

Global Equity Observer

The Pricing Power of Staples

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Consumer staples have underperformed significantly year-to-date, -7.2% versus the MSCI World Index flat at -0.1%, as the market has started to question whether or not consumer staples pricing power is waning. This concern was triggered as the sector's first-quarter results generated headlines suggesting that pricing was flat to -1% for the global food/household personal care (HPC) names. We do not believe there is a material change in their pricing power.

In order to determine whether pricing power is waning, it must be correctly defined. In our view, a company has basic pricing power if it has the ability to price to recover input cost inflation. What we do find is that the pricing of our staples stocks continues to mirror the price change in their agricultural commodities basket, just as it has for the last decade. This has meant productivity savings and improving product mix have underpinned the rise in gross margins for two of our major staples holdings, which are higher today than they were three, five and 10 years ago.

The impact of e-commerce and hard discounters in the U.S. is setting in motion the pricing dynamics that have been evident in Europe for over two decades. The dynamic they drive is greater price transparency, namely, the move away from high-low price promotions to everyday low price. During this transition, pricing softens, which is one

AUTHOR



WILLIAM LOCK
Head of International
Equity Team



BRUNO PAULSON
Managing Director



**DIRK
HOFFMANN-BECKING**
Executive Director

“...productivity savings and improving product mix have underpinned the rise in gross margins...”



of the reasons we do not own names that are heavily weighted to U.S. food/HPC in the portfolios. Two of our major staples holdings have been able to compound their sales and profits over the last two decades, despite the impact of the discounters. First, they now own the number one or two brands in each category and, second, they have increased their emerging markets presence by 59% and 39%, respectively.

For these emerging markets-exposed staples companies, dollar weakness has effectively disguised their underlying pricing power. In recent quarters, reported emerging market sales in U.S.

dollars have accelerated, as the U.S. dollar has weakened against emerging market currencies. Given that key raw materials are priced in U.S. dollars, there has been no emerging markets currency-induced cost inflation. So staples companies have not needed to employ pricing to protect their gross

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margins, meaning that in real terms even though emerging market prices have fallen, gross profits have risen as volumes accelerated to four-year highs. To complicate things further for those reporting in sterling and euros, the acceleration in U.S. dollar sales growth has been obscured by currency moves.

Ultimately, we see these two major staples holdings as well invested, with high rates of advertising spend – the key to sustaining the pricing power of their brands in the face of discounters and e-commerce. Therefore, we believe they can continue to compound.

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