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THE BIG SECRET ON WALL STREET

AMERICAN VICE #2

TOP SHELF BOOZE MAKER AT A DIVE-BAR PRICE

FROM THE DESK OF PORTER STANSBERRY

SPECIAL REPORT

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A Top-Shelf Booze Maker at a Dive-Bar Price

Centuries of Brand Power Drives This Industry Leader

Massive Scale Creates the Ultimate Competitive Advantage

Few things are scarier than a drunk Irishman brandishing a pickaxe.

And – *horrors* – using "very much improper language."

It wasn't surprising that the Dublin sheriff and his men backed down when Arthur, a brewer, came out swinging... and yelling the profane, 1770s version of "Get off my lawn."

But the officials' retreat from Arthur's property was only temporary. The sheriff planned to keep coming back until he got what he wanted: Arthur's river.

When Arthur had leased the modest, four-acre site for his new brewery business in 1759, he'd been delighted to discover that the land came with its own source of fresh, running water – perfect for high-quality stout.

And he quite naturally assumed the water rights were part of his original lease. But the Dublin government had other ideas.

Toward the end of the 18th century, the archaic and corrupt city administration, the Dublin Corporation, had started to collapse under the weight of heavy city debts and bad decisions. To drum up extra cash, it decided to take control of the water supply – mandating that Dublin citizens use (and pay for) piped-in "city water."

If, like Arthur, you had your own, non-city-controlled water source, you could expect a visit from the Corporation, which would divert your stream into city pipes, whether you liked it or not. (Ironically, the motto on Dublin's coat of arms was – and still is – "The Obedience of the citizens produces a happy city.")

Arthur was not happy with the Corporation's intrusion. Hence the pickaxe.

Hence, also, his ensuing legal battle against the Dublin Corporation... a struggle that dragged on for nine years.

In the end, likely out of sheer exhaustion, both parties gave in... a little. Arthur grudgingly consented to pay for his own water, but under very specific terms: He agreed to take out an additional lease on the property – £10 per year, just for the water.

The length of the lease? 8,795 years.

Essentially, forever.

In effect, the obstinate brewer was saying, "I and my 10 children, and their descendants, and their descendants will be here, on this four-acre property, long after the Dublin Corporation is a footnote in Irish history."

Over the next two centuries, the Corporation was razed, restructured, renamed, and reformed.

But nothing changed for Arthur's children, and grandchildren, and great-grandchildren. They stayed right where they were, paying their rent-controlled £10 per year, and using their own water to make superb beer. Even more remarkable, until the land contract was renegotiated in the 1980s, the original lease agreements stayed in place.

Today, you can still drink that beer… and invest in it, too.

Appropriately, it's now a cornerstone of a true "forever company"… shares of which this month we recommend buying, and holding (and passing on to your own descendants) for at least 8,795 years.

A Business Built on Brand Power

In the business of booze, brand power is destiny. Once consumers establish their favorite beer, wine, or spirit, they tend to stick to it for life. As new generations come of age, they mimic the favorites of their elders. As a brand becomes ingrained through generations of tradition, it becomes virtually impossible for competitors to displace them (that is, unless they hire a woke brand manager and self-destruct, as Anheuser-Busch recently showcased with the spectacular implosion of the Bud Light brand).

That's why many of today's biggest alcohol brands – across beer, wine, and spirits (liquors) – have been around for many decades, if not centuries. This includes the world's most valuable beer brand Heineken (established 1873), leading wine and Champagne maker Moët & Chandon (established 1743), and best-selling spirits like Smirnoff in vodka (established 1864) and Hennessy in cognac (established 1765).

This brand loyalty makes the business models of the top alcohol producers remarkably resilient, giving rise to the ultimate "forever stocks."

The company we're introducing its roots back to 1759. Since then, the business has amassed an industry-leading portfolio including some of the most iconic and enduring alcohol brands. As people around the world gather for the upcoming holidays, many will be consuming its products, just as previous generations have done.

Beyond brand power, this company also enjoys a strong competitive advantage through its unmatched economies of scale. This allows it to acquire small brands and turn them into global giants. The business is highly capital efficient and recession-resistant, generating positive sales and earnings growth – even in down cycles, such as during the Great Financial Crisis from 2007 through 2009.

Normally, this company's premium business model commands a premium valuation. But temporary macro factors have caused a nearly 50% decline in the company's stock price. This has created a rare opportunity to buy shares at their cheapest valuation in over a decade.

A Forever Stock Goes on Sale

Based in London, **Diageo (NYSE: DEO)** is the world's largest spirits maker. In 2022, the company generated $21 billion in sales from more than 200 brands sold in 180 countries. The company owns many of the world's best-selling spirits brands including Johnnie Walker scotch whisky, Crown Royal Canadian whisky, Smirnoff vodka, and Don Julio and Casamigos tequilas. It also owns the third largest beer brand globally, Guinness (founded in 1759 by Arthur Guinness, the angry Irishman).

(Amusingly, Diageo is famous for *porter*... and for a *Black Label* whisky product. How could Porter & Co. not recommend this business?)

Diageo was formed in 1997 from a merger between Guinness and London-based consumer-goods conglomerate Grand Metropolitan (founded in 1934).

At the time of the merger, Guinness had diversified beyond beer into spirits, through its 1986 acquisition of The Distillers Co. This gave Guinness ownership of leading scotch-whisky brand Johnnie Walker, as well as Gordon's (the best-selling gin brand globally). These two powerhouses formed the backbone of Diageo following the merger in 1997.

Grand Metropolitan had a diverse business line that included the fast-food chain Burger King and the leading global cake maker The Pillsbury Company. It also owned spirits brands Smirnoff vodka and J&B scotch whisky.

Following the merger, Diageo sold Grand Metropolitan's non-alcohol divisions. Today, the company focuses primarily on spirits, which make up 80% of its business. Only 15% of Diageo sales now come from beer, with the remaining 5% in ready-to-drink products (pre-mixed cocktails in a ready-to-drink can or bottle).

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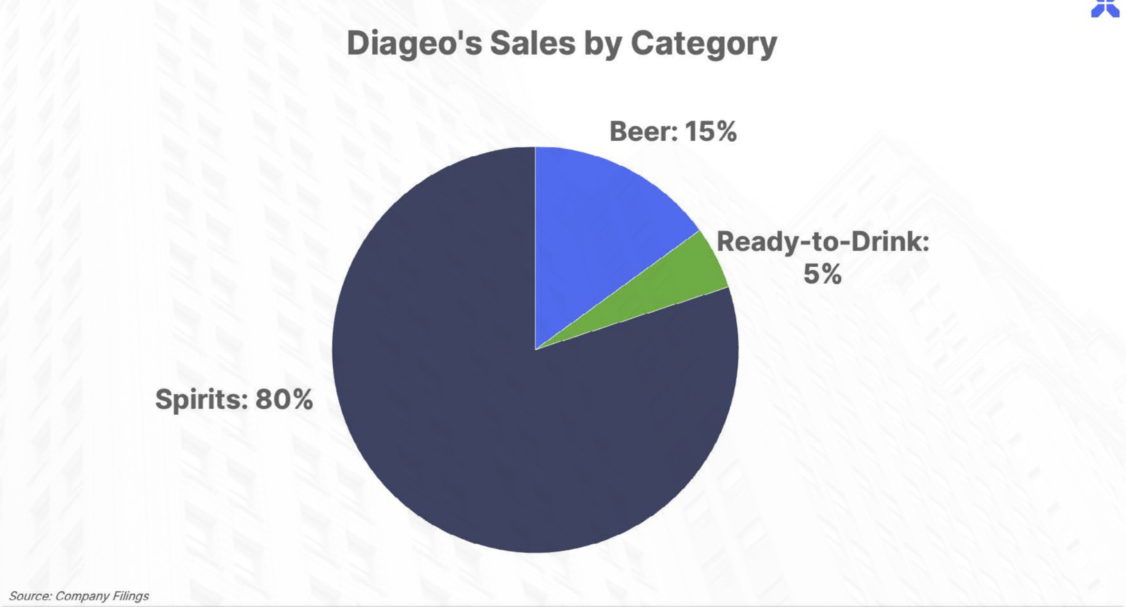


On the surface, Diageo's business model is a simple one. It manufactures various alcohol products and sells them to third-party retail distributors, who in turn sell alcohol to consumers. The complexity lies in understanding how the company capitalizes on the two key sources of competitive advantage available in this industry: brand and scale.

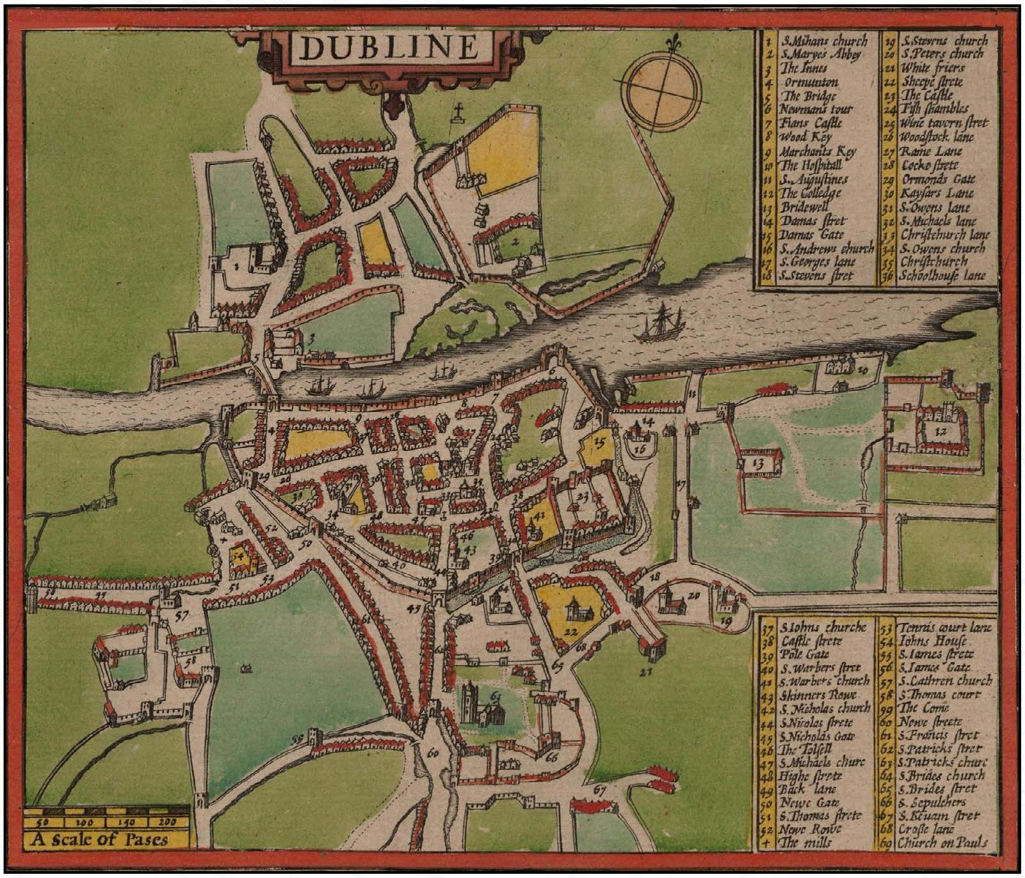
At the heart of Diageo's business is a core portfolio of "forever brands." These are long-established brands, often more than a century old, that provide a reliable source of consistent profit growth. Diageo's world-class marketing and distribution machine keeps these brands highly visible and selling around the world.

Along the way, the company reinvests a portion of profits from its core portfolio into emerging brands to capitalize on shifting consumer preferences. As the largest spirits maker in the world, Diageo uses powerful economies of scale to turbocharge the growth of these emerging brands into global powerhouses.

And the brand that started it all in 1759, Guinness, owes its great success in part to what is arguably the greatest real estate deals of all time.

A Centuries-Old Company With a 9,000-Year Lease

In the 1750s, a financial crisis crushed property values across Ireland. Arthur Guinness, a beer brewer in a small town just north of the capital city, Dublin, seized on the opportunity created by depressed land prices. He spotted a four-acre property hosting the St. James Gate Brewery, which became available to lease at the low price of just £45 per year (plus the £10 per year in water rights he eventually secured, with the help of his pickaxe).



From day one, Arthur Guinness set out to build an enduring legacy that he could pass down through generations. That's why when negotiating the lease he secured an unheard-of 9,000-year term on the St. James property. Years later, as discussed earlier, he was also able to secure a similar-duration lease to the water rights on the property.

At St. James, Guinness honed his craft over the next decade. Maniacal about product quality and innovation, he constantly experimented with new brewing methods and production techniques. This included making a new style of beer that became popular in London, the "porter," created from a happy accident when a London brewer burned the brown malt for one of his beer batches, which he balanced with extra hops to disguise the roasted flavor.

Because the brewing method called for a generous helping of hops – which act as preservatives – porter became the first beer that could be aged by breweries before it was distributed to taverns. Previously, the ale breweries could only produce pre-aged beer that taverns had to store and age on site (otherwise the beer would spoil in transit).

By creating a ready-to-drink beer, the porter brewing style allowed for lower distribution expenses and significantly greater economies of scale. Arthur Guinness saw the opportunity in porter beer to grow a global empire, and by the late 1790s shifted from producing ales, to exclusively brewing porters.

Arthur Guinness passed the business on to his son Arthur Guinness II, who expanded production and made St. James the largest brewery in Ireland, with global exports. The third generation, Edward Cecil Guinness, then grew St. James into the largest brewery in the world by 1880 with over a million barrels sold each year.

This growth came despite the company famously refusing to advertise, or sell its beer at a discount. Instead, Guinness focused on producing the highest-quality porter beer in the world, and let the product speak for itself. In 1901, the company hired a staff of chemists to establish the Guinness Research Laboratory, and began transforming the art of brewing into an industrial science.

One of Guinness's biggest production breakthroughs came from statistician William Sealy Gosset. While working for the company in the early 1900s, Gosset developed a mathematical method for determining whether the differences in each beer batch were random, or caused by specific factors in the brewing process. The framework he developed became known as the "Student's t-test," which has since become a staple of statistical analysis and industrial process control.

By leading the industry in brewing advancements and production quality, Guinness cemented its brand power and popularity around the world. The beer became particularly popular in the UK. In 1941, Britain imposed trade restrictions on Ireland in order to pressure the country to support the Allied powers. But Brits' demand for Guinness beer was so strong, it forced the UK government to relent and temporarily lift the trade restrictions in order to keep the Guinness taps open there.

Unlike its early days, when the company swore off advertising, the Guinness brand has grown into a global powerhouse through successful marketing campaigns over the last century. The company introduced the famous *Guinness Book of World Records* in 1955 that spread its brand awareness around the world. (Fun fact: the idea was spawned from a hunting trip, when a managing director of Guinness production couldn't settle an argument over which was the fastest game bird in Europe.)

In 2000, the company converted a portion of the original St. James brewing facility into the Guinness Storehouse – an immersive brewery, bar, and restaurant experience (home of the famous two-minute Guinness pour) that's become the country's second most visited tourist attraction.

More recently, under Diageo's stewardship, Guinness is heavily featured in mainstay national events across its key European markets. The brand has become a staple at events like St. Patrick's Day and European rugby, including an official sponsorship for the Six Nations – a European rugby league that hosts annual matches between England, France, Ireland, Italy, Scotland, and Wales.

These investments have paid off. In December 2022, for the first time ever, Guinness became the UK's number-one beer brand in "on-trade" (establishments like bars and restaurants that sell beer for on-site consumption). Across all markets, Diageo reported all-time highs in Guinness sales and 16% sales growth for its fiscal year 2023 (ending June 30, 2023).

Today, the Guinness brand is the world's third-largest beer brand. It's the key driver of Diageo's beer segment, which also includes smaller brands like Smithwick's, Kilkenny, and Harp Lager. Beer is the company's second-largest business line, making up 15% of total sales. Across all brands, Diageo's beer segment grew sales by 9% in 2022.

This growth is even more impressive in the context of the recent shift in consumer preferences away from beer toward spirits. From 2010 to 2020, beer's share of total beverage alcohol (TBA) fell from 52.1% to 46.9%. Over the same period, spirits rose from 20.8% to 24.7%. In 2023, spirits took the number-one spot with 42.1% of TBA market share in the U.S., surpassing beer's 41.9%.

While the beer category faces headwinds from the shift in consumer preferences toward spirits, Diageo's brands continue growing at a healthy pace. Meanwhile, the majority of Diageo's business – the 80% of its revenue coming from spirits – is thriving.

Diageo's Biggest Cash Cow

Diageo's largest business segment is scotch, making up 25% of sales. This includes the company's crown jewel, Johnnie Walker, which has held the title of the world's best-selling scotch whisky since 1945.

The brand dates back to 1820, when a 15-year old John Walker invested the inheritance from his father into a grocery store in the small Scottish town of Kilmarnock. One problem he encountered was that the single-malt-scotch brands he sold were inconsistent. The imprecise production techniques of the day meant that quality would vary widely from batch to batch.

Walker began blending different single-malt brands together to balance out their impurities. Over time, he developed popular whisky blends that his customers prized for their smooth and consistent flavor. In 1857, the business was passed down to his son Alexander, who grew the business into a global powerhouse selling 100,000 gallons per year by 1862. He then passed the business down to his sons George and Alexander II, who expanded the now-thriving product line to three blends, Old Highland (aged five years), Special Old Highland (aged nine years), and Extra Special Old Highland (aged 12 years). They distinguished the different aged blends with colored labels – white, red, and black.

Over time, the colors became the core branding feature of the different Johnnie Walker blends. Today, the core scotches range from Red Label (aged for a minimum of three years, selling for roughly $30 per one-liter bottle) all the way up to the super-premium Blue Label (aged between 28 and 60 years, selling for over $300 per bottle).

The brand has become steeped in history, as the spirit of choice among celebrities, presidents, and prime ministers.

This included British Prime Minister Winston Churchill, who famously started his day with a generous pour of Johnnie Walker mixed with club soda.

Churchill, a hobbyist painter, even created a painting in ode to his favorite scotch-whisky brand. Churchill's Jugs and Bottles piece, shown below, sold at a Sotheby's auction in November 2020. After a fierce bidding war, the painting went for $1.2 million, commanding five times its pre-sale estimate.

Churchill wasn't the only world leader that preferred Johnnie Walker. The super-premium Blue Label was a favorite of U.S. President Richard Nixon, who enjoyed it with ginger ale and a lime wedge.

The iconic brand has also infiltrated pop culture over the last half-century, particularly among the music industry. Johnnie Walker is featured in the lyrics of singers and bands ranging from Lady Gaga to ZZ Top and Elliott Smith. The heavy-metal band Black Label Society took its name after Johnnie Walker's Black Label Whisky.

While Johnnie Walker cemented itself into consumer mindshare through these organic endorsements, Diageo continues cultivating the brand through advertising and marketing campaigns today. A notable example includes its partnership with HBO's hit TV series Game of Thrones. The fantasy drama series became an international sensation from 2011 to 2019, generating record viewership while winning 59 Primetime Emmy Awards, the most by any drama series.

Johnnie Walker partnered with HBO to produce a limited-edition White Walker blend in 2018, with branding and promotion built around the show. The successful partnership led to two additional *Game of Thrones*-themed blends, A Song of Fire and A Song of Ice, which can be purchased as along with White Walker as a three-piece set for $239:

Diageo's Entrenched Competitive Advantages

Diageo's successful *Game of Thrones* partnership reflects one of its biggest competitive advantages. As the world's largest spirits maker, the company has the industry's biggest budget to spend on advertising campaigns and marketing partnerships with celebrities, event organizers, and media outlets.

Diageo's dominant size also provides another key advantage over the competition: one of the industry's best data sets to optimize its local advertising campaigns.

Diageo collaborates with its distributors and retail partners to harvest data on the latest spending trends across its portfolio. This includes the company's proprietary software and data analytics tool known as Demand Radar, which tracks 85% of the company's net retail sales across the globe. This provides a real-time feed into the company's sales trends at the individual store level, allowing it to adapt to shifting competitive dynamics and stay ahead of its rivals.

As just one example, Diageo identified what it called a "battleground" market for scotch whisky in New Jersey in 2021, where Johnnie Walker was losing share to competitors. The company used insights from its Demand Radar to develop hyper-local marketing campaigns across key zip codes and retail locations where sales were struggling. The end result: 20% growth in Johnnie Walker sales in the New Jersey market for 2021.

These structural advantages are how Diageo continues generating robust demand for centuries-old brands like Johnnie Walker. Today, 93 million consumers around the world sip Johnnie Walker each month. In each of the last three years, the brand has generated double-digit sales growth, including a 15% increase in Diageo's FY 2023.

This growth comes from a combination of taking market share from competitors, with growing volumes, plus strong pricing power. In 2022, Johnnie Walker gained market share in eight of its largest markets, with volume growth of 9%. Price increases also delivered another 6% of sales growth.

The success of the Johnnie Walker brand is a testament to Diageo's enduring competitive advantages that keep its legacy brands as relevant as ever. Those same advantages allow the company to develop new brands and capitalize on shifting consumer preferences.

Over the last decade, Diageo flexed its data and scale advantages to identify and capitalize on one of the biggest trends in the spirits market, well before the competition caught on.

The Global Tequila Boom

In 2014, tequila was a minor part of Diageo's portfolio – its only major tequila exposure was through its 50% ownership of Don Julio, a super-premium tequila produced in Mexico.

That same year, Diageo's data analytics revealed that tequila consumption was rapidly growing across North America. This prompted the company to strike a deal to acquire the remaining 50% of Don Julio from the Beckmann family in Mexico. Diageo gave up 100% of its Bushmills Irish Whiskey to the Beckmann family in exchange for the full rights to the Don Julio brand. As part of the deal, Diageo also received a $408 million payment.

While Bushmills was popular, it was a cheaper value brand with relatively low margins. For a bit of context, Bushmills sold 800,000 cases in 2014, worth $91.2 million in retail sales. That same year, Don Julio sold 590,000 cases and generated $168 million in sales.

Don Julio is sourced from the rare and highly prized agave plants in the highlands of Atotonilco, Mexico. Making Don Julio is a tedious, time-consuming process that starts with aging the agave plant for seven years. Each plant is then harvested by hand, with special care given to properly cutting its roots and shearing off the spear-like leaves. The process pays off with a one-of-a-kind, award-winning tequila flavor, and juicy point margins (prices for the super premium Don Julio tequilas can range from $200 to $2,000).

Diageo's data insights into consumer spending trends indicated massive demand for super premium tequila... and a far larger market opportunity compared to the second-rate Irish-whiskey brand it exchanged for Don Julio. The trade turned out to be a grand slam.

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Don Julio is now the world's number-two premium tequila (behind Patrón). The brand went from just over half a million in annual cases sold in 2014 to over 2 million cases sold in 2022. Despite its dominant size, it continues to grow fast, with 20% sales growth in FY 2023.

Diageo's success with Don Julio went beyond simply identifying and riding a new trend in spirits consumption. When the company took over 100% ownership of the brand, it gained control of marketing, pricing, and distribution as well. This allowed Diageo to turbocharge Don Julio's growth through the company's powerful marketing and distribution machine.

We previously highlighted how Diageo's scale gives it an industry-leading marketing budget. The other key advantage of Diageo's scale is an unmatched distribution network that can quickly boost new brands the company brings under its control.

Diageo's Distribution Advantage

In many markets around the world, including in most U.S. states, liquor cannot be sold directly to consumers. Instead, spirits manufacturers like Diageo must sell to intermediaries, like retail liquor outlets and grocery stores. These distribution intermediaries act as the gatekeepers for new products entering the market.

In order for a spirits brand to enter new retail locations, scale is key. The brand needs enough demand to sell in high enough quantities to justify precious shelf space. And the manufacturer must have sufficient production and logistics capacity to get the product to retailers, on time, every time. Finally, it helps if there's an existing and highly profitable relationship between the manufacturer and the retailer for bringing new products to market.

Because of its size, Diageo has an unmatched array of retail partners it can lean on to stock new products. As the world's largest spirits maker, with the industry's largest marketing budget, retailers can have confidence in Diageo's ability to juice demand on a national scale. It can also offer smaller retailers incentives like localized advertising campaigns to jumpstart demand in their specific markets, down to the individual store level.

This scale advantage means Diageo can offer a unique value proposition for its retail partners, as well as for brands it acquires. When the right opportunity arises, Diageo can afford to pay more than its competitors to acquire rising brands.

A case in point comes from another blockbuster tequila acquisition Diageo made when it purchased Casamigos in 2017. Founded by actor George Clooney and two friends in 2013, the start-up shook up the tequila world. Within four years, it became the fastest growing premium U.S. tequila brand. Diageo acquired it for $700 million in cash, plus up to $300 million in performance-linked future payments, for a total price tag of $1 billion.

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Many industry commentators and investors scoffed at the price tag. When Diageo made the acquisition, Casamigas was on track to sell 170,000 cases in 2017. But Diageo's marketing and distribution machine took the product into the stratosphere. By 2020, volumes had tripled to 450,000 cases. In 2023, the brand grew 96% to reach 2.2 million cases and over $1 billion in annual sales.

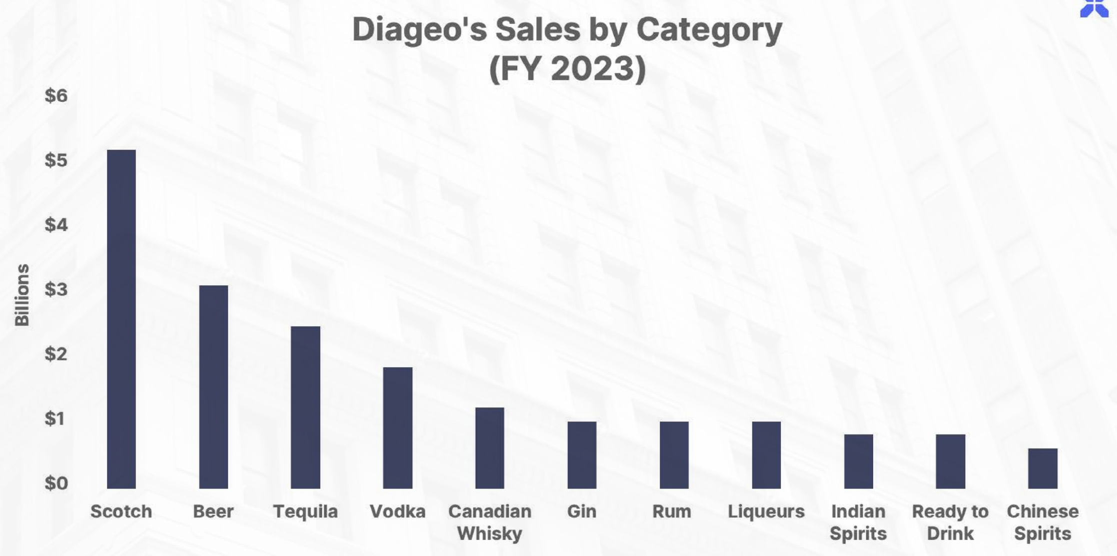
Today, Casamigos is the number-three selling premium tequila brand, behind Don Julio. It's become one of the greatest success stories in the spirits industry. Most spirits brands spend decades, even centuries, getting to the top of their categories. Casamigos, amplified by Diageo's scale advantages, went from a niche product to a global phenomenon in just five years.

With its acquisitions of Don Julio and Casamigos, Diageo has gone from a tiny presence in tequila eight years ago to the world's number-one tequila seller today. Over the past four years, Diageo's tequila sales volumes have grown by an average of 32%. And consistent gains in pricing have grown the company's tequila-based earnings even faster, at 43% per year over the same period.

All signs indicate a long runway ahead. North America currently makes up roughly 80% of global tequila consumption, but its popularity is quickly spreading around the globe. Tequila consumption across Europe has doubled in each of the last two years. The ravenous demand even caused a global shortage of the agave plant earlierin 2022.

Diageo is investing heavily to further its lead as the world's largest tequila producer, including a $500 million expansion of its production facilities in Jalisco, Mexico, that began in 2021.

With two of the world's top-selling premium tequila brands, the spirit now makes up Diageo's third-largest business line, behind scotch and beer.



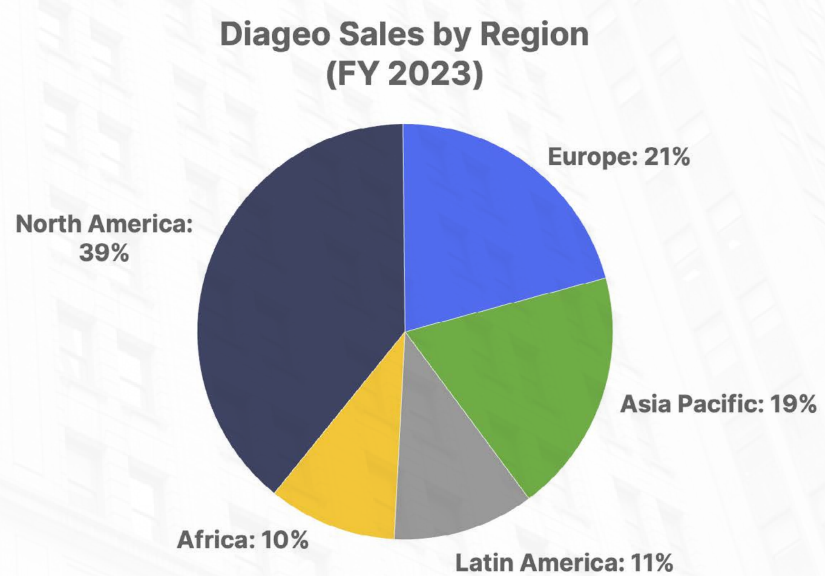
Source: Company Filings

A Dominant, Globally Diversified Business Model

Across all business lines, Diageo owns a potent portfolio containing many of the top-selling spirits brands. This includes Johnnie Walker (#1 scotch), Don Julio and Casamigos (#2 and #3 premium tequilas), Smirnoff (#1 vodka), Crown Royal (#1 Canadian whisky), Gordons and Tanqueray (#1 and #3 gins), Captain Morgan (#3 rum), and Bailey's (#1 cream liqueur). It also owns the iconic Guinness brand, the world's third-best-selling beer.

Diageo's dominant scale advantage amplifies the strength of its brands. The company's $20.6 billion in revenue in 2022 exceeds the combined sales of its next two closest competitors, Pernod Ricard ($12.7 billion) and Brown-Forman ($4.3 billion). Diageo's successful track record in pressing this scale advantage gives us confidence that the company will retain its position at the top of the industry going forward.

This makes Diageo the ultimate forever company. It's diversified mix of category-leading brands are sold into over 180 countries, giving the business resilience from a disruption in any single product segment or geographic region:



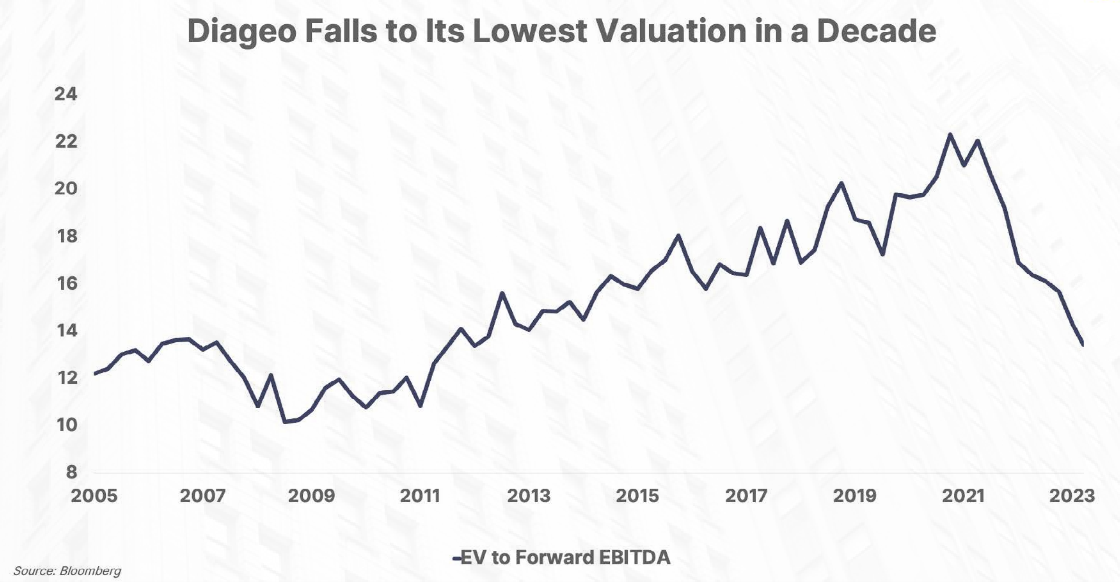
Source: Company Filings

The durability of demand for Diageo's products can also provide resilience against economic downturns. During the Great Financial Crisis, for example, Diageo grew revenue and earnings per share from 2007 to 2009.

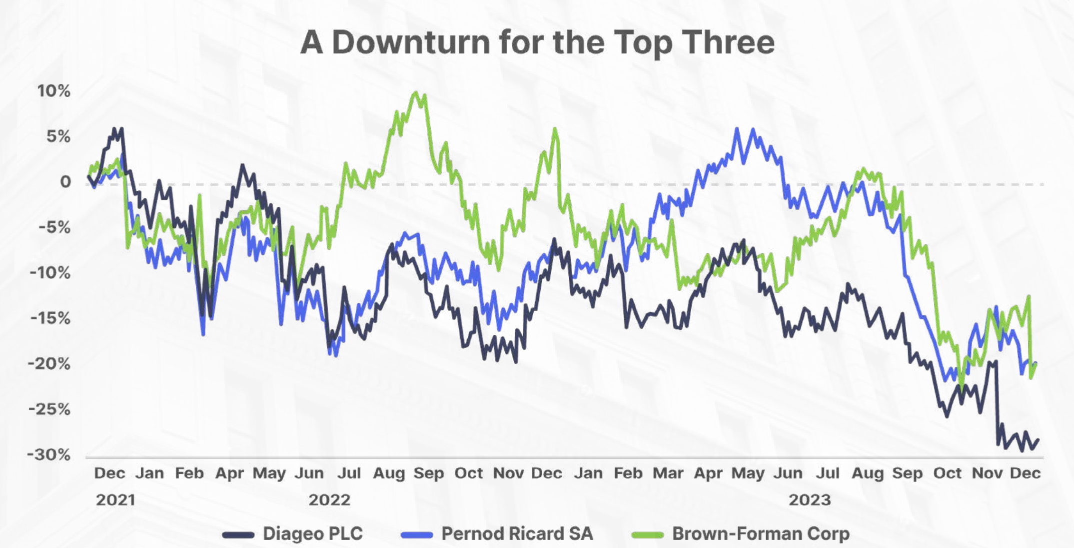
The business is also capital efficient, as it outsources many of its lower-margin bottling and retailing to third parties. Over the last 10 years, Diageo has generated an average return on equity of 33.5%, and net income margins of 21.3%. For comparison, the median S&P 500 company averaged a 14.7% return on equity and 13.1% net income margin over the same period.

A Top-Shelf Business Hits the Discount Rack

Normally, Diageo's premium business model commands a premium valuation. But a recent sell-off has cut Diageo's valuation by 40% over the last 18 months. Today, at around $145 per share, it trades at a valuation multiple of just under 14x enterprise value to EBITDA (earnings before interest, taxes, depreciation, and amortization) – the cheapest level in over a decade:



The cause for Diageo's share price decline has not come from anything related to its long-term competitive position or growth trajectory. Rather, the entire industry has faced macro factors that have caused share prices to decline:



The first factor dragging down Diageo's share price traces back to pandemic-driven supply-chain disruptions. The initial COVID-19 outbreak caused shortages of materials and labor, disrupting production facilities for alcohol producers across the board. When these disruptions were resolved, a boomerang effect followed as companies ramped up production in excess of demand. This caused inventories to build up across the industry, which then caused companies to discount their products.

A key benchmark for inventory stockpiles is measured as inventory days – the stock of inventory relative to the number of days worth of demand required to sell that inventory. By year-end 2020, Diageo's inventory days reached a record high of 445 days, up from 387 pre-COVID. The company then offered greater discounts and promotions to clear excess inventory, resulting in Diageo's profit margins falling from 24.2% in fiscal year 2019 to 21.7% in 2021, before rebounding to 22.2% in FY 2023.

Diageo has since sold its excess inventory, which fell back to pre-pandemic levels of 390 inventory days in the second half of 2023.. With improved inventory levels, Diageo should now face less pressure to discount its merchandise.

The second factor pressuring the industry has been fears surrounding the rise of GLP-1 drugs for weight loss and diabetes, including Novo Nordisk's blockbuster Ozempic and Wegovy drugs.

A series of recent studies indicate that GLP-1s could cause a significant decline in alcohol consumption. As a result, the market has priced in the risk of lower future demand for beer and spirits. Similar GLP-1 fears have also pressured other "indulgence" brands recently, including McDonald's, The Hershey Company, and Domino's.

Though these drugs have not been around long, all available evidence indicates these fears are overblown. Even with the booming demand for GLP-1 drugs (evidenced by the skyrocketing sales and share price of Novo Nordisk), we have yet to see any meaningful impact on alcohol consumption in Diageo's business. Likewise, their impact has yet to show up in the financial results of companies like McDonald's, Hershey, and Domino's.

While GLP-1s represent a potential long-term threat that warrants monitoring, we see no meaningful threat to Diageo's business from these drugs today.

For now, the opportunity lies in the attractive valuation in Diageo's shares created from fears about a future threat that has yet to materialize. Even assuming no change in Diageo's valuation, we believe investors can earn a market-beating return on shares going forward.

How Diageo Could Generate 15% Compounded Returns

In 2020, Diageo's management outlined a plan to grow its share of global alcohol consumption from 4% to 6% by 2030. Only four years into the plan, the company is more than one-third of the way there – reaching 4.7% of global TBA (total beverage alcohol) market share in 2023.

Management's guidance over the coming years is to deliver profit growth of between 6% to 9% per year. Given the company's impressive portfolio of brands improving at double-digit rates, and its successful growth performance to date, we believe this forecast is achievable.

Meanwhile, Diageo's investors stand to do even better than this 6% to 9% growth. That's because of the company's high capital efficiency, which allows it to return a substantial portion of profits back to investors. Between 2018 and 2023, Diageo has reduced its share count by 12% while also growing its dividend by 12% over the same period. The company's U.S.-listed shares (under the NYSE's "DEO" ticker) currently pay out $3.93 in annual dividends, for a yield of 2.7%.

Looking ahead, we assume that management can hit its target of 6% to 9% profit growth, while continuing to reduce share count by 2% to 3% per year, and also paying out a 2.7% (and growing) dividend. Taken together, these three factors should combine to compound shareholder returns at rates of 12% to 15% per year through 2030.

Further upside could come from the company reverting back to its historical valuation of roughly 18x EV/EBITDA.

We're not the only ones spotting value in Diageo's shares. In the first quarter of 2023, Berkshire Hathaway acquired a small (227,000-share) position in Diageo at $172.40 per share.

With a leading global footprint of the world's largest and most iconic spirits brands, and the scale to acquire the next generation of up and comers, Diageo is a prototypical Buffett stock.

It's one of the few opportunities in today's market that checks all the key boxes we and Buffett look for:

- A collection of dominant global brands, with secular growth tailwinds
- Entrenched competitive advantages
- Recession-resistant business model
- High capital efficiency
- Compellingly low valuation

Action to Take: For the latest updates on our open positions, please visit our live portfolio **here.**