Diageo
Half Year Results – US

Paul Walsh

Chief Executive Officer

Well good afternoon. Good morning everyone and thanks for joining us.

What I would like to do is give a very brief overview of our results as many of you will have participated in the webcast this morning and then Nick and I will take your questions.

It has been a challenging six months with economic trends little improved over the second half of fiscal ’09 and, as we have communicated before, we did have a tough comparable top line growth in Q1 last year of 6%. We finished the half slightly stronger than anticipated with organic net sales of 2% in quarter two despite being down 6% in Q1. Therefore, organic net sales were down 2% in the half and organic operating profit was down 3% in the half. However, EPS pre-exceptionals was up 5% due to favourable currency movements.

We’re particularly pleased with the free cash flow performance. This has been strong, driven by a number of changes to our working capital management and we generated an increase of £517m to almost £1b pre-restructuring charges.

We have confidence in the business and we are again increasing the interim dividend by 5%.

I will stop there and open it up for questions.

Question and Answer Session

John McMillan – Lord Abbett

Good day everyone. Paul, there is a lot of scepticism in terms of you doing your full year numbers. I just saw you on TV and certainly they were sceptical. The market seemed sceptical. Can you just kind of go into what type of top line trend you need to achieve this improved second half EBIT?

Paul Walsh

Sure. Go ahead.

John McMillan

And also, when you say one-offs last year, what specifically are you relating to?

Paul Walsh

Well let me ask Nick to cover the one-off costs. But basically, we are seeking a continuation of the top line trend we saw in the first quarter. That trend line coupled with the fact that we will not have the same level of one-off costs in the second half, will allow us to deliver on the guidance that we've offered. It's really as straight forward as that. Sorry, second quarter trend.

In the second quarter we were up 2%. That is the trend line we are expecting in Q3 and Q4.

John McMillan

Okay.

Nick Rose – Diageo

Yes, let me answer that. A couple of things. That is, the fundamental piece of this. We will need some top line growth as Paul has described. We will also, and we believe we can achieve, some modest expansion of our gross margin from where we are. Our gross margin in the first half, as you will have seen from the release, did actually deteriorate. A number of factors in that including some market mix as well as some down trading within the business and we are believing and seeing that we will get some of that kind of gross margin back. Maybe not all of it, but we will get some of that back and of course any movement in gross margin is very powerful as it drops down through the P&L to the bottom line. Then on top of that, as Paul has said, there are some what we have called non-recurring costs in the first half that we will not be facing in the second half.

So, for instance, you know because we've disclosed it I think, that we have a number of kind of investigations going on right now in places like Korea and the sheer amount of effort required to delve into those and to answer some questions that the SEC is asking of us right now is actually adding cost in terms of accounting and legal fees in our first half. They will not appear as incremental costs if you like in our second half.

I think the third factor that should give you some comfort is if you think about what we have to achieve in the second half compared to the second half of last year, the bulk of our cost savings which Paul talked about this morning which will be about £120m by the time we get to the end of this fiscal year, didn't start until this year.

So comparing second half of last year, we weren't really getting much in terms of overhead savings and by the end of this year we will be getting the full £120m.

So the second half performance is going to look very strong profit wise partly because of what we are lapping in the previous year. So it's a combination of the top line growth Paul talked about, the fact that some of these non-recurring one-off costs that we saw in the first half aren't going to appear and thirdly, what we're lapping from the prior year in many ways is just a lot easier, not least of all the £120m of cost savings that we're going to be getting running rate by the end of this year.

John McMillan

Thank you.

Thomas Russo – Gardner, Russo and Co

Yes, hi Paul. I hope you can hear me.

Paul Walsh

I can.

Thomas Russo

Good morning. Good morning. Good. A couple of quick questions. The first on the working capital release. To what extent do you find that the trade still needs to have vendor financing as they continue to suffer with their own credit lines? Are you too tight on the trade with your working capital demands?

Paul Walsh

First of all we haven't offered any vendor financing. In fact, if you look at the cash flow both last year and this year, our receivables showed a marked improvement and we think it is just judicious to operate on very keen terms. We haven't tightened our terms, but we are certainly driving our customers to pay on terms. So I'm feeling very good that we have managed our cash in this manner. We have not extended our receivables. In the face of some companies going into some bankruptcies or whatever, we've managed our way through it pretty well and I intend that that will remain the case.

Thomas Russo

Thank you. Anecdotes from either the India or Chinese market if you could – strength of your brands and anything in particular with your local relationships in each market that we should know?

Paul Walsh

Well let me talk about Asia generally. Asia, sort of the brakes went on there pretty fast, but equally, with the fiscal stimulus package going in particularly in China, the brakes have come off and we are definitely seeing growth in that market.

India, we did have some over-shipment in the first half of the previous fiscal year. We are lapping those in these numbers. They were unwound in the second half of last fiscal year. So to the earlier question and Nick’s point, it means in India we are lapping a lot easier numbers in the next six months.

That aside, highlights for me is the general economic improvement in Asia, the fact that in Indonesia and Malaysia we’ve seen 21% growth on the Guinness brand. Stunning performance. In fact, our beer performance overall is up 5% which I think stacks up pretty well. In fact, very well on a global basis.

We’ve seen a return to growth in Australia and we now have our own operations on the ground in Vietnam.

So I’m encouraged by our performance in Asia.

As I said, we did have some issues where we overstocked in the first half of the previous fiscal. We’ve now got beyond those numbers for the second half.

Thomas Russo

Thank you. Then lastly, the strength that you’ve got in your position in Sub Saharan Africa is remarkable and I’m wondering what kind of weight you’re putting into that market either though investment and distribution, marketing or manufacturing? Your plans broadly across Africa.

Paul Walsh

I’m down in South Africa in a couple of weeks opening a new brewery in Johannesburg. We’ve already signed an agreement to move into Angola. We have up-weighted our spend selectively in certain African markets. We are very committed to that country. We see very good returns going forward and we have very, very strong marketing positions and, by the very nature, the M&A opportunities in that region will be limited but you should expect us to move with prudence but with alacrity when we see such opportunities.

Thomas Russo

Thank you.

Paul Walsh

Thank you.

Thomas Russo

I am so sorry Paul but if no one else is going to ask, I’ve got your time. Thank you. Paul, talk a brief moment about Black Label and the announced launch of an extra distilled or special distilled Black Label. I’m just curious what you think about the health of the brand and how expandable the Black Label is up and down need states versus using other Johnnie Walker brands to meet those need states. It seems like Black Label may be expanding into territory once owned by other Johnnie collars?

Paul Walsh

The double black is...

Thomas Russo

That's it.

Paul Walsh

It is un-aged. It is priced at a premium. It is very special blend and we think it will have a role. But we reckon it will be quite small versus the parent which is Johnnie Walker Black Label.

The other variant that has been introduced in Asia, particularly in global travel, is the John Walker, which is a blend of very rare whiskies. This sells at $3,000 a bottle and I heard the other day that we've had to start air freighting some more product into that market because it has already sold through, which just shows that for these markets where we're seeing confidence return, there is still a very strong role for ultra premium products.

Thomas Russo

Thank you.

Jonathan White – Evergreen Investment Management

Hey guys, can you hear me okay?

Paul Walsh

Yes, we can hear you.

Jonathan White

Great. I just have a question about price mix. I noticed this first half, and I apologise, I haven't fully gone through the transcript from the earlier call from the UK, but there wasn't any price mix on an organic basis this half and I was just wondering if you could talk about what the drivers were there and then over the long-term, how do you see that moving forward?

Paul Walsh

Yes, there are two dynamics at play. The first dynamic, particularly in developed markets is a shift from the on-premise to the off-premise. When people don't have – even if they have the money in their pocket, if they don't have the confidence, they tend to conserve that money and stay in. That means we lose out on the opportunity to up-trade consumers in the on-premise occasion.

It's hard to replace that consumption occasion through the off-trade channel mainly because if you go out in London and you want a Johnnie Walker Blue Label it's say £15. If you want to enjoy that in your home, even if you buy a half bottle, it's probably £80. So there's a sticker shock element there. That means that our ultra premium and super premium brands have performed less well.

The brands that have performed very well are our premium spirits brands that are in the sweet spot. Brands like Smirnoff, Captain Morgan and so on. But, because we've lost that top spin, that is why you are not seeing the mix improvement coming through as you have seen in the past.

Also, you've had a situation whereby, as I said earlier, our Beer business has done very, very well and clearly, there is some mix dilution as a consequence of over-performance from beer.

Jonathan White

That's very helpful and just also, just longer term. I don't know in your own model how you see mix as well as price having an impact on the top line, but that would be helpful as well.

Paul Walsh

It's particularly interesting in the US market. When we were faced with some of these economic conditions, many people said that beer would win out over spirits. What's very interesting and very encouraging is that spirits are now getting taken into the home occasion more and in fact, spirits performance through the off-trade channel is actually out-performing beer. We are very gratified by that and it shows you that we have actually earned these consumers' respect and they stay with the brand. Maybe they don't purchase the higher end marks, maybe they don't purchase with the same frequency, but they remain very loyal to these brands. Therefore, our expectation is that when you get consumer confidence back, you will see more buoyancy in the higher end offerings.

Now we've started to see some improvement in GDP numbers, but understandably, there is a lag between GDP growth and raw consumer confidence and we've yet to see real improvement on the confidence stakes. Until we see that, I don't think we will get a kind of return to the previous trends that we enjoyed.

Jonathan White

Just lastly, did you guys take any pricing across the portfolio in the first half?

Paul Walsh

No. Minimal. In certain markets that were either high inflation or where we saw devaluation, we would have done. But other than that, no and I don't anticipate any kind of raw pricing in the balance of this fiscal year.

Jonathan White

Great. Thanks very much guys.

Paul Walsh

Thank you.

Thomas Russo

Hi Paul. Any particularly troubling spots in terms of excise tax developments for spirits or beer?

Paul Walsh

Actually there are some encouraging news. If you look in the US, we did not get a Federal excise tax as part of the recent budget. In Ireland you have seen a 20% reduction in excise taxes. Unfortunately in the UK, they have come out and said that they will increase excise tax by RPI plus 2% which given RPI is pretty low. Basically means by 2%. Not ideal, but very manageable. So I'm not seeing any huge threats and I think the reason for this is that one, it's very unpopular at a time when politicians need some popularity.

Secondly, I think there is concern that it may not yield the sort of revenue generation that they would like and thirdly, if it had negative consequences on the whole hospitality industry, those are low value jobs but they would do nothing for the unemployment statistics.

So I'm not taking anything for granted. We've got to be on our game in this area. But I'm not seeing a huge threat in this regard.

Thomas Russo

Thank you.

Kevin Dryer – Gabelli and Company

Hi. Good morning. I just had two questions. First, in the US, could you talk a little bit about the competitive environment, how promotional your competitors are being versus how you are being and also if you could a little bit about potential acquisitions? Obviously, Moet Hennessey is one that is bandied about a bit. Maybe you could relay your current thoughts on that.

Paul Walsh

Okay. In the US, there is no question that the level of competitive intensity has stepped up. But as best we can determine, it's probably notched up around the promotional spend level by between one and two points of sale. 1% to 2% and we actually believe that we're probably at the bottom of that cycle.

We have leading brands and therefore, you have customers (liquor store owners whatever). It's usually the leading brands they want to promote and our view is that we want to continue to convey excitement around such brands and therefore, the promotional intensity has increased.

I think it's very manageable. Our philosophy is that we want to maintain kind of bottle sale momentum. We need to remain vibrant with our consumers and our customers and, as I said earlier, when confidence starts to return we will go back to the trading up activities that you saw in previous periods.

So I think we've demonstrated great agility and I would do it all over again. It's the function of the environment that we're in.

Regarding M&A activity, we have said that if ever the 66% of Moet Hennessey is available we would be interested. It would have to be at the right price and really, the ball is in the court of LVMH if they wish to sell. I suspect that that is not the case.

We have announced recently a modest transaction in Africa. To an earlier point where we see opportunity for inorganic expansion in the developing markets we will take that opportunity. It's relatively modest in the overall context of our cash flow. But I think those are probably the sort of transactions that you should expect to see more of rather than any mega plays at this stage.

Kevin Dryer

Great. Thank you.

Paul Walsh

Thank you.

Well first of all, thanks for joining us. I believe that in the face of the economic situation that we have seen, these are a very resilient set of numbers. It was a tale of two quarters. 6% down in the first quarter, but 2% up in sales terms in the second quarter.

It's also a tale of kind of a polarised world. We are seeing very good growth momentum in Asia, Latin America and Africa. We expect that to continue.

However, in Europe and the US, it's pretty flat and we do not expect that to change in the short-term and our guidance does not rely on it changing.

I am very pleased with the way the organisation has responded to our call for cash management. This is an outstanding performance on cash. Not all of it can be repeated, but I believe in the current environment cash is always important, but it's particularly important in the current set of circumstances. And therefore, as I said, I think this is a resilient set of numbers. From the consumer testing that we have done, our equities are strong and I remain confident that when we see returning consumer confidence, we will see a return to premiumisation as well.

Thanks for your support and I will be seeing some of you over the next couple of weeks. Thank you.

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