TRINITY SMF

STUDENT MANAGED FUND

Consumer Staples Sector Report 2023-24

Sector Manager:
Senan Delargy

Senior Analyst:
Amy McGrath

Table of Contents:

Sector Overview:

The Consumer Staples Sector includes those products that people are unable or unwilling to cut out of their budgets regardless of their financial situation. Examples of consumer staples products are foods and beverages, household goods, and hygiene products as well as alcohol and tobacco.

Consumer Staples are a sub-category of consumer goods that are regarded as essential products. The necessity of these products and lack of substitute goods means that their prices are generally regarded as having inelastic demand. This simply means that their volume holds up well even with price increases.

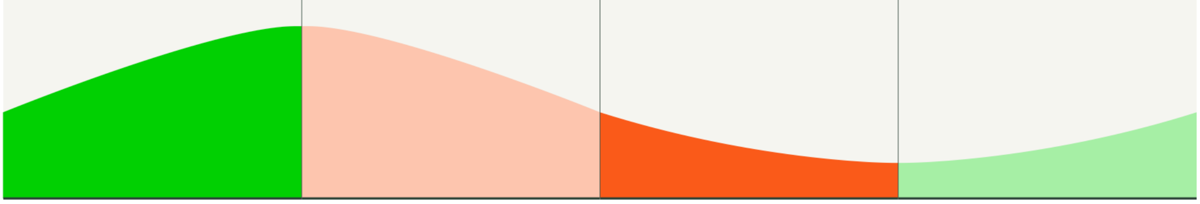
Consumer staples is considered to be a "defensive" sector for its historical ability to hold up better than most other sectors during a market rout. The Sector earned its defensive reputation in 2022 by outperforming the broader market despite rising input costs.

This sector is non-cyclical, meaning demand for these products tends to remain relatively constant all year round, regardless of product price or the health of the broader economy. This typically leads to more stable and predictable earnings, which can be a comfort to investors when a recession hits. Many identify that the global economy is experiencing a slowdown and hence now is a great time to invest in Consumer Staples.

Throughout 2022 inflation was high however, unemployment levels were at historic lows and savings levels were high due to lockdowns curtailing normal spending habits. This meant that consumers were better able to deal within price hikes within the sector and as a result consumer staples companies were able raise prices without losing customers in 2022.

A Sector Roadmap for Business Cycles:

Expansion	Slowdown	Recession	Recovery
• Growth reaches its peak • Increasing capex to improve productivity and meet increasing demand • Interest rates start rising from their relatively low levels	• Capacity utilization peaks • Positive output gaps • Positive but decelerating growth • More restrictive monetary policy	• Declining economic outputs • Falling demand from both consumers and businesses • Increasing unemployment • Low consumer confidence • Easing monetary policy	• Economy rebounds but below trends • Consumer expectations improve • Discretionary spending increases • Businesses stop cutting back on commercial activities • Monetary policy remains accommodative
++ Financials Technology	++ Consumer Staples Health Care	++ Consumer Staples Utilities	++ Consumer Discretionary Real Estate
+ Communication Services	+ Industrials	+ Health Care	+ Materials
– Consumer Staples	– Materials	– Communication Services	– Health Care
–– Health Care Utilities	–– Consumer Discretionary Real Estate	–– Real Estate Technology	–– Consumer Staples Utilities



Sector Overview:

Sector Averages:

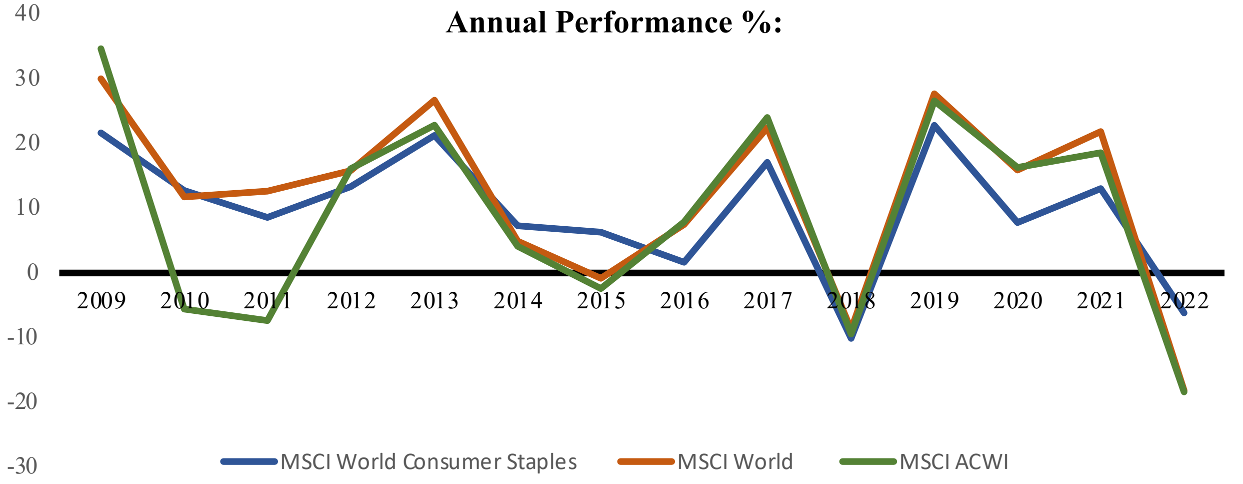
Metric	Sector Average
P/E	21.42
FWD P/E	18.79
P/BV	4.36
Revenue Growth	3.70%
Dividend Yield	2.65
Performance 1 Year	-4.43%
Performance YTD	-1.69%

According to a Morgan Stanley report while consumer spending has been resilient, management teams continue to balance pricing power and cost reductions to support margins. Nonetheless, they believe rising rates and slowing growth will lead to further deterioration in revenues, margins, and earnings. This explains the drop in the Consumer Staples Revenue growth from around 9% in 2022 to 3.70% in 2023.

The P/E ratio is found by dividing the share price by the company's earnings per share. Used to determine the relative value of a company's shares compared to other companies within the sector in a like-to-like comparison. A high P/E ratio could mean that a company's stock is overvalued, or that investors are expecting high growth rates in the future. The forward P/E ratio is ideally lower than the current P/E ratio.

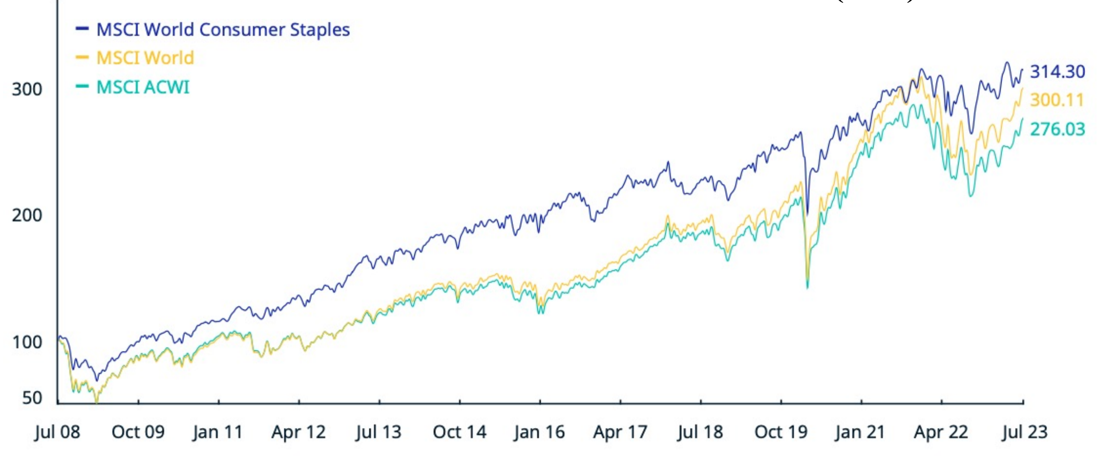
P/B ratio is Market price per share divided by the book value per share. Within staples industry P/B average is around the 6.0 mark so any company with a p/b under this figure can be viewed as being undervalued. It determines the relationship between the total value of a company's outstanding shares and the net value of its assets, as reflected in the Balance Sheet.

Sector Overview: MSCI World Consumer Staples Index



The MSCI World Consumer Staples Index is designed to track the performance of the sector. It demonstrates that the sector has had a better annual performance compared to the global equity market (MSCI World) in numerous years including 2010, 2011,2014, 2015 and 2022. The index is comprised of 111 constituents. The top ten constituents are Proctor and Gamble Co, Nestle, Pespsico, Coca Cola, Costco Wholesale Corp, Walmart, Philip Morris Intl, Unilever PLC, L'Oréal and Mondelez International A.

Cumulative Index Performance – Net Returns (USD) :



Key Risk & Return Factors Exposure

Value - Relatively more expensive stocks

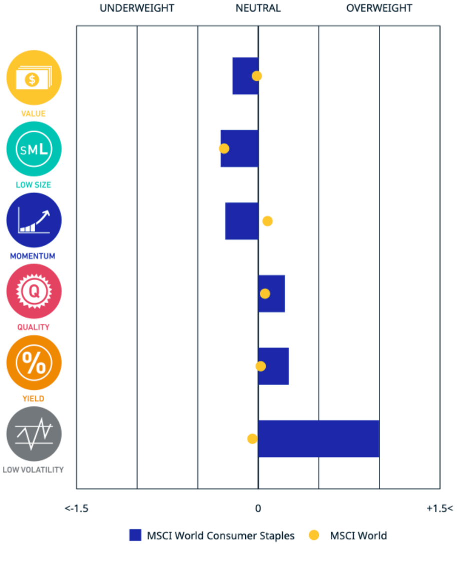
Size - Larger companies

Momentum - Rising stocks

Quality - Sound balance sheet

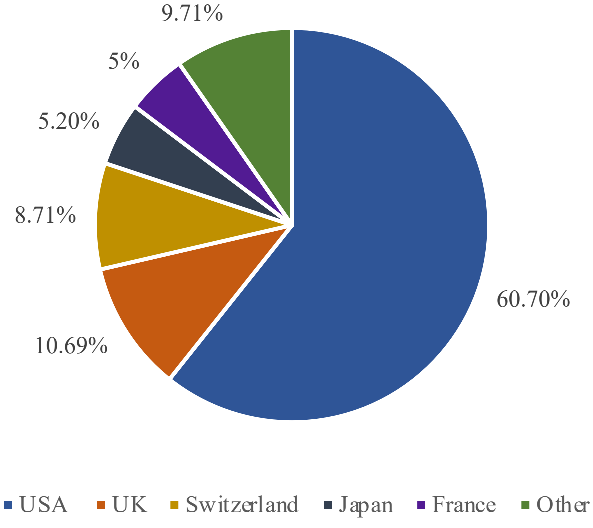
Yield - Greater cash flow pay out

Low Volatility - Much lower risk stocks



Sector Overview: Subsectors

Country Weights:



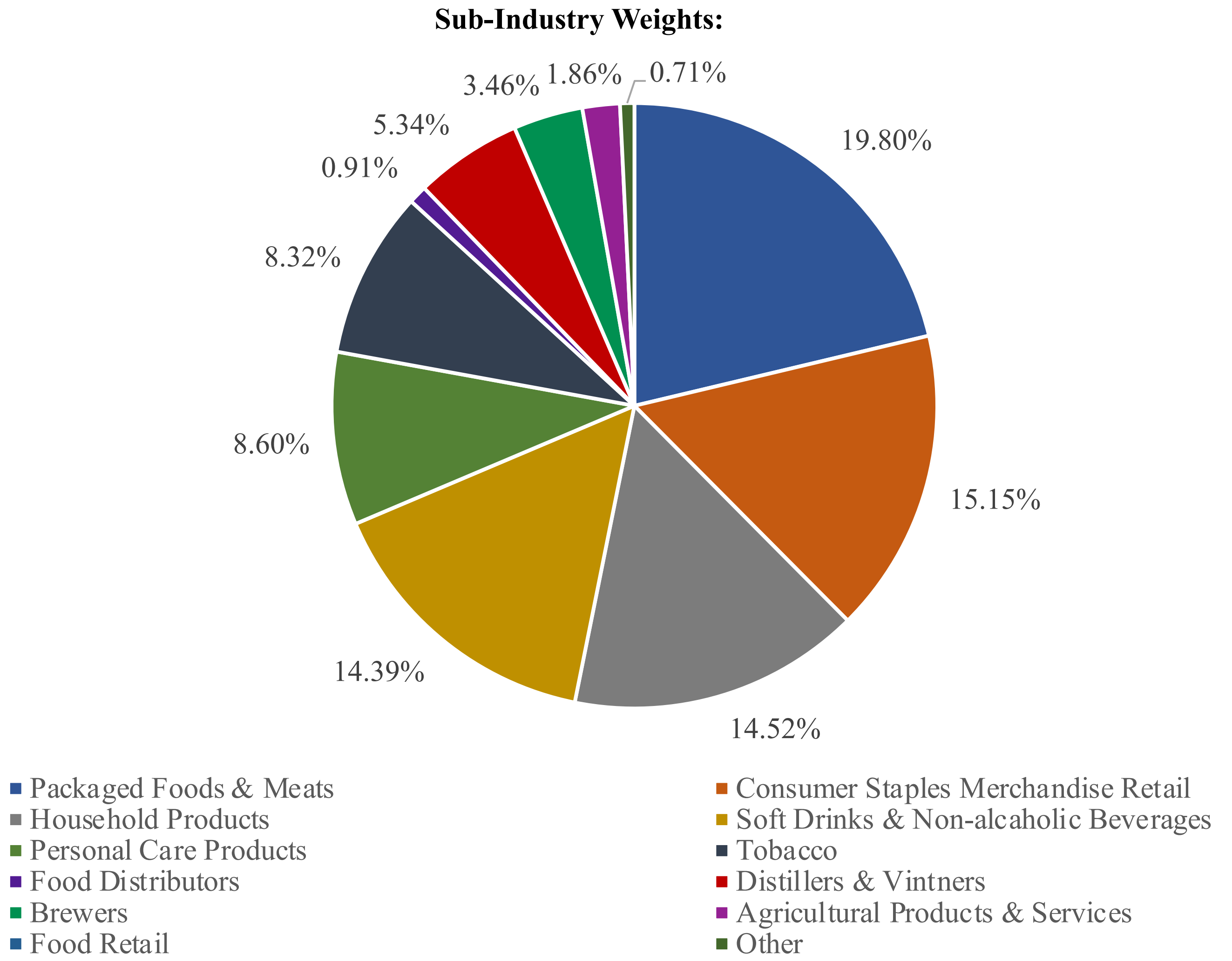
Top Constituents of Index:

Proctor & Gamble
Ticker: PG
Industry: Household Products
Market Cap (mm): 370,144.2
52 Week Range: 122.18 - 158.18
P/E: 26.6

Nestle
Ticker: NESN
Industry: Packaged Foods
Market Cap (mm): 277,700.2
52 Week Range: 103.42 - 117.56
P/E: 29.93

PepsiCo
Ticker: PEP
Industry: Soft Drinks and Non-alcoholic Beverages
Market Cap (mm): 253,345.9
52 Week Range: 160.98 - 196.88
P/E: 32.17

Sector Overview: Subsectors



Packaged foods & Meats:

The Packaged Foods and Meats industry sells a diverse portfolio of both frozen and refrigerated food products. Its primary production includes proteins, such as beef, chicken, and pork, which are sold to consumers by grocery retailers, meat distributors, chain restaurants, and many other markets. The Packaged Foods and Meats industry is additionally engaged in prepared food products, which enable customer's preference for a quick, convenient, and healthy choice for their meal while they are busy with life's everyday difficulties.

Consumer Staples Merchandise Retail:

Consumer Staples Merchandise Retail refers to the sector of the retail industry that deals with essential, everyday products that consumers regularly purchase to meet their basic needs. Big players include Walmart.

Household Products:

Household products are goods and products used within households such as cleaning products. The demand for household products is primarily driven by rising disposable income, increasing living standards, and the desire for comfort. The trend of smart and connected appliances is growing in the Household Product market. People are increasingly opting for automatic products that reduce manual labour and save time. COVID-19 had a positive impact on the market as people become more concerned about hygienic living and housekeeping.

Sector Overview: Subsectors

Soft Drinks and non-alcoholic Beverages:
The non-alcoholic beverages industry is involved in the production and marketing of all beverages which are free from alcohol. This can range from products such as water, tea, and coffee to sweet drinks like soft drinks and juices. This industry has. CAGR of 8.2% for the next five years.

Personal Care products:
The industry produces and sells beauty, personal care, and hygiene products. All the products ranging from toothpastes, soaps, shaving cream, sunscreen, face cream, razor to all the other related products fall in the category of personal care products. People, these days have become aware of their personal care, hence the market is showing positive growth and is expected grow in the coming years.

Tobacco:
Tobacco Industry is defined as entities whose principal business is the manufacture and sale of tobacco products (including e-cigarettes, or other nicotine delivery products). Key players. include Altria and British American Tobacco.

Food Distributors:
Foodservice distribution is largely comprised of an array of different programs, companies and organisations that gather products from food producers, transport them to warehouses for storage, and then distribute products to grocery stores, manufacturers, cafeterias, restaurants, government aid programs, etc. Foodservice distributors not only distribute actual foods but also products used for food consumption such as cups, napkins, utensils, plates and condiments as well.

Distillers and Vintners:
The Distillers and Vintners industry encompasses the production and distribution of alcoholic beverages, with a focus on distilled spirits (such as whiskey, vodka, rum, gin, and tequila) and wines.

Brewers:
Sector of the economy that involves the production, distribution, and sale of alcoholic beverages, specifically beer. It encompasses a diverse range of activities, from the brewing of different types of beer to packaging, marketing, and distribution. Heineken are one of the largest companies within this subsector.

Agricultural Products and Services:
This industry encompasses a broad range of activities related to the cultivation, processing, distribution, and marketing of various agricultural commodities. This industry is a fundamental pillar of the global economy, providing essential food, fiber, and other raw materials that support human sustenance, manufacturing, and trade. It includes both primary agricultural production and the subsequent processing and distribution of agricultural products.

Food Retail:
Vast and diverse sector of the economy that is involved in the sale of food and food-related products to consumers. It includes various types of retail establishments, ranging from traditional grocery stores to specialty food stores, convenience stores, supermarkets, hypermarkets, online food retailers, and more.

Themes: Private Label Goods

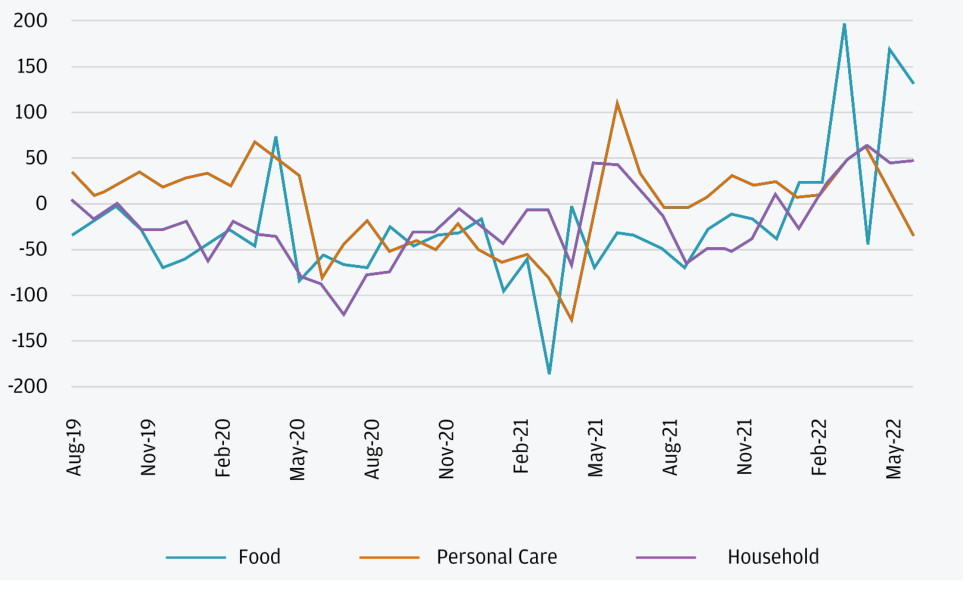
Financially-strapped consumers are trading down to label goods. These are products sold under a retailer's name, typically at a lower price than their branded counterparts. Around 40% of European consumers have tried a private-label brand this year, according to management consulting firm McKinsey & Company. This brand-switching behaviour is particularly evident for staples such as household products (31%), snacks and confectionery (27%), frozen foods (29%) and dairy and eggs (26%).

Correspondingly, supermarkets across the globe are seeing increased consumer interest in private labels. Kantar notes that in the U.K., sales of own-label lines are climbing, especially for budget ranges such as Asda Smart Price and Co-op Honest Value, which both surged by a whopping 12%. On the other hand, sales of mainstream brands fell 1% over the same period. In the U.S., Walmart's private brand penetration is increasing, with the growth rate in food categories doubling in 2Q 2022 versus 1Q 2022.

"Private labels broadly lost market share over 2020 and 2021, as big brands were beneficiaries of stronger supply chains and consumer demand for trusted brands. However, this has, to varying extents, gone into reverse during 2022 as the cost-of-living squeeze on consumers intensifies," said Pannuti. "Now, private labels are staging a recovery after two years of market share losses."

Private-label shares in Europe have started to exceed pre-pandemic levels, with sharp gains in the food sector—particularly for ice creams, yogurts and soups, J.P. Morgan estimates show. While they remain broadly below pre-COVID levels in the U.S., we see gains in 29 out of 47 key categories, including hygiene (paper towels and toilet tissue), bottled waters and baby food. Clearly, consumers are seeking more affordable alternatives to everyday essentials—a behaviour that looks set to persist during these inflationary times.

Europe private-label shares in the food, personal care and household sectors:



Themes: Emerging Markets

Consumer staples companies with exposure to emerging markets could also be well positioned to weather any further economic storms in 2023. Many of these countries have a fast-growing middle class, leading to higher per-capita growth than developed markets. Furthermore, many emerging-market nations have been battling inflation for decades, which means consumers are used to seeing prices rise and less likely to change their purchasing decisions in reaction to price hikes.

The vast majority of consumer staples stocks that have exposure to high-growth emerging markets, such as China and India will be better positioned to increase their profitability. 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, according to financial services firm Edward Jones, tailor their products to local tastes and often develop them in local markets.

For instance, Mondelez (a snack company) 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. 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. 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 market faster and more profitably than the competition.

Sector Drivers: Priced in Drivers

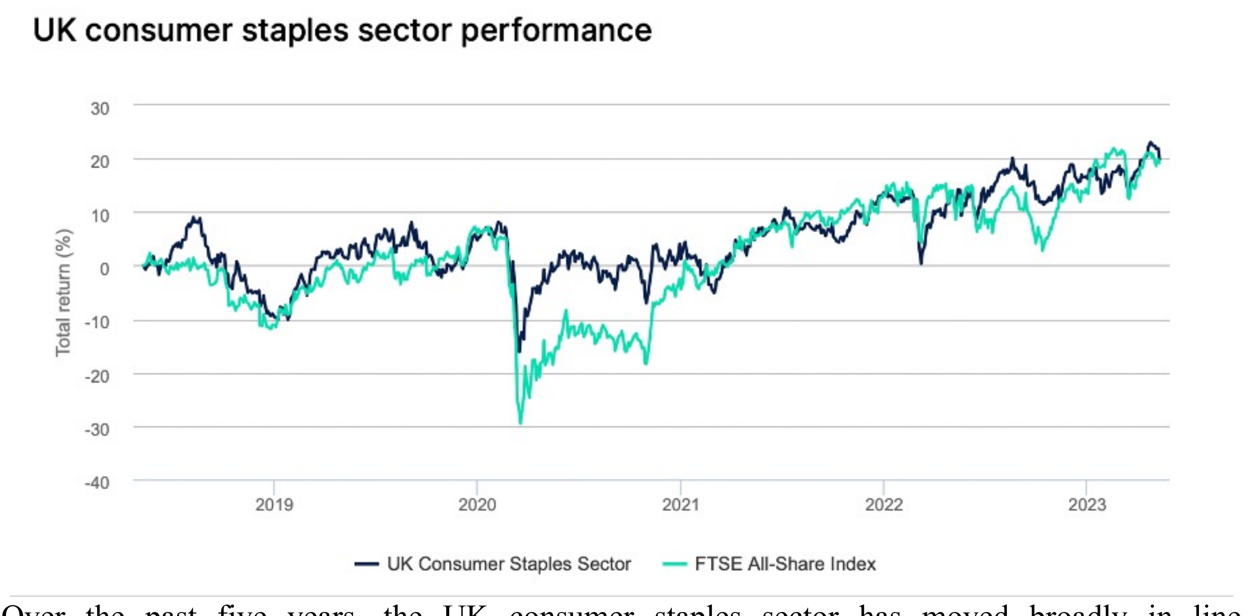
Economic Conditions

Consumer staples typically display a heightened resilience to economic downturns and high inflation in contrast to other industries. This is due to the consistent demand for fundamental necessities such as food, beverages, and personal care items, which remains steadfast even in challenging circumstances. The sector's trajectory is notably influenced by pivotal economic benchmarks, such as GDP expansion, unemployment metrics, and consumer sentiment.

During economic recessions or downturns, when consumer spending tends to decline, the consumer staples sector often performs relatively well. Consumers continue to buy basic necessities even when they cut back on discretionary spending, and as a result, the consumer staples sector may have a negative correlation with broader economic benchmarks during these times. Investors often turn to consumer staples stocks as a safe haven during economic uncertainty.

During economic expansions and bull markets, consumer staples may have a positive correlation with economic benchmarks. As the economy grows, people may have more disposable income, leading to increased consumer spending across the board, including on staple products. However, the consumer staples sector may not perform as strongly as more cyclical sectors like technology or industrials during economic upswings.

It's important to note that while this inverse correlation during downturns and positive correlation during upturns is a general tendency, there can be exceptions. Economic conditions and consumer behaviour can vary, and the performance of individual companies within the consumer staples sector can differ significantly.



Over the past five years, the UK consumer staples sector has moved broadly in line with the wider market. This synchronicity stems from consumers recognizing these goods as essentials rather than mere optional indulgences.

Sector Drivers: Priced in Drivers

Even during challenging periods marked by economic instability or constrained disposable incomes, these items remain in consumers baskets, as illustrated in the above graph. In 2020, the pandemic upset normal business conditions, and as a result, the wider market clearly underperformed relative to the resilient consumer staples sector – shown by the only major distance between the two indices across the graph.

As the cost of living crisis scourges countries across the globe, and inflation skyrocketing, most sectors are left reeling from consumer reactions, but the inelasticity of consumer staple product demand has enabled the sector to weather the storm in such uncertain circumstances.

Brand Strength

Large brands stand as prominent sector drivers. These industry giants such as Proctor and Gamble and Unilever wield substantial influence due to their widespread recognition, substantial resources, and extensive market presence. For example, some key brands held by Unilever include household names, such as Dove, Domestos, Ben & Jerry's, Vaseline and Lipton, while Proctor and Gamble hold equally recognisable brands such as Febreeze, Oral-B, Gillette and Pantene. Their performance often sets the tone for the sector's overall trajectory, as their actions and strategies can reverberate throughout the industry.

However, as consumers purchasing power* continues to weaken due to inflation and high costs of living, a fascinating trend has emerged where larger, established brands might face a more challenging path compared to their smaller counterparts. (*Purchasing power refers to the amount of goods and services that a specific amount of money can buy in a given economy or market.)

While large brands boast widespread recognition and resources, they can struggle to swiftly adapt to shifting consumer preferences and market dynamics. Smaller brands, on the other hand, exhibit the nimbleness to cater directly to customer needs and swiftly pivot their strategies. Additionally, these smaller brands often foster stronger customer relationships due to their ability to engage on a more personal level.

Moreover, consumers are expected to continue to search widely for promotional discounts and trade down to more affordable product offerings within the same product category (eg. substituting a large brand good for an unbranded good). Private-label product penetration is expected to accelerate as the cost of living rises, and although these small brands are unlikely to outperform their large brand competitors, their growth is not to be overlooked.

Sector Drivers: Anticipated Drivers

Artificial Intelligence:

Although it can be argued that AI has been used for many years in supply chain support and logistics, a new 'generative' AI has been employed by sector giants such as Unilever, Siemens and Maersk to help navigate through ESG issues, negotiate contracts and find new suppliers. This new AI technology offers more opportunity for automation within the sector.

AI algorithms can analyse data to predict how much and what product will be in demand. This predictive ability in demand forecasting extends its utility to alleviate supply pressures across various nodes in the supply chain. With advance knowledge of what products are required, supply chain businesses can make better decisions about product quantity, allowing their operations to work more efficiently.

Digitalisation & E-commerce:

Anticipated as a significant driver within the consumer staples landscape, the surge of e-commerce and digitalization is poised to reshape the sector's dynamics. The accelerated shift towards online shopping and digital engagement has catalyzed a fundamental transformation in how consumer staples are marketed, distributed, and ultimately consumed.

With consumers increasingly embracing the convenience of online platforms, companies within the sector are strategizing to enhance their online presence, optimize user experiences, and tap into data-driven insights for targeted marketing. As digital technologies continue to evolve, consumer staples enterprises are positioning themselves to meet the demands of an interconnected and tech-savvy consumer base, redefining traditional business models and fostering innovative ways to engage with their audience.

In this ever-evolving digital era, social media 'influencers' wield considerable sway over consumer preferences, and their endorsements can significantly impact purchasing decisions. By partnering with influencers who resonate with their brand values, consumer staples companies effectively tap into niche communities, amplify brand visibility, and establish a more authentic connection with consumers. Whether it's through unboxing videos, product reviews, or lifestyle endorsements, these collaborations offer an avenue for brands to showcase their products in relatable and aspirational contexts.

New Technologies affect scale advantages:

Following on from the above, consumer staples companies have long enjoyed the advantages of scale. These advantages include managing large manufacturing and complex global distribution networks and the power to influence the retail experience. Another is the ability to reach many consumers at once through mass marketing.

However, new technologies and social media influence have made it easier than ever for capital-light start-up companies to enter the market at all points, which is changing how the industry works. Enabling technology and proliferation of data and analytics have eroded sector giants traditional scale advantages. Allowing smaller start-up companies to enjoy these new head starts created by media and tech, the consumer staples sector is less reliant on sector giants.

Case Study:

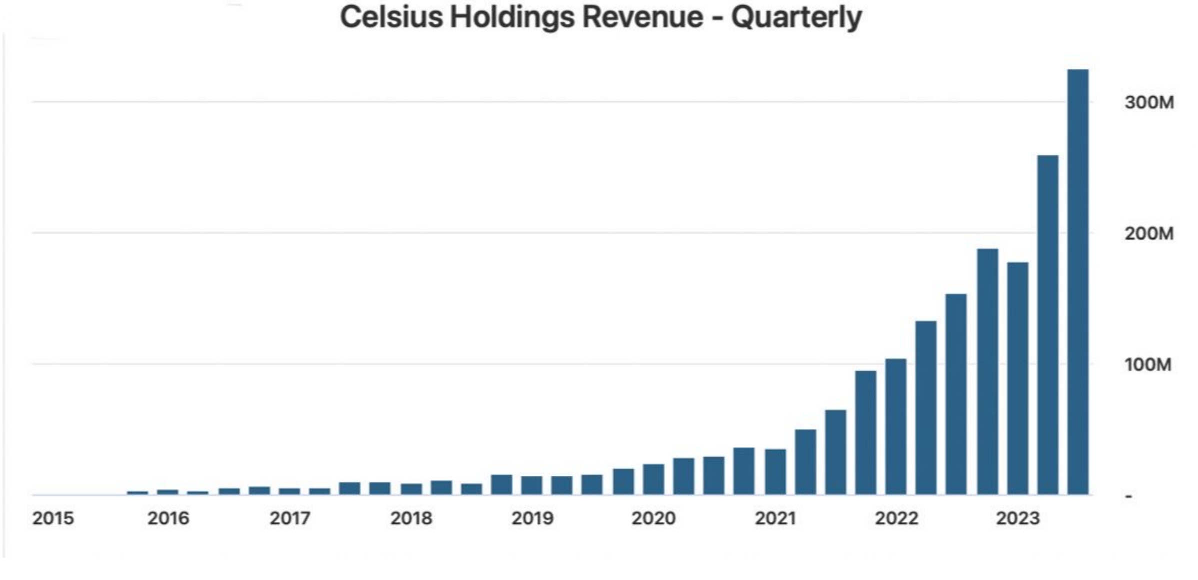
Celcius Holdings, Inc.
NASDAQ: CELH.O

About Celsius:
Celsius Holdings Ltd. is a notable company that specializes in producing and marketing a range of functional beverages designed to enhance fitness and active lifestyles. Its flagship brand is CELSIUS, which is a calorie-burning functional energy drink. Their products stand out for their unique formulation, incorporating natural ingredients and a proprietary blend known as MetaPlus® that aims to boost metabolism and provide sustained energy.

With a focus on healthier alternatives, Celsius offers a variety of flavors, catering to consumers seeking refreshment with added benefits. This brand has gained recognition for its commitment to promoting fitness and well-being through its innovative beverage offerings.

Growth:
Celsius Holdings has been growing rapidly in recent years. In 2022, the company's revenue was $400 million. The company expects to continue growing rapidly in the coming years.
The company's mission is to become the global leader in the functional beverage category, with a vision of "changing the way the world fuels itself."

Launched in the US in 2007, the company has since soared its way to the top, launching in Canada, Europe, Australia and China over the years, before going public on NASDAQ Stock Exchange in 2019.



Case Study:

Celsius has a strong growth plan, focusing on expanding its distribution network and developing new products. The company is expanding it's distribution network by partnering with PepsiCo to distribute its products through PepsiCo's vast network of retailers. This partnership is giving Celsius access to new channels and markets, such as convenience stores, drugstores, and mass merchants.

Celsius is also developing new products to meet the growing demand for functional beverages. The company recently launched a new line of sparkling waters called Celsius Sparkling. Celsius is also developing new flavors and products to appeal to a wider range of consumers.

Celsius' international sales growth is relatively small, but the company is taking steps to address this. Celsius is investing in its international marketing and sales operations and partnering with local distributors to expand its distribution network.

Celsius is also targeting specific international markets with high growth potential. For example, the company is focusing on expanding its presence in Europe, where the functional beverage market is growing rapidly. Celsius is also targeting markets such as Asia and Latin America, where there is a growing demand for functional beverages.

Overcoming Challenges:

Celsius has exhibited its strong ability to overcome issues it has faced over the past years. It has remedied competition from established brands such as Red Bull and Monster by focusing on its unique selling proposition, which is its calorie burning properties. It has also emphasised that it is sugar-free and vegan, an ever-growing trend in today’s world.

Celsius has also faced issues with securing distribution channels in new markets. To remedy this, the company has partnered with key US retailers, such as Walmart and Target. This has helped the company to secure distribution channels in new markets and make its products more accessible to consumers.

As a result of these efforts, Celsius Holdings has been able to overcome the challenges it has faced and grow its business. The company is now a leading player in the energy drink market and is well-positioned to continue growing in the future.

Overcoming Covid-19:

Celsius Company, was also not immune to the challenges posed by the COVID-19 pandemic. The company's sales declined in 2020 as gyms and fitness studios closed and people were advised to stay home. However, Celsius Company was able to overcome these challenges by taking some precautionary steps. Refocusing its marketing efforts from gyms and fitness studios to online channels was a key step in damage control. The company also launched a new campaign called "Celsius for Healthcare Workers" to support front-line workers during the pandemic.

Celsius Company also expanded into new markets in 2020, including China and Mexico. This helped the company to reach a wider audience and mitigate the impact of the pandemic on its sales. As a result of these efforts, Celsius Company was able to grow its sales in 2021 and 2022. The company is now well-positioned to continue growing in the future and has proven that it can overcome even the most severe crises.

Case Study:

Profitability:
Celsius Holdings is a profitable company. In 2022, the company reported a net income of $100 million. The company's profitability is due to a number of factors.

- **High gross margins**: Celsius Holdings has achieved remarkable gross margins on its products by implementing a pricing strategy that commands a substantial markup over its cost of goods sold.
- **Low marketing and advertising costs:** Celsius Holdings has demonstrated a remarkable ability to minimize marketing and advertising expenditures as a proportion of its sales, attributing this achievement to the strategic cultivation of substantial brand awareness via the powerful channels of word-of-mouth propagation and targeted social media marketing.
- **Strong brand:** Celsius Holdings has also focused on building a strong brand reputation. The company has been recognized for its commitment to quality and innovation. This has helped to create a positive image for the brand and make it more appealing to consumers.
- **Effective distribution channels:** Celsius Holdings maintains streamlined distribution channels that effortlessly place its products within both retail establishments and online platforms, ensuring the products' timely accessibility to discerning consumers.

Financials:
Celsius Holdings has been growing its revenue and profit margins steadily over the past few years. The company's profit margin has been consistently above the industry average of 15%.

Year	Revenue (millions)	Net income (millions)	Profit margin (%)
2022	$400	$100	25.0%
2021	$320	$75	23.8%
2020	$230	$39	17.0%
2019	$170	$18	10.6%
2018	$130	$11	8.5%

Case Study:

Referring to the comparison of Celsius Holdings' financial performance with the industry benchmarks, as shown below, Celsius Holdings has outperformed the industry in terms of revenue growth rate, profit margin, and return on equity.

Metric	Celsius Holdings	Industry average
Revenue growth rate (2022-2021)	28.1%	10.3%
Profit margin (2022)	25.0%	15.0%
Return on equity (ROE) (2022)	35.7%	15.0%

Celsius Holdings' financial performance is strong and has been improving over the past few years, thanks to its strong branding, successful marketing, unique selling proposition and expansion into new markets, as explored above. The company is well-positioned for continued growth in the future.

Overall, Celsius Holdings is an attractive investment opportunity for investors who are looking for exposure to the growing energy drink market. The company has a unique selling proposition, a strong brand, and a growth strategy that is likely to be successful.

Current Holdings: L'Oréal

Stock price over past year:

Thesis outline: Hold

Continued expansion via acquisitions:
Over the years L'Oréal's growth has been propelled by continued acquisitions of various companies such as Maybelline New York, Garnier, NYX Professional Makeup, CeraVe, and Redken. Their recent purchase of of Australian beauty brand Aesop for $2.5 billion demonstrates that this expansion is set to continue.

These acquisitions increase their market share. L'Oreal's market share increased to over 14% in 2022, from 13.2% two years ago. The company's strategy has long been to acquire small emerging brands and scale them using their extensive distribution network. For Aesop for instance, L'Oreal has identified significant growth opportunities in China.

CAGR of between 3-6% expected for personal care industry:
The beauty industry has the highest CAGR within the staples industry for numerous reasons. The growth of the global middle-class population will benefit the industry as a larger proportion of the population will have strong financial ability. Middle class consumers value their personal image and are hence willing to spend money and time on skin care. In addition, the trend of consumers becoming more aware of self care will drive sales. It is expected that luxury and derma-based products (38% and 13% of 2022 revenue) to be key growth drivers, expanding sales at 8% and 11% annually.

Certain markets offer particularly promising opportunities notably India where the addressable market is expected to double over the next three years on the back of a rapidly expanding middle class.

Chinese Economy:
L'Oréal have Looked to local Investments to grow business in China. The French-based cosmetics producer formed an investment company in Shanghai, China which will invest in local beauty technology developers. Although the recovery of Chinese economy was slower than expected, China is the second largest market for L'Oréal and the company are upbeat about their future in the country.

Current Holdings: L'Oréal

Strong financials:
In their 2023 half year report, L'Oréal reported a 13.3% increase in sales compared to that period in 2022. Furthermore, they reported growth across all regions driven by growth and value. L'Oréal's FY 2022 operating margin expanded 40 basis points to 19.5%. Net profit margin improved to nearly 15%. Margins have largely remained the same over the past decade.

R&D:
Innovation and R&D efforts could support organic market share gains and L'Oréal's size advantage could translate into advantages on the innovation front.. L'Oréal's R&D expenses have continued to grow for years, reaching EUR 1.1 billion in 2022, representing a R&D intensity of ~3%. L'Oréal's R&D spend is higher compared to rival Estee Lauder who spent $307 million on R&D translating into an R&D intensity of 1.7%. R&D stands for research and development.

Risks:

Inventory:
L'Oréal's inventory levels increased considerably in 2022 (up nearly EUR 1 billion to EUR 4 billion at the end of 2022 from EUR 3.1 billion the previous year). If the demand environment sours due to a prolonged or more severe-than-anticipated recession, L'Oréal may be stuck with excess inventory and may be forced to book inventory write downs. A write-down impacts the balance and income statement of a company-and ultimately affects the business's net income and retained earnings negatively.

Competitive risks:
In India and China, both very promising markets, competition is intense not only from international players like Unilever and Estee Lauder, but from a number of mushrooming local players as well. Notable local players in China include established players like Pechoin, and new players like Skynfuture (one of China's fastest-growing beauty players with a YoY growth of more than 900% in eCommerce sales).

Notable competitors in India include established players like Forest Essentials and Kama Ayurveda, unicorn beauty startups Mamaearth and MyGlamm, and smaller players like SUGAR Cosmetics, WOW Skin Science and Plum to name just a few. These local brands may have the advantage of a better understanding of local culture and tastes, presenting formidable competition to international players.

Risks: Concerning Outlook

Inflation:

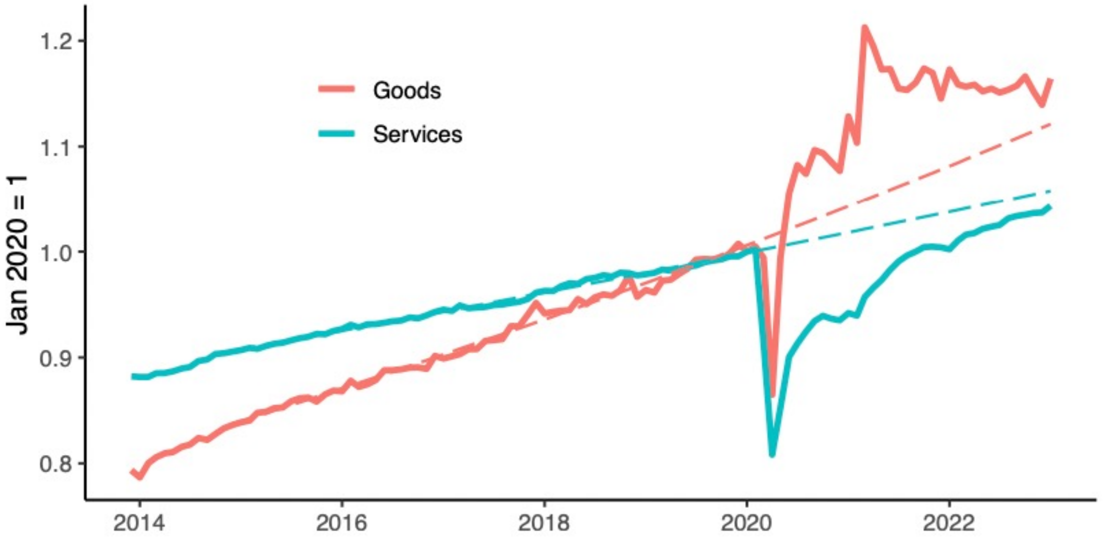
Inflation poses a significant risk to the consumer staples sector. As the general price level of the economy rises, the cost of producing and distributing these staples also increases. However, consumer staples companies often have limited flexibility to immediately pass on these higher costs to consumers, as these products are considered necessities and price-sensitive consumers might resist significant price hikes. Consequently, the profit margins of these companies can be squeezed, leading to potential challenges in maintaining profitability. Because the sector already has tight profit margins, any increase in cost imposes a significant issue in regards to profitability.

Moreover, as consumers grapple with the rising prices of everyday essentials, their purchasing power could decline, impacting overall demand for these products. Thus, inflation can create a complex environment for the consumer staples sector.

Inflation is driven by a few key factors within the past few years since the COVID-19 Pandemic:

Shifts from services to goods:

A shift in demand from services to goods has occurred since the pandemic. For example, people cancelling gym memberships due to lockdown restrictions and instead purchasing home gym equipment. This shift in demand from services to goods has been aggregated across the entire economy. As illustrated below, in a matter of months, we went from an economy that was roughly 65 percent services and 35 percent goods to one that was more like 60 percent services and 40 percent goods. This is a major shift in such a short period.



Normally, we might expect a fall in demand of a good (in this case, services) to result in a fall in price, but instead, the price of services did not fall even as the price of goods skyrocketed. But it is clear that the price of services did not fall even as demand for them decreased, which mechanically, increased inflation. As the economy began to reopen and consumer demand began to shift back to pre-pandemic proportions of goods and services, services inflation picked up from where it had been, even as goods inflation was still normalizing. This, too, has led to higher inflation.

Risks: Concerning Outlook

Vulnerability in supply chains:
The price of goods skyrocketed during lockdown period, and one reason for this was weaknesses in company supply chains. Shifts in spending (from services to goods) strained global supply chains that were already fragile due to just-in-time production and pandemic related disruptions. This strain caused significant supply bottlenecks, noticeable through increased mentions in earnings discussions and longer product unloading times at ports. Consequently, inflation rates climbed higher.

Housing Market and increased Work From Home:
Inflation has also been driven by significant changes in housing demand. The cost of shelter, a key contributor, saw a substantial rise with an annualized growth of 6.1 percent between 2021 and 2022, compared to 3.3 percent from 2018 to 2019. This increase, accounting for about a third of the Consumer Price Index, has played a significant role in driving overall inflation.

The housing market has experienced notable shifts in demand due to the widespread adoption of remote work, or "working from home". This change was swift: before the pandemic, around 5 percent of full workdays were remote, but in 2021, that number surged to 34 percent. This increased preference for remote work and its impact on housing demand is expected to persist. Even as companies aim to reintegrate employees into offices, recent data indicates that about 28 percent of workdays were still conducted from home in the last three months. This has changed housing demand patterns, such as shifting preferences toward places with more space and floor plans conducive to working from home.

Russian invasion of Ukraine:
The Russian-Ukraine war has driven inflation upwards, primarily by causing energy prices to rise. Russia is a major exporter of oil and gas, and the war has disrupted the global supply of these commodities, leading to higher prices for gasoline, heating oil, and other energy products.

The war has also disrupted global supply chains, already fragile after the covid pandemic. Russia and Ukraine are important producers of agricultural products, metals, and other commodities, and the conflict has disrupted the production and transportation of these commodities, which has led to higher prices for a wide range of goods and services.

The war has also created an unsettled uncertainty about the global economy. This uncertainty has made businesses and consumers more cautious about spending, which has also contributed to inflation. Businesses may be less likely to invest in new projects, and consumers may be less likely to make large purchases, leading to a slowdown in economic growth, which can further exacerbate inflation.