Brunchtime Call with the Presidents - Africa

Nick Blazquez and Andy Fennell

Nick

Welcome everyone and thank you for joining us. As part of our regular series of President Calls, today Andy is here to talk about the business he runs - Africa. Following a few opening remarks we will open up the line for questions.

As you saw the details of our first half performance in January we will not focus on that in our introduction today, although we will be happy to take questions on our F15 performance when we get to the Q and A. Andy will kick off by outlining our strategic priorities, describing how we plan to accelerate our performance through building on our current position and broadening our participation, and then go through a bit more detail by market.

So let's get started.

Andy

Thanks Nick and good morning or good afternoon everyone.

It's great to be talking to you today about the opportunities in Africa to Diageo.

Africa is a region with incredibly attractive fundamentals for beverage alcohol companies for three key reasons. First, the macroeconomic upside potential is huge.

Africa was home to 8 of the world's 15 fastest growing economies between 2000-2013 with a current GDP of over $2 trillion expected to grow strongly in high single digits in the medium term.

Second, the demographics are favourable. The legal drinking age population in Africa has been growing faster than any other continent and in the next 20 years Africa is expected to have the largest working age population of anywhere in the world.

And over the next 10 years, it is estimated that roughly 3 million consumers in Nigeria alone will be earning over $100k per annum.

Thirdly and of equal interest is the opportunity to bring consumers into formal alcohol. We estimate that as much as 50% of beverage alcohol consumption in Africa is informal. Moving consumers into the formal segment is an opportunity not just for producers but for governments as well, as it is aligned with many of their public health and taxation objectives.

There is no doubt that there are short term challenges from a macroeconomic and political perspective, but we're confident about our ability to manage them and capture the opportunities.

Diageo's strength in Africa is the scale of our beer business and the complementarity of our spirits.

Our strategy in the region is therefore clear.

We will grow our business across a range of price points, across beer, spirits and RTD. We will do that by expanding our route to consumer, bringing Diageo's innovation capabilities to bear, tightly managing our cost base and continuing to improve our local manufacturing capabilities, particularly in spirits, and expanding into new markets. We will continue to build on our local talent to drive this growth which we believe will return to high single digit to low double digit growth over the medium to long term with some margin expansion over time.

Let me talk first about price points. We are leveraging the strength of Diageo's brands at the luxury and the value end of the market. At the more accessible price points, we're building on our hugely popular local spirits brands such as Kenya Kane, Uganda Waragi and Jebel Gin with flavour extensions, and innovating in beer with Orijin, Balozi Lager and Ruut Extra, the first beer in Ghana made predominantly from cassava, amongst others. These local brands are not commodities. Consumers at this price point still demand substance, character and quality and we have the capabilities to deliver that.

At the other end of the market, in the top price tiers, net sales of our reserve brands were up 25% in the first half of this year. We're supporting this growth through activities such as our Master Bar Academy, training over 25,000 bartenders so far in 15 countries. And in the first half of this fiscal year we also launched Reserve Club in South Africa, which provides our key customers with the right tools to deliver true luxury experiences.

Building an effective price ladder we are increasing the penetration of our beer and spirits brands.

Having the right product at the right price and margin allows us to build scale quickly through our route to consumer initiatives. For a number of our markets we are well into the implementation phase including Ghana, Nigeria, Tanzania, Kenya and South Africa. We are seeing results and a financial payback. Our common approach, clear standards and principles and rigorous evaluation of initiatives is driving this. We are continuously leveraging our learnings across markets, allowing us to more quickly define the solution and progress to implementation faster.

Furthermore we are bringing Diageo's innovation expertise to Africa. We can choose where and how to compete with either spirits or beer or indeed create new categories. I expect innovation this year will deliver in excess of £300m in net sales, a significant contribution to the top line.

Successful innovation in Africa is about delivering quality products at the right price. That means local manufacturing and locally sourced raw materials to engineer the right cost of goods.

To achieve this we've been innovative not just from a product perspective but with our supply solutions as well. Many of you will have heard of our 'cube', a portable, stand-alone blending and bottling facility that is very low cost to construct. The cube is currently in Ghana, Nigeria and Mozambique and allows us to produce affordable spirits such as Gilbey's Gin and Orijin Bitters flexibly in market.

Just because these innovations are sold at lower price points doesn't mean they are reducing our margin. In fact, if you look at our innovation launches at an Africa level, they're broadly in line with our core business margin structure.

Our strategy is underpinned by our talent agenda. Our commitment to developing talent is as strong as it has ever been and initiatives like our future leaders programme are continuing to work. In some places, notably Nigeria, that has meant that we've had to make some changes to our senior teams, and given the importance of these markets, we've put some of the best people we have in Diageo in key roles to effectively pursue our strategy.

And finally our strategy is about increasing our capacity for margin expansion. Undoubtedly, Africa has become more competitive, but by continuing to make selective price increases and keeping our cost base under control we can deliver margin expansion whilst we invest for growth. In the first half of this year we chose to invest in A&P ahead of net sales because competitively we believed that was the right thing to do. But we've made savings elsewhere.

Take procurement. Our local sourcing is now about 70% which is a significant increase from just under 50% a few years ago.

Our sustainable local sourcing activities across Africa are primarily focused on:

- Supporting local economies and standards of living for thousands of farmers
- Reducing our dependence on the importation of agricultural raw materials from Europe and Asia, it just isn't as necessary anymore
- Creating flexibility and innovating in our raw material usage, and
- Limiting our currency exposure which is increasingly important in the current climate

By pursuing local sourcing at such a scale we are pioneering models that governments can use to attract additional private sector investment in smallholder agriculture, a sector which remains a key driver for inclusive growth in Africa.

And in logistics, improvements in our planning and forecasting, along with more efficient use of our trucks and distribution are driving savings. All of this nets out to COGS savings that this year will offset inflation.

We're taking some of these savings to the bottom line, but we're using a lot of them to re-invest. In our infrastructure, in our route to consumer and perhaps even more importantly in brands.

While I'm sure you're all well versed in our results in the first half by market, I would like to shift gears now to give you a bit more colour on each.

I'll start with East Africa Breweries as it is now our largest market.

I am very pleased with the progress we're making at EABL. The past 18 months have thrown up some significant challenges there with the change in excise tax on Senator. In Q2 of this financial year we started to lap the significant declines those changes caused, and the brand now accounts for less than 10% of EABL's net sales. We've also made some effective interventions on pricing on Senator. But Senator aside, the rest of that business is very strong.

In Kenya, which is 60% of the business, I think we've really got the affordability and pricing mix right across our portfolio, beer, spirits and RTD. We've achieved this through consistent investment in our existing brand portfolio, notably Guinness and Tusker, but also through innovations such as Kenya Kane, Jebel and Balozi. Developing these brands is investing in the future of that market.

In Tanzania, the top line was up high teens in the first half of this year, we've improved our distribution footprint so we're gaining share, and importantly, we're delivering profit. Our business in Uganda is strong with Guinness up double digit and we're improving our route to consumer. Exports are up over 100% to South Sudan as we successfully have found ways to trade in this volatile market.

So EABL is in a really good place, growing in double digits with strong momentum across the portfolio. Its scale is such that success here really moves the needle for Africa as a whole.

In Nigeria, the consumer environment remains volatile. Weak oil prices, currency devaluation and security risks will have an impact on the alcohol market, but the Nigerian consumer appears to remain positive. The strong Q2 performance, with net sales up 7%, has continued into Q3 as our ability to leverage our scale in beer and our innovation capabilities have translated into growth with Orijin which has given us the headroom to drive steady improvement in Guinness. In fact Orijin has been such a success that other players are following our lead into this space, but we have now gained share in each of the last 6 months and whilst the external environment is very uncertain I am confident that our interventions in talent and route to consumer are delivering results. We now have a very senior and experienced management team on the ground and through our route to consumer work we have doubled our outlet coverage in Lagos while testing models for other parts of the country.

So while Nigeria remains a challenging market for us, we're on the right track.

Moving on to Africa Regional Markets.

This is a part of our business that is really very strong. Beer in Cameroon was up 10% in the half, and in Ghana beer was up over 25%. Through our route to consumer work, we're putting more people through more doors and this is driving performance. Furthermore, the route to consumer changes we made last year in Angola have delivered results and through our new distributor, our spirits business there is firmly back on track.

The standout market in competitive terms in Africa Regional Markets is Ethiopia where we've seen product proliferation and increasing price pressure from the competition as capacity has expanded to accommodate anticipated growth. But we've expanded the footprint of Meta draught, launched Zemen, our latest value offering, and sales in the last quarter have been very strong. Overall we are very optimistic about the opportunity and our footprint in Ethiopia.

And finally, South Africa.

This is a challenging market from a macro perspective, there's no doubt about that, and this is obviously having an impact on consumer spending. But we're winning share.

Smirnoff 1818 will sell more than 2 million cases this year, with the strong performance of the base brand enhanced by innovation into flavours which has been hugely successful. Our performance this year has been distorted somewhat by RTDs as we've lapped the incredibly successful launch of

Smirnoff Ice Double Black and Guarana, and production of this brand has now moved into our joint venture which will impact our top line, but depletions have remained relatively stable.

We're succeeding in South Africa, despite the economic environment, with strong innovations and our continued focus on our route to consumer which is increasing our penetration and getting our products into the hands of more consumers in more outlets.

So bringing it all together, I'd like to leave you with a few key takeaways.

First, Diageo is in a unique position from a competitive perspective. There isn't another player that can combine the brand and price point breadth that we have across beer and spirits operating on the continent today. We operate locally but with the benefit of a global heavyweight behind us.

Second, we know how to win. It is all about a variety of price points, delivered through innovation, local sourcing and local manufacturing to achieve them that will make the difference.

Third, this is a business that while facing increased competition, can continue to improve profitability. We will be more competitive with our price increases, and Reserve, RTD and Guinness are offsetting the price/mix impact of our success with lower priced brands that are helping to drive scale. The initiatives we have in place for cost savings are working to offset inflation, keep COGS down and help drive margin.

As I look to the balance of this year I'm really pleased about the trajectory the business is on. Q2 was better than Q1 at 9% and I expect H2 growth to be more in line with Q2. These short term trends underpin our optimism about Diageo's African business in the future.

And so with that, I'd like to open up the session for Q&A.