

# ***Thematic The Death of a Theme***

C15.0042  
Lesson 6  
Edward M. Kerschner

## **Consumer Brands**

### ***Branded / Global Power Brands***

***Late 1980s / early 1990s consumer products  
companies were stock market darlings***

- ◆ Consumer marketing is one area where the U.S. is still the champ.
- ◆ Living standards are rising rapidly abroad.
- ◆ The gravitation of the Eastern bloc from Karl Marx to Adam Smith.
- ◆ A tougher U.S. trade policy.

*"Branded," (July 1989)*

## Consumer Brands

### *Global Power Brands*

- ◆ Corporate restructuring made a big contribution to the earnings of consumer products companies in the 1980s. Many firms streamlined operations by selling extraneous businesses and used the proceeds to repurchase shares or invest in the core business.
  - Ralston Purina divested assets; repurchased stock;
  - Quaker Oats sold Fisher Price;
  - General Mills sold an apparel company and a toy company.
- ◆ In addition, the 1980s was still a period of “brand consolidation” when the bigger firms could fill out their product lines by acquiring smaller brands that could be pushed through the distribution system. For example,
  - Philip Morris bought General Foods and Kraft.
  - Ralston acquired Continental Baking.
  - Hershey purchased Cadbury USA.

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### *Global Power Brands*

- ◆ All of these factors boosted the earnings performance of branded companies during the late 1980s. Indeed, thanks to rapid margin expansion, *most firms managed to grow earnings faster than revenues.*
- ◆ At the start of the 1980s, investors' expectations for the sector were low because performance had been poor in the 1970s when inflation hedges were the place to be. By beating these low expectations, the stocks of branded companies were awarded higher P/E multiples, a key factor behind their strong performance in the 1980s.

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## Consumer Brands

### ***Brand Breakdown***

- ◆ With corporate restructuring and brand consolidation complete, firms ran out of ways to boost earnings growth.
- ◆ The 1990-91 recession clobbered the incomes of consumers.
- ◆ A rebound in the earnings of economically sensitive sectors, which began to be discounted in the market in late 1991.
- ◆ P/E contraction because of slowing earnings growth.
- ◆ Disinflation restrained pricing power. The ultimate signal that the pricing environment had changed came on “Marlboro Friday,” the day in 1993 when Philip Morris announced that it was slashing the price of a Marlboro cigarettes by 20%.
- ◆ Branded product companies lost clout as the retail industry consolidated into giant chains of supermarkets and warehouse clubs with immense buying power.

*“Brand Breakdown,” June 1993*

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## Consumer Brands

### ***The Emerging Markets Fallacy***

- ◆ **Cost.** Many consumers in emerging markets may want to buy branded goods but, at their current income levels, simply cannot afford to.
- ◆ **Infrastructure.** Large rural populations in many emerging markets makes it difficult for branded firms to reach consumers in those regions.
- ◆ **Culture.** As they develop, global economies *do not* move along a predictable path from agriculture to industry to western-style consumerism.
- ◆ **Diet.** National food preferences change slowly, if at all.
- ◆ **Taste.** Given different tastes, identical products are not consumed globally.
- ◆ **Advertising.** Per capita advertising expenditure levels remain very low in emerging markets. But many consider ads that associate western products with a “superior” lifestyle as an arrogant form of cultural imperialism.

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# Consumer Brands

## Brand Breakdown

- ◆ Earnings growth of consumer products stocks will be lower in 1990s than 1980s because of:
  - Weaker growth in U.S. real disposable income due to slow employment growth, higher taxes;
  - Fewer opportunities for brand consolidation, corporate restructuring;
  - Private label competition from increasingly sophisticated retailers;
  - Stable to higher corporate tax rates, after a decline in 1980s.

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# Consumer Brands

## Surging Prices / Slowing Growth

Stock price performance  
July 1982 - Jan. 1992, Jan 1992 - June 1993

	7/1/82	1/2/92	6/17/93	---- % chng ----	
				'82-'92	'92-'93
American Brands	\$10 1/8	\$44 1/4	\$33 5/8	+337%	-24%
Anheuser Busch	8 5/8	60 3/8	50 1/4	+600	-17
Avon Products	23 7/8	45 1/2	54 3/4	+91	+20
CPC Intl	8 7/8	45 5/8	42	+414	-8
Coca Cola	2 3/4	40 1/8	42 1/4	+1359	+5
Colgate Palmolive	8 5/8	48 3/8	55 3/4	+461	15
General Mls	10 1/2	74 3/4	64 1/4	+612	-14
Gerber Prods	3 1/4	37 3/8	26 7/8	+1050	-28
Gillette	4 3/8	54 5/8	48 3/8	+1149	-11
Heinz H J	5 1/2	39 1/4	36 1/2	+614	-7
Hershey Foods	6 7/8	44	49 3/8	+540	+12
Kellogg	6 3/8	65 5/8	53 3/4	+929	-18
Kimberly Clark	7 3/8	51 7/8	47 3/8	+603	-9
PepsiCo	4 1/4	33 7/8	36 7/8	+697	+9
Philip Morris	6 1/4	79 5/8	48 3/8	+1174	-39
Procter & Gamble	10 3/8	46 1/2	49	+346	+5
Quaker Oats	9 3/4	74 1/4	73 1/8	+662	-2
Ralston Purina	6 5/8	57 3/4	44 5/8	+772	-23
Rubbermaid	2 5/8	35 1/2	30 7/8	+1252	-13
Sara Lee	2 1/4	27 7/8	25 1/8	+1139	-10
UST	1 3/4	32 3/4	29	+1771	-11
Wrigley W m Jr	2 3/4	26 7/8	34 7/8	+877	+30
Average				+793%	-6%
S&P 500	\$107	\$417	\$449	+290%	+8%

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# Consumer Brands

## Surging Prices / Slowing Growth

Projected Earnings Growth Rates  
July 1982, Jan. 1992, June 1993

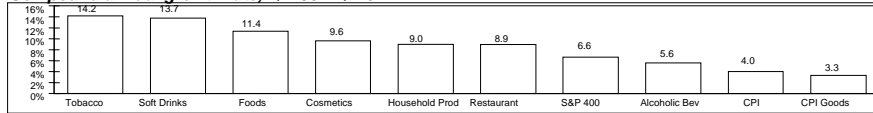
	July 1982	Jan 1992	June 1993	Change: '82 - '92	Change: '92 - '93
American Brands	6.5%	10.0%	6.5%	+3.5%	-3.5%
Anheuser-Busch	15.0	11.0	10.0	-4.0	-1.0
Avon Products	7.5	9.0	9.0	+1.5	0.0
CPC Intl Inc	10.0	12.5	10.0	+2.5	-2.5
Coca-Cola	11.0	16.5	15.5	+5.5	-1.0
Colgate Palmolive	7.5	11.5	10.5	+4.0	-1.0
General Mls Inc	12.0	13.0	12.0	+1.0	-1.0
Gerber Prods	8.0	14.0	9.0	+6.0	-5.0
Gillette	9.0	14.5	13.0	+5.5	-1.5
Heinz H J	10.0	10.5	9.0	+0.5	-1.5
Hershey Foods	na	11.0	10.0	na	-1.0
Kellogg	9.5	13.0	11.0	+3.5	-2.0
Kimberly Clark	10.0	10.0	10.0	+0.0	0.0
PepsiCo	12.5	15.0	13.5	+2.5	-1.5
Philip Morris	16.0	14.0	8.0	-2.0	-6.0
Procter & Gamble	11.0	11.0	11.0	+0.0	0.0
Quaker Oats	na	12.0	11.0	na	-1.0
Ralston Purina	9.0	10.5	9.0	+1.5	-1.5
Rubbermaid	na	15.0	13.0	na	-2.0
Sara Lee Corp	na	12.0	11.0	na	-1.0
U S T Inc	na	14.0	12.0	na	-2.0
Wrigley W m Jr	na	na	na	na	na
Average	10.3%	12.4%	10.7%	+2.0%	-1.7%
S&P 500	9.0%	7.0%	6.7%	-2.0%	-0.3%

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# Consumer Brands

## The Earnings Gap

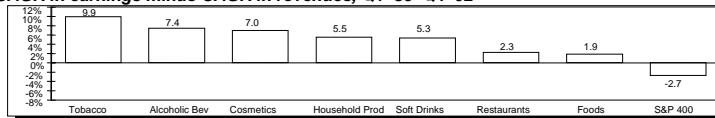
Revenue growth of S&P industry groups, 1986-1992  
Compound annual growth rate, Q1 '86 - Q4 '92



Earnings growth of S&P industry groups, 1986-1992  
Compound annual growth rate, Q1 '86 - Q4 '92



The earnings gap  
CAGR in earnings minus CAGR in revenues, Q1 '86-Q4 '92

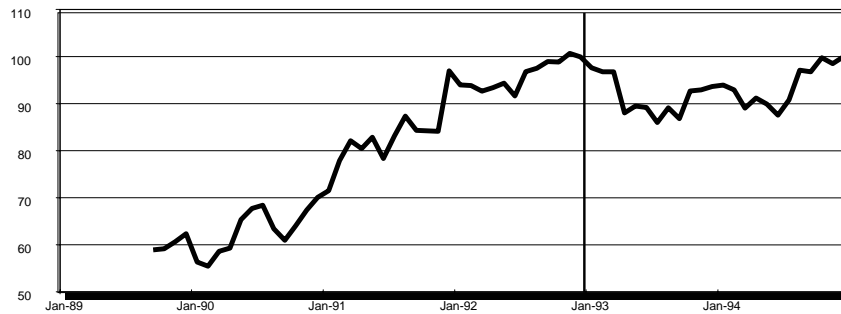


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## Consumer Brands

### *Consumer Stocks Begin to Lag*

S&P Consumer Non Durables Sector Index Prices



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## Euro-industrials

### *European growth helps select US Stocks*

#### *Expectations for Europe was too pessimistic in 1993*

- ◆ Fueled by interest rate cuts by the world's central banks, global economic growth will strengthen late in 1993 and 1994.
- ◆ Other catalysts for the European economy:
  - rapid improvement in east European economies following the fall of the Berlin Wall;
  - Euro-restructuring thanks to privatizations and
  - the removal of protectionist barriers that followed EC '92.
- ◆ Many of America's largest companies are more of a play on the global economy than on the domestic U.S. economy: we estimate that 45% of S&P 500 profits come from overseas.

*"BuBa Boom and America's Euro-Industrials," February 1993*

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## **Euro-industrials**

### ***European growth helps select US Stocks***

- ◆ U.S. companies benefit from foreign growth not just through exports, but also through sales of U.S. foreign affiliates abroad.
- ◆ Europe dominates the sales of foreign affiliates abroad, accounting for fully 60% of the sales of foreign subs.
- ◆ The stock prices of those companies that have significant European exposure should begin to reflect the likelihood of better earnings from European operations in 1994.
- ◆ The earnings of the stocks in our American Euro-Industrial index (of 33 S&P 500 stocks with more than 25% of their total sales going to Europe) rose 106% in 1994, 23% in 1995.

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## **Euro-industrials**

### ***Euro-peak?***

- ◆ The impact of strong European currencies would weaken Europe's export-driven recovery.
- ◆ European domestic demand remains constrained by very sluggish employment growth and huge government deficits.
- ◆ Nevertheless, most forecasters expected European growth to accelerate in 1996.
- ◆ Forecasters are typically too bearish at troughs, too bullish at peaks.

*"Euro-peak?" March 1995*

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# Euro-industrials

## *Euro-peak?*

**“We now may have reached that point in the cycle where the outlook for the European economies is too optimistic. This widespread optimism is vividly illustrated by the changes over the last two years in the OECD's forecasts for European economic growth.”** *March 12, 1995*

**Consensus Projected GDP Growth**

	1994e	1994e	Est change	1995e	1995e	Est change	1996e
	as of 12/93	as of 12/94	12/93 to 12/94	as of 12/93	as of 12/94	12/93 to 12/94	as of 12/94
Germany	0.8%	2.8%	+2.0%	2.2%	2.8%	+0.6%	3.5%
France	1.1	2.2	+1.1	2.7	3.1	+0.4	3.2
U.K.	2.9	3.5	+0.6	2.9	3.4	+0.5	3.0

	1994		1995		1996	
	Forecast	Actual	Forecast	Actual	Forecast	Actual
Germany	2.8	2.4	2.8	1.8	3.5	0.8
France	2.2	1.9	3.1	1.8	3.2	1.0
U.K.	3.5	4.4	3.4	2.8	3.0	2.7

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# A Healthy Opportunity

## *Healthcare stocks lead in the early '90s*

***In the 1980s, they had largely been overlooked by investors enamored with takeover plays***

- ◆ In May 1988 (7 months after the Crash), drug stocks—as well as other healthcare companies—had superb fundamentals.
- ◆ However, in the 1980s, these stocks—as well as growth stocks in general—had largely been overlooked by investors enamored with takeover plays.
- ◆ Thanks to cost reduction and strong new product introductions, drugs' earnings were forecast to rise 20%+ in 1988 and 1989. In addition the stocks were cheap.
- ◆ Longer term, as the industrialized world population aged, per capita drug consumption would rise.

*“Drug Stocks: A Healthy Opportunity,” May 1988*

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## **A Healthy Opportunity**

### ***Healthcare stocks lead in the early '90s***

- ◆ As technology improves, doctors can help more patients in more ways: pacemakers, mechanical heart valves, artificial knees and hips.
- ◆ Aging populations globally expand the number of people suffering from heart diseases and bone diseases.
- ◆ Rising living standards overseas means that more countries can afford to spend more on sophisticated healthcare.
- ◆ As the economy slowed in 1990, medical technology companies had excellent growth prospects.

*"Operating Profits," January 1990*

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## **A Healthy Opportunity**

### ***Healthcare stocks face Political Problems***

- ◆ The prospect of the Clintons' healthcare reform plan caused healthcare stocks to sell off sharply, and caused the weighting of the healthcare sector to drop from 13% in December 1991 to 8% in March 1993.
- ◆ Investors worried that the plan appeared to be a "political" and not an "economic" healthcare reform effort.
- ◆ Investors worried that the Clinton Administration and Congress would fail to recognize that they could not improve the healthcare system if they financially crippled the drug and medical supply industries.
- ◆ It seemed that the healthcare industry was viewed in Washington as the problem, and not part of the solution.

*"Medical Megamorphosis," April 1993*

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## **A Healthy Opportunity**

### ***Healthcare stocks face Political Problems***

- ◆ The President's proposals looked like the traditional Democratic blueprint for nationalized healthcare. In addition, a key concept was "managed competition" i.e., the establishment of buying groups like HMOs, which would have power to negotiate with healthcare service providers
- ◆ The Clinton Administration insisted that, as a first step, price increases for drugs and medical supplies end. In the face of this populist barrage, drug firms promised to hold price increases to the general rate of inflation. Then the key issue became how—not if—prices would be regulated under the new reform bill.

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## **A Healthy Opportunity**

### ***Healthcare stocks face Political Problems***

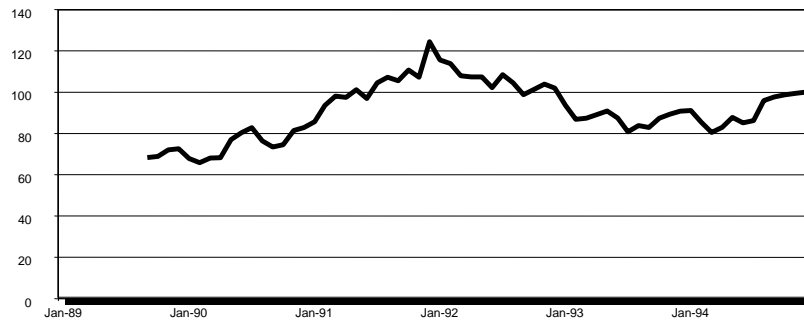
- ◆ Healthcare stocks' valuation in March 1993—cheap but getting cheaper. Cheap stocks have been known to get cheaper as fundamentals deteriorate and consensus inputs for growth rates and normal earnings decline.
- ◆ Diversified, multi-national healthcare firms such as ABT, BMY, JNJ, MRK, and PFE appeared to offer the best risk/reward tradeoff. However, even though the Clinton plan did not go through, those stocks did not regain their 1991 highs until 1995. And from their 1991 highs, those stocks dropped around 50% to their 1993 low.

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# A Healthy Opportunity

## *Healthcare stocks face Political Problems*

S&P Healthcare Sector Index Prices



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