ATLANTIC
FINANCIAL GROUP

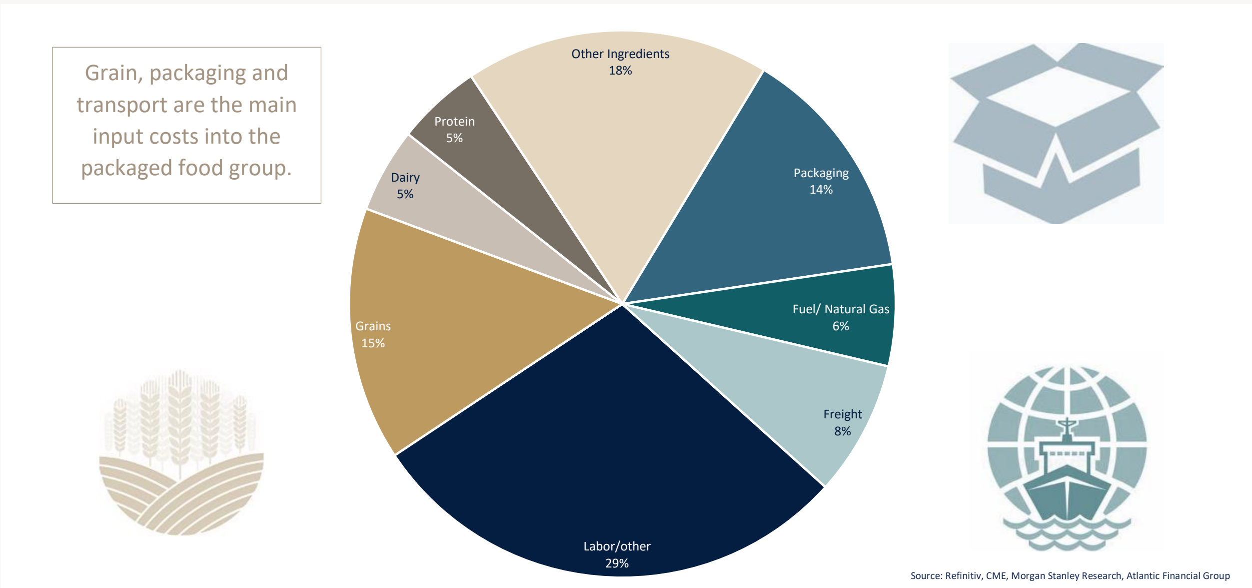
Weekly Investment Focus

27 June 2022

"PREDICTION: CLOUDY WITH A CHANCE OF MEATBALLS".

- Consumer staples companies' margins are under pressure
- Pockets of growth exist despite the prospect of a global recession
- The sector defensive features justify a valuation premium

CHART OF THE WEEK: "Production costs' breakdown of packaged foods"



FINANCIAL MARKET ANALYSIS

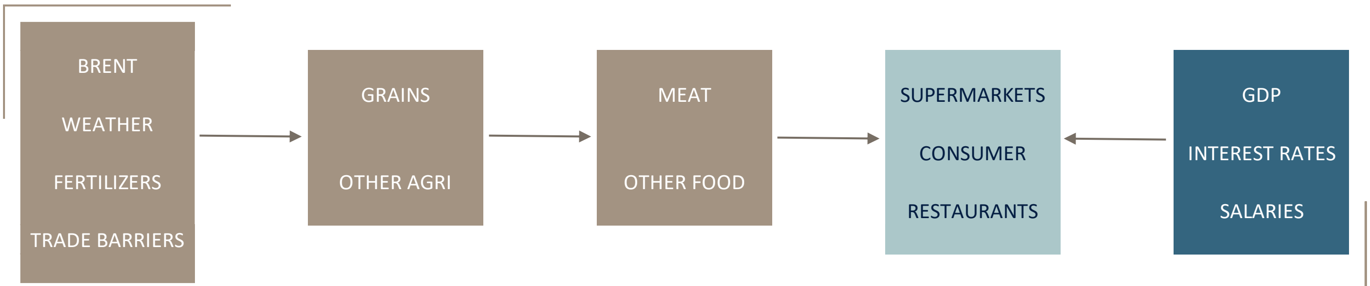
The consumer staples sector has outperformed the overall indices since the beginning of the year. For comparison, it is down -6% while the S&P500 is down -18%. This trend is found in both the US and Europe, **but there are divergences within the sector itself: +1% for the S&P 500 Food, Beverage and Tobacco versus -13% for the S&P 500 Household and Personal Products.** These differences in performance can be explained in part by the ability of companies to pass on higher raw material prices on to consumers.

♦ Consumer packaged goods companies' margins are under pressure

Food prices are influenced by both direct costs (high energy prices lead to high fertiliser prices, both of which lead to high food prices) and indirect costs (geopolitical tensions lead to restrictions on food exports, which drive up global food prices, see Fig. 2). In the US, the latest inflation figures indicate that inflation is historically high for over 70% of goods and services.

Overall, **there is a 6-month time lag between the rise in raw material prices and their impact on the price of finished products, particularly due to hedging policies.** All companies are experiencing increased pressure from input costs. However, **the companies that are suffering the most are those with the greatest exposure to grains, proteins and natural gas,** notably Conagra (CAG), JM Smucker (SJM) and General Mills (GIS). On average, raw materials account for almost 63% of input costs for packaged foods (see chart of the week).

Fig. 2 - The main elements of the food supply chain



Source: Morgan Stanley Research, Atlantic Financial Group

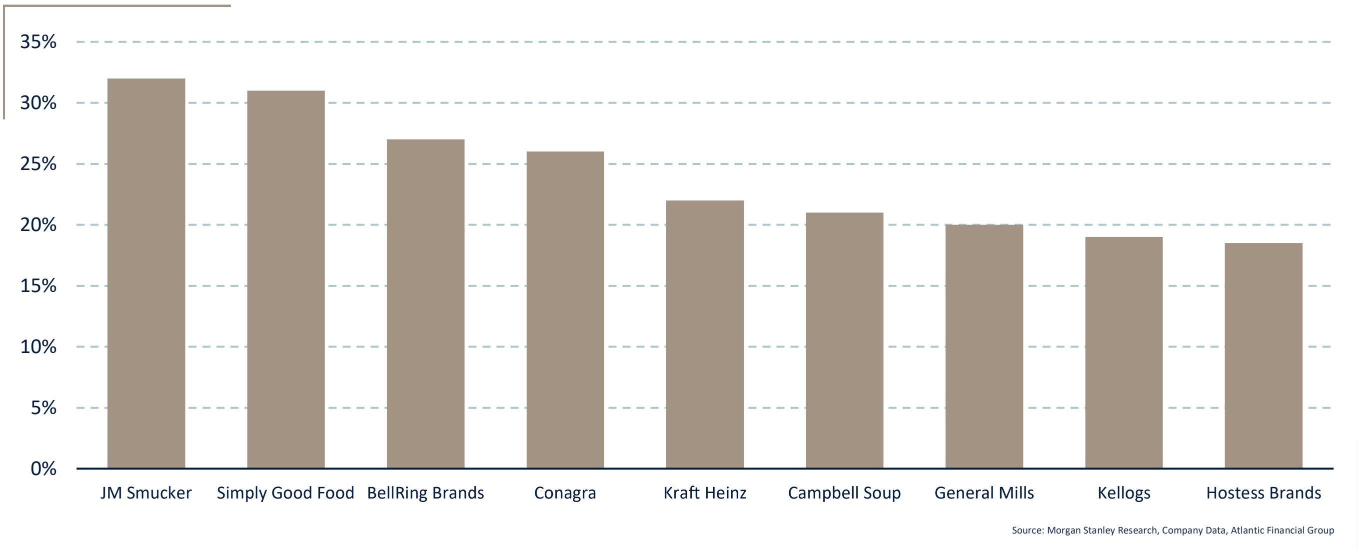
Prior to the Covid pandemic, margins were at historically high levels and could only deteriorate in the face of high production costs at a time when retailers and consumers are themselves facing significant price increases or savings pressures. In the latest quarterly results, Walmart (WMT) and Target (TGT) reported increasing tension with rising inventories. **Inflation is at its highest level of growth in two decades but is expected to normalise during 2023, allowing companies' gross margins to regain some stability.**

The majority of food companies plan to increase prices further in the coming months, on top of the approximately 8% increase set for Q1 2022. This is particularly the case for Mondelez (MDLZ), Kraft Heinz (KHC), JM Smucker (SJM), Campbell Soup (CPB), and Conagra (CAG). There are many ways to reduce cost pressures, including product reformulations or reduced quantity packaging, but above all management must remain ESG friendly and comply with new regulations. If the balance between quality, price and quantity deteriorates in the eyes of **consumers, they will seek to favour cheaper brands, such as discounters or retailers' private labels.**

In the food sector, the penetration rate of private labels was 18.5% in 2021 (24% in volume), higher than in other sectors such as beverages (7%). Branded food products have an average price premium of 45% over private labels. There is therefore a real risk of price fixing. In fact, there has already been a positive turnaround in the last three months for private labels, after two years of consecutive declines.

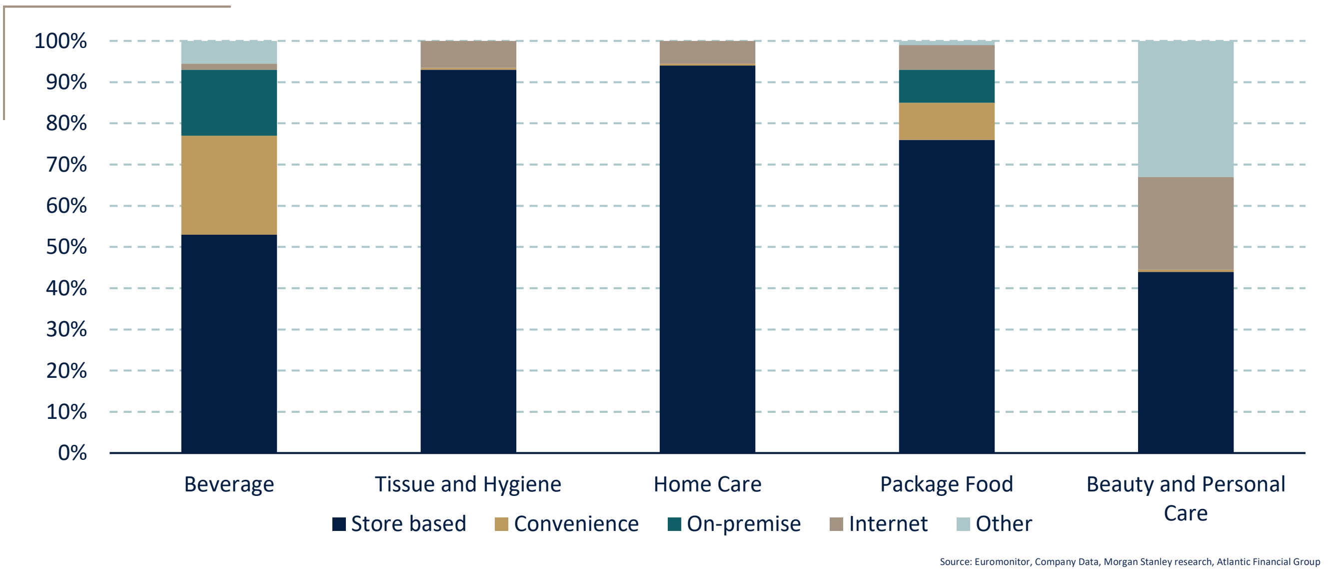
Finally, **some branded products are highly dependent on retailers such as Walmart,** which can sometimes account for more than a third of their sales (see Fig. 3). **This dependence reduces their ability to increase the prices of their products.**

Fig. 3 - Reliance on Walmart for branded food products



The beverage sector has a greater ability to set prices than either the food or the household and personal care (HPC) sectors. It is less affected by the presence of private labels, which further reduces the elasticity of demand. The beverage sector also benefits from a greater diversity of distribution choices (supermarkets, pharmacies, restaurants, internet...) and ultimately sells very little through department stores such as Walmart (see Fig. 4).

Fig. 4 - Distribution channel ventilation



◆ Pockets of growth exist despite the prospect of a global recession

Emerging markets have been a major growth driver for large food companies in recent years. The middle class in these countries is growing, gaining purchasing power and increasingly favours branded products. This was all the more visible during the pandemic when the population turned to brands at the expense of low-end products, most likely out of concern for food safety.

Specific consumer demands, such as organic foods, clean label food ingredients, vegan foods, lactose-free products and others, are opening up new growth opportunities in the packaged food market. The companies that have outperformed their index and the market have anticipated trends and consumer demand. Producers Nestlé and Tata, for example, have established new direct distribution channels, while retailers Walmart and Woolworth have implemented new digital business models (see Fig 5).

Fig. 5 - Successful initiatives that change the ecosystem over time

COMPANY	GEOGRAPHY	2016-2021 EQUITY PERFORMANCE	TRANSFORMATIONAL MOVES
TATA CONSUMER PRODUCTS	INDIA	408%	Created a new business model via joint venture with Starbucks; also has expanded core product portfolio
Walmart	US	136%	Expanded capabilities in omnichannel and online through M&A, while scaling new business including and advertising platform, and healthcare and financial services offering
Nestlé	SWITZERLAND	71%	Expanded D2C capabilities from Nespresso to meal kits and pet food, while renovating portfolio with healthier focus
Woolworths the fresh food people	AUSTRALIA	83%	Doubled down on role of e-commerce and omnichannel platform to extend toughpoints with consumers beyond groceries into mobile and insurance

Source: Innosight Analysis, Atlantic Financial Group

Finally, despite the existence of multinationals with world-renowned brands, **the sector remains highly fragmented and could undergo a new round of consolidation,** offering the leading brands the opportunity to become even more dominant. Smaller brands have struggled through the pandemic. Many have faced delays in new product launches, massive supply chain disruptions and difficulties in supporting online sales. In the US, they have been able to take advantage of the paycheck protection program loans (PPP) and temporary government subsidiaries. However, some of this money needs to be repaid and additional capital will be required to stimulate growth. This could lead to an increasing number of venture capital rounds and M&A deals, a trend already visible in 2021.

◆ The sector defensive features justify a valuation premium

The consumer staples sector is enjoying stable revenue growth due to low demand elasticity. When the first quarter results were announced, most companies were optimistic about sales growth and did not seem concerned about sales volumes.

Free cash flow continues to be strong. Dividend yields are currently between 2.8% and 3% for most US and European companies and are not at risk. Companies in the sector have little debt and could take advantage of this financial flexibility to make low-cost acquisitions.

The sector is currently paying a premium to the market, which is certainly justified in view of the better visibility and stability of results, but multiples could contract further in a pronounced *bear market* phase, especially if margins continue to compress.

Amongst the risks to the sector, **regulation is tightening to push food and drink manufacturers to transform their products to reduce the problems of obesity and diabetes around the world.** The issue of health and wellbeing is therefore also becoming more prominent with increasing consumer demand for healthy products.

On the other hand, **investors have closely followed changes in consumer behaviour during the pandemic** and have refined their investments around several categories, including online grocery, plant-based foods, novel ingredients, agricultural technology and dietary supplements. Companies in these categories are likely to have stronger valuations and could complement the portfolios of multinational companies.

Conclusion:

Consumer staples companies are exposed, like the rest of the economy, to rising commodity prices, transport costs, wages and interest rates. Revenue growth benefits from price increases but margins need to be closely monitored. Multinationals have the financial capacity to cope with the crisis and, even better, contribute to the consolidation of the sector. There is no shortage of external growth opportunities as consumer tastes and preferences change rapidly. New technologies are contributing to the accelerated transformation of the sector and the agility of companies to reinvent themselves is becoming a criterion for success.

RETURN ON FINANCIAL ASSETS

Markets Performances (local currencies)	Last Price	Momentum Indicator (RSI)	1-Week (%)	1-Month (%)	2022 Year-to-Date (%)	2021 (%)	2020 (%)
Equities							
World (MSCI)	612.7	46.65	4.8%	-1.9%	-17.9%	19.0%	16.9%
USA (S&P 500)	3 912	48.66	6.5%	-0.6%	-17.3%	28.7%	18.4%
USA (Dow Jones)	31 501	48.64	5.4%	-1.1%	-12.4%	20.9%	9.7%
USA (Nasdaq)	11 608	50.94	7.5%	3.1%	-25.5%	22.2%	45.0%
Euro Area (DJ EuroStoxx)	391.3	42.16	1.9%	-4.2%	-16.1%	23.5%	0.8%
UK (FTSE 100)	7 209	45.60	2.8%	-3.4%	-0.5%	18.4%	-11.4%
Switzerland (SMI)	10 823	41.85	3.6%	-5.7%	-13.7%	23.7%	4.3%
Japan (Nikkei)	26 887	46.07	2.0%	-1.0%	-7.1%	6.7%	18.3%
Emerging (MSCI)	1 011	43.57	0.8%	-0.2%	-16.9%	-2.3%	18.8%
Brasil (IBOVESPA)	98 672	25.94	-1.2%	-10.8%	-5.9%	-11.9%	2.9%
Russia (MOEX)	2 392	52.75	1.6%	4.9%	-36.0%	21.9%	14.8%
India (SENSEX)	53 266	43.74	2.7%	-2.0%	-8.8%	23.2%	17.2%
China (CSI)	4 446	67.72	2.2%	11.8%	-10.3%	-3.5%	29.9%
Communication Serv. (MSCI Worl	84.22	52.35	6.0%	2.4%	-23.2%	10.9%	24.2%
Consumer Discret. (MSCI World)	302.2	52.26	6.7%	6.7%	-25.9%	9.2%	37.0%
Consumer Staples (MSCI World)	262.6	53.75	5.6%	-0.3%	-8.8%	11.7%	8.8%
Energy (MSCI World)	211.0	32.99	-1.2%	-12.3%	14.4%	37.5%	-27.7%
Financials (MSCI World)	126.9	42.63	3.2%	-4.6%	-14.2%	25.1%	-3.1%
Health Care (MSCI World)	330.0	56.21	7.6%	-1.4%	-9.8%	18.0%	15.4%
Industrials (MSCI World)	262.3	40.91	2.7%	-4.2%	-20.1%	16.6%	11.8%
Info. Tech. (MSCI World)	421.5	49.04	6.3%	0.0%	-26.2%	27.6%	46.2%
Materials (MSCI World)	303.2	32.35	-0.8%	-10.1%	-15.3%	15.4%	21.6%
Real Estate (MSCI World)	191.8	48.03	6.0%	-3.4%	-17.1%	23.6%	-5.7%
Utilities (MSCI World)	150.4	43.23	4.8%	-6.9%	-6.1%	11.1%	4.8%
Bonds (FTSE)							
USA (7-10 Yr)	3.16%	48.44	0.8%	-2.4%	-11.1%	-2.4%	9.3%
Euro Area (7-10 Yr)	2.13%	48.16	1.9%	-3.5%	-12.9%	-2.9%	4.5%
Germany (7-10 Yr)	1.44%	44.94	1.7%	-3.8%	-11.7%	-2.7%	3.0%
UK (7-10 Yr)	2.30%	49.19	1.7%	-3.0%	-8.7%	-4.9%	5.4%
Switzerland (7-10 Yr)	1.28%	41.83	1.4%	-4.5%	-10.9%	-2.3%	0.4%
Japan (5-10 Yr)	0.24%	51.84	0.2%	-0.3%	-1.3%	0.0%	-0.1%
Emerging (5-10 Yr)	7.67%	31.98	0.4%	-5.2%	-19.0%	-2.3%	5.2%
USA (IG Corp.)	4.73%	42.13	0.3%	-3.4%	-14.6%	-1.0%	9.9%
Euro Area (IG Corp.)	3.16%	37.14	1.4%	-3.7%	-11.6%	-1.0%	2.8%
Emerging (IG Corp.)	7.56%	25.48	-0.3%	-3.2%	-15.8%	-3.0%	8.1%
USA (HY Corp.)	8.42%	35.30	0.6%	-5.0%	-12.6%	5.3%	7.1%
Euro Area (HY Corp.)	7.29%	13.92	-0.3%	-4.8%	-12.7%	3.4%	2.3%
Emerging (HY Corp.)	11.01%	22.00	-0.4%	-6.1%	-16.3%	-3.2%	4.3%
World (Convertibles)	357.7	44.16	2.8%	-1.3%	-18.4%	2.4%	38.8%
USA (Convertibles)	477.6	46.43	3.9%	0.1%	-19.5%	3.1%	54.5%
Euro Area (Convertibles)	3 386	21.20	-0.9%	-5.4%	-17.5%	-0.3%	6.1%
Switzerland (Convertibles)	172.5	38.17	0.7%	-2.8%	-7.2%	-0.5%	0.5%
Japan (Convertibles)	194.5	40.69	0.1%	-0.7%	-3.1%	3.3%	2.8%
Hedge Funds (Crédit Suisse)							
Hedge Funds Indus.	745.03	69.01	n.a.	-0.6%	n.a.	8.2%	6.4%
Distressed	965.81	66.60	n.a.	-1.3%	n.a.	12.5%	3.8%
Event Driven	788.05	58.87	n.a.	-1.3%	n.a.	12.9%	7.0%
Fixed Income	387.63	57.86	n.a.	0.3%	n.a.	5.2%	3.6%
Global Macro	1443.12	83.38	n.a.	1.6%	n.a.	9.6%	6.5%
Long/Short	879.97	53.30	n.a.	-0.5%	n.a.	8.3%	7.9%
CTA's	400.78	78.94	n.a.	-0.1%	n.a.	8.2%	1.9%
Market Neutral	287.22	61.57	n.a.	1.2%	n.a.	6.2%	1.7%
Multi-Strategy	727.66	62.20	n.a.	-3.9%	n.a.	7.0%	5.6%
Volatility							
VIX	27.23	46.42	-12.5%	-7.5%	58.1%	-24.3%	65.1%
VSTOXX	27.77	48.74	-10.1%	-2.9%	44.1%	-17.6%	67.5%
Commodities							
Commodities (CRB)	598.9	n.a.	-3.0%	-5.1%	3.6%	30.3%	10.5%
Gold (Troy Ounce)	1 835	47.13	-0.2%	-1.0%	0.3%	-3.6%	25.1%
Oil (WTI, Barrel)	109.47	43.98	-0.1%	-2.3%	42.2%	58.7%	-20.5%
Oil (Brent, Barrel)	114.63	44.71	-3.0%	-0.4%	46.5%	51.4%	-23.0%
Currencies (vs USD)							
USD (Dollar Index)	104.01	53.56	-0.7%	2.3%	8.7%	6.4%	-6.7%
EUR	1.0560	48.27	0.5%	-1.6%	-7.1%	-7.5%	9.7%
JPY	134.92	39.55	0.1%	-5.8%	-14.7%	-10.2%	5.1%
GBP	1.2274	44.36	0.2%	-2.8%	-9.3%	-1.0%	3.1%
AUD	0.6930	42.20	-0.3%	-3.2%	-4.6%	-5.6%	9.6%
CAD	1.2886	46.74	0.7%	-1.3%	-1.9%	0.7%	2.1%
CHF	0.9581	59.67	1.0%	-0.1%	-4.7%	-3.0%	9.4%
CNY	6.6877	48.92	0.1%	0.2%	-5.0%	2.7%	6.7%
MXN	19.853	55.36	2.1%	-1.4%	3.4%	-3.0%	-5.0%
EM (Emerging Index)	1 670.9	36.16	-0.1%	-1.1%	-3.7%	0.9%	3.3%

Source: Bloomberg, Atlantic Financial Group

Total Return by asset class (Negative \ Positive Performance)

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