



Consumer Defensive Sector Report

Total Revenue (Bil)	Market Cap (Bil)	Number of Companies	Total Employees	Sector Price/Fair Value	Universe Price/Fair Value
2,550 usd	3,485 usd	98	10,032,733	0.98	1.05

Sector Update

R.J. Hottovy, CFA
Consumer Strategist
(312) 244-7060
rj.hottovy@morningstar.com

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Pricing data through 30 September 2015.
Ratings updated as of 30 September 2015.

Currency amounts expressed
with "\$" are in U.S. dollars (USD)
unless otherwise denoted.

Industry Price/Fair Value is the median
value of the companies covered by the
Morningstar Equity Analysts.

► The consumer defensive sector trades roughly 1% above our fair value estimate, but we see a handful of undervalued industries and companies.

► We believe the market undervalues Mondelez MDLZ, and see upside stemming from the wide moat manufacturer's cost-savings initiatives.

The market currently offers a discount on global beverage behemoths Coca-Cola KO and PepsiCo PEP, in our opinion. We expect long-run earnings growth to rebound despite nearterm challenges.

► Although we see few economic moats in the European defensive retail industry, French retailer Casino Guichard-Perrachon CO offers exposure to faster-growing Latin America, and trades a sizable margin of safety, in our opinion.

The consumer defensive sector trades at a median price/fair value of 1.01, substantially more overvalued than our entire coverage universe, which trades at a median price/fair value of 0.92 following the recent market falloff. Investment opportunities remain. However, many of the stocks we see as the most undervalued (such as Coca-Cola and PepsiCo) are seeing severe foreign currency headwinds from the strong U.S. dollar, threats to their growth from slowing international consumer spending, particularly in China. Or, they are going through fundamental business changes (like top pick Procter & Gamble) that could continue to challenge these companies' revenue and earnings over the near term albeit with the long run looking quite a bit rosier. Overall, we remain cautious of global consumer spending, particularly in emerging and developing markets. We generally recommend focusing on companies in the sector with narrow or wide moats that enjoy strong brand intangible assets and/or sustainable cost advantages.

The consumer staples industry continues to see involvement by activist investors, including most recently Mondelez. These shareholders typically advocate for substantial change, and in this case, we view Bill Ackman's 7.5% stake in Mondelez as a positive for other owners. Given the firm's bloated cost structure versus that of its peers, we view the company's already announced cost-cutting plan as prudent. However, we contend there is significantly more upside in its results than management's guidance or market estimates suggest, and it appears Ackman shares our take. We also believe that given Mondelez's brand intangible asset (the basis for our wide moat), it could be an attractive acquisition target down the road if it fails to achieve meaningful margin expansion, providing a floor to its downside risk.

We also see a rare opportunity in wide-moat beverage manufacturers Coca-Cola and PepsiCo. These firms are fighting falling developed-economy volumes for carbonated soft drinks and stiff currency headwinds. However, we remain encouraged regarding the industry's long-term growth because of rising noncarbonated volumes, disciplined pricing, and the opportunity for increasing per-capita packaged beverage consumption levels in several key emerging markets (which are currently extremely low). Although there are near-term concerns surrounding emerging-market growth and the firms' abilities to continue to enact their own recent cost-savings initiatives, we believe the market underestimates this long-term potential, and also offers dividend yields topping 3% at both.

Beyond the consumer product manufacturers, we continue to see opportunity in some defensive retailers. In this space, we believe that a firm with an



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economic moat should be able to charge material price premiums for comparable products and/or have the ability to drive more traffic and sell more products than its competitors; the latter case involving higher throughput tends to drive an economies-of-scale-based cost advantage, which we view as more durable (for retailers) than pricing power alone. We assign wide moats to the small number of firms that have the strongest (and potentially mutually reinforcing combinations of) brand intangible assets and cost advantages, such as Wal-Mart WMT, a name we see as undervalued at present.

That said, we also believe no-moat European retailer Casino Guichard-Perrachon offers a decent margin of safety at its current price. Investors remain cautious about macro risks in European and Latin American economies, most notably Brazil. In addition, growth in France remains tepid, and Casino has been forced to respond to Carrefour and other discounters by lowering its prices, which has subsequently hindered profits. While Casino has considerable scale in these regions, limited switching costs and razor-thin margins limit our confidence in Casino's ability to sustain excess returns on capital over the long term. That said, we believe that many of these risks are priced into Casino's stock, and we see opportunity for patient, long-term investors looking for exposure to European grocers.