THE DRIVE YOU DEMAND

EUROPEAN EQUITIES - WHITE PAPER

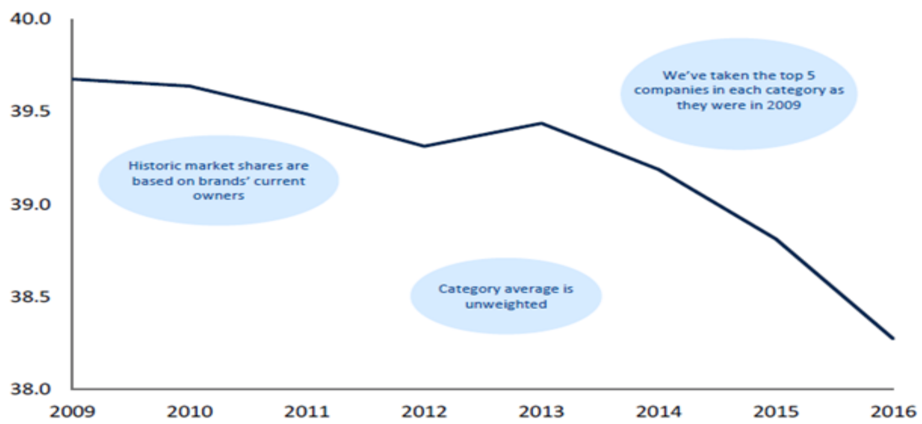
Consumer Staples - The end of an era?

For Qualified Investors in Switzerland or Professional Investors or Eligible Counterparties as defined by the relevant laws

Introduction

- Market and corporate lifecycles can last a very long time and create large valuation anomalies offering great opportunities for active managers.
- Our thesis is that the very long upcycle for Consumer Staples is showing clear signs of ending.
- Sales are slowing as consumer preferences change and high returns are attracting new entrants taking advantage of falling barriers to entry and new, disruptive, routes to market.
- This is occurring at a time when conditions in fixed income markets have pushed valuations to extreme levels in the sector based on the assumption that future returns will be reliable and 'bond-like', we strongly dispute this received wisdom.
- Our portfolios are significantly underweight and we find more attractive growth elsewhere.

Under Pressure – Average global market share of top 5 brands across a selection of categories:



Source: Euromonitor, RBC Capital Markets.

Explaining the chart above: RBC analysts took the 5 largest brands by market share in a wide range of product categories such as confectionary, haircare, hot drinks and yoghurt. They track the market share of these brands using Euromonitor data regardless of whether a brand changes ownership. The line on the chart represents the simple average market share of the top 5 brands in these categories.

Why are sales slowing?

- Life has become a lot tougher for the listed consumer staples companies. Sales growth targets have become more of a struggle and the traditional levers (brand power and marketing spend) are no longer working.
- The Fast Moving Consumer Goods (FMCGs) have, since the golden-era of advertising in the 1950s, been the gateway to the consumer. As investors, historically, there has been no more direct and reliable way to access defensive, predictable, consumer spending. This is no longer the case. Technology (social media) has lowered barriers to entry and a new generation of consumers are mistrustful of 'big business'.

Case Study: KIKO – an Italian makeup brand which has gone from 0% to 30% market share in nail products in 7 years. Their A&P spend is minimal, with social media and word of mouth creating the growth…

*A&P= Advertising & Promotion

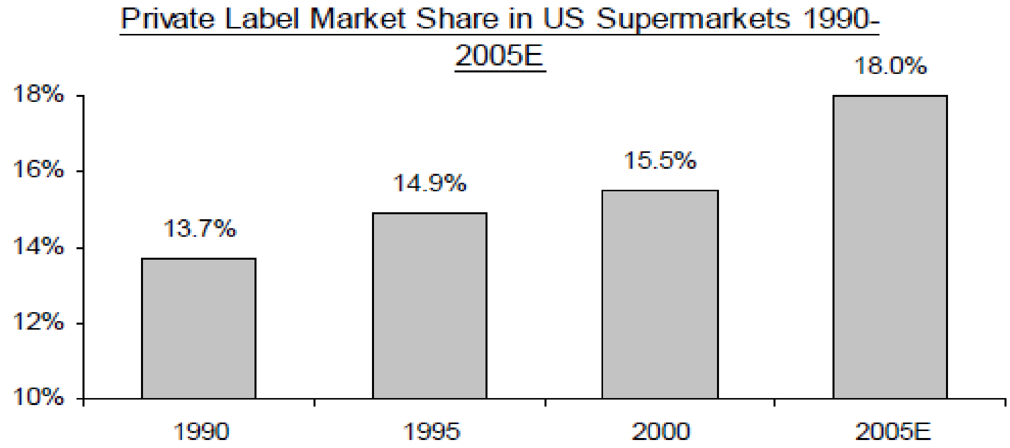
- The Consumer Staples sector has faced and defeated challenges before (private label, volatility of emerging markets, supply chain problems etc). However, these new problems present a unique challenge – one that neither price nor advertising spend can solve.
- The unique selling proposition of the sector was brand power and this has been achieved through billions of dollars of marketing spend – big brands are safe, trustworthy, higher quality and comforting. This allows them to charge a significant premium to own-label. The problem is that to Generation Y, these brands fall into the same category as the mainstream print media, and political parties…. big, with hidden agendas and run for the benefit of a few at the top. To add to this, new, niche brands are gaining huge traction as start-up costs fall and marketing can be channelled through Instagram or Twitter. These small brands often command similar, if not higher price points. Most importantly of all, they are seen as authentic and trustworthy.
- At best, this is a big shift to which the Consumer Staples will have to adapt, at worst an existential threat. But these businesses are resourceful and used to protecting market share, so although the game has changed they are fighting back. The biggest weapon so far has been M&A – in the form of big, cost-base driven mergers and also buying up the brands that are threatening them (Rachel's yoghurt – Nestle, Teapigs – Tata, Dorset Cereal – AB Foods). This strategy is not without its flaws. The opportunity for big mergers is obviously limited (and so are the benefits). Buying small brands is also a potentially dangerous strategy. The valuations of these businesses are high, the way they are run is very different and they may be growing fast, but are typically small and therefore of limited impact to group profit.
- Most importantly, can the essence of an artisan brand still appeal if it is owned by, say, Unilever? Just how deep is the Gen Y search for authenticity? If it is just appearance that counts…the big FMCGs have a chance if they leave their new acquisitions to run themselves and give the impression of being stand-alone (e.g. Heineken and Lagunitas), whilst at the same time providing the back office and distribution network of a global business.

A look back at stock-market history

- The current consensual view of Consumer Staples (low volatility, high return companies that behave like bonds) has not always prevailed.
- Just like most other industries there have been cycles; we just have to look far enough back in time to spot them, but this is perhaps too far for most market participants to remember.
- It is well worth a look at some episodes in the lifecycle of the sector that may resonate with some of today's issues, simply put they are stories of market share loss and how the industry and stock-market responded to those threats.

'Path to growth' or Road to Nowhere?

- While investors watched the tech bubble come and go at the beginning of the decade, the Consumer goods industry was facing some slower moving but disruptive trends of its own.
- Global markets for Food, Beverages and Personal goods were growing at a solid 3-4% but the Branded Goods companies struggled to capture the growth.
- The key problem was a shift in the balance of power towards the Supermarkets. Most major geographies had seen widespread retail consolidation and the Supermarkets had a competitive stick to beat suppliers with – 'Own Label' product.



Source: IRI, Bernstein Estimates

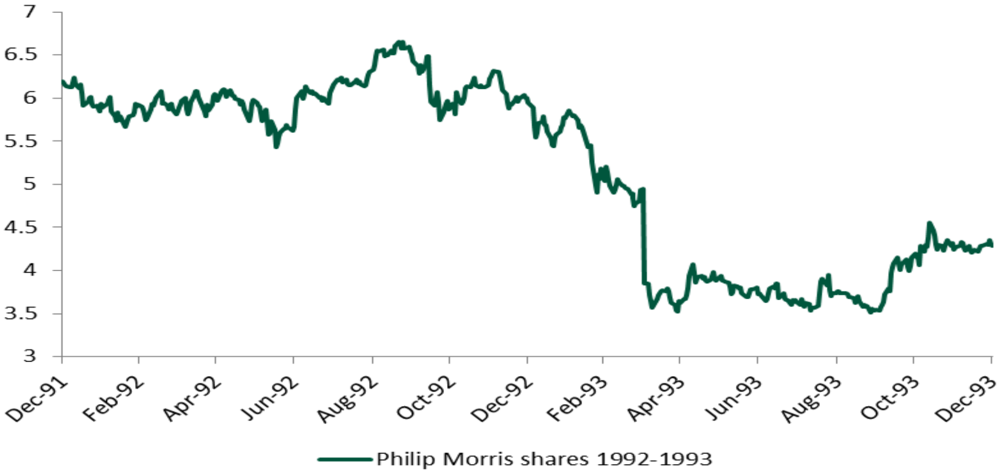
- Own label products can be priced at a discount as they do not need a high margin to support brand advertising. Consumers were happy to make the switch, particularly in more challenging times, The big retailers made it a strategic imperative to shrink shelf space for the big brands.
- As a result there was pressure on volume and prices, much as we expect for the coming years, albeit from a different source of competition. FMCG's responded with cost cutting and the sale of weaker brands, focusing on fewer 'Power Brands' that were seen as essential for consumers. This strategy was typified by Unilever's 'Path to Growth' (c.2000) which was effective in cutting cost and reducing brands but failed to relieve the pressure on sales.
- During this period the sector suffered from erratic trading trends and valuations were depressed with stocks regularly trading on discounts to the market.
- In early 2003 Unilever traded on a modest 12x Earnings, apparently cheap but not cheap enough to avoid 4 years of consistent underperformance thereafter.

'Marlboro Friday' – April 2nd 1993

- If we look back in market history a little further we find some much more dramatic evidence of disruption and sector volatility.
- In the year leading up to Marlboro Friday the iconic Marlboro brand had been losing market share. Despite increasing ad spend, they had pushed pricing too aggressively and in comparison, value brands were too cheap for consumers to ignore.

- The stock-market had already reacted badly to this loss of share sensing a problem brewing. The shares had fallen from a high of about $6.50 in September 1992 to around $5 but nobody was expecting what happened next.
- On Friday April 2nd Philip Morris announced a 20% price cut for Marlboro, 40 cents off a price per pack of $2.15. They reduced earnings guidance by 40% and the shares fell 23% on the day destroying $13.4bn of market value and creating mayhem across the sector. Who would be next? Investors wondered if they were witnessing the death of brand value.
- Fortune Magazine 1993 – 'Rarely has a single, simple statement destroyed so much wealth in so little time'
- Perhaps surprisingly it was absolutely the right thing to do, market share recovered sharply to record levels and within 2 years the share price fully recovered too.

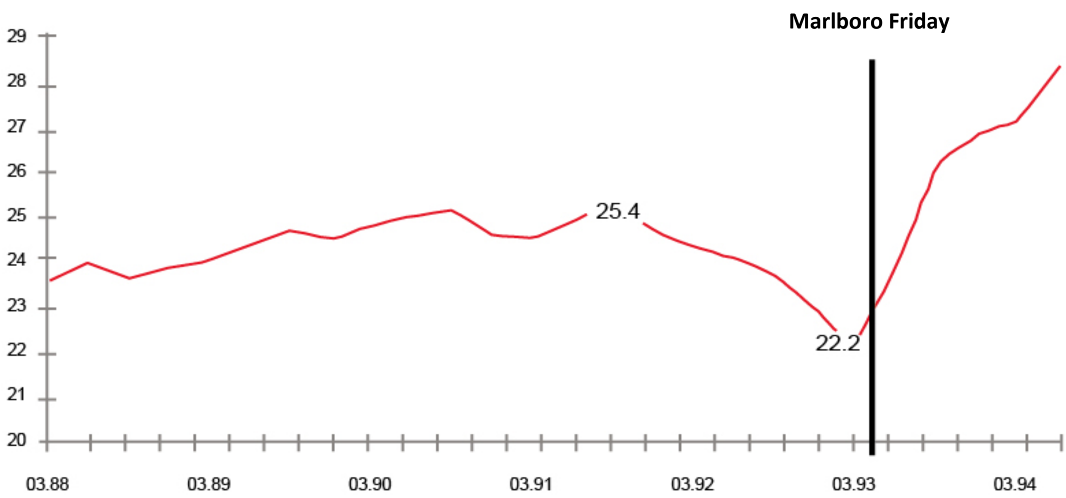
Philip Morris shares – 1992 – 1993:



Source: Bloomberg Finance L.P., as of 31/12/1993

- Marlboro Friday became a classic business school case study and an important lesson for investors' that has now largely been forgotten by all but the most grey haired of us. We would not advocate that a similar event is likely soon but it does show what can happen if sufficient pressure is applied to market share when price premiums for brands become overly stretched and alternative products proliferate.

Marlboro Friday – Market share progression

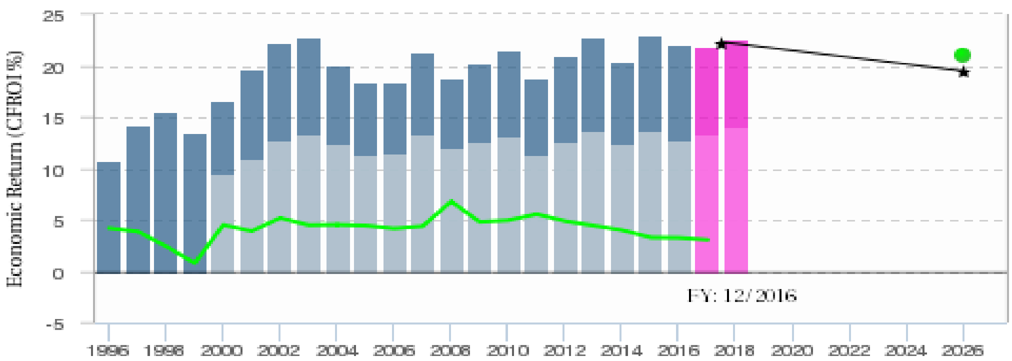


Source: UBP

Valuation and the bond effect

- There is no question that the sector is expensive, particularly considering the deterioration in fundamentals that we are seeing.
- Our preferred CFROI (Cash Flow Return On Investment) based analysis tells us that the sector is priced to continue to deliver high returns for the foreseeable future, assuming a very low discount rate and some modest sales growth. The chart below shows the example of Unilever with the green dot showing that the market is pricing another 10 years of excellent returns.

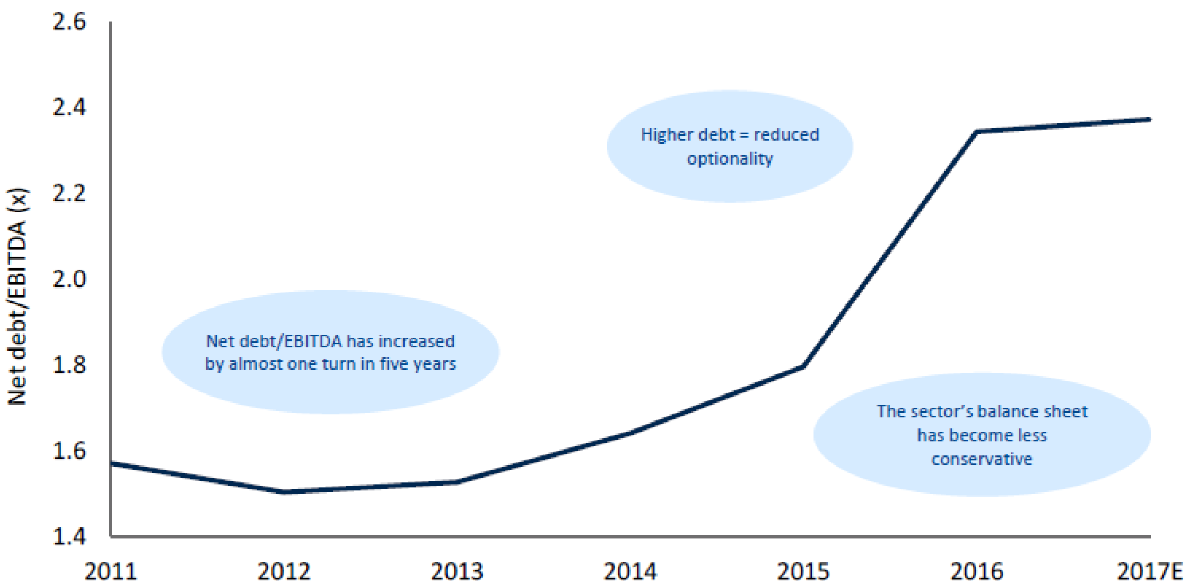
Unilever CFROI history:



Source: CS Holt, UBP as of 03/10/2017

- On more traditional metrics the sector currently trades on a 30% 2018 PE premium to the European market, a dividend yield of 3.0% compares to a market yield of 3.6%. At the same time leverage is rising as the sector turns to M&A to try and sustain returns.

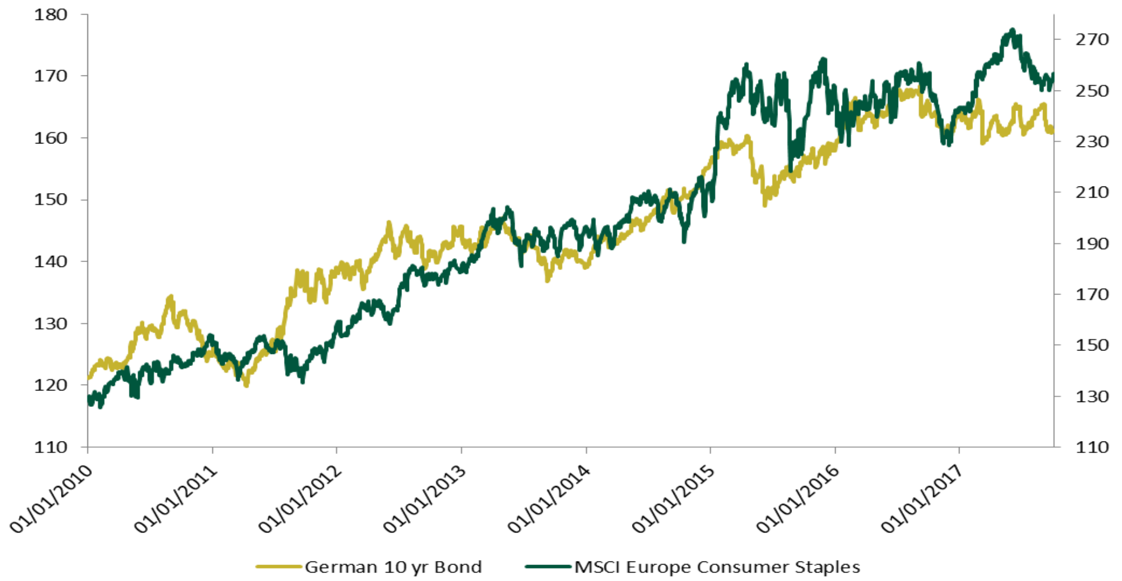
Staples – Balance sheet Leverage rising



Source: RBC Capital Markets.

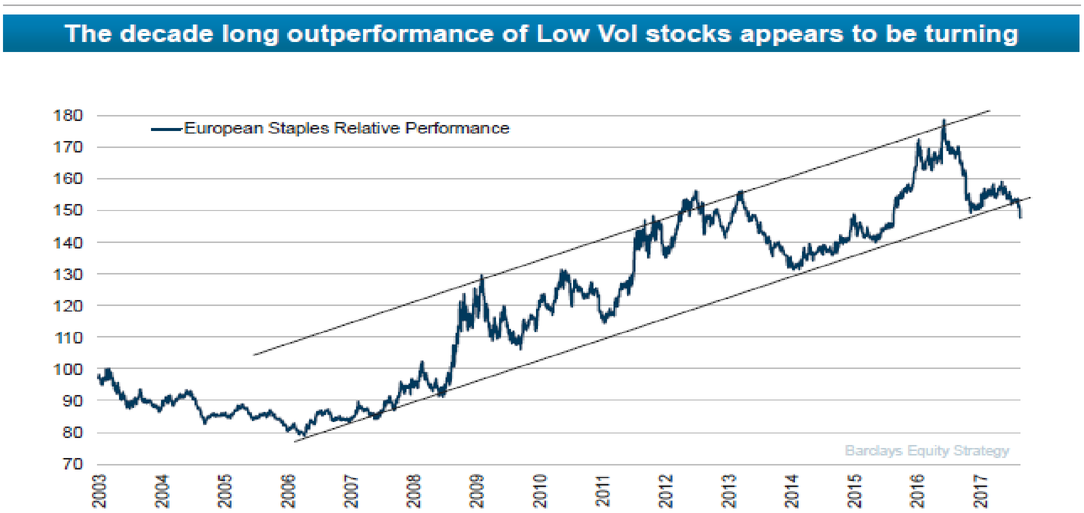
- While the management of these companies would no doubt attribute their status as market darlings to their own skills there is a simpler explanation – they have been priced off the bond market. Staples have had the highest correlation to bond yields of any sector, unless bond yields drop materially, again we would suggest that the impact on staples pricing is waning.

MSCI European Staples Index and German 10yr Yields:



Source: Bloomberg Finance L.P., UBP as of 03/10/2017

The uptrend is Staples is finally Cracking



Source: Barclays Research, Bloomberg Finance L.P.

How are we positioning the funds to take advantage of this view?

- Our cautious view on the Consumer Staples sector is reflected in the current positioning of the portfolio. UBAM - Europe Equity is 400bps under its benchmark weight in the sector.
- However within the sector we hold a number of stocks which we would consider to be either special situations or not pure defensive staples. Cranswick and Marine Harvest are both mid-cap growth stocks, Remy Cointreau is effectively a luxury goods company with high barriers to entry and Jeronimo Martins is a rapidly growing international food retailer. Stripping these positions out, the underweight in “core” staples move up to almost 1000bps, our maximum sector risk constraint.
- More generally, we currently have a strong preference for growth stocks over defensives. This is reflected in a large overweight position in the Luxury Goods sub-sector. These stocks are certainly more cyclical than Staples but exhibit some similar characteristics, most notably, strong brands, a degree of pricing power and significant cash generation. However we believe they are dealing much more effectively with some of the discussed structural trends impacting the broader consumer goods sector.

The European Equity team:

Scott Meech
Fund Manager, European Equities
T. +44 (0)20 7369 1381 | scott.meech@ubp.com

Investment Specialists:

Jean-Luc Eyssautier
Senior Investment Specialist
T. +44 (0)20 7663 1576 | jean-luc.eyssautier@ubp.com

Karim Salame
Junior Investment Specialist
T. +44 (0)20 7663 1573 | karim.salame@ubp.com

Union Bancaire Privée, UBP SA - London Branch
26 St James's Square | London | SW1Y 4JH

Signatory of: PRI Principles for Responsible Investment

Disclaimer
This document is a marketing document and reflects the opinion of Union Bancaire Privée, UBP SA,(thereafter UBP) as of the date of issue. It is not intended for distribution, publication, or use in any jurisdiction where such distribution, publication, or use would be unlawful, nor is it directed to any person or entity to which it would be unlawful to direct such a document. Reasonable efforts have been made to ensure that the content of this document is based on information and data obtained from reliable sources. However, UBP has not verified the information in this document and does not guarantee its accuracy or completeness. UBP accepts no liability whatsoever and makes no representation, warranty or undertaking, express or implied, for any information, projections or any of the opinions contained herein or for any errors, omissions or misstatements. The information contained herein is subject to change without prior notice. UBP gives no undertaking to update this document or to correct any inaccuracies it which may become apparent.
This document may refer to the past performance of investment interests. Past performance is not a guide to current or future results. The value of investment interests can fall as well as rise. Any capital invested may be at risk and you may not get back some or all of your original capital. In addition, any performance data included in this document does not take into account fees and expenses charged on issuance and redemption of securities nor any taxes that may be levied. Changes in exchange rates may cause increases or decreases in your return. All statements other than statements of historical fact in this document are “forward-looking statements”. Forward-looking statements are not guarantees of future performance. The financial projections included in this document do not represent forecasts or budgets, but are purely illustrative examples based on a series of current expectations and assumptions which may not eventuate. The actual performance, results, financial condition and prospects of an investment interest may differ materially from those expressed or implied by the forward-looking statements in this document as the projected or targeted returns are inherently subject to significant economic, market and other uncertainties that may adversely affect performance. UBP disclaims any obligation to update any forward-looking statement, as a result of new information, future events or otherwise.
The tax treatment of any investment depends on your individual circumstances and may be subject to change in the future.
This is a marketing document and is intended for informational and/or marketing purposes only. It should not be construed as advice or any form of recommendation to purchase or sell any security unless otherwise specifically stated. It does not replace a prospectus or any other legal documents that can be obtained free of charge from the registered office of a fund or from UBP. The opinions herein do not take into account individual investors’ circumstances, objectives, or needs. Each investor must make his/her own independent decision regarding any securities or financial instruments mentioned herein and should independently determine the merits or suitability of any investment. Investors are invited to read carefully the risk warnings and the regulations set out in the prospectus or other legal documents and are advised to seek professional advice from their financial, legal and tax advisors.
UBAM - Europe Equity distribution has been authorised in the following countries: AT, BE, CH, CL, DE, DK, ES, FI, FR, GI, IT, LU, NL, NO, PT, SE, SG, TW, UK

Union Bancaire Privée, UBP SA | Asset Management
26 St James's Square | London | SW1Y 4JH | United Kingdom | T +44 20 7369 1350 | ubp@ubp.ch | www.ubp.com