

Credit Rating Evaluation of Diageo PLC against Heineken, Brown-Forman and Pernod Ricard

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### **Credit Rating of Beverage Industry**

According to Bouckley (2013), credit rating agencies have revised upward the credit rating outlook for the global beverage industry. The credit rating agencies cite the reason for upward revision of the beverage industry players is due to a rising middle class that is exerting increasing demand for high-end wines, premium beers and spirits from big players such as Diageo, Heineken, Pernod Ricard, Brown-Forman, Bacardi, SAB Miller, AB InBev and Molson Coors. Bouckley (2013) asserts that Moody's, which is a bond credit rating business, has revised the global beverage industry outlook from a stable rating to a positive rating. Furthermore, the credit rating company expects operating profit for beverage players to grow on average by 6% in 2013 and into the early year of 2014. This comes against the backdrop of the global economic challenges, especially in developed markets which have been hard hit by either recession or slow growth. According to credit rating agencies the slow economic growth in developed markets of Europe and Australia, which has affected the consumption of premium beer, spirits and high-end wines, will not affect financial bottom line of beverage makers thanks to the resilience of the emerging economies and the improving economy of the United States of America. Therefore, the growth and sustained financial performance of global beverage players will be fuelled by the expanding middle class in emerging markets and the improving consumption patterns in the United States of America due to the improving economy. As a result sustaining demand for high end carbonated drinks, such as premium beer and high-end wines and spirits.

### **Credit Rating of Diageo PLC**

According to Diageo (2012), Diageo PLC was formed from the business merger of two U.K based beverage companies, Grand Metropolitan PLC and Guinness PLC. The two respective companies, before the merger, financed their operations largely from equity capital, a situation

that lowered their debt to equity ratio and net debt to total capital. As a result, the Grand Metropolitan PLC and Guinness PLC maintained a high quality credit rating of A and AA respectively. Following the merger and the creation of Diageo, the new company Diageo wanted to maintain the high quality credit rating of the two parent companies. Therefore, Diageo PLC continued to keep an interest rate coverage of between 5 and 8, a gearing at 25%, a low EBITDA/Total Debt and a low Debt/EBITDA. The low debt/EBITDA improved the ability of Diageo PLC to pay back its debt within a relatively short period. The ability of the United Kingdom based beverage maker to settle its debt obligation was furthered bolstered by the company's high EBITDA/Interest expense. Because of a conservative financial policy and the healthy solvency ratios that Diageo PLC recorded, the company probability of financial distress was very low, resulting to Diageo being awarded a high quality credit rating of A+. According to Diageo (2012), the group management improves shareholders' wealth by improving the return on investments and managing capital structure. Prudent management of capital structure aids the beverage maker to access debt from the debt market at lower yields and issue short-term commercial papers at attractive market yields.

Despite strong solvency and liquidity ratios, Diageo PLC has been subjected to numerous credit ratings, some revising the rating upward or downward. According to Moody's (2013a), on September 2013, Moody's revised the credit rating outlook of Diageo from negative to stable. This was the period after the merger of Guinness PLC and Grand Metropolitan PLC to form Diageo PLC. On July 18, 2000, Moody's confirms A1 rating of Diageo and gives the beverage maker a stable outlook. On 12 November 2000, Moody's downgrades Diageo PLC credit rating from A1 to negative. Senior unsecured rating is further downgraded to A2 on 14 March 2003. On

17 October 2005, Moody's downgrades Diageo to A3 with a short-term outlook of P-2 from P-1. The credit rating of Diageo PLC by Moody's has remained unchanged despite all the economic scenarios that have shaped the global beverage market and the expansion strategy of Diageo PLC into emerging markets and frontier markets in Africa. According to Reuters (2012), the S&P on 24 October, 2005 gave Diageo PLC a long-term credit rating of A and a short-term credit rating of A-1. On 1 September 2005, the S&P had downgraded Diageo PLC to a long-term credit rating of A- and a short-term credit rating of A-2. Fitch has also affirmed Diageo's long-term credit rating at A- and short-term credit rating at F2.

### **Evaluation of Diageo's Credit Rating with Major Competitors**

According to Diageo (2013), Diageo PLC has maintained a long-term credit rating of A3 and a short term credit rating of P-2 from 2005 to the last previous Moody's's rating action. S&P, on the other hand, in 2005, gave Diageo PLC a long-term credit rating of A-, a short-term credit rating of A-2 with a stable outlook. Fitch, in October 2009, gave Diageo PLC a long-term rating of A-, a short-term rating of F2 with a stable outlook. S&P Credit Research (2012) asserts that the reason why Diageo PLC has been rated within the A band is because Diageo PLC is a leader in the alcoholic beverage industry. As a result, Diageo PLC has maintained above average margin growth and robust cash flow generation. For example, according to Reuters (2012), Fitch in their last rating action of Diageo PLC noted that Diageo PLC continues to have rating headwinds than its major competitors because it has a wide breadth of alcoholic beverages, geographical spread, global brands and presence in all price ranges. In addition, the beverage maker has reflected strong financial figures in the financial year 2010 and 2011. Free cash flow increased to £700million from £600million, EBITDA margin improved to stand at 30% and revenue growth increased by 6% in the year 2012. The beverage industry is a cutthroat

competitive industry with other major players like Heineken, Brown-Forman and French based Pernod Ricard who compete with Diageo PLC for the global beverage market share.

Woolnough (2012) observes that in 2012, Heineken was given a credit rating of Baa1 by Moody's Investor Service while Standard & Poor, commonly referred as S&P, gave Heineken a credit rating of BBB+. In addition, the beverage maker was assigned a stable outlook, underlining the company's solid cash flows, strong brand and spread of profits. This was the first credit rating that the beverage maker has been ever assigned, having relied on its strong brand name to access credit markets. Comparing the ratings of Heineken to the ratings of Diageo, it is evident that Diageo PLC has a high quality rating than Heineken, underpinning Diageo PLC strong ability to meet its debt obligations. Pernod Ricard is another beverage maker that competes with Diageo PLC. In 2006, the beverage maker was assigned a credit rating of Baa3 on long-term borrowing and P-3 on short-term borrowing, with a stable outlook. In 2008, Moody's (2013b) observes that Moody's downgraded Pernod Ricard rating to Ba1 on long-term credit but outlook remained stable. In the last rating action, carried out in September 2011, Pernod Ricard's credit rating was upgraded to Baa3 with a stable outlook. Mercer (2011) observes that Standard & Poor has revised Pernod Ricard rating upwards to a long term credit rating of BBB- from BB+ and a short term credit rating of A-3 from B'. The upgrade was a result of the French based beer maker tightening its spending and lowering its debt/EBITDA ratio close to four. Comparing Diageo PLC and Pernod Ricard, it is evident that Diageo PLC has a lower debt/EBITDA ratio that stands at 3.0x enhancing credit rating of Diageo PLC. In September, 2011, Moody's's (2013c) notes that Moody's lifted Brown Forman Credit rating to A1 from A2 with a stable outlook due to the Louisville-based beer and wine maker strong cash flow and financial

performance. The beer and wine maker has maintained a credit rating within A band since pre 2003 when it had a long-term credit rating of A1 and short-term credit rating of P-1; however, the rating was downgraded in March 2003 to A-2/P-1 with a stable outlook. The upgrade has been fostered by a reduced debt/EBITDA that stands at 0.9x. von Nachrichten (2012) states that Fitch upgraded Brown-Forman long-term credit rating to A+ and short-term credit rating to F1. Following the payment of a special dividend of \$4 per share, which increased debt/EBITDA ratio to 1.8x from 0.9x, S&P downgraded long term credit rating of Brown-Forman to A- from A while the short term credit rating was downgraded to A-2 from A-1 with a stable outlook. Comparing Brown-Forman to Diageo PLC, it is observed that the two beer maker share similar ratings according to the S&P rating system, but a better performance according to Fitch and Moody's rating system due to its low debt/EBITDA ratio than Diageo.

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