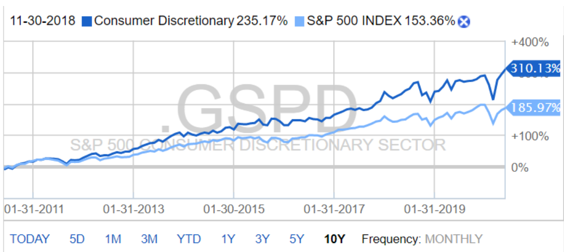
CONSUMER DISCRETIONARY SECTOR

A. What is consumer discretionary?

Consumer discretionary is the sector which consists of businesses that specialize in non-essential consumptions such as automotive, household durable goods, textiles & apparel and leisure equipment. Over the past 10 years, the sector has outperformed compared to overall market. The figure 1 indicates the alignment of the trend of this sector compared to S&P 500. Moreover, the gap between two lines illustrates the willingness of customers in spending on discretionary products and services. It implies the stronger economy overall.

Figure 1. Consumer Discretionary vs S&P 500



Source: Fidelity Investment

External Factors

External factors that impact on the sector itself includes: Disposable income, Currency, political drivers, and international trade.

B. Key Drivers Analysis

I. Consumption overall

Consumption accounted for two-third of the national economy in which 60% has spent on durable goods and services. The table 1 shows spending over the period of August 2019 to February 2020. Overall, the US consumption held up in February which is a sign of stable economy before the outbreak began ripple businesses and consumers. We can notice that, spending on durable goods is more sensitive to the change of the economy compared to non-durables expenditures. For instance, trade tension between US and China at the end of 2019 drove 2.3% decrease in durable expenditures. The economists forecasted a sharply drop in consumption in the third and fourth month of 2020.

Figure 2. Consumer Spending, 08/2019 – 02/2020

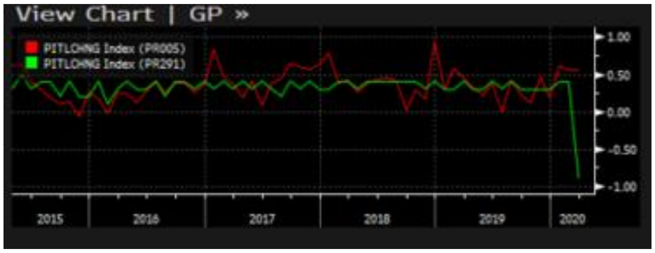
	Feb. 2020	Jan. 2020	Dec. 2019	Nov. 2019	Oct. 2019	Sept. 2019	Aug. 2019
				YOY%			
PCE Deflator	1.8%	1.8%	1.6%	1.3%	1.3%	1.3%	1.4%
(3 decimals)	1.791%	1.790%	1.562%	1.339%	1.316%	1.326%	1.428%
Goods	0.2%	0.3%	0.2%	-0.4%	-0.8%	-0.7%	-0.5%
Durables	-1.8%	-2.3%	-2.1%	-1.7%	-1.2%	-1.0%	-1.1%
Nondurables	1.2%	1.6%	1.4%	0.2%	-0.5%	-0.6%	-0.2%
Services	2.5%	2.5%	2.2%	2.1%	2.3%	2.3%	2.3%

Source: Bloomberg

Understanding disposable income and unemployment rate would help us predict the consumption fundamentally.

1) *Disposable Income*

Figure 3. Personal Income Changes Index



Source: Bloomberg

The figure 2 shows the personal income changes index over the past 5 years. Personal income includes salaries, rental income, investment, and transfer payment. The green line indicates the index survey done by Bloomberg experts, while the red data was reported by Commercial Department. For the past 5 year, the mean of changes is around 0.35% with standard deviation around 0.2%. However, a negative drop in 2020 due to the pandemic illustrates how US workers was hit.

2) *Unemployment Rate*

Figure 4. Unemployment Rate

Source: Bloomberg

The outbreak has suddenly forced businesses to close. As a consequence, millions of jobs were cut. Up until March 31, there has been 3.28 million people filed for unemployment insurance. The rate jumped to 4.4% from 3.5% at the end of 2019.

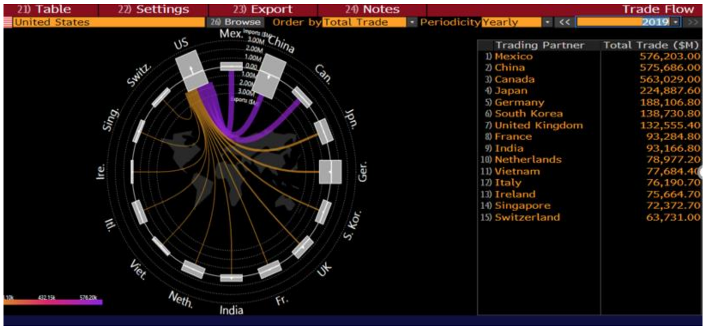
Figure 5. Unemployment Comparison

Source: Bloomberg

However, the recent increase in unemployment rate is insignificant compared to historical downturns of the economy such as 2000 dot-com bubble, or 2008 Recession (figure 4). Meanwhile, it does take at least 2-3 quarters to return to initial rate before the pandemic.

II. International Trade

Figure 6. International Trade

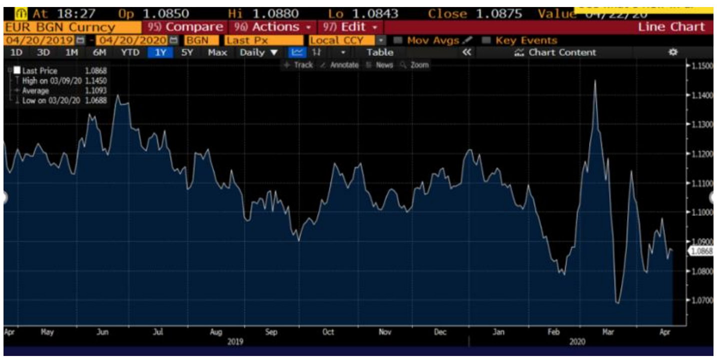


Source: Bloomberg

The pandemic forced some trade negotiations to be postponed. For instance, on March 12, 2020, the press released by the UK Department of International Trade stated that the negotiating free trade between US and UK hoped to be started as soon as possible when the outbreak become clearer. Moreover, a negotiation of a Phase Two agreement between US-China do not appear to have in progressed.

III. Exchange Rate (USD/Euros)

Figure 7. USD – Euros Exchange Rate



Source: Bloomberg

In April, the volatility of EUR/USD has begun settle (figure 6). Back to the end of February, the sudden appreciation in euro was a consequence of mechanical response (the response occurs when the capital appeared to be riskier and international investors repatriated the cash and demand more euro which increase the demand). Since the changes is not underlying fundamentals, the euro was soon back down sharply in March. The economists believe that there is a premium between USD and Euro by using the prices of McDonald's Big Mac burgers to 1 U.S dollar for food purchases while the actual exchange was closer to 0.90 euros (nearly 18% upside).

Figure 8. Italy and Germany 10-Yr Bill Spread

Source: Investing

The spreading between Italian and German 10-year indicates the less confident in financing Italy's government spending. If Italy keeps continue struggling in combatting and financing for the economy and disease issue, the ECB might have to "force down" the spreads by expanding monetary policy. It could hurt the euro and as a result, US future exports to Europe might decline due to demand suffer as euro becomes cheaper.

IV. Financial Performance of Sector

Figure 9. Sector P/E

S&P 500 Consumer Discretionary Sector GICS Level 1 Index Compare <Sec> Periodicity Annuals

1) Key Stats 2) Fundamentals 3) Custom

11) Highlights 12) Valuation 13) Profitability 14) Leverage & Liquidity 15) Market Data

12 Months Ending	2016 Y 12/30/2016	2017 Y 12/29/2017	2018 Y 12/31/2018	2019 Y 12/31/2019	Current 04/19/2020	2020 Y Est 12/31/2020	2021 Y Est 12/31/2021
Valuation Metrics							
Price/Earnings	19.49	23.22	20.33	25.34	23.76	32.85	21.68
Price/Earnings, Positive	19.49	23.08	20.22	25.34	23.76	30.37	21.68
Price/Earnings before ...	21.25	21.08	23.22	27.29	25.10		
Price/Book Value	4.68	5.22	6.56	8.12	7.74	7.26	6.44
EV/Sales	1.74	2.01	1.61	2.03	1.93	2.04	1.82
EV/EBIT	15.60	17.91	19.57	23.29	21.67		
EV/EBITDA	11.01	12.47	12.70	13.57	12.57	16.45	12.82
Dividend Yield	1.58	1.33	1.45	1.28	1.32	1.31	1.46
Fundamentals							
Gross Margin	34.51	34.99	31.48	32.13	31.96		
Operating Margin	11.08	11.08	8.18	8.64	8.84		
Profit Margin	7.00	7.94	6.25	6.46	6.65		
Return on Assets	5.97	6.53	6.44	6.21	6.37	2.05	4.09
Return on Equity	22.01	24.93	28.31	30.27	31.27	16.44	17.37

Source: Bloomberg

Up till April 2020, P/E is at the lower rate compared to previous year as stock price plummeted. The forecasting of increasing in P/E at the end of the year would be explained as the result of decreasing in earnings.

C. Subsector Analysis

I. Automotive

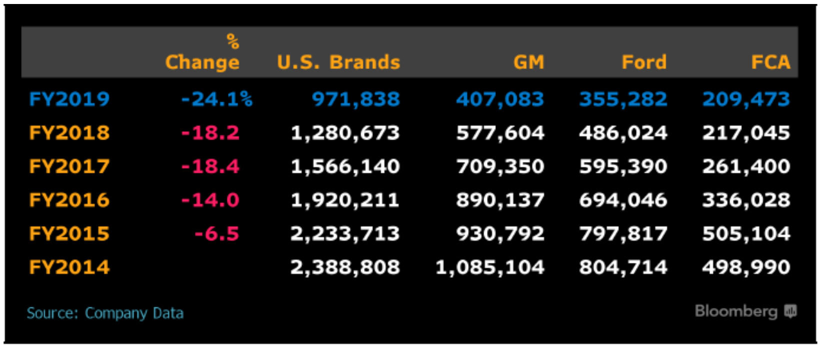
Figure 10. Automotive Revenue, 2011-2024

Source: IBISWorld

Description: The automotive industry comprises a wide range of businesses involve in designing, developing, manufacturing, marketing and selling of vehicles. Major players include Toyota, Ford, GM, and Honda.

Performance: We can see in the figure 7 that in 2011-2012, there was a huge jump in industry revenue. The reason had proven by a consumer optimistic about the economy post-recession. However, the following years performance indicates a downward trend of industry revenue. A remarkable decline in 2017 was due to a decrease in fuel and crude oil that bolstered demand for light trucks and sport utility and move away from cars and

Figure 11. US Compact Car Sales



	% Change	U.S. Brands	GM	Ford	FCA
FY2019	-24.1%	971,838	407,083	355,282	209,473
FY2018	-18.2	1,280,673	577,604	486,024	217,045
FY2017	-18.4	1,566,140	709,350	595,390	261,400
FY2016	-14.0	1,920,211	890,137	694,046	336,028
FY2015	-6.5	2,233,713	930,792	797,817	505,104
FY2014		2,388,808	1,085,104	804,714	498,990

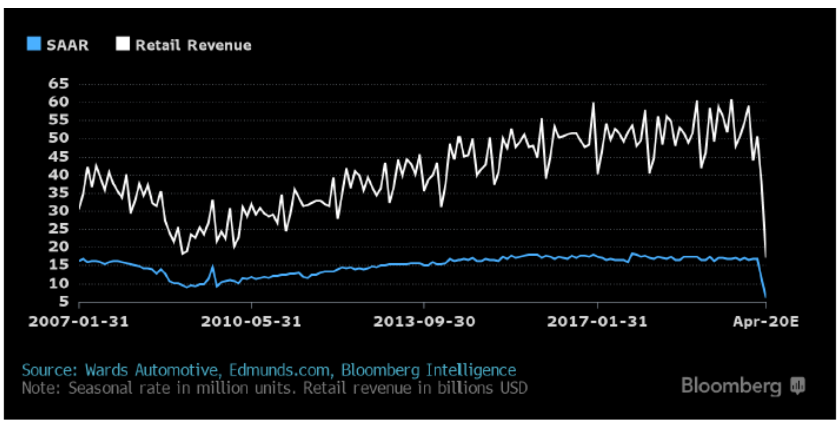
Source: Company Data

Bloomberg

Source: Bloomberg

sedan. In response to consumption shift, large automakers such as Fiat Chrysler halted its production for cars and sedan in 2017, while Ford and GM had to further restructure operations in 2018. Hence, up till now, manufacturers are continuing to focus more on producing trucks. Being as an unnecessary product, the industry demand is more elastic in response to consumer confidence. For the year 2019 alone, nearly 20 points drop at the end of 2018 posed a potential threat to the industry. Moreover, the appreciation in US dollars brought down the industry exports.

Figure 12. SAAR, 2007 - 2020



Source: Bloomberg

Before the outbreak reached US, an expectation of annual growth project was 0.7% annually. However, April estimation reported a demolish $300B in US sales this year. Using the seasonal rate changes, we can see that the trailing 12-month before the virus was average 17 million units sold. However, the SAAR (seasonal adjusted annual rate) has dropped below 6 million units which implies 66% drops in unit sold. If this trend holds for a quarter, the industry will lose $100B in revenue. And the revenue continues to drop 3 times if the market demand is still pessimistic (figure 12).

The automakers within the industry have many negotiations with dealers, or vehicle retailers. However, 52% of national April sales had been prohibited. Majors states that accounted for large part of US vehicle registrations consists of Texas, Florida, California, and New York. In which, Texas, and Florida allows for operation, but sales are still limited by isolating and tentative consumer, while 14% of national registration are from California where has restricted any sales, include online retail. Suppliers for the industry (iron and steel manufacturing, battery manufacturing, automobile manufacturing, auto parts manufacturing) terminates at closed factoring doors which eliminate from 300,000 to 700,000 vehicles of supply. The postpone was estimated $26 billion losses in retail value.

Figure 13. Selling Restrictions by State

	Registered	% of Total	Sales	Service
Total	111.2			
Yes	53.1	47.7%		
Limited	33.4	30.0		
No	24.7	22.2		
California	15.1	13.5	No	Yes
Texas	8.2	7.4	Yes	Yes
Florida	8.0	7.2	Yes	Yes
New York	4.7	4.2	Limited	Yes

Source: NADA, U.S. Dept of Transportation Federal Highway Administration   Bloomberg

Source: Bloomberg

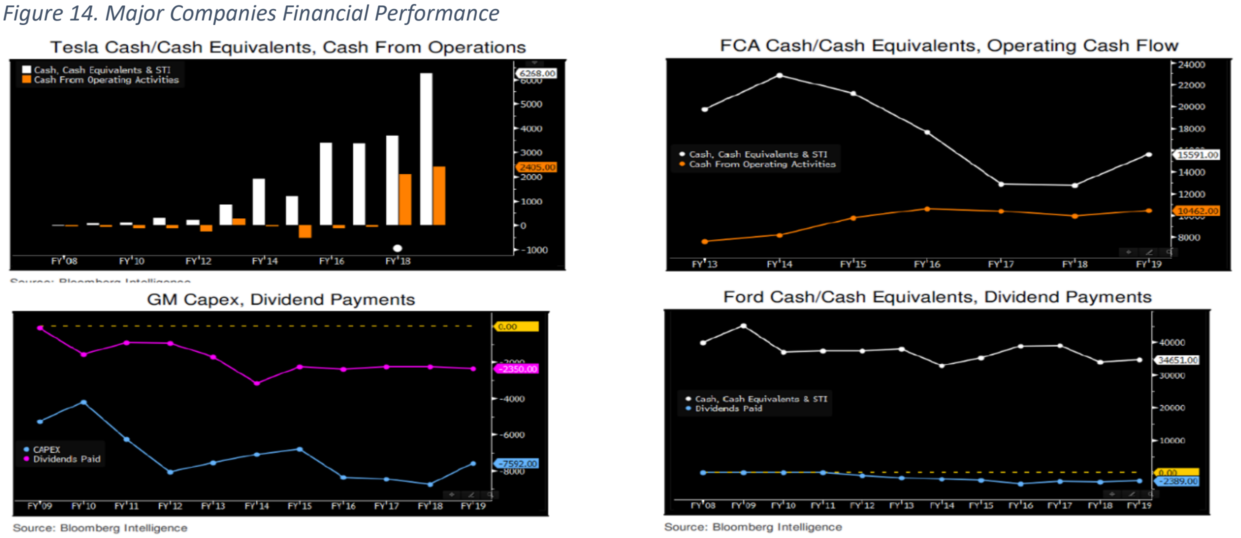
Major players liquidity: Tesla has narrowed product portfolio in US to prevent the virus. However, the record $6 billion cash on hand at the end of 2019 plus $2.3 billion from its equity offering in February was well-equipped to add capacity and response to the economic dynamic change.

A decline in cash balances at the end of 2019 after the deal with Peugeot in producing electrification and autonomous features would lead both companies to re-evaluate the merger. Given the global crisis, severe cash flow declines are a risk as manufacturing is halted in both US and Europe.

GM had just recovered from the four weeks loss due to striking UAW workers now has to face with another changing in net cash flow from the sustained shutdown. At the end of 2019, $23 billion in cash is expected to have a significant decrease in cash flow from operation during 2020. A project of $7 billion capital spending on development of electrified nameplates will be delayed.

The revenue crunch after the Covid-19 crisis would bring down the number of dealers selling US brands and put more depression on price per unit. The demand after recovery might start with pre-owned vehicle. This consumer preference change is reasonable as people tends to save more by eliminating unnecessary spending.

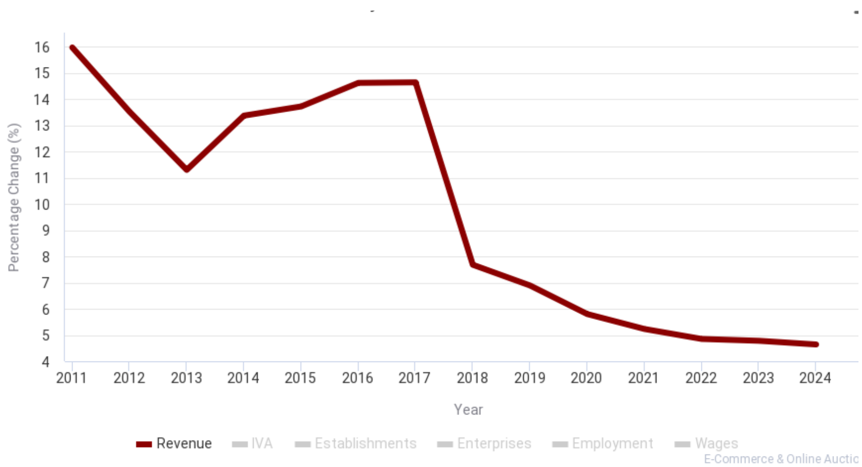
Figure 14. Major Companies Financial Performance



Source: Bloomberg

II. Online Retail

Figure 15. Online Retail Revenue



Source: IBISWorld

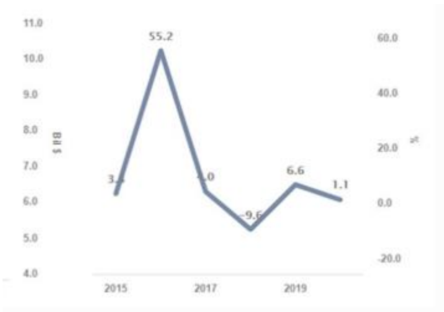
Over the past 5 years, online retails had grown at around 11.5% on average. Profit margin has increased from 4% in 2014 to 5.4% in 2019. Major reasons of increasing are due to wages expenses reduction and higher transaction volumes. Technologies per employee continue to be more productive. An improvement in Warehouse Management systems by calculating the best routes of employees should take to pick products in warehouse. Mobile connection grew at 6.5% annually as it gives consumers the opportunities to save time and shop at home. Companies are focusing to innovate artificial intelligence to help customer have better experience. For instance, the robot chat bar is 24/7 service with quick responses. Requiring lower cost of entry, number of new entrants have increased overtime. The software companies such as Squarespace or Spotify offers variety of platform for new retailer to choose. The rising in competition put more pressure on operators, so that they ought to differentiate their products chain.

III. Office and Home Supplies

Figure 16. Arts and Office Supplies Demand

Industry operators provide wide range of arts and office supplies such as plastics, ink, wood, and other materials. For the past 5 years, the industry has experienced a slightly decrease in demand. A remarkable increase in 2016 to 2018 was due to a pick-up in economic growth and consumers were willing to pay for expensive products, but jump has proven to be a temporary blimp. The long-term trend of cheaper imports and the innovation of technological substitution had soon driven down the industry' demand. China has emerged as one of the largest manufacturing centers. The advantages of low variable costs, many US operators have shifted to offshore the production. Moreover, a strong position in USD boosts the import requirement. Domestic demand for imports accounted for 44.8% and expected to be higher, according to the IBIS. Since the operators cannot control over consumer preference, they are

Figure 17. Arts and Office Supplies Revenue Changes



Source: IBISWorld

trying to cut cost through staff reduction. Operating cost reduction is able to lower prices of products, but production is likely less productive which keeps pace with lower revenue.

Offsetting that, manufacturers continuously develop new and innovative products. They are projected to continue design and market environmentally friendly products (generic supplies). As consumer and government concerns over environmental issues, which might benefit from increased demand.

IV. Apparel

Figure 18. Apparel Revenue

Source: IBISWorld

Key drivers for the Apparel industry include participant trends, weighted-trade index, import penetration, and demand from the department stores. Over the past 5 years, the intensifying competition from international manufacturers has made the industry's performance be more volatile. Imports accounted for 42.1% of domestic demand. In response to the competitive market, US operators tried to lower price which hampered their profitability. Moreover, a spike in trade-weight index in 2015 implied a strong dollar which made products manufactured in the US comparatively more expensive abroad, but it was soon moderate dropped in 2018.

Despite of those industrial threats, an increase in disposable income has shifted consumer preference into high quality products. In addition, the industry tied hardly to the retail markets (such as department stores, sport stores, and online retails) which is a primary driver for number of the orders. Those retailers aim to attract more consumers by enhancing their products portfolio by negotiating favorable contract with operators. Sporting stores comprised 45.5% share of global Athletic and Sporting Goods Manufacturing. For the last 5 years, demand for sporting goods from retailers has been increased. Thus, more operators tend to develop distribution networks to support for their products. The industry expects to see more operators to follow the trajectory of Nike Inc. who has vertically integrated their operations to include retails. Online retailers accounted for 17.7% of annually industry revenue. Taking the advantages of saving time and costs, major player such as Nike has been ramping up the share of business conducted online. Besides that, an overall rise in number of consumers participant in sports bodes well for the industry. According to the study of CDC, 42% of the US population is projected to be obese by 2030 which is a factor that push up the demand for sporting goods. Therefore, IBISWorld projected 1.3% annually growth for the industry over the next 5 years.

D. Our Current Holdings

I. NWL (Newell Brands)

Figure 19. Newell Debt

NWL US Equity | 96) Actions | 97) Export | 98) Settings | Financial Analysis

39) ADJ Newell Brands Inc ASC 842 Periodicity Annuals Cur FRC (USD)

1) Key Stats | 2) I/S | 3) B/S | 4) C/F | 5) Ratios | 6) Segments | 7) Addl | 8) ESG | 9) Custom

11) Adj Highlights | 12) GAAP Highlights | 13) Earnings | 14) Enterprise Value | 15) EV Ex Operating Leases | 16) Multiples | 17) Pe...

In Millions of USD	2016 Y	2017 Y	2018 Y	2019 Y	Current/LTM	2020 Y Est	2021 Y Est
12 Months Ending	12/31/2016	12/31/2017	12/31/2018	12/31/2019	12/31/2019	12/31/2020	12/31/2021
Market Capitalization	21,543.6	14,992.7	7,859.9	8,139.7	5,633.3		
- Cash & Equivalents	587.5	485.7	495.7	348.6	348.6		
+ Preferred & Other	35.6	36.6	34.8	32.7	32.7		
+ Total Debt	11,892.8	10,551.0	7,015.0	6,397.5	6,397.5		
Enterprise Value	32,884.5	25,094.6	14,414.0	14,221.3	11,714.9		
Revenue, Adj	13,264.0	11,170.4	10,154.0	9,714.9	8,903.1	9,127.9	9,274.4
Growth %, YoY	124.2	-15.8	-9.1	-4.3	-3.9	-6.0	1.6
Gross Profit, Adj	4,897.0	3,856.2	3,528.8	3,307.7	2,935.3	3,065.1	3,171.8
Margin %	36.9	34.5	34.8	34.0	33.0	33.6	34.2
EBITDA, Adj	2,347.2	1,957.8	1,582.5	1,593.1	1,405.0	1,273.0	1,325.0
Margin %	17.7	17.5	15.6	16.4	15.8	13.9	14.3
Net Income, Adj	1,121.6	901.3	1,839.6	621.3	419.7	562.3	615.3
Margin %	8.5	8.1	18.1	6.4	4.7	6.2	6.6
EPS, Adj	2.65	1.85	3.88	1.47	0.99	1.30	1.42
Growth %, YoY	22.7	-30.2	109.7	-62.2	-59.6	-11.6	9.2
Cash from Operations	1,840.4	966.2	680.0	1,044.0	1,044.0		
Capital Expenditures	-441.4	-406.2	-384.4	-264.9	-264.9	-238.7	-250.7
Free Cash Flow	1,399.0	560.0	295.6	779.1	779.1	841.3	747.7

Source: Bloomberg

In 2016, a success of acquiring Jarden (company who specialized in home appliances) which doubled the company sales to $9.6 billion. However, the company faced a weak cash flow and liquidity of the key consumer product “Toy R US” triggered a huge impairment. It forced a company to accelerate its transformation plan. Company reported $8.3 billion net loss compared to just half-million net gain of previous year. As a result, in 2019, the company has seen a its stock rally around October because of its asset-divestiture program. The asset sales have helped business prune down its $6.7 billion in June.

Figure 20. NWL Credit Rating

	Moody's	S&P
Outlook	NEG	NEG
Unsecured Debt Rating	Ba1	BB+
Possible Triggers: Upward Bias	Debt/Ebitda < 3.75x	Leverage < 4.25x on a sustained basis
Possible Triggers: Downward Bias	Debt/Ebitda > 4.5x through 2020	Fails to reduce leverage to low 4x area in 2021
	Click for Note	Click for Note

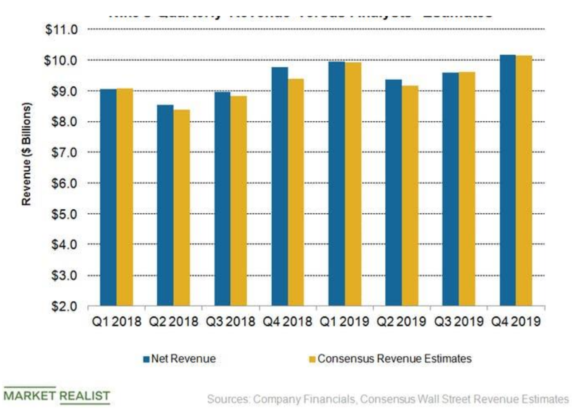
Source: Bloomberg

However, Newell bond was rated from Ba1 before the virus and currently appeared to be BB. There are couple of reasons which led the company credit rating dropped. Firstly, due to weaker consumer spending and store closures, the company might reduce its dividend or temporarily suspend to conserve cash as profitability decline and to meet leverage target. Secondly, company had decided to retain assets which would generate about $500 million dollars. As a result, the debt-to-EBITDA is expected to be 4.5x by the end of the year. The business is forecasting to have further asset-sales proceeding if the downgrade on its credit continues. They have 3.15% notes due in 2021, 3.85% notes due in 2023, 4.2% in 2026, 5.357% in 2036 and 5.5% in 2046 with total outstanding debt value is $5 billion.

In addition, an acquisition of Jarden in 2017 could hurt Newell during and post the outbreak. According to the report, U.S single family home builders have declined 60% which is estimated needed 6 years to return back. The first quarter is still expected for strong ordering of house appliances; meanwhile, a lag might hit sales in 2Q and 3Q by shelter-in-place orders.

II. Nike Inc. (NKE)

Figure 22. Nike Revenue



Recently, two-third of Nike sales are from wholesale (such as sports store, department stores), and independent distributors. They also have a solid demand from consumers through its global network of company-owned store within 50 countries. Overall, Nike has a solid financial performance growth with the mean of 25% except 2018 when it was impacted by the 2017 Tax Act. It was hit with a substantial income tax expense. Cash at the end of 2019 was $4.5 billion. Cash flow from operation was $5.9 billion with nearly $300 million in capital expenditure and $5.3 billion spent on dividend and stock repurchase. In 2018. The company acquired Israeli computer vision firm named Invertex which does 3-D body scanning with expectation of enable its direct-to-customers strategy. Currently, within Direct strategy, Nike has offered app called Nike+ to provide consumers more experiences when shopping virtually.

Figure 21. China NIKE sales

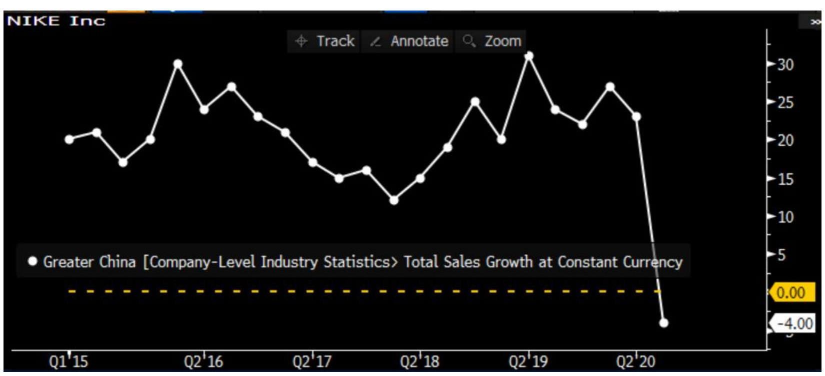
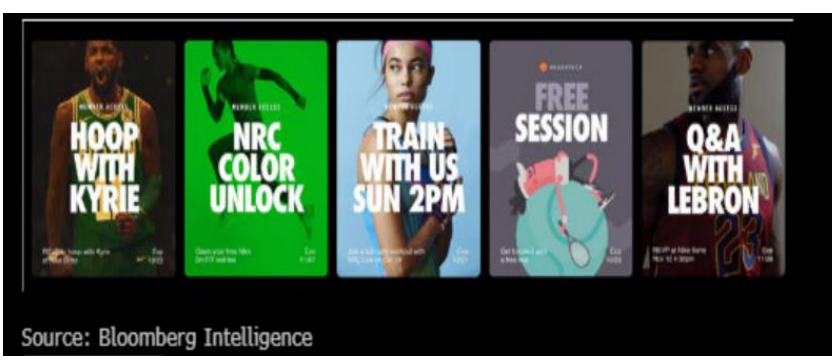


Figure 23. Decline in China Nike sales

Although Nike has underlying strength, but the virus still hurt the company operation. Social distancing required store closings. China reported sale falling by 4%. Moreover, summer events are the key success of Nike, such as Olympia Sport event, the figure shows number of viewers searched for their product during the summer is 3.6 billion while only half of that is viewed in winter. However, potential growths of the company are able to outweigh the impact of the pandemic.

Figure 24. NIKE+



Nike tries to reduce costs in supply chains with technology and automation. Nike+ continue to show its success in giving consumers joyful shopping environment which had been proven by double-digits growth in sales and active users. The Nike+ induces consumers by rewarding members with perks through its partnership with Apple Music, Class Pass, and offering discount. The integration of Nike+ with Retail app in North America could help boost wholesale revenue. They also aim to expand this concept to Europe and China. Moreover, the Nike Fit which is the company's new technology allow users to be scanned the foot to provide more accurate of their shoe size. The app will be debuted in Europe and Japan later this year. Historical data indicates 25% of total sales are women's sportwear. The trend is projected to climb at 7.7% annually for the few years.

E. Conclusion

In conclusion, the sector is under pressure due to the virus and its position in late cycle. However, within the sector, some industries might outperform compared to the others such as apparel industry. Since, non-essential products whose value cost consumers less tends to bear less risk than the rest in response to the changes of economic dynamics.