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US consumer stocks - *Embattled icons*

Consumer stocks like Kellogg's and Campbell's are battling against a shrinking market and their own past successes. Recovery depends on overcoming structural headwinds set to last for some time to come.

Paul Moore, Chief Investment Officer, PM Capital

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Over 100 companies participated in the so-called "breakfast cereal gold rush" between 1888 and 1905 in the appropriately named Battle Creek, Michigan . Among them Quaker (Oats), Post (Grape-Nuts) and probably the best known in Australia, Kellogg's, the maker of Corn Flakes.

W.K Kellogg, the founder and president of the business, used significant and pioneering methods of marketing to convince the breakfast-eating public that its health food/ cereal was better than the bread or rice that the public had been eating for centuries. It worked – by 1939, when Kellogg stepped aside, sales had hit US$33 million (US$581 million in today's money).

Close to 80 years on, US consumer giants like Kellogg and **Campbell Soup Company** are at an interesting juncture. While enjoying a significant increase in their share price over the past decade, their earnings growth has been flat. In other words, their valuations have risen sharply over that period. Now, those valuations are being tested, and their business models are likely to continue to be tested in the medium to long term.

Campbell's is the canary in the coal mine for the big US consumer stocks because it has the weakest product range. If structural problems in the industry are on their way, it is going to show up with Campbell's first, and that is exactly what has happened. Between 2009 and 2017 its earnings growth was largely flat, but its share price continued to rise. However, this has been abruptly arrested more recently.

Campbell's problems, now realised, are similar to many other US consumer stocks:

- they are already dominant in their category
- their categories are saturated, meaning top line growth is limited
- consumer choice has risen
- the internet is allowing smaller players to take advantage of better distribution

These issues mean that consumer stocks are having to cut costs, while also needing to increase marketing to retain their market share. It is a tough balancing act.

So why did those stocks rise before 2016? In large part it was due to perception. In an environment where people were frightened of an economic downturn, these stocks were seen as defensive. In about 2016 and early 2017 there were also takeover premiums baked into the stocks because it was felt that the Buffett and 3G sponsored H.J. Heinz Co could run them better. Further, the index funds bought these companies irrespective of the fundamentals, as long as they fit into their categories. They were also assisted by the emergency level low interest rates, which lifted (most) boats.

Kellogg's share price also rose significantly in the period 2009 to 2017. In this period its earnings per share were on a downward trajectory, and that is despite employing zero-based budgeting, the latest catchphrase in the industry. In other words, cutting costs when you are running out of growth options.

Figure 1: Kellogg Share Price ($USD)

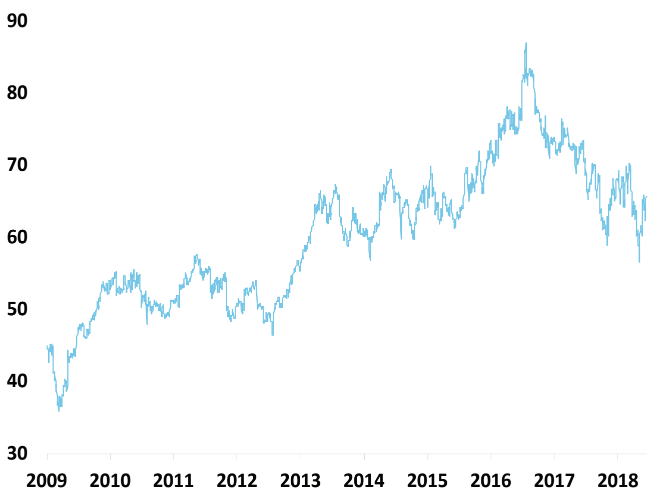
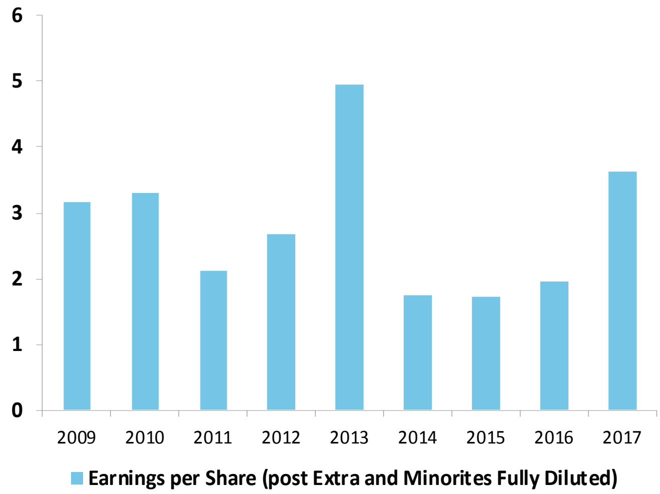


Figure 2: Kelloggs's Earnings per share (post Extra and Minorities Fully Diluted



Source: Bloomberg, Kellogg Company filings

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Kellogg's share price has risen over the past few months thanks to a better than expected earnings announcement, but the long term flattening of growth in the cereals industry continues.

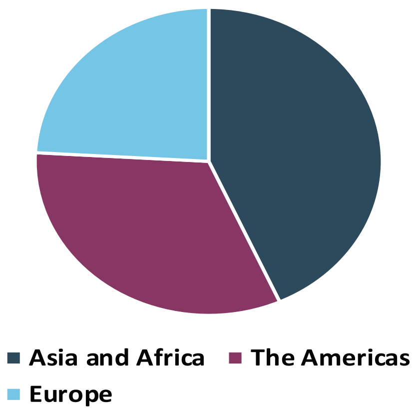
Procter & Gamble's position looks to be similar, but its financials are harder to decipher. To shore up its Earnings Per Share (EPS) it has undertaken mergers and acquisitions. The company has also been buying back stock. It is hard to tell, but the underlying results look sideways at best.

Unilever has held up more than other stocks as it appears that it has been growing, largely to due to its higher exposure to emerging markets, including China. However, investors have realised that the strength of the Euro in the first half of the last decade, followed by a weakening in the second half, had the effect of enhancing Euro-denominated revenue and earnings. The reality for Unilever is that it is seeing the same underlying trends as Procter & Gamble – they are going sideways.

Danone has had a similar boost from the Euro, but over 10 years hasn't been growing. I actually call it the Steven Bradbury of the consumer market, benefiting from the weak Euro and because it was the last to employ zero-based budgeting. So, in the current environment, it looks as though it is growing, but the reality is it is probably transitory. **Nestlé**, the same, and even the great **Coca-Cola**. Over 10 years their underlying earnings have gone backwards.

As an aside, a red flag for a sector in distress is short management tenure. Figure 4 below speaks for itself:

Figure 3: Unilever - Revenue by geographic region (C2017)



Source: Bloomberg

Figure 4: Short on experience

Company	Position	Tenure (years)
Campbells	CEO	<1
Kellogg	CEO	<1
	CFO	1
Kraft	CEO	3
	CFO	<1
Mondelez	CEO	<1
Hershey	CFO	3

Source: PM Capital

MCDONALD'S IN THE FRYER?

Underlying earnings have being going sideways for **McDonald's** since 2011, but the share price has been rising, particularly in the last couple of years. If we look at McDonald's original business model, it is simple. Buy the real estate, put the restaurant up, run the restaurant, you're responsible for the costs, you get all the revenue, you make a profit. But what type of business is it? It's actually a property business, not a burger business.

Its balance sheet has US$22 billion in property - close to all its assets. As described by Harry J. Sonneborn, former CFO, McDonald's is: "...technically not in the food business. We are in the real estate business. The only reason we sell 15 cent hamburgers is because they are the greatest producer of revenue from which our tenants can pay us our rent."

But the model has been changing. McDonald's has been selling its company-owned restaurants. So the franchiser sells the property to a franchisee who runs the restaurant. In return, they get royalties. This releases capital and allows it to buy back stock. Management is doing this because Wall Street values franchise revenues higher than anything else, so valuation multiples rise. Furthermore, in the low-interest rate environment, buybacks funded though borrowing increase EPS, so the share price rises.

This is at the same time as operational risk is transferred to the franchisee. They borrow to buy the franchise or the restaurant. But now they are responsible for royalties, labour, food, interest rates as well. As has been the case with other chain restaurants, the whole system has become fully levered right at the inflection point in interest rates. So, what happens if the industry turns sour? Who is going to provide the capital to the franchisees? McDonald's will have to step in. The market may not have priced in that eventuality.

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WHERE TO NOW?

Can the consumer stocks benefit from ongoing cost-cutting? It looks a difficult task.

The industry still does not really get it. Old habits die hard. In all likelihood higher interest rates are going to expose their lack of growth. In our view, this is exactly why the stocks have been on a downward track since early 2017. Ex-growth companies do not tend to do well in a market where rates are rising, as earnings growth is what is required.

We are also not of the view that company management should get the benefit of dismissing one-off non-recurring items, like "integration and transaction costs", or "restructuring programs", when, it would seem, these 'one-off' items have been happening every year for 10 years. We call them 'recurring non-recurring items'.

The risks in consumer stocks for investors have changed. Share prices could rise in the short to medium term, most likely due to a merger or takeover, either removed or actual. However, their saturation in the market, the lack of sector growth, the reduced ability to achieve continued product innovation and the finite financial engineering that can be undertaken are all structural headwinds for the stocks over the longer term.

Sometimes it is just as important to not invest over which you have no conviction. The situation or our views may change, but investment in this sector, as it is for all sectors, at its core is simple: buy businesses at a discount to their inherent worth, or if you do not have conviction, do not invest.

Paul Moore is the founder and Chief Investment Officer of PM Capital, leading an experienced and knowledgeable team. He developed the investment philosophy and process that has underpinned PM Capital's excess return generation compared with benchmark indices since its inception.

Paul began his career in 1985 as an industrial equity analyst. In 1986 he became Portfolio Manager of the BT Select Markets American Growth Fund, acknowledged as one of the sector's leading mutual fund performers. From 1994 to 1998 Paul assumed responsibility for the BT Split Trust and BT Select Markets International Trust, two of Australia's best performing global equities funds. During this period he was also Head of BT's Retail International Equity Group, which was awarded International Equity Manager of the Year in 1995 and 1996.

Paul established PM Capital in 1998. He is known to invest with patience and conviction, ignoring short term market trends to uncover mispriced assets in industries as diverse as brewing, banking and casinos, in countries from the US, to Ireland, to Argentina.