

Equities

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European Beverages — Spirits Initiation

We Believe In Spirits*

- **Spirits are likely to see more growth in emerging markets, for longer** — We see a much larger opportunity for spirits than for most food, beer or tobacco categories. Per capita consumption of premium spirits is currently very small in emerging markets but the vast consumption of local spirits, notably in China and India, shows EM consumers have a taste for them. Historically premium spirits in emerging markets have grown at 1½-4½x the rate of GDP.
- **And the growth is at good margins** — Premium spirits are effectively luxuries in emerging markets. This means (1) the industry can and does raise prices at or above inflation, and (2) the growth is accretive to mix as prices are at least as high as in the EU and US. It helps that there is little competition in premium spirits as EMs are dominated by just two players (Diageo and Pernod), unlike in most categories in food and HPC.
- **And the US may improve further** — We aren't factoring much in for the US but management comments and the latest Nielsen data give grounds for optimism. We think a further improvement in the US would be a material catalyst especially for Diageo (US c.35% of profit) but also for Pernod (US c.21% of profit).
- **Accelerating EBIT growth** — Even if the US and Western Europe don't improve, we think the sector's organic EBIT growth can accelerate from 2-4% in FY10 to 6-7% this year and on to 8-9% in FY12, driven by emerging markets. As the market sees this we would expect modest increases in the P/E multiples.
- **High cash flow means EPS should grow about 3-4% faster than EBIT** — The spirits companies are highly cash generative, with FCF yields (CY11E) of 6.1% (Diageo) and 6.5% (Pernod). Overall we expect 11% EPS CAGR 10-15E for Diageo (it would be 13% if the US returned to trend growth) and 13% for Pernod.
- **Pernod is the better emerging markets play** — Pernod has the largest combined exposure to China and India of any European large cap staples stock; these markets are providing about 40% of its growth. We also expect to see accelerating growth in its other emerging markets helped by an increased focus on Chivas and Absolut. Buy/Medium Risk (1M); target price €85.
- **Diageo would gain most from further US recovery** — Diageo is the most defensive way to play emerging markets in the beverages sector as no EM country contributes more than 3-4% of EBIT. It is also the best play on the US (about 35% of profit). With net debt/EBITDA heading below 2x, there has also been some market speculation about potential acquisitions. Buy/Low Risk (1L); target 1430p.

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Ticker	Company	Rating	Target Price	Current Year Earnings Estimates	Next Year Earnings Estimates
DGE.L	Diageo	1L	£14.30	p80.1	p87.8
PERP.PA	Pernod-Ricard	1M	€85.00	€4.23	€4.72

*Correction: The target price for Pernod-Ricard in the table above was not correct in the original note.

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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This note is part of initiation of entire
large cap beverages sector

This page is designed to help investors
navigate what is a rather long report

We try to add to the investment debate

Executive Summary

This is part of a set of six reports initiating on large-cap beverages. We are simultaneously publishing separate reports on each of the four brewers – AB-InBev, Carlsberg, Heineken, and SABMiller – as well as a fifth report that looks at the beer sector as a whole. This note provides an overview of what we regard as the most important and the most overlooked investment issues for the spirits sector, as well as initiating on Diageo and Pernod-Ricard.

This report is divided into 6 sections:

1. **Investment Summary** (Pages 4-20) – Summarises the investment case on the sector and companies, including valuation and risks.
2. **Spirits in emerging markets.** (Pages 20-43). We argue the opportunity for spirits markets in emerging economies is better than in most consumer sectors. To demonstrate this we show that:
 - Consumption of spirits in emerging markets is very large, but
 - The penetration of international spirits is very low, and
 - International spirits volumes were growing well into double digits before the recession
 - International spirits volumes have outperformed GDP by 1.5-4.5x historically
 - International spirits outperform beer in volume terms in emerging markets
 - Diageo and Pernod are expanding margins as well as growing volumes in EMs

In this section we also put emerging markets into context for Diageo and Pernod, comparing them to other staples and each other.
3. **The US market** (Pages 44-48). We discuss the possibility of the US surprising on the upside.
4. **Diageo.** We give a separate investment and financial summaries. Also detail Diageo's emerging and US businesses and strategies.
5. **Pernod.** Separate investment and financial summaries. Describe Chinese and Indian businesses, and the implications of it is large portfolio of local brands.
6. **Appendices** from page 100 onwards. Deep dives into the spirits markets in Brazil, China and India, which we think are particularly interesting, and the outlook for vodka.

What this report adds

This report is not supposed to be an all-encompassing reference document on spirits. (For example we barely discuss the outlook in Europe). However we do try to advance the investment debate on the stocks, particularly around the emerging market opportunity, and also point out some positive signs in the US.

Investment Summary

We believe in spirits

There's more to spirits than meets the eye

We initiate coverage of the spirits sector with a Buy rating on both Diageo and Pernod-Ricard, preferring these names to most beer and tobacco stocks. Our positive sector stance is driven by:

- **The emerging market opportunity:** The most important reason for our enthusiasm is that we believe the upside for spirits in emerging markets, in terms of (a) scale, (b) duration, or (c) profitability, is not yet fully valued.
- **The US may improve further this year:** More immediately the recovery in the US spirits industry may gather pace, and if it does it will help both stocks, but particularly Diageo.
- **The accelerating EBIT:** Even if the US business doesn't improve and Western Europe remains anaemic, we expect to see an acceleration in overall operating profit growth from 2-4% in FY10 to 6-7% growth this year and on to 7-8½% in FY12 as the proportion of the business from emerging markets increases.
- **Cash flow:** Spirits companies are more cash generative than most other companies. As a result of their deleveraging, their EPS grows at about 3-4 percentage points faster than their EBIT, according to our figures.

Overall we are forecasting EPS growth of 11% CAGR FY10-15E for Diageo and 13% for Pernod, plus about a 3.6% and 2.3% dividend yield respectively.

Figure 1. Large Cap Beverage Names – Recommendation Summary

	Latest Price ¹	CIRA Rating	Price Target	Price Upside	FY11E Dividend	Expected Total Return
1 Heineken	€36.80	Buy/ Medium Risk	€46	25%	€0.92	28%
2 Pernod-Ricard	€69.90	Buy/ Medium Risk	€85	22%	€1.45	24%
3 Diageo	1197p	Buy/ Low Risk	1430p	19%	41p	23%
4 SABMiller	2263p	Buy/ Medium Risk	2700p	19%	51p	22%
5 ABInBev	€43.00	Buy/ Medium Risk	€51	19%	€0.69	20%
6 Carlsberg	DKK 571	Hold/ High Risk	DKK 640	12%	DKK 10	14%

¹ Close on 4 Jan 2011.

Source: Reuters and Citi Investment Research and Analysis

We prefer Pernod medium term

Pernod is more a play on Asia; Diageo is more a play on the US in the short term

We prefer Pernod to Diageo on a one-year and longer view because we believe it is better placed in emerging markets. We think Pernod's profit in China and India (15% of sales and profits combined) will continue to grow fast. We also expect to see accelerating growth in its other emerging markets, helped by increased focus on Chivas and Absolut.

Short term, however, we think Diageo might do better, partly because Pernod rose 12% in December, and Diageo only 2%¹, but also because Diageo would benefit more if trading improves in the US.

¹ The stocks have historically been fairly well correlated (Figure 15).

We prefer spirits to beer

We prefer spirits companies to most beer and tobacco stocks currently. We think the risk on earnings in spirits is to the upside (from the US), but to the downside on beer, due to increasing input costs.

Price targets assume some multiple expansion

We expect that Diageo and Pernod will both rerate by around 1½ P/E points this year, moving some way towards pre-crisis peak multiples, as the market sees further evidence of their success in emerging markets. For Pernod we are assuming the forward multiple moves from 15.6x to 17x (vs ~18.5x pre-crisis) and for Diageo we are assuming a roughly similar increase, from 14.2x to 15.5x (vs ~17.5x).

Western spirits are likely to see more growth in emerging markets, for longer

We believe spirits companies can grow their volumes in emerging markets more, and for longer, than most companies in the food, beer or tobacco sectors, and as we discuss in the next section, they can do so at high margins too.

More growth

Western premium spirits have returned to strong growth in emerging markets². We argue that at least high single digit volume growth is sustainable in the very long term for three reasons:

1. **Per capita consumption of Western spirits is much lower in EMs than in developed markets** (unlike in beer or tobacco). In China per capita consumption is less than 0.03 litres/head, one twentieth of the level of Taiwan. In India it's even lower. (See Figure 3.)
2. However, **consumers already have a taste for the category** as the volume of local, non-premium spirits is very large (unlike in HPC or western types of food). The Chinese, Russian and Indian spirit markets are all larger than the US in volume terms. China is four times the size of the US. This means Diageo and Pernod do not have to build the market, unlike some other consumer staples companies.
3. **Economic development means** more and more consumers in the position to afford international spirits. International spirits volumes have grown in the past at 1.5x to 4.5x the rate of GDP growth, as we show on page 28.

We expect both Pernod and Diageo to benefit as the emerging market story unfolds, but we expect Pernod to be the main beneficiary because of its unmatched exposure to China (currently about 10% of sales) and India (about 5%)

We see a bigger opportunity for spirits than for most other consumer staples sectors

EM volumes were growing double digit before the crisis

Figure 2. International Spirits in Emerging Markets – Total Volume Growth, by Year [PS can you move up?]

	2004	2005	2006	2007	2008	2009
Top 12 Markets	10%	16%	11%	16%	4%	-5%
Top 12, ex Taiwan and Korea	16%	18%	12%	18%	5%	-5%
BRICs+Mexico	22%	25%	17%	23%	8%	-6%

Source: Citi Investment Research and Analysis, IWSR

² Throughout the report we define "Western" of "International" premium spirits as Imports plus international brands produced locally (Smirnoff in Brazil, as an example). We strip out imports of low end spirits (like CIS vodkas and brandies for Russia). In Russia we include premium local vodkas because Pernod and Diageo compete in the same space. Finally we don't consider Ready-to-Drink volumes.

In this report we consider mainly 12 key emerging markets. In these markets international premium spirits volumes were growing at 14% compound 2003-07. (The key 12 are Brazil, China, Colombia, India, Mexico, Poland, Russia, S Africa, S Korea, Taiwan, Thailand and Vietnam.)

For longer

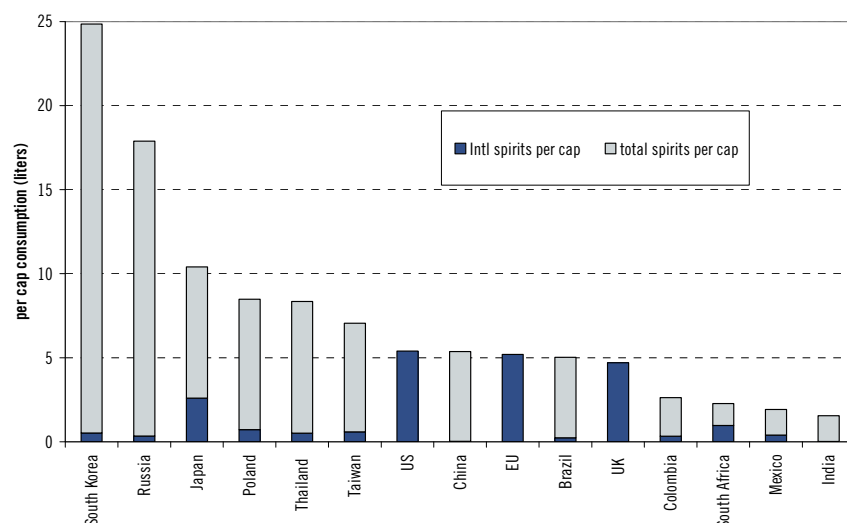
Because of the physical limitations on producing the main premium categories (Cognac and Scotch), it would be difficult for emerging markets volumes to grow much faster than high single digits. We don't see this as a particular negative, rather it means **the growth is likely to have a long duration**.

BRICs scenarios

EM volumes could double or treble

On page 30 we discuss two scenarios, which we don't think are stretched, that show that in the four BRICs alone there is enough upside to roughly double or treble the entire emerging world's volume of international spirits. (We are not assuming anything like this explicitly in our models, however.) We don't see a similar opportunity in many other consumer staples categories.

Figure 3. Per Capita Consumption of International spirits



Source: IWSR, Impact and CIRA Analysis

We believe there are three secondary reasons to be positive on volumes, beyond the arguments we made above:

Few premium alternatives in emerging markets

- There is **no credible local premium spirits for consumers to trade up to**, with the partial exception of premium baijiu in China and premium vodka in Russia (Figure 26).
- **Favourable demographics**, with higher than average growth of the 18-30 years age bracket in many emerging markets. These are the people who drink more and are most likely to aspire to western brands.
- **Development of the modern on- and off-trade**, driven by the international expansion of western retail chains, and development of modern on-trade, with more and more western style bars in China and India for example.

Growth in emerging markets is at good margins

For most other consumer staples companies a lot of the incremental volume growth in emerging markets comes at lower prices and margins

Diageo and Pernod are not only growing volumes in emerging markets, but they are also expanding margins at the same time. Over the past five years Pernod's margins in Asia/RoW have increased 700bp organically³ and Diageo's International margins have increased by 340bp, and we expect this positive trend to continue although at a reduced pace.

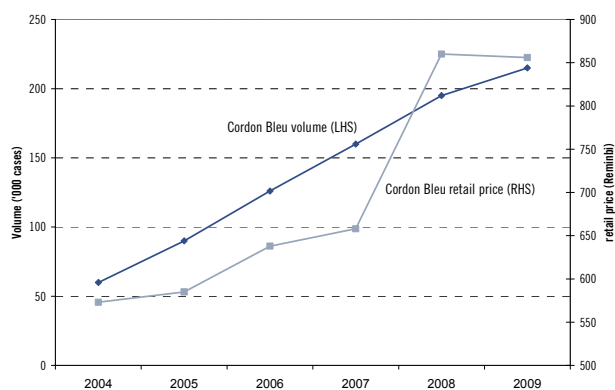
Western spirits are effectively luxuries in emerging markets. Consumers buy them because of the status they confer. Price has little relevance. By contrast in most other FMCG categories volume growth in emerging markets generates negative mix.

This has two positive implications:

1. Spirits companies have **more pricing power**. Our analysis of IWSR data across emerging markets confirms that spirits companies are pricing at or above inflation and that volume elasticity is generally low. Figure 4 and Figure 5 illustrate the case of Martell in China and Johnnie Walker in Brazil.
2. **EM growth adds to mix**⁴ unlike in other categories. Most of the volume growth for international spirits is achieved at premium prices (and margins).

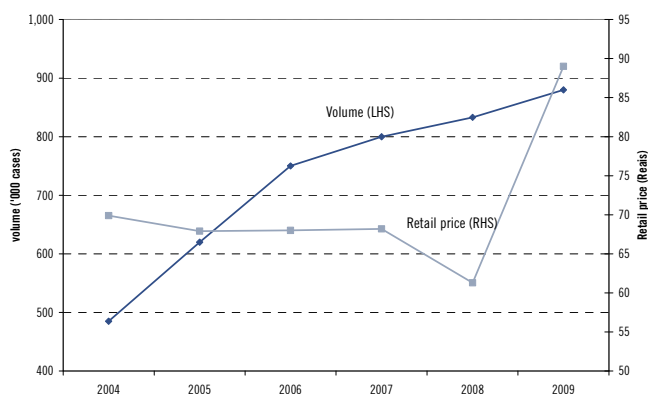
Furthermore there is **relatively little competition in the international spirits sector**, unlike in most food and HPC categories, where competition is pressuring prices as more western companies seek to rebalance their businesses.

Figure 4. Volumes and Retail price of Martell Cordon Bleu in China



Source: IWSR and CIRA Analysis

Figure 5. Volumes and Retail price of Johnnie Walker Red in Brazil



Source: IWSR and CIRA Analysis

³ Including a modest contribution from Allied Domecq synergies.

⁴ Except for Pernod in India, for reasons we explain in page 88.

The US may improve further

There are signs that the US is already on an upward path

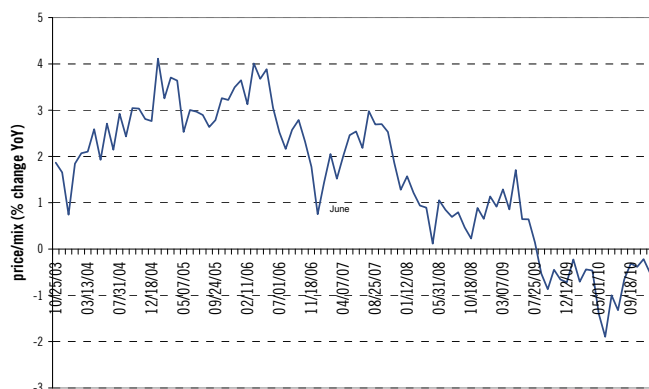
While the emerging markets opportunity is the main long-term investment positive in our view, we think the US might provide the strongest short-term catalyst.

Before the recession the US contributed substantially to profit growth in the sector, as Figure 8 and Figure 9 show, but over the last two years its contribution to growth has fallen to close to zero. Now at last there are signs that it is improving again.

1. Price/mix has got better, according to AC Nielsen data;
2. On trade indices are picking up;
3. Industry commentary is becoming cautiously optimistic.

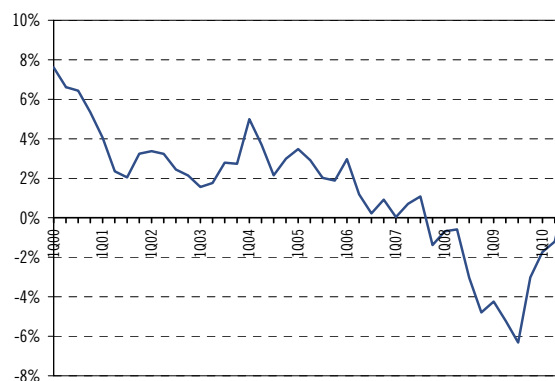
We think further evidence of better trading would have a material impact on both shares, but especially for Diageo, which has the bigger exposure to the US (about 35% of group EBIT vs about 21% for Pernod).

Figure 6. US spirits industry price/mix (2003-2010)



Source: AC Nielsen and CIRA analysis

Figure 7. Citi US Casual Dining Same Store Sales Index – 1Q00 to 3Q10



Source: CIRA

We have chosen to remain cautious on the US in our models, however, given our economists' forecasts for consumer spending and unemployment. We hope that our models turn out to be too pessimistic. We estimate that if the US returned to trend growth, Diageo's EPS would accelerate by about 2-3 points, to ~13% over FY11-13E and Pernod's growth would accelerate by about 3% points to roughly 14%.

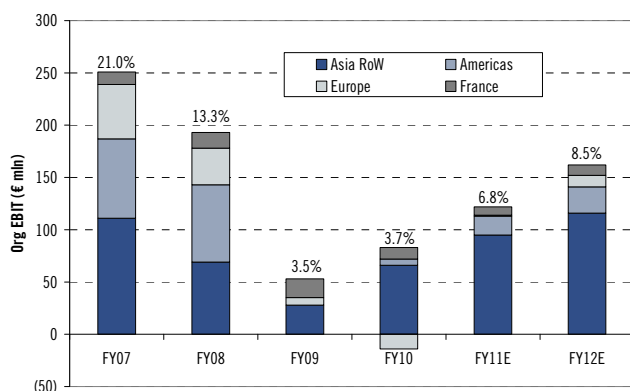
EBIT growth is accelerating, even without factoring in a US recovery

We forecast 7-8.5% by FY12

The bounce-back in emerging market demand means that even without factoring in a significant recovery in the US or Europe we think the sector's organic EBIT growth will accelerate from 2-4% in FY10 to 6-7% this year and on to 7-8.5% in FY12.

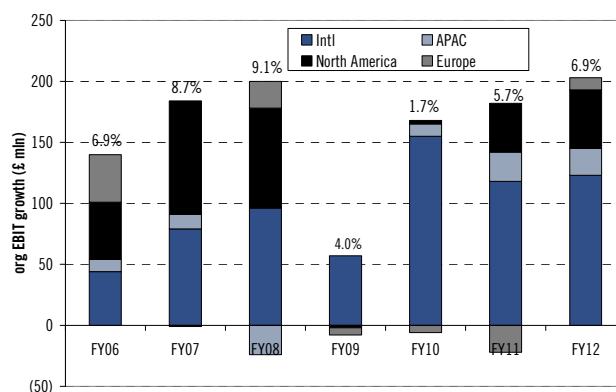
Before the recession, Pernod and Diageo were growing their EBIT, organically, double digit and ~8-9%, respectively. Developed and emerging markets were contributing equally. With the recession, EBIT growth stalled in the US and in Europe and slowed in emerging markets. As a result the stocks derated.

Figure 8. Pernod Ricard – organic EBIT growth drivers



Source: Company Reports and CIRA Estimates

Figure 9. Diageo – organic EBIT growth drivers (excludes Corporate)



Source: Company Reports and CIRA Estimates

Looking forward we expect growth to accelerate (and to rerate). In Figure 10 and Figure 11 we summarise our models for Pernod and Diageo. They show significantly improved EBIT trends based on what we think are relatively conservative assumptions. Almost all the growth is coming from emerging markets. We are not (yet) factoring in any material improvement in the US or in Europe⁵.

- **Asia-Pacific:** Before the recession sales were growing at 9-11%, and Pernod was getting good operational leverage, even if Diageo wasn't (due to its investments in emerging Asia and issues in Korea and Australia). In FY09-10 top-line growth slowed very significantly. For FY11 and beyond we are forecasting Asia will bounce back, albeit not to pre-recession levels, with a bit of margin expansion for both companies. (For Diageo we are expecting some margin expansion, because of the good momentum in its high-margin scotch business, including Korea rebounding.)
- **International** (=LatAm, Africa and Global Travel for Diageo): This is Diageo's growth engine. We are modeling a fractional pickup in sales, but a slight slowdown in profit growth.

⁵ Diageo's gets 35% of its profit from the US and Pernod 21%. Diageo's Western Europe exposure 26% and Pernod's is 32% (including France)

- **The US/Americas:** We are forecasting EBIT growth to return to ~4% for both companies, in other words to 2% above inflation. Before the recession it was about 9-10% (excluding merger synergies). We are modeling slightly better growth for Pernod, because its Americas division includes Latin America.
- **Europe:** We are forecasting modest growth only.

Figure 10. Pernod-Ricard – Organic Growth by Division

		FY06-08	FY09-10	FY11E-13E
Americas	Sales	8.9%	1.3%	3.8%
	EBIT	14.2%	0.5%	4.6%
Europe	Sales	3.8%	-4.0%	0.5%
	EBIT	7.1%	-0.6%	1.7%
France	Sales	2.3%	1.1%	1.6%
	EBIT	6.9%	9.1%	4.3%
Asia / RoW	Sales	11.2%	5.3%	12.3%
	EBIT	22.1%	10.0%	16.0%
Group	Sales	7.0%	0.7%	5.6%
	EBIT	13.0%	3.6%	7.8%

Source: Company Reports and Citi Investment Research and Analysis

Note: Includes Allied Domecq merger synergies in FY06-8. Excluding these, group EBIT growth would have been ~11% in FY06-08, on our estimates. FY06 is based on CAAP growth (contribution after marketing but before central costs), as Pernod didn't report organic EBIT at the time.

Figure 11. Diageo – Organic Growth by Division

		FY06-08	FY09-10	FY11E-13E
North America	Sales	6.3%	-1.0%	2.8%
	EBIT	9.4%	0.0%	3.8%
Europe	Sales	1.0%	-3.5%	-0.2%
	EBIT	2.8%	-0.7%	0.1%
International	Sales	16.0%	10.4%	12.4%
	EBIT	16.2%	17.3%	15.0%
Asia-Pacific	Sales	8.6%	-1.9%	6.5%
	EBIT	-0.2%	2.9%	10.0%
Group	Sales	6.7%	0.7%	5.1%
	EBIT	8.2%	2.9%	6.7%

Source: Company Reports and Citi Investment Research and Analysis

Note: Both companies have June year ends

Strong cash flow means EPS grows 3-4% faster than EBIT

High cash generation is a further positive, in particular relative to other sectors

Both Diageo and Pernod are highly cash generative. Figure 12 shows their cash conversion ratios⁶ are among the best in consumer staples. This is because they need little capex to expand capacity.

Figure 12. Selected Consumer Staples companies – Free Cash Flow measures

FY10	Free Cash Flow (USD)	FCF/sales	capex/sales	Cash conversion (x)	Net Debt/EBITDA (x)
Diageo*	2,626	16.5%	3.8%	1.2	1.9
Pernod-Ricard*	1,447	14.3%	2.6%	0.9	4.4
AB-InBev	6,207	17.1%	5.8%	0.9	2.9
SABMiller *	2,211	14.8%	9.2%	0.7	1.4
Heineken	1,854	8.7%	4.9%	0.9	2.7
Carlsberg	1,342	12.6%	4.4%	1.2	2.2
Danone	2,450	11.1%	4.5%	1.0	2.3
Nestlé	7,481	7.2%	4.2%	0.7	0.0
Unilever	4,243	7.2%	3.1%	0.7	0.6
BAT	4,824	20.8%	3.6%	0.8	1.5
Imperial Tobacco	3,132	25.2%	3.2%	1.1	3.1

*Diageo, Pernod and SAB FY11

Source: Company Reports and CIRA Estimates

⁶ Free Cash Flow (pre M&A and Dividends) divided by Adj Net Profit Before Minorities

As they deleverage, their EPS is growing about 3-4 percentage points more than the growth in operating profit. This deleveraging effect is similar to the (average) of the brewers, but is considerably more powerful than for many companies in other sectors.

Figure 13. Excess Growth in EPS Above Growth in Operating Profit

	Adjusted Operating Profit ³ CAGR	Adjusted EPS CAGR	Excess Growth in EPS
Diageo ¹	8%	11%	3%
Pernod-Ricard ¹	9%	13%	4%
AB-InBev ²	9%	15%	6%
SAB ¹	12%	14%	2%
Heineken ²	11%	14%	3%
Carlsberg ²	9%	13%	5%
Nestlé ²	7%	9%	3%
Unilever ²	7%	7%	0%
Danone ²	9%	11%	2%

¹ FY10-15E. ² CY10E-14E.

³ Includes post-tax associates and excludes exceptionals. EBITA, except for Diageo, Pernod, ABL (which are based on EBIT).

Source: Citi Investment Research and Analysis

Pernod is the biggest beneficiary of the volume growth in emerging markets

Pernod – the better emerging markets play

Figure 15 shows that Pernod and Diageo have been well correlated in the past, but nonetheless we prefer Pernod to Diageo on a one-year and longer view.

- **China and India:** What sets Pernod apart is its exposure to rapidly growing volumes in China (all premium imports) and in India (mainstream and semi-premium locally-made whiskey). It has the biggest exposure to these two markets of any large cap consumer staples company that is listed in Europe. They account for about 15% of sales currently, but are driving 40% of its growth (Diageo's exposure to China + India is ~2% of sales), and we expect their growth to be sustained.
- **Other emerging markets improving:** These account for about a further 23% of Pernod's sales currently⁷. We think the reorganisation of the brand priorities last year, with increased focus on Chivas and Absolut, means that Pernod will start to leverage the large volumes of local brands it has in Latam and other markets to grow its global brands faster, which should result in a better performance in these markets. In addition South Korea (4% of sales) is picking up strongly and we expect Eastern Europe to accelerate in 2012 as economic trends improve. In the medium term we think vodka is likely to follow the success of Scotch and Cognac in emerging markets and Pernod's Absolut brand is best placed to capture the biggest part of the upside because of its premium credentials.
- **Accelerating organic growth:** Emerging markets are driving an acceleration in organic EBIT growth, we estimate, from ~3.5% in FY09-10 to 6.8% this year (guidance is around 6%) and around 8.5% in FY12E-13E. We conservatively forecast flat EBIT growth in Europe in FY11 and +2.5% in FY12-13 (below historic trends) and only modest growth in the US and in France. We believe there may be upside to our forecasts in the medium term in these regions.

⁷ Most importantly South Korea, Mexico, Russia, Poland, and Brazil

- **Above consensus:** Our estimates are about 1% above consensus for FY11E and increase faster from there⁸ despite our conservative estimates for Europe and the US.
- **Highly geared balance sheet provides boost to EPS:** Pernod is still highly leveraged, at about 5x net debt/EBITDA currently, but in a sense we see this as helpful as it means investors can be confident that the cash should be used to pay down debt. The gearing effect of the balance sheet provides ~4% uplift to EPS, resulting in 12% EPS CAGR over the next 3 years (vs 2% CAGR FY07-10). By FY14E we estimate EPS growth should exceed 13%.
- **We expect Pernod will continue to rerate:** Since the summer the market has rerated Pernod by almost 2 P/E points on the basis of the recovery in its emerging markets, but the stock is still trading about 3 points below where it was before the recession. We expect Pernod's multiple to increase further as the growth becomes more visible and the market appreciates how good its emerging market franchise is. Our price target (€85) assumes that in January 2012, it will be trading at 17.0x forward P/E, up from 15.6x now.

Figure 14. Pernod Ricard and Diageo – Citi Estimates vs Consensus

	FY11E	FY12E	FY13E
Pernod Ricard (€/share)			
Consensus EPS	4.22	4.69	5.22
CIRA Basic Adjusted EPS	4.27	4.78	5.38
CIRA Fully Diluted Adjusted EPS	4.23	4.72	5.31
Diageo (p per share)			
Consensus EPS	78.7	86.2	94.4
CIRA Basic Adjusted EPS	80.4	88.2	97.4
CIRA Fully Diluted Adjusted EPS	80.1	87.8	97.0

Source: Reuters and CIRA Estimates

Diageo – more to gain from a further pick up in the US

Although we prefer Pernod for its better EM exposure, which drives slightly faster growth, we are still enthusiastic and have a Buy (1L) rating on Diageo, and we think it may well outperform Pernod short-term as it rose only 2% in December, 10% less than Pernod.

On a medium-term and longer view, we believe Diageo offers a defensive way to play western spirits in emerging markets and get the biggest leverage from any further recovery in US spirits. Even without a significant pickup in the US, we expect Diageo to post about 11% compound EPS growth over FY10-15E. With good cash flow, a significant emerging markets opportunity ahead and 3.6% dividend yield, we think Diageo is good value on 14.2x CY11E earnings.

- **We believe investors misunderstand the opportunity** — Many investors fail to look beyond the fact that Diageo's emerging markets exposure is lower in percentage terms than other consumer staples. As we argue throughout this report, the long-term opportunity for Western spirits in emerging markets is greater than for most other consumer sectors.

⁸ Our headline EPS figure is below consensus because we focus on diluted adjusted EPS across all beverages and tobacco stocks, whereas Pernod's consensus is based on basic adjusted EPS. On an apples-to-apples basis we are ahead of consensus.

- **The US is a potential catalyst** — Diageo has suffered most from the slowdown in the US, but has most to gain from any pickup (it still generates about 35% of its profit in the US). Our models are conservative, but there are positive signs there, both in terms of Nielsen data and management commentary. If the US returned to trend, FY12E and FY13E EPS would accelerate by about 2-3 points, to about 13%, we estimate.
- **Appetite for M&A** — With Net Debt/Ebitda falling below 2x in FY11E, there has been some speculation around potential acquisitions, which creates some uncertainty about how the excess cash will be redeployed. (Last year, Diageo was reported at different times to be considering buying Moët-Hennessy, Fortune Brands' spirits business or Mey Icki in Turkey⁹). We believe management will use the balance sheet in the best interest of shareholders.

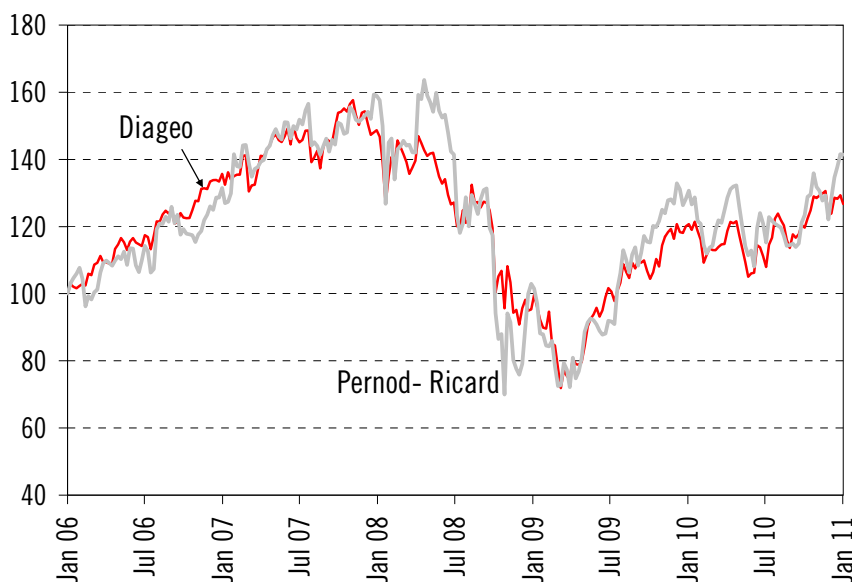
Diageo is the Low risk play in beverages

No single EM market is more than 4% of profit

Diageo has a lower risk than all the other beverage names that we are initiating on, in our view, because there is no emerging market that contributes more than 3-4% of its profit. It is true that about 35% of profit comes from the US, but we see this as lowering risk, not increasing it. We do not believe management will make a large, value-destroying acquisition.

By contrast the brewers' share prices are not well correlated, so for beer it's about individual stock picking

Figure 15. Diageo vs Pernod (USD terms) (Jan 2006 = 100)



Source: DataStream

⁹ Regards Moët Hennessy, the press has commented on several occasions about Diageo's interest in buying the 66% it doesn't own, including an interview to Reuters in August 2009 where CEO Paul Walsh said "If ever the 66% was available we would be interested". Diageo's potential interest in (parts of) Fortune Brands' spirits business has also been reported by the press (Reuters, 17 November 2010), following speculation and then announcement that Fortune Brands will be broken up. Finally, the Wall Street Journal reported on 9 December 2010 that Diageo is in preliminary talks to buy Turkish spirits company Mey Icki. The company hasn't commented on Mey Icki.

We are a little above consensus for FY11 for the spirits companies, and see risk to the upside; we are below consensus for the beer companies (excluding SAB) and see risk to the downside

We prefer Spirits to Beer

We are more positive on the spirits sector than on the brewers, even though it is likely to post lower EPS growth, because:

1. We think the market doesn't fully understand the upside in emerging markets for spirits, whereas it "gets" the beer sector pretty well (with the exception of Heineken);
2. Spirits EPS is likely to accelerate, whereas beer EPS is (if anything) likely to slow slightly;
3. We see greater potential for an acceleration of US profits in spirits than in beer;
4. Input cost inflation may have a worse-than-expected effect on beer profits in the short-term, whereas the impact on the spirits companies is likely to be minimal.

We therefore think there is more room for multiple expansion for the spirits sector.

Having said that, the beer stocks tend to move independently of each other, unlike the spirits companies, and therefore the comparison between beer and spirits is less interesting than it appears at first sight.

Figure 16. European Consumer Staples – EPS Growth FY10-13E

	FY10E	FY11E	FY12E	FY13E	CAGR FY10-13E
AB-InBev	24%	17%	18%	14%	16.0%
Carlsberg	34%	10%	19%	12%	13.6%
Heineken	13%	13%	15%	14%	14.1%
SABMiller	18%	14%	15%	14%	14.2%
Diageo	13%	12%	10%	10%	10.6%
Pernod Ricard	-10%	12%	12%	12%	12.0%
Danone	6%	11%	11%	11%	11.2%
Nestlé	11%	14%	9%	8%	10.4%
Unilever	17%	12%	8%	7%	9.0%
Henkel	45%	12%	14%	10%	12.1%
L'Oreal	18%	10%	10%	10%	10.0%
Reckitt Benckiser	16%	0%	8%	8%	5.3%
BAT	17%	9%	10%	8%	9.1%
Imperial Tobacco	10%	7%	8%	10%	8.5%

Note: For SAB we use the FY nearest the Calendar Year, so the chart shows EPS growth in FY11-14 for SAB
Source: Citi Investment Research Analysis and IBES for L'Oreal, Reckitt Benckiser and Henkel

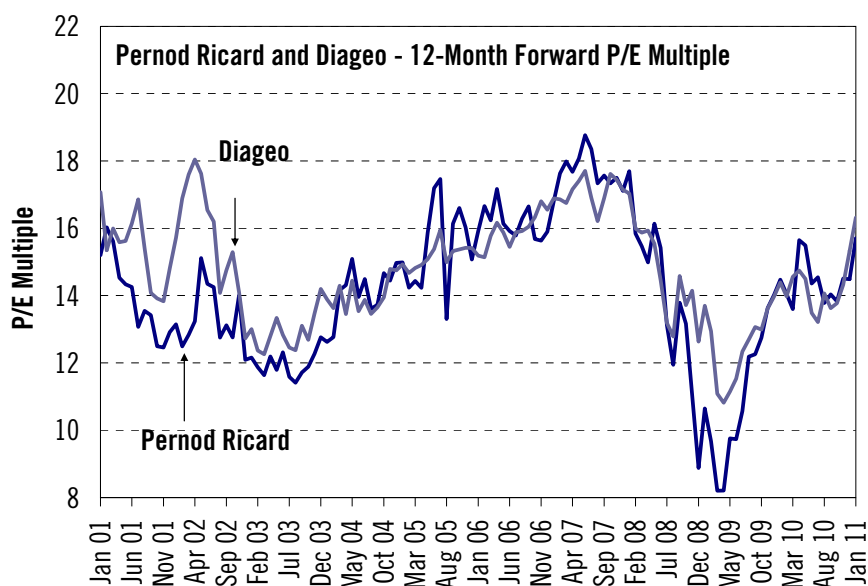
Following Pernod's strong run in December, Heineken is our top pick among all the beverages names, but Pernod is No2 and Diageo is No3, followed by SAB. Carlsberg is our least preferred name for 2011.

Valuation: We expect the stocks to rerate modestly

Our price targets assume about 1 ½ P/E points of multiple expansion this year

Diageo is trading on 14.2x CY11 EPS and Pernod is at 15.6x, both at about 3 P/E points below their pre-crisis peak. Back then, buoyant emerging markets and trading up in the US were driving strong EBIT growth. We think that during 2011 emerging market growth will become more apparent (again) so we expect the stocks to rerate some way towards their previous peaks (we assume around 1½ points to 17 for Pernod and 15½ for Diageo). The argument that the multiples should expand is supported by our strategists' view, as they are forecasting that the Stoxx will hit 310-320 by the end of 2011, which implies that the market's forward P/E multiple will rise by about ½ a P/E point.

Figure 17. Pernod Ricard and Diageo - 12-Month Forward P/E Multiple



Source: DataStream, based on consensus EPS

We use P/Es as they are the simple and well understood

Our price targets, which are set using (rounded) fair values on P/Es, represent where we think the share prices will be in 12 months' time¹⁰. Given the expected forward multiples (17.0x for Pernod and 15.5x for Diageo) and our estimates for calendar 2012, this implies price targets of €85 and 1430p. Figure 18 shows we are expecting total returns for the stocks of about 23-24%.

¹⁰ We avoid using EV-based multiples because most of the beverages stocks have large associates or minorities, and therefore determining the current or future EV is more a matter of debate than a straightforward calculation.

Figure 18. Large Cap Beverage Names – Recommendation Summary

	Latest Price ¹	CIRA Rating	Target price	Price Upside	FY11E Dividend	Expected Total Return
1 Heineken	€36.80	Buy/ Medium Risk	€46	25%	€0.92	28%
2 Pernod-Ricard	€69.90	Buy/ Medium Risk	€85	22%	€1.45	24%
3 Diageo	1197p	Buy/ Low Risk	1430p	19%	41p	23%
4 SABMiller	2263p	Buy/ Medium Risk	2700p	19%	51p	22%
5 ABInBev	€43.00	Buy/ Medium Risk	€51	19%	€0.69	20%
6 Carlsberg	DKK 571	Hold/ High Risk	DKK 640	12%	DKK 10	14%

¹ Close of 4 Jan 2011. Source: Citi Investment Research and Analysis

Figure 19. Large Cap Beverage Names – Calculation of Price Targets

	CY11E P/E	Target 2012 P/E	CY12E EPS	Implied Fair Value	Target price
ABInBev	16.0	16.0	\$4.21	€50.60	€51.0
SABMiller	16.9	17.5	\$2.38	2676p	2700p
Heineken	13.4	14.5	€3.17	€45.95	€46.0
Carlsberg	14.4	13.5	DKK 47.3	DKK 638	DKK 640
Diageo	14.2	15.5	92.5p	1433p	1430p
Pernod-Ricard	15.6	17.0	€5.02	€85.30	€85.0

Source: Citi Investment Research and Analysis

We assume modest multiple expansion where we expect positive newsflow, and contraction where we expect negative newsflow

Figure 20 explains how we have chosen the target P/Es. Essentially we are expecting expansion where we believe the market will see more evidence of emerging market-led growth during 2011, and (modest) contraction for Carlsberg where we think the newsflow is likely to be negative.

All the multiples we use are for calendar years, not fiscal years.

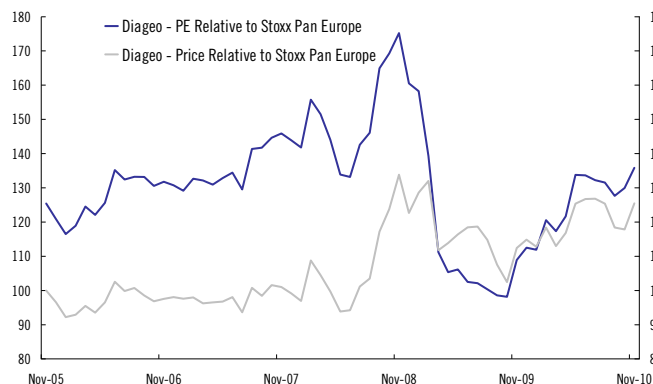
Figure 20. Large Cap Beverage Names – Calculation of Fair Value on P/Es

	CY11 P/E	Target 2012 P/E	Change in Multiple	Comment
ABInBev	16.0	16.0	+0.1	Unchanged
SABMiller	16.9	17.5	+0.6	We expect modest expansion as mkt absorbs improved trends
Heineken	13.4	14.5	+1.1	We expect expansion as market comes to appreciate true EM exposure and cost-cutting potential
Carlsberg	14.4 ¹	13.5	-0.9	Our 2011 EPS is significantly below consensus. If we are right and E Europe margins do disappoint, then we would expect multiple contraction
Diageo	14.2	15.5	+1.3	We expect spirits multiples will rise some way
Pernod-Ricard	15.6	17.0	+1.4	Towards previous peaks as EM growth come through

¹ 14.0x relative to consensus diluted EPS.

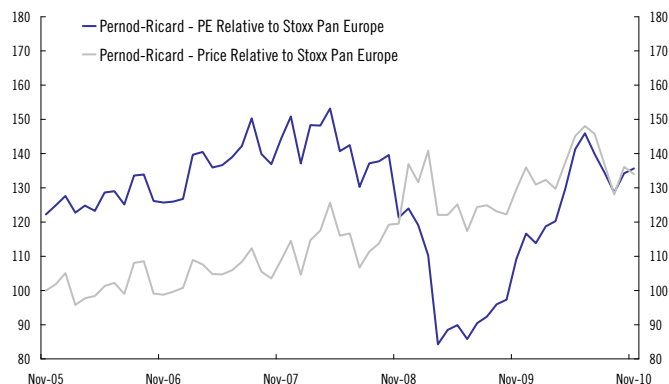
Source: Citi Investment Research and Analysis

Figure 21. Diageo P/E and Price Relative to European Market



Source: Datastream, Citi Investment Research and Analysis

Figure 22. Pernod P/E and Price Relative to European Market



Source: Datastream, Citi Investment Research and Analysis

Implied PEGs

The table below shows the PEG ratios for the companies both at the current price and at our price targets. As can be seen, we are expecting modest increases in multiples for the companies. Given our strategists' positive view of the market, we think this is reasonable – neither too bullish nor too bearish.

Figure 23. Large Cap Beverage Names – Implied PEGs at our Price Targets

	Current ¹	Implied in 12 months ²
Diageo	1.37	1.46
Pernod-Ricard	1.23	1.30
ABInBev	1.07	1.18
SABMiller	1.23	1.30
Heineken	0.98	1.13
Carlsberg	0.98	1.08

¹2011 P/E relative to 2011-14E EPS CAGR, based on current share prices and our EPS forecasts.

²2012 P/E relative to 2012-14E CAGR, based on the companies achieving our target price targets in 12 month's time.

Source: Citi Investment Research and Analysis

Risks

We think spirits is a relatively low risk sector. However, Pernod's risk is increased by its geographic bias to China and India.

Diageo – We assign a Low Risk code

US is ~35% of profit but no emerging market is more than 4%

We rate Diageo Low Risk, based on our assessment of industry and company-specific risk factors. Compared with most industries spirits is relatively predictable, like most consumer staple categories. For Diageo in particular we highlight the following risks to our target price:

The US: The outlook for the US is somewhat uncertain at the moment, and it is quite possible that demand could be stronger, or weaker, than we are modeling.

Western Europe. It is possible that a further worsening of the economy in Western Europe could result in profit below our expectations.

FX: Diageo has transactional as well as translational exposure, as it is exporting whisky from Scotland, Canada and Ireland and Bailey's from Ireland. This means a rise or fall in the pound, Canadian dollar or euro has a particularly marked impact on Diageo's earnings, for better or worse.

Excise tax risk: If taxes on spirits go up in any of its important markets, Diageo is likely to suffer.

India: If India fully liberalised its market for Scotch, there would be considerable upside for Diageo.

Regulations: It is possible that harsher anti-alcohol laws could impact Diageo's businesses.

M&A: We believe Diageo may look to make an acquisition because its balance sheet is strong and management has expressed interest in a few potential targets. If it does so, there is a risk that market responds either very favourably, or negatively, driving the share price either upwards or down.

These risks could keep the shares below, or drive them above, our target price.

Pernod – We assign a Medium Risk code

Growth dependent on China and India

We rate Pernod Medium Risk, based on our assessment of industry and company-specific risk factors. Compared with most industries spirits is relatively predictable. However, we assign Pernod a medium risk rating given its high exposure to China and India. For Pernod in particular we highlight the following risks to our target price:

China and India: These markets are contributing around 40% of the company's growth, we estimate. If the economy stalls in one of them, or the competitive situation changes, the rate of growth could slow dramatically.

Western Europe. It is possible that a further worsening of the economy there could result in profit below our expectations. About 10% of profit comes from France, and a further 22% from the rest of Western Europe.

The US: The outlook for the US is somewhat uncertain at the moment, and it is quite possible that demand could be stronger, or weaker, than we are modelling.

FX: Pernod has transactional as well as translational exposure, as it is exporting whisky from Scotland and Ireland, vodka from Sweden, Cognac and champagne from France and wine from various countries. This means a rise or fall in the pound, krona or euro has a particularly marked impact on Pernod's earnings, for better or worse.

Excise tax risk: If taxes on spirits go up in any of its important markets, Pernod is likely to suffer.

Regulations: It is possible that harsher anti-alcohol laws could impact Pernod's businesses.

These risks could keep the shares below, or drive them above, our target price.

Spirits in Emerging Economies

In this section we provide background information on spirits markets in emerging economies. We show that: (1) these markets are very large and (2) penetration of international spirits is very low, as the markets are still dominated by low price local spirits. This:

1. *Emphasises the considerable growth potential for Diageo and Pernod; and*
2. *Means that they don't have to build the market (unlike some other consumer staples companies), because emerging market consumer already have a taste for spirits.*

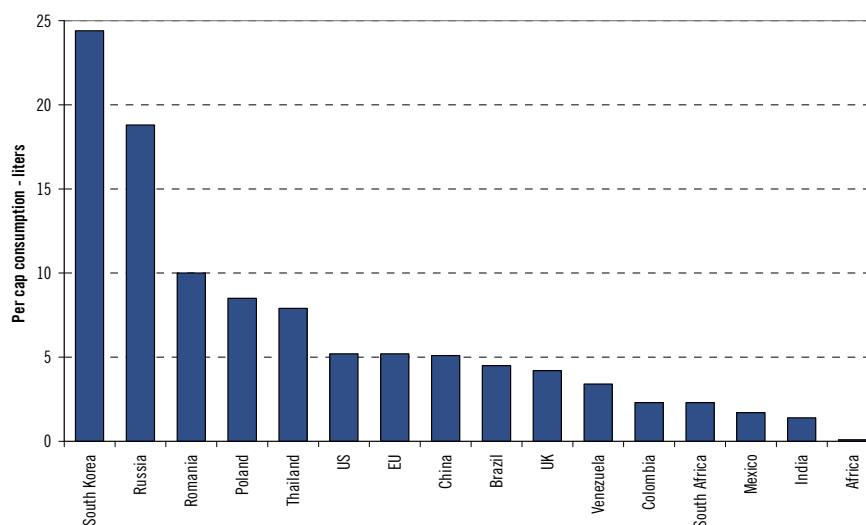
Consumption of spirits varies significantly, but it can be large

Spirits consumption in emerging markets varies significantly by country, from as high as 25 litres per year per capita in South Korea – the equivalent of half a litre of spirits per week – and 18 litres in Russia, to as little as 0.1 litres in Africa.

By comparison in Western markets consumers drink on average around 5 litres of spirits every year.

Developed markets consumption is ~5
L/head

Figure 24. Spirits per capita consumption across various countries, 2009



Source: IWSR, Impact, CIRA analysis

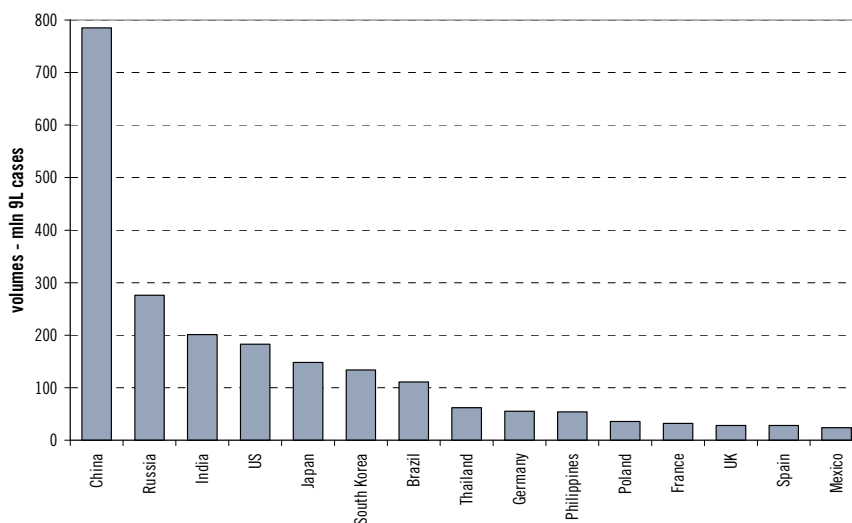
China is the largest spirits market in the world, due to the size of its population rather than per capita consumption levels. At nearly 800 million¹¹ 9-litre cases, China is nearly four times the size of the US market.

Russia is the second largest market, due the very high consumption levels of vodka mainly, but the market is declining and this trend is likely to accelerate as the government cracks down on excessive consumption¹².

¹¹ Source: IWSR. However estimates of the actual size of the market vary considerably

China, Russia and India are bigger than US

Figure 25. Largest Spirits Market Globally, by Volume, 2009



Source: ISWR, Impact, CIRA Analysis

However low-priced, local spirits dominate

Emerging spirits markets are still dominated by local spirits, be it cachaça in Brazil, baijiu in China or vodka in Russia, as Figure 26 shows.

The vast majority of local spirits are low priced. China however is the one country where a sizeable local premium segment has developed and is growing fast. To some extent this is also true in Mexico for tequila, but Mexicans have plenty of low priced alternatives to chose from (e.g. aguardiente and cane distillates) and a large low price tequila segment. In Russia, premium vodka has been growing but it is still a small percentage of the market.

Figure 26. Local Spirits (Split Between Standard/Low Price And Premium+)

Ccountry	Mkt Size ('000 cases)	Typical Local Spirit	Volume ('000 cases) Standard and Low-price		Premium and Superpremium
Brazil	111,002	cachaca	89,000	98%	2%
China	789,446	bai jiu	780,000	97%	3% (31% value)
Colombia	12,758	aguardiente	7,500	100%	0%
India	200,793	local rum, whisky, brandy	197,000	96%	4%
Mexico	23,816	tequila, cane distillates, aguardiente, brandy	15,500	94%	6%
Poland	36,278	vodka	32,800	95%	5%
Russia	275,852	vodka	230,000	> 99.5%	1%
South Korea	133,908	soju	130,000	> 99.5%	< 0.5%
Thailand	61,803	local rum, whisky	50-60,000	99%	1%

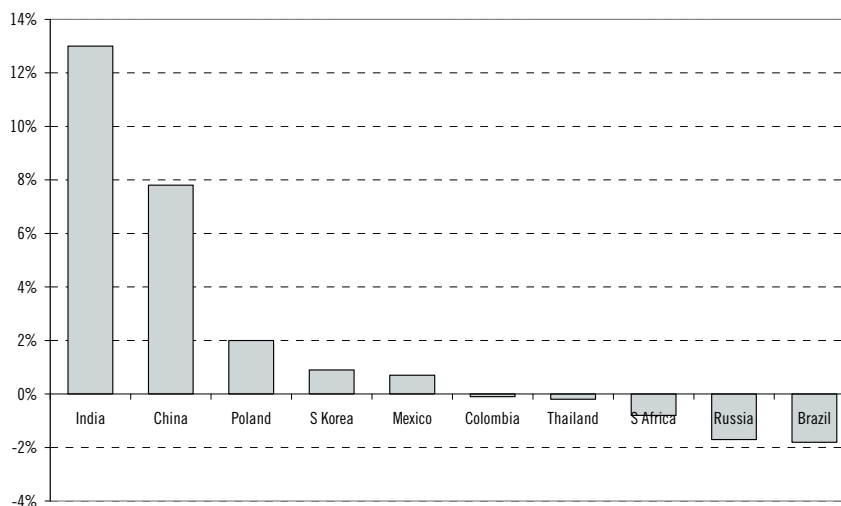
Source: IWSR and CIRA Analysis

Most emerging spirits markets have been in slight decline over the past decade, with the popularity of beer increasing. Not India and China though. The total Indian spirits market has grown at an impressive 13% CAGR since 2003, boosted by easing regulation on retail licences.

¹² We don't take this as a negative because consumers tend to drink more expensive brands as they drink less.

8-13% volume growth in India and China,
declines in many other markets

Figure 27. Emerging Spirits Markets – Volume CAGR 2003-09



Source: IWSR and CIRA Analysis

International spirits have a tiny share (still)

This creates a big opportunity

Against this backdrop, international spirits¹³ still represent a very small percentage of total spirits consumption even though they have been growing fast. In each of the three largest markets in the world – China, Russia and India – international spirits account for ~1% of total volumes, as Figure 3 shows.

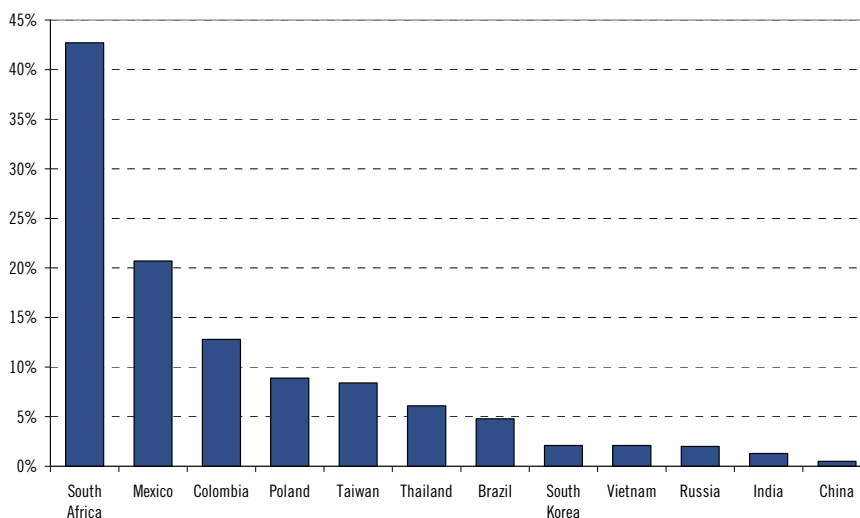
International spirits in EMs consist of mainly Scotch, Cognac and vodka so far

Figure 29 shows that Scotch, Cognac and vodka make up the bulk of international spirits volumes in emerging markets. This hasn't really changed in the last five years. Figure 30 provides a category breakdown of international spirits for each of the main emerging markets.

¹³ We focus on International spirits in this report, which we define as “imported spirits” plus international brands produced locally, like Smirnoff in Brazil, Mexico, India, South Africa and Bacardi in a few markets. We exclude RTDs. We strip out imports of low end spirits, like Ukrainian vodka and CIS brandies imported in Russia, and Spanish brandies in Mexico. The international spirits companies are not involved in these. In Russia we include premium local vodkas, like Russian Standard because Pernod and Diageo compete in the same space. Our analysis is based on detailed data up to 2009 for 12 key Emerging markets (Brazil, China, Colombia, India, Mexico, Poland, Russia, South Africa, South Korea, Taiwan, Thailand and Vietnam). These markets account for ~80% of total emerging markets spirits consumption. For the other countries, the figures we provide involve some degree of estimation.

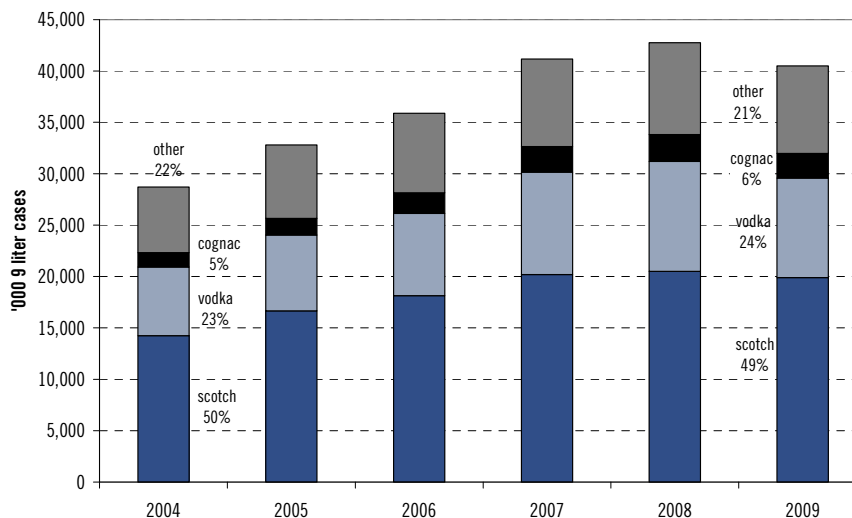
Penetration of international spirits is generally low

Figure 28. Penetration of International Spirits (% of total spirits market) – Volume, 2009



Source: IWSR and CIRA Analysis

Figure 29. International spirits in the top 12 emerging markets – Category breakdown



Source: IWSR and CIRA Analysis

Scotch is the dominant category

Scotch accounts for over half of international spirits consumption in emerging markets and is the largest imported spirits category in virtually every market.

Cognac has grown faster than Scotch overall, although it is almost exclusively drunk in a handful of Asian countries (China, Vietnam, Taiwan, Malaysia) plus Russia on a much smaller scale.

International vodka¹⁴ is also growing fast (8% CAGR 2004-09), but it remains insignificant in Asia, apart from in India. Vodka in emerging markets is mostly produced locally (e.g. in Brazil and India) and as such is positioned as a “standard” product, at a premium to most local spirits, but below imports. The premium vodka segment is growing in Russia, but international spirits companies play a small role in it. **Imported premium vodka** is still small everywhere, except Mexico and Poland, but it could be one of the largest long-term opportunities for the industry. (We discuss this opportunity more on page 32).

Other smaller categories, like **Irish whiskey** (Jameson) and **US whiskey** (Jack Daniels) are nibbling a bit of share in some markets.

Figure 30. International spirits – Category breakdown by country (2009)

	Scotch	Cognac	Vodka	Other	Total
Brazil	54%	0%	43%	4%	100%
China	41%	40%	2%	18%	100%
Colombia	79%	0%	9%	12%	100%
India	53%	0%	21%	26%	100%
Mexico	37%	4%	13%	45%	100%
Poland	19%	1%	50%	29%	100%
Russia*	24%	4%	49%	23%	100%
South Africa	40%	0%	26%	34%	100%
South Korea	88%	1%	3%	8%	100%
Taiwan	71%	14%	4%	11%	100%
Thailand	88%	1%	4%	7%	100%
Vietnam	48%	28%	12%	12%	100%

* We include premium Russian vodka. Excluding it, the breakdown would be 43%, 7%, 10%, 39%

Source: IWSR and CIRA

¹⁴ We define international vodka as imports and locally produced international brands (mainly Smirnoff in South Africa, Brazil, Poland, India). We also include the premium local segment in Russia, where price points are in line with Absolut, for instance. We exclude all low end vodkas, even if imported.

How to navigate pages 25-43, which is
the core of the report

International Spirits Can Grow Volume Faster and for Longer

We argue that international spirits can sustainably grow volume at least high single digits in emerging markets, which is faster than most other consumer categories.

We have shown that per capita consumption of international spirits is very low in most markets (Figure 3) and that emerging market consumers already have a taste for spirits. In the next few pages to substantiate our view, we show that:

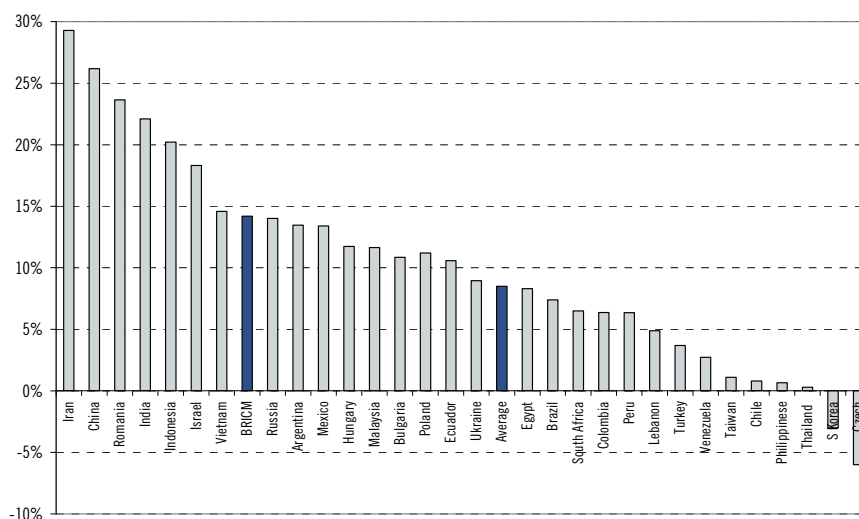
- International spirits volumes were growing well into double digits before the recession
- There is a good correlation between GDP/capita and consumption of international spirits – as consumers get wealthier they do tend to trade up to premium spirits. In the past international spirits volumes have outperformed GDP by a factor of 1.5-4.5x

On page 30 we discuss two scenarios, which we don't think are stretched, that give a sense of the scale of the opportunity in the BRICs. Then we discuss possible further upside in vodka.

We then show that in nearly all emerging markets, international spirits outperform beer in volume terms.

Finally we suggest that investors should focus on the BRICs (and Mexico), because they are driving most of the growth, China and India in particular. In this respect, Pernod provides the best exposure. We estimate that ~40% of Pernod's EBIT growth is driven by China and India.

Figure 31. International Spirits in Emerging Markets – volume CAGR 2003-09



BRICM = Brazil, Russia, India, China and Mexico

Source: IWSR and CIRA

Volumes were growing double digit

BRICs + Mexico grew 14% CAGR 2003-09

Figure 31 shows international spirits volumes have grown at 8.3% CAGR in emerging markets over 2003-09, and at over 10% excluding Taiwan and South Korea¹⁵. The BRIC countries plus Mexico have grown even faster, at 14.2% CAGR. These rates include 2009, when the recession caused international spirits volumes to decline in many markets.

These totals mask that in the period 2004-07, in other words **before the recession, volumes grew at 14% CAGR in the top 12 markets**. In 2008-9 growth stalled almost everywhere (except in India and Vietnam).

Figure 32. International Spirits – Total Volume Growth, by Year

	2004	2005	2006	2007	2008	2009
Top 12 Markets	10%	16%	11%	16%	4%	-5%
Top 12, ex Taiwan and Korea	16%	18%	12%	18%	5%	-5%
BRICs + Mexico	22%	25%	17%	23%	8%	-6%

Source: IWSR, Citi Investment Research and Analysis

Figure 33 provides granularity on the growth rates of international spirits in the major countries and compares them to GDP.

Figure 33. International Spirits growth rate vs GDP in main emerging markets

	2004	2005	2006	2007	2008	2009
Brazil						
International Spirits	9%	12%	10%	10%	2%	2%
GDP	4.9%	2.3%	2.9%	3.9%	3.4%	-0.2%
China						
International Spirits	59%	63%	36%	17%	3%	-4%
GDP	9.5%	9.9%	10.5%	11.4%	7.4%	9.1%
India						
International Spirits	14%	11%	32%	44%	21%	16%
GDP	8.1%	7.2%	8.6%	9.3%	7.7%	7.4%
Mexico						
International Spirits*	24%	28%	16%	6.7%	10%	-0.9%
GDP	4.2%	3.2%	5.1%	3.3%	1.3%	-6.5%
Poland						
International Spirits	13%	9.6%	14%	26%	17%	-9%
GDP	5.4%	3.2%	5.8%	6.5%	4.9%	1.8%
Russia						
International Spirits	25%	22%	9%	46%	13%	-21%
GDP	7.2%	6.4%	6.5%	8.1%	7.5%	-7.9%
South Africa						
International Spirits	8%	7%	11%	14%	1%	-2%
GDP	3.8%	4.3%	4.0%	5.1%	3.2%	-1.8%
Vietnam						
International Spirits	19%	16%	8%	17%	11%	18%
GDP	8.2%	8.4%	8.2%	8.4%	6.2%	5.3%
Colombia						
International Spirits	9%	10%	12%	21%	-9%	-2%
GDP	3.7%	5.1%	5.4%	7.0%	2.5%	0.4%

*Mexico excludes locally produced Bacardi. The brand is very large, but has been in decline for the last 10 years. Including Bacardi the growth rates would have been: +12%(04) +10%, +4%, +3%, +6%, -1% (09)

Source: IWSR and CIRA Analysis

¹⁵ Taiwan and South Korea are far more developed than most emerging markets. In Taiwan and South Korea Scotch grew rapidly in the '80s and '90s, but hasn't grown much in the last decade

International spirits represents a leveraged play on GDP

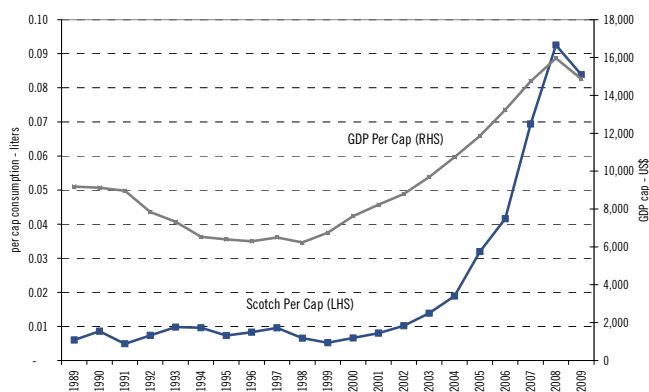
Significant correlation between international spirits consumption and GDP/capita

In most of the markets we have looked at, **there is clear, positive correlation between international spirits consumption and GDP/capita¹⁶** (at least up to certain high levels of GDP/capita): as consumers get wealthier and can afford international spirits, they will tend to trade up to premium spirits.

However, the extent and speed at which they do trade up varies considerably by market. For example, Figure 34 and Figure 35 plot per capita consumption of Scotch in Russia and Mexico against GDP per capita.

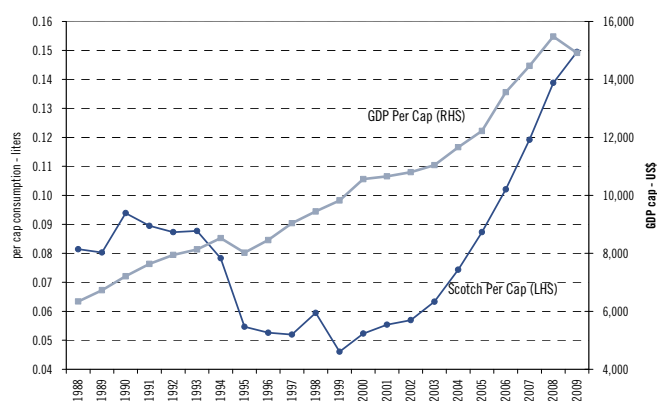
- In both countries Scotch consumption has increased considerably at rising levels of GDP;
- However, per capita consumption in Russia is roughly half the level of Mexico despite the two countries enjoying similar levels of economic development.

Figure 34. Russia – Scotch per capita vs GDP cap



Source: IWSR and CIRA Analysis

Figure 35. Mexico – Scotch per capita vs GDP cap

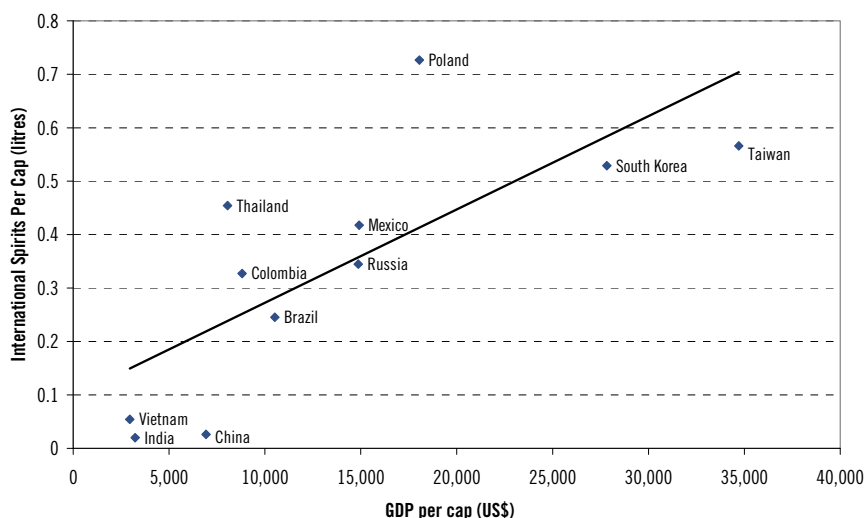


Source: IWSR and CIRA Analysis

Figure 36 shows international spirits consumption (measured per capita) and GDP per capita across the main emerging markets. The R-squared value is quite low (0.56), but the chart does clearly show that in the more developed emerging economies – South Korea, Taiwan and Poland – consumption levels of international spirits are higher.

¹⁶ Many other factors drive or influence international spirits consumption, including cultural and religious factors, local taste preferences, regulation and trade barriers.

Figure 36. Correlation between International Spirits Consumption and GDP capita – 2009



Source: IWSR and CIRA Analysis

International volumes typically grow $1\frac{1}{2}$ - $4\frac{1}{2}$ x GDP

It is important to realise that the relationship between spirits and GDP is more than a simple one-to-one correlation. Figure 33 shows that international spirits volumes in emerging markets are, in effect, a leveraged play on GDP growth, very much like luxury goods.

Before the recession, international spirits were typically outperforming emerging markets GDPs by a factor of between 1.5x and 5x, as shown in Figure 37.

Figure 37. GDP multiplier effect of Western Spirits

	2004	2005	2006	2007	2008	2009
Brazil	1.8	5.1	3.6	2.5	0.5	nm
China	6.2	6.3	3.4	1.5	0.4	nm
India	1.7	1.6	3.7	4.7	2.8	2.2
Mexico	5.6	8.6	3.2	2.0	7.4	0.1
Poland	2.6	3.0	2.7	4.6	3.9	nm
Russia	3.4	3.4	1.4	5.7	nm	2.6
South Africa	2.2	1.7	2.7	2.7	0.4	nm
Vietnam	2.7	1.6	1.8	2.1	1.4	2.3
Colombia	2.6	1.9	2.2	3.0	nm	nm

Source: IWSR and CIRA Analysis

Implies a return to at least high single digit volume growth

And volume growth could be even higher

If this relationship continues, it would imply at least high-single digit growth in 2010-11E volumes, as shown in Figure 38. This uses Citi economists' GDP forecasts but applies more conservative multipliers for international spirits of 1.5-3x. This is consistent with the sharp pick-up in sales that Diageo and Pernod have reported in many emerging market since the beginning of calendar 2010, as we summarise in Figure 39.

Figure 38. GDP growth and multiplier effect on International spirits consumption in emerging markets

	GDP Growth						Implied Spirits Vol Growth	
	2007	2008	2009	2010E	2011E	average 2010-11	Multiplier of 1.5x	3x
Brazil	3.9%	3.4%	-0.2%	7.6%	4.5%	6.1%	9%	18%
China	11.4%	7.4%	9.1%	9.8%	9.0%	9.4%	14%	28%
India	9.3%	7.7%	7.4%	8.4%	8.6%	8.5%	13%	26%
Mexico	3.3%	1.3%	-6.5%	4.8%	3.9%	4.4%	7%	13%
Poland	6.5%	4.9%	1.8%	3.5%	3.6%	3.6%	5%	11%
Russia	8.1%	7.5%	-7.9%	4.1%	4.0%	4.1%	6%	12%
South Africa	5.1%	3.2%	-1.8%	2.7%	3.3%	3.0%	5%	9%
Vietnam	8.4%	7.2%	5.3%	6.6%	6.7%	6.7%	10%	20%
Colombia	7.0%	2.5%	0.4%	4.0%	4.4%	4.2%	6%	13%

Source: Haver Analytics and Citi Investment Research and Analysis

Figure 39. Organic Sales Growth in Emerging Markets Divisions – Diageo and Pernod

	1H10 (Jul 09 – Dec 09)	2H10 (Jan 10 – Jun 10)	1Q11 (Jul 10 – Sep 10)
Diageo - International	8%	20%	mid teens
Diageo – APAC*	-1%	3%	mid single digit
Pernod - Asia/RoW**	3%	17%	24%

* nearly 50% of APAC sales are in developed markets; ~6% of International sales are global Duty Free

** ~20-25% of Asia/RoW sales are in developed markets, we estimate

Source: Company Reports and CIRA Estimates

Limitations on producing Scotch and Cognac cap the speed at which the category can develop

But there are increasing amounts of maturing inventories

Growth is likely to have a long duration

As we said, we believe high single digit growth rates are sustainable in the very long term, given very low levels of per cap consumption.

Because of the physical limitations on producing the main premium categories (supply of Cognac and Scotch is constrained by the ageing process and the rules on geographic origins), it would be difficult for emerging markets volumes to grow much faster than that, unless vodka was to really take off.

We note that Diageo and Pernod have both invested a lot in maturing inventories in the last 5 years, to underpin future growth in emerging markets, as Figure 40 shows.

Figure 40. Maturing Inventories at Diageo and Pernod

	FY06	FY07	FY08	FY09	FY10
Diageo (GBP mln)	1,644	1,745	1,939	2,274	2,506
% of sales	22.7%	23.3%	24.0%	24.4%	25.6%
Pernod (€ mln)	1,875	2,045	2,486	2,505	2,695
% of sales	30.3%	31.7%	37.7%	34.8%	38.1%

Note – the decline at Pernod of maturing inventories as % of sales in FY09 is explained by V&S acquisition (no maturing stock in vodka)

Source: Company reports, Citi Investment Research and Analysis

EM Volume Could Double or Treble

It is easy to construct scenarios in which the current global emerging market volumes of international spirits (we estimate about 55m cases) almost doubles or trebles, simply through greater penetration in the four BRICs. We are not assuming this explicitly in our models, but the key take away is that **high single digit volume growth and sales growth well into double digits seem to be underpinned for many years ahead**. We don't see an opportunity on such a scale in other consumer staples categories, particularly not in beer.

Figure 41. International spirits upside scenarios in the 4 BRICs alone

	Current Int'l Spirits Consumption			Scenario 1		Scenario 2		Incremental cases ('000)	
	Total ('000 cases)	Per Capita	Penetration	More Conservative		Less Conservative		Scenario 1	Scenario 2
Brazil	5,300	0.24	4.8%	Per capita of Mexico (0.4)		Per capita of Venezuela (1.0)		3,500	16,800
China	4,000	0.03	0.5%	Per capita 1/3 of Taiwan (0.6)		Per capita 1/2 of Taiwan (0.6)		23,600	37,500
India	2,600	0.02	1.3%	4% Penetration		8% Penetration		14,100	34,900
Russia	5,400	0.35	2.0%	Per capita 3/4 of Poland (0.7)		Per capita of 1.0x Poland (0.7)		2,900	5,700
Total	17,350							44,100	94,900
Upside from current EM total								80%	173%

Source: IWSR, Citi Investment Research and Analysis

Considerable upside with even modest increases in penetration

Pernod's sales exposure to the BRICs is 20%, Diageo's 6%

In Figure 41 we have two scenarios. (1) is more conservative, and (2) is less conservative. Under these scenarios we assume that:

- In **Brazil** per capita consumptions reaches the Mexican level (0.4 litres/head) in Scenario 1, or the Venezuelan level (1.0 litre/head) in Scenario 2.
- In **China** per capita consumption of international spirits goes to 1/3 the level of Taiwan (0.60 litres) in Scenario 1, or to half its level in Scenario 2.
- In **Russia**, consumption goes to $\frac{3}{4}$ of Polish levels (Scenario 1), or to 1x Polish levels (Scenario 2)
- In **India** penetration of international spirits goes from 1.3% currently to between 4% (Scenario 1) and 8% (Scenario 2).

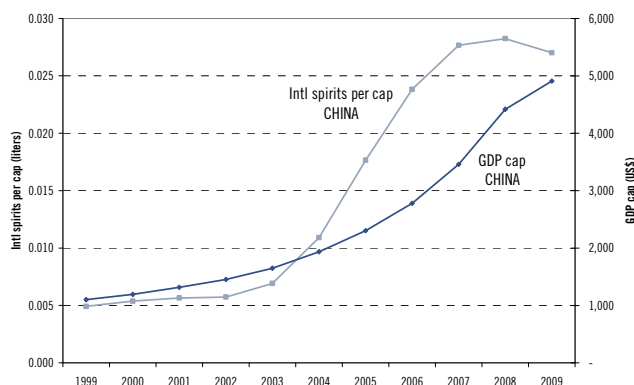
The results are quite impressive:

- Based on these back of the envelope assumptions we suggest the four BRICs could add 44-95 million cases of international spirits over the medium- to long-term, almost doubling or tripling the size of international spirits in emerging markets.
- We have only considered the four BRICs, on top of which there is clear upside from all the other emerging markets.
- We haven't considered any demographic growth

China

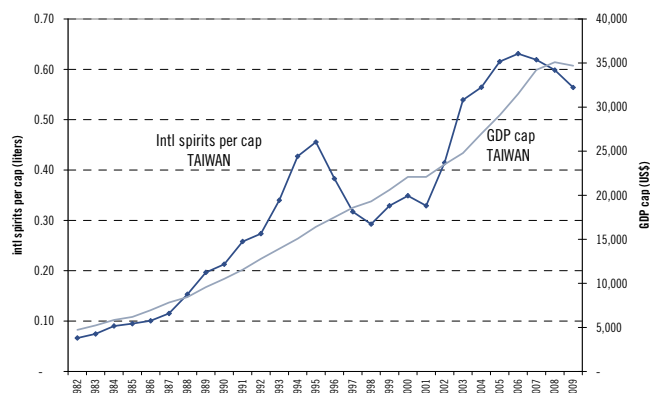
Our assumptions for China seem reasonable given the cultural similarities between China and Taiwan. The next charts illustrate how per capita consumption of international spirits is developing in China, comparing it to how it has developed over time in Taiwan. GDP/capita in China is approaching \$5,000, roughly where our chart on Taiwan begins. The charts seem to point to significant long term upside in China as disposable incomes rise.

Figure 42. China – international spirits per capita vs GDP cap



Source: IWSR and CIRA Analysis

Figure 43. Taiwan – international spirits per capita vs GDP cap



Source: IWSR and CIRA Analysis

India

The assumptions in Figure 41 seem realistic if import duties were reduced (likely at some point). India is a large and growing whisky market where Scotch consumption is growing despite Johnnie Walker Black/Chivas being priced at around \$60, which is about five times as much as a superpremium local whisky. We also assume the Indian spirits market will grow at 10% pa for 10 years (vs +17% CAGR since 2005).

Vodka is a further opportunity

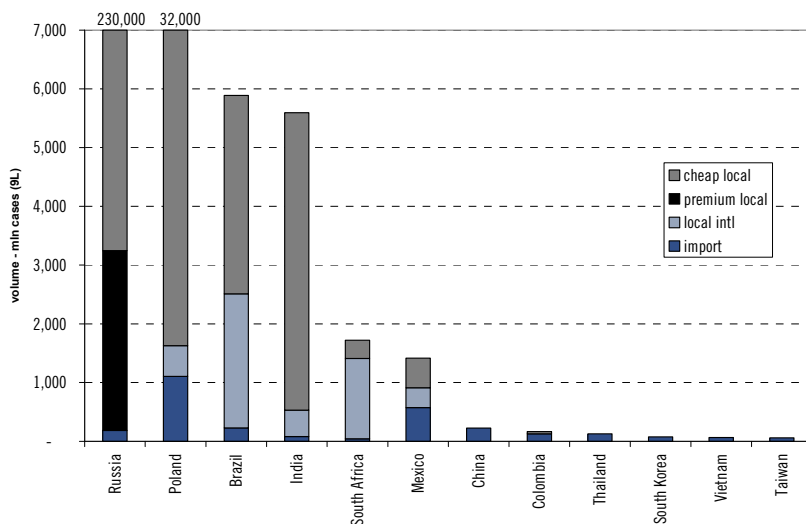
After Scotch and Cognac, we think vodka will be most important

So far the great bulk of the growth of international spirits has been in Scotch and, to less extent, Cognac. However we believe that vodka may also do well in many emerging markets in due course, and it doesn't have the supply limitations that constrain growth in Scotch and Cognac.

In developed markets vodka is seen as a cooler drink by younger consumers. In the US vodka has driven around half of total industry growth in the last few years and accounts for ~1/3 of total spirits sales. In Western Europe it has been growing mid-high single digit in most countries, despite declining spirits markets.

In emerging markets premium vodka¹⁷ has grown fast in the last few years,¹⁸ but apart from in Brazil, Russia and Poland, and a handful of other countries, it hasn't developed yet on a meaningful scale, particularly in Asia (Figure 44).

Figure 44. Main vodka markets globally - (imports vs local)



Note – analysis excludes Ukraine and other CIS markets

Source: IWSR and CIRA Analysis

We see vodka as a big opportunity, as emerging market consumers aspire to western brands and increasingly adopt western lifestyles. **China is the big prize**, with over 700 million cases of local baijiu consumed, a white spirit, like vodka.

¹⁷ We include premium vodka in Russia (priced above 350 RUB) and locally produced international brands (like Smirnoff in Brazil, India and South Africa), which are priced at a premium to the local vodka segment

¹⁸ +8% CAGR 04-09, +12% until 2008

Pernod and Diageo are both well positioned to benefit from growth in vodka: Diageo is already achieving significant volumes with Smirnoff in India and Brazil as the brand is positioned at a more affordable price point, but we believe Pernod's Absolut brand is better placed to capture a potential vodka premiumisation trend than may develop over time as it did in the US and Europe.

The downside is that barriers to entry are low in vodka compared to Scotch or Cognac (after all it is only water and fermented grain distilled a few times, put in a fancy bottle and marketed), but Pernod and Diageo have an advantage on smaller international players: their much stronger route to market.

For the interested reader, in Appendix 4 we discuss the current status of vodka in emerging markets in more detail.

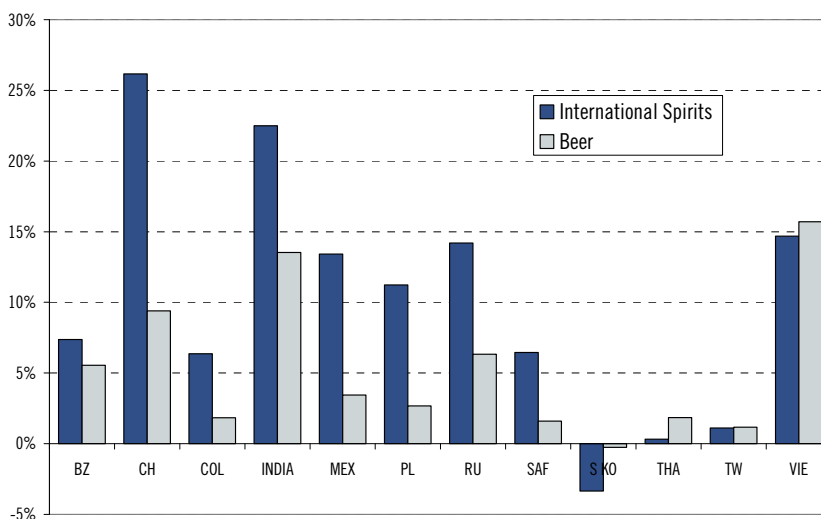
International spirits outperform beer in volume terms

That International spirits outperform beer in volume terms isn't that surprising as emerging market consumption per capita is relatively close to developed market consumption

Figure 45 shows that in general the growth of international spirits has been significantly faster than beer's growth in the main emerging markets during 2003-09.

This shouldn't surprise investors. Beer per capita consumption levels in Eastern Europe and Latin America are not far behind developed markets levels¹⁹ whereas international spirits per caps are still very low nearly everywhere.

Figure 45. International Spirits Growth vs Beer in Emerging Markets (CAGR 2003-09)

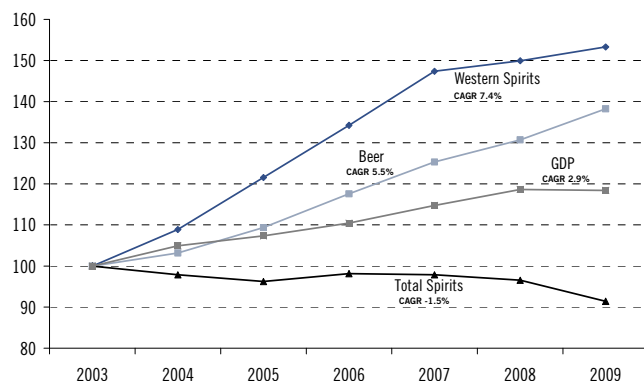


Source: IWSR, Canadean and CIRA Analysis

¹⁹ 63 litres in Eastern Europe vs 67 in Western Europe and 50 litres in Latin America vs 76 in North America

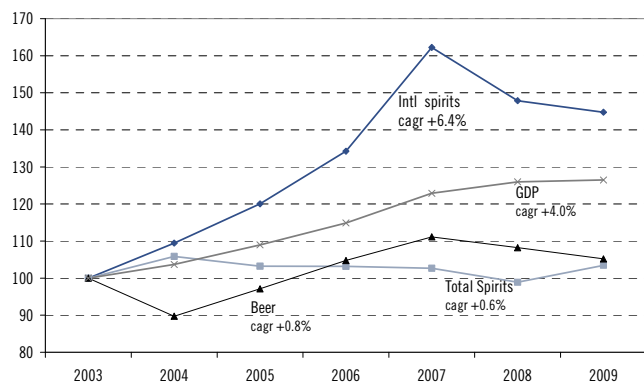
With the recession, however, international spirits suffered more than beer, given the higher price points, as evident in the following charts, which zoom in on Brazil, Russia, Colombia and Mexico. We have taken a closer look at these markets because of their relevance to the brewers.

Figure 46. Brazil – International Spirits growth vs Beer



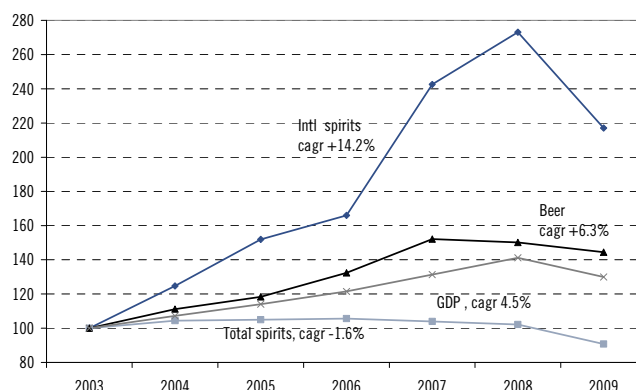
Source: IWSR, Canadean and CIRA Analysis

Figure 48. Colombia – International Spirits growth vs Beer



Source: IWSR, Canadean and CIRA Analysis

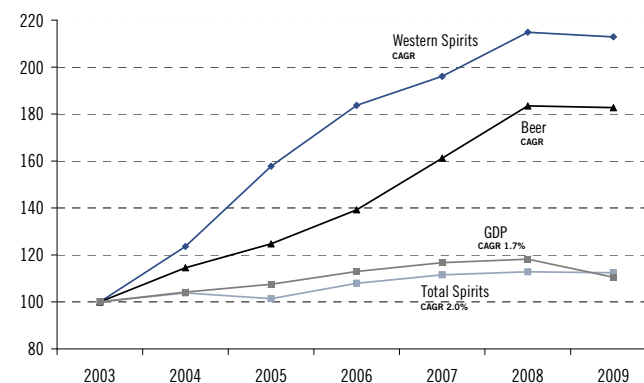
Figure 47. Russia – International Spirits growth vs Beer



Intl spirits include premium Russian vodka

Source: IWSR, Canadean and CIRA Analysis;

Figure 49. Mexico – International Spirits growth vs Beer



Source: IWSR, Canadean and CIRA Analysis

The seven key markets

These drive 80% of the growth

The 4 BRICs + Mexico, Poland & S Africa

Almost 80% of the volume growth in emerging markets has been driven by seven markets, with the BRICs plus Mexico contributing 62%, and Poland plus South Africa a further 18%, as shown in Figure 50.

Figure 50. International Spirits volumes (and growth) in Emerging markets 2003-09

	'000 cases 2003	'000 cases 2009	Increase 2003-09	contribution to growth
China	993	4,006	3,013	16%
Russia	2,494	5,414	2,920	16%
Mexico *	1,644	3,500	1,856	10%
Brazil	3,470	5,319	1,849	10%
India	788	2,611	1,822	10%
Poland	1,518	3,226	1,708	9%
South Africa	3,646	5,306	1,660	9%
Venezuela	2,007	2,635	628	3%
Colombia	1,130	1,636	506	3%
Vietnam	320	723	403	2%
Thailand	3,987	3,800	-187	-1%
South Korea	3,473	2,830	-643	-3%
Other **	8,275	11,495	3,220	17%
Total 30 Emerging Markets	33,744	52,501	18,757	100%

* excludes Bacardi, which has been in constant decline for over a decade. Including Bacardi the incremental cases 2003-09 would have been 923k, putting Mexico's contribution at 5%.

** other is estimated based on IWSR figures for Diageo and Pernod

Source: IWSR and CIRA

Figure 51 puts this into context for Diageo and Pernod Ricard.

Figure 51. Diageo and Pernod's exposure to the 7 key Emerging Markets (sales FY10E)

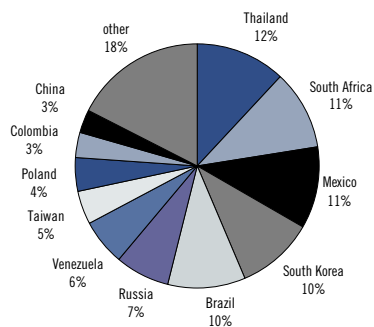
	China	Russia	Mexico	Brazil	India	Poland	S Africa
Diageo	1%	1%	2.5%	3%	1%	0.6%	1.8%
Pernod	10%	2.5%	2.5%	2%	5%	1.8%	0.6%

Source: Citi Investment Research and Analysis

Figure 52 and Figure 53 show how the emerging market map for international spirits looks like now and how it has changed since 2003.

- The BRICs and Mexico have grown from 33% to 42% of emerging market volumes in just six years
- Russia, Brazil and South Africa are the largest emerging markets in volume terms for international spirits, but China is larger in value. This is because the import segment in China is heavily skewed to premium, significantly more so than other emerging markets. For Russia we include local premium vodka.

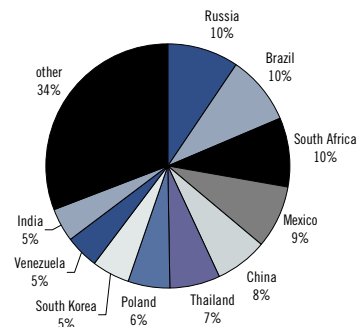
Figure 52. Intl Spirits in Emerging Markets – 2003 volume breakdown



Source: IWSR and CIRA.

Note – analysis on 30 emerging markets, accounting for, we estimate, > 95% of total volumes

Figure 53. Intl Spirits in Emerging Markets – 2009 volume breakdown



Source: IWSR and CIRA.

Although most emerging markets are poised for significant growth, China and India are likely to dominate future growth because of the sheer size of their local spirits markets and the currently very low penetration of international spirits.

Pernod's exposure to China and India (~15% of sales and close to 40% of EBIT growth comes from these two countries, on our estimates) is a key reason for our preference of Pernod over Diageo.

An overview of the Brazilian, Chinese and Indian spirits markets can be found in the Appendices, starting from page 100.

Emerging Markets Growth is Profitable Too

In most other consumer sectors,
emerging market growth dilutes margins

Diageo and Pernod are not only growing volumes in emerging markets, but they are also expanding margins at the same time.

Over the past five years from relatively high starting points, Pernod's margins in Asia/RoW have increased 700bp²⁰ organically and Diageo's International margins 340bp, more than most consumer staples companies. We expect this positive trend to continue, albeit at a reduced pace.

Figure 54. Emerging Market Organic Margin Expansion For Selected European Consumer Staples Companies

	Division	FY06	FY07	FY08	FY09	FY10E	Average	Comment
Diageo	International	(89)	9	90	60	272	68	LatAm + Africa. Global DF ~10% of divisional EBIT
Pernod Ricard	Asia/RoW	8	411	94	102	99	143	Developed mkts ~25% of divisional EBIT.
Nestlé ¹	AOA	60	(40)	20	20	30	18	Japan + ANZ ~20% of division
Unilever ¹	Asia/Africa/E EU	(10)	20	20	220	20	54	Japan + ANZ ~ 5% of division
L'Oreal ¹	ROW	100	210	30	(120)	na	55	Japan + ANZ ~ 5-10% of division
Reckitt Benckiser ¹	Developing Mkts	290	230	30	80	na	158	doesn't include E Europe
AB-Inbev	Em Mkts	194	287	(117)	92	(20)	87	average LatAm, C&E EU, APAC
SAB Miller ²	Em Mkts	20	(110)	(160)	40	112	(25)	average Europe, SAF, LatAm, Asia/Africa. FY07-10

¹ Reported margins. We don't think organic figures differ materially, as transactional FX exposure is limited for Food/HPC companies

² For SAB we use the calendar year nearest to its fiscal year end.

Source: Company reports, Citi Investment Research and Analysis

International Spirits in emerging markets are like luxury goods. Consumers buy them because of the status they confer. Price has little relevance. This has two positive implications for spirits companies, in contrast to other consumer staples:

1. Spirits companies have **more pricing power**.
2. **EM growth generally adds to mix** because most of the volume growth for international spirits is achieved at premium prices (and margins).

Furthermore there is **relatively little competition in the international spirits sector**, which means it is easier for them to raise prices.

Spirits companies have more pricing power

On luxury goods, elasticity is low

Our analysis of IWSR data across emerging markets confirms that spirits companies are pricing at or above inflation and that volume elasticity is low. Figure 55 summarises the change in retail prices²¹ over 2005-09 for a number of brands across emerging markets. In all these markets, except Russia and India, pricing has generally been at least in line with inflation, and often above it. India is different because pricing is regulated at state level. In Russia, pricing is more difficult because it's a more competitive market than others, particularly for standard and low end Scotch.

²⁰ Includes a contribution, modest we believe, from Allied Domecq synergies

²¹ The limitation of looking at retail prices is that they include tax and retail mark-up

Figure 55. Retail Price Increases on Various Brands in Emerging Markets (2005-09) and Inflation Rates

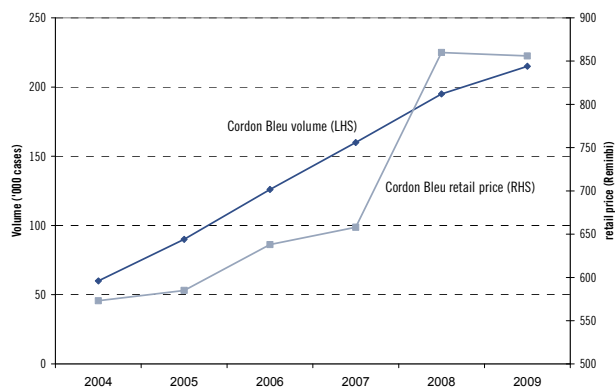
	Company	Category	Segment	Mkt Position	Price Increase						
BRAZIL					2005	2006	2007	2008	2009	04-09 CAGR	06-09 CAGR
JW Red	Diageo	Scotch	standard	#1	-3%	0%	0%	-10%	45%	5%	9%
JW Black	Diageo	Scotch	premium	#1	9%	-18%	10%	1%	23%	4%	11%
Smirnoff Red	Diageo	local vodka	standard	#1	-3%	2%	13%	13%	22%	9%	16%
inflation					5.7%	3.1%	4.0%	5.9%	4.9%	4.7%	4.9%
MEXICO					2005	2006	2007	2008	2009	04-09 CAGR	06-09 CAGR
JW Red	Diageo	Scotch	standard	#1	0%	-6%	6%	7%	19%	5%	11%
Chivas	Pernod	Scotch	premium	#2	8%	-14%	3%	23%	17%	6%	14%
Smirnoff Red	Diageo	local vodka	standard	#1	-9%	-1%	-1%	15%	13%	3%	9%
inflation					4.2%	3.6%	3.9%	6.5%	5.3%	4.7%	5.2%
RUSSIA					2005	2006	2007	2008	2009	04-09 CAGR	06-09 CAGR
JW Red	Diageo	Scotch	standard	#1	-25%	1%	42%	-22%	10%	-2%	7%
White Horse	Diageo	Scotch	low-price	#1	na	na	na	-13%	26%	-6%	na
Chivas	Pernod	Scotch	premium	#1	-30%	11%	20%	-17%	62%	4%	17%
inflation					12.6%	9.7%	9.0%	14.1%	11.7%	11.4%	11.6%
CHINA					2005	2006	2007	2008	2009	04-09 CAGR	06-09 CAGR
Chivas 12 yrs		Scotch	premium	#1	na	na	-3%	14%	2%	3%	4%
JW Black	Diageo	Scotch	premium	#2	7%	-4%	11%	4%	4%	4%	6%
Absolut	Pernod	imp vodka	premium	#1	-2%	-9%	7%	-3%	42%	6%	14%
Martell XO	Pernod	Cognac	XO	#3	-13%	34%	-1%	27%	2%	8%	8%
Martell Cordon Bleu	Pernod	Cognac	XO	#1	2%	9%	3%	31%	0%	8%	10%
Martell VSOP	Pernod	Cognac	VSOP	#3	-12%	18%	-12%	58%	2%	8%	12%
Hennessy XO	LVMH	Cognac	XO	#2	-1%	21%	4%	14%	3%	8%	7%
Hennessy VSOP	LVMH	Cognac	VSOP	#1	-7%	12%	3%	7%	2%	3%	4%
inflation					12.6%	9.7%	9.0%	14.1%	-0.7%	8.8%	7.3%
COLOMBIA					2005	2006	2007	2008	2009	05-09 CAGR	06-09 CAGR
Old Parr	Diageo	Scotch	premium	#1	na	2%	10%	20%	14%	11%	15%
Buchanans'	Diageo	Scotch	premium	#2	na	-7%	na	na	9%	8%	14%
JW Red	Diageo	Scotch	standard	#1	na	1%	0%	24%	10%	8%	11%
inflation					4.9%	4.3%	5.5%	7.7%	4.2%	5.4%	5.8%
SOUTH AFRICA					2005	2006	2007	2008	2009	04-09 CAGR	06-09 CAGR
JW Black	Diageo	Scotch	premium	#1	34%	-21%	27%	-5%	9%	7%	10%
Bells	Diageo	Scotch	standard	#1	20%	-6%	6%	11%	13%	9%	10%
Jameson	Pernod	Irish whisky	standard	#1	11%	15%	-13%	45%	10%	12%	12%
Smirnoff	Diageo	local vodka	standard	#1	33%	-6%	0%	11%	10%	9%	7%
inflation					4.3%	4.7%	8.0%	11.3%	7.2%	7.1%	8.8%
POLAND					2005	2006	2007	2008	2009	04-09 CAGR	06-09 CAGR
JW Red	Diageo	Scotch	standard	#1	-7%	3%	0%	-3%	42%	6%	11%
Ballantines Finest	Pernod	Scotch	standard	#2	-1%	-6%	-1%	3%	-2%	-1%	0%
JW Black	Diageo	Scotch	premium	#1	0%	6%	-6%	0%	30%	5%	7%
Absolut	Pernod	imp vodka	premium	#2	-1%	4%	-2%	4%	12%	3%	5%
inflation					2.1%	1.0%	3.8%	2.8%	3.8%	2.7%	3.5%
INDIA					2005	2006	2007	2008	2009	04-09 CAGR	06-09 CAGR
Smirnoff	Diageo	local vodka	standard	#1	3%	0%	na	na	7%	3%	4%
Blenders Pride	Pernod	whisky IMFL	premium	#1	0%	5%	na	na	2%	2%	2%
Royal Stag	Pernod	whisky IMFL	regular	#2	0%	0%	na	na	0%	1%	2%
inflation					4.4%	6.1%	6.1%	4.4%	3.6%	4.9%	4.7%

Source: IWSR and CIRA

Low elasticity

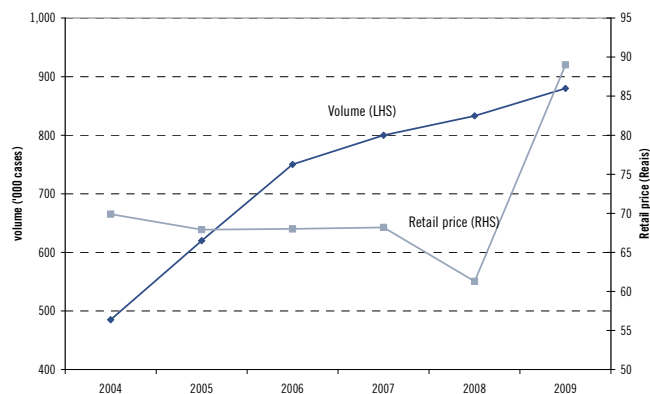
When spirit companies have taken sharp price increases (normally to recover FX or to curb demand in the case of Cognac in China) this doesn't seem to have had much impact on volumes. Figure 56 and Figure 57 illustrate the case of Martell Cordon Bleu in China and Johnnie Walker Red in Brazil. Other cases we have looked at also confirm the point.

Figure 56. Volumes and Retail price of Martell Cordon Bleu in China



Source: IWSR and CIRA Analysis

Figure 57. Volumes and Retail price of Johnnie Walker Red in Brazil



Source: IWSR and CIRA Analysis

This contrasts with packaged food, beer or home care products. When Unilever, Danone, SABMiller and others raised prices in emerging markets in 2008 to pass on input cost inflation, volumes suffered.

Emerging Markets growth adds to mix

Most of the volume growth for international spirits is achieved at premium prices and margins, unlike in most other consumer sectors.

In international spirits price points in emerging markets are no lower than in London, Paris or New York, as shown below.

Figure 58. Price points for international spirits brands in selected cities (all prices in USD) – approximate values

	J'burg	Shanghai	Sao Paulo	Mumbai	Moscow	London	New York	Paris
Johnny Walker Black	36	40	66	58	47	55	52	33
Absolut vodka	30	29	33	40	35	29	34	27
Smirnoff vodka Red	8	19	13	17	9	33	19	23
Mainstream beer	0.90	0.60	0.42	0.92	0.96	1.40	1.20	1.73

Source: Citi Investment Research and Analysis

By contrast in most other FMCG categories volume growth in emerging markets generates negative mix.

SAB's multi-beverages strategy in Africa in a sense is similar. It consists in building scale by offering cheaper products to less affluent consumers. Likewise, ABI in the North East of Brazil, with the more affordable 1-litre bottle.

Even in tobacco, although BAT and PMI have pricing power, the net prices they achieve are considerably lower than in developed markets, resulting in some margin dilution at group level, as the cost of producing Marlboro in France or in Ukraine is not different enough to compensate for the price differential (Marlboro sells at €1.13 in Kiev and €5.60 in Paris).

Competition is not too tough

One of the reasons why international spirits in emerging markets are very profitable is that competition is not especially intense, particularly in the more premium segments as Figure 59 shows. By contrast, in other more mainstream FMCG categories, international and local players fight aggressively over market share, for example in detergents in India or in beer in Russia.

Figure 59. Combined volume share of Diageo and Pernod Ricard across Emerging Markets

	BZ	CHI	COL	IND	MEX	POL	RUS	SAF	SK	THAI	TW	VIE
Premium scotch	97%	88%	98%	100%	99%	98%	91%	99%	77%	99%	69%	96%
Standard scotch	89%	56%	72%	55%	97%	80%	48%	86%	87%	97%	12%	87%
Low-price scotch	85%	Nm**	5%	55%	43%	34%	71%	53%	nm	97%	nm	nm
Standard vodka	96%	nm	nm	92%	48%	50%	0%	80%	nm	nm	nm	nm
Imported/premium vodka	72%	60%	84%	76%*	60%	90%*	3%	60%	nm	nm	nm	51%

* Pernod Ricard + Brown Forman. ** Nm means that the category is too small
Source: IWSR and CIRA

Premium spirits is an oligopoly, with limited supply and increasing demand. This helps pricing and margins

- **Premium (and ultra-premium) scotch** is an effective Diageo-Pernod duopoly in almost every market. China is fractionally more competitive, with Bacardi at ~10% share. In South Korea, a couple of local players also play in the premium segment, which nevertheless remains very profitable.
- Competition is a little more intense in **Standard scotch**, particularly in Russia and China-
- **Cognac** is a highly profitable oligopoly between Pernod, Moët Hennessy and Remy Cointreau. The fourth international player (Jim Beam) has virtually no presence in Asia.
- **Premium Vodka** doesn't appear to be very competitive either.
- Competition to Scotch from "newer" categories, like **US whiskey and Irish whiskey** is increasing, but remains fairly marginal except in Russia and in South Africa, where Irish whisky in particular has been growing fast. In Russia, Irish whisky has grown from ~6% to ~9% of the total whisky market in the last five years and Jameson (Pernod) has ~90% market share.

Local Spirits are not a threat

We don't see local spirits as a big threat, either, because they usually sell at different price point, with the partial exception of China and Russia:

- In China superpremium baijiu is priced in line, if not above, international spirits and has been growing rapidly, but for now the overlap with international spirits is limited, as baijiu is predominantly consumed in restaurants.
- In Russia, local players have been building a premium vodka segment, but international players' market share in the segment is marginal for now.

Diageo and Pernod in Emerging Markets

In this section we put emerging markets into context for Diageo and Pernod, comparing them to other staples. We highlight the most significant differences between Diageo and Pernod's emerging market exposures.

Lower exposure than for most staples, but higher than the European market

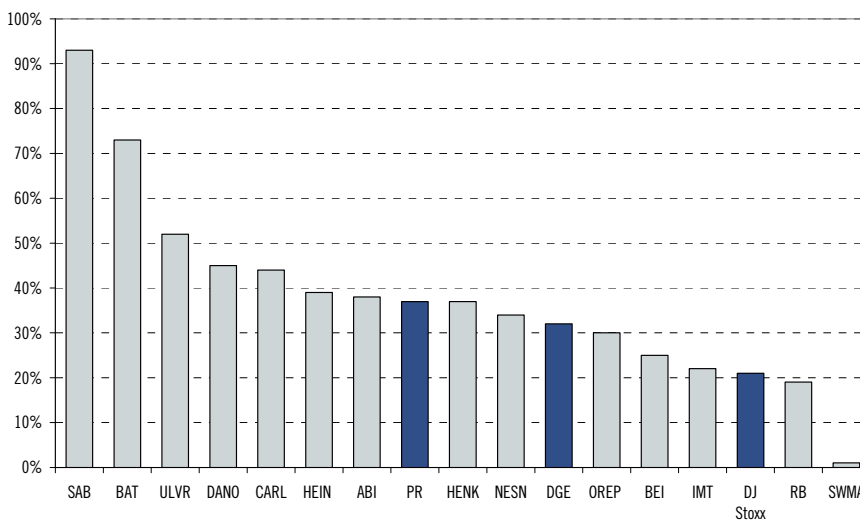
Pernod has a slightly higher exposure overall

For Diageo emerging markets account for 33% of sales and slightly below 30% of EBIT, we estimate.

Pernod's exposure is a little higher, at 37% of sales and a similar figure on EBIT.

- **Relative to the market:** Figure 60 shows Diageo and Pernod are significantly more exposed to developing markets than most European stocks.
- **Relative to other staples,** Diageo and Pernod's exposure is slightly below average. This reflects a core part of our thesis: disposable incomes need to be higher for consumers to trade into premium imported spirits. By contrast cigarettes, beer and packaged food/HPC products are more mass market products. As such they have more volumes currently in EMs, but less room to grow.

Figure 60. Sales exposure to Emerging Markets – 2010E



Note – EM EBIT exposure (adjusted to include associates and exclude minorities) is broadly similar to sales exposure for most companies. However there are a few exceptions: SAB ~82%, BAT ~51%, CARL ~58%, IMT 17%, BEI 10-15% and Diageo 28%. OREP, BEI, HENK and RB 2009.

Source: Company Reports and CIRA Estimates.

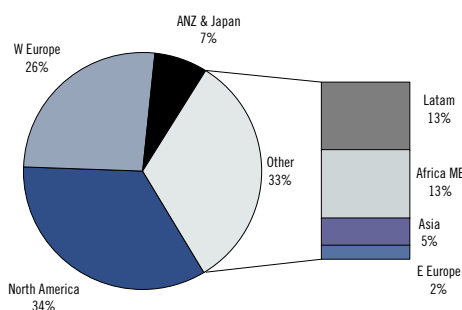
Diageo's diversification vs Pernod's exposure to China and India

Pernod is skewed to Asia

Although on the surface Diageo and Pernod appear to be fairly similar in terms of emerging market exposure, there are actually some significant differences.

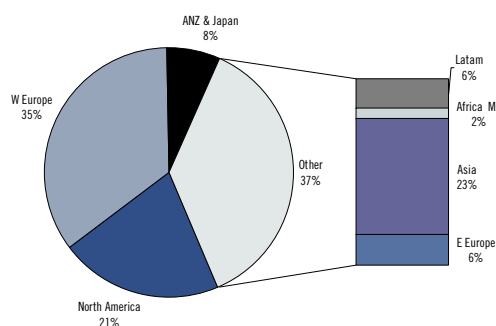
- **Geographic exposure** – Pernod is much more exposed to Asia, while Diageo's EM sales are largely skewed to Africa (70% of which is beer²²) and LatAm, as shown in Figure 61 and Figure 62.

Figure 61. Diageo sales breakdown (FY10)



Source: Company Reports and CIRA Estimates

Figure 62. Pernod Ricard sales breakdown (FY10)



Source: Company Reports and CIRA Estimates

While Diageo is genuinely global

- **Pernod has a stronger position in the markets that offer the most long-term growth: China and India.**

- At ~10% of group sales, China is **Pernod's** largest emerging market (in fact among all European large cap staples companies, Pernod has the greatest exposure to China). This position is very profitable, unlike the brewers' Chinese operations, as the mix is entirely focused on premium Cognac and Scotch. India accounts for ~5% of group sales. The profitability of India is below group average, as over 90% of Pernod's volumes are in local whiskey.
- **Diageo** has only limited exposure to China and India (just over 1% of sales in China and below 1% in India, we estimate). The position in India is still relatively weak and the one in China sub-optimal. Diageo's position would be transformed if it could buy the 66% it doesn't own of Moët-Hennessy, but it looks unlikely that LVMH will sell.

- **Diageo has a much more diversified (and hence defensive) geographic exposure**, with no country accounting for more than 3-4% of sales and EBIT. By contrast Pernod's dependence on China and India, make it riskier. We estimate that the two countries combined drive close to 40% of Pernod's growth.

²² In our report "Beer Usually Improves Performance" we highlight the positive outlook for beer in Africa and discuss other beer-related issues, which in part apply to Diageo in respect of its 22% sales exposure to beer.

Their brand portfolios are different:
Pernod is premium and local, whereas
Diageo's is premium and standard
international

Figure 63. Emerging Market Exposure – Most Important Countries For Diageo And Pernod Ricard (FY10) as % of sales

Diageo	% of sales	Pernod	% of sales
Nigeria	~3%	China	~10%
Kenya	~3%	India	~5%
Brazil	~3%	South Korea	~4%
Mexico	~3%	Mexico	~3%
South Africa	~2%	Brazil	~2%
South Korea	~2%	Russia	~2%

Source: Company Reports and CIRA Estimates

- **Brand portfolio** – Pernod's portfolio is a mixture of very expensive brands and low-priced local ones, with not much in between²³. By contrast Diageo, in addition to premium, has more standard Scotch and virtually no local product exposure.
- **Category differences** – Pernod has a strong and profitable position in Cognac, but Diageo doesn't participate in the category.

We discuss these issues in more detail in the company sections.

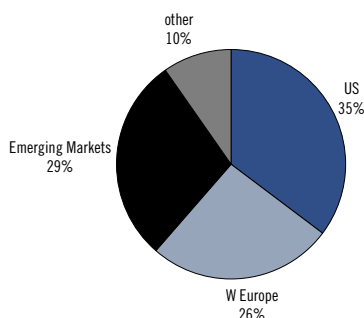
²³ Please refer to page 89 for more detail.

The US – Signs of Improvement

Why the US is important

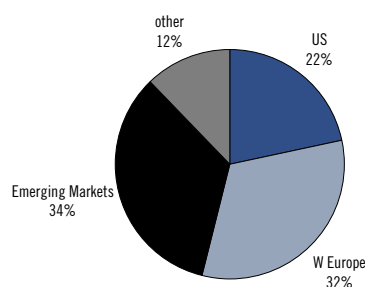
The US is the largest market globally for both Diageo and Pernod, accounting for 31% and 18% of sales respectively and a bit more in terms of EBIT as the charts below highlight.

Figure 64. Diageo – Group EBIT breakdown (FY10)



Source: Company Reports and CIRA Estimates

Figure 65. Pernod Ricard – Group EBIT breakdown (FY10)



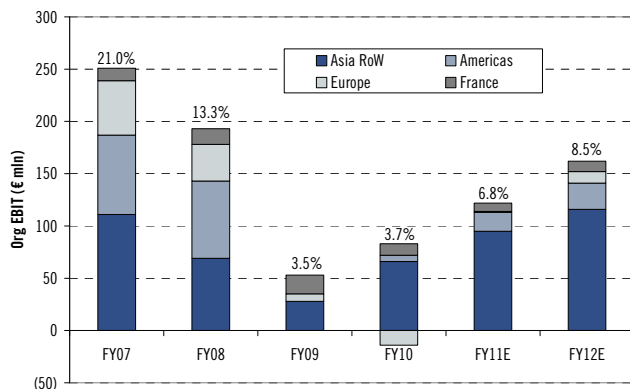
Source: Company Reports and CIRA Estimates

A major growth driver before the recession

Diageo: Up until the recession, the US had been a major growth driver for Diageo, with North America (which includes a small contribution from Canada) driving as much as ~50% of incremental group EBIT in FY07 and FY08.

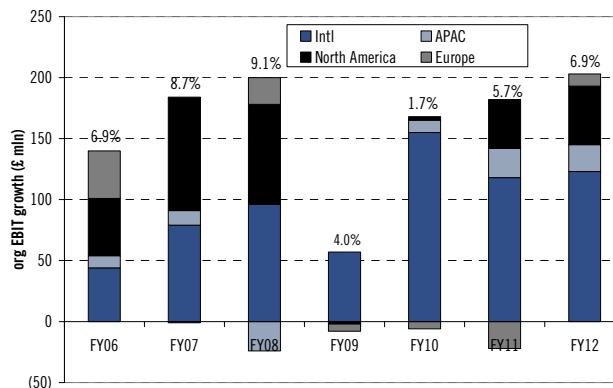
Pernod: Although not quite as important as for Diageo, the US contributed ~20% to Pernod's incremental profit in FY07-08 on our estimates. Since FY09, with the V&S (Absolut) acquisition, the US has increased its weight in the Pernod portfolio.

Figure 66. Pernod Ricard – organic EBIT growth drivers



Source: Company reports, Citi Investment Research and Analysis

Figure 67. Diageo – organic EBIT growth drivers (excludes Corporate)



Source: Company Reports and CIRA Estimates

Growth evaporated completely with the recession

Problem was reduced price/mix more than volumes

Figure 66, Figure 67 and Figure 68 show that growth in the US stalled with the recession. The real issue has not been the volume declines, but rather that price/mix has completely evaporated, driven by a combination of trading down, softness of the on-trade and increased promotions (particularly in the second half of 2009).

Figure 68. Top line and organic EBIT growth in North America/America for Diageo and Pernod

		FY06	FY07	FY08	FY09	FY10
Diageo - North America	Volume	4.5%	2.9%	1.6%	0.2%	-2.5%
	Price/mix	2.8%	3.6%	3.6%	0.5%	-0.2%
	Sales	7.3%	6.5%	5.2%	0.7%	-2.7%
	EBIT	6.0%	12.3%	10.0%	-0.2%	0.3%
Pernod – Americas*		FY06	FY07	FY08	FY09	FY10
	Sales	6.7%	12.3%	7.8%	-1.1%	3.7%
	EBIT	5.5%	19.4%	17.7%	0.0%	1.0%

* includes Latin America (~25% of divisional sales). Pernod Ricard doesn't split sales growth into volume and price/mix

Source: Company reports and CIRA Analysis

Recently there have been positive signs

Room to be cautiously optimistic

There are positive indicators which mean there is room for cautious optimism.

- **Price/mix** is improving, according to the AC Nielsen data we show on page 47, particularly for Diageo. This is mainly due to reduced discounts, but in addition mix is starting to improve.
- **Restaurant industry** sales trends (a good proxy for the on-trade) are improving, as Figure 70 shows.

This is confirmed by recent commentary from the companies.

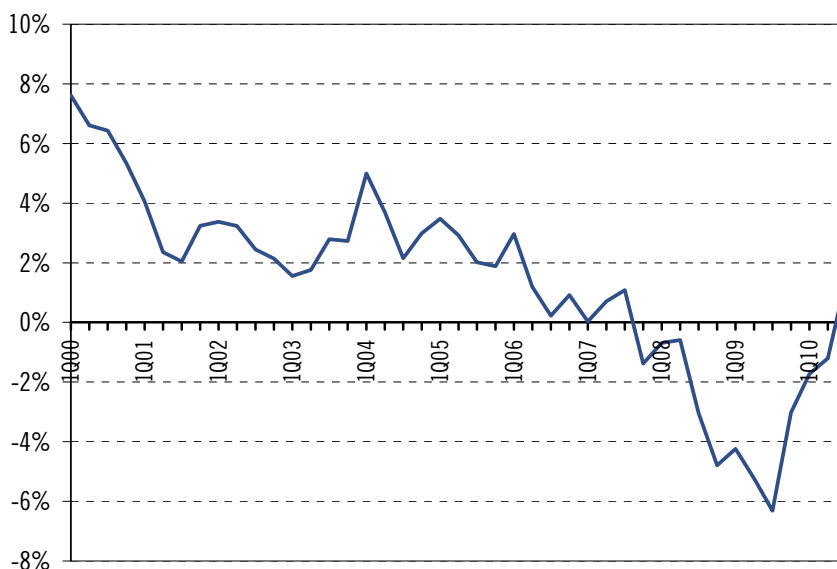
We don't want to get too carried away though, because unemployment remains stubbornly high and consumer confidence weak. Citi economists do not expect US unemployment to decline materially in 2011.

Figure 69. United States – Economic Forecasts, 2009-11F

	2009	1Q10	2Q10	3Q10	4Q10	1Q11	2Q11	3Q11	4Q11
GDP	-2.6%	2.4%	3.0%	3.2%	2.3%	2.1%	2.4%	2.6%	3.1%
Unemployment	9.3%	9.7%	9.7%	9.6%	9.6%	9.7%	9.6%	9.4%	9.2%
Consumption	-1.2%	0.8%	1.7%	1.9%	2.3%	2.6%	2.7%	2.7%	2.8%

Source: Citi Investment Research and Analysis

Figure 70. Citi US Casual Dining Same Store Sales Index – 1Q00 to 3Q10



Source: Citi Investment Research and Analysis

We believe our models are conservative

We only factor in a stabilisation in the US

To be conservative, we are factoring in a stabilisation, as opposed to a return to significant growth in the US. In other words, **if US profit trends do improve, this would provide significant profit upside, particularly for Diageo.** We discuss this in the section on Diageo.

Figure 71. Citi forecasts for Diageo North America and Pernod Americas

		FY10	FY11e	FY12e
Diageo - North America	Org Volume Growth	-2.5%	0.5%	1.2%
	Price/mix	-0.2%	1.9%	1.5%
	Org Sales Growth	-2.7%	2.4%	2.7%
	Org EBIT Growth	0.3%	3.4%	3.9%
		FY10	FY11	FY12
Pernod – US	Org Volume Growth	na	0.7%	1.1%
Pernod – US	Org Sales Growth	na	0.8%	2.1%
Pernod – Americas region	Org Sales Growth	3.7%	2.9%	3.9%
Pernod – Americas region	Org EBIT Growth	1.0%	3.3%	4.4%

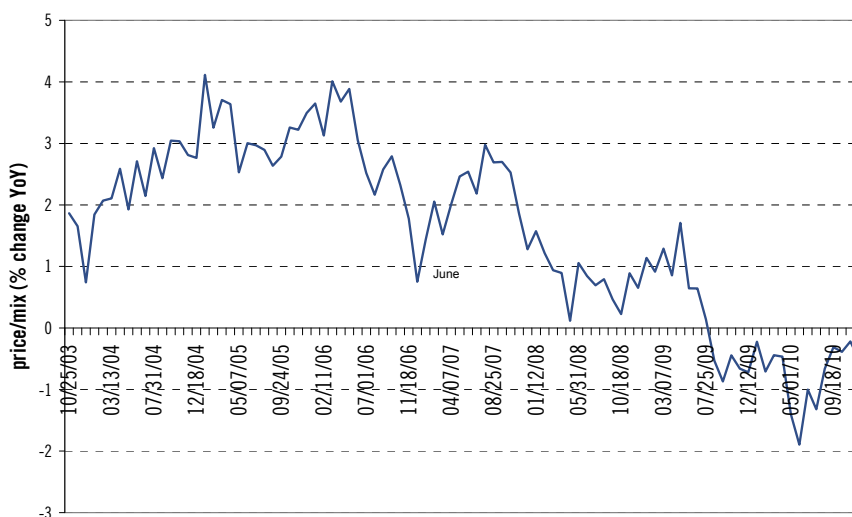
Source: Company reports, CIRA Analysis

Price/mix improvements

Price/mix is improving, but it still has a way to go

Figure 72 shows that industry price/mix has improved from June 2010, although it is still slightly negative (based on AC Nielsen data²⁴) and significantly below the 2-4% values that were the norm before the recession.

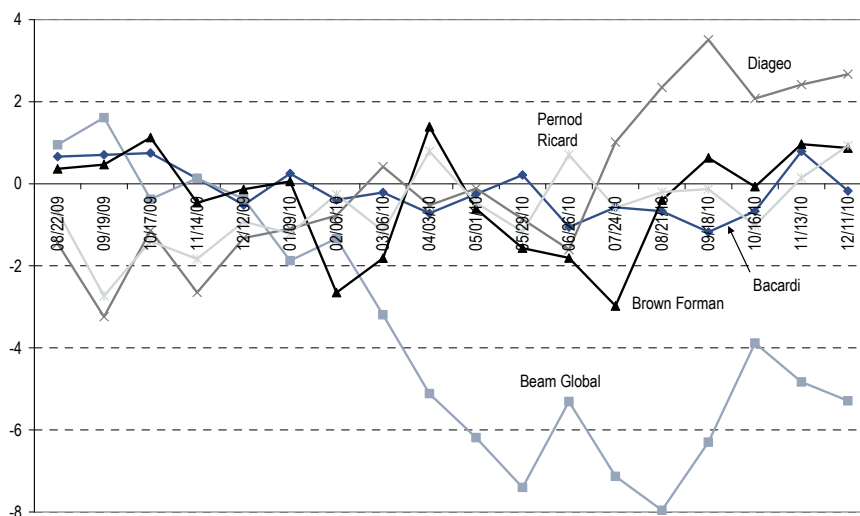
Figure 72. US spirits industry price/mix (2003 till present)



Source: AC Nielsen, CIRA analysis

The recent improvement is driven by significantly better price mix from Diageo and slightly better price mix from the other players, except Jim Beam.

Figure 73. US spirits industry price/mix (Aug 09 till present)



Source: AC Nielsen, Citi Investment Research and Analysis

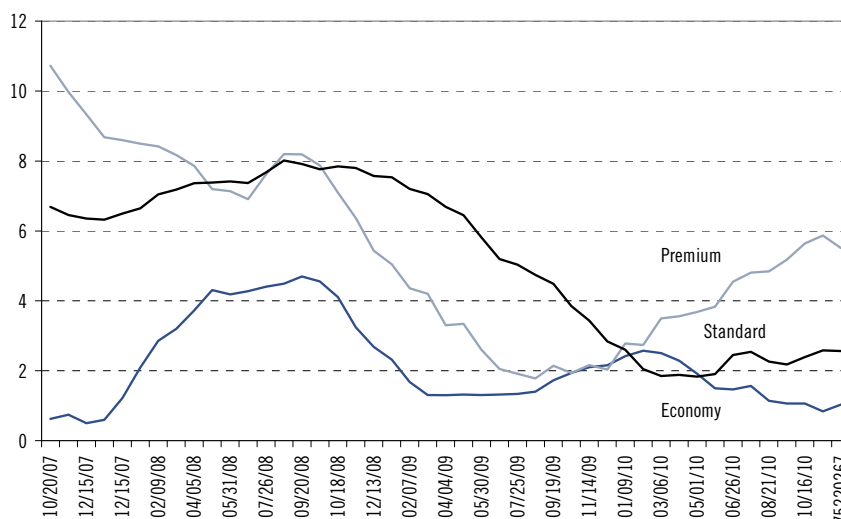
²⁴ The channels measured by Nielsen (supermarkets) are more promotional than on-trade and liquor stores

Again the signs are hopeful, but trading up is still much less powerful than it was

Signs of trading up

The main driver of the improved price mix has been reduced discounting, but Figure 74 (based on Nielsen data) indicates that trading up may also be reappearing: premium brands sales are on an upward trend and the economy segment has lost a bit of momentum.

Figure 74. Sales growth for Premium, Standard and Economy brands (MAT)



Built by averaging (weighted by sales) the performance of a group of premium, standard and economy brands²⁵. Source: AC Nielsen, CIRA analysis

Commentary from the companies is cautiously optimistic

But there is a good deal of variation by company

These encouraging signs are confirmed by recent company commentary, which on balance has turned to be cautiously optimistic.

Fortune Brands' CEO, Bruce Carbonari, at the 3Q10 conference call (28 Oct) sounded quite upbeat, saying:

- There was "a lot of promotion late last year and early part of this year. That's definitely settled down".
- "The mix has gotten better. Premiumisation has picked up again. We're also seeing on-premise growing again. I wouldn't say its back to the level it was but definitely momentum is toward getting back to the level it was."
- "Signs of the spirits business in the US are very healthy."
- "We expect it to be a pretty normal Christmas season" (from a promotions stand point).

²⁵ Our sample comprises for Premium: Ketel One, Grey Goose, Ciroc, Patron, Tanqueray, Hennessy, Maker's Mark, Bombay, Jagermeister and Crown Royal. Standard sample includes: Skyy, Smirnoff, Svedka, Jim Beam, Bacardi, Captain Morgan and Cuervo. And Economy sample includes: Popov, Kamchatka, Fleischmann's, Gordon's vodka, Sauza tequila, Canadian Mist, Black Velvet Canadian, Evan Williams Bourbon, Early Times Bourbon and Seagram's gin.

Campari's CEO, Bob Kunze-Concewitz, at the Q3 conference call (11 Nov), was a bit more cautious however:

- "We expect quite a competitive vodka market, especially in Q4."
- "We're really expecting a very competitive holiday season."
- "If you go to New York, you'd see the bars packed, but actually if you look at it on a national basis, that situation has stabilised. It hasn't worsened, but we haven't seen any significant improvement."

Somewhere in between **Pernod Ricard's CFO, Gilles Bogaert**, at Q1 conference call, (21 Oct) said:

- "In terms of the on-trade, we are in a way of stabilisation, but we cannot speak yet of a strong recovery."

Brown-Forman management at the Q2 results conference call (9 Dec) commented that:

- "The industry overall is starting to show a little bit more of recovery with each passing quarter."
- "On the pricing front it looks like it is starting to stabilise a bit."
- "We've certainly seen a lot of stabilization (in the on-premise) and have actually in more recent months started to see growth coming out of the on-premise."

Diageo President of North America, Ivan Menezes, on a conference call (14 Dec) said:

- "I am encouraged by the holiday sales report I'm hearing... We've seen on-premise sales continues to improve. Not back to full strength by any means, but getting into positive territory."
- "Spirits continues to recover with modest value and volume growth"...
- "Premium plus tiers are beginning to strengthen, but the business is still in an environment of price competition and promotions."

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Companies

Company Focus

- Company Update
- Initiation of Coverage

Buy/Low Risk	1L
Price (04 Jan 11)	£11.95
Target price	£14.30
Expected share price return	19.7%
Expected dividend yield	343.1%
Expected total return	362.8%
Market Cap	£29,908M
	US\$46,303M

Price Performance (RIC: DGE.L, BB: DGE LN)



Diageo (DGE.L)

The least risky emerging markets story and gearing to US upside

- **We initiate coverage of Diageo with a Buy/Low Risk (1L) recommendation and 1430p target price** — Diageo offers a defensive way to play western spirits in emerging markets and get the biggest leverage from any further recovery in US spirits, in our view.
- **We believe investors do not fully understand the EM opportunity** — Many investors fail to look beyond the fact that Diageo's EM exposure is lower in percentage terms than other consumer staples. But as we argue throughout this report, we believe the long-term opportunity for Western spirits in emerging markets is greater than for most other consumer sectors. Diageo dominates LatAm spirits, has very strong positions in other high growth markets like Russia and Vietnam and generates just under 10% of profit from Africa (mostly beer). Its scale in international spirits is greater than Pernod's in every emerging market except China, with strength in "standard" as well as in premium. This means Diageo can capture less affluent consumers, but also that it benefits less from the luxury dynamic that we have highlighted.
- **Defensive too** — Diageo's exposure to emerging markets is much more diversified than its peers', with no country accounting for over 3-4% of EBIT.
- **The US is a potential catalyst** — Diageo has suffered most from the slowdown in the US, but has most to gain from a further pickup (it still generates about 35% of its profits in the US). Our models are conservative, but there are positive signs there, both in terms of Nielsen data and management commentary. If the US returned to trend, we estimate EPS would accelerate by about 2-3 points.
- **Appetite for M&A** — With Net Debt/Ebitda falling below 2x in FY11E, there has been recent speculation about potential acquisitions, which could create some uncertainty about how the excess cash will be redeployed. We believe management will use the balance sheet in the best interest of shareholders.
- **We project 11% CAGR in EPS FY10-15E, without a significant pickup in the US** — With a compelling emerging markets opportunity ahead we think Diageo is good value at 14.2x calendar 2011E P/E and 3.6% dividend yield. Our price target assumes the multiple expands by 1.3 P/E point this year.

Diageo (GBP)

Year to 30 Jun	2009A	2010A	2011E	2012E	2013E
Sales (£M)	9,311.0	9,780.0	10,171.7	10,669.7	11,291.7
Profit Before Tax (£M)	2,160.0	2,431.0	2,718.1	2,981.4	3,291.8
Diluted EPS (p)	63.4	71.8	80.1	87.8	97.0
Diluted EPS (Old) (p)	63.4	71.8	80.1	87.8	97.0
PE (x)	18.9	16.7	14.9	13.6	12.3
EV/EBITDA (x)	12.8	12.5	11.5	10.4	9.5
DPS (p)	36.1	38.1	41.0	44.3	47.8
Net Div Yield (%)	3.0	3.2	3.4	3.7	4.0

Diageo – Financial Summary

Figure 75. Diageo – Financial Summary, 2006-2015E (Pounds in Millions)

Profit and Loss	2006	2007	2008	2009	2010	2011E	2012E	2013E	2014E	2015E 5-yr CAGR	
Net Sales	7,257	7,481	8,090	9,311	9,780	10,172	10,670	11,292	11,988	12,736	5.4%
EBITDA (adjusted)	2,258	2,329	2,533	2,870	3,042	3,252	3,486	3,741	4,033	4,345	7.4%
Margin	31.1%	31.1%	31.3%	30.8%	31.1%	32.0%	32.7%	33.1%	33.6%	34.1%	1.9%
Operating Profit (Adj EBIT)	2,043	2,119	2,304	2,588	2,751	2,941	3,150	3,387	3,659	3,951	7.5%
Margin	28.2%	28.3%	28.5%	27.8%	28.1%	28.9%	29.5%	30.0%	30.5%	31.0%	2.0%
Associates	131	149	177	164	142	159	184	208	232	255	12.5%
EBIT and post tax associates	2,174	2,268	2,481	2,752	2,893	3,100	3,334	3,595	3,891	4,206	7.8%
Net Finance	(186)	(212)	(319)	(592)	(462)	(382)	(353)	(303)	(247)	(184)	
Exceptionals (Pretax)	157	39	(69)	(170)	(192)	(30)	0	0	0	0	
Pretax Profit (before exceptionals)	1,988	2,056	2,162	2,160	2,431	2,718	2,981	3,292	3,644	4,022	10.6%
Underlying tax	(496)	(516)	(530)	(478)	(526)	(593)	(650)	(718)	(794)	(877)	
Underlying Tax Rate	24.9%	25.1%	24.5%	22.1%	21.6%	21.8%	21.8%	21.8%	21.8%	21.8%	
Minorities	(57)	(67)	(76)	(101)	(114)	(125)	(138)	(152)	(167)	(184)	10.0%
Adjusted Net Profit	1,435	1,473	1,556	1,581	1,791	2,000	2,193	2,422	2,683	2,961	10.6%
Per-Share Data (p)	2006	2007	2008	2009	2010	2011E	2012E	2013E	2014E	2015E 5-yr CAGR	
EPS (Adjusted, diluted)	50.3	54.4	60.2	63.4	71.8	80.1	87.8	97.0	107.4	118.6	10.6%
DPS	31.1	32.7	34.4	36.1	38.1	41.0	44.3	47.8	51.6	55.8	7.9%
Number of Dil. Shares Out (Avg FD)	2,852	2,707	2,583	2,494	2,496	2,497	2,497	2,497	2,497	2,497	0.0%
Growth Rates (%)	2006	2007	2008	2009	2010	2011E	2012E	2013E	2014E	2015E 5-yr CAGR	
Organic Vol	6.1%	5.4%	2.5%	-3.8%	1.6%	2.3%	3.1%	3.5%	3.5%	3.4%	
Organic Sales	6.1%	7.3%	6.5%	-0.3%	1.8%	4.4%	5.0%	5.8%	6.2%	6.2%	
Organic EBIT (adjusted)	6.9%	8.7%	9.1%	4.0%	1.7%	5.7%	6.9%	7.5%	8.0%	8.0%	
Sales (Reported)	8.7%	3.1%	8.1%	15.1%	5.0%	4.0%	4.9%	5.8%	6.2%	6.2%	5.4%
EBITDA	5.6%	3.1%	8.8%	13.3%	6.0%	6.9%	7.2%	7.3%	7.8%	7.8%	7.4%
Operating Profit (Adj)	5.7%	3.7%	8.7%	12.3%	6.3%	6.9%	7.1%	7.5%	8.0%	8.0%	7.8%
Profit before Tax	4.0%	3.4%	5.2%	-0.1%	12.5%	11.8%	9.7%	10.4%	10.7%	10.4%	10.6%
Net Profit (Adj)	21.6%	2.6%	5.6%	1.6%	13.3%	11.7%	9.7%	10.4%	10.8%	10.4%	10.6%
EPS (Adjusted, diluted)	26.8%	8.1%	10.7%	5.2%	13.2%	11.6%	9.7%	10.4%	10.8%	10.4%	10.6%
Cash Flow	2006	2007	2008	2009	2010	2011E	2012E	2013E	2014E	2015E 5-yr CAGR	
Operating Cash Flow	2,199	2,272	2,305	2,654	3,184	3,067	3,330	3,651	3,884	4,201	5.7%
Interest	(171)	(237)	(320)	(415)	(305)	(352)	(317)	(273)	(222)	(166)	
Tax	(393)	(368)	(369)	(522)	(474)	(527)	(585)	(646)	(715)	(789)	
Net capex	(241)	(205)	(262)	(341)	(231)	(387)	(385)	(408)	(434)	(461)	14.8%
Free Cash Flow (inc dvds to/from affiliates)	1,354	1,421	1,298	1,278	2,067	1,683	1,913	2,182	2,356	2,613	4.8%
Margin	18.7%	19.0%	16.0%	13.7%	21.1%	16.5%	17.9%	19.3%	19.7%	20.5%	
M&A	570	(72)	(567)	(125)	(248)	0	0	0	0	0	
New Equity	(1,404)	(1,404)	(1,007)	(354)	0	0	0	0	0	0	
Change in Cash Items	(376)	(988)	(1,261)	(159)	990	657	806	985	1,062	1,214	
Non-Cash Items	0	225	(341)	(813)	(525)	21	12	0	0	0	
Change in Net Debt	(376)	(763)	(1,602)	(972)	465	677	818	985	1,062	1,214	
End of Year Net Cash/(Debt)	(4,082)	(4,845)	(6,447)	(7,419)	(6,954)	(6,277)	(5,458)	(4,473)	(3,411)	(2,197)	
Ratios	2006	2007	2008	2009	2010	2011E	2012E	2013E	2014E	2015E 5-yr CAGR	
Interest Cover	11.0	10.0	7.2	4.4	6.0	7.7	8.9	11.2	14.8	21.4	
Dividend Cover	1.6	1.7	1.8	1.8	1.9	2.0	2.0	2.0	2.1	2.1	
Net Debt/EBITDA	1.8	2.1	2.5	2.6	2.3	1.9	1.6	1.2	0.8	0.5	
ROIC	19.9%	20.1%	20.0%	19.9%	19.6%	20.3%	21.4%	22.7%	24.2%	25.6%	
Historical Multiples	2006	2007	2008	2009	2010	2011E	2012E	2013E	2014E	2015E	
Historical Av Share Price (p)	851	992	1,039	891	1,028	1,162	1,197	1,197	1,197	1,197	
Historic Av Mkt Cap	24,186	26,663	26,664	22,130	25,543	28,894	29,769	29,769	29,769	29,769	
P/E	16.9	18.2	17.2	14.1	14.3	14.5	13.6	12.3	11.1	10.1	
Dividend yield	3.7%	3.3%	3.3%	4.1%	3.7%	3.5%	3.7%	4.0%	4.3%	4.7%	
FCF Yield	5.6%	5.3%	4.9%	5.8%	8.1%	5.8%	6.4%	7.3%	7.9%	8.8%	
Historic EV	27,876	30,242	30,319	29,073	33,623	36,225	36,218	35,251	34,189	33,053	
EV/EBITDA	12.3	13.0	12.0	10.1	11.1	11.1	10.4	9.4	8.5	7.6	

Source: Company Reports and CIRA Estimates

Figure 76. Diageo – Regional Summary, 2006-2015E (Pounds in Millions)

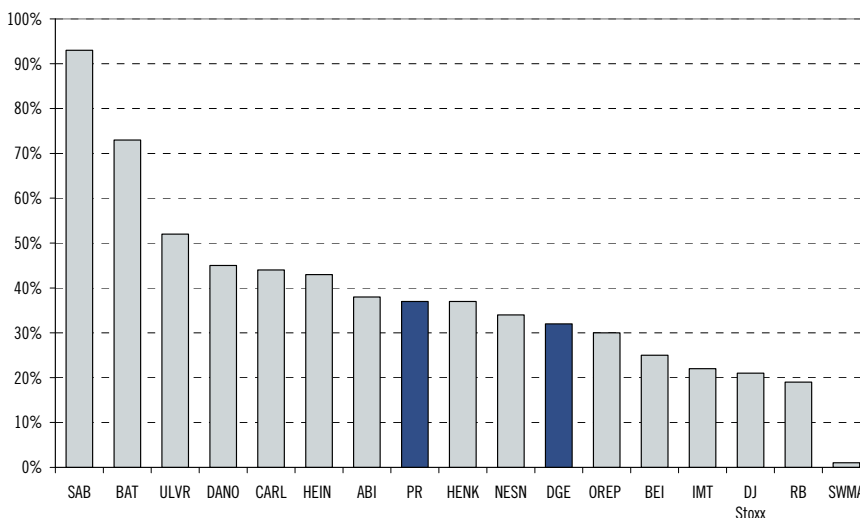
Sales	2006	2007	2008	2009	2010	2011E	2012E	2013E	2014E	2015E	5-yr CAGR
North America	2,507	2,472	2,523	3,290	3,306	3,402	3,509	3,622	3,748	3,880	3.3%
Europe	2,455	2,427	2,630	2,750	2,759	2,654	2,657	2,682	2,716	2,751	-0.1%
International	1,456	1,667	1,971	2,286	2,627	2,869	3,203	3,607	4,059	4,549	11.6%
Asia-Pacific	763	840	877	910	1,018	1,177	1,228	1,307	1,388	1,477	7.7%
Corporate	76	75	89	75	70	70	72	74	76	79	2.4%
Total Sales	7,257	7,481	8,090	9,311	9,780	10,172	10,670	11,292	11,988	12,736	5.4%
Operating profit	2006	2007	2008	2009	2010	2011E	2012E	2013E	2014E	2015E	5-yr CAGR
North America	828	850	907	1,156	1,170	1,234	1,293	1,348	1,415	1,481	4.8%
Europe	737	723	798	856	859	847	854	868	885	902	1.0%
International	445	499	593	645	771	860	983	1,131	1,295	1,475	13.8%
Asia-Pacific	199	196	170	164	176	225	245	266	290	317	12.5%
Corporate	(166)	(149)	(164)	(208)	(225)	(225)	(225)	(225)	(225)	(225)	0.0%
Total Operating Profit (Adj)	2,043	2,119	2,304	2,613	2,751	2,941	3,150	3,387	3,659	3,951	7.5%
Operating Margins	2006	2007	2008	2009	2010	2011E	2012E	2013E	2014E	2015E	5-yr change
North America	33.0%	34.4%	35.9%	35.1%	35.4%	36.3%	36.9%	37.2%	37.7%	38.2%	2.8%
Europe	30.0%	29.8%	30.3%	31.1%	31.1%	31.9%	32.1%	32.4%	32.6%	32.8%	1.7%
International	30.6%	29.9%	30.1%	28.2%	29.3%	30.0%	30.7%	31.4%	31.9%	32.4%	3.1%
Asia-Pacific	26.1%	23.3%	19.4%	18.0%	17.3%	19.1%	20.0%	20.3%	20.9%	21.5%	4.2%
Corporate	n/m	n/m	n/m	n/m	n/m	n/m	n/m	n/m	n/m	n/m	
Group Operating Margin (Adj)	28.2%	28.3%	28.5%	28.1%	28.1%	28.9%	29.5%	30.0%	30.5%	31.0%	2.9%

Source: Company Reports and CIRA Estimates

Under Appreciated Emerging Markets Story

We think Diageo's emerging market exposure is underappreciated. We believe many investors fail to look beyond the fact that, at ~33% of sales, Diageo's emerging markets exposure is objectively lower than other consumer staples'.

Figure 77. Sales exposure to Emerging Markets – 2010E



Note – EM EBIT exposure (adjusted to include associates and exclude minorities) is broadly similar to sales exposure for most companies. However there are a few exceptions: SAB ~82%, BAT ~51%, CARL ~58%, IMT 17%, BEI 10-15% and Diageo 28%. OREP, BEI, HENK and RB 2009

Source: Company Reports and CIRA Estimates

Diageo's relatively lower EM exposure
hides the scale of the opportunity

We think the 33% figure hides the scale of the opportunity.

1. **Diageo's exposure to emerging markets is much more diversified geographically than its beverages peers'**, making it a more defensive play. No single EM country accounts for more than 3-4% of Diageo sales or EBIT.
2. **It has broader scale in international spirits than Pernod**, with a strong position in the "standard" price segment, in addition to its exposure to premium. The benefits are: (1) operational leverage, (2) strong relationships with the modern trade, (3) greater flexibility to trade consumers up (or down in a recession) within its portfolio of brands.

The scale advantage is quite apparent in LatAm, where Diageo dominates the international spirits category. Vietnam and Russia are two other good examples.

3. **Diageo provides exposure to African beer** (~10% of Diageo's total sales) – we like beer and believe Africa offers the best long term opportunity in the space²⁶.

²⁶ On page 74 we provide a brief description of Diageo's beer exposure and in our report "Beer Usually Improves Performance" we discuss beer issue in greater detail.

A defensive play on emerging markets

Diageo's exposure to emerging markets is less dependent on any single country than any other large cap European beverages names, which makes it a more defensive play on the Emerging Markets upside.

Figure 78. Sales exposure to Emerging Markets for Diageo and Pernod (FY10)

Diageo	% of sales	Pernod	% of sales
Nigeria	~3%	China	~10%
Kenya	~3%	India	~5%
Brazil	~3%	South Korea	~4%
Mexico	~3%	Mexico	~3%
South Africa	~2%	Brazil	~2%
South Korea	~2%	Russia	~2%

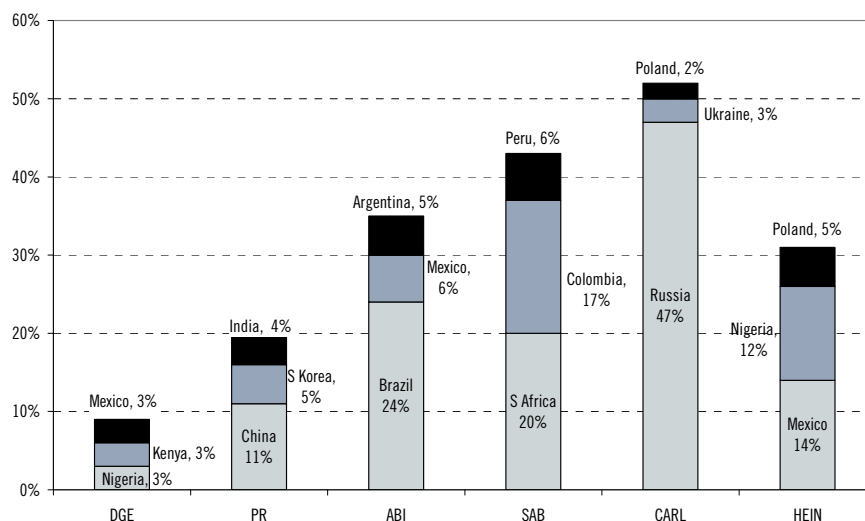
Source: Company Reports and CIRA Estimates

No single emerging market accounts for more than 3-4% of Diageo's sales

Figure 78 shows that no emerging market in Diageo's portfolio accounts for more than 3-4% of group sales (and also on EBIT).

By contrast, Pernod's two main emerging markets, China and India, account for 10% and 5% respectively of group sales and contribute about 40% of the growth between them. Amongst the brewers Carlsberg relies heavily on Russia (47% of group EBIT), ABI on Brazil (24% of EBIT, adjusted to strip out minorities and include associates), SABMiller on South Africa and Colombia and, to lesser extent, Heineken on Mexico and Nigeria.

Figure 79. Top 3 Emerging Markets for spirits and brewers (% of 2010E EBIT)



Note: Strips out minorities and includes Associates in group EBIT

Source: Company Reports and CIRA Estimates

Diageo's more defensive profile was borne out in the recent crisis. Figure 80 shows that at the worst point of the recession (2H09, Jan-Jun 2009) Diageo's international division markedly outperformed Pernod's Asia/RoW.

Figure 80. Diageo and Pernod Ricard's Emerging Market divisions through the recession

		1H09	2H09	1H10
Diageo - International	Org sales growth	11.0%	3.5%	8.3%
	Org EBIT growth	10.9%	7.6%	15.9%
Pernod Ricard - Asia/RoW	Org sales growth	9.0%	-7.2%	3.0%
	Org EBIT growth	18.0%	-7.4%	7.3%

Source: Company Reports

Diageo has greater scale than Pernod in international spirits (standard and premium)

Diageo's portfolio in emerging markets is almost exclusively focused on international spirits and offers more segmentation by price point than Pernod's.

Diageo's portfolio is more segmented by price point than Pernod's...

Figure 81 compares Diageo and Pernod's **Scotch portfolio** in most of the key emerging markets. It shows:

1. Diageo's scale in international spirits is greater than Pernod's in every market except China;
2. It achieves this because Diageo has scale in "standard" Scotch (mostly with Johnnie Walker Red), unlike Pernod, in addition to a strong position in the premium segment;
3. Diageo's volume in premium is almost double Pernod's although in percentage terms Pernod²⁷ is more exposed to premium than Diageo.

Figure 81 looks only at Scotch, so it is not exhaustive. However, the skew of portfolios are repeated in other categories:

- Diageo has strong positions in standard vodka, produced locally in some of the large markets
- Pernod is exposed to premium Cognac (mostly in Asia) and, on a smaller scale (in emerging markets), to premium vodka and Irish whisky. Pernod also has large volume exposure to declining local spirits, as we discuss in the section of the note covering Pernod.

The benefits of being big in standard

We see a number of positives from Diageo's exposure to standard international spirits as well as to premium spirits.

1. **More attractive partner for modern retailers** – Broader scale in international spirits allows Diageo to be a more attractive partner for the modern retailers, which are growing rapidly in emerging markets. For example in Russia, Diageo is doing category management work for Real and is also working closely with Metro and X5. In LatAm Diageo has over 30 category captaincies.

²⁷ The total figures for Pernod are distorted by its significant exposure to low-price locally bottled Scotch in Thailand (100 Pipers), which we look at as a local brand (including the fact that it is declining fast). We believe the total ex-Thailand probably provides a better indication of the structure by price-point of Pernod's Scotch portfolio globally

...which means it is able to recruit more consumers from local spirits

2. **Able to recruit lower-income consumers into its brands** – A strong presence in standard allows Diageo to attract consumers into its brands at lower income levels and then, hopefully, keep them loyal and trade them up (Johnnie Walker Red to Black for instance). Smirnoff's success in Brazil is another example of Diageo trading consumers up into international spirits, in this case from cachaça.
3. **Retain consumers in a downturn** – In an economic downturn, Diageo's portfolio is more likely to keep consumers in international spirits as they trade down. We saw this in Russia recently, where its value Scotch brand, White Horse, grew strongly and Diageo introduced Bell's in between Johnny Walker Red and White Horse. As a result in 2009 Diageo's volume share in Scotch increased from 47% to 54%.

The negatives are:

The offset is less pricing power

- **Less pricing power** – Partly because the target consumer is inevitably more price sensitive than in premium, and also because the segment is more competitive than premium.
- **Lower growth** – on a greater volume base, the growth rates will inevitably tend to be lower.

Figure 81. Scotch volumes ('000 9L cases) in key emerging markets – break-down by price segment, 2009

		Premium	Standard	Low-price	Total
Brazil	Diageo	296	1,071	89	1,456
	Pernod	95	117	261	473
China*	Diageo	435	35	0	470
	Pernod	845	37	0	882
Colombia	Diageo	418	257	15	690
	Pernod	75	183	5	263
India	Diageo	165	178	129	472
	Pernod	80	27	207	314
Mexico	Diageo	759	629	9	1,397
	Pernod	145	25	99	269
Poland	Diageo	29	212	5	246
	Pernod	26	159	29	214
Russia	Diageo	57	260	361	678
	Pernod	67	38	0	105
South Africa	Diageo	110	933	343	1,386
	Pernod	31	14	96	141
South Korea	Diageo	1,044	10	0	1,054
	Pernod	789	6	0	795
Thailand	Diageo	377	695	388	1,460
	Pernod	94	65	1,300	1,459
Vietnam	Diageo	106	65	0	171
	Pernod	43	2	0	45
Total	Diageo	3,796	4,345	1,339	9,479
	Pernod	2,290	673	1,997	4,960
Total	Diageo	40%	46%	14%	100%
	Pernod	46%	14%	40%	100%
	Pernod ex Thai	63%	17%	20%	100%

* For China we have included SuperPremium volumes in Premium

Source: IWSR and CIRA Analysis

Leveraged Play on US spirits market recovery

As we have highlighted, there are some clear signs of improvement in the US spirits market (price mix improving, slight on-premise recovery, all confirmed by more positive comments from the companies). On the other hand we don't want to get too carried away, because of the uncertain economic outlook.

The US is Diageo's largest market, at 35% of group EBIT

If the US were to improve further, we think it would act as a material catalyst for Diageo. The US is Diageo's largest market (~31% of group sales and ~35% of EBIT) and drove close to 50% of its organic EBIT growth in the years preceding the recession, but its contribution has been virtually zero since FY09 (Figure 82).

We estimate that if the US returned to its long-run trend, it would add about 3 percentage points to EPS growth

Our forecasts for North America are conservative

Our forecasts (Figure 82) only model a slight improvement in FY11E and thereafter for Diageo North America (and we believe the same is true for consensus) driven by:

1. **Volume stabilisation** in FY11 and modest growth thereafter.
2. **Price/mix improving in FY11**, as Diageo has reversed its promotional strategy, and remaining at ~1.5% in the outer years
3. **Marketing reinvestment** (+80bp in FY11, in our assumptions) constraining EBIT growth (which we only model at +3-4%)

The main point is that our forecasts look conservative compared to the growth rates achieved in the recent past, but at this point we believe there is not enough visibility to get too optimistic.

Figure 82. Diageo North America – organic volume, price/mix, sales, EBIT growth and contribution to org group EBIT growth (ex corporate)

	FY04	FY05	FY06	FY07	FY07	FY09	FY10	FY11E	FY12E	FY13E
Org volume growth	3.0%	4.1%	4.5%	2.9%	1.6%	0.2%	-2.5%	0.5%	1.2%	1.5%
Org price/mix	7.0%	1.4%	2.8%	3.6%	3.6%	0.5%	-0.2%	1.9%	1.5%	1.7%
Org sales growth	10.0%	5.5%	7.3%	6.5%	5.2%	0.7%	-2.7%	2.4%	2.7%	3.2%
Org EBIT growth	14.0%	11.1%	6.0%	12.3%	10.0%	-0.2%	0.3%	3.4%	3.9%	4.2%
Contribution to group EBIT	na	67%	34%	51%	47%	0%	2%	25%	24%	24%

Source: Company reports, Citi Investment Research and Analysis

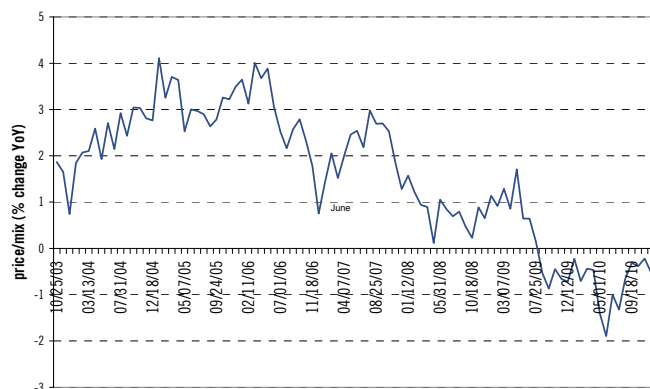
Recently there have been positive signs

Industry price/mix is improving and the on-trade is starting to recover

We have noted in the report that there are positive indicators in the market, which leave room for cautious optimism.

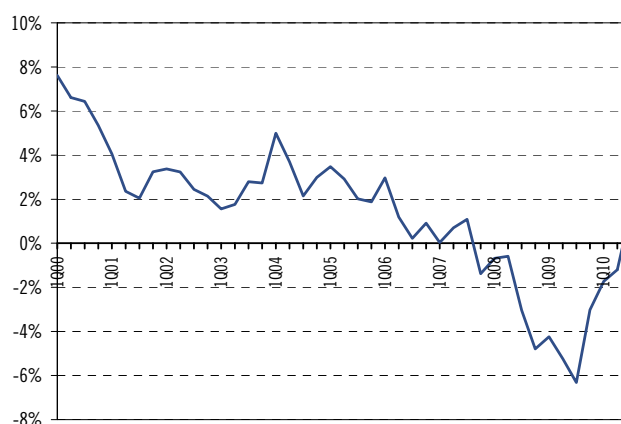
- **Industry price/mix** is improving, according to the AC Nielsen data, and
- **Restaurant industry** sales trends (a proxy for the on-trade performance) are improving.

Figure 83. US spirits industry price/mix (2003 till present)



Source: AC Nielsen, CIRA

Figure 84. Citi US Casual Dining Same Store Sales Index – 1Q00 to 3Q10



Source: Citi Investment Research and Analysis

If these signs are confirmed and the US does improve more than we expect, we believe Diageo would benefit materially, given its significant exposure to the US market.

Diageo is really behaving as the market leader

We are encouraged by the fact that Diageo now seems to be behaving as the industry leader, as we believe it should:

- It has reversed its strategy on pricing/promotions;
- It has significantly stepped up marketing spend;
- It has accelerated the pace of innovation and;
- It has stepped up investment in the on-premise channel.

No more aggressive promotions

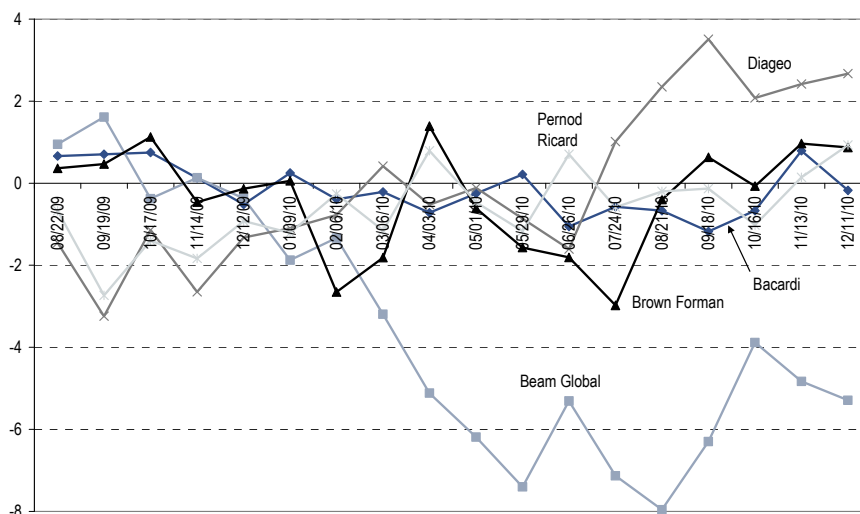
Diageo's strategy on pricing/promotions has changed significantly over the last few months.

Towards June 09 Diageo started promoting more aggressively some of its core brands (Smirnoff, Captain Morgan, Crown Royal) as a response to share losses to value brands. As the other players in the industry responded, the 2009 Thanksgiving/Christmas season became very promotional. Diageo didn't gain any value market share according to Nielsen data.

Diageo's price/mix has turned positive

After the holidays, in January 2010, Diageo eased the level of promotions and price/mix turned positive towards June, according to AC Nielsen, as they started cycling the 2009 promotions. The improvement has been stronger for Diageo than for the other players in the industry, as shown in Figure 85.

Figure 85. US spirits industry price/mix (Aug 09 till present) - % change



Source: AC Nielsen and CIRA

Higher marketing spend and innovation

Diageo's marketing spend in North America was up 21% in 2H10 and will be up high single digit in FY11

Diageo has stepped up its marketing spend significantly in recent quarters (+21% organically in North America in 2H10; +25% in the US in 4Q10. For FY11 Diageo has guided that marketing spend will be up high single digit) and has increased its innovation efforts, among other things, with Crown Royal Black (selling at a \$5 premium to Crown Royal) in 2H10 and several new launches in vodka over the summer (a Swedish import, Rokk, in three flavours; Ursus also in three flavours; Moon Mountain; chocolate infused Godiva; new flavours also for Smirnoff).

We believe Diageo is doing all the right things to prepare the conditions for the industry to take pricing again. Diageo has indeed taken some pricing in October on a selected number of brands/channels in a few states, but we understand that others have not followed. We are optimistic however that in 2H CY11 the industry can take pricing. The brewers have been pricing above inflation throughout the crisis.

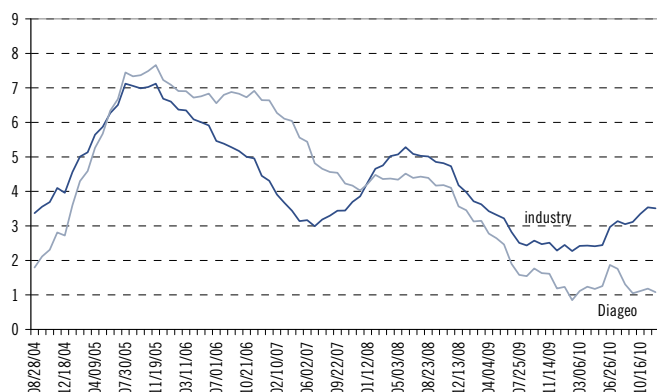
Improvements should become apparent in the results

Diageo share losses in measured channels are offset by gains in the on-premise

As Diageo has moved away from promotions, its share loss has accelerated in the measured channels (which are more promotional), but this is largely offset by share gains in the on-premise²⁸.

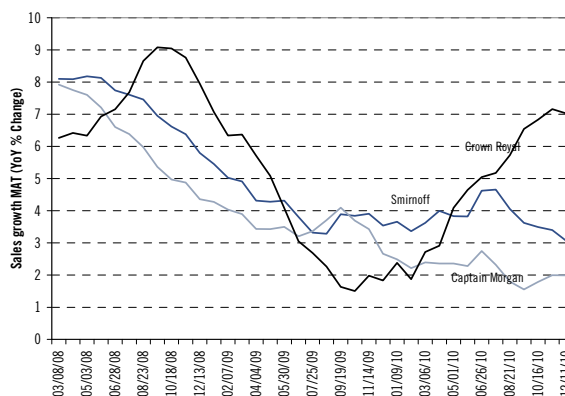
It is noteworthy that sales trends have improved markedly for Crown Royal, Diageo's most profitable large brand. Smirnoff is broadly stable at +3% (MAT) and Captain Morgan has seen some volume softness as a result of the lower level of promotions.

Figure 86. Sales growth – Diageo vs US industry (YoY % change, MAT)



Source: AC Nielsen and CIRA

Figure 87. Sales growth – Diageo 3 largest US bands (YoY % change, MAT)



Source: AC Nielsen and CIRA

We expect the positive brand mix and significantly reduced discounting activity to come through in Diageo's results: 2H10 already showed a sequential improvement in Diageo's price/mix in North America from -1.3% in 1H10 to +0.8%, contributing to +3% EBIT growth in the semester. We expect to see price/mix continue to improve to +2.2% in 1H11E (with organic sales up +2.9%) and EBIT growth at around +3.4%, held back by a double-digit increase in A&P and investments in the on-premise channel.

What if the US were to improve more than we forecast?

Our models assume that in the next 5 years, US spirits grow much slower than trend. (Sales have grown 5.5% CAGR in the last 40 years and 4-9% between 2000 and 2007.)

In Figure 88 we show what our current, modest forecasts are for North America, group EBIT and EPS, but in Figure 89 we show a scenario with 6% sales growth in the US (+3% volume and +3% price/mix), in line with the historical average, leaving all other assumptions in the model unchanged.

²⁸ According to Ivan Menezes (President of Diageo North America) on 14 December conference call.

The uplift to North American EBIT growth would be pretty material (5-6%), resulting in 2-3% accretion to group EBIT and EPS.

Figure 88. Diageo – Current growth forecasts in model

	FY11E	FY12E	FY13E
North America Sales	2.0%	2.7%	3.2%
North America EBIT	3.4%	3.9%	4.2%
Group EBIT	5.7%	6.9%	7.5%
Group EPS	11.6%	9.7%	10.4%

Source: CIRA Estimates

Figure 89. Diageo – Growth forecasts assuming 6% sales growth in FY12 and FY13

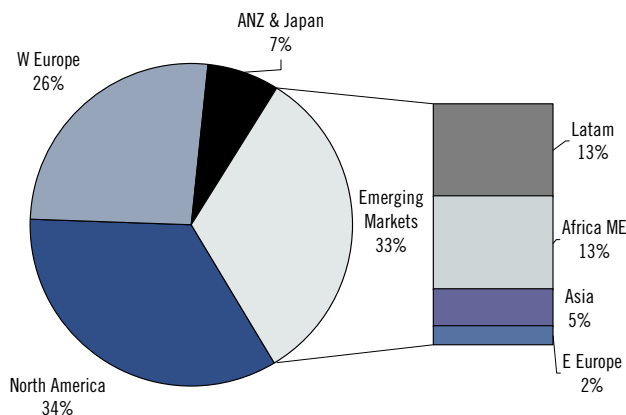
	FY11E	FY12E	FY13E
North America Sales	2.0%	6.0%	6.0%
North America EBIT	3.4%	9.9%	9.1%
Group EBIT	5.7%	9.4%	9.5%
Group EPS	11.6%	12.6%	12.7%

Source: Citi Investment Research and Analysis

Diageo's emerging markets positioning

Figure 90 gives a geographic breakdown of Diageo's sales.

Figure 90. Diageo sales breakdown (FY10)



Source: Company Reports and CIRA Estimates

Diageo over-indexes on LatAm and Africa

It over-indexes on LatAm and Africa, the complete opposite to Pernod, which is stronger in Asia.

Diageo's strengths are:

- It dominates the international spirits market in **LatAm** (13% of group sales).
- It is exposed (and makes a lot of money) to the best emerging beer region, **Africa** (13% of sales, ~70% of which comes from beer). The spirits category is still relatively underdeveloped in Africa, apart from South Africa, but in the long term will provide a growth opportunity. Diageo is ideally positioned to leverage it.
- It has pockets of strength (and high margins) in other countries like **Russia**, **Vietnam**, and **South Korea**.

We provide here a little more depth on Diageo's business in LatAm and Africa, which represent the bulk of its International division²⁹.

²⁹ International is 27% of Diageo sales and 26% of group EBIT (excluding corporate). The division includes Latam, Africa and GTME (Global Travel and Middle East).

Scotch has been growing fast,
particularly in Mexico

Latin America – Scotch domination

Diageo dominates the Scotch category, which accounts for 60-70% of the international spirits market in the region and has been growing as much as 7% CAGR (2003-09) in Colombia and Brazil and 17% in Mexico.

Figure 91³⁰ gives a sense just of how strong Diageo's position is and of how Diageo has been leveraging it to take share over the past few years.

Figure 91. Volume market shares in Scotch volumes – 2009 and 2003 in brackets

	Brazil	Mexico	Colombia
Premium	74% (63%)	82% (79%)	85% (87%)
Standard	81% (70%)	93% (83%)	34% (26%)
Low End	27% (10%)	3% (2%)	3%

Source: IWSR and CIRA Analysis

Vodka is growing fast in Brazil. Of all emerging markets, Brazil seems to be the one offering the greatest upside for the category in the medium term, as it provides young adults with an obvious trading-up alternative from the local spirit, cachaça.

Smirnoff, which Diageo produces locally, is the largest vodka brand in the country and has grown 14% CAGR since 2003. Margins however are likely to be well below Scotch, as Smirnoff retails at a price of around 13 US\$.

Outside of Brazil vodka is still relatively small, but Diageo's strong route-to-market represents a good platform to build on.

Africa – beer today, spirits tomorrow

Spirits is tiny in Africa...

Diageo's African business is very much about beer (~70% of regional sales). Apart from South Africa, where Diageo has a 70% share in Scotch and a presence in local vodka with Smirnoff, Spirits remains a tiny category in Africa. There is long term potential however.

...but Africa is the best emerging region
for beer

As far as beer is concerned, we think Africa is the best emerging region to be in, as we discuss in our accompanying document "Beer Usually Improves Performance" for two reasons:

1. **Better volume growth** (mid/high single digit), driven by favourable demographics, urbanisation and the fact that millions of Africans are moving into the cash economy;
2. **Beer is very profitable in Africa:** competition is low, as most markets are either monopolies or duopolies, as we show in Figure 92. In its two largest markets, Diageo's EBIT margins exceed 30% in Kenya and are around 23% in Nigeria.

³⁰ Diageo also has a dominant market share in Venezuela, the other large Scotch market in Latin America. Scotch consumption in the country is being hit hard however by the devaluation of the Bolivar.

Figure 92. Beer market shares in Africa (volume, 2009)

Market	Mkt size - mln HL	DGE share	Competition	% of Africa sales
Kenya	4.7	96%	SAB 1%	23%
Nigeria	11.8	25%	Heineken 67%	27%
South Africa	26.4	12%	SAB 88%	15%*
Uganda	2.3	48%	SAB 51%	6%
Ghana	1.9	65%	Castel 33%	9%
Cameroon	6	17%	Castel 80%	6%
Tanzania	4.1	15%	SAB 68%	
Cote d'Ivoire	1.3	4%	Castel 94%	
Gabon	1.1	6%	Castel 87%	

* includes spirits

Source: Canadean, company reports and CIRA Analysis

Asia is sub-optimal

Diageo's position isn't great in China and India

Asia could be better for Diageo, in our view. In China and India, the two markets that possibly offer the greatest long term upside for the industry, we believe Diageo's positioning is suboptimal.

In **India** we are concerned that the lack of a strong local distribution platform³¹ may constrain Diageo, in the event of the market opening up to international spirits.

In **China** Diageo was a bit late to the Scotch boom, but with heavy investment it has considerably narrowed the gap. The critical issue we believe is the long term outlook for its relationship with Moët Hennessy.

The relationship with Moët Hennessy in China

Not allowed to own a cognac brand

In China and a few other Asian markets³², Johnnie Walker is distributed through a JV between Diageo and Moët Hennessy³³. The terms of Diageo's relationship with Moët Hennessy do not allow Diageo to compete in Cognac (or champagne). In other words Diageo is not allowed to own a Cognac brand, as long as it has its stake in Moët Hennessy.

The Moët Hennessy JV has pros and cons

On the one hand the JV represents a powerful route-to-market for Johnnie Walker, but on the other hand it poses some conflicts:

1. Diageo is not 100% in control of the distribution of its key brand, Johnnie Walker, in the number one emerging market.
2. Diageo cannot participate directly in the Cognac category. Cognac is, with Scotch, the fastest growing category in the Chinese imported spirits market and it is very profitable.
3. One can also argue that the JV possibly constrains the development of Diageo's other brands. Diageo has had to set up a separate distribution system for these brands, but we believe they would benefit from being distributed on the same platform as Johnnie Walker.

³¹ Diageo's route to market in India mostly through its JV with Radico, the #3 player in the market (behind United Spirits and Pernod), but results to date haven't been great.

³² Thailand, Macau, Hong Kong, Singapore and Malaysia.

³³ Moët-Hennessy is 34% owned by Diageo and 66% owned by LVMH. The Diageo-MH JV also distributes Hennessy Cognac, Moët Hennessy's Champagne brands and Diageo's gin.

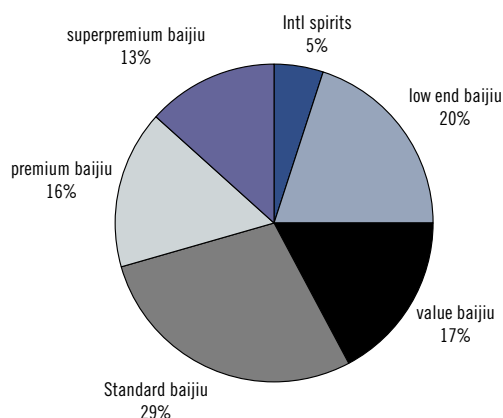
What is Diageo doing in China?

Diageo is investing heavily to support its brands and build scale for its distribution platforms, which in the short term is holding back profitability (we estimate that China just about breaks even). Johnnie Walker is enjoying strong momentum and has recently gained ~350bp of share in the premium segment³⁴ and is back to ~35% share.

Diageo has a presence in local baijiu

Diageo acquired a 49% stake in **Shui Jing Fang, the #4 player in the fast growing super-premium baijiu** (Chinese white spirit) market and is in the process of seeking regulatory approval to gain control of the company³⁵. The route-to-market for baijiu is different from that of western spirits, as baijiu is mostly consumed in restaurants whereas Scotch is sold predominantly in bars. Nevertheless, we see strategic value in having a position in the most attractive segment of the immense Chinese white spirits market. Superpremium baijiu is larger in value than international spirits in China and has been growing 10% CAGR in recent years.

Figure 93. Chinese Spirits market (value, 2009)



Source: Diageo

It is not a secret that Diageo would like to acquire the 66% stake it does not own in Moët Hennessy³⁶, if it could, but we believe this is unlikely in the short term, as we discuss in the section on Diageo's M&A.

³⁴ According to Gilbert Ghostine, Diageo's APAC President (conference call on APAC region, Sep 2010)

³⁵ Diageo announced at the beginning of 2010 an agreement to increase its stake from 49% to 53%, but the transaction hasn't yet been cleared by the Chinese authorities. If approved, it will trigger a mandatory tender offer on the minorities.

³⁶ The press has commented about this on several occasions, including interview to Reuters in August 2009 where Diageo CEO Paul Walsh said "If ever the 66% was available we would be interested".

We trust management to use the balance sheet in the best interest of shareholders, but we do believe there is some uncertainty about how the excess cash will be redeployed.

Diageo has been reported to be interested in Moët Hennessy, Fortune Brands and Mey Icki

Diageo's Appetite for M&A

There could be some uncertainty about how the excess cash Diageo is generating will be redeployed, given there is speculation that Diageo is considering possible acquisitions. We estimate that Diageo could spend £5bn without using its targets balance sheet at all, and still remain investment grade.

We believe that Diageo may want to make an acquisition because:

- Management has commented on several occasions over the past 3 years that it would like to make further acquisitions if its strategic and financial criteria are met³⁷;
- The balance sheet is beginning to get less efficient (we estimate net debt/EBITDA will fall below 2x in June 2011); and
- Management has not bought back any shares since 1H09, although the Board is considering whether to restart the buy back.
- The issue is widely discussed in the market

Ten years since the last major acquisition

The balance sheet is strong because it has been ten years since Diageo announced its last large deal, which was Seagram. Since then it has made only mid-sized and smaller acquisitions, including the 50% stake in Ketel One, a few premium wine brands, a minority stake (so far) in Shui Jing Fang and Smirnov in Russia.

Possible targets

Over the past few months Diageo has been reported to be interested in:

- The 66% **Moët Hennessy** it doesn't already own;³⁸
- Parts of **Fortune Brands'** spirits business;³⁹
- The Turkish spirits company **Mey Icki**.⁴⁰

And on a smaller scale Diageo is in talks to acquire a 50% in **Zacapa** rum⁴¹.

As we have discussed, Diageo is waiting for approval from the Chinese authorities to raise its stake in **Shui Jing Fang** from 49% to 53% which would trigger a tender offer on the minorities, costing Diageo up to £550m.

In addition, the terms of the 2008 acquisition of 50% stake in **Ketel One** allow the Nolet Group to put its 50% stake to Diageo at \$900m plus interest between June 2011 and June 2012.

³⁷ Diageo has stated in the past that potential acquisitions have to meet WACC in year 3-4, but it has recently become more flexible (Shui Jing Fang should meet WACC in year 5, according to management).

³⁸ The press has commented on several occasions about Diageo's interest in buying the 66% it doesn't own, including an interview to Reuters in August 2009 where CEO Paul Walsh said "If ever the 66% was available we would be interested".

³⁹ Reuters, 17 November 2010. Ivan Menezes (President of North America, Diageo) confirmed on a conference call on 14th December that Diageo is "looking at the Fortune Brand developments very closely"

⁴⁰ The WSJ reported on 9 December 2010 that Diageo was in preliminary talks to buy Mey Icki. The company hasn't commented on this.

⁴¹ Reuters, 23rd November 2010. Diageo distributes the brand on the basis of a 3-year agreement that ends in April 11 and has the option to acquire 50% stake in the company.

Diageo currently has distribution rights for the **Cuervo** tequila brand (one of its eight Global Priority brands), which will expire in 2013. It would be beneficial for the company to own the brand, but we don't know if the brand is for sale.

All these targets, with the exception of Moët Hennessy (which we believe is the most interesting strategically, but also the most unlikely in the short term) **could be debt financed quite easily**, in our opinion.

We can't rule out a buy back

This means that we can't rule out the possibility that Diageo also restarts buying back its own shares in 2H11. The issue is under discussion at Board level, but management has also stated in the past that strategic deals are the preferred use of its cash.

How much could Diageo afford?

Diageo's credit rating is A- with S&P and A3 with Moody's. We believe that Diageo would be keen to maintain investment grade and we believe it might consider equity issuance if needed.

Diageo could raise £5bn in debt if it needed to

With an estimated FY11 net debt of £6.3bn⁴² and net debt /EBITDA at 1.9x, we believe Diageo could raise around £5bn in debt and still be investment grade (this would take its Net Debt/Ebitda to 3.5x) on top of which Diageo could leverage up the balance sheet a potential M&A target if it needed to.

Moët Hennessy would be the best strategically (and most expensive) deal, but it seems unlikely in the short term

In our opinion, Moët Hennessy would be the best possible deal for Diageo and we believe it is also at the top of management's wish list. However, **we don't believe it is likely to happen any time soon, as we don't think LVMH has any intention to sell its 66% stake at least for now⁴³. Even if it did, we believe Diageo would have to pay a very full price and may raise equity**, which would make it less compelling for its shareholders in the short term.

Owning 100% of MH could be game changing for Diageo

However, **owning 100% of Moët Hennessy would be game-changing for Diageo from a strategic perspective**, in our view.

- It would completely transform Diageo's positioning in China, solving the issues we discussed above. Hennessy is the number 1 Cognac brand in the market in volumes terms with 41% share, although Martell, Pernod's brand, is stronger in the ultra premium (XO and above) and intermediate segments. In addition Moët Hennessy has a strong position in Russia.
- It would provide Diageo with some of the best premium brands globally (Hennessy cognac, Belvedere vodka – likely antitrust issues in the US however – and the most iconic champagne brands, including Krug, Veuve Clicquot, Moët & Chandon).

Synergies wouldn't be limited however

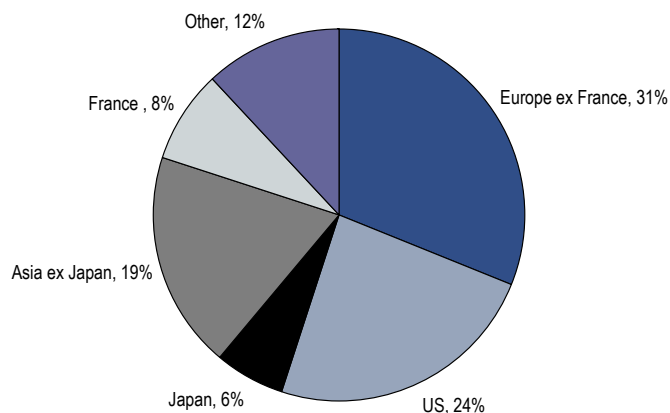
Synergies wouldn't be very large in our view, as Moët Hennessy and Diageo already go to market jointly in a number of countries, including China, France and the US (where they are distributed by the same exclusive distributors).

⁴² Year end value

⁴³ In October, following the Hermes stake build speculation, LVMH publicly denied once more that it was considering selling Moët Hennessy (Reuters, 21 October 2010). Citi's Luxury Goods analyst, Thomas Chauvet, believes that LVMH may consider selling only in the event that it needed to raise cash for a large acquisition, but a Hermes deal looks unlikely in the short term, given that the controlling shareholders are strongly opposed to a takeover.

Nevertheless there would be benefits in terms of overheads and sales force reductions in other markets (mainly in Europe) and on media procurement.

Figure 94. Moët Hennessy sales breakdown (FY09)



Source: Company Reports and CIRA Estimates

As we said, we think it is unlikely that Diageo would be able to buy Moët Hennessy in the short term. Even if it could, we believe the multiple paid would clearly reflect the strategic value of the assets for Diageo and the quality of the portfolio. Based on precedent transaction multiples, it is unlikely that the deal would be valued at any less than 20x EBITDA. "High end" brands like Absolut and Grey Goose have been sold at over 20x (See Figure 95).

20x EBITDA would value the 66% stake Diageo doesn't own at about €13.5bn, which is fairly consistent with valuations reported in the press⁴⁴ and would require issuing equity (assuming that Diageo would want to maintain an investment grade credit rating and that it would acquire the whole of Moët Hennessy, including the champagne brands).

⁴⁴ Reuters, 21 October 2010.

Figure 95. Spirits M&A Transaction Multiples

Date	Acquirer	Target	ebitda multiple
Jan-97	Guinness	Grand Metropolitan	9.2
Jun-98	Bacardi	Dewar's Scotch and Bombay Gin	15.2
Nov-99	Edrington Group	Highland Distillers	15.1
Aug-00	Remy Cointreau	Bols Royal Distillers	8.5
Dec-00	Diageo	Seagram Brands (incl Crown Royal, Capt Morgan, 7 Crown, VO)	12.9
Dec-00	Pernod Ricard	Seagram brands (incl Chivas, Seagrams Gin, Martell)	11.2
Dec-01	Campari	Skyv vodka (70%)	16.0
Mar-02	Allied Domecq	Malibu + Mumm Cuvee Napa brands	14.5
Dec-03	Campari	Barbero 1891	11.8
Jun-04	Bacardi	Grey Goose	26.0
Oct-04	Moet Hennessy	Glenmorangie	21.9
Apr-05	Pernod + Fortune Brands	Allied Domecq	14.7
Jun-05	Diageo	Bushmills	18.0
Oct-05	CL Financial	Belvedere	12.1
Mar-06	Brown Forman	Chambord	23.2
Aug-06	Brown Forman	Herradura (Tequila)	13.4
Mar-08	Diageo	Ketel One	19.0
Jul-08	Pernod Ricard	Vin & Spirit (Absolut)	20.8
Jan-09	Sazerac	Constellation Brands	14.0
Apr-09	Campari	Wild Turkey	12.0
Sep-10	Campari	Carolans, Frangelico, Irish Mist	7.5
Average			15.1

Source: Company reports and CIRA Estimates

Fortune Brands' spirits division (Beam Global)

On 8 December Fortune Brands confirmed it would break itself up by spinning off the Home & Security business and spinning off or selling the Golf business. Under the plan the spirits business will continue to operate as an independent, publicly traded company called Fortune Brands.

Beam Global is reported to be worth
~\$10bn...

Immediately there was speculation that Diageo and other companies, including Bacardi, might be interested in the remaining spirits business (Beam Global), or some of its brands⁴⁵. Beam Global is reported to be worth around \$10bn (approximately 15x Ebitda)⁴⁶.

We don't think Diageo would be able to buy the whole business for antitrust reasons.

...but we think Diageo would only like to
buy the Bourbon brands, possibly worth
\$3.5-4bn

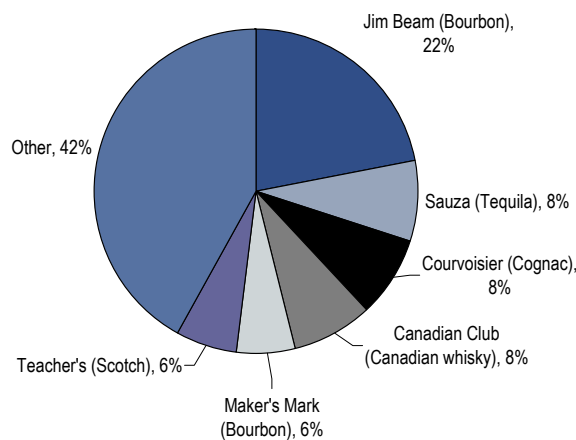
There could be attraction for Diageo in the Bourbon business (Jim Beam and Makers Mark) and the opportunity to achieve some cost savings. US whisky represents one of the few gaps in Diageo's US portfolio. Moreover the category is growing nicely in Western Europe and offers good long term potential in emerging markets. Both brands would benefit significantly from Diageo's distribution machine in Europe and in emerging markets.

However, Jim Beam is positioned as a mainstream/low end brand, retailing at ~30% discount to the market leader Jack Daniels, according to AC Nielsen. Maker's Mark sells at a ~20% premium to Jack Daniels though.

⁴⁵ Reuters 8 December; Wine and Spirits Daily 22 December.

⁴⁶ Reuters 8 December.

Figure 96. Fortune Brands sales breakdown (by brand) – FY09



Source: Company Reports and CIRA Estimates

Several other brands pose antitrust conflicts

Besides Bourbon, we don't see many attractions in Fortune Brands' portfolio, which is mostly made up of value brands with high exposure to the US (and very limited emerging markets exposure). The few other brands that could be of interest to Diageo either pose potential antitrust conflicts (**Sauza tequila**⁴⁷) or Diageo is not able to buy them (**Courvoisier cognac**⁴⁸).

We believe Diageo would run into antitrust problems even with **Canadian Club** and Fortune's value **vodka** brands (Gilbey's, Kamchatka, Woldschmidt and Vox account for ~15-20% of Fortune's sales), but we don't think Diageo would want to buy these brands anyway as it would give Diageo more non-premium US exposure.

Fortune Brands is quite exposed to Spain (~7% of sales: Larios gin and DYC whisky), which may pose antitrust issues given Diageo's presence in Spain.

The bottom line of this is that we would be surprised if Diageo were to acquire much more than Fortune's Bourbon brands, which in our view could be worth \$3.5-4bn⁴⁹.

Mey Icki – Turkish spirits

On 8 December the *Wall Street Journal* reported that Diageo is in exploratory discussions to buy Mey Icki in Turkey from TPG for up to \$2.5bn. The company is market leader in local Turkish spirits, mainly raki.

We would be quite surprised if Diageo were to acquire the company. Diageo has so far shown very limited interest in owning local brands (with the exception of Shui Jing Fang in China). We understand that Mey Icki's brands are mostly low end and we fail to see much export potential for them.

Most of Mey Icki's brands are "low-end" and don't have much export potential

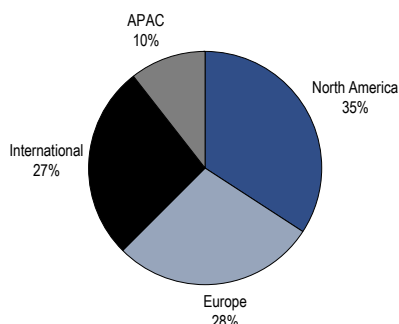
⁴⁷ It is unlikely that Diageo would be able to own Sauza, the #2 tequila brand in the US (17% share) as it already has the distribution rights for Cuervo (38% share).

⁴⁸ The terms of Diageo's relationship with LVMH prevent it from owning a Cognac brand

⁴⁹ Jim Beam and Makers Mark represent about 30% of Fortune Brands' sales, but we estimate their profitability to be somewhat above group average (particularly Makers Mark's, which is more premium). Based on a ~\$10bn value for the whole of the business (Reuters), we derive the \$3.5-4bn for Bourbon.

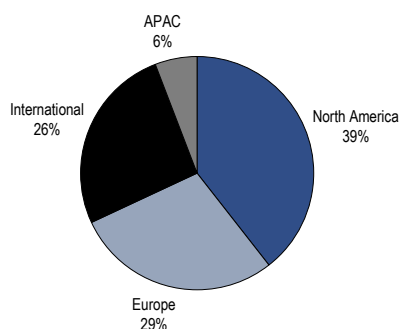
Diageo Company Description

Figure 97. Diageo Net Sales Divisional Breakdown (ex Corporate) – FY10



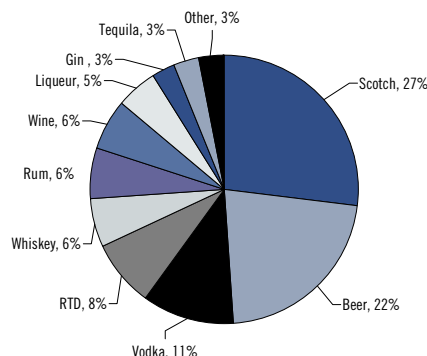
Source: Company Reports, CIRA

Figure 99. Diageo EBIT Divisional Breakdown (ex Corporate) – FY10



Source: Citi Investment Research and Analysis

Figure 98. Diageo Net Sales Category Breakdown – FY10



Source: Company Reports, CIRA

Figure 100. Diageo's 8 Global Priority Brands

Brand	Category	Volume, mln Eq Units (FY10)
Johnnie Walker	Whiskey	16.0
Smirnoff	Vodka	28.3
Baileys	Liqueur	6.6
Captain Morgan	Rum	8.9
Jose Cuervo	Tequila	4.5
J&B	Whiskey	4.9
Tanqueray	Gin	2.0
Guinness	Beer	10.7

Source: Company Reports, CIRA

Other important brands in Diageo's portfolio include: Crown Royal (Canadian whiskey), Buchanan's (Scotch), Ketel One (vodka), Windsor (Scotch), Gordon's (Gin), Old Parr (Scotch), Segrain 7 (Canadian whiskey), Cachique (Rum), Bundaberg (Rum), Bell's (Scotch), The Classic Malts (Scotch), Ciroc (vodka), White Horse (Scotch), Don Julio (Tequila), Bushmills' (Irish whiskey), Harp (beer), Red Stripe (beer), Tusker (beer), Kilkeny (beer).

Beer – Diageo has a beer business, which represents around 21% of group sales, but we assume a bit less in terms of profit. The beer business sits mostly in the International division (42%), particularly in Africa and in Europe (38%). 12% is in North America and 8% in APAC. As we highlight in our accompanying beer report, Africa is one of the best growing regions for beer.

Diageo

Company description

Diageo is the world's largest spirits company and also has sizeable interests in beer (c20% of net sales and wine (c5%). About 40% of its profit comes from N America and 28% from Europe (including Russia). It dominates spirits in Latin America, and it is investing heavily to bolster its currently relatively weak position in China. In Africa, its business is dominated by beer, especially in Kenya and Nigeria. Its main brands are Smirnoff, Ketel One, Johnnie Walker, Guinness, Captain Morgan, Baileys, J&B, Jose Cuervo (distribution rights) and Tanqueray. Diageo also owns 34% of Moët Hennessy, which owns the Moët & Chandon, Veuve Clicquot, Krug and Dom Pérignon champagne brands, as well as Hennessy cognac, Glenmorangie Scotch whisky and Belvedere vodka.

Investment strategy

We have a Buy/Low Risk (1L) rating on Diageo. We believe it offers a defensive play on emerging markets upside, and an effective play on any recovery in the US. Its emerging market exposure is diversified because no emerging market country contributes more than 3-4% of EBIT. Furthermore we think the longevity of the emerging opportunity is not fully priced in. Even without a significant pick-up in the US, we expect Diageo to post about 10% EPS in FY11-13E. With impressive cash flow, a strong balance sheet and a significant Emerging Markets opportunity ahead, we think Diageo is good value at its current depressed multiple.

Valuation

Our Diageo 12-month target price is 1430p. We set this target using a fair value on P/Es. In broad terms we assume that in 12 months' time, the stock will be trading at roughly the same forward multiple, but by then applied to CY12E EPS. However, as we believe investors will see more evidence of emerging market-led growth during 2011, we expect the stock to rerate somewhat towards its pre-crisis peak level of about 17.5x. We are targeting a rise in the forward multiple to 15.5x (+1.3 P/E points). Applied to our estimate for CY12 EPS, this implies a fair value of 1433p, which we round to 1430p.

Risks

We rate Diageo Low Risk, based on our assessment of industry and company-specific risk factors. Compared with most industries spirits is relatively predictable. For Diageo in particular we highlight the following risks to our target price: The US: The outlook for the US is somewhat uncertain at the moment, and it is quite possible that demand could be stronger, or weaker, than we are modeling.

Western Europe. It is possible that a further worsening of the economy there could result in profit below our expectations.

FX: Diageo has transactional as well as translational exposure, as it is exporting whisky from Scotland. This means a rise or fall in the pound has a particularly marked impact on Diageo's earnings, for better or worse.

Excise tax risk: If taxes on spirits go up in any of its important markets, Diageo is likely to suffer.

India: If India truly liberalized its market for Scotch, there would be considerable upside for Diageo.

Regulations: It is possible that harsher anti-alcohol laws could impact Diageo's businesses.

Company Focus

- Company Update
- Initiation of Coverage

Buy/Medium Risk	1M
Price (05 Jan 11)	€68.67
Target price	€85.00
Expected share price return	23.8%
Expected dividend yield	2.1%
Expected total return	25.9%
Market Cap	€18,145M
	US\$24,139M

Price Performance (RIC: PERP.PA, BB: RI FP)



Pernod-Ricard (PERP.PA) Greatest exposure to China and India

- **We initiate coverage of Pernod Ricard with a Buy/ Medium Risk (1M) recommendation and €85 target price** — Pernod is one the best plays on emerging markets in the European consumer staples space, in our opinion, offering both good long-term growth and margin upside, but we believe the valuation still isn't reflecting it, even after December's run.
- **Greater exposure to China and India** — Pernod's strong position in China (about 10% of sales, the highest among all European large cap consumer staples) and India (about 5% of sales) provides exposure to the best long term volume growth opportunities in the industry, in our view. Unlike for many companies, China is very profitable for Pernod. We expect China and India to drive around 40% of Pernod's EBIT growth.
- **Other emerging markets improving too** — So far Pernod hasn't been able to use its scale in local brands in LatAm and other markets to grow its international brands in a meaningful way. However, in May 2010 Pernod redefined its brand priorities and portfolio segmentation so we expect the local companies to be more focused behind the international brands, Chivas and Absolut in particular, which should lead to a better performance.
- **Profitable growth** — Pernod's Asia/RoW margins have increased ~700bp organically since FY06. We think Pernod will continue this trend, albeit at a slower pace, because of its exposure to the premium segment of international spirits, which is less competitive than standard and offers more pricing power. The decline of its local brands is also accretive to margins.
- **EBIT growth close to pre-crisis levels not factored in** — Emerging markets are driving an acceleration in organic EBIT growth to 8-9% (FY12-13E). In addition, our conservative forecasts for the US and Europe may provide scope for upgrades in the medium term. Pernod will continue to benefit from its deleveraging so it is likely to post ~13% compound EPS growth FY10-15E, yet the stock is trading approximately 3 points lower on P/E than it was before the crisis, at 15.6x forward earnings.
- **We expect multiple expansion** — Of all the beverages names we cover, we believe Pernod is most likely to enjoy the greatest multiple expansion as investors see accumulating evidence of success in EM. Our €85 price target assumes Pernod's multiple expands ~1½ P/E points, to 17.0x, by Jan 2012.

Pernod-Ricard (EUR)

Year to 30 Jun	2009A	2010A	2011E	2012E	2013E
Sales (€M)	7,203.0	7,081.0	7,568.0	7,974.1	8,479.8
Net Income (€M)	1,010.0	1,001.0	1,129.4	1,261.9	1,421.7
Diluted EPS (€)	4.19	3.78	4.23	4.72	5.31
Diluted EPS (Old) (€)	4.19	3.78	4.23	4.72	5.31
PE (x)	16.4	18.2	16.2	14.5	12.9
EV/EBITDA (x)	15.2	15.2	13.6	12.2	10.8
DPS (€)	0.50	1.34	1.45	1.60	1.77
Net Div Yield (%)	0.7	2.0	2.1	2.3	2.6

Pernod — Financial Summary

Figure 101. Pernod Ricard — Financial Summary, 2006-2015E (Euros in Millions)

Profit and Loss	2006	2007	2008	2009	2010	2011E	2012E	2013E	2014E	2015E 5-yr CAGR
Net Sales	6,066	6,443	6,589	7,203	7,081	7,568	7,974	8,480	9,031	9,635 6.4%
EBITDA	1,403	1,596	1,688	2,003	1,953	2,132	2,283	2,477	2,690	2,922 8.4%
Margin	23.1%	24.8%	25.6%	27.8%	27.6%	28.2%	28.6%	29.2%	29.8%	30.3% 2.7%
Profit from Recurring operations (EBIT)	1,255	1,447	1,522	1,846	1,795	1,965	2,107	2,287	2,483	2,700 8.5%
Margin	20.7%	22.5%	23.1%	25.6%	25.3%	26.0%	26.4%	27.0%	27.5%	28.0% 2.7%
Net Financial charges (from recurring ops)	(350)	(341)	(333)	(619)	(497)	(480)	(449)	(420)	(367)	(306)
Pretax Profit	905	1,106	1,189	1,227	1,298	1,485	1,658	1,866	2,116	2,394 13.0%
Exceptionals (Pretax)	(186)	10	(97)	(160)	(98)	0	0	0	0	0
Underlying tax	(222)	(249)	(263)	(204)	(271)	(327)	(365)	(411)	(465)	(527)
Underlying Tax Rate	24.5%	22.5%	22.2%	16.6%	20.9%	22.0%	22.0%	22.0%	22.0%	22.0%
Minorities	28	(24)	(29)	(13)	(26)	(29)	(31)	(34)	(37)	(40) 8.8%
Adjusted Net Profit	652	832	897	1,010	1,001	1,129	1,262	1,422	1,613	1,828 12.8%
Per-Share Data (€)	2006	2007	2008	2009	2010	2011E	2012E	2013E	2014E	2015E 5-yr CAGR
EPS (Adjusted, diluted)	2.87	3.58	3.82	4.19	3.78	4.23	4.72	5.31	6.01	6.81 12.5%
DPS	0.97	1.17	1.22	0.50	1.34	1.45	1.60	1.77	2.00	2.25 32.0%
Average Number of Shares (FD)	228	232	235	241	265	267	267	268	268	268 2.1%
Growth Rates (%)	2006	2007	2008	2009	2010	2011E	2012E	2013E	2014E	2015E 5-yr CAGR
Organic Sales	3.3%	9.1%	8.7%	-0.4%	1.8%	4.7%	5.7%	6.3%	6.5%	6.7%
Organic EBIT	4.7%	21.0%	13.3%	3.5%	3.7%	6.8%	8.2%	8.5%	8.6%	8.8%
Sales (Reported)	68.0%	6.2%	2.3%	9.3%	-1.7%	6.9%	5.4%	6.3%	6.5%	6.7% 6.4%
EBIT (Reported)	72.2%	15.3%	5.2%	21.3%	-2.8%	9.5%	7.2%	8.5%	8.6%	8.8% 8.5%
Profit before Tax	43.4%	22.2%	7.5%	3.2%	5.8%	14.4%	11.6%	12.5%	13.4%	13.2% 13.0%
Net Profit	43.0%	27.6%	7.8%	12.7%	-0.9%	12.8%	11.7%	12.7%	13.5%	13.3% 12.8%
EPS	15.9%	24.9%	6.6%	9.7%	-9.7%	12.0%	11.5%	12.5%	13.3%	13.3% 12.5%
Cash Flow	2006	2007	2008	2009	2010	2011E	2012E	2013E	2014E	2015E 5-yr CAGR
Operating Cash Flow	1,225	1,163	847	1,928	1,879	1,959	2,150	2,331	2,536	2,770 8.1%
Interest	(337)	(362)	(366)	(630)	(493)	(456)	(427)	(399)	(349)	(291)
Tax	(175)	(732)	(213)	(164)	(181)	(229)	(255)	(287)	(326)	(369)
Net capex	(37)	(140)	(207)	(184)	(163)	(193)	(214)	(218)	(232)	(249) 8.9%
Free Cash Flow	676	(71)	61	950	1,042	1,082	1,254	1,426	1,629	1,862 12.3%
FCF/Net Sales	11.1%	-1.1%	0.9%	13.2%	14.7%	14.3%	15.7%	16.8%	18.0%	19.3%
M&A	(2,636)	(33)	(22)	(4,928)	209	121	0	0	0	0
New Equity	24	34	10	1,001	11	0	0	0	0	0
Change in Cash Items	(2,069)	(346)	(35)	(3,272)	1,088	849	871	1,004	1,162	1,333
Non-Cash Items	(2,137)	182	407	(1,473)	(784)	418	0	0	0	0
Change in Net Debt	(4,206)	(164)	372	(4,745)	304	1,266	871	1,004	1,162	1,333
End of Year Net Cash/(Debt)	(6,351)	(6,515)	(6,143)	(10,888)	(10,584)	(9,318)	(8,447)	(7,443)	(6,281)	(4,948)
Ratios	2006	2007	2008	2009	2010	2011E	2012E	2013E	2014E	2015E 5-yr CAGR
Interest Cover	3.6	4.2	4.6	3.0	3.6	4.1	4.7	5.4	6.8	8.8
Dividend Cover	3.0	3.1	3.1	8.4	2.8	2.9	3.0	3.0	3.0	3.0
Net Debt/EBITDA	4.5	4.1	3.6	5.4	5.4	4.4	3.7	3.0	2.3	1.7
ROIC	10.1%	8.8%	6.9%	7.7%	8.7%	6.6%	6.8%	7.3%	7.8%	8.4%
Historical Multiples	2006	2007	2008	2009	2010	2011E	2012E	2013E	2014E	2015E
Historical Average Share Price	56.3	67.1	56.3	46.6	57.3	66.6	69.9	69.9	69.9	69.9
Historic Mkt Cap	12,414	15,328	13,042	11,166	15,058	17,595	18,470	18,470	18,470	18,470
P/E (FY)	19.7	18.7	14.8	11.1	15.2	15.7	14.8	13.2	11.6	10.3
Dividend yield	1.7%	1.7%	2.2%	1.1%	2.3%	2.2%	2.3%	2.5%	2.9%	3.2%
FCF Yield	5.4%	-0.5%	0.5%	8.5%	6.9%	6.1%	6.8%	7.7%	8.8%	10.1%
Historic EV	17,867	23,121	20,424	23,521	26,610	28,387	28,151	27,145	26,017	24,750
EV/EBITDA	12.7	14.5	12.1	11.7	13.6	13.3	12.3	11.0	9.7	8.5

Source: Company Reports and CIRA Estimates

Figure 102. Pernod Ricard — Divisional Summary, 2006-2015E (Euros in Millions)

Sales	2006	2007	2008	2009	2010	2011E	2012E	2013E	2014E	2015E	5-yr CAGR
APAC	1,717	1,884	2,007	2,023	2,273	2,699	2,994	3,354	3,744	4,176	12.9%
Americas	1,681	1,786	1,699	2,027	1,911	2,019	2,101	2,197	2,305	2,420	4.8%
Europe	2,014	2,090	2,171	2,417	2,176	2,119	2,134	2,172	2,218	2,267	0.8%
France	654	682	711	735	721	731	745	757	764	772	1.4%
Total Sales	6,066	6,442	6,588	7,202	7,080	7,568	7,974	8,480	9,031	9,635	6.4%
Operating profit	2006	2007	2008	2009	2010	2011E	2012E	2013E	2014E	2015E	5-yr CAGR
APAC	289	389	422	495	566	717	823	947	1,081	1,231	16.8%
Americas	391	418	421	610	541	571	594	629	670	715	5.7%
Europe	453	506	530	563	501	485	488	500	517	535	1.3%
France	121	134	149	178	187	193	203	210	214	218	3.2%
Total EBIT	1,254	1,447	1,522	1,846	1,795	1,965	2,107	2,287	2,483	2,700	8.5%
Operating Margins	2006	2007	2008	2009	2010	2011E	2012E	2013E	2014E	2015E	5-yr change
APAC	16.8%	20.6%	21.0%	24.5%	24.9%	26.6%	27.5%	28.2%	28.9%	29.5%	4.6%
Americas	23.3%	23.4%	24.8%	30.1%	28.3%	28.3%	28.2%	28.6%	29.1%	29.5%	1.2%
Europe	22.5%	24.2%	24.4%	23.3%	23.0%	22.9%	22.9%	23.0%	23.3%	23.6%	0.6%
France	18.5%	19.6%	21.0%	24.2%	26.0%	26.4%	27.2%	27.7%	28.0%	28.3%	2.4%
Total Beverages	20.7%	22.5%	23.1%	25.6%	25.4%	26.0%	26.4%	27.0%	27.5%	28.0%	2.7%

Source: Company Reports and CIRA Estimates

Preferred Name in Spirits

We are initiating with a Buy/Medium Risk (1M) rating because we think Pernod Ricard is one of the best plays on emerging markets in the European consumer staples space and we believe this is not completely factored into its valuation, despite Pernod's recent rerating.

We expect emerging markets to drive an acceleration in organic EBIT growth from ~3.5% in FY09-10 to 8.5%+ in FY13E and beyond, on top of which we believe Pernod will benefit from its deleveraging and therefore post around 13% EPS CAGR over 10-15E. In addition there could be some upside to our conservative US forecasts (should the recovery in the spirits market gain momentum) and to our bearish forecasts for Europe (as we show on page 94).

The highest sales and profit exposure to China and India than any other large cap consumer staples in Europe

1. Growth from China and India

Pernod has the greatest exposure to China and India among all the large cap beverages names⁵⁰ and a very strong position in both countries. We think these markets have **the best long term outlook in the beverages industry** because:

- **China** (~10% of sales) is the largest spirits market in the world, four times the size of the US in volume terms, but per capita consumption of international spirits is less than 0.03 litres/head (one twentieth of the level of Taiwan). Pernod's business in China is 100% in premium international spirits, essentially Cognac and Scotch.
- **India** (~5% of sales) is the number 3 market globally, also larger than the US, and is growing at 13% CAGR (2003-09). Per capita consumption of international spirits is even lower than it is in China, constrained as it is by very high import duties. Differently from China, Pernod's business in India is almost entirely in local spirits and it is growing faster than the market.
- These two countries have the fastest growing large economies. 99% of volumes in both markets are in local spirits.

China and India drive 3-3.5% of Pernod's EBIT growth

Together China and India contribute ~15% of sales and drive 3-3.5% of Pernod's EBIT growth (~40% of total). *We think Pernod's disproportionate exposure here is a risk as well as an opportunity.*

2. We expect Pernod's other emerging markets to improve, driven by Chivas and Absolut

We expect them to start benefiting more from Pernod's scale in its local brands

China and India are the main growth engines of the group, but we expect Pernod's other emerging markets (LatAm ~6.5% of sales, South Korea ~4%, Eastern Europe ~6%, other Asia/RoW 6.5%) to increasingly contribute to growth too.

Unlike Diageo (but like SAB and BAT), 70% of Pernod's emerging markets volumes are in local brands. So far Pernod hasn't been able to use its position in **LatAm** (particularly) and Poland to grow its international brands in a meaningful way. However in May 2010 Pernod redefined its brand priorities and portfolio segmentation, so we expect the local companies to become more

⁵⁰ Pernod has the equal greatest exposure to China and India among all the large cap consumer stocks that are listed in developed markets, alongside Mead Johnson.

We expect South Korea and Eastern Europe to improve too

focused behind the international brands, Chivas and Absolut in particular, which should lead to a better performance in these markets.

South Korea is a more mature emerging market for Pernod (and Diageo), but a very profitable one. It hasn't grown much in the past few years, but it has picked up quite strongly in recent quarters. With private consumption in Korea forecast to accelerate from 0-1.5% in 2008-09 to 4%+ in 2010-12 we expect the recent positive trend to continue.

In **Eastern Europe**, Russia and Ukraine (~3% of group sales) are growing strongly again, but Poland, Czech and Romania (also ~3% of sales combined) are "still difficult" as of 1Q11. Our economists expect GDP and private consumption in these countries to accelerate meaningfully in 2012 (but not 2011), which we believe will benefit spirits sales.

3. Pernod will continue expanding margins in EMs, we project

Pernod's margins in Asia/RoW have increased ~700bp organically since FY06, far more than any other consumer staples company. We are optimistic on emerging market margins because:

- The premium segment, where Pernod is strongest, is less competitive than standard and offers more pricing power;
- The growth of the international brands, and the decline of the local ones, should result in better mix over time.

Although only ~30% of its emerging market volumes, Pernod's international brands are skewed to premium (as opposed to standard international) in emerging markets, typically retailing at least \$30/bottle, and often much more. By contrast Diageo's emerging market volumes include a lot of standard Scotch and locally made Smirnoff, which usually retails at \$8-20.

Organic growth is already benefiting from EM

EBIT growth accelerating from 3.5% to 8.5% in FY12-13E

Emerging markets are already firmly back into double-digit growth for Pernod and are forecast to drive an acceleration of EBIT growth for the group from ~3.5% in FY09-10 to 6.8% this year (guidance "close to 6%") and ~8.5% in FY12E-13E, not far off pre-recession levels. The improvement is almost entirely driven by emerging markets. And as the emerging markets outperform the rest of the portfolio, they will increasingly contribute to growth by becoming a larger portion of the business, in our view.

W Europe and the US could provide scope for upgrades in the medium term

Our forecasts by division are summarised in Figure 103. We remain bearish on Western Europe and cautious on the US, where we don't model any meaningful improvement⁵¹, but these regions could provide scope for upgrades to our forecasts in the medium term, as we discuss in the following pages.

- If growth in the US returned to ~6% trend (sales), it would add ~3% to EPS.

⁵¹ The slight improvement that our forecasts show for "Americas" and "Europe" is largely driven by LatAm and Eastern Europe

- If in Europe and France Pernod managed to generate as much sales/EBIT leverage as it did in the recession (through cost control and positive mix), this could provide 1-1½% upside to EPS.

Figure 103. Pernod Ricard – organic growth rates by division

		FY06-08	FY09-10	FY11	FY12-13
Asia / RoW	sales	11.2%	5.3%	13.0%	11.9%
	EBIT	22.1%	10.0%	16.8%	15.6%
Americas	sales	8.9%	1.3%	2.9%	4.3%
	EBIT	14.2%	0.5%	3.3%	5.2%
Europe	sales	3.8%	-4.0%	-1.1%	1.4%
	EBIT	7.1%	-0.6%	0.2%	2.4%
France	sales	2.3%	1.1%	1.3%	1.8%
	EBIT	6.9%	9.1%	4.3%	4.3%
Group	sales	7.0%	0.7%	4.7%	6.0%
	EBIT	13.0% ⁵²	3.6%	6.8%	8.4%

Source: Company Reports and CIRA Estimates

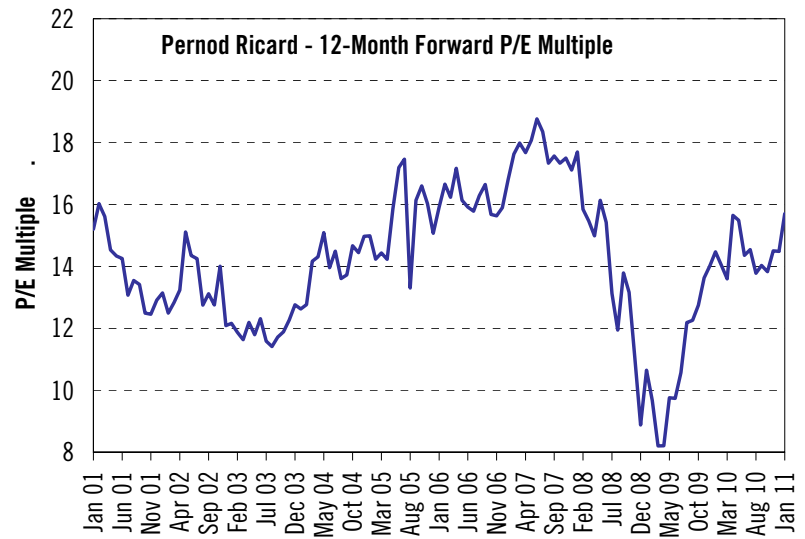
We expect the multiple to expand

The valuation isn't factoring in Pernod's advantaged position in emerging markets

In short, we think Pernod is in an advantaged position in emerging markets spirits. However, we believe its valuation still isn't reflecting this, with the stock still trading roughly 3 P/E points below its pre-crisis peak levels. We believe Pernod's multiple expansion will continue, as the acceleration in growth becomes more visible and the market appreciates just how good its emerging market franchise is. Our target price (€85) is based on the expectation that Pernod's forward PE will re-rate by around 1 ½ points from 15.6x to 17.0x over the next twelve months, moving somewhat towards its pre-crisis peak of around 18.5x.

⁵² We estimate that ~2% of the growth was driven by Allied Domecq synergies. Ex synergies organic EBIT growth was ~11% on average over the three year period FY06-08

Figure 104. Pernod – 12 Month Forward P/E (Relative to Consensus)



Source: DataStream

China & India – Pernod's Growth Engines

Central to the investment case

China and India are Pernod's two largest emerging markets, accounting for 10% and 5% of sales respectively, as shown in Figure 105. They are also Pernod's co-number 2 and number 4 countries respectively, with the US being the largest (~18% of group sales) and France similar to China at ~10% contribution.

Figure 105. Pernod Ricard – largest emerging markets (FY10)

	% of sales
China	10%
India	5%
South Korea	4%
Mexico	3%
Brazil	2%
Russia	2%
Other	11%

Source: Company reports and CIRA Analysis

China + India have delivered 40% of
Pernod's growth in the last few years

What is more important, they have contributed significantly to growth: we estimate that in the last few years, China's contribution to group EBIT growth may have been as much as 20-40% (depending on the years) and India's around 10-15%, meaning that the two countries combined have delivered around 40% of Pernod's growth. We don't expect the group's dependence on China and India to be any lower.

Estimates of contribution to growth by China and India

Figure 106 and Figure 107 show our estimates of the contribution to growth from China and India. The estimates are based on our understanding that:

- in FY10 China accounted for ~10% of group sales and India ~5%
- Margins in China are slightly above group average, as its portfolio is heavily skewed to premium international products, with profitability only partially held back by higher than average A&P costs and modern on-trade "listing fees". We believe that positive mix and pricing has driven an increase in Chinese margins in recent years, possibly greater than we show in the table. Indian margins we think are in the high-teens, around the level of United Spirits, the number one player in the market

Figure 106. China – Estimated contribution to group EBIT growth

	FY08	FY09	FY10	FY11E	FY12E	FY13E
Sales - € mln	585	644	708	871	1,007	1,164
growth rate	29%	10%	10%	22%	15%	15%
margin	26.0%	27.0%	28.0%	28.5%	29.0%	29.5%
EBIT - € mln	152	174	198	248	292	343
EBIT growth - € mln	39	22	24	50	44	51
Contribution to group EBIT growth	20%	41%	35%	43%	28%	29%

Source: Company Reports and CIRA Estimates

Figure 107. India – Estimated contribution to group EBIT growth

	FY08	FY09	FY10	FY11E	FY12E	FY13E
Sales - € mln	222	266	333	420	508	609
growth rate	39%	20%	25%	26%	21%	20%
margin	18.0%	18.0%	18.0%	18.0%	18.0%	18.0%
EBIT - € mln	40	48	60	76	91	110
EBIT growth - € mln	11	8	12	16	16	18
Contribution to group EBIT growth	6%	15%	17%	13%	10%	10%

Source: Company Reports and CIRA Estimates

According to our estimates, by FY11 China and India will represent 14% and 7% respectively of group sales.

Pernod Ricard in China

For the interested reader, Appendices 2 and 3, provide more detail on the Indian and Chinese markets.

As we said, China is Pernod's largest emerging market. It represents approximately 10% of group sales, a little more on EBIT and it is the key growth engine of the group.

The Chinese market

The international spirits market in China has been growing at +26% compound since 2003, but slowed abruptly in 2008 (+3%) and 2009 (-4%). This was partly driven by the economic slowdown. By far the category that was hit hardest was Scotch, which fell 10% in 2009, having grown six-fold in the space of four years up until 2007. Scotch is now back to mid-high single digit growth.

Cognac, the other large category in the Chinese market – and of particular importance to Pernod – remains very healthy. Pernod raised prices (again) in 2010 to curb demand.

Pernod's position in China – Cognac, Scotch and high margins

China is a very profitable market for Pernod today, unlike what we see in many other consumer categories. We attribute this to the facts that:

1. Pernod's Chinese portfolio is almost 100% skewed to premium Cognac and Scotch, as Figure 108 shows;
2. Pernod has pricing power, particularly in Cognac;
3. It is generating positive mix, also because Cognac is outperforming Scotch.

Figure 108. Pernod Ricard's Portfolio in China – volumes ('000 cases)

Brand	Category	2003	2004	2005	2006	2007	2008	2009	CAGR
Martell Xo+	Superpremium Cognac	64	78	110	153	192	240	267	27%
Martell Noblige	Premium Cognac	13	17	33	72	150	225	295	68%
Martell Vsop	Standard Cognac	38	50	69	87	100	55	30	-4%
Chivas	Premium Scotch	132	300	660	725	715	643	566	27%
Ballantines 12+	Premium Scotch	17	54	63	119	180	245	248	56%
Absolut	Imported Vodka	14	50	80	110	110	96	81	34%
Ballantines Finest	Standard Scotch	4	8	11	21	30	33	37	45%
Royal Salute	Superpremium Scotch	8	15	21	25	28	30	31	25%
Other		15						73.4	30%
Total		305	591	1,100	1,403	1,607	1,662	1628	32%

Source: IWSR and CIRA Analysis

Scotch

Pernod's Scotch volumes have been in decline since 2007, because:

- The market contracted in 2008-09, having increased six-fold in the period 2003-07.
- Chivas dropped 15 points of share from 72% in 2005 to 57% in 2007, mostly to the advantage of Johnnie Walker (Diageo). Since then it has changed its media campaign to "Live with Chivalry", holding share at 57% despite Bacardi entering the market with Dewars.
- More recently Pernod has lost share with Ballantines as it decided to focus more on Chivas.

We expect scotch to return to growth as: (1) the market is growing again, (2) more focus behind the Chivas brand.

Cognac

Cognac is a more established category than scotch in China, particularly in the South and the East. It is also highly profitable, because:

1. **Limited competition** – there are only three players in the Chinese market (and only four main players globally);
2. **Premium skew** – the Chinese cognac market is very much skewed to the more expensive premium varieties and Pernod has been consistently taking share, as Figure 109 shows.
3. **Pricing** – to curb demand Pernod has put through double digit price increases in 2006, 2008 and high-single digit increases in 2010.

We expect these drivers to continue and we believe Pernod's availability of aged stock is enough to sustain high single-digit volume growth and mid-teens sales growth.

Pernod has a very strong position in Cognac

Figure 109. Cognac Category in China – volumes (million cases) and market shares

	2003	2004	2005	2006	2007	2008	2009
cognac XO & extra	157	177	242	313	385	442	451
Hennessy	40%	37%	40%	39%	40%	37%	32%
Martell	40%	44%	45%	49%	50%	54%	59%
Remy Martin	19%	18%	14%	11%	10%	8%	8%
Courvoisier	1%	1%	1%	1%	1%	1%	1%
Cognac - intermediate	65	83	110	172	285	363	431
Martell	20%	20%	29%	42%	53%	62%	68%
Remy Martin	57%	63%	63%	52%	42%	36%	30%
Hennessy	22%	17%	7%	6%	5%	2%	1%
Courvoisier	0%	0%	0%	0%	0%	0%	0%
Cognac - VSOP	252	321	441	624	778	741	688
Hennessy	43%	44%	51%	60%	67%	72%	72%
Remy Martin	41%	38%	31%	25%	19%	20%	22%
Martell	15%	15%	16%	14%	13%	7%	4%
Courvoisier	1%	2%	2%	1%	1%	1%	2%

Source: IWSR and CIRA Analysis

Pernod Ricard in India

India is Pernod's second largest emerging market, at 5% of group sales, but a bit less on EBIT, given India's lower margins.

The Indian market

The largest whisky market in the world

India is the largest whisky market in the world, but 99% of it is IMFL (Indian-Made Foreign Liqueur), most of which retails for as little as US\$3-5. Imports are still very small due to prohibitively high duties (300-500% combining Federal and State duties). International pressure is mounting for India to lower the rates. However, it may take more than this to make India a large international spirits market, as regulation is stifling and there are powerful lobbies intent on maintaining the status quo.

In the long term however, we are convinced that it is as good an opportunity as China. Scotch consumption is only 1.4million cases, with a 118 million-case local whiskey market to tap into, growing at 20%+.

Pernod's position in India – consistently taking share in local spirits

The profile of Pernod's Indian business is the opposite to the one in China, in the sense that Pernod's business is almost entirely focused on local (IMFL) whiskey, as opposed to premium international brands, as Figure 110 shows.

Figure 110. Pernod Ricard's Portfolio in India – volume ('000 cases)

Brand	Category	Volume 2003	Volume 2009	CAGR
Royal Stag	Semi-Premium IMFL Whiskey	2,500	8,050	22%
Imperial Blue	Regular IMFL Whiskey	1,600	4,930	21%
Blender's Pride	Premium IMFL Whiskey	97	1,870	64%
Fuel	Local Vodka	0	210	n/m
100 Pipers	Locally Bottled Low End Scotch	27	193	39%
Chivas Regal	Premium Scotch	26	80	21%
Absolut	Imported Vodka	19	35	11%
Ballantines	Standard Scotch	4	27	37%
Other		45	64	6%
Total		4,318	15,459	24%

Source: IWSR and CIRA Analysis

With its three main brands, Royal Stag, Imperial Blue and Blender's Pride, Pernod has succeeded in taking share consistently over the past few years in all segments it competes in, even from the market leader United Spirits. Pernod's share in premium IMFL whiskey has increased from 7% in 2003 to 41% in 2009 and from 22% to 26% in the semi-premium segment.

Sales volumes of imported spirits are only 2% of Pernod's total and we don't expect them to contribute much more unless excise duties are reduced considerably.

Revenue/case much lower than in China

Strong growth in Pernod's Indian business in recent years has been diluted at group sales level by the fact that revenue/case achieved in India is much lower than elsewhere in the business, particularly China (we estimate as low as ~1/10th of China). The faster growth within the Indian portfolio of Blender's Pride (the premium brand) slightly mitigates this negative country mix effect.

But margins are still in the high teens

At EBIT level, however, the dilution is less because of much lower marketing costs (In India it is illegal to advertise alcohol (and tobacco), although the companies can advertise other products with the same names). In addition the operational leverage generated by the volume growth compensates in part for the lower gross margin. We believe EBIT margins in India are in the high-teens.

Despite lower margins, India is a substantial contributor to Pernod's EBIT growth, but we believe **the real value of the Indian business lies in the long term opportunity it offers**: if/when the market does open up to imports, Pernod's established route-to-market should represent a significant competitive advantage.

70% of Pernod's EM volumes are in local brands

Local brand platforms

About 70% of Pernod's emerging markets volumes are in local brands. Of this 70%, about half is in India, and these brands (Royal Stag, Imperial Blue, Blenders' Pride) have been growing at 20%+ since 2006 as we have discussed. The local brands in the other emerging markets have been declining at 6% CAGR 2003-09. On the surface this doesn't appear great. However we see two clear positives:

1. **Opportunity to leverage premium brands** – The large local businesses should provide a good base from which to grow Pernod's international brands. This hasn't really happened until now, but the May 2010 redefinition of brand priorities and portfolio segmentation within the group (Pernod Ricard Brand House), ought to be instrumental in focusing the local companies behind the international brands, Chivas and Absolut in particular.
2. **Positive mix**, resulting from the faster growth of the high margin international brands as opposed to the decline of the low margin local brands.

Pernod's local brand platforms

Figure 111 lists Pernod's main local brand positions.

Apart from Argentina, which was already in Pernod's portfolio, the other local platforms have been "inherited" by Pernod over the past ten years with the Seagram and Allied Domecq acquisitions.

Figure 111. Pernod Ricard – local brands platforms (volumes, '000 cases)

	2003	2009	2003-09 CAGR
Argentina	1,140	1,710*	7%
Brazil	3,228	3,184	0%
Czech	480	431*	-2%
India	4,197	15,060	24%
Mexico	4,052	2,047	-11%
Poland	4,346	3,105	-5%
Russia	400	304	-4%
Thailand**	3495	1300	-15%
Total	21,339	27,142	4%
Total ex India	17,142	12,082	-6%

* 2008

** In Thailand, the bulk of the volumes are in locally bottles scotch (100 Pipers brand), low margin and in decline

Source: IWSR and CIRA Analysis

Apart from India, Pernod's local brands have been declining

Excluding India, (~1/2 of total), the performance has been far from great:

- **Volume declines in all main markets (excluding India)** – Ex-India the other local brands combined have declined 6% CAGR 2003-09.
- **Low price points** – The retail price points (and gross margins) of the local brands are well below those of the international portfolio. The local brands retail at anything from \$5-6 for Royal Stag in India to \$8 for Montilla rum in Brazil, to \$8-10 for most of the Polish vodka brands and ~\$17 for Natu Nobilis local whiskey in Brazil.
- **Margins below group average** – lower gross margins on these brads are partially compensated by much lower marketing spend and lower structure costs per unit, given the scale of some of these businesses. Nevertheless we doubt that any of these brands achieve margins higher than high teens.

Pernod's international brands

The "international brands" make up the other 30% of Pernod's emerging market volumes and, in contrast to the local brands, have grown strongly, at 9% CAGR 2003-09 in the emerging markets we have focused on (+13% stripping out South Korea). Diageo's volume growth in the same period and same markets has been 7% (8% ex South Korea).

Figure 112. Pernod – International brand volumes in emerging markets ('000 cases)

	2003	2009	2003-09 CAGR
Brazil	976	1,414	6%
China	305	1,628	32%
Colombia	227	397	10%
India	121	399	22%
Mexico	469	1042	14%
Poland	256	512	12%
Russia	177	493	19%
South Africa	648	807	4%
South Korea	1259	863	-6%
Taiwan	161	206	4%
Thailand	75	94	4%
Vietnam	64	134	13%
Total	4,739	7,990	9%
Total ex S Korea	3,480	7,127	13%

Source: IWSR and CIRA Analysis

Opportunity to better leverage its local platforms

Pernod hasn't done a good job so far in growing its international brands in markets where it has strong local platforms

Although it would appear from Figure 112 that Pernod has done a fairly decent job at growing its international brands, we feel that it should have done better in countries like Mexico, Brazil, Poland, where it has the advantage of strong local distribution platforms.

- In **Brazil** Pernod has dropped 8 points of market share in six years (to 23% in 2009) in premium scotch and 5 points in standard (now 8%).
- In **Mexico** Chivas' share in premium scotch has declined from 20% to 16% in the last 6 years.
- In **Poland**, after taking control of the business from Allied Domecq in 2005/06, Pernod has added less than 100k cases of scotch in the following 2 years (preceding the recession) compared to +400k for Diageo.

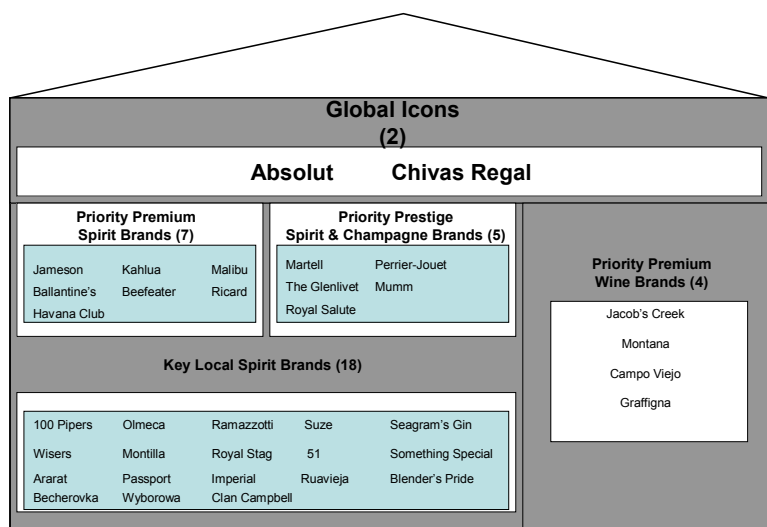
Following the acquisitions of Seagram and Allied Domecq some time was likely spent integrating the businesses more than thinking about growth opportunities. However Brazil has now been in Pernod's portfolio for nine years and Mexico for five. We believe it is time to focus on growth.

We view this as an opportunity

We view this as an opportunity, not a problem, because we think the local companies will be more focused on the international brands. In May 2010 Pernod redefined its brand priorities and portfolio segmentation, elevating Absolut and Chivas to the status of Global Icons and separating the prestige brands (Martell, Royal Salute, The Glenlivet and the champagne brands) within the portfolio. The idea behind the new brand strategy ("The Pernod Ricard

House of Brands”) is precisely to focus resources behind the international portfolio and particularly Chivas and Absolut.

Figure 113. The Pernod Ricard House of Brands



Source: Pernod Ricard, capital markets day presentation (May 2010), CIRA

We believe this creates an opportunity particularly in those emerging markets where Pernod has a strong platform of local brands and an established route to market: Mexico, Brazil and Poland are the main ones.

Pernod has a strong presence on the ground in each of these markets, which combined represent about 6-7% of group sales, but around 11-12% of group spirits volumes, on our estimates.

Figure 114. Number of employees in a few of Pernod's local companies

	Full time employees	Of which in sales
PR Mexico	1500	500
PR Brazil	400	200
PR Poland	500	250

Source: Company reports and CIRA Estimates

The US is Pernod's largest market, at 22% of profits

Possible Upside to Forecasts in the US and Europe

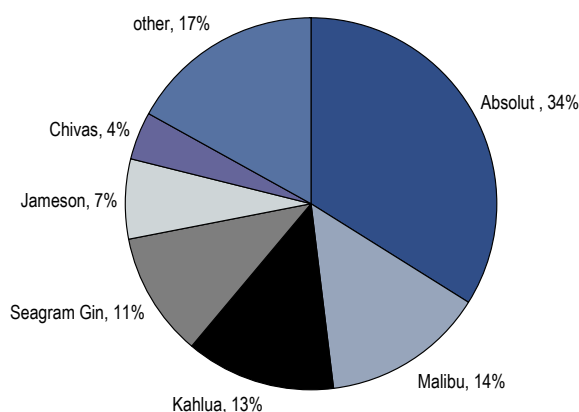
We have said throughout the report that Diageo is the most geared play on any further recovery in US spirits, given its higher exposure to the US market. Pernod is set to gain too, however, with ~22% of its profits coming from the US.

We believe our forecasts for the US are conservative as we have shown in Figure 71 on page 46. We forecast Pernod's US sales to grow only 0.8% this year and 2.1% in FY12 and Americas EBIT (which includes LatAm) to grow 3.3% this year and 4.5% in FY12. Before the recession Americas EBIT was growing in the high teens.

The main reason for our conservative stance is the uncertainty on the economic recovery (similarly to Diageo) and, specific to Pernod, the unclear outlook for Absolut.

However as for Diageo, should the US improve more than we forecast (on the back of a stronger than expected, but not completely unlikely, recovery) and return to ~6% sales growth (3% volume +3% price/mix), this would have a material impact on group profit: our FY12 and FY13 EPS would be boosted by ~3% (similar to Diageo, despite Pernod's lower exposure to the region, because our base case forecasts are more conservative).

Figure 115. Pernod US spirits sales breakdown (2009)



Note: excludes wine and champagne

Source: CIRA, AC Nielsen

Absolut trends have improved but deteriorated again since the summer

We are watching **Absolut's** US performance closely. The brand represents as much as 1/3 of Pernod's US sales (based on Nielsen data) and a bit more we believe in terms of profits. Since the acquisition the brand has been struggling, but trends have been looking a bit better recently.

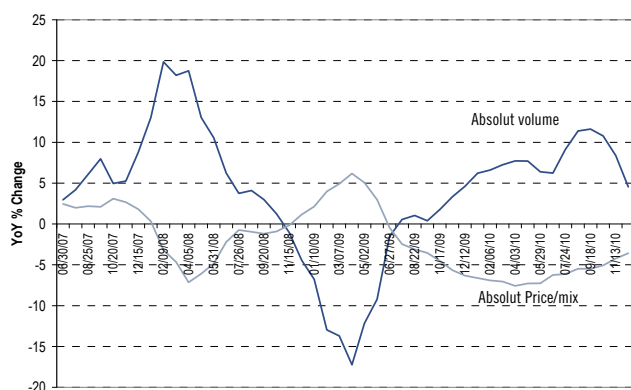
Figure 116 shows that on the back of FY10 price repositioning (and of easing economic headwinds), Absolut's volumes improved substantially and the brand narrowed the sales underperformance gap against the vodka category (Figure 117). However, the charts also show that in the last few months, as the price reductions have been anniversaried, the positive volume momentum has softened and Absolut has started to underperform the category again.

Trends overall are substantially better than they were a few quarters ago, but the outlook remains uncertain.

Jameson is very strong

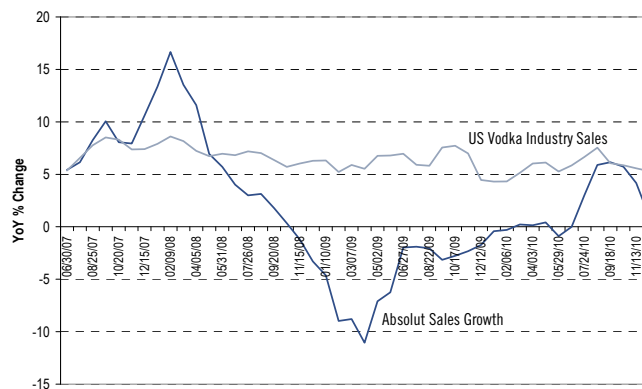
Out of the other main brands in Pernod's portfolio, **Jameson** continues to grow rapidly, **Kahlua** is performing better than it has done in the past couple of years, but **Malibu** and **Seagram Gin** are declining in the low to mid single digits, worse than in 2008-2009 (Figure 118). It is worth reminding, as always on Nielsen data, that they capture less than 20% of the US market and the data are biased to the most promotional portion of the market (the grocery store channel).

Figure 116. Pernod Ricard US – Absolut volume and price/mix



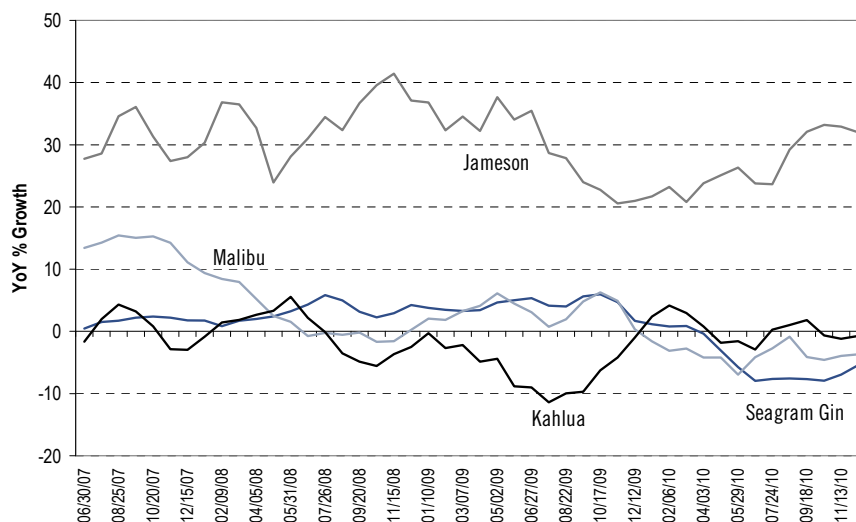
Source: CIRA, AC Nielsen

Figure 117. Pernod US – Absolut vs Vodka Category Sales



Source: CIRA, AC Nielsen

Figure 118. Pernod Ricard USA - Sales Growth (based on AC Nielsen data)



Source: CIRA, AC Nielsen

We are particularly cautious on price/mix in Europe

Europe

We are less optimistic about a recovery in Western Europe and our forecasts definitely reflect this (Figure 119). Our cautious stance reflects our belief that pricing will remain constrained in Western Europe and mix will remain under pressure due to ongoing on- to off-premise channel shift and weakness in the high margin Spanish and Greek businesses.

However, it is worth noting that even through the recession (FY09-10), cost control and positive mix (mostly related to the growth of Absolut and disposal of a few low margin brands) generated positive leverage between the sales and the EBIT line of about 3.5pp in Europe and 8pp in France.

We haven't factored a continuation of this "leverage" into our model, as the table shows. If it were to continue, however, we estimate it would provide 1-1½% upside to our EPS forecasts.

Figure 119. Pernod Forecasts- Organic Sales and EBIT Growth for Europe and France

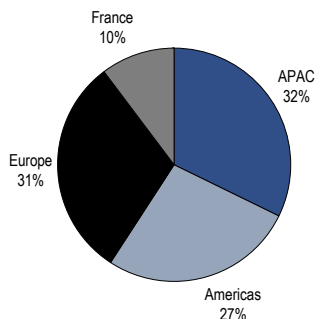
		FY06-08	FY09-10	FY11E	FY12-13E
Europe ⁵³	sales	3.8%	-4.0%	-1.1%	1.4%
	EBIT	7.1%	-0.6%	0.2%	2.4%
France	sales	2.3%	1.1%	1.3%	1.8%
	EBIT	6.9%	9.1%	4.3%	4.3%

Source: Company Reports and CIRA Estimates

⁵³ Includes Eastern Europe (~20% of European sales)

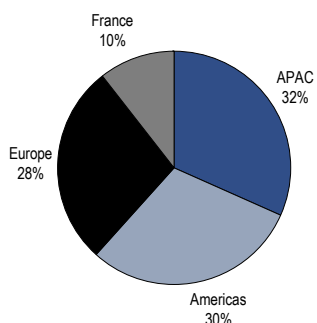
Pernod Ricard Company Description

Figure 120. Pernod Ricard Divisional Breakdown – Sales FY10



Source: Company Reports, CIRA

Figure 122. Pernod Ricard Divisional Breakdown – EBIT FY10



Source: Company Reports, CIRA

Figure 121. Pernod Ricard's 14 Strategic brands

Brand	Category	Volume (Mn 9l cases, FY10)
Absolut	Vodka	10.4
Ballantine's	Scotch	5.9
Ricard	Aniseed	5.4
Chivas Regal	Scotch	5.2
Havana Club	Rum	3.5
Malibu	Liqueur	3.3
Jameson	Irish Whiskey	2.9
Beefeater	Gin	2.3
Kahlua	Liqueur	1.8
Martell	Cognac	1.6
The Glenlivet	Scotch	0.6
Mumm	Champagne	0.6
Perrier-Jouet	Champagne	0.2
Royal Salute	Scotch	0.1

Source: Company Reports, CIRA

Figure 123. Pernod Ricard most important markets (sales FY10)

Top countries	% of sales	Cumulated
US	18%	18%
China	10%	28%
France	10%	38%
Spain	8%	46%
India	5%	51%
UK	4%	55%
South Korea	4%	59%
Australia	3%	62%
Mexico	3%	65%
Germany	2%	68%
Brazil	2%	70%
Sweden	2%	72%
New Zealand	2%	73%
Poland	2%	75%

Source: Citi Investment Research and Analysis

Wine – Pernod has a wine business, which accounts for just under 10% of group sales (and around 5% of group profit). The 4 strategic wine brands (which account for ~1/2 of total wine sales) are: Jacobs Creek (Australian), Brancott (New Zealand), Campo Viejo (Spain) and Graffigna (Argentina). The UK is Pernod's largest wine market. The wine business has underperformed in recent years.

Spirits – Pernod has 14 Strategic Spirits and Champagne brands (Figure 121). These account for ~40% of group volumes, ~58% of group sales and over 60% of group EBIT, we estimate. Besides the Strategic brands (which are global), the key local brands are shown on Figure 113.

Pernod-Ricard

Company description

Pernod is the world's second-largest wine & spirits company. It has reached this position through a combination of organic growth and acquisitions, notably those of Seagram Spirits&Wine (2001) and Allied Domecq (2005). About a 1/3 of its profit comes from Asia and 30% from the Americas (of which the US is about 22%).

Investment strategy

We have a Buy/Medium Risk (1M) rating on Pernod because we believe its exposure to emerging markets is under-appreciated both in terms of longevity and in terms of scale. Because western spirits are effectively luxuries in emerging markets, we believe demand will go on increasing for many years, whereas we see it slowing in beer. About 40% of the company's growth is coming from India and China. The growth in China is accretive to margins, as it sells only high end products there. We expect effectively zero organic profit in Europe in FY11, and about 2½% in FY12 and FY13, but we believe the market is already discounting a poor performance there.

Valuation

Our price target is €85. This target represents where we think the share price will be in 12 months' time and is set using a (rounded) fair value on P/Es. In broad terms we assume that in 12 months' time, the stock will be trading at roughly the same forward multiple, but by then applied to CY12E EPS. As we believe investors will see more evidence of emerging market-led growth during 2011 we are targeting a rise in the forward multiple to 17.0x (+1.4 P/E points), as we believe investors continue to rerate the stock somewhat towards pre-crisis peak levels of about 18.5x. Given our estimate for CY12 EPS, this implies a fair value of €85.30, which we round to €85.

Risks

We rate Pernod Medium Risk, based on our assessment of industry and company-specific risk factors. In particular we highlight:

China and India: These markets are contributing around 40% of the company's growth, we estimate. If the economy stalls in one of them, the rate of growth could slow dramatically.

Western Europe. It is possible that a further worsening of the economy there could result in profit below our expectations. About 10% of profit comes from France, and a further 28% from the rest of Western Europe.

The US: The outlook for the US is somewhat uncertain at the moment, and it is quite possible that demand could be stronger, or weaker, than we are modeling.

FX: Pernod has transactional as well as translational exposure, as it is exporting whisky from Scotland, vodka from Sweden and Cognac from France. This means a rise or fall in the pound, krona or euro has a particularly marked impact on Pernod's earnings.

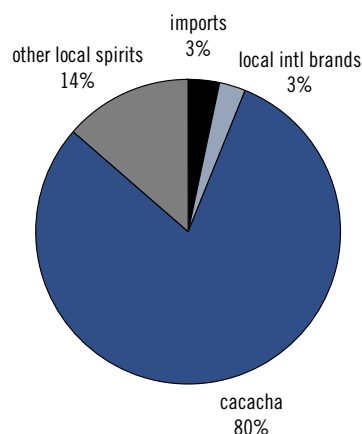
Excise tax risk: If taxes on spirits go up in any of its important markets, Pernod is likely to suffer.

Appendices

Appendix 1 – The Brazilian Spirits Market

- **Spirits market dominated by declining cachaça** – At an estimated 111 mln 9-litre cases⁵⁴, Brazil is unsurprisingly (given its population) one of the largest spirits markets in the world. The market has been declining at 1% CAGR over the past 10 years, entirely explained by the decline in cachaça, the bulk of which is low-priced. Cachaça still dominates the market, as shown in Figure 124.

Figure 124. Brazilian Spirits market split by volume (2009) – Total 111mln 9L cases



Source: IWSR and CIRA

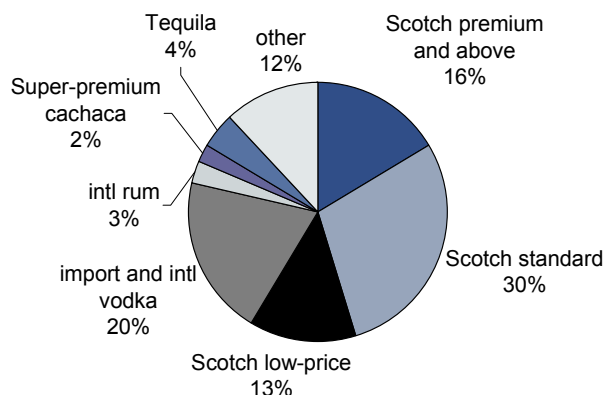
- **Premium spirits still small in volume, but relevant in value terms** – Premium spirits⁵⁵, which essentially is synonym for Imports (plus a few cases of superpremium cachaça), account for only 3% of the total market in volume terms. We estimate however that “Premium” represents as much as around 20-25% of the value of the market and this is because mid and low price cachaça retail at BRL 2-8, a fraction of the retail price of Scotch, which makes up the lion share of imports.
- **... and growing strongly** – “Premium spirits” has been growing strongly since the Brazilian economy stabilised under Lula’s presidency. With an 8% 2003-09 CAGR “Premium spirits” have outperformed beer and local spirits and have consistently grown ahead of GDP.
- **Premium spirits is mostly about Scotch** – Scotch makes up around 50% of the Premium spirits market in Brazil in volume and more in value. Most of the Scotch sold in Brazil is Standard (Johnnie Walker Red and similar), but Premium Scotch is also relevant, as is Low price. Low price is mostly bottled

⁵⁴ The figure doesn’t include the illegal cachaça market, estimated to be around 10 mln cases (IWSR).

⁵⁵ We have divided the spirits market into 4 price brackets: 1) “Premium” includes all imports and superpremium cachaça, typically retailing at ~30 BRL (~US\$17) and above; 2) “Local international”, essentially locally produced international spirits brands, typically retailing around 20 BRL. We have included in this category Smirnoff, Bacardi, Campari and, rather generously, Orloff, Pernod Ricard’s local vodka brand; 3) “Medium Price” includes all local spirits retailing above 10 BRL (rum, whiskey, premium cachaça) and 4) “Low price”, mostly low-end cachaça and local brandy (all selling below 10 BRL).

in Brazil and sells at around 40-50 BRL, which is still considerably more than local spirits.

Figure 125. Brazilian “Premium spirits” breakdown by value (2009)



Source: IWSRA and CIRA

- **Diageo dominates Scotch** – Premium scotch is a duopoly between Diageo and Pernod: Diageo ~75-80% share in Premium/Standard, Pernod 23% in Premium, 8% in Standard and 27% in Low-price.
- **Vodka is a big opportunity** – Vodka is a fast growing category in Brazil, as it offers consumers a trading-up alternative to cachaça. There is a large local vodka market, with plenty of small cheap regional brands, but only two national brands: Smirnoff (Diageo), by far the largest brand in the market, and Orloff (Pernod), which are both priced well above local vodkas. Both brands are growing fast. RTD vodka is also large and buoyant in Brazil.
- **Imported vodka has grown almost four-fold** from 60k cases in 2003 to 230k cases in 09. The category is completely dominated by Absolut (Pernod Ricard), with 90% share.
- **Diageo dominates premium spirits** – Brazil represents ~3% of Diageo's sales (and a similar proportion, we believe, of EBIT). Diageo has a remarkably strong position in the Brazilian spirits market, virtually dominating premium scotch and a significant share in vodka. Diageo's portfolio consists entirely of international brands, as highlighted in Figure 126.

Figure 126. Diageo's portfolio in Brazil – 2009

Brand	'000 cases	% of to vol	Comment
Smirnoff	1,433	49%	Leading local vodka brand, sells at 20% above #2 Orloff. 12% CAGR since 2003, outperforming fast growing category
J Walker Red	880	30%	66% share of standard Scotch. Has doubled volumes since 2003.
J Walker Black	197	7%	50% share of premium Scotch. Has outperformed Chivas. Similar price point
Bells	89	3%	Bottled in Brazil Scotch. Priced around BRL 40, 15% discount to Pernod's brand Passport
Black & White	75	3%	Standard Scotch, c15% discount to JW Red.
Old Parr	46	2%	Premium Scotch, retails at small discount to JW Black
other	228	8%	Buchanan's, Bailey's, J&B
Total	2,948	100%	

Note – in addition to Smirnoff volumes, Diageo sells ~3.5m cases of Smirnoff RTDs.
Source: IWSR and CIRA

- **Pernod is much more exposed to local spirits** – Pernod’s portfolio is dominated by local brands (Montilla rum, Natu Nobilis local whisky and a few others), which are very skewed to the North East of the country. These brands offer much lower revenues/case than international brands, but reasonable margins, in our view, still well below Scotch however. We estimate that Brazil accounts for ~2% of group sales and 1-2% of profits.
- **Opportunity to better leverage its local scale** – As we discussed in the company section of the report, Pernod has not been able so far to leverage its distribution platform for its Scotch brands. Since taking control of Chivas in 2001 and Ballantines in 2005, Pernod has barely added any volumes to the brands. Over the same period Diageo has doubled Johnnie Walker Red’s volumes to almost 900k cases and almost doubled Johnnie Walker Black’s to just under 200k cases. We believe that with the recent redefinition of brand priorities within the group (Pernod Ricard Brand House), local management should be more focused behind the international brands, Chivas and Absolut in particular.

Figure 127. Pernod Ricard’s portfolio in Brazil

Brand	'000 cases	% of to vol	Comment
Montilla	2,065	45%	Local rum, priced at ~ 18 BRL. Hasn't grown in last 10 yrs. Sells mainly in N-East. Very sensitive to economic cycle
Orloff	764	17%	local vodka priced at around 19 BRL, c20% discount to Smirnoff. Most smaller local vodkas sell at < 10 BRL
Natu Nobilis	450	10%	Leading Brazilian whiskey, retailing at around BRL 30, ~1/2 the price of Johnnie Walker Red
Passport	255	6%	Locally bottled (low price) Scotch, retailing at a slight premium to local whiskey
Sao Francisco	250	5%	Standard cachaça (<10 Real), small mkt share
Domecq	234	5%	Local Brandy, retails at around BRL 13, double the price point of most local other brandies
Absolut	200	4%	90% share in imported vodka, growing strongly
Ballantines	136	3%	the bulk of the volume is on Ballantines Finest, with ~8% share of the standard Scotch segment (vs JW Red 66%)
Wall Street	120	3%	Low price Brazilian whiskey, 20% discount to Natu Nobilis
Chivas	71	2%	Similar price point to Johnnie Walker Black (BRL 130-140). ~18% share vs JW Black 50%
other	53	1%	Jameson, Wyborowa, etc
Total	4,598	100%	

Note – in addition to Orloff volumes, PR sells ~200k cases of Orloff RTDs

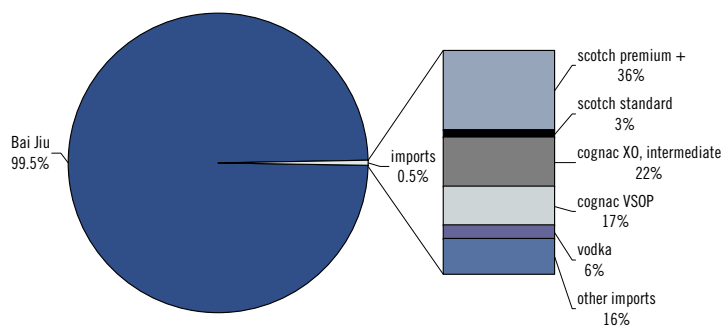
Source: IWSR and CIRA

- **Limited competition from international players** – Diageo and Pernod between them control ~70% of the value of the international spirits market. Jim Beam (Teacher’s), Campari (Campari, local brandies and whiskies), Bacardi and Brown Forman have all been in the market for some time. Apart from Brown Forman setting up its own in-market distribution, we haven’t detected any meaningful change in the level of competition.
- **Limited competitive threat from local players** – There isn’t much overlap between cachaça and international spirits, as 98% of cachaça volumes are of low quality and very low price. The format is generally a returnable bottle.

Appendix 2 – The Chinese Spirits Market

- **The Chinese spirits market is the largest in the world:** at an estimated 790 million cases, it is almost **four times the size of the US** or as large as India, US, Russia and Japan put together.
- **99.5% of the market is baijiu**, the typical Chinese white spirit.

Figure 128. Chinese spirits market – volume breakdown, 2009



Source: IWSR and CIRA Analysis

- **The upside for international spirits is very substantial.** Imports are only 0.5% of the market. Per capita consumption of international spirits is less than 0.03 litres. Taiwanese people drink 20x as much international spirits per cap. As we show earlier in the report, if China, which is now the third largest emerging market for international spirits in volume terms (and the largest in value), achieves just one third of the level of Taiwanese per cap, this would add nearly 50% to total emerging market Western spirits consumption.
- **Skew to premium** – in contrast to other emerging markets, consumption of Western spirits in China is heavily skewed to premium: 75% of Scotch and Cognac is premium, **which makes the Chinese market particularly profitable at gross margin level.**
- **The cost to compete has gone up**, as media rates have increased and international spirits companies have been bidding up the listing fees in the modern on-trade⁵⁶. More recently, however, the trend of increasing listing fees has stabilised and we understand that Bacardi and Brown Forman have been reducing their investment. **Despite all this, China is a very profitable market for Pernod**, even at EBIT level (we estimate margins to be in the high 20s, slightly above group average). In contrast, Diageo just about breaks even, we estimate.

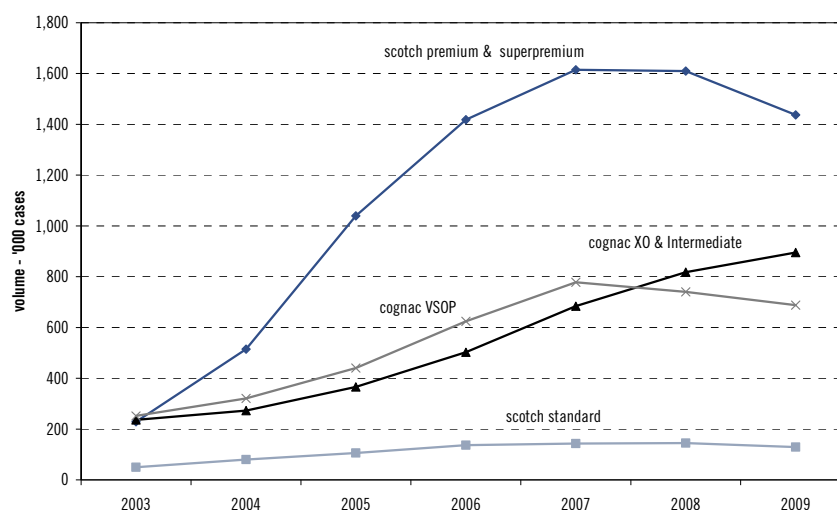
⁵⁶ Typically Diageo, Pernod, Bacardi, etc tie-in the modern on-trade outlets (bars, clubs) with exclusive or non-exclusive contracts to supply their brands. The outlets have to guarantee minimum volumes.

■ **Cognac vs Scotch** – The international spirits market is really all about Cognac and Scotch, for now at least. The two categories account for 80% of import volumes and 90-95% of the value. Cognac and scotch are different in several respects:

- Cognac is a relatively more established category in China, whereas scotch only took off around 2002-03
- In geographical terms, Cognac's strong-hold is the South (Guangdong and Fujian), whereas Scotch is stronger in the inland (Sichuan) and Northern provinces. They overlap somewhat in the coastal provinces
- Cognac is mostly consumed in traditional on-trade outlets (Chinese restaurants and karaokes), whereas Scotch is predominantly drunk in Western-style bars. Accordingly, the Cognac consumer is typically older, with greater disposable income and is more brand loyal. Brand loyalty is significantly lower among younger scotch consumers. More recently Pernod has been promoting Cognac also in the modern on-trade, at a price-point above Scotch's.

■ **The international spirits market has slowed in the last two years.**
Should we be concerned? Having grown at an impressive and unsustainable 38% CAGR since 2002, in 2008 the market slowed abruptly, despite the fact that China wasn't too badly affected by the global recession: +3% in 2008 and -4% in 2009. The slowdown was entirely driven by Scotch, as Figure 129 shows. We believe the Scotch market had simply grown too fast in too short a space of time, effectively increasing six-fold in the space of four years. More recently the scotch market is back into growth and expected to grow mid-high single digit this year.

Figure 129. International Spirits in China – Scotch slows, but not premium Cognac



Source: IWSR and CIRA Analysis

- **Baijiu**, the typical Chinese White Spirit, accounts for over 99% of total spirits volumes in the market. Chinese people typically drink Baijiu during meals, so the overlap with international spirits in terms of distribution channels and consumption occasions is not significant. Unlike in most other emerging spirits markets, where local spirits tend to be very low end, a strong premium segment has developed in baijiu. The main premium brands (Mao Tai, Wu Liang Ye) sell at ~\$80 and above (½ liter bottles). The premium segment has grown at 10% CAGR in recent years and constitutes as much as ~30% of the value of the market.
- **Pernod and Diageo** – We don't provide much detail in this section, because we discuss Diageo and Pernod's position in China in the company sections on pages 68 and 86 respectively. The following table however provides an overview of market share trends by segment.

Figure 130. Chinese imported spirits – market share trends by segment

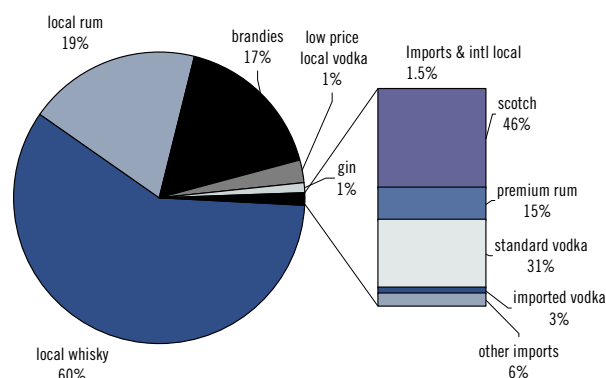
		2003	2004	2005	2006	2007	2008	2009
Scotch - ultra/superpremium	'000 cases	20	32	47	70	94	105	106
Pernod	Royal Salute, Chivas, Ballantines	85%	88%	82%	75%	77%	78%	82%
Diageo	Johnnie Walker, J&B, Dimple	15%	12%	18%	25%	23%	22%	17%
others	others	0%	0%	0%	0%	1%	1%	1%
		100%	100%	100%	100%	100%	100%	100%
Scotch - premium	'000 cases	209	483	993	1,348	1,521	1,505	1,331
Pernod	Chivas, Ballantines	67%	71%	72%	61%	57%	57%	57%
Johnnie Walker Black	Johnnie Walker	31%	27%	23%	32%	35%	34%	31%
Bacardi	Dewars	0%	0%	0%	3%	5%	7%	10%
others		2%	3%	5%	3%	3%	3%	2%
		100%	100%	100%	100%	100%	100%	100%
Scotch - standard	'000 cases	50	80	105.8	137	143	145	130
Diageo	Johnnie Walker Red	57%	53%	53%	49%	46%	46%	27%
Pernod	Ballantines	7%	10%	10%	15%	21%	23%	29%
Wm Grants	Grants	10%	19%	9%	8%	8%	8%	18%
Maxxium	Famouse Grouse	14%	6%	7%	3%	2%	2%	4%
other		12%	12%	21%	24%	23%	21%	23%
		100%	100%	100%	100%	100%	100%	100%
Vodka	'000 cases	54	118	210	291	292	261	241
Pernod	Absolut, Wyborowa	26%	44%	45%	51%	52%	47%	41%
Diageo	Smirnoff	19%	17%	17%	15%	13%	17%	19%
Bacardi	Eristoff	4%	7%	11%	7%	7%	5%	6%
Campari	Sky	0%	0%	0%	0%	2%	5%	8%
Brown Forman	Finlandia	6%	6%	7%	6%	5%	4%	4%
other		44%	27%	20%	21%	21%	22%	21%
		100%	100%	100%	100%	100%	100%	100%
Cognac XO & Extra	'000 cases	157	177	242	313	385	442	451
MH	Hennessy XO	40%	37%	40%	39%	40%	37%	32%
Pernod	Martell Cordon Bleu, XO	40%	44%	45%	49%	50%	54%	59%
Remy	Remy Martin XO	19%	18%	14%	11%	10%	8%	8%
other		1%	1%	1%	1%	1%	1%	1%
		100%	100%	100%	100%	100%	100%	100%
Cognac - intermediate	'000 cases	65	83	110	172	285	363	431
Pernod	Martell Noblige	20%	20%	29%	42%	53%	62%	68%
Remy	Remy Martin	57%	63%	63%	52%	42%	36%	30%
MH	Hennessy	22%	17%	7%	6%	5%	2%	1%
		100%	100%	100%	100%	100%	100%	100%
Cognac - VSOP	'000 cases	252	321	441	624	778	741	688
MH	Hennessy	43%	44%	51%	60%	67%	72%	72%
Remy	Remy Martin	41%	38%	31%	25%	19%	20%	22%
Pernod	Martell	15%	15%	16%	14%	13%	7%	4%
other		1%	2%	2%	1%	1%	1%	2%
		100%	100%	100%	100%	100%	100%	100%

Source: IWSR and CIRA Analysis

Appendix 3 – The Indian Spirits Market

- **The Indian spirits market has experienced remarkable growth rates over the past few years (2003-09 CAGR +13%)** driven by growth in disposable incomes and changes in the retail licensing system⁵⁷. Lower state taxes in some instances and the government crack down on “country liqueur” have helped.
- **India is the largest whisky market in the world**, but 99% is IMFL (Indian made Foreign Liqueur), most of which retails at around 3-5 US\$.
- Aside from whisky, local rum and brandies are also large categories. Although growing in absolute terms, rum is declining as a percentage of total, while brandies are stable. **Vodka is growing fast** from a small base and now accounts for just over 2% of the total market. Diageo is the leading player in the standard vodka segment.

Figure 131. Indian spirits market – volume breakdown, 2009



Source: IWSR and CIRA

- **Imports are still very small due to high import duties** (as high as 400-600% once state excise duties are added). Scotch makes up 85% of imported volumes and more than that in terms of value. However, around 50% of Scotch is smuggled, according to IWSR.
- **The international players (and the local ones) also have to deal with a very complex and bureaucratic regulatory framework** – Every state has its own rules in terms of taxes, distribution controls, price setting, etc. Many states don't even allow the importation of spirits and excises are levied when products cross state borders.

⁵⁷ The auction system for retail licenses was ended, driving a reduction in retail prices

- **International pressure is mounting for India to open up its market** and lower import duties. We remain fairly cautious on this happening any time soon however. Alcohol is a politically sensitive issue in many states and there are a lot of vested interests in maintaining the status quo⁵⁸. Even if duties were reduced, it is possible that the situation wouldn't change much in the short term, as the States could easily increase taxes to offset the lower import duties.
- Despite all these issues, **India (along with China) represents the biggest opportunity for the spirits industry in the long term**. Spirits consumption is growing very fast and imports even faster (22% CAGR 03-09). Scotch consumption is only 1.4million cases, with a 118 million-case local whisky market to tap into, growing at 20%+.
- **Pernod has a very strong position in India**, focused on IMFL whisky. Figure 132 shows how successful Pernod has been, taking share consistently over the past few years, in all segments it competes in, even from the market leader United Spirits.
- **Diageo**, on the other hand, is under-scale in India. It distributes its imported products on its own and, separately, through a JV with Radico, the number 3 player in the market. Diageo has a leading market share in Scotch with Johnnie Walker, which in our view owes more to the brand's international visibility rather than any distribution merits, but its dominance is slowly being eroded by Pernod. Diageo's growth driver in India is Smirnoff which is produced locally and is riding the popularity of vodka. Competition in standard vodka has intensified however with Pernod launching a brand called Fuel which has rapidly taken share. We estimate that Diageo's Indian business makes a small loss at EBIT level.
- **The other international players play a marginal role in India**: Bacardi dominates the IMFL premium rum segment (440k cases), which is smaller and growing less than IMFL vodka. Imported vodka is small and dominated by Absolut (44% share). Brown Forman is growing the Finlandia brand. In Scotch, apart from Diageo and Pernod, the only notable player is Beam Global (Fortune Brands). Its Teacher's brand is bottled locally and has been losing share in the segment.

⁵⁸ The majority of the female population and ~20% of men don't drink, with many opposing alcohol for religious reasons. Even the Indian Constitution includes the prohibition of alcohol among its directive principles.

Figure 132. Indian spirits – market share trends by segment

		2003	2004	2005	2006	2007	2008	2009
Premium IMFL whisky		4.5m cases						
Pernod Ricard	Blenders Pride	7%	15%	20%	26%	32%	37%	41%
United Spirits	Royal Challenge, Signature	82%	79%	75%	69%	57%	57%	53%
others		11%	7%	5%	5%	11%	7%	5%
		100%	100%	100%	100%	100%	100%	100%
Semi-premium IMFL whisky		31m cases						
United Spirits	Baggiper, Directors Special...	45%	43%	46%	48%	55%	53%	48%
Pernod Ricard	Royal Stag	22%	23%	23%	24%	27%	25%	26%
Jagatjit	Aristocrat	28%	29%	27%	23%	13%	17%	21%
others		6%	4%	4%	5%	5%	4%	4%
		100%	100%	100%	100%	100%	100%	100%
Regular IMFL whisky		65m cases						
United Spirits	Baggiper, Old Tavern, ...	64%	58%	58%	60%	52%	53%	50%
John Distillers	Officers Choice	16%	13%	11%	13%	14%	17%	18%
BDA	Original Choice	0%	8%	9%	10%	14%	16%	16%
Pernod	Imperial Blue	7%	6%	6%	6%	7%	7%	8%
others		13%	15%	15%	12%	13%	8%	8%
		100%	100%	100%	100%	100%	100%	100%
Standard IMFL vodka		940k cases						
Diageo	Smirnoff, Shark Tooth	100%	100%	79%	76%	80%	79%	69%
Pernod	Fuel	0%	0%	17%	21%	20%	16%	22%
Bacardi	Eristoff	0%	0%	0%	0%	0%	1%	1%
other		0%	0%	3%	3%	0%	5%	7%
		100%	100%	100%	100%	100%	100%	100%
Premium Scotch Bottled at Origin		245k cases						
Diageo	Johnnie Walker Black	77%	75%	73%	72%	73%	69%	67%
Pernod	Chivas Regal	23%	25%	27%	28%	27%	31%	33%
		100%	100%	100%	100%	100%	100%	100%
Standard Scotch Bottled at Origin		255k cases						
Diageo	Johnnie Walker Red, J&B	82%	80%	84%	82%	80%	72%	70%
Pernod	Ballantines	4%	5%	3%	2%	3%	9%	11%
others		14%	15%	13%	15%	18%	20%	20%
		100%	100%	100%	100%	100%	100%	100%
Scotch Bottled in India - Premium		170k cases						
United Spirits	Black Dog	56%	60%	65%	58%	49%	55%	68%
Beam Global	Teachers	44%	40%	35%	42%	51%	45%	32%
		100%	100%	100%	100%	100%	100%	100%
Scotch Bottled in India - Premium		591k cases						
Beam Global	Teachers	56%	50%	48%	41%	35%	35%	41%
Pernod	100 Pipers, Passport	26%	23%	22%	28%	35%	34%	35%
Diageo	VAT 69, Black & White	18%	22%	22%	28%	30%	30%	22%
others		0%	5%	8%	3%	0%	1%	3%
		100%	100%	100%	100%	100%	100%	100%

Source: IWSR and CIRA Analysis

Appendix 4 – Vodka in Emerging Markets

In this Appendix we take a more detailed look at the status of vodka in emerging markets and its prospects.

- Apart from Russia, Poland, Ukraine and a few smaller CIS countries, vodka is a reasonably large category only in four other countries: Brazil, India, South Africa and Mexico, where it is produced locally. In all other emerging markets vodka is very small.
- The import segment is small everywhere except in Mexico and Poland.
- **Brazil** appears to be the most promising market for vodka, at least in the medium term. It has been growing fast because it offers consumers a trading-up alternative from cachaça, which is also a white spirit. The two leading brands in the market are Smirnoff (Diageo) and Orloff (Pernod Ricard). They both have national distribution and are priced well above the many local vodka brands.
- In **India** vodka is the fastest growing category in the market. Since 2003 vodka has grown almost 40% CAGR to over 5 million cases, essentially all locally produced. Smirnoff Red dominates the standard segment (60% share), but in the last two years it has dropped some share to Pernod's relatively new brand, Fuel, priced 35% cheaper. Imported vodka is small, due to the high duties levels. Absolut's retail price is around \$40, putting it out of the reach of most.
- The **South African** vodka market, dominated by Smirnoff (~75% share) is large but hasn't been growing since the late 90s.
- In **Mexico**, because of the proximity to the US, imported vodka has been growing strongly. The segment has more than doubled its size from 250k cases in 2003. Mexico is the largest emerging market for Absolut, with a 65% share of imports. Smirnoff is produced locally (340k cases) but hasn't grown in the last five years.
- **Asia** – Vodka hasn't taken off yet in Asia (apart from India). The vodka market in China has been stuck at ~200k cases (all imports) for the last three years. As we suggest on page 32, we think vodka in Asia could be a very large opportunity for the industry.
- **Poland** is interesting because a premium segment has developed in the past few years, but the local players are not in it. Premium imports have grown from 190k cases in 2002 to 1.1 million in 2009. Finlandia (Brown-Forman), has taken most of the growth (80% market share). Poland could become an increasingly important market for Absolut (15% share currently), given Pernod's strong distribution platform in the market. The upside is significant, as Poles drink over 270 million litres of local vodka every year!
- **The Russian vodka market**, unsurprisingly, is the largest in the world, at over 200 million 9-litre cases. The market is dominated by low price products and is declining. The trend is likely to accelerate as the government cracks down on cheap and illegal vodka. Premium vodka (> 350 RUB, 11 US\$), however, is growing. The segment has doubled in size over the past 5 years to 3 million cases, just over 1% of the total market. The segment is controlled by local players and imports remain small (200k cases, mostly Finlandia and Absolut). We think it will be difficult for the situation to change much in the short term. For more background on the Russian vodka market and its two key players, CEDC and Synergy, we refer the reader to a Citi report "*Russian Vodka: High Risk, High Reward*" (Brady Martin, 13 September 2010).

Companies mentioned

Company	RIC	Rating	TP	Currency	Target Price	SP	Currency	Share Price
ABInBev	ABI.BR	1	M	EUR	51.00		EUR	42.78
Carlsberg	CARLb.CO	2	H	DKK	640.00		DKK	565.00
Heineken	HEIN.AS	1	M	EUR	46.00		EUR	36.62
SABMiller	SAB.L	1	M	GBP	27.00		GBP	22.51
Diageo	DGE.L	1	L	GBP	14.30		GBP	11.91
Pernod-Ricard	PERP.PA	1	M	EUR	85.00		EUR	69.20
Danone	DANO.PA	2	L	EUR	48.00		EUR	46.54
Nestle	NESN.VX	2	L	CHF	56.00		CHF	53.85
Unilever	ULVR.L	1	L	GBP	24.00		GBP	19.55
Henkel	HNKG_p.DE			EUR			EUR	45.66
L'OREAL S.A.	OREP.PA			EUR			EUR	84.66
Reckitt Benckiser	RB.L			GBP			GBP	35.80
Brit Am Tobacco	BATS.L	1	L	GBP	25.70		GBP	24.69
Imperial Tobacco	IMT.L	1	L	GBP	22.60		GBP	19.76
Swedish Match	SWMA.ST	2	M	SEK	187.00		SEK	193.00
Beiersdorf	BEIG.DE			EUR			EUR	42.58

Source: Citi Investment Research and Analysis. Priced January 5th

Notes

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Appendix A-1

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The research analyst(s) primarily responsible for the preparation and content of this research report are named in bold text in the author block at the front of the product except for those sections where an analyst's name appears in bold alongside content which is attributable to that analyst. Each of these analyst(s) certify, with respect to the section(s) of the report for which they are responsible, that the views expressed therein accurately reflect their personal views about each issuer and security referenced and were prepared in an independent manner, including with respect to Citigroup Global Markets Inc and its affiliates. No part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this report.

IMPORTANT DISCLOSURES

Diageo (DGE.L)

Ratings and Target Price History Fundamental Research



Chart current as of 4 January 2011

	Date	Rating	Target Price	Closing Price
1	8-Feb-08	2L	*10.85	10.21
2	23-May-08	2L	*10.40	9.84

* Indicates change

	Date	Rating	Target Price	Closing Price
3	24-Aug-09	2L	*10.20	9.63
4	26-Apr-10	Coverage terminated		

Rating/target price changes above reflect Eastern Standard Time

Diageo (DGE.L)

Ratings and Target Price History Best Ideas Research Relative Call (3 Month)

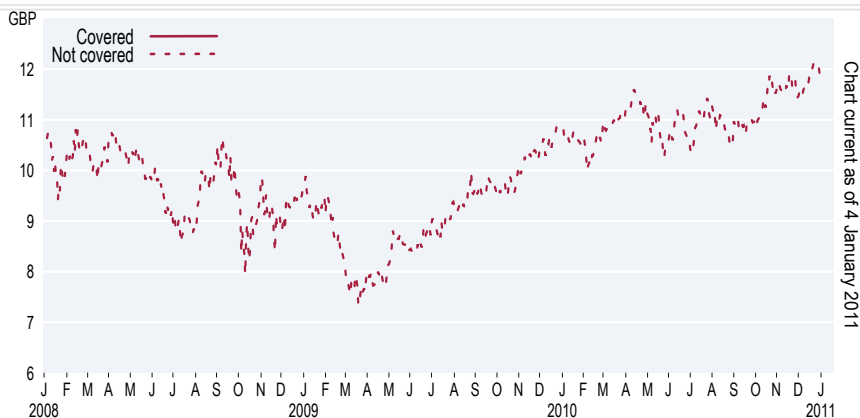


Chart current as of 4 January 2011

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Pernod-Ricard (PERP.PA)
Ratings and Target Price History
Fundamental Research



Chart current as of 4 January 2011

Date	Rating	Target Price	Closing Price
1 21-Feb-08	1L	*74.90	64.94
2 23-May-08	*2L	*70.27	66.08
3 1-Sep-08	2L	*63.34	59.01

* Indicates change

Date	Rating	Target Price	Closing Price
4 18-Sep-08	2L	*55.48	51.68
5 16-Apr-09	2L	*42.16	41.50
6 27-May-09	2L	*47.06	43.39

Date	Rating	Target Price	Closing Price
7 26-Apr-10	Coverage terminated		

Rating/target price changes above reflect Eastern Standard Time

Pernod-Ricard (PERP.PA)
Ratings and Target Price History
Best Ideas Research
Relative Call (3 Month)

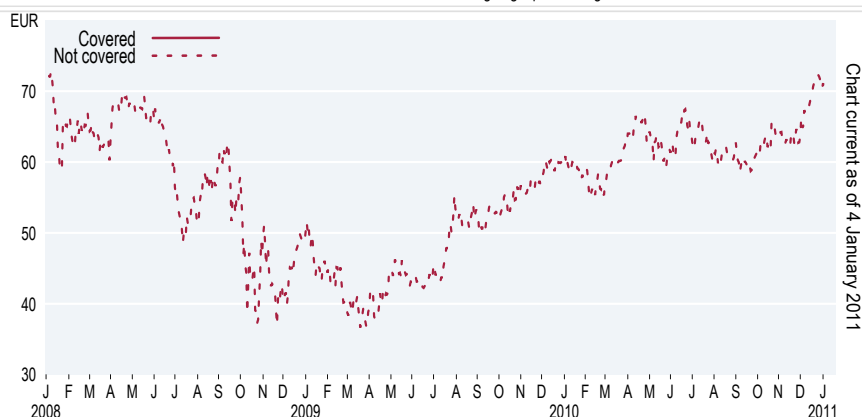


Chart current as of 4 January 2011

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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