1	Q2	Q3	Q4	Annual*
2021					\$7.60 E
2020					\$7.20 E
2019					\$6.75 A

*Quarterly figures may not add up to annual.

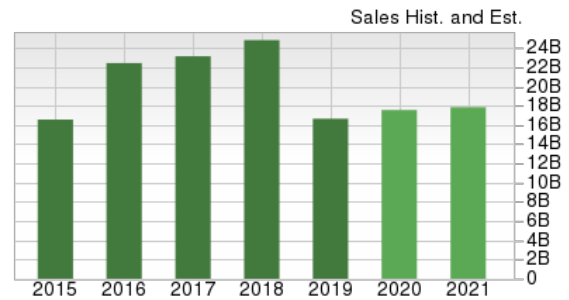
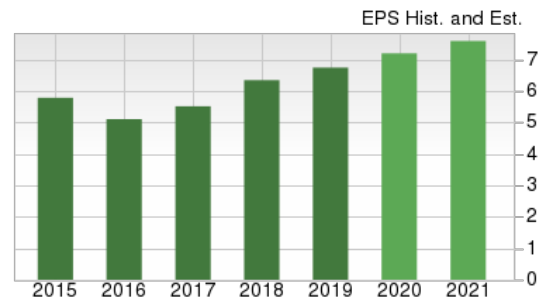
The data in the charts and tables, including the Zacks Consensus EPS and Sales estimates, is as of 01/03/2020. The reports text is as of 01/06/2020.

Overview

London-based Diageo plc operates in approximately 180 countries and is involved in producing, distilling, brewing, bottling, packaging as well as distributing spirits, wine and beer. The company offers its products under globally recognized flagship brands, such as Smirnoff, Johnnie Walker, Captain Morgan, Baileys, Buchanan's, J&B, Tanqueray and Guinness. Among these, 14 brands – Johnnie Walker, Smirnoff, Baileys, Crown Royal, Captain Morgan, Jose Cuervo, JeB, Buchanan's, Windsor, Ketel One vodka, Ciroc, Tanqueray, Bushmills and Guinness – are classified as global strategic brands.

The company operates through five regions:—

- **North America** includes four operating units — U.S. Spirits, Diageo-Guinness USA, Diageo Chateau & Estate Wines Co. and Diageo Canada.
- **Europe** comprises Great Britain, Ireland, Iberia, France, Germany, Benelux, Italy, Nordics, Greece, Switzerland, Austria, the Western European reserve brands, Diageo Guinness Continental Europe, European wines and the Western European operations of Global Travel. Western Europe.
- **Africa** is one of the oldest and largest markets for the Guinness brand. The company operates either through subsidiaries or under license.
- **Latin America and the Caribbean** region, which includes Mexico, Diageo distributes mainly through a mixture of Diageo companies and third-party distributors. In addition, Diageo owns a controlling interest in Desnoes & Geddes Limited, the Jamaican brewer of Red Stripe lager.
- **Asia Pacific** includes operations in India, China, Australia, New Zealand, South Korea, Japan, Thailand, Vietnam, Singapore, Malaysia and other Asian markets.



Reasons To Buy:

- ▲ **Solid Fiscal 2019 Results, Stock Outperforms:** Diageo has been gaining from strong fundamentals, continuous innovation and focus on expansion despite soft industry trends. These factors largely fueled the company's results in recent years. Consequently, the Diageo stock has rallied 20.1% in the past year compared with the industry's growth of 16.9%. The company reported strong results in fiscal 2019, wherein sales and earnings improved year over year. Earnings gained from strong organic operating profit growth, lower finance charges, positive impact of share buybacks and favorable currency. Meanwhile, top-line improvement was backed by solid organic growth, benefiting from broad-based sales gains across all regions and categories. Organic sales increased 6.1%, with organic volume up 2.3% and positive price mix of 3.8%. Moreover, the company's organic operating profit grew 9%, ahead of sales growth, owing to improved price/mix and efficiencies from the productivity program.
- ▲ **Reiterated Medium-Term View:** As already stated, Diageo delivered solid organic operating profit in fiscal 2019. This not only aided earnings but also instilled confidence in reaching its medium-term targets. Notably, the company's organic operating margin expanded 83 bps in fiscal 2019, marking a 198-bps organic operating margin expansion over the last three years. This expansion was above the company's long-term organic operating margin guidance of 175-bps improvement from fiscal 2017 through 2019. Backed by this better-than-expected performance over the last three years, Diageo reiterated its medium-term guidance for the period between fiscal 2020 and 2022, which was announced in May 2019. The company continues to expect organic net sales growth in a mid-single digit between fiscal 2020 and 2022. Further, it expects to sustainably grow organic operating profit by 5-7%, suggesting growth of about 1% ahead of net sales.
- ▲ **Portfolio Management Initiatives:** Diageo explores opportunities to expand geographically through acquisitions to further strengthen its exposure in the fast-growing categories. In sync with this strategy, the company increased its shareholding in Shui Jing Fang from 40% to just over 63% in fiscal 2019. This enhanced its presence in the premium Baijiu segment. Further, it acquired the fastest-growing premium tequila brand in the U.S., Casamigos, in August 2017, which boosted its market share in the tequila category. Further, the company enhanced its portfolio with the acquisition of 26% stake in India's leading brewer, United Spirits Limited (in July 2014) and the premium brand, De Leon Comb Wine & Spirits (in fiscal 2014). Additionally, Diageo's distribution deal with Minnesota-based broker — United Brokerage, Inc. in 2013, solidifies its position in traditional markets. Additionally, the company has been divesting assets to enhance its portfolio — including the recent divestiture of 19 brands to Sazerac. This divestiture will enable Diageo to focus on the premium and above-premium brands, with stronger growth and profit opportunities.
- ▲ **Emerging Markets Penetration:** Diageo, like most other multinationals, is turning its attention to the emerging markets. It is the leading international spirits company in the emerging markets of Africa, Latin America and Asia. Moreover, Diageo caters to the local tastes of the regions. Its products like Johnnie Walker Blue Label bottle, which was designed through a series of exclusive private tasting in China, India, Thailand, Vietnam, Brazil and Mexico with local cultural relevance, testify this strategy. Moreover, the acquisition of India's largest spirits company, United Spirits Ltd, in Jul 2014, extended its reach to one of the most populous countries, with growing middle class and beer consumption trends. With the opening of first Johnnie Walker House in Seoul in Oct 2013 Diageo was able to boost sales in Korea.
- ▲ **Solid Financial Strength:** Diageo boasts strong financials evident from solid generation of operating and free cash flows. Cash flow provides management the opportunity to invest in product innovations, acquisitions and brand development in addition to regularly paying dividends and repurchasing shares. Diageo generated solid cash flows in fiscal 2019, with £3.2 billion of net cash from operating activities. The company also reported strong free cash flow of about £2.6 billion, up from the last year. In sync with its disciplined approach to capital allocation, primarily to enhance shareholder value, the company returned £4.4 billion to shareholders in fiscal 2019 through share repurchases and dividend payouts. This included £2.8 billion worth of share repurchases during fiscal 2019. Backed by strong free cash flow, the company announced that it will further return capital to shareholders of up to £4.5 billion over the next three years. It also increased the annual dividend by 5%.

Diageo's strong fundamentals as well as continuous innovation and expansion largely aided top and bottom lines in recent years. Notably, it reported sales and earnings growth in fiscal 2019.

Reasons To Sell:

- ▼ **Valuation Looks Stretched:** Considering price-to-earnings (P/E) ratio, Diageo looks overvalued when compared with the Consumer Staples sector and the S&P 500. The stock has a trailing 12-month P/E ratio of 24.6x, which is below the median level of 24.8x and the high level of 27.5x scaled in the past year. On the contrary, the trailing 12-month P/E ratio is 22.4x for the Consumer Staples sector and 20.2x for the S&P 500. Given these factors, we believe that the stock is quite stretched from the P/E aspect.
- ▼ **Soft Fiscal 2020 Sales View:** Though Diageo reiterated its medium-term view, it expects a slowdown in sales growth in fiscal 2020, owing to the lapping of several successful innovation launches in fiscal 2019. For fiscal 2020, the company anticipates net sales growth at the mid-point of 4-6% compared with 5.8% gain recorded in fiscal 2019.
- ▼ **Higher Costs Remain a Headwind:** Though Diageo's margin performance was significantly aided by favorable price/mix and efficiencies from the productivity program; it continued to witness pressures from cost inflation and higher marketing expenses. Marketing spends increased 8% in fiscal 2019, reflecting a 22-bps increase as a percentage of sales. This resulted from increased marketing investment in all regions, with the largest investments in US Spirits. Notably, the company's overall rate of marketing investments over the past two years has risen nearly 50 bps, owing to increased investments in marketing and new technology to build a sustainable growth platform. Moreover, the company expects an increase in marketing investment rate in fiscal 2020, focused on sustaining gains witnessed in the US Spirits segment through investments in new brands.
- ▼ **Macroeconomic Concerns:** Diageo's customers remain sensitive to macroeconomic factors including interest rate hikes, increase in fuel and energy costs, credit availability, unemployment levels, and high household debt levels, which may negatively impact their discretionary spending, and in turn the company's growth and profitability.
- ▼ **Higher Taxes May Hurt Performance:** The beer and beverage industry remains susceptible to unfavorable changes in taxes. In many regions, these taxes constitute a major chunk of the cost of beer that is charged to customers. Thus, any rise in excise taxes or indirect taxes on Diageo's products is likely to shift consumers' preferences to other beverages and weigh upon the overall consumption of the company's products, thus hurting its revenues and margins. Consequently, adverse taxation amendments remain a hurdle for the company's profitability.

Diageo expects a slowdown in sales growth in fiscal 2020 due to the lapping of several successful innovation launches in fiscal 2019. It expects sales growth at the mid-point of 4-6% in fiscal 2020.

Last Earnings Report

Diageo FY19 Earnings Gain, Soft Sales View Hurts Stock

Diageo reported preliminary fiscal 2019 results, ending Jun 30, 2019, wherein pre-exceptional earnings per share improved 10.3% year over year (in local currency). This was mainly driven by robust organic operating profit growth, lower finance charges, positive impact of share buybacks and favorable currency, offset by increased tax expenses and higher non-controlling interests.

Fiscal 2019 Highlights

On a reported basis, net sales and operating profit rose 5.8% and 9.5%, respectively, owing to organic growth. Top-line growth was, however, partly negated by acquisitions and divestitures. Its top line and operating profit also included modest favorable impacts of foreign exchange due to the strengthening of the U.S. dollar, offset by the weakening of several currencies like the Turkish Lira, Indian Rupee and Australian Dollar.

Organic sales increased 6.1%, benefiting from broad-based sales growth across all regions and categories. Additionally, sales growth was backed by a 2.3% increase in organic volume and positive price mix of 3.8%. Price/mix benefited from continued premiumization, improved capabilities through the ongoing revenue management initiatives and a premium innovation performance of recently launched brands.

Improved price/mix and efficiencies from the productivity program aided organic operating profit, which grew 9% and was higher than top-line growth. Notably, impacts of cost inflation and higher marketing expenses were fully offset by the aforementioned positives. Further, organic operating margin expanded 83 bps in fiscal 2019, marking a 198-bps organic operating margin expansion over the last three years. This expansion was above the company's long-term organic operating margin guidance of 175-bps improvement from fiscal 2017 through 2019.

Financials

Diageo continues to generate solid cash flows in fiscal 2019, with net cash from operating activities of £3.2 billion. Furthermore, the company reported strong free cash flow of about £2.6 billion in fiscal 2019, up from the last year.

Diageo remains committed to its disciplined approach to capital allocation primarily to enhance shareholder value. In sync with that, the company returned £4.4 billion in cash to shareholders in fiscal 2019 through share repurchases and dividends. This included £2.8 billion worth of share repurchases during fiscal 2019.

Backed by strong free cash flow, the company announced that it will further return capital up to £4.5 billion to shareholders over the next three years. It also increased the annual dividend by 5%.

Outlook

Backed by robust organic profit growth over the last three years, Diageo reiterated its medium-term projection for the period between fiscal 2020 and 2022, which was announced in May 2019. The company continues to expect organic net sales growth in a mid-single digit for this period. Further, it expects to sustainably grow organic operating profit by about 1% ahead of net sales, in the 5-7% range.

For fiscal 2020, the company anticipates net sales growth at the mid-point of 4-6%. This reflects a slowdown from fiscal 2019, lapping several successful innovation launches in the year. Based on current rates, the company expects foreign exchange to favorably impact net sales by £375 million and operating profit by £135 million.

Quarter Ending 06/2019

Report Date	Jul 25, 2019
Sales Surprise	NA
EPS Surprise	NA
Quarterly EPS	NA
Annual EPS (TTM)	NA

Valuation

Diageo shares are up 20.1% over the trailing 12-month period. Stocks in the Zacks sub-industry and the Zacks Consumer Staples sector are up 16.9% and 17.5%, respectively, in the past year.

The S&P 500 index is up 25.7% in the past year.

The stock is currently trading at 22.47X forward 12-month earnings, which compares to 24.26X for the Zacks sub-industry, 19.62X for the Zacks sector and 18.71X for the S&P 500 index.

Over the past five years, the stock has traded as high as 26.07X and as low as 16.63X, with a 5-year median of 20.59X. Our Neutral recommendation indicates that the stock will perform in-line with the market. Our \$175 price target reflects 23.63X forward 12-month earnings.

The table below shows summary valuation data for DEO

Valuation Multiples - DEO					
		Stock	Sub-Industry	Sector	S&P 500
P/E F12M	Current	22.47	24.26	19.62	18.71
	5-Year High	26.07	27.52	22.39	19.34
	5-Year Low	16.63	18.91	16.65	15.17
	5-Year Median	20.59	23.27	19.72	17.44
P/S F12M	Current	6.11	16.69	9.75	3.47
	5-Year High	6.95	20.67	11.03	3.47
	5-Year Low	3.81	14.42	8.02	2.54
	5-Year Median	4.93	17.56	9.78	3
EV/EBITDA TTM	Current	21.99	45.08	39.85	11.99
	5-Year High	23.12	53.07	44.63	12.87
	5-Year Low	15.61	33.68	31.32	8.48
	5-Year Median	18.71	42.96	37.92	10.67

As of 01/03/2020

Industry Analysis Zacks Industry Rank: Bottom 8% (231 out of 252)



Top Peers

Ambev S.A. (ABEV)	Neutral
Brown-Forman Corporation (BF.B)	Neutral
Anheuser-Busch InBev SA/NV (BUD)	Neutral
Heineken NV (HEINY)	Neutral
Pernod Ricard SA (PDRDY)	Neutral
Constellation Brands Inc (STZ)	Neutral
Molson Coors Brewing Company (TAP)	Neutral
Craft Brew Alliance, Inc. (BREW)	Underperform

Industry Comparison Industry: Beverages - Alcohol				Industry Peers		
	DEO Neutral	X Industry	S&P 500	BUD Neutral	HEINY Neutral	TAP Neutral
VGM Score	B	-	-	D	B	B
Market Cap	108.21 B	9.65 B	23.66 B	135.14 B	61.68 B	11.55 B
# of Analysts	3	1.5	13	3	3	7
Dividend Yield	2.50%	0.00%	1.79%	1.59%	1.06%	4.27%
Value Score	D	-	-	D	C	A
Cash/Price	0.01	0.03	0.04	0.00	0.03	0.04
EV/EBITDA	17.55	9.70	13.88	6.15	NA	7.57
PEG Ratio	2.79	3.12	1.99	2.30	2.80	2.24
Price/Book (P/B)	8.23	2.43	3.36	1.73	3.37	0.86
Price/Cash Flow (P/CF)	23.64	15.70	13.62	12.68	12.69	5.88
P/E (F1)	23.11	23.34	18.74	19.30	20.46	13.41
Price/Sales (P/S)	NA	2.30	2.67	2.50	NA	0.89
Earnings Yield	4.33%	4.27%	5.32%	5.18%	4.89%	7.46%
Debt/Equity	1.06	0.40	0.72	NA	0.87	0.60
Cash Flow (\$/share)	7.04	1.90	6.94	6.53	4.22	9.08
Growth Score	A	-	-	D	A	C
Hist. EPS Growth (3-5 yrs)	NA%	7.35%	10.56%	-6.80%	NA	5.82%
Proj. EPS Growth (F1/F0)	6.72%	8.62%	7.41%	-0.23%	8.43%	-7.38%
Curr. Cash Flow Growth	-1.12%	4.60%	14.83%	-9.50%	12.24%	8.69%
Hist. Cash Flow Growth (3-5 yrs)	-0.55%	4.63%	9.00%	0.24%	4.17%	12.93%
Current Ratio	1.34	1.61	1.23	0.54	0.71	0.59
Debt/Capital	51.35%	29.41%	42.92%	56.55%	46.43%	37.54%
Net Margin	NA%	7.96%	11.08%	17.63%	NA	1.19%
Return on Equity	NA%	8.39%	17.10%	23.92%	NA	6.86%
Sales/Assets	NA	0.52	0.55	0.46	NA	0.44
Proj. Sales Growth (F1/F0)	5.41%	4.56%	4.20%	1.27%	5.00%	-0.97%
Momentum Score	A	-	-	F	D	B
Daily Price Chg	-0.20%	0.00%	-0.61%	-0.84%	-0.06%	-0.30%
1 Week Price Chg	1.62%	0.28%	0.13%	1.38%	1.49%	-0.06%
4 Week Price Chg	3.14%	2.33%	2.60%	5.24%	2.33%	6.02%
12 Week Price Chg	1.41%	-1.04%	8.87%	-9.62%	0.83%	-4.20%
52 Week Price Chg	20.50%	13.55%	29.34%	24.59%	23.53%	-7.76%
20 Day Average Volume	271,531	30,050	1,603,615	846,666	69,108	1,725,536
(F1) EPS Est 1 week change	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
(F1) EPS Est 4 week change	1.17%	0.00%	0.00%	-0.77%	-1.01%	0.00%
(F1) EPS Est 12 week change	1.53%	-2.81%	-0.57%	-8.34%	-3.92%	-8.08%
(Q1) EPS Est Mthly Chg	NA%	0.00%	0.00%	0.00%	NA	0.00%

Zacks Stock Rating System

We offer two rating systems that take into account investors' holding horizons: Zacks Rank and Zacks Recommendation. Each provides valuable insights into the future profitability of the stock and can be used separately or in combination with each other depending on your investment style.

Zacks Recommendation

The Zacks Recommendation aims to predict performance over the next 6 to 12 months. The foundation for the quantitatively determined Zacks Recommendation is trends in the company's estimate revisions and earnings outlook. The Zacks Recommendation is broken down into 3 Levels; Outperform, Neutral and Underperform. Unlike many Wall Street firms, we have an excellent balance between the number of Outperform and Neutral recommendations. Our team of 70 analysts are fully versed in the benefits of earnings estimate revisions and how that is harnessed through the Zacks quantitative rating system. But we have given our analysts the ability to override the Zacks Recommendation for the 1200 stocks that they follow. The reason for the analyst over-rides is that there are often factors such as valuation, industry conditions and management effectiveness that a trained investment professional can spot better than a quantitative model.

Zacks Rank

The Zacks Rank is our short-term rating system that is most effective over the one- to three-month holding horizon. The underlying driver for the quantitatively-determined Zacks Rank is the same as the Zacks Recommendation, and reflects trends in earnings estimate revisions.

Zacks Style Scores

The Zacks Style Score is as a complementary indicator to the Zacks rating system, giving investors a way to focus on the highest rated stocks that best fit their own stock picking preferences.

Academic research has proven that stocks with the best Value, Growth and Momentum characteristics outperform the market. The Zacks Style Scores rate stocks on each of these individual styles and assigns a rating of A, B, C, D and F. We also produce the VGM Score (V for Value, G for Growth and M for Momentum), which combines the weighted average of the individual Style Scores into one score. This is perfectly suited for those who want their stocks to have the best scores across the board.

Value Score	D
Growth Score	A
Momentum Score	A
VGM Score	B

As an investor, you want to buy stocks with the highest probability of success. That means buying stocks with a Zacks Recommendation of Outperform, which also has a Style Score of an A or a B.

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