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Case 20 From beds, to burgers, to booze – Grand Metropolitan and the creation of a drinks giant.

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Introduction

Diageo is the world's largest alcoholic beverages company and was formed in December 1997 from the merger of its two predecessor firms, Grand Metropolitan and Guinness. This case examines the transformation of Grand Metropolitan from its origins as a hotel company in post Second World War London, through the various changes of direction it experienced prior to the merger with Guinness in 1997 and follows the story through to the present day to analyse the problems and challenges that have and continue to face Diageo.

The foundation of Grand Metropolitan

The foundation of Grand Metropolitan in the late 1940s was down to the entrepreneurial activities of one man – Max Joseph. Joseph was a career entrepreneur, who had been a successful real estate investor and estate agent prior to the start of the Second World War. He began purchasing a serious of hotels from 1947 onwards. These Hotels were originally focused on London but gradually expanded to cover various overseas locations including Paris, Amsterdam, Monte Carlo and New York.

During this initial period of Grand Metropolitan's development and expansion, the culture of the organisation remained relaxed and non-bureaucratic. For example, the purchase of hotels was undertaken quickly, based on Joseph's innate business judgement and without the aid of detailed business analysis. The growth of the business, however, gradually forced a change and introduced a demand for more advanced management control systems and resulted in the hiring of Stanley Grinstead, a future CEO of the business, as it's Chief Accountant in 1960. This move was quickly followed by the firm's IPO in 1961.

Although Grand Metropolitan started to acquire various non-hotel businesses from the mid 1960s, during this period of the company's history, Joseph was still keen to follow the same basic business concepts and ideas that had worked with his acquisitions in the hotel trade. Throughout this period, the core principle was that the business acquired 'trading property assets', with the idea being that the cash flow from the business needed to be sufficient to cover the costs of servicing any debts that had been built up to acquire the properties concerned.

While Joseph focused on only acquiring those assets which he believed would innately rise in value (e.g. because of the increasing demand for hotels), his management style didn't specifically focus on the subsequent ongoing control and management of the acquired business. The focus of Grand Metropolitan at this time was based on 'making deals' rather than specifically looking to add shareholder value from the acquired entities. It was therefore standard practice for Grand Metropolitan to leave the existing management of an acquired organisation in place following an acquisition, while the CEO or Chairman of any significant businesses that were acquired was typically invited on to the Grand Metropolitan board of directors.[1]

Though the acquisitions of the mid to late 1960s extended the company's original management and business philosophy into new areas, Jospeh insisted that all acquisitions satisfied the following criteria:

1. the companies acquired needed to be in businesses that were in some generic sense related to the hotel trade; and
2. the businesses were required to be property intensive – this was an extension of the 'trading property assets' concept that has been mentioned above.

Among the businesses that were acquired during this period were several catering firms, pub-restaurants and a chain of off-licences. However, by the late 1960s, the firm's requirements regarding its future acquisitions were gradually relaxing and the early 1970s saw a move into less related industries and segments. This period saw the acquisition of

[1] The practice of inviting the Chairman/CEO of acquired businesses on to the Grand Metropolitan board resulted in the company's board growing to 18 at one stage.

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Express Dairies in 1969,[2] and Mecca, a dance hall, bingo hall and casino group, in 1970.

Most acquisitions until this stage had been undertaken on a friendly basis (Express Dairies was the one notable exception). However, this focus on friendly acquisitions changed with the take over of the brewer Truman, Hanbury and Buxton (THB) in 1972 after an acquisition process that lasted 9 months. The eventual price paid (£48 million) was the most paid by Grand Metropolitan for any acquisition up to that date and was approximately 50% more than the price for Express Dairies only 3 years earlier.

The acquisition of THB subsequently led to the the acquisition of British brewer, Watney Mann, later in 1972. Watney Mann was a significantly bigger brewer than THB and also included its own distillery subsidiary, IDV. As with the THB acquisition, the takeover process was drawn out and Grand Metropolitan was required to make three separate offers for the company before a bid of £435 million was eventually agreed upon. This price was the most ever paid for an acquisition in Britain up to that date and left Grand Metropolitan with significant debt levels, just as economic conditions in Britain began to deteriorate significantly.

The years of struggle

From 1973, Britain was racked with a serious of economic problems, caused by the effects of international oil price rises and intensive industrial action by Britain's coal miners, which resulted in a 3-day working week being introduced by the British government due to serious energy shortages. At the same time, Grand Metropolitan was being seriously squeezed because of its high debt levels and these problems were being compounded by the following circumstances:

1. Its failure to successfully divest the spirits division (IDV) of Watney Mann, as had originally been planned when the acquisition was undertaken.
2. a significant fall in UK property values, which threatened to undermine the strength of Grand Metropolitan's balance sheet.

The pressures faced by the company during this period resulted in it having to announce its first fall in trading profits in 1974, and resulted in the firm focusing on trying to improve the trading performance of its various divisions to avoid a genuine threat of bankruptcy. As part of the focus on improving the group's trading performance, Allen Sheppard was recruited by Joseph to specifically head up the brewing division of Grand Metropolitan. At the same time, the group's spirits division, IDV, was separated from the brewing division and placed under the leadership of Anthony Tennant.

Sheppard and Tennant both set about improving the performance of their respective divisions aggressively, but did this in very different styles. While Sheppard successfully revitalised and strengthened the sales of Watney Mann's regional beers, his core focus during this period was on reducing head count within the division and on cutting costs. In contrast, the focus at IDV was very much on improving the marketing and promotion of IDV's brands and there was no significant focus during this period on product or cost rationalisation.

Despite the very different business philosophies that had been followed by Sheppard and Tennant, both approaches proved highly successful. By the late 1970s, Grand Metropolitan's profits and cash flows had significantly improved and the firm was once again in a strong financial position – this was the result of both the improvement in the firm's trading income and the revitalised UK property market which helped increase the value of the assets shown on the company's balance sheet.

US diversification

Joseph and Grinstead were aware that Grand Metropolitan had been on the edge of bankruptcy during the mid 1970s and took from this experience a determination that the firm should never again be as dependant purely on the UK economy as it had been at that stage. Therefore, as the company's

[2] Although the Express Dairies business did include hotel and restaurant subsidiaries, the door-to-door milk delivery business was at the core of its operations. At this time, the firm controlled approximately 25% of all door-to-door milk deliveries in the UK.

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financial position improved in the late 1970s, they became increasingly receptive to the idea of international expansion.

The first serious opportunity for international expansion resulted in the acquisition of the US-based Liggett Group in 1981. While the Liggett Group included the distributor of IDV's products in the US, the firm was involved in a wide range of other products (e.g. pet food, cigarettes and fitness equipment), and had only a limited focus on property. Although Joseph was unconvinced about the merits of this acquisition, it was pushed through by Grinstead who had by this stage replaced Joseph as Chairman of Grand Metropolitan, despite the fact that it brought the company into areas of business in which they had little or no experience.

Following the acquisition of the Liggett Group, Grand Metropolitan acquired Intercontinental Hotels from Pan-Am Airlines. As with many of the acquisitions of the 1950s and 1960s, the Intercontinental Hotels acquisition was completed quickly (within one week). However, while the Intercontinental deal offered Grant Metropolitan the 'comfort' of being in a business which it new well, this acquisition did at the same time represent a step away from the focus on acquiring 'trading property assets'. In reality, few of the Intercontinental hotels were actually directly owned – rather, they were typically operated by the group under management contract and franchise arrangements.

Following Joseph's death in the early 1980s, Grinstead continued to focus on acquiring further companies in the US. During this period, Grinstead's principles when considering potential purchases and acquisitions were based around the following:

1. Acquiring service companies in general, on the basis that he believed the service sector in general would expand more quickly over the coming years than manufacturing.
2. Looking to continue diversifying away the risks associated with only doing most of Grand Metropolitan's business purely in the UK.

During the period up until the mid 1980s, the span of acquisitions undertaken by Grand Metropolitan under Grinstead's chairmanship was wide ranging and diverse. The companies acquired provided services ranging from childcare, home-based healthcare and optical retailing.

While Grinstead was focused on the US acquisitions policy during the early to mid 1980s, the company also became increasingly focused on trying to increase the operational performance of its business units, in contrast to the very 'hands-off' management style that had traditionally been a feature of Grand Metropolitan's philosophy. The process of focusing on operational improvement was, in many respects, led by Sheppard, and his team pursued an aggressive policy of rationalising the business units for which they were responsible. The 'Sheppard approach' to operational improvement focused on the divestment of under-performing or peripheral facilities or business units, but also tried to combine this rationalisation focus with improved marketing performance and a decentralised management policy that provided operational managers with real autonomy.

The Sheppard approach worked very effectively in the areas under his responsibility (basically the UK brewing and food businesses). However, Tennant at IDV continued to pursue a very different policy and was in some respects even more successful. IDV gradually became Grand Metropolitan's largest profit source, based on a strategy that focused heavily on trying to control the distribution channels, so that IDV could get as close as possible to the end-customers of its products, and an ongoing heavy investment in product marketing and branding. During this period under Tennant, IDV also successfully focused on the development of a range of new alcoholic beverages.[3] Under Tennant, throughout this period there continued to be no specific focus at IDV on cost control and product rationalisation.

However, despite the successes of Tennant and Sheppard, by 1986, the investors in the City of London had begun to loose confidence in Grinstead's emphasis on expansion. Grand Metropolitan's earnings per share growth had ceased by 1986 (although the company remained profitable), and around this

[3] Among the products that were developed by IDV during this period was Bailey's Irish Cream, which became the best selling product in ist market segment worldwide. During the 1980s, IDV introduced 32% of all the new products of the world's 7 biggest alcoholic beverages companies.

time, the Grand Metropolitan's shares were being downgraded by the City. By the time that Grinstead stepped down in 1987, to be replaced by Sheppard as CEO and Chairman, there were strong rumours and suggestions in the City that a corporate raider might try to take over Grand Metropolitan with the aim of selling off the individual divisions of the firm.

The Sheppard years

Despite the City's dissatisfaction with the acquisitions policy that had been pursued by Grand Metropolitan during the early to mid 1980s, acquisitions continued under Sheppard's leadership. The two key acquisitions during the Sheppard years were Heublein from RJR Nabisco in 1987 (a move which doubled the size of IDV's spirits business) and Pillsbury in 1989. The acquisition of Pillsbury enabled Grand Metropolitan to expand its food business on an international scale,[4] while also providing it with significant rationalisation opportunities in accordance with Sheppard's tried and tested approach to business.

The Grand Metropolitan team that moved into Pillsbury's operations after its acquisition was led by Ian Martin, one of Sheppard's key disciples. This team removed about one-third of Pillsbury's existing management within 12 months of the acquisition as part of its stated policy of cutting the division's operating costs, improving the impact of the well-known Pillsbury brands and developing new products and/or markets.

While Sheppard oversaw the acquisition of these two businesses, there was a simultaneous focus on divesting unwanted or unnecessary Grand Metropolitan businesses in a move that became known as 'Operation De-cluster'. The strategic focus under Sheppard was for Grand Metropolitan to increasingly focus on food, drinks and retailing with all businesses that remained in the group needing to show that they could satisfy the following three criteria:

1 a good brand image;
2 good market shares; and
3 an international scope.

The decision to focus on only the food, drinks and retail businesses was based on the idea that it was better to be a leader in a few areas than a real 'jack-of-all-trades' with no specific strengths. As part of this policy of greater specialisation, Grand Metropolitan did consider the possibility of focusing on purely one market area, but at the end of the day, the company was not at this stage willing to 'put all of its eggs in one basket'. This was despite the fact that Sheppard was aware that the highly focused approach would provide Grand Metropolitan with the opportunity to benefit from the maximum amount of specialist knowledge and focus.

In addition to the big acquisitions and the wide ranging series of corporate disposals, the Sheppard years were characterised by a significant focus on trying to change the overall management philosophy and corporate culture within Grand Metropolitan. Many of Sheppard's key management team from his time in charge of the UK food and brewing businesses replaced the existing central Grand Metropolitan management teams in areas such as personnel and finance. At IDV, where George Bull had replaced Anthony Tennant,[5] the influence of Sheppard and his management policies was slightly more muted than elsewhere within Grand Metropolitan, because of IDV's long history of closely guarded independence and overall level of profitability relative to other areas of the business. However, even so, IDV saw a greater emphasis on cost reduction and rationalisation during these years than had previously been the case.

At the same time, under Sheppard, Grand Metropolitan placed a great deal of emphasis on the training of managers – e.g. via an organised policy of internal transfers throughout the group, in an attempt to spread best practices as widely as possible. Per Sheppard, the role of the corporate centre during this period encompassed the following factors:

1 It was responsible for providing a 'tough and challenging culture' for top management that

[4] Among the businesses owned by Pillsbury were Burger King, Pillsbury Doughboy, Haagen Dazs Ice Cream and Green Giant.

[5] Tennant left IDV in 1990 to become CEO of Guinness.

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was focused on demanding superior operational performance and cost leadership.

2 It focused on spotting and nurturing management talent within the various Grand Metropolitan business units.
3 It should focus simultaneously on improving operational performance with the business units and improving the branding and promotion of Grand Metropolitan's products.

The post-Sheppard years

Sheppard retired as Chairman and CEO of Grand Metropolitan in 1993. Although he had originally proposed that he should be replaced by Ian Martin, who had been responsible for overseeing the rationalisation and turnaround of the Pillsbury acquisition, Sheppard's recommendation in this respect was ignored by Grand Metropolitan's board of directors. They argued that George Bull's experience in successful brand building at IDV was more appropriate for the CEO role of a consumer products company in the 1990s than Martin's traditional focus on cost cutting and rationalisation. Therefore, Bull replaced Sheppard as CEO in 1993, while Martin subsequently left the company to pursue other interests.

Under Bull's leadership, the period from 1993 to 1996 was characterised by a continuous focus on the divestment of Grand Metropolitan's non-branded businesses, combined with ongoing attempts to acquire strong brands and to widen the international scope of the business. While the focus on cost control and restructuring remained from Sheppard's era, under Bull the group was also keen on maximising its international strengths, opportunities and alliances as he believed that Grand Metropolitan's growth potential depended on its ability to successfully access the high growth potential offered by the alcoholic drinks market in the world's emerging economies. However, while it remained a profitable company under Bull, it was also recognised by commentators and analysts that Grand Metropolitan struggled to effectively manage the demands of trying to build up an international business with far-flung operations.[6]

Furthermore, the group's share price continued to 'underperform' on the London Stock Exchange.[7] This continued underperformance, combined with the desire to strengthen Grand Metropolitan's international access, provided the background for the decision to merge Grand Metropolitan and Guinness in 1997. The new group was originally led by Bull and Tony Greener of Guinness, until Bull's retirement in 1998, when Greener took over sole responsibility. At the time of the merger, Diageo (as the merged group was called), consisted of the following core businesses:

1 Guinness Brewing; this included a wide range of brewing businesses around the world, including Spain's biggest brewer (Cruz Campo) and Desnoes & Geddes in the West Indies.
2 Pillsbury.
3 United Distillers and Vintners (this was the merged name for the combination of Guinness's United Distillers subsidiary and Grand Metropolitan's IDV division).
4 Burger King.

Diageo: the early years

The merger of Grand Metropolitan and Guinness created the world's sixth largest food and drinks business and was initially well regarded by City analysts, who saw genuine opportunities for the new business. At the time of the merger, it was claimed that the merged entity would be able to 'cut costs and exploit marketing synergies, while building global economies of scale.'[8] The perceived attractiveness of the merged company can be found by comparing the pre- and post-merger share prices. Immediately prior to the merger announcement, Grand Metropolitan and Guinness stock had been trading at 516 and 515 pence respectively; after the formal merger went through in December, the market price of the combined group was 590 pence per share.

At the time of the merger, the idea had been for the combined entity to continue operating and growing in all of the two predecessor firms' existing

[6] Ernest Beck, Wall *Street Journal*, 19–01–98.

[7] Ernest Beck, *Wall Street Journal*, 19–01–98.

[8] Article in the *Wall Street Journal*, 20–05–00.

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business units. In both the brewing and food divisions, it had famous and popular brands, while in the spirits area it had, through the merger, become the world's biggest spirits company. Nine of the world's top 25 global spirits brands, including such famous names as Smirnoff, Johnnie Walker and Bailey's, were owned by the group.

At the time of the merger announcement, there was, despite the general City approval of the alleged benefits that would arise from the fusion, some criticism of the proposal for the merged entity to continue operating in both the food and alcoholic beverages markets. Perhaps the strongest critic of the proposed strategy was Bernaud Arnaut, a non-executive director of Guinness at the time and Chairman of the French drinks company LVMH Moet Hennessy, which was a major shareholder in Guinness at this time. Arnaut strongly argued for the benefits that would arise from his alternative proposal to merge the alcoholic drinks divisions of LVMH, Guinness and Grand Metropolitan while selling off Grand Metropolitan's Pillsbury and Burger King divisions. Despite Arnaut's proposals to the contrary, the merger of Grand Metropolitan and Guinness went through as originally proposed in December 1997, after a delay of approximately seven months.

The early months of Diageo appeared to be well regarded by the City and in July 1998, the Diageo share price reached a high of over 700 pence per share – a rise of over 18% in the seven months since the merger of Grand Metropolitan and Guinness was finalised and the shares started trading on the London Stock Exchange. At this time, Diageo was already able to announce that the anticipated annual savings of £195 million that were due to arise as a result of the merger would be reached and analysts were suggesting that annual savings from the merger would actually be approximately £50 million greater than originally estimated.[9]

However, despite the fact that Diageo shares were still well regarded by the City in 1998, the merged entity was experiencing a range of problems at this stage. In 1998, John McGrath, the CEO of Diageo, admitted that the group's performance was actually destroying shareholder value – while its weighted average cost of capital was 10.5%, its actual return on total invested capital was during this period, only 9.5%.[10] While Diageo was one of the few British companies in this period to publicly focus on shareholder value creation as a core aim of the business, the fact that the business was, at least initially, undermining real shareholder value creation shows that there was plenty of work to do in improving the performance of the business as a whole.

Throughout 1998 and 1999, despite relatively moderate overall financial results, Diageo continued to argue that there was nothing wrong with the Diageo business model. Paul Walsh, who led Diageo's Pillsbury division at the time of the merger and who would go on to replace McGrath as CEO on the latter's retirement in 2000, publicly stated in 1998 that 'Pillsbury will be a principal contributor in achieving Diageo's aims of doubling total shareholder returns every four years.'[11]

In an attempt to improve Diageo's performance and support the combined food and drinks business model, McGrath announced plans for the formal sharing of best practice throughout the Diageo group. These plans focused on having the executives of the various Diageo divisions take responsibility for 'looking at each other's patches to transfer best practice across the group.'[12] In addition, in January 1999, Diageo set up a cross-divisional marketing excellence team with members from Burger King, Guinness, UDV and Pillsbury in order to try to achieve marketing and promotional synergies and best practice across its various business divisions. However, while Diageo was able to develop and exploit minor marketing synergies (e.g. Burger King was able to utilise Pillsbury products in some of its restaurant promotions), by 2000 Diageo was admitting that the marketing synergies and benefits of the merger were negligible and journalists and commentators were pointing out that Diageo's shares had under-performed the market by 31% between January 1999 and September 2000.[13]

[9] *Financial Times*, 07–07–98.

[10] Report of interview with John McGrath, *Financial Times*, 18–03–98.

[11] Paul Walsh reported in the *Financial Times* by Maggie Urry, 21–10–02.

[12] John McGrath quoted in the *Financial Times*, 18–03–98.

[13] John Thornhill, *Financial Times*, 08–09–00.

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At the same time that Diageo had been struggling to make the merger a clear success in its core business areas, the policy of sell-off and disposal continued as it had at Grand Metropolitan throughout much of the 1980s and the first half of the 1990s. While the disposal of many of the group's minor spirit brands was often because of the need to satisfy the various regulatory bodies around the world, other disposals (e.g. the disposal of the Spanish brewer Cruz Campo in 1999) were undertaken because of the perceived need to dispose of underperforming units and could be compared to the disposals that had been undertaken by Grand Metropolitan under Sheppard and Bull's leadership.

Diageo: the Paul Walsh era

At the time of McGrath's retirement as CEO of Diageo in 2000 and his replacement by Paul Walsh, a long-time Grand Metropolitan employee who had been partially responsible for the turnaround at Pillsbury, the company still faced a difficult post-merger future. The promised marketing synergies had largely failed to materialise while the performance of Burger King and Pillsbury was perceived by analysts to be undermining the success of the group's drinks divisions. In addition, franchisee holders at Burger King had become increasingly restless at what they perceived to be the failure of Diageo to manage the fast-food restaurant business effectively,[14] and had begun to publicly call for the Burger King business to be spun off as a separate entity.

The problems facing the company during this period resulted in Diageo agreeing to merge its Pillsbury division with General Mills, Inc., in 2000 (as part of the agreement, Diageo took a substantial minority stake in the expanded General Mills, Inc.). This development followed the announcement of Diageo's plans to put up 20% of Burger King for sale via an Initial Public Offering. Although Diageo under Walsh was clearly keen to dispose of Burger King in its entirety, US capital gains tax rules worked against the idea of initially offering more than 20% of Burger King for sale.

While the disposal of Pillsbury to General Mills went through without any significant problems, the planned partial disposal of Burger King was a much more drawn out and convoluted process. The initial plan to offer 20% of Burger King to the public via an IPO was eventually dropped because of stock market problems in 2000 and 2001 and Diageo didn't manage to dispose of Burger King until 2002, when it agreed to sell the business to a private equity consortium. Even then, Diageo had to accept getting only $1.5 billion for the business (when the original IPO plan had been launched, the business had been valued at $2.5–3.0 billion), while also having to provide the buying consortium with a wide range of financial assistance and guarantees.[15]

At the same time that Diageo was disposing (or trying to dispose) of Burger King and Pillsbury, it focused on trying to acquire some of the brands held by the spirits division of the Canadian drinks company Seagram, in an association with the French company Pernod Ricard. Diageo entered into a consortium with Pernod to acquire them, because it was keen to stop major rivals from acquiring them and it was not in a position to acquire the Seagram spirits brands in their totality, because of regulatory constraints in various countries. Although the acquisition process was long-drawn-out and convoluted, Diageo eventually agreed to pay $5.3 billion to obtain famous Seagram brands such as Crown Royal and Captain Morgan Rum. However, while Walsh called the deal a success, some commentators argued that Diageo's partner did better from the Seagram deal. In addition, despite having entered into the alliance with Pernod to specifically avoid getting into problems with the competition regulators around the world, this move was only partially successful, as US regulators insisted that Diageo needed to sell off either its newly acquired Captain Morgan Rum brand or its existing Malibu brand.[16]

[14] For example, during the 1990s under Grand Metropolitan and Diageo, Burger King was led by four separate Chief Executives.

[15] According to Newspaper reports (e.g. *Financial Times*, 20–02–04), Diageo's financial guarantees in respect of the Burger King sale amounted to $1.05 billion.

[16] Diageo eventually disposed of Malibu to Allied Domecq in 2002.

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Diageo: what does the future hold?

Following the generally successful integration of Seagram's spirit brands and the disposals of Pillsbury and Burger King, the divisions that had been holding back Diageo's growth since the merger, one would perhaps imagine that the company's future is assured. However, while Diageo's stated goal for the future is now based clearly 'on delivering high quality growth in premium drinks,'[17] there are still significant problems and issues which the company needs to address if it is going to enjoy significant growth over the coming years.

The volume growth in the alcoholic beverages market is limited (typically 1–2% per annum),[18] and this means that the innate future growth prospects for Diageo are also limited. In addition, while being the largest alcoholic beverages company in the world may be an attractive position to be in, it does also bring potential disadvantages in Diageo's case, as it would appear that the pure size of the company and the dominant position that it enjoys in many areas of the drinks markets may limit its ability to undertake any further significant acquisitions. Furthermore, Diageo in general (and Guinness in particular) is struggling in the core UK and Irish markets, as drinkers increasingly move away from going to pubs and prefer to buy their drinks in supermarket to enjoy at home. This development could result in Diageo facing thinner profit margins on its products, as they become increasingly squeezed by the powerful supermarkets.

Given the above problems and issues, future profit increases may therefore have to be achieved by one (or more) of the following methods:

1. Focusing on continually cutting the company's costs.
2. Stealing market share away from other firms and types of alcoholic beverage (e.g. from wine).
3. Continuing to successfully develop new alcoholic products that can help attract new drinkers.
4. Improving marketing and getting closer to the customer than any of the competition.

While Diageo (and previously Grand Metropolitan) have shown that they have been able to successfully develop new alcoholic beverages over an extended period of time, some commentators have questioned the long-term viability and/or stability of such a tactic. In this regard, one should note that some of Diageo's more recent innovations have only met with limited market success, while serious concerns have also been raised about the long-term market sustainability of some of Diageo's more successful, recent introductions such as Captain Morgan Spiced Rum in the US which, although produced like a beer (to benefit from lower US tax duties), is specifically designed to taste like a spirit (these types of drink are called malternatives). Overall, critics argue that too many of Diageo's new products are akin to brand extensions rather than the introduction of genuinely new products that help steal market shares from rivals.

Some commentators have also pointed out that the aggressive way in which Diageo has tried to change the 'rules of the game' in respect to the boundaries that apply to the alcoholic drinks industry has not always been successful. For example, Diageo has tried to persuade the major US TV broadcasters to remove their voluntary ban on the advertising of spirits without long-term success.[19] Additionally, the aggressive way that Diageo exploited the brewing rules in the US when developing the 'malternative' drinks concept resulted in heavy government lobbying from the influential US brewing industry. This lobbying has provisionally succeeded in that the US government agreed to change the rules so that 'malternative'-style drinks can only qualify for the reduced beer tax rates if they actually 'taste more like beer'. As one journalist has said, it has often appeared 'one step forward and two steps back for Diageo.'[20]

In addition, some commentators have raised question marks about the long-term future of Guinness within the Diageo empire. Although Diageo publicly remained committed to the Guinness brand, sales of

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[17] Chief Executive's Review, Diageo Annual Report, 2003.
[18] *Business Week*, May 2003.

[19] Although Diageo was initially successful in persuading NBC to drop its advertising ban on spirits, NBC backed down under pressure and never screened the advertisements.
[20] Gerry Khermouth and Kerry Capell, *Business Week*, 19–05–03.

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the stout are falling in both the UK and Ireland and Diageo have recently announced plans to close the Guinness brewery and Park Royal in London and centralise all European and North American Guinness production in Dublin. One also needs to ask whether the values associated with a traditional beer or stout are actually closely linked with the various spirits brands with which Diageo is most closely associated and whether there are genuine and significant marketing and distribution synergies between spirits and beers for the company.

However, despite the above concerns, it is clear that under Walsh's leadership Diageo will aggressively challenge the status quo in its markets and is keen to try new products and to challenge old market assumptions. Walsh remains publicly committed to ensuring that Diageo grows by more than the 1–2% market average growth rates, and it is clear that Diageo is willing to copy the successful practices of potential rivals to help achieve this growth. In this respect, Diageo in the US has started to use it power in the spirits sector to follow the example of Anheuser-Busch in the US beer market by increasingly centralising its US distribution network (with one distributor now taking responsibility for one whole state). As part of this pattern of increased centralisation, Diageo have started to simultaneously demand that each distributor appoints a specialist team to look after the whole of the Diageo account in their region as one of the requirements for being awarded the account.

Despite possible concerns about the company's long-term growth prospects, during the first part of the 21st century Diageo shares have outperformed the overall London Stock Exchange and its shares are continuing to trade at a premium compared to some of its major rivals such as Allied Domecq, while it remains well regarded by City analysts. The company has also shown that it has a strong cash flow stream over a period of several years and has shown itself over the past few years to be happy to return excess cash to shareholders. Perhaps the real question is, however, whether Diageo can continue to satisfy and exceed stock market expectations in the longer term with its present format and focus, or whether it will need to reinvent and redefine its strategic direction to maintain this favoured position with investors.

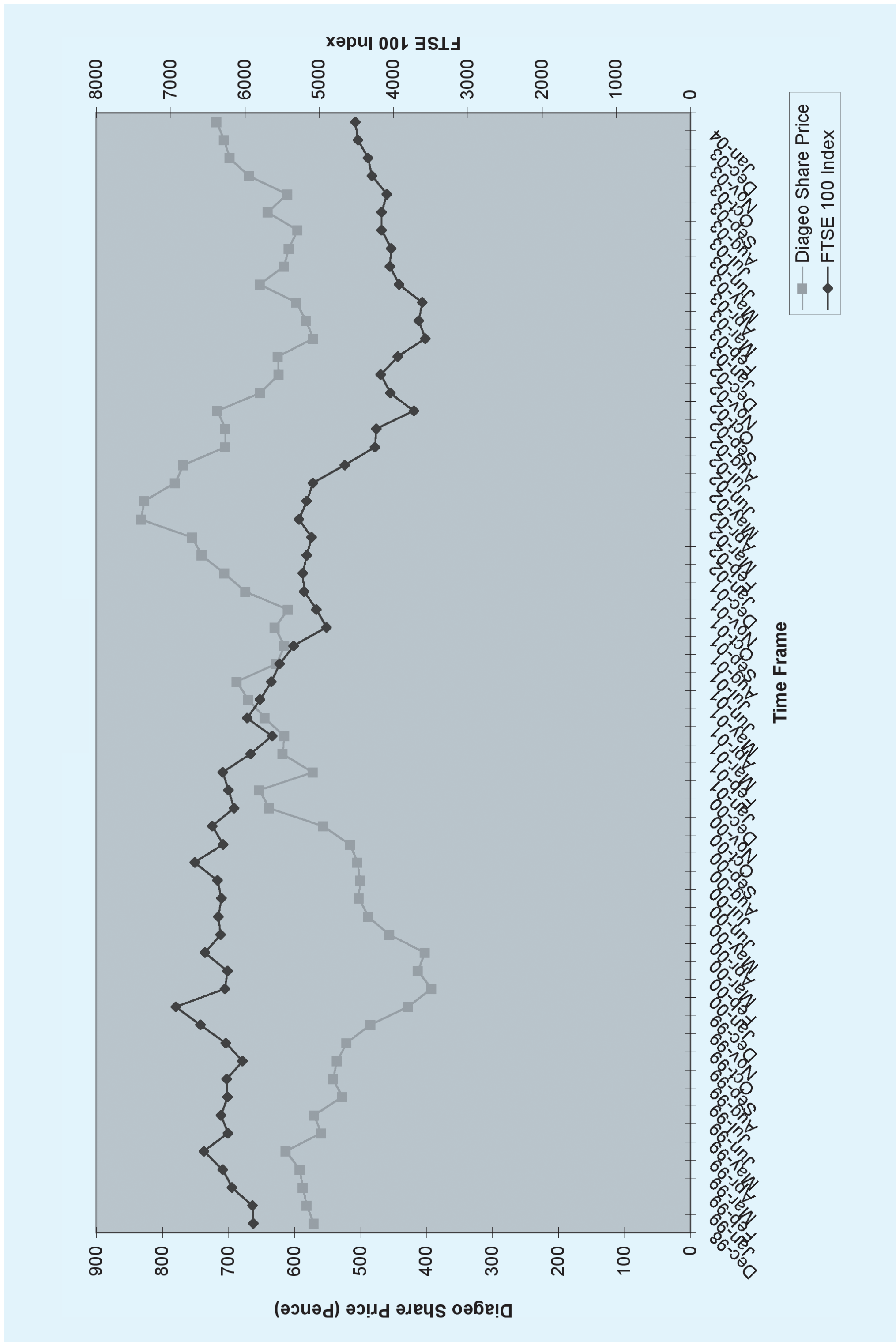

Exhibit 1 Diageo share price fluctuations

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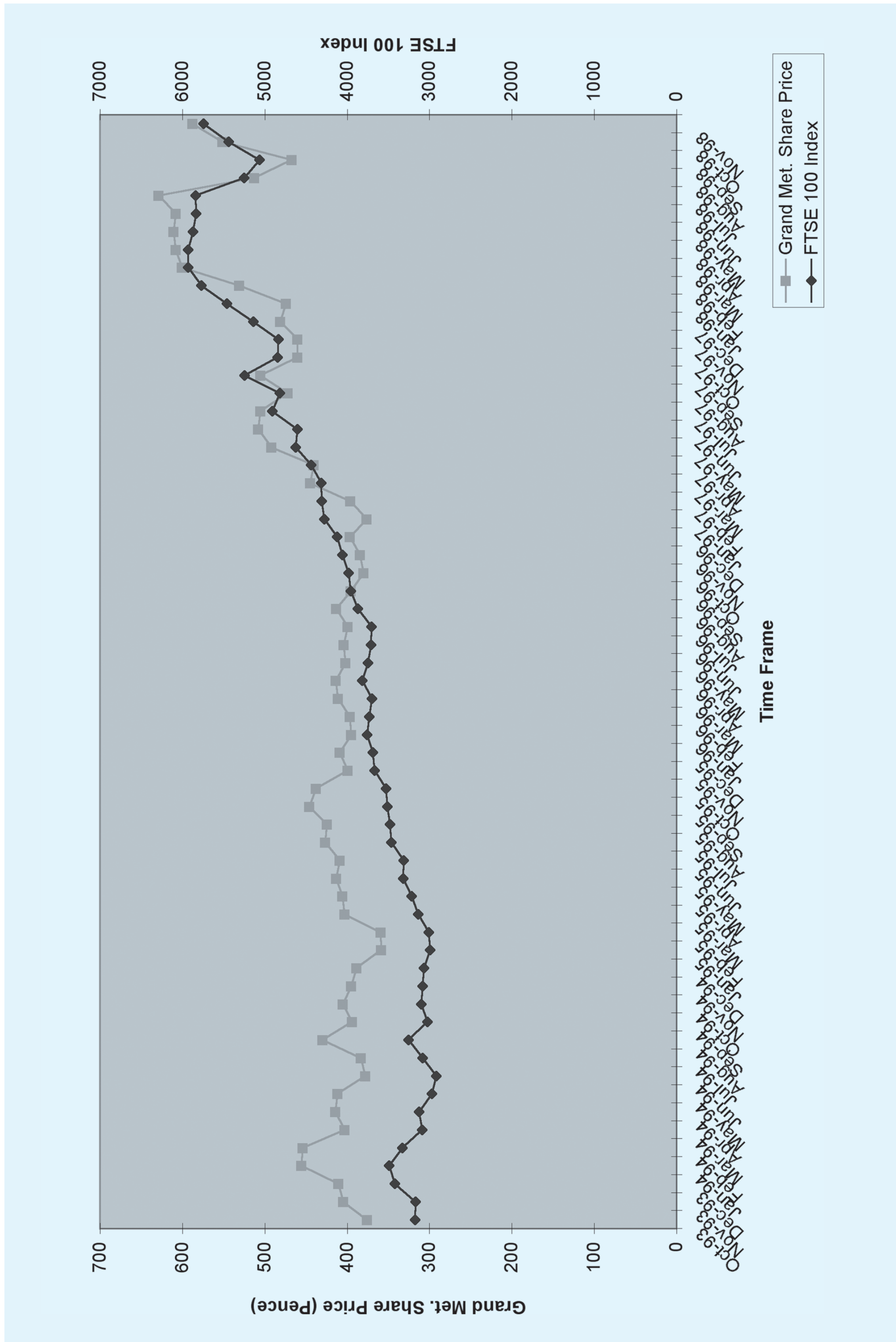

Exhibit 2 Grand Metropolitan share price fluctuations

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Appendix 1 Diageo profit figures

	30 Dec 1996	30 June 1998	30 June 1999	30 June 2000	30 June 2001	30 June 2002	30 June 2003
Turnover – continuing activities	12,753	17,596	11,795	11,870	8,622	9,254	8,961
Turnover – disposals	687	106			4,199	1,455	479
Turnover – acquisition						573	
Group turnover	13,440	17,698	11,795	11,870	12,821	11,282	9,440
Profit on ordinary activities before tax	1,332	2,368	1,467	1,451	1,722	2,336	654

Notes:
1 The accounting period ended 30 June 1998 covers a period of 18 months. All other accounting periods cover a period of 12 months.
2 The accounts for the period ended 30 June 2003 include a special provision of £1.5 billion in respect of the disposal of Burger King.
3 Accounts have not been adjusted to reflect any changes to UK Generally Accepted Accounting Principles (GAAP) during the above periods.

Appendix 2 The core Diageo brands as at July 2003

Smirnoff – The world's best selling premium Vodka.
Johnnie Walker – The world's best selling Scotch whisky.
Captain Morgan – The world's number two selling rum.
Bailey's – The world's number one cream liqueur.
J&B – The number two selling Scotch whisky in the world.
Cuervo – The number one selling tequila in the world.
Tanqueray – The number one selling premium gin in the US market.
Guinness – The world's best selling (and best known) stout.

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Appendix 3 A summary of major acquisitions and disposals within Grand Metropolitan and Diageo between 1988 and 2002

2002 calendar year
– Sale of Burger King to a private equity consortium is finalised.
– Sale of the Malibu brand to Allied Domecq is finalised.

2001 calendar year
– Acquisition of Seagram spirit and wine business (in association with Pernod Ricard) is finalised.
– Disposal of Pillsbury via a combination with General Mills, Inc., is finalised.

2000 calendar year
– Diageo initially decides on the partial flotation of Burger King (subsequently not executed).

1999 calendar year
– Sale of Cruz Campo (Spain's largest brewer) to Heineken.
– Disposal of a range of 'minor' spirit brands including Cinzano Vermouth (to Campari).

1998 calendar year
– Acquisition by Pillsbury of the Bakery products business of Heinz.
– Disposal of Dewar's whisky and Bombey gin to Bacardi.

1996 calendar year
– Sale of Pearle Vision Optical Retailers to the Cole National Corporation.

1995 calendar year
– Purchase by Pillsbury of Old El Paso Mexican-style food products.

1993 calendar year
– Disposal of Chef & Brewer pub-restaurant chain to Scottish & Newcastle brewers.

1992 calendar year
– Sale of Express Dairy and Eden Vale businesses to Northern Foods.
– Purchase of Cinzano Vermouth.
– Sale of Burger King's distribution services arm.

1991 calendar year
– Disposal of Grand Metropolitan's brewing interests.
– Sale of Wienerwald (a German/central European Restaurant chain).

1990 calendar year
– Disposal of Wimpy table service restaurants.
– Disposal of Berni pub-restaurants.

1989 calendar year
– Grand Metropolitan acquires the Pillsbury food chain (including its Burger King subsidiary).
– Purchase of UB chain of fast-food restaurants.
– Purchase of Eyelab optical retailers in the US.
– Sale of UK Casino Interests.

1988 calendar year
– Sale of Intercontinental hotel chain.
– Purchase of various US optical retail firms including Vision Express and Eye & Tech.
– Disposal of Grand Metropolitan's soft drink bottling facilities.