

INVESTMENT WEEKLY BRIEF: THE DIAGEO (\$DGE)

EQUILIBRIUM

1. Executive Summary: The Quality Trap vs. The Durable Moat

In the current macroeconomic environment, \$DGE serves as a key bellwether for the global Consumer Staples space.

As a dominant force in premium spirits, Diageo sits at an important point of equilibrium: exceptional business quality and an outstanding brand portfolio on one side, and high leverage with stagnant physical volumes on the other.

We do not view \$DGE as a high-octane growth story, but rather as a stable, high-quality compounder that is gradually growing into its valuation.

The heart of the investment case lies in a central tension: a quasi-monopoly brand moat and elite profitability are offset by a 3.3x Net Debt/EBITDA profile and near-zero revenue growth. (see Figure 1)

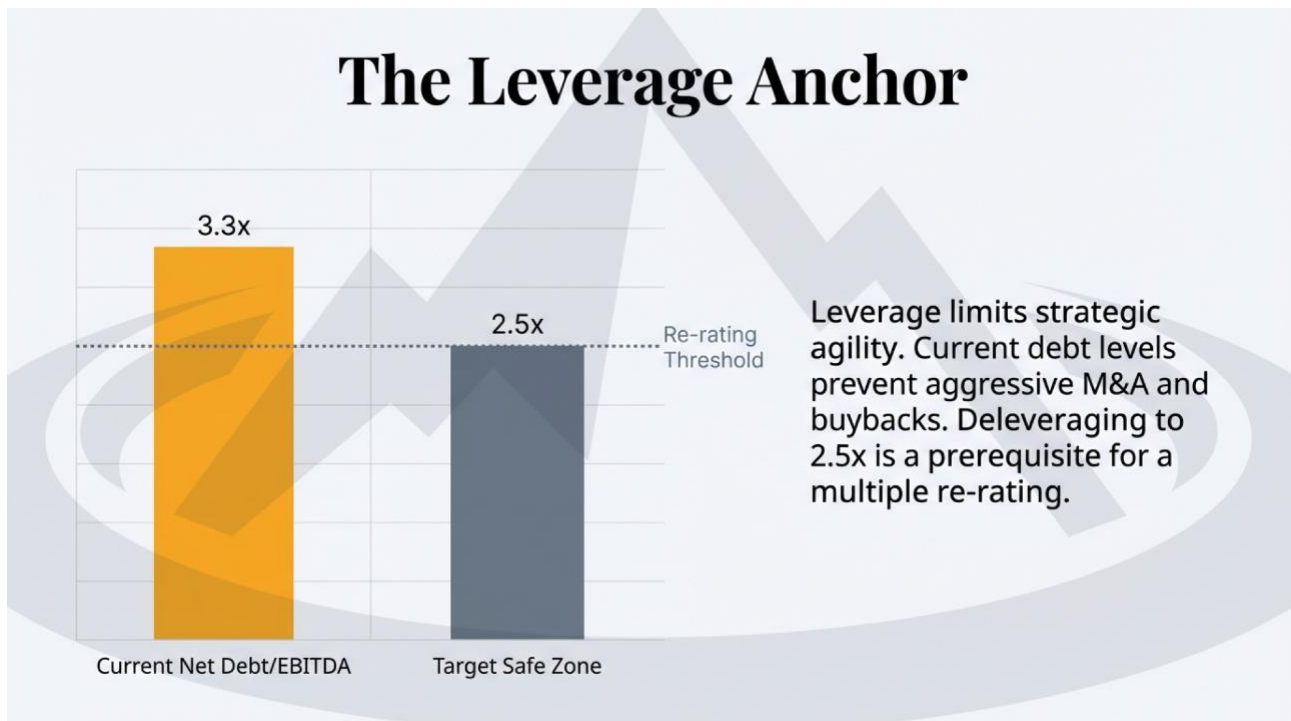


Figure 1. Balance-sheet leverage versus the de-leveraging target (Net Debt/EBITDA).

Key takeaway: High leverage (3.3x Net Debt/EBITDA) is a key constraint; reducing leverage toward 2.5x is central to closing the execution gap.

Our work highlights a clear divergence across valuation lenses.

Our blended fair value estimate is 1,746p, implying only a 4.2% upside from current levels. (see Figure 2)

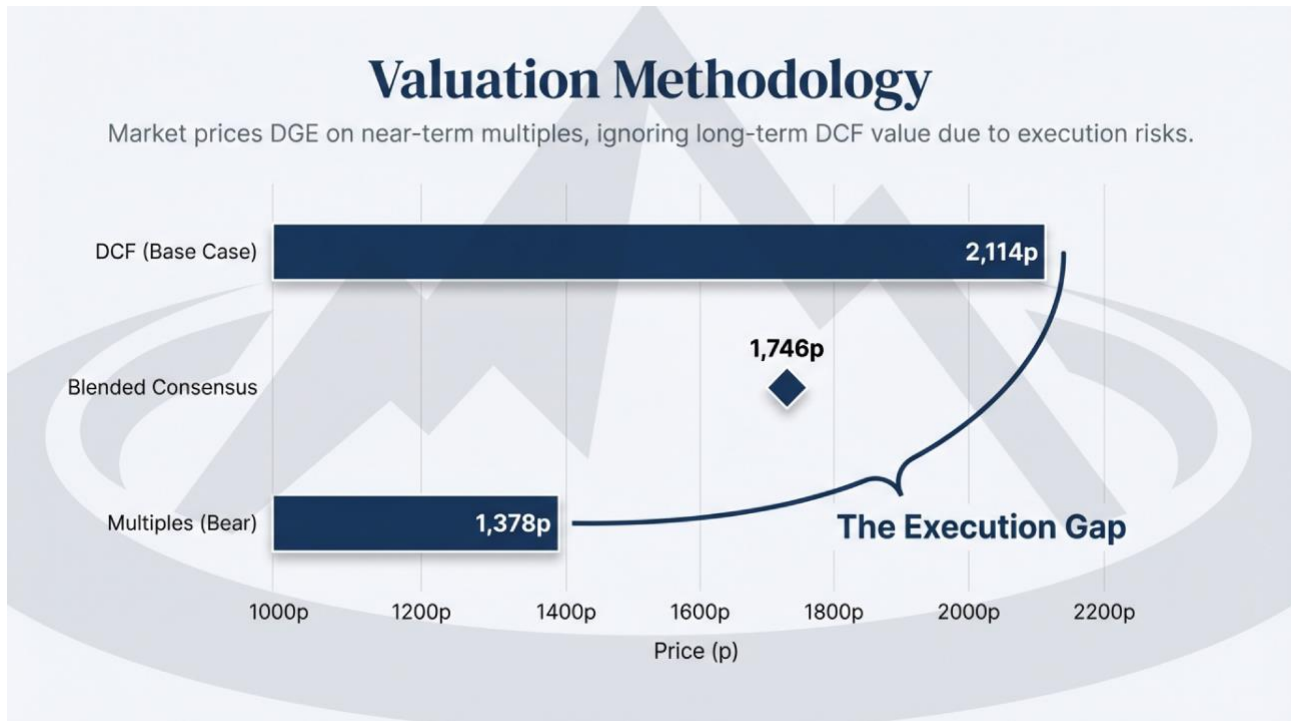


Figure 2. Valuation lens divergence and the “Execution Gap”.

Key takeaway: Valuation signals diverge—blended fair value implies modest upside, while outcomes widen materially once we incorporate scenario dispersion.

However, when we incorporate a full range of outcomes—both aggressive bull and conservative bear scenarios—our probability-weighted value rises to 2,222p.

This spread underlines a highly asymmetric risk profile: a theoretical 32.6% upside if the bullish case unfolds versus a roughly 37% downside if the bear case materializes.

At MoatPeak, we therefore maintain a HOLD stance for existing investors and a WAIT position for new capital. (see Figure 3)

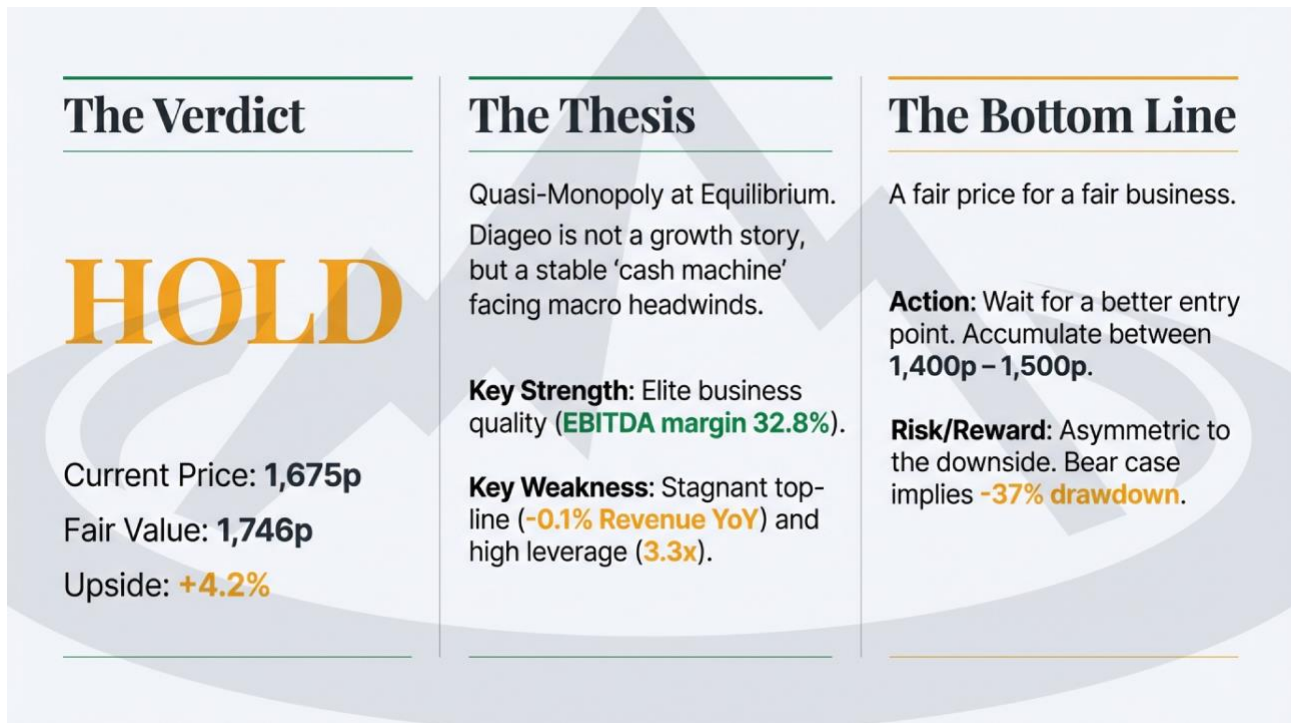


Figure 3. Recommendation and investment thesis summary (HOLD / WAIT).

Key takeaway: We maintain a HOLD stance for existing investors and a WAIT position for new capital given a limited margin of safety at current levels.

In our view, the current margin of safety is not sufficient to warrant fresh buying.

The rest of this note explores how Diageo’s internal dynamics are increasingly shaped by the gravitational pull of the US market.

2. Impact on US Markets: Interest Rates, Yields, and Consumer Resilience

The US remains the primary engine for global Consumer Staples, and Diageo is no exception.

With a significant portion of its revenue effectively tied to the US Dollar, the health of the American consumer and US monetary policy are the ultimate determinants of value for \$DGE.

The US 10-year Treasury yield, currently around 4.24%, forms the base of our valuation work. (see Figure 4)

Appendix: DCF Assumptions

Parameter	Value
Risk-Free Rate	4.24%
Beta	0.8x
Equity Risk Premium	6.0%
Cost of Equity	9.04%
Cost of Debt (After-tax)	3.68%
WACC	7.33%
Terminal Growth	2.2%

WACC of 7.33% reflects a capital structure of 68.2% Equity / 31.8% Debt.

Figure 4. DCF framework inputs: risk-free rate and discount rate assumptions.

Key takeaway: US rates are the anchor for our valuation work; changes in the risk-free backdrop flow directly into fair value.

This risk-free anchor feeds directly into our Weighted Average Cost of Capital (WACC) of 7.33%, setting a demanding hurdle for Diageo’s capital allocation decisions. (see Figure 5)

Key Valuation Drivers & Sensitivities

Sensitivity: WACC vs. Terminal Growth

WACC	Terminal Growth				
	1.5%	2.0%	2.2% (Base)	2.5%	3.0%
6.5%	1,280p	2,010p	2,330p	3,477p	3,650p
7.0%	1,320p	1,640p	2,002p	2,652p	3,730p
7.33% (Base)	1,290p	1,830p	2,114p	2,492p	3,950p
8.0%	1,240p	1,660p	2,014p	2,052p	2,760p
8.5%	1,020p	1,730p	1,950p	2,078p	2,320p

Small changes in regulation (margin compression) or rates drastically impact fair value.

Figure 5. DCF sensitivity: WACC versus terminal growth assumptions.

Key takeaway: Small moves in discount-rate assumptions can produce large shifts in intrinsic value, reinforcing why the US rate regime is decisive.

On the income side, \$DGE offers a 4.5% dividend yield, supported by a healthy 13.6% Free Cash Flow margin. (see Figure 6)

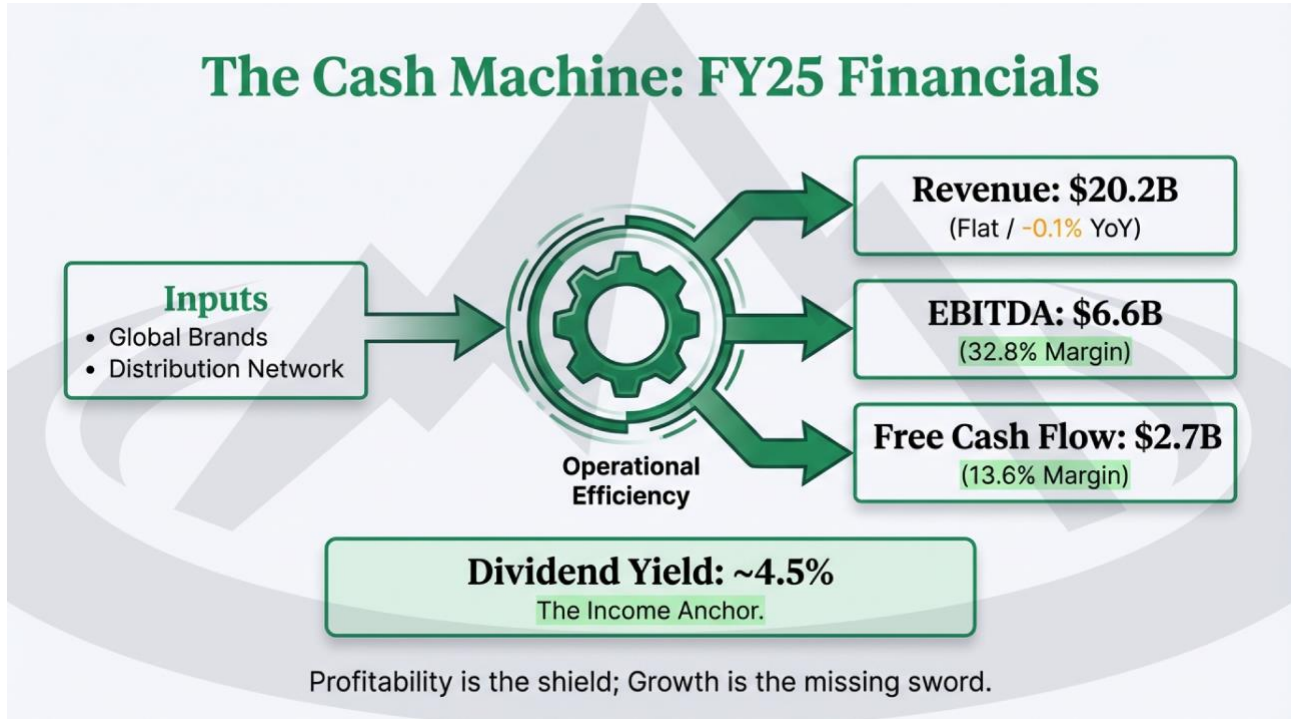


Figure 6. Cash-generation profile: FY25 revenue, EBITDA, free cash flow, and dividend yield.

Key takeaway: The equity’s appeal is predominantly income and cash generation rather than growth, consistent with the “defensive premium” framework.

However, investors need to weigh that yield against what is available in “risk-free” Treasuries.

As the spread between Treasury yields and staple dividends narrows, the traditional “defensive premium” of a stock like Diageo tends to compress.

We also need to be mindful of the wealth effect.

The premiumization trend in spirits depends heavily on wealth creation driven by the S&P 500 and Nasdaq.

If US equity markets turn more volatile or correct meaningfully, the discretionary element of spending on super-premium spirits usually weakens.

In other words, the higher-margin tiers of Diageo’s portfolio are closely linked to US asset price dynamics.

These US monetary and market conditions create the baseline upon which Diageo must then navigate a more complex currency and regulatory matrix in Europe and beyond.

3. European and Global Market Dynamics: Currency and Regulation

With distribution across roughly 180 countries and a primary listing on the London Stock Exchange, Diageo is fundamentally a global operator that happens to report in pence sterling (GBP).

This leads to a structural and persistent mismatch between where it earns its money and how it reports those earnings.

Factor	Strategic Impact	Investor Quantitative Risk
Reporting Currency	Pence Sterling (GBP)	High:
Revenue Mix	High USD and EUR exposure	Moderate:
Cost Inflation	Grain, glass, logistics	Margin pressure:
Regulatory Tax	UK, France, Germany	Structural:

Beyond currency, we are closely tracking what we call the Regulatory Tax Frontier.

Governments in core European markets—pressured by post-pandemic deficits and long-term fiscal shortfalls—are increasingly targeting spirits as a convenient tax base. (see Figure 7)

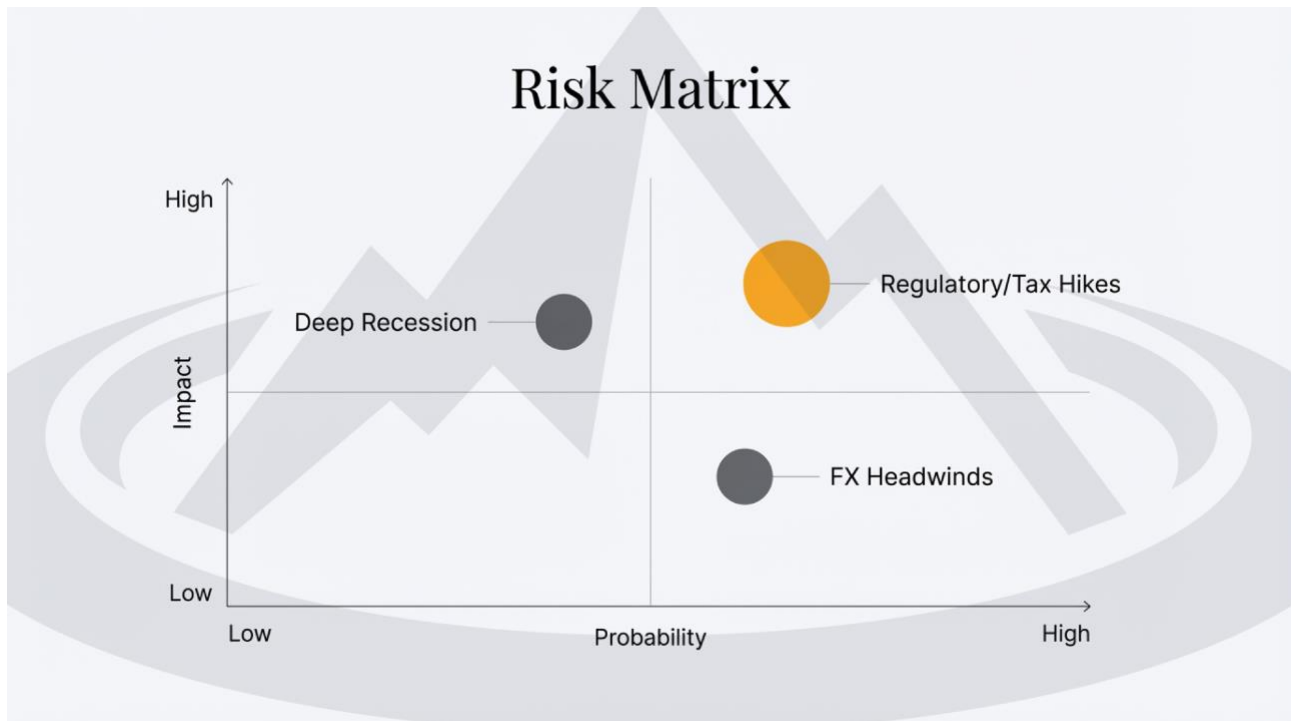


Figure 7. Risk matrix: regulatory/tax hikes, FX headwinds, and recession sensitivity.

Key takeaway: Currency and regulatory risk are structural headwinds for a global operator reporting in sterling, with Europe a key policy watch.

This form of regulatory “harvesting” is a classic late-cycle signal, in which the state systematically extracts value from mature, high-margin industries.

Diageo, with its strong profitability, sits squarely in that crosshairs.

4. Sectoral Movements and Peer Analysis

The global Alcohol & Spirits industry is currently a clear case study in Capital Cycle Theory.

For years, high margins in premium and super-premium spirits drew in substantial capital and new entrants.

The result is a crowded high-end market that now faces stagnant volumes and structurally elevated marketing spend to defend market share.

Within this backdrop, \$DGE trades at approximately 21.6x P/E, almost identical to the sector median of 21.7x.

The market, in other words, is not prepared to pay a premium for Diageo's brand moat at this stage.

To reflect Diageo's higher leverage (3.3x Net Debt/EBITDA) relative to peers, we apply a 10% discount to industry medians in our multiples-based valuation.

Key tickers we track as reference points include \$DGE / \$DEO as the central gauges of the premiumization cycle; \$PRNDY (Pernod Ricard) and Rémy Cointreau as direct competitors across premium spirits; \$STZ (Constellation Brands) as an important indicator of US consumer resilience; and \$BF.B (Brown-Forman) alongside \$HEINY (Heineken) as more classically defensive beverage names.

For investors, the implication is straightforward: the market currently prices Diageo as a fair business at a fair price.

It is effectively demanding proof of volume recovery before it is willing to expand the multiple or re-rate the equity meaningfully above peers.

5. The “Grey Rhinos”: Ignored Signals and Structural Consequences

We define Grey Rhinos as highly probable, high-impact risks that are visible but often underappreciated until they fully materialize.

For \$DGE today, the dominant Grey Rhino is the demographic shift in alcohol consumption.

Younger cohorts in the US and Europe are either consuming less alcohol overall or shifting into categories where Diageo has less historical dominance. (see Figure 8)

Strategic Friction: Why Growth is Stalling



The Volume Problem

Shifting demographics. Younger generations are drinking less. Growth currently depends on price hikes, not volume expansion.



The Regulation Wall

Spirits as a Tax Piggybank. Governments in EU/UK targeting alcohol for revenue. Excise duties threaten margin compression.



Currency & Inflation

FX Headwinds. Strong GBP eats reported revenue against USD/EUR earnings. Input inflation pressures the cost base.

Figure 8. Strategic friction: volume pressure, regulation, and currency/inflation headwinds.

Key takeaway: Demographic-driven volume pressure is the core grey rhino; relying on pricing to offset weaker volumes risks widening the execution gap and balance-sheet strain.

When we apply Second-Order Thinking, the progression becomes clear:

- First-order effect: Younger consumers drink less volume.
- Second-order effect: To maintain top-line momentum, \$DGE must invest more aggressively in marketing and pursue costly acquisitions of craft and niche brands.
- Third-order effect: This additional spending places further strain on the balance sheet, making it significantly harder to reduce Net Debt/EBITDA from 3.3x toward the target 2.5x.

This growing Execution Gap—between strategic intent and balance-sheet reality—is a key reason why the market is reluctant to reward the stock with a higher multiple.

If volume declines were to accelerate, Diageo's reliance on pricing power to offset weaker physical throughput would eventually encounter a ceiling.

At that point, the equity could be pushed toward a re-rating closer to our bear case.

6. MoatPeak Scenarios and Probabilities

We approach \$DGE through a probabilistic lens rather than a binary “buy or sell” framework. (see Figure 9)

Scenario Analysis: Risk vs. Reward

BEAR CASE (25% Prob)	BASE CASE (50% Prob)	BULL CASE (25% Prob)
Price: 1,054p (-37%)	Price: 2,114p (+26%)	Price: 3,603p (+115%)
Drivers: Excise tax hikes. Volume drop.	Drivers: 2.5% Growth. Discipline.	Drivers: Premiumization. Deleveraging.
Margin: Falls to 31%	Margin: Expands to 33.5%	Margin: Hits 35%

Figure 9. Scenario analysis: bear/base/bull outcomes and probabilities.

Key takeaway: The distribution of outcomes is wide, with meaningful upside if the bull case unfolds versus material downside in the bear case—supporting a patient stance.

Our internal scenario matrix through 2026 is summarized below:

Case	Probability	Target Price	Key Triggers
Bull Case	25%	3,603p	EBITDA margin expands toward
Base Case	50%	2,114p	Revenue grows at
Bear Case	25%	1,054p	Material excise tax hikes, EBITDA margin contracts to

We would consider our Base Case invalidated if Diageo fails to stabilize US physical volumes by the February 2026 guidance update. (see Figure 10)

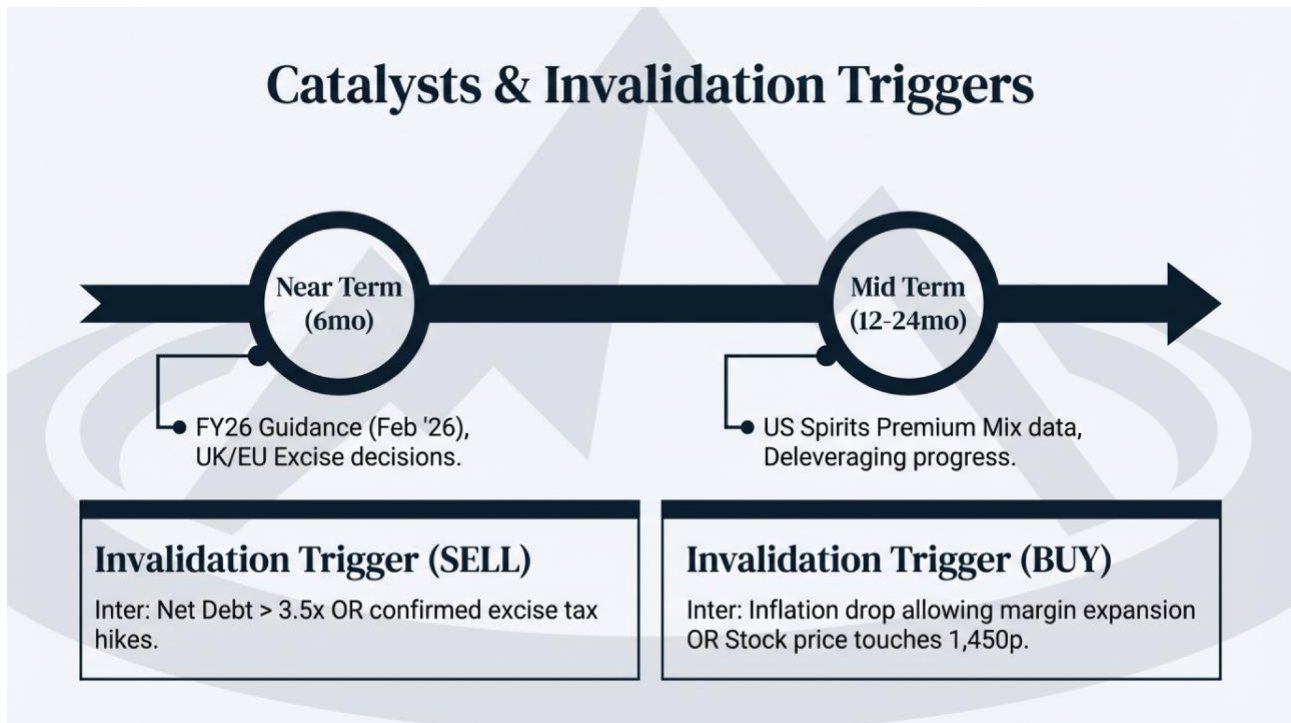


Figure 10. Catalysts and scenario invalidation triggers (FY26 guidance waypoint).

Key takeaway: February 2026 guidance is the next critical waypoint; failure to stabilize US volumes would increase bear-case probability.

A further deterioration at that point would significantly increase the probability of our Bear Case (1,054p) and, in turn, undermine the current valuation framework.

7. MoatPeak Insights: The Quality Scorecard

Our proprietary Quality Scorecard assigns Diageo a 6.7/10. (see Figure 11)



Figure 11. MoatPeak Quality Scorecard snapshot (6.7/10).

Key takeaway: Quality is robust, supported by elite profitability and a strong brand moat, but leverage and volume stagnation keep the setup below “Excellent”.

This is a robust result that confirms the company’s strength, yet it falls short of the “Excellent” threshold that we require before committing aggressive capital at today’s price.

From a profitability standpoint (NAVY/fact-based), Diageo is still very much an elite operator.

The company delivers an EBITDA margin of 32.8% and a Net Margin of 12.5%, while its Return on Equity of 19.3% underscores the fundamental quality of the franchise.

On the moat dimension (NAVY/fact-based), the 10-year durability of cornerstone brands such as Johnnie Walker and Guinness provides a powerful defensive buffer that very few competitors can replicate.

The weakness (GREEN/insight-based) lies in the over-reliance on pricing power to offset flat or declining physical volumes.

This is inherently fragile.

Price is what you pay; value is what you get.

At around 1,675p, investors are unequivocally paying for quality, but they are not being compensated for the leverage and execution risks embedded in the story.

In simple terms, we see \$DGE as a fair business at a fair price, but the margin of safety—the gap between market price and intrinsic value—is, in our view, too thin at this point.

8. Strategic Implications for the Retail Investor (Horizon 2026)

Looking out to 2026, we believe \$DGE is best approached as a defensive anchor within a diversified portfolio, rather than a core source of alpha.

For value and income-oriented investors, the 4.5% dividend yield appears well covered, backed by a 13.6% FCF margin. (see Figure 12)

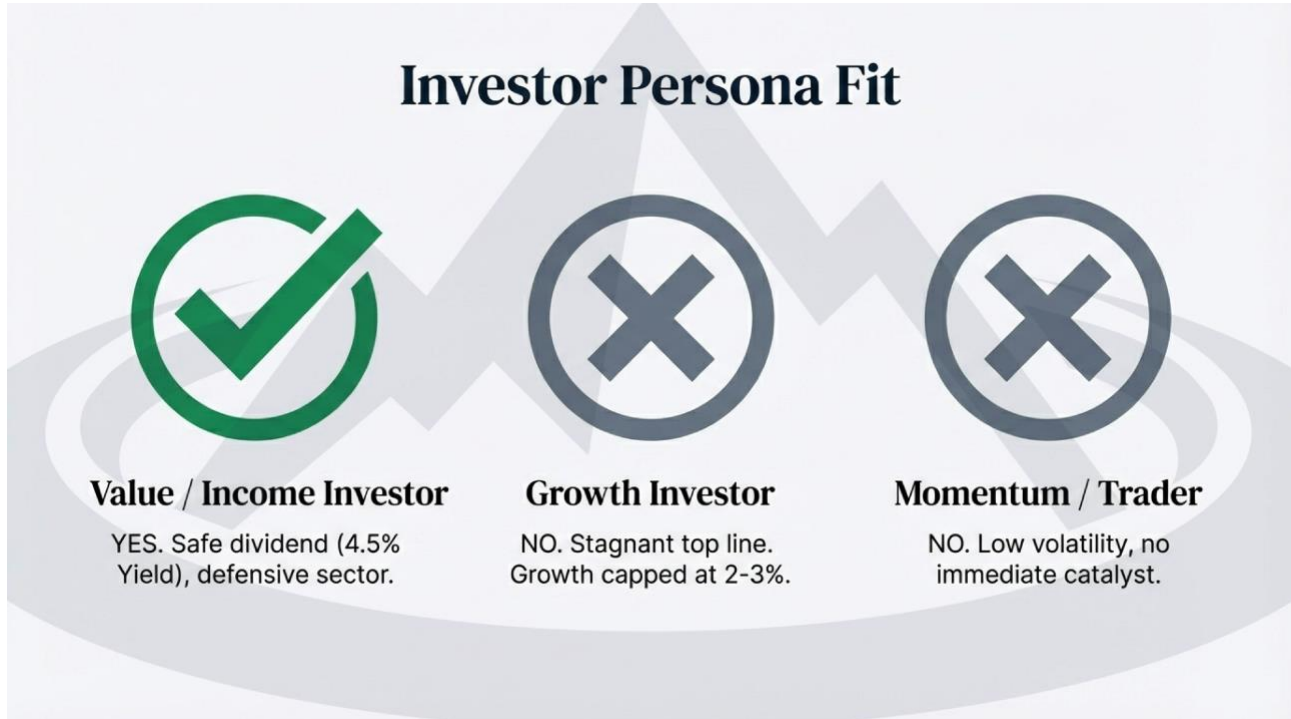


Figure 12. Investor persona fit: income/value versus growth and momentum profiles.

Key takeaway: DGE fits value/income investors seeking a defensive anchor; we see limited appeal for growth-oriented investors until volumes recover.

Our stance is to hold for income, while remaining disciplined on position sizing and cautious about materially adding at current levels.

For growth-oriented investors, the story does not yet offer the tailwinds we associate with genuine alpha generation.

The combination of demographic headwinds, regulatory risk, and elevated leverage suggests that more attractive risk-reward profiles likely exist in other sectors.

In terms of monitoring, the February 2026 guidance is the next critical waypoint.

It should provide a clear signal as to whether Diageo is closing the Execution Gap or slipping further behind.

When it comes to entry timing, we see the 1,400p–1,500p range as the zone where the risk-reward trade-off becomes genuinely compelling. (see Figure 13)

WAIT.

Great Company. Wrong Price. Wrong Macro.

Accumulate Zone: 1,400p – 1,500p

Today, Diageo is a fair price for a fair business. But we demand a discount.

Figure 13. Preferred entry zone and WAIT stance (1,400p–1,500p).

Key takeaway: We see 1,400p–1,500p as the range where the margin of safety better matches Diageo’s underlying quality.

At those levels, the margin of safety would, in our view, begin to align more closely with Diageo’s underlying quality.

At MoatPeak, our philosophy is grounded in intellectual honesty.

We regard Diageo as a superior company, but history reminds us that even the best businesses can become mediocre investments when the entry price does not adequately reflect the risks.

For now, we are comfortable being patient.

We prefer to wait for a wider margin of safety so that, when we do deploy capital, time and probability are working with us—not against us. (see Figure 14)

Portfolio Decision Checklist

- Do you need a 4.5% yield? (If yes, KEEP).
- Can you tolerate a 37% drawdown if taxes hike? (Bear case risk).
- Are you willing to hold for 3-5 years for the execution gap to close?
- Is the price below 1,500p? (Ideal entry zone).

If you cannot check all boxes, the recommendation remains WAIT.

Figure 14. Portfolio decision checklist for position sizing and patience.

Key takeaway: Position sizing should reflect downside tolerance and the time required for the execution gap to close; discipline on entry matters.

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Our research integrates insights from global investment banks, asset managers, and macroeconomic data sources, translated into clear, actionable perspectives for long-term, strategic investors.

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