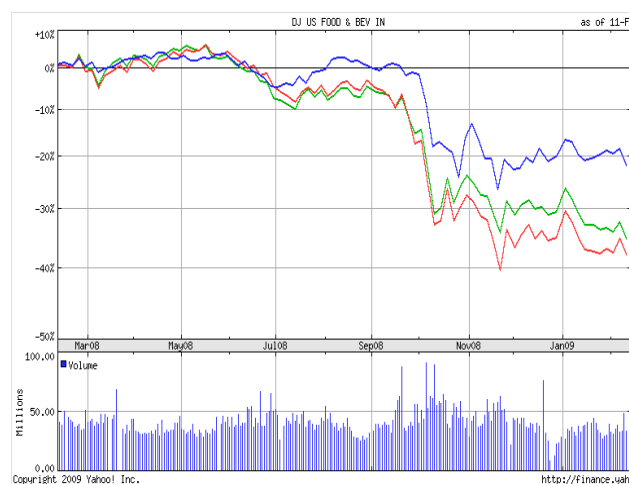




## Consumer Staples (Food & Beverage)

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### Dow Jones US Food and Beverage Index (DJUSFB)

Index Value	226.07
52-Week Range	207-298
1-Yr % Change	↓ 59.11 (-20.73%)

### Major Players by Market Cap (B)

Coca-Cola Co (KO)	95
PepsiCo Inc (PEP)	79
Kraft Foods Inc (KFT)	37
General Mills Inc (GIS)	19
Archer Daniels Midland Co (ADM)	18
Kellogg Co (K)	16
HJ Heinz Co (HNZ)	11
Campbell Soup Co (CPB)	11
ConAgra Food Co (CAG)	7
Sara Lee Corp (SLE)	6
Coca Cola Enterprise Inc (CCE)	6
Bunge Ltd (BG)	6
JM Smucker Co (SJM)	5

### INVESTMENT THESIS

- ▶ The consumer staple industry and the food and beverage sector usually outperform the market in a recessionary environment. The sensitivity of the industry to performance of the economy is low.
- ▶ The food and beverage sector was recession resistant in 2008 and the trend will continue. When the S&P 500 declined 40%, the Dow Jones US Food and Beverage Index (DJUSFB) witnessed half the decline, with only 20.73% fall. If the F&B companies are removed from the S&P 500 list, the fall in the S&P 500 will be much higher, magnifying the gap between S&P 500 and DJUSFB.
- ▶ Packaged food companies will benefit as consumers will start eating more at home. The high unemployment rate will also contribute to controlled spending. Per USDA figures, food sales at grocery stores totaled \$500B in '08, up by more than 6% over '07. The trend will continue in 2009.
- ▶ Weaker overseas economic conditions present a challenge for the F&B sector. However, in the long run, the demand from developing nations will increase because of westernization and changing eating habits, a growing middle class and increased disposable income, and an increased demand for nutritional packaged food.
- ▶ Strengthening the US dollar is another challenge for the companies with international exposure in the industry as a stronger dollar means reduced revenues from foreign operations.
- ▶ Volatility in commodity prices is another problem. The USDA's 'Index for Crop Prices Received' moved from 158 points in Jan. '08 to 183 points in June '08 to 157 points in Jan. '09. While the companies hedge against volatility, reduction in commodity prices has been a problem because of long-term commodity contracts. However, because of the inelastic nature of staples' demand, companies manage to pass the increased costs to customers.
- ▶ In the short run, consumers will shift from premium products to less expensive generic and in-store brands. The long-term trends, however, will be a continued demand for healthier food and beverages, both domestically and internationally.

**EXECUTIVE SUMMARY**

The current recession in the US economy has led to a 37% decline in the S&P 500 in 2008. However, the consumer staples sector is one of the few sectors that have outperformed the market.

The major sub-sector of consumer staples is food and beverage. The Dow Jones US Food and Beverage Index (DJUSFB) has also outshined the S&P 500. The F&B sector declined only 20% against 40% of the S&P 500. Because of its recession resistance, the sector offers promising investment opportunities in comparison to other sectors in the economy.

The food and beverage industry is extremely concentrated which is evident by the fact three large carbonated drinks manufacturers enjoy 89% of the market share. In contrast to many other sectors, the leading national companies in F&B have strong brand recognition. These companies manage to garner manufacturing efficiencies and economies of scale by focusing on large national and international brands.

In particular, the packaged food and beverage sector will provide good investment opportunities because of change in consumer preferences. In the current recession market and increasing unemployment, consumers will shift their food consumption from eating at relatively expensive restaurants to eating at home, thereby increasing demand for processed food.

At the national level, the entry barriers in the food and beverage industry are very high. The capital expenditure for production coupled with high marketing and distribution costs can be prohibitive for new entrants.

In the near future, the demand for expensive healthy and nutritional food products will be hit, which will offer higher growth opportunities for less expensive and generic brands.

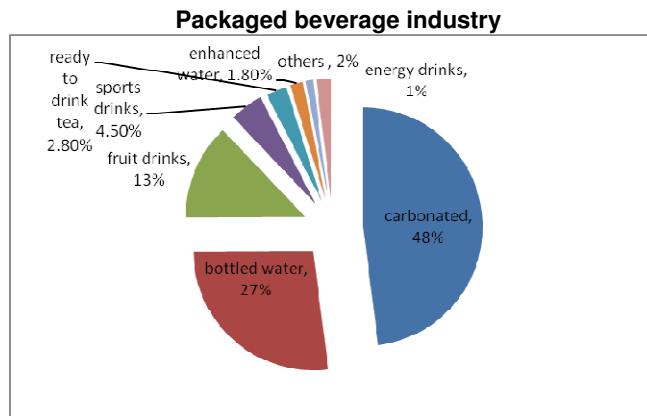
**INDUSTRY DESCRIPTION**

The food and beverage industry comprises diverse products: farm products, processed and packaged goods, meat products, dairy products, confectioneries, soft drinks, and beverages from breweries, wineries, and distilleries. However, we have considered only packaged and processed food and soft drink beverages for this analysis.

The food and beverage industry in the US is highly concentrated, with a small number of companies enjoying a large market share. The beverage industry is

especially concentrated. In the carbonated drinks category, the three largest beverage manufacturers—Coca-Cola, PepsiCo, and Dr Pepper Snapple—own the brands that enjoy as much as 89% of the total market share.

The US non-alcoholic packaged beverage market comprises of few key components. The largest sections are carbonated drinks (48%), bottled water (27%), fruit drinks (13%), sports drinks (4.5%), ready-to-drink teas (2.8%), enhanced water (1.8%), and energy drinks (1%).



Source: Standard and Poor's industry report

**RECENT DEVELOPMENTS**

The food and beverage industry has been witnessing changes in consumer demand patterns that are shifting from simple food products that satisfy physiological needs to products that have additional values, including high vitamin content, organic food, supplementary proteins, and energy food.

Top 10 publicly held food & beverage companies (ranked on the basis on billion dollar of sales)			
Company	2007	2006	% change
PepsiCo	39	35	12.3
Kraft Foods	37	34	8.4
Coca-Cola	29	24	19.8
Tyson Foods	27	27	(0.1)
Coca-Cola enterprise	20	20	5.7
General Mills	14	12	9.7
Pepsi Bottling	14	13	6.8
Sara Lee	13	12	7.6
Dean foods	12	10	17.1
Kellogg	12	11	8.0

Source: finance.Yahoo.com

Therefore, most food and beverages companies are increasing their focus on healthy food products through developing new product lines or acquiring popular healthy brands.

Also, an increasingly fast-paced life is motivating consumers to demand faster food alternatives. In the

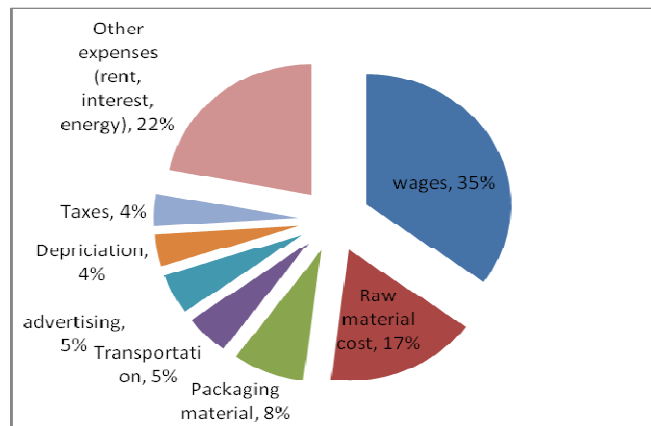


beverage industry, this has made the demand for energy drinks and non-carbonated drinks higher.

A few large players dominate the packaged food industry. The entry barriers in the sector are steep, with high costs of setting up plants, and high distribution and marketing costs that will discourage many new entrants in the sector.

The convenience of eating-on-the-go, double income families, longer travel times, and increasingly busier schedules has led to long-term trends of increased dollar spending on food consumption outside of the home. According to the US Department of Agriculture, in 1960, US consumers spent 76% of their food dollars on at-home food consumption. The number declined to 53% in 2006. The increase in 2007 and 2008 can be attributed to a weaker economy and higher food prices.

Packaged food companies' financial performances are less affected by sharp increases in raw material. This is because of the insensitivity of consumer demand to price; producers can pass on the increased prices—primarily from packaging, distribution, and marketing—to the end consumer. The pie chart below showcases the cost structure at a typical packaged food company.



Source: Standard and Poor's industry report

Between 2006 and 2008, commodity prices for corn, wheat, and dairy products—all major ingredients in the industry—jumped, placing additional pressure on packaged food companies. The factors that led to higher prices during this period included growing foreign demand of packaged food due to changing lifestyles and increased income, erratic global weather, higher demand for grain (corn) for ethanol production, higher energy prices increasing transportation costs, and weakness in the US dollar.

Selected Index Numbers for Prices Received and Paid, 1990-92=100, by Month, United States, 2008 and 2009<sup>1</sup>

Month	Index of Prices Received						Index of Prices Paid			
	All Farm Products		All Crops		Livestock and Products		All Items		Production Items	
	2008	2009	2008	2009	2008	2009	2008	2009	2008	2009
Jan	144	137	158	157	129	115	169	175	170	178
Feb	146		164		131		171		173	
Mar	146		167		129		174		177	
Apr	146		169		127		179		185	
May	152		173		134		183		190	
Jun	158		183		137		187		195	
Jul	159		182		138		190		200	
Aug	156		177		137		190		200	
Sep	154		174		133		189		198	
Oct	150		167		127		184		192	
Nov	141		156		124		179		185	
Dec	135		149		119		175		179	

<sup>1</sup> Revised historical price indexes for months not shown are available at [www.nass.usda.gov](http://www.nass.usda.gov).

Source: usda.gov

While these prices declined in the second half of 2008, the commodity market's volatility has escalated problems for packaged food companies. These companies can hedge against volatility in an elevating price scenario; however, when the situation reverses, the hedging activity can lock in food companies to a higher price for raw material.

Commodity prices stabilized towards the end of 2008 and in the beginning of 2009, which will relieve some pressure and help improve profitability in the coming period.

In general, because of food costing more in stores, as well as reductions in consumer spending because of economic weakness, the packaged food industry will witness two strong changes: an increase in at-home food consumption, increasing demand for packaged food at the cost of restaurant revenue; and consumers moving towards the less expensive private labels.

**Non-alcoholic beverages**

A US decline in the sales of traditional carbonated drinks has prompted both Coca-Cola and PepsiCo to introduce new non-carbonated drinks, ready-to-drink-teas, energy drinks, and enhanced water. However, diet soda continues to strengthen market share in the cola category. Leading brands from Coca-Cola like Coke Zero, Sprite Zero, Vanilla Zero, and Cherry Coke Zero have seen increased demand and sales in 2008.

At Pepsi, while traditional Pepsi and Mountain Dew continue to be the strongest brands, the company is extensively promoting Diet Mountain Dew and Pepsi Max—a recently launched diet formulation with caffeine and ginseng.

Beverage companies are trying to pack more benefits, like vitamins, into their products. In 2008, Pepsi launched Tava—a zero-calorie cola that contains vitamins. At the same time, Red Bull joined the cola



industry by launching Red Bull Cola, which has higher caffeine content than Pepsi or Coke.

While the cola sales have been declining in the United States, most cola consumption growth is coming from overseas markets. In 2008, foreign sales increased by 3% for Coca-Cola and by 11% for Pepsi. Both companies will push their existing carbonated brands for higher sales in overseas markets.

In the juice category, beverage companies are highlighting premium ingredients. Companies have launched juice products with more value adds like added fiber and plant sterols.

Sports and energy drinks continued to gain popularity in 2008. The growth of this sector can be attributed to increasing health consciousness and fast-paced lifestyles. Consumers are replacing their cola and coffee consumption with more caffeinated energy drinks. Smaller players like Hansen Natural (makers of Monster), Red Bull, and Rockstar dominate the energy drinks sector.

### **Bottled water**

Bottled water contributes 27% of the total US beverage consumption. The sector has seen two interesting trends in 2008. One is the decline in the sales for bottled water. This is largely because in the financial crisis, consumers are going back to tap water, and also because of increasing awareness about environmental hazards of plastic bottles. Secondly, because there is little or no differentiation among the products offered, consumers are buying less expensive generic brands.

Overall, we will witness a number of new beverage introductions in 2009, including the zero-calorie compound Rebiana. Coca-Cola will launch its brand Truvia, and Pepsi will launch Purevia.

### **International business**

The packaged food industry in the US generates more than two-thirds of its revenue from domestic sales. Packaged food is therefore less dependent than beverage companies on foreign markets. This protects it from volatility in international business.

On the other hand, beverage companies like Coca-Cola and PepsiCo get a major portion of their revenue from overseas operations. Both companies see reduction in profitability whenever the dollar gets stronger and foreign demand fluctuates.

However, both the packaged food and beverage sectors are increasing their promotion of global sales

because the domestic market is maturing and becoming saturated. The future growth potential of packaged food and beverages will come from developing nations because of the westernization of eating habits, changing sociological settings, an increasing middle class, and rising incomes.

### **MARKETS AND COMPETITION**

The food and beverage industry is very concentrated, with few companies having a major market share. In the packaged food industry, the largest players in terms of market capitalization are PepsiCo, Kraft Foods, General Mills, Archer Daniels Midland Co, Kellogg Co., HJ Heinz Co., and Campbell Soup Co. In the beverage industry, the largest players are Coca-Cola, PepsiCo, and Dr Pepper.

The food industry can be classified into two sub-categories: Agribusiness and processed foods. The agribusiness companies concentrate on early stages of food production and engage in activities like harvesting, milling, and processing raw material commodities. Large agribusiness companies include Archer Daniels, Bunge Ltd, Corn Production Ltd., and the world's largest privately owned Cargill Inc. these companies process and merchandize raw grains and supply end products like oils, syrups, meals, and corn syrups to processed and packaged food and beverage companies.

The other category is food manufacturers or food packagers, and includes Kellogg Co, PepsiCo, HJ Heinz Co, General Mills, Kraft Foods, and Campbell Soup. These companies sell finished goods to retailers who then sell these goods to end consumers.

Most players in the food and beverage industry are very large global players, with big cash flows and deep pockets. They also have established brand names and developed product categories. Entry into the sector is largely prohibitive because a new entrant will not only need a large production system, but will also need an extensive distribution network and sales and marketing capabilities.

These large companies also have strong buying capabilities; therefore they manage to buy raw material at cheaper prices as well as lock these prices against volatility. A new entrant or a smaller player does not enjoy such capabilities and therefore cannot compete with the established players.

The main distribution channels for retail sales are supermarkets, mass merchandisers, vending machines, convenience stores, and other outlets including groceries and drug stores.



With the kind of food that the average US consumer purchases to eat at home, the importance of traditional grocery stores has declined recently. The non-traditional stores like supermarkets and warehouse clubs have grown both in numbers and in total share of the consumer food and beverage spending.

Acquisitions: acquisition of other businesses has been the most reliable process for growth in the food and beverage industry over the last 3 decades. With an objective to grow fast, the F&B companies acquired several unrelated businesses in the 70s and 80s. However, they have restricted their acquisition spree in the last 2 decades to related area of business. Most of the recent acquisitions have been in a similar line of business that complemented the acquirer's existing business line. The latest acquisition was privately-held Mars Inc. acquiring WM Wrigley in Oct '08.

Major recent acquisitions			
Acquirer	Target	Value (BI \$)	Date
Mars Inc	Wrigley	22.00	Oct'08
PepsiCo	JSC Lebedyansky	1.40	Oct'08
Ralcorp	Kraft Foods' post	1.65	Aug'08
	cereal business		
Osprale	ConAgra Foods'	2.10	Jun'07
	commodity trading		
Kraft	Danone biscuit	7.70	Nov'07
Foods	business		
Nestle	Gerber	7.70	Aug'07
Coca-Cola	Energy Brands (Glaceau)	4.10	Jun'07
Pilgrim's			
Pride	Gold Kist Inc	1.10	Jan'07
Kraft	United Biscuits		
Foods	(Spain)	1.07	Sep'06

Source: Standard and Poor's industry report

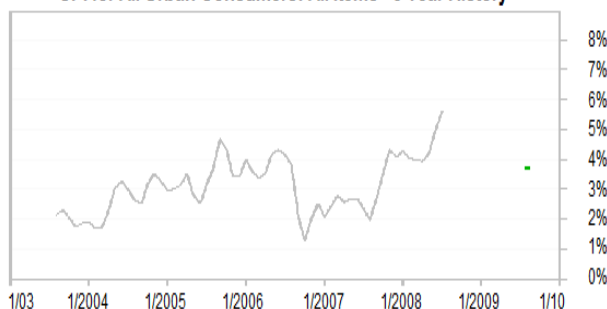
**ECONOMIC OUTLOOK**

While the current economic condition is not promising for the entire industry, consumer staples, in general, and food and beverage, specifically, is expected to be hurt the least because of the economic meltdown. Traditionally, the sector has been recession-resistant. This is because even in the economic slowdown, consumers will not stop eating food. In fact, consumers may sacrifice other products, including basic and luxury products, but food and beverage is usually the last sector hurt.

However, while food and beverage is recession resistant, it is not recession proof. If the recession hits the economy too hard and inflation becomes very high,

even the food and beverage industry will get hurt badly. One positive, though, is that in recession the consumers will move their food and beverage habits to less expensive and generic brands. Most of these generic brands are owned by large retailers who outsource the manufacturing to traditional food and beverage manufacturers. Thus, while food-manufacturing companies may witness lower sales of their own brand, they will tend to recover some part of their lost revenue through increased revenue from generic brand companies.

CPI for All Urban Consumers: All Items - 5 Year History



Source: inflationdata.com

In addition to problems faced due to difficult economic conditions, inflation in the economy has further increased problems for consumers. As per data by the US Department of Labor, in the year 2008, retail food prices increased by 5.8%. The producer price index for the food-finished goods declined by 150bps, whereas the producer price index for the entire economy was up by 20 bps. The producer prices in the food & beverage industry is expected to decline in 2009, which will provide growth opportunities to the sector.

**Producer Price Index**

Table A. Monthly and annual percent changes in selected stage-of-processing price indexes, seasonally adjusted

Month	Finished goods					Intermediate goods	Crude goods
	Total	Foods	Energy	Except foods and energy	Change in finished goods from 12 months ago (unadj.)		
<b>2007</b>							
Dec.....	-0.5	1.3	-3.5	0.1	6.2	0.2	1.8
<b>2008</b>							
Jan.....	1.2	1.7	2.2	0.6	7.4	1.2	2.9
Feb.....	0.3	-0.6	1.0	0.4	6.5	0.9	3.9
Mar.....	0.9	1.4	2.5	0.1	6.7	2.4	6.7
Apr.....	0.3	0.0	-0.1	0.5	6.4	1.0	4.7
May.....	1.4	0.6	5.3	0.2	7.3	2.7	6.1
June.....	1.7	1.5	5.6	0.2	9.1	2.2	2.8
July.....	1.2	0.3	3.4	0.6	9.9	2.7	4.0
Aug. <sup>1</sup> .....	-0.9	0.3	-4.8	0.5	9.7	-1.5	-12.3
Sept. <sup>1</sup> .....	-0.4	0.2	-3.0	0.4	8.7	-0.9	-6.0
Oct.....	-2.8	-0.2	-12.8	0.4	5.2	-3.9	-18.6
Nov.....	-2.2	0.0	-11.2	0.1	0.4	-4.3	-12.5
Dec.....	-1.9	-1.5	-9.3	0.2	-0.9	-4.2	-5.3

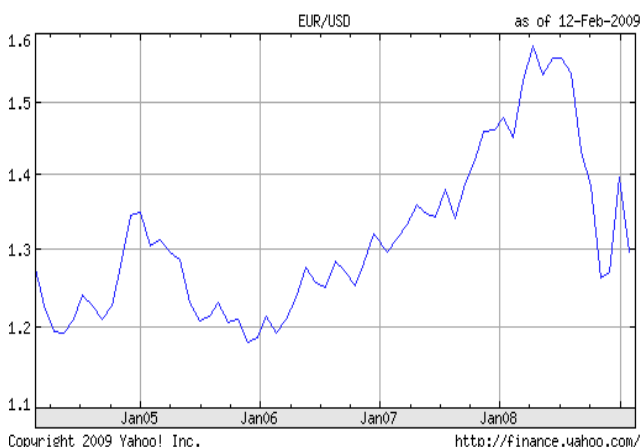
Source: United States Department of Agriculture data

Another positive aspect for the food and beverage industry is reduced commodity prices. The All Crops Index of Prices Received by the US Department of Commerce showcased earlier that commodity prices were extremely volatile in 2008, ranging from 158



points in Jan. '08 to 183 points in June '08 and then declining to 157 points in Jan. '09. Volatility, especially when the prices are falling, can be a problem for large manufacturers, who lock in purchase price ahead of time. However, in the long run, reducing prices of crops that are the main raw materials for the food and beverage industry will further boost profitability. At the same time, if there is substantial increase in commodity prices, profitability in the industry will suffer.

Another problem for all industries that have heavy international business, and for the food and beverage industry specifically, is strengthening of the dollar. Most of the large food and beverage companies have a significant international presence. Improvement in the dollar in relation to other global currencies means lower in-dollar revenues from international operations. As indicated in the following chart, from a peak of 1.6 dollars to one euro in Feb. '08, the current prices are 1.31 euros to a dollar. Yen to dollar rates are no exception and have moved from 110 yen/dollar in Jan. '08 to 88 yen/dollar in Jan. '09.



## CATALYSTS FOR GROWTH

The food and beverage industry is likely to outpace the growth of many industries in the coming year. The major catalysts for domestic growth include higher

demand for packaged food because of changing lifestyles and less time available for cooking food. Consciousness for healthier food, with high nutritional value, high fiber content, organic food, or natural food will be another driver for growth.

The economic condition in developing markets is growing at a fast pace, along with a strong preference for packaged food. The disposable income growth and population explosion are other important factors for impetus in demand in emerging economies. Stronger demand from overseas operations will be one of the biggest growth opportunities for food and beverage companies.

## INVESTMENT POSITIVES

- The consumer staple sector generally has low sensitivity to recession. Food and beverage companies are affected less by economic slowdown. The current economic crisis will offer the food and beverage sector as an investment haven when all other sectors are bleeding red.
- Most companies in the food and beverage sector are corporations with stable cash flows and deep pockets. Even if the recession continues for a long time, these large companies have the strength to withstand the slowdown.
- The current trend of reduction in commodity prices promises higher profitability in the sector.
- We will witness increased demand for healthy and organic food, which are expected to be high-margin products.
- The ever-increasing baby-boomer population will demand healthier and more nutritional products.
- The demand for packaged food from developing nations, especially in Europe and Asia, continues to be strong. Changing lifestyle, stressful work environment, less available time, double-income families, and demand for healthy and handy packaged food will propel growth for food and beverage companies.
- Once the economy sees some sign of stabilization, the current rock-bottom interest rates will trigger a spree of M&A activities in the sector.

## INVESTMENT NEGATIVES

- The meltdown in the global economy has hit all industries, including food and beverage. If the trend continues, even this sector will get a powerful blow.



- If the bio-fuel movement picks up, commodity prices will soar. This will increase the raw material cost for food and beverage companies, which they will be forced to pass on to customers.
- A stronger US dollar will erode a large part of the revenue earned in the foreign markets. The new US government has proposed a change in tax regulation. The new regulation, if implemented will tax the overseas income of US corporations immediately, against the past practice of levying taxes when the income is brought back to US. The new proposed, if implemented, will have a severe negative impact on f&b companies most of which have large overseas operations.

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