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INVESTMENT NOTE **27 JANUARY 2015**

Hermes: Beware of 'bond proxy' consumer stocks in 2015

By Tim Crockford, Portfolio Manager, Hermes Sourcecap

In a world of weak aggregate demand, price competition is going to become an increasingly important weapon in winning sales growth. We already started to see this in the latter part of last year, with a broadening range of European companies mentioning a weak pricing environment.

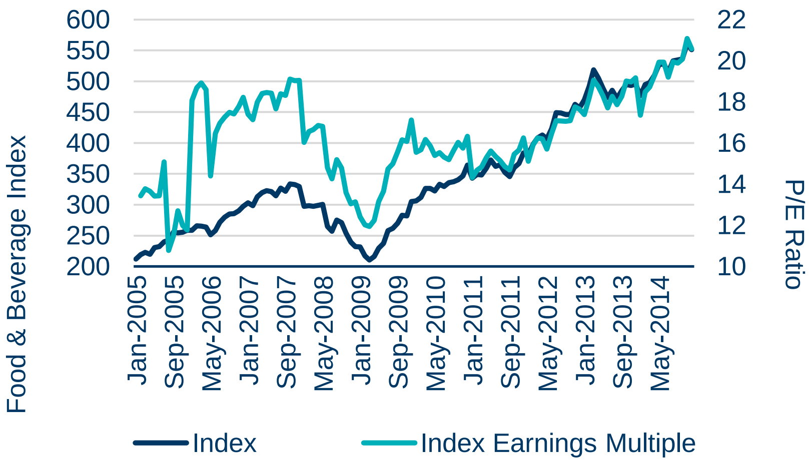
There are few sectors where the effects of price deflation have been more pronounced than in the food retail sector, as lower commodity prices and fierce competitive environments have combined to pile on the pain. A good example can be seen in the actions by UK supermarket chains, which recently released plans detailing their latest round of 'pricing investment'.

While these companies have no doubt tried to pass some of the pain to smaller suppliers, the mega cap consumer staples companies have yet to be affected in a major way. However, we increasingly question to what extent the share prices can continue to perform as the food retailers these companies supply come under increasing pressure.

Unilever, for example, has recorded pricing growth in every single financial year since 2011. Pricing at the group level has been positive for eleven consecutive quarters. Pricing gains generated nearly 50% of organic growth between 2007 and 2013, driving its substantial re-rating from a low double digit P/E to about 20x. However, this trend has broken down in Unilever's weaker markets, with prices realised in Europe falling for each of the last five consecutive quarters. With Chinese demand growth slowing, we wonder whether the Asian giant will be next to join this trend.
Similarly, Nestle enjoyed a pricing CAGR of 2.4% over 22 years to the end of 2013, with price generating about 40% of total organic growth during this period. In fact, the company last saw a group level price decline in the third quarter of 2013. However, pricing growth has been slowing recently, with gains of 3.6% in 2011 reducing to 1.5% in 2013. Again, Europe has been weak, with negative pricing in each of the last eight quarters.

Furthermore, one of the tricks food-producing companies have been using to hide inflation is the old game of reducing the amount of product sold in each package, while keeping the same price. However, there is a natural limit to how far this tactic can be pushed. We suspect even the most inattentive shopper is likely to catch on.

Food & Beverage earnings multiples



Source: Bloomberg

Liked by many investors for ‘bond proxy’ qualities – stable growth and a reasonable dividend yield – we worry these safe-haven stocks could present shareholders with nasty surprises during 2015. If commodity price falls and global macro weakness continue to take a toll on headline inflation numbers, these companies can no longer use price rises in stronger economies to mitigate slowing volume growth. This may start to make the twenty-something P/E multiples unjustifiably hefty.

With margins at near record highs, there is plenty of scope for the successful companies to sacrifice a bit of margin to gain higher volume growth, but this will prove a challenge for the majority of consumer-facing businesses. Against such a challenging backdrop, the strategy will be to focus on those companies able to deliver reliable and consistent growth in cash-profits.

The challenge will be determining which companies can handle the more competitive environment we find ourselves in, where lower prices will be more widely used to gain market share. This should favour strong businesses with healthy balance sheets, high margins and strong free cash flow generation.

Overall, we are quite optimistic on the outlook for European equities. In this triple-zero economy we have in the eurozone – near zero rates, zero inflation and zero growth – growth is a scarce asset and companies able to deliver it should command a much higher premium. We prefer structural growth plays and those companies taking destiny into their own hands through restructuring. With the eurozone now on the right side of the QE policy arbitrage as the ECB expands its balance sheet by €1.2trn over the next few years, Europe could finally fulfil its potential and provide some surprises of the positive variety.

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