ANALYZE THIS: FOOD FOR THOUGHT

THE FOOD-AND-BEVERAGE SECTOR HAS GENERALLY ADJUSTED WELL DURING THE PANDEMIC, BUT IMPORTANT QUESTIONS REMAIN.

We recently asked Michael Long, a managing director at Pacific Asset Management, sub-advisor to Pacific Funds fixed-income funds, to analyze the food and beverage sector amid the economic rebound.

COVID and the resulting work-from-home trend have transformed the food-and-beverage industry. When the pandemic hit, food-and-beverage consumption made a major shift from restaurants and bars to homes. Consumers flooded grocery stores and stocked their pantries while also increasing their online food-and-beverage purchases. As a result, the performance of the food-and-beverage sector was solid in 2020 and through the first half of 2021, especially for packaged-food companies such as Conagra, Campbell Soup and General Mills that make food for at-home consumption.

On the beverage side, away-from-home demand was negatively impacted by COVID, which impacted companies such as Coke, Keurig Dr Pepper and Anheuser-Busch InBev. But at-home and e-commerce sales showed strength, and companies focused on the premiumization of spirits, beer and wine to increase sales and improve margins. Reduced regulation allowed restaurants in many areas to offer delivery and takeout sales of high-margin alcoholic beverages that are likely to continue long after the pandemic. Quickly rebounding quick-service restaurants (QSRs) drove a solid rebound in soft drink sales.

Some consumer trends that we noticed over the past 12 months include an increased focus on health and wellness and a preference for branded products, specifically big, familiar brands at the expense of private labels. Price was less of a driving factor for consumers increasingly stuck at home and willing to pay for brands they know and grew up with. Health and wellness trends that have been underway for several years not surprisingly accelerated during the COVID period, although many companies struggled to maintain the availability of all of their products amid manufacturing and other disruptions.

With COVID slowly becoming a less disruptive part of consumer lives, companies are forced to pivot once again. We are now seeing a deceleration of at-home consumption as restaurants open and restrictions ease, resulting in increased away-from-home sales and a downturn in grocery-store sales for packaged-food companies.

Stuck in the middle from a performance perspective are the foodservice companies where sales continue to improve compared to 2020 levels, though they remain depressed relative to 2019. Kellogg continues to expect a normalization in its foodservice sales in the coming quarters, but management cautioned that a full return to pre-pandemic levels would take time as travel, lodging, school, sporting-event and convenience channels have been normalizing at various rates throughout 2021. Foodservice distribution companies such as Sysco and US Foods have been beneficiaries of the away-from-home growth.

Food-and-beverage companies have done a good job over the past year generating free cash flow and reducing debt, putting themselves in position to increase shareholder-friendly activities in the form of dividends and increased share buybacks. Management teams will have to weigh the challenging fundamentals with capital-allocation decisions.

Among the biggest likely challenges for food and beverage companies for the rest of the year and into 2022 will be the increasing uncertainty around inflation. Higher input costs, labor inflation, transportation constraints and supply-chain disruption will challenge managers in yet new ways. While we remain positive about the defensive nature and likely steady performance of the sector overall, important questions remain: Will supply-chain shocks be temporary or continue into 2022? Will the Delta variant shift consumption back to at-home in the near term? Can companies stay nimble amid the changes? It's a lot to chew on for a sector that is quite literally the definition of an essential sector.

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As of 9/2/21, Pacific Funds Fixed-Income Funds did not hold any Conagra, Coke, Keurig, Dr. Pepper or Sysco securities. Pacific Funds Short Duration Income had less than a 1% holding in each the following: Campbell Soup, General Mills and US Foods. Pacific Funds Strategic Income had less than a 1% holding in Anheuser-Busch InBev.

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