

Brand Breakdown

Disinflation finds another victim

Highlights

■ Despite recent underperformance, consumer products stocks are not particularly attractive because:

- 1) Expected growth rates are coming down.
- 2) Stocks still are not that remarkably cheap.
- 3) Earnings momentum in 1993 and 1994 will be *relatively* poor.

■ Earnings growth of consumer products stocks will be lower in 1990s than 1980s because of:

- 1) Weaker growth in U.S. real disposable income due to slow employment growth, higher taxes;
- 2) Fewer opportunities for brand consolidation, corporate restructuring;
- 3) Private label competition from increasingly sophisticated retailers;
- 4) Stable to higher corporate tax rates, after a decline in 1980s.

■ Foreign markets will be key avenue of earnings growth in 1990s, but not all firms with large foreign operations are well positioned. Firms must have *room to grow* in foreign markets.

■ *Winners:* Coca-Cola, Procter & Gamble.

■ *Losers:* American Brands, Anheuser-Busch, CPC International, Kellogg.

Recent evidence of a slowdown in the U.S. recovery, as well as the broad-based sell-off of consumer products stocks sparked by a price war in cigarettes, raises an important question: Is this an opportunity to buy the shares of high-quality defensive companies cheap, or will the same factors that hammered Philip Morris damage the fundamentals of many other stocks?

Our answer: The recovery will continue, albeit at a tepid pace, and while the Marlboro situation is unique and not likely to be replicated in other industries, *it is symptomatic*

of a difficult environment for other U.S. branded companies. It will be much tougher in the 1990s than it was in the 1980s for major consumer products firms to meet or exceed investors' expectations, because earnings growth will be *slower* while expectations are *higher*. America's supermarkets have become jungles where only the strongest and most agile will survive.

In this tough business environment, we view the sector cautiously:

- *Growth rates are coming down*, and the sustainable growth rates of many firms are probably below Wall Street's already reduced expectations. Table 1 shows that since the start of 1992, investors' EPS growth expectations for most companies have declined, with the average drop being 1.7%. This marks a dramatic reversal from the *rise* in expected growth rates during the 1980s.
- Despite the recent sell-off, *stocks in the sector are not remarkably cheap*. Of the 50 cheapest stocks in our June 1 PaineWebber Equity Valuation Model, only 13 are consumer products firms; of the 100 cheapest, only 19. Investors have not dumped these stocks indiscriminately, to the point where a contrarian investor might want to hold his nose and buy on the theory that all the "bad news is in the stocks."
- Relative to more cyclical sectors, *consumer nondurables will have poor earnings momentum* in 1993 and 1994 because their comparisons are much more difficult. Table 2 shows the operating earnings (i.e., net income plus major write-offs) of 11 major sectors of the S&P 500 since 1986. From 1989 through 1992, earnings of cyclical sectors were down big—by 63% for commodity cyclicals such as chemicals and papers and 65% for consumer cyclicals such as autos. If these two sectors merely got back to their 1989 earnings levels between 1992 and 1997, their earnings would grow at a compound rate of 22% and 23%,

respectively. As the major industrial countries—led by Bundesbank easing and fiscal stimulus in Japan—experience synchronized growth next year for the first time since 1989, cyclical firms' earnings should rise impressively. Consumer nondurables, on the other hand, have tough comparisons, because their earnings rose 46% between 1989 and 1992. In 1993 their earnings are expected to rise 4.9%, which is well below the 13.3% growth forecast for S&P 500 operating EPS (Table 3).

Table 1

Projected growth rates in PW Equity Valuation Model

	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
UST Inc	na	14.0	12.0	na	-2.0
Wrigley Wm 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%

Table 2

Operating earnings of major S&P 500 industry sectors (\$ billions)

Based on 120 large firms in S&P 500, comprising 70% of S&P earnings

	1986	1987	1988	1989	1990	1991	1992	% change 1989-92
Capital goods	\$6.0	\$6.5	\$8.0	\$9.8	\$10.4	\$9.3	\$10.1	+3.1%
Commodities	3.9	7.7	13.0	13.7	10.4	5.8	5.1	-62.8
Consumer cyclical	11.2	13.7	15.1	12.4	4.6	-2.7	4.4	-64.5
Consumer nondurable	8.4	9.8	12.0	14.6	17.2	18.5	21.3	+45.9
Electric utilities	8.5	8.0	7.6	8.7	7.7	8.4	8.0	-8.0
Financials	8.5	4.2	12.2	9.0	12.0	10.8	14.3	+58.9
Health	4.1	5.0	6.2	6.9	8.9	10.4	11.5	+66.7
Oils	9.1	13.3	16.6	13.3	17.6	15.2	14.9	+12.0
Other	1.5	3.6	3.8	3.4	4.2	3.6	3.4	+0.0
Technology	6.1	7.3	8.1	6.2	7.8	4.0	2.0	-67.7
Telephone utilities	10.2	11.9	12.9	13.1	13.6	14.2	15.5	+18.3

Table 3
Net income

	1992	1993E	% chng
American Brands	\$884	\$819	-7.3%
Anheuser-Busch	994	1,031	+3.7
Avon Products	239	274	+14.6
CPC Intl	431	471	+9.4
Coca-Cola	1,884	2,250	+19.4
Colgate Palmolive	477	547	+14.7
General Mls	506	565	+11.7
Gerber Prods	121	125	+3.4
Gillette	513	595	+15.9
Heinz H J	647	685	+5.9
Hershey Foods	243	266	+9.6
Kellogg	657	696	+5.9
Kimberly Clark	516	533	+3.3
PepsiCo	1,302	1,629	+25.2
Philip Morris	4,939	4,317	-12.6
Procter & Gamble	1,872	2,055	+9.8
Quaker Oats	248	310	+25.3
Ralston Purina	354	368	+4.0
Rubbermaid	184	212	+15.1
Sara Lee	621	706	+13.8
UST	313	362	+15.7
Wrigley Wm Jr	149	167	+12.1
Total	\$18,091	\$18,983	+4.9%
S&P 500 op EPS	\$22.49	\$25.47	+13.3%

It's the growth rate, stupid

With the business environment becoming tougher and growth rates coming down, the central issue for this group is: How fast will these companies really grow in the future? Will they continue to grow, but more moderately than in the past? Alternatively, is this a "growth" industry that has run out of gas and essentially stopped growing? There is no one blanket conclusion for all consumer products stocks.

The companies most likely to hit their growth targets are firms that possess: 1) good opportunities to *grow* in foreign markets; 2) exceptionally strong consumer franchises in the U.S.; 3) earnings growth that is driven by unit growth rather than price increases; 4) superior management.

Yes, Marlboro is a special situation. . .

Fans of consumer products stocks are quick to point out that one cannot extrapolate from cigarettes to other products. Cigarettes are special because there has been not just *slow* unit growth but *negative* unit growth in the U.S. Moreover, the price of Marlboros has been rising 10% a year, while most branded goods have increased 1-4% in recent years. Over the past three years, the price of a pack of Marlboro rose 46% while real disposable income rose just 4%, making full-priced cigarettes prohibitively expensive. At \$2.20 a pack, a two-pack-a-day smoker would spend \$1600 per year. It is little wonder that private label brands snuck under this huge pricing umbrella and grabbed market share—particularly in view of the facts that Philip Morris could not advertise Marlboros on TV and that smokers tend to be less affluent consumers.

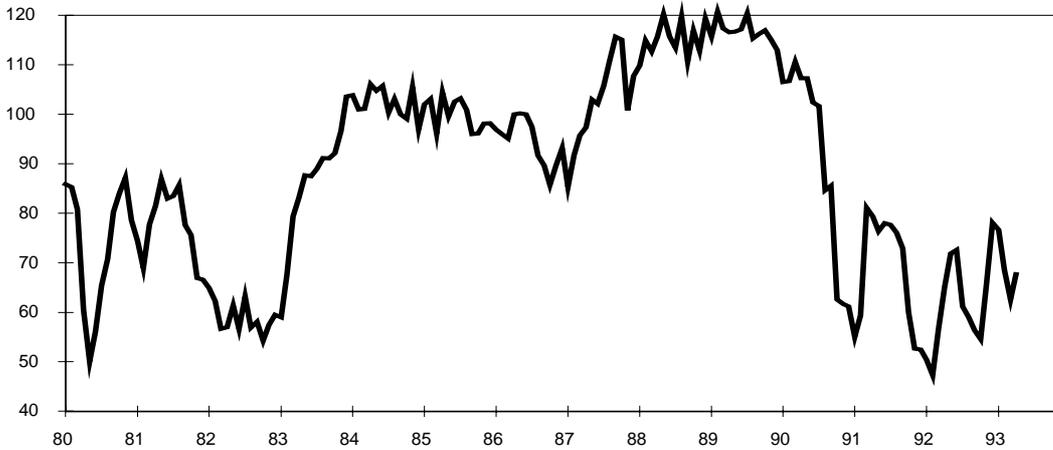
. . .but other branded goods will have a tougher time in the 1990s

Philip Morris has special problems, but other firms are in the same boat. With consumers squeezed by weak employment growth and higher taxes, disinflation has spread from the oil patch and the factory to the supermarket and the shopping mall. This is making it difficult for many branded firms to produce the double-digit earnings growth that investors have come to expect. It is useful to put the current situation in perspective by taking a brief look back.

The balmy 80s

Real disposable income rose at a 3.2% rate from 1982 through 1989 mainly because employment rose a fast 2.7% per year, and the tax burden was generally flat to down. Discretionary income—the money consumers can spend in stores after covering the bare necessities—grew even faster than disposable income because energy prices plunged 44% between 1981 and 1989. Prices of most other commodities, notably food, were also weak in the 1980s, and a flood of cheap imports from Asia likewise boosted the real buying power of consumers. This was a big improvement over the stagflationary "malaise" of the 1970s, and consumer confidence soared (Chart 1).

Chart 1
Consumer confidence



With discretionary income growing rapidly and consumer confidence high, shoppers were willing to pay up for premium brands. And the companies enjoyed other advantages during the 1980s. This 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, Hershey purchased Cadbury USA.

Another major plus for branded stocks in the 80s was that 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 and made massive share repurchases; Quaker Oats sold Fisher Price; General Mills sold an apparel company and a toy company; Gerber divested assets; and Coca-Cola sold Columbia Pictures to Sony in 1989 for a big profit.

Table 4

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	+348	+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 Wm Jr	2 3/4	26 7/8	34 7/8	+877	+30
Average				+793%	-6%
S&P 500	\$107	\$417	\$449	+290%	+8%

All these factors boosted the earnings performance of branded companies during the 1980s. Yet at the start of the decade, 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 expectations, the stocks performed superbly in the 1980s (Table 4). However, as the stocks' prices rose, so did investors' expectations for future earnings growth. As shown in Table 1, investors' consensus growth rate for 22 major branded product firms rose 200 basis points between 1982 and 1992, while growth expectations for the S&P 500 as a whole *declined* by 200 basis points.

The nasty 90s

As detailed in our October 1990 report *Squeezed*, conditions have deteriorated for American consumers since the halcyon days of the 1980s. Employment growth has slowed sharply, hurting both consumers' incomes and

their confidence. After growing 2.7% annually during the expansion of the 1980s, employment declined slightly between 1989 and 1992 (Chart 2). Meanwhile real wages have been sliding, and taxes at all levels of government have been rising. Consequently, real disposable income has grown at just a 1.3% pace over the past three years, versus the 3.2% rate of 1982-89 (Chart 3). And *discretionary* income available to spend in stores has grown even more slowly, thanks to the rising burden of health care costs—a burden boosted not only by high health care inflation, but also by employers' reductions in benefits. These and other factors are causing consumers to feel and act poorer; today, two years into an "economic expansion," consumer confidence remains way below mid-1980s levels (Chart 1). As a result, firms have not been able to raise prices of branded merchandise nearly as rapidly as they could in the 1980s.

Chart 2
Year-to-year change in non-agricultural employment

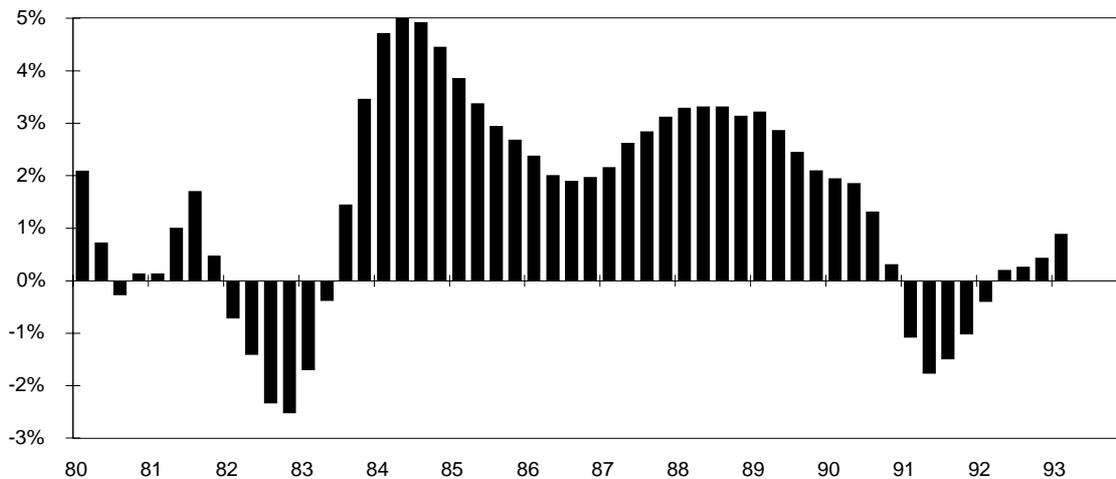
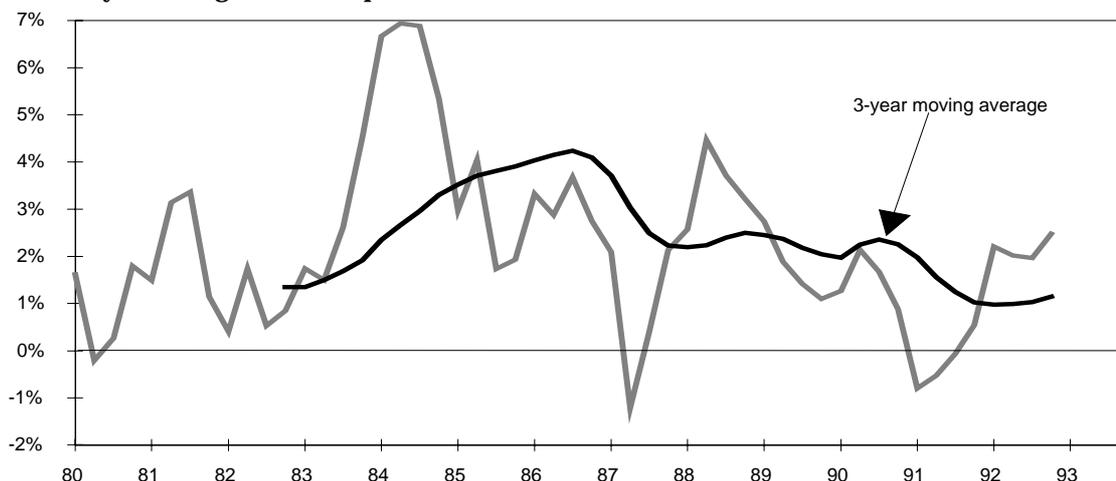


Chart 3
Year-to-year change in real disposable income



While a difficult consumer environment is curbing demand for pricey branded goods, the companies face other hurdles. There are *fewer opportunities for brand consolidation and for corporate restructuring*. And because many of the weak players have been gobbled up or vanquished, major firms are increasingly battling other first-tier players. Branded product companies also have lost clout in the market place as the retail industry has consolidated into giant chains of supermarkets and warehouse clubs that possess immense buying power, sophisticated managements and—thanks to check-out scanners and other technological improvements—a mountain of usable information about which products are moving off the shelves quickly and which products are not.

Tax rate decline has ended

Trends in Federal tax policy are yet another bearish factor for the earnings growth of consumer products firms. *No industrial sector benefited more from the 1986 reform of the Federal Tax Code than did consumer products*. The essence of tax reform at the corporate level was two changes—a big cut in the corporate tax rate from 46% to 34% and elimination of the Investment Tax Credit. For corporate America as a whole, these two change were of roughly similar magnitude; i.e., the cut in tax rates *cost* Uncle Sam about as much as elimination of the ITC *added* to federal revenues. However, heavy industry was hurt by tax reform, while light manufacturing and service gained.

Food, tobacco, beverage and household products are not particularly capital intensive and, therefore, were not big beneficiaries of the Investment Tax Credit. Consequently, their tax burden was high prior to 1986—whether that burden is measured by the reported tax rate in income statements (affects EPS) or by cash taxes actually paid to the IRS (affects cash flow). So these industries were big winners from tax reform because *their tax rate plummeted*. For example, the 15 firms listed in the Appendix saw their average tax rate drop from 43.3% in 1984 to 37.1% in 1992, and all 15 firms enjoyed a drop in tax rates. This 620 basis point decline in tax rates over an eight-year period would contribute, by itself, 130 basis points to EPS growth. Clearly, *this decline in tax rates has ended and may well be reversed in coming years*. Indeed, President Clinton's budget proposals call for an increase in the corporate tax rate from 34% to 36%.

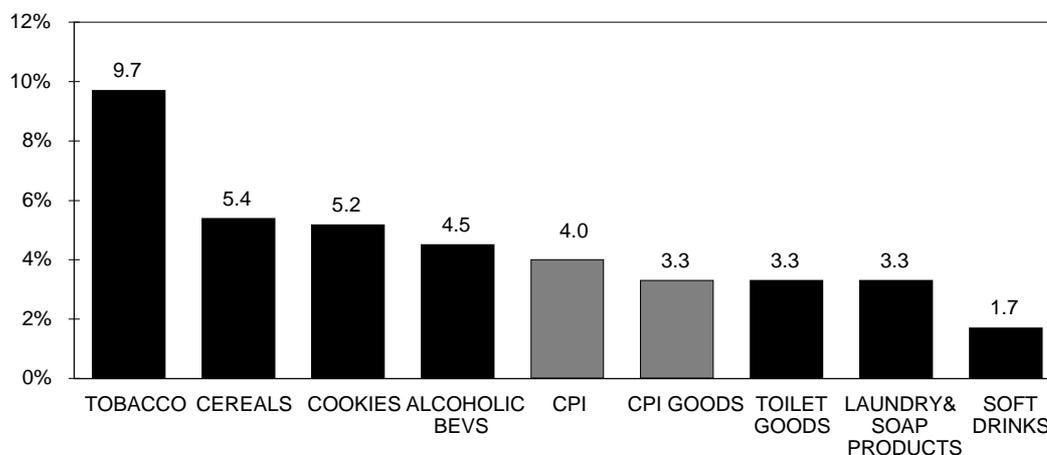
Who is most vulnerable to disinflation?

Of course, some industries are more vulnerable than others to consumers' resistance to price increases. Charts 4 through 7 provide strong evidence that tobacco, food and alcoholic beverages are most vulnerable because they raised prices the most; cosmetic and household products are less vulnerable; and soft drink companies are the least vulnerable by far. Specifically:

Chart 4

Compound growth rate of components of Consumer Price Index, 1986–1992

Compound annual growth rate, Q1 '86–Q4 '92



- *Tobacco* prices rose 10% per year in the period 1986 - 1992 as measured by the tobacco component of the CPI; revenues of the S&P tobacco group rose at a rapid 14% pace, and earnings soared at a 24% pace. The gap between earnings and revenue growth was a very high 9.9 percentage points. This set the industry up for the recent collapse in cigarette prices and stock prices.
- The situation is less extreme, but also rather ominous, for the *food industry*. Prices of food products such as cereals and cookies rose much faster than the CPI-goods (Chart 4). Revenue growth of food companies was a strong 11.4% (Chart 5), and earnings growth was a little faster at 13.2% (Chart 6). Clearly, there is a risk that consumers will balk at rising prices for Oreos and Frosted Flakes, leading to a major slow-down in earnings growth. The bright spot for foods is that earnings growth did not much exceed revenue growth; in other words, the industry did not rely heavily on margin expansion.
- The situation is quite a bit brighter for *household products and cosmetics*. These industries have turned in double-digit earnings gains since 1986 even though product prices kept pace with the CPI-goods. There is limited risk that a consumer revolt against the price of Tide and Colgate will crater earnings growth, although earnings will not rise as fast as in the 1980s.
- But the situation is best by far for *soft drinks*. Remarkably, the industry produced 13% revenue growth and 19% earnings growth even though product prices rose just 1.7% per year—only half of the pace of the CPI. Consumers of Coke and Pepsi are getting a good deal; there is not a big price umbrella for private label.

Chart 5
Revenue growth of S&P industry groups, 1986–1992
 Compound annual growth rate, Q1 '86 - Q4 '92

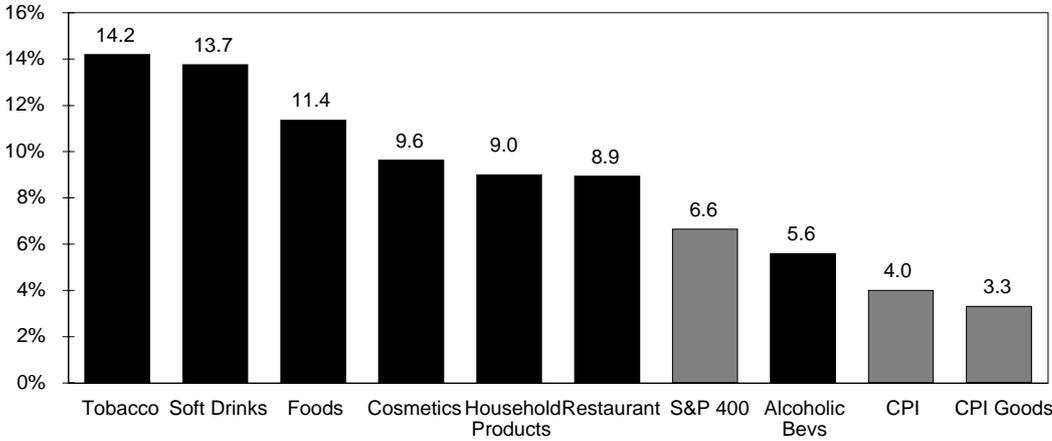


Chart 6
Earnings growth of S&P industry groups, 1986–1992
 Compound annual growth rate, Q1 '86 - Q4 '92

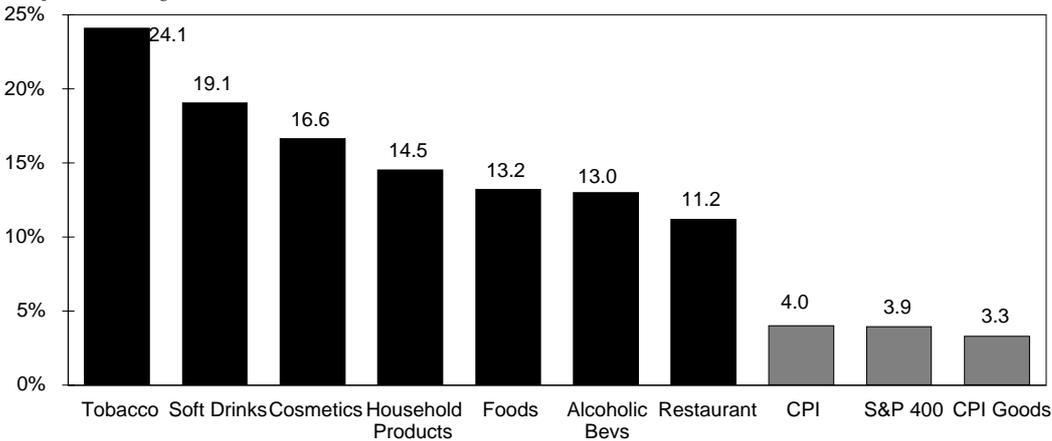
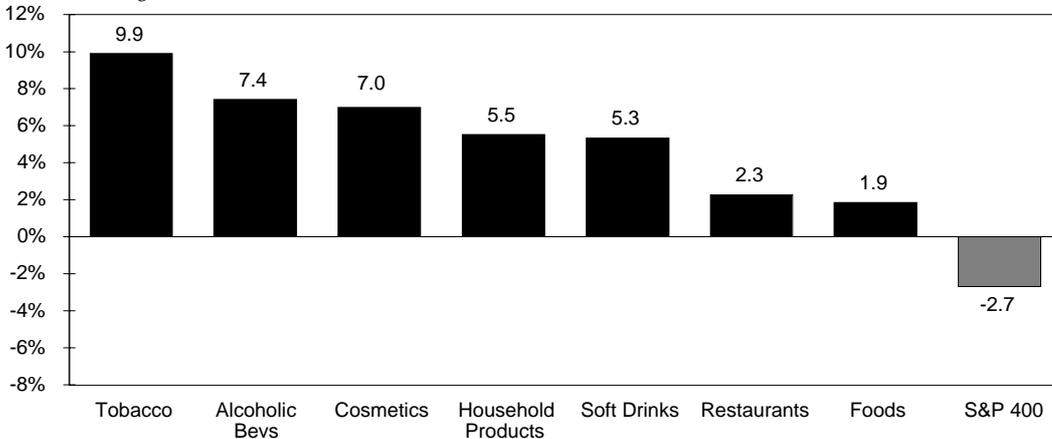


Chart 7
The earnings gap

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



A firm-by-firm perspective on revenue and earnings growth

It is enlightening to extend this analysis down to the level of the individual firm, although one must remember that revenue growth is powerfully affected by acquisitions and divestitures, as well as internal growth. Chart 8 shows that, with the exception of PepsiCo (which acquired KFC and Seven Up International) and Philip Morris (which acquired General Foods, Kraft and smaller firms), most firms registered revenue growth from 1986 to 1992 that was either in the 10-11% area or the 7-8% area. However, most firms managed to produce double-digit income growth in this period (Chart 9), and most firms managed to grow earnings faster than revenue (Chart 10); the average spread was a hefty 680 basis points per year.

Among the factors driving this margin expansion were: The aforementioned decline in tax rates; lower interest expense as interest rates dropped and debt was paid down; corporate restructuring as underperforming units were sold; weak commodity prices that created a favorable spread in the gross margin; and the ability to spread advertising, distribution and corporate overhead costs over more and more units. As our discussion in the Appendix shows, we generally expect this margin expansion to continue. But margin expansion is likely to slow down. Commodity prices and tax rates have bottomed out, and companies are having a harder time raising prices while costs continue to climb.

Chart 8
Revenue growth of selected companies, 1986–1992
Compound annual growth rate

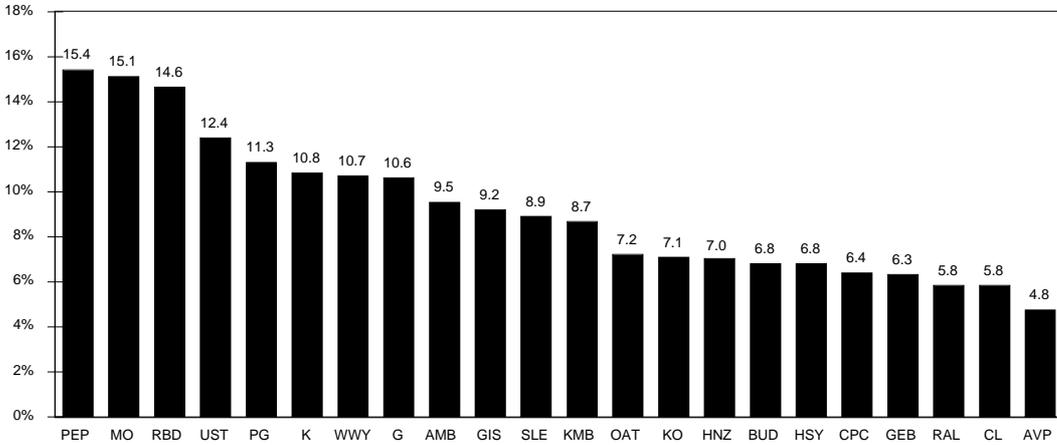


Chart 9
Earnings growth of selected companies, 1986–1992
Compound annual growth rate

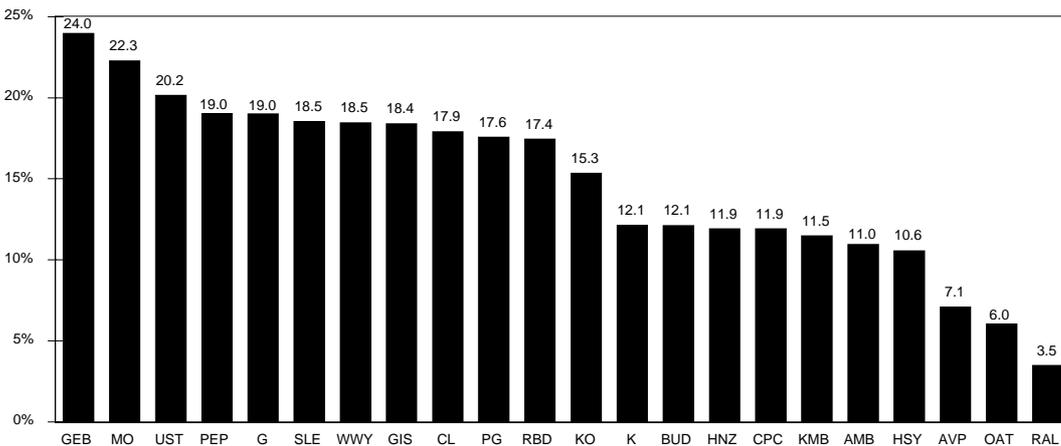
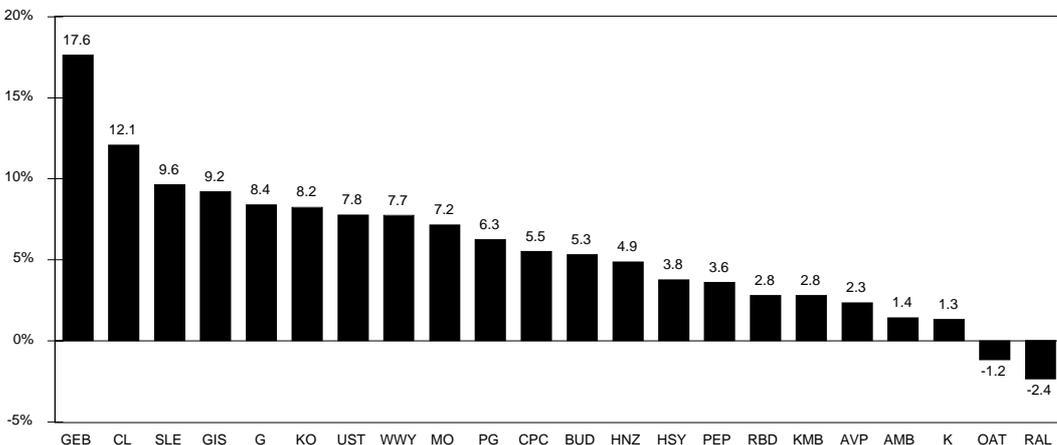


Chart 10
The earnings gap of selected companies, 1986–1992
CAGR in earnings minus CAGR in sales



Disinflation has already hurt many companies besides Philip Morris

As business conditions have gotten tougher in brand land, weak sales growth and earnings disappointments have become more and more common. Charts 11 and 12 show the growth in sales and net income of 22 major consumer products companies since 1980. The three-year moving average of sales growth is now 560 basis points below where it was at the start of 1989; the three-year moving average of net income growth is 400 basis points lower.

Many other facts confirm the slowdown in these companies. A group of 22 household product categories monitored by PaineWebber analyst Andrew Shore registered zero revenue growth in 1992—a 1% decline in units offset by a 1% rise in prices. Tambrands' attempts to raise

Tampon prices backfired disastrously, even though private label has less than 1% of the market. Back in 1990, McDonald's earnings growth faltered when its prices rose too high and it lost market share. A year later PepsiCo's Frito Lay snack business was forced to slash prices and costs to regain market share lost to Anheuser-Busch's Eagle Snacks. In the last two years, CPC's EPS grew at just a 7% pace, versus 13.6% from 1983 to 1990, even though it has extensive operations in Europe and Latin America. Operating profits of Philip Morris' huge U.S. food business grew at just a 5% rate from 1990 to 1992, in part because shoppers resisted price increases on Kraft cheese. All in all, it is not surprising to read in the annual report of Sara Lee Corp. the frank statement, "The competitive food industry is not an area where heavy investment will generate substantial growth."

Chart 11

Year-to-year percent change in sales of 22 major consumer products companies

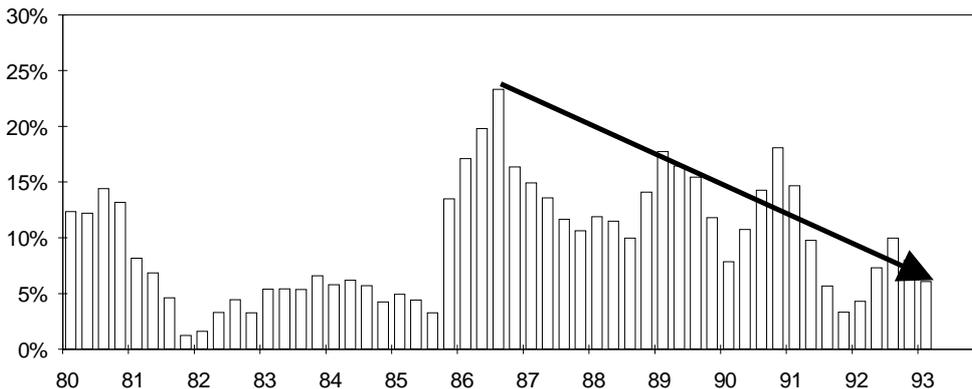
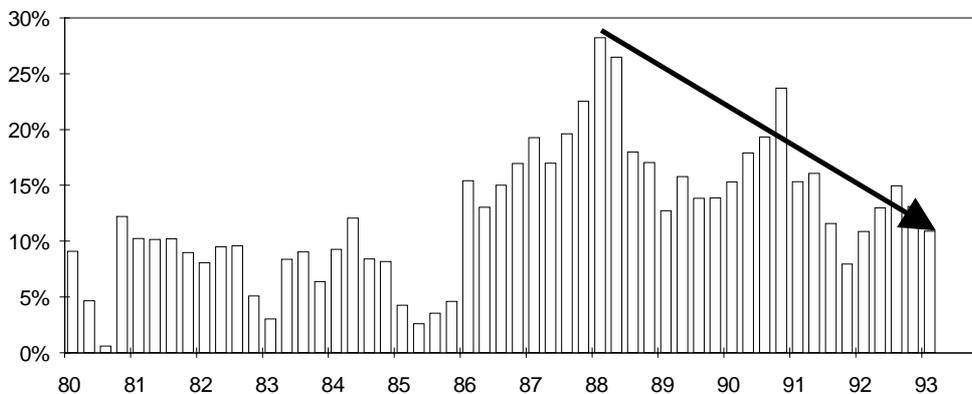


Chart 12

Year-to-year percent change in net income of 22 major consumer products companies



Weak consumer environment to continue

But won't business conditions improve for branded companies as consumers' incomes pick up during an economic recovery? Yes, but the improvement will be slow for the next couple of years because the two key negatives for consumers remain in place. At both the state and federal level, taxes will be rising and government benefits will be shrinking. And as we have argued in the past, employment growth will continue to be weak for five reasons:

1. Continued layoffs by large firms such as GM, IBM, Sears and aerospace firms, as well as the military itself.
2. Service firms in such areas as retailing and finance are avoiding payroll expansion by using computers more effectively.
3. Small firms, the traditional engine of job growth in the U.S., are spooked by the torrent of new regulation emanating from Washington, including the Clean Air Act, the Americans with Disabilities Act, the Family Leave Bill and, above all, health care reform.
4. We are starting to see an employment crunch in the health care sector, which generated most of the new jobs created over the past three years.
5. State and local governments, which employ one-seventh of U.S. workers, are financially strapped.

To be sure, current weakness in the consumer sector may not last forever. By 1996 or so, things could improve. If employment gradually expands over the next couple of years, the U.S. labor market will tighten because the labor force is growing slowly. Corporations will then have to "pay up" to get good workers. And corporations will be able to afford these higher wages because productivity has been rising rapidly as firms streamline and automate their operations. Premium brands may well come back into vogue in the late 1990s as the unemployment rate falls, real wages rise and consumer confidence increases.

Private label will pinch margins

In addition to the problem of weak consumer demand in the nasty 90s, branded companies face the problem that strong and sophisticated retail chains increasingly are substituting store brands for national brands. The motivations for doing so are compelling. By carrying a high-quality attractively-packaged store brand, retailers can do two important things at once: win the loyalty of shoppers by offering a good product at a 15-40% discount to the national brand, and perhaps make more money because gross margins on store brands are 2-4 times gross margins on national brands. For shoppers and retailers, this can be

a win-win situation, provided inventory turns on store brands are reasonably high. The losers are branded-goods companies.

Some observers downplay the threat from private label by pointing out that it does best in a handful of categories where the following conditions exist:

- *Commodity type products* that are not much differentiated by product quality, such as disposable diapers, bleach, milk, cheese, ice cream etc.
- Relatively *expensive products* where price matters a lot to consumers, such as cigarettes and disposable diapers.
- Categories where there is a *big price differential* between the national brand and the discount brand.
- Categories where the *major manufacturers produce the private label product*. Cigarettes are the best example, but the generalization also applies to cereals, where Ralston is a producer of generics.

Since most product categories do not have these characteristics, the bullish argument runs, the risk from private label products is not all that important for most consumer product companies. We agree up to a point; clearly one cannot mechanically extrapolate from cigarettes and diapers to toothpastes and detergents. On the other hand, we see no reason for complacency; knowing where store brands *have been* a threat in the past does not necessarily limit where they *may become a threat in the future*.

With consumers clamoring for good value, and retailers becoming more aggressive and sophisticated in developing new sources of revenue, generics do pose a significant challenge to branded companies. A new generation of high-quality store brands is appearing on supermarket shelves in such product categories as cookies, crackers, pastas and colas that enjoy the strong support of the retailers carrying them. In this connection, it is significant that in the U.K. "store brands" tend to be of premium quality. As part of its assault on the grocery business, Wal-Mart is developing Sam's American Choice, an extensive line of premium quality store brands in the food business. Equate, Wal-Mart's line of health and beauty aids, is already outselling national brands in Wal-Mart stores.

We do not claim to know how much market share the new breed of generics will pick up. But whether it's widgets or cereals, new sources of competition are never bullish for the profitability of established players. Whatever the branded firms do to fend off this competition will hurt their profitability, directly or indirectly. Among the tactics they will resort to are:

- Restraining price increases or, in some cases, cutting prices. Although each product category is different, some observers say that private label gets an opening when the national brand price is more than 15% above private label.
- Improving product quality to keep it ahead of private label.
- Developing catchy new products; innovation is not a strength of private label firms.
- Provide plenty of sophisticated operational back-up to retailers, in the form of MIS personnel, financial consultants, marketing specialists. Private label firms do not have the expertise to match these programs.
- Boost advertising to rebuild “brand equity,” which many marketing experts believe was frittered away in the 1980s because consumer firms shifted their marketing dollars from national advertising to trade promotions.

All of these tactics have two things in common: *They cost money, and they require high-quality management.* Long-term investors in brand land should concentrate on companies that have plenty of both. More specifically, they should concentrate on firms that have:

- strong domestic franchises and high market shares, but with room to grow;
- excellent, proactive, flexible managements that know how to cut costs and come up with innovative products;
- solid opportunities to boost earnings overseas;
- generation of free cash flow that can be used to make acquisitions, repurchase shares, raise dividends.

Branded firms’ growth formula for the 1990s

When it comes to generating EPS growth, every branded company is different. However, many firms are variations on a single formula:

- Grow domestic earnings at an acceptable rate through some combination of modest unit growth, price increases and cost-cutting.
- Use cash generated in these high-margin domestic operations to *expand the foreign business*, where margins are lower but unit growth is higher.
- Use any cash that is left over to repurchase shares, which boosts EPS growth by reducing the denominator rather than increasing the numerator.

Table 5

Percent of revenues from overseas

	1988	1992	Change
American Brands	63%	64%	+1%
Anheuser Busch	0	0	0
Avon Products	49	59	+10
CPC Intl	57	63	+6
Coca Cola	56	64	+8
Colgate Palmolive	64	64	+0
General Mls	10	9	-1
Gerber Prods	0	0	0
Gillette	65	69	+4
Heinz H J	40	41	+1
Hershey Foods	9	11	+2
Kellogg	36	41	+5
Kimberly Clark	31	28	-3
PepsiCo	19	22	+3
Philip Morris	28	33	+5
Procter & Gamble	37	48	+11
Quaker Oats	29	34	+5
Ralston Purina	24	29	+5
Rubbermaid	12	11	-1
Sara Lee	26	31	+5
UST	0	0	0
Wrigley Wm Jr	36	41	+5
Average	31%	35%	+4%

In effect, then, the engine of growth is shifting from the U.S. to foreign markets. Whether foreign operations contribute much to EPS growth is obviously a function not only of *how fast* the foreign business is growing, but *how big* it is relative to the overall company. If foreign earnings are growing 20% but comprise only 10% of total earnings, they contribute only 2% to EPS growth; if they are 60% they contribute 12% and the entire firm would have a double-digit growth rate even if domestic profits did not grow at all. Many firms such as Philip Morris, Kellogg and PepsiCo are straining to expand their foreign business so that it will be big enough to “carry” the growth rate of the overall firm as growth in domestic operations slows down. Table 5 shows that from 1988 to 1992 the share of revenues generated overseas by 22 major firms rose, on average, from 31% to 35%.

The domestic cash cow

As we have seen, most firms will have a tough time growing U.S. earnings rapidly during the 1990s. Most firms get 1-3% unit growth domestically and 1-4% price increases. A key to good unit growth is product innovation that creates pizzazz in mature categories. Some firms have particularly strong franchises because of a technological edge (e.g., Gillette) or an irreplaceable distribution system (UST). Firms with the highest domestic market shares tend to have the highest profit margins and the

most secure business franchises, because in the event of a price war they can reduce prices and still make money while their competitors—who are spreading overhead costs and marketing costs over fewer units—quickly lose money. Case in point: Anheuser-Busch's Eagle Snacks, which got into a price war with PepsiCo's Frito Lay in 1991 and has yet to make a penny, even though it makes a mighty fine potato chip. Another example is Keebler's disastrous price war with RJR Nabisco in cookies. Philip Morris hopes that it can do to RJR in cigarettes what RJR did to Keebler in cookies.

A major risk for firms that dominate the domestic market is *running out of room to grow*. They own the market, but the market may not grow much. Examples include Anheuser-Busch in beer, Heinz in pickles and relishes, CPC in mayonnaise and corn oil, Gerber in baby foods and, potentially, Gillette in razors.

Foreign frontiers

In general, it is easier to grow overseas, but growth tends to be slower in developed markets than developing markets. In developed markets, some U.S. firms have only mediocre growth prospects because they already have huge market shares in mature product lines—e.g., their situation in Europe is not so different from their situation in the U.S. Examples include CPC in mayonnaise and corn oil or Gillette in razors. Firms of this type are vulnerable to near-term weakness in the European economy, though they will also benefit from the economic upturn that is occurring in the U.K. and will likely occur on the Continent in 1994. In a different situation are such firms as Coca-Cola, PepsiCo and Procter and Gamble. Whether it is soft drinks, salty snacks or disposable diapers, their products still have low per capita consumption levels in developed markets overseas. The firms are in a protracted campaign to boost consumption toward U.S. levels. There is plenty of room for growth, but the growth may not necessarily be fast.

Another avenue of growth in developed foreign markets is acquisitions. In Europe and Latin America the industry is still relatively fragmented, so U.S. firms with plenty of cash can buy small companies with strong market positions. Over the past couple of years, Philip Morris has bought Jacob Suchard and Freia Marabou, as well as cigarette makers in eastern Europe. Sara Lee has bought various European apparel firms, which it plans to build into "mega-brands." PepsiCo has acquired dozens of foreign firms, particularly in snack foods and beverage bottling.

Developing markets

Among the most exciting unit growth stories for any firms anywhere in the world is the opportunity to sell branded packaged products to consumers in developing economies. The number of potential consumers is huge; they are attracted to U.S. products ranging from Mickey Mouse to the Marlboro Man; and in many key markets they are becoming increasingly affluent and able to afford exotic foreign luxuries such as a bottle of Coke or a Big Mac. Moreover, as these consumers migrate from the countryside to the city and from the farm to the factory they have more day-to-day need for convenient consumer products purchased at a store or a vending machine. And a tougher U.S. trade policy is encouraging many developing countries to open up their markets to imports and to respect trademarks. The U.S. has plenty of bargaining power because it is a huge importer of goods produced in developing nations. For example, the sixth biggest exporter to the U.S. is China.

To put in perspective just how mammoth these developing markets are, it is instructive to compare the estimated 1995 population of major markets in the "developed world" with the population of selected parts of the "developing world." The developing markets listed in Table 6 have a total population equal to four times that of the developed markets. Obviously, the developing markets will not become big buyers of U.S. branded products all at once, but they are so big that if fairly modest portions of them become decent markets, they represent enormous incremental demand.

Table 6

Estimated 1995 population of selected regions

Selected developed regions:	
North America	285.8
Europe, except eastern Europe	389.4
Japan	125.9
Australia	17.9
Total	819.0
Selected developing regions	
Latin America	493.1
Eastern Europe	114.8
Former USSR	298.6
India	946.7
Indonesia	201.8
China	1,222.6
Total	3,277.6

Source: United Nations, "Sex and Age Distributions of Populations," 1990. Figures reflect "medium variant" of estimate range.

Every consumer product company wants to grab a big share of these markets, but a few firms—by virtue of their history and management acumen—are already there in force. They include CPC in the Latin American food business, Coca-Cola in soft drinks, Colgate in personal care products, and Philip Morris in cigarettes. The early entrants into these developing markets have a big advantage over johnny-come-latelies. They get to hire the best local managers, establish distribution systems and build their brand equity before consumers have been exposed to competing brands. The best competition is no competition. Once a firm with a good product line and persuasive marketing has grabbed a big share of the market, it is expensive and risky for others to move into the market. Clorox, for example, has announced several forays into foreign markets but has never really managed to pull it off.

Margin expansion overseas

With the exception of a few companies such as Coca-Cola (which faces less competition overseas than in the U.S.), most branded product firms have lower profit margins overseas. Because U.S. firms are still investing to build a marketing and distribution system, costs are higher in relation to current sales. Then, too, foreign consumers just cannot afford to spend as much on a pack of Marlboros or a can of Gatorade. While these low margins are obviously a negative right now, they can be a positive from the standpoint of future growth rates, because margins have room to expand. Higher margins on rising revenues is a recipe for healthy profit growth.

Winners and losers

The Appendix (see page 17) spells out our view of growth prospects for 15 major consumer products firms. In light of the pressures on earnings growth discussed in this report, which stocks should be avoided because they are vulnerable to earnings disappointments and declining expectations about growth rates? And which stocks are attractive because growth will come through as expected, yet are reasonably valued?

Winners

At the top of our list of winners is **Coca-Cola**. We have high confidence in our 16-18% growth rate because KO has a well-defined opportunity to expand sales in recently opened markets such as Russia, Eastern Europe, China, India, etc. Soft consumer demand in the U.S. is not a big threat because the U.S. comprises only 19.3% of total operating income and—as we documented earlier—soft drink prices have risen less than the CPI recently, which means that consumers are getting a very good deal. Investors' expectations about KO's growth rate are not excessive; the IBES mean growth is 17.7%. Finally, the stock is cheap, ranking 20th cheapest out of 330 stocks in the PaineWebber Equity Valuation Model. For KO to be of just average attraction in our model, its growth rate would have to be cut from the current buy side consensus of 15.5% to 13.0%. And for KO to rank in the bottom quintile of the model its growth rate would have to be cut to 11.5%. Manny Goldman rates the stock buy.

Another stock that we like, and that is rated attractive by Andrew Shore, is **Procter & Gamble**. P&G is not particularly vulnerable to disinflation because prices of toiletries and laundry products have been rising more slowly than the CPI (Chart 4). P&G has good overseas growth opportunities. It is one of the best managed, most dominant companies in brand land and should have little trouble hitting the IBES mean growth rate of 12.3%, which matches our own growth estimate of 11-13%. But the stock has done little over the past three years and is now cheap, ranking 36th in the PaineWebber Equity Valuation Model. For P&G to be of just average attraction in our model, its growth rate would have to be cut from the current buy side consensus of 11.0% to 9.25%. And for P&G to rank in the bottom quintile of the model its growth rate would have to be cut to 8.0%.

Losers

Four stocks we would avoid are American Brands, Kellogg, CPC International and Anheuser-Busch.

American Brands is a slow-growing company in a troubled industry. While its non-tobacco businesses are expected to achieve high-single digit earnings gains this year, price deflation in the U.S. cigarette market and the weakness of the pound sterling caused Manny Goldman recently (May 27) to cut his earnings estimates for 1993 and 1994. Weak near-term earnings growth, coupled with the possibility of downside surprises from even those levels, is the basis for Manny Goldman's unattractive rating on the stock.

Kellogg has been losing share in the U.S. cereal market mainly because it is not as innovative as General Mills. Sell-side consensus growth rates are too high; the lowest growth rate reported by IBES is 12%, well above our 9-10% number. The buy-side consensus in our Equity Valuation Model is 11.0%.

As a producer of slow-growing, price-sensitive supermarket staples, **CPC** will only grow 9-10% at best, well below the IBES consensus of 11.7%. The buy-side consensus in our Equity Valuation Model is 10.0%, down from 12.5% early in 1992.

Similarly, **Anheuser-Busch**, which Manny Goldman recently downgraded to neutral, is unlikely to grow faster than 10%, significantly below the 11.6% IBES consensus. **BUD** is a fine company but it has a problem: With very limited international exposure, it is dependent on the highly price-sensitive U.S. beer market, which is growing a sluggish 1-2% annually. Demand for Budweiser and other premium beers should pick up as the economic expansion continues, but so may commodity prices for grain and aluminum, which would tend to pressure profit margins.

Additional information is available upon request.

Prices of companies mentioned as of 6/22/93:

American Brands AMB \$33 1/8
 Anheuser-Busch Cos BUD \$49 5/8
 Avon Products¹ AVP \$56 5/8
 Cadbury Schweppes² CADBY \$27 1/4
 Clorox Co³ CLX \$27 1/4
 Coca-Cola³ KO \$41 1/8
 Colgate Palmolive CL \$57 3/8
 CPC Int'l CPC \$41 1/4
 Fisher-Price^{2,3} FPP \$19 3/4
 General Mills³ GIS \$64
 General Motors^{1,3} GM \$43 5/8
 Gerber Products GEB \$26 1/4
 Gillette Co³ G \$49 3/4
 Heinz (H.J.)³ HNZ \$36 1/2
 Hershey Foods HSY \$49 5/8
 International Business Mach. IBM \$49 1/4
 Kellogg Co K \$54 1/4
 Kimberly-Clark KMB \$47 3/4
 McDonalds Corp^{1,3} MCD \$48 1/2
 Nestle^{2,4} (6/21/93) 1130 Swiss francs
 PepsiCo³ PEP \$ 36 1/2
 Phillip Morris³ MO \$47 7/8
 Procter & Gamble³ PG \$49 1/2
 Quaker Oats³ OAT \$72 5/8
 Ralston Purina³ RAL \$45 7/8
 RJR Nabisco^{2,3} RN \$5 1/4
 Rubbermaid RBD \$29 1/2
 Sara Lee Corp³ SLE \$24 3/4
 Sears, Roebuck³ S \$53 1/4
 Sony³ SNE \$39 3/4
 Tambrands Inc TMB \$45 1/2
 UST³ UST \$28 3/4
 Wal-Mart Stores³ WMT \$24 7/8
 Wrigley (Wm) Jr. WWY \$34 3/4

¹ PaineWebber Incorporated and/or Rotan Mosle Inc., an affiliated corporation of PaineWebber Incorporated, has acted in an investment banking capacity for this company.

² PaineWebber Incorporated makes a market in this security.

³ A subsidiary of PaineWebber Incorporated acts as a specialist that makes a market in this security. At any given time the specialist may have a position, either long or short, in the security, and as a result of the associated specialist's function as a market maker, such a specialist may be on the opposite side of orders executed on the floor of a national securities exchange.

⁴ These securities can only be offered in such states as may be legally permissible.

Appendix**Components of EPS growth of 15 major consumer products firms**

American Brands: 7-10% EPS growth

Revenue growth: 7%

Unit growth: 4%

Price increases: 3%

Comment: Unit growth should be slightly negative in domestic tobacco, flattish in distilled spirits, and slightly positive in foreign tobacco. Office products and hardware should produce mid-single digits growth as economy expands.

Margin expansion: 0.5-2%

Comment: Margin expansion likely in foreign tobacco and non-tobacco U.S. businesses. But U.S. cigarette margins will be squeezed by price war.

Share repurchases / deleveraging : 0-1%

Comment: Free cash flow to be used for acquisitions, share repurchases.

Anheuser-Busch: 10% EPS growth

Revenue growth: 5%

Unit growth: 2%

Price increases: 2-3%

Comment: U.S. beer market is growing slowly and is quite price-sensitive.

Margin expansion: 5%

Comment: With 44% market share and highly efficient breweries, BUD has continuously expanded margins and should be able to do so. A negative: commodity price trends should be less favorable in late 1990s than over past few years.

Share repurchases / deleveraging: 0%

Coca-Cola: 16-18% EPS growth

Revenue growth: 10%

Unit growth: 5.5%

Pricing: 4.5%

Comment: Worldwide unit growth has been 5% annually over past five years, despite recessions in U.S., Europe. Superb unit growth opportunities in eastern Europe, Russia, China, Indonesia, India, Latin America. Prices will be raised as local conditions warrant; they will rise fairly rapidly in areas with rapidly increasing living standards. Private label will put damper on U.S. price increases.

Margin expansion: 3.5%

Comment: Thanks to operating leverage, KO has boosted net margins almost continuously since 1980. Because of huge market shares and limited competition in most foreign markets, KO has plenty of leeway to manipulate pricing and marketing expenditures to expand margins.

Share repurchases: 2.5%

Comment: Beverage business is highly profitable and throws off plenty of free cash. In five of the years since 1984, share repurchases equaled 4-5% of shares outstanding.

Colgate-Palmolive: 11-13% EPS growth

Revenue growth: 8.5%

Unit growth: 5%

Pricing: 3.5%

Comment: Unit growth rapid because of big exposure to developing world.

Margin expansion: 3%

Comment: CEO Reuben Mark is in middle of successful campaign to improve profitability of CL's domestic businesses, which had been neglected by previous management, while also acquiring businesses in personal care area, where margins are higher.

Share repurchases: Just announced a five million share repurchase.

CPC International: 9-10% EPS growth

Revenue growth: 6%
 Unit growth: 3.5%
 Price increases: 2.5%

Comment: 2.5% unit growth in U.S., Europe, but 8-9% in Latin America (15% of sales). Good growth opportunities in eastern Europe as well, but price increases will be slim.

Margin expansion: 2%

Comment: Operating leverage as unit growth rebounds in U.S., Europe. Historically, CPC has managed to expand margins modestly.

Share repurchases / deleveraging / niche acquisitions: 1-2%

General Mills: 12-13% EPS growth

Revenue growth: 8%
 Unit growth: 5%
 Price increases: 3%

Comment: Cereal market has 3% unit growth, but GIS gains market share through product innovation. Betty Crocker produces double-digit unit growth and restaurant chains will add units. After including coupons, cereal price inflation in U.S. is not excessive.

Margin expansion: 2.5%

Comment: GIS has best management in food industry and continuously boosts margins through cost-cutting.

Share repurchases / deleveraging / new ventures: 1.5-2.5%

Comment: Cereal plants are highly efficient, throw off free cash. Cereal Partners Worldwide (joint venture with Nestle), which loses 10-15 cents per share, Snack Ventures Europe (joint venture with PepsiCo) and China Coast will contribute to growth in later 1990s.

Gillette: 13-14% EPS growth

Revenue growth: 8.5%
 Unit growth: 5%
 Price increases: 3.5%

Comment: Very rapid unit growth in developing markets; growth remains strong in U.S. and Europe with roll out of Sensor and Sensor for Women.

Margin expansion: 3.5%

Comment: Heavy emphasis placed on re-engineering production process to cut costs.

Share repurchases / Deleveraging: 1%

Comment: Company uses free cash to pay down debt.

Hershey: 10-11% EPS growth

Revenue growth: 8.5%
 Unit growth: 6.5%
 Price increases: 2%

Comment: Candy market grows 3.5% per year, but HSY is gaining share through product innovation. Pasta market has similar growth rate and HSY should be able to grow 4-5%, exclusive of acquisitions. Free cash flow will be used to expand overseas, probably in Mexico.

Margin expansion: 1.5%-2.5%

Comment: Firm has continuously expanded margins through operating leverage, which should continue.

Share repurchases / deleveraging: 0%

Kellogg: 9-10% EPS growth

Revenue growth: 7.5-8%
 Unit growth: 4.5%
 Price increases: 3.25%

Comment: Kellogg will lag General Mills in U.S., but has big market shares overseas (50% in Europe, 80% in Latin America) where unit growth and pricing flexibility are greater.

Margin expansion: 1%

Comment: Cereal plants will become more efficient, in effort to stay competitive with General Mills.

Share repurchases / deleveraging: 1.25%

Comment: Cereal business generates free cash.

PepsiCo: 15-16% EPS growth

Revenue growth: 10%
 Unit growth: 5.5%
 Price increases 4.5%

Comment: Rapid unit growth in overseas soft drinks, snack foods, restaurants, which generate about 22% of earnings. Free cash flow will be used to finance overseas expansion.

Margin expansion: 5%

Comment: PEP has one of the best managements in brand land and is very good at boosting profitability. Net margin has doubled since 1983 but is still less than half of Coca-Cola's.

Share repurchases: 0%

Comment: Free cash will be used for acquisitions, mainly overseas.

Philip Morris: 10-13% EPS Growth

Revenue growth: 7%

Unit growth: 3.5%

Price increases: 3.5%

Comment: Even from the depressed 1993 base, domestic tobacco's unit growth will be about -1% and price hikes just 4%. However, unit growth should be a strong 15% in international tobacco, as MO moves into Russia, eastern Europe, China, and other markets, and price hikes 4%. In domestic foods, both unit growth and price hikes will be about 2.5%. Unit growth in international food should be 6% (thanks in part to acquisitions), and price hikes 2.5%.

Margin expansion: 2%

Comment: Rapid unit growth in international food and tobacco will enable MO to spread overhead over more units.

Share Repurchases: 3-4%

Comment: Despite the stall in domestic tobacco growth, that business and other MO operations will still throw off, over next five years, \$15 - \$17 billion in free cash. At current stock prices, this would buy back more than 30% of MO shares, or 6% per year. However, share price will increase over time and some of free cash will be used to finance acquisitions, particularly in international food area.

Procter & Gamble: 11-13% EPS growth

Revenue growth: 7.5%

Unit growth: 4.5%

Price increases: 3%

Comment: Unit growth about 2% domestically, 10% overseas, where growth opportunities are excellent. Acquisitions will add another point to unit growth.

Margin expansion: 3.5%

Comment: Cost-cutting, shift to "every day low pricing" will boost margins.

Share repurchases / deleveraging: 0%

Sara Lee: 10-11% EPS growth

Revenue growth: 7%

Unit growth: 4.5%

Price increases: 2.5%

Comment: Rapid unit growth, especially in Europe, of Personal Products Division (hosiery, underwear, active wear) by creating "mega-brands" such as Hanes, L'eggs, Dim. Competition is mainly mom and pops, and SLE is highly efficient low-cost producer. Price hikes will be modest, so private label is not a threat.

Margin expansion: 2.5%

Comment: SLE has expanded net margin in each of last 7 years and can continue to do so because: 1) domestic food business is run for margin expansion, not market share growth and 2) Operating leverage in personal products, where SLE is highly efficient manufacturer.

Share repurchases / deleveraging / acquisitions: 0.5 - 1.5%

UST Corp. 16-18% EPS growth

Revenue growth: 14-15%

Unit growth: 4%

Price Increases: 10%

Comment: Healthy unit growth may be driven by smokers shifting to alternative tobacco source that can be used where cigarette smoking is banned. Hefty price hikes possible because of very limited competition, but even though the 10% pricing is still holding, memories of Marlboro leave us uneasy.

Margin expansion: 0-1%

Comment: Margin expansion has slowed in recent years.

Share repurchases / deleveraging: 2%

Comment: Business throws off plenty of free cash.

Wrigley: 10-11% EPS growth

Revenue growth: 8%

Unit growth: 6%

Price increases: 2%

Comment: Unit growth is 3% in the U.S. where WWY is gaining market share, and 9-10% overseas (42% of earnings), led by Asia. As in the past, price hikes will be modest; private label is not a threat.

Margin expansion: 1.5%

Comment: Operating margins improve steadily, thanks to operating leverage.

Share repurchases / deleveraging: 0.5%

June 29, 1993

Edward M. Kerschner, CFA (212) 713-2448
Thomas M. Doerflinger (212) 713-2540

The information contained herein is based on sources we believe to be reliable, but its accuracy is not guaranteed. PaineWebber Incorporated and/or Mitchell Hutchins Asset Management Inc., affiliated companies and/or their officers, directors, employees or stockholders may at times have a position, including an arbitrage or option position, in the securities described herein and may sell or buy them to or from customers. These companies may from time to time act as a consultant to a company being reported upon.
Copyright © 1993 by PaineWebber Incorporated, all rights reserved