Diageo – managing for value, aiming for expansion

Andrew Moorfield of Diageo analyses the multinational's corporate strategy, 'managing for value'.

Diageo plc was formed in December 1997 through the merger of Guinness plc and GrandMet plc, creating the largest wine and spirits company in the world, UDV, with leading international brands such as J&B, Johnnie Walker, Baileys and Gordons. UDV accounts for approximately 50% of Diageo's PBT of £1.9bn with the balance spread across Pillsbury (25%), Guinness (15%) and Burger King (10%).

With this combination of four businesses, Diageo is one of the world's leading branded consumer companies with an annual turnover of nearly £12bn and a market capitalisation of £20bn.

Managing for value

At the time of the merger, Diageo's senior management decided to continue the GrandMet philosophy of 'managing for value' to drive shareholder value. Intrinsic within this philosophy is a requirement that Diageo be able to optimise its cost of capital and undertake efficient financing and sophisticated risk management techniques. This meant that Diageo needed to maintain dedicated corporate finance skills within the company. As a result of this focus, corporate finance at Diageo is seen as being at the heart of the treasury function, and no line is drawn between the two. In what follows, it is therefore fair to treat the two terms as interchangeable.

Diageo senior management have a straightforward aim – within five years from the 1997 merger, the company will be in the top five of its global peers as measured by total shareholder return (TSR). TSR measures the share price appreciation (including dividends paid) of the Diageo stock relative to our 20 global peers – including McDonalds, Pepsi, Heineken, Colgate and Unilever.

To fully optimise TSR, Diageo must maximise each business unit's economic profit (EP – a derivation of the Stern Stewart EVA concept). EP measures the total returns generated by Diageo in excess of our weighted average cost of capital (WACC). In effect, it is the premium generated by Diageo above the minimum level required by our shareholders. This concept drives the Diageo 'managing for value' ethos.

> From a business perspective, the EP calculation rewards the generation of cashflow

Management of WACC

The corporate finance implications of EP are significant as Diageo faces the conflict between maintaining the lowest possible WACC (in order to drive up EP) but also maintaining maximum financial flexibility. In order to lower WACC, the proportion of the company funded by (cheaper) debt, rather than (expensive) equity, must increase. As Diageo increases its reliance upon debt financing, pressure on our rating category increases.

Diageo regularly issues a significant level of US commercial paper (USCP). USCP is short-term (usually issued with an average maturity of 45 days) and is extremely rating-sensitive. To maintain aggressive pricing on our USCP programme, it is imperative that fixed income investors remain confident that Diageo maintain its coveted A1/P1 short-term credit rating.

In that context, purely increasing Diageo's reliance upon debt funding to lower WACC is a blunt exercise – as debt increases, pressure on the rating category also increases. In turn, this will increase the cost of debt funding which ultimately feeds into a higher cost of debt. This has negative implications for WACC.

Economic profit analysis

From a business perspective, the EP calculation rewards the generation of cashflow. From a treasury perspective, the EP calculation rewards the implementation of tax efficient financing that minimises interest expense.

The Diageo corporate finance strategy is therefore driven by the requirement to implement efficient financing and investment structures. These structures reduce funding costs that lower WACC and generates increased cash flow (relative to other funding or investment sources).

In order to structure efficient transactions, Diageo has established a specialised corporate finance team located jointly within the treasury and tax functions. The team is headed by a mathematician who has significant interest rate management, foreign exchange exposure management and corporate finance experience. Within his team are two financial mathematics PhDs, a corporate finance MBA with an operations background and a US tax accountant.

Our corporate finance skill base is skewed towards quantitative analysis and risk management. These skills allow Diageo to analyse and quantify corporate finance structures using an EP methodology. For example, Diageo will always decompose corporate finance solutions into constituent elements and then separately analyse (and price) those elements. The transaction will then be assessed in an EP context in which the risk and reward balance will be valued.

As an example, it has been our experience that a number of banks will present a corporate finance structure that may contain a series of embedded options. Using our methodology, each option is analysed and priced. Under this analysis, the characteristics of the transaction can alter dramatically (it is also our experience that banks 'over price' the options to increase fee income in a non-transparent manner). Through truly analysing the transaction in a risk and reward framework, such a transaction may be EP negative, despite it being prima facie overwhelmingly positive when initially presented.

In-house corporate finance skills

The benefit of maintaining corporate finance skills 'in house' is two-fold:

- first, advisers (principally investment banks and a limited number of commercial banks) treat Diageo as an informed professional counterpart. Discussions between our organisations are undertaken as equal parties. Implicit in this understanding is that Diageo maintain an open dialogue with our major corporate finance providers. For example, if a transaction proves inappropriate for Diageo, we feel obligated to explain why and how a best fit was not achieved. Inevitably this dialogue allows more bespoke transactions to be presented to Diageo; and
- second, in-house expertise reduces our reliance upon external advisers. Although Diageo Corporate Finance extensively use external specialists, we believe it is our responsibility to be the role of gatekeeper and sift out inappropriate transactions. As a team we have built up considerable knowledge of corporate finance transactions and their unique accounting, legal and tax implications creating a body of knowledge which provides a database for future transactions. To replicate this database would be both expensive and time consuming.

Corporate finance approach

Diageo's approach to corporate finance transactions is straightforward.

It has been our experience that we should clearly articulate our requirements for transactions (for example, we would rarely undertake a transaction where the all-in benefit is less than $Libor +/–100 basis points) and we also state our up-front documentary requirements.

A requirement for all proposed transactions is that banks must be able to provide both accounting and tax based opinions. This is not because we rely upon such opinions (indeed, we will always obtain our independent opinions) but it is evidence that the proposing bank has undertaken sufficient 'homework'. Although Diageo is willing to enter into unique transactions for which there is no track record, we do not pay for the R&D costs of an investment bank. The requirement for up-front accounting and legal opinions has proven a useful means to separate workable transactions from totally impracticable concepts.

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Fee philosophy

The Diageo fee philosophy is usually the cause for the greatest angst with our relationship banks. As mentioned, we do not pay for the R&D banks undertake for their products and our fees are agreed irrespective of the size of the transaction. This is because the development work for a £100m transaction is equivalent to that of a £500m transaction. The only exception where we link fees to deal size is when the bank is providing services directly related to the deal size (for example, distribution or underwriting fees).

A result of this policy is that Diageo has declined proposed transactions (and no doubt will again in the future). However, Diageo ultimately has a limited capacity for funding and investment structures and it is in our shareholders' interest to ensure transactions completed maximise value and minimise value leakage (notably bank fees). In return for a disciplined fee approach, Diageo offers banks two significant benefits:

- **quick implementation** – upon approval of a transaction by the Diageo finance committee (broadly the executive directors of Diageo), the corporate finance team has the resources to execute transactions professionally and with minimal delay. Professional services such as specialised tax, legal and accounting are provided in house or outsourced to advisers and our internal database has allowed us to negotiate the more obvious pitfalls; and
- **transactions are executed 'in size'** – Diageo's relatively large short-term debt look combined with a significant tax base allows us to have a unique fact profile. This profile has allowed Diageo to execute transactions with a significant minimum deal size.

The Diageo corporate finance team has built a substantial reputation as a leading corporate finance counterpart. This success is due to a relatively straightforward strategy:

- maintaining clear parameters for deal expectations (all-in benefits as measured by EP, minimum deal size, accounting and tax treatments);
- requiring a minimum of documentation and opinions up front (notably, accounting and tax legal opinions); and
- stating fee guidelines and be willing to decline transactions when fee expectations will not be met.

However, the underlying strength of Diageo in completing corporate finance transactions is the overriding corporate strategy of 'managing for value' through EP. This allows us to dedicate internal resources to an experienced and qualified corporate finance team able to engage banks in a long term and mutually informative relationship. ■

Andrew Moorfield is Director of Corporate Finance and Capital Markets in Diageo plc, the multinational food and drinks group. Since joining the company in March 1999, he has been responsible for launching Diageo's first global bond, and three Yankee bonds, the establishment of Diageo's US MTN programme, European medium-term note issues and a number of structured corporate finance transactions. Andrew came from Citibank where he was a senior banker in global relationship management. Prior to this he worked in banking in New York, London and his home town of Melbourne, Australia.