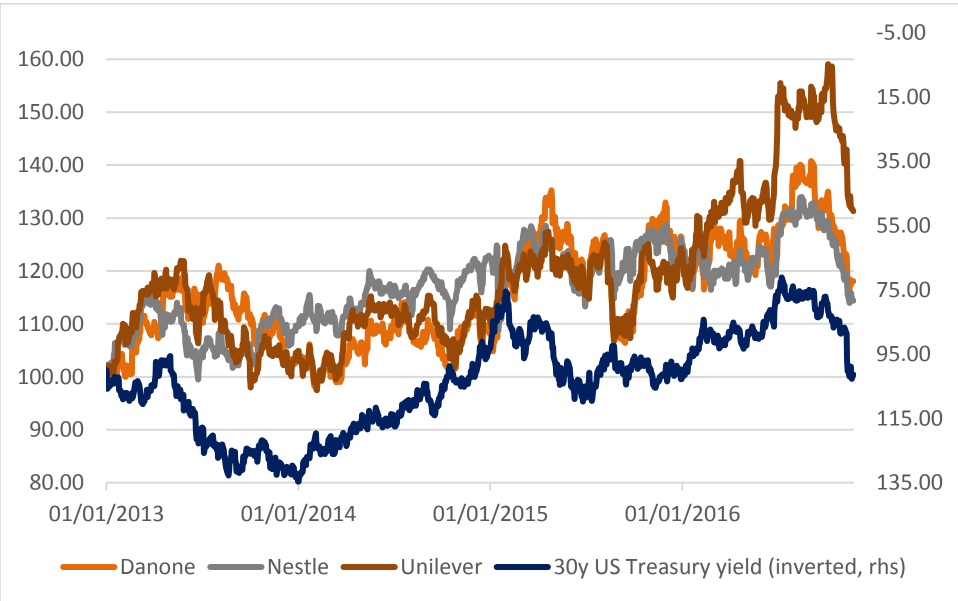
SARACEN
share success

Because you're not worth it!

I wonder if you do the same thing as me, that is stocking up on cleaning or personal care products like toothpaste and shampoo or even some foods and treats when they are on offer? Sometimes I end up with lots of different toothpastes in my cupboard while other times I've run out and have to go out hunting for the best offer on the high street. This made me think, if customers keep looking for bargains - bearing in mind you can't really increase your consumption of toothpaste or shampoo indefinitely –how will these so-called staples companies generate their profits in the future?

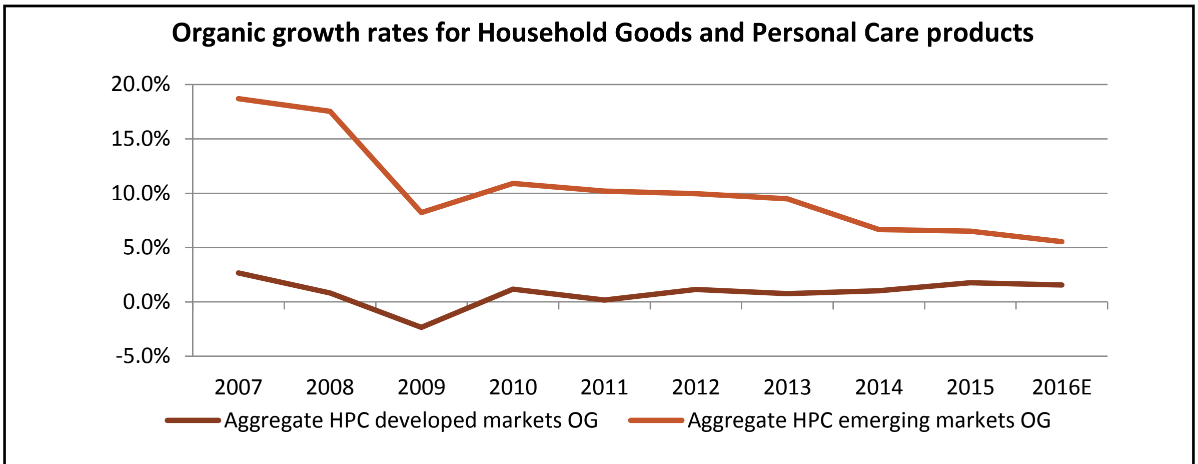
Defensive stocks have performed strongly over the last few years. This is especially true for consumer staples, i.e. food, beverage, household and personal care companies such as Nestle, Unilever, Coca-Cola, Colgate or Kimberly-Clark. One of the main reasons behind the strong performance is that investors who rely on a steady income from their portfolios had to shift from bonds into what we call bond proxies. The yield requirement could not be met with traditional bond investing so we have seen a shift into those equities with reliable dividend payments, such as consumer staples. The large inflows have driven-up their share price substantially over the last five years. In fact, the price performance is very strongly correlated with the inverted bond yield and has increased over the last few years:

Share prices versus inverted 30 year US Treasury yield

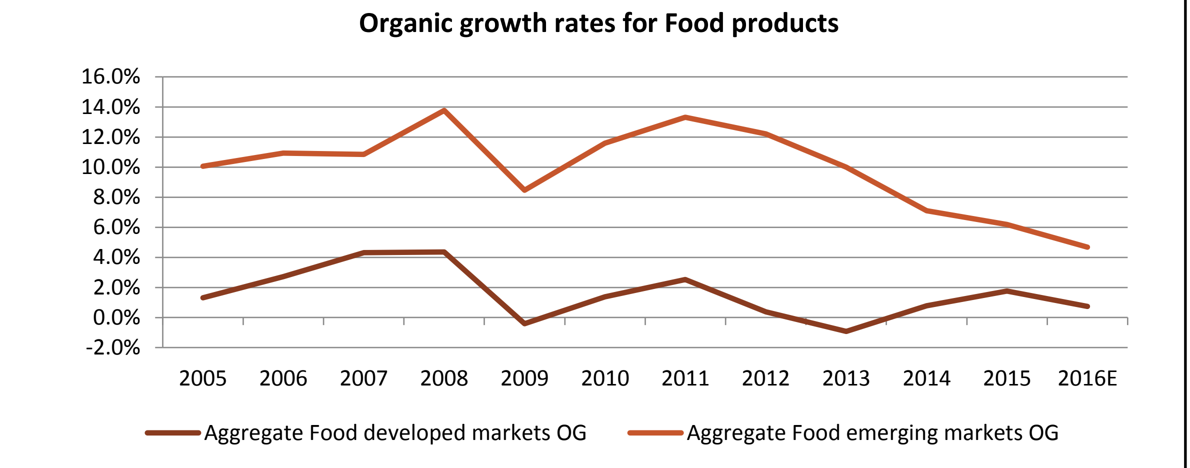


Source: Factset

However, the underlying fundamentals of these shares paint a very different picture. Organic growth rates are slowing, both in the food space, but also in Household Goods and Personal Care products:

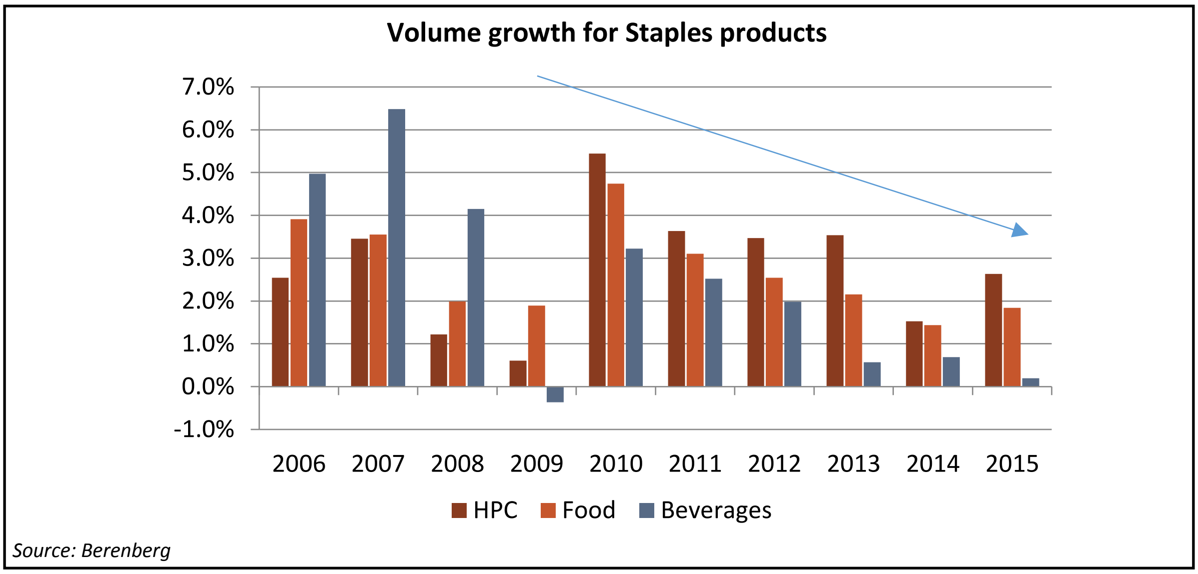


Source: Berenberg



Source: Berenberg

There are two main drivers behind this slowdown. Firstly, the growth rates in emerging markets have retracted from the lofty 15-20% p.a. experienced from 2003 through to 2011. The low hanging fruit for staples in these markets has been picked and there is a move amongst consumers away from multinational big brand products to local, smaller offerings. The second driver for lower organic growth rates is the decline in volumes (both in emerging and developed markets).

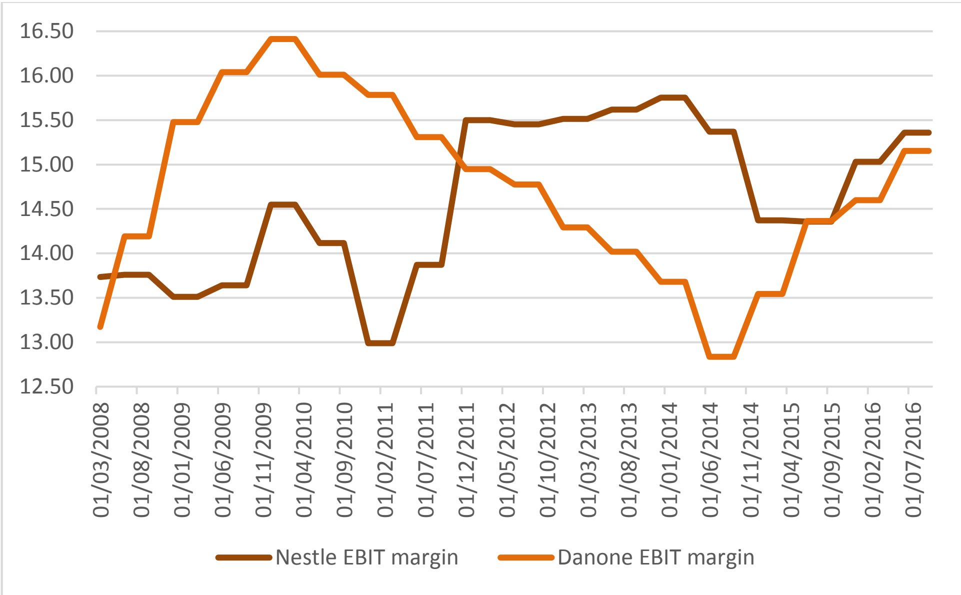


The slowdown in volumes is due to consumers switching away from multinational products. In emerging markets the trend is towards locally produced niche products, especially in personal care. In developed markets, private label continues to gain market share from branded manufacturers. Additionally, in high inflation countries (e.g. Brazil) where the multinationals have had to increase pricing substantially in order to offset the currency impact, a loss in sales volume has been triggered. In recent months, the volume loss has been higher than price increases resulting in negative organic growth rates.

Even in the UK we have seen attempts of large price increases in the wake of the weak Sterling after Brexit. One just has to remember, the spat between Tesco and Unilever or the 'wider valleys' of Toblerone.

Furthermore, staples companies have benefitted from a decline in raw material prices over the last 2-3 years. Although margins did improve by about 200bps in the last ten years, this equals an average margin increase of 20bps p.a. In future, we expect raw material prices to rise and become a headwind hampering the already pedestrian margin expansion we have seen over the last ten years.

EBIT margins for Nestle & Danone



Source: Factset

Raw material prices is just one factor which will contribute to rising inflation. We also see labour costs rising on a global basis. This will automatically lead to pressure on staples companies to increase pricing. However, as we've mentioned earlier, pricing often results in lower volumes and often the negative volume decline is higher than the positive pricing effect.

In our opinion there are many headwinds on the horizon for these staple companies, not least a recovery in bond yields. At current hefty valuations, the risk of a continued correction and money being pulled out of bond proxies is high. We are happy to avoid these shares for the time being.

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