Consumer Products Outlook 2021

The credit outlook for European consumer products sector is stable. The Covid-19 pandemic is disrupting demand, but Scope expects there will be limited impact on credit quality for investment-grade companies.

Consumer Products, Scope Ratings GmbH, 14 January 2021

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| Bloomberg: RESP SCOP

Executive summary

The coronavirus pandemic has disrupted demand for consumer goods but suppliers have proved resilient. Consumer goods companies are helped by the spread of e-commerce as Covid-19 restrictions have forced people to spend more time at home. We see a recovery in demand in 2021 amid possible further changes in the structure of distribution channels. The credit outlook for the European consumer goods sector in 2021 is stable.

The main trends for the year ahead are:

- Sustained changes in shopping habits triggered by the pandemic will enhance the potential growth for consumer-product companies with direct e-commerce channels.
- The adverse effects of the pandemic on the broad economy and employment have resulted in weaker demand for less-essential products. Demand for non-discretionary consumer goods remains resilient.
- Demand for travel items will remain relatively weak before widespread vaccination against Covid-19 allows a ‘return to normal’ which would lead to improved consumer sentiment – reversing the recent trend favouring savings over consumption – and the lifting of restrictions on travel.
- Lockdowns and other physical distancing protocols have led to more eating and drinking at home rather than at cafés, bars and restaurants, so food and beverage manufacturers can expect continued weak out-of-home sales until Covid-19 restrictions are eased.
- Investment grade consumer goods companies, characterised by diversified product line-ups and strong cash flow, have generally taken prompt action to reduce costs and cash outlays (such as dividends), to protect themselves from the worst economic and financial consequences of the pandemic. We expect to see limited rating impact on investment grade consumer products companies in our coverage.

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Key trends for 2021

Changing habits

The Covid-19 pandemic has disrupted demand for European consumer goods companies, from the heavy hit the region's economies have taken to the altered patterns in consumer behaviour (**Figure 1**). Broadly speaking, changes in demand stemmed from two groups of people: those adversely affected by the pandemic financially and those whose habits changed due to physical distancing and other pandemic control measures.

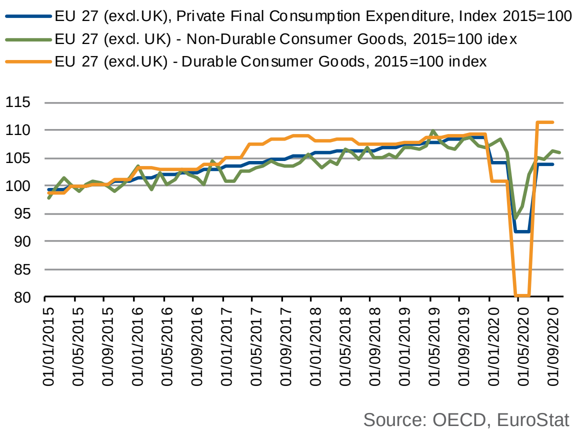
These changes in consumer behaviour have an impact on the consumer goods industry in three ways: they have encouraged greater savings in the wake of negative consumer sentiment, increased consumption at home, and lowered spending on non-discretionary goods. These changes will manifest in shifts in distribution channels and in the mix of consumer goods bought and consumed.

We believe that both consumer groups affected by the pandemic will shop less at physical stores, even after these re-open, as any 'return to normal' will take time to change pandemic-related behaviour, even after vaccines are administered and herd immunity takes effect.

More innovative companies that are more attuned to understand consumer preferences are also more likely to take advantage of multi-distribution channels to connect with their customers in 2021.

The negative direct effects on the industry in the EU (**Figure 1**) mirrors the drop in consumer demand. Production of durable goods in the EU declined by 27% peak-to-trough, with non-durables declining by 14% and overall consumption spending down by 16%.

Figure 1. Consumer spending, consumer goods manufacturing take big hit from Covid-19 crisis



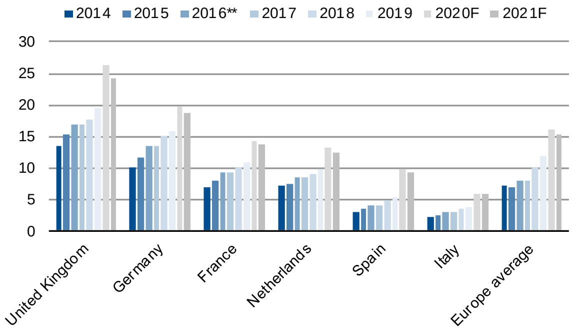
Source: OECD, EuroStat

Hence both durable and non-durable consumer goods show both a strong negative impact and strong recoveries through the end of 2020, with durable goods now above pre-pandemic levels. While production was reduced significantly, consumer goods companies have come through the pandemic with relatively few major upsets and bruises. Many companies reacted robustly to shifts in demand and government actions to counter-act the pandemic and have been proactive in adjusting to shifts in sales channels.

Consumer goods companies have always faced the challenge of staying ahead of disruptive forces. The pandemic intensified this challenge. While many consumer behaviour shifts are almost certain to be temporary, there are strong indicators that there will be some permanent changes to consumer behaviour. Possible changes might include a shift to brand value away from private-label, budget and generic products, and a general tendency to consume more at home.

The accelerating shift to e-commerce is clear and has grown dramatically in 2020 (**Figure 2**). In Europe, the UK clearly leads the way in online shopping, while a proportionately larger shift took place in Spain last year. The expected drop in e-commerce shares of retail trade in 2021 reflects recoveries in more traditional channels as the pandemic ends.

Figure 2. E-commerce share of retail trade



Source: retailresearch.org

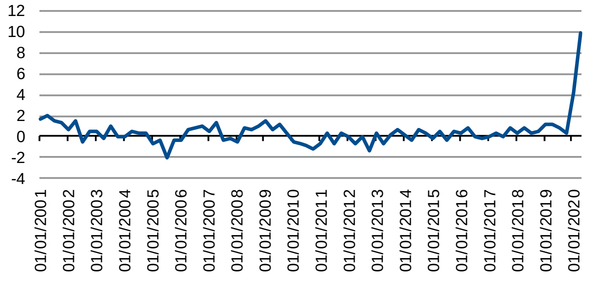
We expect that much of the shift in distribution channels will last into 2021 and beyond, away from low-margin, high-volume bricks-and-mortar retailers to e-commerce and brand-value channels.

One of the side-effects of the pandemic has been significant increases in savings (**Figure 3**) as consumers, facing the negative effects of the pandemic, saved personal disposable income rather than spending it.

Travel goods in a squeeze

We expect this big shift from consumption to savings to prove temporary, but, in the meantime, one sector is especially vulnerable: travel goods (not including travel services). Overall demand will return once the pandemic is more under control with many people vaccinated, but any recovery in passenger traffic looks as if it will be slower and more protracted than first anticipated in the early phases of the pandemic. Some indications today suggest that air travel volumes will not return to 2019 levels before 2025. As a result, travel goods remain particularly vulnerable to pandemic-related lockdowns and travel restrictions, as well as decreased spending for non-essentials.

Figure 3. Euro area YoY % increase in private household savings



Source: ECB

We believe that some companies will need to rethink some of their business models in order to get demand back quicker in 2021. Although some recovery is expected in passenger air traffic in 2021 (and other form of international travel), it is definitely not high enough to restore confidence. In our current view, the first year of significant demand rebound is 2022, based on the expectation of global vaccinations and lifting of government travel restrictions.

Branding to increase in importance

We expect brands to become even more important in the consumer goods sector than they have been in the past as companies differentiate themselves in a market increasingly reliant on online sales and marketing and distribution direct to consumers. Companies with already established brands with loyal followings are at an advantage.

As an example of this trend, French luxury conglomerate LVHM – with its stable of strong brands such as Moët, Vuitton, Dior – succeeded in accelerating its direct online sales last year when sales from retail stores declined. This is not necessarily been the case for smaller rivals with less strong finances and less well-known brands.

In the food & beverage sector, companies with strong global branding were able to offset declines in the sales from significant lower out-of-home volumes - as the pandemic forced the partial or complete closure of bars, sporting events and restaurants - to some degree by exploiting other sales channels. However, we still saw that beer giants like Heineken NV or AB InBev were adversely affected by the crisis and have started to re-think responses to the impact of government lockdowns and restrictions on social gatherings.

Non-discretionary items in demand

Consumer product companies with strong market positions are more resilient during economic downturns. Such companies are not only large with high market shares but are also favourably positioned in supply and distribution chains, with low dependence on any specific distribution channel or customer. These companies enjoy more purchasing power with key suppliers, which also makes it easier to be a price-setter among competitors.

Consumer durable production has already exceeded pre-pandemic levels (**Figure 1**), with strong recovery (+39% trough-to-peak, vs. 13% for both personal consumption and consumer non-durables). This reflects strong pent-up demand that should provide solid impetus for further growth in 2021, provided that pandemic side-effects (i.e. higher unemployment) do not continue strongly into 2021.

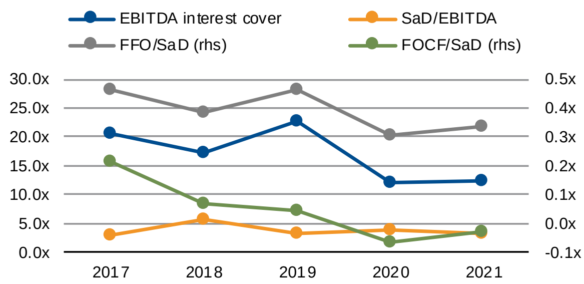
Rating impacts

We rate numerous consumer goods companies ranging from investment grade to speculative grade. Of these companies, a couple of entities have seen their rating outlook turn to Negative from Stable. Both companies were rated below investment grade.

We expect investment grade companies to continue to show strong resilience and remain healthy, with relatively low free operating cash-flow volatility. Companies here have reduced uncertainty of recovery from the pandemic, as they generally tend to be makers of non-durable goods and have strong brand presence.

For the non-investment grade companies, we expect free operating cash flow generation to remain volatile, reflecting not only the smaller sizes of these companies and their dependence on more limited distribution chains and products, but also weaker brands and thus the uncertainty of demand recovery from the pandemic.

Figure 4. Consumer goods credit metrics (average)



Source: Scope Ratings GmbH

When assessing the impact of the Covid-19 pandemic on Scope credit metrics, we have looked at analyst forecast expectations of our rated consumer product universe (**Figure 4**). Currently, Scope expects FY2020 cash flow metrics[1] such as FFO/SaD and FOCF/SaD multiples to be clearly weaker than 2019. Still, looking at the overall average forecasts for SaD/EBITDA at YE2020, the average expectations are for increases, if not severe ones. Going into 2021, the average analyst consensus is for leverage to decline again, but not all the way back to the level at end-2019.

[1] Funds from operations/Scope-adjusted debt; free operating cash flow/Scope-adjusted debt; Scope-adjusted debt/earnings before interest taxes depreciation and amortisation

Annex II: Related research

European corporates: creditors, taxpayers bear Covid-19 financial burden; will shareholders in 2021?, published Dec 2020, available here

Rating Methodology: Consumer Products, published Sep 2020, available here

Commercial real estate in Europe: retailing-exposed segment faces tough months ahead; UK in focus, published Sep 2020, available here

European retailing: Covid-19 separates e-commerce leaders from rest; credit outlook still negative, published Mar 2020, available here

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