Diageo – Brunch-time call with the presidents - Africa

John O'Keeffe – President Diageo Africa
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Welcome, everyone, and thank you for joining me. I am John O'Keefe, and as a brief introduction, I've been with Diageo for 20 years now, and have previously held a wide range of senior marketing and GM roles, and lived in six different countries over the course of my career. More recently, I was the managing director for Diageo in Russia and eastern Europe for four years, then global beer director along with assuming responsibility for Diageo global innovation. And then last year, I was the managing director for our business in Nigeria before stepping up into this role in July.

I'm delighted to be hosting this call today, so I can explain why I believe Africa is the most exciting growth region in the world, and why the business I'm leading is in a unique position to take advantage of that opportunity. I'll spend about 25 minutes talking through the Africa TBA market growth landscape, and explain why our existing business is so well-placed to take advantage of this; how we would accelerate our strategy to participate across a broader range of price points; and importantly, how we will grow our beers fast, but our spirits faster. I'll share some insights into the enablers we are leveraging to deliver the opportunity and the progress we are making in our markets. Finally, whilst I know many of you have had the chance to understand our H1 results, I will share some thoughts on F16 performance, and then open up the session for questions and answers.

OK, so let me start with some regional context within Diageo. Africa accounts for approximately 13 percent of Diageo's global net sales, and this has more than doubled over the last 10 years. Beer and Malta net sales represent just over 60 percent of the business, and within this, Guinness, Malta and Talisker are the largest brands. Spirits are just under 30 percent of net sales, more than half of which is scotch, and most of the rest is mainstream spirits. Our business is made up of four of the 21 Diageo markets, East Africa, Nigeria, ARM or African Regional Markets and South Africa. This is a strong business with significant scale, infrastructure, and leading brands, and it's based in a region that presents us with an exciting growth opportunity.

So let me firstly start with the opportunity in Africa.

We expect Africa to be the fastest growing TBA region in the world over the next five years. We expect to see the LPA population of Africa grow by around 35 percent over the coming decade. That's about 130 million people. The rate of population growth is faster than any other continent, and in the next 20 years, Africa is expected to have the largest working age population anywhere in the world. In addition, Africa's TBA consumption per head stands at below a quarter of other regions across the world except for India.

Now it is clear that in Africa, participation in the informal TBA market is significant, at around 40 percent of alcohol consumption. However this is a further opportunity as consumers will start to aspire to progress towards more formal, safer drinks, and as Africa's population is urbanizing, it will gain ever improving access to formal channels. These growth benefits are coupled with the opportunity to better partner with governments to help build them a stronger regulatory framework.

Consumers are becoming better off financially, and so increasing incomes will also drive TBA growth over time. However the pace of this growth is more difficult to predict given the volatility in the macroeconomic and political environment in Africa. Therefore I believe that in addition to capturing the benefits of premiumisation, we will sustain our growth in the volatile environment through equal focus on mainstream spirits and value beer. We will ensure that we are proving our ability to provide products that consumers can afford all the way through the economic cycle.

In terms of the impact on TBA, these consumer fundamentals will translate into very positive growth for the industry. Africa TBA volume is forecast to increase by around 25 percent over the next five years. Now the high inflation environment should enable price increases on higher end products in the medium term, however affordability remains crucial. We will ensure we balance price with volume growth in order to deliver operational efficiency, which will also drive margin improvement.

So that's the opportunity as I see it that exists in Africa. Let me now move on to discussing the strategy for accelerating that opportunity.

Our strategic intent is to grow our portfolio in beer fast, and spirits faster, focusing on our key markets. We will achieve this by participating at all price points across the TBA categories. To deliver this, we will continue to extend our route to consumer and provide the products consumers want via a strong innovation capability. We will manage our cost base, and continue to seek opportunity to source locally. We will maximize the benefit from our local manufacturing capabilities, to allow us to grow our business across the portfolio, leveraging our strength on beer to accelerate access to the spirits opportunity. And we will continue to build our local talent base to sustain this growth. We expect that this strategy will drive our business to deliver sales and profit growth in the high single digits over the medium to long-term, with modest margin expansion, as our increasing scale drives operating efficiencies across the business.

So let's deal with beer first. Now it's true that our beer performance has been significantly skewed by Nigeria over the last few years, where we have seen increased competition and challenging economic and consumer dynamics. However over the last six months, we have seen a return to growth in Africa with our beer net sales up 15 percent in the first half of the financial year, driven by the recovery of Guinness and Malta in Nigeria, together with exceptional growth in Satzenbrau, continued momentum of Guinness and Malta across ARM, and a strong first half from Senator in Kenya. Given beer is a key foundation of our region. Let me talk you through a little bit more detail here.

On Guinness, our flagship brand, net sales were up 15 percent in the first half, driven by strong performance in Nigeria, growth in Kenya, Cameroon, and Ghana. Over the past two years, we've overhauled all elements of the marketing mix with new packaging, better tasting consistently high quality liquid, the new above the line “Made of Black” campaign, along with leveraging the English Premiere League broadcast platform. In addition, where price relativity to mainstream beer has been excessive, we have been less aggressive on price. Looking to the second half and the future, we will further underpin growth with innovation. We are launching the first Guinness innovation in Nigeria for 10 years. Guinness African Special is a new Guinness-created with natural African extracts, made by Africans, for Africa. I expect this extension to recruit new consumers to Guinness with a new pack, more affordable taste profile, lower ABV, and a lower price premium to mainstream beer versus Foreign Extra Stout.

So that's Guinness. Now, moving onto value beer, which continues to be a growing and important category in the region. In Nigeria for example, we estimate that around 10 percent of beer category volume is shifting annually to value beer, which now accounts for around 40 percent of the Nigerian market. We are now delivering compelling beer propositions to consumers at more affordable price levels, and the volumes are significant. This scale is critical to optimising the capacity of our breweries and driving out cost through efficiencies. In Nigeria, we have seen particularly strong results with Satzenbrau's H1 net sales were up 54 percent. In East Africa in EABL, total beer net sales were up 14 percent in the half, largely driven by the impact of Senator from the recent net reduction in duty rates. On Malta Guinness, our non-alcoholic malt drink, the brand has returned strong double-digit growth this year, driven by both Nigeria and Africa regional markets.

Let me now tell you why this strong, growing beer business is going to be key to unlocking the spirits opportunity.

Our beer business gives us a unique position to drive spirits growth. Over the past five years, we have delivered almost double the growth rate of spirits in our markets with a beer platform compared to those with spirits alone. In an operating environment such as Africa, there are clear operational, commercial, and talent benefits to putting spirits through a beer network. Just to bring this operational synergy to life for you, in Africa we often tend to use the same trucks to deliver both beer and spirits to the same network of distributors and wholesalers utilizing common warehouses who in turn service bars and retailers who sell to consumers who have both beer and spirits in their repertoire, and easily move between the two categories. So our beer business really does give us a unique position to drive spirits growth faster.

Now we estimate that international premium spirits are out of reach for about 80 percent of African consumers. That said, this is a scenario that will change over the long-term as the emerging middle class will benefit from economic growth. However at the moment, affordability is a key consideration in the growth agenda for our region. We have already seen value beer takeoff, and have responded to that dynamic. We plan to take the opportunity to step change our participation in mainstream spirits, and compete at similar value orientated price points. Participating in mainstream spirits will certainly deliver short-term growth, however we will focus opportunities that build sustainability into the portfolio. We are setting the business up to shape consumers' drinking trends over the longer term, by recruiting them into the spirits category at an earlier stage. Mainstream spirits are made locally, and increasing local production will also help us mitigate the impacts from further economic and FX volatility. It's also worth noting that these products are not necessarily margin dilutive to our African business overall, and they are less capital intensive than beer.

Mainstream spirits are not new to us. Where we see real opportunity is getting after the mainstream spirits opportunity in a more systematic way across the continent. Today mainstream spirits represent over 10 percent of our net sales and include brands, such as Smirnoff 1818 in South Africa, Orijin Bitters in Nigeria and Ghana, and Kenya Cane in Kenya. We are clear what it takes to win here, and what the elements are that drive success in this category. The opportunity is in front of us to get at it in a more systematic and aggressive way in all markets across all price points. I will now give you an overview of the elements we will focus on.

Firstly, scale. In order to deliver the margins we require, yet sustainably participate at these more competitive price points, we need to get brands to scale quickly to drive efficiency into the production. Next, we will only launch products that deliver a disruptive consumer proposition, to ensure we deliver distinct consumer benefit with each product. Then, we will only launch brands where we have the right reach in route to consumer. Scale is important here also to ensure we can compete effectively, and command more than our fair share. We will design fit for purpose standards to ensure we win at the point of purchase with brilliant execution, where visibility is key. Next is cost leadership. Given the lower price points in mainstream spirits and the importance of driving overall profitability, cost discipline is key. And finally, we are engendering the right culture and capabilities to make us successful.

Our people need to be oriented towards continuous productivity, faster results, and a rapid reaction to the external environment.

We're laying down capacity to enable local deployment of our mainstream spirits brands. For example in Nigeria and Ghana, in H2 we're installing spirit blending and packaging capability to deliver attractive consumer product offerings, and this will allow us to compete at scale whilst pursuing local manufacturing options to reduce cost. We will develop brands, including Orijin, and prepare for opportunities to leverage USL portfolio. We're looking forward to this part of the business being a strong growth driver for our markets, and expect growth of strong double-digit levels over the coming years.

Now we've said that international premium spirits are out of reach for most Africans at the moment, however premium spirits will remain an important part of our growth agenda. More than 15 percent of Africa's H1 net sales were comprised of these brands, and as you can imagine, the share of our profit will be greater still. It is a key part of our strategy to participate across all price points. In H1 we faced some headwinds in South Africa and Angola, which led to decline. Overall however, we expect to see some recovery in H2. It is worth calling out Reserve brands however with H1 net sales of 65 percent, driven by Johnnie Walker Blue in particular, and also Ciroc.

OK, so I've covered off beer, mainstream spirits, and international premium spirits. Let me now turn to key enablers.

I believe there are a number of key enablers needed to deliver on these opportunities. For the purposes of this conversation, I'll just focus on two, namely innovation and route to consumer.

Firstly, let me start with innovation. Innovation is an area where we already have a highly successful track record with almost a fifth of our business now being comprised of innovation products. In the context of a broad, TBA portfolio, it is critical that we innovate to recruit consumers broadly across all price points. In the last two to three years, we have expanded down the price ladder in both beer and spirits to access a large section of consumers who cannot afford to drink premium core products regularly. Our strong innovation capability is key to successfully providing brands these consumers want. We've innovated in beer occasions with Orijin in Nigeria, Balozi Lager in Kenya, and Ruut Extra, the first beer in Ghana made predominantly from cassava. We have built on our hugely popular spirit brand which is Orijin bitters, Kenya Cane, Uganda Waragi, and Jebel Gin with flavour extensions. And we've bold innovation plans for mainstream spirits in key markets like Nigeria, Ghana, Cameroon, and Kenya. This expanding portfolio gives us that opportunity to grow across a broader range of price points, however to truly underpin success, we also need to be able to deliver these products to our consumers in a highly effective way.

The second key enabler right across the portfolio is our route to consumer. I think it's important to bring to light some of the success we've had in bringing more rigour to this area. We know that where executional rigour is in place, the business will perform more strongly. We are now in a position where our key markets have mapped out and segmented their outlets, they've set exactly which SKU's they expect to see listed in all of this by segment, and the executional standards that should be met. Our teams are well on the way in implementation of measurements and reporting to enable gap analysis and corrective action to be taking place at pace. Let me give you just one example where we're seeing results. In Ghana, where net sales were up 27 percent for H1, we've built a stronger route to consumer which is delivering tangible results. We've expanded trade coverage, and a better trained sales force that has increased accounts sold to by 10 percent over the last half alone, and we've implemented sales force automation, giving us reliable and timely outlet data, driving insights for business decisions and trade activities.

So we have a clear strategy to participate across all price points across the TBA categories, growing beer fast, and spirits faster. And we will plan to leverage the strengths we have as an organization to grow our share of the opportunity in this exciting region.

Before we move on to Q&A, I'll share some top line thoughts by market, both in terms of performance and also some thoughts on progress against the execution of the strategy.

Overall, Africa net sales were 3 percent up for the first half of this year, with beer up 15 percent. Excluding the year-on-year movement in innovation, H1's growth profile would have been in high single digits. Looking forward, we have an expectation to improve spirits and our RTD performance through the second half.

In East Africa breweries, I'm pleased to see the markets deliver double-digit growth in the first half, net sales were up 13 percent. Guinness and overall spirit sales contributed to this result, however as I mentioned, Senator was a key driver. I would expect EABL overall to continue growing net sales at low double-digits, given that we expect Senator to continue strong performance into the second half.

Kenya is our largest country within this group, and over 70 percent of sales. Senator was a key driver behind the strong growth. That said, the market's net sales without Senator were still up 9 percent. In Kenya, we're applying the strategy I've talked through. Beer's in growth across the portfolio, mainstream spirits are growing driven by Kenya Cane, as are our reserve brands. We have not yet seen the performance we wanted on mainstream beers, however with the recently launched pack on Bell in Uganda, and a new marketing campaign on Tusker, we anticipate an improvement in trajectory going forward.

Moving over to Nigeria, in terms of H1 headline performance, net sales declined by 9 percent. Apart from the macroeconomic impact on the market, I would like to share a couple thoughts on the main driver of this financial headline, Orijin. At a strategic level, I'm really pleased about what we've created in Orijin. Its potential to be a key driver of mid-term regional growth and indeed its early H1 success in Ghana are clear. This impact of Nigeria's H1 performance is driven by the very strong launch through F15 and then developing market dynamics since then. Orijin delivered very strong sales through its launch, and understandably competitors subsequently entered the category. Whilst this competitive entry put pressure on growth, Orijin continues to maintain a very strong lead position versus competitor brands. However we've also seen value beer continuing to take category share. These factors are driving the year-on-year impacts. When we look at other brands performances in the market, I'm pleased to say that Guinness, Malta, Satzenbrau, and Dubic were all up in strong double-digits. Thinking out towards the end of H2, setting aside potential for currency devaluation for a moment, I would expect to see a slightly better second half compared to the first half. However given local economic dynamics and potential devaluation, Nigeria is tough to call.

Looking further ahead in Nigeria, I see real opportunity to accelerate our strategy. Our beer business is back in growth, and as I said, we're expanding the mainstream spirits category, which we estimate represents over 80 percent of total spirits in the market.

If I now turn to Africa regional markets, or ARM, the business grew by 6 percent in the first half across Ghana, Cameroon and Ethiopia, which is partially offset by the impact of performance in Angola. Ghana's growth benefited from Orijin's launch, but also continued to grow other key lines, including

Guinness, Malta, and international premium spirits. Cameroon had a strong first half driven by Guinness and Johnnie Walker, which benefited from an improved route to consumer. The growth in Ethiopia is driven by Malta, and we've just relaunched Meta with early signs that the new campaign is gaining traction in this competitive market. Angola's performance was driven by current economic challenges in that market. For H2, I would expect ARM would improve its top line performance compared to H1.

Then finally South Africa, the market is facing tough economic conditions, and while it's delivering a growth of 2 percent net sales, we saw scotch sales drop offset by growth of vodka. Smirnoff 1818 net sales were up 3 percent, and is now the biggest spirits volume brand in the market. Looking ahead, now that the JV with Heineken has been dismantled, we are fully operational and a more focused organisation to take us into H2. We have a significant third party sales force, and our own on-trade team all now focused on just spirits and our RTD brands. We believe this focus will bring real benefit to our business in the coming months. The teams have plans in place to reinvigorate scotch in H2, however the competitive pressure is high, so I would expect modest improvement through the second half here.

So let me sum up.

The opportunity for Diageo in Africa is clear. We have the ability to participate across all TBA price points to recruit the broadest range of consumers and take them on a journey through our portfolio. Our existing beer and spirits business across Africa gives us a strong infrastructure. We will grow our beer portfolio fast and our spirits faster as we accelerate our mainstream spirits agenda, whilst also growing our international premium spirits and reserve brands. To deliver this opportunity, we have developed and are extending a route to consumer and our innovation pipeline. We will build local capability and our local talent to underpin and lead the business through this exciting period.

We expect our growth agenda to deliver consistent, high single-digit growth with a keen eye on margin. Whilst we are clearly targeting mainstream value opportunities, we will continue to grow operating margin modestly over time to scale efficiency, increasing local production, and sourcing of local materials and embedding a productivity culture through the business. Our growth agenda is based on managing the short-term economic volatility that exists in these emerging markets.

As I look at the second half, I expect we will build positively on our H1 performance across most markets, but I am mindful of the short-term uncertainty in Nigeria which could include devaluation.

Thank you. And now I would like to open up the session for any questions that you may have.

Q&A Session

Simon Hales - Barclays
Thank you. Hi, John. A couple of questions if I can. Firstly, could I just sort of just get a bit more clarity around how you think about the medium term guidance? I know previously on these calls you've talked about high single-digit, low double-digit as being the aspiration medium term for the sales growth across the region. I wonder if you could confirm you know that that is still the case, and how you think about the split of that perhaps now, with beer relative to the spirits opportunity. And you just mentioned at the end your expectation of modest margin growth. Should we take that to be very similar to what you said a year ago when it was 20 to 30 bips a year medium-term?

Secondly, just on Nigeria specifically, could you just talk a little bit more about how you see the devaluation risk there, perhaps what scenario planning you've been doing around that possible threat, and how easy you're seeing at the moment it is to access hard currency from a raw material import standpoint?

And then just finally briefly, I mean you mentioned the launch of the Guinness Africa Special. Now when is that going to be in market, and you know when should we start to be able to see some benefits from that?

John O'Keeffe
Great. Thanks, Simon. No more questions there? So let me start with the first one. Medium-term guidance, yes, I would reiterate that we're looking to high single-digit top line growth with, as I say, modest margin expansion. I think, yes, we did mention 20 to 30 bps last year, I think it will be there thereabouts.

In terms of Nigeria – I think you also asked the question on the split of that. I think that one of the benefits of operating a TBA portfolio is that we don't – we don't have to be entirely accurate as to how quickly the middle class emerges, the pace at which that happens. So by having our brand at all price points, I think we can de-risk the timing around the pace of economic development, and so to a certain extent, difficult to call it. I would expect that all the time given that spirits will grow fast, and mainstream spirits will grow the fastest, that would increasingly take a larger share of growth. But again, starting from a relatively modest base, and so beer will remain critical to our overall business, and it's critical that we remain at…in healthy growth, as we've seen in the first half of this year.

In terms of Nigeria, it's very difficult to call you know clearly pretty much all commentators expect a devaluation to happen, so that devaluation could be quite significant, and for that to happen in the near-term. Obviously that is outside of our control. What is in our control is our ability to mitigate that as much as possible, so we are using…we are increasing the amount of local raw materials that we're using, so not that long ago we were using about 30 percent in Nigeria, and that has moved up to 50 percent, and we will be kicking on from that at an accelerated pace.

In terms of your question on hard currency, it is difficult, it is tough, and I guess we are finding it difficult along all operators in the market to get hands on the quantity of hard currency that we'd like. That said, we're obviously very well-established, we've been there a long time, and there's a number of ways we can access FX. And I think we've got the added benefit of having an export business in Nigeria, exporting across Africa, and actually also exporting to GB, which is another source of hard currency which is very helpful at this time. OK, I think they are all the questions. Simon, thank you for that. Next question, please.

Edward Mundy - Nomura
Good afternoon, John. Three questions, please. You mentioned the greater push behind affordability and mainstream beer and spirits is not margin-diluted given you know scale efficiencies, liquid production, and increasing local materials. Can you provide a bit more granularity around this?

Secondly you know clearly you've got a number of priorities in Africa, beer, (near beer, local and mainstream spirits, international spirits. I appreciate you've got some route to market benefits from your TBA strategy, but arguably your strategy is a lot more complicated than many beer companies where the strategy is essentially make good beer and sell more of it. I mean how do you ensure that each operating company is crystal clear on what the priorities are?

And my third question is what impact, if any, do you see in your business from the proposed ABI/SAB transaction?

John O'Keeffe
OK, thank you. Let me take the last question first. You know the reality is that ABI don't have really a footprint in Africa at all, and therefore I don't see the competitive landscaping – as a competitive landscape changing with the consolidation of those two entities. SAB have always, and I imagine will remain, extremely competitive going forward, and so I don't really see a change on that front from an Africa perspective.

In terms of your question on operating margins around mainstream spirits I think it varies because it's less capital intensive, and because we are using essentially all local raw materials, even though we are selling at lower price points to compete in mainstream spirits. Our experience thus far with launching Orijin Bitters in Nigeria, or some of our upper mainstream brands in East Africa is that the margin can be accretive to the business, but it also depends on the extent to which you participate in what I would call lower mainstream spirits businesses, where I think the margins become more diluted.

So on balance, I think we're very aware of what it takes to win, we're very aware of the criticality of managing the cost base to participate successfully in this, and as I mentioned at the start you know this is not a new space for us. It's 10 percent of our business already, and we've been in this area for quite some time. I think what's new is that we're going to be getting at this opportunity in a much more systematic way, and laying down CapEx across all our operating – most of our operating units where required in order to make sure that we're playing in mainstream spirits more methodical than we have been, and I'm really excited about that.

I think the last thing I would say, Edward, is we see quite the interplay actually between value beer and mainstream spirits, and consumers do flow between one category and the other quite fluidly in – across a number of occasions. We again see that play out in Kenya where we're participating in both lower value beer and mainstream spirits.

Your last question I think was you know how do we balance TBA with having kind of a focus operationally? I think we - I think it can be a risk, however if you break it down to an element level, what you find is at the very top of the pyramid where you've got a reserve business, we would have a dedicated – typically a dedicated reserve spirits branch who would be focusing pretty much exclusively on a higher spirits brand.

As you move down in the kind of pyramid of outlets, you would see our premium brand and our premium spirit brand interacting in outlets and that's what our sales force would be selling in. And then as you move down the pyramid again to what we call the home-based bars, and more local bars, the interaction is more with beer, our portfolio that we're selling is more beer and mainstream spirits.
So really from a sales force perspective, and from an executional perspective, depending on the outlet type you're talking about, the portfolio is quite manageable, and as I mentioned in my introduction, we've set very specific standards by outlet type with which we can then measure and track and make interventions where required.

So I'm not concerned about our ability to execute TBA strategy because of that over-segmentation approach as I've spoken to.

Edward Mundy - Nomura
Great, that's very clear. Thank you. Just as a follow up on Simon's question, I appreciate the macro is a little bit uncertain maybe in places such as Nigeria, but do you have a sense as to when you might be hitting that medium term growth algorithm of high single digits?

John O'Keeffe
Look I think is very difficult to call with the volatility that's at play in Africa, so you know I've already given my view on the second half which I think will be better than the first half, and our operation in the medium-term is to get high single-digits, but we have to see to what extent the macroeconomic environment will facilitate that sooner rather than later. I think a big driver of any outlook will dependent on what happens in Nigeria.

Edward Mundy
Thanks.

John O'Keeffe
Yes, thank you. OK, Celine (operator), next question, please.

Chris Pitcher - Redburn
Hello there. Thank you very much for taking the questions. A couple of questions on Nigeria. If we think about your beer business, Guinness Nigeria, are you more exposed to imported goods, commodities, et cetera, than your competition? And in the event of a – of a devaluation, are you comfortable that you will be able to get sort of the price increases through to help protect your profitability?

And then if we look at the profitability of Guinness Nigeria, and put it up against say, East Africa Breweries, I mean there's a significant gap now between the two businesses. Should we think of Nigeria now as having re-based lower because of this push into mainstream, or within your expectation of modest margin improvement, do you have a more substantial recovery in Nigeria coming through?

And then last question, margins are under quite a bit of pressure in the first half. You're talking about a modest improvement in the top line, however will that be met with a step up in sales and marketing in terms of you know second half margin improvement? Should we get – expect that to be a bit better? Thank you.

John O'Keeffe
OK, thanks, Chris. So the first question I think was on are we more exposed, or what are the indications I guess of devaluation throughout the business. I think it's difficult to judge the impact of devaluation in Nigeria. I think there will be a direct impact associated with direct input materials that are not available in Nigeria, and I think that's going to be common across all the competitive sets, not just ourselves. And in addition, we expect local packaging material inflation to be impacted by both FX on domestically produced goods, and again that will be common across all players.

Ultimately an element of the inflation impact will have to be passed off to the consumer, whilst being mindful of affordability. However I think the likelihood of that in the short-term will take you know downward pressure on market growth and result in margin compression. So I think it's going to remain quite bumpy in Nigeria for everyone.

As I said, I’m really happy with the progress with which we are now accelerating on local kind of sourcing agenda, and we've made some very, very big in roads in that over the last number of months. And then finally, I mentioned already that we're also exporting and looking to get even more momentum behind us as we go through in the difficult period in Nigeria.

I think the other question, Chris, you had there was around the relative profitability of Nigeria versus EABL …

Chris Pitcher - Redburn
Yes, it's really to understand I mean EABL already has a mainstream, a lower end business, and it's clearly a significantly better operating margin than the Nigerian business, and I'm just wondering if we can understand the difference between the two, and whether we should expect you know within your guidance for Nigeria to get back up to sort of African margin levels, nearer the high 20s, or whether we're down in the low 20s for a bit.

John O'Keeffe
Yes, I think it's bigger driver of margin in Nigeria for the industry actually is less about – it's less about the fact that we're now getting up the mainstream spirits, because as I mentioned, it's not – it's not necessarily true that getting up the mainstream spirits will reduce our margins.

The bigger driver actually in Nigeria right now is the – is the flight to value – to the value segment by all consumers as they come under disposable income [pressure]. And you know we have – we are partaking of that by the significant growth in Satzenbrau, and obviously we would partake in that through an expanded participation with mainstream spirits.

So I think – I don't see that trend reversing any time in the near future. I think that flight to value will stay as long as the economic pressure in Nigeria will stay, which I think is going to be here for the short to medium-term. So I don't expect an immediate bounce back on margins for Nigeria in the near-term.

Chris Pitcher - Redburn
OK, and just lastly on your second half margin, whether a modest sales recovery is going to be met with an increase in marketing spend, or whether we should expect a better margin performance for the region in H2.

John O'Keeffe
I think we will see a similar dynamic on margins in the second half than we've had in the first, Chris.

Chris Pitcher
Thank you.

John O'Keeffe
Thank you. Next question, Celine (operator).

Carl Walton - UBS
Thanks very much. Just a few questions from my side. You touched on marketing spend there in Nigeria, but more broadly across the region as you think about more pushing into mainstream spirits, I mean as that is already part of your business, does it mean you don't expect more effort here or perhaps do you? Just in terms of the region overall.

Secondly, in terms of the mainstream spirits, so 10 percent of the business, are there key countries or regions you'd highlight where it's significantly lower, and there is a real gap in terms of – or real opportunity in terms of your business potentially pushing that a bit further? Or is that 10 percent sort of broadly similar across all of the regions?

And then finally, I may have missed it, there was an earlier question just about the Guinness Africa Special. Apologies if I missed the answer, but when exactly that will be launched, and potentially sort of making an impact? Thank you.

John O'Keeffe
Yes, apologies, I didn't pick up on Guinness Africa Special. Let me start with that actually. So yes, we're really excited about Guinness Africa Special. We've launched it in November in Nigeria just for now, and we started off with 2 regions, and then in January we expanded into Lagos and across the country more broadly.

And we are you know encouraged – it's early days, but we're encouraged by how well both the liquid and the proposition on the pack have been received, and you would expect us to you know to roll out brand out across the continent more broadly in the future.

So that's the Guinness Africa Special, it's a big strategic launch for us, as I said, such innovation wasn't done on Guinness in 10 years, so very, very exciting.

On mainstream spirits, in terms of your second question, on you know where do I see the opportunity, I mean really I'd say we have – we've been operating and have quite a sizable businesses in South Africa and in East Africa for quite some time, and only more recently in Nigeria with the launch – the very successful launch of Orijin Bitters.

Apart from that, everywhere else I see a very significant opportunity as we lay down and take all those learnings of what it takes to win mainstream spirits and deploy portfolios there. So I think it's kind of twofold.

One is all those markets you know the Ghanas, the Cameroons and so forth, where we haven't entered the space, and then secondly, but even the markets where we have, like in Nigeria, I would see us broadening out the breadth of participation quite significantly, and I'm excited by the fact that we're now taking on the USL brands that will also give further breadth to our portfolio, as well as obviously organic innovation.

Now I didn't catch quite – your first question was in marketing spend, but I didn't quite hear it. Would you mind repeating it, please?

Carl Walton - UBS
Yes, no problem. Just asking in relation to that push into the mainstream spirits in some new regions, does that mean for the division overall there might be – you see a sort of increase in marketing spend as percentage of sales, and if so, how significant? Or is it sort of tied in with your current spending and a reshuffle?

John O'Keeffe
Yes, I understand. No, I wouldn't expect a significant change to the rate of investment that we'd be deploying. It would be within that.

Carl Walton - UBS
OK, perfect. And just one follow-up, sorry, just in terms of local sourcing, you were very clear in terms of Nigeria, kind of percentage has gone from you know about 30 percent up to 50. Across the region, are there – are there further opportunities? What's the kind of average rate of the region?

John O'Keeffe
Yes, good question. So we're making good progress. We've been really getting out of this quite consciously, so from the base about three years ago, around 50 percent local sourcing, we've now just financially moved that up to 70 percent, and I would have a target in the near to medium-term of pushing that to 80 percent.

I don't expect it to get all the way to 100 percent because of the number of raw materials that are not available locally, so we've been pushing that quite aggressively.

Carl Walton - UBS
OK, great. Thank you.

John O'Keeffe
Thank you very much. OK, next question, please.

Tristan Van Strien – Deutsche Bank
Hi. Good afternoon, John. Three questions, please. The first one, you now have full control over your Chibuku business in South Africa, national sorghum breweries, so where really does that sit in your plans? Because I don't really think that fits with the whole TBA strategy, particularly in South Africa.

The second one, you're doing quite well in Cameroon, and also getting back to Ethiopia, both markets where you're competing quite aggressively with Castel. At the same time, Castel does Guinness in 10 of their markets, so I'm wondering how Guinness is doing in their markets, and if that's – is that relationship really sustainable for that matter?

And then the last question is about Kenya, how do you see – do you see any change in the competitive environment there? You have a dominant share I believe, so I just want to understand if you see anything on the ground that perhaps threatens your dominant share at the moment?

John O'Keeffe
OK, again let me do that in reverse order. In Kenya, yes, we have a very, very large share in beer and a significant share in spirits. The opportunity and if anything I would and intend to kind of grow our share further.

We're feeling really good about the growth profile of our business in Kenya right now, which is still in double digit, and the fact that we are – we have deployed a full TBA portfolio there, and we are growing across pretty much all the segments.

I think the big opportunity in Kenya is that the penetration of alcohol is less than 30 percent, so you know 7 out of 10 consumers, for either cultural or religious, but predominantly affordability reasons, are not participating in the formal alcohol sector.

So I think there is huge room to grow within Kenya, notwithstanding our very significant market share there today, and that comes back to the point that about 80 percent of consumers across Africa can't afford premium brands today on a regular basis.

And so I think it's really important that we continue to get after successes like Senator, and Jebel in spirits in order to accelerate, I guess, the movement of consumers from illicit to legal, and also to shape it, and again, that's one of the points I do want to share today, which is mainstream spirits is more than just about getting after an opportunity in the short-term, it's also about shaping the spirits trend of a critical continent for years to come.

On your question on Cameroon and Ethiopia, yes we are growing strongly, and Guinness within that has performed – it's not in Ethiopia but in Cameroon it's performed very, very well. I think the relationship with Castel has been a very longstanding one. For us I think that already speaks to the sustainability, and within the Castel markets we've also grown Guinness this half, so I think that further underlines the fact that there's no reason why that relationship isn't sustainable.

In terms of your question on UNB, over in South Africa, we're going to continue to run that business separately for now you know the sorghum business provides Diageo with an entry point into the segment of South Africa. Sorghum beer will continue to exist as a separate segment in the beer market, and will be an important part of South African beer landscape.

In particular we see an opportunity to reduce the illicit liquor and kind of home brew market, to increase support of key brands that currently enjoy you know quite good consumer recognition. Outside South Africa, the sorghum beer market has seen significant investment by other multinational brewing companies in South Africa, and accessing the sorghum businesses brand and know how really provides an opportunity to participate in this category across Africa.

Tristan Van Strien – Deutsche Bank

Just a follow-up on Kenya, just to go back to obviously you got Senator now, and you got the excise break back.

John O'Keeffe
Yes?

Tristan Van Strien – Deutsche Bank

What is different this time around that makes that excise break sustainable? I mean what prevents the government from taking it away again?

John O'Keeffe
I think we've had very long and deep conversations with all the stakeholders, and I think what is now very well understood, that probably wasn't understood a few years ago was the impact that a successful business Senator has in giving employment to 35,000 farmers in Kenya.

So apart from just the economic impact for the government in being able to collect taxes and excises on Senator, they now also see the real benefit in domestic value creation that is coming from local employment derived from local sourcing, and I think that is much better understood now than it was in the past, and I think that reassures me as to sustainability of that situation.

Tristan Van Strien – Deutsche Bank

Thank you very much. Very clear.

John O'Keeffe
Thank you. Next question please, Celine (operator).

Laurence Whyatt – Societe Generale
Good afternoon, John. Thanks very much for the question. Three for me. We previously heard that Diageo had been focusing sort of its efforts on much smaller aircraft sized bottles in being able to use its distribution capabilities with beer, and using these smaller bottles at a lower price point. Just wondering if you could give any update as to whether that's still happening, or if it's part of your plans.

Secondly, could you give us sort of an overview on your marketing strategy of how to encourage your customers to drive premiumization? How do you get them to spend slightly more on your slightly more premium products? What sort of marketing strategy do you use?

And then finally, one of the large tobacco companies has recently been accused of corruption in Africa, and just wanted to understand how you ensure that that sort of thing doesn't happen in Diageo, what procedures you've got in place. Thanks very much.

John O'Keeffe
Thank you. Thanks, Laurence. I think on the first question, I would speak to kind of format. For format I think we have – when I speak about innovation, I speak to format as much as liquid innovation, and we have certainly been more active on this front more recently.

Again, back to the affordability point, we are seeing the benefit of making our brand available in smaller pack sizes in order to hit a certain price point that certain consumers find very, very attractive, and you know it's early days with some of our – some of our beer bottle sizes, 33 for example in Kenya.

But frankly we've also seen that across spirits and TBA, the benefit of putting what would be quite an expensive cash outlay you know for a consumer to buy a 70 cl bottle of international premium spirits. We see that 20 cl for example, 30 cl packs are very big.

And in fact if you moved down into the mainstream spirits category, the smaller serve sizes are the critical format to be in. So formats are quite fluid, and are very often highly correlated with the segment you're playing in, but what is common across all of them is making sure you've got formats that can drive price accessibility and affordability.

In terms of you know marketing strategy, I guess it's a bit more of a broader question. I think that's kind of what we do in Diageo is about building aspiration, and I think if you see what we've done with Guinness in the last 18 months you know how have we – how have we turned that brand around from under-performing to kind of double-digit growth in the first half.

It's been – a lot has been done to very, very good marketing you know we've overhauled the pack, which is critical when you're charging a significant premium to mainstream beer. We recognize the advertising campaign is speaking to existing drinkers rather than necessarily residents with the next generation.

So we've overhauled that with our “Made of Black” campaign, and along with how we bring to life two passion points, and we know that consumers are very passionate about EPL across Africa, hence our broadcast sponsorship of EPL which is broadcast into the homes and bars across Africa with Guinness around that.

All that marketing, in addition to how we manage price, is a great example of what we're doing to kind of drive premiumisation, and I think Guinness is a great example of what we're doing across other brands as well.

In terms of corruption, look, we get that Africa is a – is a tough operating environment. We also have a pretty much a zero tolerance for any compliance issues with all our distributors, with all our customers, with all employees. We are very, very vocal about the need to do business in a compliant and sustainable way.

You know I guess we've been in Africa a very, very long time. I mean you know we set up our first brewery outside the British Isles in Lagos in 1960, and so you know we know how to operate there, we know how to do that in a way that's compliant and that's holistic.

And I think it's really important that you know you get a reputation for that across the continent, and I think our reputation in regards to that is quite a strong one. Thanks, Laurence.

Laurence Whyatt – Societe Generale
Thanks. Just a follow up on the size question. Could you give us any guidance as to what's the proportion of your bottles are in the sort of smaller, sort of 33 or 20 cl size rather than the traditional 70 cl?

John O'Keeffe
I don't – I mean I wouldn't want to get into that level of detail. I mean to be honest with you, it would be a bit meaningless to kind of give some of that stats at an Africa level, I think you'd have to get into a brand level by country for that to have – for that to kind of make sense I guess. So I won't be able to give you any more detail on that one.

Laurence Whyatt – Societe Generale
OK, John. Thanks very much.

John O'Keeffe
Thank you. OK, and let's take one more question then.

Martin Deboo – Jefferies International
Good afternoon. Two quick ones. Just you put a very eloquent defense of sort of spirits and beer synergies in Central Africa, but you said later in South Africa you were getting the benefits of focus, having come out of brandhouse.

And I'm just sort of how do I reconcile those two statements, I guess is a question, I'm guessing that you'll say it is to do with relative scale of beer and spirits. Perhaps you could give me a sense of the relative scale of beer and spirits in South Africa to contextualize that.

And then just developing that theme, I think the last time we had this call with Nick Blazquez he just gave us some colour on how you go to market in different markets, I know some markets have separate beer and spirits sales forces, some don't. So if you could just refresh that.

And then a technical question, I'm sorry, it may be more appropriate if there's anyone from IR there, but any chance that you will do hyper inflation accounting in Nigeria?

John O'Keeffe
OK, well you can certainly pick up the third questions with our investor relations team, Martin. I think the difference is – when I speak about focus in South Africa, is that we were two different entities, right, positively Heineken driving its beer business, and Diageo driving you know spirits business.

And so I think what we have now, and why it's different for the rest of Africa is that we have a Diageo South African business that's entirely focused on the Diageo portfolio of spirits and RTD's. So that's why I think South Africa is separate to when I speak about the benefits of deploying TBA to you know a single entity Diageo essentially, and our partners across the rest of Africa.

So I think – and look, the reality is, as I said you know whether we take a three, or five, or seven year view, every time we look at the data, and you know we grow businesses faster with our beer footprint, and that speaks to the synergy that I've spoken to on the call, and we really believe in that, and one of the reasons why not only are we deploying IPS and Reserve but now we're getting back to mainstream spirits even more aggressively than we have in the past.

And in terms of how we go to market, again you know kind of difficult to generalise, but you know pretty much at this stage now, we have a – we would tend to have a sort of dedicated team around the reserve business that would call on a few very limited outlets, and that's – that model is working really, really well for us as we're you know we're growing over 60 percent in the first half.

And then for the rest of the markets where we have our only market units, we would pretty much have at this stage our IPS, mainstream spirits, and beer business working you know merged or working alongside one another, and that speaks to the kind of synergy point I've spoken to earlier on the call.

Obviously in countries where we don't have an in market unit, we very often would have separate distributors looking after our spirits business from maybe Castel who would be driving our Guinness businesses.

So again, very hard to kind of generalize about how we go to market, but I do think you know there's a commonality of where we've got it in market versus you know where we don't.

OK. Thanks, Martin. And let me, I'm conscious that we've run over time, so let me just draw the call to an end. Thank you for your questions, and look, I believe Africa represents an exciting opportunity over the coming years, but what is even more compelling is whether Diageo is positioned to take advantage of that.

By extending our reach over a broader range of consumers and price points, we will deliver growth, and do so in a way that allows us to better manage volatility along the way. If you have any questions from today's call, please contact our investor relations team. Thanks again, and I will close the call now. Good-bye.