

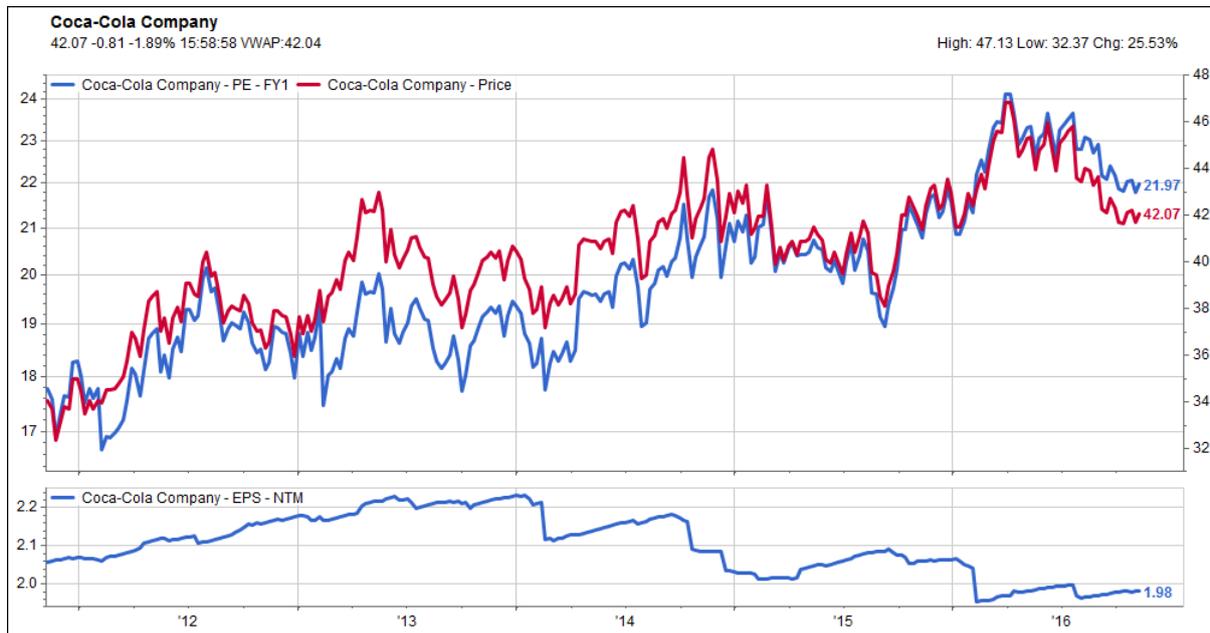
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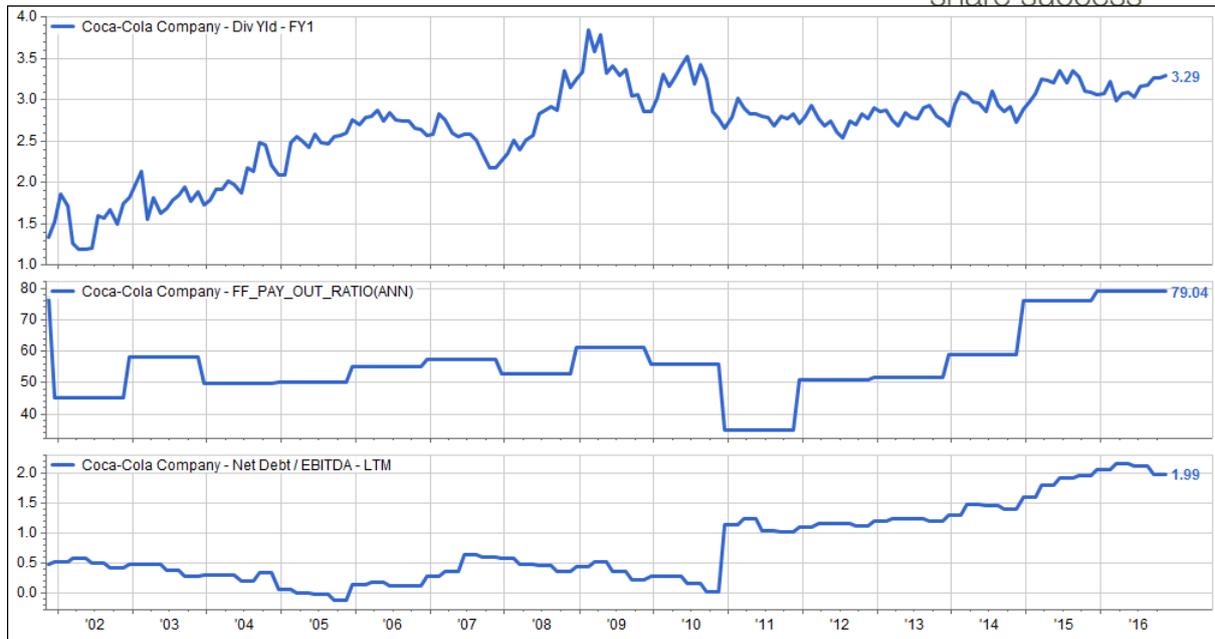
The Demise of Expensive Staples – Coca Cola Inc.

On a recent trip to my local grocery store, I noticed a shift from the ever-ubiquitous sugary confectionaries which typically reside by the checkout. In their place were drinks and snacks labelled as 'sugar free', 'paleo' and 'fuller for longer'. In my sugar-craving state, I went in search for something far less virtuous; a can of coke. However, on discovering the Coca Cola section I was surprised not to be greeted with a sea of red, the classic Coca Cola packaging. Instead I was welcomed to a wide range of apparently, healthier alternatives, for example; Coca Cola Zero (sugar free) and Coca Cola Life (made with stevia, a zero-calorie plant based sweetener). This sparked a thought in my mind: could this be the demise of Coca Cola?

Founded in 1886, and one of America's most iconic brands, Coca Cola has long been a firm favourite in households across the globe. With an extensive corporate history spanning over 125 years, the shares have typically been viewed as a low-risk, high-dividend option. The company has paid dividends since 1920 and increased this in each of the last 54 years. Over the last 5 years the shares have rerated from 17x to 22x. However, with a rise in health conscious, green juice guzzling millennials, and a tax on sugary drinks set for 2018, is there even a future in such longstanding brands?



Since 2012, earnings forecast has fallen almost every year with 2016 earnings expectations 11% below the 2013 forecast at just \$1.98. With such negative growth in the business, how can the dividend yield sustainably be kept above 3%? Put simply, it cannot. In order to keep the dividend, yield around 3%, the payout ratio increased from 35% in 2011 to 79% in 2016 while net debt/EBITDA more than doubled from 1x to 2.2x.



By leveraging up and increasing the payout ratio on a large scale, there is no room for back-up in bond yields would likely cause significant underperformance and with interest rates in the US set to rise, this is not a sustainable situation.

Overall, the underlying growth outlook for sugar-rich drinks is stagnant at best. With lack of growth and a new market saturated by healthy alternatives, demands are changing. Moving forward, economically cyclical businesses are outperforming expensive defensives and the market is finally beginning to look beyond expensive staples.

We have sold almost all our defensive holdings and have been positioned for this shift in the market for a while. Accordingly, our performance has benefited from this move.

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