DIAGEO NORTH AMERICA - CALL WITH THE PRESIDENTS

Deirdre Mahlan – President, Diageo North America
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Deirdre Mahlan:
Hi, and welcome, everyone. It's Deirdre here. And thanks very much for joining the North America call today.

Having been in the role for over a year now, I want to talk about what I have achieved and the foundations that we've laid for the business for the future. As you know, this is Diageo's biggest and most profitable region; a third of total sales and half of Diageo's operating profit. In fiscal 2016 after a couple of challenging years, we restored top line growth.

Building on that improvement is key to our performance ambition in the coming years. To do this, our focus will be three-fold. First, improve the performance of our spirits business in the U.S. and Canada. Second, deliver on the opportunity for Diageo Beer Company. And the third is to continue to drive productivity to provide the fuel to invest and grow for the future.

So today I will cover the trends in the spirits industry and our plans to deliver our goal of moving towards industry growth, in particular, in U.S. spirits, which is 80 percent of North America's net sales. And I'll touch briefly on beer and productivity at the end.

U.S. spirits is an attractive industry with consumer spend of $80 billion a year. At around 4 percent net sales growth, spirits growth outpaces that of other consumer goods categories, driven by share gains from beer and also on the benefits from an increasingly multicultural and higher income legal purchasing age consumer driving premiumization.

Diageo is the leader in the U.S. spirits category with share over 20 percent – around double that of other companies. Given the growth of the category, U.S. spirits is vibrant with innovation and new entrants.

In Canada, we expect that the spirits industry will continue at the current 2 to 3 percent value growth rate, despite a slowdown in parts of the economy.

Across North America, consumer dynamics are changing, with the growth in millennial and multicultural consumers influencing shifts in behavior and approach to brands. Millennials, which are comprising of, for our purposes today, 21 to 34 year old legal purchasing age consumers – will continue to have a big impact on the performance of the spirits category.

So, why is this? First, they're the biggest age cohort; 34 percent of spirits consumption, which is increasingly multicultural and increasingly drinking spirits. Second, they expect more from brands and they want to do business with a brand that shares their beliefs. They choose their brands for quality and taste and for talkability. They value experiences and are willing to spend on them.

They interchange between brands depending on their mood, on the occasion, and the company they are in. So, gone are the days of consumers who are single category or brand drinkers.

This makes for a very exciting market today. And millennials are digital natives; they're reliant on technology for many aspects of their lives with their mobile phones critical to driving research and purchase. They spend almost as much time on their mobile device as they do watching TV, and as you know, they often multi screen.

In addition, the American society is becoming increasingly culturally diverse. Multicultural consumers – primarily Hispanic and African American consumers – are expected to drive 75 percent of the LDA-plus population growth through 2020, reaching 36 percent of legal drinking age population. These consumers also have a higher propensity for spirits. Clearly, successfully reaching out to these consumers is critical to growth in U.S. spirits.

Which leads me neatly to growth and our actions to improve performance in our spirits business. We have a relatively simple strategy, which is about recruiting more consumers to our brands and therefore selling more drinks. We will do this by winning with the right brands in the right occasions and at the right price. Making our brands relevant in shifting consumer trends and with the growing millennial and multicultural cohort.

In Diageo North America, we now talk about right occasions, right brands, right price as the core to our strategy. It's simple but it has needed a significant change in how we approach our business and our view of growth. So, let me share with you the actions we've taken over the past year to enable the delivery of the right occasions, right brands, right price strategy.

First, I needed to put in place an executive team that's aligned, highly motivated, and connected to the whole organization and committed to realizing the full potential of Diageo North America. This required some changes in accountabilities and some changes in talent.

The marketing team has been transformed; its ambition is to create the most exciting and effective consumer marketing organization in the world, bar none. It has been significantly upgraded, now led by James Thompson, with external recruitment from leading CPG companies and alternate sources of talent, such as digital marketing agencies. The marketing team now has a stronger performance mindset in addition to its creative agenda. It is increasingly diverse to reflect our consumer base and focused on core priorities.

The team is supported by a consumer planning and research team, a media team with digital expertise, and a culture and partnerships team. We've codified our marketing framework to the four Ps – purpose, personal, partnerships and performance.

I'm going to talk a little bit about each of these. Purpose is the core of all of our brands. I'll illustrate this with Crown Royal. Our goal is to cement Crown Royal as a modern icon for status based on its quality credentials. Our research highlighted that in today's environment, if you want others to think highly of you, accumulating things is less effective than giving them away.

This insight is that generosity is aspirational. Consumers want to be more generous than they are. Crown Royal's brand history and purpose fits comfortable with this consumer mindset. We describe Crown Royal's purpose as inspiring exceptional generosity. To bring this to life, we've launched a new campaign with the tagline, Live Generously, and Life Will Treat You Royally.

The second P is personal. This is about connecting in a targeted and local way with consumers through more digital, increased multicultural activation, and in the on-premise. To deliver this, we've put in place a five-fold increase in spend behind search and always-on digital content. And we will spend four times this year on activating against the multicultural consumer.

Let me give you some examples. Our partnership with the food recipe site, Tasty, leverages the digital platform. We launched more than 20 culturally relevant cocktail recipes during key occasion moments, like Memorial Day or the Fourth of July tailgating, et cetera, driving significant reach and engagement with our target consumers and resulting in an increase in purchase intent.

Buchanan's is a great example of how we're activating against the Hispanic consumer. It's a strong brand with momentum, aiming to break the half million case mark in the U.S. this fiscal year. We recently launched a new campaign in Spanish -- Es Nuestro Momento – which means, it's our time. For a generation that thirsts for more, who wants to make the most of the opportunities they are given, but need to be given absolute faith that this is their time. We will partner with urban Latino star, J Balvin, who has more than 20 million Facebook fans and whose videos on YouTube garner between 200 million and 900 million views.

Now, we're in year two of the Activation Army program, which I know you've already heard about. It's a significant up-weight in the on-premise targeting 6,000 accounts frequented by millennial consumers. The Activation Army is focused on securing menu placements, setting up drink features, educating gate keepers, engaging on social media and recruiting and re-recruiting millennial consumers into our brand portfolio. The initial results are strong, with Activation Army accounts growing faster than the general market accounts. In 2016, in accounts activated by the Activation Army grew 12 percent and the rest of market would have grown 2 percent, so it was a significant uplift. And that was driven by strong growth in our focus brands – Smirnoff, Captain Morgan, Crown Royal and Ketel One. We're going to continue to optimize this program in 2017. Our results in the first quarter were, again, good, showing similar kinds of results and we're going to supplement the Activation Army with reserve ambassadors focusing on activating our reserve brands in trend-leading accounts.

So, the third P is about amplifying our brands through partnerships. For example, our partnership with our online retailer, Drizly, with Thrillist, a site that helps young people live fun lives, the ride home program with Uber, and the app, Reserve, which allows you to find and book restaurants. These partnerships allow us to place ads for our brands and give us a wealth of first party data and discoverability in search results.

The last P, importantly, is driving performance. We are building data infrastructure and management procedures to continually evaluate, review, and optimize commercial execution plans. This will drive improved spend effectiveness, and we've also established cross functional brand boards for each of our major brands, empowered to make timely interventions to capture growth opportunities.

These changes will allow us to maintain performance on our fastest growing brands and improve performance on biggest brands. So, let’s look at the impact on some of these.

Starting with Smirnoff, America’s number one vodka. Smirnoff’s net sales has been declining for a couple of years and it’s been losing share in an increasingly competitive vodka category.

In 2016, we stabilized Smirnoff as we focused marketing efforts on recruiting millennials with a campaign highlighting the brand’s inclusive purpose and activating against electronic dance music. In evaluating the results from this work, we recognize there's more to do in recruiting and re-recruiting multicultural consumers as well as Generation X and Baby Boomers, who remain core to the consumer base.

Our strategy is focused on building on the strong credentials that Smirnoff has, that it’s an award-winning, quality vodka and continuing to bring fresh news to the brand through targeted innovations like Red, White and Berry and Peppermint Twist, and highlighting Smirnoff’s innovative history as the creator of the Moscow mule. In 2017, we're refocusing our efforts on the core Smirnoff flavors and utilizing limited-time offers to test new ideas and bring fresh news to the brands.

We expect performance on the brand to be flat-ish this year as we re-focus on core flavors and adjust communication to reach our core consumer more effectively. Shipments and net sales will be down as we continue to work to optimize our value chain. As part of this effort, shipments on some brands, including Smirnoff, will be reduced to offset increases relating to innovation so that we can manage working capital impacts across the portfolio for both Diageo and our customers.

Our goal for Smirnoff is to remain America's number one vodka. So in fiscal 2017, we're going to execute against that strategy by focusing on three things.

First, Smirnoff 21 is being introduced to a new generation of consumers and re-introduced to current consumers. As I said before, recruit and re-recruit. We are telling this story of how after the Great Depression and World War II, Smirnoff Number 21 democratized vodka so everyone could buy it. It created a cocktail revolution and we are building awareness at scale that Smirnoff invented the Moscow mule, America's number one cocktail by America's number on brand through digital recipes and influencers, T.V. advertising, sampling, and a mule P.R. tour.

Second, we're reminding current consumers that Smirnoff 21 is a quality vodka at a great price by highlighting it is the most awarded vodka and partnering with industry and influencers. To support the great price message, we're addressing the price disparity we had for certain sizes against key competitors.

And we are activating against multicultural and LGBT consumer groups through targeted media digital innovation of participation leading community events, like Pride.

Now moving on to Capital Morgan. Captain Morgan returned to growth in fiscal 2016 and gained share in the rum category as we went back to executing proven growth drivers, reminding consumers the brand is the captain of fun with renewed on premise focus, innovation and a digitally weighted media plan supported by price corrects in key markets.

Awareness and penetration with millennials has increased with this shift to digital media and our strong millennial recruitment focus. Innovation has also delivered with Cannon Blast launched for the shot occasion on driving trial. And we recently launched Jack-O'Blast, a limited edition, delicious pumpkin spiced rum shot for the holiday season.

There is still more to be done to improve performance, and we've optimized our F17 plans based on the learnings in F16 with a trademark campaign against the Captain's purpose, which is Captain Morgan champions, the power of fun. We're also optimizing the media plan to focus on digital media while expanding television and connecting personally with Hispanic consumers through targeted T.V. and digital partnering with influencers to build credibility and targeted sampling to drive trial. So look out in 2017 as Captain steps up the fun.

So now on to our biggest brand by value in North America, Crown Royal – and the hottest brand in the category Bulleit. In F16, Crown Royal grew net sales 6 percent and gained share with Crown Royal Deluxe growing and Crown Regal Apple continuing momentum, surpassing the one million case mark. Fiscal 2016 was also a big year for Bulleit, growing more than four times faster than the category and adding nearly a quarter of a million cases. It has continued that performance in F17 and Bulleit has just passed a million cases.

Since July this year, our value share in Nielsen and NABCA made Diageo the leader in the North American whiskey category in the U.S.

In fiscal 2017, our Crown Royal strategy has evolved and will focus on four priorities.

First, amplifying the brand's purpose of inspiring exceptional generosity; all activities and partnerships will be aligned behind a purpose. Second, leveraging digital partnerships. Crown Royal is partnering with GoodWorld, a tech startup that is the number one fundraising resource for donations on Facebook, Twitter, and online. GoodWorld makes hashtag donations on social media possible and facilitates Crown's purpose of inspiring exceptional generosity. Third, recruiting African American and Hispanic consumers through an up-weighted multicultural plan. And fourth, leveraging innovation to actively diversify our consumer base with millennials, women, and multicultural consumers. We've recently launched Crown Royal Vanilla; delicious liquid supported with a big launch. And we will also continue to drive Regal Apple, which remains in growth.

Bulleit still have enormous upside. We're scaling up in fiscal 2017, but with the Bulleit touch in a way that's very consistent with the brand's heritage, using the proven growth drivers with the goal of becoming the number one super premium bourbon.

As the whiskey renaissance continues, we expect it to benefit the scotch category. Last time North American whisky was hot, scotch followed. Scotch also has a multicultural consumer tailwind since the growth Hispanic and Asian population has a strong existing affinity for scotch. Within our scotch portfolio Johnnie Walker, Buchanan's, and single malts will remain a priority.

We will establish Johnnie Walker as an American icon of progress; inspiring personal progress in today's increasingly diverse America, and we'll do this through three things. First, our just launched Keep Walking American platform will build relevance through purpose to recruit a new and diverse generation of drinkers. Second, increasing investment behind proven drivers, taking mentorship to an unprecedented scale with physical and digital mentorships, and making Johnnie Walker the first choice to gift, including with Blue Label. And third, placing bets on future growth, expanding the red and ginger cocktail to more cities at pace.

Let me now talk about our growth through agave. Our strategy is focused on the super premium plus segments with the ultra premium variants of tequila, Don Julio being the focus, while we test the super premium segment with Peligroso and De Leon. We're also participating in the small but high-growth Mezcal category with Mezcal Union.

Tequila Don Julio is the real deal, growing net sales at 34 percent in F16. It was the fastest growing brand in our portfolio. In fiscal '17, we'll be investing more to continue to strong growth. We will tell the story of the man behind Don Julio, Don Julio Gonzalez, with a digital media plan focused on increasing reach and showcase our brand home through our heritage center in Mexico. And we'll deliver more mentoring and sampling with the goal of reaching 300,000 consumers.

Let me close the brand roundup by talking briefly about the tail brands where our performance is weaker and it is driving a significant portion of Diageo's overall share decline in the U.S. in the last few years. We've gathered learnings in fiscal 2016 with a combination of price reductions and merchandising support and have started to reposition these brands. We're also looking at other ways of driving the brands, including advertising support and partnerships in the on and off premise. There will be more news on this as we go through the fiscal year and evaluate the results of the work underway.

So now let's talk about beer, now branded the Diageo beer company USA, we're positioning our beer business for growth and to take advantage of underlying industry trends. These changes support our strategy to position Guinness as a brewer with advertising highlighting our brewing credentials, our people and beers. We have expanded the Guinness portfolio with beers from The Brewers Project; Guinness Blonde American Lager, Nitro IPA, and porters.

Within ready-to-drink, we’re aligning our Smirnoff ready-to-drink portfolio ever more closely to the Smirnoff Vodka marketing efforts, driving a total trademark growth agenda. The strategy is working with Guinness stabilizing in fiscal 2016, and ready-to-drink growing net sales 7 percent.

Let me close with our final strategic priority; driving costs out through the productivity program to invest in growth. We have made significant progress on the productivity work streams and have a clear view of the fiscal 2017 savings.

We are embedding new ways of working with our distributor, aligning spend, and driving increased transparency of trade investment and effectiveness.

To drive marketing effectiveness and efficiency, we’re deploying new tools that enable optimal investment allocation and measure effectiveness. We’ve reset our creative and production budgets by brand to drive a more efficient ratio of agency fees to media, and drive more leverage from the assets we create.

In supply, we have various on-going initiatives, which will reduce our manufacturing and logistics cost. An example is our recent announcement to move Captain Morgan aging from the U.S. Virgin Islands to Relay, Maryland, which will drive processing and logistics savings.

Also, ZBB was implemented for fiscal 2017 in direct spend budget. And in September, we announced organizational changes, which will drive savings across our commercial business units as well as key supporting functions through centralizing activity. Similar work is happening in other functions.

In summary, we brought the business back to growth in fiscal 2016 to establishing a clear strategy and making the changes necessary to deliver that strategy. We've created a consumer-focused organization. We have the right plans in place to accelerate growth and create a reliable compounder of growth. Our focus on productivity will fuel growth as we invest to drive our top line performance in this high margin business.

Now I'm happy to take questions.

Olivier Nicolai:
Hi, good morning. Thank you for taking this question. I just got one question on my side. One of your targets is to actually grow in line with the market, which has been growing at about 4 percent. Now, can you realistically do this growing in-line with the market if the value brands are still declining?

I know you – I understand that you're going to push those brands a bit more next year, but could you also give us an idea of which brands you think have potential? Thank you very much.

Deirdre Mahlan:
Thanks for the question, Olivier. Yes, we can still grow at 4 percent with the value brands declining, although clearly the performance of those brands needs to improve. Over the last two years they were declining as high as, on a volume basis, 7 or 8 percent.

We have already reduced that decline to something at around 5 percent. And that has already contributed to some recent share improvements that you've been seeing in Nielsen. Again, I wouldn't say they're dramatic improvements yet at this stage, but we are seeing an improving trend.

The brands where we're seeing the biggest improvement, for example, would be Seagram's 7 and VO where we have made price adjustments because we felt that over time those prices had become too high, and we've also seen some improvements in brands like Rumple Minze.

The work that we're doing is to actually look at those – all of the brands that are in that group, and then develop very specific actions depending on the brand grouping. Some brands we believe we will likely spend a bit of marketing on because we believe there is equity in those brands and we can get them back based on their categories to a stronger performance.

Other ones we'll probably do more in the way of merchandising or price adjustments to get in the right place. And then there will be other brands where we just need to actually establish them from a cost point of view. We also are working with supply and have supply initiatives underway to make sure that each of those brands have the right cost structure so that they can be priced competitively in the very competitive value priced portion of the spirits category in the U.S.

But I feel good about the actions already made and would expect the performance of these brands to continue to improve over time. As you know, when you make adjustments of brands of these size in the market, it takes some time for those actions to show up on the shelf.

We're not going to see anything like an overnight shift, but we are already seeing improvements from actions we took last year. And I expect we'll continue to see improvements in those brands over time.

Olivier Nicolai:
That makes sense, thank you. And just to follow up on this; are you confident that you can improve, therefore, the profitability on an organic basis, even if it's a modest improvements if those value brands, which I assume have a lower margin, were to come back?

Deirdre Mahlan:

Yes. As you remember – you have to remember a few things about the value brands. I mean, they are profitable brands. And the amount of consumer marketing on those brands tends to be lower. From an overall margin perspective, if the NSV increases, we'll still contribute overall growth.

The goal is not to grow significant amount of share, but to actually just improve the underlying performance. And then the higher margin brands, which will grow faster than those of course, will improve [margin]. For example, we'll get positive mix on the strong performance of Bulleit, Don Julio, Buchanan's.

And as I mentioned earlier, we're going to manage the cost base of those brands. We do not expect the faster growth of those brands to have any marked negative impact on our margin performance.

Olivier Nicolai:

Thank you very much.

Deirdre Mahlan:

You're welcome.

Edward Mundy:

Hi, Deirdre. Three questions, please. Similar to Olivier's question, your target's to grow in line with the market -- can you still do this is Smirnoff doesn't pick up to 2 to 3 percent revenue growth? The second question is at the – with the AGM statement, there was some commentary that the U.S. is seeing strong performance versus fiscal 2016. Can you confirm that that's certainly the case?

And then the third question is really around the impact of Trump's potential policies on tax reform and fiscal spending. How do you see this impacting your business at the high end, the premium end, and also the value end of the portfolio?

Deirdre Mahlan:

Let me start with the question around Smirnoff. Smirnoff is of course a large brand in the portfolio. And Smirnoff and the value brands have been contributing to a weight on share growth. That said, if you actually look at the Crown Royal brand, Crown Royal is 15 percent of our underlying performance [approximately 15% of volume of Diageo's US Spirits business]. It has been growing faster than the industry.

This isn't about one brand. Clearly, we intend to improve the underlying performance of Smirnoff, but there's a whole host of permutations and combinations. It doesn't have to get to 2 percent or 3 percent; it really is a factor of improving all elements of the portfolio. We are focused on improving the performance of Smirnoff, Smirnoff 21, Smirnoff flavors. As you know, Smirnoff flavors have been a bit of drag as that has kind of worked its way through the large number of flavors in the category. And we have been replacing that with a strategy that we believe will drive more sustainable performance over time, including limited time offers.

We're going to make sure we've got the right price in place; we've got a focus in activation and the Activation Army. We're recruiting consistently, as I mentioned in my remarks earlier, and also refining our flavor strategy so we won't get a lot of volatility from that. We will expect to improve it, but I wouldn't point to any specific growth rate that it would have to get to, although we do expect to get back to and remain in growth with Smirnoff.

I forgot now, I've lost track of your second question. I remember the third one.

Edward Mundy:
Yes, the second question was around the AGM statement back in September.

Deirdre Mahlan:
Yes, the business continues to perform in line with our expectations in this half. I would say the answer to that is yes. With the third question, with respect to Trump, as everyone knows, there's been a lot of discussion about President-elect Trump and the potential policies on tax, in particular corporate tax and imports and a whole host of other things.

It is very early days. We have a long history of working with government as these policies are developed, and I think it is very early to say the impact of any given policy or even what those policies may be as he gets his plan in place. That said, we believe that regardless, as far as how we see the economy developing in the U.S. today, we would expect the industry to continue to grow strongly about in line with where it is today. And that our place in it in particular at the premium end will continue to be strong.

Edward Mundy:

Thanks, Deirdre. And as a quick follow up, just in terms of the phasing between H1 and H2 growth, I appreciate you need to go back a couple years to understand the comps, but should we expect broadly equal growth at the revenue line H1 and H2 this year, or should it be more weighted to how the comps look for fiscal 2016?

Deirdre Mahlan:

You know, as you know, I don't want to give guidance on any particular period so I'm going to stay away from that. As you know, what I can tell you is that we feel confident in the performance of the business and the plans that we have in place.

Edward Mundy:

Thanks.

Simon Hales:

Morning, Deirdre. Three questions, please. Sorry to come back to this again, but just in terms of your target of moving the business to grow in line with the category in the U.S., can you just confirm that you still don't expect that to happen in the current fiscal year, and therefore, should we expect and are you hoping that it's going to happen in fiscal 2018?

Secondly, just in terms of more recent trading trends, I wonder if you could just talk a little bit about maybe the wholesaler selling around Thanksgiving and what off take trends you've seen, what channel trends you've seen perhaps over the first half between on and off-trade.

And then finally, you mentioned in your comments some pricing adjustment you'd made in Smirnoff. I think that was flagged with the full year results. Can you quantify that a little bit and just explain what you've done there?

Deirdre Mahlan:

Sure. I mean, kind of back to this question of whether we can get progress to getting to industry growth, we made progress last year. We said at the end of last year that we expected to continue to make progress. You know, of course our goal is to get the best possible performance we can get for the business. We certainly expect to approach the industry growth rate.

We have some great plans in place for our brands. I went through a lot of them. A lot of this is new – these are new interventions that will take some time to embed. So predicting precise moments that I'm going to actually get to the same growth rate is a bit difficult, and I'm sure you can appreciate that. But we certainly expect to improve the performance overall versus where we were last year and get closer to that growth rate and with a fair wind and a strong performance against some of these, and depending on what else happens in the industry, it's possible we could get there this year, but I'm certainly not going to predict that at this stage.

Our intent would be in fiscal 2018 to grow in line with the industry. That's what we've said, that's what we're positioning ourselves to do, and I remain confident and encouraged by the responses to the interventions we've made so far that that is achievable.

And as I did with the first time, I've now forgotten the second question.

Simon Hales:
It was just in terms of recent trading and the sell-in of the wholesalers.

Deirdre Mahlan:
Recent trading about Thanksgiving, that's right. So, we've got some early read on Thanksgiving, which has overall been good. I would not say that the retailers are saying it's the best year they've ever had, but overall I think that the view is that the performance has been good. Sometimes on when you come through this period, it can be a bit difficult to say what the overall momentum will be coming out of it.

But I would characterize it all as pretty much good and in line with what we expected, so there wasn't any significant outlier that we can see either on the upside or the downside versus this point in the holiday season.

The third question I think was around Smirnoff and Smirnoff prices. So if you recall, we did say at the end of last year that Smirnoff was adjusted downward in certain markets where we felt that over time, as we were executing our strategy of taking prices up and the competition did not follow and, in fact, the vodka category became increasingly competitive, we made some adjustments last year to bring key markets back in line with our own strategy and then we continued to do that again this year.

So the ones that we made in fiscal 2016 have now been in effect for over six months and we have seen improving trends from that, and an impressive response. So, as we expected, we're getting good response on that.

So last year, for example, we had a strong volume lift of double digits on both the 1.75L and the 750 ml sizes in F16. Now in F17, we've made additional adjustments, I think to the tune of around $5 million or $6 million in F17 to get other markets, remaining markets[to the right price point]. Now, by the time we get to the end of this year, we expect all of our markets to pretty much be in line with our strategy. And I would just say in case the question comes up -- it's the same for Captain Morgan. So we've made similar kinds of adjustments for Captain Morgan. We continue to evaluate the impacts of those changes, but I feel good about where we have adjusted our prices to, and believe they're now back in-line with our strategy.

I do want to note we have not repositioned these brands. I don't want anyone to take that away. In fact, we just got too far outside of our own pricing strategy relative to the competition. So, they are still positioned where they were; they're just now back within the tram lines of where they should be competitively.

Simon Hales:
That's very clear. Thank you.

Caroline Levy:
Thank you, good morning. I'm just wondering, with the change in the way you measure sales performance if you could talk a little bit about your relationship with the distributors and just give a little bit of color on their reaction. And then separately, just to talk specifically about the competition from Tito's, which appears to have – I don't know if it was 10 years ago, but come out of nowhere to become a major force in vodka and what you think drove that and how you think you can really combat that, is Bulleit enough and what else can you do?

Deirdre Mahlan:
First, with respect to the work with our distributors, I mean, we have continued to evolve the ways of working with our distributors to build capabilities and to get the best possible outcome for our brands. And I would say that this year that continues, and in fact, we've extended the work that we've done with our distributors now into supply chain and are working closely together to – first to match up very closely what we're doing on depletion and depletion net sales by working with our distributors to improve forecasting and then, by

improving that forecasting; it has allowed us to manage our underlying supply chain and working capital optimization much more effectively.

So, that's just some examples of what we're doing. We've also aligned our systems and we can now get a better read on the ROI on the various activations that we have in place. I would characterize the relationships with the distributors as good; very strong and positive, and I expect that to continue. So I think we're in a really good place on what we need to do to be able to continue to drive performance.

With respect to Tito's, I mean, unlike many brands, and I think we've said this before, brands – there are very few brands in the U.S. that materialize overnight, and Tito's is not an exception. If you go back and look at what's happened in history over time, the brand has been building and growing for some time until it got to an inflection point. Often that's around a million cases. We've had some of that same experience ourselves with Bulleit and with actually Crown Royal Regal Apple, which got to a million cases in one year.

And when those brands go and get momentum, they all continue to build. I think if people go back and look at it, the way this was done was by systematically working and recruiting in both the on trade and in educating consumers in the off trade when it gets to a point, when it got a significant amount. I referenced this earlier on what we're wanting to do with our own brands, which is it got talkability and it had a high level of distribution and it got talkability among consumers, and that's what's driving the performance. And it is quite a momentum that it has today.

With respect to what we can do and what others are doing with respect to this; first of all – I mean, in the vodka category, I'll just make one other point about this. What happened in the vodka category in general was a significant amount of increased competitiveness as people realized how much value there was in the category. And if I was to look back and say in hindsight what might have been different, if there were gaps in the pricing ladder that were allowed to evolve and then those have been exploited by competitors up and down the value chain and we have a very – a very competitive vodka category at the moment.

So, what's important that we have to do there? This kind of – exactly what I've described is what's informing our actions with respect to Smirnoff and our other vodka brands, as well as the rest of our brands, which is number one, you have to make sure your brand is priced properly. You can't get out of line with respect to where your brand is positioned and how the consumer values that. Do they see your brand as being good value for money?

So, we've taken those actions and we're seeing a response with respect to Smirnoff. The second one is make sure that the consumer does not forget what your brand is about and why they've loved it for so long, and this is back to the recruit and re-recruit. Again, if I were to look back, I think we focused for a couple of years – you know, and appropriately, on making sure that we were reaching the new generation of consumers with Smirnoff, and so we focused on millennials.

If I were to look back in hindsight, and I mentioned this in my remarks, when we evaluated that work, we did make progress on millennials, and if you look at the penetration of Smirnoff with millennials, it's improved. However, the core of Smirnoff today is really above 30 years old and that would be where the bulk of the volume is and we, I think, under-indexed on communicating with those consumers.

So, hence this year, a much larger focus on reminding the consumer of the history of Smirnoff and its innovation. We invented the Moscow Mule. This is a high quality, crafted brand and is the biggest and most awarded vodka in the industry. And so, what you'll see from us more and more is to remind people about that.

Now am I going to say that we're going to get a turn overnight and people are all going to move? Well I'm not going to predict that. But what I will say, that we expect these interventions to continue to improve the underlying performance of Smirnoff, and then we're using – when I went through the four Ps, we're finding that is very effective across the rest of our brands; whether it be scotch or North American whiskey or tequila and we're going to be very consistent in driving those communications with our brands and making sure that we target the right occasions with the right brands at the right price.

That has been something that has worked successfully, and I think over time. Again, where a few people will say, OK, well then why haven't you been doing it? Remember, the environment moves. When circumstances change, we change our strategy. We were deploying a strategy that was a market leader price-driven strategy, very focused on distribution and innovation that was very successful for us. To actually look back at what's happened since 2010, people say, you've been losing share since 2010 in fact. If you actually go back and look at the numbers, it's really just the last two years. There was a period where we swapped volume share for value share. We had value share growing, but volume share not. That was working very effectively for us for a period. In the last two years post the economic crisis where we continued to take price up and at competitive dynamic change, that strategy no longer worked, so we now have made an adjustment to our strategy.

So, I do think that the interventions that we're making are working and that we'll continue to see results and improvement in the underlying performance of the results.

Caroline Levy:
That's great. Thank you very much, Deirdre.

Deirdre Mahlan:
You are welcome

Brett Cooper:
Good morning. A few from my side. In the 4 percent growth outlook, can you just talk about how you see growth coming from your existing portfolio, innovation, price and mix? And then, what are you seeing from competition as you adjust pricing? And then my last one goes to about building brands as consumers shift consumption venues from the on premise to the off-premise. Is there something you need to do to make the cocktail culture easier to translate at home? Thanks.

Deirdre Mahlan:
First with respect to the 4 percent. I think that the 4 percent that we're driving can be achieved through a whole mix of different avenues, so I wouldn't say that there's some specific element that needs to be addressed on driving the 4 percent. Although I might have lost the initial thread of your question, can you set the first question again about the 4 percent?

Brett Cooper:
Yes, I think – I mean, you guys have done a great job on the innovation front over the last …

Deirdre Mahlan:
I'm sorry, that's what it was. Innovation versus – sorry, I just lost the thread. So on the base business and innovation, this is a fully penetrated market. I've said this many times. We're fully penetrated in this market across all the core categories from a consumer and from a distribution point of view in spirits in general, not just in Diageo.

So therefore, there will always be, for some time, a significant amount of growth that comes from new news in the various categories and for innovation.

I think the amount of growth that comes from innovation versus the core will vary from period to period and we have been continuing to deploy and refine our innovation strategy so that we're focused on either big wins, such as Crown Royal Regal Apple, or where we believe there's new news or something interesting or a package format that might work for the consumer, limited time offers like we've done with Smirnoff.

So, I think we will continue to do that but we do expect to get growth from the base and from innovation. How much we get from each will depend by brand and by period, actually.

With respect to price and mix, it's a very muted pricing environment today. We don't expect to get any real net price in the current fiscal year, so we are taking price in the categories where we see that there's price strength. But as I mentioned, we are also making some other price adjustments. So on a net basis, it'll be relatively little amount in price, so most of it will come from, most of the difference between volume and net sales will comes from mix.

And as you'll see in the strongest growing portions of our portfolio, as you know, are Crown Royal, Bulleit Bourbon, Don Julio, Buchanan's, Cîroc innovation are all growing faster. And from a mix perspective, they will drive positive mix in the portfolio. Some of those brands also have some price with them, but as I said, they're being offset by some other places where we're making pricing adjustments.

Chris Pitcher:
Good afternoon. A couple of questions, please. Going back to the wholesaler discussion, can you give us a feel for how buying patterns have changed with the wholesalers since you moved to the sellout culture? Have they become smaller and more frequent? And you touched upon it, but in terms of shortening the supply chain, bringing more functions on shore, what are you doing to ensure that you can sort of move if indeed those buying patterns are changing?

And then secondly, could you talk a little bit more -- in a bit more detail about some of your other vodka brands, Cîroc and Ketel One and particularly, when looking at Cîroc, whether you think there's sort of the flavor cycle is sustainable or not and what you're doing to maybe more out of that? Thanks.

Deirdre Mahlan:

First, with respect to the supply chain with our distributors, we said at the end of last year when we were talking about moving to the replenishment model that we were looking to do – was to optimize the value chain. As I referred to earlier, there's a lot of innovation in the industry right now and it certainly becomes inefficient for both suppliers and distributors to just continue to add on more SKUs and at higher levels of inventory.

So we move to replenishment model, which as you pointed out, does require an improved forecasting capability and a better connection on data to be able to make sure that we don't run into out of stocks. So I can tell you, with our largest customer, we're working very closely where we have the two supply organizations working together to improve forecast capabilities and also to look at our various logistics chains. Everything down to pallet formats, et cetera, which will allow more efficient delivery from our warehouse to theirs and also, more efficient use of inventory.

But also, as I mentioned earlier in the script, it is changing the amounts of inventory by brand. So what we may see is, so, for example, if we have a significant innovation in a period, because we're matching up shipments and depletions period to period, and over time, actually, trying to get depletions to exceed shipments so that we can actually optimize our total amount of inventory. That's going to be done over time; it's not going to be any significant to a material shift.

But we are looking to make more efficient the total amount of working capital. So that means if there is a significant innovation with a lot of stock and we believe we've got good forecasting on Smirnoff 21 or on Captain Morgan OSR, we will actually reduce the shipments on those brands because we tend to move full truckloads or full pallets of those brands and we produce them every other day or every week.

And so we know from an economic order quantity point of view, we can get those in stock pretty quickly. So that will result in some movement on a brand by brand basis with the over level of inventory. But we're not expecting any material change in the total amount of inventory but there will be some movements brand by brand.

Chris Pitcher:

Thank you. And just on the other brands?

Deirdre Mahlan:

The second question was about the other brands, yes. So the Cîroc, the flavor cycle you're right, absolutely. Cîroc has been on a flavor cycle, a very successful one, which has been copied by others in the industry. So I think what we are seeing on Cîroc are the flavor cycles are getting shorter. We're thinking more creatively about how we can manage those cycles. And we are also working on back to the four P's on purpose with respect to Cîroc.

So when we came out with mango at the same time that we launched mango, we started talking about Cîroc and the spirit of the hustle. This is, again, back to making sure that the consumers engage with Cîroc, both from the substance of the brand, that it’s not all just about the end success, but also about the effort to get there. I think it will take some time before we can get to a place where we can get the unflavored variant back into stronger growth or back into growth, and therefore, become less reliant on the flavor cycle.

We will also be deploying, as I mentioned earlier, in order to move the consumer kind of off that cycle, similar as we've done with Smirnoff, limited time offers which sort of just bring new news to the brand so that we can continue to build the equity of the brand over time with its consumer base. So we've been using other influencers you may have noticed like DJ Khaled to actually supplement the work that Sean is doing and continue to appear to that broad base of millennial consumers.

So the new work on Ciroc is still early days. We’ll be evaluating the outcome of that in the third quarter and we’ll be able to say a bit more about our expectations going forward from there.

I think Ketel One – Ketel One came off of a strong year last year. You’ll know that Ketel One also is sitting right in the midst of that very competitive vodka category. We have, with Ketel One, just launched a new campaign which is, again, to remind the consumers about the long heritage and quality of the Ketel One brand.

So I would say that it is a challenging environment right now, in particular in the on premise for Ketel One. But we, again, need to see how the work that we’ve put in place is going to respond, how the brand will respond to the new consumer communication plan

Chris Pitcher:

Thank you very much.

Alicia Forry:

Hi, good afternoon. A couple of questions, please. So I guess my first would be, what are you doing to capture growth in the single malt category in the U.S., which I believe is where most of the growth in scotch is at the moment? And perhaps related to that; Buchanan's slowed quite a bit in the U.S. during F16, it still was growing nicely -- I think organic sales were about 9 percent, but that's half the rate it grew at in the previous three years. Is this natural maturation of the Buchanan's brand and should we expect the growth to slow further going forward?

Deirdre Mahlan:

First on single malts, our single malts business is growing high single digit or double digit over the period – over the most recent periods, even on a three year CAGR basis it's been growing pretty well. But what we have identified was a gap at certain price points in our single malt business. So we are successful at the higher price points with brands like Lagavulin and Talisker and Oban.

So what we are doing is we are relaunching and introducing a brand – The Singleton, which will be at a competitive price point and will be competing that same place where the Glens are. So we're going to grow that share through the Singleton and by repositioning our younger age expressions on our core brands like Lagavulin and Talisker and Oban, to recruit new drinkers in the $50 to $70 segment. And then we're going to continue to drive discovery and trial on the four core malts that we have. So we're pretty excited about the possibility, in particular of The Singleton being able to capture share at that lower price point.

The question about Buchanan's. Buchanan's is an incredibly exciting brand. Last year we took the price up in some markets because we had announced price increases in previous year, but the price did not go up through the wholesale and retail channels. In a couple of markets the brand went up more than two price points, and that resulted in a slowing down in F16.

In F17, we are seeing the brand return back to strong growth. It is growing double digit. I think in this most recent period it was up 20 percent, so we are expecting – are even higher. So we expect the brand to not really have muted growth at all, but it will go back to more historic growth rates.

Alicia Forry:

Great, thank you. And if I could just follow-up with just two more quick questions. The Activation Army, you said that that will continue to optimize in 2017. Can you please clarify what you mean by optimize? Are you broadening the nets, or is it selling more brands?

And then – sorry -- secondly – and last, given the multicultural nature of the U.S. and the desire for craft and imports in that market, why isn't Diageo taking some of the brands from, I don't know, Latin America or Asia or Africa to the U.S. markets? Obviously not all will resonate, but I would think things like Ypioca might, or something else where there's a strong consumer affinity for that culture in the U.S.

Deirdre Mahlan:

First on the Activation Army, what I mean by optimize is take the learning to the prior year and either dial up the bits that work well and make adjustments. So for example, we were really clear last year when we started having success; we were focusing on the core brands, plus Ketel One. I had people coming to me and asking me to add other brands to the Activation Army because they were very excited about it and we refused to do that.

And the reason why we didn't change it is because we needed to actually go through the entire cycle and evaluate the results so that we could determine where do we need to make adjustments? If we start changing it every couple of months, it's very difficult to evaluate what works and what isn't working.

So when we go into F17, what we decided to do was we increased the number of accounts that each of the members of the Activation Army is representing, and we made some adjustments to the kinds of activities that they do and where they focus. We've not made other changes, we're not adding other brands, and again, for the same reason. Why? Because I want to know whether the success they we had in year one is sustainable through year two. Because sometimes when you add a new activity to a market, it's very easy to get an initial lift.

Whether or not you can sustain that lift, and whether or not that lift will extend out of those specific outlets more broadly in the market if people start talking about your brand, is much harder to know unless you actually stick with what you've said. So many of the brands that have been built, particularly in the on-premise, are because they stuck with the activity for several years until the brand got the right level of talk ability and would take on an organic momentum itself.

So when I say optimize, I mean we're just making some small adjustments based upon the evaluation of the prior year's results. We may, at the end of the second year after we can have two years, we may decide to expand it into additional accounts, but we don't want to do that until we're satisfied that the uplift is sustainable overtime because otherwise we won't get a good payback for it.

What we did do is we've extended what we've done in the Activation Army to our reserve brands. So we used to have a model for reserve brands that was much more about ambassadors talking and educating on the brands. The difference now is that the reserve brands are doing similar to what the Activation Army is. They basically go into an account and talk to the account owner or the bar manger about how do I help you grow you business and let me help you do that with my whole collection of brands [reserve brands], rather than with a single brand.

So it is a much more collaborative effort at retail to kind of have the right kinds of activations that will help that outlet grow its business as well as our brands. And the same kind of thing has been extended into beer. So in beer, same thing that the Activation Army except there's an additional element of quality checks that we do in beer to make sure that Guinness quality is showing up as well as it should.

Alicia Forry:
And, sorry, just the overseas …

Deirdre Mahlan:
The Latin American brands, sorry. First off all, the first thing I would say about that is, Buchanan's is a great example. Buchanan's is really a Latin American brand, the strength of Buchanan's in the U.S. is based upon Latin American consumers living in the U.S., first and second generation. So Buchanan's is a great example of that.

We have brought other brands in, and we most recently tested a lower level scotch variant in Texas called Black & White, which is also called -- in Mexico, it was very successful because they launched Black & White at a lower price point. It's a brand that's been around for a very long time, and they basically say from the Casa de Buchanan, it says it right on the label. And in Mexico, the Buchanan's franchise is so strong that Black & White has now been flying because Black & White is more affordable than Buchanan's, and you might have Buchanan's for a special occasion, but if you can't afford it, you might get Black & White.

So we tested that in the U.S., but we did not get the same response. And I think the reason we -- our conclusion is the reason why we didn't get the same response since the per capita incomes of Americans made that price point, for example, the Buchanan's price point in smaller sizes, for example, is affordable to most Americans, and so we didn't get the kind of lift on looking at Black & White.

We do, periodically, we have launched Zwack in the U.S.; we have had Ypioca. Ypioca is available in the U.S., we have not seen that in terms of the consumer poll for Cachaça in the U.S. With the Brazilian consumer has not been strong enough, although it is available. Certainly we continue to evaluate whether or not there are opportunities in particulate ethnic groups where we can activate those brands and when.

Alicia Forry:
Thank you.

Deirdre Mahlan:
You're welcome.

Andrea Pistacchi:
Yes, hi, Deirdre. Three questions, please, if I may. Firstly on the operational leverage of your U.S. business, as your top line accelerates from 3 percent to 4 percent, how should would we think about how this impacts your P&L? Will you reinvest more to maintain the momentum, or does this translate in better margin expansion?

The second one on Don Julio, please, if you can comment on the bit on the opportunity to grow the brand; it's still a lot smaller than Patron, for example. If you can talk a bit about the channel and geographic opportunity within the U.S.

And then the last question is on the cost of innovation. If you think about the cost of innovation at Diageo today versus a few years ago, maybe when in your previous experience in the U.S. Now, the way the industry is going you have to do a lot more innovation; you probably got more efficient at doing it. So the overall cost of innovation, has that moved much?

Deirdre Mahlan:

So first, let me answer the question about operational leverage. I mean, certainly, if we can get more net sales growth at a similar cost base, it would translate into more operational leverage. The U.S. has delivered more than 300 basis points of operating margin expansion over the last several years. And certainly, it is still the strongest margin contributor to Diageo and will remain the strongest margin contributor.

That said, and I think Ivan has said this and I'll repeat it for the voices of doubt, where we see an opportunity to grow this business we will invest and we will invest ahead if we see that that opportunity is there. So purely, the underlying business at growth, all other things being equal, yes, we'll get operational leverage. We were also driving productivity across a number of areas, which I mentioned, which would also drive productivity. And those will provide us with the fuel for growth. If we see a disproportionate opportunity for investment, we will take it in that period, but we would expect that we would do so only because we expect it to give us a strong return.

So period to period, from a margin perspective, we're still expecting to have to maintain or improve our margins. Although there may be specific months or quarters where there's an up-weight of investment. But on an ongoing kind of sustained basis, we're not expecting anything other than strong performance from a margin perspective.

With respect to Don Julio, Don Julio is a fantastic brand. It is growing double digit – has been growing double digit for a long time. We have an opportunity to continue to extend our off premise distribution beyond its core markets. Because, again, Don Julio tends to be strongest on the coasts. It's very strong in California and a few other markets. But there is huge opportunity to continue to extend Don Julio distribution on the base of the strong performance of the tequila category in the U.S.

We also have, on the high end, we've premiumised up. Don Julio 1942 is an incredibly popular brand; in many places it's kind of hard to keep it in stock as fast as people order it. And we supply it, it sells out. So we have a significant amount of confidence in the Don Julio brand.

With respect to the cost of innovation, undoubtedly we've become more efficient at innovation. We have been investing in innovation and refining our approach to innovation, both with respect to liquid development and commercialization of innovation and manufacturing of innovation through out procurement organization for 15 or more years. Just almost since the business was formed, and have continued to build on that experience over time. We have a strong multi-functional team in innovation that has been getting refined over a number of years, including supply, sales and brand. And we've been investing in R&D to find ways to not only be more efficient and to keep the cost down, but to be able to bring innovation to market faster.

The opportunity in innovation is always to be able to get the idea and to get out there and to get the first mover advantage. And I still believe we're leaders in innovation in the U.S.; Crown Royal Regal Apple is a great example of that. I think our liquid development is best in class. And we have been able to do that while managing out cost. So I would say, yes, the cost of innovation has become on a per unit basis less expensive for us over time.

Andrea Pistacchi:
Thank you.

Deirdre Mahlan:
I think that was the last question. So I'm just going to – there's nothing left for me to do but to thank all of you for taking the time to join. I appreciate all of your questions, which were very focused and spot on in terms of what's happening in the industry.

In closing, let me just say our plans and recent performance I noted again a minute ago, give me the confidence that we're on track to deliver and to accelerate growth. You should by now have in your inbox an e-mail that's going to bring to life the F17 activities that I was talking about by brand. We just want to give you a bit more color on the specific brand activities that we've been deploying, including links to the new campaign so you can see how we're bringing brand purpose to life. I really would recommend that you spend 15 or 20 minutes going through it.

And so, I'll look forward to speaking with you again on the next call, if not before. So take care and I hope everyone has a good week. Thank you.