The season of staples: it is no longer Modelo time

By Evan Hughes and Evan Weerts

Consumer staples has been a very popular topic of discussion throughout the equity market's wild ride in 2022. Generally thought of as a defensive sector, the Consumer Staples sector returned -0.83% in 2022, while the S&P 500 returned –19.44%. The Consumer Staples sector has provided investors with downside protection throughout the calendar year. The CUSP Fund has capitalized on this opportunity by being slightly overweight in the sector for the past year.

As analysts, we pitched the sale of Constellation Brands (STZ) from the CUSP Fund's Consumer Staples sector holdings and replacing it with Kroger (KR). We believe that Kroger can thrive in the grocery business because of its private label goods and its use of data science to enhance the customer experience.

First, Kroger has continued to expand and innovate in both its strategy and products. In 2021, Kroger's private label goods enjoyed $28 billion in sales. These goods add approximately 6% to the grocer's gross profit margin. Kroger's private label goods are the nineth largest CPG portfolio in the United States. We expect this margin to trickle down to the bottom line more and more as inflationary pressures ease. On top of that, Kroger manufactures 29% of its own private label goods, cutting out the middleman to provide cost savings to its consumers. In 2021 alone, Kroger made over $1 billion in Home Chef ready-to-cook meals. Kroger has strategically shifted, predicting that the average consumers are trying to stretch their dollars more while still demanding delicious meals in their own homes. Whether it's meal prep for home or organic products courtesy its Simple Truth product line, Kroger is constantly expanding its product mix to serve all.

Second, Kroger has managed to capture data on about 92% of sales via its loyalty cards. Kroger cultivates the customer relationship from several angles. Connecting data back to customer's behaviors, motivations and influences allows for Kroger to individualize the grocery experience. Kroger doesn't just let this data sit there either; leadership uses it to drive actionable results. Nearly 80% of Kroger customers have asked to receive relevant information and offers from the company, resulting in a redemption rate that is significantly higher than the national average. Kroger uses data science to individualize coupons and market new product offerings to consumers. In fact, approximately 95% of customer interactions with products on Kroger's website and app are enabled by personalization. This personalization drives a significantly higher level of engagement in product offerings and nearly doubles the likelihood of customers adding those items to their carts, according to Kroger's 2021 annual report.

Lastly, Kroger's valuation appears attractive relative to other grocers in the market. Compared to its peers with a median P/E ratio of 20.3x, Kroger is cheaper, with a P/E ratio of 15.2x. The same picture is painted with EV/EBITDA as well. Kroger's EV/EBITDA ratio of 6.9x is lower than the Consumer Staple's average EV/EBITDA of 8.3x. Kroger compares well to its closer peers, such as Costco's EV/EBITDA ratio of 21.9x or Weis Market's EV/EBITDA ratio of 8.1x. Kroger's current ratio is below its five-year historical EV/EBITDA ratio of 7.6x, leading us to conclude the company is attractively priced both historically and comparatively.

After analyzing Constellation's recent performance and strategic outlook, the CUSP Fund managers voted to exit the CUSP position in the firm in March 2023. Two recent strategic moves by the firm have failed to pay off. Constellation's change of focus in its Wine and Spirits market has generated negative growth in operating income each of the last four years, with no promising catalyst for meaningful growth on the horizon. Additionally, a 2017 investment in Canopy Growth Corporation has generated losses nearing $2 billion. Given the firm's recent strategic missteps and lack of a meaningful strategy to recover, the CUSP managers decided to direct investment in this sector to other firms.

The first of these missteps is the dedication to the Wine and Spirits market despite consistent underperformance. Since 2018, this segment has seen its revenues steadily decrease each year while costs have been increasing. The combination of declining revenue with increased expenditures has harmed Constellation's margins in this segment. Similarly, operating income has decreased every year since 2018. While the firm's Beer segment has experienced favorable growth, the profitability of the Beer segment has been quickly eaten away by the lackluster performance of the Wine and Spirit segment. In 2017, to gain exposure to the cannabis market, Constellation Brands entered into a 10% ownership of Canopy Growth Corporation, which subsequently grew to a 38% stake by the end of 2018. The 38% stake represented about a $4 billion investment in Canopy. The acquisition proved to be disastrous. Extensive impairment losses in Canopy have led to Constellation reporting negative net income in three of the last four years, including losses of $71 million for fiscal year 2023. The Canopy segment generated a $2 billion loss in operating income for 2023. Constellation brands announced in October of 2022 that the firm would be surrendering its controlling interest in Canopy. Considering these missteps, the CUSP managers voted to sell Constellation in March 2023.

In addition to Constellation Brands and Kroger, we investigated Monster Energy (MNST) as a potential buy for the portfolio. However, given the firm's current valuation and its irregular cost structure, the team decided that the long-term growth potential did not outweigh the costs.

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