BSVI - DIAGEO EQUITY RESEARCH

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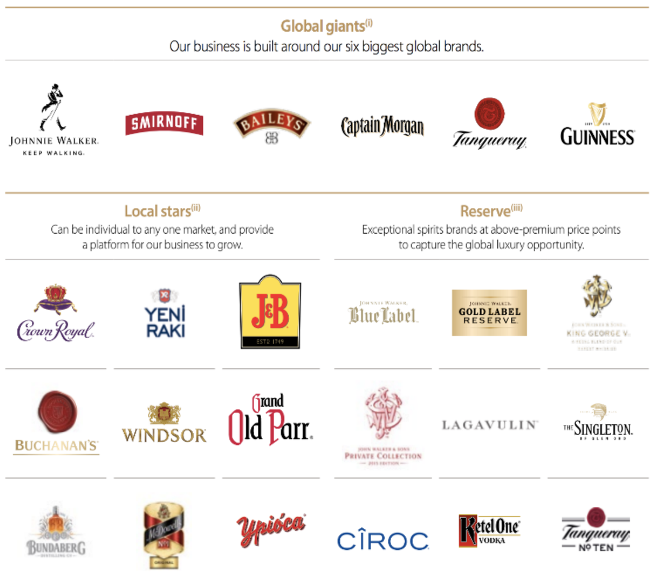
COMPANY OVERVIEW

Diageo, a global leader in the alcoholic beverages industry, stands as a prominent player with a rich history and an extensive portfolio of iconic brands. Established in 1997 through the merger of Grand Metropolitan and Guinness, Diageo has since evolved into a powerhouse, headquartered in London, with operations spanning the globe. Renowned for its diverse and premium brand portfolio, Diageo boasts a collection of well-known labels in various spirits, beer, and wine categories. Some of its flagship brands include Johnnie Walker, Guinness, Smirnoff, Tanqueray, Captain Morgan, and Baileys. The company's commitment to quality, innovation, and craftsmanship has solidified its position as a key player in the global alcoholic beverages market. Geographically, Diageo has a robust presence across both mature and emerging markets. Its strategic approach involves tailoring products to local preferences and leveraging its extensive distribution networks to reach consumers worldwide. The company's operations encompass the entire value chain, from sourcing raw materials to production, marketing, and distribution. In terms of strategy, Diageo places a strong emphasis on premiumization, recognizing the growing consumer demand for high-quality, distinctive beverages. Innovation is a driving force, as seen in the development of new flavors, products, and packaging to stay ahead of evolving market trends. The company has a history of strategic acquisitions, strengthening its brand portfolio and expanding its global footprint. Sustainability is a key pillar of Diageo's corporate agenda. The company actively engages in sustainable sourcing of raw materials, environmentally conscious production processes, and initiatives to reduce its environmental impact. This commitment aligns with consumer expectations for responsible and eco-friendly business practices.

Diageo's financial performance reflects its market leadership, with a focus on revenue growth, profitability, and shareholder value. The company's ability to navigate regulatory complexities, adapt to changing consumer preferences, and innovate in response to industry dynamics underscores its resilience and agility. Diageo stands as a global force in the alcoholic beverages industry, driven by a rich heritage, a commitment to quality, and a diverse portfolio of iconic brands. Its strategic focus on premiumization, innovation, and sustainability positions the company for continued success in the dynamic and competitive landscape of the alcoholic beverages market.



SECTOR & STRATEGY ANALYSIS

The Alcoholic Drinks market includes all alcoholic beverages that are produced by fermentation or distillation and we can find five categories: Beer, Wine, Spirits, Ciders and Hard Seltzer.

The revenues in the Alcoholic drinks market amounts to $1,609 B in 2023, and it is expected to grow annually by 5.42% (CAGR 2023-2027).

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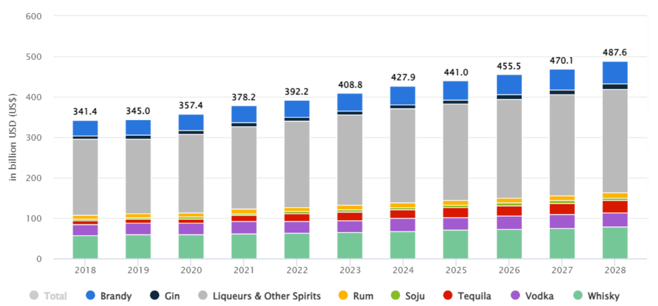
Just 2.7% of total revenues in 2023 is generated through online sale. To understand better the volume of alcohol consumption in 2023 the average volume per person is estimated to be around 36.73L. In 2023 the revenues among the five categories expected to be split as follows:

- Beer $610B
- Ciders $118.80 B
- Hard seltzer $21.65 B
- Spirits $525.30 B
- Wine $333 B

CONSUMER MARKET: Geographically, the Asia Pacific holds the majority of the market size. Rising consumer awareness of the impact of alcohol on health and weight is driving the demand for spirits products with “low sugar” or “low calorie” claims. As a result, they are actively moderating their intake of alcohol to maintain their health, which is driving the demand for “low alcohol by volume (ABV)”, “low-calorie”, or “low-sugar” spirits. This is creating more opportunities for spirits drinks with health claims. Furthermore, rising disposable income coupled with decreasing unemployment rates are driving the demand for spirits globally.

PREMIUMIZATION AND INNOVATION: Many companies adopt a premiumization strategy, emphasizing high-quality and premium products to capture higher margins.
Continuous innovation in flavors, packaging, and product formulations to cater to changing consumer tastes are also common strategies adopted by the players in the market.



FIVE FORCES ANALYSIS

Rivalry in the market: the rivalry among established brands is high. Even if the demand is increasing, these brands are trying to capture the increasing market shares. As Diageo competitors we can mention Constellation, TAP, Remy and Campari. In the competitive landscape of the alcoholic beverages market, the dynamics of internal rivalry are shaped by critical factors such as cost structure, the significance of brand equity, and exit barriers. Cost structure, with its distinction between fixed and variable costs, plays a pivotal role in determining the competitive standing of companies. Larger producers benefit from economies of scale, leveraging lower unit costs associated with fixed expenses like manufacturing and distribution. In contrast, smaller and craft producers, while potentially facing higher variable costs per unit, possess the advantage of nimbleness and adaptability to emerging market trends. The importance of brand equity stands out as a key determinant of internal rivalry. Well-established brands wield a substantial influence, fostering customer loyalty and trust. Exit barriers further intensify internal rivalry within the market. Companies encountering challenges or shifts in market conditions may find it difficult to exit the industry due to significant investments in infrastructure, technology, and brand development. The reluctance to exit, driven by these substantial barriers, can contribute to heightened competition as companies strive to overcome challenges and maintain market share. The intricate interplay of these factors—cost structure, brand equity, and exit barriers—defines the landscape of internal rivalry in the alcoholic beverages market. Companies must strategically navigate these elements to establish and fortify their positions in an ever evolving and competitive industry.

Threat of substitutes: moderate. In this industry there are no price or quality limitations over the use of products and more costly beverages will negatively affect the sales. The market is highly differentiated, and the switching costs for customers are extremely low, however the customers become loyal and do not switch easily. Non-alcoholic alternatives, including a growing array of premium soft drinks, mocktails, and alcohol-free beers, contribute to the threat of substitutes. The increasing emphasis on health and wellness, coupled with a rising trend of mindful drinking, has elevated the appeal of these substitutes among consumers seeking alternatives to traditional alcoholic beverages. Furthermore, the emergence of innovative beverages, such as botanical-infused waters

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and functional drinks, adds complexity to the substitute landscape. These alternatives often position themselves as healthier choices, catering to consumers who prioritize well-being without compromising on taste or experience. Regulatory changes and evolving societal norms that promote responsible drinking also contribute to the rising prominence of substitutes. As consumers become more conscious of the potential health impacts of alcohol consumption, they may increasingly turn to substitute products that align with their lifestyle choices.

Threat of new entrants: low. The presence of very established brands, characterized by economies of scale, and the requirement of high investments in fixed costs for equipment, and plant constructions make it difficult for a new player to enter the market. Additionally, building brand recognition and competing with established players requires considerable time and resources. Distribution channels and shelf space in retail outlets are often dominated by major brands, making it challenging for new entrants to secure visibility and market access.

Bargaining power of Buyers: moderate. The brands offer comparable alternatives, and the customers seem to be quite sensitive to prices, and not bound to any switching costs. Although customers appear loyal, the bargaining power of buyers is moderate.

Bargaining power of Suppliers: low. The industry presents a high number of suppliers, and the competitive landscape is concentrated. Suppliers provide a wide range of products from raw materials to produce the beverage itself to the packaging. Usually, beverage companies also built a specific portion of their own supply firms. Thus, the supplier power is low.

BUSINESS MODEL ANALYSIS

Business Definition: Renowned for its commitment to quality and innovation, Diageo strategically positions itself in the global market, catering to a wide range of consumer preferences. The company's business model encompasses brand development, manufacturing excellence, and extensive distribution networks, fostering a strong presence in various regions. With a focus on responsible drinking and corporate social responsibility, Diageo aims to deliver sustained growth and shareholder value while maintaining a leadership position in the dynamic and competitive beverage industry.

Consumer Segment: The company targets a wide range of consumers who appreciate premium and well-established brands in spirits, beer, and wine. Diageo's portfolio encompasses products that appeal to both discerning connoisseurs seeking luxury and quality, as well as those looking for more accessible and popular choices. By offering a variety of beverage options and maintaining a strong marketing presence, Diageo engages with consumers across different demographics, ensuring a broad market reach in the competitive landscape of the alcoholic beverages market.

Profit Logic: Diageo's profit logic revolves around its strategic positioning in the global alcoholic beverages market. The company focuses on developing and maintaining a diverse portfolio of premium brands, including spirits, beer, and wine, to cater to various consumer preferences and market segments. By investing in brand development, quality manufacturing processes, and effective marketing strategies, Diageo aims to create and sustain a strong brand image. Through its commitment to innovation and product excellence, Diageo seeks to capture market share and command premium pricing for its offerings. The company's extensive distribution networks enable it to reach consumers on a global scale, maximizing sales opportunities. Additionally, the company's focus on operational efficiency and cost management plays a crucial role in enhancing profitability. By optimizing its supply chain and production processes, Diageo strives to achieve economies of scale and maintain a competitive cost structure.

Value Proposition: Diageo's value proposition lies in its commitment to delivering an exceptional and diverse range of premium alcoholic beverages that cater to the varying tastes and preferences of consumers worldwide. The company distinguishes itself by consistently producing high-quality spirits, beer, and wine, underpinned by a legacy of craftsmanship and innovation.

Through its well-established and globally recognized brands, Diageo provides consumers with a unique and enriching experience, emphasizing the artistry and heritage behind each product. The company's portfolio spans from iconic, luxury labels to more accessible and popular choices, ensuring a broad appeal across different market segments.

Diageo places a strong emphasis on responsible drinking, promoting a culture of moderation and awareness. This commitment aligns with evolving societal expectations and regulatory standards, reinforcing the brand's integrity and social responsibility. Furthermore, the company's global distribution network ensures that consumers have widespread access to its diverse offerings, solidifying its position as a leader in the competitive alcoholic beverages industry. By continually investing in brand development, innovation, and sustainability practices, Diageo strives to exceed consumer expectations and maintain its reputation as a trusted and influential player in the market.

PEST ANALYSIS

POLITICAL FACTORS:

Regulation and Legislation: Diageo operates in a highly regulated industry, and changes in alcohol-related regulations, taxes, or trade policies can significantly impact its operations.

Global Political Stability: Political stability in the regions where Diageo operates is crucial for uninterrupted production, distribution, and sales.

ECONOMIC FACTORS:

Consumer Spending: Economic downturns or fluctuations in consumer spending can influence the demand for premium alcoholic beverages, impacting Diageo's sales.

Currency Exchange Rates: As a global company, fluctuations in currency exchange rates can affect Diageo's costs and profitability.

SOCIAL FACTORS:

Changing Consumer Preferences: Shifting consumer trends and preferences for healthier lifestyles or alternative beverages may impact the demand for traditional alcoholic products.

Cultural Attitudes Toward Alcohol: Cultural shifts and changing attitudes towards alcohol consumption can affect Diageo's marketing strategies and product positioning.

TECHNOLOGICAL FACTORS:

Production Technology: Advancements in production technology can impact efficiency, quality, and cost-effectiveness in manufacturing alcoholic beverages.

Digital Marketing: The use of digital platforms for marketing and e-commerce is increasingly important in reaching and engaging consumers.

ENVIRONMENTAL FACTORS:

Sustainability: Growing concerns about environmental sustainability may influence consumer choices. Diageo's commitment to sustainable and responsible business practices is essential.

Climate Change: Changes in climate patterns can impact the availability and quality of raw materials used in beverage production.

Capcom Co Ltd has benefitted from lower taxation policies throughout the western hemisphere. It has resulted in high profits and increasing spending in the research and development.

The increasing inequality in Japan can lead to changes in the taxation policies. Secondly local governments are also looking into Software & Programming specific taxation policies to contain the carbon footprint of the Technology sector.

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FINANCIAL STATEMENTS ANALYSIS

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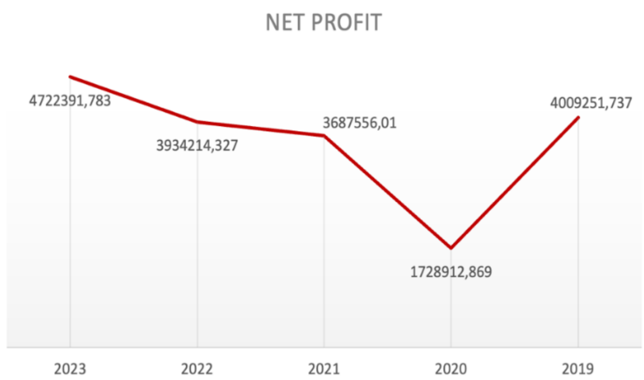
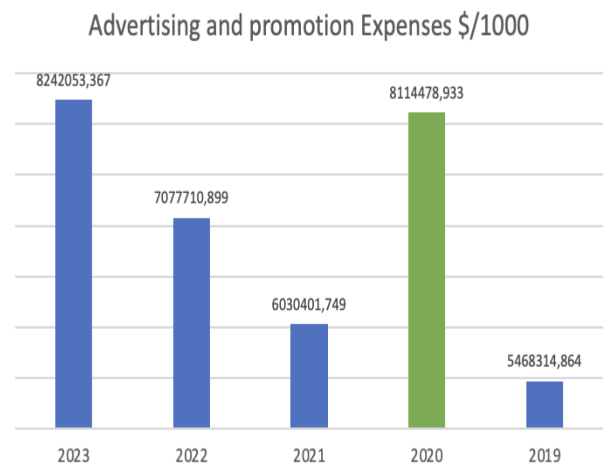
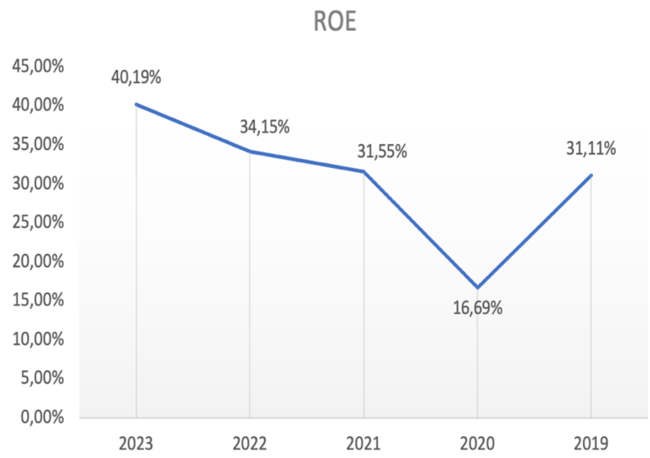
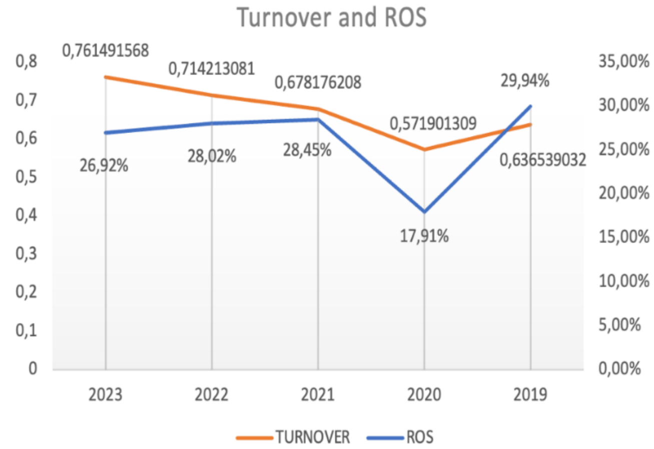
Financial Performance during the Pandemic: The year 2020 brought substantial challenges for Diageo, with a notable 11.67% decline in revenues, leading to a significant 47.16% reduction in Earnings Before Interest and Taxes (EBIT), and a noteworthy 56.88% decrease in net profit compared to the previous year. Despite these setbacks, the company's sustained investments in marketing and promotions laid a robust foundation for future growth, setting the stage for a strong recovery post-pandemic.





Post-Pandemic Resurgence: Diageo's swift recovery post the pandemic was highlighted by a remarkable resurgence, surpassing pre-pandemic performance and exhibiting robust growth across crucial financial metrics. Notably, the Return on Equity (ROE) displayed a steady upward trajectory, rising from 31.11% in 2019 to an impressive 40.19% in 2023. This upward trend was supported by a consistent increase in turnover, while the Return on Sales (ROS) has witnessed a minor decline from 28.02% in 2019 to 26.92% in 2023.





RATIO ANALYSIS

Impact of Financial Leverage: The notable surge in ROE, approximately ten percent over the last two years, can be attributed to the company's heightened utilization of financial leverage. Diageo's gearing ratio rose from 1.23 in 2021 to 1.42 in 2023, leveraging the significant difference between the company's cost of debt and its operating profitability (RONA=20.5% in 2023). This strategic use of leverage has significantly contributed to Diageo's enhanced financial performance and profitability.

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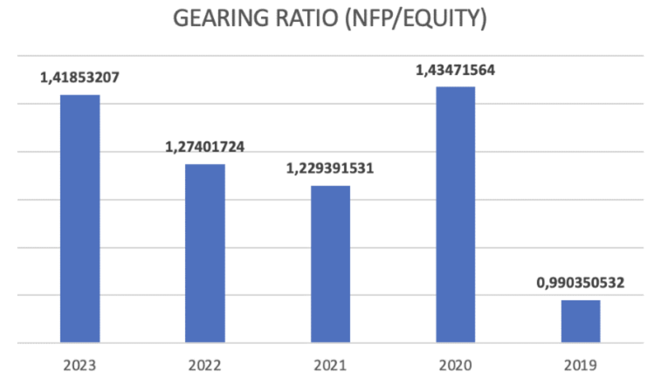
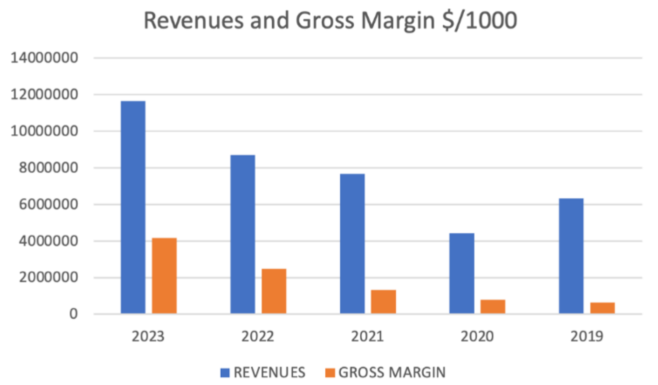


Successful Growth Strategy: Diageo's successful growth strategy is evidenced by its remarkable revenue growth of 22.52% in 2021, 5.88% in 2022, and 15.67% in 2023, along with a consistent expansion in the gross margin by 4.75% in 2021, 10.38% in 2022, and 13.57% in 2023. This trend highlights the company's ability to accelerate revenue growth at a pace surpassing its costs, reflecting its strategic emphasis on sustainable growth and efficient cost management.



CONCLUSION

In summary, Diageo's robust financial performance, underscored by its strategic resilience, prudent financial management, and effective market penetration, positions the company favorably for continued success and sustained growth in the dynamic global beverage industry. With a strong foundation built on resilience and innovation, Diageo is well-equipped to capitalize on emerging market opportunities and solidify its position as a frontrunner in the international spirits and beverage domain.

Through the optimal utilization of its Martech stack, DIAGEO's strategic approach enables the execution of captivating campaigns, fostering customer engagement and prospect excitement. The company's commitment to continuous innovation and its emphasis on sustained, long-term growth underscore its determination to exceed market benchmarks, leading to a strengthened positioning within the total beverage alcohol (TBA) market.

In pursuit of the goal to achieve a 6% TBA market share by 2030, DIAGEO's diversified global brand portfolio, coupled with an ongoing focus on portfolio diversification, is poised to facilitate this growth trajectory. As part of its discerning investment strategy, DIAGEO is strategically allocating capital towards key areas expected to yield optimal returns, including targeted capital expenditure in critical product categories, the development of digital capabilities, and the implementation of an ambitious supply chain agility program. Notably, the company's commitment to expanding production capacity is anticipated to yield favorable effects on the income statement, manifesting in potentially higher revenues and improved profitability over the long term. Furthermore, DIAGEO's investments in establishing new whiskey distilleries and expanding its tequila manufacturing footprint are expected to reflect on the balance sheet, potentially leading to an increase in the company's asset base. This expansion initiative will likely be accompanied by a corresponding increase in liabilities as the company mobilizes resources to facilitate these expansion efforts. The overall effect on the balance sheet would depend on the precise magnitude and structure of these investments, with potential implications for the company's financial leverage and liquidity position.

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COMPANY VALUATION

(under the finance division)

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THE GROWTH RATE

In order to decide what growth rate to use in the DCF model, both historical and fundamental growth were analyzed.

YEAR	REVENUES (in million £)	HISTORICAL GROWTH RATE
2019	£ 16,325	2.1%
2020	£ 14,420	-11.7%
2021	£ 17,671	22.5%
2022	£ 18,711	5.9%
2023	£ 21,642	15.7%

Japanese GDP growth	1.6%
US GDP growth	5.7%
Japanese Risk-Free Rate	0.3%
US Risk free	3.8%
Japanese Inflation	3%
US Inflation	7.7%
Nikkei225 Mkt return	6%
S&P Mkt return	11%

Historical Growth: The company grew with middle double digits in 2021 and 2023. Years 2019, 2020 and 2022 reveled lower growth for the company or even a decrease in revenues (for the FY2020)

Fundamental Growth: We considered the industry CAGR expected growth between 2021 and 2026 of 7.3% and the macro situation both in the US and Japan.

Conclusion: We therefore decided to consider a growth rate of 10% for the first five years and 4% after that.

WACC

Beta: Given the source of revenues for capcom, to compute the WACC an average of the US and Japan Cost of Equity were computed and therefore the Beta between capcom and the **S&P 500** and the **Nikkey225** were both used, which respectively were **0.97** and **0.29.**

Cost of equity: Using the Beta computed above and the risk-free rates illustrated in the first section of this page, the US cost of Equity for Capcom was computed to be 10.8, while the Japanese one 1.9%. Considering the average of the two the **Cost of Equity** used for the DCF was **6.35%**

WACC: Weighting cost of debt and equity, we obtained the weighted average cost of capital of 6.31%. It must in fact be considered that the company finances itself almost absolutely through equity and therefore the WACC depends mainly on the cost of equity.

DISCOUNTED CASH FLOW MODEL

After deciding the growth rate to apply, and the discount rate to use we managed to run a Discounted cash flow model to compute Capcom's intrinsic value. Also thanks to the free cash flow projection illustrated below we can see that the **enterprise value** derived from the DCF is of **¥ 625,991.10**. After subtracting the net financial position and dividing by the number of shares we obtained the **share price of ¥2740.**

Year	2023	2024	2025	2026	2027	2028	Terminal Value
FCFF	£ 3,753	£ 2,774	£ 3,016	£ 3,197	£ 3,368	£ 3,108	£ 127,420
Disc. Rate	1.00	1.05	1.11	1.17	1.23	1.30	1.30
Discounted FCFF	£ 3,753	£ 2,634	£ 2,719	£ 2,738	£ 2,739	£ 2,854	£ 98,391
ENTERPRISE VALUE							

MULTIPLE ANALYSIS

CAPCOM'S MULTIPLES	
Price to Book Value Ratio	9.14
P/E	19.42
EV/EBITDA	14.40
EV/Sales	5.09

Here below are the comments we would like to present for each of the four multiples listed in the table above:

- **Price to Book Value** is an average one when we compare with the competitors. This shows that Diageo stock might not be overwhelmingly overvalued.
- **Price to Earnings**, however, gives us stronger evidence that the stock might be overvalued since this value is higher than all the values for the other comparable firms.
- **EV/EBITDA:** Further evidence the strong growth prospects for the firm that, as we think, are not reasonable.

- **The EV/Sales** multiple at 5.09 is one of the highest we obtain when we compare with peers. This supports our argument and forecasts.

CONCLUSION

Taking into account our valuation that included both the multiple analysis and the discounted cash flow we reach conclude that **on 11/27/2023 the stock is 2% overvalued** and therefore we take the decision of selling the stock.
Furthermore, our team would like to point out a risk inherent to the industry for the upcoming years. The core business of alcohol companies raises a range of potential Environmental, Social, and Governance (ESG) risks for investors, in areas including reputational risks, regulatory intervention, legal action, and environmental impact and this is a further consideration when deciding to buy or sell the stocks.

OVERVALUED

Fair Price = £140.67

VS

Current Price =

£143.42

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