

Diageo plc (DEO)

\$130.37 (As of 03/26/20)

Price Target (6-12 Months): **\$137.00**

Long Term: 6-12 Months

Zacks Recommendation:

Neutral

(Since: 04/01/19)

Prior Recommendation: Outperform

Short Term: 1-3 Months

Zacks Rank: (1-5)

4-Sell

Zacks Style Scores:

VGM:C

Value: D

Growth: A

Momentum: D

Summary

Diageo has outpaced the industry in the past three months driven by its expansion and innovation strategy which has been aiding results. Earnings and sales in first-half of fiscal 2020 improved on robust organic sales growth backed by growth 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 also cut net sales view for fiscal 2020 due to the ongoing trade conflicts in key markets and the spread of coronavirus in China.

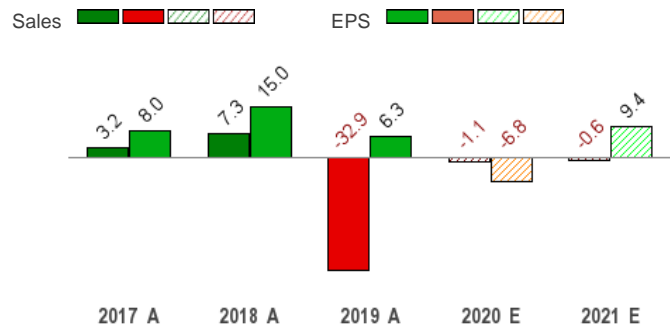
Price, Consensus & Surprise



Data Overview

52 Week High-Low	\$176.22 - \$100.52
20 Day Average Volume (sh)	1,209,194
Market Cap	\$84.8 B
YTD Price Change	-22.6%
Beta	0.54
Dividend / Div Yld	\$2.85 / 2.2%
Industry	Beverages - Alcohol
Zacks Industry Rank	Bottom 5% (241 out of 253)

Sales and EPS Growth Rates (Y/Y %)



Last EPS Surprise	NA
Last Sales Surprise	NA
EPS F1 Est- 4 week change	-10.3%
Expected Report Date	NA
Earnings ESP	0.0%

Sales Estimates (millions of \$)

	Q1	Q2	Q3	Q4	Annual*
2021					16,359 E
2020					16,463 E
2019					16,653 A

EPS Estimates

	Q1	Q2	Q3	Q4	Annual*
2021					\$6.88 E
2020					\$6.29 E
2019					\$6.75 A

*Quarterly figures may not add up to annual.

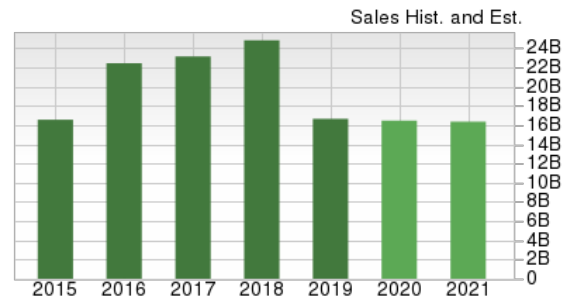
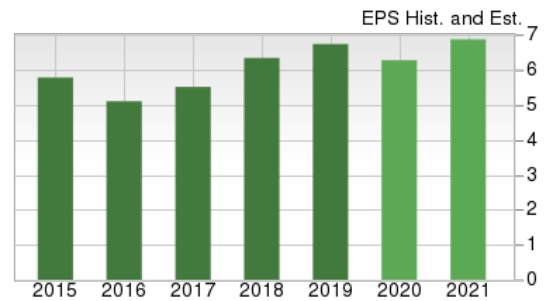
The data in the charts and tables, including the Zacks Consensus EPS and Sales estimates, is as of 03/26/2020. The reports text is as of 03/27/2020.

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 First-Half Fiscal 2020 Results:** 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. The company reported strong results in first-half of fiscal 2020, wherein sales and earnings improved year over year. Earnings gained from organic operating profit growth and the capital return program. Meanwhile, top-line improvement was backed by solid organic growth, benefiting from broad-based sales gains across all regions and categories. Organic sales increased 4.2%, driven by 0.2% rise in organic volume and 4% growth in price/mix.

Diageo's strong fundamentals and continued innovation and expansion largely aided top and bottom lines in recent years. Notably, it reported sales and earnings growth in first-half of fiscal 2020.

Volume growth was mainly attributed to rapid growth in tequila, Canadian whiskey and Chinese white spirits. Price/mix was particularly aided by premiumization, improved revenue-management capabilities and sustained innovation, with the launch of Crown Royal Regal Apple and Tanqueray Flor de Sevilla in the prior years. Though the Diageo stock fell 22.6% in the past three months, it fared better than the industry's 32.3% decline.

- ▲ **Organic Operating Profit Growth Aid Earnings:** Diageo's organic operating profit grew 4.6%, higher than organic net sales growth, owing to improved price/mix and productivity benefits from everyday cost efficiencies. Further, organic operating margin expanded 13 bps, driven by the focus on productivity, revenue-management initiatives and the mitigation of cost inflation. For fiscal 2020, it continues to anticipate organic operating profit growth of about 1% ahead of organic net sales. This is consistent with its medium-term target.
- ▲ **Reiterated Medium-Term View:** Diageo reiterated its growth targets for the medium-term between fiscal 2020 and 2022, which was initially announced in May 2019. The company continues to expect organic net sales growth in mid-single digits for the period. Further, it expects organic operating profit to sustainably grow by 1% ahead of net sales to 5-7%.
- ▲ **Portfolio Management & Premiumization Bode Well:** 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 has acquired a number of companies and brands, including Don Julio, United Spirits and Casamigos, as well as increased shareholding in Shui Jing Fang. Additionally, the company has been divesting assets to enhance its portfolio — including the divestiture of 19 brands to Sazerac. These actions enable Diageo to focus on the premium and above-premium brands, with stronger growth and profit opportunities. Moreover, the company is set to grab a share of the momentum in the fast-growing hard seltzer category by promoting the Smirnoff Seltzer with endorsements. Notably, seltzers are stealing a large share from the beer, and wine & spirits categories, with a significant share sourced from the beer category.
- ▲ **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. In the first half of fiscal 2020, Diageo delivered net cash from operating activities of £1.3 billion and free cash flow of £966 million. In sync with its disciplined approach to capital allocation, primarily to enhance shareholder value, the company returned £1.1 billion to in the first half of fiscal 2020 through share repurchases. It also increased the annual dividend by 5%. For fiscal 2020, the company now expects net capital expenditure of £700-£750 million as it is ahead of the plan, with the implementation of some IT projects. This reflects a modest increase from the previous guidance.
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Reasons To Sell:

- ▼ **Valuation Looks Stretched:** Considering price-to-earnings (P/E) ratio, Diageo looks overvalued when compared with the broader industry and the S&P 500. The stock has a trailing 12-month P/E ratio of 19.3x, which is below the median level of 24.7x and the high level of 27.5x scaled in the past year. On the contrary, the trailing 12-month P/E ratio is 18.8x for the industry and 16.4x for the S&P 500. Given these factors, we believe that the stock is quite stretched from the P/E aspect.
- ▼ **Soft Fiscal 2020 View:** On its earnings call, Diageo cut net sales view for fiscal 2020 on the ongoing trade conflicts in key markets and the spread of coronavirus in China. The company expects the persistence of increased levels of volatility in India, Latin America and the Caribbean, and Travel Retail to hurt sales for fiscal 2020. It now expects net sales for fiscal 2020 at the lower end of 4-6% growth range mentioned earlier. It had earlier expected sales growth at the mid-point of the aforementioned range. Later, on Feb 26, the company stated that it anticipates the negative impact of coronavirus outbreak on its fiscal 2020 organic net sales to be £225-£325 million and organic operating profit to be £140-£200 million.
- ▼ **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. Notably, the company gross margin contracted 65 basis points (bps) in first-half fiscal 2020 driven by inflation in cost of goods sold (COGS) and nearly flat volumes. During the first half, the company witnessed inflationary pressures from commodity costs, including Agave and glass. Further, operating margin gains were partly offset by cost inflation and increased marketing expenses. Notably, marketing spends increased 6% in the first half, reflecting a 25-bps increase as a percentage of sales, on higher marketing investments for attractive growth categories and regions.
- ▼ **Currency Headwinds:** As a substantial portion of Diageo's business comes from international operations. Consequently, exchange rate fluctuations have been hampering its sales. Though currency headwinds had minimal impacts on first-half fiscal 2020 results, the company expects negative impacts in fiscal 2020. Based on current rates, the company now expects foreign exchange to hurt net sales by £110 million and operating profit by £40 million in fiscal 2020.
- ▼ **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 cut net sales view for fiscal 2020 on the ongoing trade conflicts in key markets and the spread of coronavirus in China. It expects net sales for fiscal 2020 at the lower end of 4-6% growth range.

Last Earnings Report

Diageo 1H20 Earnings Solid, Cuts View

Diageo plc reported interim results for the first half of fiscal 2020, ended Dec 31, 2019, wherein pre-exceptional earnings per share improved 4.2% year over year to 80.2 pence (in local currency). This was backed by higher operating profits and the capital return program.

However, the company cut net sales view for fiscal 2020 on the ongoing trade conflicts in key markets and the spread of coronavirus in China. The company expects the persistence of increased levels of volatility in India, Latin America and the Caribbean, and Travel Retail to hurt sales for fiscal 2020.

For fiscal 2020, it now expects net sales at the lower end of 4-6% growth mentioned earlier. The company had earlier expected sales growth at the mid-point of the aforementioned range. However, it continues to anticipate organic operating profit growth of about 1% ahead of organic net sales. This is consistent with its medium-term target stated earlier. Based on current rates, the company now expects foreign exchange to hurt net sales by £110 million and operating profit by £40 million in fiscal 2020.

First-Half Fiscal 2020 Highlights

On a reported basis, net sales and operating profit moved up 4.2% and 0.5%, respectively, owing to organic growth. Top-line growth also included slight negative impacts of the sale of a portfolio of 19 brands to Sazerac in December 2018.

Organic sales also rose 4.2%, benefiting from broad-based sales growth across all regions and categories, as well as rise in organic volume. This was, however, offset by challenges in India, Latin America and the Caribbean, and weak Travel Retail. Notably, organic volume was up 0.2% and price/mix grew 4%. Organic sales growth was above the company's medium-term target of mid-single digits.

Volume growth was mainly attributed to rapid growth in tequila, Canadian whiskey and Chinese white spirits. Price/mix was particularly aided by premiumization, improved revenue-management capabilities and sustained innovation, with the launch of Crown Royal Regal Apple and Tanqueray Flor de Sevilla in the prior years.

Gross margin contracted 65 bps in the first half, hurt by inflation in cost of goods sold (COGS) and nearly flat volumes. This was partly negated by favorable price/mix. During the first half, the company witnessed inflationary pressures from commodity costs, including Agave and glass.

Improved price/mix and productivity benefits from everyday cost efficiencies aided organic operating profit, which grew 4.6%, higher than organic net sales growth. Further, organic operating margin expanded 13 bps, driven by the focus on productivity, revenue-management initiatives and the mitigation of cost inflation.

Financials

In the first half of fiscal 2020, Diageo delivered net cash from operating activities of £1.3 billion, marking a decline of £0.3 billion year over year. Furthermore, the company reported strong free cash flow of £966 million, down from the last year due to one-time tax payments.

Diageo remains committed to its disciplined approach to capital allocation primarily to enhance shareholder value. In sync with that, it returned £1.1 billion to shareholders in the first half of fiscal 2020 through share repurchases.

The company earlier announced plans to repurchase shares worth up to £3 billion for the year ending on 30 Jun, 2019. It now increased the interim dividend by 5%.

For fiscal 2020, the company now expects net capital expenditure of £700-£750 million as it is ahead of the plan, with the implementation of some IT projects. This reflects a modest increase from the previous guidance.

Medium-Term View Intact

Diageo reiterated its growth targets for the medium-term between fiscal 2020 and 2022, which was initially announced in May 2019. The company continues to expect organic net sales growth in mid-single digits for the period. Further, it expects organic operating profit to sustainably grow by 1% ahead of net sales to 5-7%.

Quarter Ending 06/2019

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

Recent News

Diageo Commits Alcohol Supplies for Making Hand Sanitizers Amid Coronavirus – Mar 23, 2020

Diageo revealed it will donate up to two million liters of alcohol to manufacturing partners to overcome the shortage of hand sanitizers for healthcare workers due to the wide spread global coronavirus pandemic. The company stated that this donation will be enough to make 8 billion 250ml bottles of hand sanitizers, which will be primarily supplied to frontline healthcare professionals in the fight against COVID-19. The company will provide Grain Neutral Spirit, a 96% strength ethyl alcohol, for no cost to manufacturers of hand sanitizers in various countries to overcome the shortage of hand sanitizers. This spirit is used to produce vodka and gin.

Diageo's FY20 Profits to be Hurt by Coronavirus Outbreak – Feb 26, 2020

The outbreak of COVID-19 virus in China has given rise to a tough situation for companies operating in the region. In this situation, Diageo has assessed how much impact the deadly coronavirus outbreak will have on its fiscal 2020 results. Notably, public health measures undertaken across impacted countries in Asia Pacific, primarily in China, have resulted in restrictions on public gatherings, the postponement of events and the closure of many hospitality and retail outlets. Several countries and many businesses have also imposed restrictions on travel. Diageo mentioned that bars and restaurants have largely been closed in China and there has been a significant decrease in dine-out. Also, it cited significant disruption since the end of January as majority of consumption is in the on-trade.

Consequently, it expects China operations to witness softness in the near term, which should have a pronounced impact on fiscal 2020 results. The company anticipates the negative impact of coronavirus outbreak on its fiscal 2020 organic net sales to be £225-£325 million and organic operating profit to be £140-£200 million. Nevertheless, management expects a gradual improvement with consumption returning to normal levels toward the end of fiscal 2020.

Diageo Relocates North America HQ to Lower Manhattan – Feb 12, 2020

In a bid to take its business to the next level, Diageo relocated its North America headquarters to Lower Manhattan in the city of New York. Last year, the company revealed intentions of moving the headquarters of its largest market from Norwalk in Connecticut to New York. Per management, this move signifies an important shift as the company is focused on eliminating boundaries, becoming bolder and more future-focused, and moving closer to a nucleus of diverse consumers. Also, this shift will help it to enhance flexibility and collaboration. Moreover, the company's relocation is likely to allow it to expand access to various talent pools and capabilities. This is expected to add 350 new job opportunities to New York City, in addition to the existing 150 Diageo jobs already on payroll. The company expects to gain from its positioning in the heart of one of the world's most exciting cities.

Valuation

Diageo shares are down 22.6% in the year-to-date period and nearly 20.4% over the trailing 12-month period. Stocks in the Zacks sub-industry and the Zacks Consumer Staples are down 32.4% and 20.9% in the year-to-date period, respectively. Over the past year, the Zacks sub-industry and the sector are down 24.9% and 15%, respectively. The S&P 500 index is down 18.4% in the year-to-date period and 7.5% in the past year.

The stock is currently trading at 18.29X forward 12-month earnings, which compares to 19.22X for the Zacks sub-industry, 16.47X for the Zacks sector and 14.92X for the S&P 500 index.

Over the past five years, the stock has traded as high as 26.07X and as low as 14.61X, with a 5-year median of 20.68X. Our Neutral recommendation indicates that the stock will perform in-line with the market. Our \$137.00 price target reflects 19.22X 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	18.29	19.22	16.47	14.92
	5-Year High	26.07	27.52	22.37	19.34
	5-Year Low	14.61	18.91	16.47	14.92
	5-Year Median	20.68	23.13	19.66	17.42
P/S F12M	Current	4.89	17.44	8.17	2.68
	5-Year High	6.95	20.67	11.16	3.43
	5-Year Low	3.81	14.42	8.1	2.54
	5-Year Median	4.99	17.49	9.89	3
EV/EBITDA TTM	Current	17.72	34.61	31.66	9.74
	5-Year High	23.12	53.27	45.11	12.88
	5-Year Low	14.43	29.08	27.89	8.27
	5-Year Median	18.92	43.33	38.49	10.78

As of 03/26/2020

Industry Analysis Zacks Industry Rank: Bottom 5% (241 out of 253)



Top Peers

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

Industry Comparison Industry: Beverages - Alcohol				Industry Peers		
	DEO Neutral	X Industry	S&P 500	BUD Underperform	HEINY Neutral	TAP Neutral
VGM Score	C	-	-	D	A	B
Market Cap	84.77 B	7.64 B	18.50 B	93.36 B	47.22 B	8.36 B
# of Analysts	4	3	13	2	2	7
Dividend Yield	2.19%	0.00%	2.35%	2.84%	1.39%	5.90%
Value Score	D	-	-	C	C	A
Cash/Price	0.02	0.04	0.07	0.09	0.04	0.07
EV/EBITDA	14.11	8.16	11.16	8.22	NA	9.76
PEG Ratio	2.41	2.79	1.74	1.38	2.25	1.80
Price/Book (P/B)	7.13	2.23	2.44	1.10	2.44	0.61
Price/Cash Flow (P/CF)	18.52	11.09	9.87	7.33	9.48	4.50
P/E (F1)	19.99	18.70	15.29	14.86	16.73	10.81
Price/Sales (P/S)	NA	1.59	1.93	1.76	NA	0.64
Earnings Yield	4.82%	4.86%	6.47%	6.74%	5.98%	9.24%
Debt/Equity	1.14	0.45	0.70	1.15	0.77	0.59
Cash Flow (\$/share)	7.04	1.87	7.01	6.32	4.32	8.59
Growth Score	A	-	-	D	A	B
Hist. EPS Growth (3-5 yrs)	NA%	7.53%	10.85%	-5.02%	NA	6.66%
Proj. EPS Growth (F1/F0)	-6.89%	-0.41%	2.89%	-23.65%	0.82%	-21.27%
Curr. Cash Flow Growth	-1.12%	2.72%	5.93%	15.28%	2.45%	-5.29%
Hist. Cash Flow Growth (3-5 yrs)	-0.55%	4.22%	8.55%	0.84%	4.17%	11.28%
Current Ratio	1.15	1.41	1.23	0.83	0.68	0.59
Debt/Capital	53.21%	31.20%	42.57%	53.57%	43.57%	37.23%
Net Margin	NA%	7.61%	11.64%	17.29%	NA	1.86%
Return on Equity	NA%	8.39%	16.74%	20.56%	NA	7.15%
Sales/Assets	NA	0.51	0.54	0.45	NA	0.44
Proj. Sales Growth (F1/F0)	-1.14%	0.00%	2.37%	-8.65%	-0.51%	-2.53%
Momentum Score	D	-	-	D	B	D
Daily Price Chg	10.17%	1.56%	6.21%	1.56%	3.41%	2.88%
1 Week Price Chg	-14.22%	-9.01%	-16.96%	-9.01%	-11.27%	-13.20%
4 Week Price Chg	-9.49%	-12.47%	-15.70%	-23.10%	-19.47%	-22.78%
12 Week Price Chg	-21.82%	-22.17%	-23.67%	-44.52%	-23.48%	-27.87%
52 Week Price Chg	-20.41%	-18.44%	-13.99%	-44.02%	-22.26%	-34.84%
20 Day Average Volume	1,209,194	41,759	4,286,768	5,600,119	127,033	3,171,350
(F1) EPS Est 1 week change	0.00%	0.00%	-0.15%	1.36%	-3.29%	-6.50%
(F1) EPS Est 4 week change	-10.34%	-7.70%	-2.28%	-25.83%	-6.25%	-8.28%
(F1) EPS Est 12 week change	-12.75%	-10.19%	-3.22%	-27.33%	-6.37%	-10.19%
(Q1) EPS Est Mthly Chg	NA%	-7.47%	-1.60%	NA	NA	-9.43%

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	D
VGM Score	C

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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