Strategist's Corner
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The Evolution of the Consumer Staples Sector

Author

Robert M. Almeida, Jr.
Portfolio Manager and
Global Investment Strategist

In brief

- Profit visibility in the staples sector was clearer before the introduction of mobile devices.
- Technology has disrupted the sector, leveling the competitive playing field.
- Separating the winners from the losers requires deep research and an appreciation for nuance.

The era of clear visibility…

Technology and mobile devices have obviously had a tremendous impact on our lives. But tech's impact has arguably been most acute in retailing, forcing many brick and mortar stores to adapt or fail. Less obvious is the impact tech has had on consumer staples.

For decades, consumer staples enjoyed relatively stable customer demand and a comparatively low risk of product obsolescence. Since we all need to eat and drink, staples displayed lower volume and profit cyclicality compared with many other industries. At the same time, for decades, big, well-known staples brands dominated shelf space, customer wallet share and ultimately industry profit pools. There was little need for innovation as new competition was low relative to other sectors. All this created an economic moat that generally translated to an earnings cycle that was steadier, longer and with greater visibility than for other businesses.

But that was before technology changed things.

Before e-commerce, establishing a brand was difficult. It required time and a significant advertising budget. Well-established players could sustain brand power thanks to their deep pockets, leading to high customer mind- and wallet-share. In addition, their balance sheet muscle gave them firepower to crowd out potential shelf-space threats in stores. As a result, scale begot scale. In totality, owning an established brand in a consumable good with steady demand — regardless of any economic ups and downs and coupled with the ability to spend on advertising and promotion — drove high cash flow durability for a lot of these businesses, which attracted investors over many years.

… has given way to tech-driven disruption

However, the landscape changed when social media went mainstream back in the late 2000s. Technology often exposes inefficiencies and cost frictions in society, and it tends to be deflationary because it opens the door to change by increasing consumer choice. The staples industry was not immune to this.

Entrepreneurs with a good idea but without the firepower to advertise or buy shelf space could now compete thanks to social media and e-commerce. While brands remained powerful, customer mindshare was no longer impenetrable. Social media opened the door to a greater connection between consumers and brands, particularly around consumers' purpose or values. In some cases, product authenticity, rather than mass marketing or advertising has become the economic moat.

Staples have become another example of digital becoming the great democratizer. The consumer has become more informed on price and quality and has more choices, and barriers to entry have been lowered. However, with change comes challenges and opportunities.

Advantaged and disadvantaged staples

It's difficult to generalize about which staples categories are advantaged or disadvantaged since context is required, but it's an area where fundamental research should drive value. For example, while food is nondiscretionary and beverage is discretionary, each category faces private-label risk as new entrants seek to compete on price, quality or both. Consequently, our analysts spend a lot of time differentiating between companies' category exposures, and we prefer companies leveraged to categories that are growing faster than the economy because their customers are willing to pay a premium to buy products that align with their values and meet their needs. This is particularly prevalent in categories such as beauty and spirits. We also prefer companies with categories exposed to greater- than-per-capita volume growth through "occasion growth" or whose products are used in response to particular needs or desires. Additionally, we like companies that sell products such as toothpaste and diapers that benefit from rising middle class usage in developing countries. While these companies may face private-label risk, we see trust in the brand is a differentiator because getting a customer to switch brands when there is an unknown impact to health can be a high hurdle for a new entrant to clear.

Conclusion

Like all sectors and industries, staples stocks derive their value from profits. While the demand for staples is evergreen, what people buy and what they're willing to pay has changed. It's now critical for investors to understand industry nuances and how they apply on a company-by-company basis as those idiosyncrasies have become larger factors driving the range of potential profit outcomes and ultimately stock and bond prices. Accordingly, we view security selection within the sector as more important than ever.

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