Investing in the Consumer Staples Sector

Consumer Staples Sector Report

Companies Mentioned in This Report:

- **Coca-Cola** (KO - $58.51): Buy
- **Colgate Palmolive** (CL - $86.75): Buy
- **General Mills** (GIS - $68.51): Buy
- **Kellanova** (K - $56.07): Hold
- **Kraft Heinz** (KHC - $36.90): Hold
- **Molson Coors** (TAP - $63.54): Hold
- **Mondelez** (MDLZ - $66.51): Buy
- **PepsiCo** (PEP - $169.48): Buy
- **Procter & Gamble** (PG - $156.96): Buy
- **Sysco** (SYY - $75.44): Buy

Source: Reuters. Prices are as of market close on 4/17/24 and subject to change without notice.

For more information:

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Investment Summary

The consumer staples sector is often viewed as less volatile than the broader market because of the often steady sales of the everyday products created by these companies. However, differences between these companies exist, and those that embrace technology, improve distribution and have experience in emerging markets should benefit over the long term, in our view.

Consumer staples represent about 6% of the S&P 500, and many consumer staples stocks provide healthy dividend yields. When investing in consumer staples, we recommend diversifying across multiple subsectors, starting with the larger food, beverage & tobacco subsector. Then we recommend diversifying into the smaller subsectors, which include household & personal products and food & staples retail.

Growth Drivers

1. **Data investments and structural changes improve speed to market.** For many of our Buy-rated companies, getting a product from concept to shelf now takes months as opposed to what used to take a year or two.
2. **Online grocery shopping and distribution should fuel growth**. The number of consumers that buy their groceries online is increasing rapidly. Large, high-selling brands are often prominently featured on online-shopping websites, making them easier to buy.
3. **Emerging-market exposure is important, but experience is needed.** Tailoring products to emerging markets takes extensive knowledge of those markets. Local distribution networks are also crucial, as nationwide grocery chains are rare to nonexistent.

Risks

There are several risks associated with investing in consumer staples companies. Changing consumer trends, product recalls, ineffective marketing and advertising, lack of innovation, and poor management can negatively affect the stock price of companies in this sector. Additionally, increasing regulations, the further escalation of trade uncertainty, and negative foreign currency fluctuations could negatively impact growth.

Analyst: Brittany Quatrochi, CFA

Getting New Products to Market Faster Fuels Growth

Developing and launching new products is an expensive endeavor, costing millions of dollars. In the past, many companies spent a great deal of time and money to ensure a potential new product would succeed in the marketplace before it was launched. This process could take as long as two years. However, with the growing importance of data analysis to find underserved markets, along with using flexible manufacturing (i.e., outsourcing), smaller companies were able to condense the time and expense of getting an innovative product to market. This helped these smaller companies gain market share.

Additionally, a few years ago many consumer staples companies focused on aggressively lowering costs, in our view. At the time, Hold-rated Kraft Heinz was at the forefront of this trend. The good news was that profits increased (for a while), but the bad news was that new product development, manufacturing and marketing sometimes suffered. This often led to more market-share losses.

However, large consumer staples companies began to recognize this problem and started improving their operations and structures. Increased investments in computer systems, data analytics, distribution methodologies, product design and marketing were made to develop successful competing products cheaper and faster. Companies redesigned their business structures to foster faster, and more entrepreneurial, decision-making. Product introduction times are now usually measured in months, instead of a year or two.

While costs were often notably increased as these investments were being made, especially after years of cost-cutting, it eventually led to better innovation, sales and profitability. Buy-rated Procter & Gamble, Coca-Cola and Pepsi are some examples, in our opinion. We think other companies, such as General Mills, and Colgate Palmolive, and Molson Coors are following suit. Sysco is doing something similar in foodservice.

The Growth in Online Grocery Shopping May Create Opportunities

While online grocery shopping is not new, it is increasing in popularity. We estimate online grocery sales are about 12% of total grocery dollar sales but could reach 20% or more by the middle of this decade. Many retailers fill these online orders from the store closest to the customer. Maintaining adequate inventory is important to these retailers; an unexpected sellout can potentially disappoint a customer. Therefore, staples companies can help retailers with an online strategy to keep an adequate amount of inventory, and consumer staples companies that invest in distribution systems have an advantage with those retailers, in our observation.

Additionally, we think the growth in online shopping should help big brands, as high-selling products often are the ones most prominently featured on online shopping websites. This makes them easier to shop (i.e., not having to scroll down a number of Web pages to find what you want) and increases the chance of purchase, in our view. We also think it is in the retailer's best interest to attractively place products that are heavily advertised because it can cause a win-win situation for the store, as increased product promotions may increase demand for both branded and store-branded products.

Based on these placement trends, we believe large, familiar brands should benefit for the foreseeable future and, in our view, should positively impact our Buy-rated companies.

Emerging-Market Exposure Is Not Enough - Proven Experience Is Crucial

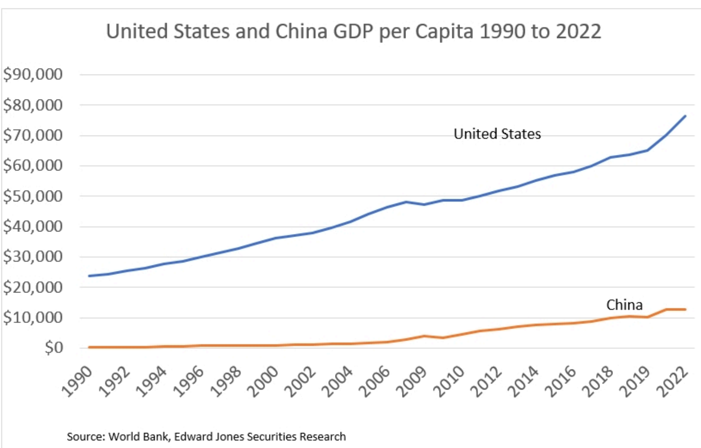
The vast majority of our consumer staples stocks have exposure to high-growth emerging markets, such as China and India. However, in the past companies attempted to enter into these markets by taking their existing products and simply repackaging the label in the local language with mixed success. Successful companies now, in our view, tailor their products to local tastes and often develop them in local markets.

For instance, Mondelez (a snack company) recently introduced additional Oreo flavors in China to reflect Chinese taste preferences. These Oreo flavors include green tea cake, spicy pepper pastry, and barbecue pork pastry. Another example is Kellanova. It is marketing breakfast noodles in certain parts of Africa because noodles are a traditional breakfast meal, as opposed to boxed cereal. We think products designed with local preferences such as these have a better chance of success in emerging markets over the long term.

Additionally, many emerging markets do not have nationwide store chains like most developed countries. This can make distribution an enormous challenge, as companies need to identify and sell to hundreds of small operators. Perishable and refrigerated products add to the complication. Also, average incomes in emerging markets such as China, while rising, remain low compared with Western economies. **See Figure 1.** As a result, keeping products affordable, despite all these challenges, is crucial.

Many companies own established emerging-market distribution arms, or partner with large local firms, to get their products to market faster and more profitably than the competition. Therefore, we prefer companies that have experience with local tastes (especially companies that develop products within the local country) and have robust distribution systems to profitably get these products to market. Buy-rated companies that we believe do this well include Buy-rated Coca-Cola, Mondelez and Pepsi.

Figure 1: While the Chinese economy (measured as gross domestic product per person) is growing, it still lags the U.S.



Environmental, Social and Governance (ESG) Considerations

ESG concerns in consumer staples often revolve around two issues: environmental impact and human health. Deforestation due to agriculture may increase greenhouse gasses and water use. Plastic waste harms the environment. Tobacco and alcohol products can pose health risks, as can products high in sugar or chemicals. We see most of our Buy-rated companies taking positive steps to reduce those concerns. For example, PepsiCo is striving to lower plastic use. General Mills is encouraging sustainable water usage and farming through internal standards and new, healthier products. Because these initiatives are popular with many consumers, they could provide these companies' products a competitive advantage in the marketplace.

Valuation

Methods we use to evaluate the attractiveness of consumer staples stocks include traditional ratios such as price to earnings (P/E) and price to sales (P/S), both on an absolute and relative basis; PEGY ratios (P/E vs. estimated growth and dividend yield); and discounted cash flow (DCF) analysis. Please see your financial advisor and read the individual company research reports, which contain additional information on valuation and risks, to see which stocks are appropriate for you and are good values at their current price.

Please see the individual research reports for additional information, including disclosures, analyst certifications, valuation and risks specific to each company.

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