Our Outlook for Consumer Stocks

The soft consumer situation is slowly improving, but we're bracing for mediocrity.

By Joel Bloomer, Associate Director of Equity Research

- Deflationary pressures in consumer packaged goods are abating, but competition is still running high.

- In media, advertising spending continues to improve and, as usual, content is still king in the entertainment world.

- The second half of 2010 in retail will likely be weaker than the first half as difficult comps approach and soft income growth lingers.

As expected, consumers are still trying to find their bearings. The situation is little changed since our last quarterly update—the unemployment rate remains high, incomes are roughly stagnant and the outlook is opaque. These factors are not confidence inspiring, particularly as stimulus measures are replaced with austerity in several large markets around the world.

Still, there are signs that some consumers have found their wallets. High-end retailers have, for the most part, shown an admirable bounce in sales. While it's hard to parse out the impact of easy comps and difficult-to-predict (and recently fleeting...) equity market bounces, this is still a positive sign. In consumer packaged goods, prices appear to have finally stabilized, and we've even seen private-label share gains slow to a crawl. Lastly, travel and leisure, a couple of the more discretionary categories, have experienced improved occupancy and could benefit from selectively higher room rates in the near future.

Nonetheless, downside risks remain. Consumers seem especially cognizant of moves in asset markets, particularly home and equity values. The former could be especially important over the second half of the year, as material stimulus winds down and actual market fundamentals (remember those?) either shine are get foreclosed upon. The latter is anyone's guess in the short term, but volatility is probably here to stay, making it more difficult for consumer spending to sustain any trend.

Where does that leave us? Well, on Morningstar's consumer equity research team, we're bracing for mediocrity. At the moment, we see consumer stocks as about fairly valued, reflecting mild recoveries in both revenue and profitability on average. With various macro measures limiting growth potential in developed markets, our optimism rests primarily in large competitively advantaged companies that have pricing power, preferably with some exposure to faster-growing (and less financially leveraged) emerging economies. In the report that follows, we discuss prevalent trends in several consumer-driven industries and end with several trades that appear compelling enough to make today.

Consumer Packaged Goods

Consumer behavior has changed rapidly throughout this global economic slowdown, affecting both discretionary spending, as well as purchases of everyday staples. Shoppers are switching to more-affordable channels, such as hard discounters in Europe, and consumers have traded down or out of brands in many categories. Some signs of life from the consumer emerged this past quarter, but we continue to believe consumer product firms face headwinds (such as elevated input costs and intense competitive pressures) that could weigh on results over the next several quarters.

Over the past three months, higher-income consumers appear to be slowly resuming classic purchasing behaviors, as indicated in Whole Foods' WFMI solid results, which were driven by increases in transaction count and basket size. Further, recent results from a handful of consumer product firms (such as Sara Lee SLE, Unilever UN UL, and Alberto Culver ACV) suggest that branded offerings appear to be winning at the shelf at the expense of private-label products, partly reflecting increased promotional spending. Underscoring this was Ralcorp's RAH recent earnings downgrade, suggesting that in certain segments, price competition on branded goods is having a significant impact on private-label suppliers.

Increased promotional spending and aggressive pricing, however, are not sustainable strategies over the long term, in our opinion. If input cost inflation returns as demand for commodities in developing markets increases, branded players could start to see margin pressure. Further, if branded firms subsequently ratchet back promotional spending in order to preserve margins, Ralcorp (and other private-label players) could stand to benefit since consumers have become conditioned to expect lower prices.

We also believe that retailers are trying to end excessive promotional spending. Heinz HNZ management recently commented that retailers have not been supportive of price promotions in the frozen meals aisle (where Heinz primarily competes against Nestle NSRGY and ConAgra CAG), a category that has struggled during the downturn as lower prices have failed to drive incremental sales. As a result, we expect some CPG firms to ultimately return to investing in product innovation and marketing support for core brands to stimulate profitable growth.

Not all categories have experienced the same resilience. Competitive pressures within the dairy category have intensified, for example, as major retailers are accepting little to no profit on private-label offerings to drive traffic to stores. This weighed on the results of Dean Foods DF and Danone BN in the quarter. Although we don't believe this pricing structure is sustainable over the long term, it is possible that retailers will continue to use dairy as a traffic driver since consumers who traded down to private-label dairy offerings may not switch back to branded products when the economy improves because product differentiation is difficult to achieve in many dairy categories.

Developed markets are very mature, and austerity measures in already-weak Western European markets could put any resurgent consumer spending on hold. In addition, the translational impact of the euro could be another short-term headwind for large international firms that report in U.S. dollars, like Procter & Gamble PG, Avon Products AVP, Estee Lauder EL, and Colgate CL, all of which have significant exposure to the continent.

Despite problems besetting mature markets, developing and emerging economies are still generating healthy growth. The strength of emerging markets is evident in the beverage and tobacco industries. Both Coca-Cola KO and PepsiCo PEP reported double-digit revenue growth in India and China, but experienced flat or declining volume in Western Europe and North America. The trends were echoed in Imperial Tobacco's ITYBY IMT interim report, which showed declining sales in Spain but more robust growth in emerging markets such as Eastern Europe and Asia. We expect CPG firms will continue to look to developing markets for the bulk of their near-term growth.

Media

During the latest round of earnings reports, it became clear that media companies are benefiting from corporations increasing their marketing spend. The best barometer of broad-based spending on advertising is the results of marketing conglomerates like Omnicom OMC and Interpublic IPG, as these firms provide a wide variety of marketing services around the globe. Omnicom returned to growth for the first time in several quarters, indicating that companies are slowly starting to reinvest in their brands. Organic revenue at Interpublic grew 3% in the U.S., the company's first quarter of growth since the third quarter of 2008.

Ad revenue for cable networks owners like Time Warner TWX, Disney DIS, and Viacom VIA.B also improved, and Time Warner's CEO Jeffrey Bewkes commented that "even though there is still uncertainty about the health of the economy, we're seeing demand come back across key advertising categories."

While some media sectors—for example, newspapers—are facing secular declines and may never return to revenue growth, we expect most advertising-dependent companies to post improved financial results throughout 2010. Firms with exposure to online advertising and cable networks—particularly Google GOOG and Discovery DISCA—are the best positioned to capture advertising dollars in the long run.

We continue to see content owners maneuver to better monetize assets as the media landscape evolves. In our last quarterly update, we mentioned that other movie studios would follow Time Warner's lead and look to establish "windowing" with Netflix NFLX for newly released DVDs. In April, Netflix renewed agreements with Universal, a unit of General Electric GE, and News Corp. NWSA that included a 28-day window for new release films in exchange for more access to digital content. Redbox also agreed to 28-day windows with Universal and News Corp.

We anticipate that further experimentation with film windows as well as the amount of time between the theatrical release and DVD sales will be tested by the movie studios. For example, Disney shortened the typical four-month window between the theater and DVD release date for Alice in Wonderland, which upset theater owners in Europe. The studios feel they can spend less marketing dollars on home video if this window is shortened as the spillover buzz from the box office remains. Warner Bros. is likely to attempt something similar in the future, given its aggressive approach as the first to negotiate the 28-day windows for new release rentals with Redbox and Netflix.

The risk for Warner Bros. (and other studios) in testing the traditional window is that it will upset its theater-owner partners, whose share of box office receipts increases over time. We think shortening the window will be difficult, but if successful, it would be a net positive for movie studios.

Retail

Although positive sales trends in recent months are encouraging, economic indicators that suggest anything more than a mild recovery in consumer spending for the year remain scarce. June retail sales results should show modest growth due to still easy year-over-year comparisons and a few extra shopping days that shifted from May, but we expect sales growth in the back half of 2010 to be more muted than year-to-date numbers would suggest due to more difficult comparisons and the continuation of high unemployment rates and stagnant wage growth. In our view, the next several months of consumer spending are set to be choppy, with consumers coming out to spend during key events but taking pauses in between. In fact, we do not see many positive sales catalysts until back-to-school season in late summer.

Consumables categories such as food, health care, and beauty products were generally the strongest performers for mass merchants and warehouse clubs like Wal-Mart WMT, Target TGT, and Costco COST in recent months, suggesting that consumers remain price sensitive for everyday purchases. In our view, concerns over consumers trading up and away from these retailers have been overblown due to the compelling value proposition these firms offer, a combination of tremendous bargaining power, and expansive private-label programs.

In the second half of the year, Wal-Mart should benefit from more stable prices in grocery (49% of sales) and continued international growth, which is steadily driving more of the top line. Target is on track to meet our mid-single-digit full-year comp outlook, aided by the PFresh fresh food rollout and mild food inflation over the next several months. We forecast warehouse clubs to post high-single-digit comp growth this fiscal year, as higher gas prices and food inflation help to balance more difficult traffic comparisons starting in the third quarter.

Despite most consumers' focus on value and everyday goods in the near term, we believe a few discretionary retail categories will outperform the broader market over the course of the year. Premium players like Nordstrom JWN, Saks SKS, and Tiffany TIF, whose customers are less sensitive to job market constraints and other spending headwinds, should benefit from pent-up demand for women's apparel and accessories as well as leaner inventory positions.

We also believe that consumer demand for sporting goods has improved, aided by major sporting event catalysts like the World Cup and new product innovations across a number of categories including women's footwear and golf. This bodes well for major athletic apparel and footwear manufacturers such as Nike NKE and Adidas ADS as well as major sporting goods retailers like Dick's Sporting Goods DKS.

Best Buy BBY should also benefit from strong mobile phone and notebook computer sales over the next several months due to several highly publicized product launches, with television sales likely to improve in the back half of the year due to increased vendor promotional activity. We continue to monitor recent stock market volatility and the reappearance of economic distress in Europe, as these pressures could have an adverse impact on the mindset of middle- to upper-income consumers and potentially the valuation assumptions for many discretionary retailers in our coverage universe.

In the home improvement space, we remain optimistic about the long-term growth prospects for Home Depot HD and Lowe's LOW, which recently reported positive quarterly comparable-store sales for the first time in nearly four years. Although we acknowledge that the expiration of the first-time homebuyer credit at the end of April could lead to softer building material retail sales over the next few months, we believe recovering fundamentals at both home improvement firms have been underappreciated by the market. Our proprietary regression model, which uses residential construction put in place, 30-year Freddie Mac fixed mortgage rates, and the University of Michigan Consumer Sentiment Index to predict changes in single-family home sales, suggests that these firms are well positioned to benefit from a multiyear housing recovery, and we have increased conviction that Home Depot and Lowe's will deliver mid-single-digit comp growth this year.

We expect restaurant sales growth trends to lag the broader retail segment, with fewer consumers dining out because of the preponderance of low-priced alternatives at grocery stores and warehouse clubs. Still, we see a similar dichotomy between the lower- and upper-income demographics in this space, with full-service restaurant operators likely to outperform quick-service restaurant chains over the near future.

We are seeing improved guest traffic and spending patterns at casual dining restaurant chains, including Darden Restaurants DRI, Brinker International EAT, and Cheesecake Factory CAKE, with an uptick in dessert orders and alcoholic beverages suggesting that middle-income consumers are loosening the purse strings a bit. Conversely, we don't expect a meaningful improvement in restaurant traffic until unemployment levels subside among mass-tier consumers, although larger players with scale advantages, significant advertising resources, and international diversity—such as McDonald's MCD and Yum Brands YUM—are likely to outperform on a relative basis. We expect fast-casual restaurant chains like Chipotle Mexican Grill CMG and Panera PNRA—which have carved out an intriguing niche by offering higher-quality ingredients than quick-service chains but at lower average prices than casual-dining restaurants—to deliver the strongest sales performance of any restaurant chains over the near term, though these expectations are likely reflected in the stock price.

From a cost perspective, we see cost inflation on the horizon and believe some firms with heavy exposure to China could see cost pressures as early as the second part of this year. Over the past few weeks, we have started to see signs of labor cost increases in China, where large manufacturers like electronics maker Foxconn and automaker Honda HMC have agreed to 20%-30% salary increases effective immediately.

Additionally, Yum Brands, owner of the KFC fast-food chain, recently raised the minimum wage for workers in the Liaoning province to CNY 900 a month from CNY 700 and committed to an annual 5% pay increase following protests from local trade union officials.
Salary increases in the Chinese manufacturing sector have lagged national inflation rates for the past two decades, and we believe the Chinese government is now more committed to enforcing its Labor Contract Law, which will likely place upward pressure on minimum wages. Furthermore, birth control policies over the past 30 years have led to a smaller pool of migrant workers, providing employees with slightly more negotiating power. Therefore, we believe a double-digit increase in labor wages across the Chinese manufacturing industry is likely, especially in the coastal regions, where the bulk of apparel factories are located.

In our view, apparel companies will probably start to see input cost pressures in the back half of 2010, offsetting some of the benefits from tighter inventory management and cost reduction initiatives currently in place. In response to wage inflation trends, apparel retailers and shoe manufacturers such as Adidas, Collective Brands PSS, and Kohl's KSS have already started to move their manufacturing facilities to inland regions of China, or relocate to low-cost alternatives in other parts of Asia such as Indonesia, India, Cambodia, and Vietnam. This change will likely be a gradual process for most firms, since merchandise manufactured in China still represents more than 50% of the total product sourced for many apparel companies.

In contrast, we project wage hikes in China will have a smaller impact on larger retailers and manufacturers like Gap GPS and Nike who have a more diversified sourcing portfolio, where only a third of their products are sourced from China. Furthermore, we believe premium-priced companies with well-established brands like Urban Outfitters URBN and J. Crew JCG will probably fare better than value players like Aeropostale ARO, as they could easily pass these price increases on to their customers, who tend to be more affluent and less price sensitive.

Travel & Leisure
The travel and leisure industry was one of the hardest hit in the downturn, but we are seeing signs that a gradual recovery is taking hold. Hotel operators' first-quarter results reflected a return in demand, characterized by increased occupancy levels and early signs of pricing power.

Marriott International MAR released key statistics from its most recent accounting period, which includes most of May: RevPAR increased 9% in its North American segment, driven by increases in both occupancy and rate, and room rates grew 1%, the first positive growth in two years. We believe that the firm's higher-end brands drove the increase, given that they were hardest hit in the downturn.

Considering that easy comparisons continue in the second and third quarters, we may see a bit of acceleration in operating results. Brands on the value end of the spectrum should experience a more gradual recovery, as they were not as badly affected as those in the luxury category. Industry publication Smith Travel Research increased its outlook for the travel market with a projection of a 3% increase in RevPAR, supporting sentiments that we've expressed before.

Credit

Consumer companies with weaker balance sheets learned a tough lesson during the economic downturn. Some learned it well; others need to go to summer school. An ill-timed share repurchase initiative increased Macy's M (Morningstar credit rating: BB+) leverage at the start of the downturn, but the retailer has since been focused on improving credit metrics by halting share repurchases, reducing its dividend, and recently repaying $500 million in debt ahead of maturity.

Gaming and lodging companies—typically highly levered—got hit hard by the declines in travel and consumer spending. While we still think debt levels need to be reduced, we're pleased that Wynn Resorts WYNN (credit rating: BB) and Las Vegas Sands LVS (credit rating: B+) both tapped the equity markets to improve cash flow. Lastly, a number of companies, including J.C. Penney JCP (credit rating: BBB-), Dollar General DG (credit rating: BB+), RadioShack RSH (credit rating: BB+), Hanesbrands HBI (credit rating: BB), Constellation Brands STZ (credit rating: BB), and Supervalu SVU (credit rating: BB) continue to pay down debt even as the economy improves.

We applaud those companies with less stable financial footing that are improving their balance sheets, but we are concerned that other companies may be celebrating the end of the downturn too soon. Wendy's/Arby's WEN (credit rating: BB) has a weak balance sheet relative to peers, but announced a $50 million increase to its $200 million share-repurchase program. Another below-investment-grade company, Limited Brands LTD (credit rating: BB+), paid a special dividend of roughly $300 million this past quarter.

Lastly, Brinker EAT (credit rating: BBB), whose credit metrics deteriorated during the economic downturn, has a $250 million debt maturity in October, but the $180 million in proceeds from the sale of On the Border will largely benefit shareholders, as the company recently increased its dividend and share-repurchase authorization. We would prefer that companies with less solid balance sheets or material near-term debt maturities take a more defensive stance for the remainder of the year and maintain their cash reserves.

Top Consumer Sector Picks

Company	Star Rating	Fair Value Estimate (USD)	Economic Moat™	Fair Value Uncertainty	Price/ Fair Value
Lowe's Companies	★★★★★	36.00	Wide	Medium	0.60
Energizer Holdings	★★★★★	80.00	Narrow	Medium	0.67
Molson Coors Brewing	★★★★	59.00	Narrow	Medium	0.74
Procter & Gamble	★★★★★	77.00	Wide	Low	0.79
Netflix	★	43.00	None	High	2.71

Data as of 6-23-10.

Our Top Consumer Picks

Lowe's LOW

Despite a shaky macro environment, Lowe's has remained profitable and continues to generate significant cash from operations. The market's pessimism reflects persistent fears over housing and consumer spending. However, catalysts should arrive in 2010 as consumers gain confidence and resume investing in their homes, relieving overblown market fears on the stock. The removal of the homebuying stimulus and higher interest rates could present mild downside risks in the short term.

Energizer Holdings ENR

Energizer survived significant retailer inventory destocking, which negatively impacted profitability. The battery business is slowly pulling out of its steep decline, however, and Energizer's household products business, under the Schick brand, is rolling out the new Hydro razor. At the current valuation we think the market is being overly pessimistic about the long-term prospects for the firm's businesses. The largest risk to our valuation would likely be a cheap alkaline alternative in developing markets.

Molson Coors Brewing TAP

Molson Coors' earnings growth potential is strong with the MillerCoors joint venture in the U.S. in its fold, but the market continues to be spooked by lackluster top-line growth at the firm. We don't expect Molson Coors to generate robust sales growth in the near future, but given its potential $210 million in cost savings from MillerCoors, its two-year earnings growth potential and long-run cash generation trajectory are being undervalued by the market.

Procter & Gamble PG

Procter & Gamble was caught flat-footed in its response to the dramatic downturn in consumer spending, but with a new CEO at the helm, the firm has implemented plans to reinvigorate top-line and earnings growth. We are confident that P&G will be able to reposition itself for a more challenging economy and provide positive returns for shareholders due to its market-leading brands and relationships with suppliers. On the latter point, a continuation of the firm's amicable relationship with Wal-Mart is key (and likely).

Netflix NFLX

Over the next few years, we expect more digital distribution of movies as online speeds and interfaces improve, allowing studios to partially offset falling DVD sales. This should cause Netflix's distribution and cheap content advantages to fade, leading to lower profitability over time because there are more competitors in the space and digital content redistribution laws are less favorable than for physical media. In the short-run though, fundamentals will be strong, potentially pushing the stock higher before it moves lower.

Joel Bloomer does not own shares in any of the securities mentioned above.