Diageo plc — Pre-Acquisition Financial Analysis

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Group project. Collaborator names and student identifiers are omitted from this public copy.

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Part 1. Analysis and Assessment of Financial Health

The following ratios were calculated and analysed following ratios to assess Diageo's profitability, cash generation and financial position over the last 5 years.

Gross margin

Figure 1.

We can observe stable levels of gross margin for the company throughout the last 5 years (Figure 1). Diageo has done a great job passing the inflation down to the costumers amid significant inflationary pressures during 2022 and kept around 60% margin from there forward. It also shows the maturity and the strong brand image of the company that can endure demand elasticity despite the price change.

Operating margin

Operating margins were kept around ~25-30% ranges (Figure 2). Despite the revenue levels were kept stable in 2023, the cost side inflation has pressured the operating margin further down (Table 1). It quickly recovered after the inflationary pressures were over in 2024, and the price of the goods caught up with costs. Additionally, since 2024 the premiumisation strategy has played a significant role in keeping the operating margins in place while pushing the costs down (premium brands => higher margins).

Figure 2.

Table 1.

	FY 2022	FY 2023	FY 2024
Revenue	20,516	20,555	20,269
Cost of sales	7,923	8,289	8,071
Gross profit	**12,593**	**12,266**	**12,198**

Net margin

Figure 3.

Net margin has dropped significantly during 2025, however, due to non-operating charges (Figure 3). Brand and investment impairments were the main drivers, accounting for ~$910m, across Distill Ventures, Aviation American Gin, Bell's and other US brands, which reflect the downward changes in sensitive valuation assumptions, further compounded by ~$220m restructuring charge for the Accelerate programme, and $114m non-operating loss for the planned sale of Guinness Ghana.

Adjusted Net margin

We have excluded the impact of non-operational items such as gain/loss, from FX and affiliates, asset write-downs, losses on disposals, legal settlements, restructuring costs, and other non-operational items. As illustrated in the Figure 4, Adjusted Net Margin follows a more stable trend. The distortions in 2023 and 2025 reflect significant asset write-downs, $613m and $910m respectively. Therefore, we conclude that the margin shifts are mostly non-performance related.

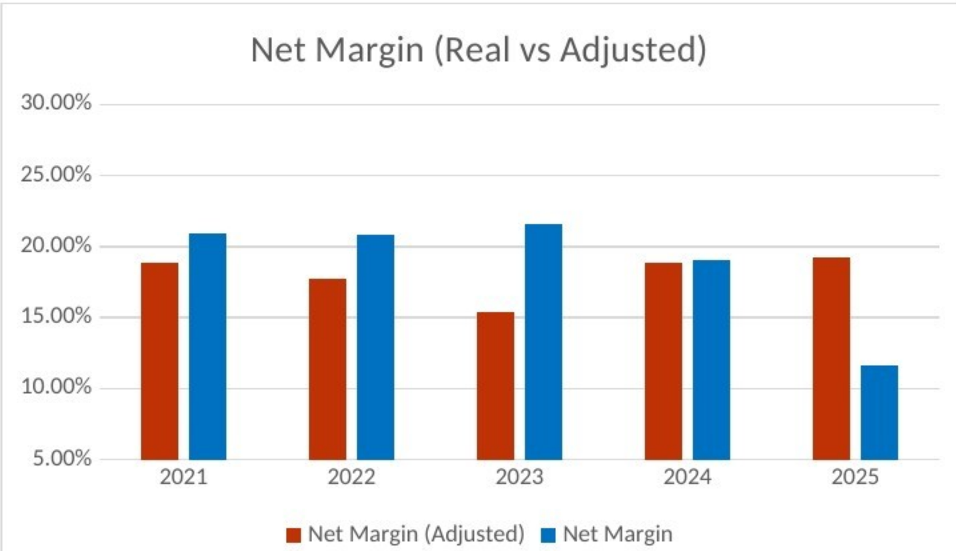

Figure 4.

ROIC

Figure 5. portrays the Return on Invested Capital in comparison with the WACC of the company. We have calculated ROIC as:

$$ROIC = \frac{EBIT * (1 - Tax \;\; rate)}{Average \;\; Invested \;\; Capital} \qquad (Eq.1)$$

$$Invested \;\; Capital = \; Equity + Net \;\; debt - Cash \;\; \& \;\; Eq. \qquad (Eq.2)$$

The comparison reveals despite inflation and non-operational challenges (like impairment pressure), the company kept its ROIC almost double the level of WACC, which means the company generates strong economic profits.

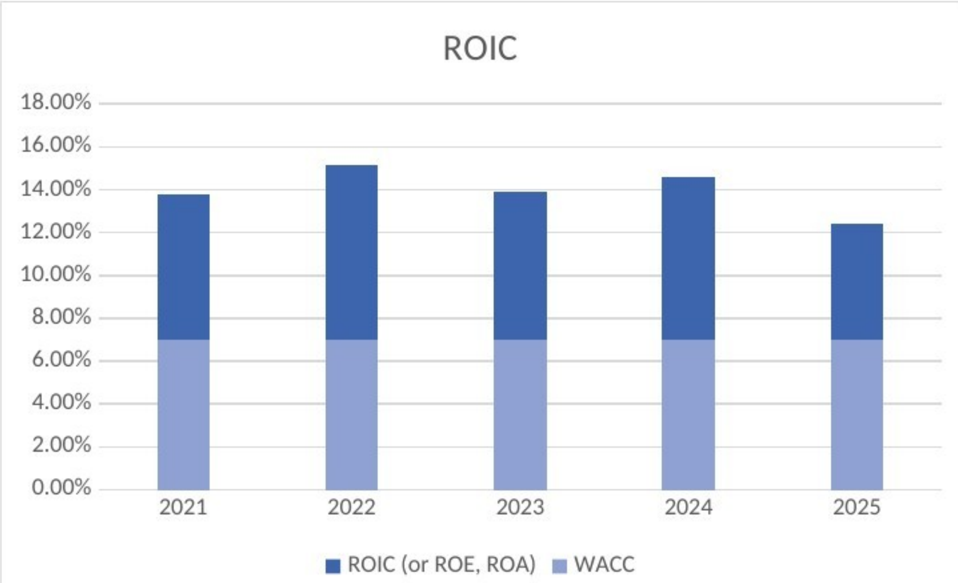

Figure 5.

Net debt - EBITDA

Decrease in the Net Debt to EBITDA multiple in 2022 is due to post-pandemic sales boom: Net Debt remained stable however, EBITDA saw a considerable increase. The slight upward movement in 2024 is due to the weight of added ~$1.5m long term borrowing. Overall, for a strong cash generating consumer staples company, the Net Debt/EBITDA multiple of ~2.8 can be considerate moderate.

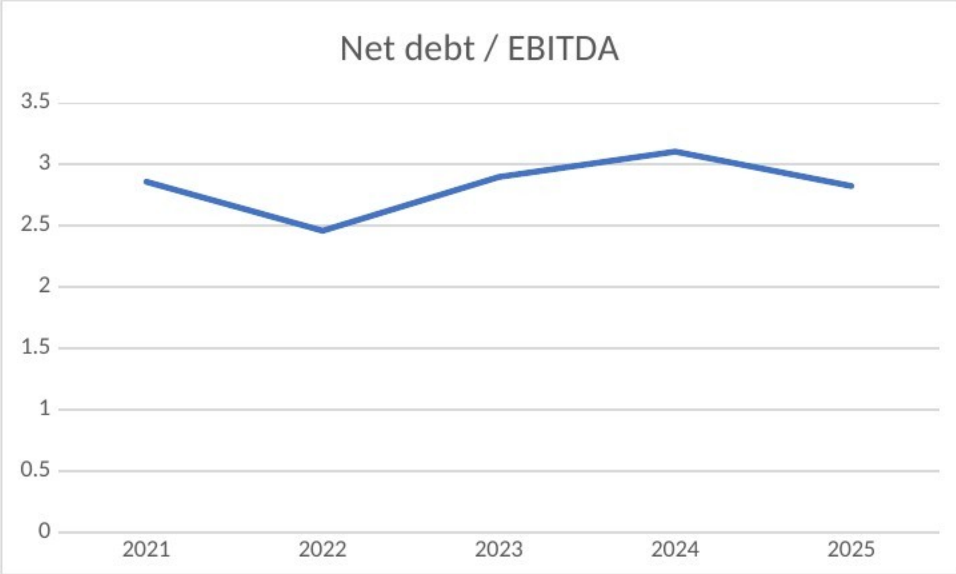

Figure 6.

Operating Cash Flow/EBITDA

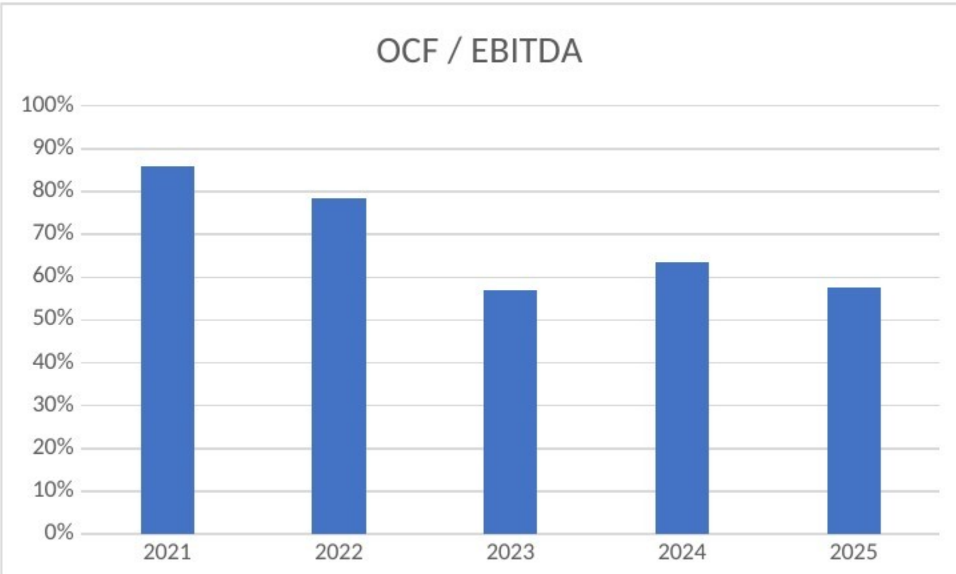

Figure 7.

Operating Cash Flow/EBITDA fell over the 5 years, meaning that the cash conversion from EBITDA weakened. One of the main reasons is that inventory days have increased from 389 days (2022) to 460 days (2025). The ratio is particularly low in 2023 and 2025, which is in line with the bulk impairment recognitions in those years, as impairments inflated the CFO.

CFO/Net Income

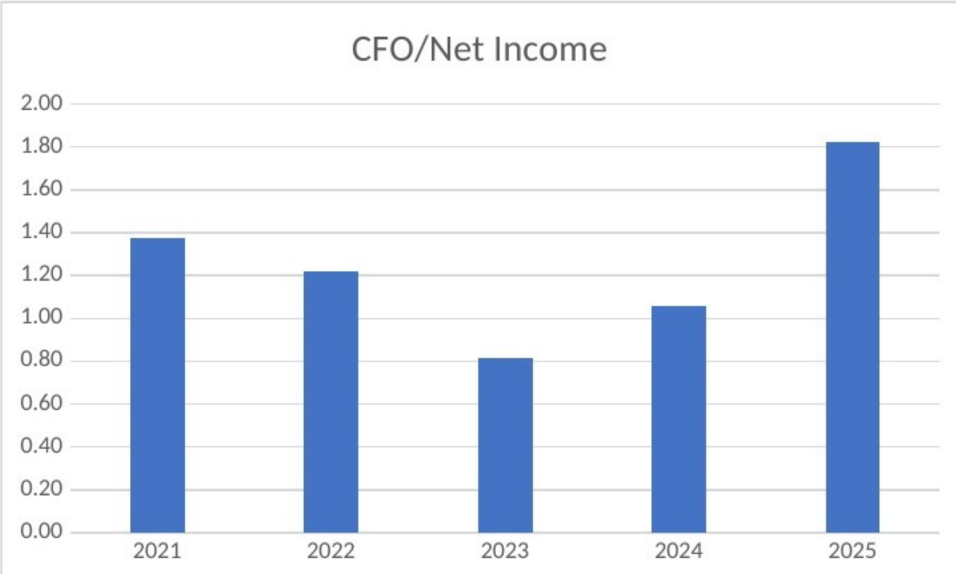

Figure 8.

Despite the initial decline, the CFO/Net Income ratio above 1 shows cash conversion of the net profit is high (Figure 8). The dramatic decrease to 0.82 in 2023, is caused by inventory build-up and increased receivables, leading to reduction in the operating cash flow relative to net income. Since 2024 the ratio recovered to healthy levels, reaching 1.83 in 2025, which proves the decline in 2023 was mostly due to working capital build up and cash timing difference that reversed thereafter.

Inventory days

The inventory days have increased gradually from 2021 until 2025 (Figure 9). Diageo produces aged spirits that gain value as left in the inventory, therefore, they stay in the inventory for long periods. Hence, even though operations are healthy, the inventory days are naturally high. Moreover, post COVID, due to higher demand anticipation, the firm has intentionally built up their inventory.

Figure 9.

Dividend Payout Ratio

The dividend payout ratio has been stable between 2021-2024, averaging around 60%, which is textbook for a mature consumer staples company (Figure 10). Above 100% payout in 2025 is not a sign of an operational weakness, as the decline in the profit was attributed to non-operational items. Therefore, the payout above 100% in 2025 does not involve any extra leverage, and is a one-off case.

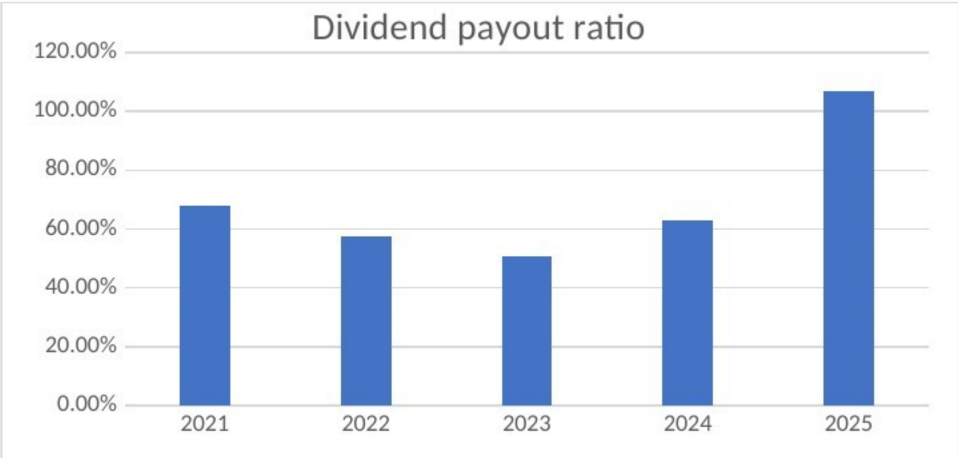

Figure 10.

Part 2. Assessment of Accounting Policies

Diageo's accounting policies reveals that certain areas have a substantial impact on the ability to compare performance to that of competitors such as Pernod Ricard, Brown-Forman, and Campari. Under IFRS 15, revenue recognition is consistent across the sector, with revenue reported net of excise duties. However, this fundamentally influences gross margin interpretation (≈60%), making margins sensitive to changes in local tax regimes rather than purely operating efficiency. Under IAS 2, inventory accounting is highly subjective due to the long maturation time of spirits. This means demand has the potential to reduce capitalized manufacturing and ageing costs. Recent impairments of US-based inventories and assets demonstrate how this could reduce gross and operational margins without having the same impact on cash flow, thereby affecting ROIC in the short run.

The most significant sensitivity comes from how IAS 38 and 36 manage intangible assets and goodwill. Diageo owned brand intangibles that are not amortized, but are tested for impairment annually due to their indefinite life. The significant impairment charges recognized between 2023 and 2025 (for US brands including Aviation Gin, Distil Ventures, Bell's, and others) resulted in a reduction of operating profit, net income margin (11.6% in 2025), ROIC, and dividend coverage, even though cash flows had slight impact. Diageo's larger brand portfolio and venture-style investments increase the impairment risk compared to more specialised competitors such as Brown-Forman, making evaluating results harder when demand is low.

Another element to consider is how to categorise unusual items under IAS 1. Management claims that these expenditures are not recurring, but the fact that restructuring charges, litigation costs, and portfolio disposals (such as the Accelerate program and exits from the African brewery) occur on a regular basis demonstrates that they are a permanent feature of the business model. As a result, the reported operating margin, net profit margin, interest cover, and payout ratios fluctuate significantly from year to year. So, when it comes to valuation and credit analysis, adjusted EBIT and cash-based metrics are more reliable indications of performance.

Part 3. 2-year Forecast

We have forecasted upcoming 2 years simplified Financial Statements (Please see Appendix 1, 2, and 3) based on the following assumptions:

Income statement

[1]- Revenue was forecasted based on the 5-year moving average, as the company is mature and there are no major plans of expansion (currently the focus is more on the cost efficiency). Additionally, the overall alcohol sales globally have been slightly declining due to economic pressures and mindful drinking. Thus, this trend is expected to offset organic revenue growth and inflation adjustments.

[2]- Depreciation figure has been estimated based on the 5-year moving average.

[3]- Gross Profit, Operating Income and Net Income are tied to the Revenue, with the profitability ratios calculated before. For Net Margin, we have taken adjusted margin figure.

Cash Flow Statement

[1]- Net income and Depreciation - taken from the Forecasted Income statement.

[2]- Non-cash items - moving average of last 5 years.

[3]- Inventories and Other changes in working capital – taken from Forecasted BS

[4]- The company is planning to cut CAPEX to mid-single digit percentage of net sales (page 23 of the 2025 Annual report) down from 7.7% starting from FY2026 (~5% of forecasted net sales)

[5]- Other investing activities were assumed zero for simplicity.

[6]- Dividend paid = Average Payout % * Forecasted Net Income

[7]- Company has kept stable debt to equity ratio of around 1.8 for last 5 years. For simplicity, we assumed debt to remain unchanged.

[8]- Please see Balance Sheet note [9].

[9]- FX loss was projected based on 4 year moving average (2021 effect excluded, as it represents a large FX effect due to company changing its reporting currency)

[10]- Tax and interest charged and paid were assumed to be equal. Both were forecasted based on the 5-year moving average (therefore has no effect on the cash flow from operating activities, and moved below the CFs).

Balance Sheet

[1]- $Cash = Opening\ balance + Net\ movement \in the\ forecasted\ CF\ statement.$ (Eq.3)

[2]- (Eq.4)

$$Receivables = \frac{Average\ days\ sales\ outstanding\ (\sim 50\ for\ last\ 5\ years) \times Projected\ Revenue}{365}$$

[3]- 2% average increase in the inventory was assumed (5 year moving average).

[4]- All the figures marked for note [4] has been assumed constant for simplicity.

[5]- No impairment assumed for goodwill.

[6]- (Eq.5)

$$Payables = \frac{Average\ days\ payables\ outstanding\ (\sim 159\ for\ last\ 5\ years) \times Projected\ COGS}{365}$$

[7]- Changes in Inventory was added to Other Payables, for simplicity.

(Eq.6)

[8]- $Retained\ \ earnings\ =\ Opening\ +\ Net\ \ Income\ (forecasted)\ -\ Dividends$

[9]- Net Income after dividends are likely to be used for share buybacks, however, this decision is entirely at management's discretion and depend on capital allocation priorities. As a result, share buybacks were not forecasted.

Part 4. Overall recommendations and conclusions

Diageo's aims, financials, and external factors indicate that their objectives are sustainable. It continues to demonstrate strong financial stability, brand-led pricing power, and strategic flexibility, all of which contribute to the long-term sustainability of its stated aims.

Sustainable Growth and Premiumization

Diageo capitalized on its growth strategy of concentrating on high-end products, despite slow sales growth. Net sales dropped from $20.27 billion to $20.25 billion in FY25. However, gross margins stayed close to 60%, suggesting that the company's pricing power and brand are still strong. Rather than discounting or a loss of market share, cost and volume issues are the cause of the operating profit decline from 29.4% to 28%.

Category Leadership in Whisky and Tequila

The balance sheet and profitability indicators show that Diageo is on track to become the market leader for whisky and tequila. The brand's basic economics are strong, even when sales are down as the Adjusted EBIT was $5.73 billion in FY25, while operating margin remained stable around 28%. Inventory went up to $10.66 billion, which is usual for spirits that require an extended period to mature.

Operating Efficiency, Cash Generation, and Deleveraging

The Accelerate program is financially feasible. Diageo's free cash flow rose from $2.60 billion in FY24 to $2.69 billion in FY25. This means the company is on track to attain its objective of roughly $3 billion by FY26. The conversion of cash has improved with operational cash flow being roughly 1.83x net income. However, net debt rose from $20 billion to $21 billion. However, with the interest coverage of ~9x, there are no signs of financial distress due to acquired debt, and strong operational cash flows can easily back up the leverage.

Summary

Our analysis can be summarised by the following points:

- Diageo is a high-quality strategic asset with a long-term stability and very little risk of failure.
- Its current growth is slow, mainly due to the maturity and size of the company. Their strategic plans involving premiumisation, cost discipline, selective M&A and Guinness expansion are expected to bring additional value to its shareholders, however these are yet to be proven.
- Rapid upside growth is not expected in the near future.
- Recent impairments are slight warning signs; however, portfolio of global dominant brands can mostly justify the pricy intangibles.
- Diageo is financially stable, with a free cash flow of $2.69 billion giving security against losses and allowing it be flexible in its plans.

The acquisition is recommended if the goal is long-term stability, pricing power, inflation protection, or strong cash flow generation. Cost-based synergies (procurement, overhead, distribution) are likely to bring considerable value.

References:

Diageo PLC (2025). *Annual Reports*. [online] www.diageo.com. Available at: https://www.diageo.com/en/investors/results-reports-and-events/annual-reports.

Value Investing (n.d.). *WACC of Diageo plc*. [online] valueinvesting.io. Available at: https://valueinvesting.io/DGE.L/valuation/wacc.

Appendices

Appendix 1.

Diageo PLC - Forecasted IS 12 Months Ending	FY 2026 Est 06/30/2026	FY 2027 Est 06/30/2027	Notes
Revenue	**20,396.3**	**20,366.3**	[1]
- Cost of Revenue	8,076.9	8,013.3	
Gross Profit	**12,319.3**	**12,353.0**	
- Operating Expenses	5,573.5	5,325.4	
- Depreciation and Amortization	1,034.9	1,121.4	[2]
Operating Income (Loss)	**5,711.0**	**5,906.2**	
- Non-operating expenses	554.8	602.8	
Pretax Income (Loss), GAAP	**5,156.2**	**5,303.4**	
- Income Tax Expense	1,484.8	1,535.6	
Net Income	**3,671.3**	**3,767.8**	
Reference ratios			
Gross Margin	60.4%	60.7%	
Operating Margin	28.0%	29.0%	[3]
Net Margin	18.0%	18.5%	

Appendix 2.

Diageo PLC - Forecasted CF 12 Months Ending	FY 2024 06/30/2024	FY 2025 06/30/2025	FY 2026 Est 06/30/2026	FY 2027 Est 06/30/2027	Notes
Cash from Operating Activities					
+ Net Income	3,870.0	2,354.0	3,671.3	3,767.8	[1]
+ Depreciation & Amortization	493.0	1,718.0	1,034.9	1,121.4	
+ Non-Cash Items	510.0	302.0	303.3	306.3	[2]
+ (Inc) Dec in Inventories	-156.0	-470.0	-213.2	-217.4	[3]
+ Inc (Dec) in Other	-612.0	393.0	-5.6	-23.6	
Cash from Operating Activities	**4,105.0**	**4,297.0**	**4,790.7**	**4,954.4**	
Cash from Investing Activities					
+ Change in Fixed & Intang.	-1,496.0	-1,549.0	-1,019.8	-1,018.3	[4]
+ Other Investing Activities	-99.0	-171.0			[5]
Cash from Investing Activities	**-1,595.0**	**-1,720.0**	**-1,019.8**	**-1,018.3**	
Cash from Financing Activities					
+ Dividends Paid	-2,242.0	-2,298.0	-2,191.6	-2,249.2	[6]
+ Cash From (Repayment) Debt	452.0	898.0			[7]
+ Cash (Repurchase) of Equity	-1,220.0	-1.0			[8]
+ Other Financing Activities	-96.0	-93.0			
Cash from Financing Activities	**-3,106.0**	**-1,494.0**	**-2,191.6**	**-2,249.2**	
Effect of FX rates	-33.0	-35.0	-45.5	-47.4	[9]

Net Changes in Cash	**-629.0**	**1,048.0**	**1,533.8**	**1,639.6**	
Cash Paid for Taxes	1,099.0	1,114.0	1,212.8	1,225.8	**[10]**
Cash Paid for Interest	1,017.0	980.0	798.8	840.0	

Appendix 3.

Diageo PLC - Forecasted BS	**FY 2024**	**FY 2025**	**FY 2026 Est**	**FY 2027 Est**	**Notes**
12 Months Ending	**06/30/2024**	**06/30/2025**	**06/30/2026**	**06/30/2027**	
Total Assets					
+ Cash, Cash Equivalents & STI	1,485.0	2,724.0	4,257.8	5,897.3	**[1]**
+ Accounts & Notes Receiv.	2,705.0	2,808.0	2,794.0	2,789.9	**[2]**
+ Inventories	9,720.0	10,658.0	10,871.2	11,088.6	**[3]**
+ Other ST Assets	1,216.0	1,307.0	1,307.0	1,307.0	**[4]**
Total Current Assets	**15,126.0**	**17,497.0**	**19,229.9**	**21,082.8**	
+ Property, Plant & Equip, Net	8,509.0	9,528.0	9,513.0	9,409.9	
+ LT Investments & Receivables	467.0	662.0	662.0	662.0	**[4]**
+ *Goodwill*	*2,860.0*	*2,949.0*	2,949.0	2,949.0	**[5]**
+ *Other Intangible Assets*	11,954.0	11,827.0	11,827.0	11,827.0	
+ Deferred Tax Assets	143.0	150.0	150.0	150.0	
+ Prepaid Pension Costs	1,146.0	1,161.0	1,161.0	1,161.0	**[4]**
+ Investments in Affiliates	5,032.0	5,334.0	5,334.0	5,334.0	
+ Misc LT Assets	237.0	214.0	214.0	214.0	
Total Noncurrent Assets	**30,348.0**	**31,825.0**	**31,810.0**	**31,706.9**	
Total Assets	**45,474.0**	**49,322.0**	**51,039.9**	**52,789.7**	
Liabilities & Shareholders' Equity					
+ Accounts Payable	3,429.0	3,538.0	3,518.4	3,490.7	**[6]**
+ Other Payables & Accruals	2,954.0	3,470.0	3,749.8	3,986.7	**[7]**
+ ST Debt	2,885.0	2,928.0	2,928.0	2,928.0	**[4]**
+ Other ST Liabilities	600.0	776.0	776.0	776.0	
Total Current Liabilities	**9,868.0**	**10,712.0**	**10,972.2**	**11,181.4**	
+ LT Debt	18,616.0	20,820.0	20,820.0	20,820.0	**[4]**
+ Other LT Liabilities	4,920.0	4,612.0	4,612.0	4,612.0	
Total Noncurrent Liabilities	**23,536.0**	**25,432.0**	**25,432.0**	**25,432.0**	
Total Liabilities	**33,404.0**	**36,144.0**	**36,404.2**	**36,613.4**	
+ Common Stock	887.0	887.0	887.0	887.0	
+ Additional Paid in Capital	1,703.0	1,703.0	1,703.0	1,703.0	**[4]**
- Treasury Stock	-2,250.0	-2,228.0	-2,250.0	-2,228.0	
+ Retained Earnings	9,783.0	10,274.0	11,753.7	13,272.3	**[8]**
+ Other Equity	-91.0	454.0	454.0	454.0	**[4]**
Equity Before Minority Interest	**10,032.0**	**11,090.0**	**12,547.7**	**14,088.3**	**[9]**
+ Minority/Non-Controlling Interest	2,038.0	2,088.0	2,088.0	2,088.0	**[4]**
Total Equity	**12,070.0**	**13,178.0**	**14,635.7**	**16,176.3**	
Total Liabilities & Equity	**45,474.0**	**49,322.0**	**51,039.9**	**52,789.7**	