HSBC Global Research

Diageo (DGE LN)

Hold: Easy US comparisons are not a structural cure

EQUITIES
BEVERAGES

United Kingdom

- US comparisons are easy for 2H 2015/16e, which should help flatter numbers
- However, when we look under the numbers, we do not see evidence of a US turnaround yet
- With minor adjustments, we have raised our target price to 2,000p from 1,900p but lowered our longer-term outlook

Are easy US comparatives a cure – or just a band aid for inconsistency? We believe Diageo will benefit from some technical and currency issues in the medium term. But the US is at the heart of the equity story, and without the US performing at a high level in a normalised environment, we argue the stock remains structurally impaired versus other more robust stories in the European beverage sector.

Diageo shares have shown signs of life this year (+1% YTD) after several years of weak performance following management's downshifted expectations from November 2013. From a macro perspective, Diageo is less exposed to the challenging Chinese market than European spirits peers and is benefiting from a diminished GBP versus the USD, a decline that began in mid-2014. Most importantly, we think the market is looking forward to an easy US comparison cycle in 2H 2015/16e. As a result, the market has become generally bullish on the stock.

There are positives to be observed. However, we are not yet convinced as we do not think a decent half-year in the US against an easy comparison is enough to unwind and improve the structural issues in the US market that continue to haunt the company. Simply put, the five-year performance of the US business has not been good enough for a potent market leader in a healthy US spirits market. Diageo continues to suffer from previous decisions and we are unsure from where the future turnaround will come.

Over the past five years, the company's most crucial brands have stalled volumetrically in the US, losing market share, and the most successful brand stories are either still in the process of gaining meaningful scale or possibly at the end of an innovation cycle. Complicating matters, we think, is that the aggregate US portfolio remains off trend: a white spirits-dominant collection in a US market that is now driven almost entirely by brown spirits.

We increase our TP by 5% to 2,000p from 1,900p as we make minor adjustments to our model. However, we believe Diageo's US business is still early in the turnaround process, and we therefore retain our Hold rating on the stock.

MAINTAIN HOLD

TARGET PRICE (GBPp)	PREVIOUS TARGET (GBPp)
2,000	1,900

SHARE PRICE (GBPp)	UPSIDE/DOWNSIDE
1,846	+8.3%
(as of 02 May 2016)	

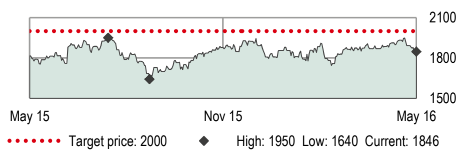
MARKET DATA

Market cap (GBPm)	46,459	Free float	100%
Market cap (USDm)	68,169	BBG	DGE LN
3m ADTV (USDm)	188	RIC	DGE.L

FINANCIALS AND RATIOS (GBPp)

Year to	06/2015a	06/2016e	06/2017e	06/2018e
HSBC EPS	88.80	88.64	100.57	104.15
HSBC EPS (prev)	-	87.54	100.40	106.22
Change (%)	-	1.3	0.2	-1.9
Consensus EPS	90.07	88.54	95.89	102.80
PE (x)	20.8	20.8	18.4	17.7
Dividend yield (%)	3.1	3.1	3.6	3.8
EV/EBITDA (x)	15.3	15.2	14.4	13.8
ROE (%)	30.6	27.2	27.9	26.4

52-WEEK PRICE (GBPp)



Source: Thomson Reuters IBES, HSBC estimates

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Financials & valuation: Diageo

Hold

Financial statements

Year to	06/2015a	06/2016e	06/2017e	06/2018e
Profit & loss summary (GBPm)				
Revenue	10,813	10,788	11,198	11,495
EBITDA	3,506	3,509	3,672	3,770
Depreciation & amortisation	-440	-464	-481	-483
Operating profit/EBIT	3,066	3,045	3,190	3,287
Net interest	-39	-351	-352	-347
PBT	2,933	2,783	3,040	3,152
HSBC PBT	2,933	2,783	3,040	3,152
Taxation	-466	-536	-607	-630
Net profit	2,381	2,347	2,532	2,623
HSBC net profit	2,235	2,232	2,532	2,623
Cash flow summary (GBPm)				
Cash flow from operations	2,564	2,820	2,869	3,000
Capex	-586	-496	-515	-529
Cash flow from investment	-2,968	-489	-637	-617
Dividends	-1,413	-1,443	-1,675	-1,774
Change in net debt	774	-450	-427	-882
FCF equity	2,193	2,135	2,045	2,155
Balance sheet summary (GBPm)				
Intangible fixed assets	11,667	11,666	11,683	11,695
Tangible fixed assets	4,093	4,124	4,173	4,230
Current assets	7,670	7,454	8,494	9,280
Cash & others	472	272	1,040	1,628
Total assets	25,804	25,613	26,808	27,729
Operating liabilities	4,471	4,461	4,630	4,753
Gross debt	9,838	9,188	9,529	9,235
Net debt	9,366	8,916	8,489	7,607
Shareholders' funds	7,771	8,664	9,510	10,346
Invested capital	18,487	18,511	18,680	18,824

Ratio, growth and per share analysis

Year to	06/2015a	06/2016e	06/2017e	06/2018e
Y-o-y % change				
Revenue	5.4	-0.2	3.8	2.7
EBITDA	5.1	0.1	4.6	2.7
Operating profit	13.3	-0.7	4.8	3.0
PBT	8.2	-5.1	9.2	3.7
HSBC EPS	-6.6	-0.2	13.5	3.6
Ratios (%)				
Revenue/IC (x)	0.7	0.6	0.6	0.6
ROIC	15.7	13.3	13.7	14.0
ROE	30.6	27.2	27.9	26.4
ROA	10.1	8.7	9.3	9.3
EBITDA margin	32.4	32.5	32.8	32.8
Operating profit margin	28.4	28.2	28.5	28.6
EBITDA/net interest (x)	89.9	10.0	10.4	10.9
Net debt/equity	101.2	87.9	76.8	63.8
Net debt/EBITDA (x)	2.7	2.5	2.3	2.0
CF from operations/net debt	27.4	31.6	33.8	39.4
Per share data (GBPp)				
EPS Rep (diluted)	94.60	93.21	100.57	104.15
HSBC EPS (diluted)	88.80	88.64	100.57	104.15
DPS	56.40	57.62	66.88	70.83
Book value	310.22	345.89	379.63	413.00

Key forecast drivers

Year to	06/2015a	06/2016e	06/2017e	06/2018e
Organic volume	-1	1	2	1
Organic sales	0	2	4	3
Organic EBIT	1	3	5	3
Organic EBIT margin	0	0	0	0

Valuation data

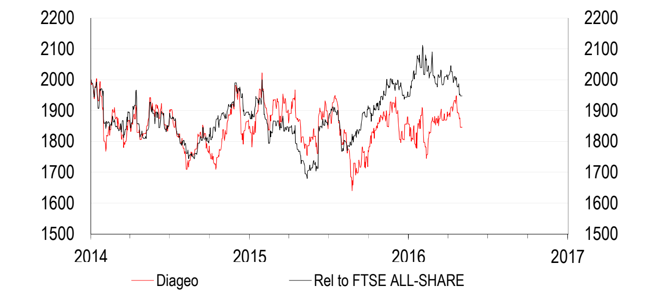
Year to	06/2015a	06/2016e	06/2017e	06/2018e
EV/sales	5.0	4.9	4.7	4.5
EV/EBITDA	15.3	15.2	14.4	13.8
EV/IC	2.9	2.9	2.8	2.8
PE*	20.8	20.8	18.4	17.7
PB	6.0	5.3	4.9	4.5
FCF yield (%)	5.0	4.8	4.6	4.9
Dividend yield (%)	3.1	3.1	3.6	3.8

* Based on HSBC EPS (diluted)

Issuer information

Share price (GBPp)	1,846	Free float	100%
Target price (GBPp)	2,000	Sector	Beverages
Reuters (Equity)	DGE.L	Country	United Kingdom
Bloomberg (Equity)	DGE LN	Analyst	Anthony Bucalo
Market cap (USDm)	68,169	Contact	+4420 7991 9815

Price relative



Source: HSBC

Note: Priced at close of 02 May 2016

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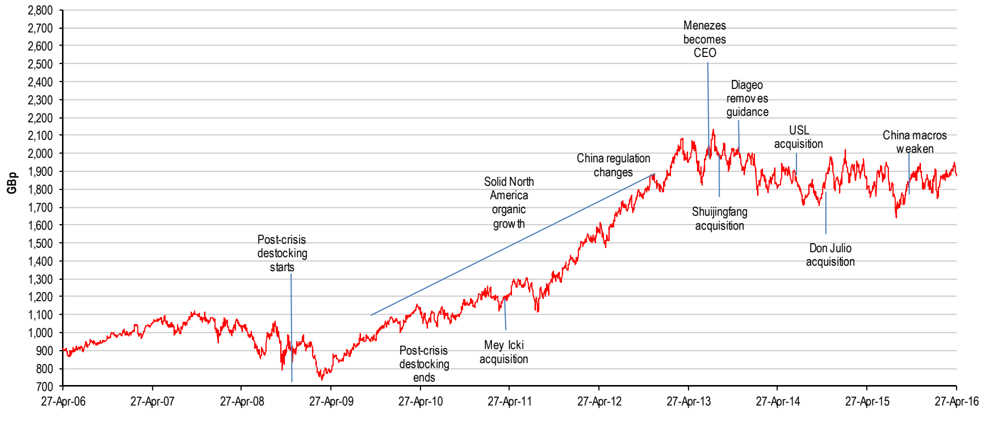
Can Diageo get America back on track?

- We believe consensus expectations for Diageo's US business are too optimistic
- Diageo's US portfolio is still not aligned with current trends
- In contrast to the market's positive view, we maintain our Hold rating

What if Diageo cannot turn around its US division?

Since Diageo's management prepared the market in 2013 for tougher times ahead, the company's shares have done little to impress. Emerging market currency and demand weakness, the changing dynamics of the Nigerian beer market, the frustrating and seemingly never-ending impact of gifting rule changes in China, and a slowdown in the US market have all combined to mute Diageo's most recent results.

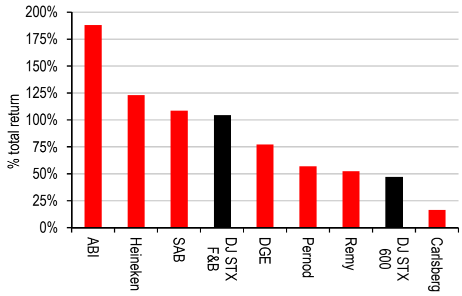
Drivers of Diageo's share price performance, 2006-2016



Source: Thomson Reuters Datastream, HSBC analysis

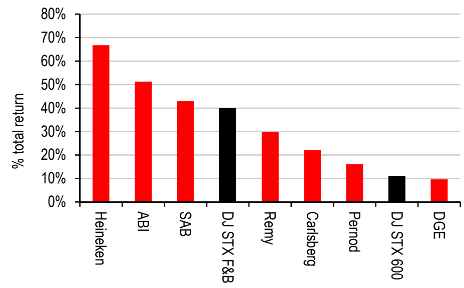
Diageo shares have not materially changed in value since our October 2015 initiation on the company and have also been a relative laggard on a total return basis (stock appreciation plus dividends) over a five- and two- year time frame. Diageo's inwardly focused cultural and operational changes have not demonstrably appeared in the share price as of yet. We believe the past few years have been distinctly disappointing.

European Beverages, 5-year total returns



Note: Total return is stock appreciation plus dividends).
Source: Thomson Reuters Datastream

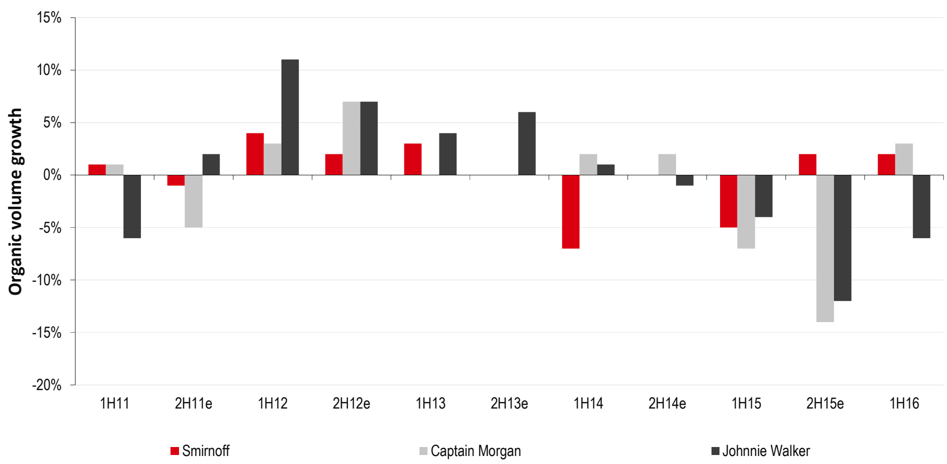
European Beverages, 2-year total returns



Note: Total return is stock appreciation plus dividends).
Source: Thomson Reuters Datastream

That being said, we believe there is optimism in the market based on the assumption that a US rebound is around the corner and this will drive the stock forward into 2017. North American comparisons get easier into the back half of FY 2015/16e as the company laps new product launches, specifically *Cîroc* and *Crown Royal* flavour extensions. Key brands *Captain Morgan* and *Johnnie Walker* demonstrated mid-teens declines in 2H 2014/15 and *Smirnoff* has a relatively easy comp as well. Additionally, management has an array of ambitious cost savings plans, focused mostly on supply chain improvements. We do not see major asset sales or purchases in the near term.

Diageo key brand organic volume trend, FY 2010/11 to 1H 2015/16



Source: Company data, HSBC estimates

Additionally, when the SABMiller-ABI merger closes later this year as expected, it would be entirely reasonable for former SABMiller shareholders looking for global consumer exposure to redeploy some of their proceeds into Diageo shares as well. As for US leadership, although we are not yet entirely comfortable with the logic of sending a finance specialist to fix a company with brand and product issues, we do believe there is considerable goodwill in the market toward new North America head and former CFO Deidre Mahlan, who has been tasked with recasting and reviving the North American business.

Taken overall, we understand and appreciate the underlying rationale for a more bullish stance on the stock. However, we do not see this combination of factors as compelling enough for that more bullish stance yet; a US rebound will be the most important yardstick for driving success and we are simply not sure that the optimism of a turnaround is entirely warranted. Looking ahead, we are concerned that the company may have become a permanent share donor with little hope for climbing back to profitable market share growth.

Diageo North America Vuma Consensus vs HSBC

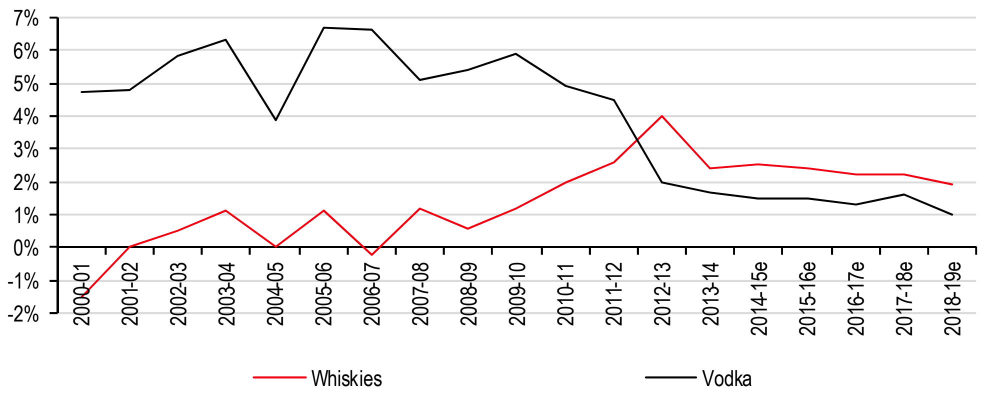
	Vuma Cons.	HSBC
FY 2015/16e		
Organic sales	2.1%	-0.2%
Organic EBIT	1.7%	0.2%
FY 2016/17e		
Organic sales	3.3%	1.5%
Organic EBIT	4.5%	2.3%

Source: Vuma, HSBC estimates

Recent history is not on Diageo's side

We believe Diageo has struggled in the US in recent times because management capitalised on the market's preference for white spirits to the exclusion of developing its brown spirits portfolio and, when the market shifted to brown spirits as the primary growth driver, the company did not have the product or brand tools to exploit the change in market dynamics.

Y-o-Y growth of whisky and vodka volumes, 2000-19e



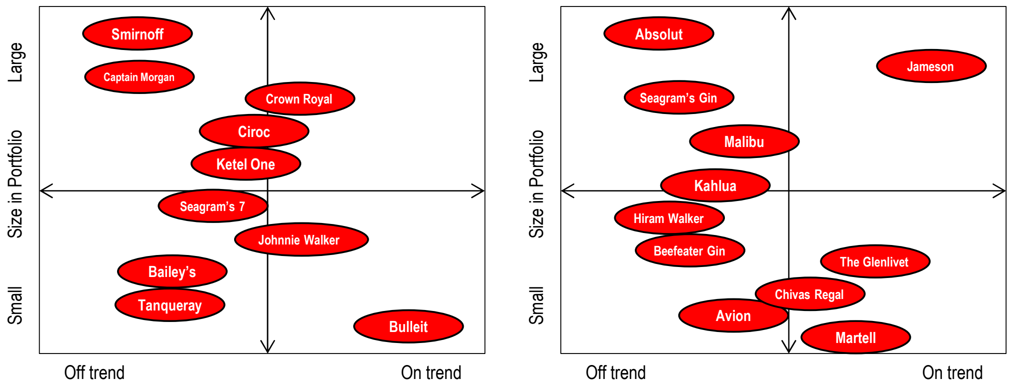
Source: Euromonitor

After the 2008 financial crisis, the US market shifted sharply from a white spirits driven market to a brown spirits. We believe there is no one specific reason for the change in market dynamics, although we suspect it was caused by the end of the vodka flavour innovation cycle in combination with the consumer desire for greater authenticity in beverage alcohol choices.

We do not believe it is a coincidence that craft beer – a generally local phenomenon defined by its anti-corporate orientation – has also thrived during an era when US consumer tastes shifted toward local whiskies.

Without a US-based whiskey of scale in the portfolio and a weak entry in Irish whisky, Diageo did not have a big brand backbone from which to innovate. There was M&A available that could have mitigated this, but the company chose to move forward organically with its own brown spirits entries.

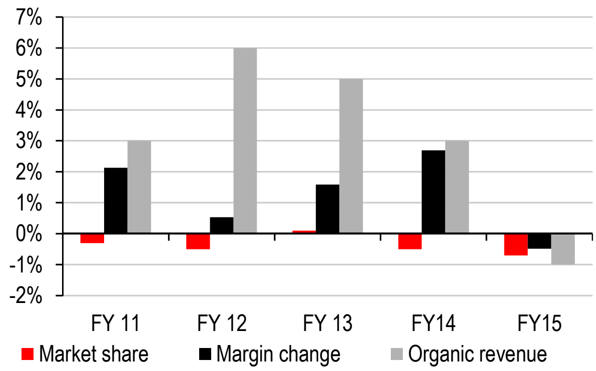
Diageo (left) vs Pernod Ricard (right) US portfolio analysis



Source: Beverage Marketing Corporation DrinkTell, HSBC analysis

In our launch of coverage in October 2015, we opined that Diageo's five-year North America performance was not overtly terrible and the company had reported a reasonable amount of growth, even in light of several disposals. But we think the underlying truth was that the company had been effectively trading market share for margin and we did not see this as a sustainable strategy in our launch of coverage. We still don't.

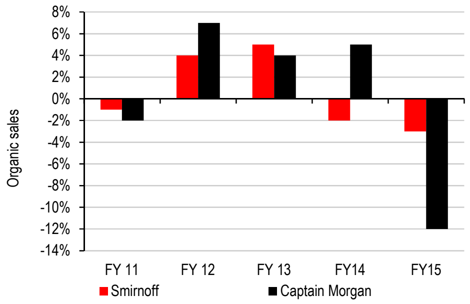
Diageo North America organic Sales, EBIT and market share trends, FY11-FY15



Source: Company data, HSBC estimates

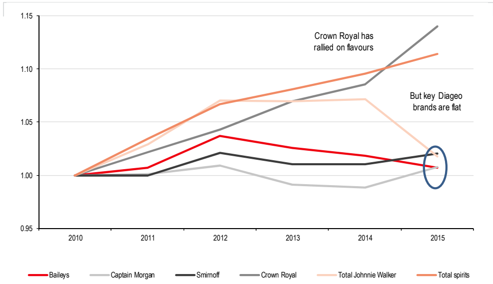
This is not necessarily new news as the US market has been a struggle for Diageo for some time. The company has lost market share organically as its core top two brands have lost momentum, *Smirnoff* and *Captain Morgan*. The company's top brands have stalled volumetrically and are now generally off-trend, save for *Cîroc*, which we think is a unique brand proposition and has been the company's market share saviour over the past few years. However, even *Cîroc* is showing signs of a slowdown.

Diageo core brands organic sales trends



Source: Company data, HSBC analysis

Diageo top brands organic sales trends

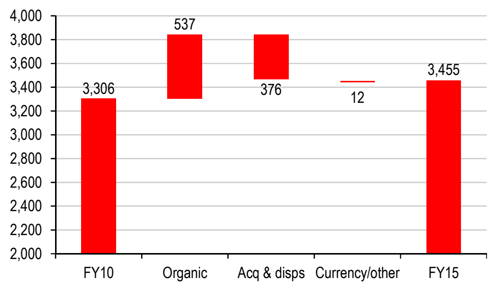


Source: Beverage Marketing Corporation DrinkTell, HSBC analysis

The volume base of the two most important Diageo brands *Smirnoff* and *Captain Morgan* has not budged in five years, while the industry on whole has grown at an average of roughly 2-3% annually. The growth trends have recovered somewhat recently, but the medium-term trend is poor. The impact of this brand weakness has been a major drag on momentum.

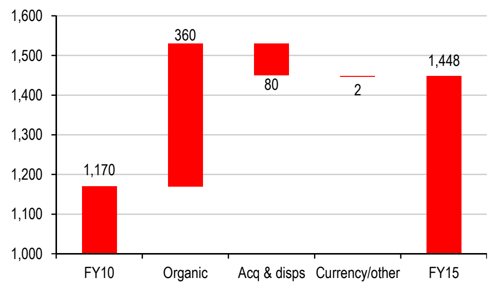
From FY 2010/11 through FY 2013/14, the company managed to grow North America margins and organic revenue every year but shed market share along the way as those big brands lost relevance. However, we believe the underlying performance in FY 2014/15 was unacceptably bad for a market leader with the brands and reach of Diageo.

Diageo North America sales, FY10-FY15 GBPm



Source: Company data, HSBC estimates

Diageo North America EBIT, FY10-FY15 GBPm



Source: Company data, HSBC estimates

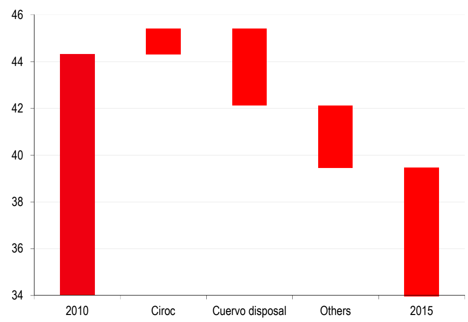
The company lost market share, organic revenue, and margin simultaneously after several years of being able to capture at least positive revenue and margin growth. The trends were even worse in 1H 2015/16. Diageo shares – which are very much staked to the success of North America – are unlikely to outperform peers if these trends continue, in our view.

Has Diageo become a permanent share donor?

In the US market, the reality is that the leading players have been market share donors in one way or another in recent years, so Diageo is not unique at the top of the league table. However, in comparison with Diageo, it appears that many of the company's main competitors either already have the necessary portfolio or have arguably been ahead of Diageo in mitigating the changes in the market.

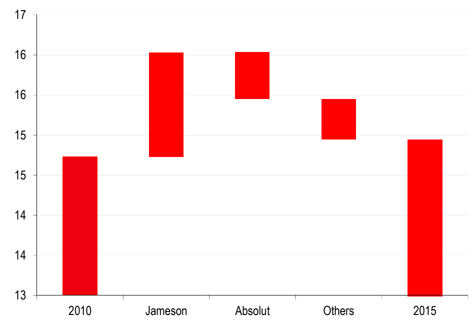
Diageo's main competitor, Pernod Ricard (RI FP, EUR95.37, Hold, TP EUR103.0) has hung in there with *Jameson* Irish whisky, a powerful brand and product combination, which has been able to draft behind the US brown spirits trend. This has worked to offset the market share plummet of *Absolut*, the premium vodka brand that has performed poorly for Pernod.

Diageo US case volume movement, 2010-15



Source: Beverage Marketing Corporation DrinkTell

Pernod US case volume movement, 2010-15

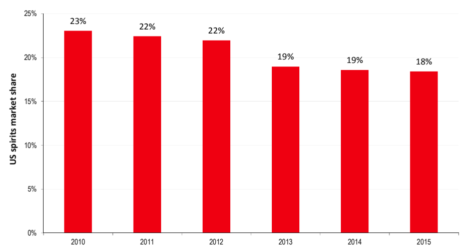


Source: Beverage Marketing Corporation DrinkTell

Privately held Sazerac purchased the highly prized bourbon-related operations of Constellation Brands for USD334m in 2009; this transaction included about 40 brands, including *Buffalo Trace* and *Pappy Van Winkle* bourbons. These brands are on-trend and the company has been a significant share gainer as a result.

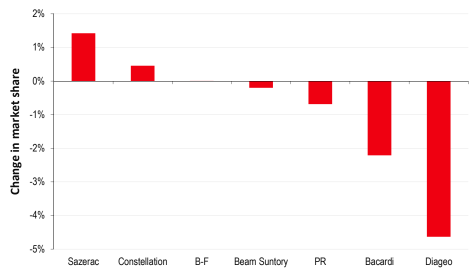
Brown Forman has benefited from the trend towards American whiskey with *Jack Daniel's* and *Woodford Reserve*. Asahi bought its way into the market through Fortune Brands. Heaven Hill has its own reasonably successful line of bourbons.

Diageo US volume market share, 2010-15



Source: Beverage Marketing Corporation DrinkTell

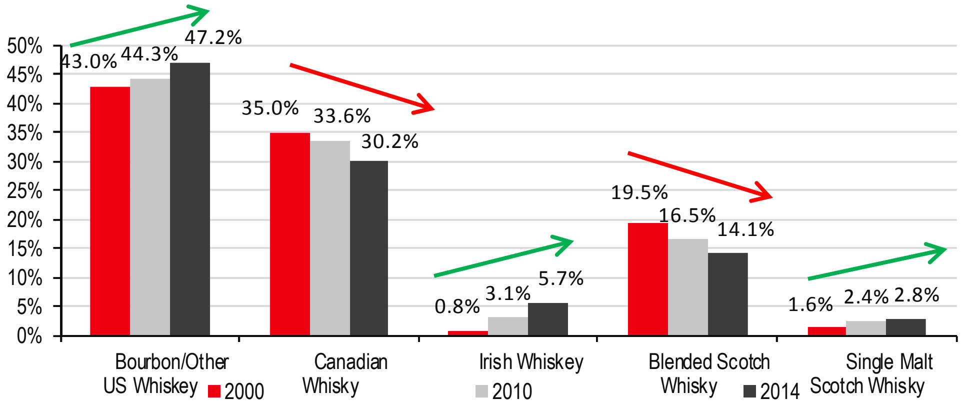
US spirits market change in volume market share, 2010-15



Source: Beverage Marketing Corporation DrinkTell

Diageo's brown spirits portfolio is solid but generally off-trend or under-scaled at this time. In Scotch, *Johnnie Walker* is pure class and recent results have been constructive but the boom has been in mainstream US brands and Scotch as a category has a more narrow appeal than US or Irish whisky. *Bulleit* bourbon is very successful, but is still small and will need time to reach appropriate scale.

Volume share of whisky categories



Source: Euromonitor

We think that *Crown Royal* is a strong brand, but Canadian whiskey does not have the cache of imported whiskies, or high-profile American products like *Jack Daniel's, Jim Beam,* or smaller brands like *Maker's Mark* or *Knob Creek*. There has been reasonably good innovation recently, for example with *Crown Royal* flavour extensions, but we are not clear how sustainable that flavour innovation model will be over time – flavour extensions historically tend to have a relatively short half-life.

Diageo cannot rationalise US market share losses in the long term

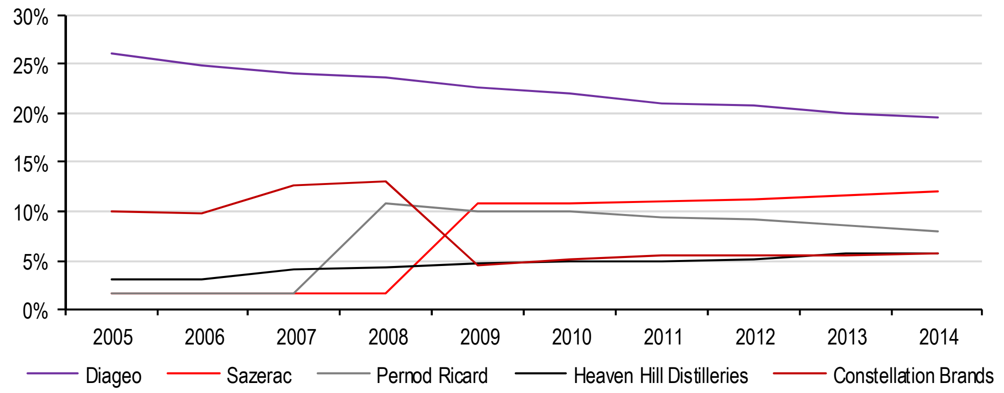
The parallel to Diageo in the US market is AB Inbev (ABI BB, EUR109.1, Buy, TP EUR129.0) as both are sizable leaders with problematic market share trajectories caused by the static or declining trends of their biggest brands. But we see differences in the story that flatter ABI much more so than Diageo.

We have been critical of ABI for its failure to hold market share in the US and have had our quibbles with ABI's strategies and tactics – especially the strategic abandonment of value brands (*Natural Light*, *Busch* family) during an economic era when American beer's young, male, blue-collar constituency is clearly under financial pressure.

We believe ABI's decision to walk away from supporting a strong value portfolio is at the core of ABI's market share challenges and endangers the industry's ability to keep consumers in the American mass beer category for the long-term.

However, in parallel we have also been cognizant that the big American beer brand model built over decades by A-B's preceding ownership and used by A-B, Miller and Coors was already under strain coming into InBev's 2008 acquisition of the old A-B. At the time of the merger, we did not see a magic wand available for ABI management to recast the macro trends of the previous 15 years in its favour as the previous management had desperately tried leading up to InBev's bid on the company.

US vodka volume share trends, 2005-14



Source: Euromonitor

We, along with the market we believe, were willing to accept ABI's US market share losses within the old A-B's tired and out-of-date beer portfolio in exchange for higher profitability and cash flow. Ultimately, this would yield an evolution to a leaner, more on-trend and more valuable stable of brands. The process has been imperfect, but ABI mostly got its desired result as the focus on US profitability over market share allowed ABI to deleverage rapidly its balance sheet post both the A-B and Grupo Modelo transactions as well as the pending SABMiller deal. Market share has suffered, however, with no clear path back to growth.

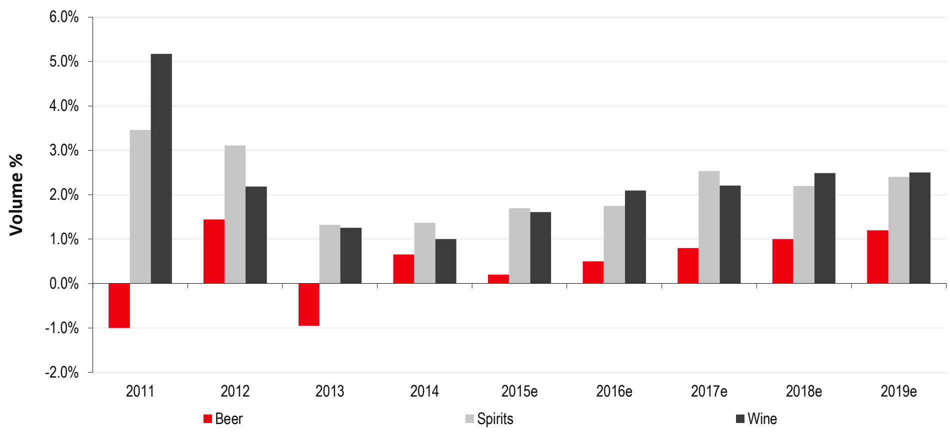
US mass beer is unhealthy while US spirits is healthy

In comparison to ABI, however, the US market is the central narrative for the Diageo equity story and this makes success in that market much more important for Diageo than for ABI. Diageo is in effect the leader in an industry that is getting more relevant with consumers, growing volumetrically and taking share within beverage alcohol. Unlike beer, there is no structural headwind handed down from previous generations of owners who built massive portfolios of products that are now no longer relevant. We cannot identify why Diageo is struggling.

Unlike the spent force that is the US domestic beer industry, the US spirits market is in fact healthy for a variety of reasons. Primarily we believe that the US spirits industry in aggregate has done a much better job innovating and competing for young consumers than has Big Beer over the past 20 years.

First, the US spirits industry has demonstrated significantly improved on-trade execution in recent years. Additionally, cultural hot points like the television programme *Sex and the City* provided additional glamour for the category starting in the 1990s. This was also during a period when late night cable television opened up above-the-line advertising in a new direction for the category. Flavour innovation, especially in vodka, has been constructive as well, although that benefit appears to have waned.

US beverage alcohol growth trends, 2011-19e

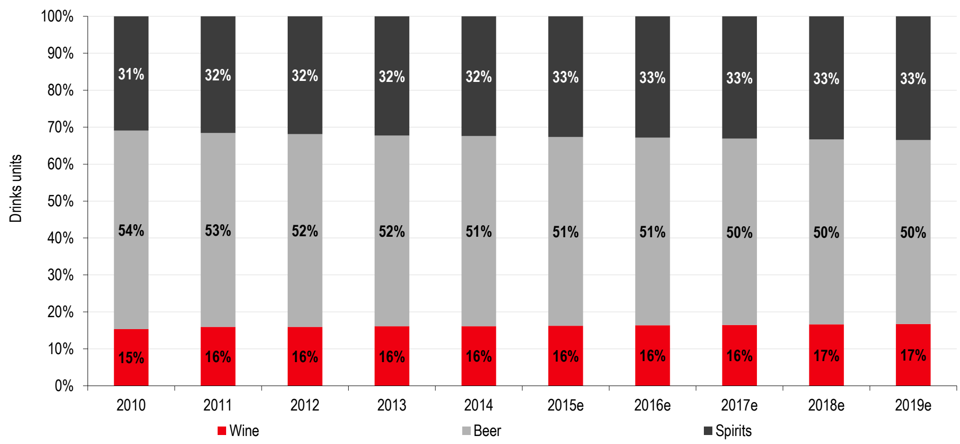


Source: Beverage Marketing Corporation DrinkTell

We think this investment in the 1990s and 2000s set the stage for today's successful push with trend-chasing Millennials and their focus on individuality, customisation, and personal brand building. This generation appears particularly ripe for development by spirits companies which – backed by social media penetration – can offer a nearly limitless supply of different products and brands at nearly any price point or brand positioning. Without social media, the previous generation of drinkers was much tougher to reach and were more sceptical of the hard sell, we believe.

Thinking in the broadest possible terms, mass American beer brands continue to lose relevance and ABI is essentially losing share within a huge but increasingly less relevant sector. But after the formal integration of SABMiller later this year, the US will no longer be the market that decides ABI's success in black or white terms.

US alcohol consumption by drink unit, 2010-19e



Source: Beverage Marketing Corporation DrinkTell

For ABI at the global level, the US business has always been a means to end – a generator of significant cash flow to fund ABI's imperial objectives and a source of high-quality beer brands for global expansion. It will remain as such and as long as the US market doesn't weaken appreciably, we think ABI's US market will likely be perceived as a net positive post the ABI-SABMiller merger.

Estimates changes drive DCF update

We have updated our Diageo estimates with new currency estimates and other minor adjustments. We have not materially changed our organic expectations for FY 2015/16e, but our EPS estimate increases by +1% (88.64p vs previous 87.54p). We have lowered our organic expectation for FY 2016/17e and have not materially changed our EPS estimate (100.57p vs 100.40p). Our FY 2017/18 EPS is reduced by 1.9% to 104.15p from 106.22p.

Diageo change in earnings estimates, FY2016e-FY2017e

GBPm	New FY16e	Previous FY16e	Chg.	New FY17e	Previous FY17e	Chg.
Volume (m CEs)	243.3	243.6	-0.1%	247.6	248.1	-0.2%
Gross sales	15,798	15,738	0.4%	16,288	16,196	0.6%
Net sales	**10,788**	**10,715**	**0.7%**	**11,198**	**11,090**	**1.0%**
Gross Profit	6,189	6,149	0.7%	6,430	6,369	1.0%
Marketing	-1,588	-1,573	1.0%	-1,650	-1,621	1.8%
EBIT (pre-exceptionals)	**3,045**	**3,019**	**0.9%**	**3,190**	**3,157**	**1.1%**
PBET	2,783	2,746	1.3%	3,040	3,022	0.6%
EBIT Margin	28.2%	28.2%	0.1%	28.5%	28.5%	0.0%
EPS (pre exceptionals)	**88.64**	**87.54**	**1.3%**	**100.57**	**100.40**	**0.2%**
Free Cash Flow	2,324	2,323	0.0%	2,348	2,357	-0.4%
Organic Volume	1.3%	1.1%	0.2%	1.7%	1.8%	-0.1%
Organic Sales	2.0%	1.9%	0.1%	2.9%	3.5%	-0.6%
Organic EBIT	2.9%	2.8%	0.1%	3.2%	4.0%	-0.7%

Source: Company data, HSBC estimates

Diageo: Valuation and risks

DCF-based target price of 2,000p (from 1,900p)

Our target price of 2,000p/share is derived from a DCF methodology and cross-checked against price-to-earnings multiple. Our DCF valuation is based on medium-term NOPAT growth of 3.8% (from 4.6%), a beta of 0.92 and a tax rate of 20%. From 2016e to 2026e, our capex/D&A ratio is equal to 105%.

We have used HSBC's updated market risk by country to create a weighted average cost of equity of 8.0% (from 8.5%); combined, this gives us a WACC of 6.7% (from 7.0%). Our +2% terminal growth rate is consistent with our Food and HPC sector perpetuity rates; we believe this is a fair comparative. With our target price implying 8.3% upside versus the current price and a relatively soft medium-term outlook, we rate Diageo Hold.

Diageo DCF: FY16e-FY25e

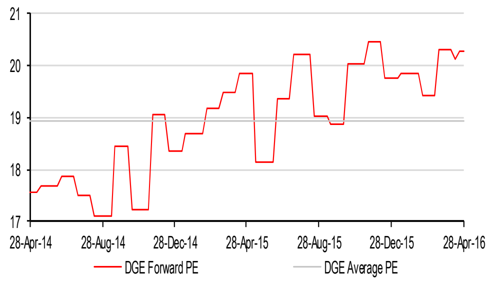
	FY16e	FY17e	FY18e	FY19e	FY20e	FY21e	FY22e	FY23e	FY24e	FY25e	CAGR
EBIT*(1-tax rate)	2,517	2,725	2,811	2,900	2,993	3,090	3,190	3,295	3,404	3,517	3.8%
(+) Depreciation	464	481	483	496	509	523	538	553	568	584	2.6%
(-) CAPEX	-496	-515	-529	-543	-558	-573	-589	-605	-622	-640	2.9%
(+/-) Changes in WC	9	-151	-110	-114	-118	-122	-127	-132	-137	-142	na
FCFF (GBPm)	**2,494**	**2,540**	**2,655**	**2,739**	**2,826**	**2,917**	**3,012**	**3,111**	**3,213**	**3,320**	**3.2%**
WACC	6.7%										
Long-term growth	**3.8%**										
Levered terminal value	71,942										
Present value levered terminal value	39,670										
Present value of UFCFs @ WACC	21,290										
Total value of the Firm	**60,960**										
(-) Net debt 2015	-9,324										
(-) Minority 2015	-1,538										
Equity value (GBPm)	**50,098**										
Total number of shares (m)	2,505										
Fair value per share (GBP)	**2,000**										

Source: HSBC estimates

Price-to-earnings analysis

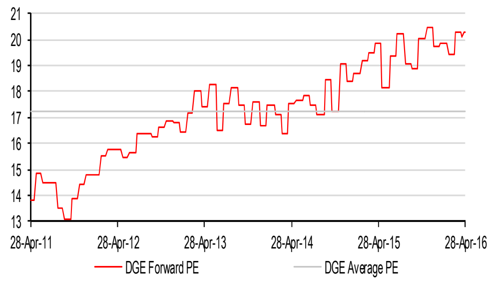
Our target price of 2,000p values the shares at a PE of 21.1x on our calendar 2016e EPS estimate of 0.95p. This compares with a current consensus forward PE of 20.3x, average 2-year PE of 18.9x, and 5-year average of 17.3x.

Diageo 2-year PE valuation



Source: Thomson Reuters Datastream

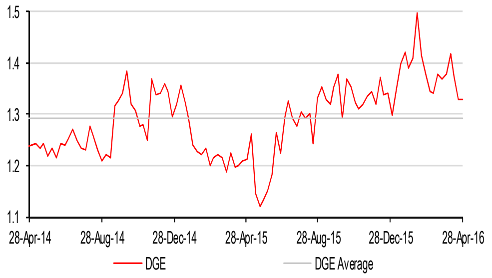
Diageo 5-year PE valuation



Source: Thomson Reuters Datastream

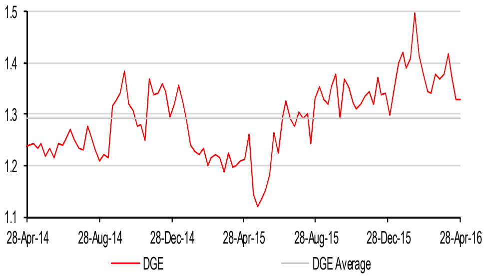
Relative to the market, Diageo shares are trading at a 33% premium versus a 2-year average of 29% and a 5-year average of 38%.

Diageo 2-year valuation relative to Stoxx 600



Source: Thomson Reuters Datastream

Diageo 5-year valuation relative to Stoxx 600



Source: Thomson Reuters Datastream

Risks

Downside risks include: (i) global consumer weakness, especially in the US, India or China; (ii) increased regulation in key emerging markets like China and India; (iii) missing the next round of global M&A; (iv) more aggressive competition from local players in China; (v) FX volatility.

Upside risks include: (i) better than expected performances in key markets like the US, India, China or across Europe; (ii) FX tailwinds; (iii) better than expected delivery of cost savings programmes; (iv) an unexpected acquisition by a larger player.

HSBC

ABI Inbev (ABI BB; CP EUR109.10; TP EUR129.00; Buy)

ABI-SAB Provisional DCF, 2016e-2026e

	2016e	2017e	2018e	2019e…	...2023e	2024e	2025e	2026e	CAGR
EBIT*(1-tax rate)	13,529	14,413	15,217	16,244	20,860	22,218	23,676	25,243	6.4%
(+) Depreciation	3,689	4,109	4,440	4,573	5,601	5,945	6,315	6,712	6.2%
(-) CAPEX	-3,878	-4,350	-4,694	-4,840	-5,934	-6,298	-6,689	-7,108	6.2%
(+/-) Changes in WC	4,641	1,028	1,097	1,171	1,529	1,636	1,751	1,875	-8.7%
FCFF (USDm)	**17,981**	**15,201**	**16,060**	**17,148**	**22,056**	**23,501**	**25,053**	**26,722**	**4.0%**
WACC	7.4%								
Long-term growth	6.4%								
Levered terminal value	505,373								
Present value of LT value	251,357								
Present value of UFCFs @ WACC	156,022								
Total value of the Firm	**407,378**								
(-) Net debt 2015	-101,384								
(-) Minority 2015	-29,863								
Equity value (USDm)	**276,131**								
Total number of shares (m)	**1,922**								
Fair value per share (USD)	**144**								
Fair value per share (EUR)	**129**								

Source: Company data, HSBC estimates

Valuation and risks

Our target price of EUR129 (implying 20% upside) and Buy rating are based on ABI's dominant structure in key global profit pools (US, Brazil, Mexico) as well as the company's ability to integrate new assets and drive increased profitability as a result. ABI is an HSBC Europe Super Ten constituent.

Potential upside catalysts include: (i) transformational M&A opportunities that provide new avenues for growth; (ii) faster than expected recovery of the Brazilian economy; (iii) extraordinary improvements in China's profitability; (iv) unexpected megabrand revival in the US; (v) extraordinary dividend payment.

Risks

Downside risks include: (i) faster-than-expected decreases in volumes in core markets like Mexico, US, Brazil, etc; (ii) excise tax increases in key markets; (iii) greater competition from local players in Europe, Mexico, South America; (iv) more FX volatility in key markets like Brazil and Mexico.

HSBC

Diageo operating income, FY 2013-FY 2018e, GBPm

YE June	FY13	FY14	FY15	FY16e	FY17e	FY18e	FY19e
Sales	15,276	13,980	15,966	15,798	16,288	16,626	16,995
Excise duties	(3,973)	(3,722)	(5,153)	(5,010)	(5,090)	(5,131)	(5,191)
Net sales	**11,303**	**10,258**	**10,813**	**10,788**	**11,198**	**11,495**	**11,804**
Operating costs	(7,923)	(7,551)	(8,016)	(7,847)	(8,007)	(8,208)	(8,416)
Cost of sales	(4,470)	(4,029)	(4,610)	(4,599)	(4,768)	(4,891)	(5,019)
Gross profit	**6,833**	**6,229**	**6,203**	**6,189**	**6,430**	**6,604**	**6,785**
Marketing	(1,769)	(1,620)	(1,626)	(1,588)	(1,650)	(1,709)	(1,771)
Other operating expenses	(1,585)	(1,902)	(1,780)	(1,556)	(1,590)	(1,608)	(1,626)
EBIT pre-exceptionals	**3,380**	**2,707**	**3,066**	**3,045**	**3,190**	**3,287**	**3,388**
Exceptionals	(99)	(427)	(269)	(104)			
EBIT	3,380	2,707	2,797	2,941			
EBIT (pre-exceptionals) margin	29.9%	26.4%	25.9%	27.3%	28.5%	28.6%	28.7%
% Change	0.6%	-3.5%	-0.5%	1.4%	1.2%	0.1%	0.1%
Share of associates' profits after tax	217	252	175	193	202	212	223
EBIT group (+ minorities)	3,597	2,959	2,972	3,133	3,392	3,499	3,611
EBITDA pre-exceptionals	**3,882**	**3,763**	**3,506**	**3,509**	**3,672**	**3,770**	**3,884**
EBITDA (pre-exceptionals) margin	34.3%	36.7%	32.4%	32.5%	32.8%	32.8%	32.9%
% Change	0.8%	2.3%	-4.3%	0.1%	0.3%	0.0%	0.1%
Net finance charges	(540)	(248)	(39)	(351)	(352)	(347)	(342)
Profit before tax	**3,057**	**2,711**	**2,933**	**2,783**	**3,040**	**3,152**	**3,269**
Total tax	(507)	(447)	(466)	(536)	(607)	(630)	(653)
Profit after tax	2,550	2,181	2,467	2,247	2,432	2,523	2,616
Attributable to:							
Minority interests	98	67	(86)	(100)	(100)	(100)	(100)
Equity shareholders	2,452	2,248	2,381	2,347	2,532	2,623	2,716
Equity shareholders (net of exceptionals)	**2,580**	**2,393**	**2,235**	**2,232**	**2,532**	**2,623**	**2,716**
Reported EPS (GBP)							
Diluted net of one times	**103.10**	**95.50**	**88.80**	**88.64**	**100.57**	**104.15**	**107.85**
Average shares (m)	2,502	2,506	2,505	2,505	2,505	2,505	2,505

Source: Company data, HSBC estimates

Diageo operating estimates, FY 2011-FY 2017e, GBPm

Group	FY11	FY12	FY13	FY14	FY15E	FY16E	Chg.	FY17E	Chg.
Volumes	147.5	155.7	164.2	156.1	246.2	243.3	-1.2%	247.6	1.7%
Net Sales	9,936	10,639	11,303	10,258	10,813	10,788	-0.2%	11,198	3.8%
Operating Profit (net exp)	2,884	3,148	3,479	3,134	3,066	3,045	-0.7%	3,190	4.8%
Op margin	*29.0%*	*29.6%*	*30.8%*	*30.6%*	*28.4%*	*28.2%*	*-0.1%*	*28.5%*	*0.3%*
Marketing Spend	1,538	1,687	1,769	1,620	1,626	1,588	-2.3%	1,650	3.9%
Marketing % of sales	*15.5%*	*15.9%*	*15.7%*	*15.8%*	*15.0%*	*14.7%*	*-0.3%*	*14.7%*	*0.0%*
North America									
Volumes	52.3	52.9	53.6	49.3	47.3	46.8	-1.0%	47.1	0.5%
Net Sales	3,366	3,547	3,723	3,444	3,455	3,580	3.6%	3,653	2.0%
Operating Profit (net exp)	1,265	1,352	1,478	1,460	1,448	1,495	3.2%	1,536	2.8%
Op margin	*37.6%*	*38.1%*	*39.7%*	*42.4%*	*41.9%*	*41.7%*	*-0.2%*	*42.1%*	*0.3%*
Marketing Spend	508	543	581	540	542	542	0.1%	561	3.5%
Marketing % of sales	*15.1%*	*15.3%*	*15.6%*	*15.7%*	*15.7%*	*15.1%*	*-0.5%*	*15.4%*	*0.2%*
Western Europe/Europe									
Volumes	35.6	34.7	45.4	44.6	44.1	43.7	-0.9%	44.2	1.0%
Net Sales	2,433	2,331	2,915	2,814	2,617	2,587	-1.1%	2,678	3.5%
Operating Profit (net exp)	727	712	903	853	804	794	-1.2%	829	4.3%
Op margin	*29.9%*	*30.5%*	*31.0%*	*30.3%*	*30.7%*	*30.7%*	*0.0%*	*30.9%*	*0.2%*
Marketing Spend	357	355	431	413	388	389	0.3%	401	3.1%
Marketing % of sales	*14.7%*	*15.2%*	*14.8%*	*14.7%*	*14.8%*	*15.0%*	*0.2%*	*15.0%*	*-0.1%*
Africa, EE, Turkey/Africa									
Volumes	28.0	35.4	26.1	24.4	26.2	29.0	10.6%	29.8	3.0%
Net Sales	1,627	2,048	1,564	1,430	1,415	1,383	-2.3%	1,478	6.9%
Operating Profit (net exp)	420	574	400	340	318	280	-11.8%	301	7.3%
Op margin	*25.8%*	*28.0%*	*25.6%*	*23.8%*	*22.5%*	*20.3%*	*-2.2%*	*20.4%*	*0.1%*
Marketing Spend	184	232	162	152	147	136	-7.6%	144	6.4%
Marketing % of sales	*11.3%*	*11.3%*	*10.4%*	*10.6%*	*10.4%*	*9.8%*	*-0.6%*	*9.8%*	*0.0%*
LatAm &Carib									
Volumes	15.7	17.2	23.3	23.0	21.6	22.4	3.8%	23.1	3.0%
Net Sales	1,063	1,236	1,453	1,144	1,033	951	-8.0%	1,005	5.7%
Operating Profit (net exp)	320	367	468	328	263	214	-18.6%	227	5.9%
Op margin	*30.1%*	*29.7%*	*32.2%*	*28.7%*	*25.5%*	*22.5%*	*-2.9%*	*22.6%*	*0.0%*
Marketing Spend	181	208	233	203	194	181	-6.8%	189	4.6%
Marketing % of sales	*17.0%*	*16.8%*	*16.0%*	*17.7%*	*18.8%*	*19.0%*	*0.2%*	*18.8%*	*-0.2%*
APAC									
Volumes	15.9	15.5	15.8	14.8	107.0	101.4	-5.3%	103.4	2.0%
Net Sales	1,377	1,407	1,572	1,347	2,213	2,206	-0.3%	2,301	4.3%
Operating Profit (net exp)	286	332	381	283	356	381	7.0%	420	10.4%
Op margin	*20.8%*	*23.6%*	*24.2%*	*21.0%*	*16.1%*	*17.3%*	*1.2%*	*18.3%*	*1.0%*
Marketing Spend	303	343	356	305	344	340	-1.2%	354	4.0%
Marketing % of sales	*22.0%*	*24.4%*	*22.6%*	*22.6%*	*15.5%*	*15.4%*	*-0.1%*	*15.4%*	*0.0%*
Corporate									
Net Sales	70	70	76	79	80	82	2.0%	83	2.0%
Operating Profit (net exp)	(134)	(167)	(151)	(130)	(123)	(119)	-3.0%	(123)	3.0%

Source: Company data, HSBC estimates

Diageo organic growth estimates, FY 2012/13 to FY 2016/17e

FY 2012/13	Volume	Net sales	Marketing spend	Operating Profit
North America	1%	5%	10%	9%
Western Europe	-3%	-4%	-6%	-7%
Africa, EE, Turkey	4%	10%	16%	10%
LatAm & Carib	4%	15%	11%	26%
Asia-Pacific	-1%	3%	-1%	6%
Total	**1%**	**5%**	**5%**	**8%**
FY 2013/14	**Volume**	**Net sales**	**Marketing spend**	**Operating Profit**
North America	-1%	3%	2%	8%
Europe	-1%	1%	-1%	1%
Africa	-6%	0%	3%	-2%
LatAm & Carib	-1%	2%	1%	3%
Asia-Pacific	-5%	-7%	-7%	-13%
Total	**-2%**	**0%**	**-1%**	**3%**
FY 2014/15	**Volume**	**Net sales**	**Marketing spend**	**Operating Profit**
North America	-3%	-1%	-4%	-3%
Europe	-1%	0%	2%	3%
Africa	7%	6%	4%	10%
LatAm & Carib	-7%	-1%	6%	-3%
Asia-Pacific	-3%	-2%	-8%	7%
Total	**-1%**	**0%**	**-1%**	**1%**
FY 2015/16e	**Volume**	**Net sales**	**Marketing spend**	**Operating Profit**
North America	0%	0%	-4%	0%
Europe	0%	2%	0%	3%
Africa	5%	1%	-2%	0%
LatAm & Carib	4%	6%	3%	5%
Asia-Pacific	-5%	4%	-1%	13%
Total	**1%**	**2%**	**-2%**	**3%**
FY 2016/17e	**Volume**	**Net sales**	**Marketing spend**	**Operating Profit**
North America	1%	2%	3%	2%
Europe	1%	2%	1%	3%
Africa	3%	5%	5%	6%
LatAm & Carib	3%	5%	4%	5%
Asia-Pacific	2%	4%	4%	5%
Total	**2%**	**3%**	**3%**	**3%**

Source: Company data, HSBC analysis

Disclosure appendix

Analyst Certification
The following analyst(s), economist(s), and/or strategist(s) who is(are) primarily responsible for this report, certifies(y) that the opinion(s) on the subject security(ies) or issuer(s) and/or any other views or forecasts expressed herein accurately reflect their personal view(s) and that no part of their compensation was, is or will be directly or indirectly related to the specific recommendation(s) or views contained in this research report: Anthony Bucalo.

Important disclosures

Equities: Stock ratings and basis for financial analysis
HSBC believes an investor's decision to buy or sell a stock should depend on individual circumstances such as the investor's existing holdings, risk tolerance and other considerations and that investors utilise various disciplines and investment horizons when making investment decisions. Ratings should not be used or relied on in isolation as investment advice. Different securities firms use a variety of ratings terms as well as different rating systems to describe their recommendations and therefore investors should carefully read the definitions of the ratings used in each research report. Further, investors should carefully read the entire research report and not infer its contents from the rating because research reports contain more complete information concerning the analysts' views and the basis for the rating.

From 23rd March 2015 HSBC has assigned ratings on the following basis:
The target price is based on the analyst's assessment of the stock's actual current value, although we expect it to take six to 12 months for the market price to reflect this. When the target price is more than 20% above the current share price, the stock will be classified as a Buy; when it is between 5% and 20% above the current share price, the stock may be classified as a Buy or a Hold; when it is between 5% below and 5% above the current share price, the stock will be classified as a Hold; when it is between 5% and 20% below the current share price, the stock may be classified as a Hold or a Reduce; and when it is more than 20% below the current share price, the stock will be classified as a Reduce.

Our ratings are re-calibrated against these bands at the time of any 'material change' (initiation or resumption of coverage, change in target price or estimates).

Upside/Downside is the percentage difference between the target price and the share price.

Prior to this date, HSBC's rating structure was applied on the following basis:
For each stock we set a required rate of return calculated from the cost of equity for that stock's domestic or, as appropriate, regional market established by our strategy team. The target price for a stock represented the value the analyst expected the stock to reach over our performance horizon. The performance horizon was 12 months. For a stock to be classified as Overweight, the potential return, which equals the percentage difference between the current share price and the target price, including the forecast dividend yield when indicated, had to exceed the required return by at least 5 percentage points over the succeeding 12 months (or 10 percentage points for a stock classified as Volatile*). For a stock to be classified as Underweight, the stock was expected to underperform its required return by at least 5 percentage points over the succeeding 12 months (or 10 percentage points for a stock classified as Volatile*). Stocks between these bands were classified as Neutral.

*A stock was classified as volatile if its historical volatility had exceeded 40%, if the stock had been listed for less than 12 months (unless it was in an industry or sector where volatility is low) or if the analyst expected significant volatility. However, stocks which we did not consider volatile may in fact also have behaved in such a way. Historical volatility was defined as the past month's average of the daily 365-day moving average volatilities. In order to avoid misleadingly frequent changes in rating, however, volatility had to move 2.5 percentage points past the 40% benchmark in either direction for a stock's status to change.

Rating distribution for long-term investment opportunities

As of 03 May 2016, the distribution of all ratings published is as follows:

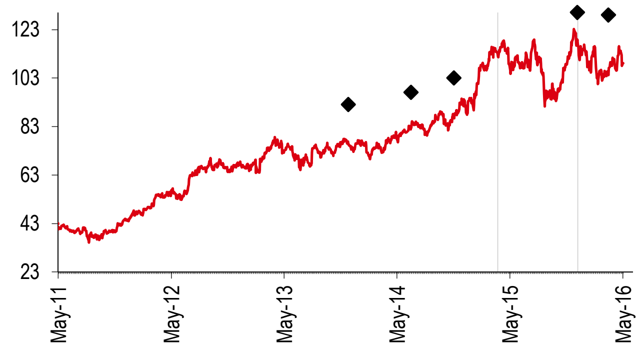
Buy	45%	(27% of these provided with Investment Banking Services)
Hold	40%	(26% of these provided with Investment Banking Services)

Sell	15%	(18% of these provided with Investment Banking Services)

For the purposes of the distribution above the following mapping structure is used during the transition from the previous to current rating models: under our previous model, Overweight = Buy, Neutral = Hold and Underweight = Sell; under our current model Buy = Buy, Hold = Hold and Reduce = Sell. For rating definitions under both models, please see "Stock ratings and basis for financial analysis" above.

Share price and rating changes for long-term investment opportunities

AB InBev (ABI.BR) share price performance EUR Vs HSBC rating history



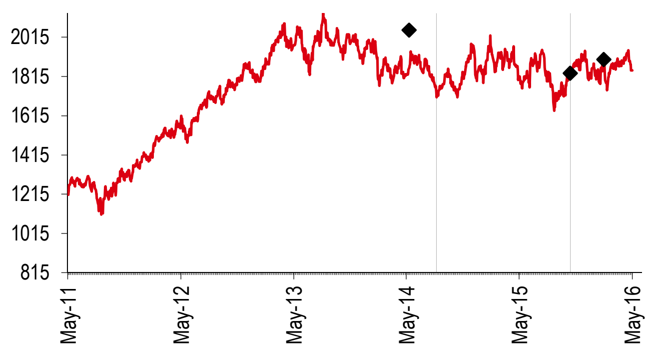
Source: HSBC

Rating & target price history

From	To	Date
Overweight	N/A	25 March 2015
N/A	Buy	08 December 2015
Target price	**Value**	**Date**
Price 1	92.00	27 November 2013
Price 2	97.00	18 June 2014
Price 3	103.00	03 November 2014
Price 4	N/A	25 March 2015
Price 5	130.00	08 December 2015
Price 6	129.00	17 March 2016

Source: HSBC

Diageo (DGE.L) share price performance GBp Vs HSBC rating history



Source: HSBC

Rating & target price history

From	To	Date
Neutral	N/A	07 August 2014
N/A	Hold	15 October 2015
Target price	**Value**	**Date**
Price 1	2050	12 May 2014
Price 2	N/A	07 August 2014
Price 3	1830	15 October 2015
Price 4	1900	01 February 2016

Source: HSBC

HSBC & Analyst disclosures

Disclosure checklist

Company	Ticker	Recent price	Price date	Disclosure
AB INBEV	ABI.BR	109.10	03-May-2016	5, 6
DIAGEO	DGE.L	18.46	03-May-2016	2, 4, 6, 7

Source: HSBC

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