COMPANY UPDATE

CREDIT SUISSE | FIRST BOSTON

Equity Research

Diageo

DGE.L

N(ow) G(oing) G(angbusters)

- **US distribution story becoming visible**
- **Further upside likely**
- **Reiterate outperform**

Distribution advantage. We believe that the roll-out of the Next Generation Growth (NGG) programme in the USA will provide tangible evidence in the next year of the benefits of critical mass in the global spirits industry.

Survey results. Our survey of US wholesalers confirms our view that NGG could offer more upside for Diageo than the company has previously indicated. Most wholesalers believe that their margins could contract, at least in the short-term, with Diageo's margins growing. In addition, they believe that their sales volumes of Diageo products will grow faster in future.

NGG could provide catalyst. 2003 results produced few surprises and our 2004 estimates remain unchanged. However, we believe that the success of NGG could become more visible during the busy calendar Q4 trading period and could act as a catalyst for the share price.

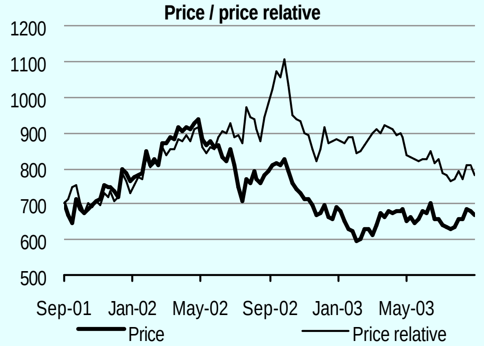
Valuation. We retain our estimates, 870p target price driven by our DCF. The current share price values the company at a discount to Allied Domecq on EV/EBITDA (2004 9.2x). In 2003 total cash return to shareholders including dividend and share buybacks was over 7.5%.

Diageo is the world's largest premium drinks company.

Rating	**OUTPERFORM***
Price (04 Sep 03)	**669 (p)**
Target price (12 months)	**870.00 (p)**
Market cap. (£ m)	**20,254.65**
Enterprise value (£ m)	**23,477.24**
Region/country	**European/United Kingdom**
Sector	**Beer & Alcoholic Beverages**
Analyst's Coverage Universe	**Beverages**
Weighting (vs. broad market)	**UNDERWEIGHT**
Date	**08 September 2003**

**** Stock ratings are relative to the coverage universe in each analyst's or each team's respective sector.***

Price / price relative



The price relative chart measures performance against the FTALLSH index.
On 04/09/03 the FTALLSH index dosed at 2108.3.
On 04/09/03 the spot exchange rate was £0.69/eu 1.- eu1.09/US$1.

Performance over	1mth	3mths	12mths
Absolute (%)	**5.5**	**-1.2**	**-12.5**
Relative (%)	**1.3**	**-6.0**	**-18.8**

Year	6/02A	6/03A	6/04E	6/05E
Revenues (£ m)	**11,281.8**	**9,440.0**	**9,343.1**	**9,735.3**
EBITDA (£ m)	**2,420.00**	**2,305.22**	**2,255.86**	**2,416.75**
Pre-tax profit (£ m)	**2,031.2**	**2,152.4**	**2,157.3**	**2,315.4**
CSFB adj. EPS (p)	**43.22**	**48.90**	**49.95**	**54.79**
ROIC (%)	**11.8**	**13.5**	**14.5**	**15.2**
P/E (x)	**15.5**	**13.7**	**13.4**	**12.2**
P/E rel (%)	**90.4**	**90.1**	**97.3**	**90.8**
EV/EBITDA (x)	**9.9**	**10.2**	**9.5**	**8.9**

Dividend 2003 (p)	**25.60**	Book value/share (6/03, £)	**–**
Dividend yield (%)	**3.8**	Free float (%)	**100.0**
IC (6/04E, £ m)	**12,888.58**	Number of shares (m)	**3,055.00**
Net debt (6/04E, £ m)	**5,488.4**	EV/IC (6/04E, x)	**1.8**
Net debt/equity (6/04E, %)	**73.5**	Current WACC (6/04E, %)	**–**

Source: FTI, Company data, Datastream, CSFB (EUROPE) LTD. Estimates.

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Investment summary

Since the Seagram acquisition was announced in 2001, we have believed that this deal would improve the competitive position of the spirits industry and give Diageo a strong leadership position within the industry. In the USA the Seagram acquisition has given the company the critical mass to implement a new distribution model, under the title Next Generation Growth (NGG). Under NGG the company has renegotiated its agreements with wholesalers in the USA, firstly to consolidate the number of wholesalers it uses, and secondly to establish more exclusive arrangements with those wholesalers. This model is not totally dissimilar from that, which Anheuser Busch has introduced into the US beer industry over the last few years, with tremendous success for its top and bottom line growth.

The NGG programme commenced in June 2002 and has now been rolled out across the US to cover nearly 80% of the company's sales volumes. After an intended hiatus during the busy holiday season in calendar Q4, the company intends to complete the roll-out by June 2004. We have undertaken during July and August a survey of major wine and spirit wholesalers in the USA. This included interviews with 8 significant wholesalers from across the US, 5 of which have signed up with Diageo under the Next Generation Growth programme and 3 of which have not.

The survey confirms our view that NGG could offer more upside for Diageo than the company has previously indicated. Most wholesalers believe that their margins could contract, at least in the short-term, with Diageo's margins growing. In addition, they believe that their sales volumes of Diageo products will grow faster in future. We view all these comments as positive for Diageo.

Our modelling already includes some improved top line momentum and some margin upside. However, our analysis of US beer v. spirit system profitability suggests that, if US spirits system margin was to match beer, this could add £100m of EBIT, adding 5% to Diageo's bottom line. If US spirits system margin moved to a slight premium (say 23% v. beer 20%), this would add £250m or 12% to the bottom line.

2003 results produced few surprises and our 2004 estimates remain unchanged. However, we believe that the success of NGG could become more visible during the busy calendar Q4 trading period and could act as a catalyst for the share price.

Our 2004 estimates (which assume 4% underlying sales growth and 6% underlying EBIT growth) provide a conservative base, which could see acceleration, both as NGG kicks in and as key economies recover.

Background to NGG

In June 2002 Diageo, together with Schieffelin & Somerset, the joint venture with LVMH's Moet-Hennessy, embarked on a long-term strategy to build more effective and efficient relationships through the three-tier system in the US. This followed Diageo's acquisition at the end of 2001 of several key brands from Seagram, which increased the company's brand portfolio in the US.

This has involved a major programme in re-engineering the company's distribution base. The company has called this programme Next Generation Growth.

In our review *Exploiting Distribution Advantage* (21 February 2002), we analysed in some detail Diageo's planned moves in the US towards consolidating its wholesaler structure and establishing more exclusive arrangements with its wholesalers and explained that this would occur on a state-by-state basis. The section "US distribution system" contains more detail on how the industry currently works and the way that Diageo is changing the industry model.

The table below indicates the 34 states (and New York City and Washington DC) where Diageo has selected partners under these new agreements. The table below indicates the states where Diageo has new agreements in place and that these account for c.80% of the US spirits market.

Figure 1: **Strategic relationships with wholesalers**

%, unless otherwise stated

State	Distributor	Proportion of US market	State	Distributor	Proportion of US market
Alabama	#	1.2	Minnesota	United Brokerage	2.4
Alaska	Alaska Distributors	0.3	Montana	#	0.3
Arizona	Alliance Distributing	2.0	New Hampshire	United Liquors	1.1
California	Southern wines & spirits	11.8	NY City	Peerless	5.9
Colorado	Sunbelt-Charmer	2.3	NY State	Colony	
Florida	Southern wines & spirits	7.5	N. Carolina	Hannah and Dunn	2.3
Hawaii	Southern wines & spirits	0.4	Ohio	Glazer's	2.9
Idaho	#	0.4	Oregon	Alaska Distributors	1.2
Illinois	Judge & Dolph	4.8	Pennsylvania	Direct to state	3.3
Iowa	#	0.8	Rhode Island	Rhode Island Distributing	0.4
Indiana	National Wine & Spirits	2.0	Texas	Glazer's	5.6
Kentucky	Southern wines & spirits	1.2	Utah	#	0.5
Louisiana	Glazer's	1.7	Vermont	United Liquors	0.2
Maine	United Liquors	0.5	Virginia	Hannah and Dunn	2.0
Maryland	Sunbelt-Charmer	2.2	Washington	Alaska Distributors	2.1
Massachusetts	United Liquors	2.8	Washington DC	Sunbelt-Charmer	0.5
Michigan	National Wine & Spirits	3.8	W. Virginia	North Central Distributing	0.4
Mississippi	#	0.9	Wyoming	#	0.2
			Total		**77.9**

 # not disclosed by company

Source: Adams Liquor Handbook, Company data, CSFB estimates.

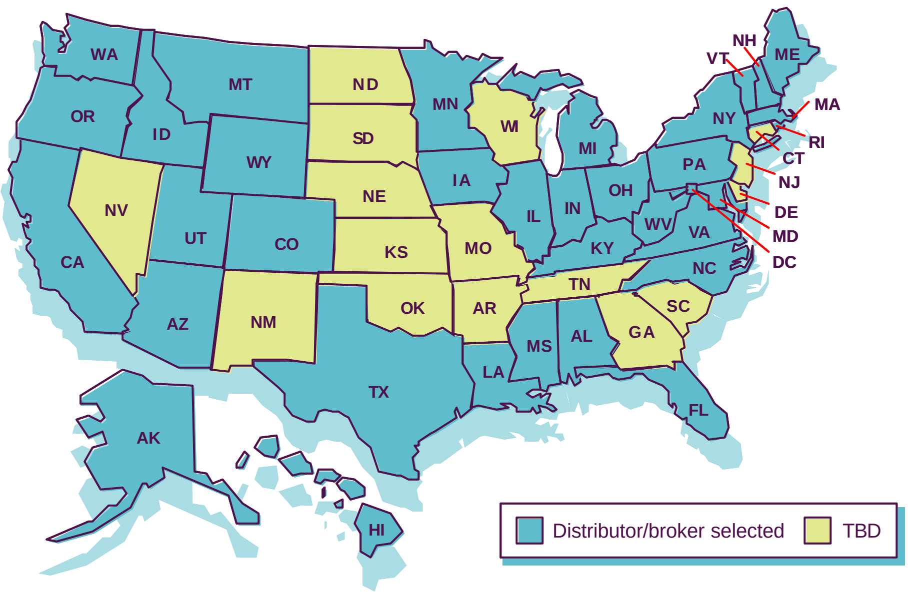
We believe that Diageo has carefully balanced working with large wholesalers, which can act as partners in more than one state, and smaller wholesalers, which are active probably in one state. The larger wholesalers can generally bring a stronger market position; on the other hand, we believe that Diageo does not want to become totally reliant on a handful of major wholesalers. The table above indicates that Diageo is working with some 14 wholesalers.

Southern Wines and Spirits, Glazers, and Peerless are all key players in the top ten distributors by volume sales. Others such as Judge and Dolph operate uniquely in one state. However, the historic 'league table' of wholesalers is likely to change radically over the next year or so as the industry adjusts to the NGG programmes.

Wide geographical coverage

Geographically, Diageo has wide coverage now over the USA for the NGG agreements. With its results presentation on 4 September the company indicated that it would not make further changes during the business holiday season in calendar Q4 but would complete the NGG roll-out by June 2004.

Figure 2: **Diageo—Distribution/broker selection to date**



> Distributors/brokers selected in 34 states and Washington DC

> 78% of US volume currently sold through NGG distributors/ brokers

> Nearly 2,000 dedicated sales people representing our brands

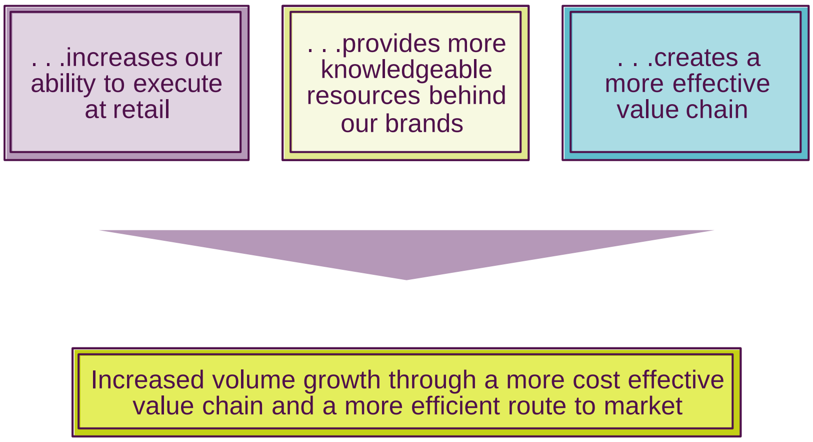
Source: Diageo

What does this mean for Diageo?

Diageo has appointed a single wholesaler in key states and will require that wholesaler to establish a dedicated sales force for Diageo products. The wholesaler can sell other suppliers' products but will be required to use a separate sales force.

In its results presentation on 4 September Diageo set out its summary of the benefits of NGG:

Figure 3: Consolidating to a single distributor in each state and creating dedicated distributor sales resources



Source: Diageo.

What are the implications for wholesalers?

(1) The wholesaler will have to take on some additional cost to establish the dedicated sales force. In addition, we understand that he effectively pays an annual fee for the franchise.

(2) The wholesaler will generally have a longer contract period with the supplier Diageo than previously (at least 5 years), so he will have more security. Currently many contracts only require 30 days notice.

(3) The wholesaler will obtain better incentive payments for increased sales. This emulates the Anheuser Busch model.

(4) The wholesaler obtains access to efficient technology to run his business from the producer. This could replicate the Anheuser Busch model where the BudNet system provides the wholesaler with an efficient inventory control system. In return, the supplier will obtain improved market data, which should improve the operational efficiency of his business.

(5) The whole supply chain should require less working capital, particularly stocks, if efficiency gains are made. This should free up capital both for the system as a whole, the wholesaler and the supplier.

The wholesaler view

Our survey of wholesaler views included interviews with eight significant wholesalers from across the US, 5 of which have signed up with Diageo under Next Generation Growth and 3 of which have not. We used third party interviewers to undertake the survey and have recorded the full responses in Appendix 1 (note that we have aggregated responses in order to preserve anonymity for the wholesalers). The survey was undertaken during late July and August.

In the text and table below we summarize some of the key findings from the survey and then include some brief comments on key issues. This separates comments from wholesalers, which have signed up with Diageo from those from wholesalers which have not signed up. For more general industry comments we have combined the comments.

Positives and negatives of Next Generation Growth

On the positive side, the Diageo wholesalers had a consensus view that they would see better volume growth due to market share gains. This partly reflected the better brand portfolio, as well as the benefit from long-term alignment of objectives between brand owner and distributor. This would allow the virtual circle to develop where better trading performance would allow higher marketing spend which would fuel further trading improvement. One wholesaler quote – "if they can iron out their distributor relations, Diageo will be formidable".

There was a general consensus from both Diageo and non-Diageo wholesalers that the new agreements would have a negative impact on wholesalers' margins, at least in the short-term. Much of this was attributable to higher costs, from the dedicated sales force and rebates or franchise fees payable to Diageo. There was some scepticism about whether Diageo was viewing the new relationship with wholesalers as a genuine partnership or as a means of transferring margin from the wholesaler to the brand owner, and one wholesaler contrasted this with Anheuser's genuine partnership approach.

Much of this may reflect transitional issues—such as the scepticism about Diageo's commitment to reinvest in brand marketing—and the bedding down of new ways of operating (one wholesaler specifically mentioned the split in sales and merchandising forces, the first with the wholesaler, the second with the brand owner, which was leading to some disagreements). One wholesaler commented that "*it will take them 18 months to get through transition issues*" and said that "*Christmas 2004 should be huge*".

However, most Diageo wholesalers expressed the view that Diageo's margins were likely to grow, whilst their own margins would stand still or decline in the short-term.

A further issue, particularly for the non-Diageo wholesalers, was the perceived loss of control of their business that Next Generation Growth demanded.

Implementation of NGG contracts

A number of comments indicated a pragmatic approach by Diageo to implementing the NGG programme—"*Diageo has been nothing but pragmatic in resolving operating issues*". Examples were given of allowing the wholesaler still to use a shared sales force in rural areas which would not support the further cost of a dedicated sales structure, or allowing a phasing in of full exclusivity over a 24 month period.

Diageo was mentioned as providing training and IT services. The new contracts run for between 5 and 7 years, compared with the standard industry agreement of 30 days.

Other comments on NGG

Some wholesalers expressed some concern about the reaction of small retail customers, with Diageo increasingly focusing on larger customers. A number of wholesalers recalled comments made by one of the previous heads of Diageo North America, Chuck Philips, who had talked about the collapse of the three tier structure, which would cause concern for smaller customers.

Diageo's brand strengths

There was a unanimity of view amongst wholesalers over which were the strongest brands in the portfolio (Smirnoff, Captain Morgan, Crown Royal). A few gaps were noted in the portfolio (bourbon, premium vodka, wine); however, it was generally acknowledged that Diageo had the leading brand in most categories. Three non-Diageo brands were generally viewed by the non-Diageo wholesalers as offering a competitive advantage—Bacardi rum, Grey Goose premium vodka (independently owned), Jack Daniels bourbon (Brown Forman).

Industry views

There were contrasting views on the importance of wine to the wholesaler, which may reflect geographical variations (wine is more important on East and West Coasts). However, the lower profitability of wine was reflected by the wholesaler which revealed wine was 50% of his case volumes, 20% of his revenues but only 15% of his profits).

On the risk of state tax increase, a number of wholesalers were concerned about increases over the next few years, but were confident that for 2003 either increases had happened or were now off the agenda.

In terms of general trading, several wholesalers talked of trading down in spirits as a serious issue. There was a split of view on volumes between those seeing a flat market place and those seeing low single digit growth. Most wholesalers talked about some price increases.

However, in wine there was a general pessimism about pricing being flat to down, although optimism remained on volume growth.

No wholesaler expected dramatic change to the three tier system, but many expected further consolidation amongst brand owners. There was a consensus view that advertising would be allowed on network TV in the next few years.

Figure 4: Survey summary

Questions	Summary of questionnaire answers					Comments
Wholesalers signed up with Diageo						
Key positives	Volume upside ¦ ¦ ¦	Improved Sales Push ¦ ¦ ¦	Increased Marketing ¦ ¦			General agreement about positives
Key negatives	Increased overhead ¦ ¦ ¦	Disruption ¦	Internal conflicts ¦ ¦			Agreement over increased costs/negative impact to wholesaler margins
Length of contract	7 years ¦	5 years ¦ ¦				All on evergreen terms which provide for renewal
Other terms of contract	Training ¦ ¦ ¦	Flexibility on exclusivity ¦	Volume targets ¦ ¦	Includes Schieffelin ¦ ¦ ¦ ¦		Agreement that Diageo being pragmatic in implementation
Volume growth expected	In line with industry ¦	Ahead of industry ¦ ¦ ¦ ¦				
Wholesaler margins expected	Decline ¦	Stay same ¦ ¦	Increase ¦ ¦			Increase in margin only in long-term
Diageo margins expected	Decline	Stay same ¦	Increase ¦ ¦			Net margin could stay the same if marketing spend increased
Retailer reaction	Positive	Negative ¦	No change ¦ ¦			Smaller independent customers are concerned about supplier power
View of product portfolio	Complete ¦ ¦	Some gaps ¦ ¦ ¦				Gaps in premium vodka and bourbon
Strong brands	Smirnoff ¦ ¦ ¦	Captain Morgan ¦ ¦ ¦	Crown Royal ¦ ¦ ¦ ¦	Baileys ¦	Jose Cuervo ¦ ¦ ¦	
Weak brands	VO ¦	Seagram 7 Crown ¦	JW Red ¦	Gordons ¦	Wine ¦	

¦ *number of responses*

Source: CSFB research.

Figure 5: Survey summary

Questions	Summary of questionnaire answers					Comments
Wholesalers NOT signed up with Diageo						
	Margin issues	Control issues				
Why not with Diageo	¦¦	¦¦				Margin issues relate to high rebate levels
	Brown Forman	Bacardi	Pernod	Jim Beam		
Main suppliers	¦¦	¦	¦¦	¦		
	30 days	3 years				
Length of contract	¦¦	¦				No specific resources provided
	Premium vodka	Bacardi	Grey Goose	Jack Daniels		
Strong brands	¦	¦¦¦	¦¦	¦¦		
	Fine wines	Absolut	VO	Chivas Regal		
Weak brands	¦	¦	¦	¦		
All wholesalers						
	Important	Not important				
View on wine	¦¦¦	¦¦¦				No general agreement
	Big issue	An issue	Not an issue			
Risk of state tax rises	¦¦	¦¦	¦			Considered an issue over the next few years
	Grow 1%-3%	Flat	Trading down	Prices up	Prices flat	
View on volumes, price for spirits	¦¦	¦¦	¦¦¦¦	¦¦¦	¦	General view of some trading down
	Growth	Flat	Prices down	Prices up	Prices flat	
View on volumes, price, for wine	¦¦¦¦	¦¦¦	¦¦¦		¦¦	No positive comments
	Yes	No				
Change to 3 tier structure		¦¦¦¦¦¦				Some increase in direct wine shipping
	Yes	No				
Likely merging of distribution	¦¦¦¦	¦¦¦				
	Yes	No				
Spirits advertising on network	¦¦¦¦¦	¦				Unlikely in 2003 but within 3 years

¦ *number of responses*

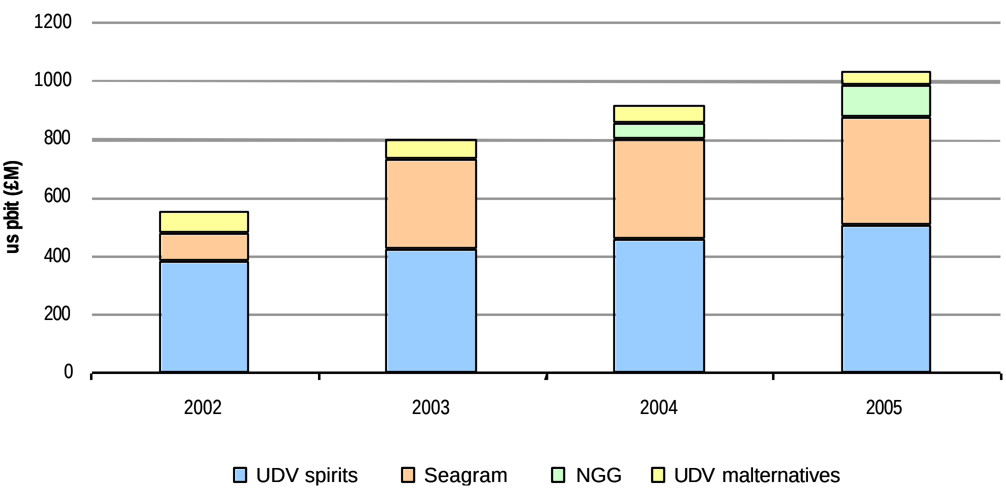
Source: CSFB research.

Possible financial implications

Volume potential

Diageo has indicated that the implementation of NGG should allow its volumes to grow faster than the industry in the USA. This is supported by the comments from the Diageo wholesalers in our survey. We have already built this into our modelling from fiscal 2004, with an expectation that Diageo's US volumes will grow 1% point faster than the industry. This would in turn drive better profit growth.

Figure 6: Diageo North America profit build to 2005E



Source: Company data, CSFB estimates.

However, we also believe that NGG will allow improved margins within the spirits supply chain within the USA.

Margin potential

In our note Exploiting Distribution Advantage (21 February 2003) we analysed the value chain in US spirits compared with beer, looking separately at Anheuser Busch and Coors. This showed that wholesaler margins for spirits (4% on average, we estimate) were lower than for beer (5-7%), despite the fact that spirits offers a better value v volume equation, which should justify a higher margin, in our view.

Figure 7: Value chain—profit and loss accounts (2001)

US$ per case, unless otherwise stated

	Average Spirits		Anheuser Busch		Coors	
	US$ per case	%	US$ per case	%	US$ per case	%
Supplier P&L						
Gross revenue	92		8.5		8.6	
Federal Excise Tax	(27)		(1.4)		(1.4)	
Net revenue	65	100	7.1	100	7.2	100
COS	(26)	(40)	(4.2)	(59)	(4.5)	(62)
Gross profit	39	60	2.9	41	2.7	38
MD&A	(23)	(35)	(1.2)	(17)	(2.2)	(31)
Operating income	**16**	**25**	**1.7**	**24**	**0.5**	**7**
Wholesaler P&L						
Net revenue	120	100	12.3	100	12.3	100
COS	(92)	(77)	(9.0)	(73)	(9.1)	(74)
State tax	(12)	(10)	0.0	0	0.0	0
Gross profit	16	13	3.3	27	3.2	26
Delivery	(3)	(3)	(0.8)	(7)	(0.8)	(7)
Warehousing	(3)	(3)	(0.4)	(3)	(0.4)	(3)
MD&A	(5)	(4)	(1.3)	(11)	(1.4)	(11)
Operating income	**5**	**4**	**0.8**	**7**	**0.6**	**5**
Retailer P&L						
Net sales	145	100	15.4	100	15.4	100
COS	(120)	(83)	(12.3)	(80)	(12.3)	(80)
Gross profit	25	17	3.1	20	3.1	20
MD&A	(15)	(10)	(2.1)	(14)	(2.1)	(14)
Operating income	**10**	**7**	**1.0**	**6**	**1.0**	**6**

Source: Company data, CSFB estimates.

Analysing the data in another way, on spirits the total supplier/wholesaler margin is c. 18% (total operating income of US$21 on a net revenue of £120), compared with the total Anheuser Busch supplier/margin of over 20% (US$2.5 operating income on a net revenue of US$12.3). We believe that this offers significant potential for the spirits margin to rise, at least to the Anheuser Busch level, and probably beyond. The NGG programme should allow Diageo supplier/wholesaler margin to achieve this in the medium term, we believe.

How are the benefits to be divided?

The responses from the wholesalers in our survey indicate that they expect their margins to be negatively impacted by NGG, at least in the short-term, as they bear a large proportion of the additional costs of implementing the programme. In general, they expect Diageo's margin to rise. This would appear to confirm our belief that much of the margin benefit will accrue to the brand owner rather than to the distributor.

We calculate that, assuming an additional 200 basis points of margin in the US (which would bring spirits up to the Anheuser Busch level) would produce c. an additional £100m of EBIT for the system. If 500 basis points of margin could be added (which would take spirits system margin to 23% v. beer just over 20%), this would add £250m of EBIT. If most of this was to accrue to the brand owner, the 200 basis points improvement would add c.5% to Diageo’s bottom line; the 500 basis points would add over 12%.

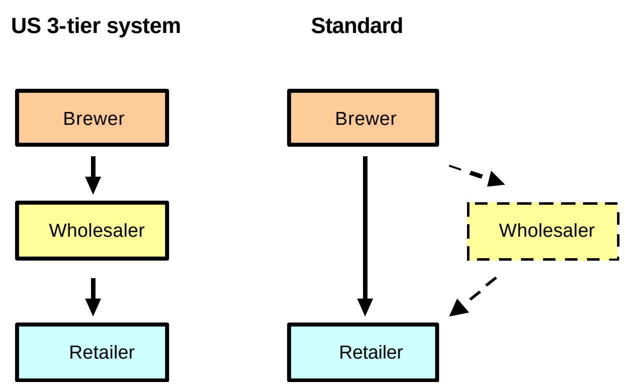
At its results presentation on 4 September Diageo indicated that a proportion of the synergy benefits which it had indicated would accrue from the Seagram deal would related to the NGG programme. We estimate that, of the total target of £118m of synergy benefits, some £60m could accrue from NGG. This is built into our estimates over the next few years, but this figure is materially less than our estimate of the theoretical upside mentioned above.

The US distribution system

The three tier structure is the standard structure for doing business in the alcoholic beverages industry in the USA. After the repeal of Prohibition in the USA in 1933, the 21st Amendment allowed state governments to regulate the sale of spirits, wine and beer. Most states introduced a system where the alcohol beverages producer had to sell to an intermediary, i.e. a wholesaler, rather than directly to the retailer, i.e. the three-tier system. Tier one was represented by suppliers or importers; tier two by distributors/wholesalers; tier three by the retailers

This system aimed to prevent producers from having undue influence on the retailer and made the selling process on alcoholic beverages transparent. This system remains intact across most states today and applies to beer, wine and spirits. It contrasts with the business practice in most countries where the alcohol beverage producer can sell directly to retailers (although third party wholesalers are often used as well).

Figure 8: Distribution in the US



Source: CSFB estimates.

In addition, there are two regulatory frameworks across the USA: control states and open (or licence) states. In control states the state controls the distribution of the product and/or the retail sale. Wholesalers usually have a minor role in control states. In open states wholesalers and retailers are usually privately owned businesses, which are subject to real competition.

Historically, wine and spirits wholesalers in the USA have operated separately from beer wholesalers. We believe that this separation has been influenced both by different regulatory requirements particularly at the point of sale, as well as by the requirement for different logistics given the volume/value differences in the products, i.e. spirits and wine tend to be higher value but lower volume than beer. However, the same distribution system applies to the different categories.

In open states the alcohol beverages producer appoints a wholesaler to distribute his products, usually with an exclusive territory (a state, or part of a state). Traditionally, the wholesaler would distribute the products of several producers in order to offer his customer, i.e. the retailer, a full portfolio of brands.

The three-tier system raises several potential commercial problems:

(1) It prevents the supplier from getting close to his customer, i.e. the retailer. In every consumer goods industry a close relationship with the customer should improve business efficiency and increase profitability.

(2) The wholesale tier acts as a barrier to the flow in information from retailer to producer and back again.

(3) It inhibits the effective rollout of marketing programmes.

The 3-tier structure is now well established, and we believe that any material change is unlikely in the short to medium term as it would involve individual states changing their own legislation. On the other hand, there may be ways for suppliers and wholesalers to work together to remove some of these inefficiencies in the system. We will discuss below how Anheuser Busch has addressed these issues in the beer industry and then indicate how we believe that Diageo will respond in the spirits industry.

How Anheuser Busch has used its distribution muscle

In the beer category the relationship between producer and wholesaler has evolved in recent years with the wholesaler providing more than a simple distribution function. He has also become involved in providing advertising/promotional support and market intelligence for the brewer.

One other key development is the move by Anheuser Busch over the last 20 years towards "exclusive" distribution contracts with its wholesalers. These contracts stipulate that the wholesaler will not take on competing products; effectively, they allow the relationship between producer and wholesaler to become much closer, with the wholesaler potentially becoming an extension of the producer's own business.

In the last few years other US brewers have responded to this. No.2 Miller Brewing (owned by SABMiller), Coors and Heineken have started to use the same wholesalers in order to set up an alternative system.

Together with a strong brand portfolio, we believe that the rollout of exclusive distribution is one of the key reasons behind the continuing growth of Anheuser Busch within the US beer market over the last few years. Anheuser has grown steadily towards a 50% market share of the US beer market. In the 1996 Annual Report Anheuser Busch stated that "*We believe that in order to maximise sales growth, we must have wholesalers' share of mind*. *We must make sure their attention is focused on our products. To put it simply, focus drives volume."* The company also indicated that volume growth rates with exclusive wholesalers have exceeded those of non-exclusive wholesalers by about 1% annually.

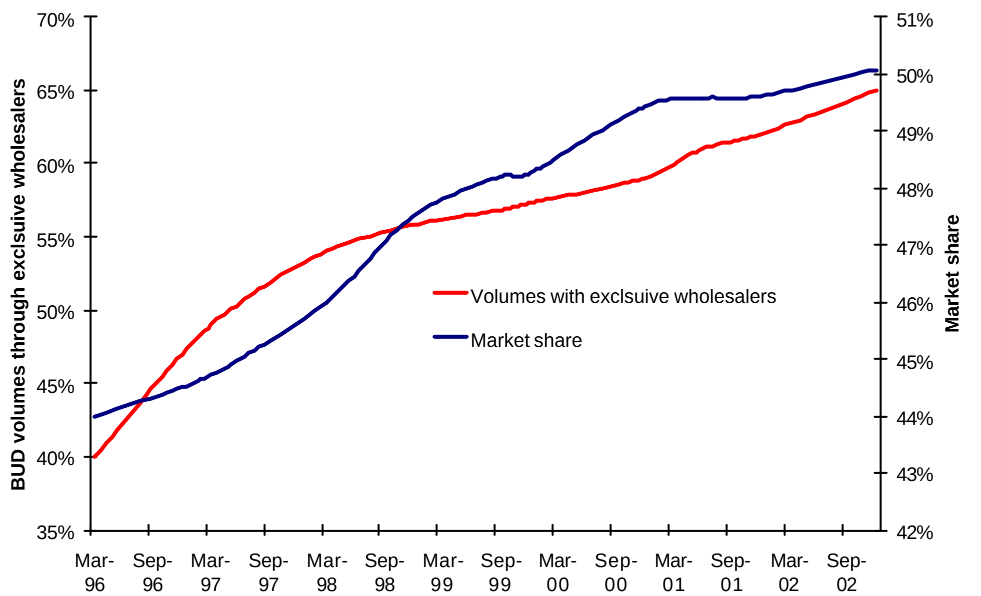
Anheuser Busch has described this move towards exclusive wholesaler contracts as reflecting "*the transition from order taker to sales generator*" among its 700 wholesalers. The initial rollout of the contracts in the 1980's and early 1990's was "*a voluntary exclusivity program, which rewards wholesalers for carrying only Anheuser Busch brands*". In 1996 the agreement was changed towards exclusive handing of AB products. The new agreement also updated standards for distributing the brands and servicing retail customers and obliged the wholesaler to implement the Impact Selling program.

The 1998 Annual Report described how this new arrangement would work:

"Carrying competitors' beer distracted wholesalers from selling our products. You are a salesperson for XYZ Beer Distributors. When you started this job a few years ago, your biggest sellers were Anheuser Busch products. But your company also carried other brands. You had to devote time to them during customer calls. And if you were going to complete your route for the day, you didn't have much time to sell. Sometimes you were little more than an order taker. That's changed. Last year your distributorship decided to carry Anheuser Busch brands alone. And you were trained by Anheuser Busch in "Impact Selling", a structured process for every retail call that builds in time to actually sell your Anheuser Busch brands. Now you are a sales generator."

Below we plot the increase in AB's market share during the rollout of exclusive distribution over the last few years. There was a particular surge in the rollout following the 1996 change in the agreement, with sales volume from wholesalers carrying AB brands exclusively rising almost 17% points to 57% in 1998. The company has targeted a figure of 70%.

Figure 9: **Anheuser Busch exclusivity and market share**



Source: Company data

What has happened to the beer wholesale structure?

There have been several trends amongst the beer wholesalers:

- *Consolidation*. In 2000 Impact International estimates that the top 10 US beer wholesalers now account for 64% of total sales.
- *Exclusivity contracts*. With the rollout of the AB exclusive contracts, many wholesalers are now aligned with AB, or alternatively are becoming part of the alternative "shared house" system, where Miller/Coors/Heineken brands are increasingly being sold by the same wholesalers. The large wholesalers are effectively forming two systems which are linked with the beer producers: 10 of the top 20 beer wholesalers are AB distributors (7 of these are exclusive); 9 of the top 20 are Miller distributors (8 of these

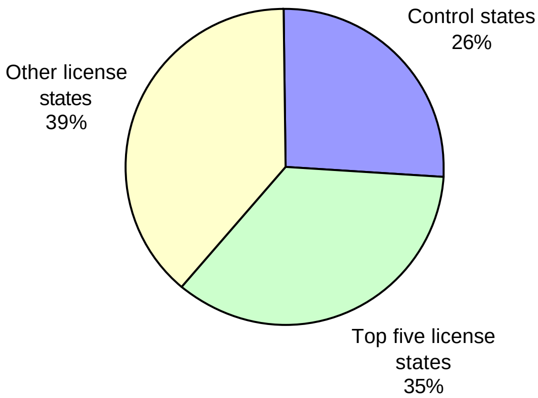
also handle Coors). Only one wholesaler represents AB, Miller and Coors (Source Impact International).

The wine and spirits wholesale structure today

There is a difference between distribution of beer and wines and spirits in the US, For wine and spirits there is a fundamental split between open (or licence) states, which allow the wholesale and retail of alcoholic beverages by third party operators, and control states, where the state governs the distribution and/or retail. For beer all states are classified as open.

For most of the control states the NGG structure may not be fully applicable. However, control states only represent 26% of the US spirits market by volume. The open (licence) states represent almost three quarters of the volume.

Figure 10: **US Spirits—Volume Breakdown**



Source: Adams Liquor Handbook

However, with this difference, there are many similarities with the beer system. As with beer, there has been a consolidation dynamic also amongst wine and spirits wholesalers, with the top 10 now accounting for 51% of total sales (Source: Impact International). However, there are a significant number of smaller operators—the trade association WSWA (The Wine and Spirit Wholesalers Association) has some 500 members, which it estimates account for 90% of the US wholesale market. However, the WSWA acknowledges that this number is falling in most states due to consolidation activity. With the implementation of Diageo's NGG programme, this consolidation activity is likely to accelerate.

In general, wholesalers have tended to sell the brands of several wines and spirits companies. Only in some of the large states, e.g. California, where the number of large wholesalers has been reduced to a small number, has there historically been a formal alignment between brand owners and distributor. We believe that the average wholesaler has been selling 5,000 SKU's, which makes it difficult for the supplier to gain a consistent wholesaler focus on his products. Wholesalers are susceptible to being influenced heavily for a period of time by one-off promotional activity on a brand. There are several industry examples of brands achieving phenomenal performance due to wholesaler push during a promotion, which does not translate into sustainable long-term success.

This is an unsatisfactory industry environment for a company like Diageo, which is interesting in gaining sustained wholesaler interest in helping develop its brands for the long-term.

The table below sets out the historical size position for US wholesaler. However, with the realignment of brand owners and wholesalers across the whole industry, which NGG has engendered, this league table has become extremely fluid.

Figure 11: Leading Wholesalers in US Wines and Spirits

US$ in millions, unless otherwise stated

Wholesaler	Markets	Sales	Market share (%) *
Southern Wine & Spirits of America	California, Florida, Nevada, South Carolina, Kentucky, New Mexico, Arizona, Hawaii	3,440	13.9
Sunbelt Beverage Corp/Charmer Industries Inc	New York, Florida, Maryland, South Carolina, Colorado, Connecticut, Washington DC, Alaska, Washington, Arizona	1,700	6.9
National Distributing Co. Inc	Florida, Georgia, Colorado, New Mexico, Virginia, Washington DC, Maryland, South Carolina	1,630	6.6
Glazer's Wholesale Distributors	Texas, Missouri, Louisiana, Arizona, Indiana, Arkansas, Ohio, Iowa	1,350	5.5
Young's Market Co.	California, Hawaii, Alaska, Washington	1,310	5.3
Total Top 5		**9,430**	**38.2**
Wirtz Corp	Illinois, Nevada, Minnesota, Wisconsin, Texas	755	3.1
Peerless Importers Inc	New York, Connecticut	690	2.8
Johnson Brothers Wholesale Liquor Co	Minnesota, Indiana, S Dakota, Wisconsin, N Dakota, Hawaii, Rhode Island, Massachusetts, N Carolina, Alabama, Florida	600	2.4
Republic Beverages	Texas	570	2.3
National Wine & Spirits Corp	Illinois, Indiana	545	2.2
Total Top 10		**12,590**	**51.0**
Magnolia Marketing Co	Louisiana, Arizona, Florida	460	1.9
Romano Brothers Beverages	Illinois, Indiana	435	1.8
Horizon Beverage Co	Massachusetts, Rhode Island	330	1.3
Eber Brothers Wine & Liquor	New York	315	1.3
Fedway Associates Inc.	New Jersey	310	1.3
Total Top 15		**14,440**	**58.5**
Allied Beverage Group LLC	New Jersey	295	1.2
United Distributors Inc	Georgia	240	1.0
United Liquors Ltd	Massachusetts, North Carolina, Virginia	235	1.0
Wine Warehouse	California	230	0.9
Empire Distributors Inc	Georgia, North Carolina	220	0.9
Total Top 20		**15,660**	**63.4**
Gallo Wine Distributors Inc	New York	215	0.9
Block Distributors Inc	Texas	210	0.9
Georgia Crown Distributing Co. Inc.	Georgia, Alabama	205	0.8
R & R Marketing LLC	New Jersey	195	0.8
General-Standard/Major Brands Inc	Missouri	190	0.8
Total Top 25		**16,675**	**67.5**
Other Wholesalers		8,020	32.5
Total US Market*		**24,695**	**100.0**

** Addition of columns may not agree due to rounding*

Source: Impact

Is Diageo big enough to change the distribution template?

We estimate that Diageo's wholly owned distribution operation in the US accounts for c.19% of the market by volumes. However, in value terms we estimate that this is over 25%. This includes the newly acquired brands from Seagram but excludes the Malibu brand which the company is obliged to sell by the US regulator as the price of completing the Seagram acquisition.

In addition, Diageo has a 50/50 joint venture distribution vehicle Schieffelin & Somerset with Moet Hennessy, which distributes Diageo brands such as Johnnie Walker and Tanqueray gin, as well as Hennessy cognac and Moet et Chandon champagne. Including this vehicle would lift the volume share to an estimated 25% and the value share to c.35%.

This strong market position is visible across all of the top 20 open states within the USA, which account for c.70% of the total volume of the US market. On average the Diageo wholly owned distribution operation has an average of 6 out of the top 20 brands in each state, with a range of a low of 4 in Michigan to a high of 7 in Maryland. Including the Schieffelin & Somerset business moves the average up to 7, with a range of between 5 and 10.

The likely competitive reaction

In the US beer industry there was a competitive response to Anheuser's move towards exclusive wholesaling. The no.2 operator Miller Brewing, no.3 Coors and Heineken have sought to combine their sales in the same wholesalers in recent years (referred to as the shared house system); however, it took several years after Anheuser changed its distribution template for this to occur. However, the rival system remains inferior both in terms of overall size and in quality of impact in the market-place.

We believe that the competitive reaction will come quicker in the spirits industry as Diageo's competitors can see the enormous impact that Anheuser's move had on its competitive position in the US beer industry. There has already been one reaction, with Bacardi and Brown Forman forming the Gemini alliance, with the aiming of amalgamating their sales into control states initially. However, they have now consolidated distribution in 3 open states – Texas, California and Louisiana.. In most markets outside the US Jim Beam Brands works through a distribution joint venture with Remy Cointreau, Highland Distillers and Vin & Sprit (owning Absolut vodka) and it could look to expand its market share in the USA by expanding the Maxxium arrangements to the USA where it already distributes Absolut. However, this would only add a point or so of share to its existing 13% by volume, 12% by value share.

Whatever happens, we remain convinced that Diageo will benefit from first mover advantage in establishing the best dedicated salesforces in the industry in their wholesalers and no other likely combination will be powerful enough to match the strength of the Diageo network.

FY2003 results review

Diageo full year results were slightly ahead of market expectations with EPS at 49.0p versus a consensus of 48.6p. Full year organic net sales growth was 4% as widely anticipated by the market while organic profit growth came in at 7% slightly ahead of our 6% underlying profit growth forecast. At a net profit level there was no currency impact but exchange did reduce premium drinks profits by £38m in the period.

We are retaining our EPS estimates of 49.9p in FY2004E and 54.8p in FY2005E. Our P&L forecasts profit by geographic area and profit / revenue forecasts by geographic area are shown in Figure 14.

On key shareholder value measures the group is likely to continue to show improvement.

Return on capital

Return on capital increased by 0.8 percentage points in FY 2003E (12.0% to 12.8%) at a group level while the premium drinks business delivered a return of 15% (down 50 basis points from FY 2003) as a result of the impact of the Seagram acquisition. The restructuring at Diageo (sale of General Mills interests and integration of the Seagram acquisition) continues to point to promise an improvement in returns on capital at the group to the 16% to 17%

Cashflow

Capex and investment in working capital are likely to reduce next year. Capital expenditure this year (£426m) should reduce to £285m on our estimates as the group turns to more normative levels of investment after a year of heavy investment in infrastructure (next Generation growth linked),

The group also reiterated its strategic intention to dispose of its General Mills stake.

Diageo currently holds 79 million shares in General Mills. 50 million of these shares can be sold any time post November of this year, 29 million of the shares are to be held by Diageo until June 2005 when General Mills has a call option to buy the shares for cancellation. Per se, this is not likely to preclude Diageo from selling the full stake and passing the call option on to a would be purchaser. The group did not comment on the timing of any potential disposal but gave guidance on the net profit impact of selling the whole stake.

Figure 11 below shows that the group will lose a net £135 million of net income on the back of selling 50 million of the shares it owns while retaining the 29 million shares from which it will receive a dividend (c.£15 million). If the group sells the whole stake (79 million shares) then the net profit impact is likely to be around £150 million on our estimates.

The impact of a partial and full disposal option on EPS are included in Figure 11. Assuming that all proceeds from a sale were used to buy back shares, a partial disposal would dilute 2004E earnings by 2.5% while the full disposal option would be mildly accretive to 2004E earnings

Figure 12: General Mills disposal—P&L impact FY2004E

£ in millions, unless otherwise stated

	Partial disposal 50m shares	Full disposal 79m shares
PBT impact	(200)	(200)
PAT impact	(150)	(150)
Dividends retained pre tax	20	0
Dividends retained post tax	15	0
Net impact on net earnings	**(135)**	**(150)**
Disposal price (US$ per share)	45	45
Disposal value	1,406	2,222
Interest cost reduction after tax	0	0
Net impact	(135)	(150)
Net impact on 2004 earnings	-8.9%	-9.8%
Implied earnings	1,391	1,376
Buyback potential at 700p (m shares)	201	317
Implied number of shares	2,854	2,738
Implied EPS	48.73	50.26
Current EPS	49.9	49.9
Dilution / accretion	**-2.4%**	**0.6%**

Source: Company data, CSFB estimates.

CSFB forecasts

Figure 13: Profit and loss account
£ in millions, unless otherwise stated

	H1	H2	2001	H1	H2	2002	H1	H2	2003	2004E	2005E	2006E
Turnover												
Beverages	4,064	3,516	7,580	4,458	4,245	8,703	4,949	4,012	8,961	9,343	9,735	10,114
Food	2,259	1,940	4,199	1,455	0	1,455	0	0	0	0	0	0
Fastfood	519	522	1,041	565	558	1,123	479	0	479	0	0	0
Total sales	**6,842**	**5,978**	**12,820**	**6,478**	**4,804**	**11,282**	**5,428**	**4,012**	**9,440**	**9,343**	**9,735**	**10,114**
Trading profit												
Core Beverages	694	429	1,123	819	598	1,415	1,023	565	1,588	1,674	1,779	1,901
Cost savings	140	169	309	148	203	351	165	223	388	425	471	471
Additional pension charge										(103)	(103)	(103)
Total beverages	834	598	1,432	967	801	1,766	1,188	788	1,976	1,996	2,147	2,269
Food	302	216	518	190	(190)	0	0	0	0	0	0	0
Fastfood	99	78	177	79	81	160	55	0	53	0	0	0
Discontinued	0	0	0	0	0	180	0	0	0	0	0	0
Total trading profit	**1,235**	**892**	**2,127**	**1,236**	**692**	**2,106**	**1,243**	**788**	**2,029**	**1,996**	**2,147**	**2,269**
Moet Hennessy	116	34	150	95	55	150	105	76	181	190	199	210
General Mills	0			46	97	143	155	132	287	299	305	344
Other	23	30	53	21	10	31	6	4	10	15	15	15
Total associates	139	64	203	162	162	324	266	212	478	504	519	569
Group EBIT	**1,374**	**956**	**2,330**	**1,398**	**854**	**2,430**	**1,509**	**1,000**	**2,507**	**2,500**	**2,666**	**2,838**
Group interest	(185)	(165)	(350)	(156)	(183)	(339)	(171)	(108)	(279)	(269)	(282)	(298)
General Mills interest	0	0	0	(14)	(46)	(60)	(43)	(33)	(76)	(73)	(68)	(62)
PBET	**1,189**	**791**	**1,980**	**1,228**	**625**	**2,031**	**1,295**	**859**	**2,152**	**2,157**	**2,315**	**2,479**
Restructuring	0	(170)	(219)	(78)	(416)	(494)	(107)	(82)	(189)	(93)	(26)	0
Other exceptionals	0	0	0	125	674	799	(1,396)	83	(1,313)	0	0	0
PBT	1,189	621	1,761	1,275	883	2,336	(208)	860	650	2,064	2,289	2,479
Total tax	(297)	(158)	(455)	(423)	(209)	(632)	(206)	(281)	(487)	(514)	(583)	(644)
Effective tax rate (%)	25	20	23	25	33	25	25	25	25	25	26	26
Profit after taxation	0	0	0	0	0	1,520	971	642	1,613	1,618	1,725	1,834
Minorities	(42)	(38)	(80)	(42)	(45)	(87)	(45)	(46)	(91)	(92)	(95)	(100)
Net earnings	850	425	1,226	810	629	1,433	926	596	1,522	1,526	1,630	1,734
Earnings post exceptionals	0	0	0	0	0	1,617	(459)	531	72	1,458	1,611	1,734
Basic EPS (p)	25.1	11.2	36.3	24.1	24.6	48.8	(14.6)	16.9	2.3	47.7	54.2	59.8
Adjusted EPS (p)	**25.1**	**17.6**	**42.8**	**26.2**	**17.0**	**43.2**	**29.5**	**19.4**	**48.9**	**49.9**	**54.8**	**59.8**
No of shares (m)			3,377			3,316			3,113	3,055	2,975	2,900
Net Dividend (p)	8.9	13.4	22.3	9.3	14.5	23.8	9.9	15.7	25.6	27.4	29.3	31.4

Source: Company data, CSFB estimates.

Figure 14: Geographical segmentation

£ in millions, unless otherwise stated

	2000	2001	2002	2003	2004E	2005E	2006E
Turnover							
North America	1,717	2,092	2,669	2,795	3,000	3,180	3,371
Chg		21.8%	27.6%	4.7%	7.3%	6.0%	6.0%
Great Britain	1,218	1,304	1,467	1,429	1,515	1,606	1,686
Chg		0.1	0.1	(0.0)	0.1	0.1	0.1
Ireland	927	942	937	953	939	939	939
Chg		1.6%	-0.5%	1.7%	-1.5%	0.0%	0.0%
Spain	494	335	380	424	462	490	514
Chg		-32.2%	13.4%	11.6%	9.0%	6.0%	5.0%
Major markets	**4,356**	**4,673**	**5,453**	**5,601**	**5,916**	**6,214**	**6,510**
		7.3%	16.7%	2.7%	5.6%	5.0%	4.8%
Key Markets	1,615	1,807	2,078	2,129	2,172	2,215	2,259
Chg		11.9%	15.0%	-5.0%	2.0%	2.0%	2.0%
Venture Markets	1,146	1,100	1,173	1,231	1,256	1,306	1,345
Chg		-4.0%	6.6%	-5.0%	2.0%	4.0%	3.0%
Total	**7,117**	**7,580**	**8,704**	**8,961**	**9,343**	**9,735**	**10,114**
		6.5%	14.8%	2.9%	4.3%	4.2%	3.9%
Operating profit							
North America	317	363	550	729	811	880	933
Chg		14.5%	51.5%	32.5%	11.2%	8.5%	6.0%
Great Britain	150	162	204	219	232	246	261
Chg		8.0%	25.9%	7.4%	6.0%	6.0%	6.0%
Ireland	135	156	152	141	128	137	140
Chg		15.6%	-2.6%	-7.2%	-9.0%	6.9%	2.0%
Spain	96	85	94	99	113	136	152
Chg		-11.5%	10.0%	5.9%	14.1%	20.6%	11.3%
Major markets	**698**	**766**	**1,000**	**1,188**	**1,284**	**1,400**	**1,485**
		9.8%	30.5%	18.8%	8.1%	9.0%	6.1%
Key Markets	392	447	524	522	532	554	576
Chg		14.0%	17.2%	1.0%	2.0%	4.0%	4.0%
Venture Markets	196	219	244	266	282	296	311
Chg		11.7%	11.2%	7.0%	6.0%	5.0%	5.0%
Total	**1,286**	**1,433**	**1,768**	**1,977**	**2,099**	**2,250**	**2,372**
		11.4%	23.4%	11.8%	6.2%	7.2%	5.4%

Source: Company data, CSFB estimates.

Figure 15: Cash flow statement
£ in millions, unless otherwise stated

	2000	2001	2002	2003	2004E	2005E	2006E
Operating profit (incl assocs)	1,980	2,127	2,106	2,029	1,996	2,147	2,147
Depreciation	365	403	314	276	260	270	280
Working Capital	(62)	(54)	(125)	(227)	(110)	(115)	(120)
Provisions Utilised	(198)	(144)	(148)	(185)	(163)	(25)	0
Other Items	(42)	(56)	(139)	77	5	0	0
Operating Cash Flow	**2,043**	**2,276**	**2,008**	**1,970**	**1,987**	**2,277**	**2,307**
Interest	(432)	(446)	(360)	(327)	(342)	(350)	(359)
Dividends Received	64	101	87	60	64	69	74
Ordinary Dividends Paid	(683)	(725)	(758)	(767)	(813)	(862)	(914)
Dividends Paid to Minorities	(16)	(31)	(40)	(28)	(32)	(36)	(40)
Taxation	(285)	(230)	(311)	(105)	(250)	(485)	(531)
Capital Expends	(547)	(439)	(520)	(341)	(285)	(300)	(310)
Trading Cash Flow	**144**	**506**	**34**	**377**	**329**	**312**	**226**
Acquisitions	(151)	(105)	(3,592)	(137)	0	0	0
Disposals	697	43	5,100	970	0	0	0
Shares Issued/(Buy -backs)	80	(54)	(1,784)	(848)	(600)	(600)	(600)
Currency effects	(286)	(424)	162	118	0	0	0
Net Debt Change	**484**	**(34)**	**(80)**	**480**	**(271)**	**(288)**	**(374)**
Net (Debt)/Cash	**(5,719)**	**(5,753)**	**(5,833)**	**(5,353)**	**(5,624)**	**(5,912)**	**(6,286)**

Source: Company data, CSFB estimates.

Appendix 1: Response to questionnaire for US wholesalers

For wholesalers which have signed up with Diageo under the Next Generation Growth programme.

Q: What are the key positive factors from NGG that will benefit your business? Also what do you consider as the largest negative issue?

Biggest benefit is strategic. Long term alignment with the key global supplier in the industry. Also, to an extent, a zero sum game: if I am aligned then my key competitors in my markets are not. Substantial increase in volume.

Biggest negative is the cost. The yearly price tag is steep: cost of dedicated sales force; yearly cost of “rebate”/franchise fee. Very sceptical about Diageo’s ability to follow up on all of the public language. Believes fees will go first to help manage Diageo’s earnings before filtering down to improving brand development.

Biggest Benefits:

(1) Significant incremental volume in key categories;

(2) Subscribe to vision that Diageo will grow portfolio faster than the industry;

(3) Diageo will be a key acquirer in wine (especially with depressed wine values: good wine portfolios may now be available).
Biggest Negative:

Bad short-term economics for wholesalers. While there is a lot of confusion over what the deal actually was; a big question, still unanswered, is whether Diageo will follow through with all of the marketing and operational statements they have made regarding “partnering” with their wholesalers. Signs that raise this question include excluding wholesalers from the development of the selection process (Budweiser, for example, has explicit structures in place to solicit input from and include their distributors in key decisions).

Biggest benefits are the dedicated sales force, new sales tools and the Diageo portal. Tools provide a big increase to quality selling time.

Biggest negative issues are related to transition. These have been internal competition – political and fiefdom issues. There is also some unhealthy rivalry with the rest of the organization representing non-Diageo brands.

Diageo has raised the “price to play poker” with significant increases in brand spending. However, they are aggressively squeezing distributor margins.

“0 positives, and people are being squeezed.”

Biggest benefit is the massive increase in brand spending. Biggest negative is the split sales and merchandising forces are really irritating retailers.

Q: Would you be willing to give some details on the new contract signed with Diageo?

Length of contract, plus any renewal clauses

7 years evergreen. This is good – first time in the industry.

5 year with evergreen provision (renew automatically based on performance).

5 years.

Provision of resources (sales training, IT systems)

Mentioned but not specific.

Monthly training has been very helpful.

Required fixed investment and commitment of people.

Commitment to minimum volumes

No explicit commitment. Yearly negotiated targets instead.

Targets are negotiated annually.

Changes in the way POS activity is handled.

Not in contract. Do have a local person who helps with POS but overall POS management is bad.

Key open item.

Closer tracking was promised, but it was all talk.

Q: Provision of separate sales force (what is timing?)

Yes, but they are pragmatic. In areas where there is insufficient customer density to support dedicated sales people the wholesaler can use a shared sales force. This mostly impacts the on-premise customers in rural areas. Dedicated sales company is already established.

Yes but nothing is written in stone: "Diageo has been nothing but pragmatic in resolving operating issues" – for example covering rural areas.

24 months to reach 100%, negotiated scale-up benchmarks and timing, i.e. 60%, 80% coverage.

Does it include Schieffelin & Somerset brands?

Yes.

Yes.

Yes and Chateau and Estates.

No.

Yes.

Q: What do you forecast for volume growth for the Diageo portfolio over the next 3 years? How does this compare for your volume forecasts for non-Diageo brands?

Expect Diageo brands to grow in line with the industry over the short term (again, lack of $ applied to marketing and lack of assistance to wholesaler in the near term will drive this). Over the longer term Diageo may outpace the industry because of share gains. Industry expected to grow 3% - 5% in dollars, 1% - 3% in cases.

No hard figures, but intuition suggests that increasing advertising and promotions expense; a dedicated sales force; and the premium brands should allow growth faster than the industry. Most of growth driven by share gains of perhaps 1% per year.

Diageo brands will outpace the industry.

3% - same as the rest of the industry.

Diageo has the healthiest brands to begin with. They are starting so far ahead of the competition, but it will depend on how they spend and manage distributors.

Q: What do you forecast for margin expansion for the Diageo portfolio over the next 3 years? How does this compare with margins for non-Diageo brands?

Wholesaler margins will not grow in the near term. Although Diageo's business creates significant incremental case and $ volume, total $ margin (net) will be the same as last year. The reason is the huge up front costs (rebate, sales force, systems upgrades). Quote: "Margin increase? I just got kicked in the head!"

Quote: They are taking "dollars out [of wholesalers], so we cannot improve on the ground marketing and sales".

Over the longer term (2 – 3 years) expect efficiencies from new systems and additional volumes to kick in. Total net margin expansion may be 1% + (approximately 10% – 15% increase from current margins).

Less change in margins for non-Diageo portfolio (although will get some spill over efficiency benefits from new systems).

Current margins no worse than the rest of the industry. Do expect longer term margin growth (both $ and %) based on premium portfolio, more effective programs, and the sales training Diageo will be providing.

Note – we also asked this question of the non-Diageo wholesalers.

Answers follow:

Cannot imagine Diageo wholesalers' margins increasing given the size of the rebate and costs of the dedicated sales force. There is not as much inefficiency in the wholesaler tier as Diageo expects.

For example: Many costs (warehousing, security) are fixed; Inventory carrying costs are very low given low interest rates so increasing turns will have little benefit (in addition, the respondent believes Diageo is still requiring the same number of days inventory on the floor); # of trucks is driven by # of accounts – which does not change – and not number of SKUs, so focusing on fewer, better SKUs will not help with delivery expenses.

Believes wholesaler margins will erode because of extra costs. Promised savings will not accrue, as many believe. For example there will be no inventory savings in the near term as Diageo is still loading their wholesalers to make numbers. "All suppliers have learned how to get more money out of wholesalers". Diageo is reducing price/discount support yet wholesalers must still discount to counter the soft market. Diageo wholesalers are not seeing the margins Diageo told them they would see during the RFP process.

Diageo is having to soften and cooperate.

Neutral to down.

Diageo will be able to take selective price increases.

Q: Do you expect Diageo itself to see a significant margin increase as a result of NGG?

Yes. They have new franchise fees, they have done layoffs in conjunction with this effort – they are making the wholesalers do all the work so they can get efficiencies.

Yes. Diageo has been effectively extracting more margin for themselves.

Gross margin will increase but net will remain the same because of brand spending.

Some of Diageo management is listening to distributor complaints. They will have to throw distributors some bone like Anheuser Busch does.

Q: Have you experienced any negative reaction from your retail customers?

Diageo has stated they will focus on chain sales. We have been hearing nervous comments from independent customers. They are worried they will face increased prices that they will not be able to pass on to their customers.

There was some concern early but that has dissipated.

Note – we also asked this question of the non-Diageo wholesalers. Answers follow:

Retailers have shown apathy to the changes. However, if Diageo forces their wholesalers to make their goals then retailers will increase their ordering on deal for the Diageo brands. Has heard that Diageo's public and corporate statements about partnerships and brand building have not affected local operations, where they are pushing their wholesalers to make their numbers.

All retailers except large chains are nervous. Worried that Diageo will reduce support for independent retailer programs, focusing only on the chains – "Retailers are worried that Chuck Phillips' comments about the industry from a few years ago will happen with the Diageo changes".

Retailers revolted, especially on-premise. There was no desire to see additional sales reps, but the sales force worked hard to prove it and win over holdouts.

No.

Multiple sales and merchandising forces is making them angry.

Q: Do the Diageo brands give your sales force a complete portfolio? Will Ciroc fill the gap in premium vodka?

Ciroc "will never be Grey Goose or Ketel One". It will not fill the premium vodka gap. "If Ciroc is the reason to buy Diageo [stock] then I am a short seller right now".

Somewhat sceptical on Ciroc. There is no certainty around any new brand. Otherwise the portfolio, as mentioned above, is strong.

No, Diageo needs a bourbon. Ciroc has been a surprising success. It has a sellable point of difference with bartenders in being the only Vodka made from grapes.

No – can't see Ciroc becoming a very big deal.

They seem to be replicating what Seagram did in the 80s. They have the dominant brand in every category with a 30 to 40% market share. Ciroc is doing very well.

Q: Which 3 Diageo brands are you most optimistic about? Which 3 are you most pessimistic about?

Optimistic: Smirnoff because of the category; Captain Morgan because of the brand; Crown Royal because of the product/brand.

Pessimistic: VO, Seagram 7, Johnny Walker Red because of brand/product. All fine wines because of category.

Optimistic: Crown Royal (product and brand); Baileys (brand); Cuervo (category and brand).

Pessimistic: Gordons Gin and Vodka (weak brands within category); all wines – a salesperson "cannot survive on Diageo's wine portfolio". They will need others.

Optimistic: Smirnoff because of the package changes and flavour introductions, Captain Morgan and Crown Royal are also strong brands.

Pessimistic: all the RTD brands.

Optimistic: Cuervo. Pessimistic: 2nd tier/RTD brands.

Optimistic: Smirnoff, Crown and Captain Morgan or Cuervo.

Q: Does your agreement with Diageo include any ready-to-drink or beer products? Do you envisage that these may be included on a three year view?

No. Cannot legally carry beer (state law) and would not want to.

No. However, Diageo should consider consolidating distribution for beer and malt-based beverages with their wine and spirits wholesalers. There are good opportunities for cross promotions, especially in the off-trade. For example promotions and displays with Smirnoff and Smirnoff Ice.

Yes, but these brands don't fit with the wine and spirits portfolio for the most part and should be kept with beer wholesalers.

Yes.

No.

For wholesalers that have not signed up with Diageo under NGG

Q: If you have not signed up with Diageo under NGG, what was the key factor which influenced your decision? What would make you reconsider this decision at a later date?

a) Not willing to give "huge" rebates.

b) Not willing to give up control of how they run their business.

Diageo deal not worth it due to size of required rebates. Theory: the biggest wholesalers went after the Diageo business despite the onerous terms because they knew they could "renegotiate" terms after the contract was signed. Many other wholesalers agreed to the deal for purely defensive reasons – they did not buy in to the rhetoric.

Happier not to have it. Don't need it. Want to run the business without taking orders.

Q: Which are your main suppliers today? (Give percentages) how might this be influenced by future distribution links between brand owners?

1) Brown Forman

2) Bacardi

3) Pernod. (Did not give %) No other players can pull off similar strategy. Some wholesalers are getting and will pick up brands from other suppliers who are "scared" of Diageo.

In the wholesaler's biggest market 1) Diageo 33% 2) Future Brands 33% 3) Pernod 8%. None of the much-discussed "alternate network" will actually happen. Look at Gemini – Bacardi and Brown Forman are still fighting over management and control issues. The kind of deal being discussed now is much more complex than Gemini: "All talk". On a smaller scale, consolidation will continue.

Brown Forman is distributor friendly with good management. 2nd tier suppliers are becoming much more important. They focus on building quality brands with distributors over the long-term.

Q: What are the terms of your current contracts with suppliers?

Length of contract, plus renewal terms

No strict requirements. 30 days notice of termination. Good faith clause with opportunity to cure.

7 year (Diageo); 3 year (Beam); year to year with others (30 days notice).

Provision of resources

None specific.

Restrictions on selling other suppliers' brands

Not typically

Q: Do you believe that these contracts will change in the next 12 months?

No major changes.

In general all contracts will become more onerous to the wholesaler over the next few years.

Q: Which 3 brands in your portfolio are you most optimistic about? Which 3 brands are you most pessimistic about? What brand would you like in the portfolio which is not there currently?

Optimistic: Premium Vodkas (category), Bacardi (driven by flavours)

Pessimistic: Fine wines – economy will make people trade down and not return because of the great values they find.

Optimistic: Grey Goose because category still has legs. Crown Royal will benefit from a switch from Bourbon.

Pessimistic: Absolut (brand has peaked – not a super-premium); VO, Chivas.

Optimistic: Jack Daniels and Bacardi.

Optimistic: Jack Daniels, Bacardi, and Grey Goose.

For all wholesalers

Q: How important is wine in your portfolio(% of volumes v % of profits)?
With the current weakening of wine pricing, will wine become less important to your business in the next 3 years?

Diageo: Wine is reasonably important. “The additional scale allows efficiencies and we believe wine can provide incremental profit”.

Non-Diageo: Wine’s are a growing part of the business. Will become more important as prices firm up.

Wines will become a bigger part of the business vs. spirits (currently 20% revenues, 50% of cases, 15% of profits).

Wine is an important but very, very small part of the overall business. Chateau and Estates was completely lost in the transition, and they just reorganized again. Some guy from Chateau and Estates in California communicates prices and goals, “wishes us a nice year”, and we never hear from them again.

High-end wine is very important and will not be less so in 3 years.

Increasingly less important with declining margins.

“Premium varietal wine is dead”

Q: Do you consider the threat of increased state taxes to be more of an issue than in the early 1990’s? How do you rate the chances of a significant increase in your state in 2003?

In 03 no. In the next 5 years yes – for all beverage alcohol categories.

Yes.

2003 no. 2004 <20% chance.

Just had an increase of 10%, and do not expect any more.

Spirits will be a target.

Yes.

Q: Do you expect both volumes and prices in US spirits to hold up well in 2003? Do you expect any trading down?

Industry will “hold up”. Expected to grow 3% - 5% in dollars, 1% - 3% in cases. There will be some trading down.

Minimal growth in volume or price. Some trading down.

No changes in consumption but people are trading/will trade down. Expects Diageo to be a price leader and raise spirits prices over next few years. Other suppliers will follow.

Prices will increase but volume will be flat to down. Reason: suppliers (with Diageo leading the way) have become better at extracting cash from wholesalers, so wholesalers will respond by raising prices.

Consumption is category and brand driven, so there is little to no trading down. Expect increases in volume and some price increases.

Expect some trading down, and the market is still soft.

Premium side is up, especially on-premise. Not much trade-down.

Q: What are your expectations for volume and price in the US wine market in 2003?

Pricing will be flat because of over supply. Volume will be up because of consumer perceived value. "Fine wine is dead" – tough economic times; reduced on-premise T&E have caused a reduction in volume for fine wines. Consumers are trading down, discovering outstanding values in lower priced wines, and will not return to the higher end when economic conditions improve "I challenge people to show me a bad wine at any price point".

Within the segment Australian wine volumes will improve. Gallo and Constellation have the right business model for wine.

No growth in prices. Volume should grow based on better pricing/value to consumer. Fine wines have significant challenges because of economy and the discovery of great values as consumers trade down. Opportunity for Diageo to make good acquisitions in this environment.

Wine prices will come down, volume will go up – better value.

"High end wine is dead" (eerily similar to first quote above). Same reasons; economy is forcing consumers and businesses to trade down where they will find great values and see no reason to return to high end once economy turns around. Other wine will face continued price pressure from over supply. Volume in other than fine wines will increase.

Stable and depressed at low prices – "pretty shitty".

Flat to down.

Wine is weak.

Q: Do you expect any major changes in the 3-tier structure in your state in the next 3 years?

No. Although there will be continued supplier and wholesaler consolidation.

Only change will be an increase in direct wine shipping.

No. NGG markets will be relatively stable. There may be more consolidations at the supplier level and Diageo wholesalers will likely lose those suppliers brands. There will be more direct shipping which is an insignificant but economically odious part of the business for wholesalers anyway.

No.

Direct shipment is a minor issue. Distributors fill a needed logistics and marketing function.

Just a continued financial squeeze on distributors.

Q: Do you envisage any further moves by brand owners to replicate Diageo's exclusive salesdesk template? Is this likely to mirror the shared house structure which Miller and Coors have set up in beer?

Yes. Expect duopoly in key markets.

Nothing imminent, just speculation.

No one big enough to do it alone. Regarding aligning with others: "All talk, no action. If they cannot make Gemini work then they have no shot at executing something more complex".

Absolutely – any supplier that can get mass will replicate this.

Distributors are becoming more technologically savvy and will begin replicating on their own.

Gemini failed, so no.

Non-Diageo suppliers feel like they have seen this all tried and failed at before and are staying with the old way of doing things.

Q: Do you believe that advertising of spirits will be allowed on mainstream network TV during 2003 or in the next 3 years?

Not in 03, yes over next 3 years.

Only cable – not network.

Not in 2003, but soon thereafter. TV advertising drives sales. Smirnoff is ready to drop a ton of dollars into ads. Impact of Bailey's ads even with a price increase was "scary"

Yes within 3 years.

Yes – Diageo is pushing this hard.

Rumour is $40 to 50 million versus Smirnoff – yes.

Further Comments:

It will take them 18 months to get through transition issues. However, they are hiring the right people and have a solid marketing team. If they can get over their past (Chuck Phillips—basically we dislike distributors), continue to work toward partnering, and get out of their own way (stop talking and DO!), they could become very successful. They have the ability to apply the best from the whole world. Not this year but "Christmas season 2004 should be huge!"

If they can iron out their distributor relations, Diageo will be formidable.

Companies Mentioned *(Price as of 04 Sep 03)*
Diageo (DGE.L, p669.00, OUTPERFORM, TP p870.00, UNDERWEIGHT)
Anheuser-Busch Companies, Inc. (BUD, $52.15, OUTPERFORM, TP $60, MARKET WEIGHT)
Adolph Coors Co. (RKY, $56.53, NEUTRAL, TP $56, MARKET WEIGHT)

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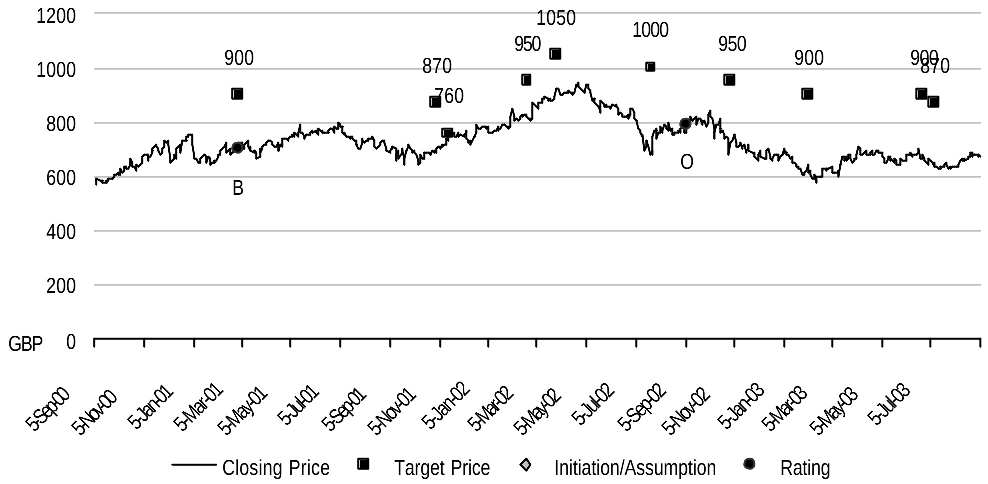
3-Year Price, Target Price and Rating Change History Chart for DGE.L



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Prior to 9-Sep-02: SB=Strong Buy; B=Buy; H=Hold; S=Sell; R=Restricted; NR=Not Rated

DGE.L Date	Closing Price (GBP)	Target Price (GBP)	Rating	Initiation/ Assumption
28-Feb-01	702.5	900	BUY	
01-Nov-01	700	870		
10-Nov-01	715	760		X
22-Feb-02	811	950		
28-Mar-02	918	1050		
25-Jul-02	740	1000		
06-Sep-02	792		OUTPERFORM	
30-Oct-02	718	950		
04-Feb-03	616	900		
24-Jun-03	662.5	900		
10-Jul-03	636	870		

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Price Target: (12 months) for (DGE.L)
Method: Discounted cash flow
Risks: RTD slowdown, execution of Next Generation Growth strategy in the US

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