

**ANALYST(S)**

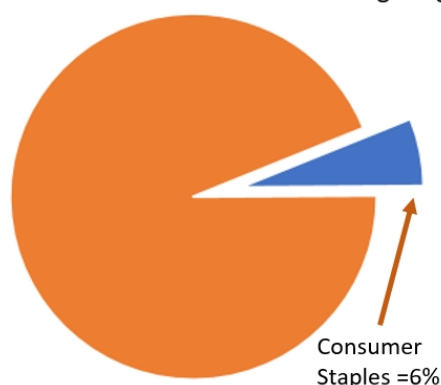
John Boylan, CFA

Companies Mentioned in This Report:

- **Coca Cola** (KO - \$50.00): Buy
- **Conagra** (CAG - \$34.70): Buy
- **General Mills** (GIS - \$58.49): Buy
- **Hershey** (HSY - \$145.15): Buy
- **Kellogg** (K - \$66.00): Buy
- **Kraft Heinz** (KHC - \$31.51): Hold
- **Loblaw** (L.TO - \$68.41): Buy
- **Molson Coors** (TAP - \$35.60): Buy
- **Mondelez** (MDLZ - \$57.10): Buy
- **PepsiCo** (PEP - \$134.76): Buy
- **Philip Morris** (PM - \$80.41): Buy
- **Procter & Gamble** (PG - \$136.70): Buy
- **Sysco** (SYY - \$61.78): Buy
- **Target** (TGT - \$146.04): Hold

Source: Reuters. Prices are as of market close on 9/10/20 and subject to change without notice.

Canada Recommended Sector Weighting



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The consumer staples sector is often viewed as less volatile than the broader market because of the usually steady sales of the everyday products created by these companies. However, differences between these companies exist, and those that embrace technology, improve distribution and have experience in emerging markets should benefit over the long term, in our view.

**Data investments and structural changes improve speed to market.** A few years ago, smaller companies were able to take market share by identifying new trends faster and getting products to market before larger companies. Now larger companies are starting to invest more in data analysis and are structured to make decisions faster. For many of our Buy-rated companies, getting a product from concept to shelf now takes months as opposed to what used to take a year or two.

**Online grocery shopping should fuel growth.** The number of consumers that buy at least a portion of their groceries online is increasing rapidly. These purchases are often filled and picked up or delivered from a local grocery store. Therefore, stores are working closely with staples companies to ensure the appropriate amount of inventory is delivered to increase product sales and product turnover. Also, large, high-selling brands are often prominently featured on online-shopping websites, making them easier to buy, in our view. We think these trends will favour larger companies over time.

**Emerging-market exposure is important, but experience is needed.** Flavours and brands that are successful in developed markets, such as the U.S., don't always translate well to tastes in emerging markets, such as China. Thus, we favour companies that tailor products to those emerging markets, which takes experience. Also, many emerging markets do not have nationwide grocery chains. Servicing hundreds of small stores can be complicated and costly. Companies that have local distribution networks often are more successful, in our observation.

**Coronavirus has a mixed impact for Consumer Staples Companies.** Companies that have large foodservice exposure (i.e., sell to restaurants) could see a negative short-term impact to sales and earnings during the crisis. Food distributors should feel the impact the most, but food companies that make products for foodservice or products eaten on-the-go (e.g., beverages and snacking products) may also see fewer sales. However, for food companies, we also see a potential offsetting benefit in more people eating at home. Some household-product companies may benefit from this, as home cleaning becomes more frequent. Long-term, we think the coronavirus epidemic may accelerate the trend of people ordering groceries online, which may help large-brand-product companies, as these brands are often prominently displayed on these websites.

## Getting Products to Market More Quickly Fuels Growth

Developing and launching new products is an expensive endeavour, costing millions of dollars. In the past, many consumer staples companies spent a great deal of time and money to ensure a potential new product would succeed in the marketplace before it was launched. This process could take as long as two years. However, with the growing importance of data analysis to find underserved markets, along with using flexible manufacturing (i.e., outsourcing), smaller companies were able to condense the time and expense of getting an innovative product to market. This helped these smaller companies gain market share.

Additionally, a couple of years ago many consumer staples companies focused on aggressively lowering costs, in our observation. Up until recently, Hold-rated Kraft Heinz was at the forefront of this trend. The good news was that profits increased (for a while), but the bad news was that new product development, manufacturing and marketing sometimes suffered. This often led to more market-share losses.

However, large consumer staples companies began to recognize this problem and started improving their operations and structures. Increased investments in computer systems, data analytics, distribution methodologies, product design and marketing were made to develop successful competing products cheaper and faster. Business structures were also created to foster faster, and more entrepreneurial, decision making. Product introduction times are now usually measured in months, instead of a year or two.

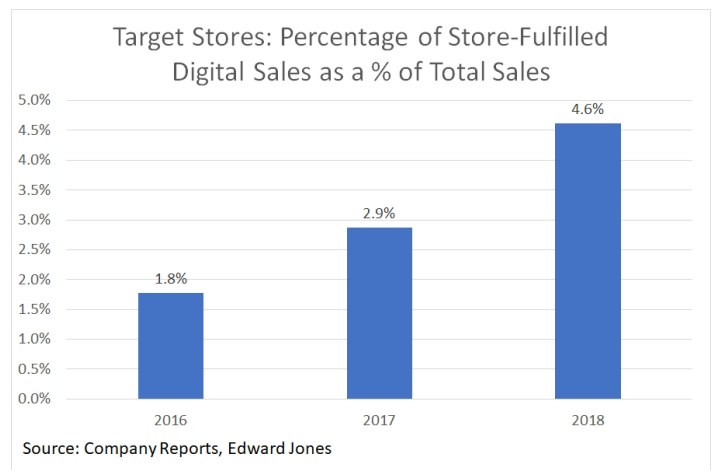
While costs were often notably increased as these investments were being made, especially after years of cost-cutting, it led to better innovation, sales and profitability. Buy-rated Procter & Gamble, Coca Cola and Pepsi are some early examples, in our opinion. We think other companies, such as Buy-rated General Mills, Hershey, Kellogg and Conagra, are following suit, and Molson Coors is now starting the process. Sysco is doing something similar in foodservice.

## The Growth in Online Grocery Shopping May Create Opportunities

While online grocery shopping is not new, it is increasing in popularity. We estimate online grocery sales are 5% or less of total grocery dollar sales but could reach 15% or more by the middle of this decade. Target (a Hold-rated Consumer Discretionary stock) is one company that has seen growth in online sales. While Target sells products besides grocery items, we think its online grocery represents a

continuation of the online trend. **See Figure 1.** Many retailers fill these online orders from the store closest to the customer. Maintaining adequate inventory is important to these retailers; an unexpected sellout can potentially disappoint a customer. Therefore, staples companies can help retailers with an online strategy to keep an adequate amount of inventory, and consumer staples companies that invest in distribution systems have an advantage with those retailers, in our observation.

Figure 1: We think the importance of fulfilling online orders in stores that have grocery is growing. (using Target as an example.)



Additionally, we think the growth in online shopping should help big brands, as high-selling products often are the ones most prominently featured on online shopping websites. This makes them easier to shop (i.e., not having to scroll down a number of Web pages to find what you want) and increases the chance of purchase, in our view. We also think it is in the retailer's best interest to attractively place products that are heavily advertised because it can cause a win-win situation for the store, as increased product promotions may increase demand for both branded and store-branded products.

Based on these placement trends, we believe large, familiar brands should benefit for the foreseeable future and, in our view, should positively impact our Buy-rated consumer product and food companies. The trend in online shopping should also help staples retailers like Buy-rated Loblaw, as well, as it has been adopting this strategy in its stores, in our opinion.

## Emerging-Market Exposure Is Not Enough -- We Like to See Proven Experience

The vast majority of our consumer staples stocks have exposure to high-growth emerging markets, such as China and India. However, in the past companies attempted to enter into these markets by taking their existing products and simply repackaging

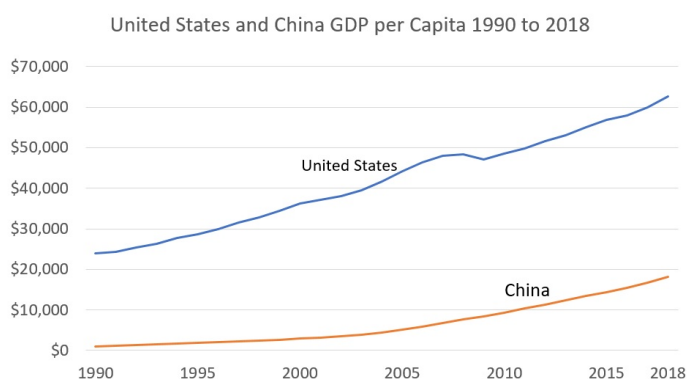
the label in the local language with mixed success. Successful companies now, in our view, tailor their products to local tastes and often develop them in local markets.

For instance, Mondelez recently introduced additional Oreo flavours in China to reflect Chinese taste preferences. These Oreo flavours include green tea cake, spicy pepper pastry, and barbecue pork pastry. Another example is Kellogg. It is marketing breakfast noodles in certain parts of Africa because noodles are a traditional breakfast meal, as opposed to boxed cereal. We think products designed with local preferences such as these have a better chance of success in emerging markets over the long term.

Additionally, many emerging markets do not have nationwide store chains like most developed countries. This can make distribution an enormous challenge, as companies need to identify and sell to hundreds of small operators. Perishable and refrigerated products add to the complication. Also, average incomes in emerging markets such as China, while rising, remain low compared with Western economies. **See Figure 2.** As a result, keeping products affordable, despite all these challenges, is crucial.

Many companies own established emerging-market distribution arms, or partner with large local firms, to get their products to market faster and more profitably than the competition. Therefore, we prefer companies that have experience with local tastes (especially companies that develop products within the local country) and have robust distribution systems to profitably get these products to market. Buy-rated companies that we believe do this well include Coca Cola Mondelez, Philip Morris and Pepsi.

Figure 2: While the Chinese economy (measured as gross domestic product per person) is growing, it still lags the U.S.



Source: World Bank, Edward Jones

## Valuation

Methods we use to evaluate the attractiveness of consumer staples stocks include traditional ratios

such as price to earnings (P/E) and price to sales (P/S), both on an absolute and relative basis; PEGY ratios (P/E vs. estimated growth and dividend yield); and discounted cash flow (DCF) analysis.

**Please see your financial advisor and read the individual company research reports, which contain additional information on valuation and risks, to see which stocks are appropriate for you and are good values at their current price.**

## Risks

There are several risks associated with investing in consumer staples companies. Changing consumer trends, product recalls, ineffective marketing and advertising, lack of innovation, and poor management all can negatively affect the stock price of companies in this sector. Additionally, increasing regulations, the further escalation of trade uncertainty, and negative foreign currency fluctuations could negatively impact growth.

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