QV UPDATE
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Value Creation in Consumer Staples

'Accelerated shareholder value creation' has been a common bombast associated with global consumer staples companies in 2017. Both Nestle and Procter & Gamble have recently been engaged by an activist investor, Third Point and Trian Partners respectively, that is intent on driving shareholder value creation through sweeping corporate and financial transformations at each business. Meanwhile, Unilever has embarked on a multi-year plan which is also aimed at 'accelerating shareholder value creation' following its rejection of a proposed acquisition by Kraft Heinz in February.

In many ways, the heightened pressure being exerted on these multi-national businesses is an outcome of anemic global economic growth. Despite low interest rates having driven stock valuations to decade highs, investors have been disappointed with staples' underwhelming revenue growth. Persistently low inflation has constrained the ability to raise prices and pressure on consumption has bridled volume growth. Since 2008, aggregate revenue for global consumer staples has only grown at 2.3% annually compared to 7.4% in the prior ten years. In a world of weak topline growth, companies who have pivoted to aggressive cost cutting or leveraged share repurchases have been rewarded in the market. Those who have not are incidentally becoming ripe targets for outside parties intent on extracting similar outcomes.

Increased external scrutiny can often be healthy for large conglomerates. With time, major multi-nationals' sprawling empires have a tendency to become bloated, overly bureaucratic and entrenched in the status quo. Cages need to be occasionally rattled. In many cases though, shareholder value creation plans don't always drive long-term improvements in a business as much as they do near-term earnings growth and share price gains for activist investors who crusade for sweeping transformation and then subsequently sell their positions after a spike in the stock.

As an example, Third Point is seeking the following concessions from Nestle: improve margins by as much as 400 basis points over the next few years and set a formal margin target range of 18-20% by 2020; increase debt levels to at least 2x EBITDA, sell its $27 billion holding in L'Oréal and use the proceeds from both actions to repurchase common shares; and divest mature/declining products from the company's portfolio of more than 2,000 brands to increase the focus on higher growth priorities.

Nestle has had a long history of productivity and margin improvement. In recent years however, efficiency gains have lagged peers and we agree that there appear to be opportunities for improvement beyond those already identified by management - whether in optimizing its industrial footprint or reducing procurement costs and general overhead. But a formal margin target can be an imperfect benchmark for improving long-term results if cost cutting takes precedence over more important drivers like reinvesting in sales growth and innovation. For Nestle, innovation and premiumization have always been at the core of their strategy for value creation.

In a company as large as Nestle, we also concede that there are almost always under-managed assets which can be distractions for management. But divesting brands which generate strong cash flows and require little incremental capital only makes sense if substantially better reinvestment opportunities exist. Absent this, selling one asset to buy another is similar to churning a portfolio of stocks out of impatience. Both kinds of transactions should only be the result of a prudent comparative analysis of long-term expected returns.

Leveraged buybacks have been very popular with investors in recent years. Unfortunately, selling liquid assets and issuing debt to repurchase shares is a one-time shot. While it engineers near-term per-share growth, it robs a company of the flexibility and strategic value that liquidity can provide for opportunistic investments and acquisitions in the future.

While some of Third Point's proposals are reasonable, others more closely resemble a fox inviting himself to enter the henhouse. Conversely, Trian Partners' engagement of Procter & Gamble looks like a much needed wake-up call for a business that has gone through three CEO's in five years, a decade of stagnant growth, and $10b in cost cutting as well as a brand rationalization that has produced few tangible results. While the pressure to accelerate shareholder value creation will likely persist until industry-wide revenue growth improves, the merits of such initiatives vary greatly. From our perspective, the best strategies remain long-term focused pursuits, despite the allure of initiatives which can drive near-term growth.