



Consumer Staples Sector

(XLP)

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Overview

The consumer staples sector was created to group together all the industries that consumers rely on for everyday necessities, regardless of the state of the economy or their personal financial situation. Stocks in this sector often provide good stability in a portfolio and allow for solid growth over a long period of time.

There are six industries that fall into this category. The first is Food and Staples Retailing which includes the sub-industries drug retail, food distributors, food retail, and hypermarkets and super centers. Companies that fall under the title of retailers or distributors are Walmart (WMT), Wholefoods (WFM) and Safeway (SWY). Then, there is Household Products which does not have sub-industries but includes companies such as Proctor and Gamble (PG) and Clorox (CLX). The Beverage industry includes a wide array of sub-industries; brewers, soft drinks, distillers and vintners. Coors (TAP) and Coca Cola (KO) are both companies in this industry. Food Products is an industry that includes both agriculture products and packaged foods placing companies like General Mills (GIS) and Tootsie roll (TR) here. Tobacco is also an industry that is listed as a consumer staple. Large companies in this industry include Reynolds (RAI) who own camel cigarettes, and Altria Group (MO). The final industry in this sector is Personal Products, also having no sub-industries, which includes Revlon (REV), Avon (AVP) and other beauty product companies. Overall, this sector is fairly evenly divided between five of the six industries, the exception being personal products which makes up only 2.1% of the sector, each of the others make up roughly 16-25% (Select 2014). This means no single industry has a substantial influence on the sector as a whole.

Industry Environment

These six industries are all very highly competitive. Being staple products the issue is not if the product is wanted or needed, it is if the consumer will choose your company's product over the competition. Since there are many options for these types of products creating a sustainable competitive advantage is difficult. Companies fight to become the low cost leader or to differentiate their product enough that consumers are willing to pay a premium. Brand recognition plays a large role in these industries which is why many companies in this sector have large marketing and branding budgets (Consumers 2013).

Sensitivity

This sector is designed to include the industries that people rely on in everyday use. This creates a sector that has very low price elasticity of demand, is non-cyclical, has low volatility, and an overall low correlation to the market. The sensitivity based on macro-economic factors is relatively low for most of these industries. There are, however, a few exceptions. It has been found that sales in the tobacco industry and alcoholic beverages sub-industries tend to increase during times of economic downturn (Aued 2009). Overall, it is safe to say the sector is insensitive to the market.

It is more accurate to assess these industry's sensitivity to consumer preferences and popular trends. Emerging trends must be identified early on for companies to differentiate their products in this very competitive environment. The number one predicted trend forecast is local, healthier foods (Zacks). Another popular trend is being environmentally friendly, so many companies in this sector are working to create more sustainable products and packaging.

Legal Expenses

Legal expenses are generally not a large focus in this sector. However, there are times when companies get involved in legislation if they feel it will threaten one of their products. Recently, energy drink companies have been fighting the purposed ban of sales to children under the age of 16. There are grocery stores in Europe who have already put this into effect on their own as a company policy and there are many states within the U.S. that are fighting to make this law (Bouckley). Another current example happened on Washington State's last ballot when GMO labeling was put to a vote. Coca Cola, General Mills, and Hershey very discretely paid large amounts of money to stop this initiative from passing, and they won (Leschin-Hoar). While it is uncommon for companies in this sector to have large legal fees against them they occasionally choose to provide funds to fight legislation on their company's behalf.

Research and Development

When it comes to the Consumer Staples sector new, industry changing developments are few and far between. Most of the progress is simply adding to already stable lines of products or tweaking the main brands. An example of a major company that is quite good at altering their original products is Hershey Co. In recent years they took one of their most popular products, Reese's, and shrunk them with Reese's Minis. After receiving a positive response they proceeded to do this process for many of their core candies to meet their consumers' needs of wanting to "eat fewer at a time and save more for later," (Zacks). Beverage companies have also become quite good at introducing new products alongside their already established ones. PepsiCo and Coca-Cola have been expanding their options by introducing non-carbonated drinks that are more calorie-conscious to account for the declining demand for carbonated beverages (Zacks). Both of these examples prove research and development is rooted in adjusting to consumer desires and popular trends.

One of the larger innovations in this sector that is picking up steam comes from the tobacco industry, in the form of electronic cigarettes. Lorillard Inc. has been leading the way for this new innovation. Electronic cigarettes have known to be promoted as "healthier" than the traditional cigarette. Using this as their main marketing focus the tobacco industry has begun to be seen in a more positive way to the public, leading to new customers and an increasing sales momentum. Many other tobacco companies are following suit and investing in this new innovation. Electronic cigarettes have already become 1% of the industry's overall sales- an astonishing feat considering how new this product is to the market (Zacks).

Research and development is not a driving force in the Consumer Staples Sector, averaging to be only 2% of these companies' expenditures. In comparison, an average of 8-10% is spent on advertising alone (Consumer Staples). With a main focus on adjusting previously existing

products there is little emphasis on research and development therefore it will not generally have a drastic effect on these companies' earnings.

Macro Drivers

As industries producing staple products what are generally seen as macro drivers hold little effects in this sector. Generally, these industries as a whole see little change from interest rates, unemployment, or consumer spending (Cannivet, Teufel). The strongest driver of the consumer staples sector is consumer preferences. Everyone consumes staples in some form, so when it comes to deciding which company to purchase from, it all comes down to personal preference. This creates strong competition between companies producing the same products. Differentiation between products and consumers is what allows them to co-exist within the same area. For example, college students are far more likely to choose budget or discounted groceries while older generations with a larger budget choose to purchase higher quality (nutrition based) food items. These differences in preferences allow competing companies such as Whole Foods and Safeway to differentiate their products for different groups of people.

As mentioned in the sensitivity section, healthy food options and 'green' products are currently very popular. In the past few years companies have begun to embrace these trends. Many have been and are continuing to introduce new, healthier products. For example, Starbucks began offering juice based drinks and added fresh salads to their menu (Zacks). They continue to serve the products seen as 'unhealthy' to some but have now expanded their customer base to those who have made these trends a life style.

Another driver that can affect industries in this sector is currency fluctuations. Many of the companies in consumer staples make a significant percentage of their overall profits from overseas sales. In some situations, because of these fluctuations, it is beneficial for U.S. companies when other country's currencies are stronger than the dollar, but this can lead to weaker domestic sales overall (Lee). For multinational companies the sales eventually balance out. History shows that currencies rise and fall in a cyclical fashion, so it is less likely fluctuations will hold a strong, long-term impact although, in the short term profit margins and other indicators can be greatly influenced when one form of currency is dominating the others.

Current Environment and Outlook

The Consumer Staples sector seems to be at its best when the economy is in its late cycle and about to head into any kind of recession. The sector begins to pick up steam around the transition from a bullish market to a bearish market, when the outlook ahead does not seem as promising. During these periods investors become defensive and aim towards non-sensitive industries. This is why the sector outperformed the S&P 500 in early 2013 but then fell under once the market proved that it was doing well, and has been under ever since. When investors are looking ahead this sector does not always have the steady increase it is known for. Recently, many investors have been testing the waters with the companies that supply to the staples sector, instead of the companies in the sector itself. A good example of this can be found looking forward into 2014 for the European food producing companies where there is expected to be very little growth in

earnings, if any at all. While this may be, European food ingredients companies are expected to see an average of 6% earnings growth in 2014 (Lee).

Tobacco and alcohol products are expected to have ample opportunities to do well in the coming months of 2014. The companies within these industries have pricing power because their products can project a social status image or can satisfy emotional needs that some customers may have to particular products (Lee).

The progression of emerging markets, which have greater sensitivity than developed countries' markets, is also predicted to impact how the sector will perform in the coming months. Developed nations have, roughly, an annual income of \$50,000 or more. In these countries items such as toiletries, beverages, and household products are seen as necessities because they are affordable. However, in countries such as Brazil, where the annual household income is less than \$10,000, these items are seen as discretionary purchases (Lee). As emerging markets continue to grow it is likely some of these products will become seen as necessities as they are in many developed nations.

Price Charts

Three Month (Exhibit 2): In this price chart one can see the recent, relatively large, dip in early February. This is likely attributed to the release of consumer sentiment about the market. The premature expectation was that the general consumer for all income brackets would have a positive outlook on the market's future. However, this report showed that households with an income of under 75 thousand had decreased confidence in the economy (Peralta 2014). Whenever expectations are not met it is common to see a decrease in the market.

Six Month (Exhibit 3): This chart shows a dip in October. This decrease could be related to slow job growth and raising interest rates. Surprisingly impacted the consumer staples sector slightly more than the S&P 500 which may have been related to the difficult operating conditions in Europe and Asia during this time (Zack).

One-Year (Exhibit 4): The 1-year price chart does not deviate too much from what we have seen in the 1-month and 6-month, except for back towards the beginning of the comparison in early 2013. That early 2013 time period until June is a time where the consumer staples sector outperformed the S&P 500. The reason for this could be that the market as a whole was not predicted to do very well in 2013, it is likely many investors decided to go with safer, more reliable stocks in consumer staples. Where it begins to drop below the S&P 500 as a whole is when analysts began to realize that 2013 would be a better year than initially predicted and the other sectors began to take off, leaving staples behind.

Five-Year (Exhibit 5): The 5-year price chart really reiterates just how stable and steady the consumer staples sector is. It may not outperform the other sectors or the S&P 500 in terms of growth, but there is more certainty that it will not take as drastic of losses. This sector may not be for investors looking to make large gains in a short amount of time as it is more known for its slow and steady growth.

Valuation

Valuation between two companies that SPDR puts in the same sub-industry can be considerably difficult because different valuating sources classify sub-industries in different ways. The price ratio analysis shown in Exhibit 1 gives sub-industries in bold followed by a company specific analysis. A few things stand out in these calculations. First, is the large difference between the P/CF and P/FCF for both Walgreens and Costco. This difference can normally be attributed to large capital expenditure, which is not common in the Consumer Staples sector. Costco currently has the highest capital expenditure growth in the retail industry right now which is potentially a sign they are confidently restructuring (Costco). Second, is the large difference between the P/E ratio for Reynolds American Inc. (RAI) in comparison to the tobacco industry. Although this cannot be used as a valuing factor on its own, generally a high P/E ratio shows that investors are expecting a higher growth in earnings in the future (Schmidt).

Betas and Correlation

The consumer staples sector has historically had a beta and correlation to the S&P 500 well below 1. As seen in Exhibit 1, only one of the four stocks, and none of the industries, has a beta over 1. Assets that have low correlations are important tools used to diversify a portfolio. There are times certain assets that are usually deemed to have low correlation actually have higher than expected and take dramatic drops, while consumer staple stocks are known for its stability. This makes stocks in the consumer staples sector a very easy and relatively safe way to diversify. This simply adds to the already established idea that business in consumer staples may not be the most exciting and flashy, or show drastic swings, but it is a smart choice for those more defensive minded looking to diversify into a market that is relatively easy to understand (Schmidt).

Exhibit 1: Price Ratio Analysis

	P/E	P/S	P/B	P/Tangible Book	P/CF	P/FCF	Beta
Beverages -Brewers	14.62	8.32	1.34	2.19	1.32	16.2	0.69
TAP	17.94	2.4	1.17	n/a	11.34	15.8	0.84
Retail Discount	24.03	1.05	4.40	10.07	15.92	49.81	0.83
COST	25.01	0.48	4.55	4.55	16.82	71.5	0.59
Retail-Drug	16.96	0.37	1.86	3.10	6.69	2.75	0.55
WAG	22.73	0.84	3.07	3.79	15.07	40.63	1.31
Tobacco	8.72	1.79	1.70	9.64	7.27	28.14	0.67
RAI	15.46	3.14	5.02		14.21		0.50

Exhibit 2: Three Month Price Chart

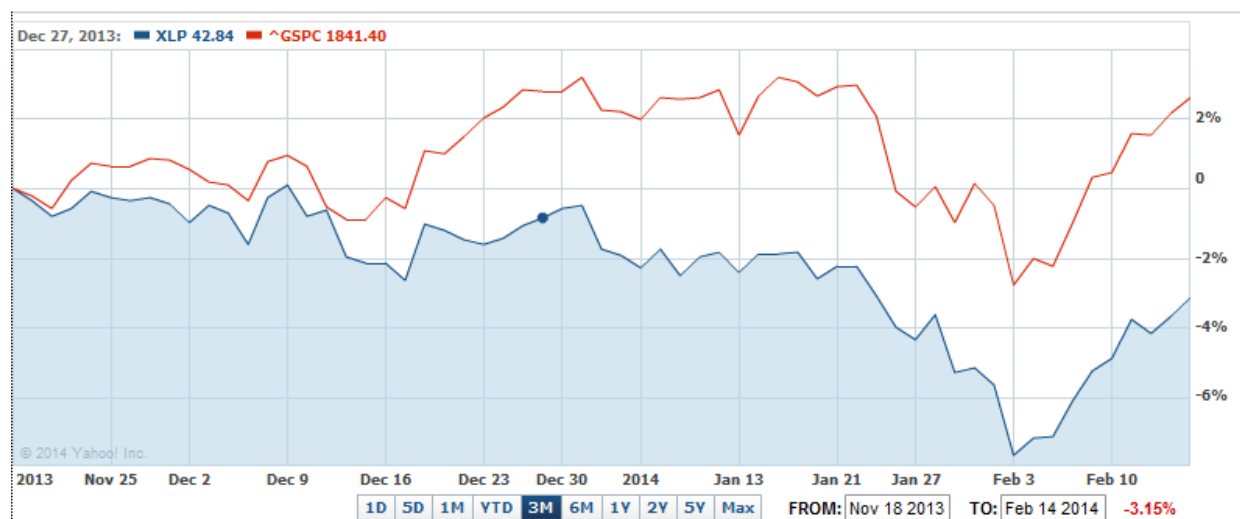


Exhibit 3: Six Month Price Chart

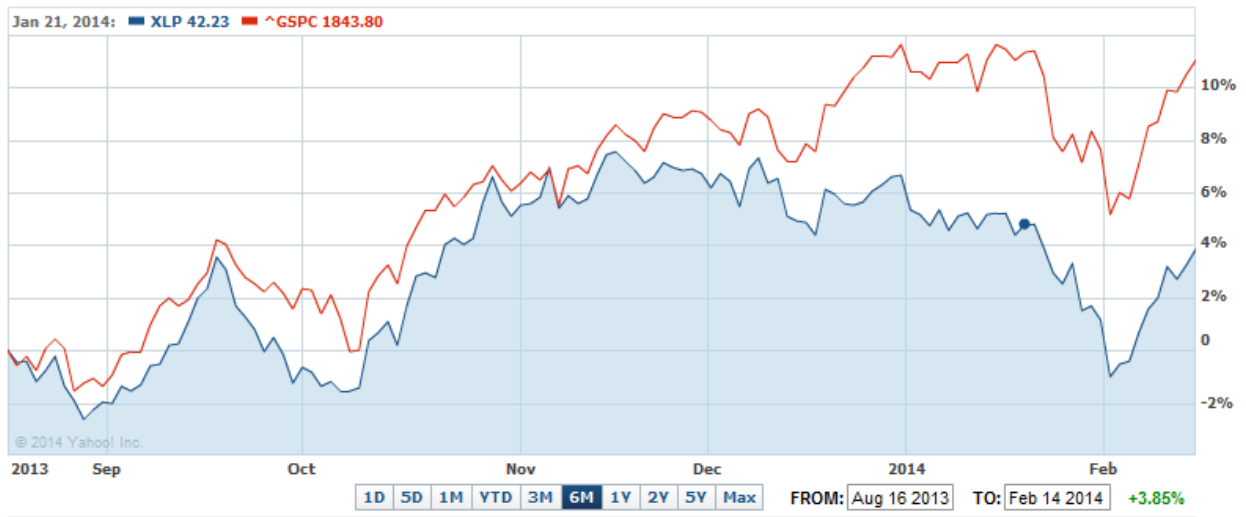


Exhibit 4: One Year Price Chart

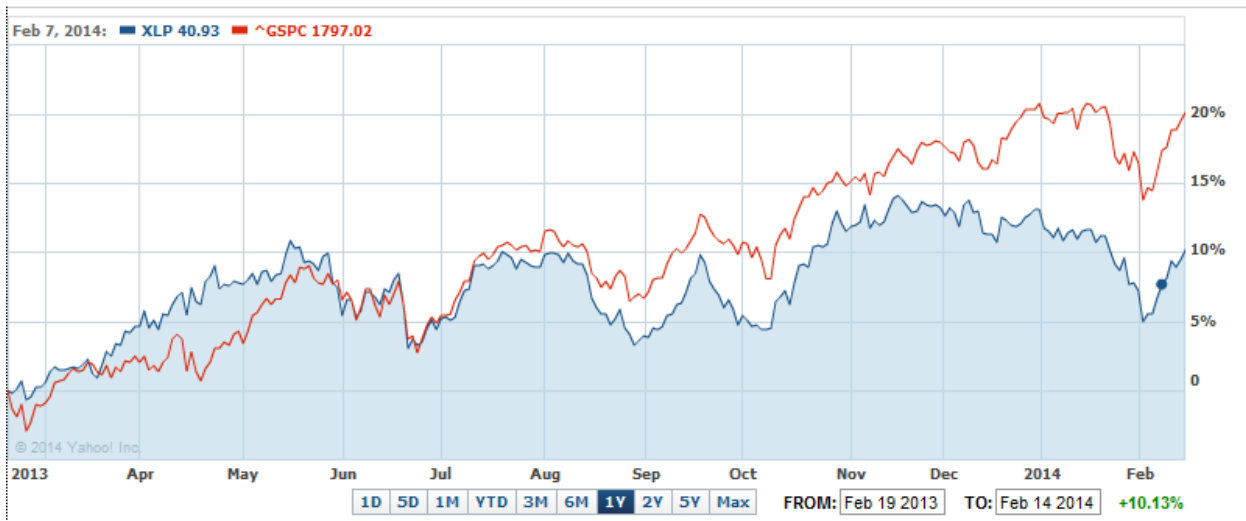


Exhibit 5: Five Year Price Chart



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