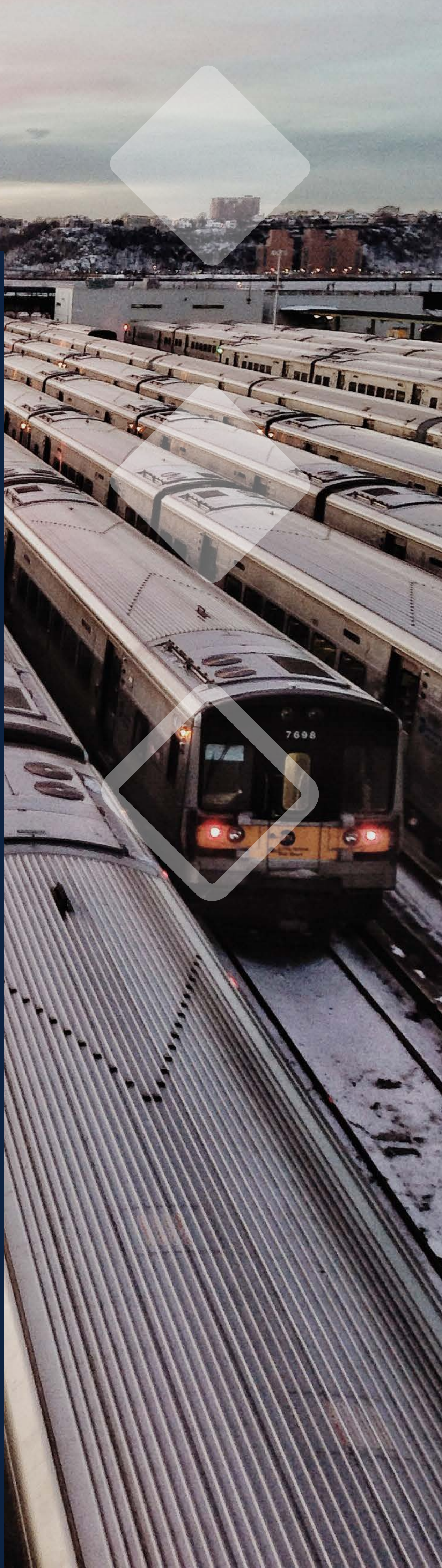


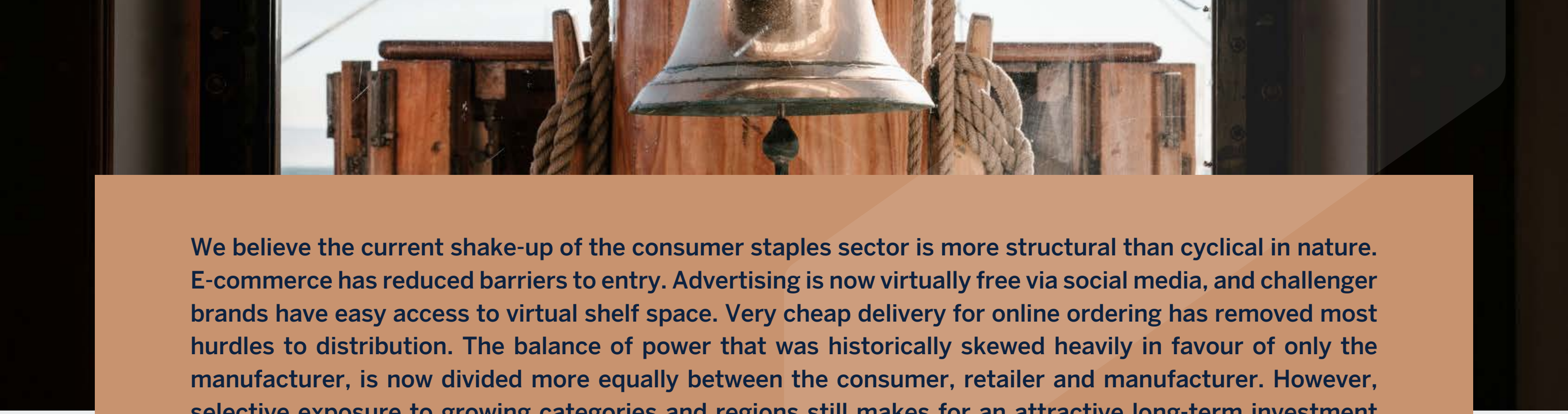
Sector Focus:
Consumer Staples

Author: Prandhana Naidu
/ Portfolio Manager

Investors have long seen consumer staples businesses as a safe port in stormy waters, being able to weather the ups and downs of the marketplace with more certainty than most other businesses. However, as the adage goes, the only constant is change, and so even these companies now find some challenges they cannot surmount without transforming the way they do business.

Selling soap, razor blades, soft drinks, beer or snacks is a dependable revenue stream in an uncertain world: consumers are unlikely to completely stop buying these items even in an economic slowdown. As such, large consumer staples companies – the likes of a Unilever, PepsiCo or Anheuser Busch InBev – have enjoyed decades of market dominance. Profitability in staples is driven by scale, leading market shares and branded goods with pricing power that result in high barriers to entry. Together with moderate competition, this delivered attractive economics for many years, generating significant amounts of cash and leading to a virtuous cycle: the largest consumer goods names could invest huge sums of money into marketing to persuade consumers to pay a premium for their brands, and controlled large volumes through the distribution channel. This investment in marketing lead to growth in the volumes and price of products sold, which allowed the company to again invest the surplus cash flow to further expand their market share over time.

However, in a world where consumers are more discerning and e-commerce has dramatically increased price transparency, the playing field becomes much more competitive. The scale that was once the defensive moat of these large companies has become somewhat of a millstone around their neck, as the benefits of massive production and distribution capability is largely negated by new competitors speed to market, innovation and greater choice which addresses many more niches.



We believe the current shake-up of the consumer staples sector is more structural than cyclical in nature. E-commerce has reduced barriers to entry. Advertising is now virtually free via social media, and challenger brands have easy access to virtual shelf space. Very cheap delivery for online ordering has removed most hurdles to distribution. The balance of power that was historically skewed heavily in favour of only the manufacturer, is now divided more equally between the consumer, retailer and manufacturer. However, selective exposure to growing categories and regions still makes for an attractive long-term investment case in staples names who are beginning to transform their business models to address this new paradigm.

Valuations for the sector have corrected – in part due to uncertainty of how the aforementioned disruption plays out, but also due to the rise in US bond yields. Staples companies are viewed as bond proxies. Their stability and consistency in delivering earnings allowed them to commit to healthy dividend yields well ahead of the market average. These yields were incredibly attractive to investors looking for income in the low-to-no yield environment of the last decade, pushing valuations higher. However, this continued price appreciation masked the competitive challenges the companies were being presented with.

British American Tobacco

A prime example of a stock regarded as a bond proxy is British American Tobacco (BAT). Being a highly cash generative company in a mature industry meant that its dividend yield was one of the most attractive in the sector, providing a good substitute to owning a bond for investors looking to enhance their income.

At its most recent peak in June 2017, BAT traded at a forward P/E of 18x – a 20% premium to its long-term average of 15x, but not excessive relative to other staples peers. Since then, BAT has underperformed the market. This has been driven by a rotation out of the defensive, high yielding staples sector into more growth- or cyclically- oriented names as the outlook for global growth improved, but also due to certain company specific issues.

Incumbents in the cigarette industry are facing their own challenges from smaller competitors. Historically, it was seen as an unattractive market for new entrants. Today, there are a host of e-cigarette or vaping companies trying to win market share from the established players, either by enticing first time smokers or converting smokers of traditional cigarettes to their product. One such new entrant – Juul – has made impressive inroads in the US market, largely at the cost of BAT and others. Juul has been very good at rapidly innovating, using social media to market their product, and relying on non-traditional distribution methods to get their products in the hands of its customers.

BAT has not been idle. The company took full control of Reynolds (a US tobacco firm that it previously owned as an associate) in 2017. The strategic rationale for the deal made sense, giving BAT greater exposure to a highly profitable market and greater access to a portfolio of so-called 'next generation' smoking products (such as e-cigarettes) with which to defend its position over time. However, a day after the deal was finalized, the US Food and Drug Administration (FDA) published a proposal detailing their intent to reduce the levels of nicotine in cigarettes to non-addictive levels, souring sentiment to the sector.

From our analysis of the facts, we believe that there is limited risk of any change to the earnings outlook over the next few years. Even if adverse regulation is passed, BAT is well positioned in alternative smoking channels (such as e-cigarettes, vaping, heat-not-burn, or snuff) that should offset some of the weakness. Moreover, BAT is making significant strides in transforming the business to be nimbler in responding to new challengers, all while continuing to generate and return substantial amounts of free cash flow to shareholders.

While the primacy of the incumbent consumer staples names is being challenged, we believe there are enough reasons to be remain invested over the longer term. The large consumer goods players are all in the process of transforming their business models to succeed in the new landscape enabled by e-commerce – and ultimately, the efficiencies afforded by scale will matter when trying to sell products on a global scale. Equally, the global growth outlook will not remain as rosy as it is today into perpetuity, and this out-of-favour sector will again find itself back in demand.