DIAGEO 2016 PRELIMINARY RESULTS CONFERENCE CALL WITH MANAGEMENT

Moderator: Ivan Menezes & Kathryn Mikells
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Operator: Good morning, and welcome to the Diageo Preliminary Results call with Ivan Menezes, Chief Executive, and Kathryn Mikells, Chief Financial Officer.

If you wish to ask a question on today's call, you will need to press "star one" on your telephone keypad.

I will now hand over to Ivan to introduce today's call.

Ivan Menezes: Hello, everyone, and welcome to the call. I'm sure by now you've had a chance to look at our press release and the webcast that Kathy and I did earlier this morning. We're both in London, and ready to take your questions.

So, with that, operator, let's take the first one.

Operator: Thank you, Ivan. And your first caller is Olivier Nicolaï from Morgan Stanley.

Olivier Nicolaï: Hi, good morning, Ivan, Kathy. I've got a couple of questions, please.

First of all, your margin in Africa was down particularly in H2, affected by negative mix. How should we think about margin in 2017 in Africa? And, particularly, what could be the impact from the sharply positioned Euro.

And, just regarding your FX guidance of 370 million impact on EBIT for 2017, could you give us an idea of how much is the – coming from transactional versus translational? Thank you.

Ivan Menezes: Hi, Olivier. I'll take the first one and then ask Kathy to jump in on the second.

On Africa margin, yes, we were impacted by Nigeria in particular on the margin, and – in this year's organic. But going forward to your question, I do expect Africa to expand margins going forward, and getting operating margin up again. So that's very much in our plans.

Kathryn Mikells: And then your question with regard to the impact on operating process coming from a FX benefit -- about seventy percent is translation, relative to transaction.

Olivier Nicolaï: OK, thank you very much. And just to – just to follow up on the FX -- concerning your hedging profile on FX, should we expect to have a positive transactional again in full year '18? Or, in other words, if you will not hedge on your transactional, if you will have expected more than 370 million for this year?

Kathryn Mikells: Yes. Our hedging profile, generally, we're, at any point in time, out about 18 to 24 months, right? And so that diminishes -- kind of -- the immediate impact, either positive or negative, with regard to transaction. And so, we'll still have that rolling off in fiscal '18.

Olivier Nicolaï: Very clear. Thank you very much.

Operator: Our next caller is Sanjid Owsler from Credit Suisse.

Please ask your question.

Sanjeet Aujla: Hi, Ivan, Kathy, just a few questions from the U.S., please. Can you give us a little bit more colour on the new agreements you have with your distributors there? What's actually changing?

Also, can you – can you try and help us quantify the price adjustment on Smirnoff, and are you adjusting price anywhere else in the – in the portfolio?

And, thirdly, you're talking more positively about margins in the U.S. I think the message at the investor day was not to expect much margin expansion out of that business in the foreseeable future. So what's really changing there to give you more optimism on expanding margins in the U.S.? Thanks.

Ivan Menezes: Hi, Sanjid, sure. The distributor agreements are basically focused on strengthening our sales executional capability. So, things like we run the activation armies in the top 40 cities, how we support behind the activation army – things like more focus on multicultural and on premise; more focus on reserve brands.

We're at a point now where our distributor partnerships are strong. We are getting better real-time data on performance. We are aligning supply chains closer, so we can really get efficiency and working capital both for our distributors and for ourselves.

So I'd say it's just raising the game to the next level of execution, and, just, to me, the key is widening our advantage relative to competition.

On the price adjustments on Smirnoff, I would say we've had to make a back and statewide adjustments on the 175; then, the 750s. We've done most of it; there's a little more to do. As you know, vodka is very competitive.

But the way I would characterise pricing in the U.S. is in fiscal '16, we virtually got no price. But, under the surface, we took price on brands like Crown Royal and Bulleit and Don Julio. And we've had to make adjustments in brands like Smirnoff and Captain Morgan. In fiscal '17, I don't expect us to get much price.

Mix is very positive. Mix is driving a couple of points of improvement; that should continue. And we will stay on the premium core brands, particularly on Smirnoff and Captain Morgan, just to ensure we are – our price premiums are not too high. So I'm not expecting price in the next year as well.

On margins, we have – we have a strong productivity programme in North America. There's still a – as you know, this is a scale business; it is very efficient, but we see room for more. Supply chains can be run more efficiently; we will be taking tramlining through our product lines, working with distributors more closely; and we're looking at our back office activities, and driving more efficiency there.

The margin picture in North America – since fiscal '12 to fiscal '14, we grew 100 basis points in margin – a lot. Last year, we dropped because our volumes were down. In fiscal '16, we grew 40 basis points.

I would say the underlying business algorithm should drive some small margin expansion – not as big as it's been in the past years. But, at the same time, I would say we are – this is the market I'm looking to invest. And in our global productivity programme, we talk about two-thirds coming back into reinvestment. North America is going to be high on our priorities to reinvest in marketing once we are confident we can get the returns.

So that's how I would characterise margins going forward.

Sanjeet Aujla: Many thanks.

Operator: Our next caller is Chris Pitcher from Redburn.

Please ask your question.

Chris Pitcher: Hi, there. A couple of questions. You mentioned how much it increased your European sales force files. I wonder if you could give us some similar statistics on your U.S. business.

And then, you singled out in the presentation, Scotch India and the United States as central to your medium-term guidance. Could you give us an idea of what you think the gross ranges are for those three different parts of the business? Thanks very much.

Ivan Menezes: Yes. Hi, Chris. On the distributors' sales force in the U.S., we've made adjustments. As you know, we got out of the wine business. And so, we've had to resize them based on that.

But I'd say, more than the share numbers, it's the redeployment. We've got a 3,000 plus sales force in the U.S., but we're putting more focus on multicultural segments, and more focus on the on premise, and on reserve.

And activating in beyond trade, and in third space, and the communities in the big cities, I'd say it's more that. And better data, more disciplined execution, where we've released a lot of capacity by getting out of wine. And our – we're redirecting that against third's execution. And then, ...

Chris Pitcher: Can I – ...

Ivan Menezes: … the three priorities ...

Chris Pitcher: … can I ask a followup ...

Ivan Menezes: Go ahead?

Chris Pitcher: … on that? Sorry. If I understand how your sales force go to the market, how many – how many of your salespeople now would be going, and selling the whole Diageo portfolio, versus more specialist teams going in, and focusing on, reserve or whisky, and the like? Is that the way it's going? It's got much less of a portfolio approach?

Ivan Menezes: No, the – I'd say the vast majority in the U.S. are selling the full portfolio. So we do have specialist resources that focus on malt – say, on African-American and Asian accounts, or the Korean clubs in California. I mean, we've got a very tailored sales force against the opportunities. So it's tailored by channel, by type of outlet. But the vast majority is selling the full portfolio.

Chris Pitcher: OK, thank you.

Ivan Menezes: On three priorities, Scotch, as you know, we got it back to flat this year from the decline in the last couple of years. I would expect us to improve that this year. I'm not going to give you a Scotch forecast, but you can expect momentum to continue and build.

India, we grew five percent this year. I would expect that to improve. You know our medium-term goal in India is to get to double digit growth on USL. And the third was ...

Kathryn Mikells: The U.S.

Chris Pitcher: The U.S., thanks.

Ivan Menezes: ... the U.S.

Chris Pitcher: Yes.

Ivan Menezes: Oh, the U.S. - next year, we'll grow in line with the market. That's the goal.

Chris Pitcher: When do you think the market will grow?

Ivan Menezes: Sorry?

Kathryn Mikells: When do you think the market will grow?

Ivan Menezes: Well, it grew this year at about four percent on spirits in fiscal '16.

Chris Pitcher: Thank you very much.

Ivan Menezes: Yes.

Operator: Our next question comes from Trevor Stirling from Bernstein.

Please ask your question.

Trevor Stirling: Morning, Ivan, Kathy. Just three questions from my side, please, Ivan.

So, the first one, concerning the top line aspiration of mid-single-digits, at 17 to 19, is that – is that an average across the three years, or sifted by the end of estimate 19, you'll be up at, to, like, the mid-single-digit growth?

The second question, maybe for Kathy, the overhead drag as of the, sort of, a good performance on gross margin expansion on the marketing tradings, that are by the 110 bits of drag from overhead, is that something that we can expect to go forward, at least the inflationary element of that?

And the third question, I said, Ivan, going back to U.S. Scotch strategy, you mentioned Buchanan's and Johnnie Walker, but single malt seems to be the fastest bit – fastest growing bit of the U.S. Scotch category. What are your plans in malts in the U.S.?

Ivan Menezes: Sure, why don't I take the first, and the – the growth rate is the average over the three years, mid-single-digit. On Scotch malt, we absolutely see this as the vibrant end of the whisky market. We do have stepped-up plans on growing our malt business to – we're up weighting our reserve focus in the U.S. significantly.

And it's not just malts – it's also super deluxe Johnnie Walker blends as well, where brands like Blue Label are doing very well in the U.S., and I want to really accelerate that momentum as well.

So going into fiscal '17, the team has, I think, quite robust plans against Scotch in total, Johnnie Walker in particular. Malt strong and super deluxe Scotch I expect to continue to accelerate because it's – that's the very vibrant end of the marketplace.

Kathryn Mikells: Yes, and then, I'll take your question, with respect to overhead. So, as you looked at the overhead impact to our margin, about 50 basis points [this figure was actually over 50 bps] of that was as a result of a bigger bonus accrual, effectively, this fiscal, relative to last fiscal. Last fiscal, it would've been artificially – well, obviously, off of what wasn't a great year for Diageo overall.

When you think about the inflationary impact, I say, overall, will continue to have an inflationary impact. But we will be looking to address that in part by getting more productive overall within our workforce. So that impact is going to continue to be there. We'd at least be looking to get partial offset against that impact.

Trevor Stirling: Thank you very much Ivan and Kathy.

Ivan Menezes: Thanks, Trevor.

Operator: The next question comes from Nik Oliver from UBS.

Please ask your question.

Nik Oliver: Hey, good morning, thanks for the question. And two from my side.

Firstly, on the marketing spends, another year of good efficiencies there. How should we think about that line going forward? Is this good for efficiency? Or should we think about marketing spend gradually increasing as percent of sales in FY17 and FY18?

And, secondly, Ivan, just coming back on to your comment on the U.S. market growth – and in terms of growing in line with the market, was that a commitment for the full year on average, or by the year-end? And if it is the full year-end average, just a sense on what are the key building blocks getting us from that three percent depletion rate this year, up to circa four next year? Thank you.

Ivan Menezes: The second one, I'm not going to give you decimal point forecast ...

Nik Oliver: OK.

Ivan Menezes: ... on the U.S. spirits business. We grew three this year; it'll improve. Let's face it, we are underperforming the market right now because of the drag of Smirnoff and Captain Morgan. Both of them grew two percent this year. We expect improvement, but it will be gradual – it'll be through the course of the year.

The thing I would point to is, I have confidence in the momentum in the U.S., which is really coming through stronger execution. Our marketing has significantly stepped up. I spent a week in the U.S. a few weeks back, and just went through all the brands, and our marketing programmes. Very, very strong. The commercial execution, we talked – I talked about it earlier, is also stronger. And the distributor alignment against what we want to get done in the on- and off-trade in the multicultural segments, et cetera, is good.

So that's why I feel confident we'll get improvement. But it will be gradual. This is a super tanker, and we will steadily get it better.

Nik Oliver: OK, thanks. And, I think, in the past, you'd talked about stabilising …

Nik Oliver: … some of the low-end brands as being part of that, sort of, driver of the sequential improvement. Is that still part of the strategy as well?

Ivan Menezes: That is part of the strategy. So we are – there's still a drag, the low-end brands. And so, Deirdre and the team have plans underway to improve our competitiveness at that end of the market as well.

Kathryn Mikells: And then, your last question, with regard to marketing spend, I thought I'd go ahead and address. If you look at how we basically lowered our overall marketing spend most recently, it's come from really getting efficiency out of our marketing spend. So, consolidating our vendors, benchmarking our contracts, negotiating better deals, using our agencies in more smart ways – that has given us a lot of benefit in the U.S. as well as Europe.

We're concentrating that programme on the rest of the world. But, obviously, we have a disproportionate amount of our marketing spend in Europe, in the U.S. And so, I'd expect we'll continue to get more from that, but not to the same degree that we've seen over the last couple of years.

But the place that we're really looking to step up, then, across the board, as I say, marketing effectiveness, right? And that's really a set of better tools and data so that we can really use that spend in a more effective manner, and, therefore, get more pounds of revenue, sort of, for our money. But, overall, I think it is fair to say that, given we want to really invest and grow in two-thirds of our overall productivity savings, we're looking to target to invest in growth – that we're not looking to get a lot of incremental benefit on marketing as a percent of sales.

Nik Oliver: OK, thanks a lot.

Ivan Menezes: Thanks, Oliver.

Operator: Your next question comes from Simon Hales from Barclays.

Please ask your question.

Simon Hales: Thank you, and good morning, all. Two or three questions, please.

I mean, Ivan, you – what you mentioned earlier, you expected Africa margins to increase in 2017. Does that, sort of, also apply specifically to the Nigerian markets? And I'd just be grateful if you could give us a little bit more detail as to perhaps how you're thinking of dealing with the naira devaluation there. Is there cost savings you can take out of that business? Is there – are you aiming to pass on some of those FX moves, in terms of pricing?

And then, secondly – and not wanting to get buried down in quarterly trends – but I was just struck by some of the change in trends in Q4 versus Q3, in terms of your sales growth rates getting much better in Africa, and much worse in Latin America. Is there anything specific? And it would – you know, it would – or changes happening in those markets we should be aware of? Or is it just, sort of, comp issues on that?

And then, just, finally, on the U.S., good to see Captain Morgan back in growth. That two percent growth for the full year, how much of a contribution was Cannon Blast to that?

Ivan Menezes: Let me – hi, Simon.

Africa margins, yes, Nigeria's a big, big piece of the improvement. We are taking a very aggressive approach, in terms of how we manage in the volatility and the challenges in Nigeria, managing our cost base very tightly. We've gone through quite a significant change in that business and organization to get our cost base down.

We're managing mix pricing, local sourcing of materials. So Nigeria will be a contributor, and I am expecting margin expansion out of them for next year.

On the Q4, Q3 trends, I wouldn't read too much. I mean, there are some specific things in the phasing of Brazil, et cetera. Underlying trends in Latin

America are good, in terms of market share performance – very broad-based. Our Scotch business is doing well. And, in Africa, you've seen our overall beer business is doing – is doing well.

Captain Morgan, we had – OSR was up nicely. Cannon Blast did contribute, but, overall, we had, I'd say, a broad-based recovery in Captain Morgan. We were cycling some stuff in Captain Morgan White, et cetera. But, overall, the Captain momentum has improved. It's – I would not declare victory yet because this is a slight improvement.

But our marketing programmes, both in the – we've up-weighted on premise activities a lot, and we're seeing in the activation armies in the 40 cities where we're backing the on premise, you can see the uplift coming through on brands like Captain Morgan from the activation armies.

So we will continue to work at that. We still need some pricing adjustments relative to the key rum competitor, and most of them were made this year, in fiscal '16. We have some more to make as we go into fiscal '17.

So that's how I would characterise Captain Morgan – encouraging, but not yet where we want it.

Simon Hales: Perfect, thank you.

Operator: Your next question comes from Andrea Pistacchi, Citigroup.

Please ask your question.

Andrea Pistacchi: Yes, good morning. I have three questions, please.

The first one on Cîroc in the U.S., which had a more difficult year. I think part of the problem were the technical issues related to the timing of the launches in H1. But, more broadly, if you could give us more colour on, well, what do you think the problem is for Cîroc, and what you're planning to do to address it? You referred to some more seasonal flavours.

Second question, where, please, is your – the main focus for your innovation this fiscal '17, in terms of brands or categories?

And, thirdly, on emerging markets, three percent organic growth about – in fiscal '16. There were some technical factors there, some destocking still holding you back in H1.

So do you think the underlying performance is a – is a little better than that? And, given the macro outlook – with some countries probably – some macro bottoming out in Brazil, Russia – do you expect – what do you expect for EMs in FY17? Thank you.

Ivan Menezes: Sure. Hi, Andrea.

On Cîroc, you're right. It's two – there are – it was a tale of two halves in the U.S., where in the first half, with the shift in the innovation replenishment model, we had a big decline. The second half actually had a big increase. Overall, for the year, we were down seven percent in the U.S. But the key issue for Cîroc in the U.S., and I'll – it – and its U.S. specific – is to really stabilise the core, and get less dependent on big flavours needing to continuously recruit back the same consumers.

So we're out to build – broaden the franchise beyond the urban market, get the core variant more stable. We – we've got good plans on the marketing front with. We will be taking a differentiated approach from what we'd done before on how we broadened and strengthened the franchise. I expect in fiscal '17, we will do better overall on Cîroc in the U.S.

Outside the U.S., Cîroc is in an amazing place. I – you will have seen in our presentation, in the U.K., for example, we've overtaken the other French vodka competitor, who long dominated this market. I mean, we're building it in reserve very nicely around the world. So I see Cîroc growing really nicely there. In the U.S., we've got to get more resilience, and less dependence on big – on big flavours every year, and that's the direction we're taking in our marketing.

On innovation, it's – I'd say the core direction on innovation is less straight-line extension; more innovation that recruits new consumers to our franchise; and is more disruptive. So we are redirecting our resources to build more sustainable innovation, and less from what we would just call recruiting existing consumers with line extensions.

And it's hard to give you, kind of, market-by-market. We've got a pipeline. I'm very confident we will have a strong year in innovation. And the quality of sustainability will also improve because we're putting our resources behind things that, we really drive incremental growth, and bring new consumers to our brands, and less on straight-line extensions.

Emerging markets, there is – underlying business is better. And, as you point out, we did have part of the world where we had – like, in – for Southeast Asia, where we had taken stock levels down. So the underlying momentum is slightly better than what you see.

Andrea Pistacchi: And so, next year – sorry, fiscal '17 – what, sort of, broadly …

Ivan Menezes: It – ...

Andrea Pistacchi: … do you expect?

Ivan Menezes: … yes, I would say it's – in total, I would expect to see better. But, again, I come back to, the strength of Diageo right now is, you saw seventy percent of our growth came from North America, and the – and Europe in last year. And so, I think the world is volatile, right? I mean, it's hard to predict the pace at which Brazil changes or comes back, or what happens in Russia, parts of, the pace of recovery in China on international spirits.

So we've got some degree of volatility still out there. But, overall, I feel good in ability to drive up some degree of improvement. I mean, India will be a big factor. India only grew five this year. We expect – certainly, expect it to do better going into next year. And that would be a big piece of it as well.

Andrea Pistacchi: Thank you.

Operator: Your next question comes from Anthony Bucaro from HSBC.

Please ask your question.

Ivan Menezes: Good, OK.

Anthony Bucalo: Thank you.

Ivan Menezes: Yes.

Anthony Bucalo: Ivan, just two questions. One, in Africa, are you having the same hard currency shortage problems as everyone else? And what kind of mitigating strategies do you have in the market, if you do?

And the second question is a – is a bit more, I guess, existential, in that, the U.S. elections cycle is usually a rather stressful time. This election cycle seems to be more stressful than any in recent memory. Do you see anything in your U.S. consumer feedback or chatter that indicates that maybe U.S. consumers are feeling a little bit anxious into the – into the election in November? And are you seeing any impact, maybe in the on-trade, or possibly at the – sort of, local, off-trade level?

Kathryn Mikells: Yes, I'm happy to take the first question. You know, we would see the same kind of currency constraints as other companies would see in Africa, but we have – I'd say, gotten much better at getting out in front of these issues. And some of the big actions that we take is to get maximum local sourcing for products. We actually have introduced a number of new products that are made in country, getting more into mainstream spirits, and, basically, distilling and bottling in country.

And so, the more of our cost footprint that we can put into those countries, the less issue that we have associated with some of the hard currency constraints that we see. And I say that's one of the places that we've gotten much better at getting out in front of. And so it hasn't been that big of an issue for us overall.

Anthony Bucalo: And is that why you're confident that Africa margins can pick up again next year? Is that part of the positive story there?

Kathryn Mikells: So a big part of that positive story is what's gone on underneath Nigeria. I mean, within Nigeria, you – our – beer actually grew eight percent this year, right? What's gone on in Nigeria has a lot to do with just Orijin.

And if you look at what went on in Orijin, I mean, we basically did something very disruptive. We created a new category. A lot of people, kind of, came into the category initially. We lapped peak Orijin sales in Nigeria in June, and the decline that we saw year-over-year in Orijin is really what's stressed our margins. You know, we've seen a little bit of a move towards value brands throughout Africa as well.

And so, we have a little bit of negative mix, I would say, across the board generally. But it's really the story of Orijin, and the fact that Orijin has now stabilised in Nigeria, that gives us very good confidence, in terms of improved margins in Africa next year.

Anthony Bucalo: Great, thank you.

Ivan Menezes: Great. And on the U.S., Anthony, I'd say the trends we're seeing right now, we don't see much change. The spirits category continues to be very healthy.

I mean, I think one of the factors to your point, on – the on-trade is not as robust as we would like. At-home consumption is still stronger than the on-trade. You've seen it in some of the recent restaurant data coming out of the U.S. So – and that's a good indicator of people's levels of, let's say, confidence.

But as it relates to the spirits category overall – and including the trends we've seen in July – we feel …

Ivan Menezes: … confident that, what's driving the growth there is much more demographics and taste changes than response to consumer confidence. And that's why it's a secular trend, which will underpin solid growth for spirits. And so we feel confident about the spirits side continuing good growth.

Anthony Bucalo: OK, thank you.

Operator: Your next question comes from Stephanie Diaz from Bank of America.

Please ask your question.

Stephanie D’Ath: Hi, good morning. My first question comes on organic sales growth, and your growth across mid-single-digit. Could you maybe speak, or give up the trajectory? We have come from flat to two percent; consensus next year is at four percent. How – can you maybe comment on that?

My second question is regarding developed markets versus emerging markets. So you already mentioned that EM underlying was actually slightly ahead. How do you expect that to continue to be the case or not? And, more particularly, maybe, on Brazil, Nigeria and Middle East, which were dragging the performance down.

And then, finally, can you maybe give up a little bit on reserve? It has been taking it up, and driving up growth in your portfolio. How accretive is it on the margin, and where do you see it going forward? Thank you.

Kathryn Mikells: OK, maybe I'll take those first couple, ...

Ivan Menezes: Yes, ...

Kathryn Mikells: ... and …

Ivan Menezes: … yes.

Kathryn Mikells: … throw the third one to Ivan.

You know, with regard to the trajectory, in terms of how we see our sales this year, we had 2.8 percent organic sales growth. And, earlier in the call, Ivan said, over the next three years, we'd expect to average mid-single-digits, right? We consider that to be at the low-end, kind of, four; at the high-end, six. You know, you look at where consensus is for fiscal '17 for us, and I think it takes that appropriately into consideration.

Stephanie D’Ath: Right.

Kathryn Mikells: When we look at emerging markets, a couple of things. So I had mentioned earlier that depletions are actually a little bit ahead of where our sales curve was in emerging markets. We did have some destocking in place like Southeast Asia, also in free trade zones. Specifically, within West LAC, we would have had some destocking. And so, the strength underlying the business in emerging markets is a little bit better than the net sales, organic growth that we had this year.

I talked a little bit about Nigeria already. It was down 15 [percent] NSV this year. And that – that's really attributable to Orijin. Orijin has really settled out. In the last couple of months, we've introduced new products there – Orijin Zero more recently. And we've lapped the most difficult, high-peaking sales period. And so, that will help Nigeria, in terms of having an easier comp year-over-year, and an easier comp, kind of, as the year progresses.

In Brazil, we did see the impact of a big tax increase there. You know, effectively, in the middle of this last fiscal year, ahead of that tax increase, there was quite a lot of advance buying, right? So we – Brazil was actually up nine percent NSV in the first half. Obviously, down significantly in the second half.

So Brazil's pattern, as we look next year, will be a weaker first half, relative to the second half, as a result of some of the changes that have occurred there, in terms of tax. And, obviously, the economy has been weak there as well. But we would expect to see positive progression over the course of the year in '17.

So that, kind of, underpins some of our confidence, in terms of emerging market overall improvement next year. And India, obviously, is a big market for us, and we'd expect the India growth to move up next year, relative to the five percent it had this year.

Ivan Menezes: Great. On reserve, Stephanie, the gross margins in reserve are higher. The marketing investment is higher. But the overall contribution is also higher.

So this – the reserve business is accretive from a margin standpoint. And, clearly, growing faster is very good for Diageo's margin development.

As you know, in the last four, five years, we've doubled this business [actually grew 90% in the last 5 years]. It's now about fourteen, fifteen percent of Diageo. I do see it remaining the fastest growing part of our business. We are investing heavily behind it. Just in the course of the last few years, if you take the top 100 cities in the world, we've all doubled the number of outlets in which we're activating reserve.

We put a huge number of brand ambassadors around the globe on our portfolio. We – you would have seen in our – in my presentation on the webcast, we are segmenting the reserve business into three distinct segments, and taking more tailored approaches here. I expect reserve to be a very – a fast growing business for Diageo, and very helpful in the mix impacts on our – on our margins.

It's really a consumer trend that is strong and sustained, not just in the developed world, but as much in the emerging worlds. In Africa, small base, but we were up thirty percent [actually 35%] on our reserve business. And so, you're seeing it really take hold everywhere, and I'm really pleased with Diageo's approach, and we're – advantaged in building this business.

Stephanie D'Ath: Thank you, and maybe following up on that, could you – just a summary – you are taking share in reserve, and how you are doing it, what level? I see you are more flat year-on-year-end. So it's really …

Ivan Menezes: Yes, this – that – ...

Stephanie D'Ath: ... upset – upsetting.

Ivan Menezes: ... this year, we didn't, and some of it was driven by Cîroc in the U.S. because of what we talked about earlier. But if you look at us over a sustained period, we've – we have grown shares steadily. And I certainly expect us to grow share going forward.

So, I'll tell you, this year, reserve grew at seven percent, and it was held back a bit by the U.S. performance, and some of the corrections we took on super deluxe Scotch in parts of Asia and Latin America. But, underlying, I expect us absolutely grow shares.

Stephanie Diaz: OK. And on Scotch, you mentioned, about a year ago, your inventory, or your production being slowed down a bit. Can you maybe comment on where production inventories, and what those are, please?

Kathryn Mikells: So we continue to grow, maturing whisky overall and Scotch. We had some adjustments, I would say, within some of our distilleries this year. We had a project, with regard to environmental recycling at one of our distilleries. That caused the distillery to be, kind of, taken out of production for a period of time. But, overall, our expectation is, we're going to continue to grow ...

Stephanie D'Ath: Yes.

Kathryn Mikells: ... our maturing whisky stats against a long-term average. So kind of, roughly in a two to three percent range pretty steadily.

Ivan Menezes: Thank you.

Operator: Your next question comes from Laurence Whyatt from Société Générale.

Please ask your question.

Laurence Whyatt: Good morning, Ivan and Kathy.

Ivan Menezes: Yes, yes, go ahead.

Laurence Whyatt: A couple on your U.S. Spirits division. Can you just explain to us the numbers on Smirnoff? You'd taken the prices down, as I understand, yet your price mix has increased? Can you just run through how that works on the – presumably on the mix side?

And then, secondly, could you give us a bit more detail on Crown Royal, and where the growth is coming from? Is – how much is growing in the core, and how much are they from the flavour and line extensions? And how many line extensions do you expect their product to be able to do?

Ivan Menezes: Sure, Laurence. Overall, on Smirnoff itself, yes, we have had to sharpen pricing to be more competitive. But the advantage of our portfolio in North America is, the overall portfolio has a very strong mix in its favour.

So when Bulleit grows thirty-three percent [actually 28%], and Don Julio grows to high single-digits [actually high double digit], and super deluxe

Scotch is growing fast, and Crown Royal is growing fast, all of that is mix benefit, while we sharpen our competitiveness on Smirnoff and Captain Morgan.

So ...

Laurence Whyatt: Sorry, I was may – sorry, I probably wasn't specific enough on the question. On the – you've got one percent volume movement for Smirnoff, but you've got two percent net sales movement on Smirnoff in North America? Just wondering on that precise price mix, and how that works on Smirnoff on its own, not including other brands.

Ivan Menezes: Yes, we also have – we've – it's the mix within Smirnoff. So some of the flavours which we had, kind of, grown over the last few years, those have – we've lost some of the cheaper flavours. We've introduced some higher-priced mixed-in innovation, like Smirnoff Sourced, et cetera. So it's the mix within Smirnoff that's – that is helping that.

You also have pack size mix that's changing. You know, the 750s, in general, in the U.S., are much more appealing to millennials than the 175 of old, where the growth used to happen a lot more in the 175s. So we've got some of that dynamic.

On Crown Royal, total Crown Royal, I'm pleased to say the base is also strong, growing a mid-single-digit. And Crown Royal Apple grew about fifteen percent in the year. To your point on flavours, we are going to be very careful about how we look at flavour extension on Crown Royal. I certainly don't see this as one where we will keep introducing flavours.

We did a limited time offer in the summer for Honey with a limited quantity. But that's to keep news in the category. We will probably do one more flavour.

But what we measure when we introduce a new flavour on Crown [Royal] is, is it bringing new consumers to the franchise. And we – our innovation approach is really targeted as recruiting more into the franchise, and not cannibalizing existing consumers. But it's an area of high watch out, and whisky flavor proliferation is not something we believe in.

Kathryn Mikells: Yes, and Regal Apple I think is such a great example of bringing new consumers to the brand because it's brought more women to the brand, and it's brought the shot occasion to the brand, where it wasn't necessarily participating as richly in that occasion. So it's a great example of bringing new consumers to a brand through an innovation.

Laurence Whyatt: Just to follow up on that, then, could you give us any more detail on the, sort of, percentage of women consumers you think are drinking Crown Royal, or …

Male: Yes.

Laurence Whyatt: … Apple in particular?

Kathryn Mikells: I don't have the percentage off the top of my head, but it's a significant movement, relative to the base variant.

Laurence Whyatt: OK, thank you ...

Ivan Menezes: No problem, Laurence.

Laurence Whyatt: ... very much.

Operator: Your next question comes from the line of Alex Smith from Investec.

Please ask your question.

Alex Smith: Morning. I had a follow up question on FX transaction from earlier, the benefits you expect to see coming through this year, and into full year '18.

How, I guess, should we think about these benefits playing out? Do we expect them, or should we expect them to all fall through to the bottom line, or are there other means that you can benefit from this? I guess I'm thinking about your competitive positioning in Scotch, in emerging markets, where, I guess, over the last few years, you've been hurt by quite a significant local currency devaluations.

And then, I had a second question, which is, I guess, a follow up on Simon's question, and I'm – without wishing to be overly obsessed, in terms of quarterly sales trends – but I was struck in the U.S. that sales in Q3 were significantly stronger than Q4, whereas, last year, it was Q4 that was particularly weak.

So I'm just wondering if there's anything we need to be aware of, in terms of shipments, as we look to H1 this year in North America. Thanks.

Kathryn Mikells: So I'll take the first question on FX. Because we hedge our major currencies, when currencies move, either positively or negatively, the transaction effect is dampened, right? So it, kind of, rolls into our P&L over a period of time, and I said, we're typically hedging over an 18 to 14 [24] month period, right?

So, if spot rate stayed right where they are today, and stayed in that place for the next 24 months eventually, we would end up at the spot rate. But, what happens is, we end up moving towards the spot rate more slowly through the transaction impact on FX. And that's why we would expect to see some benefit continue into fiscal '18. But, at this point, we would not be at all close to fully hedged for fiscal '18.

You then came back to talk a little bit about the Scotch portfolio. One of the things I would just mention is, overall, while Diageo has had the impact of FX over the last couple of years, other competitors have as well, with regard to their imported products into emerging markets.

So we always look, first and foremost, at making sure that our products are priced competitively, right? While FX moves, and that puts pressure on us to raise price, we've got to be competitive in the markets. And so, those decisions are really made on a market-by-market level, and we're obviously looking at things like demand elasticity relative to price as we make those decisions as well.

So we'll continue to monitor that situation. If we feel like there is a good trade for us to make with regard to price, and volume, and how that will impact our profit, we'll make those trades. But we do that in a very detailed basis, market-by-market.

Ivan Menezes: Alex, on the phasing in the U.S., I wouldn't read – that's not – Q3, Q4's not the issue, and there were some comps in Q3. I think what I would look at – and, actually, all I look at is depletions, and what's happening every month, every week, every quarter.

The depletion momentum is improving. We had H2 depletions ahead of H1. And as we finish fiscal '17, we had a tale of two halves, right? In terms of our shipment performance. But we're now on a – on a more sustained shipments in line with depletions profile. So underlying business momentum I expect to hold, and improve slightly from where we are.

Alex Smith: And H2 depletions ahead of H1, would you say your market share trends within that – results are better in H2 than H1?

Ivan Menezes: Market share trends get a little messy because if you look at the NABCA and Nielsen, that's not quite the case. If you look overall – so NABCA uses about a third, a little more than a third of the market.

If you look at independent in on-trade, we're doing better. So H2 depletions were about three – were running about three, 3.1. And, as I said, we estimate the market at four. And we were under three in H1. So I am encouraged by the momentum.

But we still lost share in Nielsen and NABCA in H2 – more in Nielsen than in NABCA. And some of that relates back to getting our Smirnoff and Captain Morgan momentum improving – Smirnoff in particular in the Nielsen markets.

Alex Smith: Thanks.

Operator: You're next question comes from Edward Mundy from Jefferies.

Please ask your question.

Edward Mundy: Good morning, everyone. Three questions, please.

The first is on slide 66 of the presentation pack, where you show you often set ZBB process by cost line and benchmarking versus other CPG. Once you've put through your 500 million of cost savings, which quartile would you be in for each of these subcategories? Do you – would you expect to be in the top quartile, or is there, through getting into the top quartile, more than 500 million of cost savings?

Secondly, in terms of stock levels, you've taken a lot of pain in the last couple of years from destocking in emerging markets. As you see some growth from renewing in emerging markets, is there potential for shipments to run ahead of depletions?

And the third question is on Seedlip. You know, clearly, very attractive margins, given the high price and no excise. I mean, how do you think about the prospects for zero-alcohol as a subcategory? How big could it be?

Kathryn Mikells: OK, so I'll take the ZBB question. You know, I'd say two things. So, first, clearly, as we target saving, kind of, over this next three year period of time, our desire is to kind of, move towards a top quartile.

That said ZBB and some of the other things that we're doing are really just about creating a culture of everyday efficiency and effectiveness across every aspect of the business, and every line item of expense in the business. And it's really getting that embedded in the culture that will continue to give Diageo benefits, I would say, far beyond fiscal '19.

Benchmarking is a pretty helpful tool in trying to think about cost or an approach in a different way. And I'd also expect, three years from now, the benchmark will have moved, right? So this is really about continuous improvement, and continuing to look across every aspect of our business to get more efficient and more effective.

Ivan Menezes: Yes, and on your stock question, I mean, there are some technical factors which you'll see bounce back where we had reduced stock levels. But on an ongoing basis, to your question about, as the emerging markets come back, or Scotch gets stronger, we are very focused on really having everyone's eye, and measurement, and incentives, and data around what's selling out and depleting – and really managing the stock levels and distributors very tightly as a result.

So I don't expect us to get back into a position of having stock levels out of line in distributors, where, we've got rigour, we've got data now. And the measurements systems in the organisation are very focused on sellout and depletions, and that's how we incentivise our people.

On Seedlip, as you know, Seedlip is one of our 10 investments in Distill Ventures, where we're backing entrepreneurs who have new, interesting ideas. Most of these we don't disclose. We've got a pipeline of exciting stuff there.

I mean, our – we are interested in the space, and, clearly, that is part of why we have made this investment. But to your question on non-alcohol in general, I mean, Diageo, we do have plays, right? We have Guinness Malta in Africa, is a big play. We'd done Guinness Zero into Indonesia. And in non-alcoholic adult beverages, we will continue to test and expand our opportunities as we see them.

And the Seedlip opportunity attracted us because we do keep a track of what's trending, what's interesting. I mean, in – today, in London's hot restaurants, I mean, Seedlip is on the cocktail menu. It's doing pretty well. It's selling for 30 pounds in Selfridges, selling very well there.

And we are – intend to be at the forefront of new consumer trends. And that's all I would say is what we're doing right now, we're experimenting, we're learning, and we're backing up new developments in this space as we are with our other investments and Distill Ventures.

Edward Mundy: Great, thank you.

Operator: Your next question comes from Mitch Collett from Goldman Sachs.

Please ask your question.

Mitch Collett: Hello. I wanted to come back to FX, and I wondered, if current spot rate remains by the time your hedges have fully rolled off, how much would their cumulative benefit be?

And then, secondly, I wondered, going back to Scotch, you've obviously had a difficult couple of years of having to take up pricing in certain markets because of FX. How do you expect that to play out now that isn't a drag?

And then, finally, a question I think I asked at the first half stage, you've obviously had some good savings on marketing. At the first half stage, I thought the message was that you would step it up in the second half. And it looks like that hasn't really happened. Was there a temptation, perhaps, to reinvest some of the benefit of your savings to try and get your share, in the U.S. in particular, back to stable. Thank you.

Kathryn Mikells: OK, I'll start with the FX question. So I mentioned that transaction FX was in the 370 million – was about call it thirty-eight percent. So a little over 100, and call it 110 million of transaction benefit. We would get some incremental benefit in F18 because we have some hedges on right now for F18 that would roll off.

But that is relatively small, compared to what we would have on hedges on right now for fiscal '17. So I'm not going to give very specific FX guidance out a year plus into the future. But that's how I would think about it. So we get some incremental benefit in '18, but it'll be a fraction of what we would have in fiscal '17.

Ivan Menezes: I mentioned Scotch pricing. We – we're going to manage this very, very closely, and its very market specific. But the broad principles, I would say, generally, in deluxe Scotch and above, I don't see us rolling back price. In standard and primary Scotches in certain markets where, if we've got currency benefits, and we're uncompetitive, we will make adjustments. But then, on the other hand, in so-called hard currency markets, like the U.S., I expect our Scotch margins to really improve.

So we manage it on a global basis, we manage global pricing very tightly. Our goal is to improve equity and improve shares country-by-country, and, clearly, with a lens on improving margins over time.

So we don't – we don't need share pricing on Scotch. We take it very – on a very – we take a sustained view of, even when these currencies, like in Brazil and Russia devalued – I mean, we didn't recover the devaluations right away. We move slowly. You want to make sure you don't drive consumers away from your category.

So we have a global team that looks at Scotch pricing in excruciating detail. And we are making some adjustments clearly where we are uncompetitive, then we can benefit from and see the return we would get from adjusting pricing because of FX.

Your last one was on marketing...

Female: Yes.

Ivan Menezes: ... savings?

Female: I didn't mention that one.

Mitch Collett: Yes, so, what do you think about that?

Ivan Menezes: Well, I think to the U.S., yes, I think, if you look to the U.S. – actually, U.S. is a good example, yes. Within – we got good savings in procurement and efficiencies. However, if you look at our premium core brands in the U.S. – so Captain [Morgan], Smirnoff, Crown Royal – we increased investments six percent on those brands. If you look at our momentum brands, like Bulleit and Don Julio and Buchanan's, we increased investment sixteen percent.

So the real weight against our brands is going up. We're really driving out the inefficiency, we're reallocating effectively, and, in the U.S., we really put our money behind the brands that really need to move the needle. And there's a real shift in weight against, those brands.

Mitch Collett: If I can just come back to the FX side of things, if you do hedge eighteen to twenty four months forward, I guess I'm struggling to understand why the transactional benefit wouldn't be more material in 18 to 24 months' time. And so, why wouldn't you have a bigger impact than the – than the 110 you've guided to for F17?

And, I guess, if the underlying assumption, perhaps, Scotch pricing, behind the transactional benefit you expect?

Kathryn Mikells: Again, it's a year-on-year impact, right? FX is always a year-on-year impact. And so, we're going to get a pretty significant transactional benefit this year, right? And in F18, at current spot rates, we'll get another impact. But then ultimately, that impact is going to get weighted against what we've already achieved in fiscal '17.

And, finally, I'm not going to give specific items for fiscal '18. You can ask me about it again in a year – in a year's time. But that's – it's a year-over-year, and that's what I'm giving you colour against.

Mitch Collett: OK, thank you.

Kathryn Mikells: Yes.

Operator: Your next question comes from Tristan van Strien from Deutsche Bank.

Please ask your question.

Tristan van Strien: Hi, good morning, guys, thank you very much for the question. I just wanted to ask a little bit more about India. In particular, you – just three things on that – one, your margin increase was 700 bps. How much of that, if you take – if you strip out the UB share buyback, what is the margin, then? How should we think about the margin progression in India the next three years actually emphasizing growth in the business?

The second one is, on working capital, Kathy, you mentioned it in the webcast about there were local regulations really preventing some of the working capital improvement. I was hoping you could give a little bit more insight into that, and what the opportunity really is around working capital in India.

And then, the third bit, you benefited a bit from excise reductions in Uttar Pradesh. I was wondering if there are any other regulatory risks or opportunities that you're seeing in the horizon over the next 18 months in India, please. Thank you.

Kathryn Mikells: Yes. OK, and so, on the first question, the benefit from the UBL share sale was a gain...

Tristan van Strien: OK.

Kathryn Mikells: ... of 28 million pounds, so you can think about it ...

Tristan van Strien: OK.

Kathryn Mikells: ... in those terms.

On working capital in India two things. What I mentioned in the presentation was, India runs at a heavier working capital, the NSV rate, relative to the rest of the company, right? That doesn't at all take away from the fact that, there are areas where we can and are improving overall in our working capital efficiency in India as well.

Like the rest of Diageo, as the company grows, right? We get a natural headwind, in terms of building inventory, and building receivables supporting that growth that we then look to offset, right? We get a little bit of benefit on trade credit. But we then have to offset that by getting more efficient, by effectively reducing our working capital days on average. But the growth naturally causes a use for us.

Ivan Menezes: On your bit about Uttar Pradesh, I mean, the nature of India is, you've got ups and downs all the time across the states. And, yes, we do get some gains and benefits, and we are – our business in U.K. is strong, and coming back strong.

I would say there's, in the overall context, there's no real change up or down, when I look across all the states. But it's something we obviously stay very close to, and manage very tightly against.

OK, I think we have time for one last question?

Operator: And that question comes from Komal Dhillon from JP Morgan.

Please ask your question.

Komal Dhillon: Hi, morning, Ivan, morning Kathy. Just another to fully follow up on India, particularly on GST. So it seems to be gaining traction. But could you comment on how much pressure we put on USL margins if the bill does become law, and what mitigating steps USL can take?

And then, the second one, on Nigeria, I know it's a relatively small market for Diageo, and you have obviously an easy comp as you mentioned in F17. But just wanted to get an idea of the underlying demand impact, as long as the naira doesn't devalue further, in – given the discrepancy between the official and black market rate. Thank you.

Ivan Menezes: Hi, Komal. On India GST, it's as you – as you point out, yes, it's gaining steam, but it's still in Parliament, and going through the political process. So, really hard to predict as and when it'll happen. Also, the timing of implementation is also unclear because, I mean, this is a massive change, and getting all the systems and information in place also will take time.

What are we in the industry doing about it is, alcohol was being excluded from GST. We have a – very detailed work underway on the – I mean, the two issues we've had to look at is, how do we recover, trap taxes on input costs, and b) how do we get pricing flexibility in states which have price control. And both the industry forum and the – us as a company have got a lot of activity in both of those.

So let's see what happens. We're very closely on top of it, and we will manage through the margin impacts of it by working very hard with the regulators and the government to ensure that the industry doesn't suffer.

Komal Dhillon: OK.

Ivan Menezes: Nigeria, the underlying demand is about – trending at about five percent. You've clearly got stronger growth on the value brands than on the premium segments in beer. And spirits continues to do well at the high-end, and we're going into mainstream spirits in a bigger way next year.

Komal Dhillon: Thank you.

Ivan Menezes: Good. Thank you. So let me just close the call here. Thanks, everyone, for joining. Appreciate you calling in early in the morning or evening, wherever you are.

Just summarize, we're pleased. This was a good set of results. We delivered on the goals we set for ourselves. We do have momentum as we go into the new fiscal, and are positioned well to improve our performance again in fiscal '17, and on delivering our guidance.

Kathy and I look forward to meeting many of you on our road shows. And if you've got any more questions, do contact Catherine and the IR team. They're all on standby, and ready to help.

Thanks again. Bye-bye.

Operator: Ladies and gentlemen, that does conclude today's call. Thank you for participating. You may now disconnect.

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