Santa Clara Investment Fund Research Report

Consumer Sector

Fall 2023

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Overview

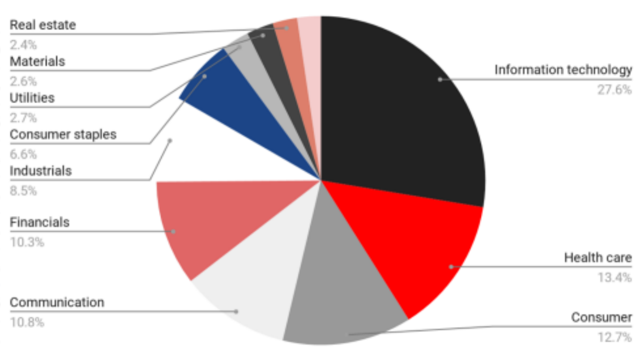
Globally, consumer products and the retail market is estimated to be valued at $18.18 trillion as of 2021 and projects a CAGR of 7.5% from 2021 to 2028. While global economies are still recovering from record inflation, supply chain issues, labor shortages, global conflicts, and climate change, the consumer products industry has also been directly hit. In an industry where success is based so much on consistency, it is imperative that companies who wish to capture and retain market share maintain profitable growth by making financial decisions that set them apart from the rest of the competition.

There are several large companies which dominate the consumer products industry: Nestle SA, Procter & Gamble, Pepsi Co, Unilever N.V., LVMH Moët Hennessy Louis Vuitton, Imperial Brands PLC, Anheuser-Busch InBev, Tyson Foods, Nike Inc., Kroger Company, Wal-Mart, Costco Wholesale. In addition, there are several smaller, up and coming companies within the space that have managed to capture significant market share in the industry, based on growth in the past three years: Zimba & Plus Ultra, Athena Club, Herb'N Eden, MUD/WTR, and Thesis.

Consumer Staples Overview

Sector Fundamentals AS OF 02/12/2021

P/E (Last Year GAAP Actual)	27.31
P/E (This Year's Estimate)	25.30
Enterprise Value	$179.44B
EPS (TTM)	$3.75
EPS Growth (TTM vs. Prior TTM)	41.85%
Revenue Growth (TTM vs. Prior TTM)	3.49%
Return on Equity (TTM)	50.30%
Return on Investment (TTM)	13.02%
Total Debt/Equity (TTM)	235.25
Dividend Yield	2.68%



With an overall year-to-date industry growth of 17.19%, the consumer products industry ranked as the 8th highest growth rate out of all industries. As previously mentioned, profitable growth is the driving force of a top company in the consumer industry. This is an industry that experienced measurable growth and exhibited stronger resilience over the last year more than most other industries. The consumer sector also experienced employment growth as well, with

2.2 million Americans being employed in the consumer industry, and 96,000 new positions in September added in 2023; this is further evidence of an industry experiencing measurable growth. Overall, the consumer sector has grown significantly in the last few years and has strong statistics which indicate growth in the near and far future.

The macroeconomic conditions in the past year significantly slowed down growth, but now the market is on a path to recovery and is returning to growth levels similar to those before the slowdown. The consumer discretionary and consumer staples industries divide the consumer sector into the consumer discretionary purchases and consumer needs. From June 2023, year to date, consumer staples has decreased by 0.04%, while consumer discretionary increased by a sizable 32.33% as consumer spending has increased solidly in April. Over the last several years, however, both industries have experienced relatively similar growth at the same rate the sector has.

Market Trends

Overall consumer demand is currently and usually driven by the consumers themselves rather than enterprises. The manufacturing and selling of products is for the direct use of buyers with a focus on satisfaction and affordability. Optimism of economic improvements corresponds heavily with consumer confidence, which we are now seeing as the demand for goods and services continues to exponentially increase.

With the shift in the outlook of the economy following the rapid interest rate rises by the Federal Reserve to 22-year highs, the consumer has continued to remain resilient alongside the labor market driving up wages and thus increasing demand from consumers to make purchases and indulge in the present. Consumer behavior is slowly becoming the focal point that dictates the direction of overall demand.

Consumer desires' are constantly changing but coupled with the strength of consumer sentiment, fulfilling those desires have become companies' main priority. This is especially prevalent with Generation Z and millennials who are very susceptible to brand switching to look for more innovative products that follow current trends.

Digital-innovation is now emerging with developments in augmented reality (AR), virtual reality (VR) and artificial intelligence (AI) transforming the ability for companies to capture significant market value. Integrating these new technologies have enabled companies to create profound efficiencies for both the consumer and the company simultaneously.

With these technological developments and ones that will continue to emerge in what seems to be the near future, the impact it will have on the players in and beyond the sector will be substantial as insight into consumer behavior continues to be refined.

Only time will tell if something as revolutionary as e-commerce will arise for consumers, but the recent adoption and advancement of AR, VR, and AI into the sector has become the key to immersing consumers further by predicting behavior as well as trends.

The emergence of AI has allowed businesses to build stronger relationships with their customers through tailored experiences that meet individual needs and preferences both on the product and service end. This has vividly increased the expectations consumers have for personalized experiences but comes with the implications of data privacy.

However, California has been the first state to initiate data privacy legislation through the California Consumer Privacy Act (CCPA) and the California Privacy Rights Act (CPRA). These acts establish privacy rights and business requirements for collecting and selling Californians' personal information. More importantly, the movement has been followed with other states such as New York, Texas, and more approaching the issue similarly.

As e-commerce continues to expand and be refined through the emergence of these new technologies, legislation against data collection can mitigate the effects of AI's development into the consumer sector ultimately dictating the growth rate of the industry and benefiting companies that don't rely heavily on their online marketplace.

Key Drivers

In the current macroeconomic climate, characterized by fluctuating inflation rates, global supply chain disruptions, and potential labor market shifts, the consumer sector is experiencing a juxtaposition of challenges and opportunities. Following the pandemic, e-commerce adoption has accelerated, driving a surge in online shopping and digital engagement among consumers. Simultaneously, the sector is confronted with increased costs due to supply chain issues, causing price hikes that may reduce consumer spending.

Historically, the consumer sector displays split performance during economic downturns. Non-cyclical consumer goods, like food and personal care products, typically maintain resilience due to their essential nature. Conversely, cyclical consumer goods like luxury items and electronics may see varied demand as consumers prioritize essentials and cut down on discretionary spending.

The main drivers of the consumer sector are primarily driven by technological innovations. With emerging technologies like AI and IoT redefining consumer experiences, facilitating personalized marketing, and improving operational efficiency through automation processes and more data analytics.

Additionally, the growing shift towards sustainability is prompting brands to incorporate eco-friendly practices, products, and packaging, which positively influence the purchasing decisions of the rising demographic of environmentally-conscious customers.

The larger players in the consumer sector, especially those with established brands, extensive distribution networks, and robust digital platforms, demonstrate the strengths of economic moats. Brand recognition and customer loyalty accumulated over time, footprints a company’s market position, fostering a competitive advantage that protects them against price wars and enables the ability for premium pricing.

While creating an economic moat from scratch is challenging, creating opportunities in niche market segments and innovative product offerings shapes firm forecasting of success. While barriers to entry in terms of capital investments, market penetration, and regulatory compliances are difficult to overcome, aligning strategic approaches with dominant consumer trends offers a stronger opportunity for smaller players to build up their own unique economic moats. The consumer sector, while resilient, is clearly shaped by evolving consumer behaviors, technological advancements, and macroeconomic elements.

Challenges and Opportunities

The challenges experienced in the consumer sector, especially regarding supply chain disruptions have been widely recognized. According to a survey conducted by the Institute for Supply Management (ISM) in 2022, approximately 75% of companies reported supply chain disruptions due to global transportation issues and logistical bottlenecks. Furthermore, several industries, including automotive and electronics, have faced notable setbacks due to these disruptions, illustrating the deep-rooted impact across various consumer sub-sectors.

Consumer behavior has also shifted tremendously with technological adoption. A report by the Pew Research Center showed that as of 2021, over 85% of Americans were using the internet for daily activities and purchases, highlighting the urgency for businesses to adapt and cater to the evolving digital consumer landscape. Another aspect underlining the importance of a digital shift is the rising prominence of e-commerce. According to Statista, global e-commerce sales are expected to reach $6.3 trillion by 2024, indicative of the pressing need for businesses to augment their online presence and capabilities.

The push towards sustainability is another challenge rooted in emerging consumer behavior. According to a 2020 report by IBM and the National Retail Federation, nearly ⅔ of consumers in the U.S. and Canada prefer to buy from brands that are sustainable and ethical. This underlines a compelling need for companies to incorporate and emphasize ethical practices and sustainability, often requiring significant restructuring and investment, to stay relevant and competitive. On the contrary, employing technology as an operational and customer engagement tool presents substantial opportunities. According to a report by Adobe, AI is predicted to be involved in 80% of all customer interactions by 2025, implying a significant role in enhancing customer service and personalizing consumer experiences. A study by Capgemini also emphasized that 75% of organizations utilizing AI and machine learning have experienced enhanced customer satisfaction by at least 10%. In regards to sustainability and ethical practices, while it demands initial investment, it also offers a palpable ROI through enhanced consumer loyalty and brand perception. The 2020 Zeno Group's Strength of Purpose Study reveals that consumers are four to six times more likely to purchase from, protect, and champion companies with a strong purpose that aligns with their values. Thus, investments in sustainable practices may not only mitigate potential future regulatory and reputational risks but can actively drive consumer preference and loyalty, offering a competitive edge in the increasingly conscientious marketplace.

Outlook and Conclusion

As a dynamic and ever-evolving sector, the consumer industry has experienced a shift toward technological innovations with increasing investment in e-commerce and digital shopping offerings. With firms in the consumer goods industry preparing for post-pandemic growth, there has been a heightened pressure placed on innovation and sustainability efforts. In order to gain that upper edge, consumer goods companies have focused on meeting the constantly evolving preferences of their consumers, especially in the consumer staples sector of the industry. However, there are several challenges these consumer companies face, these include supply chain disruptions and rising costs of raw materials. These factors indicate the growing demand for innovation within the industry, as the highest-performing consumer companies have proven to be those that invest heavily in technological innovation.

As a historically "value" industry for investing, it is evident that in the current consumer landscape, there is an opportunity for growth investment. We believe that the sub-sectors of sustainability driven by consumers to an IoT, data-driven approach by retail will drive growth. Thus, we intend to take a mixed investment approach where growth is sought but value is intended in our investments.