Investment Team Corner

In conversation with Jonathan Menor, CFA, an analyst on the Consumer Products Research Team

Inflation has affected many consumer products companies, prompting some to raise prices and move manufacturing closer to end markets (a concept known as *nearshoring*). To understand the nuances of these trends, we spoke with Jonathan Menor, CFA. He discusses the investment potential he sees in the consumer sectors and the long-term trends affecting consumer demand. Jonathan has 25 years of experience and has been with Brandes for 21 years.

Households have seen sharp price increases for many goods, with some prices rising even faster than the inflation rate. Do you believe this will continue?

There are a few points to unpack here. Cost inflation has significantly impacted the consumer sectors in recent years, affecting profit and loss statements to varying degrees across different sub-sectors. In response to rising costs, many companies have implemented notable price increases over the past year. For many companies, this has caused sales volume growth to diverge from historical trends, or even turn negative. This issue presents a key investment controversy, especially regarding how volumes and top-line growth will adjust if or when price effects stabilize. I believe that will depend on several factors such as consumer strength, particularly real wage growth, the health of the product categories, and competitive dynamics.

Additionally, should gross profit margins begin to widen, the debate centers on whether these will be directed towards marketing to boost top-line growth or towards the companies' bottom lines. Once again, I think the answer will depend on factors such as brand health and market structure. Inflation has led to shifts towards more-affordable or private-label products across many markets and categories. However, an anticipated moderation in inflation, an increase in real wages, and stable employment could provide a solid foundation for sales volume recovery in 2024.

There has been a lot of discussion around shifting supply chains and geopolitical pressures, with some companies opting for nearshoring. Might this be an ongoing trend?

The impact of nearshoring varies across industries, potentially being less significant for consumer products compared to areas such as industrial technology or aerospace. Many consumer products companies have their manufacturing facilities in the markets they serve, which could mitigate some nearshoring impacts. However, when key inputs are sourced internationally, factors such as shipping and freight rates, along with a country's foreign exchange rate, can influence the cost structure. Recent escalations in shipping costs and geopolitical conflicts, such as the instability in the Red Sea, have increased overall landed costs, affecting the prices of certain commodities such as coffee. Nearshoring is expected to positively influence consumption in beneficiary countries, such as Mexico, potentially boosting gross domestic product and enhancing the consumption environment, especially in border states, according to a Morgan Stanley report. This discussion highlights the complexity of issues arising from the shift towards nearshoring.

Consumer staples companies are typically viewed as more defensive. They tend to trade at higher multiples, making them less attractive for value investors. Have you been finding any opportunities here?

As we know, investing in a company can be influenced by a variety of factors, which typically fall into two categories: macroeconomic (external) factors and company-specific factors. At the macro level, not all countries move in unison. So, if a company has high exposure to a country that experiences a significant macro slowdown, this may be an issue where investors might not be willing to wait and see if a recovery plays out.

However, with our approach of looking at investments from a medium- to long-term perspective, we're prepared to wait out cyclical downturns and wait for the long-term structural trends to unfold. Investment opportunities can also arise when a company is significantly affected by the soaring prices of a raw material, to the extent that it can't pass on these costs within a year. This situation may temporarily weaken its financials and affect stock sentiment in the near term. But again, by adopting a long-term outlook, we look beyond these cycles, anticipating a recovery either through the normalization of raw material prices or by the company successfully passing on cost increases to consumers. The ability for a company to do so is often dependent on market structure. For example, many companies in the consumer sectors benefit from operating in a concentrated market structure, such as a duopoly or oligopoly. This market structure allows them to pass through raw material prices more easily than in more-fragmented markets.

On the side of company-specific factors, the reasons for investment opportunities vary widely. A dip in organic growth due to poor execution could be one reason, which may stem from companies spreading themselves too thin or having poorly planned growth strategies. Poor execution can also be a function of not having the right incentives in place, or not tying compensation to a longer-term key performance indicator. Corporate structure can also play a significant role, as evidenced by recent issues with a major household and personal care company in the U.S. Another consideration is the matter of cost concerns, which may offer a chance for the company to optimize its cost base. Conversely, a company might be overperforming because it reduced marketing expenses, which are crucial for sustaining brand vitality. Lastly, apprehensions regarding capital allocation, whether through costly mergers and acquisitions or ineffective shareholder return strategies, can also depress sentiment and earnings in the short term. These are all potential reasons a company might be facing difficulties or underperformance, presenting value investors with an appealing entry point.

As investors with a long-term perspective, we believe it's important to take a step back and consider the broader, long-term trends affecting consumer behavior. What factors do you think could impact demand for consumer companies in your coverage universe over the medium to long term?

One trend I would highlight is the potential impact that GLP-1 weight-loss drugs, such as Ozempic, could have on the consumption of packaged food and beverages over the medium to long term. This theme started to gain traction with the market in the second half of 2023 and contributed to significant share price underperformance for the packaged food industry. This downturn, compounded by other factors such as rising interest rates, led to valuation multiples falling below their long-term historical averages.

To put some numbers around the potential impact of GLP-1, the CDC’s 2022 national health survey indicated that about 32% of U.S. adults reported being obese. When expanding this categorization to include those who said they are merely overweight, the figure rises to about 65%.[1] According to Bernstein research estimates, around 1% of the adult population has a current prescription for a GLP-1 drug.[2] Though it's too early to determine what percentage of the population will use GLP-1 five to ten years from now, assuming it reaches 10% of adults in five years, we could see a reduction in packaged food sales by roughly half a percent per year over this period. Assuming a flow-through rate or margin that reflects the cost structure of a food company, this could translate to an approximate 2% reduction per year in earnings before interest and taxes.

However, companies have a combination of pricing power, productivity improvements, and moderation of input costs to help offset this potential headwind. Therefore, we think the impact of GLP-1 is manageable, although we fully acknowledge this estimate may evolve as more information becomes available.

[1] 2022 National Health Interview Survey, Centers for Disease Control

[2] "ESG 'MAQ:' Measuring the Unmeasured – How much impact could GLP-1 weight loss drugs have on the U.S. food sector?" October 3, 2023, Sanford C. Bernstein and Company, LLC

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