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VIEWPOINT

Ready for a Reboot? A Case of Consumer Déjà Vu

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With television studios redeveloping former hits like *Will & Grace* and *The X-Files*, you could be forgiven for experiencing a case of déjà vu. For investors, these shows aren't the only thing that's reminiscent of the 1990s. After several years of steady growth and multiple expansion, the consumer staples sector is being re-rated by frustrated investors after a slew of unimpressive earnings. Valuation compression in the sector hasn't been this extreme since 1999. While many assume this is a case of secular headwinds, history suggests it is reflective of shifting risk preferences – and a signal that cyclical pressure may be due for a reboot as well.

1990s as Analogue

The current operating environment for consumer staples resembles that of the late 1990s, and reflects three cyclical conditions: 1. Recovery-fueled growth, 2. Topline pressure from vendor consolidation, and 3. Late-cycle margin compression from cost inflation. This process mirrors what former Gillette CEO and industry icon James Kilts termed the "Circle of Doom" in the early 2000s.

- **Growth:** Despite having already reached maturity, the staples category experienced a growth heyday in the early 1990s. Volumes generally grew in line to slightly above global GDP (2%-4%), and the retail landscape was still regional in nature. Supermarkets had not yet consolidated, discounters such as Wal-Mart had yet to fully wade into the consumer products realm, and the club stores were still in the growth stage. Consumer staples conglomerates wielded nationwide scale, providing significant power in pricing negotiations.
- **Deceleration:** Organic sales growth for the sector slowed from 7% in 1993 to 3% in 1999. Both price and volume headwinds were evident, as supermarkets consolidated and big box concepts began to eclipse regional retailers. This new channel spurred supply chain rationalization, eventually becoming the industry pricing leader. The sheer length of the expansion was an issue too, as innovation could not keep pace with a consumer leaning toward premium categories.

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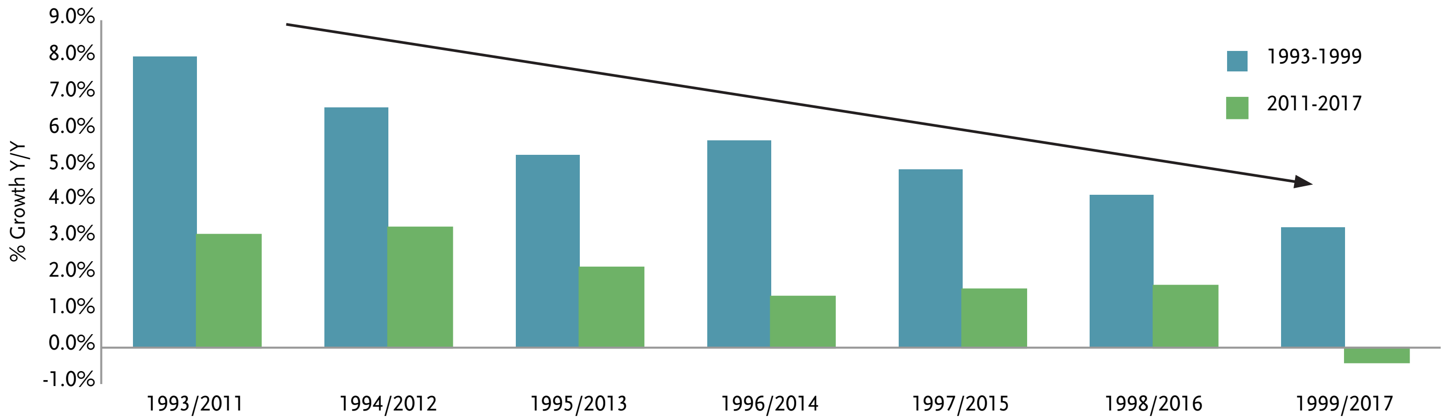
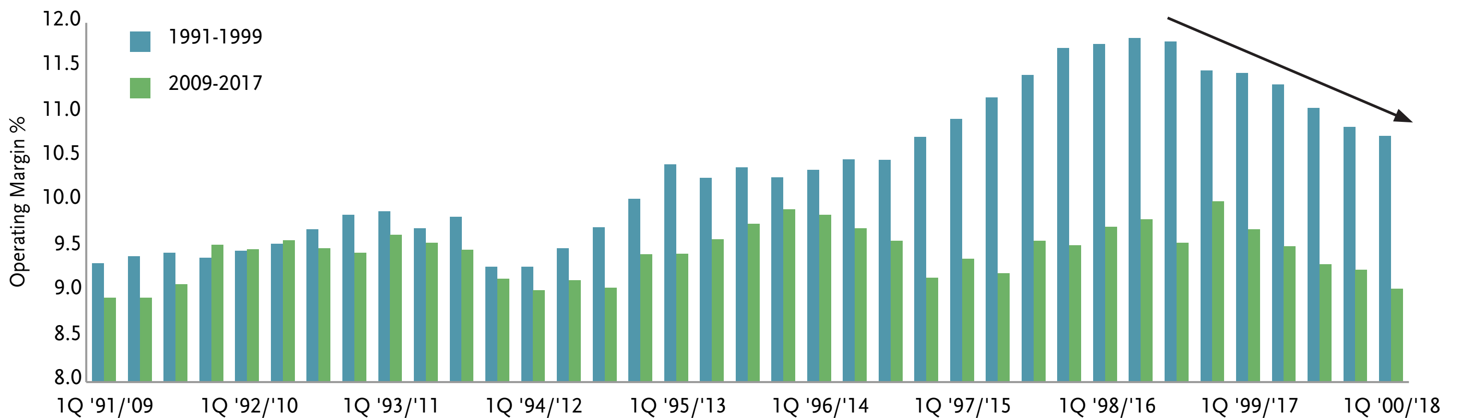


Source: Company Filings

While the rise of e-commerce in this cycle presents an entirely new distribution channel, the shift echoes the earlier era. Initially, staples companies viewed e-commerce as more of a novelty, but underestimated the consumer penchant for an online buying experience. This has led to pressure on volumes and price, as retailers have streamlined supply chains and increased reliance on private label. Financially rehabilitated, consumers are trading up to premium products from familiar stalwarts in a typical late cycle pattern.

- **Margin Pressure:** Topline struggles in recent years are not the only corollary to the late 1990s. Rising input costs from consolidation in the packaging space and an uptick in freight expense were margin headwinds in the late 1990s. If this sounds familiar, it's because nearly every consumer staples company blamed higher input costs and elevated freight rates for gross margin compression in 1Q18.



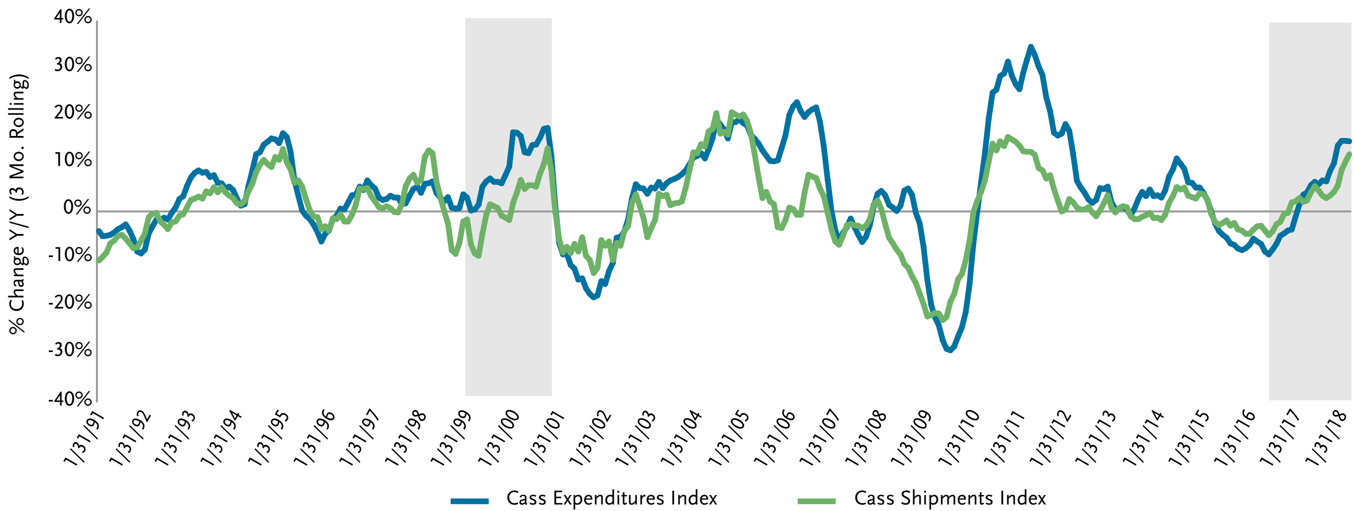
Source: Bloomberg

The rising cost of freight looks poised to remain a headwind. This is primarily due to tightness in the trucking market, driven by a shortage of drivers and regulatory changes. The industry was short 248,000 drivers at the end of 2017 according to data from transportation consultant FTR, due to in part to low unemployment and competition from other industries (energy, construction, etc.). Exacerbating this shortage is the new Electronic Logging Device Rule that took effect in 2017, which prevents drivers from exceeding federal limits on hours.

Based on FTR's 1Q18 commentary, freight costs are trending 10% to 15% higher for the year. Food manufacturer Treehouse noted that freight costs increased by 12% in March, and that freight carrier acceptance – that is, the proportion of loads taken on by transport partners – has declined by 25%. General Mills also stated that roughly 20% of shipping has occurred on a spot basis, above the 5% historical average. Historically, consumer staples have been able to pass through costs with a lag averaging two to three quarters, but given the structural changes afoot in retail, it is currently difficult to do so.

Tight conditions in the freight market matches up well with the trend of the late 1990s. The Cass Freight Indices have accelerated dramatically, and this coincides with rising inflation. CPI remains in the 2% area, near the same levels observed in 1999.

Cass Freight Indices Accelerating Again

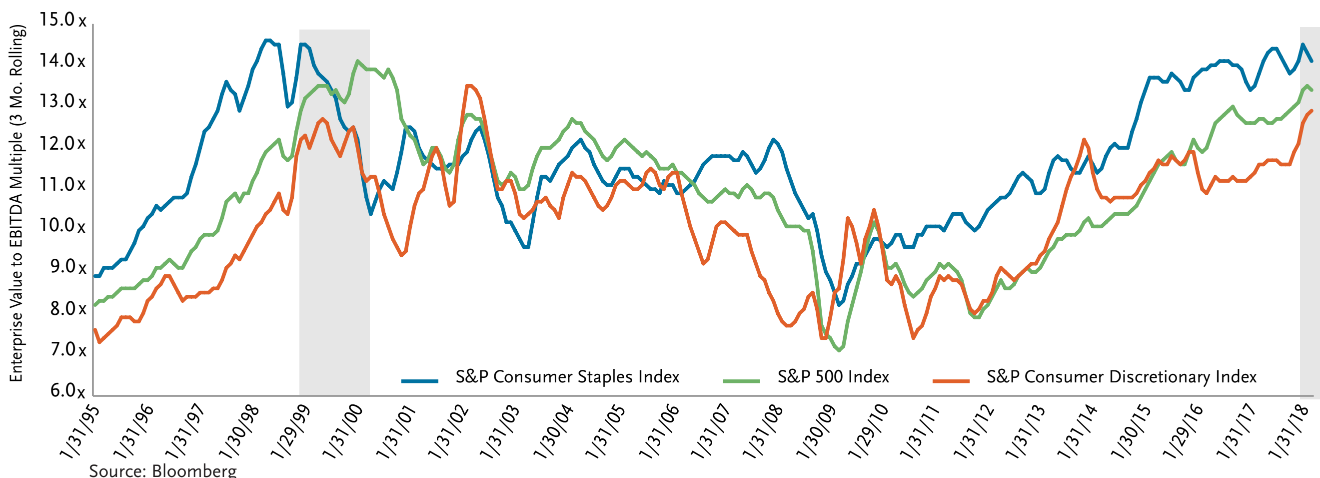


Source: Bloomberg

Valuation as Prologue?

The resemblance of current operational results to those of the late 1990s is notable, and the deterioration in investor sentiment is similar as well. Valuation multiples for the consumer staples sector have exhibited significant compression in recent weeks. The trailing EV/EBITDA multiple for the S&P Consumer Staples index has fallen from 14.9x at the end of January to 13.1x now, the largest multiple (1.8x) and percentage declines (11%) since 2009. This decline is twice that of the S&P 500, and four times that of the S&P Consumer Discretionary index – a degree of underperformance that hasn't been seen since 1999. The fundamental similarities between then and now – along with ebullience in technology – provide evidence that consumer staples may be signaling the conclusion of this cycle.

As in 1999, Multiple Compression is Being Led by Staples



Source: Bloomberg

Hollywood studios will continue rebooting hits from the 1990s in the near future, with beloved films like *The Lion King* and *Aladdin* expected to induce déjà vu for parents everywhere. We get that same eerie familiarity when looking at the recent declines in consumer staples, and would submit that it is another example of late cycle behavior. Fortunately, the companies in this sector boast resilient models that will outperform in downturns, even as the "safe" growth companies of today reach unanticipated breaking points. Sector underperformance in 1999 proved to be an opportunity for the cycle-aware value investor, and we expect recent weakness to provide a similar opportunity. ■

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