The Global Baby Food and Pediatric Nutrition industry is part of the Consumer Staples sector. It is comprised of mature companies competing on price and brand differentiation to grab market share around the globe. The demand for these products looks to grow as more people around the world continue to enter the middle class and purchase higher quality food products. The global growth for products in this segment of consumer staples outpaces its peers, and companies best positioned to capture this growth could deliver solid returns for our portfolio.

**Drivers of Thesis**

- Demographic trends in Emerging Markets will increase demand for pediatric nutrition products as parents have more disposable income to allocate to children’s development, and work outside of the home, opting for the convenience of formula.

- Low price elasticity due to brand equity allows brand names to operate with wide margins. A handful of compete as premium brands, working with health professionals to advocate for their products.

- Industry offers exposure to high growth industry with defensive characteristics.

**Risks to Thesis**

- Industry is dependent on Emerging Markets for growth. With the current concerns of a global slowdown, growth may not continue at recent pace.

- Wide margins and competition for market share allow room for competitors to drive margin compression.

**Infant Formula**

**Consumer Staples: Food, Beverage, & Tobacco**

### Investment Thesis

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### Stock Rating

**Market Caps (in billions)**

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**12 Month Performance**

![Graph showing 12 Month Performance](source)

**Company Description**

Infant Formula is a growing $50-billion-dollar industry worldwide. A handful of companies compete in this space to provide science based infant formula and early stage development products. Infant formula is used as both a substitute and a complement to traditional breastfeeding. The industry relies on emerging markets to drive growth and has stable revenue streams in more mature markets, where government regulation plays a significant part in determining market share.
EXECUTIVE SUMMARY

In the past few years, there has been heavy competition in the infant formula industry as companies compete for market share in expanding economies across the globe. The major players in the developed economy see emerging markets as a source for better than average sector growth for the future, while still maintaining strong and steady cash flows in the United States and Europe. Should company forecasts of growth in emerging markets be recognized, the industry will drive strong returns.

However, the past couple of years have provided new concerns about the health of emerging economies. Growth in China is slowing, and other emerging economies are not immune to the slowdown. More widespread problems could reduce demand for packaged and more expensive infant formula products that are offered by US and European packaged foods producers.

Changing consumer preferences as well as the strength of the US dollar provide additional headwinds for the industry, but overall we expect the emerging market increases to make up for any flattening growth in consumption in the US and European markets. Finding companies best able to capture this new growth in a high margin industry presents a good opportunity for the fund.

INDUSTRY DESCRIPTION

Scientists have been trying to create an infant formula that is equal to breastmilk since 1865. During the late 1800’s many different companies brought new products to market. Scientists have continued to study breast milk and have developed continuously improving formulas to be used as an alternative to or in conjunction with breast feeding. As formulas continued to improve, companies began to directly market their products to medical professionals. The FDA passed the Infant Formula Act of 1980 to regulate the industry to ensure quality in all products marketed in the US.

Infant formula comes in three forms: Powder, concentrate and ready-to-drink. Along with primary routine formulas, there are also products directed to serve special dietary needs in the form of special formulas. Routine formulas are for healthy infants without special dietary needs such as food allergies and gastrointestinal disorders. Routine infant formula is meant to be used from birth to about the one-year mark, whereas specialty products may be used longer.

There are four major companies world-wide that make up a significant portion of the overall market in mature economies. There are smaller producers within some developing economies that are less regulated having more regional producers compete for market share. The global sales for infant formula reached $41 billion in 2013, and market in China alone is expected to reach $27 billion by 2017. Because of the large markets in emerging economies, significant investments are being made in these countries in order to capture market share.

The four largest brands are Nestlé’s Gerber, Abbott Laboratory’s Similac, Danone’s Dumex, and Mead Johnson’s Enfamil. These four brands made up 92% of total infant formula revenues in the United States in 2015.

Marketing to Medical Professionals

The only substitute for infant formula is breast milk. Infant formula provides a convenience for mothers who do not wish to breast feed, as well as an alternative for mothers who are unable to. Mothers can choose to use formula as the sole source of nutrition for their infant for as a supplement to breastfeeding. Formula is a product of convenience, but parents will choose the formula they believe is best when choosing for the first time. The first formula that an infant consumes is almost always supplied by the hospital, and it is crucial for companies in this space to advocate for their product to medical professionals. The companies employ a sales forces that interacts directly with medical professionals to highlight the benefits of their formula. Medical professionals have significant influence as a trusted voice to mothers, and after the decision to use formula is made, they will recommend the brand that they trust most. After leaving the hospital, the mother has usually made her choice based on the best interest of her child and is unlikely to switch brands after making the initial choice. This is due to the fact that in this market, mothers make the first choice believing that the brand they have chosen is the best for the development and health of their newborn. As long as the formula is providing the healthy development expected, it is unlikely that a mother would switch formula choice.
Because of this unwillingness to switch brands, the competition occurs for the first purchase, which is often influenced by medical professionals providing care for newborns. This causes companies to fiercely compete for medical professional favor by advocating why their brand is the best for the healthy development of infant children. This point is illustrated by the announcement last summer that Mead Johnson settled charges that a Chinese subsidiary made improper payments to health-care professionals to recommend Mead Johnson products to new or expecting mothers.

WIC in the US

In the United States, the WIC (Special Supplemental Nutrition Program for Women, Infants, and Children) program purchases a large amount of the infant formula in the United States. The program believes that by providing needed financial assistance to mothers of infants they can help the development of these children and avoid future health issues. The program provides a benefits card for qualifying participants to use at authorized retailers and is the third largest food assistance program in the US. The benefits card specifies the type and brand of formula that can be purchased, as well as when in the month that the card can be used. Each individual state operates its own rebate program, and they make the choice as to which brands that their beneficiaries can purchase. Since the 1990’s, only 3 manufactures have been chosen as the manufacturer of choice for these states, Mead Johnson (Enfamil), Abbott Technologies (Similac), and Nestle (Gerber). WIC state agencies reimburse the vendor (grocery store, drug store, etc.) for the full retail price and then the state requests a rebate reimbursement from the manufacturer. Manufacturer’s bid for these contracts, and offer the lower price to the state agencies through the rebate. According to the USDA, the rebates given to the state for these programs are large. The program cost $6.2 billion in FY 2015.

Though this program does not provide great profit margins for the manufacturers, it is most likely part of the reason that the three manufacturers stated above maintain almost all market share in the United States. This wide moat protects the incumbent companies (Mead Johnson, Nestle, and Abbott) from outside competition entering the market. Also interesting is that being the WIC brand provided support to the rest of the WIC brand company’s product line. Even products not covered by WIC were more likely to be the WIC brand.

M&A History

The baby food industry, like many in consumer staples, has a long history of mergers and acquisitions. Companies have realized that instead of needing to innovate and discover new consumer preferences themselves, they can sit back and let these trends play out in the markets, and when a trend presents itself, either produce an identical product or acquire the manufacture who has developed the new product.

When new companies enter the baby food market and become successful, the behemoths in the industry take the opportunity to purchase these smaller companies and integrate synergies that exist between the businesses and expand their market share. The most recent acquisition occurred when Nestle bought Pfizer’s baby food division for $11.9 Billion in 2012. Acquiring the Pfizer product line expanded Nestle’s reach into emerging markets, as 85% of the Pfizer’s baby food division sales were in emerging markets. Nestle also made a $12 billion purchase of super-premium infant nutrition business Wyeth.

RECENT DEVELOPMENTS

China Relaxes One Child Policy

Recently in the news is the Chinese government’s decision to soften the one child policy. This will allow certain Chinese citizens to have more than one child. Currently 16 million children per annum, competitors in this industry rely on growth within the formula consumption as well as number of children being born. Some do not believe that this government policy will have a dynamic affect, due to the Chinese culture trend of one child families. The government’s decision was in part due to the concern of China’s aging society. The policy was initially enacted due to fears that the populous would grow at an unsustainable rate. In hindsight, those fears appear to be unfounded and currently the birth rate is lagging behind the replacement rate.

Since the government in China does not support a societal safety net such as social security, it is often the job of the children to take care of aging parents. Having more than one child while taking care of parents could stretch resources thin and may not be feasible for many Chinese families. How the Chinese populous responds to this relaxation of policy is one of many areas of uncertainty
surrounding China growth that will affect the pediatric nutrition industry’s growth in the future.

Milk Prices Fall

Commodity Prices fell sharply in 2015 after a five year run-up. The most important commodity to the baby food industry is predictably milk. In 2015, milk prices dropped 29% in 2015. The price was driven down by global demand. Economists expect the milk prices to stabilize and hover around $16.00 per hundredweight.

Contrary to intuition, these lower milk prices may not be good for the industry’s margins long term. In the past, lower input prices have helped widen margins. However, with the focus on capturing market share, companies are levying heavier discounts in order to obtain volume growth, most notably in the Chinese market. The price cutting appears that it will continue longer term, and could have a more lasting negative effect on margins across the industry. When milk prices rebound, producers may not have the flexibility to pass cost increases along to the consumer.

Dollar Strength Puts Pressure on Profits

U.S. companies such as Abbott Laboratories and Mead Johnson are exposed to significant foreign exchange rate risk, and as the dollar has strengthened in recent years, the companies make less money on goods sold outside of the U.S. If market volatility continues and investors see the U.S. dollar as a secure asset, the companies will continue to operate at a disadvantage to local competitors overseas. In contrast, any weakening in the dollar would provide relief. The company reported that the unfavorable foreign exchange rate impact caused reported earnings to be 6% lower than they would have been on a constant dollar basis.

Our team does not see exchange rates reversing trend significantly in the near term, and the currency headwinds will remain for the US companies. In the long term, weakening of the dollar vs. currencies in markets in Southeast Asia and Latin America will help relieve the pressure.

INDUSTRY TRENDS

China Regulation

In recent news, foreign companies were aided by the news that the Chinese government passed legislation that places strict rules on baby formula in China. The law requires more monitoring by the Chinese government, and limits each company to just three brands to be sold in the country for quality control purposes. Some estimates have claimed that up to 80% of current brands on the Chinese market will be eliminated due to the law.

The market in China has come under the government’s watchful eye after a series of scandals have caused panic among Chinese consumers. In 2008, milk formula containing melamine killed at least six children and caused many more illnesses. Two company officials were put to death due to their involvement in the scandal. Because of this tainted past, many consumers view imported formula as safer. Currently the imports only take up about a third of the market-share in China, but many analysts see this trending up as there is less clutter on the shelves and consumers continue to trust western brands over locally
produced formula. Foreign market share is up to 50% from 30% before the scandal. The graph below shows the recent trend of the top five company’s collective share of the China market in the past five years.9

![Top 5 Market Share](image)

Source: Bloomberg

The concern going forward for foreign producers will be that China will create regulations making it more expensive for consumers to purchase imported product or regulation making it more difficult for foreign producers to sell their product. If there are significant regulatory burdens put in place, it could change our investment thesis.

Zika Virus Sparks Fear in Latin America

News of the Zika virus in Latin America has raised serious concerns with women who are pregnant or trying to become pregnant. The virus has been reported in 31 countries and recently some experts have suggested that the best way to prevent birth defects caused by the virus is to postpone pregnancy. The CDC has advised American women to avoid travel to affected areas.10

The effect on birth rates in Latin American countries remains to be seen, but Latin America accounted for 18.5% of Mead Johnson sales in 2015. A key to monitor will be what Zika does to birth rates in Latin American countries and how it could affect revenues for Mead Johnson long term. Latin America makes up a chunk of the other category in the revenue decomposition, and slower than historical growth estimates were forecasted in order to account for the likely slowdown that will be caused by the effects of the Zika virus.

WHO Advocates for Breastfeeding

The World Health Organization (WHO) has advocated that all able mothers breastfeed as opposed to using infant formula. The WHO has recommended that all mothers exclusively breast feed for up to six months of age. According to the WHO, currently only 38% of children are exclusively breastfed, and they have called for limitations to advertising companies that sell infant formula can do. They have published a goal of 50% of children being fed exclusively through breastfeeding by 2025. There is empirical evidence that supports breastfeeding, and its benefits are well known. Not only is breastfeeding recommended by WHO, it is much cheaper than buying infant formula. Despite this information, many women choose not to exclusively breastfeed. Companies in this industry compete to offer the best quality alternative or supplement to breast feeding while also providing convenient quality nutrition11.

Gluten-Free/Organic Baby Food

The U.S. food market has been dominated by baby food from a jar for years, but recent trends in the industry about food source have changed the way that manufacturers must operate in order to compete. Parents are now more aware and conscious about where the food they buy comes from, and some are starting to look for healthier alternatives for their children. This is not currently a major concern in developing markets, but company’s will be forced to monitor and adapt to any significant change in consumer preference in developed markets12.

MARKETS AND COMPETITION

US Market

The U.S. Powdered Infant Formula market is dominated by Mead Johnson Nutritional (MJN) with the brand Enfamil and Abbott Laboratories (ABT) with Similac. The companies control near 80% of the market, with Nestle SA contributing 16% of overall market share. The industry is very difficult to enter in U.S. due to strict FDA regulation on marketing infant formula. This regulation includes testing for certain pathogens and puts a burden of proof on companies to prove their formula supports normal infant growth. With the high quality standards present in this market, it is difficult for a small company to find a profitable to enter on a small scale13.
Ready-to-drink formula is infant formula that is produced and shipped in liquid form and bought by the bottle. In the U.S., three main competitors (Abbott Laboratories, Mead Johnson, and Nestle SA) compete for a piece of the relatively new $200 million U.S. market. The ready-to-drink market is a small portion of the overall infant formula market, as its convenience is largely outweighed by its much higher cost.

Outside of the U.S., the market is less regulated and more diversified among competitors. However, the three main players in the U.S., along with Danone, are well positioned to be market leaders long term in emerging markets as more consumers enter the middle class and choose higher end branded formula. Demand is also different in emerging markets, with potential per capita use increases coming in the future. Currently, China uses just 24kg per birth of growing up milk, which is significantly less than Western Europe (34kg) and the United States (42kg). The industry expects that as incomes rise in China that this number will also increase.

The United States market is mature and heavily concentrated to the top 3 competitors in infant formula, and is dominated heavily by Nestle/Gerber in the prepared baby food market. Nestlé’s Gerber accounted for 68% of U.S. market share in 2012. A bevy of other companies compete for space, but the company that came in second was private company Beech-Nut Nutritional with just 8.9% market share. Numbers in the past 3 years were not readily available, but trends suggest that there could be movement towards organic branded baby foods.

**European Market**

According to Nielsen research, Europe accounted for $6.6 Billion is sales in 2015. Danone (BN-FR) and Nestle (NESN-CH) are the largest producers by revenues in the European market, and the market looks similar to that of the US market. Infant formula is strictly regulated and the barriers to entry are high. Around one quarter of Danone’s revenues come from its early life nutrition segment. In the past couple of years, Danone has increased its market share in the UK from 61% in 2010 to 75% in 2015, mostly at the expense of Nestle.

**Emerging Markets**

Zenith International estimates the global market for infant nutrition is over $50 billion and it forecasts to be the fastest growing packaged food category over the next five years with estimated 7% per year growth. Over 80% of the world population lives in developing economies. The chart below helps show why the emerging markets are so important, and why companies like Mead Johnson are focusing so much of their capital in the Asia Pacific market, which is expected to account for the majority of the global market by 2020.

---


- **Asia Pacific**
- **United States**
- **Europe**
- **Rest of World

Source: Kalorama Information

This makes it no surprise that emerging markets currently dominate the market, China accounting for 65% of infant formula sales and Euromonitor projects that this will increase to 74% by 2020. Other emerging markets, India and Africa in particular, are other areas where companies see long term growth opportunities as incomes rise.

Nestle, Danone, Abbott, and Mead Johnson have all bet big on emerging markets. Growth prospects for all of these companies are heavily reliant on success in these emerging markets.

**Peer Comparisons**

On the formula side, there are four companies that compete with marketed formulas worldwide. Mead Johnson, Abbott Technologies (Similac), Nestle (Gerber), and Danone ( Dumex). Also mentioned is generic formula producer Perrigo (Generics and Bright Beginnings). Outside of these five, there are economies with local competitors but the market is concentrated and
continuing to consolidate. The graph below shows the concentration of the four major brands across the ten largest markets for infant formula.

Source: JP Morgan

Global sales in 2014 for infant formulas were $19.4 billion, increasing by about 5% CAGR over 2007. Demand in new markets drive estimates up to $26.9 billion by 2021. Of that estimated $26.9 billion in revenue by 2021, over $14 billion is expected to come from the Asia Pacific region. The mature markets such as the US and Europe are very concentrated to the names listed above, and the emerging markets are more fragmented with the large multinationals and small local distributors. As these markets mature, expect to see more concentration in market share among the giants. The industry leaders use promotional pricing in order to offer prices that are more competitive with local distributors, and after the market is more concentrated can increase prices to more desirable levels. The below chart outlines the major competitors in the infant formula industry as well as some company characteristics. Mead Johnson’s position as a player only in the pediatric nutrition market likely explains the higher level of operating margins it maintains relative to its peers. 60% of MJN’s sales come from infant formula, whereas only <10% of Nestle sales and about 20% of Danone sales.

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<th>Op Margin</th>
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<td>Perrigo</td>
<td>18.48</td>
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Source: FactSet

Nestle

The largest company in the space is Nestle, the Swiss food giant with a market cap of over $225 billion. However, Nestle is a large conglomerate that is the manufacturer of many of the packaged goods you would find in your local grocery store.

Nestle acquired Gerber in 2008 and has since rebranded its formula products under the Gerber name. We see Nestle as the key competitor, because they have the resources and infrastructure that dwarfs the other competitors and could most easily afford a price war in emerging markets in order to grab market share. They also acquired market leader in infant nutrition Wyeth. Nestle clearly sees the opportunities available in this market and is aggressively looking to allocate resources to capitalize on those opportunities. Worldwide, Nestle is the largest supplier of pediatric nutrition.

Danone

Danone is a French company and the maker of the brand Dumex. Dumex is largest infant formula brand in China. Dumex was acquired by Danone in 2007. Danone operates three different product segments, one of them being early life nutrition. Outside of the US, Danone is a formidable competitor to Mead Johnson’s brands. Danone has partnered with state-owned Yashili for Dumex, its locally made brand in China. However, with the shift in preference to imported brands, Danone may see market share deteriorate if they are not able to make up losses in Dumex with their own imported brand of formula.

Mead Johnson

Mead Johnson is a Glenview, IL based company that was one of the first US based companies to enter the market. They currently hold a large share of the US market, and significant shares in many other markets around the world. They are the only publically traded company that is a pure infant formula play, generating all revenue from infant formula and children’s nutrition products.

Abbott Technologies

Abbott Technologies branded infant formula Similac is a market leader in the United States and expanded into emerging markets in 2012. Abbott is Mead Johnson’s primary competitor in the US, both making up about 40% of the market. Abbott is the leader in the US in the high
priced ready-to-drink formula, accounting for 68% of marker share compared to Mead Johnson’s 28%.

**Perrigo**

Perrigo is the manufacturer of many of the generic store branded formulas. In most of the developed markets, generics do not hold significant market share. It will be key to watch if the lower prices of generics will drive more consumers to choose their brands, but that seems unlikely based on historical trends.

**ECONOMIC OUTLOOK**

**Slowing Growth in China**

One of the lags on performance for Mead Johnson was due to a decrease in China sales. In January, the Chinese government announced that its $10 trillion economy grew at a rate of 6.9%, the country’s slowest rate in over a quarter century. It’s important to note that a 6.9% growth rates yields more than 14.2% did in 2007.

The more important concern is about the authenticity of the numbers. There has been concern expressed that the Chinese government is massaging the GDP numbers to smooth its growth trajectory.

China also made news last year by announcing that it would be softening its current one child policy and allowing certain couples to have two children. It remains to be seen what long term affects that the policy change will have on population growth in China. The policy relaxation requires couples to apply for permission give birth to a second child. Many economists have stated that the policy of limiting children at all needs to be eliminated all together because China needs stronger population growth if they want to see the government’s targeted GDP growth. Economist Huang Wenzheng has stated that a shrinking population would be detrimental to China development. The total population continues to grow, but the working age population (aged 16-59) declined in both 2012 and 2013. The concern is that China could become the new Japan, where the aging population (25% of all residents) has contributed in part to what economists have called the lost decade in Japan.

**Growth in Other Emerging Markets**

There is a significant opportunity in Africa and the Middle East in a relatively untapped market. By 2018, it is estimated here will be 7.3 million more 0-3 year olds in the region than there were in 2013. The large multinational players focused on in this report will likely be able to target more affluent areas with their high end product lines.

Indonesia is home to world’s 4th largest population and is home to 22 million children under the age of 4. The country has an expanding middle class and multinational competitors are lining up to penetrate the market. Nestle invested $200 million to start production in the country. The government has encouraged exclusive breast feeding for the first 6 months after birth, so the challenge for producers is to convince parents of the developmental benefits of using formula.

India has the largest population of children under 4, however, the market for infant formula is very small relative to China and Indonesia.
CATALYSTS FOR GROWTH

Growing Middle Class in Emerging Markets

There is significant opportunity for revenue and volume growth in emerging markets especially in Southeast Asia due to favorable social and demographic trends. However, any economic downturn in emerging markets could limit consumer demand for product. The infant formula business segment specifically targets working mothers, and if less working mothers are in the workforce, the potential customer base shrinks.

Continued Flight to Quality

Since 2008, the market in China in particular has shifted towards a preference of well known international brands and the quality associated with them. This trend will have to continue for the large investments made in emerging markets to pay off.

Operating Efficiencies

Most companies in this space are currently undergoing cost cutting programs hoping to increase operating efficiencies to gain competitive advantage over their peers. However, it may be increasingly important as there are currently downward pressures on margins.

INVESTMENT POSITIVES

1. Positive news in China would help all business in this sector. Seeing larger volume sales in emerging markets with existing margins could provide industry wide opportunity.
2. High Barriers to entry have left a handful of large global competitors to compete in a global market.
3. Despite growth potential, shares trade at similar multiple as other consumer staple peers.

INVESTMENT NEGATIVES

1. Due to the international nature of the business, there are many different government regulations in play and changes to regulations could have significant affect on the industry. In the United States, the government affects sales through food stamps and also WIC, program that specifically targets the nutritional needs of women, infants, and children.
2. Large operating margins across the industry could lead to intense price competition and margin compression over the long run.
3. Emerging market volatility will continue to affect industry sentiment as growth is driven from developing economies.

KEYS TO MONITOR

Regulatory Changes – The infant formula business is subject to government programs and regulations (such as the WIC program in the US). Changes in these programs or regulations that are unfavorable for MJN could adversely affect MJN’s growth prospects.

Birth Rates – This industry relies on birth rates remaining steady or increasing. It’s important to monitor economy health and birth rate trends in key markets.

Female Workforce Penetration – As of 2012, only 25% of Indian women were in the labor force in some capacity or seeking employment. As these numbers rise, not only in India but in many markets across the globe, the number of women that use formula for feeding will also increase. 80% of the world lives in these developing areas that represent more opportunities for MJN.

Conclusion

The infant formula industry offers the portfolio exposure to high growth emerging markets with an industry that operates with large margins and is in the process of consolidating. The industry’s profitable growth will drive long-term shareholder value. The companies that are best positioned to capture that value are those that are invested in emerging markets and gain market share as more consumers enter the middle class and chose branded formula.

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