DIAGEO

Diageo Half Year Results Presentation Script

9 February 2012

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- Title Slide - No script.

Paul Walsh, CEO

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- Good morning and welcome to this interim results webcast.
- Deirdre and I are going to follow our usual format and speak for about 40 minutes on the key highlights of these results. Then we will be joined by our executive colleagues to take your questions.
- Today, we are also joined by Nick Blazquez and Randy Millian as this is the first time we have reported our results across five regions.

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- As you saw from our announcement this morning, our first half performance has been strong and it is balanced across regions and categories.
- In an environment of uneven global economic growth and of varying consumer trends we have seen our performance improve in developed markets and continue to strengthen in the faster growth markets of the world.
- Stronger volume growth and improved price/mix has accelerated our top line performance.
- Our volume performance improved in the developed markets but it was the performance of our scotch, vodka and beer brands in the emerging markets, where volume was up 10%, which was the main driver of our overall growth. Together with the acquisition of Mey İçki and Serengeti Breweries, this increased our emerging markets business to almost 40% of the total.
- In markets where the economic trends are stronger we have taken price, which together with almost 20% volume growth of our super premium brands drove 4 percentage points of price/mix.
- This price/mix together with the cost savings we have delivered expanded operating margin in a period in which we have significantly increased marketing spend behind our brands.
- Our first half performance of 9% organic operating profit growth and double digit eps growth underpins the confidence we have in our brands, our routes to market and our people and we are signalling this with a 7% increase in the interim dividend.

- However, this is an uncertain world and the economic and political prospects in some markets in which we operate are challenging. We are cautious as to the trends we will face in the second half but we believe this first half performance gives us the platform from which to deliver our medium term goals.
- I am going to stop there for now and hand over to Deirdre who will look at our financial performance in more detail.
- Deirdre.

Deirdre Mahlan, CFO

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- Thank you Paul.
- Good morning everybody.

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- At our November conference I spoke about efficient growth. By that I mean investing to drive the top line while generating margin improvement.
- This first half performance demonstrates that the investments we have made, and continue to make, in our brands and in our sales capabilities are delivering efficient growth.
- Our marketing spend was up again, 10% in this first half and as a percent of net sales it was up 40 basis points. The bulk of this increased investment, over 70%, was targeted at emerging markets where we see the greatest opportunities for growth.
- Net sales grew 7% in the half reflecting a continuation of the underlying trends we saw in the first quarter. It was driven by solid volume growth of 3%, and 4 percentage points of positive price/mix split almost evenly between price and mix, reflecting the strength of our brands and our investments in them.
- This price/mix, together with the efficiencies we've made in our supply footprint, drove gross margin expansion of 70 basis points.
- We've reduced overheads in developed markets and we're beginning to reach scale in many of our key emerging markets, resulting in operating margin expansion of 60 basis points.
- Free cash flow was £500 million in the half and we are maintaining our progressive dividend policy with a 7% increase in the interim dividend.

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- Now I'll take you through some of the detail underlying this performance and I'll start with the drivers of net sales growth.
- Growth of scotch in emerging markets, especially Johnnie Walker, Cîroc in North America and our beer brands in Africa continued to be key drivers of volume growth, while Smirnoff 's return to growth and the continued growth of Captain Morgan outside of North America provided additional volume upside.

- Mix was driven by the strong performance of scotch, particularly the deluxe and super deluxe segments which accounted for 41% of net sales growth. This was due to continued emerging market growth and consumer confidence at higher income levels in developed markets.
- Double digit growth of our premium vodka brands also drove positive mix.
- Price increases in the emerging markets were the biggest driver of the price element of net sales growth.
- The completion of the acquisition of Mey İçki accounted for most of the non-organic net sales growth in the period. Scope changes also reflect the purchase of our controlling stake in Serengeti Breweries and the sale of wine brands in North America in fiscal 11. Under recent accounting changes, acquisition costs are taken to the Income Statement and we have reported operating profit from acquisitions net of £39 million of acquisition costs.
- Weakness in some African currencies and in the US dollar was partially offset by the strengthening of the Euro giving a slightly negative overall FX impact on net sales.

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- The underlying performance was strong throughout the half, although as we described when we reported first quarter results, one-off factors, flattered our net sales growth in that quarter.
- The phasing in North America was balanced, 5% in both quarters, although the first quarter benefitted from better price/mix.
- In Western Europe, the first quarter was flattered by lapping the destock in Spain last year. In the second quarter, we reduced promotional discounts, primarily in GB, which led to lower volumes.
- In Africa, Guinness growth slowed in the second quarter with weaker performance in Nigeria. This was due to the environmental, social and economic factors including heavy rains and increased security challenges.
- In the first quarter in Latin America, we saw buy-in ahead of price increases in Mexico, and in Venezuela, phasing was affected by soft comps as currency restrictions constrained sales last year.
- First quarter net sales in Asia were strong due to a buy-in ahead of price increases in the Middle East and phasing of shipments in South East Asia. Our second quarter performance was in line with expectations with a strong festive season.
- In summary, our first half top line performance has been robust across our regions and categories.

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- We continued to invest behind our brands to support this top line growth.
- Our reinvestment rate increased by 40 basis points to 15.8% with marketing investment up 10% and nearly three quarters of that increase was focused on emerging markets.

- For most categories spend was up in line with the total increase.
- In scotch, 80% of the incremental spend was in emerging markets, principally focused on Johnnie Walker. Investment behind the brand was driven by Asia and Latin America as we continue to drive recruitment and premiumisation.
- Spend on our vodka brands increased in both the developed and emerging markets. We increased spend significantly behind Smirnoff on the "I Choose" and "Nightlife Exchange" campaigns. In developed markets, investment was again driven by Cîroc, Smirnoff and Ketel One in North America.
- In beer, spend was also focused in the fastest growth markets with spend in Africa up 25%. Investment in Guinness increased across all its major markets and was up double-digit in North America and mid-single digits in Europe and Asia Pacific.

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- Turning now to margin.
- Gross margin improved on an organic basis, up 70 basis points, mainly driven by price increases and the mix improvement delivered by the growth in scotch. Input cost inflation has been mitigated by cost savings from restructuring, coupled with our continuing programme to improve the efficiency of our supply footprint. As a result increases in COGS per unit were held at about 1.5%, mainly driven by a 3% increase in Africa given the higher inflation rate there.
- Every region delivered gross margin improvement.
- North America benefitted from their supply restructuring programmes and the positive price/mix they delivered. In Western Europe, gross margins improved due to lower cost of goods, particularly on beer.
- In Latin America, Africa and Asia Pacific, strong volume growth and price increases drove gross margin expansion. In Africa, double-digit top line growth reflected the higher inflation rate which also affected input costs, but gross margin still improved.
- As you saw in the previous slide, we have invested behind our brands and targeted those opportunities that will drive the greatest future growth.
- We continue to invest in our emerging market platforms and overheads in these markets were up 15%. These investments were largely offset by savings from our restructuring programmes which delivered benefits of £13 million in the first half.
- In summary, we have increased our gross margin and invested in the long term growth of the business while expanding our operating margin.

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- We delivered free cash flow of £500 million in the half. Higher operating profit drove nearly £125 million of incremental free cash flow, however, outflows were higher in the half driven primarily by the increase in working capital.
- This half always has a seasonal increase in working capital. In addition, we increased investment in maturing stock to fuel our future growth and incurred costs in respect of the move to our new rum distillery in the Virgin Islands which has now started production. One off factors included higher debtors due to the buy-in ahead of expected duty increases in January 2012 in France. Nigeria also

increased its stock holdings to mitigate the potential disruption as we brought on much needed new capacity in the peak season. This impact was amplified by weaker sales due to the current economic challenges there.

- Higher interest payments were primarily driven by lapping the interest rate swaps which we monetised last year. Higher tax payments were due to the phasing of payments and tax audit settlements in the UK.
- Our capital expenditure is higher this year due to our investments in Nigeria, East Africa and North America coupled with lower disposal proceeds.

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- The costs associated with the initiatives that we have put in place to improve operating margin and make this business stronger are reflected in exceptional charges. I anticipate these charges will actually be lower in fiscal 12 than we had originally planned with a total cost of about £100 million against the £120 million we announced in August.
- Similarly, I expect the cash outflow from these activities to be lower than we had originally estimated, about £180 million this year, roughly £25 million lower than we announced in August.
- The gain we reported as sale of businesses reflects the change in accounting for our additional Shui Jing Fang investment, as we now have majority control of the Quanxing holding company.
- Now let me spend a little time on the exceptional tax charge of £518 million.

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- As we anticipated, the tax rate before exceptional items has reduced to 18% this year from 22% previously. We currently anticipate that 18% will be our ongoing tax rate.
- The reported tax rate includes the exceptional tax item you saw on the previous slide and is therefore 45.2%. Last year we didn’t have any exceptional tax charges and so the pre and post exceptional tax rates were in line.
- During the period we finalised negotiations with tax authorities which confirmed a favourable change in the basis of taxation relating to intangible assets, mainly brand values and how they are amortised for tax purposes. This has reduced the on going tax rate and brought it in line with our cash tax rate.
- However, this change in the basis of taxation resulted in the write off of deferred tax assets which we had established under the previous tax basis. This write off gave rise to a non cash charge of £524 million which increased the reported tax rate.

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- And finally, moving down the income statement to eps.
- Associate income was up £18 million, driven by the performance of Moët Hennessy.
- The net finance charge was broadly unchanged. Our effective interest rate was about 50 basis points lower at 4.7% and average net debt was up roughly £750

million to £8.3 billion as we funded the acquisition of Mey İçki with short term debt and our strong free cash flow.

- I would expect our interest rate for the full year to be a little higher than in the first half given current floating rate forecasts. Also I am currently assuming we will move to a higher proportion of fixed debt but the final decision will depend on the interest rate outlook and market conditions.
- eps excluding exceptional items was up 16%. Excluding the impact of the reduction in the tax rate from 22% to 18%, eps was up 10%.

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- In summary, Diageo is building momentum.
- Our net sales growth was strong in the half with continued growth in emerging markets and a solid performance in North America. The restructuring of our European business was achieved as planned and overall the performance there was in line with our expectations.
- 4 percentage points of positive price/mix marks a significant improvement over last year.
- This price/mix improvement and our efficiency programmes led to a further gross margin increase.
- We have invested behind a number of priorities we believe will drive growth, primarily in emerging markets and behind growing categories in North America and Europe.
- Our increased focus on costs is delivering results, and, coupled with our top line performance, generated 60 basis points of margin expansion.
- And finally we've maintained our robust financial base and our strong debt to EBIT ratios while funding our acquisitions in the half.
- As Paul said, we are cautious about economic trends in 2012, but the solid and well balanced results we've delivered in the half give me confidence that we are on track to achieve the medium term guidance we described last August.
- And now I will hand back to Paul.

Paul Walsh, CEO

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- Thank you Deirdre.

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- At our conference in November I spoke about making a strong business stronger.
- And these results demonstrate that we are doing that.
- I am going to spend some time now talking about how we built the momentum which Deirdre has just described, and I will start with the investments we have made to drive top line growth.

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- The momentum behind our improving top line growth is the result of our consistent investment in marketing behind effective campaigns; our successful innovation programme and the renewed focus we have put behind our regional sales teams.
- We have more of the world's leading brands than any other company. We are focused on extending those leadership positions and in the half we have gained share in over 60% of our markets.
- Our strategic brands have grown fastest. Johnnie Walker has generated a third of our growth but it didn't set the pace. Buchanan's grew faster with 27% growth and Cîroc grew 50%. In vodka, Ketel One grew over 10% and the strong performance of Smirnoff in Western Europe, where it grew 9%, was a big contributor to the overall improvement in the brand's performance. 11% growth of Guinness in the emerging markets helped offset the weakness of the beer category in Europe and Guinness grew 5% globally.
- Let me start with marketing which we increased by 10% in this half following a 10% increase in the same period last year.

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- Our incremental marketing spend has been focused on the biggest growth opportunities and that is why over 70% of our incremental spend was in the emerging markets.
- But we have also increased our marketing spend in North America targeted on the growth opportunities. As consumer trends are mixed in that market, in some areas spend has been maintained. We are increasing our spend on our vodka brands to lead the growth of that category and we have increased marketing spend behind the launch of new products. We are also spending more on advertising specifically to the increasing ethnic diversity of our consumers. This focused approach to our spend in North America is also demonstrated by our spend by price point with investment up significantly on premium and super premium brands.
- In Western Europe, spend is up behind Smirnoff Red and Captain Morgan as these are growth categories where we have clear leadership.
- Smirnoff has had a strong performance in H1, particularly in our key focus markets for Western Europe of GB, Ireland, Germany, and France. Our spend was around mass participation in Smirnoff "Nightlife Exchange" and our media spend reached 23 million consumers with 14,000 mentions in print media.
- Similarly, Captain Morgan grew double digit in Western Europe behind significant upweighted spend in Germany and France.

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- In addition to increasing spend, the range of our brands gives us enormous scope to reach consumers over a number of platforms.
- So while marketing was up, our marketing impact increased by even more.

- In China, for example, we now have an on line shopping page for Baileys on the Chinese equivalent of eBay providing a cost effective way to reach 190 million female internet shoppers.
- In Mexico and Columbia, we launched Buchanan´s “Time to Share”. It’s a word of mouth campaign supported by TV where consumers who donate 4 hours of their time for volunteer work connected to education get a ticket for an exclusive concert with an international artist. Nobody will be able to buy a ticket, the only way to go is by donating the 4 hours.
- The launch of the new Johnnie Walker Blue Label bottle this half was through a series of exclusive private tastings in China, India, Thailand, Vietnam, Brazil and Mexico where each had local cultural relevance. We then leveraged social media and created nearly $30 million of coverage.
- In Africa, Guinness has carved out an important space as the number 1 beer for football fans in Nigeria with activities such as bringing the Argentina football team to play the Nigerian Super-Eagles for the first time in ‘Guinness. The Match’. It generated £2 million in earned media value as the match was broadcast live to an estimated audience of 42 million. And of course we are now running a second series of the highly successful Guinness Football Challenge.
- In Africa, we are now filming our ads in the region in several local dialects and featuring the local community.

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- Diageo has a track record of successful and sustainable innovations and at our conference in November we showcased the depth of our innovation pipeline in North America, with particular focus on Cîroc which we introduced, new to world, and is now a major super premium vodka brand.
- We are using innovation to access the key growth trends: the luxury opportunity, the emerging middle class and the female consumer, and in the half, we launched a further 80 new products.
- We are premiumising our brands through innovations and we delivered nearly 20% growth of our Johnnie Walker super premium brands through special gift packs first for Diwali and more recently for Chinese New Year. You can see the great packaging we used for Johnnie Walker XR21 on this slide.
- Understanding consumer motivations in this luxury space is key to success. Gold is an important part of the festival occasion across Asia and we test launched Smirnoff Gold priced at 3 times that of Smirnoff Red. The rate of sale is 1.5 times that of Smirnoff Red and has driven 3ppts of share gain and gained 5ppt of share against the nearest competitor.
- Innovations are also meeting the opportunity we see in the growth of the emerging middle class and we are launching heritage brands such as Haig in Latin America at affordable price points.
- We also believe there is a significant opportunity to unlock growth from exclusively targeting female consumers. We are doing this across all markets, for example, with Smirnoff Whipped Cream and Fluffed Marshmallow in the US and Baileys Biscotti in Europe.

- Innovation unlocks growth in the developed markets. In Ireland, for example, we have introduced new liquids and dispense mechanisms to offer perfect cocktails in bars which do not usually serve cocktails. Smirnoff Mojito is now available in over 600 outlets which are selling a total of nearly 40 thousand cocktails a week.

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- Having built our sales capabilities centrally, last year we moved the focus of our sales operations into the regions as part of our operating model changes.
- We can now tailor our consumer programmes and our innovation agenda with each of our key global customers. In Western Europe, for example, more than 50 customers agreed new initiatives in shopper marketing and category development, which are forecast to deliver an incremental net sales benefit of over £20 million.
- All our regions increased their “Ease of Shop” programmes. In Western Europe, it was implemented in 27,000 stores up nearly 25% on last year.
- In the half, we also deployed more Shopper Marketing initiatives than in any previous half with an increasing mix of programmes that are differentiated for our priority customers and where we can leverage our wide brand range by category and on the slide you can see our Smirnoff execution in European duty free.

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- The operating model changes we implemented for F12 had two aims; to drive efficiency across the group and to focus our resources to drive growth.
- The new operating model is now in place. We have delivered the overhead reductions we planned in corporate costs and in Western Europe and North America. Overheads are flat in North America, down £10 million in Western Europe and corporate costs are down £13 million.
- While overheads are up in the emerging markets they are down as a percentage of net sales as we drove efficiencies in those markets as well.
- Our supply restructuring, primarily in North America and in the UK, is also on track and as Deirdre said has mitigated input cost inflation in these regions. We have therefore been able to hold COGS per unit flat in these markets which has contributed to the gross margin improvement we have delivered.
- We have announced changes to our Irish brewing operations to create a centre of excellence. Just like our investments in distilling capacity in Scotland and in brewing in Africa this investment in a single facility for Ireland will improve our cost per unit and reduce our environmental footprint.
- At the beginning of the fiscal year we introduced a new performance management system based on 21 key markets and aligned our incentive systems to drive enhanced accountability. As I travel between our markets I can see the impact this is having in improving the line of sight between actions and outcomes. It is early days but I am confident that this change will be key to delivering our aspirations at a market and region level.

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- Diageo's emerging markets business is based on the routes to market and brand strength which we have built through consistent investment.
- The individual leadership positions of our brands combine to make Diageo the leading international spirits company in Latin America, Africa and Asia.
- The focus of our investment in the emerging markets has continued again this year and in the half we increased marketing spend by 20% and investment in our sales and marketing organisations by 15%.
- This investment drove volume growth and 8 percentage points of price/mix as we accelerated the organic top line growth of our emerging market business to 18%.
- In addition we are expanding our brand portfolio in these markets. In Brazil, for example where our business was 80% scotch we have seen very strong growth of our vodka brands, especially Ketel One and Cîroc, and while our scotch brands grew over 20% we are now building leading positions across more categories in these important markets.
- Innovation is also expanding our reach into fast growing consumer trends especially the rapid growth of the middle class.
- In India, for example, we have recently launched Rowson's Reserve into the growing IMFL prestige segment. It is a great tasting brand in a growth segment and given the improvements we have made to our route to market in the past 2 years, we are now confident in our ability to access this segment successfully.
- We have also expanded our presence through acquisitions which have given us leading brands in premium local spirits and beer.
- Our acquisition of Mey İçki added over 2 million cases at an operating margin of over 40%. In addition we have folded our international brands into the Mey sales organisation which has already contributed to the improved growth rates we have seen for these brands.
- Serengeti breweries, which we acquired last year, has delivered a strong performance and in the half we agreed the acquisition of the Meta Abo brewery in Ethiopia.
- We have now extended our ownership in Shui Jing Fang and seen a marked increase in sales outside China now that we have distribution of the brand in duty free.

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- Our North American business is our biggest and our most profitable.
- In the last year we have made changes to enhance our position.
- As the leader in US spirits we have introduced new ways of working with our distributors which give us an aligned approach across the key growth opportunities. This has already improved our focus and has contributed to improved top line growth.

- We have rationalised our wine business and integrated it into our spirits business. And while the wine category remains weak we have seen our performance improve.
- We have increased marketing spend behind new campaigns which have reenergised Smirnoff, Captain Morgan and Tanqueray.
- Stronger volume growth of our strategic brands together with moderate price increases had driven 5 percentage points of price/mix driving further gross margin expansion. While marketing increased as a percent of sales operating margin improved as overheads fell as a percent of net sales.
- This is efficient growth.

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- Given the current economic environment in Europe we made the decision in 2011 to create an integrated Western European business which could focus on our leading brands and our key customers, and to separate our in market organisations for the faster growing markets of Russia, Eastern Europe and Turkey.
- Investment decisions would be made centrally for Western Europe delivering efficiencies in spend and speeding up the decision making process. It also gave us a sharper focus on the biggest growth opportunities.
- We have begun to see the benefits of this new model. In key categories such as rum and vodka we have delivered strong growth with Captain Morgan up double digit and Smirnoff up 9%. The economic situation in Ireland, Spain and Greece is reflected in the performance of those countries but in countries with a more benign economy we have delivered a good performance and in Germany and France we have delivered double digit growth.
- In addition, our focus on the super premium opportunity has driven over 20% growth in our core reserve brand portfolio across Western Europe.

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- As you may recall, at our last results presentation we laid out this slide with our route map for the business over the medium term.
- This first half performance demonstrates the sharper focus we have brought to bear through the changes we made. It is driving the efficient growth we believed it would.
- We have delivered good growth in an uncertain world with 7% organic net sales growth and 9% organic operating profit growth.
- But the global economic outlook, whilst improving, remains uncertain and therefore we believe it is prudent to be cautious about the market environment we will face in 2012.
- But this is a good set of balanced first half results and it has reinforced our confidence in our brands, our routes to market and in our teams around the world.
- We are confident that it has provided us with a good start to the delivery of our medium term guidance.

- Thank you.

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