



## Stock story: Diageo

The world's biggest distiller benefits from people drinking better, even if they drink less.

**In the mid-2010s, UK-based distiller Diageo invested in proprietary technology tools to uncover growth opportunities and improve returns on marketing spending. The analysis revealed the US was a ripe market for premium tequila, an alcoholic brew made from the blue agave plant that flourishes around the town of Tequila in the western Mexican state of Jalisco. Tequila volumes in the US doubled from 2003 to 2015, as Hispanic influence took hold and millennials-come-mixologists began making margaritas or sipping the liquid straight.**

Diageo's key step in its campaign to penetrate the high-end US tequila market came in 2017 when the company spent US\$1 billion (including a US\$300-million 'earn-out' based on sales) to acquire Casamigos tequila, a company founded four years earlier by US actor George Clooney and two others. Casamigos, which translates to 'house of friends' in Spanish, was the fastest-growing (40%+) 'super premium' tequila in the US. With the purchase, Diageo added Casamigos, which Clooney still promotes, to its tequila portfolio that includes complementary brands such as Don Julio.

By 2021, the campaign's success was obvious. Diageo's 'organic net sales' of tequila in fiscal 2021 had soared 79% from the previous year, numbers that meant tequila sales comprised 8% of the company's organic net sales. (This sales measurement excludes the effects of currency translation and takeovers and divestments.) The company subsequently announced it would spend US\$500 million to expand production in Jalisco where it has two tequila plants.

Thanks to strategic portfolio adjustments such as this, Diageo has outperformed peers in the US, which accounts for nearly 60% of group operating profit. Globally, the owner of Baileys Irish Cream liqueur, Captain Morgan rum, Johnnie Walker whisky, Tanqueray gin and Smirnoff vodka posted sales of 12.7 billion pounds in fiscal 2021, an increase of 12% from the year earlier.

Diageo, whose spirits hold the No. 1 spot in six of the nine biggest spirit categories, extends beyond spirits. The company brews beer including Guinness, makes wine and offers ready-to-drink (pre-mixed) options. All up, the company boasts more than 200 global, local, and luxury brands that are sold in more than 180 countries. Through a 34% stake in LVMH's Moët Hennessy, Diageo stretches into the high-end cognac and champagne categories.

Spirits represent about 80% of Diageo's revenue – scotch generates 25% of Diageo sales, while vodka accounts for 10%. Beer brings in about 15% of sales while other categories such as ready-to-drink products and wine generate the remainder. In terms of locations, the company sources about 40% of sales in North America, 20% in Europe (including Turkey) and another 20% in Asia Pacific.

The modern history of Diageo, which can trace its start to 1759 when Arthur Guinness leased a brewery in Ireland, began in 1997 when Guinness and GrandMet merged. This union and subsequent bolt-on acquisitions have created a company with three key competitive advantages.

The first is that Diageo owns brands for which consumers are prepared to pay a premium. Spirits variants are distinguishable in terms of flavour, production process, provenance, and vintage. Such points of differentiation allow distillers to charge higher prices for luxury categories. Johnnie Walker's 18-years-to-produce Black Label scotch, for instance, sells at 3.7 times the price of Johnnie Walker Red Label whisky.

Diageo's second competitive advantage is that it has secured superior access to distribution channels. Bars, bottle shops, pubs, restaurants and supermarkets have finite space to display drinks. They favour brands that sell quickly and deliver higher margins. They want brands that can be supplied and restocked by a reputable and reliable company such as Diageo.

The third advantage is Diageo has the turnover to achieve economies of scale in advertising, data analytics, distribution, manufacturing, research and development and procurement of ingredients. Lower average costs mean competitive pricing and higher margins.

Because of these three key advantages we believe that the company is likely to generate superior returns for the foreseeable future, the attribute that stocks must possess to enter the



Magellan global portfolio.

To be sure, Diageo faces challenges. Hot categories such as tequila inevitably attract competition. Celebrities Dwayne Johnson (the Rock) and Kendall Jenner have launched tequila brands in recent years that they promote via their widely followed Instagram accounts. There is a risk that this could dent category returns, as new brands take market share and prompt existing players to increase their marketing spending. The counterargument to this point is that new celebrity-backed brands generate buzz for the category, and they typically compete based on product differentiation rather than unhealthy price competition. Diageo must be quick to adapt to fresh competitive threats and new industry trends, as the company did when it stormed the top end of the tequila category in the US in 2017.

Sources: Dunn & Bradstreet, company filings and Bloomberg.

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