The Consumer Staples Sector is No Place Hide

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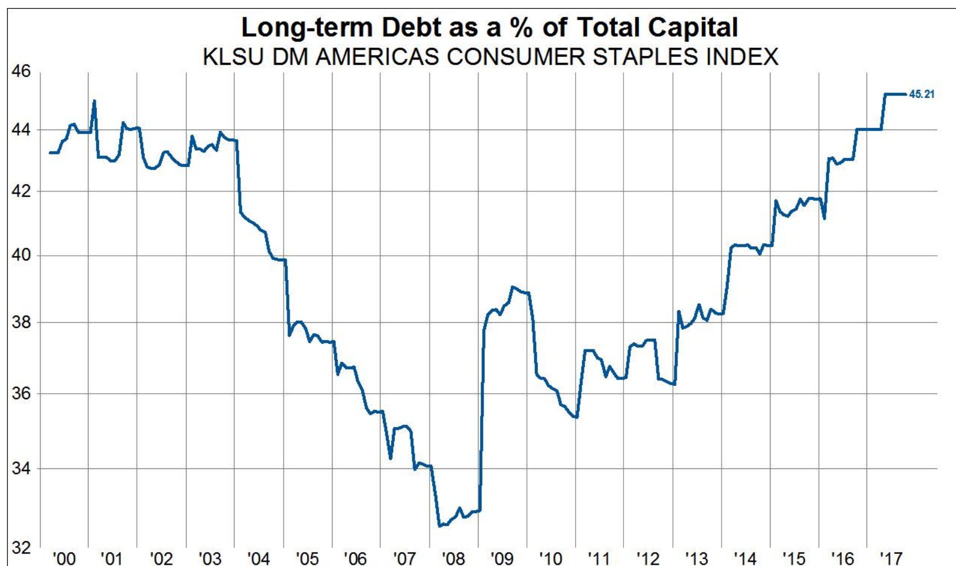
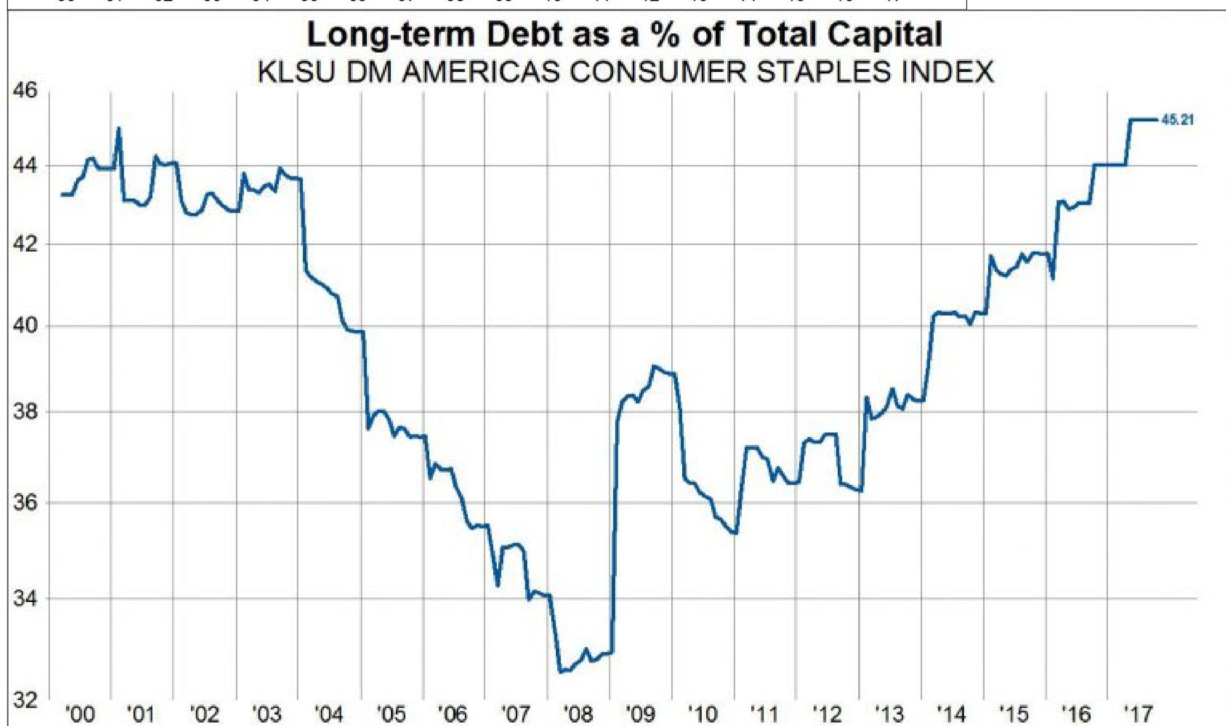
The Consumer Staples sector is often viewed as a safe haven; a sector that, because of its inherent cash flow stability, market participants can turn to as a place of refuge when things get shaky. Yet, persistent fundamental decline among North American Staples companies may well be throwing a wrench in these companies' abilities to weather a broad market downturn. In this post we'll briefly touch on financial statement and valuation indicators that suggest Staples may not be as risk averse as they used to be.

One highly important quality factor is long-term debt as a percent of capital. As the first chart below demonstrates, North American Staples companies have been loading up on debt year after year for the entirety of this recovery. Long-term debt as a percent of capital is now at levels not seen in at least 18 years.





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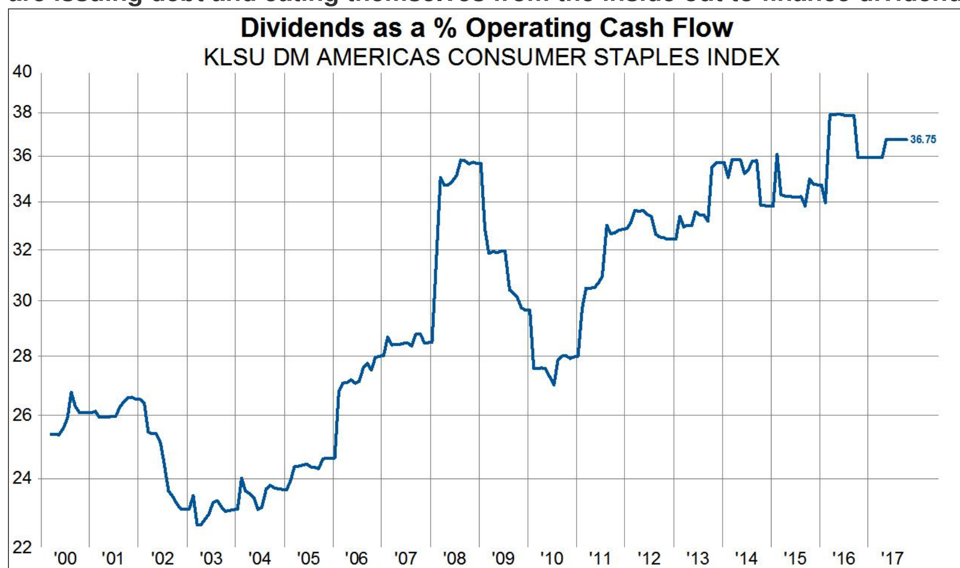
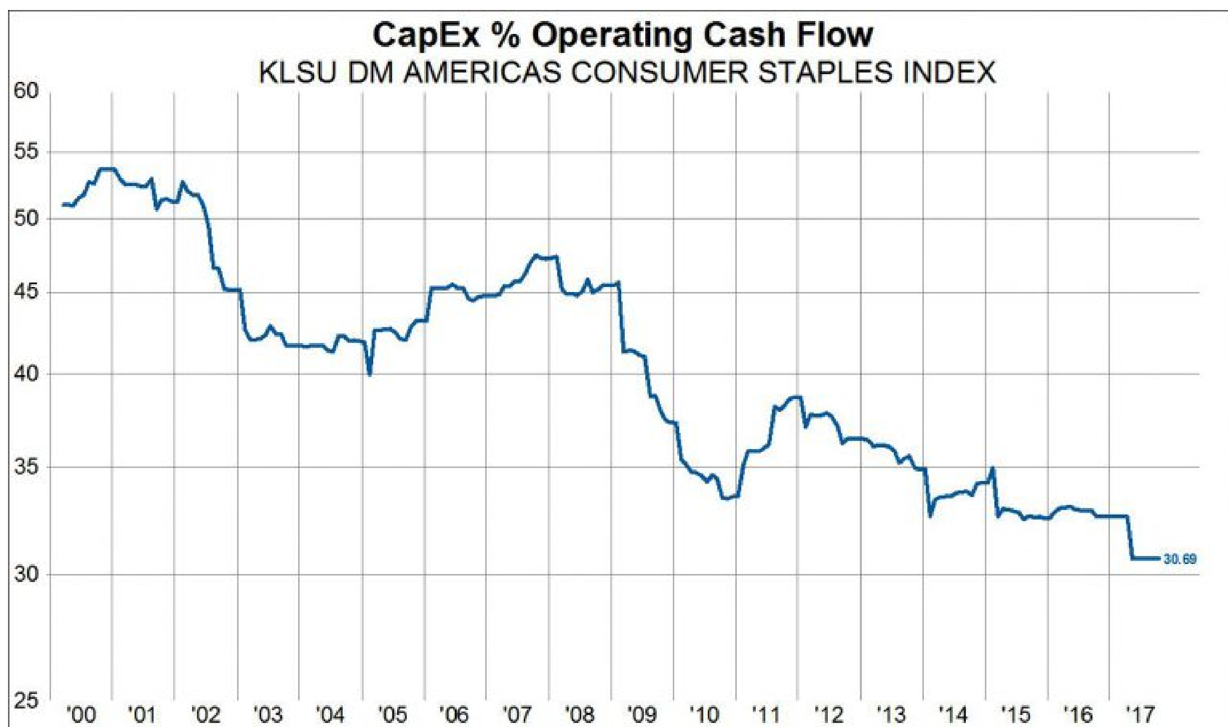
This begs the question of what are these companies doing with all that debt? The next four charts show capex, R&D, share repurchases, and dividends as a percent of operating cash flow, respectively. The trends are unmistakable. Capex and R&D investments have nearly halved since 2000 and have been cut especially hard since 2008 while share repurchases are basically range bound at a high level and dividends have been on an unabated uptrend. Together, capex + R&D + share buybacks + dividends = 111% of operating cash flow. Debt must be issued to finance that which operating cash flow cannot fund, and this after slashing reinvestment in the capital stock. **This is to say, North American Staples companies are issuing debt and eating themselves from the inside out to finance dividends and maintain stock buy backs.**





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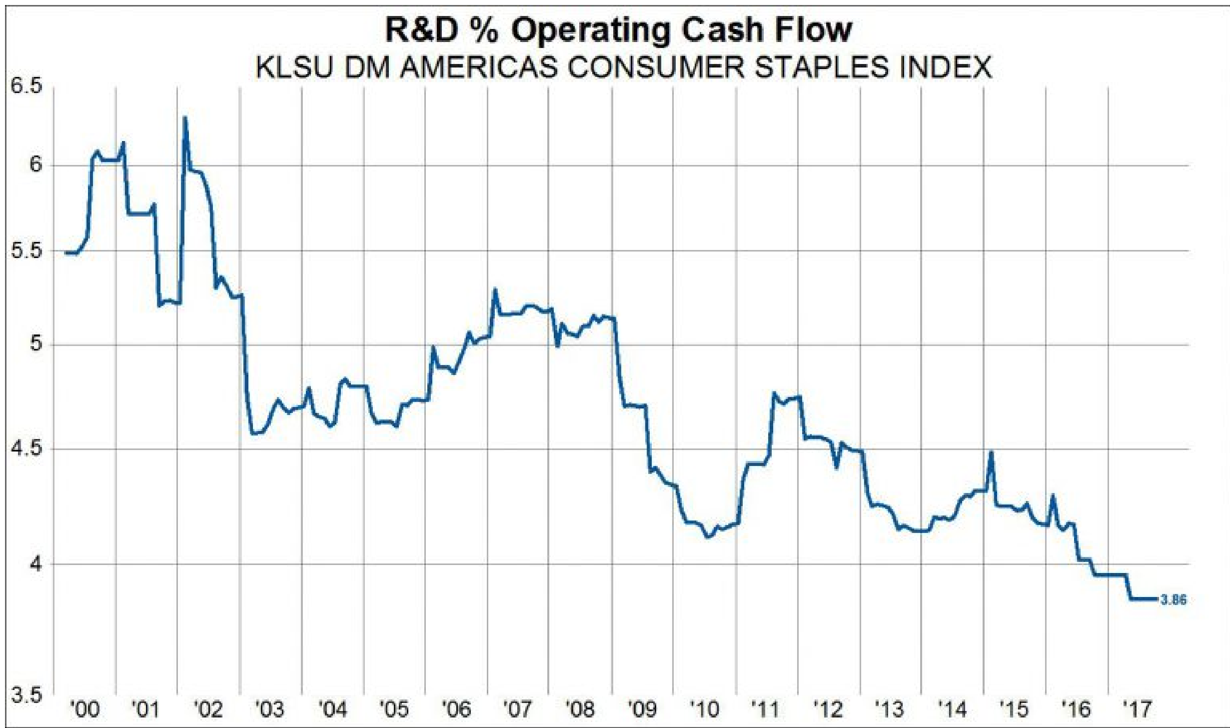

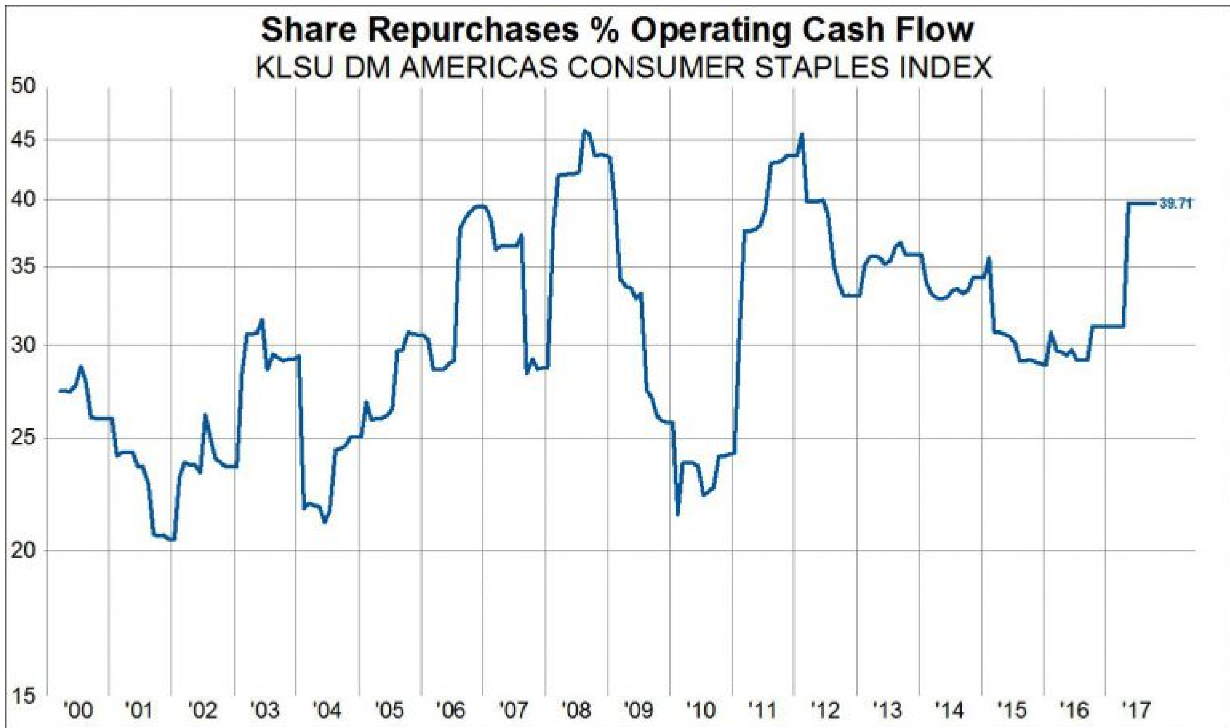

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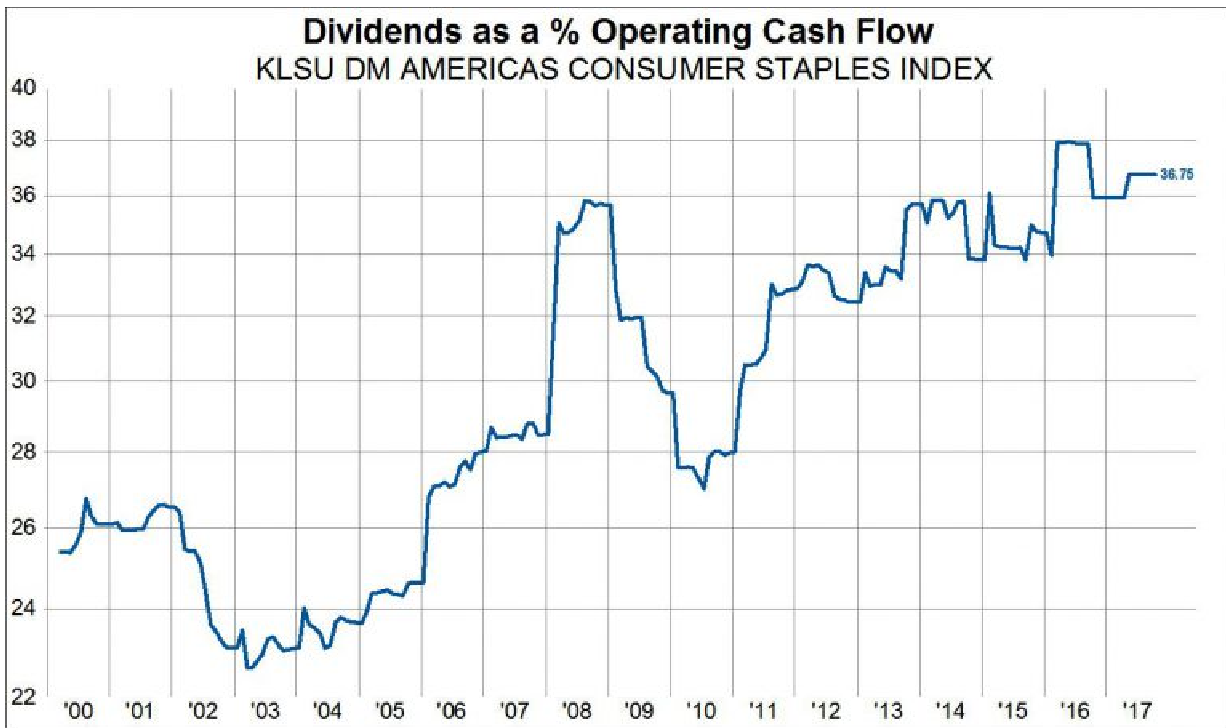
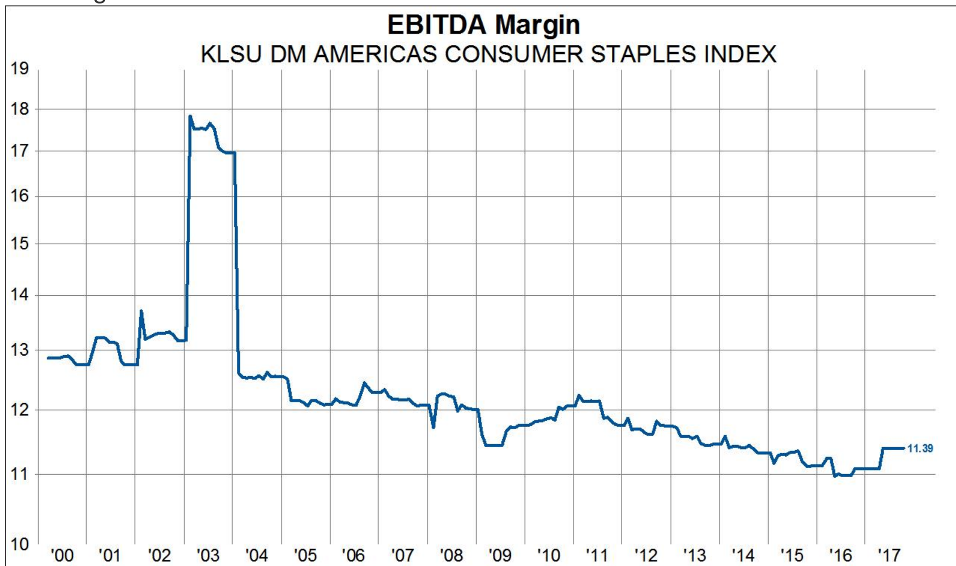


Unfortunately it doesn't end there. Margins are under pressure too as a result of the productivity draining decision to neglect the lifeblood of innovation: R&D investments. The aggregate gross margin among North American Staples companies has fallen from 32% in the early 2000s to just 28% today. The EBITDA margin at 11% has seen a steady withering from 2000s levels that were closer to 13%.



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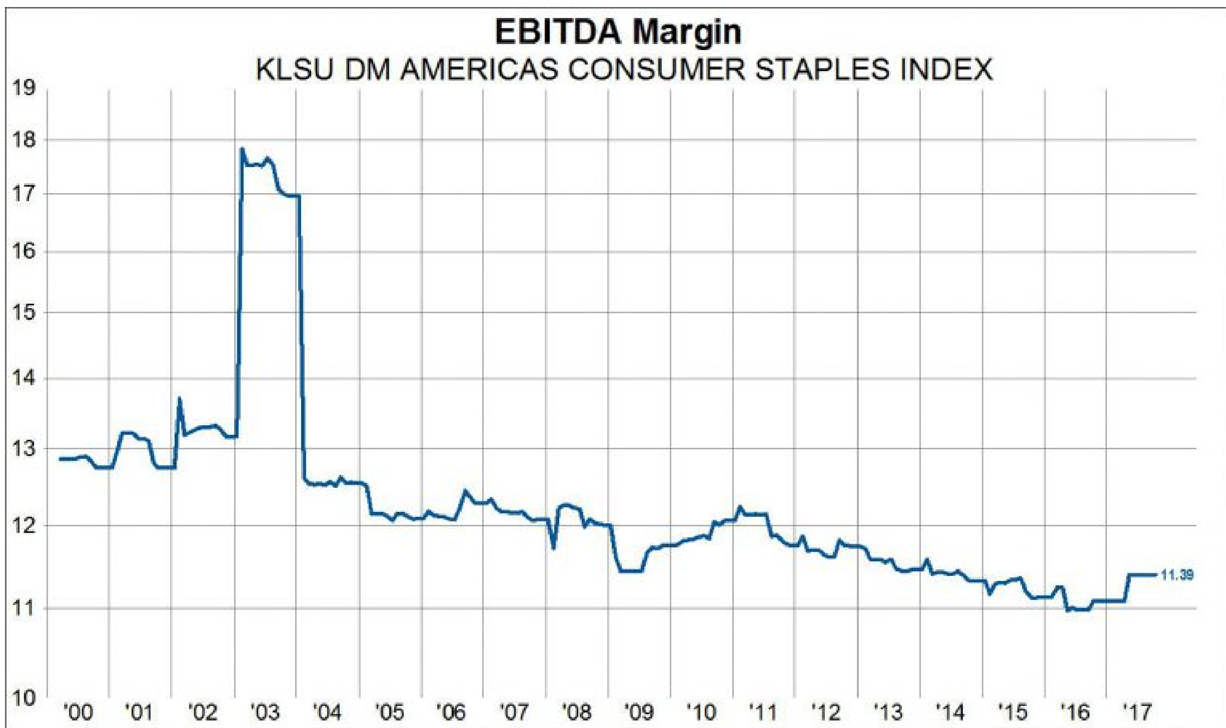

Given the deterioration in the quality of Staples in aggregate, one might expect valuations to clock in at below average levels, but one would be wrong. The median North American Staples name is currently valued just shy of its all-time peak going back to 2000. These last three charts show the median Staples company's price to sales, price to EBITDA, and price to earnings ratios, respectively.

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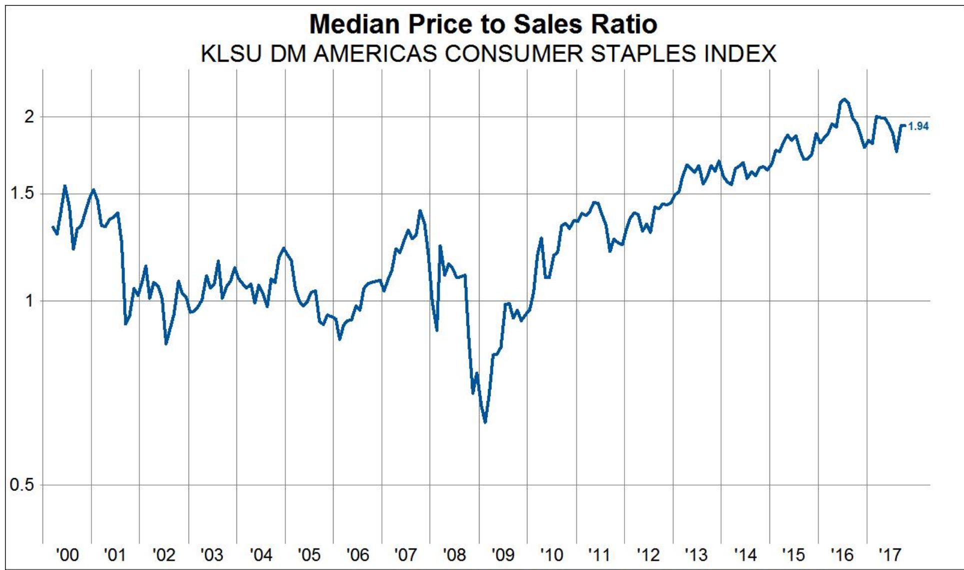

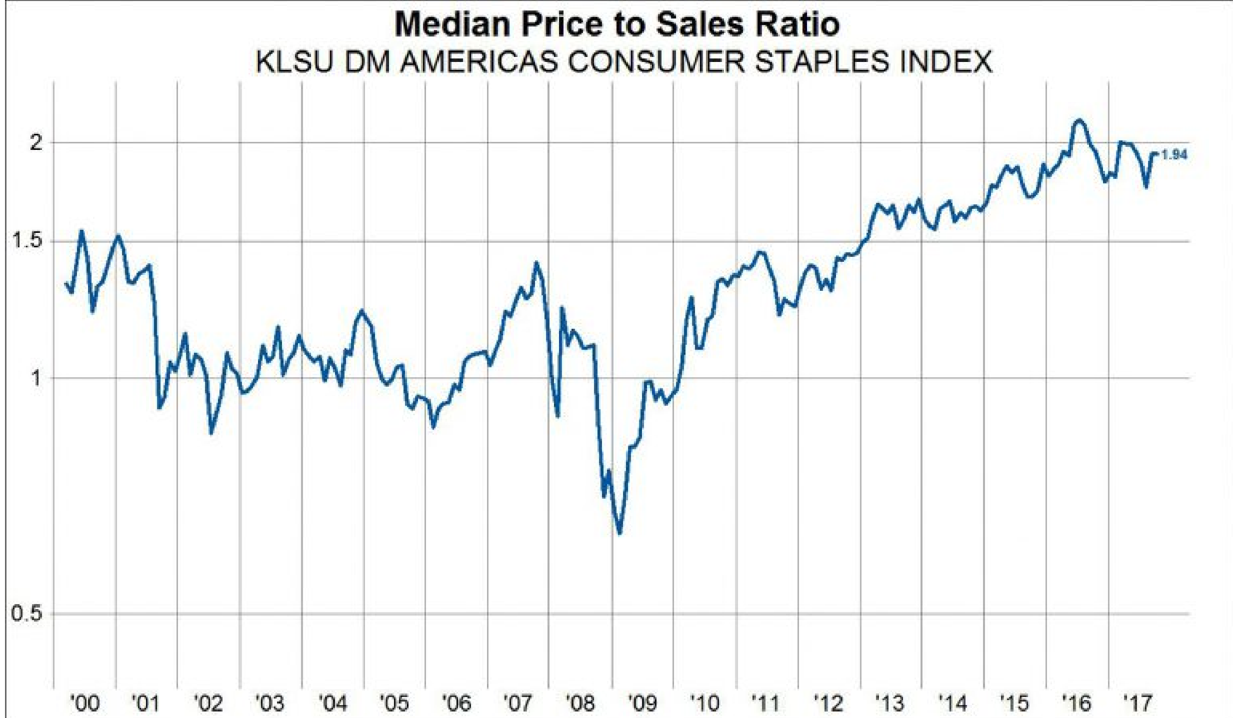

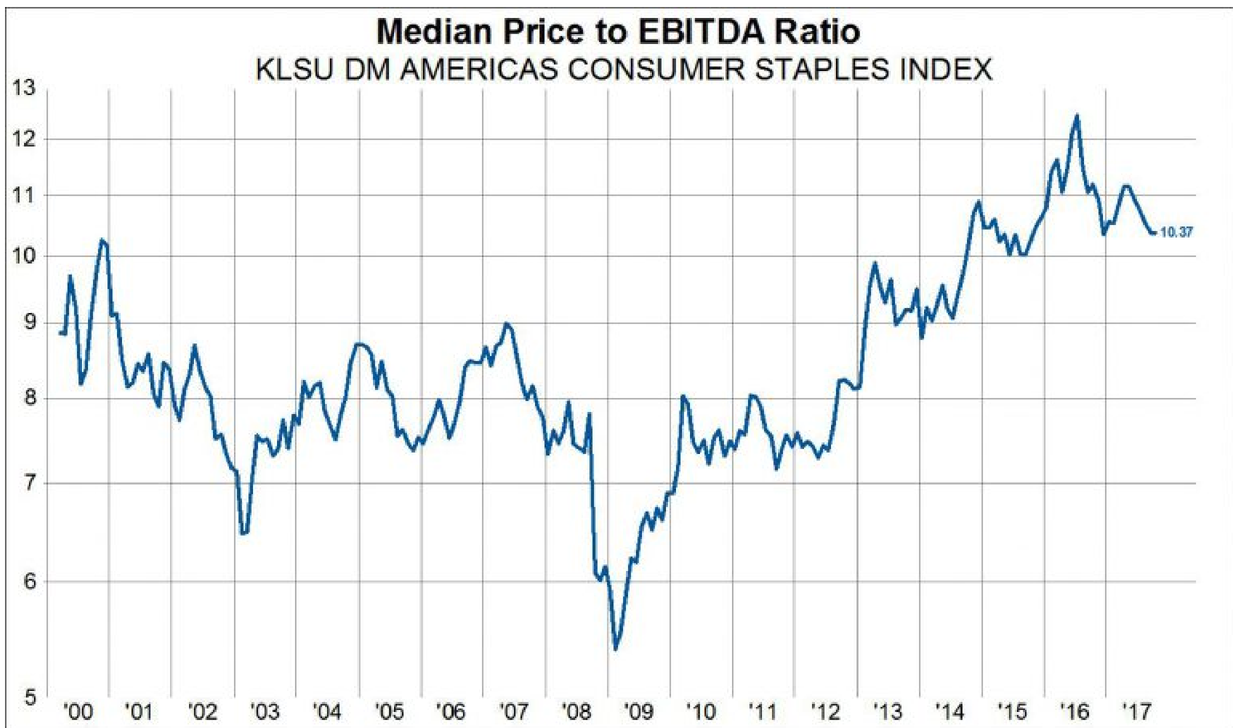

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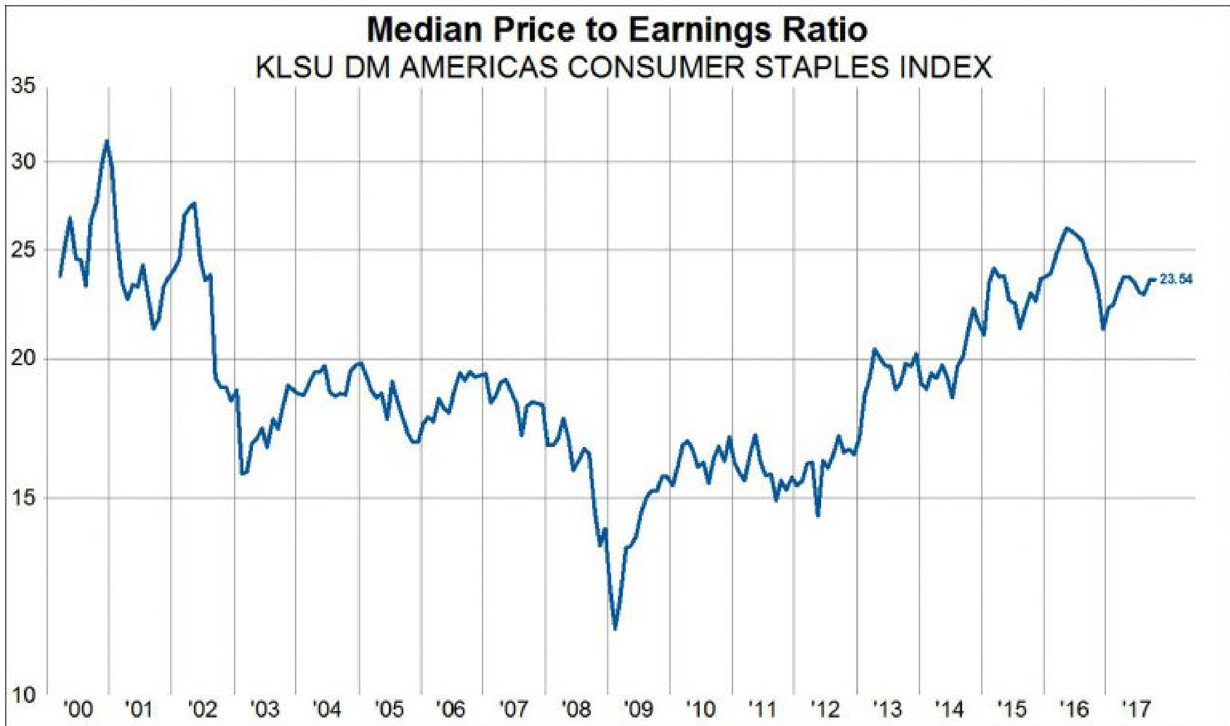

One thing that is a stable feature of Staples is the consistent deterioration of quality and valuation support. For the better part of two decades, and especially since 2008, Consumer Staples companies have made a conscious decision to build leverage and cut productive investments in order to fund an ever increasing dividend payment. The result is of course poorer profitability and a riskier capital structure. At the same time, the market, in its never ending search for yield, has bid up the price of these one-time bastions of stability and eliminated any sort of margin of safety. Staples may be low beta, but they are no longer low risk.

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