

When Retailers and Manufacturers Compete

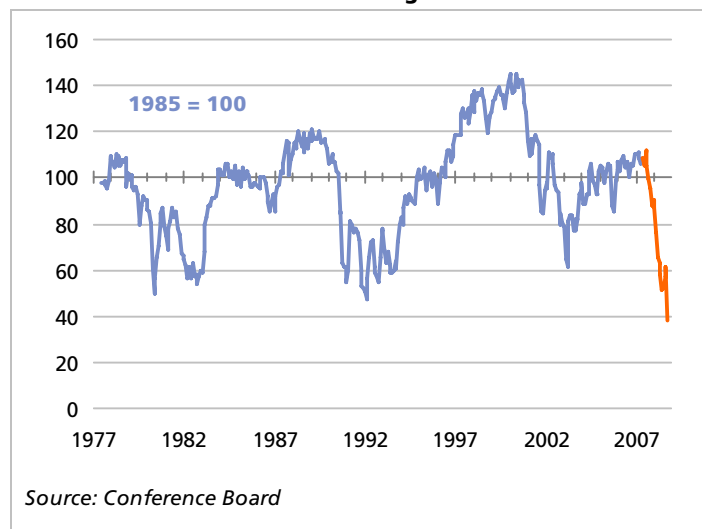
by David Rabinowitz, Senior Sector Analyst, Consumer Staples, and Kristy Finnegan, CFA, Research Analyst

As a group, the consumer staples stocks have been the best performing sector within the S&P 500 Index, down (only) 18% versus the 42% decline in the broader market. This relatively strong showing reflects investor preference for those companies whose earnings are less likely to be adversely affected by difficult economic times. As the logic goes, people will still need to eat, brush their teeth, and diaper their children, even if their personal financial situation precludes buying a house or car.

While this broad logic has been borne out and results for manufacturers of basic consumer necessities have held up reasonably well, it is important to dive a bit deeper into recent consumer behavior in order to distinguish between temporary changes that will reverse when the economy recovers, and permanent changes in consumer purchasing behavior that will persist even when times improve.

A look at the numbers reveals just how shaken the U.S. consumer is. As of October, consumer confidence hit its lowest level since the Conference Board began its widely-watched survey over 40 years ago. The October reading is also significant because it marks a continuation of a consistent downward trend that dates back 15 months to July 2007.

Consumer Confidence is Plummeting



Source: Conference Board

This dramatic and sustained decline in our confidence has prompted many striking changes in the way we spend, both in terms of what we buy and where we buy it. We are buying fewer big ticket durable items, such as motor vehicles, furniture, and appliances, and to the extent we are buying, our choices are more likely to be value-oriented. Spending on apparel is weak in general and in particular at the higher end. Even the luxury buyers among us are not immune to economic downturns. Across all segments of retail, consumers are migrating to discounters like Wal-Mart and Costco at the expense of full-price competitors.

We are spending more time at home. Leisure travel is down. Reversing a 35 year trend, we are eating out less, and when we do so, it's much more likely to be at less expensive eateries such as McDonalds. When we prepare our meals, whether for home consumption or to bring to work, we are foregoing more expensive options (think chicken instead of beef).

Arguably, all of the foregoing trends can be expected to reverse when an improving economy restores consumer confidence. It may be difficult for some (most) of us to contemplate that one day things will be better, however, there is little question that when that day arrives we will resume eating out, buying clothes, and even traveling for vacation. However, there is an area in which we expect that changes in consumer behavior that have been accelerated by current difficult economic times will prove permanent, even when the economy improves, namely the trend among consumers to swap the more expensive national brands for lower priced store brand versions of the food, household products, and personal care items we need. This poses an important challenge to the companies that comprise the consumer staples sector.

Store brand products now account for 18% of consumer spending on food, beverages, household products, personal care items and over the counter medicine. Store brand share has been growing consistently for at least a decade, but the growth has accelerated over the last few quarters as consumer confidence has waned. Most observers focus on the cyclical drivers of store brand growth – how consumers respond to difficult economic times by trading down to store brands in order to save some money.

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In fact, the more powerful drivers of what has been significant long-term growth of store brands are secular considerations, primarily the desire of smart retailers to seize for themselves the margin and growth opportunities inherent in branding their stores. Retailers realize that there is a big revenue opportunity in creating a brand image around their stores and an array of products that consumers can only get there.

Owning the brand also creates an opportunity for retailers to enhance the low margins they earn in their primary capacity as retailers, by seizing some of the higher margins achieved by manufacturers. There is even more margin benefit for retailers to the extent that having their own store brands gives them leverage in their negotiations for the national brands they do buy. The steadily improving quality of these offerings is another important secular trend that has contributed to growing consumer acceptance of store brands.

To be sure, when the economy improves, the economic impetus for increased store brand consumption will wane. However, it would be a mistake for branded manufacturers or investors to think of store brands as purely or even primarily a cyclical phenomenon. The powerful secular forces will drive continued growth in store brand consumption even when the economy improves, both in terms of retailers' desire to push store brands for the benefits it brings them and consumers' willingness to purchase these products based on recent favorable experience with them.

National brand manufacturers must have a strategy for dealing with this ongoing challenge. We believe that successful companies will do so through a combination of brand marketing that maintains the unique advantages of their brands in consumers' minds, focusing their portfolios on leading brands (i.e., number one or number two in their respective categories) and smart innovation that creates differentiated products that consumers value and are willing to pay for. ■