Diageo Trading Update
Q&A Call

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Trading Update

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Welcome

Good morning. At our year end results for fiscal 2023 I guided that we expected to see sequential improvement in our business results in the current fiscal year. At the Group level we are seeing slower than expected growth and we no longer are expecting fiscal 2024 H1 to be stronger than fiscal 2023 H2. This is due to a materially weaker performance outlook in Latin America which makes up nearly 11% of Diageo's net sales value. Importantly we have momentum continuing in four out of five regions, including seeing sequential improvement in our largest region of North America.

What are we seeing in Latin America? LAC is now expected to decline organic net sales by more than 20% year-over-year in the first half of fiscal 2024. If you remember, we disclosed back in August, that we ended fiscal 2023 with higher than expected inventory levels as economic activity had slowed post our shipments for the World Cup. However, we are now seeing two additional headwinds in the region. First, consumer conditions have worsened. Macroeconomic pressure in the region is resulting in lower consumption for the category and consumer downtrading. Second, due to higher interest rates and inflation we are seeing customers destocking. Both of these impacts are slowing down progress and reducing channel inventory to appropriate levels for the current environment. It is important to note that despite the slowing category growth, our business in LAC continues to win share in most markets within the categories we participate in. If you remember this business grew 20% in the first half of last year and so we are lapping extremely high comps.

For the impact at the Group level, what this means is we now expect organic operating profit growth for the first half of fiscal 2024 to decline compared to the first half of fiscal 2023, primarily due to LAC's declining net sales, increased trade investment, lower operating leverage and adverse mix resulting from downtrading. Across other regions we expect to continue to invest additional A&P ahead of net sales. We expect that there will be continued, albeit moderating, cost inflation which will be partially offset by pricing actions.

Looking ahead to the second half of fiscal 2024 at the Group level, we expect to see a gradual improvement in organic net sales and organic operating profit growth from the first half of fiscal 2024, while we continue to invest in marketing and in the business to drive long term sustainable growth. I recognise the magnitude of this issue and we are putting together the right actions to manage it. We will come back to you at our interim results in January 2024 to give details on actions being taken.

Most importantly the rest of the regions, which is 90% of our portfolio, are on the right trajectory. As for the other regions, we are seeing strong momentum in APAC despite the slower recovery in China. While our Baijiu business is proving to be more resilient, we are seeing less momentum than we expected on the international spirits business which is true also for the industry in general. In Europe we still see momentum, albeit slower than in the second half of fiscal 2023. With geopolitical tensions escalating in the region, trading has unfortunately stopped in key geographies in the Middle East where we hold leading positions in spirits and this has reduced some of the momentum of the region.

As we said at the end of the year, globally we still expect to see growth and gradual improvement through fiscal 2024. While we see green shoots, we also continue to experience volatility and the operating environment is likely to remain challenging. These are however short term challenges and we run the business for the long term. We will continue to invest in the business as I am confident in the long term sustainable growth for our portfolio. All of us at Diageo have huge confidence in the medium to long term attractiveness of the industry and category. We believe in the solid business we have built over the years, the consistent investment we have made in it, and we have the talent, tools and capabilities to drive sustainable growth.

Now on to our medium term guidance, moving forward we expect to deliver organic net sales growth between 5% and 7%. This is ahead of what we were growing pre-Covid. Our confidence in this guidance is underpinned by three things. First, our participation in the attractive segment of international spirits which is growing ahead of total beverage alcohol sourcing from beer and wine occasions. Second, our advantaged portfolio and footprint, which enables us to grow ahead of spirits and third, the investments we will continue to make to grow share. Given our share ambition, we will continue to invest behind our brands. As for operating profit we expect to grow broadly in line with organic net sales growth in the medium term driven by the investments we will make to further strengthen the business as the industry normalises from the growth super cycle and driven by continued higher inflation. Over time as inflation moderates and productivity from our supply agility programme flow through, we expect operating profit to grow ahead of organic sales growth.

That is what I have in my prepared remarks this morning. I think we can open it up for Q&A.

Q&A

Laurence Whyatt (Barclays): Morning, thanks very much for the question. Three from me if that is okay. In terms of the medium term guide where you have got the 5-7% top line and then the organic profit in line in the medium term, you also mentioned over the longer term you do expect that to improve. Could you give any sort of timeframe on that? Are we looking one or two years of limited margin expansion and then maybe expansion in a couple of years or is that simply due to the inflation levels and as we expect inflation to drop to a more normal say 2-3% globally that is when we would start to expect the margin expansion to take place? Secondly, I was wondering if you could talk us through really exactly what happened in October. Of course you made your AGM statement back in September where presumably things were performing a bit better but clearly something happened in October and I was wondering if you could run us through precisely what that was. Then finally on LATAM within that region, are there any specific countries that you would call out that are performing better or worse than some of the others? Thank you very much.

Debra Crew: Thanks, I will take your second question about October and then I will let Lavanya talk about the medium term guidance a little bit further. What has happened since the AGM? Really three things have happened. One of course we knew about, disclosed and knew would be challenging, which we did end the year with higher inventory levels. Within the region, the team really expected to be able to move through that within the first quarter of our fiscal. We really did expect October to be a key month for coming back to regular ordering. Two additional things have happened that really have worsened the consumer environment. We talked a little bit about that in the call in August, about what had led originally to that inventory build, particularly in Brazil. However, conditions have really worsened. Things like US interest rates do impact Latin America quite immediately as well as elections in several key markets. All of this really has created a very tough consumer environment. Seeing more downtrading caused us to spend a fair amount of trade spend on pricing in order to move that inventory. In addition, while we have good visibility in inventory levels through our distributors, we have less visibility to inventory at wholesale and retailers that they sell to. Latin America is one where our point of sale information is much more limited. If you remember, we have had to take multiple rounds of pricing through really the last two fiscals and in an environment of benign interest rates these channels purchased ahead clearly of anticipated consumption. You also have to recognise that in many of these markets our products are often viewed as a hedge against devaluation.

We do have a very experienced team in Latin America and in a more stable environment you can see where these customers do these prebuys. Unfortunately in the environment of this extreme volatility and coming through that Covid super cycle, it was just difficult to see what part was going on was true consumption growth versus inventory increases. It became very clear to the team as they were working through October orders that clearly there was more inventory below that in those more opaque layers underneath our direct distributors that we did not anticipate.

As far as where we are performing better and/or worse, I mentioned that we were gaining share in most of our markets in Latin America. The one exception that is Mexico and certainly Mexico is a place that we are seeing some of the most challenges right now in our business. But, we are seeing real pressure throughout the region, I would say, but we are gaining share in those other markets. Then Lavanya, I will let you take the medium term guidance. Of course for those of you who are joining us for Capital Markets Day next week we will go much deeper into this.

Lavanya Chandrashekar (Chief Financial Officer, Diageo): Thank you Debra. Hi Laurence. I would say three things. The first one is I do want to reiterate that we do feel good about the strength of this business, the resilience of the business and the long term outlook of the business. In terms of our frame, we will want to continue to invest in this business to continue to drive growth. You have heard us say many times that we are only a 4.7% market share of total beverage alcohol and our ambition to get to a 6% market share is very much strong. Second, we are continuing to see inflation that although it has slowed, it continues to be there. That is influencing our guidance on operating profit. Third, we will accelerate productivity as we go through the next several years. You have heard me talk about our supply agility programme and the expectation that we have that it will help make resilience for our supply chain deliver incremental operating profit as well as help from a cash and a carbon perspective. This is the programme that as the benefits of it start to come through it will help from an operating profit perspective as well. I am not putting a timeframe around this simply because of the uncertainty that exists in the marketplace today. As we do see inflation moderate and as we see the benefits of our accelerated productivity come through, we do expect that despite increasing investment behind our business we will see operating margin improvement.

Laurence Whyatt: Thanks very much. Just coming back to Debra, your comment on Mexico, do you think that is specifically a spirits comment or do you think that is an overall consumer comment?

Debra Crew: That would be overall for consumer, but certainly spirits have been impacted more than beer.

Laurence Whyatt: Great, thank you very much.

Edward Mundy (Jefferies): Hi Debra, hi Lavanya, two questions from me please. The first is you are talking to improvement in the second half of 2024. Does that mean growth in both revenues and profit for the second half of 2024 to help us calibrate our fiscal 2024 numbers? Then second of all on the medium term framework of 5-7%, clearly we have been through this super cycle. You do operate in a particularly good industry, and you do have a great footprint and a great portfolio. Why not bring this back down to 4-6% which is where the guidance was before? Why have you stuck with the 5-7%?

Lavanya Chandrashekar: In terms of our guidance for this fiscal year what we are guiding to is that we will see gradual improvement in both organic net sales and operating profit in the second half of fiscal 2024 compared to the first half of fiscal 2024. That is what we are guiding to.

Debra Crew: As far as why not go back to 4-6%, this is something we certainly will dive more into. It is an attractive industry and we have a great advantaged portfolio and footprint that we expect to grow ahead of that industry growth. We are seeing the industry get back to that mid-single digit. We do feel very confident in our footprint and we are investing against that. Those are really the three components and as I mentioned, we can certainly talk a lot more about that next week.

Andrea Pistacchi (Bank of America): Hi, two from me please. One on the US. At your full year results, which you then confirmed at the AGM, on the US I think the message was that the market is growing around the low end of mid-single digit. Maybe because of a couple of things like prepared cocktails, etc you are growing a bit below that now. Then in H1 you have also got some more difficult comps. Has anything really changed on the US? I think in the press release your comment on North America is you expect gradual improvement in organic net sales growth in the first half. Does this suggest that you are actually expecting some growth in North America in the first half? Then the second question please, slightly broader but again focused on US and Europe, is about pricing. In this 1H you are benefitting from price increases that you put through mainly at the beginning of the year so how are you feeling about pricing over the next 12 months in the more difficult consumer environment? What are you seeing in the US in terms of pricing environment? There has been some commentary, for example on cognac. Obviously you are not directly exposed to that but cognac being very competitive. Is that specific to that category or are you seeing anything slightly broader? Thank you.

Debra Crew: I will take the first one and then Lavanya if you want to take that second one. All we are saying at this point from a North America perspective is that we are expecting sequential improvement from the second half of last fiscal. Clearly right now is an important time for the industry. This is a high seasonal business so certainly it is underway, but we are expecting sequential improvement.

Lavanya Chandrashekar: I would just add from a pricing perspective we are definitely seeing the rate of price increases that were being taken both within our business, but more broadly within the industry and even more broadly within consumer products is moderating as time has gone by. What we are seeing on pricing is we have a great suite of tools, data and capabilities to be able to analyse and understand where there is pricing opportunity and what is the right equation between trade spend, headline pricing to be able to get to the right equation between volume, price and mix. What we are seeing right now is moderation in pricing. There is definitely in some parts of the world more pressure, such as in Latin America where we are seeing some downtrading but broadly speaking I would say that this industry in general does not have an environment where there is dramatic changes in the pricing environment. If we find at any point in time that we are slightly out of kilter on price, we will make the adjustments but those will happen in both directions.

Simon Hales (Citi): Hi Debra, hi Lavanya, two for me please. Can I just come back to the destock issue? I think over the last decade at Diageo you have clearly been focused on sell-in not sell-out, not sell-in as a strategy and I think we were of the view that the destock cycles that we had seen historically would be less of an issue going forward when we saw macro weakness. From what you are saying today Debra, it feels that outside of a lot of maybe your tier-1 wholesalers you are perhaps still struggling in some markets to still see the inventory levels we might see in trade. I am just wondering, is that fair? Is that harsh against that backdrop? How do we think about your visibility now on how much more stock levels you really think are left in LAC? Do you think the destock will be done by the end of the first half? A bit of a broad waffly first question. Then secondly if I can just ask you about Europe a little bit. You flagged the weakening in the Middle East having some impact on the division of late. Are you also seeing a bit of a slowdown from a broader consumer standpoint across Western Europe yet? Some of the other FMCGs have been calling that out in recent weeks. I wonder if you have seen it.

Debra Crew: Yes, I will start with Europe and then Lavanya if you want to take the destock. In Europe, we still have strong momentum, I would say. It is just certainly since the tensions have escalated in the Middle East we definitely are seeing a more cautious consumer. That is a few weeks. Overall, we still feel good about our momentum in Europe. We are gaining share so that certainly helps us, but I would say it has just been a little tempered certainly in the last few weeks. Of course, we are a leading spirit company within actually the Middle East. We have in effect stopped trading. Certainly, there has been an impact there and that rolls into our Europe numbers.

Lavanya Chandrashekar: Simon, your question on the destock, we are indeed a sell-out culture, and we have very strong controls around the reporting of this and the tracking of inventory levels at our direct customers. What has happened in Latin America is while we have good visibility of the inventory levels at our distributors, we have less visibility to the inventory levels at the wholesalers and the retailers that they sell to. As Debra mentioned, over the last two fiscals we have taken multiple rounds of pricing and this was at least at the beginning of these price increases, it was an environment of very benign interest rates. What we believe has happened is that this part of the channel below the distributors they have purchased ahead of consumption. It was hard to see, as Debra mentioned, how much of this was actual consumption versus how much of this was inventory increases in the layers.

However, in terms of our own visibility to distributors' inventory levels, those are strong. We have regular reporting about it. You have heard me talk about this. This is a part of our routine financial assurance committee process and so we definitely continue to be a sell-out culture.

Mitch Collett (Deutsche Bank): Morning Debra, morning Lavanya. I would love to ask again about the US. You have said that you expect a sequential improvement versus 2H. I guess that means better than -2.6% in terms of organic sales growth for both 1H 2024 and full year 2024. Can you perhaps give some colour on why it is going to improve versus the second half of 2023? The industry data certainly seems to have got worse and tequila growth specifically for you seems to have slowed. That is my first question. Then secondly can you talk about the time period more specifically for the medium term guidance? I am guessing given what you have said about 1H F24 will not be within the range but does the medium term guidance start in F25? Do you think F25 is likely to be within your medium term guidance? I appreciate it is a long way away. Thank you.

Debra Crew: Yes, I will start with your second question. The medium term guidance is medium term guidance. We do not have a specific timeframe that we are assigning to that. Your other question about the US, we are in the middle of the half, but we are still expecting sequential improvement. We are seeing actually some green shoots in many parts of the industry. I know that there has been a lot of reporting from other competitors and other things. It is a market that is quite volatile right now, but we are in a critical period and we still expect sequential improvement.

Lavanya Chandrashekar: On your question on medium term guidance, yes I think it is safe to say that fiscal 2024 is not going to be within our medium term guidance. In terms of when that medium term guidance comes into place, we have to look at this medium term guidance from a perspective of that is what we expect to structurally be able to grow. That is anchored in the fact that our medium term guidance the confidence comes from the fact that TBA continues to be an attractive category, international spirits within TBA is growing faster than the rest of the category and our footprint is clearly advantaged in terms of the geographies and the brand portfolio that we have across this business. We are investing behind the business and we will continue to expect to pursue our ambition of growing share in this business. Uncertainty exists in the near term, but I do expect that over the medium term we will be able to deliver between 5% and 7% growth on the top line.

Cedric Lecasble (Stifel): Good morning, most of the questions have been answered. I have one remaining. If you had to quantify the impact of LATAM in this morning's communication and change in tone, would you say LATAM is 50% of the move? 70% of the move? I understand that there are some other moving parts hurting the business or making it a little more challenging in the short term so what would be the way to quantify the weight of LATAM in your change of views this morning? Thank you very much.

Lavanya Chandrashekar: Cedric, what we have said in our RNS is that we have issued this guidance because of the change in outlook in Latin America. Just to reiterate what is in the guidance, we are seeing sequential improvement in our biggest and probably the most important market for this business in North America. We are seeing sequential improvement in Africa. We are seeing strong momentum in Europe and in APAC. In APAC, despite the slower than expected recovery in China. Latin America is about 11% of our business. This was as of the end of fiscal 2023 and as we have said in our press release, this business is now expected to decline above 20%. You can do the maths in terms of the percentage of impact that we are seeing from the Latin America business.

Chris Pitcher (Redburn Atlantic): Good morning Debra, Lavanya. Can I dig into Latin America again? Sorry to come back but over the years you guys had theoretically moved your business away from the free trade zones and the use of wholesalers. There was a big focus on the domestic business and having greater visibility. You also invested significantly in your primary scotches which were meant to soften any economic impact and yet looking at the numbers today this is not as bad but almost as bad as what happened in Covid when it was a supply restriction. This is nothing like the sort of decline we have seen in previous economic cycles. Are you comfortable that the work that was done in Latin America really worked and reduced the cyclicality or is there a major overhaul of your reporting and route-to-market structure that needs to happen in order to avoid something of this magnitude? Then secondly on the medium term guidance I appreciate that 5-7% reflects the structural growth of your business but it does not reflect the cyclicality. Your main competitor has a wider range. Have you considered widening the range just to better reflect the reality of operating in a more cyclical distilled spirits market? Thanks.

Debra Crew: I will take the first one. On Latin America in general, our business has grown. Over the last four years we are still looking at a 15% CAGR and it continues to be margin accretive to the Group importantly. Our business, overall, we feel very good about what we have built in Latin America over the past several years and that business has premiumised. It is of course though still an emerging market and in emerging markets it is never a straight line. Certainly, there is volatility and as we premiumised clearly with this consumer environment with downtrading we have had to invest against price as well. We are not only suffering from the decline. Even through the inventory we are having to spend a fair amount in trade.

Still overall and in the long run we feel good about what we are building and have built in Latin America. However, we did have to come out this morning with this announcement because we were no longer seeing the sequential improvement at the Group level. This has caused us to no longer see at the Group level that sequential improvement that we had previously guided to. Per our regulatory requirements we absolutely wanted to get out to the market as soon as was appropriate. That is what has happened in Latin America but overall, in the long run scope of the business we still feel very good about what we have built there.

Lavanya Chandrashekar: Just to clarify, what do you mean when you use the word cyclical? Chris, are you there? Okay, what I will say about this business is our business, our portfolio is extremely resilient. You will see more of this next week during our Capital Markets Day so I do not want to steal all of the thunder of next week but one of the things that you will see next week in our Capital Markets Day is we have a very broad portfolio. Our presence in this category spans across every type of international spirit. Scotch is a big part of our business but also, we have a strong presence in premium beer with Guinness in Europe and North America. We have a great portfolio within tequila, within gin, within rum. I can go on. We also have a deep portfolio from a price point perspective and our presence across geographies because not every geography moves in the same direction from a macroeconomic perspective. One of the things that really works for Diageo is this breadth of portfolio and footprint that we have, which is gives us real resilience. Depending on what is happening with the consumer in terms of what type of spirits they are more interested in or depending on what is happening from a macroeconomic perspective our portfolio within this category really is very resilient. That is what gives us the confidence in our medium term guidance. More around that next week.

Debra Crew: Thanks. We are at time, so I wanted to thank you for joining us this morning on this call. For those of you who we will be seeing next week we look forward to it. For those not, I think it is going to be webcast so you will be able to see it as well. Thank you very much.

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