Diageo F21 Interim Results Investor Q&A Call

Date: Thursday, 28th January 2021

Conference Time: 09:30 (UTC+00:00)

Ivan Menezes: Hello, everyone. Kathy and I welcome you to our interim results call. I hope you and families are staying well during this time.

I'm pleased and encouraged by our financial results for the first half of fiscal '21. We delivered a strong performance in a challenging operating environment. We returned to top line organic sales growth in the half, driven by strong sequential improvement across our regions compared to the second half of fiscal '20. This was ahead of our expectations at the start of the fiscal year.

In particular, we delivered strong growth in North America, our largest and most profitable market. Consumer demand in North America has been extremely resilient, and spirits continues to take share from beer and wine. We also benefited from the replenishment of stock levels by distributors and retailers.

Across regions, we have rapidly responded to increased demand of the off-trade channel, delivering broad-based category growth and market share gains. Our strategic actions in recent years have created an agile business, with a strong position in fast-growing markets such as the US and China, and in high growth categories, including US whiskey, Canadian whisky, tequila and gin.

Our deep understanding of consumer behavior using proprietary tools and data meant we were able to pivot quickly to at home occasions and convenience and invest effectively in marketing and innovation. We are strengthening brand equity, premiumising our portfolio and expanding our digital capabilities, including in e-commerce.

Our business continues to be impacted by the on-trade channel restrictions and the reduction in global travel. This impacts our beer and scotch performance in particular.

Due to the ongoing volatility, we're not providing specific guidance for the second half of fiscal '21. However, we will be lapping the second half of fiscal '20, which was significantly impacted by the onset of COVID-19.

So we expect to see improvement across all regions versus this weak comparative period. We also expect continued momentum in North America, augmented by lapping inventory reductions by distributors.

The pace of recovery in other regions will be more closely aligned with the gradual reopening of the on-trade and the degree to which restrictions continue to be in place. We expect travel retail to continue to be heavily impacted by the reduction in international travel.

Despite the challenges created by COVID-19, I am cautiously optimistic about the outlook for our business. Today, we announced a 2% increase in our interim dividend. This reflects our confidence that Diageo will continue to navigate strongly in this environment and that the fundamental growth drivers for our business remain intact.

I'm confident in our people, our strategy, the resilience of our business and our ability to deliver long-term shareholder value.

And with that, I'll open the line for questions for Kathy and myself.

Operator: We will now take our first question. It comes from Simon Hales of Citi.

Simon Hales: A couple of questions, please. Obviously, I think Kathy talked in the presentation about the strong data analytic tools that you've now got in place with Catalyst and Radar coming onto stream and the benefits they've had as you've pivoted to focus on those more off-premise occasions. I think, Kathy, you talked in the presentation about the further reinvestment in insight tools in North America. I wonder if you could just maybe frame the levels of investment that we perhaps need to continue to see in these tools over the next sort of few years. And also, more generally, how widespread now is the rollout of these insight tools all across the organization? And how widely are they been using? You obviously flagged North America a lot, but more generally.

And then secondly, I wonder if I could just ask a little bit about e-commerce. I think, Ivan, you said that e-commerce is clearly gathering momentum in spirits having historically been low versus other FMCG. How should we think about the potential medium-term implications of growth in that trade channel from a value and a margin standpoint at the group level? And I appreciate it varies very much by market depending on the type of e-commerce channel. But I think if you look at something like Drizly, I think you've historically said in the U.S., you tend to sell more premium brands through the Drizly platform. But does that come at an accretive margin? Or are you having to pay more away for those third-party sites to get your brand in the right place?

Ivan Menezes: Okay. Simon, thanks. Kathy, you take the first. I'll take the second.

Kathryn Mikells: Yes. Thanks so much, Ivan. So look, as we think about our reinvestment rate, I'd say we have always felt good about the ongoing building capabilities that we've continued to invest in to just ensure that the choices we're making are really going to drive good returns from that investments that we're making. And you would have seen in the first half, overall, our reinvestment rate was pretty similar to what we would have seen in the prior period. And we've clearly looked to significantly upweight our investment relative to what you would have seen in the second half of fiscal '20, and specifically, the fourth quarter of fiscal '20, where we really made the decision that certain investments in A&P were just not going to earn a return, and we therefore decreased our A&P spending in the fourth quarter pretty significantly.

As I look at that continued investments in tools, clearly, North America is always the first market, if not one of the first markets, we're looking to invest in just because it's our largest market and it tends to be the market that has the richest data set. But Radar as an example, which Ivan would have talked about a little bit when we announced preliminaries at the end of fiscal '20, that's something that we expanded very quickly, a bit over a 2-month period over the summer, and it's covering about 80% of the company's A&P. So clearly, we look to expand these tools and deploy them in our biggest markets with pace. And I think you can see that based on that number.

As I look forward to what we've done in this first half and our expectations for the second half, I'm expecting to see our reinvestment rate in the second half go up relative to a pre-COVID period as we've gained more confidence in the programs that we're investing behind. And I think you really see that in terms of the off-trade share gains that we've had, especially in the markets where we have the largest off-trade businesses, the US, GB, France, Australia. Germany would be another one we've seen really good gains behind our investment. And so as we look to the second half, I would tell you, we're going to continue to put more money behind the programs that are working, that tends to be over-indexing into category and brands within markets that already have momentum. And obviously, we're seeing that come through our results in this first half. And so we're going to continue to invest really smartly in the second half, looking to gain that quality market share.

Ivan Menezes: On e-commerce, I'd say pre-COVID, it was roughly about 2% of the business was in e-commerce. It's clearly accelerated. And in our business, it's still small, but it's growing very fast. So it's under 5%, but growing rapidly. And what we're seeing, just to give you an example of the speed, say in GB, in the UK, it took 10 years to step up 5 points of alcohol penetration in e-commerce. And with COVID, 8 points got added in 4 months of penetration, so a significant increase.

Our businesses, we pivoted very quickly and moved teams and dollars into e-commerce right around the world, from Colombia to Uganda. It's not just Germany, China, US, UK. And we are seeing acceleration, I mean, significant growth in this channel, as you'd expect, off a small base, but really accelerating. What I'm pleased about is we're gaining market share. And typically, our market share on e-commerce platforms tends to be higher than our market share in brick-and-mortar. Point 1.

Point 2, to your question. We actually sell a more premium mix in e-commerce than we do in brick-and-mortar as well. Now some of this is deliberate. So for example, we've done a lot on whisky and premium whisky and gifting and indulgence are two consumer motivations that have really gone up through COVID. And so our margins too are strong. I anticipate e-commerce continuing to grow very nicely. We certainly want to lead in this channel. And as I said, we are putting the investment behind it strongly. On platforms like Drizly in the US, we're doing very well. Our brands performed strongly in that channel. And spirits does particularly well on a platform like Drizly. But also in the United States, within states, you've got retailers whose e-commerce platforms have actually significantly picked up through COVID. So we're working closely with our distributors and retailers to make sure we can kind of support them effectively in that growth. So I remain confident that this is the long-term sustained trend.

In some markets, we've broken new ground. For example, home delivery in some states in India, which didn't exist before. And our teams and the industry are hoping to retain that round going forward or take-home cocktails in New York from the on-trade. So to me, this is going to be an attractive segment. And we are very focused on keeping it a premium and profitable one.

Operator: Our next question comes from Sanjeet Aujla of Crédit Suisse.

Sanjeet Aujla: Ivan and Kathy, a couple of questions, please, on the US. I was hoping you might be able to break down that 15% growth in US spirits a bit further. I think you talked about 3 points of distributor restocking. What sort of benefit did you get in with retailer restocking? I'm really trying to think about your underlying sellout trends there relative to the market in the first half period. That's the first question. And then just on the outlook for the US spirits market, we saw a bit of a slowdown, I think, in some of the Scanner data through November and December. How are you feeling about the category as we go into the first half of 2021?

Ivan Menezes: Sure. I'm happy to take that. If you look at our US business, we had underlying depletion growth in double-digits. And as we indicated, US spirits had about 3 points of distributor restocking impact in that 15% growth. Consumer offtake, if we take Nielsen-NABCA combined, we're growing in the mid-teens. Our market share performance in Nielsen and NABCA channels has sequentially improved. So the improvement in the run rate has steadily got better as we went through the half. And I would say in the first 3 weeks of January in Nielsen, we've had share gains.

We measure this every week. So consumer uptake is strong and has continued. Thanksgiving was a little weaker. Christmas and New Year came in a little stronger. Clearly, in the second half, we are lapping a much weaker period with the onset of COVID last year.

But I would just point to the long-term trends in the US and say that, spirits penetration through COVID has increased. The penetration of spirits has gone up 3 times that of beer and wine. The increase in penetration has been 3 times greater. So I do expect those habits to stick. And you do see the long-term trends of both premiumisation, and spirits growing ahead of beer and wine, continuing. Now clearly, you will have a reversion to norm as we come through this period. But the fundamentals of sustained quality growth and continued premiumisation, we feel very confident about.

On retailer inventory, I think what you've got to remember is, when we were in June, there was a huge degree of anxiety on what the world was going to look like and what forward demand was going to look like, for retailers, for distributors, for us. And so everyone was tight on working capital. And we certainly, right across the world, were very focused on ensuring we ended up with very healthy levels of inventory assuming a cautious outlook on forward demand and very healthy levels of receivables right through the business everywhere. Clearly, as the growth accelerated, retailers started accelerating their buying. So there is some impact there, but it's purely responding to the end consumer demand and the refilling of the pipeline as demand came in stronger than I'd say retailers expected at the end of June.

Operator: Our next question comes from Mitch Collett of Deutsche Bank.

Mitch Collet: I have two questions, if that's okay. Just to come back to stock levels. Can you just confirm where you think stock levels are at the end of the first half by region or just highlight any areas where you think it might be different to where it should be? I appreciate that's difficult because of understanding demand at the same time. And then secondly, I appreciate it's very difficult to give guidance for this year. But if we think longer-term and the mix shift towards premium that you've highlighted in the slides, combined with the strong growth in the US and the productivity savings that I hope are still applicable, is there any reason why you can't get back to the previous peak in terms of profitability, which I think was 32% at the EBIT line in F19 or even perhaps beyond it given all those positive drivers?

Kathryn Mikells: So I'm happy to take that question. Look, if we think about stock levels, I'd say we felt incredibly good about where we ended fiscal '20. I think the shift towards a sellout culture when Ivan first stepped in as CEO and then just the ongoing focus on being consumer-centric and really focusing on consumer trends and consumer offtake has enabled us to adjust our stock levels across the globe very quickly. The company acts in a much faster, sharper manner. So we felt very good about where we ended fiscal '20. And I'd say as we've ended this half, again, we feel pretty good about overall stock levels in terms of stock in trade.

The global travel duty free business, I'd say that has experienced a more dramatic shift in demand as international travel has just declined so significantly. And so it has taken longer, I'd say, to get stock levels in that particular part of the business down to where we want it.

If we looked at that impact, at a total Diageo level, the impact of needing to start to reseed stock levels after the end of fiscal, Ivan mentioned that was worth 3 points in our US Spirits business. That refilling of stock and trade was worth about 1.5 points at a total Diageo level.

If we think about margins and the margin evolution of your business, which is the second half of your question, I'd say as we look out to the second half, we will continue to upgrade our A&P investment. We would expect that our reinvestment rate, so A&P as a percent of NSV, is going to be above what a pre-COVID level would be. And we're going to continue to have the impact of both the duty-free global travel channel being greatly reduced as well as the on-trade channel not yet being back to, I'll call it, a pre-COVID level and just a continued level of uncertainty in terms of on-trade closures and restrictions. So certainly, that's going to continue to put a certain level of pressure on our margins. And, seasonally, we always see our margins in the second half decline relative to the first half because we see a seasonal peak in the first half.

As we think longer-term about the structure of the business, I would say we feel very good that the fundamentals of the business post COVID should revert to something similar to what we've seen in the past just in terms of growth being fueled by premiumisation, in emerging markets by growth in legal drinking age consumers as well as growth in per capita income, and then as Ivan mentioned earlier, just spirits gaining penetration relative to beer and wine. I mean if you look at the 2014 to 2019 period, spirits gained 5 percentage points of share in the total alc-bev industry. And clearly, that's especially accentuated in the US, which is our largest business.

So I would say long term, we feel very good about the industry recovery and we feel very good about our ability to manage the uncertainty that we have and to continue to drive productivity to bring our bottom line results. You saw that coming through our margins. Even in this half, if I look at our overhead line, our overheads contributed about 70 basis points to gross margin positively. That was partially offset by some one-offs running through other expenses. But overall, productivity continues to be alive and well at Diageo embedded in our DNA and so we would expect that to continue to be part of how we'll get margin leverage over the long term.

Operator: Our next question comes from Laurence Whyatt of Barclays.

Laurence Whyatt: Three from me, if that's okay. First one, just building on Sanjeet's question around the US. Obviously, we've seen quite significant changes in consumer behavior during the pandemic with a significant shift to the off-trade. As we emerge from the pandemic and the on-trade starts to reopen, do you believe that the underlying market, the underlying spirits market, has reached a new base, and therefore, we can grow from the levels that we saw during calendar 2020? Or do you think as people return to the on-trade and return to their place of work and the like, that there will be perhaps a set of difficult comps that we'll be facing during the 2021 year? My second question is on India. Obviously, we saw a lot of changes in regulation, and in particular, tax increases. What do you think will be the impact of those tax increases on the prices in India, and therefore will we see some price volume elasticity following those price increases, and do you think any of that would be able to be offset by the changes in e-commerce that you outlined? And then finally, you've made some acquisitions in the gin market. Obviously, gin has been anticipated as a category for growth in the US. We haven't seen so much evidence of that over the past few years. Is there anything in particular that has made you think that gin is a much more attractive category in recent months than it has been over the past few years?

Ivan Menezes: Sure. Shall I go first, Kathy?

Kathryn Mikells: Sure. That's fine with me.

Ivan Menezes: I'll do US Spirits and India, why don't you do gin? For US Spirits, yes, to your point, Laurence, as you get the recovery of the on-trade and as people socialize outside the home more, you will see that mix change. So I don't expect the growth rates we're seeing in the off-trade sustaining. I mean those will come down. To your point, will there be a correction and adjustment? We've worked out different scenarios, but the thing I'd point to is at Diageo, we will work through that, but the key thing we're focused on is improving the momentum and quality of our business. We're only 6% of TBA in North America. So there's plenty of opportunity to go after. But there will be some shifts that do happen as people spend less time at home and get back to work and to socializing outside the home. And there will be some lapping issues, but I'm not concerned about that. We're focused on really sustained quality growth out of North America and continued premiumisation coming through. So your point is valid. Yes, there will be some impacts. It's a little hard to predict because so much of it is based on the progression of the easing of the pandemic and how household behavior changes in home versus out of home. But the fundamental attractiveness of spirits penetration growing on TBA and premiumisation continuing, we feel very good about.

On India, yes, the taxes had some impact on pricing. I'm not that concerned about it. I'd say the bigger thing on India is just getting the recovery of the economy and consumer spending. And I would expect our business to come back. In our first half, our India business was better than we expected. It grew 1%. And interestingly, within our portfolio, actually, our scotch whisky brands like Johnnie Walker, which you know has high duty and high price, actually did the best. We had strong performance in brands like Johnnie Walker in India through the last 6 months. So the premiumisation trend in India is strong. And the tax pricing environment, I wouldn't say there's a dramatic change. We will work through it.

And then to your point on e-commerce and at-home delivery, we're working hard with governments and state governments to try and keep some of the gains we've had on things like home delivery, because, as you know, India has such a tiny universe of outputs for alcohol, bars and off-premise outlets, 70,000, 80,000, which is nothing. We were 3 times, 4 times, that number in Spain. So getting more access on e-commerce or through home delivery is a real positive. And that we are working as an industry with state governments to try and keep some of those gains or indeed take them even further to make access easier for consumers.

Kathryn Mikells: And then I'm happy to pick up the question about gin and then gin specifically in the US. We feel good about our overall results in gin in the half. The category for Diageo was up at 6%. Tanqueray was up. Gordon's was up. And the gin momentum, Ivan talked about before, it started 6 or 7 years ago in Southern Europe. It expanded. It's a phenomena in many different countries than just Europe, right? So when we look behind our numbers for this half, strong gin growth in Australia and South Africa and Brazil. It's still a small category in many other countries. But when we do our analysis, we would say gin is a category globally that we actually think has momentum, because in many different countries off of a small base, it's growing strongly. In the US, we've always talked about the fact that juniper is quite polarizing. So when you think of a more traditional London dry gin like Tanqueray, juniper as a flavor can be polarizing. That said, Tanqueray was actually up in the half in North America.

Now importantly, when you kind of pick apart the gin category, what you see in the US is that it's the super-premium plus price points within the category that are actually growing more strongly. And so when you think about the Aviation gin acquisition that we did earlier in the half, it was both targeted to that strong premiumisation phenomenon we're starting to see in gin, and importantly, also targeted to just being a liquid that isn't so juniper-centric. And so it's a much more versatile liquid, and therefore, used in many different types of cocktails, and I'd say more appealing to more US consumers. So we feel good that, at higher price points, gin is really starting to pick up some momentum in the US, and we're obviously investing behind that, both organically and inorganically.

Operator: Our next question comes from Olivier Nicolai from Goldman Sachs.

Olivier Nicolai: Congratulations on these results. Just three question from my side, two on the US and one on China. If we start on the US, Ciroc has been an issue for a number of years. Do you think the brand has now reached a flow and is going to return to growth going forward? And what has been the driver behind the growth we've seen in H1? Then second question, again, on the US. More generally, when you look at your business, do you think the government support to consumer has had an important impact on the demand that you're seeing on the ongoing premiumisation, or do you think it's quite marginal? And then just lastly, on China, quite amazing growth of 15% in H1, driven by baijiu and then also scotch. That's very strong. But was it negatively affected by the Chinese New Year timing? And should we expect a stronger H2 in China? And how you think or your teams on the ground are thinking about Chinese New Year this year?

Ivan Menezes: Okay. I'll take the first. Kathy, you want to take the second on the US and then I'll come back to China. So on Ciroc, yes, this was extraordinary growth in the half. I think we were up 17% in the US. And part of what's happened on Ciroc, as you know, we've been working at this hard for many years to get stability and the health of the brand back and in better shape. And you're seeing some of those actions on the brand coming through. We pivoted our marketing very strongly. We've eased out some of the volatility on flavours. We've had some good innovation. That's helped. I don't expect it to continue at double-digit growth. To me, the key on Ciroc would be to get it into steady growth on an ongoing basis. And I wouldn't declare victory yet, but we're certainly encouraged by the performance we've seen here. Our overall vodka business in the US was up 6%, and so that's clearly also benefited by the at home consumption surges that we've seen in demand. Ciroc is definitely the standout performer within our vodka portfolio. And I'm pleased that the brand is in healthier shape and should have a better trajectory than the declines we've seen in the prior years.

Kathryn Mikells: Now I'll take it the second question. Just in terms of how we think about the US and the fact that there's been a fair amount of fiscal stimulus that certainly has supported the consumer. I think the other thing going on there, Olivier, is that consumer habits just in terms of what they're able to spend on has really shifted. So people are not traveling as much. They're not able to go out to concerts and sports events and those types of things. And so they're spending more money on food and beverage. They're interested in treating themselves. If you look at our Bailey's results in the half, they were in North America up 12%. And they've been leaning more into big trusted brands, and that clearly has been something that we've also been putting money behind. And you've seen that come through in our innovations in the US, Apple Pie for Bailey's, Captain Morgan Spiced Apple, as an example. They've also really been looking for convenience. So I would just mention launching Tanqueray canned cocktails, similarly doing the same thing in terms of looking at Crown Royal. So the consumers' behavior has shifted as a result in part of certain things they're unable to do or not do to the same degree. And certainly, the fiscal stimulus has helped so that consumer pocketbooks haven't been squeezed to the same degree. But the fact that people want to treat themselves is also part of what even further accelerated the premiumisation trends, which are already incredibly strong pre-COVID, but have actually accelerated a bit through COVID. And clearly, these consumer shifts have been going on for not quite a year now. So as we try and think forward, we will see some reversion of some of these shifts, but they're not going to come immediately. So we certainly think some of these habits are likely going to stick for a while.

Ivan Menezes: And on China, Olivier. As you say, Greater China, we were up 15%; baijiu up 18%, 20%; international spirits, up 9%. We're feeling very good about China. You will have seen in my presentation, a few years ago, 5 years ago, China was 2% of Diageo's business. It's now 5%, and it's going to get bigger. And certainly, as we look at current trading, I'd say that we're feeling good about the sentiment into Chinese New Year. Now I will point out, we should not assume that there won't be disruptions. As we know, COVID does pop up here and there and the government takes very tough action right away to lock down. So that is something we clearly need to watch. But our focus, both on Shuijingfang and on our international spirits, largely high-end scotch, the brands are healthy, the momentum is strong, we're gaining, our performance in e-commerce is really strong. So I do expect continued good momentum in China, certainly, for the next several years, and it is one of the big growth opportunities for the company. And I'd say our platform today has never been healthier, both on baijiu and on international spirits.

Operator: Our next question comes from Edward Mundy of Jefferies.

Edward Mundy: Three from me. The first is on low and no alcohol. We've seen quite a good step-up in innovation in the last couple of years, Ketel One Botanicals, Gordon’s 0. Can you talk about the opportunity here and how broad can really go with both the offering and also across different categories? The second question is on, coming back to your Slide 6, which shows the strong shift in off-trade market share momentum, 70% of off-trade you're holding or gaining share. Can you talk about some of the key drivers here across, for instance, the portfolio, better growth in portfolio as well as execution? And then the third question is really, as the on-trade comes back, do you think you can hold and gain share in the on-trade in the similar way as you've done in the off-trade?

Kathryn Mikells: I am happy to take the first one, Ivan?

Ivan Menezes: Yes. Why don't you go, Kathy?

Kathryn Mikells: So as we look at the low and no opportunity, I'd say we know people continue to drink better, not more. And the low and no opportunity really plays into that long-term shift. We feel good about the innovations that we've continued to roll out. And obviously, Seedlip was really the first large, I'd say, non-alcoholic spirit type drink. And we continue to feel great about that brand that came out of the DV portfolio.

If you look at just some of the things we've done in the half, we launched Gordon 0.0%, right? And that just is a complementary product to previously having Gordon's ultralow canned cocktails out in the marketplace as well. Seedlip also launching canned cocktails, so that's another innovation that we're behind. And we don't talk about a lot of the investments that we do in distill ventures. But I'd say your question in terms of, can it cut across different categories? We certainly think that's a future opportunity, and we've made a number of incremental investments through Distill looking to build brands in that area. So we do think this is a really positive long-term trend. And another area that it's still a nascent part of the business today, but one that should provide us with very good growth over the long term.

Ivan Menezes: On your other two, Ed. On the off-trade, we have from a commercial and sales capability and what we do with our tools like edge and data, we have been building over the last few years, I'd say, a real differentiated strength in our commercial capability to serve the off-trade. And as the pandemic hit, we pivoted first to the consumer in really ensuring our marketing and innovation and at home engagement and the occasions we went after, we shifted clearly significantly and quickly our marketing investment against the at-home occasion. And that's where you see kind of very strong growth on brands like Baileys and Bullet and right across our portfolio, Crown Royal, etc.

The second thing I would say is the customer relationships and what we have done in terms of serving and working with our retail partners in the off-trade, again, the teams have again moved very rapidly in the early days of the pandemic. Supply was the big issue and so really ensuring our supply chain coped well, and we were able to get product in time. We worked very closely with our retail partners on getting the right level of programming and support. We pivoted to e-commerce, as I talked about earlier, in a big way, and that has been a big source of growth. So I'm really pleased with the market share performance in the off-trade that's happening right around the world. And we put a huge focus on all our markets around the world. We can't control the external environment. There's still a lot of volatility there. What is in our control is winning, and winning in the off-trade was a key focus.

On the on-trade, stayed very close to our on-trade customers. We've made significant investments in supporting the on-trade through this very tough period. Our focus and our objective is, as the on-trade recovers, we absolutely want to be growing share there. And we do think with our portfolio and the brands, and even a brand like Guinness, when things opened up over the summer in Europe, we saw market share gains for Guinness as the consumers started coming back to the pub. So we are certainly not pivoting our business just to win in the off-trade. We absolutely want to be ready to win in the on-trade when it comes back and we do believe it will come back because the consumer orientation to wanting to socialize out of the home is very strong.

Operator: Our next question comes from Pinar Ergun of Morgan Stanley.

Pinar Ergun: You've talked about strong premiumisation trends across your markets. Are you seeing down-trading anywhere? And two quick follow-ups on my side as well. We've seen a nice acceleration in some of your brands this half year, but Crown Royal appears to have slowed. Can you help us bridge the gap between slower reported figures to still very strong sellout trends implied by the Scanner data? And finally, I know you've commented on this before, but I've been getting questions from investors lately. What are your latest thoughts on the potential impact of Brexit on your business?

Ivan Menezes: Sure, I'm happy to take those. The down trading, we are in emerging markets, and we see it in Latin America. As the economic crunch and the pandemic has hit, you are seeing the growth of primary scotch whiskies. So Black and White and White House is growing at accelerated rates. And you're seeing the down-trading from deluxe scotch. Now we very deliberately 5 years ago built a strategy of creating that flow with primary scotch whisky, and I'm really glad we have it because we've got this very fast growth on those brands. So we do see pockets of down-trading. But I'd say we remain confident that as conditions stabilise and economic growth returns, that the trading up will happen again. I mean we've seen this in Latin America over many cycles. But most parts of the world, the premiumisation trend is really strong through this period.

On Crown Royal, the demand is high, and we're struggling to keep up with it. So that's part of what you're seeing there. The consumer demand is really healthy and we just had a hard time keeping up and creating big purple mountains in Texas over the holidays. I think some of those mountains were smaller hills because we had to allocate our product a little more carefully. So that's a bit what's behind that.

And Brexit, as we've always said, we take Brexit in our stride. Our operations post January, we've been able to handle very effectively. The long-term prize really is the UK's ability to pursue an independent trade policy. And if we can get breakthroughs there, say like with the market like India, where the UK and the Indian government are talking about trade arrangements going forward, that would obviously be a big bonanza if the customs duty came down on scotch. So Brexit does not have a major impact. It doesn't have an impact. And all the other countries where we benefited from EU FTAs for scotch whisky, the UK government has done a very good job of being able to retain those same conditions with countries so we are not disadvantaged in any significant market for us.

Operator: Our next question comes from Nik Oliver of UBS.

Nik Oliver: Apologies if any of these were asked before, my line broke a couple of times. But one, on North America, just looking at the RTD performance, very strong again. And I think, Ivan, in the past, you were maybe a little bit skeptical on the life cycle of things like seltzers. But is there any sort of change in thought going forward just given, that category appears to be sourcing more from beer than spirits? And then the second one is on Europe margins. I guess a lot of uncertainty. But is there any help you can give us in terms of the kind of operational deleverage we should think about it for Europe, given obviously, things like Guinness Keg, are very high-margin in Europe? How we should think about that piece going into the June year-end?

Ivan Menezes: I'll take the first, Kathy you take the second. So the way we think about the consumer opportunity is around convenience, single-serve convenience, which, by the way, has accelerated through the last year, and products that are perceived to be better for you and good for you. And that's been a big factor that's been behind seltzer. We fully plan to participate in a broad way across the convenience opportunity in the United States. And, I think Kathy referred to it, for example, we've launched the Kettle One Spritzers in single-serve cans. We've gone into Texas and Louisiana with Crown Royal single-serve products, which have, it's just a few weeks in, and have had terrific success in the early days. So Debra and the team in North America have a strong focus on building an attractive, significant, convenience single-serve business.

We do think there's an opportunity for trade up from malt based into spirits based single serves. And that's part of what's driving our innovation agenda on spirit-based single serves, but we're clearly going to participate as well in the malt-based trend. And we do see this trend, this segment, continuing to grow ahead of the market. And we'll participate in a bigger way in the next few years.

Kathryn Mikells: And then overall, Nik, I'll start at a higher level, and then I'll talk specifically about Europe, which was your question. As we look at margins from a total company level and we think about the second half, we're clearly going to continue to be impacted by the global travel duty-free business continuing to be down year-over-year. Global travel will have started, international travel will have started, to have fallen off more significantly come like in mid-March in the prior year comparable. We're going to continue to see year-over-year declines there. And then obviously, we're going to be dependent on the on-trade reopening to see margins come back closer to a level that we've seen previously in the business.

Europe is hit particularly hard by both of these things. So Europe has a relatively large global travel duty-free part of the business. And obviously, beer is very big in Europe and Guinness is literally our largest brand in Europe. And the fact that the strategic keg business, our big brands like Guinness, that keg business declining, has really pressured the margins in Europe. And while at a total Diageo level, our volumes recovered in the half, you can see our volumes were only down 0.2%, in the beer business, and specifically the beer business in Europe, volumes are obviously down significantly. And so we get that negative pressure just in terms of the fixed cost base in Europe that sits in the beer business and seeing those big declines.

So overall, I expect to see margins seasonally soften in the second half relative to the first half, as they always do. And relative to a pre-COVID level, I expect to see our A&P investment rate go up. So those things will impact margins in the second half as you think about our recovery, but Europe is going to depend a lot on just what we see in terms of the reopening of the on-trade. And we're obviously starting from a tough place if you just look at the UK and GB and the situation that exists today.

Operator: Our next question comes from Alicia Forry from Investec.

Alicia Forry: Most of my questions have been answered, so I have just one actually. I wanted to know a little bit more from you, how you see or how would you characterise the health of the value chain that you operate in? So upstream and downstream with regards to your suppliers and your on-trade and off-trade customers. Obviously, differing trends there. But just overall, looking at your value chain, how healthy is it? And if you could discuss any ongoing cash flow implications from your assessment of that situation.

Kathryn Mikells: All right. So I'm happy to take, Ivan, maybe the first part of that question on suppliers. As we look upstream on suppliers, I would say we feel very good just about the resiliency of supply for Diageo. And certainly, one of the things that we did during this period where there's been more volatility, and you can see this in our financials, is we have been willing to sit on a bit more inventory ourselves just to ensure that we don't have any supply disruptions. But as we think about the supply base which feeds into our value chain, I would say we feel very good about that. Overall, coming off of a relatively low base at the end of the fourth quarter of fiscal '20, our production and business has recovered strongly, which also helps to support that supplier base. But we've done a lot of work to just make sure that we have the resiliency and supply that we need. And we used this disruption in order to reduce the number of SKUs we have and take certain actions to just really ensure that in our biggest, most important brands and SKUs, we have adequate supply to be able to serve the market.

And then maybe I'll give it to you, Ivan, to just talk about how we think about the on-trade and off-trade customers.

Ivan Menezes: So on the customer front, well, clearly, our off-trade customer base is healthy and doing well and pretty much around the world wherever they're open. The on-trade has clearly taken a significant hit. Firstly, if I go one step earlier, our distributors around the world, by and large, are very well capitalised businesses. And so the health of our distributor network, not just the United States but everywhere in the world, is strong and they are resilient and well capitalised.

I think the biggest challenge in the on-trade is there is going to be a level of shakeout. And you are going to see outlets that will not be able to survive and small businesses that will not be able to survive.

I just want to say what we've done on Guinness. We moved very quickly to support the on-trade when the pandemic hit, we took back Guinness ahead of any other competitor. So we've gone into this with a view, we want to be very supportive to the on-trade through this difficult period. We announced a $100 million fund, which is supported at the recovery of the on-trade. That money doesn't go to promote brands. It is to help create COVID-safe environments in the on-trade, and we are rolling that out across multiple countries in the world. Our goal is to be really the best partners to the on-trade through this difficult time. And we're training over 150,000 bartenders around the world remotely. Our brands are getting back, in the US for example, Bulleit and Crown Royal, Guinness in Ireland, had very specific programs to support the on-trade. So certainly as far as our business is concerned, as Kathy talked about, we've taken a significant hit in the on-trade, but we remain confident about the recovery of the consumer demand in the on-trade coming back and we're supporting our partners through this difficult period to ensure that they can come back in a healthy shape as well.

Operator: Our next question comes from Chris Pitcher of Redburn.

Chris Pitcher: Two questions from me, please. Firstly, on the sort of structural changes you're seeing in route to market. You've talked about the investments you've made in e-commerce and direct-to-consumer. But could you give us a bit more color on how you see the global travel retail channel having changed? Specifically, are you rebalancing your exposure to where you see the recovery coming, such as more domestic than international travel? And can you give us a sense for how much you're investing in Hainan in China? And then, secondly, it's very rare we get the chance to talk about cricket on the results call, so I couldn't resist the question. If I look at the IPL, it used to be about 2% to 3% of USL's revenue. So if that shifted from H2 to your H1 '21, that seems to account for the whole difference between USL's growth and your reported India growth. I just wanted to check that. And then secondly, on that, how contingent on success is that? So if Royal Challengers make it to the final next year, should we expect a double bounce in the half?

Ivan Menezes: I'll give you the last answer quickly. The Royal Challengers franchise is an extraordinary franchise, and it's got great consumer engagement across India. Of course, we'd love to win. But even when we don't win, we do pretty well, both with the media rights and the extraordinary levels of consumer engagement that, that franchise has.

On route to market, global travel, as we pointed out, is very challenged. So the recovery is very slow. We do see it taking several years to get back to 2019 levels. It's clearly dependent on passenger traffic and demand. So our assessment is based on how the airlines and the aerospace companies look at the airline recovery. We are pivoting to pick up domestic consumption that would normally have gone through global travel. So for example, in India, one of the reasons Johnnie Walker has good success is the team in India pivoted very quickly with programs to pick up the whisky that Indians would buy as they travel the world and that in part has helped our scotch whisky business in India.

On Hainan, we see China actually tilting strategically to driving more domestic consumption and taking those dollars that went to overseas more at home. We're relatively small in Hainan, but we do see domestic travel and duty-free zones like in Hainan, shopping retail environment, building. And so that is going to be a big area of focus for us. It's very small today. But as I look at the next 5 years, it should be an attractive channel for growth.

Kathy, you want to handle India?

Kathryn Mikells: Sure. So I would say, yes, you're correct. When we look at how results are reported, the IPL is one of the differences between USL's results and what we report at the Diageo level.

Chris Pitcher: And just on Hainan, how easy is it to build presence in Hainan as an international supplier, just to give us a sense? Are you small through a deliberate decision? Or is it just taking longer?

Ivan Menezes: Traditionally the sector has been small, but it will build. So it's not a force. Whisky in particular, international spirits, has been relatively small, but we do see it as an opportunity. We see good growth there and those types of travel retail zones that get created in China. And spirits only got included, I think, in the middle of this year. So it wasn't included in Hainan earlier. So it's just opened up, the spirits.

Okay. I think we're out of time. I just want to say thank you to all of you for your interest in the company and joining us on the call and Kathy and I look forward to meeting many of you over the next few days. Thank you and stay safe. And I hope to see many of you or talk to you again soon. Bye-bye.

Operator: This concludes today's conference. Thank you for your participation. You may now disconnect.