S&P Global
Ratings

Industry Top Trends 2020

Consumer Products

Challenge to innovate amid evolving preferences and slow growth

What's changed?

Ratings outlook. Rating trends have become more negative, largely at the low-end of the speculative-grade rating categories, mostly because of unsustainable capital structures and weak operating performance.

Growth prospects lie with omnichannel and emerging market strategies. Companies will have to continue developing these strategies in the face of the value-conscious consumer and their increasing preference for convenience.

Global trade tariffs. China-U.S. trade tensions have increased price volatility of grains. The outbreak of the African Swine Fever has increased prices for proteins and should offset the impact of the trade war on agribusinesses next year.

What to look for in the sector in 2020?

Remaining relevant. Companies are seeking relevance through innovation, repositioning, and renovating portfolios at a time when margins are under pressure.

Sustainability. The social and environmental agenda is increasingly prominent in consumer discourse, focusing on wellness as well as packaging and fabrics.

Margin pressure. Changing market realities, input cost increases, and subdued growth are likely to result in flat to modestly lower margins.

What are the key medium-term credit drivers?

Recession. Consumer products companies could face a tough road ahead as global GDP economic growth is slowing and the odds of a U.S. recession has increased.

Financial Policies. Financial policies relating to shareholder returns and investment are key factors affecting credit quality.

Liquidity constraints for weaker issuers. For issuers in the lower end of the ratings spectrum, shortfalls in operating performance that result in tightening liquidity and could drive downgrades.

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Ratings trends and outlook

Global Consumer Products

Chart 1

Ratings distribution by region

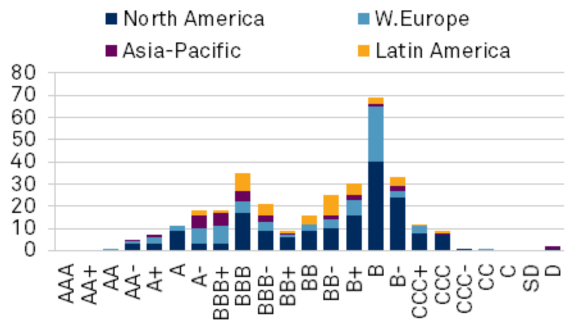


Chart 2

Ratings distribution by subsector

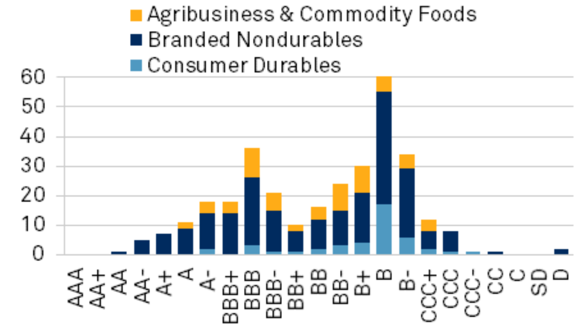


Chart 3

Ratings outlooks by region

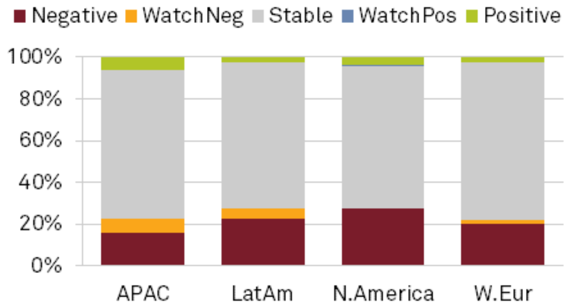


Chart 4

Ratings outlooks by subsector

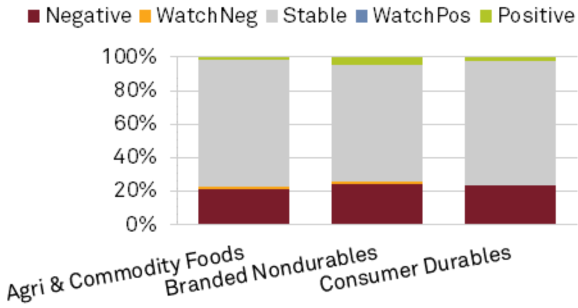


Chart 5

Ratings outlooks net bias by region

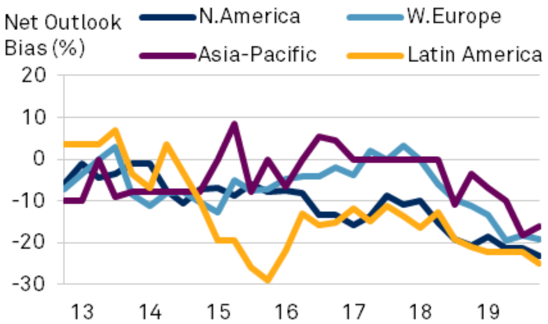


Chart 6

Ratings net outlook bias by subsector

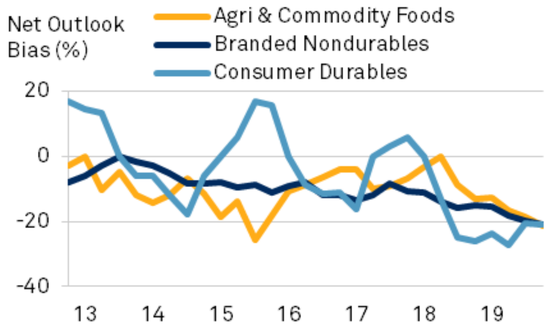


Chart 7

Ratings outlooks

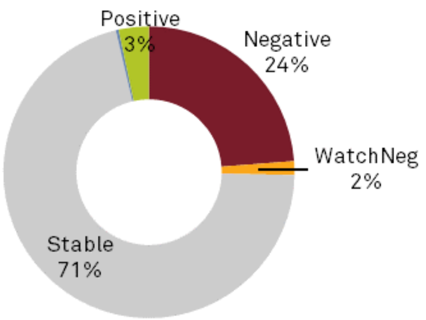
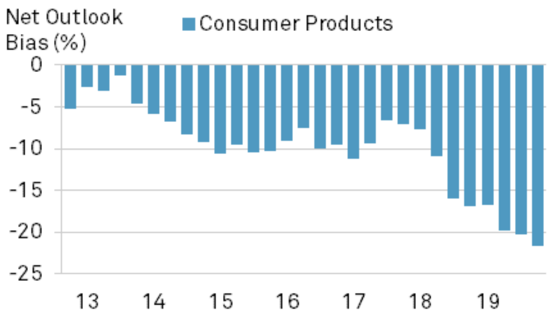


Chart 8

Ratings net outlook bias



Source: S&P Global Ratings. Ratings data measured at quarter end. Data for Q4 2019 is end October, 2019

North America

Key assumptions

1. Slowing economic growth but consumer spending likely to be healthy

Our economists forecast slowing economic growth. Still, the labor and housing markets should remain healthy and consumer spending should only slow modestly.

2. Tepid organic sales growth and margin pressure

We forecast flat to low-single-digit organic sales growth driven mainly by favorable price mix. Margins will be under pressure from focus on top line growth, limited benefit from productivity programs, and retail pressure.

3. Credit metrics will likely strengthen but won't trigger upgrades

We forecast credit metrics will strengthen modestly over the next 12 months because many investment-grade companies that made transformational acquisitions in 2017 and 2018 are repaying debt and achieving synergies.

Economic growth in 2020 in the U.S. and Canada should slow modestly. Still, we believe the consumer will continue to spend as the labor and housing markets remain robust. We forecast the U.S. GDP will slow to 1.7% in 2020 from an estimated 2.3% in 2019 and consumer spending will slow to 2.2% in 2020 from 2.6% in 2019. We expect Canada's growth to modestly slow to 1.4% in 2020 from 1.5% in 2019. The U.S. GDP growth is underpinned by the strong labor market, wage growth, and U.S. household balance sheets that are in relatively good shape. The escalation of trade disputes—and the secondary effects they can have on consumer spending—remains a major risk to economic growth.

Organic sales will continue to be in the low-single digit rates because of changing consumer tastes, intense competition, and consumers continuing to be value oriented. Adding to the pressure is retailers are increasing private label offerings to differentiate themselves and drive loyalty, as well as to shore up profit margins. We expect branded goods companies to lose some shelf space this year, and will need to focus on managing price gaps with private label to keep consumers from switching. To remain relevant, companies are increasing innovation, reformulating products, and acquiring on-trend brands

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

Credit metrics will strengthen slightly over the next 12 months but will likely not result in upgrades. A few investment-grade companies that made transformational acquisitions over the past year or so will strengthen credit metrics as they focus on repaying debt and achieving synergies. We do not believe these actions will result in many upgrades as we lowered the ratings on many of the issuers, such as ConAgra, General Mills and Campbell, that materially leveraged their balance sheets and do not believe their leverage will be sustained below 3.0x. Nevertheless, we expect the companies' leverage to be below 4.0x in 2020. Any lower leverage in the speculative-grade segment would signal potential dividend recapitalizations or sale on sponsor-owned companies. Similarly, In Canada, we expect most companies to modestly deleverage, driven by slight EBITDA improvement following significant cost cutting.

Europe

Key assumptions

1. Household consumption will be a key support for slowing growth

Household consumption will remain a main pillar of economic growth, which continues to slow further. Trade is unlikely to add to growth, as trade tensions remain on the agenda.

2. Sales growth will remain low with broadly flat margins

We see limited ability to grow sales in the mature markets of Europe, with polarization of the product ranges. Investment in fresh, organic, innovative products and ecofriendly packaging will pressure margins.

3. Product diversity and global reach will mitigate downside risks

Companies with narrow product ranges or with operations concentrated in niche areas are most exposed to downside risks, relating to weakening profitability or inability to reduce leverage or manage refinancing risks.

We expect GDP growth to slow further to 1.1% in 2020 and return to trend growth of 1.3% in 2021 and 1.4% in 2022. Similar to this year, net trade is unlikely to add to growth, as trade tensions and Brexit could influence tariffs. Household consumption will remain a key pillar of growth. Unemployment remains low, inflation will be contained, and lower borrowing costs will incentivize household consumption, both on consumables and larger expenditures like housing. We expect interest rates to remain low for both consumers and firms. That said, credit standards tightened for consumption loans to households, which could limit consumer demand, especially for discretionary or big ticket items.

Given the macroeconomic environment, we forecast low-single-digit top line growth as we see limited ability for consumer goods companies to grow sales in mature European markets. We see continuing polarization of the product ranges with premium and convenience products maintaining good demand while the mid-range gets squeezed. Investment in fresh, organic and innovative products will be the key differentiators and will greatly feed into the brand perception, as a growing segment of discerning consumers demand higher levels of product quality at reasonable prices. The social and environmental agenda is increasingly prominent, with a focus on sustainability, health, and nutrition, as well as the use of plastics in packaging and fabrics. Expenditures on product and packaging innovation together with higher input prices on certain commodities like sugar, together with a tough retail pricing environment, will push down margins. That said, most European consumer goods companies will be able to limit these pressures due to cost reduction efforts, which will help maintain relatively flat margins.

EMEA multinationals are unlikely to engage in mega mergers and acquisitions, and will continue to focus their strategies on in-fill acquisitions and spin-offs of non-core activities. Further, the high product diversity and the wide global reach will help mitigate exposure to weaker economic growth and evolving consumer preferences. As a result, leverage ratios for large investment-grade companies have peaked and should trend gradually down. However, shareholder returns and acquisitions in the luxury space remain risks, especially for larger companies. Smaller companies in the 'B' category, with narrower product or geographical diversity, will have very limited headroom to absorb higher leverage due to stagnation or weakening profitability despite some top line growth. Despite weakening credit quality for these companies, liquidity remains generally adequate.

Latin America

Key assumptions

1. Still weak domestic consumption, but a bright export-volumes horizon

The main domestic economies in the region, such as Mexico and Brazil, have promoted tepid economic growth, which make price adjustments to sustain margins challenging. On the other hand, the increase of protein demand from China from the ASF outbreak is boosting export prices for protein processors, improving cash flows.

2. Foreign exchange is a double-edged sword

While currency depreciation helps to boost export profits, and still-sound global liquidity increases demand for cross-border issuances, cash flow and balance sheet hedges are important to protect the companies in a scenario of currency swings, mainly amid credit scarcity that could happen in 2020-21. We expect companies to use of derivative tools to hedge currency exposure, even if the cost of funding increases.

3. Historically low interest rates boost funds from operations (FFO) generation

Low interest rates and still-sound liquidity have lowered the cost of funding in Latin America. But the level of private investments continues to be low.

Investments continue to be limited in the main economies in Latin America. Low investor confidence in the AMLO administration in Mexico, recession in Argentina exacerbated by uncertainties with the incoming president, and the need for further reforms in Brazil following the recent approved pension reform have undermined economic growth. We forecast Brazil growing 0.8% in 2019 and 2% in 2020; Mexico expanding only 0.4% this year and 1.3% in 2021; Chile, Peru, and Colombia growing between 2%-3% per year; and Argentina to contract 3% this year and 1% in 2020.

This tepid growth environment will mean fierce competition domestically, to enable companies to release inventories. Inflation has been contained in Brazil, Mexico, Chile, Paraguay, Uruguay, Colombia, and we estimate companies will be able to adjust prices at least by inflation and input costs to fairly sustain profits.

We continue to see a conservative approach to shareholders' remuneration and for M&A, and companies might pursue tuck in acquisitions to improve product portfolios. Slightly better fundamentals for global sugar prices and profitable ethanol should support higher investments in the sugarcane fields in Latin America, and growing free cash flows will alleviate refinancing pressures and leveraged balance sheets for entities rated at 'B-' or in the 'CCC' category.

Protein companies have benefited from higher export prices and volumes to China and the increased demand for all proteins. This has helped to offset still-weak volumes in some domestic economies and subsequent difficulty in increasing internal prices. The stronger cash flows have already contributed to positive rating actions in protein giants BRF and JBS, and boosted partnerships and investments with Asia-Pacific (APAC) companies.

Governance has been a key rating factor in the region, and a rating limitation in Brazil following several corruption investigations. However, these cases are helping to improve transparency on risk assessment and the implementation of internal controls, which should improve overall governance in the future.

Asia-Pacific

Key assumptions

1. Product upgrades are driving growth and mitigating consumer sentiment

Healthier and higher-end products are getting more popular among customers in Asia-Pacific, driven by many customers' rising health awareness. However, growth in food staples and low-end products is likely to be low-single digits in the region, given subdued consumer sentiment.

2. Margin pressure from higher raw material prices and fierce competition

Potentially higher input costs and rising promotional expenses may pressure profitability. Competition on product development to meet changing tastes and online shopping preferences will remain intense.

3. Discipline, new products, and efficiency will differentiate credit quality

Companies' financial discipline, capability to launch new products faster, sensitivity to consumer preference, and operating efficiency will differentiate credit quality. Small companies could face rising refinancing risks.

The rise of the middle classes will continue to lift consumption, albeit at a slowing pace, and support sales of consumer products in the region. Growth in dairy products and sportswear in China will continue to outpace the Chinese GDP growth, driven by rising health awareness among some consumers. Sales of cosmetics products in Japan is also likely to grow fast at 6%-7%, driven by solid growth of inbound tourists. However, growth in food staples and low-end products may hit low-single digits in the region given subdued consumer sentiment.

We believe the direct impact of the escalated China-U.S. trade tensions would be manageable for most rated consumer product companies in China, given their focus on domestic consumption. However, the potential impact on consumer sentiment and supply chains to reroute procurement may pressure consumer product companies' growth prospects and profitability.

Profitability of consumer product manufacturers is likely to come under pressure, given the potentially higher raw material prices and persistent, intense competition. Companies also need to invest more on new products to adapt to shifts in consumer tastes.

We expect credit metrics of rated consumer product companies to slightly improve over the next 12 months, driven by steady (albeit slower) profit growth and more prudent financial investment against the backdrop of macro uncertainty. Nevertheless, we still expect large Chinese and Japanese consumer product companies with ample financial cushion to pursue overseas acquisitions, given their desire to control high-quality raw material sources or better brands or to improve the growth prospect.

Financial discipline as well as companies' capability to develop new products and improve operating efficiency will differentiate credit quality. Small companies with weaker balance sheets or limited access to credit markets could face rising refinancing risks and deteriorating competitive position and growth prospects.

Consumer Products

Key risks and opportunities

1. Changing consumption drivers are likely to result in modestly lower margins

Technology and changes in consumers' behavior, tastes, and preferences have increased the pace of change in the consumer products industry and branded goods companies have been focusing on being more agile to repositioning their portfolios to meet these changes. Consumers are also paying increasing attention to topics related to sustainable development and responsible consumption, and companies are increasingly communicating plans and achievements in this area.

2. Geopolitical, trade and regulatory pressures loom over the horizon

The extra costs on goods imported from China is clearly bad news for U.S. companies. The U.S.-China dispute has hurt the smaller, speculative-grade durable and apparel companies and some seafood processors in Canada that rely heavily on imports from China. These companies have taken pricing actions and, in some cases, increased the diversity of their supply base, but have not been fully able to offset the lower profitability.

3. Speculative-grade credit quality will erode rapidly in case of a recession

While S&P Global economists don't expect a sharp downturn in the global economy next year, such an event would almost certainly result in a jump in downgrades of those speculative-grade borrowers barely treading water. We would also expect downgrades or negative outlooks on some companies currently performing relatively well as price-conscious shoppers focus on value and buy only what they need. We believe volume growth could improve from increased food consumption at home, as consumers spend less on dining out. However, rising sales of lower-priced private-label products and the trade down to lower-end products may restrict revenue growth, with the unfavorable mix shrinking margins. To limit the effect of trade-downs, we expect brands to focus on strategic pricing and promotions with retailers while continuing to trim costs.

Changing consumption drivers are likely to result in modestly lower margins and ongoing reshuffling of portfolios

Companies know the world is changing around them and are increasing product innovation, reformulating products, acquiring on-trend brands, improving speed-to-market, and diversifying channels and geographies. All major consumer product companies are investing more in the online channel, including launching exclusive products and spending more on digital marketing, to enlarge exposure to the faster growing retail channel. North American companies are shifting their portfolios towards healthier and more-eco-friendly products. For European companies, not surprisingly the sectors that are experiencing the largest growth are plant-based vegan alternatives, low-impact soaps for personal use or laundry, and natural cosmetics. In Latin America, bottlers have increased the share of sugar-free or low sugar content drinks in the portfolio, which has helped to sustain volumes.

Large European branded consumer companies like Danone, Unilever, Nestlé, and Reckitt Benckiser want to achieve an annual organic growth of at least 3%. Not all of them will reach this result in 2019 and this might become even more challenging in 2020, though only a small part of this increase will come from Europe as trading conditions will remain tough in the next few quarters. In the U.S., Procter & Gamble has transformed its portfolio over the past few years and organic sales have accelerated from low-single digits to 7%

in its recent quarter. Mondelez has also consistently outpaced industry growth because of its on-trend portfolio. Leading consumer product companies in APAC, such as Shiseido Co. Ltd. and China Mengniu Dairy Co. Ltd., will continue to outgrow the GDP growth in the region, driven by the "premiumization" of their product portfolio. Consumer producers in Latin America have been challenged to sustain volumes amid macro difficulties, with political uncertainties, weak currency, and low consumer confidence weighting on volume consumption.

In light of the various challenges in the sector, we expect margins to be under pressure. Favorable product mix and cost savings initiatives will likely soften the impact, but EBITDA margins could be flat to down for at least the next year.

Geopolitical, trade and regulatory pressures loom over the horizon

Global trade has hurt several agribusinesses as key U.S. agricultural exports to China have ground to a halt, and farmer profits are under pressure. Some grain and ethanol producers in North America have seen profits under pressure with the increase of purchases from South American processors and more volatile prices. U.S. pork producers, whose exports to China and Mexico faced stiff tariffs, have also been hurt. In addition, the sector still waits on congressional approval of the USMCA to ensure continued free trade with Mexico and Canada while facing increased production capacity from new entrants at home.

Irrespective of whether a trade agreement is struck between the U.S. and China, a brighter future for global agribusiness players is starting to emerge. Ironically it is coming from China, whose domestic pork supplies are dwindling as the country’s farmers cull their herds in response to an unprecedented epidemic of African Swine Fever (ASF). We expect the impact of ASF in China to reverberate throughout the sector globally for years to come, mostly to the advantage of much of the industry as it is boosting demand for alternative proteins and increasing prices all around. So far, this helped to support positive rating actions in JBS S.A., BRF S.A., and Pilgrim's Pride Corp.

We see limited direct impact on consumer products manufactures located in China because of the trade tensions between China and the U.S., given most of the rated consumer product companies focus on the domestic market in China. However, the second-order repercussions of the trade friction--such as weakening consumer sentiment, currency fluctuations, and changes required to reroute procurement--may undermine the growth and profitability of all consumer products companies.

Brexit uncertainties and U.S.-China tariff skirmishes are not expected to have a material credit impact on most EMEA consumer good companies, thanks to their good manufacturing and distribution diversity.

However, like European automakers, consumer goods companies in Europe also face the risk that trade conflicts may escalate. The effect of the first round of the W.T.O ruling on the trade dispute between Boeing-Airbus, has given a clear example of how sudden tax increases can hit specific sectors. For now, the U.S. administration can impose tariffs on $7.5 billion of European products annually. The taxes have been imposed on goods that in most of the cases have very limited connection with airplanes. The list ranges from steel products to biscuits, cheeses, and alcoholic beverages. The second round will be settled next year and will probably give the EU the right to adopt similar tariffs on US products.

The tobacco sector globally continues to face legal and regulatory adversities and we do not expect this to change in 2020. After the decision of the Canadian court in the class-actions against local subsidiaries of PMI, Japan Tobacco, and British American Tobacco that forced these subsidiaries to seek creditor protection under the Companies' Creditors Arrangement Act (the CCAA), the sector was also hit by the negative news flow on e-cigarettes, and bans on the sale of e-cigarettes in some cities in the U.S. and India. The issue is under scrutiny and will probably trigger a more severe regulation on the use and the sale of these products.

While we are convinced that the NGPs are crucial for future growth, the inexorable reduction of combustible cigarettes volume sales continues. However, the setback in e-cigarettes reflects the risks with all new products. It also shows that stringent regulatory control on products--the best way to protect consumers--could ultimately be positive for major tobacco companies that are used to coping with stringent regulatory approval procedures and scrutiny. We expect more regulation to come in 2020 and volatility in the tobacco sector to be higher.

Speculative-grade credit quality will erode rapidly in case of a recession

Consumer products companies could face a tough road ahead as global GDP economic growth is slowing and the odds of a U.S. recession has increased. Over 2020, we expect the effect of the economic slowdown in major European economies like Germany or the U.K. to impact demand for consumer goods. We expect polarization, with premium products and convenience products maintaining decent demand and the middle part of the range squeezed. In this situation, brand recognition and ability to continue introducing new products will be important differentiating factors. In the potential recession we are envisaging in 2020 (and in contrast with the previous one), we expect pressure to come more from shrinking operating profits than from refinancing issues that affect liquidity.

As their higher ratings indicate, investment-grade companies seem to be better-positioned to withstand a more difficult operating environment. They are generally larger, more diversified, and benefit from purchasing and pricing power and economies of scale. They generally also have stronger cash flows and more solid balance sheets, with easier and less costly access to the capital markets than their spec-grade counterparts. Consumer staples manufacturers performing well now may not face negative rating actions; they demonstrated solid performance during the last recession because of the nondiscretionary nature of their products, diversified portfolios, and solid cash flow. Nevertheless, our ratings on investment-grade companies that took on significant leverage to make large acquisitions could suffer downgrades if those companies can’t reach deleveraging targets. Ratings at the spec-grade level would be more exposed to a weaker economy. These companies tend to be smaller and highly leveraged, which results in less margin for error on operating shortfalls. We note that potential issues related to covenants are likely to be limited, as in the last four years covenants have been light in the majority of the European debt issuances.

To navigate more difficult economic and credit conditions, we expect borrowers to be more cautious with their financial policies to preserve liquidity and flexibility. It's likely that most investment-grade companies would reduce share repurchases but continue to increase dividends in line with earnings growth. That said, dividend increases may not be as prevalent as during stronger economic times. We believe that credit access to finance aggressive shareholder dividends and leveraged buyouts for spec-grade companies will be scarce.

Related Research

- Investment-Grade U.S. Consumer Product Companies Are Meeting Leverage Targets By Prioritizing Debt Repayment Over M&A, Nov. 14, 2019.
- Research Update: JBS S.A. And JBS USA Upgraded To 'BB' From 'BB-'On Substantial Deleveraging And Lower Volatility, Outlook Stable, Oct. 30, 2019
- LVMH's Plan To Buy Tiffany Will Reinforce Its Hard Luxury Business But Limit Rating Headroom For Future External Growth, Oct. 29, 2019
- Global Trade At A Crossroads: China's African Swine Fever May Warm Agribusiness Elsewhere, Oct. 25, 2019
- Who Will Pay For A Plastic-Free Future? Sept. 19, 2019
- Anheuser-Busch InBev Outlook Revised To Stable; 'A-/A-2' Ratings Affirmed, Oct 31, 2019
- Imperial Brands Hit By The Increasing U.S. Aversion To Vaping Segment, Sep 27, 2019
- Mainstream Marijuana: How Consumer Goods Companies Will Capitalize On The Growing Acceptance Of Cannabis, June 19, 2019
- ESG Industry Report Card: Consumer Products And Agribusiness, May 21, 2019
- U.S. Combustible Cigarette Volume Decline Expected To Accelerate, April 22, 2019
- Japan Credit Spotlight: Retail; Consumer Products; Pharmaceuticals, Aug 6, 2019
- China's Small Consumer And Tech Companies Rely On Refinancing To Survive, June 10, 2019

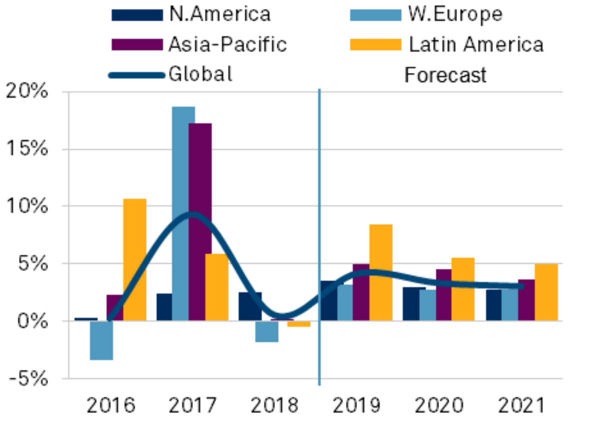
This report does not constitute a rating action.

Industry forecasts

Global Consumer Products

Chart 9

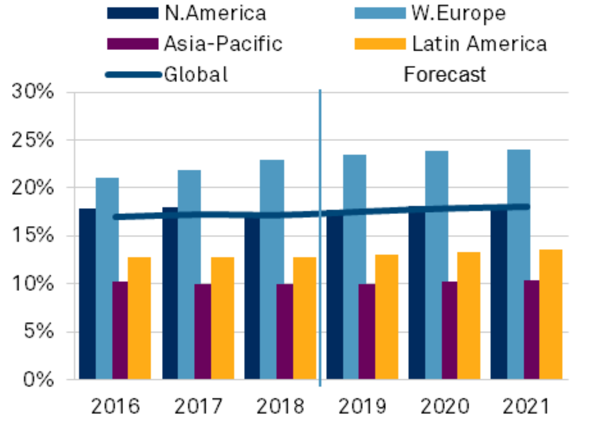
Revenue growth (local currency)



Revenue growth will continue to be weak given the rapidly changing environment and weak macroeconomic conditions. Ability to reinvest in the business protects the top line of U.S. companies

Chart 10

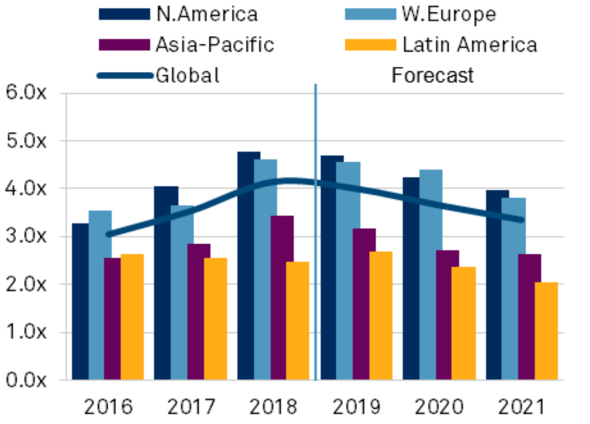
EBITDA margin (median, adjusted)



Margins are protected due to synergies from acquisitions being integrated. That said, we see margin growth at risk due to the tough competitive environment. Latin America should benefit from improved operating profitability of large agribusiness groups.

Chart 11

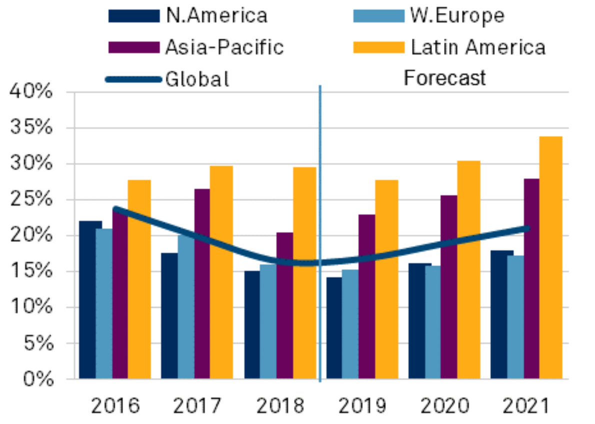
Debt / EBITDA (median, adjusted)



We see some deleveraging due to acquisitions being integrated and synergies realized.

Chart 12

FFO / Debt (median, adjusted)



The low financing costs in North America and Europe should support cash flow repayment metrics in the next two years.

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.

Cash, debt, and returns

Global Consumer Products

Chart 13

Cash flow and primary uses

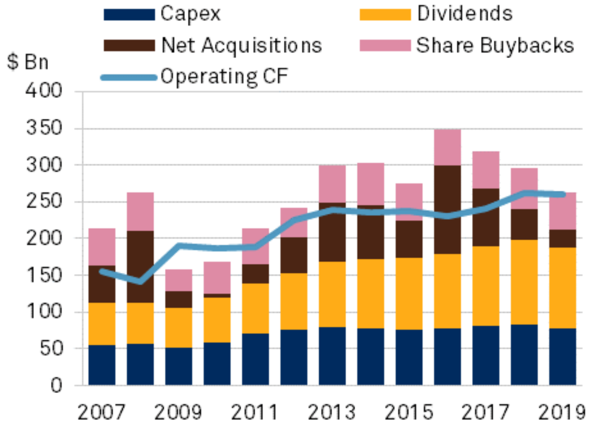


Chart 14

Return on capital employed

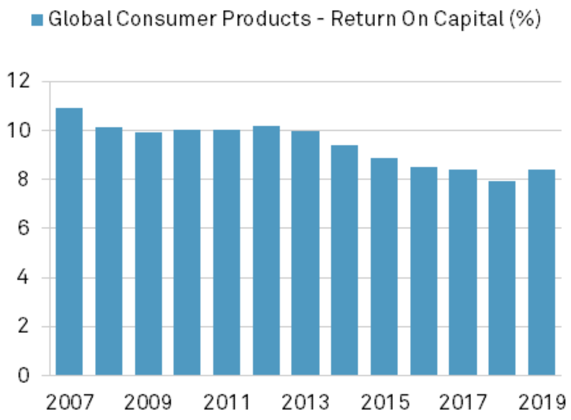


Chart 15

Fixed versus variable rate exposure

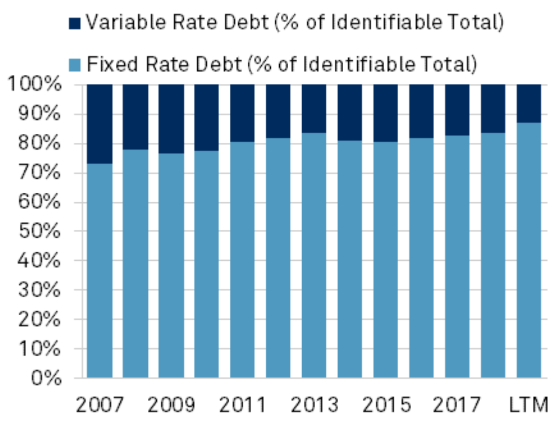


Chart 16

Long term debt term structure

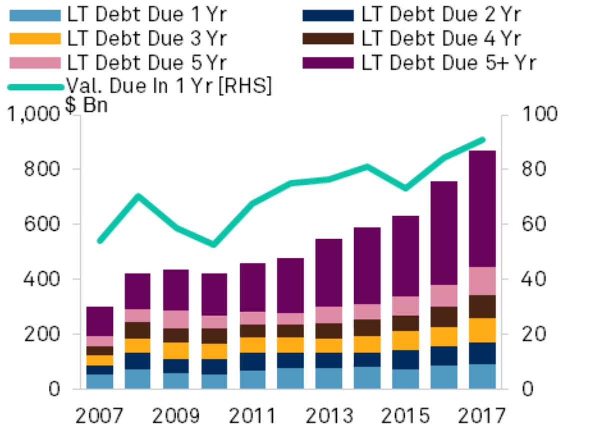


Chart 17

Cash and equivalents / Total assets

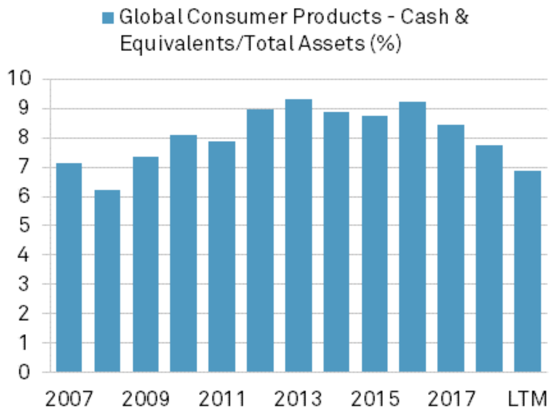
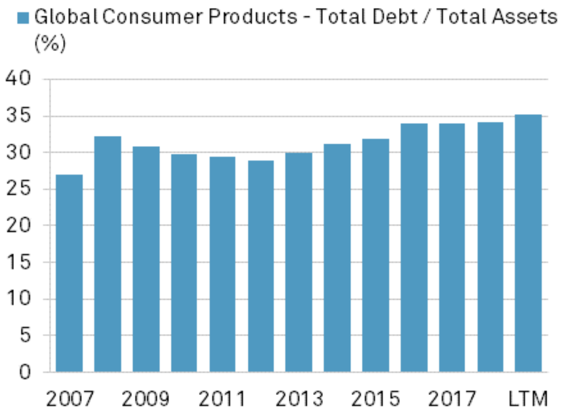


Chart 18

Total debt / Total assets



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

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