S&P Global Ratings

Industry Top Trends 2019

Consumer Products

November 13, 2018

Key Takeaways

- **Ratings Outlook:** Ratings trends should continue to be modestly negative in 2019. We expect rating actions to result from mergers and acquisitions (M&A) activity and financial policy decisions given the low growth environment. We have stable outlooks on the majority of the rated companies, reflecting the generally good cash flow capabilities of the companies and the nondiscretionary nature of many of the products.
- **Forecasts:** We forecast volumes will be down a little and organic sales growth in the low-single digits driven mostly by price/mix and emerging markets. Margins expand slightly because of M&A synergies, and companies managing pricing and promotions. Cost-cutting initiatives will likely be more than offset by commodity inflation and higher freight costs. Credit metrics strengthen slightly because of companies benefiting from earnings growth from acquisitions and some debt repayment.
- **Assumptions:** Global GDP growth of 3.9% in 2019. Spending habits continue to shift to healthier food and experiences. Medical and energy expenses increase, taking a larger share of the consumers' wallet. Environment remains highly promotional.
- **Risks:** We see M&A as the biggest risk to the ratings given companies' needs to shift portfolios into faster-growth categories and regions. Retailers accelerate growth in the e-commerce channel and demand better pricing and/or add fees from the manufacturers and at the same time reduce shelf space for branded goods. Companies with exposure to slow or declining category growth are most at risk. Geopolitical risks cause trade restrictions.
- **Industry Trends:** Companies continue to reposition their portfolios to meeting changing consumer tastes and preferences, and to accelerate top line by getting into faster growing categories. Companies will protect/grow market share by investing in their brands, product innovation, e-commerce channel, and price. Companies will continue to focus on driving out costs and using the savings to invest in their businesses.

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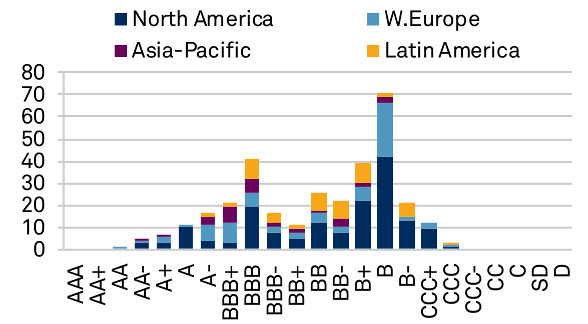
Ratings trends and outlook

Global Consumer Products

Chart 1

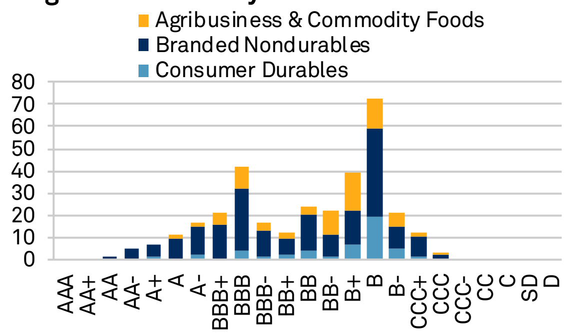
Ratings distribution by region



The vast majority of ratings are speculative grade, reflecting aggressive financial policies because of private equity ownership.

Chart 2

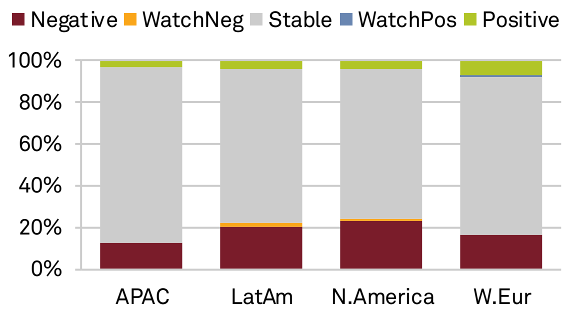
Ratings distribution by subsector



The single B category ratings are vulnerable to the end of the business cycle and more subject to costly funding rates.

Chart 3

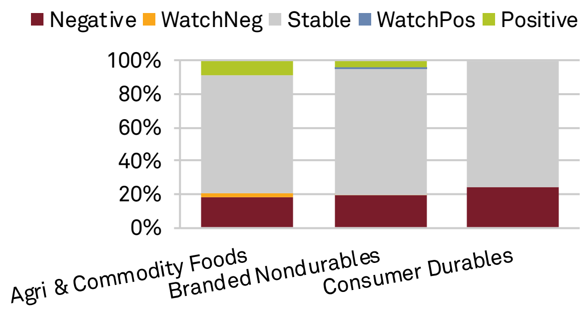
Ratings outlooks by region



Negative outlooks reflect higher leverage and in some cases weaker external conditions and foreign exchange volatility.

Chart 4

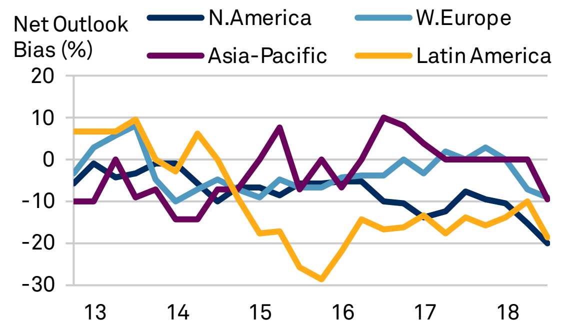
Ratings outlooks by subsector



Agri & commodity foods have the most positive outlooks because of favorable demand, in some cases higher prices, and diversification,

Chart 5

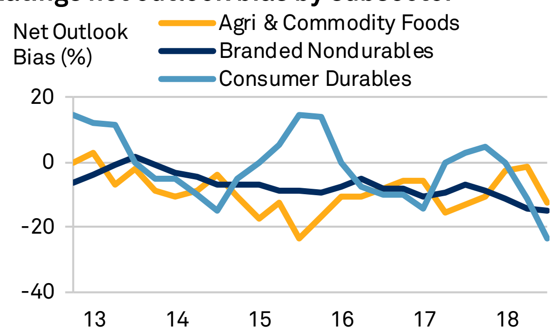
Ratings outlooks net bias by region



Negative outlooks reflect higher leverage and in some cases weaker external conditions and foreign exchange volatility.

Chart 6

Ratings net outlook bias by subsector



Agri & commodity foods have the most positive outlooks because of favorable demand, in some cases higher prices, and diversification.

Source: S&P Global Ratings. Ratings data measured quarterly with last shown quarter ending September 30, 2018

Chart 7

Ratings outlooks

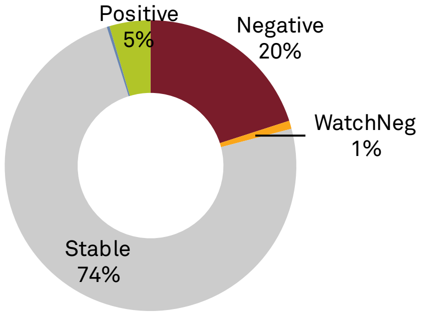
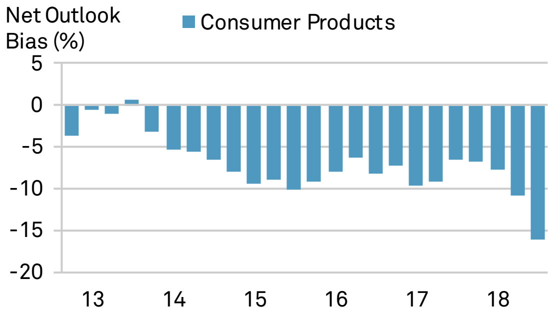


Chart 8

Ratings net outlook bias



The mostly stable outlooks reflects the good cash flow generation capabilities of the sector. The sector has had a negative bias for many years but the trend has accelerated in the past several quarters, reflecting strategic and financial choices to leverage capital structures.

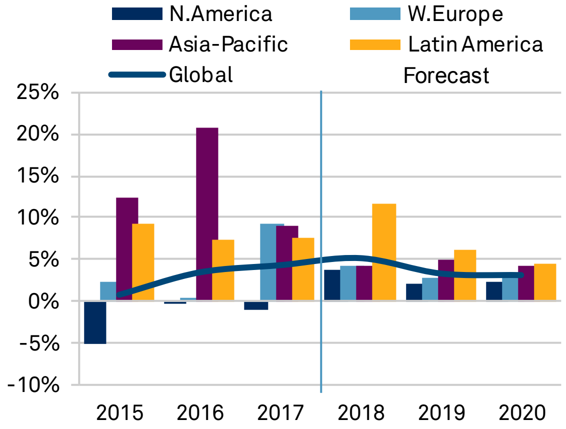
Source: S&P Global Ratings. Ratings data measured quarterly with last shown quarter ending September 30, 2018

Industry forecasts

Global Consumer Products

Chart 9

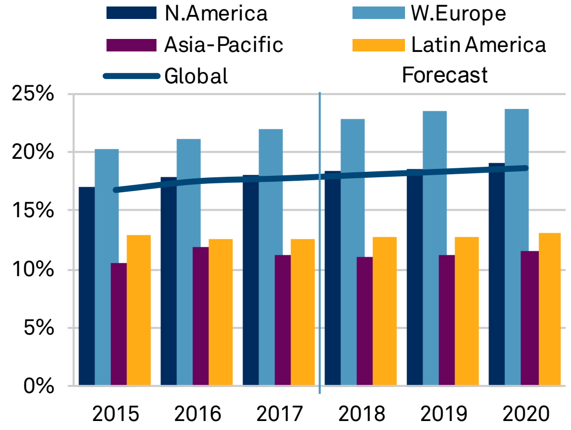
Revenue growth (local currency)



We expect slow revenue growth for the sector overall. In developed markets, low population growth and intense competition will hold down growth. In emerging markets, consumption upgrades and recovering economies and inflation adjustment in Latin America are driving sales.

Chart 10

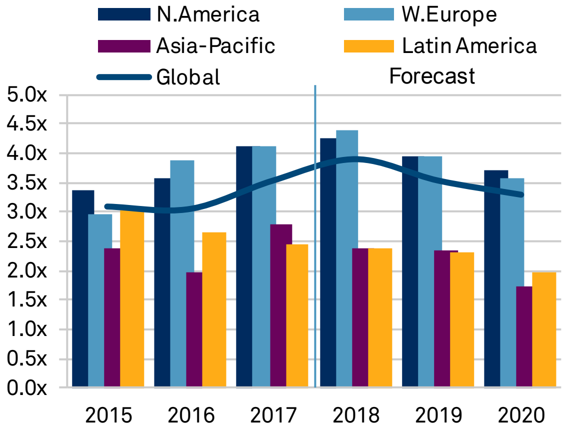
EBITDA margin (adjusted)



We anticipate margins will expand modestly for the industry overall, reflecting product innovation and synergies from acquisitions.

Chart 11

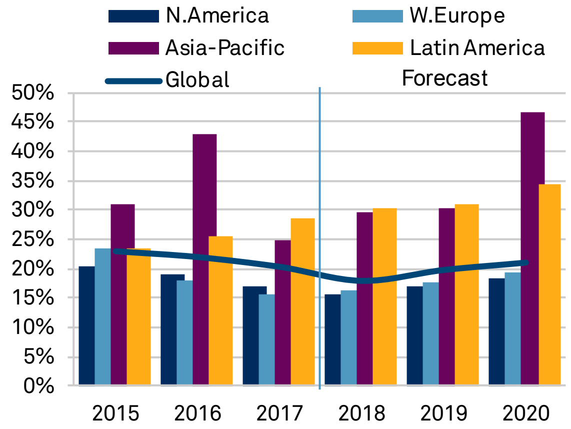
Debt / EBITDA (median, adjusted)



We think the sector will deleverage slightly over the next two years in all regions. In part, leverage has increased over the past few years because of large debt-financed M&A transactions. It is unlikely that aggregate deleveraging will be sufficient to trigger widespread upgrades. We think growth in EBITDA, rather than significant reduction in debt, will account for most of the deleveraging. Any lower leverage in the speculative-grade segment would signal potential dividend recapitalizations or sale on sponsor-owned companies.

Chart 12

FFO / Debt (median, adjusted)



FFO/debt declined in 2018 because of an increase in transformational acquisitions, which were largely financed with debt. We expect companies to focus on restoring their balance sheet strength over the next few years. In Latin America, FFO increased due to significant reduction in interest rates in Brazil.

Source: S&P Global Ratings. Revenue growth shows local currency growth weighted by prior-year common-currency revenue-share. All other figures are converted into U.S. Dollars using historic exchange rates. Forecasts are converted at the last financial year-end spot rate. FFO--Funds from operations.

Key assumptions

U.S.

1. Steady economic environment but weak fundamentals in the industry will pressure sales growth

Although we expect continued economic growth in 2019 in the U.S. and Canada, it will not have much positive impact on the organic sales of the consumer products companies we rate because of weak industry fundamentals. We forecast the U.S. GDP will expand 2.3% in 2019 and 1.7% in 2020 and Canada's will grow 1.7% and 1.5%; respectively. The U.S. GDP growth is underpinned by the strong labor market, still-bullish consumer confidence, and favorable manufacturing sentiment. Moreover, wages are finally showing signs of acceleration.

U.S. household balance sheets are in relatively good shape, household net worth is at a record high, and delinquency rates across loan types are either declining or low, which shows headroom to sustain spending. Instead of stereotypically spending beyond their means, households have been spending more in line with their income strength.

In Canada, heavy consumer debt burdens are constraining credit growth and consumer spending, although we don't think it will have a material impact on the rated consumer products issuers headquartered in Canada because their sales and profits are more skewed to the U.S.

We do not believe the good macro environment will translate into better sales growth as shifting demand and grocer consolidation will make it difficult to achieve organic sales growth above 1%-2%. Grocers have been consolidating because of heightened competition and changing shopping habits, and have more of an ability to gain better pricing and cost reductions from branded consumer products manufacturers. In addition, deep discounters such as Aldi and Lidl, which focus on selling private label products, have entered the U.S. market, and many other retailers have been increasing and improving the quality of their private label offerings, adding more premium products. Digital-savvy brands have also been able to gain share because technology has lowered the barriers to entry and they outsource manufacturing, which decreases start-up costs. On top of this, consumers are gaining greater price transparency because of e-retailers. These headwinds, among others, combined with movements in foreign exchange, will likely result in tepid top-line growth in 2019 and 2020.

2. Headwinds to margins:

We expect margins to be flat to down as higher inflation, the need to reinvest in their businesses, as well as higher freight and commodity costs will likely absorb or exceed all the benefits from cost savings programs. Those companies that are able to increase margins will likely benefit from synergies from M&A.

Many U.S. consumer products companies have announced plans to increase prices to help absorb rising commodity costs and high freight costs because of shortages of drivers, the U.S. government's limitations on driving hours, and higher energy costs. Over the past month or so companies are increasing prices but we believe these increases will not stick given consumers are facing higher inflation, rising interest rates, and rising healthcare and energy costs, and the benefits from tax cuts is fading. Moreover, if the U.S. increases tariffs to 25% on imported goods this could further weigh on companies' ability to pass on rising input costs to consumers as the tariffs are broad-based and there would be a wide base of companies needing to increase prices to offset higher costs.

3. Credit metrics strengthen but will not have much of a positive impact on ratings

We forecast credit metrics will strengthen over the next 12 months because investment-grade companies that have made transformational acquisitions over the past year or so are focusing on repaying debt. We also expect these companies to benefit from synergies. Although the sector remains acquisitive, we expect M&A activity to slow in 2019 compared with 2018 as the U.S. companies digest the acquisitions that have occurred in 2017 and 2018. In addition, we expect companies to curtail share repurchases until they strengthen their balance sheets. We do not believe these actions will result in many upgrades as we lowered the ratings on many of the issuers that materially leveraged their balance sheets and do not believe their leverage will return to historical levels of 2x-3x. Nevertheless, we expect the companies' leverage to be below 4.0x within two years of the close of the acquisitions. Any lower leverage in the speculative-grade segment would signal potential dividend recapitalizations or sale on sponsor-owned companies.

Europe

1. Slow GDP growth across Europe and the ECB tapering off its bond buyback program should have an impact on the financing conditions in the near term

Eurozone growth has been gradually slipping from its 2017 levels and we now see modest growth in the eurozone economy for the coming years. Modest wage growth alongside inflationary pressures had resulted in a benefit to the European economy albeit at a slower pace. Our expectations for 2019 would be a gradual deceleration across Europe on the back of weaker external demand. We've scaled back our European GDP growth expectation to 2.0% for the remaining year and is unchanged at 1.7% for 2019. We also expect a widening interest rate differential with the U.S. and mounting European political risks, which would further weaken the euro-dollar exchange rate over the medium term.

Uncertainties abound in 2019 and we have scaled down our growth expectations on the back of a disruptive Brexit in March 2019 followed by European Elections in May alongside looming pressures in other European countries, especially Italy. Spain, on one hand, is reflecting faster growth momentum compared to other Western European companies; however, politically the country is at a standstill with a minority Government with no majority to pass reforms. With all the above, we now expect euro appreciation to not kick in before the second half of next year.

Low core inflation should not, however, prevent the ECB from ending its bonds purchase program in December and heading for a first rate hike in third-quarter 2019 as scheduled. That's because when the Fed tightens U.S. monetary policy, it typically opens a window for the ECB to do the same. Consequently, we now expect a faster pace of monetary normalization over the longer term, so that the refinancing rate should reach near 1.25% by 2021.

The U.K. government increased interest rates by 25 basis points (bps), reflecting a 0.75% interest rate and tighter funding conditions that may prevail in the longer term. We believe the main threats to markets continue to be external, specifically the mounting trade tensions between the U.S. and China, which would invariably impact European companies. We also believe that if these are not resolved in the near term, the potential for the contagion could potentially spread among emerging markets. Future disruption could potentially come from a disruptive Brexit scenario impacting the pound sterling devaluation and overall slowdown to the U.K. economy in the medium term.

Most companies in the U.K. have been addressing their financing needs and have actively approached the market for opportunistic refinancings and are not hitting maturity walls in the near term. Benign interest rates of the past 12-18 months had been helpful and most consumer goods companies had accessed the markets for opportunistic M&A

activities, which helped in brand-building activities via portfolio reshuffle, which also improved brand equity for their companies.

2. Political uncertainty across eurozone alongside the possibility of a disruptive Brexit could impact consumer confidence

The likelihood of a disruptive Brexit in March 2019 is increasing as both sides (the U.K. and the E.U.) haven't been able to negotiate a future treaty. Though this is not the base case, the escalating tensions are impacting consumer confidence, and companies are postponing their capital expenditure plans.

With parliamentary elections planned in May 2019, the Eurosceptic parties continue to challenge the mainstream political parties, with the latest pressure on Sweden to swerve to the right. This could further slow the momentum of a united E.U. Labor issues and free travel amongst Schengen countries have been impacting the hospitality industry. Further, the Italian coalition government's policy program is at a crossroads with the expectation that the government would be reducing their very ambitious 2019 targets and would reduce the deficit to about 2% of their GDP.

3. Credit metrics are likely to weaken but it won't trigger downgrades

Credit metrics will likely slip over the next 12 months because of low volume growth, pricing pressures, and rising commodity costs. We see further disruptions from changing consumer behaviors, pressure from retailers, and ever-increasing competition, resulting in pressure on EBITDA margins. Large FMCGs (Fast Moving Consumer Goods Companies) have been focused on opportunistic M&A and product reshuffles as their first response to disruption, largely because this is within their control. Weak consumer confidence in the past five years in Europe has already pushed manufacturers to focus much more closely on "price cliffs"--that is, the level at which consumers might switch to a cheaper product or substitute. In many segments of the grocery store, such price points have put a stop to growth that couldn't be overcome by new product development. As a result, multinational groups such as Unilever (A+/Stable/A-1) and Nestle (AA-/Stable/A-1+) have spun off some of their slower-expanding divisions, in segments such as spreads, ice cream, and confectionery. Going forward we don't expect large transformational M&A activity but more resources behind product innovation and time to market. We see challenges to maintain stable profitability and debt leverage as most companies have executed deep cost cuttings in recent years and have now to cope with lower growth prospects and an increasing consolidation in the retail sector.

Latin America

1. Sluggish growth and commodity price volatility weigh on margins

Subdued GDP growth and still-high unemployment rates in large Latin American countries such as Brazil and Argentina result in stagnant household income and sluggish demand in the domestic markets, a major risk for companies with concentrated sales internally. One exception is Mexico, where activity and consumer confidence are on the rise since the July 2018 election, but we still expect GDP to grow at a modest level of around 2.4% in 2019 versus our estimate of 2.2% for 2018, and smaller economies such as Chile and Peru with expected growth around 4%. However, Mexico's President-elect Andres Manuel Lopez Obrador recently announced that plans to cancel the construction of the new Mexico City Airport, following a public consultation launched by the incoming administration. In our view, this announcement will trigger a period of volatility and uncertainty that could undermine investment confidence and affect consumer decisions, which may very well hinder the sector's short and medium-term growth prospects. Except in Argentina, inflation remains contained in other countries, which--along with cost savings efforts and capex reduced to maintenance levels--has allowed companies to defend margins, especially strong brands and despite fierce competition to maintain volumes. Commodity price volatility also impacts companies' revenues and cost structures: livestock and grain prices continue to pressure protein processors' margins in South America; bottlers benefit from persistently low sugar prices despite the depreciated foreign exchange (FX) impairing packaging costs, while sugar and ethanol players' cash generation continue to struggle amid low global sugar prices, despite some relief arising from high ethanol profits in Brazil.

2. Weaker external conditions and foreign exchange volatility on the horizon

The tighter financing conditions for emerging markets and interest rates on the rise in the U.S. could pose a challenge for companies with high refinancing needs for the next year, especially for 'B' or lower ratings. Despite a liquid capital market, risk aversion has increased, and despite an active first quarter 2018 for issuances, the cross-border market remained closed for several Latin American issuers most of the year. We see some improvements with recent bond issuances, but rising interest rates, volatile FX, and uncertain economic policies could increase the flight to quality, curbing funds mainly to local players. In addition, companies with higher exposure to foreign-denominated raw material and debt could suffer from foreign exchange volatility in the region, although exporters such as protein and sugarcane processors generally benefit from more depreciated domestic currencies in the longer-term. Companies with diversified operations in developed countries could also benefit from more depreciated domestic currencies. Increasing protectionism could add sanitary barriers to agricultural exporters, increasing supply in the domestic markets, affecting earnings and profits.

3. Rising political and trade risks hinder private investments

New government administrations in several Latin American countries, including Brazil and Mexico, and escalating trade disputes add uncertainties to the region. In this scenario, we believe companies will mostly focus on preserving liquidity and strengthening credit metrics and capital structure while taking a more conservative stance on financial policy – with only opportunistic M&A transactions and limited shareholders' remuneration such as minimum dividend payouts and limited share buybacks. Although most companies have a stable outlook, tighter financing conditions could result in downgrades for low-diversified and highly leveraged companies, particularly those with weaker liquidity and covenant cushion to deal with a more volatile market environment. Declining sovereign ratings could also impact the industry's ratings in the region, especially those more linked with domestic markets. On a positive note, if the USMCA is approved, the new agreement will largely preserves the existing trade framework to Mexico's exports as it only contains marginal changes and maintains the overall status quo. The USMCA will require approval by the legislature of the United States, Mexico, and Canada to take effect, which will not happen until 2019 due to congressional timeline procedures.

Asia-Pacific

1. Consumption upgrades driving growth

We expect regional GDP to vary by country, and the growing middle class will continue to moderately lift regional consumption, supporting stable credits trends. Although consumer sentiment in China may be dampened by U.S.-China trade tensions if escalated, we expect the growing middle class in the region to be willing to pay more for premium and healthier consumer products. Growth in cosmetics, sportswear, and healthcare sectors would continue to outpace GDP expansion.

2. Higher raw material prices and selling costs amid fierce competition

Potentially higher input costs and rising advertising and promotional expenses may keep the pressure on consumer product companies' profitability. In addition, to catch up with rapidly changing consumer tastes and shopping preferences to online channels, competition will continue to be intense. Product upgrades, joint procurement of raw materials, or cost streamlining might moderately temper the impact. We believe companies' adaptability to rapid changes in consumer tastes and preferences, and capability to cope with rising online sales, online to offline, and mobile payments are key to companies surviving the intense competition.

3. Debt-funded M&A remains an event risk

Downward rating pressure is moderately increasing, due mainly to debt-funded acquisition and investment seen in China and Japan. This is the major reason for the net negative outlook in the Asia-Pacific consumer products sector. Given slowing organic growth, companies could borrow to pursue M&A. For China, market fragmentation and companies' initiatives to gain control over high-quality raw material sources or better brands could spur M&A. Japan's major food, beverage, and tobacco producers have continued to seek growth opportunities overseas through acquisitions. We believe this trend will continue in 2019. We will incorporate any potential damage to their business performance resulting from changes such as foreign exchange fluctuations and regulatory changes as well as financials. We will also reflect the risks of insufficient group management systems into our assessments of their creditworthiness.

Key risks and opportunities

Packaged Foods

1. Convergence toward 'BBB' category as companies continue to buy growth

Overall, the number of packaged food companies rated in the 'BBB' category has increased after the last wave of acquisitions. Anemic organic revenue growth in the U.S. combined with trends in consumer preferences and the channel shift towards e-commerce continues to fuel M&A activity.

In 2018 we've seen many large transactions, including General Mills' acquisition of Blue Buffalo Pet Products and Conagra Brands' purchase of Pinnacle Foods. As consumers prefer brands that they perceive to be healthier, natural, or more socially responsible, the packaged food companies are attempting to change their product portfolios. For many, that means buying smaller rivals that provide these increasingly popular products and brands.

While many companies are still digesting their recent acquisitions and need to focus on deleveraging (such as General Mills, Conagra, Campbell Soup, Hershey, and McCormick), several others still are likely on the hunt, including Kraft Heinz, Kellogg, and Mondelez. Global giants such as Nestlé and Unilever are also carrying out this strategy. Among other things, Nestlé acquired the perpetual global license to market Starbucks products outside the Starbucks coffee shops and sold its confectionary business in the U.S. Unilever sold the spreads business and continued to acquire small/medium-size companies, enlarging its exposure to coffee and personal care.

Given the higher debt leverage and convergence toward the 'BBB' category, we do not believe that fallen angel risk is substantially heightened because of their ability to generate strong discretionary cash flows, to pull back on shareholder returns, or to sell assets in their large portfolios, if needed. We think the risk of falling to 'BBB-' is greater if the companies do not perform as expected and deleveraging would take longer than two years after the transactions close.

2. Commodity cost inflation and freight inflation will likely pressure margins

Packaged food companies have enjoyed lower commodity costs during the past several years. As commodity inflation returns along with elevated freight, labor, and transportation costs, we believe many packaged food companies will experience some margin compression. Companies plan to partially offset with pricing, fewer promotions, improved mix, and potential structural changes to their supply chains.

Increases in freight and logistic costs have been fueled by various factors, depending upon the region--for instance, by labor shortages in the U.S., mandated wage increases in Canada, increase in oil prices, train strikes in France, and the truckers' strikes in Brazil. We believe the issues in France and Brazil are one-time and are unlikely to recur; however, it shows the negative impact to companies' results from disruption in the supply chain.

For the E.U. based companies reporting in euros, another negative factor is currency translation and we expect this to hit all companies due to volatility in some Latin American currencies, including the Brazilian real and the Argentinian peso.

All these negative factors are pushing companies to adopt specific measures to counterbalance the increase in costs. We note a broad effort to enlarge the base of raw materials and to reduce when possible dependency on specific ones. This is also in line with the trend to diversify product portfolios to meet changing customer preferences. We also realize that the optimization of the logistic costs is necessary as these are likely permanent structural cost increases. Most companies will need to take price increases to offset, which may result in some volume pressures.

Companies selling value-based products will be challenged to pass on these costs and will have to look elsewhere to mitigate these risks. However, the industry as a whole is facing the same pressures, so we think companies that do price will not be disadvantaged for long.

3. E-commerce and channel shifts will require greater investments, but offer opportunities for differentiation

The penetration of e-commerce among packaged food companies is in the lower end of the range for consumer products. The average of the global industry is below 5% with significant differences among the product categories and geographies. Many companies are increasing their exposure to pure online retailers and the click-and-collect model. To gain a competitive advantage in e-commerce requires substantial investment in the supply chain and product offerings along with packaging modifications. Logistics around inventory management are critical and can be costly, potentially hurting margins.

With the increase in online sales, we believe private label penetration could also increase as retailers prioritize digital space to their products online and Amazon places greater emphasis on Whole Foods private label products on their sites. Branded packaged food companies will have to cope with new competition coming from their traditional customers. While in Europe and Canada private label presence is already well established, we envision a widening presence in other markets, like the U.S., as demonstrated by the continued footprint expansion in the U.S. of European private label retailers such as Aldi and Lidl.

Beverages

1. Premium pricing should drive growth for spirits companies, but not all have joined the party

Spirits and wine consumption growth continues to outpace the broader alcoholic category globally, but beer has been left out in the cold. So growth should continue to be uneven across the sector next year with issuers that have large spirits portfolios continuing to innovate and invest in strong growing categories such as bourbon, whiskey, and tequila. Issuers that are benefitting the most from this trend include Jack Daniels (import tariffs notwithstanding), Diageo, Pernod Ricard, and to a lesser degree Bacardi, which is integrating recently acquired Patron, a premium tequila brand. Similarly, In Canada, Arterra is benefitting from a favorable mix by promoting its innovative brands as overall volumes remain lackluster.

By contrast, beer companies, particularly domestic brands in North America, will likely continue to lose share to spirits, wine, and higher priced craft and imported beer. This trend is particularly acute for Molson Coors with almost half of its business in North American domestic beer, and to a lesser degree ABI given its global footprint which mitigates North American exposure, and Heineken, which has more of a premium tilt to its portfolio and less exposure to North America.

Not all trends last forever, and we recognize the current frothy market conditions in spirits can change when the economic cycle turns. Still, most rated spirits companies have enough brand and product diversity to weather a turn in the cycle. For example, the sudden end of the big premium and flavored vodka trend about five years ago was initially a shock for producers like Pernod Ricard and Diageo, but over time it proved to be an opportunity as more profitable brown spirits gained momentum. Those that are currently underperforming the broader industry remain disciplined with cost reductions, such that they should be lean enough to manage through tougher economic times as well.

2. There may be growing pains as several acquisitions are in fast-growing but new categories for the buyers, while cost headwinds in core businesses may crimp margin expansion

Several beverage companies have completed a slate of acquisitions aimed at broadening their product mix into fast-growing categories and/or leveraging distribution and scale to grow faster.

- This includes Keurig's merger with Dr Pepper, which seeks to leverage Dr Pepper's distribution to aggressively grow single-serve coffee.
- PepsiCo acquired Soda-stream in a bid to leverage the fast growing flavored water category in the still nascent at-home market.
- Meanwhile Coke is looking to broaden its still regional coffee business with UK coffee retailer Costa Ltd. Cott Corp. continues to shed its legacy private label carbonated soft drink (CSD) business and seek more stable water and coffee delivery opportunities, but might face integration risk and rising freight costs.
- Likewise, rising bulk-wine costs and ongoing investments to spin off from Constellation Brands will remain headwinds for Arterra in 2019. The biggest surprise is Constellation's entry into cannabis with a near 50% stake in Canopy, a Canadian cannabis producer.

While these acquisitions seek to leverage growth in faster growing categories, they are either in highly competitive markets or in untested ones. This means companies will likely require additional investment in distribution, marketing, and innovation to meet growth expectations. At the same time there are several cost headwinds, including freight, material input cost (particularly aluminum in tariff facing markets like the U.S.), and labor. Given this backdrop, meeting next year's growth and profit targets will depend on disciplined cost management and capturing post-acquisition operating synergies, which should be achievable for most issuers.

3. Many companies are still deleveraging from large M&A, and 2019 will test their tightened financial policy commitments in response to stubbornly higher leverage

A handful of issuers have steered clear of taking on debt to fund transformative M&A, instead leveraging innovation while pursuing a more measured bolt-on approach. For example, Brown-Forman Corp., Diageo PLC, Pernod Ricard, and PepsiCo have largely followed this script.

Still, many beverage issuers continue to work down M&A debt but have not quite met their targets yet. Therefore, they have reiterated their commitment to meeting clear targets in 2019 in a bid to demonstrate their commitments to the ratings.

- This would include Molson Coors, which remains focused on deleveraging following its 2016 acquisition of Miller Coors. It has indicated it will not raise its dividend until it improves debt to EBITDA to 3.75x in early 2019 from about 4.3x as of June 2018.
- Constellation Brands' recent stake in Canopy with options to take a majority stake down the road has taken pro forma leverage to over 4.5x, well above its target leverage ratio of 3.5x. So it has committed not to make share repurchase nor material acquisitions until it restores leverage to its target. It's also looking to sell non-core wine assets and possibly use proceeds to repay debt.
- Coke's debt to EBITDA is likely to remain near 3x as it acquires Costa Coffee in early 2019 before improving to its newly announced 2x to 2.5x debt to EBITDA target. This should happen by the end of 2019 once its bottling and distribution costs roll off and capital expenditure requirements decline.
- To maintain the current rating, ABI should achieve 4x leverage by the end of 2019 from 5x at year-end 2017. However, in 2018 it is facing few headwinds like the currency volatility in Brazil and Argentina and still weak demand in U.S. that reduce the

deleveraging capability. For this reason the company has announced a 50% dividend rebase starting from the November 2018 dividend.

While these financial policy statements signal companies' commitments to their ratings, whether or not they execute on these commitment over the next year will be critical ratings drivers, particularly if they alter their financial profiles to pursue more growth.

Agribusiness and Commodity Foods

1. Protein processor balance sheets are holding up despite rising trade barriers, but speculative grade ratings could suffer if the credit cycle turns

The risk of weaker performance for agribusiness companies because of trade restrictions so far appears limited to the protein sector, particularly pork producers in the U.S. (and the risk of contagion to poultry) were tariffs to persist and newfound markets to close.

Other regions face barriers too, including Brazil, whose beef and poultry processors continue to suffer import restrictions in several Asian and European economies including Russia (an important market for Brazil) following several political scandals in Brazil as well as various safety irregularities uncovered in 2017. Nevertheless, Brazilian players that are diversified in neighboring countries are well-positioned to replace any lost exports, while the U.S. pork sector so far has found new markets for its production (Japan and South Korea to name two, while Mexico should resume more buying with the likely USMCA approval). Barriers imposed by India, however, are likely to remain a headwind for Canadian producer and exporter of pulses AGT Foods and Ingredients through 2019, while seafood processor High Liner Foods might be affected by the U.S.–China trade dispute.

In addition, most rated protein processors have kept leverage well in check. Companies like Smithfield Foods, WH Group, and Pilgrim's Pride all have leverage well below their respective downgrade triggers while Brazilian giant JBS has a positive outlook as it recently shored up its liquidity and looks to further deleverage given a favorably profit outlook.

Still, negative and positive outlooks are evenly balanced in part because high-yield protein issuers that are narrowly focused in one specific area in protein (like contract manufacturing with customer concentration) remain exposed to earnings volatility (given their limited ability to quickly adjust pricing to changes in input costs), and their operating performance has been choppy. Examples include Simmons Foods Inc. and CTI Foods. These companies could possibly face downgrades if the economy were to lose steam and trade restrictions persist, further weakening their already-under-pressure core operations.

2. For the global grain companies, M&A may be back on the plate in 2019

Strong North American soybean crush margins in 2018 will boost what had been depressed EBITDA from a tough 2017 grain origination landscape in Brazil. This will likely restore credit measures to historical levels for many players in the sector by year-end 2018. Moreover, trade disruptions from Chinese soybean tariffs is also indirectly benefitting our rated grain traders as they are best suited to redirect trade flows to new markets with China avoiding buying U.S. beans. They also benefited from a short Argentine crop because of a drought in 2018.

If the South American harvest normalizes next year, some of the margin tailwinds will not repeat, and the sector may yet again consider consolidation. Bunge just added board seats to appease activist investors possibly looking for a sale of the company. Last year, ADM had been rumored to consider acquiring Bunge before the trade war began and the year before there were rumors about Glencore buying Bunge.

It's not just defensive consolidation that may bring M&A back. Companies are looking to expand into more value-added ingredients to diversify away from commodity grain trading and processing, and have restored their balance sheets strength. Hence, we believe M&A will pick back up. Cargill's debt to EBITDA remains near 1x, well below its 2.5x downgrade trigger. ADM is likely to keep leverage below 2x over the next year, and Bunge will likely be back near 2x. Companies may very well believe they have more firepower to hunt for new acquisitions.

3. Sugar producer ratings could be pressured if weak market conditions persist next year

Sugar producers in Brazil and Europe face weak profitability this year due to historically low sugar prices driven by India and Thailand's continued output growth, and to a lesser degree by continued European production surpluses following recent deregulation. Some players (notably producers in Brazil) are likely to continue shifting production to ethanol to offset the weak sugar production margin outlook, but not entirely, given production at most mills cannot be diverted entirely to ethanol. Therefore, the profit outlook in sugar for the first half of 2019 is challenging given the overall surplus of sugar globally and in Europe.

In addition to shifting to ethanol, producers are likely to continue diversifying into food and beverages or starches, particularly in Europe to ease the pain. The profit outlook in sugar for the second half of 2019 may improve but will depend on government policies (including whether India or Thailand produce less and if policies in Brazil change after its upcoming presidential elections). Less favorable weather this year should help reduce supply in Brazil and Europe. The planting season in Brazil saw planted acreage decline by about 5% year over year due to a mild drought, and can be further reduced with recent high volumes of rain. Agriculture yields in Europe should be lower from the dry conditions last summer and beet acreage next year could reduce as farmers could turn to other crops. Lowering operating costs and managing supply agreements with farmers will be critical to stabilize profitability for sugar producers as most mills are not covering their operating cost in the current pricing environment.

Household Products

1. High input costs and currency volatility will weigh on margins

Global household and personal care (HPC) issuers will face cost inflation in 2019. Higher oil prices in particular will lead to increased packaging and surfactants costs (in cleaning products), and drive up transportation expenses. Issuers are also facing higher freight costs to ship products globally. Better logistics planning will only partly help over the near term.

Significant currency devaluations in certain countries, including Turkey, Argentina, and Brazil, will likely lead to higher inflation and likely lower demand as HPC companies raise prices. U.S.-based HPC issuers are likely to see top line currency translation headwinds which filter down and constrain operating profits. E.U. companies are expected to report negative currency impact as the euro has appreciated versus most of the currencies.

We assume that branded companies will maintain discipline on price increases to recover the cost increases. However, the tough negotiation with traditional retailers and the aggressiveness of the private labels will represents headwinds that might jeopardize part of the price recovery or translate into lower volumes.

2. Continued shifts in consumer spending patterns

We expect a continued shift towards e-commerce sales in the HPC space. While the total amount of HPC product sold online still remains small, we believe there are sizable variations amongst product categories and geographies. E-commerce penetration is much higher in categories such as diapers, razors, and beauty products compared with cleaning and paper products. We do not, however, expect a large increase in the overall penetration rate over the near term. It's likely that we will see an increase in click-and-collect, as brick-and-mortar retailers emphasize this service to compete with e-commerce. It's probable that a modest increase in e-commerce penetration (which at best has comparable margins to traditional sales channels) and retailer demands for more competitive pricing to support their initiatives (including click and collect) will hurt margins.

We expect HPC issuers will continue to invest in digital marketing to reach customers, notwithstanding large advertisers such as Unilever and P&G reducing digital spending. Stringent demands by large advertisers could lead to more effective marketing spending and to more measurable results. After years of reliance on professional advertising companies, large advertisers are starting to produce in-house as they have learnt more about this new channel and are on a constant cost-optimization effort.

3. Mature and emerging markets have different needs and offer diversity opportunity

The divergence in HPC products between mature markets and emerging economies continues to be significant and we do not expect this to change in the near term. In emerging markets the living standards are improving and this brings the adoption of new products (i.e., dishwashers) that were previously unnecessary. The key strategic factor in this case is the distribution channel that gives access to new potential buyers. In mature markets, the growth in demand for HPC products continues to be weak and the ability to meet fast-changing consumer tastes is the main driver for profitable growth. In this case the success factor is the ability to innovate and earn a premium on the products. We expect environmental topics to be a main factor that will drive consumers' preferences in mature markets; packaging, raw materials, biodegradability, and waste impact are among the aspects to which companies will have to adapt.

We continue to see exposure to new markets as a positive factor since these offer the best growth rates and they will likely scale up product demand in the future. We are aware that local brands are gaining momentum but we still think that given the growth trend, there will be space also for multinationals. Besides, in mature markets we see growing competition from private labels that are becoming increasingly innovative. We note that sale composition in our HCP rated universe is different. For example, Reckitt is largely exposed to mature markets and achieves lower growth and higher margins, while Unilever is much more reliant on new economies and usually achieves high growth and has lower margins.

Cosmetics Manufacturers

1. Social media, influencers, and e-commerce are driving forces behind growth in the industry

E-commerce will remain the fastest growing channel in the beauty industry in 2019. As consumers are increasingly switching their shopping preferences to online channels, and more than ever relying on social media to learn about new products and services, the beauty companies are responding accordingly by strengthening their digital capabilities, and increasingly using social media influencers as marketing tools. Beauty continues to be one of the fastest growing sectors in the consumer products industry and the companies that have well-established e-commerce presence should continue to exhibit stronger performance than peers that mainly relay on brick-and-mortar locations to drive sales.

Estee Lauder's solid digital penetration (with more than 10% of its sales generated from the online channel) and ability to engage global and local influencers in order to appeal to younger consumers and increase brand awareness allows the company to maintain above-industry-average growth and offset top line challenges. Anastasia Beverly Hills emerged as a niche, independent brand, selling color cosmetics and demonstrating strong double-digit growth over the past few years. The company benefits from strong social presence and affiliation with beauty influencers and is an early adopter of Instagram, with over 18 million followers. This strategy helps the company generate a loyal, technology- and beauty-savvy customer base with very little traditional marketing spending.

Rodan & Fields has also capitalized on Instagram, Facebook, and YouTube, and positioned itself as one of the top performers in the skincare segment of the beauty industry. Coty is also doing well in the e-commerce channel, with approximately 10% of its total net revenues, including Younique. We expect it to continue to grow at a double-digit rate in this channel as it is investing disproportionately in this growing channel. This is particularly important for the company as its portfolio is heavily skewed to slow-growing developed markets. In Brazil, young consumers have significantly increased e-commerce consumption, but the amount of online sales still makes up only around 4% of sales for the leading player in the cosmetic industry, Natura Cosmeticos. Along with trends in developing markets, there is significant growth opportunity ahead in the e-commerce channel.

We expect the rated beauty companies will continue their strategic emphasis on technology in order to increase brand awareness and consumers engagement, enhance competitive advantage, and increase penetration of the e-commerce channel.

2. Emergence of new brands increases fragmentation and could create disruption in the industry.

The low barriers to entry because of broader customer access through online advertising and fast-changing customers behavior creates a favorable setting for a large number of small, indie brands to enter the beauty market and create disruption in the industry. These small brands are using makeup artists and celebrities to increasingly gain visibility in the industry, and are able to market their products with very little marketing spending thanks to social media channels. Although they have not materially eroded the branded players' share, there are a large number of them and as a group they are taking growth away from branded players, who are responding by increasing business diversification, acquiring smaller and fast-growing innovative companies.

In addition, the branded cosmetics companies are increasing investments in innovation and increasing speed-to-market for new product launches. This should help accelerate sales growth but pressure margins. We believe that the well-established brands in the premium channel (Estee Lauder, Sheishido) will continue to benefit from strong brand loyalty, their ability to innovate, deliver high-quality products, and engage with the consumer, while strong growth potential in China will help offset competitive pressures the branded players are incurring.

3. The premium segment will continue to thrive thanks to strong demand in the U.S. and China

Premium segment of the cosmetics industry will continue to outpace growth in the mass segment, which has been under a lot of pressure over the past years as consumers are increasingly willing to trade up to higher-priced beauty products and foot traffic in the channel has been declining. The prestige beauty brands will continue to benefit from increasing demand in the U.S., Western Europe, and China, and the increasing spending power of Gen Z and millennial consumer who show growing appetite for newness, innovation, and high-quality products. Shiseido is also enjoying popularity with millennials in China, while Estee Lauder's sales from China exceeded $1 billion for the first time.

The companies that have a high exposure to the mass segment will continue to face very big challenges. In the U.S., Revlon is the most vulnerable as it has suffered from ongoing weakness in the mass segment of the cosmetics industry. The company's liquidity is very constrained and it has already been relying on additional liquidity funding to support its struggling operations. Coty's profits have also been impacted by weak demand in the mass channel. The company has been launching new products and reinvigorating the image of its Cover Girl and Rimmel brands. Still, we believe its growth will come from its luxury and professional segments and that it will struggle in the mass channel in 2019 given the channel's weak fundamentals and its own supply chain issues.

Tobacco Manufacturers

1. Global sales volumes expected to decline

We expect tobacco firms' global sales volumes to continue to decline by about 2%-3% a year on average over the next five to 10 years, driven by falling cigarette sales. The industry faces continued increases in excise taxes, more-stringent regulations, and increased health awareness among consumers. There is, however, geographic variation: we forecast some emerging market countries will see cigarette volume growth over the next five years, largely driven by demographics, even as more-developed markets continue to see structural volume declines, including Western Europe, Eastern Europe, the U.S., and Japan.

2. Alternative Products May Hold the Key

Health concerns remain the central industry risk factor. Tobacco players have sought to counter this problem by investing in new solutions that can address, at least partially, these associated health risks. Philip Morris International (PMI) has been most active in investing in next-generation products (NGPs), with a particular emphasis on heated tobacco products (HTP). These are thought to carry fewer health risks for consumers. NGPs represent an increasing proportion of tobacco companies' investments and are expected to represent the largest source of volume growth in the next 20 years. NGP demand in the U.S. was below expectations until 2017, when significant growth occurred because of the JUUL e-cig, which the USFDA is now cracking down on because of youth initiation. We expect the USFDA to approve sales of PMI's IQOS heat-not-burn (HNB) cigarette (which will be distributed by Altria) by 2019.

If companies can capture a sizable share of the NGP market and grow volumes, it will help them secure the long-term viability of the industry and counter some of the fundamental regulatory and demand issues being faced by traditional combustible tobacco products. Tobacco companies that successfully access this market will gain an additional product category that carries very attractive profit margins and cash flow generation potential. Possessing a solid portfolio of NGP's will be critical in the U.S. especially if the USFDA is successful in reducing nicotine in combustible cigarettes to non-addictive or minimally addictive levels. However, it's not clear that the USFDA will be successful with this proposal, and if it is, we do not expect it to take effect for five to 15 years. PMI and to a lesser extent British American Tobacco (BAT) presently have the global lead in HNB products.

3. Further consolidation could help companies position themselves

We consider the market very likely to see further consolidation in the medium/long term as the profit pool shrinks and regulations change. In the face of declining global cigarette volumes, we expect companies to seek to optimize supply chains and production; as we saw with BAT's 2017 acquisition of RAI, a merger can boost volumes and revenues. It may also prove easier for some companies to buy expertise and market share in NGPs than to develop it. That said, a merger between any of the larger entities may attract the attention of regional antitrust and competition authorities. We suspect more certainty around the future of combustible cigarettes in the U.S. will be necessary for PMI to make a bid for Altria, which has been speculated.

Luxury Goods

1. Travel retail is one of main growth drivers

The travel retail segment is experiencing strong momentum especially within the luxury goods sector, and we expect this trend to continue also during 2019 and 2020. According to a recent survey conducted by Deloitte (see Global Powers of Luxury Goods 2017) consumers at airports while travelling make about 15% of total luxury purchases and this is even more prominent among millennials. The growth of the segment is mainly supported by the ongoing annual growth of international travelers (with about +7% CAGR 2013-2017 air passengers -- World Bank), the favorable demographics of passengers (both in terms of age and income profiles), coupled with a much better and appealing utilization of retail space within airports and train stations.

Some luxury brands have also developed products for the travel retail environment only, such as Kering SA within its eyewear division. L'Oreal also appreciates the potential that travel retail has to offer, reporting in 2017 revenues within this channel growing 20% year over year, and it expects to reach the €2 billion revenues mark (representing about 10% of total sales).

The potential risk to travel retail growth could come from an exacerbation of the tariff war between U.S. and China or more generally from a global deterioration of the global trade conditions. This could be the consequence of the increasing nationalist sentiment in some European countries and in large economies like Brazil.

2. Understanding the Chinese consumers

Chinese consumers account for about one third of the total personal luxury goods spending worldwide, whereas China as a geography accounts for less than 10%. Chinese purchases represents between 30%-40% of the revenues of the rated European luxury goods companies. On average, the proportion to total income that Chinese consumers allocate to luxury goods is higher but also more volatile compared with the Western world.

Compared with five or six years ago, it seems that the Chinese luxury spending has moved towards a more self-consumption base as opposed to the gifting practice. Additionally, the luxury spending is less focused on a few mega-metropolises, expanding gradually also to tier two/three cities, thus allowing for a better diversification within Chinese domestic borders. We believe this transition is positive as it reduces the risk of a sudden fall in consumption coming from a restricted group of people.

However, we still see reasons for potential volatility in the coming months. In fact, Chinese authorities have started to crack down the practice known as "daigou" (the reselling in China of bulk purchases made abroad). It seems Chinese authorities want to ensure the Chinese spend more at home to support the domestic economy. Considering the grey area in which this practice operates, it is difficult for luxury companies to estimate the potential cost of it. We see increasing caution from investors as the drop in Chinese demand in 2014-2015 is still very fresh in memory. We assume there might be some negative effect but the reduction in prices operated by several luxury companies in the last months should support local consumption.

3. We expected further consolidation in the industry

The luxury world is becoming increasingly polarized between large luxury groups such as LVMH, Kering, Richemont, and famous luxury brands that operate on a stand-alone basis. Looking at the expected trend in growth we realize that luxury offers probably the best growth rate in the consumer space, at least mid-single digits in the medium term. On the other hand, it is probably also exposed to higher volatility compared to the average of the consumer goods industries.

We believe the consolidating trend has not ended, and in our view the main constraints to further deals are the very high multiples and the very selective approach that consolidators are taking when a new brand is considered as a potential addition to their portfolio. However, in 2018 we have noted increasing interest from new potential consolidators, as proven by the recent acquisition of Versace by Michael Kors, and by Chinese private equity funds that have taken over Lanvin, Sandro, Cerruti, and other small-medium brands. We know that several fashion companies are still held by families and in some cases are struggling with generational replacement issues or different family interests that are difficult to reconcile. A sale could represent a way out, as happened for the Bulgari sale to LVMH. We believe the healthy balance sheets of the large consolidators in the luxury industry and the appetite of private equity companies could trigger new M&A in the sector in the short-medium term.

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This report does not constitute a rating action.

Cash, debt, and returns

Global Consumer Products

Chart 13

Cash flow and primary uses

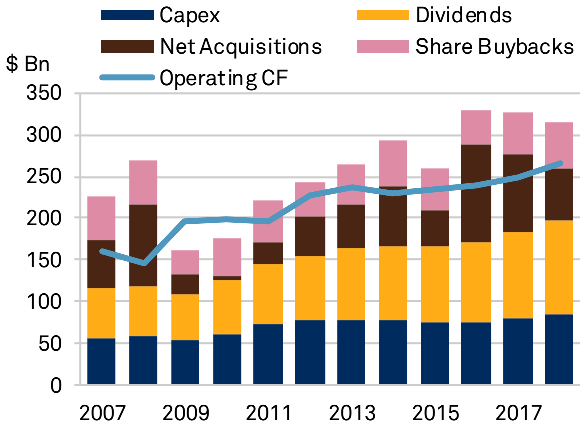


Chart 14

Return on capital employed

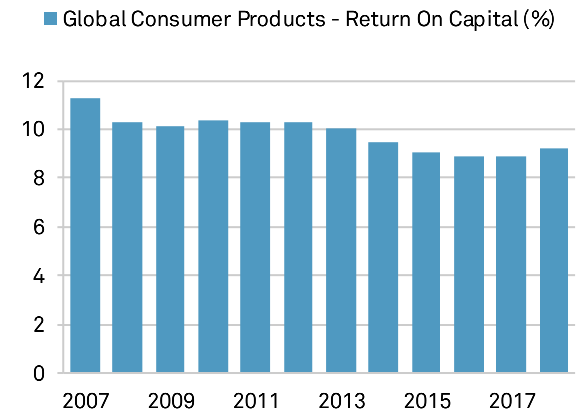


Chart 15

Fixed versus variable rate exposure

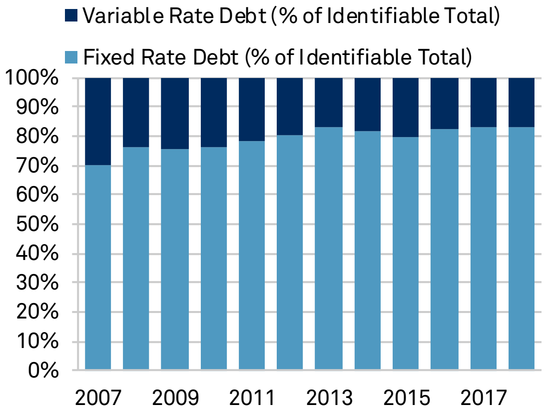


Chart 16

Long term debt term structure

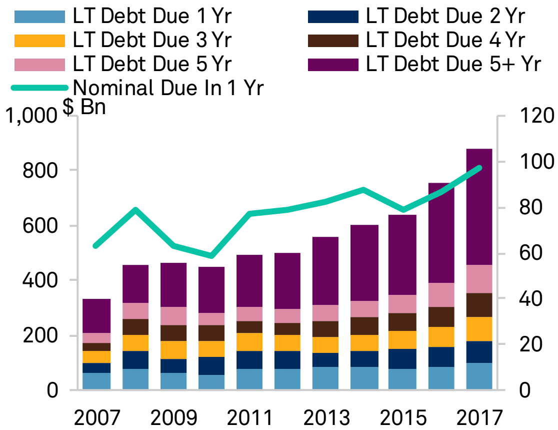


Chart 17

Cash and equivalents / Total assets

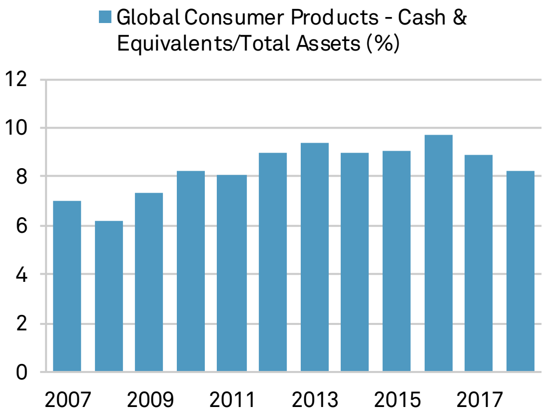
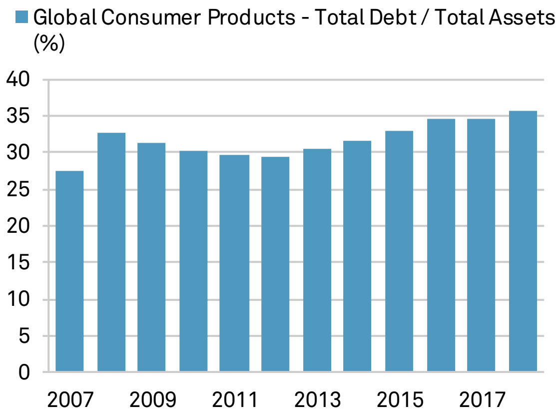


Chart 18

Total debt / Total assets



Source: S&P Global Market Intelligence, S&P Global Ratings calculations

spglobal.com/ratings