

Consumer Staples

September 2024



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Sector Overview

The consumer staples sector is comprised of products that consumers require for their day-to-day living. Regardless of someone's financial situation or economic environment, they will continue to buy these goods. Examples of consumer staples products are food products, alcohol, tobacco, hygiene products and household goods.

Companies within the consumer staples sector are considered a sub-category of products regarded as essential goods. This means that companies in the consumer staples sector usually benefit from inelastic demand for their products, which means that if prices increase, the demand, and hence the volume of sales, remains relatively the same.

Consumer staples is also considered a sub-category of "defensive sectors" (along with healthcare and utilities), this is due to the sector's reputation of outperforming other sectors in recessionary times and continuing to generate stable revenues. This means the consumer staples sector is non-cyclical. This makes it a favourable sector for investors as stable demand leads to predictable earnings.

Figure 1: A Sector Roadmap for the Business Cycle (1)

Expansion	Slowdown	Recession	Recovery
++ Financials, Technology	++ Consumer Staples, Healthcare	++ Consumer Staples, Utilities	++ Consumer Discretionary, Real Estate
+ Communications	+ Industrials	+ Healthcare	+ Materials
- Consumer Staples	- Materials	- Communications	- Healthcare
-- Healthcare, Utilities	-- Consumer Discretionary, Real Estate	-- Real Estate, Technology	-- Consumer Staples, Utilities

Current Outlook for Consumer Staples

The past two years have presented significant challenges for the consumer staples sector. In 2022, the sector's underperformance was largely due to the overall economic environment, with global inflation that year at a rate of five percentage points higher than its average this century, which led to an increase in interest rates (2). These higher interest rates led to valuations decreasing. The inflationary pressures caused a market share loss for big brand names as consumers switched to own-brand substitutes.

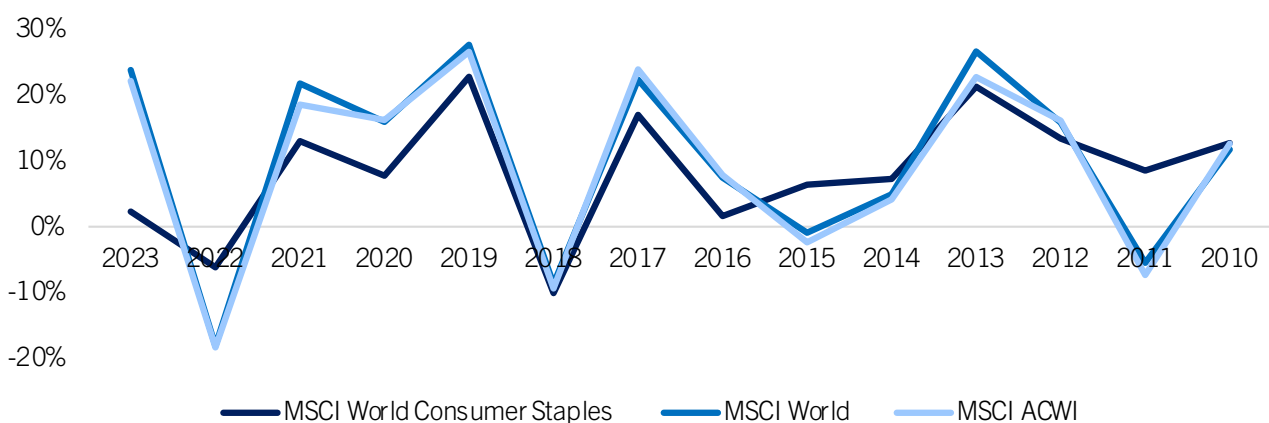
In 2023, companies in the sector tried to regain market share by slowing their price increases. However, this caused the sector to experience a slowing in revenue growth. Last year, concerns about the long-term growth potential of the sector emerged, furthering the issue of underperformance in the sector.

However, JP Morgan has stated there is a probability of c.35% of a recession starting before the end of 2024 and c.45% chance of a recession by the end of 2025 (3). This is good news for the consumer staples sector due to its historical outperformance of other sectors in times of economic downturn. If a full recession does not occur, an economic slowdown is considered almost a certainty. EY Parthenon's Chief Macroeconomist Gregory Deco reported at the end of July that "We're expecting a bit of a slowdown in consumer spending (...) a deceleration overall in the economy year-on-year" (4).

MSCI World Consumer Staples Index

The MSCI World Consumer Staples Index is designed to capture the large- and mid-market cap segments across 23 developed markets around the world. The lag of the Consumer Staples sector behind the global equity market (MSCI World) can be seen from the graph below.

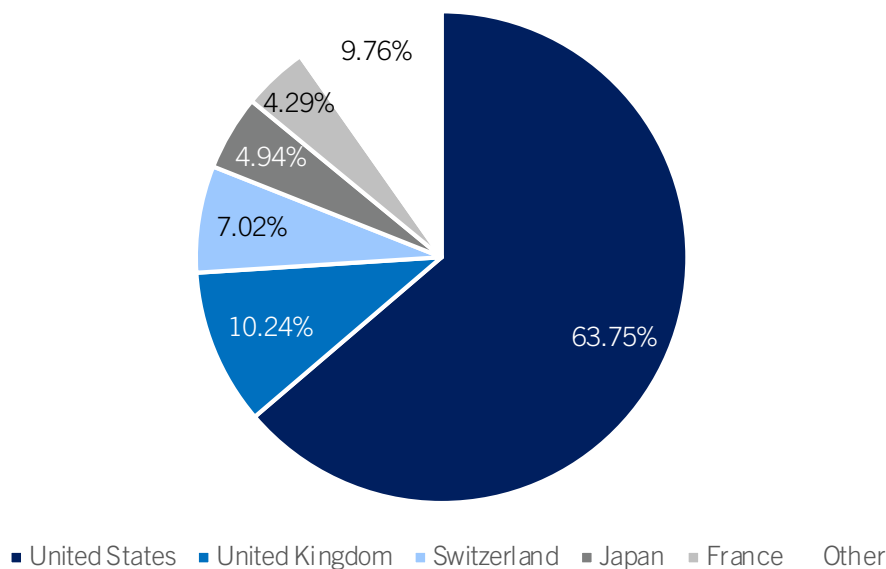
Figure 2: Annual Performance as a Percentage (5)



Country Weights

Geographically, the United States is the biggest constituent of the consumer staples sector, taking up nearly 64% of the index (5), as a large proportion of these big conglomerate staples companies are based in the US. Illustratively, each of the three biggest companies in this sector, Proctor & Gamble, Costco and Walmart, are all based in the United States. The United Kingdom also retains some of the largest companies in this sector such as Unilever and British American Tobacco.

Figure 3: County Weights of the MSCI Consumer Staples Index (5)



Key Players



Procter & Gamble

- Ticker: PG
- Industry: Household Products
- Market Cap: \$398bn
- 52-week range: 141.45-171.89
- P/E: 28.50



Costco

- Ticker: COST
- Industry: Merchandise Retail
- Market Cap: \$393.7bn
- 52-week range: 540.18-918.93
- P/E: 55.26

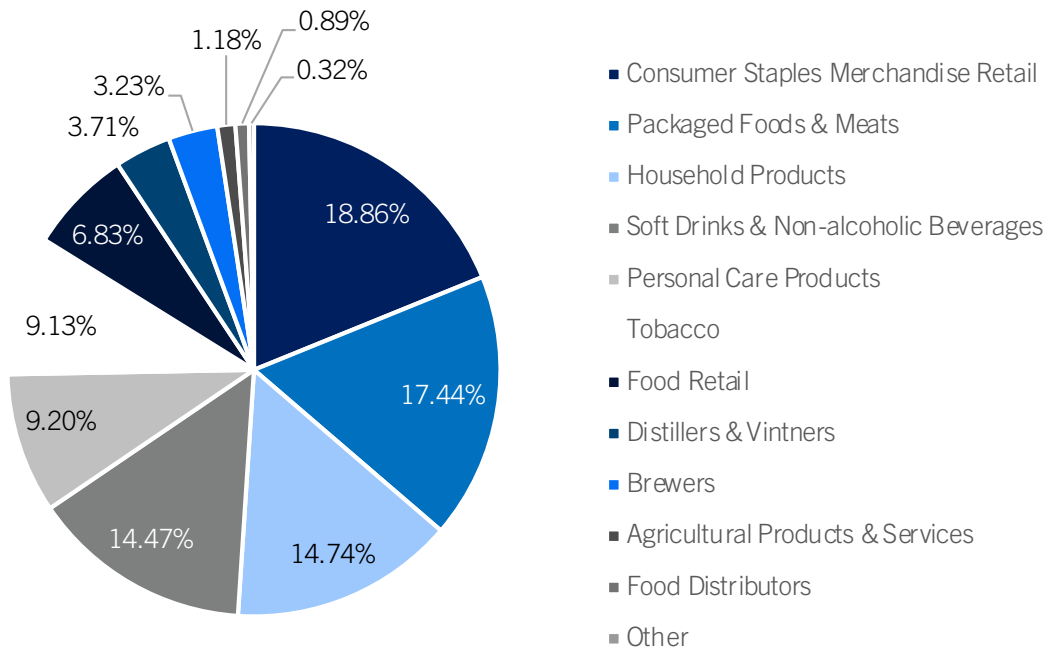


Walmart

- Ticker: WMT
- Industry: Merchandise Retail
- Market Cap: \$621.2bn
- 52-week range: 49.85-77.47
- P/E: 40.22

Subsectors

Figure 3: Sub-Industry Weights of the MSCI Consumer Staples Index (5)



Consumer Staples Merchandise Retail

Consumer Staples Merchandise Retail is the section of the retail industry that provides products that are essential to consumer's day-to-day living. Walmart and Costco are examples of Consumer Staple Merchandise Retailers.

Packaged Food and Meats

The Packaged Food and Meats industry consists of companies that produce food and meats that are ready for consumer consumption. The products range from ready meals to processed meats and canned goods. They typically have a long shelf life and provide convenience to the consumer. Nestle is a key player in this industry.

Household products

Household products are goods that are essential to the running of a household, such as cleaning products and home appliances. Households require regular cleaning and maintenance leading to constant demand for products in this sector Procter and Gamble is a company that produces and distributes household products.

Soft Drinks and Non-Alcoholic Beverages

The non-alcoholic beverage industry refers to all companies that produce drinks without alcohol. This industry has experienced 'increasing demand for nutritious beverages that deliver extensive health benefits' (6), allowing for niche brands, like Vit-Hit, to gain market share in a market once completely dominated by Coca Cola and Pepsi.

Personal Care Products

The Personal Care Product industry sells hygiene and cosmetic products. Products ranging from razors, toothpaste, face cream and mascara fall under the category of the personal care product industry. 'Growing concerns regarding the side effects of chemicals in personal care products' are 'driving the demand for natural and organic personal care products' (7). L'Oréal is a key player in this industry.

Tobacco

The tobacco industry refers to companies involved in the production and sale of tobacco products. Key players in this industry are Phillip Morris International and Altria.

Food Retail

The Food Retail industry involves the selling of food to consumers. This can range from independent grocery stores to local farmer's markets, online food retailers, supermarkets and more. They make food accessible to the consumer.

Distillers and Vintners

The Distiller and Vintner industry refers to the production of alcoholic beverages, more specifically spirits and wines.

Brewers

The brewing industry focuses on the production and sale of beer and other fermented alcoholic beverages, such as Sake. The industry includes large-scale commercial brewers, like Carlsberg, and microbreweries.

Agricultural Products and Services

The Agricultural Products and Services industry refers to the production of crops and livestock. Agricultural production is a key driver in the global economy.

Food Distributors

The Food Distributors industry refers to the transportation and delivery of food from the producer to the consumer. Companies typically gather products from the producers and move them to warehouses or storage places before they get passed on to retailers, who give consumers access to buy the products.

Key Performance Indicators

Profit margins

The Profit Margin is a company's earnings relative to its revenue expressed as a percentage. It is the level of revenue that remains after all expenses have been deducted. It is calculated by dividing the net profit by total revenue and multiplying by a hundred.

Debt levels

This refers to the amount of debt the company holds. Investors will use a Debt-to-Equity Ratio, in which the company's debt is compared to the shareholder's equity, to provide insight into the financial leverage and risk of a company. A high ratio implies increased financial risk.

Consumer staples can handle higher debt levels than other industries, such as the energy or the technology software sectors, whose D/E ratios were roughly 0.5 in 2023 while consumer staples' D/E ratio was 0.83 (8). This is because it is a stable sector and requires less investment.

Market Share

A company's market share refers to its total sales in relation to the overall sales in that industry. It can be calculated by dividing total company sales by total industry sales.

Brand Reputation

Brand Reputation is the public's opinion of a brand or company. It can be based on many things, including past performance and public image. A company with a good reputation usually gains Customer loyalty, benefiting their sales in the long term.

Supply Chain Efficiency

This refers to how well a company gets their product from manufacturing to the consumer or a retailer in sufficient time while using the least amount of resources and keeping costs to a minimum.

Dividends

Dividends are payments made by a company to its shareholders. They are a percentage of the profits. They are a way to get ROI apart from changes in the stock price. Sectors with predictable profits typically pay the best dividends, meaning the consumer staples sector is a good sector for an investor wishing to earn dividends.

Current Holdings

Costco (NASDAQ: COST) – HOLD

Costco is a leading global wholesale retailer known for its membership-based warehouse clubs offering bulk products at low prices. The company has a strong reputation for high-quality goods, particularly in private label brands like Kirkland Signature, which contribute significantly to its revenue. Costco's business model focuses on high sales volumes and rapid inventory turnover, allowing it to maintain low margins while generating consistent profitability. Additionally, its membership fees provide a steady income stream, reinforcing its financial stability and customer loyalty.

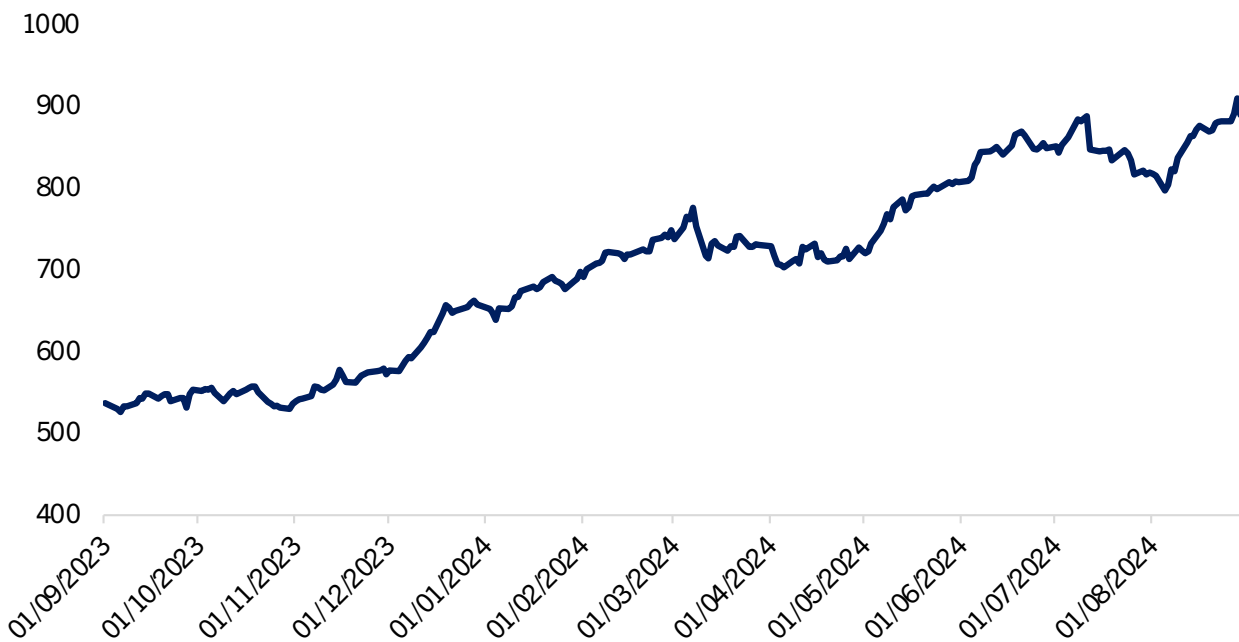
Current Performance (9)

The COST share price has increased 63.4% year on year, growing from \$542.7 to \$886.6.

In May 2024, Costco Wholesale Corporation reached a market value of \$361.47 billion, and revenue grew to \$58.52 billion, up 9.07% year on year. Net income has grown by 29.11%, from \$1.199 billion to \$1.68 billion. This shows that operations within the company have become more efficient and profitable.

As of 31st December 2023, Costco has 871 warehouse locations spread across 14 countries. 73% of their revenue comes from the United States of America. Canada makes up a further 13.5% and the 12 other countries Costco has warehouses in collectively make up 13.5%.

Figure 6: Stock Price Performance over the Past Year in \$USD (10)



Hold Thesis

E-Commerce Growth

For a long time, Costco has lagged behind its competitors when it came to e-commerce. However, the company is now offering a new feature whereby consumers can now order online but also view live inventory in their local store. In Q2 2024, e-commerce sales increased by 18.2% (11).

Efficient Inventory and Supply Chain Management

Costco’s highly efficient inventory turnover and supply chain management enable it to maintain low costs and high operational efficiency. Its ‘no frills’ warehouses undercut its competitors’ labour and rental costs of holding both warehouses and retail stores for distribution. This capability helps Costco sustain its competitive pricing and protect margins.

Membership Renewal Rates and Loyalty

Costco boasts exceptionally high membership renewal rates, consistently above 90% (9) (11), reflecting strong customer loyalty. This not only secures a reliable source of income through membership fees but also indicates a committed customer base, which is likely to drive steady sales growth and long-term profitability. The power of subscription-based revenue cannot be underestimated as it allows Costco to make accurate long-term cash-flow forecasts enabling it to plan and grow efficiently and tactically.

Head winds

Over-reliance on the United States

Costco’s revenue is highly dependent on The United States. 73% of Costco’s revenue came from the USA in FY2023 (9). With the US potentially facing a period of uncertainty due to the upcoming presidential election and elevated trade tensions with China, Costco may be exposed to this with little to fall back on.

Table 1: Costco Retail Locations FY2023 (9)

Country	No. Retail Locations
United States & Puerto Rico	600
Canada	108
Mexico	40
Japan	33
United Kingdom	29
South Korea	18
Australia	15
Taiwan	14
China	5
Spain	4
France	2
Iceland	1
Sweden	1
New Zealand	1

From *Table 1* it can be seen that Costco has effectively taken advantage of emerging markets in Asia, with 8.04% of its points-of-sale based there as opposed to only 4.25% of its retail locations based in Europe.

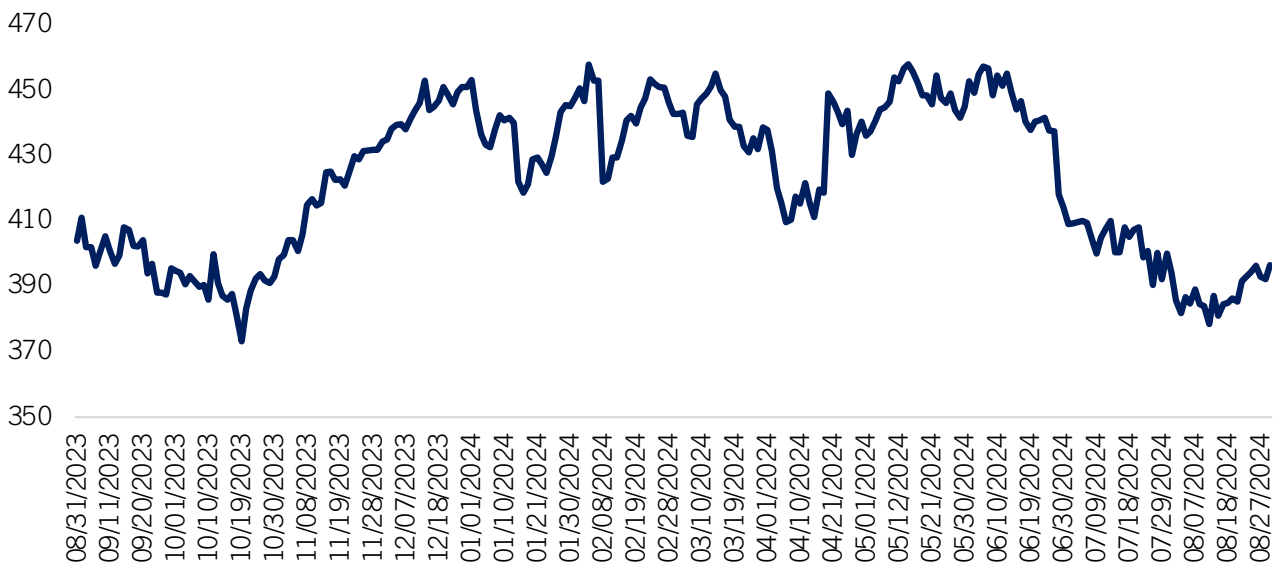
Countries such as Brazil and other South-American countries with large cities present opportunity for Costco as this untouched market is geographically close to, hence relatively cheap to import from, Costco’s headquarters in the US.

L'Oréal (EPA: OR.PA) – SELL

L'Oréal is a global leader in the beauty and cosmetics industry, renowned for its diverse portfolio of over 30 well-known brands. It separates its portfolio of companies into four divisions: L'Oréal Luxe (including Prada, Valentino, Lancôme), consumer products (including Garnier, Maybelline, NYX), Dermatological Beauty (including LaRoche Pose, Vichy, CeraVe) and professional products (such as Kérastase, Redken, Pureology). The company excels in product innovation and has a strong focus on research and development, driving advancements in skincare, haircare, makeup, and fragrances.

L'Oréal's extensive global presence, with a solid foothold in both developed and emerging markets, supports its consistent revenue growth.

Figure 7: Stock Price Performance over the Past Year (12)



Sell Thesis

Margin Pressure from Rising Input Costs

L'Oréal could face margin compression due to rising costs of raw materials, packaging, and logistics, particularly in an inflationary environment. If the company is unable to pass these costs on to consumers through price increases without sacrificing volume, it could lead to declining profitability and impact the stock's attractiveness.

Slower-than-Expected Digital Transformation

While L'Oréal has invested heavily in digital initiatives, any delays or inefficiencies in its digital transformation strategy could hinder its ability to compete effectively in the rapidly growing e-commerce and direct-to-consumer segments. If L'Oréal lags behind competitors in capturing online market share, it could miss out on significant growth opportunities, diminishing its long-term growth potential.

Geopolitical and Regulatory Risks

L'Oréal's extensive global operations expose it to geopolitical risks, such as trade tensions, regulatory changes, and protectionist policies in key markets like China and the European Union. These risks could lead to increased operational costs, supply chain disruptions, or restricted market access, potentially eroding profit margins and impacting the company's ability to sustain its current growth trajectory.

Tail winds

Growth of the Beauty Industry as a Whole

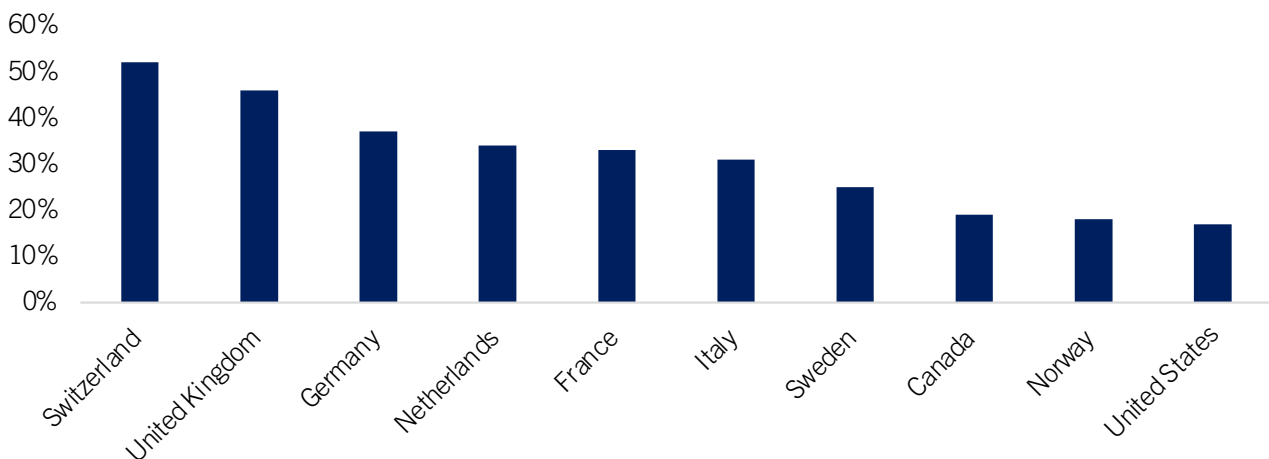
Despite being the largest player in the personal products industry, L'Oréal itself finds itself under scrutiny by investors for being an overvalued stock and for being unlikely to hit double-digit growth figures in 2024 as projected. However, it must be noted that analysts forecast a CAGR for the personal products industry of c.6.76% between 2024 and 2034 (13) and as the biggest player in the industry, L'Oréal will benefit from these tailwinds.

Investment Themes

Private Label Goods

Amidst an economic slowdown as consumers become increasingly financially prudent, they turn to private-label goods. These are products sold under a retailer's own name, which typically undercut the prices of their branded competitors. These products had been on the rise in the first half of 2024, as according to a McKinsey & Co. analyst, there has been a shift in consumer sentiment towards valuing affordability more than sustainability recently (14). A study by Circana, from June 2023 to June 2024 saw private-label dollar sales rise across nine out of ten store departments, measuring goods such as beauty products (up 10%), liquor (up 8.8%), general food (up 6.9%), and home care (up 6.8%).

Figure 8: Private Label Value Share of Global Retail by Country (%) (16)



Illustratively, Walmart and Costco are up 44.78% and 34.54% YTD respectively, beating the Consumer Staples SPDR index which is up 14.22% YTD. The Chief Financial Officers of both of these companies have explained how 2024 strategies for each of them have been focused on lowering prices as they have seen consumers put an increased proportion of their income towards non-discretionary products and strayed away from general merchandise. In particular, Walmart CFO John David Rainey pointed out how private-label goods were included in more than half of all customer grocery baskets between June 2023 and June 2024 which has led to Walmart “investing further in value within their private brands” (15).

Key growth drivers for the private label industry include increased retail investment. As brands scaled back their ranges due to surging supply chain costs, room has been left for private label expansion, from across the premium private label, mid-market to value-based private label products. This provides omnichannel growth for companies such as Walmart as they control costs from the discovery stage to the consumer purchase.

Personal Products

This industry produces and sells hygiene, personal care, beauty and wellness products from razors and female hygiene products to makeup and hair care. Consumers have been increasingly investing in these products as people are focusing more heavily on ingredient quality and longevity impacts of these products. The global beauty and personal care products market size was USD 560.32 billion in 2023, calculated at USD 598.59 billion in 2024 and is expected to reach around USD 1151.25 billion by 2034, expanding at a CAGR of 6.76% from 2024 to 2034 (13).

A McKinsey & Co. analyst in August 2024 highlighted the push in this sector saying “I would say that consumers are more discerning (...) When it comes to enhancing their quality of life and indulging in more experiences or discretionary spend categories—think about beauty or personal care—you’re going to see a much higher intent to spend versus historical levels” (14).

Key Growth Drivers

Premiumisation versus Affordability

As global inflation cools down, consumers are adopting a mindful purchasing approach. Reduced disposable income is shifting consumer behaviour towards buying more affordable beauty products as opposed to reduced consumption. In China, 2023 data showed a stark increase in beauty consumers who looked for “lower price” instead of “premium formulations” (17).

Ingredient-Led Beauty

Mimicking the vitamins industry, consumer behaviour has shifted towards taking an ingredient-driven approach to their beauty purchases. Ingredients such as SPF, collagen, and retinol have surged in popularity post-pandemic and are considered critical to a healthy lifestyle by many consumers. This has driven growth in the personal products

industry as many customers now consider a larger pool of goods as essentials as opposed to luxuries. In 2023, 34% of global consumers used a multi-benefit day cream with SPF regularly and 26% used specialized sun protection products. These numbers are up from 23% and 16%, respectively, in 2020, which demonstrates the huge growth in this sector (17).

Men's Grooming

Fortune Business Insights reported that the global market for men's grooming products is expected to be worth \$85.53bn in 2032, up from \$58.46bn in 2023 (18). This is due to shifting notions of masculinity and growing influence of social media and rising self-appearance consciousness among men which has propelled the market growth significantly. CNN reported there has been a 389% year-on-year increase in TikTok video views on male skincare which is a key factor of growth in this market (19).

Risks

Post-Inflation Concerns

Despite inflation being the lowest it has been over the last three years, the economy experienced exceptionally high inflation over the last number of years, which reached a high of 9.1% in June 2022, which had been the highest recorded inflation since 1981 (20). Consumer confidence has been recovering slowly since inflation started easing but has lagged behind the actual decrease in inflation rates. It will take a number of months for consumer sentiment towards prices to catch up with inflation figures. Consumers will spend less as they believe inflation to still be at the high levels of the last number of years. This will have a negative effect on consumer staples companies as people will be more frugal with their spending as they are awaiting price decreases. Furthermore, if large consumer staples companies calculated their earnings forecast expecting a faster return to consumer confidence than what was actually experienced, there is potential for them to miss their earnings in the coming quarters and underperform relative to investor expectations.

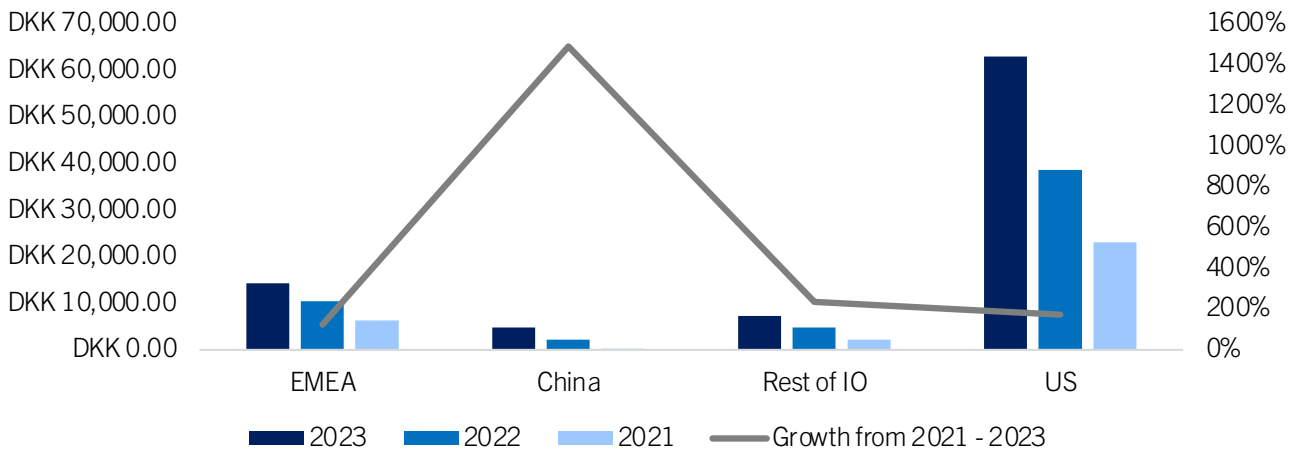
Impact of Weight-Loss Drugs

Obesity drugs have surged in demand over the last number of months and Morgan Stanley have forecasted the market for them will reach \$105 billion in 2030 (21). This will have a huge effect on the consumer staples sector as these drugs typically work by reducing appetite, hence decreasing the amount of calories consumed and additionally changing the type of calories consumed.

Morgan Stanley's analyst said, "Behavioural shifts among a group that already consumes a disproportionate share of food and beverages are expected to have an effect on the food and drink industry" (21). A research survey found that half of the people taking weight-loss drugs stopped consuming sugary drinks, alcohol, confections and salty snacks, and a quarter of people taking these drugs stopped drinking alcohol completely. As these drugs continue to rise in popularity they will undoubtedly have a major effect on

both the packaged food sector and the alcohol sector.

Figure 9: Novo Nordisk's Ozempic Sales 2021 - 2023 (22)



US Presidential Election

The United States 2024 presidential election has already and will continue to have a large impact on the consumer staples sector. A Morgan Stanley economist (23) found that net sentiment towards the US economy improved from negative -23 percent to -1 percent when Joe Biden dropped out of the presidential race and endorsed Kamala Harris. The result of who becomes the President Elect in November will have a multitude of effects on the economy. For example, a Democratic administration might impose stricter regulations on food companies, hence increasing compliance costs for companies such as Costco, Walmart and Pepsico. On the other hand, a Republican administration would most likely look to deregulate US-based companies, but it would impose tariffs and trade laws that could result in additional costs for US companies looking to engage in global commerce.

Outlook for the Year

The outlook for consumer staples remains positive for the year ahead. Despite underperformance last year, we believe the consumer staples sector is well-equipped to bounce back over the coming months. The key growth drivers for this sector in the second half of 2024 include:

- **Economic Slowdown:** As purchasing power falls, “essential goods” will take up a larger proportion of consumer’s baskets hence allowing for the sector to perform above benchmark.
- **Inflation Slowdown:** A continued slowdown in inflation is forecasted to bolster consumer goods retail volume growth by 6.7% in USD terms and 2% in volume terms (24).
- **Continued Pricing Power:** Large consumer staples companies such as PepsiCo and General Mills retained the ability to increase prices despite input costs lowering in 2023 (25). Companies in this sector who retain this ability, to increase prices or hold them steady, particularly during deflationary times, will have high chances of reaching their forecasted profit margins over the coming months.
- **Rebounding Volumes:** The biggest problem for consumer staples in 2023 was volume reductions, however, easing of global conflict and a reduction of inflation rates have meant that volume sales are improving, following three consecutive years of volume decline in 2023, 2022 and 2021 (26).

Costco will undoubtedly perform well under these conditions, and L’Oréal also may regain some of the confidence it lost in its investors over the last few months. However, overall L’Oréal is overvalued for a variety of reasons, primarily due to its rising input costs and exposure to regulatory risks, in addition to its lag behind its competitors’ technological advancements which has proven to be a huge factor in investor decisions this year.

Buy-List

Walmart Inc. (NYSE:WMC) – BUY



Walmart Inc. is an American multinational retail corporation that operates a chain of hypermarkets, discount department stores and grocery stores in the US and across 27 countries. It also operates Sam’s Club which is a membership-based retail warehouse chain. As of August 2024, Walmart has a market cap of \$551.65 billion and is the world’s 14th most valuable company.

Investment Thesis

Subscription-Based Model of Sam’s Club

Sam’s Club, a branch of Walmart, mimics the Costco business model, it provides retail warehouse-stores to its members, who primarily consist of businesses and families looking to buy in bulk. Members pay annual fees to Sam’s Club access and benefits. Sam’s Club introduces an ‘exclusivity’ to the Walmart customer base, which Walmart has not boasted before. The subscription-based model of Sam’s Club contributes to healthy margins while its “exclusivity” provides a luxury dimension to Walmart which has expanded its range of customers.

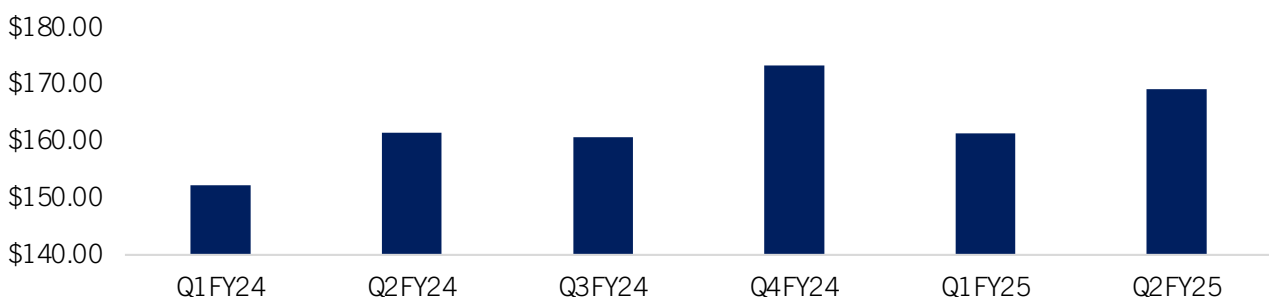
Digital Transformation

Despite traditionally being a brick-and-mortar company, Walmart has invested heavily in various modern technologies to enhance its customer’s experience, from Generative-AI to AR and VR. It has also surpassed its competitors regarding investments in drone delivery, which many believe to be a key feature of the future of commerce. As of May 2024, Walmart had completed 20,000 drone deliveries (27).

Steady Financials

Amidst a period of economic uncertainty from a potential recession to the US Presidential election, Walmart provides a stable and reliable investment. The company’s size and scale allow it to operate efficiently, maintaining healthy profit margins even in challenging environments. Its historic financials below demonstrate its consistency and its reliable dividend payments further its attractiveness as a growth stock.

Figure 10: Last 18 months Revenue (\$ billions) (28)



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