2016 Interim Results

DIAGEO Plc

Ivan Menezes

Chief Executive

Hello, everyone and welcome to our call. I hope by now you've had a chance to look at our press release and the webcast. I'm delighted to have Kathy Mikells with me here, our new CFO. We are both in London and ready to take your questions. So, with that, operator, let's take the first question.

Question and Answer Session

Olivier Nicolai - Morgan Stanley.

Hi. Good morning, Ivan and Kathy. I've got three questions, please. First of all in the US, Captain Morgan performance was much better. Are you comfortable with the price points of the brand at the moment or does it need to be adjusted further?

Second question is on China. The scotch sales were down 42%. Now, could you give us a bit more detail on this and do you see wholesaler destocking and what's actually the underlying performance there?

And just lastly on Nigeria. You still have the distribution gains from Orijin in H2 this year. Could you comment perhaps on the consumer environment over the last few months, if it has deteriorated or not? Thanks a lot.

Ivan Menezes

Sure. Thank you, Olivier. I think on the US let me just take a minute and just describe just how I am feeling about the US business overall and I will touch on Captain Morgan specifically.

As you would expect, this market is my top priority and I'm pleased with our performance and progress in this half. We came in exactly where we told you we would and, as we've explained, the timing of our first half/second half is driven by the timing of Ciroc's innovation and the replenishment model in innovation.

I mean our overall spirits business is growing depletion-wise about 3% in a market that's growing about 4%. We are slightly ahead in the first half on NABCA. We are slightly behind on Nielsen.

Now, to your points. The things I'm most confident about in what we are doing in North America on the key brands, so, Smirnoff and Captain Morgan in particular we have taken the pricing adjustments. Not all of them have worked through because you've got some timings in certain states where we move. We've moved on adjusting Captain Morgan White to be more competitively priced and in some markets OSR as well. Beyond the pricing adjustments we've done, the on premise activation is heavily up-weighted through the activation army and particularly targeting the 21 to 29 year segments and the on trade. That is up-weighted and we have a significant weight behind our new campaign Go Full Captain. So, all of that will go into greater impact as we go into H2.

But just a few other points on North America. The new team, Deirdre, James Thompson who is now the CMO, Tom Looney heading up the US, Jacob Ripshtein our new CFO, I feel very confident about the new team. We've made significant changes in marketing and I can see the programmes coming through much more strongly. We've made the pricing adjustments as we've talked about. We've got a lot of momentum in the portfolio on Crown, Bulleit, Buchanan's Malt, Don Julio. We're going to keep feeding that.

Route to consumer is stronger with some of the changes we made with our distributors. We are putting more resources in the on premise and on activation armies. We have shifted to this replenishment model on innovation. On the value brands like VO and Seagram's Seven we made adjustments. And I also believe, and it only starts in January, with the exit from wine we are going to get a lot more executional focus against spirits and that will play out in the second half. And, of course, we are driving good productivity both on supply chain and on our trade spend and marketing.

So, net/net I am confident that H2 will be stronger. But I just wanted to share that perspective overall on North America.

On China. In China, there's a few things going on. Scotch in total is down. It's mostly deluxe scotch and it's primarily driven by a very conscious decision from us to back off the very high cost of investment in the on trade. And, you know, most of deluxe scotch is consumed through contracts in the on trade. It is not profitable business and that segment of consumption is still declining in China so we are backing off it.

Super deluxe scotch we're doing very well and in fact are growing share on Johnnie Walker Blue with the Johnnie Walker houses. Haig Club is doing well. Then our main business in Mainland China I'm delighted to say Shuijingfang and Baijiu continues to do very well. We were up 60%-plus on the half and I expect that momentum to continue.

Conditions in Nigeria, your third question Olivier, no question, the macro environment is tough. We are seeing continued down trading. Our business in Nigeria actually was significantly impacted by Orijin which was lapping an extraordinary year last year. But I'm pleased to see our Guinness business back into momentum. We're in double-digit growth on Guinness, Malta and our value beers, Satzenbrau in particular, is also performing well and as we go into the second half I'm also optimistic about what we're going to be doing in mainstream spirits.

So, I think it's fair to assume Nigeria will stay a challenged market, but our portfolio now is much more balanced and will be more resilient in our performance going forward.

Olivier Nicolai

Thank you very much. Very clear.

Ian Shackleton - Nomura

Yes, good morning, Ivan and Kathy. Three financial questions I guess for Kathy. When we think about working capital going forward, certainly you're bringing down the maturing stocks in this half. Is there real opportunity to shrink working capital further in the next few years?

Second question was around, I think on slide 15, you had highlighted obviously overheads had gone up and explained a little bit why. There again, I'm quite keen to know what will happen in the second half and looking further out on the overhead line.

The third question was around tax. I think you were reiterating that 19% is the right number for the full year. Can you give us some thoughts about where that might go longer term?

Kathryn Mikells

Sure. So, why don't I start in with the first question overall about working capital. Working capital, on a total combined basis, was an incremental use compared to the prior period of £45m. You're right, within that we saw inventory come down a little bit. If you dig a little further in terms of what was happening in the debtor and creditor piece, we actually saw on the debtor side long overdues coming down which I think is really positive and so I think there continues to be further opportunity there.

If you also consider our United Spirits subsidiary, they have a heavier working capital model right now than we have and we think there is incremental gains to be made there.

So, you know, there is a little bit of timing things going on, on the creditor side. In the prior period we had the Korean tax settlement embedded in there and so that was giving us overall creditors on that not increasing on a year-over-year compare basis. But we continue to push working capital really hard and we're looking to bring it down as a percent of sales and I would expect over time, we will continue to make positive progress there.

I think the second question that you asked me about was specifically as it related to overheads. So, we did see, you know, an increase overall in overheads. Specifically, we have a lot going on half over half in the bonus accrual, so that went up £33m. You know, in addition to that, we're obviously seeing some inflation in overheads.

If we look to the second half, I would say from a bonus perspective we'd probably still see a little bit of increase, but nothing near like we saw in the first half and, again, the inflationary upward movement that we're seeing is also going to continue.

If I look forward beyond that, which I think is pretty important, we've got a big productivity plan underway to really embed productivity on an ongoing basis. The company has put out a very big programme for the next three years of £500m. We are well underway across six big areas and how we're going to get at that and the detailed plans to get us off to a good start in 2017 and so that's what we've got to do ultimately to get overheads down.

The last question you asked overall is about tax rate. We've guided to a tax rate for the full year of 19%.

You know, I would characterise the environment overall as headwinds on tax rate. Every jurisdiction is scrutinising this much more specifically. We pay the right taxes absolutely, but as you look at just how the environment is changing, I think for Diageo and most forecasts over time we're going to generally see tax rates floating up.

Now, you know, this is direct tax. Obviously, Diageo pays a whole lot of indirect tax. Within that productivity programme we will continue to look at our overall footprint, look at our approach in terms of where we're importing products, what products we can potentially manufacture within market and everything else we can do I would say to look to bring down our total tax bill, both direct and indirect combined.

Ian Shackleton

Just coming back on the first one on working capital, should we expect maturing stock inventory to continue to come down in the next year or so?

Kathryn Mikells

You know, we have a long-term programme on maturing stock. And so while we may have a given half or a given quarter where we see differences in, I would say, our overall production levels relative to shipments and how we're balancing out capacity and manufacturing, long-term we're looking to lay down stock consistent with a long-term growth rate in the scotch market.

Ian Shackleton

Okay. Thanks very much.

Simon Hales - Barclays Capital

Thank you. Morning, Ivan. Morning, Kathy. Two or three questions if I can please. Just firstly, can I drill down a little bit more into your comments around the H2 margin expectations of broadly flat? I would have thought given the absence of the 30bps drag you flagged in relation to the US in the first half that we should have been expecting to see a little bit of underlying pickup in H2. You talked in the presentation around higher A&P spend in the second half, but I would just be interested in any more colour you can give me in terms of maybe where that spend is going, why it's stepping up?

Then secondly, going back to Nigeria, some companies have been flagging some more recent difficulties getting hold of hard currency on the ground there. Is that something that your subsidiary is seeing and how do you think about potentially dealing with those issues when it comes to importing raw materials?

Then finally, Ivan, back at the full-year results, in the US you were talking about the focus on improving some of the tail brands of the portfolio. I would just be interested in an update as to where we are on that journey.

Ivan Menezes

Sure. Thank you, Simon. Why don't I deal with Nigeria and tail brands, then I will ask Kathy to come back on H2 margin.

On Nigeria, no, you are right, I think there is more potential downside on FX and currency that we are not facing yet. I mean the government is tightening up certain things on taxation etc. and making it a little more difficult. I am assuming Nigeria is going to get tougher and I would say that is the mindset the management team is working to over there in terms of managing local raw material sourcing, how we manage our FX exposures, our management of imported products. As an example, you will see us focus more on local manufacture and mainstream spirits which products today from USL, for example, get imported. But we're in the process of setting up a route to market there and a production capability where we will look at local manufacturer McDowells. So, we are taking those kinds of actions and we are assuming an environment that will get tougher.

On the US tail brands, we've been testing a variety of things in the first half. One of the things which I'm encouraged by was in 13 markets we took Seagram's Seven and VO and ran some tests to stabilise volumes there, which were encouraging. I've said before, the tail brands have been quite a bit of a drag on US spirits' performance, so we're making adjustments there and I expect some improved trajectory on the tail brands and the testing we did in H1 was encouraging in that regard.

Kathy.

Kathryn Mikells

Okay, so I will come back to talk a little bit about margins. We talked about marketing overall in this half and that we saw marketing spend come down significantly. If you kind of peel that back for what's really going on underneath marketing spend, part of what we saw is less spend on US innovation because we just had less innovation in the half on a year over year basis. We also had a lot of procurement savings and Ivan already talked about some of the specific withdrawal of marketing in China with regard to scotch. So when you go to look at the second half, we're not expecting to see that £40m decline year over year that we saw in the first half, and so that's a part of what's going on.

The other thing that I would call out is we did have a gain on the UBL shares in the first half as well. So, overall, we're not expecting something like that to repeat in the second half and so that's really what's going on overall.

If I come back to our full year expectation I would say we're at exactly what we thought we would be at last July. We were expecting that for the full year we would get a little bit of margin expansion and that's what we're still expecting.

Simon Hales

Okay. Thank you. Just to clarify with regards to your comments, Ivan, around Nigeria. You're building in some caution there. Is that embedded into your margin expectations for the full year? I.e., if we were to see Naira devaluation, are you building in some flexibility for that at this stage, or is it incremental if we do see that move on the ground?

Ivan Menezes

No. I would say we haven't, in terms of our FX outlook. If you get another dramatic devaluation I think it will impact the FX impact on the company. But I would say operationally we're geared to assume that the environment will get more difficult. I mean if the Naira drops another 50%, it's going to have an impact, so that's not really built in to our projections. I was talking about the things we can do on the ground to really ensure we're managing imports versus domestic, managing our cash exposures etc. We're talking about all those actions strongly.

Simon Hales

Perfect. Fully understood. Thank you.

Trevor Stirling - Bernstein Research

Morning, Ivan and Kathy. Three questions from my side. First one then, what do you think the impact is going to be of the US wholesaler consolidation? We've seen two massive deals in recent months. Does that have any impact and particularly when it comes to renegotiating NGG, do you think there will be more power on the other side of the table?

Second impact is you mentioned that the impact of the replenishment model and sales in North America is about 3%. If I try to estimate impact on operating profit, would I be right to think it's probably about 5% given how profitable Ciroc is, or roughly £40m hit to operating profit?

The third question is could you just give us a little bit more colour on the bonus accrual, the increased bonus accrual, and in particular, which aspects of improved performance or different performance has triggered that bonus accrual?

Ivan Menezes

Sure. Let me deal with the first two and I will ask Kathy to come back on the bonus accruals. Trevor, the US wholesaler consolidation, the way I look at it is what it's doing is it's driving greater efficiency into the system. As you know and what you've seen with the combination of Charmer and Wirtz and Southern and Glazer, part of their business rationale and the business model of what they're moving to is to create and drive more efficiency and I view that as a positive, right, in supply chains and salesforces and technology investments and all of that.

As it relates to our competitive edge in our route to market in the United States, we obviously are constantly looking at widening our edge against other suppliers. As you know, we work with both these combined houses. Charmer, Wirtz are our partners in New York and Chicago and other markets and Southern and Glazer will now be with us in California, Texas, Florida, and many other states as well. We continue to do work with them and have made some changes on sales structures, on teams, on information systems, on running more efficiency in supply chains on better data coming back. One of the big thrusts that Deirdre and the team are driving is getting far closer to reading consumer trends and anticipating them and spending our money more wisely, both in trade spend and in marketing spend.

Now, competitors, you've seen some of our competitors have consolidated all their operations with one wholesaler. I fully expect competitors to try to play catch-up. I am confident we will keep taking our edge further because there is a lot of improvement still to be made in our route to market. We are putting a lot more focus on the on trade and in this activation army concept which is all around building brands at a grassroots level. I see the name of the game really in execution through the route to market being very much around creating consumer pull and consumer engagement with our brands and with our scale position, I expect that we will do that better than anyone else.

On Ciroc, it has had a big impact. Net sales was 3% [down] because of the reduction. The impact on profits I haven't calculated it.

Kathryn Mikells

So if you look out to the second half, one of the things that we pointed to and saw is we obviously reduced marketing on Ciroc in the first half as well because we had less innovation this year relative to last year. That's not going to be the case in the second half, and so we wouldn't expect to see, I would say, a big overall impact on our margins in the second half in North America coming from the difference we're seeing in year over year and sequentially on Ciroc.

Then I will take then I think the last question that you mentioned was just about bonus accrual and the big difference year over year. You know what that is really being driven by is where the company was last year. So, you're accruing your bonus at any given point in time based on what your full year outlook is kind of relative to what your planned targets were and at this point last year, what the company was staring at at that point in time didn't suggest that it was going to meet its plan and it accrued appropriately. If you look at where we're at this year, I would describe this first half as very much in line with our expectations. We've basically put up on the board pretty much exactly what we expected and we're accruing bonuses in line with that.

Trevor Stirling

Thank you very much indeed.

Ivan Menezes

Thanks, Trevor.

Chris Pitcher - Redburn Partners

Thank you very much. A couple of questions from me. Specific to the Crown Royal business in the US, can you give us a feel for what the total depletions are now for Crown Royal Regal Apple are? I mean is it around a million case brand? And what the plans are with the Northern Harvest Rye given the fact that it has won several plaudits, whether that's enough to sort of keep the Crown Royal franchise going well?

Then secondly, you talk positively about the outlook in India, but can you give us some feel for what your contingency plans are for the GST plans at the moment?

Then thirdly, on the maturing stock situation, can you say specifically what scotch stocks did because obviously there will have been some stock through divestments and so forth? Were scotch stocks stable to up slightly in the half? Thank you.

Ivan Menezes

Hi, Chris. Sure, I will take the first two on Crown and India. I will ask Kathy to cover scotch inventory.

Crown Royal overall, Regal Apple continues to do very well. The dynamic we're seeing right now is base Crown Royal is roughly flat and in H1 we had 16% overall depletion growth and Regal Apple was about 600,000 cases of depletions. So, as you say, it's about a million case business, which is fantastic.

What we're seeing from a consumer standpoint is most of is incremental. There is very little cannibalisation. There is some, but most of it is drawing new consumers into the franchise. It has strong on premise help. It's drunk in shots and cocktails. We see the equity measures on Crown Royal improving and Regal Apple is clearly a big piece of it.

Northern Harvest Rye, which is fantastic to get the accolade of best whisky in the world, it's in the early stages. We ran out of it in December in Canada. The Canadians were very proud. In the US we've got more effort behind it, so I expect that to pick up. I don't expect it to be anywhere near the scale of Regal Apple, but it would be nice to build a good premium additional business and the team has got that as one of the H2 initiatives, building Northern Harvest Rye. I mean just the pipeline and distribution build should give us some nice growth as well.

India GST, the GST bill has still not gone through. We and the industry are fighting very hard to get alcohol included. The politics and the two houses of parliament have the bill still under debate and we're working very hard for inclusion. If alcohol is excluded, we're also working very hard so that we put in place the mechanisms to recover the taxes and get the pricing flexibility. So, the entire industry is very well aligned and working this agenda strongly. It's hard to predict when GST will go through and in what shape, but we're fully engaged on it.

Scotch.

Kathryn Mikells

And with regard to the last question about just maturing stock in scotch, it did come down a little bit, about roughly £10m. So a little bit of movement there.

Chris Pitcher

Thank you.

Ivan Menezes

Thank you, Chris.

Andrew Stott - BoA-ML

Yes, good morning. Thanks. A couple of questions. Firstly just on Johnnie Walker. I just wondered if you could just give us a feel for the trajectory through the half and particularly the second quarter obviously. I'm just mindful of the fact that first half last year was particularly weak at minus 12. I'm just wondering about your conviction around still growing into the second half for that category globally.

The second question was just picking up on a comment, Ivan, you made earlier on a question around the exit from wine can benefit the spirits business. Could you just explain that, please? Thank you.

Ivan Menezes

Sure. Firstly on Johnnie Walker. As you saw, we grew 1% in the first half. But when you go under that, the scotch and Johnnie Walker is, we feel, more confident about going into the second half. So Latin America had a strong performance in scotch and Johnnie Walker I think up about

9%, 10%. We had South East Asia we're seeing some nice rebound in the export wholesale markets. Europe did well.

Where we've had some downside has been China which was a deliberate strategy where we've, as I talked about earlier, we backed off. I mean we're not making money on that business, so we've just backed off it on the deluxe and below scotch end.

Then we've got some markets in Africa where, due to the currency volatility etc., things have slowed down.

Now, with the emerging market currency slowdowns, we are trying to recover as much of the pricing as we can in places like Brazil. In Russia we're getting about half of it now, but it's still moving the price point up.

The actions we've taken on primary scotch whiskies, and you see it come through strongly in Latin America and you will see more of it in Asia and Africa as we move forward is in part to really keep the affordability of scotch within reach in economies where currencies are devaluing. We've had tremendous success with Black and White in Mexico. It's almost doubled its business there. It's going to be 400,000, 500,000 cases White Horse and in Brazil. So that piece of mainstream primary scotch is part of our answer to the volatility.

Our overall feel on the category and the health both of scotch and of Johnnie Walker is positive and we expect to continue to do better as we go into the second half.

On the US question, very simply, we've got a salesforce of over 3,000 people, dedicated people on our business. Relative to its size of business and certainly its profitability, wine took a significant amount of time. It's an intensive category to sell. What we see now with having our salesforce just focus on spirits, I mean I expect that incremental effort that was going against wine - I'm talking about the salesforces and the distributors - to be really focused much more on our premium core brands in spirits. That's a big piece of what our US team is focused on is getting that attention on Smirnoff and Captain Morgan and Crown Royal incrementally and you can see some of the additional emphasis we are putting on the on premise and the activation armies etc. is a reflection of that.

Andrew Stott

Okay. Thank you very much.

Ivan Menezes

Thank you.

Andrea Pistacchi - Citi Investment Research

Yes, good morning. I have three questions, please. Firstly on emerging markets. I don't think you talked about the destocking which is effective, particularly in South East Asia, LATAM. So, is this over now completely and did it have any impact in this half year?

Secondly, Ivan, going back to the point about price increases in emerging markets to recover FX. I think at the full year you flagged that scotch had become, in some instances, more competitive because some players weren't really putting through the necessary price increases. So if you could update a bit on the competitive environment, particularly in scotch and emerging markets.

My last question is on the US where you've had clearly a good improvement in shipment trends for most of your brands except Ciroc. You sounded quite confident also on the outlook. But recent Nielsen data have showed some softening in the last few months. I appreciate Nielsen only gives a partial picture of what's going on. I'm wondering whether you could sort of say if you've seen on the ground any sort of slight maybe softening in either market trends or your brands over recent months?

Ivan Menezes

Sure. Thanks, Andrea. Let me take the three questions. On emerging market destocking, as we had flagged, our remaining piece of destocking was in South East Asia and that was pretty much on track. It was about £17m of impact in the half.

You know, in South East Asia we're seeing actually a faster depletion improvement. In West LAC we're seeing slower depletion improvement, but that we're just managing the demand signal better, but that was the main destocking which we had flagged that we did in South East Asia.

On how we manage pricing in scotch, I would say we are far more rigorous and in tune with how we manage our pricing relative to, you know the currencies are moving so much and ensuring we get the right balance of volumes and share performance.

Now, we are the market leader in many of these markets. We, for example, in Russia, on deluxe standard scotch we have lost a bit of share but we are doing far better on super deluxe scotch and we've taken price regardless because in the near term you've got some trade-offs where you lose a bit of share but it's the right thing to do to keep the economics and the aspiration for the category strong. I would say we are much more disciplined and rigorous on how we are doing this in places like Brazil and South Africa and Russia which have had the biggest currency impacts.

In Brazil, market share performance was good. Generally speaking, our market share performance in the emerging markets on scotch has been good.

Your final point on US trends. US trends continue to be solid. I mean we anticipate, when we look at all the data points, Nielsen, NABCA, on premise trends and the independent markets, we figure the US spirits market is growing at a little over 4%. The recent trends, I mean there was a little bit of slowdown in December, but January is looking solid. I remain confident that we've got kind of good sustained 4%-ish growth happening in US spirits and I expect that to continue.

The on trade is a little softer. It's growing about 3%. But overall the industry is still running at about a 4%.

Andrea Pistacchi

Okay, thank you. Great. Thanks.

Nik Oliver - UBS

Good morning. Just one question left for me. Just regarding the use of the balance sheet. With the balance sheet now looking stronger and your comments about looking to repair the dividend cover ratio, how should we think about use of cash as we move into FY17? Is it more a focus on sort of bolt-on M&A, or could we see potential buybacks in the next fiscal year?

Kathryn Mikells

So, I think as you look at our M&A activity, we're going to continue to be inquisitive in the marketplace. But at this point we would really expect that those transactions are going to be smaller in nature, so that will be something that we continue to look at.

Our leverage ratio has come down and we would expect that it will come down further and later in the year we will be discussing with our Board to the extent we get in a position where we've got more excess cash, what would be the appropriate uses of that excess cash.

We gave a 5% increase in the dividend. Looking to basically stay there as we seek to build our dividend cover.

Nik Oliver

Okay, that's very clear. Thank you.

Sanjeet Aujla - Credit Suisse Securities

Hi, Ivan, Kathryn. Can you just give us a sense of where value depletions were for the company as a whole in H1 and is there any reason, on a full year basis, why depletions won't equal shipments?

Also, you made some comments on the US for the second half, expecting a bit of a pickup in Diageo's performance. Do you think that's enough to get back into market share gain territory and would that be sustainable thereon? Thanks.

Ivan Menezes

Sure. Thanks, Sanjeet. Overall company depletions are running a little over 3.5% in value terms, so, ahead of our reported sales, clearly, so we're in a healthy position. Depletions are running ahead of shipments as we continue to kind of embed the sell-out culture everywhere.

On US market share I don't expect us to be growing market share in the second half. You know, we've got catch-up to do. I'm talking about Nielsen's-type market share. I think through the course of this year why we will get relative improvement, it won't be enough to get back into growth. However, let's be very clear, our objective, and Deirdre and team's objective, is absolutely in the US to grow at least in line with the market with the portfolio we have and the actions we are taking on the portfolio. You know, I talked about the value brands, shoring those up more, kind of accelerating where we've got momentum and clearly getting Smirnoff and Captain into better shape. But I would see that really happen more in F17.

Sanjeet Aujla

Got it. Thanks.

Eamonn Ferry - Exane BNP Paribas

Thank you. Good morning, Ivan and Kathy. Just two questions from me, if I may. The first one is on Ciroc Apple. I appreciate it's quite early days, but some of the data we've seen in December suggests it's got off to a very strong start. Is that something you see from your end and what's your views on it as we look to calendar 2016 I guess obviously in the context of you guys lapping some pretty demanding comps on Regal Apple for the rest of the year?

Then just, I guess, a minor technical point. It's a question on slide 56 which suggests Q1 organic sales growth was slightly negative. 1.2% I think is the number. That seems a little bit at odds with the 5% to 6% growth intimated in the AGM statement at the very end of September. I guess my question is what am I missing on that one? Thank you.

Ivan Menezes

Okay, let me take the first question on Ciroc Apple. It is, Eamonn, off to a good start. Actually, if you look at the NABCA numbers in December, Ciroc Apple had a very strong month which was pretty much its month of introduction, or one or two months in. So we are very pleased with where we started. One of challenges, as you know well, is predicting the trajectory on a Ciroc flavour is not exactly the easiest thing, but I'm pleased with the change we've made in our supply chain and our replenishment model. We're going to watch this very closely and, as we read the marketplace, respond and build from there.

On total Ciroc trademark, we are looking at having a stronger H2 in terms of depletions performance than we did in H1.

The second one was, I'm just trying to understand it, the AGM statement was?

Eamonn Ferry

I think the message at the AGM statement was volumes mid-single digits. Let's call 4% to 6% plus mix slightly positive, so I guess you're getting to a number of 5% to 6% for Q1 unless I misread it. The number in the statement, i.e. the quarterly growth, was, I think, minus 1.2%. So I guess the delta there is quite big. My question is have I misread? Have I misunderstood? What explains the delta?

Ivan Menezes

Just the phasing of the quarters and the impact of the US. So it's purely the technical phasing of the two quarters last year versus this year and the move to the Ciroc comparison and the replenishment model shift. We will come back to you with a more detailed answer of that.

Eamonn Ferry

All right. Okay. Thank you very much.

Martin Deboo - Jefferies

Morning, everybody. Two questions. The first one is on USL. You've obviously talked about GST. But just looking at USL from a sort of broader perspective, Ivan, how are you feeling about how it is going there? They seem to have posted quite a decent quarter on the top line overnight, but I haven't gone into the entrails of that, so I would just appreciate your general feeling about USL as we stand at the moment.

I just want to ask again about the tail brands in the US. Given what you've said about the benefits of focus from being out of wine, I just wonder, and just noting transactions in the market like Southern Comfort going to Sazerac, whether there is anything more creative you can do in terms of getting rid of the drag of the tail brands, either exiting them totally or putting them through a different organisation, or just any thoughts on the tail brand issue in the US? Those are the two questions.

Ivan Menezes

Sure. Thank you, Martin. On USL, operating performance and execution against the strategy is going well. You will see in our numbers Q2 was much stronger than Q1 and I expect H2 to be stronger than H1.

The core element of our strategy is winning in prestige and above whisky. I mean that's the main battleground, the real profit pool where historically USL has underperformed its key competitor and I'm very encouraged by the actions we've taken there.

Royal Challenge is doing very well. It's been completely restaged product back marketing and that's gone into the market and is growing 50%, 60%. We've got a renovation of McDowells No 1. That's going into the market. A few states have started. It will go H2 more broadly. I feel good about that. Signature, another brand, and Antiquity, we've got renovation plans.

So that piece of the market, the scotch whisky business, the Diageo brands on the USL platform, all doing well, so I expect top line growth to improve in H2.

We do have a few challenges. There are some states where they don't quite like our way of doing business as we put our new practices into place and we're underperforming in these five states. But that's a matter of time because we're working with them and I fully expect those to get better as we go into next year and beyond.

On the margin and productivity front, USL had about 3 points of gross margin improvement driven by really driving an efficiency programme very hard in the supply chain, in our procurement, and in total. Anand Kripalu and the team have a, I would say, an end-to-end productivity agenda which is aggressive. It is on track. They are resourced to do it. That, combined with moving the centre of gravity of the portfolio up will, over time, lead to continued margin expansion.

So, on the operating front of USL, I'm feeling good. There is obviously a hell of a lot of work to do, but the management team is strong. We've got a new CFO in place and, indeed, you would have seen in the results that USL posted overnight that the Diageo Q2 was stronger.

On tail brands, you know, we've looked at this question very objectively as to the role of trade tail brands and should we be in them or out. Firstly, the actions we are taking on tail brands are really, I call it, putting them on autopilot. It's getting the pricing rhythm right so that they hold their share of the value segment in the marketplace.

The volume is important and it gives us advantage both in our supply chain and manufacturing. There is overhead recovery that comes through and the volume is important for our distributors in terms of the scale that they provide. For the salesforce, being able to sell brands across the price points, whether it's into the off trade or, indeed, getting a greater share of the well in the on trade, in our dedicated salesforce, that does have value. So, historically, we took price. We got uncompetitive and really what we're talking about is get more competitive. We're not talking about spending marketing against those brands, or indeed, a lot of salesforce time. It's really about getting the pricing right and then ensuring we get more than our fair share of the value segment. So I expect the tail brands, in spirits, to continue to play an important role in our portfolio and our distributors would also agree with that, that they are important in terms of the scale for the dedicated divisions.

Martin Deboo

Okay, thank you.

Ivan Menezes

Thank you.

Alex Smith - Investec

Hi. Morning. Just a technical question on North America. I think you said, or you implied at least that growth would have been up around 1% to Trevor's point if you strip out the shipping technicalities around Ciroc, but your spirits depletions are running at around 3%. So I appreciate beer is a technicality, or a driver there as well, but it feels like your spirits shipments are still running below your depletion rates there. If you could clarify that and whether for the full year you still expect shipments and depletions to be aligned in that market.

Then a quick question on emerging markets. I think you said in aggregate emerging market growth was around 4% for the half, but I think you said at your investor conference in Q1 sales in emerging markets were up 6%. So I was just wondering what caused that slowdown in the second quarter. If there is some technical there, or anything else we should be aware of.

Then, finally, a question on marketing. Again, going back to your investor conference, Deirdre spoke about transforming marketing as being her number one priority there and I think you do refer to some changes having been made in the release. I was just wondering if you could share anything on that, please. Thanks.

Ivan Menezes

Sure. Firstly on the depletes/ships, it's purely again the comparisons to the prior year. For the full year, to answer your question, we do anticipate ships and depletes in the US to come in line.

On the emerging markets, one of the areas that has slowed a bit has been the impact in Nigeria and in Africa. On the other hand, we have offsets. India, we expect to get stronger as we get into the second half. Latin America did well and we've got pockets in Asia where, again, we would expect to see improvement in the second half.

Kathryn Mikells

Our number for our emerging markets is up more like 4.5%.

Ivan Menezes

4.5%.

Kathryn Mikells

And the number that we would have given in November was rounded and so while there is certainly a little bit of difference there, as Ivan mentioned, it isn't as large as you originally suggested.

Alex Smith

Sure.

Ivan Menezes

Yes, not a big number.

Alex Smith

Can I just ask what the emerging market depletion rate for the half was? I know you've given it for the US and the Group. We can probably work it out, but I was just wondering if you could give us the number?

Ivan Menezes

It will be 5%-ish. I don't have it in front of me right now.

Alex Smith

Okay. Thank you.

Ivan Menezes

US marketing, I mean the big changes we're making are, if I just bring it to life and I showed some of it on the webcast with what we're doing on Smirnoff and Captain Morgan, a greater level of social and digital engagement, much stronger on premise activation and experiential. Our effectiveness of what we are spending on and how it is working we are bringing, I would say, a lot more rigour to. The winning with millennials, the 60 million millennials, is really at the heart of where we have changed. We call it our next generation marketing model. So on every brand and in all our categories we are really making the changes that ensure we get steady recruitment and re-recruitment on these brands.

The things that jump out on a brand like Smirnoff is we're really doubling down on electronic dance music and festivals and really getting those experiential moments amplified massively. Even on a brand like Johnnie Walker, we're scaling up mentorship in a very big way through a lot more experiential stuff on our whisky portfolio. Captain Morgan, it's going back to the on premise. On a brand like Captain Morgan you will see less mainstream TV and more frequent social and digital engagement with the target group. So those are some of the shifts that we are making on the marketing front.

Alex Smith

Thanks.

Javier Gonzalez Lastra - Berenberg Bank

Yes, thank you. Good morning, Ivan, and good morning, Kathy. Just two quick questions. You showed on your slide number 22 of your presentation a big improvement in the performance of scotch in H1 versus fiscal 2015. I just wonder how much was that helped by the Brazil buy-in ahead of the excise duty increase and should we expect this H1 improvement to sustain into H2?

My second question is a bit more broad on disposals. You've done a few of those in the past months. Is that exercise finished, or are there more non-core assets that we should expect you to dispose of?

Ivan Menezes

Hi, Javier. The H1, in fact, if you look at the ups and downs, yes, Brazil had a bit more tax increase buy-in, but we also had destocking still happening in South East Asia and we had markets in Africa that couldn't buy because of currency. H1 is not flattered just by Brazil. In total, I would say the scotch trend is very well balanced in terms of what you see in our overall numbers.

I'm sorry, your second question?

Javier Gonzalez Lastra

Yes, it's on disposals.

Ivan Menezes

Non-core, we're pretty much done. I mean you never say you're done, of course, if you look at the fringes. But I would say the most important disposals that we wanted to make have been done in terms of wines, the non-core beer, and Gleneagles. At the margin we look at a few more things, but nothing of significant scale and our focus really now is on making the core perform.

Javier Gonzalez Lastra

Thank you.

Ivan Menezes

Okay. Well, I think we have run out of time. Thank you very much, everyone, for your questions and joining the call. Those of you in the US I know it's really early, so thank you for making it early and let me hand it back to the operator. Thanks everyone and I look forward to seeing some of you in the next few weeks.

[End]