December 2, 2019 05:01 AM GMT

US Equity Strategy | North America

Consumer Conference: Strategy Sector Views + Analyst Stock Picks

Trade, the election, and a late cycle economy keep the market searching for new leadership amid high uncertainty. We expect disappointing EPS and are overweight defensive Staples and underweight Discretionary, a typical late cycle underperformer. Our consumer analysts highlight their top picks.

Our US Consumer Discretionary and Staples analysts highlight a few of their high conviction stock picks:

Coca-Cola (OW, $60 PT): KO is our top pick in US beverages as we see clearly superior topline growth vs. large cap CPG peers, driven by stronger pricing power, strategy changes, ramping innovation, and momentum in emerging markets, which we believe is not reflected in its current valuation. Catalysts include inflecting EPS growth in 2020 and improving FCF conversion.

Lowe's Companies (OW, $130 PT): The housing backdrop is improving and likely to be a tailwind in 2020 vs. a headwind in 2019, LOW is delivering healthier results and its transformation seems to be working, LOW appears to have greater relative momentum than HD into 2020, and the flight to quality among Retail looks set to continue. We see ~10% upside to our $130 price target and a positive risk/reward skew (+50%/-30% to our $180 bull/$85 bear cases), making LOW our top pick in Hardline/Broadline/Food Retail.

McDonald's Corporation (OW, $214 PT): We believe MCD's Experience of the Future and technology investments are creating competitive moats in its business globally, supporting EPS and FCF growth in FY21 and beyond. The stock is well positioned vs peers, in our view, on the back of digital and delivery sales growth, efficiency gains, recently completed refranchising that will likely lead to increased operating margin growth and MCD's defensive profile in periods of market turmoil.

Mondelez (OW, $60 PT): MDLZ is our top pick in US food as we view MDLZ's recent topline acceleration as sustainable, aided by successful strategic changes implemented by management, increased reinvestment, as well as a favorable geographic/category footprint. This should result in multiple expansion as the market shifts to revaluing MDLZ relative to a multinational CPG peer comparison set instead of the less appropriate (in our minds) lower growth US-centric food peers.

Nike Inc. (OW, $118 PT): We believe NKE is in the early innings of transition from a traditional wholesale business to a digitally-driven, direct-to-consumer ("DTC")

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brand. The business appears positioned to take share in the high-growth, global activewear market as well as increase profitability. This should make it one of the highest-growth consumer names, as well as one of the few within our coverage universe to potentially benefit from the shift to digital.

Penn National Gaming (OW, $27 PT): PENN is our top pick in US gaming as it is arguably best positioned to benefit from the recent legalization of US sports betting given its 4 top class online partners and 19 state property footprint. The stock has underperformed peers in '19 given leverage concerns, despite positive estimate revisions and stable regional gaming trends. We see 2% upside to 2020e consensus EBITDAR driven by organic growth and acquisition synergies, and a very attractive risk-reward with the stock trading at just 6.6x '20e EBITDAR / a 17% FCF yield.

Philip Morris (OW, $92 PT): Philip Morris (PM) is our top pick in Tobacco as we think it should generate peer-leading, HSD EPS growth driven by modest global cigarette volume declines, strong pricing due to a rational competitive and accelerating IQOS market share momentum.

Procter & Gamble (OW, $134 PT): PG is our top pick in US household products given its recent high-quality topline acceleration, with strong breadth of improvement across the portfolio, and US share gains despite greater pricing than peers. When combined with inflecting gross margins, which we expect to be above consensus based on our detailed GM build, we expect higher PG topline/EPS growth than peers, which should drive multiple expansion vs. in line relative valuation levels today.

US Equity Strategy - Underweight Consumer Discretionary & Overweight Consumer Staples

Michael Wilson, Chief US Equity Strategist and CIO of Morgan Stanley Institutional Securities

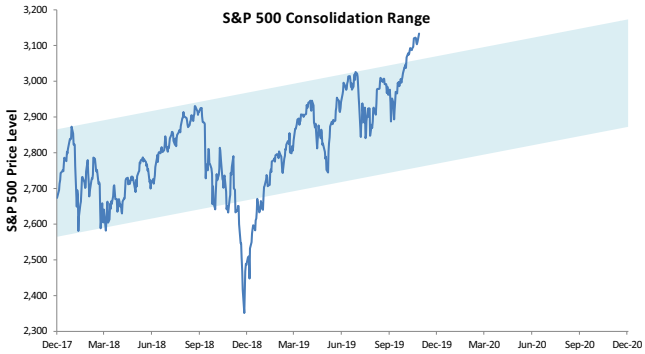
Part I: Market Outlook

Our 2020 Outlook in Brief: We see easing monetary policy and trade relief helping global growth to inflect higher, but in the US see only a stabilization at sub-2% GDP growth with continued risks to corporate margins as labor markets tighten further. Near term, central bank liquidity and positive seasonality could help the S&P 500 overshoot the upper end of our 2020 year-end bull case of 3,250, but by April, we believe the liquidity tailwind will fade and the market will focus more on fundamentals. Uncertainty means rotations should continue and their durability will depend on whether growth is accelerating or decelerating. We expect the market to vacillate between a pro-cyclical outcome and a defensive one as data comes in and trade tensions and the election evolve. We slightly favor the more defensive outcome given our well below consensus forecast for S&P 500 earnings growth next year (flat versus approximately 10% growth for the bottom up consensus). We remain overweight Consumer Staples, Utilities and Financials as the lowest risk means of participating in sporadic pro-cyclical upside.

A Return to Fundamentals

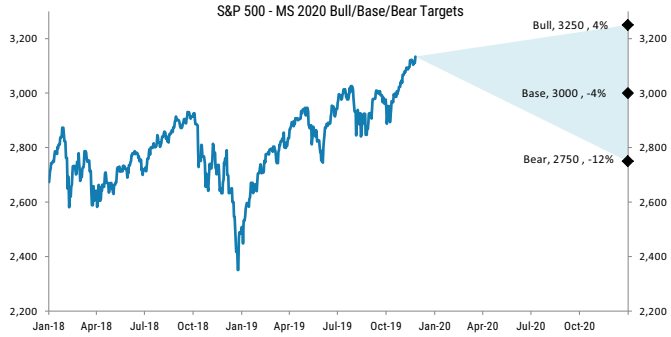
At the index level we see the S&P 500 continuing to move within an upward sloping channel (Exhibit 1) and would look to trade off the highs and lows of that range over the next year. With the S&P 500 currently above the upper end of the channel due primarily to excessive central bank balance sheet expansion, we think risk reward skews lower (Exhibit 2), and would prefer to be more opportunistic when adding risk. It appears to us that a modest rebound in economic data from monetary stimulus and a pause in trade tensions are priced in (Exhibit 3). However, we suspect the turn in PMIs and economic data will be more elusive in the US than in international markets, which saw data weaken before the US in the latest slowdown, are arguably more levered to a relief from trade pressures, and have more achievable earnings outlooks than the US.

Exhibit 1: S&P 500's upward sloping channel still applies



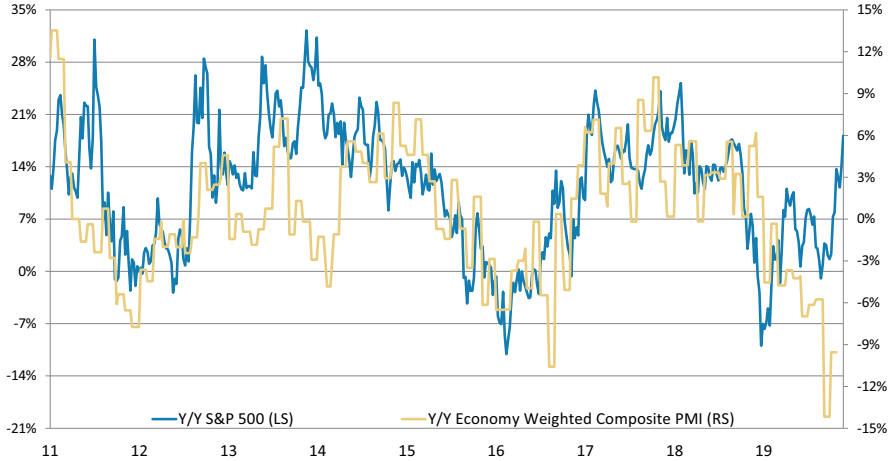
Source: FactSet, Morgan stanley Research.

Exhibit 2: Our S&P 500 Bull/Base/Bear Targets - Risk Reward Skews by year end 2020



Source: FactSet, Morgan Stanley Research estimates.

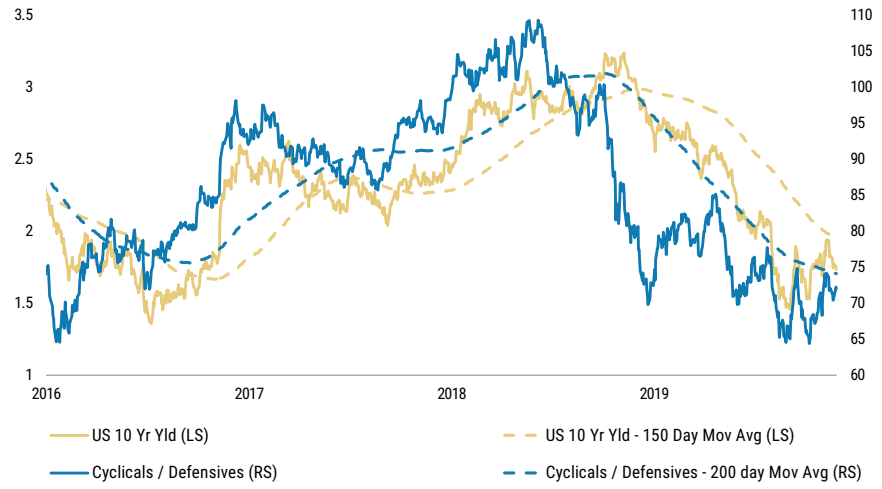
Exhibit 3: Equities Are Pricing In Strong Rebounds in PMIs



Source: Bloomberg, Morgan Stanley Research.

With a range-bound index, rotations will be more important, and we expect that 2020 brings one or more shifts. The muddle through environment of slow/slowing growth and supportive monetary policy is well understood and well advanced. The same is true of the leadership of the Defensive/Quality/Growth parts of the market. The older the cycle and the greater bifurcation in the markets, the harder it is for the same trends to continue indefinitely, but it is hard to say how and when the trend breaks. Periodic unwinds of this trend have all failed to gain traction over the last 18 months, but with each successive attempt, investors have been more focused on whether the change in leadership is sustainable. For example, both 10-year Treasury yields and the relative performance of Cyclicals versus Defensives look like they are making their strongest attempt yet to break out of the down trends that started in mid-2018 (Exhibit 4), yet each have failed to break through technical resistance at the 150- and 200-day moving average, respectively.

Exhibit 4: Cyclicals vs Defensives Trying to Break Higher, Again. Can It Succeed This Time?



Source: Bloomberg, Morgan Stanley Research. Note: The index above represents an equal notional pair trade of going long a group of higher beta cyclicals from the Discretionary, Energy, Industrials, Materials, and Technology sectors vs short a group of stocks from more defensive sectors – Health Care, Consumer Staples, Telco Services, an Utilities. The long and short sides are rebalanced to equal notional amounts at the start of each day.

We think the base case for most investors, and indeed for our own economics team, is something of a muddle-through on growth … In this scenario, global growth and US growth improve modestly, with international economies showing more acceleration than the US. Consensus earnings for the US prove to be modestly too high, but no more so than usual, meaning forward 12-month numbers continue to rise through the year, even as 2020 numbers modestly fall. Rates remain range-bound (i.e., supportive to valuations) and investors continue to favor Growth and Quality, though somewhat unenthusiastically as rich valuations in this part of the market limit material upside. The big decision that has plagued investors recently is whether to continue to favor defensives or skew more cyclically. We skew slightly more defensively in the near term given the recent rally in rate and cyclicals that appears to be running out of gas. We would look to revisit that should rates fall and defensives rally significantly.

… but weak growth year to date and low visibility around trade creates higher uncertainty over whether this cycle is due for a mini-reset or its final act. If the base case is a muddle-through, then either of these alternate scenarios creates rotational risk.

- **Rotation Scenario 1: Pro-Cyclical.** In this scenario, trade tensions reach a positive resolution with possible rollbacks, growth improves faster than our economics team and we expect, and rates begin to back up more sharply. A better growth environment favors the underperformers of the last 18 months and Cyclicals/Lower Quality/Value all begin to lead the market, while richly valued Defensives and Growth lag behind. This scenario, which would be closest to our bull case, still sees capped upside on the market as a whole as cost pressures rise in tandem with top line growth and higher rates offset lower equity risk premiums. The relative performance of Cyclicals over Growth continues to weaken the momentum factor, which negatively impacts many portfolios.

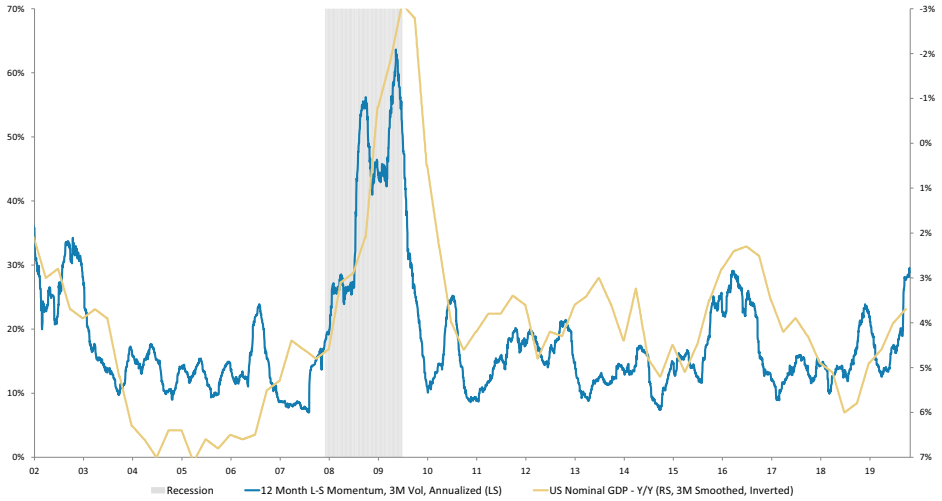
- **Rotation Scenario 2: Growth Scare.** Whether due to trade escalation or margin pressures, growth disappoints, earnings cuts come faster and deeper than the market expects, the labor market begins to feel more pressure, rates fall, businesses defer/cancel more spending, and recession fears reignite. The market heads lower at the index level, but led lower by the growthier parts of the market

not priced for any slowdown.

High Momentum Volatility Signals a Change in Growth

The increased volatility of the momentum factor is signalling that the market sees a change in leadership ahead and the muddle-through coming to an end in 2020, one way or another. Exhibit 5 shows the annualized volatility of momentum against the y/y change in nominal US GDP (inverted). Increasing volatility of momentum generally runs just ahead of inflecting (accelerating or decelerating) GDP growth, and has tended not to rise above current levels in the absence of a recession. This tells us the market is searching for new leadership as Defensive/Quality/Growth are expensive and no longer particularly attractive, while their counterparts offer better upside, so long as a recession is avoided.

Exhibit 5: Volatility of Momentum Tends to Lead GDP Growth



Source: Bloomberg, Morgan Stanley Research.

Recent volatility in momentum reflects the market beginning to discount better growth as trade tensions, monetary policy, and comparisons all begin to ease, but we lean more defensively in the near term as market optimism is running ahead of achievable earnings. Even if economic growth rebounds and continues at a modestly below-trend rate, we think rising costs and tight labor markets lead earnings growth to materially disappoint expectations over the next few months, creating elevated short-term downside risk. Accelerating wage and cost pressures are difficult to overcome, and this is very different than the last time we recovered from a growth / recession scare in 2016.

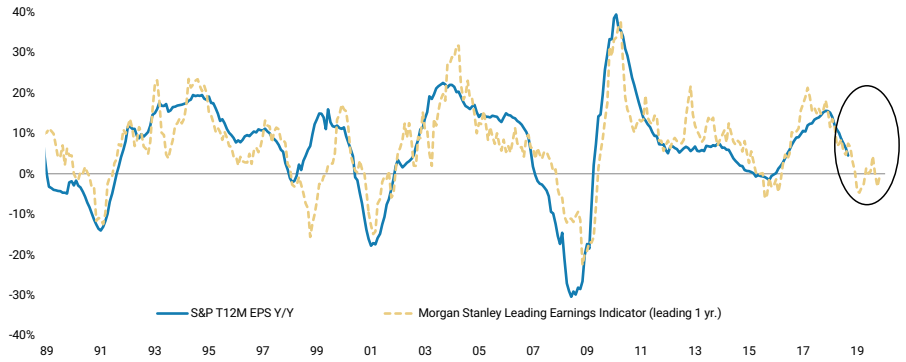
Whether the volatility of momentum comes from optimism or pessimism on growth, we think the long side of momentum continues to weaken, driven by *expensive* Growth underperforming. If economic growth picks up, recent Cyclical leadership can continue and if it slows further, then Defensives outperform other momentum longs.

Earnings Focus

Our cautious view on earnings is the primary limiting factor on upside for the overall market and one that creates near-term risk. Our proprietary Leading Earnings Indicators (a top-down model based on consumer confidence, manufacturing PMIs, housing starts,

USD, and credit spreads) called the lack of earnings growth in 2019 and continues to send a similar signal for 2020. As shown in Exhibit 6, our model projects S&P 500 earnings growth to be modestly down over the next 12 months. Given that the model uses currently available data, this projection is locked for the next 12 months, and we think it would require a material exogenous positive shock to change this trajectory.

Exhibit 6: Earnings Model Says S&P Earnings Growth Is Likely to Be Flat Over the Coming Year



Source: Bloomberg, Morgan Stanley Research. MSLEI is a macro factor based earnings model that leads actual earnings growth by one year. Note: S&P 500 fundamental data used post March 1993; Top 500 by market cap data used before 1993. LTM equity risk premium average is since 1920. ERP based on forward earnings yield and 10-year Treasury Yield. 2018 EPS growth adjusted to remove the effects of TCJA.

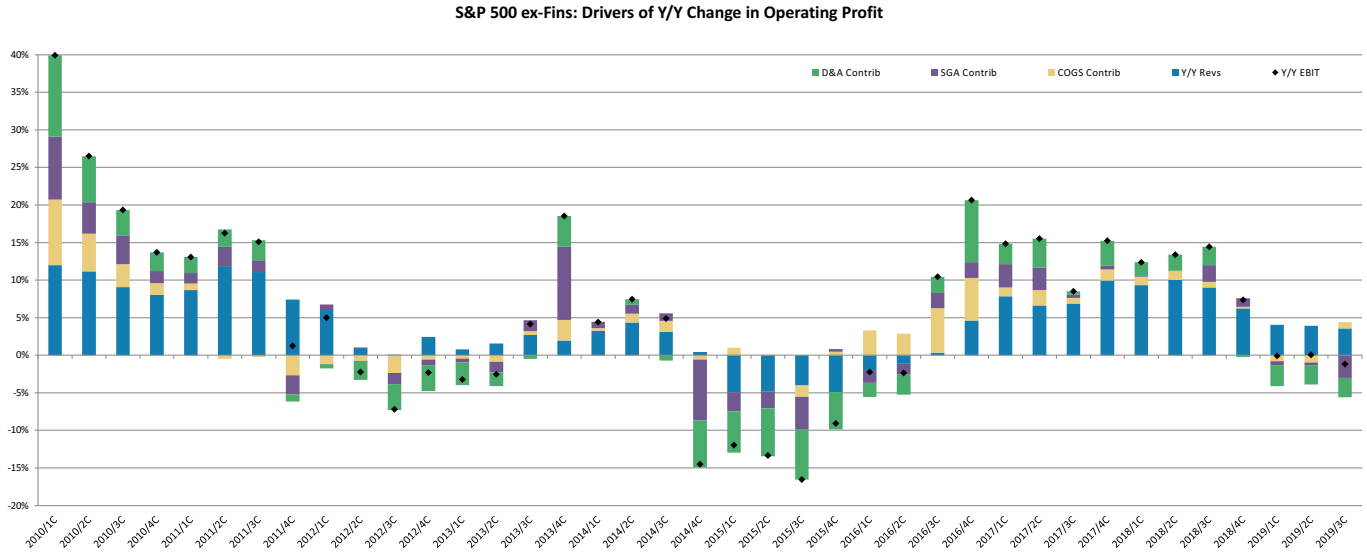
The drivers of flat earnings growth in 2019 tell us that a 2020 rebound in growth is unlikely. Exhibit 7 looks at the growth of EBIT for the S&P 500 ex-Financials each quarter and disaggregates the growth drivers into (a) sales, (b) COGS over Sales, (c) SG&A over Gross Income, and (d) D&A over EBITDA. Among the things that stand out to us are:

- **Sales growth is generally the principal driver of earnings growth.** Robust sales growth is a basis for earnings growth on its own, and when it allows companies to generate operating leverage on costs bases that are not growing as quickly, operating profit moves materially higher. Sales growth has been slowing for 6 quarters, and we see this as unlikely to improve much given the forecasts from our economics team for stable, but slow GDP growth.

- **COGS, SG&A, and D&A have all been growing sufficiently fast to offset the growth in sales this year, and this has been getting worse through the year.** The net effect has been flat to down operating profits. We generally are not too concerned about the D&A de-leverage, but the COGS and SG&A offset to EBIT growth is alarming as it indicates costs have been rising faster than revenues. Based on 3Q19 data to date, it seems the COGS pressure may be lightening, but the SG&A pressure is actually growing such that overall operating profit growth is deteriorating.

- **Operating Leverage issues are magnified when sales growth dips below 0%.** YTD sales growth has remained positive, even if it has been sequentially decelerating on tougher compares. Looking over prior periods, sales growth going below 0% has the affect of amplifying the operating leverage issues. To the extent sales growth continues to deteriorate, then we would expect companies will be more focused on controlling the SG&A de-leverage via cost cutting, a move that would bring us closer to our bear case.

Exhibit 7: COGS & SG&A De-Leveraging Has Offset Modest Revenue Growth This Year



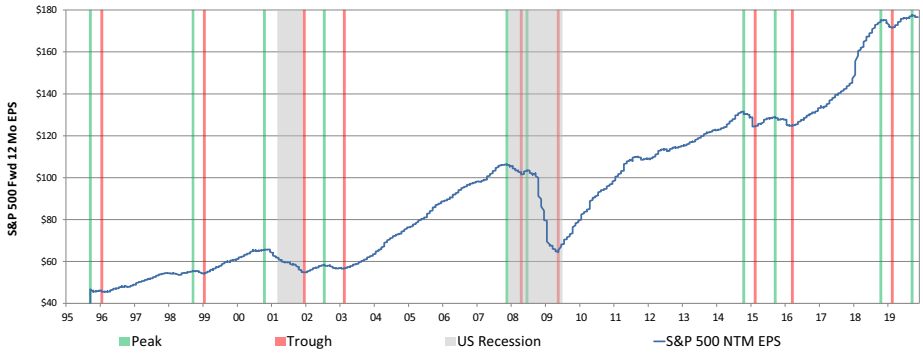
Source: FactSet, Morgan Stanley Research.

Given the trends above, the baseline forecast from our economics team of GDP growth stabilizing below trend while labor costs accelerate means we struggle to see material earnings upside as operating leverage pressures persist. Indeed, if late cycle wage pressures return as soon as 2H20, as our economics team is forecasting, companies may have no other choice left but to continue to cut costs and capex in the face of margins that have yet to recover.

Flat 2020 Earnings Means Forward 12-Month Numbers May Have Downside Risk

It is generally difficult for forward 12-month numbers to fall, but … We think the market focuses on next twelve months earnings, which have a natural upward bias over time as analysts tend to consistently embed about 10% growth in the following calendar year. That upward bias makes it hard for forward 12 month estimates to fall. For that to happen, (a) the first year numbers (2020 for our purposes) need to fall fast enough to offset the following year's (2021) 10% uplift or (b) the assumption of 10% growth in the following year needs to be challenged. Exhibit 8 shows periods of decline of more than 2% in forward 12-month estimates over at least a quarter — something that has happened fewer than 10 times in the last 25 years. On our forecasts, 2020 numbers need to come down by ~10%, which fully offsets the assumed 2021 growth. The question becomes one of timing — if the 2020 number decline is front loaded, similar to what we saw for 2019 numbers, then the cuts may be enough to pull forward estimates lower. If that happens, equities likely see some near term downside.

Exhibit 8: Forward 12 Month EPS Tends to Rise Over Time, But When It Moves Lower ...



Source: FactSet, ClariFi, Morgan Stanley Research.

... history is clear that the market moves lower when they do. Exhibit 9 isolates the periods shown above where forward 12-month earnings estimates actually fell and shows the return of the top 1500 stocks by market cap across US equities, from (a) the date of peak forward earnings to the date of trough forward earnings and (b) the max drawdowns (based on weekly ending values) from the date of peak forward earnings to the market low before the forward earnings trough. For full period peak-trough earnings dates, the returns are mixed, but the full period returns hide the fact that the market always sells off between the peak and trough dates (last column). It is also worth noting that the numbers shown below may understate the full drawdown amounts because the drawdowns often start before forward earnings estimates actually begin to fall and the returns data is based on weekly series, so may miss actual intra-week nadirs.

Exhibit 9: ... Equities Move Lower As Well

Falling S&P 500 12 Mo Fwd EPS				
Peak Fwd EPS Date	Trough Fwd EPS Date	Months	Mkt Rtn b/w Peak/Trough Fwd EPS	Max Mkt Drawdown From Peak Fwd EPS
9/29/1995	1/26/1996	4.0	6.2%	-0.9%
9/25/1998	1/8/1999	3.5	22.2%	-7.6%
10/27/2000	12/14/2001	13.8	-20.6%	-32.4%
7/19/2002	2/7/2003	6.8	-1.3%	-5.4%
11/16/2007	4/25/2008	5.4	-3.2%	-11.0%
6/27/2008	5/8/2009	10.5	-26.1%	-45.9%
10/3/2014	2/6/2015	4.2	5.5%	-4.0%
9/4/2015	3/4/2016	6.1	3.6%	-4.2%
10/26/2018	2/1/2019	3.3	2.9%	-9.0%
9/20/2019	??	--	--	--
Average		6.4	-1.2%	-13.4%

Source: FactSet, ClariFi, Morgan Stanley Research.

Falling Forward 12-Month Earnings - A Mild Correction or Something More?

Not all periods of falling forward earnings are created equal — the associated market drops vary in size and duration with a recession being the key differentiator. In the drawdown periods shown above, the two obvious outliers to the downside (2000/2001 and 2008/2009) line up with recessions, whereas other drawdowns are less steep and more fleeting in nature. In the absence of a recession, any associated pullback is likely to be a buying opportunity, so assessing the risk of recession is key.

Recession probability models are signalling lower risk … Our economics team is not forecasting a recession in their base case as their recession probability models have actually seen a decrease in the probability of recession in the next 12 months, primarily due to yield curves steepening. Given late cycle dynamics of a low unemployment rate and exogenous factors like trade, which are hard to analyze, their subjective probability of a recession in the next 12 months sits at roughly 25%. We explored recession probabilities with our economics team here — Recession Probability: Defining the Debate — and our work on indicators to watch for recession from our Recession Playbook produced a scorecard of metrics we suggested investors watch — Exhibit 10. While many of those indicators have deteriorated relative to a few months ago, few are outright signalling an imminent recession and some have shown modest sequential improvement in the last month.

Exhibit 10: Recession Indicators to Watch - No Imminent Signal

	Avg. Series Values Before/After Start of Prior 5* Recessions									Trailing 12 Months				
	T-12	T-6	T-3	T-1	T-0	T+1	T+3	T+6	T+12	T-12	T-6	T-3	T-1	Current
Aggregate														
Conf. Board Coincident Indicators Y/Y (%)	3.4%	2.3%	1.8%	1.5%	1.4%	0.9%	0.0%	-1.2%	-1.9%	2.2%	1.8%	1.7%	1.6%	1.4%
Conf. Board Leading Indicators Y/Y (%)	1.6%	-0.8%	-3.0%	-3.9%	-4.7%	-5.7%	-7.8%	-9.3%	-7.9%	5.3%	2.5%	1.6%	0.3%	0.3%
Business/Manufacturing														
Credit Spreads (Baa OAS, bps)	141.7	165.8	174.4	196.9	194.5	190.5	219.2	236.3	286.1	171.0	158.0	157.0	144.0	143.0
Durable Goods Orders ex-Transport. Y/Y (%)	8.8%	3.3%	1.7%	1.7%	3.2%	2.1%	-2.3%	-3.7%	-7.8%	5.2%	1.5%	0.3%	-0.2%	-0.2%
ISM Manufacturing	49.1	50.3	49.7	47.7	46.5	47.6	42.7	41.7	45.0	57.5	52.8	51.2	47.8	48.3
Consumer														
Avg. Hourly Earnings Growth (Prod, Non-Supervisory) - 1 Yr. Chg. (bps)	63	-10	-23	-10	-35	-30	5	-18	3	100	50	60	50	30
Consumer Confidence	106.5	102.0	101.8	94.6	95.7	90.6	76.7	66.7	72.9	136.4	131.3	134.2	126.1	125.5
Consumer Confidence Y/Y (%)	1.7%	-6.2%	-9.6%	-15.8%	-15.4%	-20.9%	-34.1%	-37.9%	-24.9%	6.1%	1.9%	-0.4%	-8.6%	-8.0%
Real PCE Y/Y (%)	4.2%	3.1%	2.6%	2.2%	2.1%	1.5%	0.9%	-0.1%	0.1%	3.1%	2.8%	2.6%	2.4%	2.6%
Employment														
Hours Worked, Y/Y (%)	3.5%	1.9%	1.3%	1.1%	0.6%	0.4%	-0.3%	-2.1%	-2.4%	2.0%	1.2%	0.7%	1.3%	1.1%
Init. Jobless Claims, 4W MA, Y/Y (%)	-0.6%	9.7%	15.9%	23.5%	18.9%	21.4%	25.3%	34.6%	21.0%	-8.6%	1.1%	-0.5%	-0.2%	0.1%
Jobs Plentiful - Hard to Get (Conf. Board, %)	5.9%	4.6%	4.1%	0.6%	0.6%	-2.0%	-8.1%	-20.1%	-28.9%	34.2%	33.5%	38.3%	36.1%	32.1%
NFP Payrolls, 3 MMA	90	175	93	89	74	23	-80	-216	-156	222	142	135	188	176
U-3 Unemployment 1 Yr. Chg. (bps)	-35	-20	13	5	40	48	73	130	155	-30	-30	-20	-20	-20
Yield Curve														
3M -10Y Yield Curve, bps	27.9	-37.1	-23.0	-17.5	19.3	58.9	147.7	196.9	196.6	64.3	-1.7	-41.8	13.3	19.4
NY Fed Prob of Recession	28.3%	44.5%	40.5%	44.1%	37.9%	30.9%	22.6%	4.2%	20.2%	14.1%	27.5%	31.5%	34.8%	29.0%

*For certain related employment data like Jobless Claims and the Unemployment Rate, we note trough levels in the "Peak" column and peak levels in the "Trough" column as low values are indicative of a stronger economy. This better lines up the stronger economic periods with the other data points in the table.

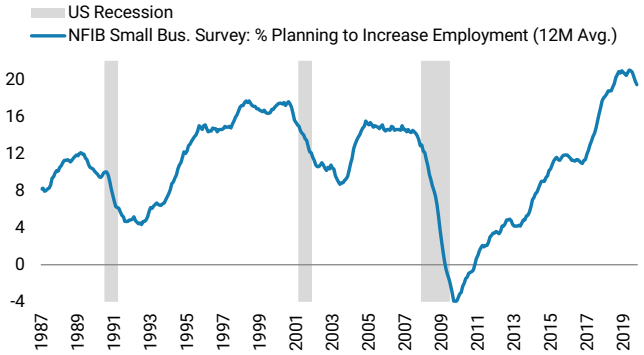
Source: Bloomberg, Morgan Stanley Research. Note: Due to distortions from base effects in the double dip recession of the 1980s, variables involving year on year changes omit data points around the second of the 80s recessions.

… but tight labor markets and trade remain key variables to watch. The pressures to profit growth noted for the S&P 500 above, are significantly larger for small and mid-size companies as S&P 400/600 companies have generally seen negative profit growth of 8-9% this year. We think these firms are more representative of the average business across the US economy than large caps, which is important as small and medium businesses employ the bulk of the US workforce. We expect these businesses to see continued cost pressure in an environment of slow top line growth and rising labor costs, which should evoke a response function from management and business owners to control costs. That response function has been evident year-to-date in slower discretionary spend, anemic business investment and capex, and the slowing of hours

worked. To the extent that top line growth slows further than expected and exacerbates operating leverage problems (whether due to trade escalation or otherwise) we see a risk of that response function spilling over to the jobs market, which is at the root of a recession.

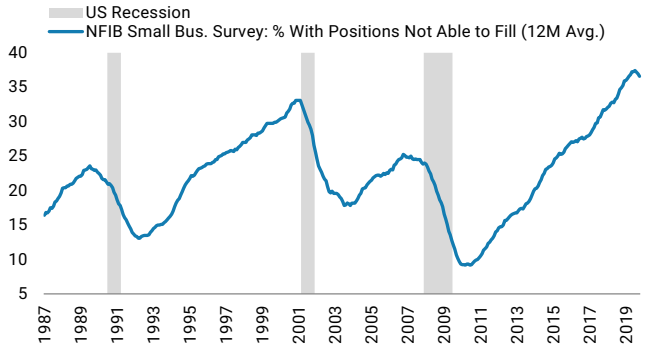
The NFIB small business survey suggests we may be at a critical inflection point. As noted above, the jobs market is the key variable that determines consumer behavior. Small/medium sized businesses are the heartbeat of the American economy and job creation. Exhibit 11 through Exhibit 14 show several key subcomponents of the National Federation of Independent Business survey related to the jobs markets. After 12 months of deteriorating profit growth, it appears that small/medium sized businesses are showing early warning signs of potential labor market weakness. It's notable that this is the first time we have seen such uniform deterioration across these metrics since the economic expansion began 10 years ago. Furthermore, given the extreme levels from which these measures are falling, it looks much different than the slowdown in 2015-16, and we think it's due to the much broader slowdown we are witnessing in profit growth/margins. When thinking about the outlook for the consumer, this may be a more important survey to watch than the PMIs.

Exhibit 11: We're Starting to See Deterioration in Hiring Plans



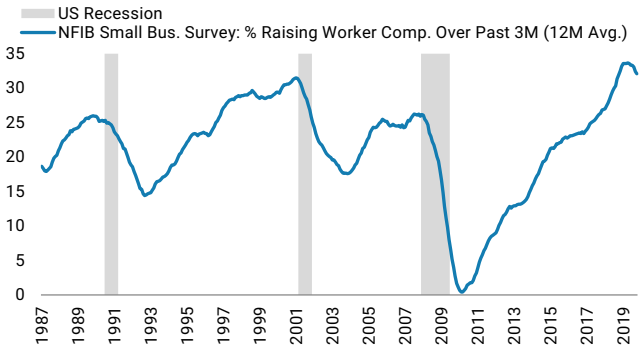
Source: Haver Analytics, Morgan Stanley Research.

Exhibit 12: Less Slack in Labor Hurting Margins



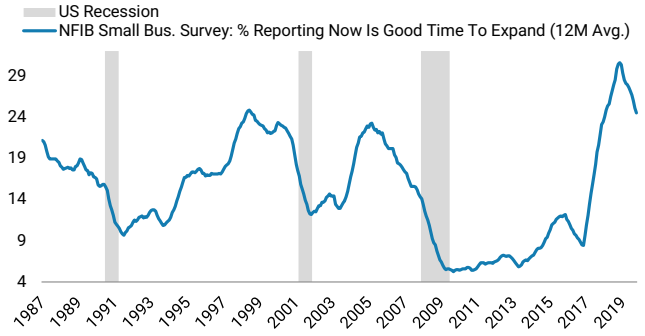
Source: Haver Analytics, Morgan Stanley Research.

Exhibit 13: Companies Are Less Willing to Pay Up for Labor...



Source: Haver Analytics, Morgan Stanley Research.

Exhibit 14: ....And Are Less Bullish on the Future



Source: Haver Analytics, Morgan Stanley Research.

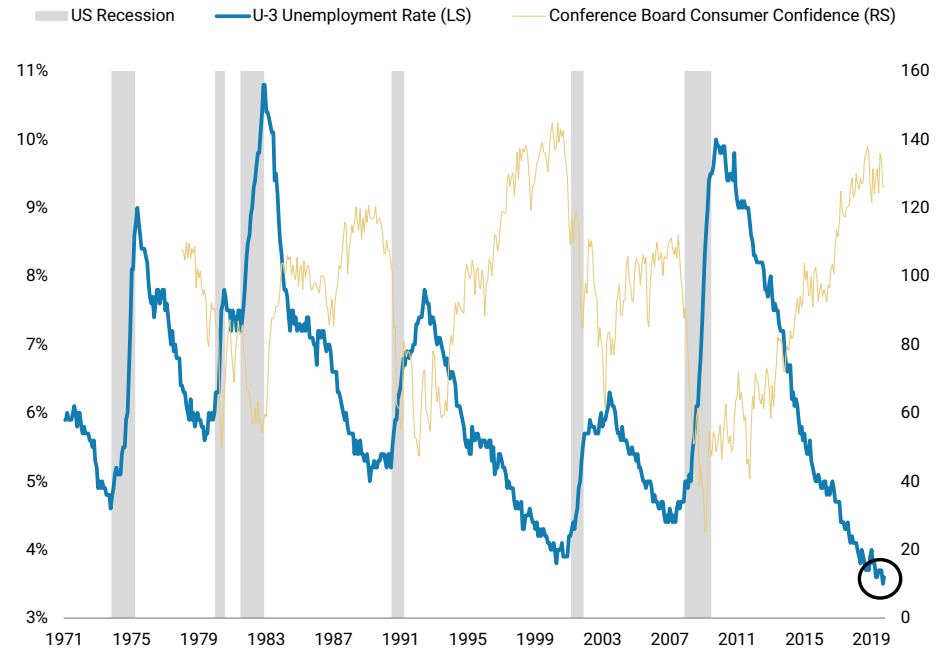
Part II: Consumer Views

A Top Down View on the Consumer

From a macro perspective, the US consumer remains healthy... Our US economics team sees real consumer spending growing in line with the average during this cycle—2.2%. They believe that the lift from lower rates was largely absorbed last year and that higher prices from tariffs may act as an offset in 2020 (see 2020 US Economic Outlook, November 17, 2019). As Exhibit 15 shows, the unemployment rate is exceptionally low. This tightness in the labor market has fostered wage gains late in the cycle. This has been a tailwind for consumers over the past several years. While this strength in wage growth has acted as a headwind for corporate profit margins, it hasn't been so constricting as to prompt an unemployment cycle. Exhibit 15 also illustrates that consumer confidence, which tends to respond to changes in the unemployment rate, is still near cycle highs. In fact, the only time the Conference Board Consumer Confidence survey was higher was just prior to the 2001 recession.

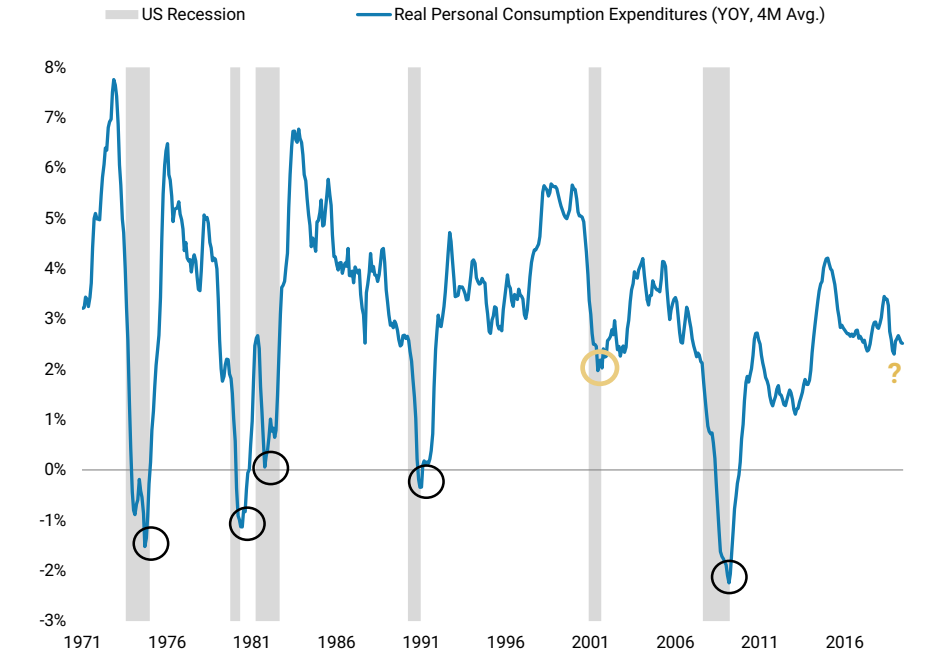
...but we are not looking for an upward inflection in consumer spending. While consumer confidence and the labor market appear very strong, consumer spending has been relatively modest this cycle. Exhibit 16 shows that real personal consumption growth is currently 2.5% and the average for this cycle is 2.2%, below the long term average of 3.0% back to 1971. Exhibit 17 helps to explain this dynamic—it shows that the personal savings rate is elevated this cycle compared to the prior cycle. In other words, consumers have been more conservative in their spending behavior post the financial crisis. Given our economists' view that consumer spending will remain subdued over the next 12 months, we struggle to see a late cycle consumer demand impulse manifesting itself. We think this will serve as an overhang for Discretionary stocks. Furthermore, our Specialty Apparel & Department Store analyst Kimberly Greenberger recently discussed risks to the 2019 softline retail holiday season (see 2019 Holiday Outlook: Fright Before Christmas, November 8, 2019). She is cautious for five key reasons: "1) The holiday calendar features six fewer shopping days between Thanksgiving and Christmas, 2) the 2-year stack compare appears the most difficult since 4Q13, 3) inventory will likely remain elevated at 3Q19's exit, 4) the weather outlook favors a late outerwear season, and 5) list 3 and 4 tariff exposure add incremental COGS pressure."

Exhibit 15: Consumer Remains Healthy for Now—Unemployment Rate Near Historical Lows and Consumer Confidence Near Historical Highs



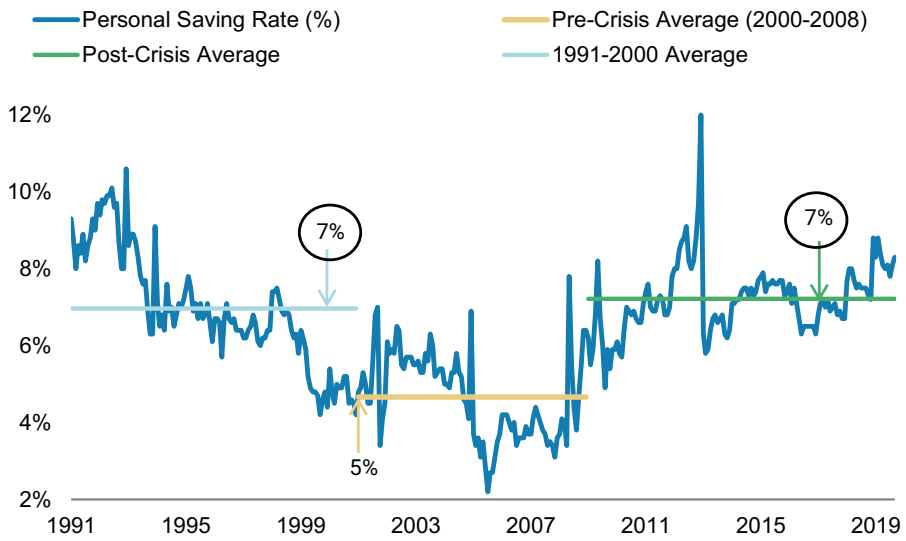
Source: Bloomberg, Morgan Stanley Research as of October 31, 2019.

Exhibit 16: Real Personal Consumption Growth Is Well Off Cycle Highs, but Remains Relatively Resilient in a Late Cycle Environment



Source: Haver Analytics, Morgan Stanley Research as of October 31, 2019.

Exhibit 17: Personal Savings Rate Is Elevated this Cycle Vs. Last Cycle—Another Sign of A Strong Consumer

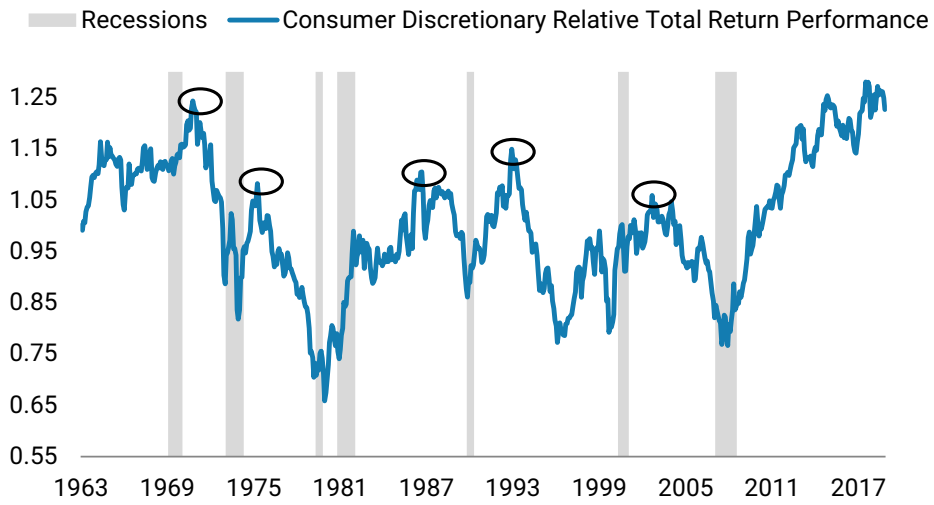


Source: Haver Analytics, Morgan Stanley Research as of October 31, 2019.

Consumer Discretionary - A Relative Underweight

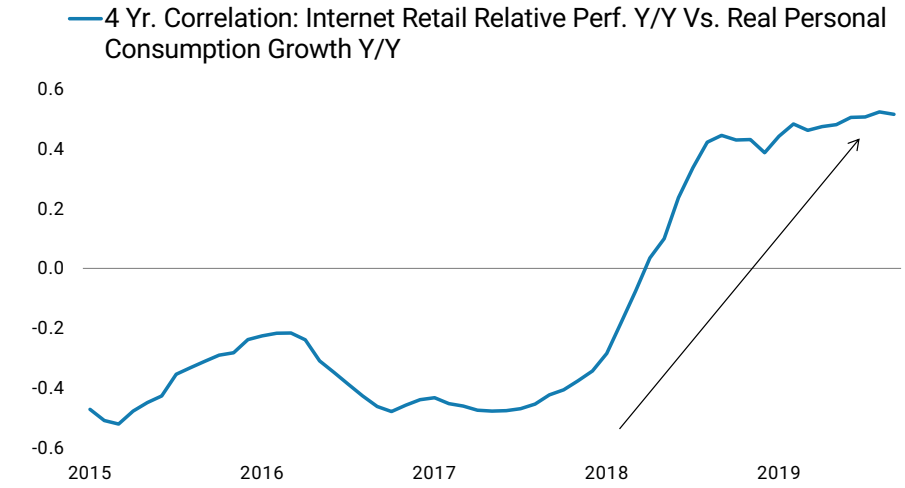
Consumer Discretionary is typically an early cycle outperformer and a late cycle underperformer (Exhibit 18)—a trend we expected to play out this cycle. Clearly this has not occurred, and we have been wrong to have been underweight this sector. What did we miss? For one, tax reform provided a boost to consumer spending and the bottom lines of consumer-oriented companies. Further, we underestimated investors' appetite to own expensive secular growth stories within the space despite their exposure to consumer cyclicality. Why are we sticking with our underweight on the sector? (1) The one-off shift higher in after-tax income as a result of tax reform is behind us; (2) we believe the secular growth mega cap stocks within Discretionary (particularly within Internet Retail) are more cyclically exposed than consensus appreciates. We go into more detail on this in Value Over Growth: A Recession Could Trigger A Secular Shift, but Exhibit 19 shows that the relative performance of Internet Retail is now exhibiting a fairly strong positive correlation versus real consumer spending. This is a relatively new phenomenon and indicates that this group is more exposed to the consumer backdrop than consensus appreciates, in our view. As we get later in the economic cycle and a recession approaches, we would expect prospects for a slowing consumer to weigh on the earnings revisions and multiple of this cohort. For reference, this group has outperformed the S&P 500 by more than 2200% since March of 2009 and is the best performing industry group by far over that period. In other words, we believe secular tailwinds have been priced, but cyclical headwinds as we head later into the cycle have not. This group makes up 34% of the broader S&P 500 Consumer Discretionary sector.

Exhibit 18: The Consumer Discretionary Sector Is Typically An Early Cycle Outperformer



Source: Morgan Stanley Research as of October 31, 2019.

Exhibit 19: Internet Retail (34% of Discretionary) Is Increasingly Tied to Consumer Spending

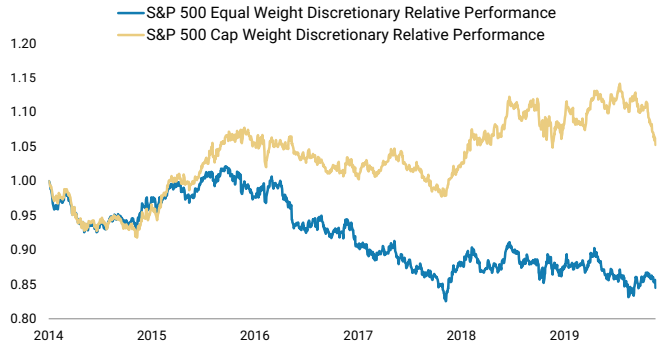


Source: FactSet, Haver Analytics, Morgan Stanley Research as of 3Q 2019.

Exhibit 20 and Exhibit 21 show that performance breadth within the Discretionary sector has been very narrow. Cap weighted relative performance has remained in a long term uptrend despite recent underperformance. Meanwhile, equal weighted relative performance has been in a downtrend since 2015. This dynamic is a reflection of the performance strength of a handful of mega cap secular growers within Internet Retail—as discussed above. Given the notion that the relative performance of Internet Retail is now increasingly tied to consumer spending, and our economists' view for subdued consumer spending over the next 12 months, we have a hard time seeing meaningful relative upside in this cohort from here—particularly given the outperformance that's already taken place this cycle. On a related note, there is a real bifurcation between valuation levels within the Discretionary sector. Retailing (driven by Internet Retail) is expensive on both a relative forward P/E and price/sales basis (top 20% of historical levels). The elevated valuation of Retailing has driven the aggregate sector's valuation to rich levels over this cycle as the other industry groups—Autos, Consumer Durables and Consumer Services—are all trading in the bottom 40% of historical levels on both

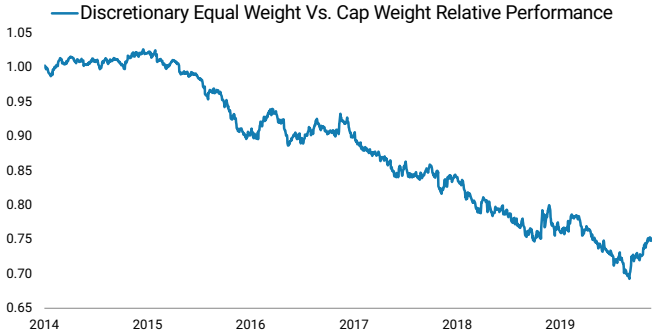
P/E and price/sales.

Exhibit 20: The Performance Divergence between Cap Weighted and Equal Weighted Returns Helps Explain Why Discretionary Has Outperformed Late in the Cycle



Source: Bloomberg, Morgan Stanley Research as of October 31, 2019.

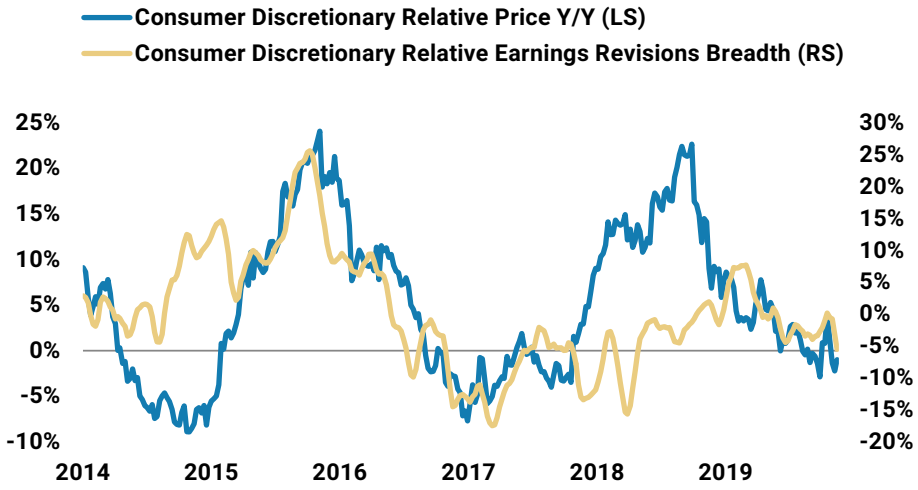
Exhibit 21: Relative Cap Weighted Vs. Equal Weighted Performance Shows a Similar Trend



Source: Bloomberg, Morgan Stanley Research as of October 31, 2019.

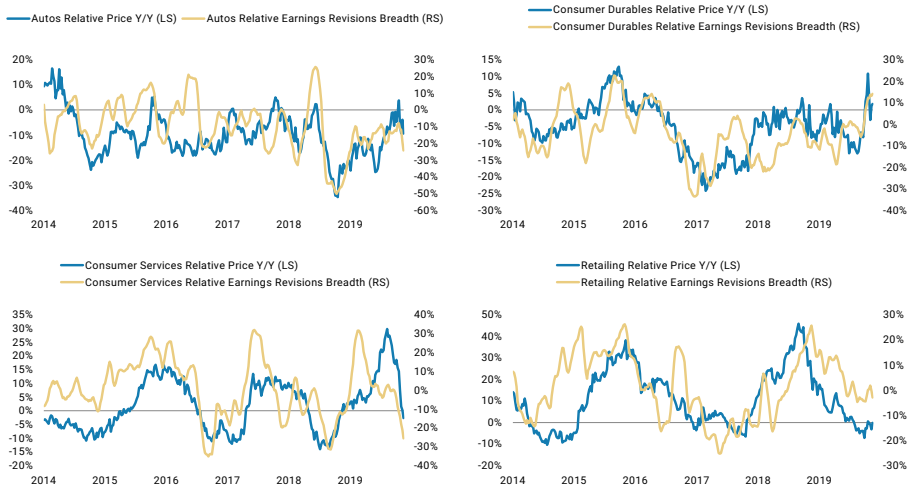
It's important to point out that **relative earnings revisions breadth for the Discretionary sector has been decelerating since February of 2019 and performance has trended lower as well** (Exhibit 22). With the exception of Consumer Durables, all industry groups have seen revisions decelerate recently (Exhibit 23). Relative performance for all of these groups has trended lower as well. We expect this to continue over the intermediate term at the sector level as cyclical pressures continue to build in a late cycle environment.

Exhibit 22: Relative Earnings Revisions Are Continuing to Decelerate...Performance Has Followed...



Source: FactSet, Morgan Stanley Research as of October 31, 2019.

Exhibit 23: ...This Trend Has Really Been Driven by Every Sub Industry; Recent Downside in Consumer Services Revisions Looks Particularly Extreme



Source: FactSet, Morgan Stanley Research as of October 31, 2019.

Consumer Staples - A Relative Overweight

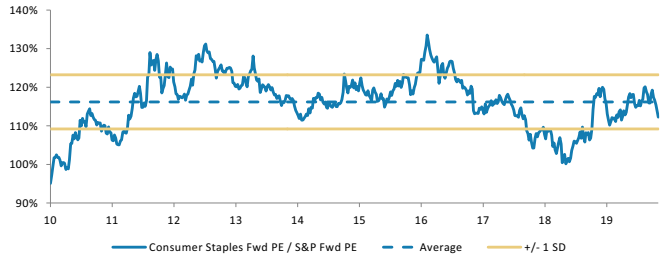
Our overweight in Consumer Staples has been based on the group's more defensive properties in a slowing growth environment as well as the group's ability to take price while lapping particularly acute cost headwinds. However, the relative valuations are now stretched, limiting upside to earnings growth and creating relative downside risk in any kind of recovery scenario more robust than our base case. **We remain overweight for now due to their defensive properties as catalysts around trade and falling 2020 earnings estimates raise near term market risks, but on the back of a market earnings reset or a more obvious pickup in global growth we may need to revisit this view.**

We have some concerns about growth... Our Staples analyst Dara Mohsenian has noted a number of reasons for concern on the horizon, including: (1) decelerating pricing as companies cycle price increases put into place to offset higher commodity costs, and given commodities are now down y/y, (2) more difficult comparisons over the next year, (3) decelerating y/y gross margin expansion as pricing dissipates vs. what will likely be a peak level of expansion in Q2, (4) inconsistent company commentary and results from companies around organic sales growth in emerging markets, and (5) high valuations.

... and valuations are elevated ... For the group as a whole, Staples valuations relative to the market look to be in line with the post-crisis average (Exhibit 24). However, at the industry group level, the story is different with Food/Beverage/Tobacco trading at near its low relative multiple and Household Products and Food/Stapes Retailing near their highs (Exhibit 25).

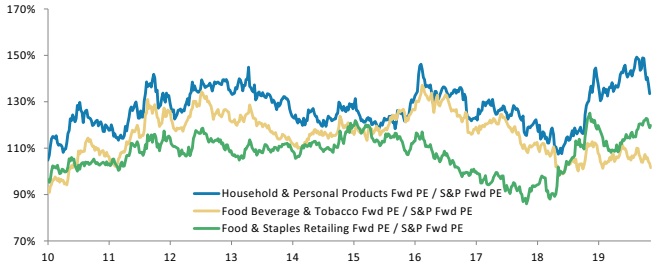
... but we like the defensiveness of Staples in a generally weaker earnings environment. Our Defensive Scorecard ranked industries and sub-industries on a variety of defensive metrics and highlighted 4 / 6 industries within Staples as among the 10 most defensive industries in the market (Exhibit 26). Staples industries performed particularly well on metrics related to relative performance around periods with weaker equity markets and higher volatility. With the broader market near the top of our range and elevated risks in the near term, we are retaining the overweight in staples for these properties.

Exhibit 24: Staples Valuations Look In Line With Post-Crisis Average ...



Source: FactSet, Morgan Stanley Research.

Exhibit 25: ... But Industry Groups Show Wide Divergences



Source: FactSet, Morgan Stanley Research.

Exhibit 26: Staples Subgroups Screen Well As Defensive Equities

Rank	Industry / Sub-Industry	Sector	Defensive Metrics Avg. Rank
1	Food Products	Consumer Staples	11.9 / 86
2	Health Care REITs	Real Estate	12.1 / 86
3	Beverages	Consumer Staples	12.7 / 86
4	Electric Utilities	Utilities	13.1 / 86
5	Household Products	Consumer Staples	15.6 / 86
6	Food & Staples Retailing	Consumer Staples	17.5 / 86
7	Gas Utilities	Utilities	19.2 / 86
8	Diversified Telecom Services	Communication Services	20.9 / 86
9	Pharmaceuticals	Health Care	21.5 / 86
10	Aerospace & Defense	Industrials	24.2 / 86

Source: Morgan Stanley Research.
Numbers above indicate average rank among 86 industries across a range of metrics to measure defensive attributes.

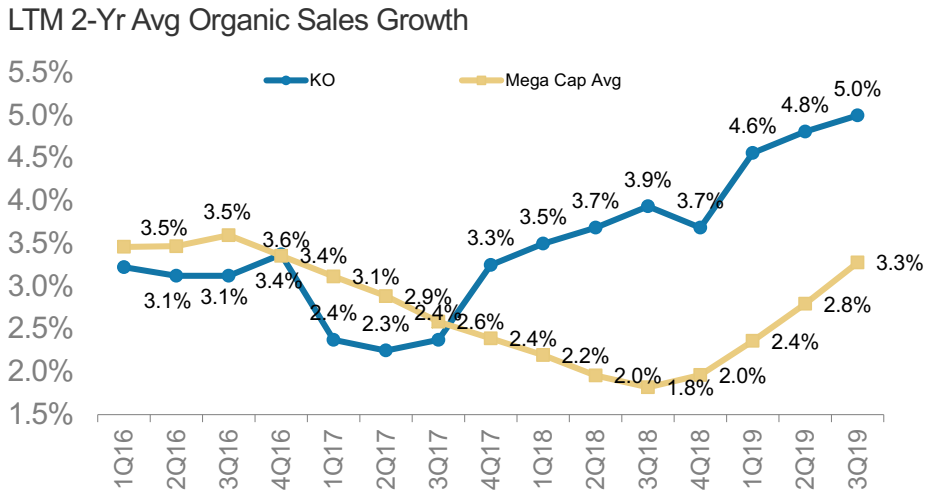
Coca-Cola (KO): OW, PT $60

Dara Mohsenian, Household Products, Beverages, & Food

Industry View: We view beverages as attractive, mainly given we believe the beverage industry has the strongest long-term pricing power within CPG at the company, retailer, and consumer level. There are three key factors that contribute to stronger pricing power, including: (i) greater channel diversity that limits retailer balance of power and provides protection from retailer pricing pushback, (ii) lower private label penetration (and PL market share momentum) that limits consumer trade-down risk from pricing as well as limits consumer demand elasticity, (iii) higher company market share concentration that limits competitive intensity (the top two companies in beverages maintain a combined share of ~40%).

Investment Thesis: Our top pick in US beverages is Coca-Cola (KO) as we forecast clearly superior MSD% topline growth outlook vs. large cap CPG peers in the ~3-4%, driven by stronger pricing power and favorable strategy changes, as well as momentum in emerging markets, which we believe is not reflected in relative valuation close to peers. We also believe a forecast 2020 EPS growth inflection back to HSD% growth after six years of flat EPS, and a 2020 FCF conversion inflection from ~70% recently to ~80-90% could act as potential positive catalysts. Coke offers clearly superior LT topline growth vs. peers in our minds, at a 5% LTM 2-yr organic sales growth avg vs. 3.3% at peers, with eight straight quarters of stronger KO growth.

Exhibit 27: KO Offers Superior Organic Sales Growth Relative to Mega-Cap Peers

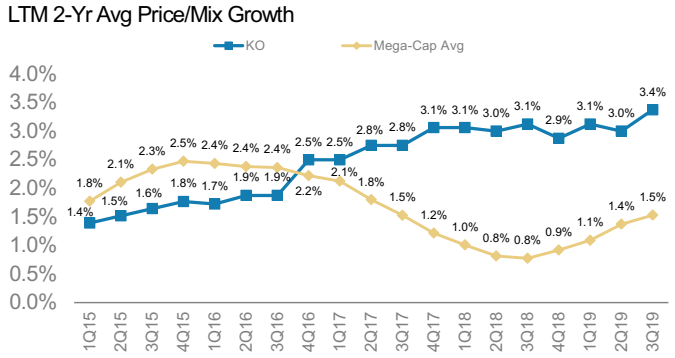


Source: Company data, Morgan Stanley Research

We view KO's return to MSD organic sales growth as sustainable, with KO reporting a sequential improvement in 2-yr avg LTM org sales in seven of the last eight quarters to the +5.0% level in 3Q19. On top of strategy changes, the other key driver of KO's organic topline growth has been stronger price/mix realization at KO vs. CPG peers. Greater pricing has occurred particularly in volume challenged developed markets with KO's strategic changes to drive sales growth rather than volume growth, and through

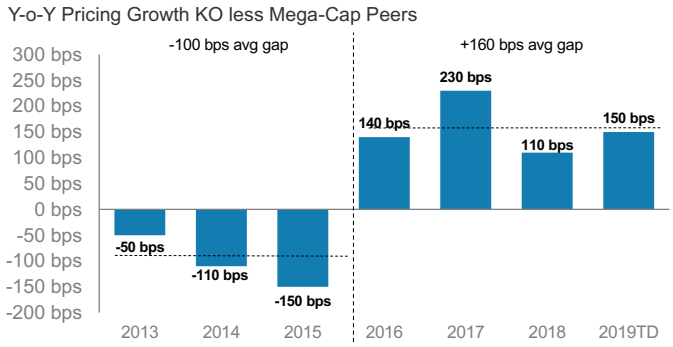
mix (with a focus on higher-priced smaller packages, such as mini-cans). KO has sustained higher price/mix growth than mega-cap peers since 4Q16 with Coke 2-yr avg LTM pricing of +3.4% in 3Q19, well above mega-cap peers at +1.5% 2-year avg LTM pricing. **Importantly, we expect KO's y-o-y price/mix growth gap to widen, particularly vs. HPC peers**, as we see pricing power as more sustainable in beverages vs. household products.

Exhibit 28: We See Greater Price/Mix Growth at KO Post Its Strategic Changes



Source: Company data, Morgan Stanley Research

Exhibit 29: Positive Pricing Gap Between Mega-Cap Peers Have Continued

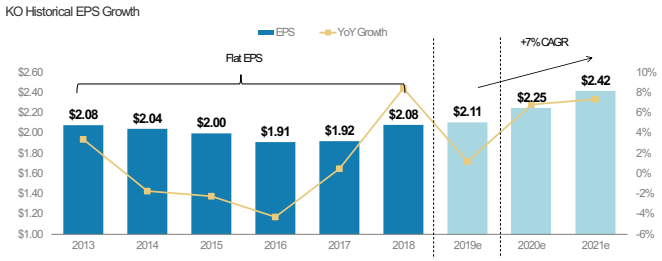


Source: Company data, Morgan Stanley Research

In 2020, we see a clear EPS growth inflection, after six consecutive years of flat EPS, which should act as a catalyst for Coke. Given continued solid underlying topline/profit trends, even with an unfavorable FX impact in FY20 (which KO guided to a -2% to -3% profit headwind with Q3 EPS), we expect a ~6-7% EPS growth range for FY20. Long term, we believe a return to EPS growth will attract new investors in KO's stock, particularly after six years of flat historical EPS growth (including the midpoint of FY19 guidance, which is flat), as we believe some investors want to see KO guide to actual EPS growth before getting involved.

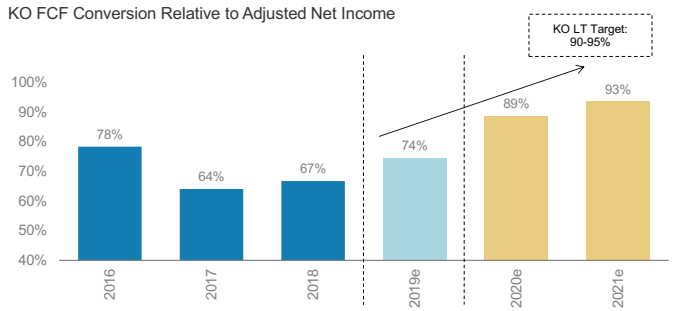
We also believe KO's FCF conversion will improve steadily beginning in 2020 and over the next few years, with our view strengthened by solid Q3 and YTD FCF results, as well as raised FY19 FCF guidance. We forecast KO's FCF conversion to improve from ~67% in 2018 to ~93% in 2021e (at the midpoint of KO's 90-95% LT guidance), driven by the following factors: an improvement in working capital, moderation of cash restructuring costs, lower base business cap-ex post 2019, and potential monetization of KO's equity stakes to drive cash flow.

Exhibit 30: We Forecast an EPS Growth Inflection at KO to +HSD% Post 2019



Source: Company data, Morgan Stanley Research estimates

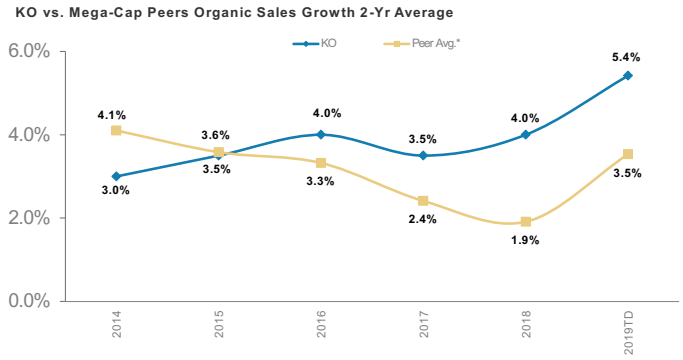
Exhibit 31: We Forecast KO's FCF Conversion to Improve Post 2019 Back to the 90-95% Range



Source: Company data, Morgan Stanley Research estimates

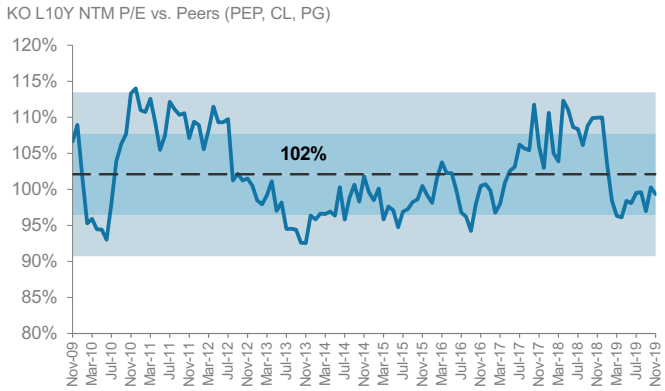
Compelling Valuation: We believe KO's valuation is too low and does not reflect a clearly improved fundamental outlook, as 2-year average organic sales growth is clearly outpacing mega-cap peers. KO continues to trade slightly below its L10Y average relative P/E premium despite the 2-year average organic sales gap between KO and mega-cap peers increasing from +70 bps in 2016 to +190 bps in 2019TD.

Exhibit 32: KO Has Outgrown Mega-Cap Peers on a 2-Yr Avg Basis



Source: Company data, Morgan Stanley Research

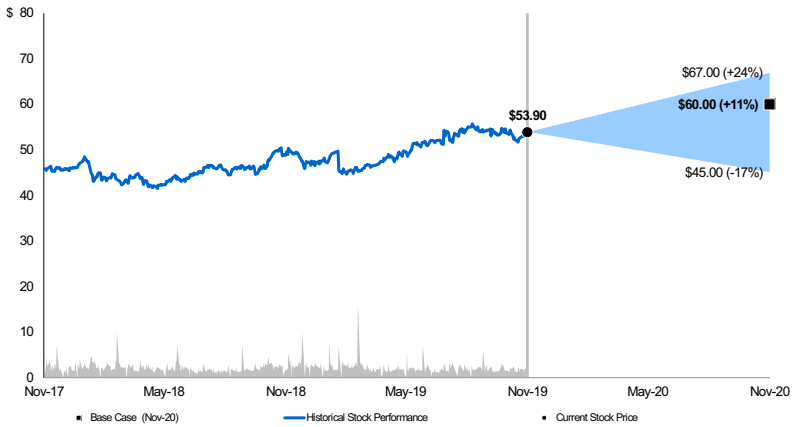
Exhibit 33: KO Trades Slightly Below its L10Y Average Premium



Source: Refinitiv, Morgan Stanley Research

Risk Reward: Coca-Cola (KO)

Coca-Cola (KO.N): Superior Growth vs Peers Not Reflected in Valuation



Source: Thomson Reuters (historical share price data), Morgan Stanley Research estimates

Price Target **$60**

Derived from base case scenario

Bull **$67**

28.5x Bull Case 2020e EPS

+6.5% Organic Sales Growth (Slightly Above KO's +4-6% LT Target): Share gains in non-carbonates drive 100 bps of volume upside, KO realizes $150M of productivity upside (1/2 reinvested), and posts 50 bps of pricing upside, driving +LDD% EPS growth and multiple expansion to 28.5x our bull case 2020e EPS.

Base **$60**

26.5x Base Case 2020e EPS

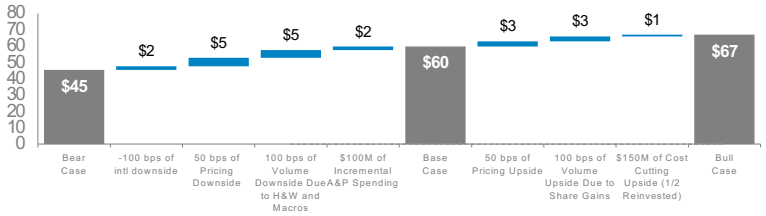
KO Delivers +5% Topline Growth: We forecast +5% organic topline growth and HSD% EPS growth in FY20 and beyond. We apply a 26.5x P/E multiple to our base case 2020e EPS, above CPG peers, driven by strong pricing power and KO's transformation to a higher growth/ROIC concentrate model with bottling divestitures and positive changes under Coke's new CEO.

Bear **$45**

21.5x Bear Case 2020e EPS

Topline slowdown: Weak macros and health and wellness pressure drive 100 bps of volume downside, while competitive pressure drives 50 bps of pricing downside, with +3.5% KO organic sales growth below its +4-6% LT target, and $100M in incremental marketing, driving +MSD% EPS growth and compressing valuation to 21.5x 2020e EPS.

Exhibit 34: Bear to Bull: Topline Upside/Downside Is the Key Driver of KO's Multiple



Source: Morgan Stanley Research estimates

Why Overweight?

- **Stronger Pricing Power Than Peers:** Coke's pricing power has increased over the last few years as it has shifted to a price/mix focus in slower growth developed markets (Coke's last three year price/mix growth of +2.9% is ahead of peers at +1.3%, a reversal from an unfavorable -120 bps gap in 2011-15). We believe KO's greater pricing power is sustainable with Coke's focus on mix through price pack architecture, as well as more favorable structural drivers of pricing in the beverage sector.
- **Favorable Strategy Tweaks Including a Total Beverage Strategy:** We believe there are numerous favorable strategy tweaks under Coke's relatively new CEO, including a cultural shift to become a more nimble company with a total beverage focus that should allow Coke to penetrate to a greater extent higher growth non-carbonated soft drink (CSD) subcategories.
- **Solid Volume Growth Outlook:** Despite greater pricing at KO, with relatively low demand elasticity to price increases, KO volume growth of +1.0% in the last two years has been in line with mega-cap peers at +0.9%. We believe KO's volume growth outlook will improve going forward with KO's efforts to diversify its portfolio towards higher growth non-CSD beverages.
- **Valuation Still Compelling:** Coke trades at a +2% P/E premium to mega-cap peers (PEP/PG/CL), close to its historical +2% premium, which seems clearly too low given high visibility of greater organic sales and EPS growth potential at KO, as well as higher returns.

Risks to Achieving Price Target

- **Downside risks include:** Unfavorable FX movements, tariffs, emerging markets macro volatility, health & wellness pressures, lower than expected productivity, and soda taxes.

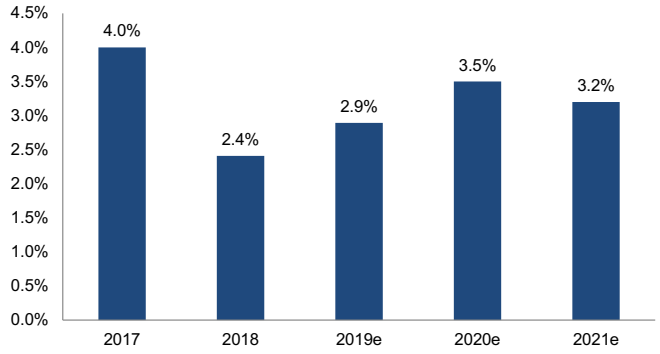
Lowe's Companies (LOW): OW, PT $130

Simeon Gutman, Hardline/Broadline/Food Retail

Industry View: Tailwinds from recent positive inflections in housing data (particularly existing home sales) and declining mortgage rates keep us constructive on the outlook for Home Improvement in 2020. Our Home Improvement Leading Indicator (HILI) is supportive of 3-4% growth in home improvement retail sales (HIRS) in 2020, suggesting a similar level of comp growth is achievable for our big box Home Improvement retailers (LOW and HD). The HILI model uses historical data for home improvement retail sales, existing home sales, median home prices, the ISM survey, and 30-year mortgage rates as inputs to project future home improvement sales (~78% correlated). HILI points to HIRS acceleration to ~3.5% by March 2020; we believe this rate of growth could persist through 2020 as we expect key housing metrics (existing home sales and home price appreciation) to continue improving over the next six months.

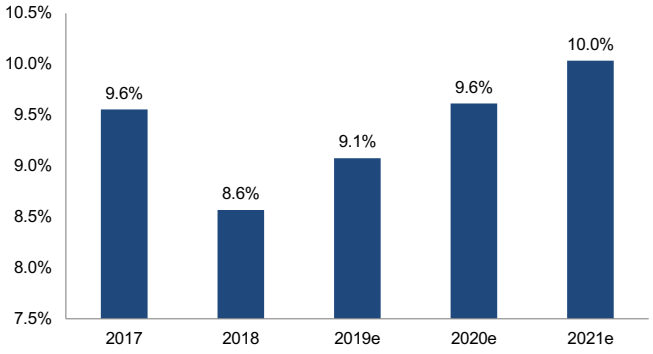
Investment Thesis: Favorable stock setup for LOW into 2020. LOW represents one of the largest margin upside opportunities in Retail. We believe a 12% EBIT margin is possible in the medium- to long-term (up from 9% today), with margin expansion unlocked by comp growth/higher sales productivity and expense leverage, alongside flattish gross margin over time; we discuss the key components of LOW's strategic plan below. The transformation appears to be working and LOW is delivering healthy results both in absolute terms and relative to most retailers. Importantly, the business is showing progress in line with its guidance/strategic plan, despite having to navigate a tougher home improvement macro backdrop than most expected coming into 2019 and softer than expected Q1'19 results. In addition, LOW is likely to benefit from improving housing trends in 2020 (as discussed above) and we think relative momentum favors LOW over HD in the short term due to significant investments HD is making that are placing pressure on its P&L (we forecast ~55 bps EBIT margin expansion for LOW in 2020 vs. flat for HD). Overall, we are Overweight LOW as risk/reward remains positive (+50%/-30% to our $180 bull/$85 bear cases), improving macro trends could yield upside to our forecasts, and the market still appears to be paying for quality in Retail.

Exhibit 35: LOW's comp trajectory (MSe)



Source: Company data, Morgan Stanley Research

Exhibit 36: LOW's EBIT margin trajectory (MSe)



Source: Company data, Morgan Stanley Research

LOW's ongoing transformation rests on four pillars: Merchandising Excellence, Omni-

channel, Operational Efficiency, and Customer Engagement. Within these, we highlight four specific areas of focus which could lead to meaningfully higher sales growth and margins over time (assuming solid execution).

1. **Increase Pro wallet share.** LOW has just ~4% wallet share of the ~$450b Pro market vs. ~15% for HD. Strategies to better engage the Pro customer revolve around i) offering competitive prices, ii) stocking Pro relevant brands in job lot quantities, iii) delivering consistent service levels, iv) providing a differentiated experience, and v) developing strong Pro relationships. Given Pros spend 5x more than DIY customers on average, improving productivity in this key channel likely represents LOW's best opportunity to reach its longer-term $370 sales per sq ft. target (from ~$335 today).

2. **Fix the supply chain.** LOW is taking steps to address several issues in its supply chain which could resolve longstanding in-stock problems, reduce payroll expenses and unlock significant working capital benefits. As it stands today, LOW has limited visibility into inventory as it moves through the supply chain and stores often don't know when trucks will be arriving or what inventory they will be carrying, meaning stores are frequently under/overstocked in certain items. Anecdotally, certain stores were comping 2%+ despite having over 1,000 out-of-stocks vs. 200-250 in HD stores in the same area, highlighting the potential for improvement from better inventory management. In addition, LOW's traditional hub-and-spoke logistics model has not been optimized for omni-channel; consider ~90% of floor space in store back rooms is dedicated to appliances (tying up labor and working capital) despite the fact ~80% of appliance purchases are delivered and thus could come from a local DC. To fix these issues LOW is investing ~$1.7b in optimizing its supply chain over five years, including the addition of 20+ bulk distribution centers, two direct fulfillment centers, and over 90 cross-dock delivery terminals which will touch 95%+ of deliveries.

3. **Drive labor productivity.** LOW has outlined a plan aimed at delivering higher comps and cost efficiencies by simplifying store operations, streamlining labor/payroll, and updating store systems. In the past, store managers were overwhelmed by the high volume of raw data flowing to their stores and priorities were frequently unclear; going forward, LOW has cut 95% of (unnecessary) communications and is establishing critical weekly priorities, equipping managers to run their stores more effectively. Further, labor planning has traditionally been a heavily manual process (consuming over one million labor hours per year) and scheduling was done 13 weeks in advance with little regard for allocating Associates to peak traffic times/departments. This is changing, and scheduling will be largely automated and aligned with customer demand patterns in the future. LOW is also improving its store IT capabilities so Associates are no longer hampered by outdated and non-intuitive point of sale systems and inefficient technology. For example, Associates will be provided with handheld label printers for pricing merchandise vs. having to walk from each aisle to one of two printers in stores today. As a result of all its labor productivity initiatives, LOW intends to transition from a 40%/60% service/tasking labor split to 60%/40% by 2021. In addition to the potential cost savings stemming from this shift (not quantified), we believe LOW's greater emphasis on customer service is likely to drive stronger engagement and increase conversion.

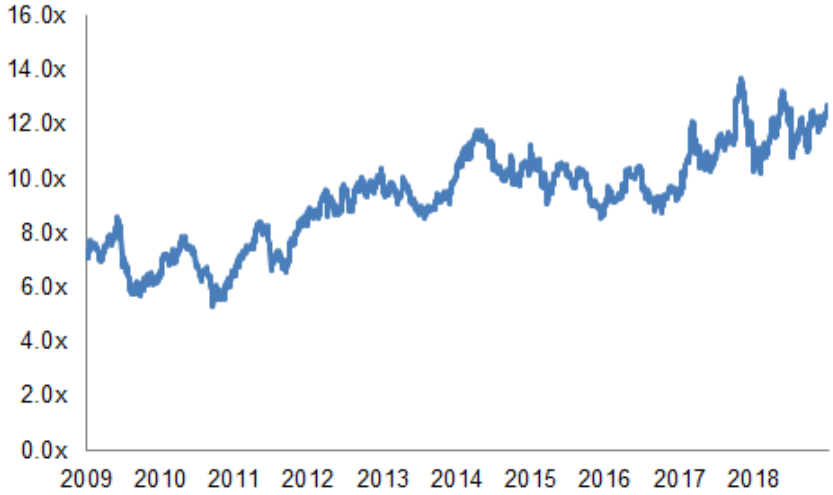
4. **Improve IT capabilities.** LOW's technology is primitive, with many of its key systems

dating back to the 1990s/2000s. In an extreme example, as recently as 2018 store Associates used dry erase boards to help customers plan projects and customers received physical binders rather than online project summaries. Given LOW's history of buying and attempting to customize packaged software (rather than developing bespoke software internally), its systems are not tailored to effectively meet the evolving needs of the business. It is telling that of the ten initiatives LOW laid out at its 2018 Investor Day 's meeting, six list better IT capabilities as a critical dependency. To correct this, LOW is investing ~$1.5b in technology through 2021, including hiring approximately 2,000 IT engineers. Ultimately, 80% of its software/systems development will be handled internally to maximize LOW's IT flexibility.

Shareholder friendly capital allocation policies also provide upside. We model ~$20b of capital return to shareholders through 2021 (~$5b via dividends and ~$15b via share repurchases). This level of buyback is a step up from historical trends but consistent with LOW's guidance, and represents ~17% of the company's current ~$90b market cap. Overall, we see buybacks contributing to an extra ~500 bps of earnings growth per year through 2021 (we model ~13.5% EPS growth on average vs. ~8.5% annual EBIT growth over the same period).

The greatest risk to the story is execution. Progress is unlikely to be linear, as LOW is pursuing many things at once and Retail turnarounds/transformations rarely proceed as smoothly as planned. We glimpsed this in Q1'19 when LOW reported much weaker than expected gross margin and reduced 2019 guidance as a result (the stock has since recovered its losses as the issues appear to have been largely transitory). Still, we think LOW is attractively valued at ~12.5x 2020e EV/EBITDA and see ~10% upside to our $130 price target as well as a positive risk/reward skew (+50%/-30% to our $180 bull/$85 bear cases). In our view, as LOW seems to have greater relative momentum heading into 2020 than HD (its biggest competitor and a steadier retailer), LOW's ~1.5x multiple discount to HD accounts for its higher execution risk.

Exhibit 37: LOW trades at ~12.5x NTM EV/EBITDA, 1x below its 2018 high but ~3x above its LT average (reflecting progress in its transformation)



Source: Refinitiv, Morgan Stanley Research

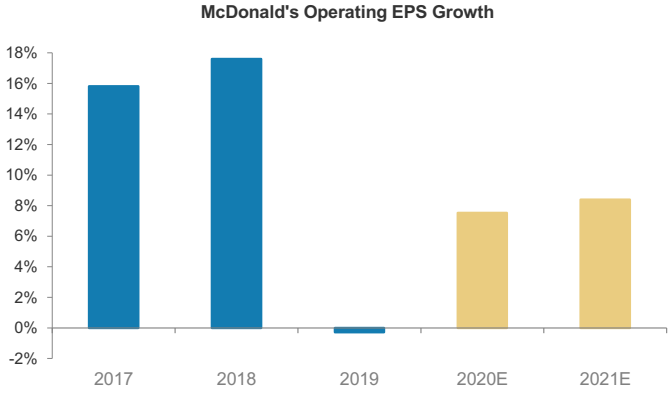
McDonald's Corporation (MCD): OW, PT $214

John Glass, Restaurants

Industry View: Within our in-line view of the U.S. Restaurant industry, we prefer limited service dining over full service given the structural business model advantages of franchised fast food and the lower degree of cyclicality. Consistent with our MS colleagues, we expect a relatively favorable consumer backdrop to continue into 2020, but already full service dining trends have weakened post-tax reform benefits and amid some economic uncertainty, while limited service has held up better, in part driven by new access channels (delivery/mobile). While the stocks have de-rated modestly vs mid-year, restaurants have been haven stocks vs the balance of retail given relatively greater isolation from trade issues and ecommerce disruption, as well as diverse and expanding international exposure for large/mid-cap fast food; we expect this narrative to continue longer term.

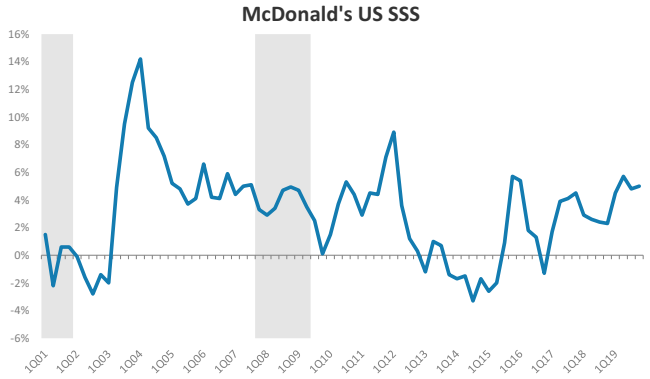
Investment Thesis: We believe MCD's Experience of the Future and technology investments will support EPS and FCF growth in FY21 and beyond. Since 2018, we think MCD's stock has been underappreciated due to not yet visible competitive advantages that Experience of the Future (EOTF) remodeling and modernization efforts will provide the company, as there had been temporary disruptions from store closures and large capital expenditures. In 3Q19, the company continued with remodel and technology-related investments which, in our view, will likely result in HSD EPS growth to FY21. We believe the stock is well positioned vs peers and we model FY20/21 EPS growth of ~7-8% on the back of 1) EOTF remodeling likely to enable digital and delivery sales growth, 2) technology investment (AI, voice ordering, etc.) to drive sales and improve efficiency, especially in a higher labor cost environment, 3) capex expenditures to fall and FCF to accelerate post re-imaging and technology investments, 4) completed refranchising enabling operating margin growth, and 5) the defensive characteristic that MCD has in terms of fundamentals and low volatility in periods of market declines should provide additional upside.

Exhibit 38: We expect 2019's EPS drag to reverse in coming years, with HSD EPS growth in FY20 and FY21



Source: Company Data, Morgan Stanley Research

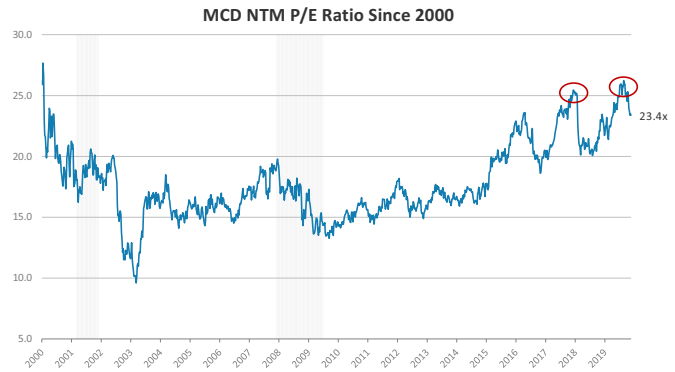
Exhibit 39: Quarterly comps for MCD US remained positive during the last recession (shaded area)



Source: Company Data, Morgan Stanley Research

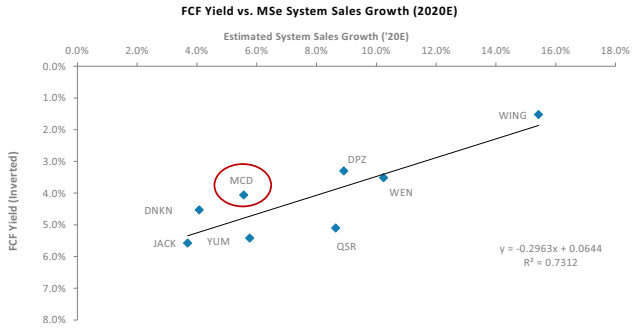
Our valuation suggests MCD is still being discounted relative to peers: MCD has been trading at 23.4x NTM P/E, below 2017 and mid-19 levels it reached of ~25-26x. Another valuation framework which we believe best captures a number of moving pieces (i.e., capital intensity and capacity for shareholder returns) within the all-franchised universe of quick service stocks within our coverage is estimated system sales growth relative to free cash flow yield. As a slower-growing, asset-intensive business relative to peers, MCD had historically screened unfavorably within this framework. However, given the relative valuation shifts within this universe (most have continued to re-rate higher), MCD valuation looks more favorable relative to peers, as it offers higher yield relative to other QSR peers (adj for system sales growth).

Exhibit 40: MCD is currently trading at 23.4x NTM P/E and in our view it could again reach '17 and mid-19 levels of >25x



Source: Thomson Reuters, Morgan Stanley Research

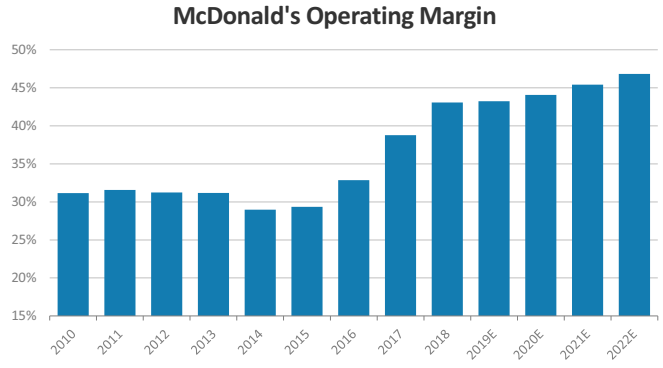
Exhibit 41: MCD screens more favorably relative to peers when comparing FCF to system sales growth and factoring in falling capex in future years



Source: Company Data, Thomson Reuters, Morgan Stanley Research

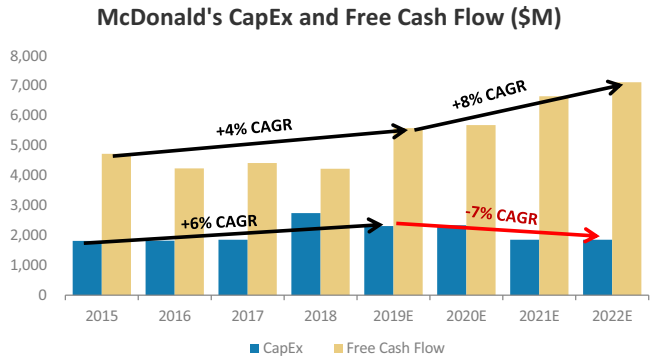
Margins, FCF and ROIC should improve in the next three years: A combination of the residual benefits from refranchising to operating margins, and reduced capital spending post remodeling and technology investments will result in 1) stronger margins, 2) accelerating FCF growth and 3) increasing ROIC. The result will be a better, more capital efficient business model with higher ROIC and higher sustainable capital returns to shareholders than the company has even had in the past. That should argue for a higher sustained valuation vs historical periods.

Exhibit 42: We see margins reaching >45% in FY21



Source: Company Data, Morgan Stanley Research

Exhibit 43: We expect FCF growth to accelerate over the next few years as capex spend materially declines

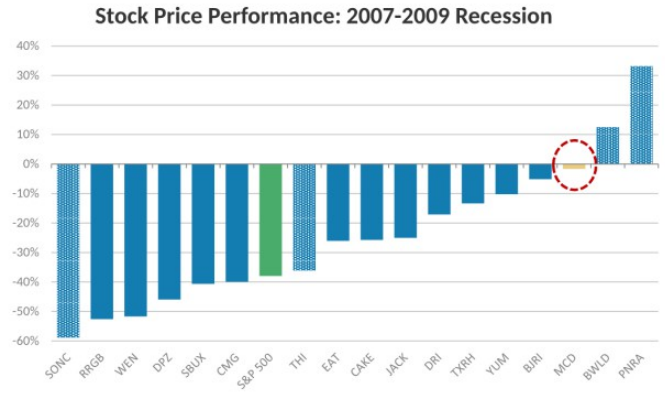


Source: Company Data, Morgan Stanley Research

Past recession performance frames MCD's defensive qualities: MCD is one of the very

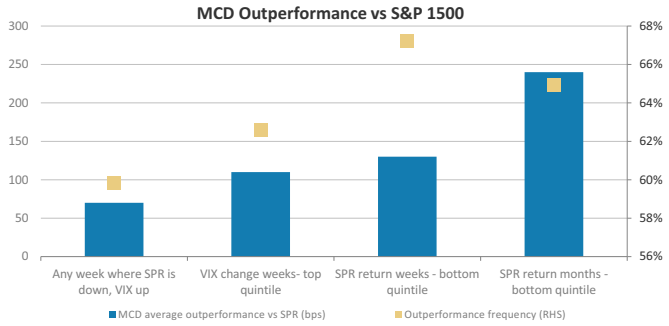
few consumer discretionary names that has demonstrated defensive characteristics as measured by: 1) fundamental performance during the last economic downturn; 2) stock performance relative to peers during that period; and 3) lower share price volatility versus the market in periods of market declines. We raise this point in the context of the call from the Morgan Stanley US equity strategy team, which has a preference for Defensive stocks (see Part I of the US equity strategy section). We outline the evidence and historical track record below.

Exhibit 44: McDonald's outperformed peers during the last recession, except for fast growing chains Buffalo Wild Wings and Panera



Source: Thomson Reuters

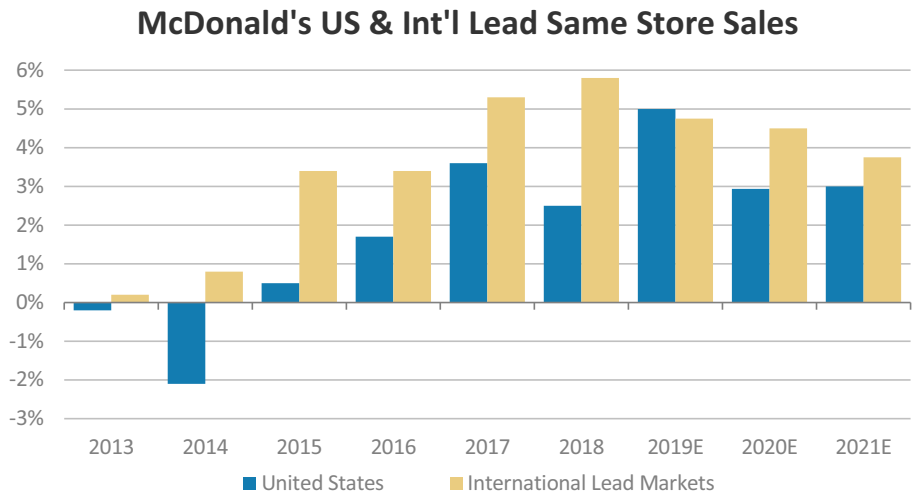
Exhibit 45: During periods of market decline or rising volatility, MCD frequently outperforms a broad measure of the market, indicating its lower beta and defensive traits



Source: Morgan Stanley Equity Strategy

Remodels and international exposure build a strong sales base for the next downturn: MCD's reimage program will leave the U.S. system substantially modernized by the end of 2019, positioning it well for the next economic downturn. In addition to having a better asset base than peers, the business model has been re-formulated, with a company store ownership base of ~5% (vs. ~11% last downturn). As our strategy team highlighted in Part I, international markets currently have a better outlook when it comes to growth and earnings potential, which could be captured by MCD's strong presence globally (~64% of sales are international). EOTF has been rolled out across a number of international markets, to varying degrees, which have seen comps accelerate and maintain momentum in recent years; we view these strong results in diversified markets as supportive of the global business, as well as indicative of the potential upside from EOTF deployment for the US market.

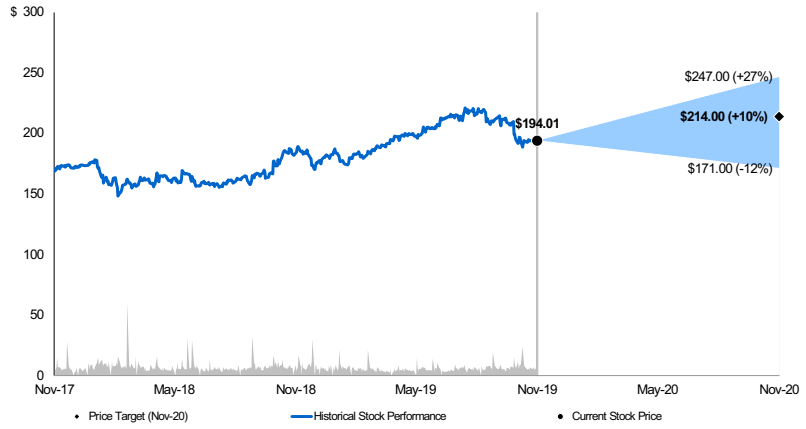
Exhibit 46: EOTF has reached 'critical mass' in large int'l markets, supporting SSS growth momentum, which is likely to continue



Source: Company Data, Morgan Stanley Research

Risk Reward: McDonald's Corporation (MCD)

Risk-Reward View: Top line momentum should improve, and structural advantages remain



Source: Thomson Reuters, Morgan Stanley Research

Price Target **$214**

Assumes a 25.5x multiple on 2020e EPS of $8.41, as comps improve with remodel/EOTF momentum outweighing remodel downtime drag. Multiple expansion supported by accelerating FCF, improved ROIC. Our DCF model which assumes a 6.6% WACC and 2% terminal growth rate yields a similar one year out valuation.

Bull **$247**

Assumes a 28x multiple on bull case EPS of ~$8.80

Big 'n Tasty: Our bull case is based on scenario analysis incorporates incremental cost saves and even stronger comp momentum, with US SSS remaining 5% in 2020. We apply a 28x multiple, which would be near best-in-class among large cap QSR peers.

Base **$214**

Assumes a 25.5x multiple on base case EPS of $8.41

Value Combo: US SSS of ~+5% in 2019E––on the back of EOTF momentum––along with International >6%. Store margins expand as cost saves are implemented and refranchising leaves MCD with a more profitable store portfolio. Defensive qualities of MCD also support multiple.

Bear **$171**

Assumes a 21x multiple on bear case EPS of ~$8.15

Unhappy Meal: Major market comps modestly positive, with all segments' margins contracting due to due to sales deleverage, and G&A cuts are not fully achieved. Multiple contracts to below-peer average, reflecting lack of system sales growth and margin declines.

Investment Thesis

- **US top-line should accelerate** as remodels, organizational changes settle in, though competition in QSR remains fierce.
- **Best-in-class asset quality, scale in advertising, other areas = key structural advantages.** Experience of Future (EOTF) reimages enable digital and delivery sales, among other drivers. MCD spends materially more on reimaging than average peers.
- **ROIC rising, capex to fall, and FCF and return of capital to accelerate post '19.** Post-US reimaging, capex should fall by nearly 50%, increasing FCF. We estimate FCF will grow at a CAGR of 13% ('19-'21) vs. 2% over the prior three years.
- **Refranchising** to 95% will be fully visible by '19, with operating margins in the mid-40% range, improved FCF and lower earnings volatility.
- **Defensive stock,** both in terms of fundamentals and low stock price volatility in periods of market declines.

Key Value Drivers

- **SSS:** Driven by the "Experience of the Future" initiative, including mobile and kiosk ordering and customization.
- **Further driven by delivery** being rolled out globally.
- **Improved FCF** in '20 and beyond.
- **'Self help'** benefits to the business, including refranchising and corporate cost reduction.

Risks to Achieving Price Target

- Failure to generate expected sales & return targets for remodels.
- Increasingly competitive US landscape, including at breakfast.
- Sensitivity to consumer discretionary spending.

Mondelez (MDLZ): OW, PT $60

Dara Mohsenian, Household Products, Beverages, & Food

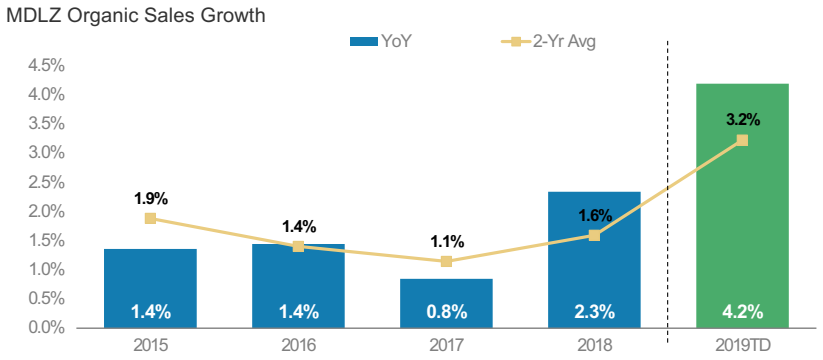
Industry View: We are In-Line on the food sector as we see secular headwinds from reduced center of the store consumption and lack of pricing power.

Investment Thesis: MDLZ is our top pick in food as positive strategy changes are gaining traction, aided by recent reinvestment in A&P, numerous strategic changes, as well as MDLZ's favorable geographic/category growth footprint. This should result in higher topline growth than peers and multiple expansion as the market shifts to revaluing MDLZ relative to a multinational CPG peer comparison set instead of the less appropriate (in our minds) lower growth US-centric food peers.

Strategy changes are driving higher topline growth: Recent strategy changes (under new management) appear to have taken hold at MDLZ and are resulting in a sustainable topline growth acceleration in our view. These strategic changes include: (a) a shift in corporate focus to topline growth from margin expansion, with a particular emphasis on volume growth relative to an historical price-driven topline growth; (b) a change in its organizational structure with a shift away from a regional focus to more of a country-based approach, pushing down accountability to local markets; and (c) a change in incentive compensation to emphasize volume growth and gross profit growth (rather than gross margins), (d) an increased focus on local brands, which were historically de-prioritized vs. MDLZ's global power brands (e.g. Oreos, Cadbury); (e) greater marketing effectiveness after increased consumer research; and (f) after recent positive changes in strategy have yielded higher topline growth, now higher reinvestment in the business in advertising/marketing, digital capabilities, new product development, and routes-to-market. This reinvestment has already occurred the past few quarters, but importantly is embedded in forward guidance.

With the new strategy changes, MDLZ LTM volume growth has rebounded over the last two years, resulting in an acceleration in overall MDLZ organic sales growth from ~1.2% y-o-y in the 2015-2017 period to +2.3% y-o-y in 2018 and +4.2% in 2019TD. On a two-year average basis, MDLZ organic sales growth has also accelerated from +1.4% in 2015-2017 to +1.6% in 2018 and +3.2% in 2019TD. Going forward, we believe MDLZ's organic sales growth has accelerated sustainably to the ~3.5% range, with an improvement in category trends, as well as MDLZ's market share and volume trends.

Exhibit 47: MDLZ's Organic Sales Growth Has Positively Inflected



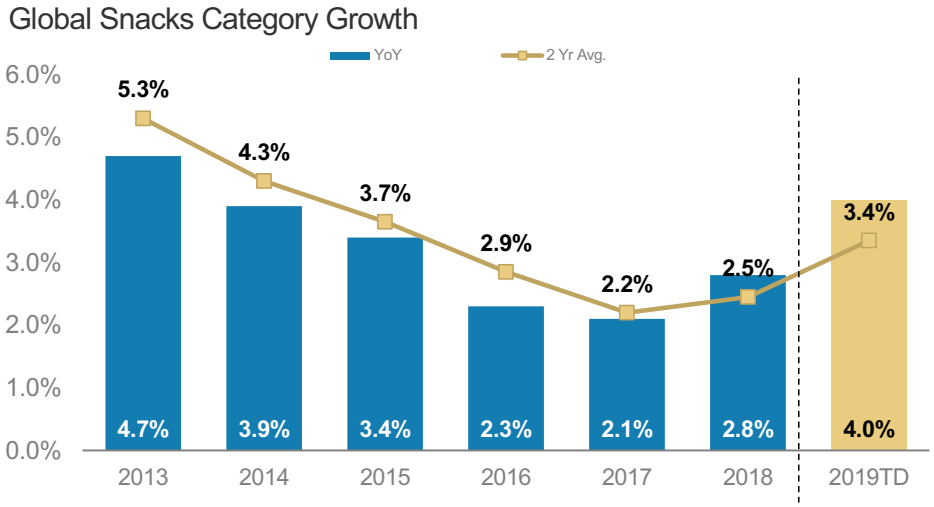
Source: Company data, Morgan Stanley Research estimates

We see a sustainable topline acceleration due to: (1) improved category growth and (2) rebounding MDLZ market share.

(1) Category Improvement

MDLZ's global snacking category growth has improved recently, giving us increased confidence in the achievability of our ~3.5% LT MDLZ organic sales growth outlook. We are particularly encouraged by the sequential improvement in MDLZ's reported global snacks category growth, which includes biscuits, chocolate, gum, and candy (together accounting for ~87% of MDLZ's sales), which has accelerated to +4.0% in 2019TD (+3.4% 2-yr avg), and when combined with market share gains, we believe the growth will be more than enough to sustain our ~3.5% organic sales growth forecast.

Exhibit 48: Global Snacks Category Growth Has Rebounded



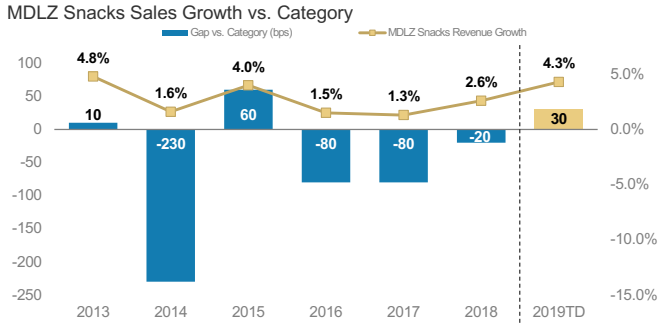
Note: Global snacks include cookies, crackers, chocolate, and gum & candy.
Source: Company data, Morgan Stanley Research

(2) MDLZ Market Share Improvement

MDLZ historically underperformed in its global snacks category growth by ~65 bps (using MDLZ reported snacks category growth vs. MDLZ results). However, we have seen recovery in MDLZ relative performance vs. its global snacking growth, with a more modest ~20 bps underperformance in 2018 and +30 bps of outperformance in 2019TD

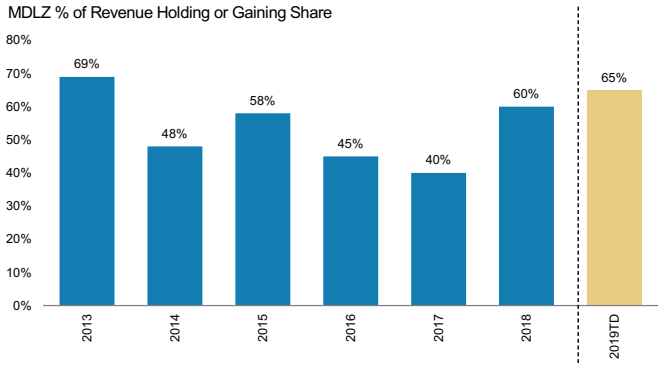
through Q3. We attribute the progress behind MDLZ's strategic changes and increased topline focus to the following areas: (1) increased innovation efforts, particularly in healthier categories; (2) increased A&P and brand support of local and smaller brands; (3) pursuing growth opportunities in incremental profit areas with lower margins in some cases; (4) increased investment in sales and marketing capabilities; and (5) increased focus on bolt-on M&A of higher-growth businesses as evidenced by the recent Tate's Bake Shop purchase. Additionally, MDLZ's reported % of snacking revenue holding or gaining share had historically declined to 40% in 2017, but gradually improved to 65% in 2019TD, through Q3. **The rebound in MDLZ's market share trends supports our view that MDLZ's increased focus on topline growth and reinvestment is paying off.**

Exhibit 49: MDLZ's Snacks Growth Relative to the Category Improved...



Source: Company data, Morgan Stanley Research

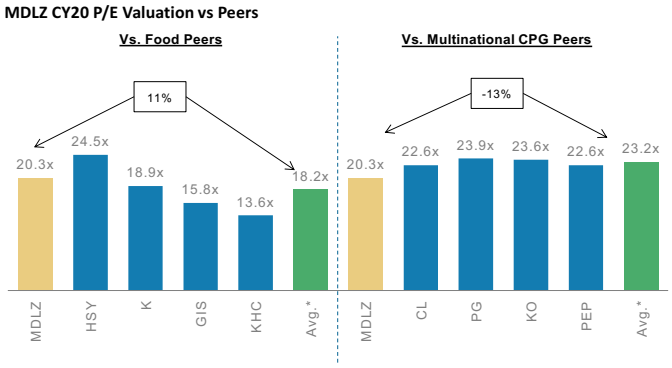
Exhibit 50: ...As Well as the % of MDLZ's Snacks Gaining or Holding Share



Source: Company data, Morgan Stanley Research

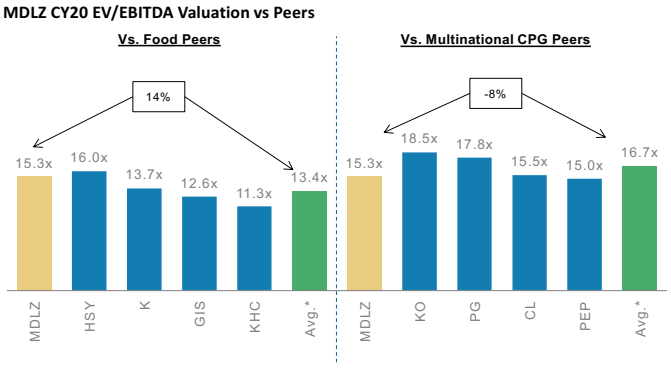
Compelling Valuation Relative to CPG Peers: MDLZ's valuation is compelling in our minds, as we believe the market has pegged the company vs. lower growth US food peers, as opposed to the more appropriate peer set of multinational CPG peers given accelerating growth at MDLZ recently. We see MDLZ bridging part of its -13% P/E discount vs. multinational peers over time as the market becomes more comfortable with the sustainability of higher MDLZ topline growth.

Exhibit 51: MDLZ Trades at a CY20 P/E Premium to Food Peers but at a Discount to Multinational CPG Peers



* Note Food peers valuation adjusted for pension income.
Source: Company data, Thomson Reuters, Morgan Stanley Research estimates

Exhibit 52: MDLZ Trades at a CY20 EV/EBITDA Premium to Food Peers but at a Discount to Multinational CPG Peers

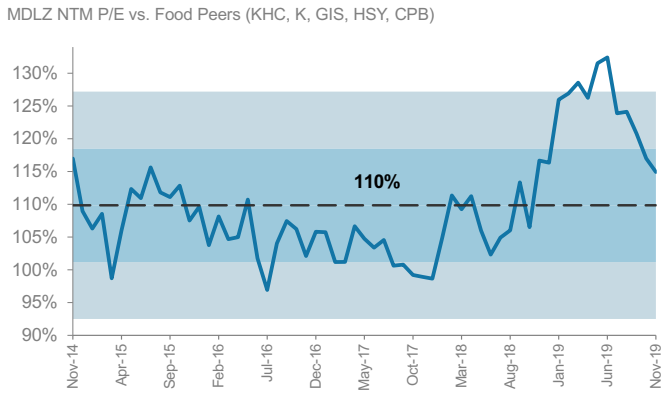


Source: Company data, Thomson Reuters, Morgan Stanley Research estimates

When looking at MDLZ's relative valuation to US food peers, MDLZ trades slightly less than one standard deviation above its average five-year ~10% premium to peers (KHC, K,

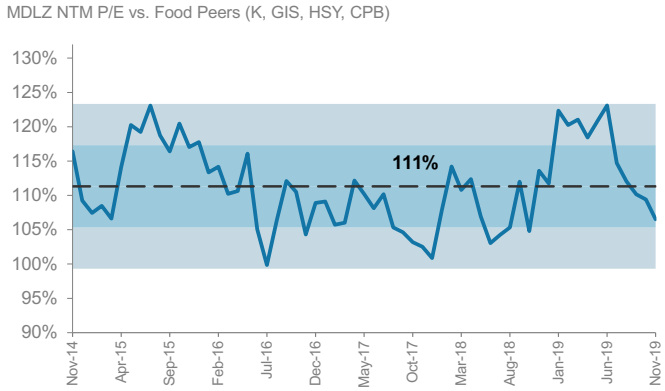
GIS, HSY, CPB). However, MDLZ actually trades below its average ~11% five-year premium to the rest of US food peers (K, GIS, HSY, CPB), despite a widening fundamental gap.

Exhibit 53: MDLZ Trades Slightly Below 1 Standard Deviation Above Its Average Premium to Food Peers...



Source: Refinitiv, Morgan Stanley Research

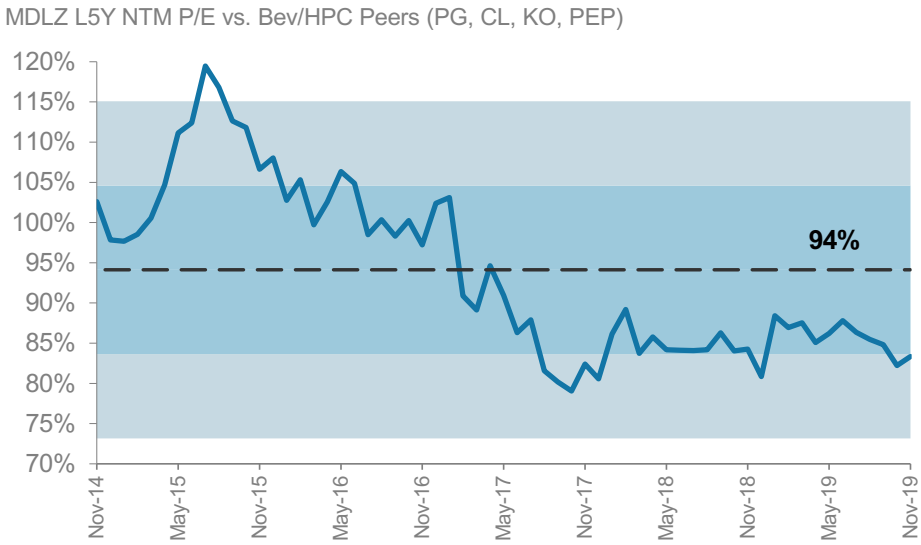
Exhibit 54: ...But Trades Below Its Historical Premium Excluding KHC



Source: Refinitiv, Morgan Stanley Research

Importantly, MDLZ trades one standard deviation below its average ~6% five-year NTM P/E discount to mega-cap beverages/HPC peers (PG, CL, KO, PEP). We view this discount as unfair considering a closing fundamental gap vs. those peers, with MDLZ's LT outlook being very similar to multinational CPG peers.

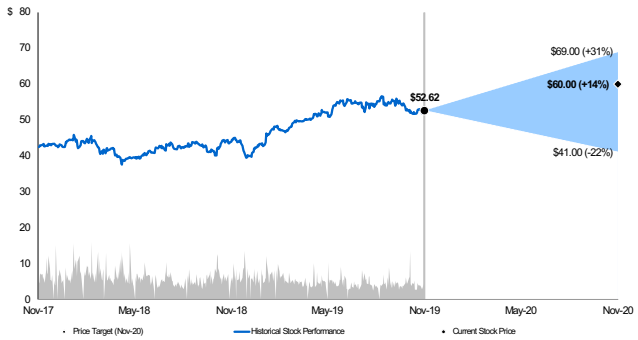
Exhibit 55: MDLZ Trades ~1 Standard Deviation Below Its Historical Discount to Multinational CPG Peers



Source: Refinitiv, Morgan Stanley Research

Risk Reward: Mondelez International (MDLZ)

Favorable Risk Reward



Source: Thomson Reuters, Morgan Stanley Research

Price Target $60

Our price target is based on 23x CY20e EPS of $2.63. Our 23x CY20e P/E multiple is at a ~HSD% discount to our average target multiple for multinational CPG peers, slightly below MDLZ's historical 5% discount.

Bull $69

~25x CY20 EPS (implies ~19x EV/EBITDA)

~5% organic topline growth, ~7% EBIT growth: +150 bps of volume upside from higher market share trends; robust cost savings drive $100M of profit upside. The market attributes increased strategic potential, driving valuation to ~25x CY20e EPS (implies ~19x EV/EBITDA).

Base $60

~23x CY20 EPS (implies ~17.5x EV/EBITDA)

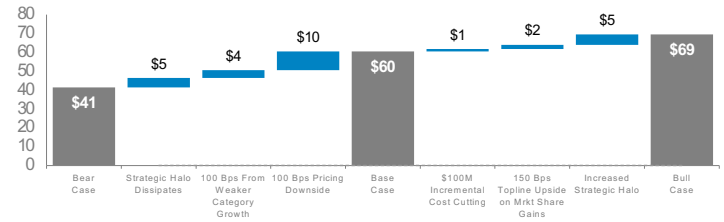
Organic topline growth of ~3.5%, EBIT growth of ~5.5%: Organic sales growth of ~3.5% in 2020 and beyond with OM's up ~30 bps annually on topline growth, pricing, and cost savings. Valuation expands to ~23x CY20e EPS (implies ~17.5x EV/EBITDA).

Bear $41

~17x CY20 EPS (implies ~13.5x EV/EBITDA)

~1.5% organic sales growth, ~2.5% EBIT growth: Pricing moderates vs. historical trends due to lower inflation in emerging markets, category volume growth does not fully recover on lower pricing and is pressured by health & wellness concerns. Dissipating strategic potential contracts valuation contracts to ~17x CY20e EPS (implies ~13.5x EV/EBITDA).

Exhibit 56: Bear to Bull: Market Share, Pricing, Commodities, and Cost Cutting Are Key Drivers



Source: Company data, Morgan Stanley Research estimates

Why Overweight?

- **Accelerating Topline Growth Sustainably to the 3-4% level:** We believe MDLZ's organic topline growth has accelerated sustainably to the ~3.5% level vs. the ~1.5% growth rate over the last few years driven by the following items: (1) MDLZ's more favorable geographic and category exposure, with exposure to emerging markets and snacking categories; (2) MDLZ's strategy changes (higher reinvestment, focus on local brands, shift in focus to topline from margin expansion, changes in incentive compensation, and more focus on volume growth); (3) MDLZ's volume trends in emerging markets have improved; (4) MDLZ's market share trends have improved as a result of higher investment; (5) Global category growth in MDLZ's category has improved; and (6) MDLZ's US topline growth trends have accelerated particularly in cookies/crackers, led by pricing.
- **Margin Expansion Opportunity Above Food Peers, Albeit Lower than History**: We forecast ~33 bps of annual operating margin expansion, after 2019 reinvestment, well above food peers.
- **Valuation Compelling Relatively to Multinational CPG Peers:** We believe the market incorrectly compares MDLZ valuation to US-centric food peers, while we argue MDLZ's topline/EPS growth profile is more similar to multinational CPG peers (KO/PEP/PG/CL). MDLZ's valuation of ~20.3x P/E looks compelling, at an ~13% discount to multinational CPG peers.

Risks to Achieving Price Target

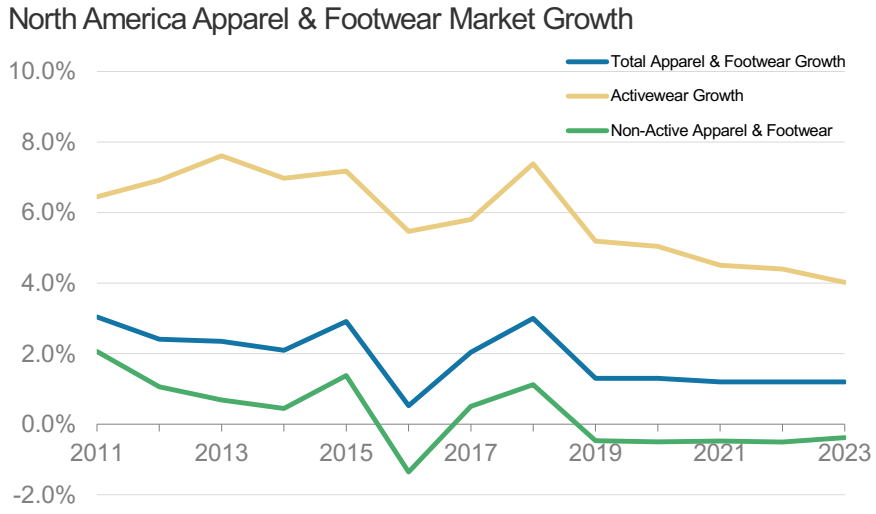
- **Downside Risks:** Lower than expected volume growth from lower pricing, weaker pricing due to lower inflation in EMs, volume pressure in MDLZ's categories, health/wellness pressure, higher FX headwinds, Brexit, weaker margin expansion on higher reinvestment, and dissipating strategic potential.

Nike Inc. (NKE): OW, PT $118

Kimberly Greenberger, Specialty Apparel & Department Stores

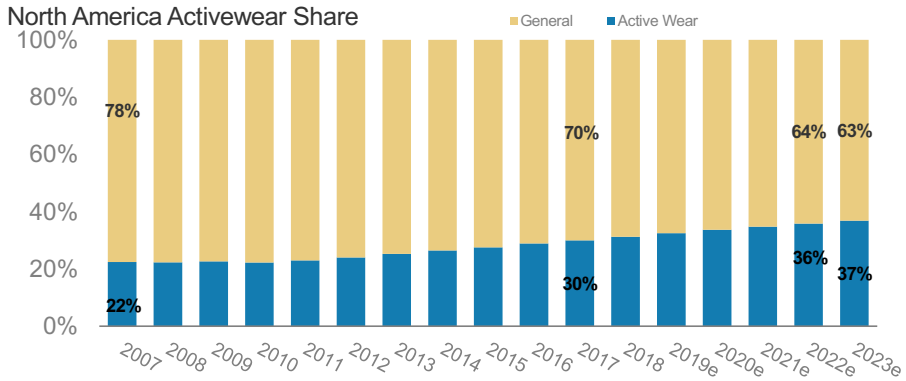
Industry View: We continue to prefer athleticwear (active apparel and footwear) over general apparel and footwear (t-shirts, sweaters, jeans, etc.) heading into both holiday 2019 and full year 2020 given sustained share gains. We forecast a 4.5%+ North America activewear CAGR over the next five years, slightly below 2010-2018's 6.5%+ CAGR, and outpacing general apparel's -1% 2018-2023 CAGR (Exhibit 57). This results in ~100 bps of annual North America activewear share gains (Exhibit 58). With respect to the global activewear market, we forecast an 7.5%+ activewear market CAGR through 2023, above the 6.5%+ 2010-2018 CAGR (Exhibit 59). Though international activewear has taken share from general apparel and footwear similar to North America, it has occurred at a much slower rate. Activewear currently represents ~19% of global apparel and footwear sales, 300+ bps over the last 10 years. We expect share gains to accelerate over the next five years (300+ bps) which would imply ~22% activewear share in 2023 (Exhibit 60). Two interrelated secular trends are supporting activewear's move in North America and globally: health and wellness and casual fashion. Though some momentum has slowed since 2013-2015's athleisure "peak," we believe health and wellness and casual fashion are long-term secular trends still in early innings. Both should continue to drive ongoing share gains. Additionally, we expect international activewear will further benefit from increasing global incomes (particularly in China and India), which often foster higher discretionary spending and sports participation

Exhibit 57: Activewear now drives the entirety of North America's apparel and footwear growth; we forecast non-active general apparel and footwear to continue to decline overtime



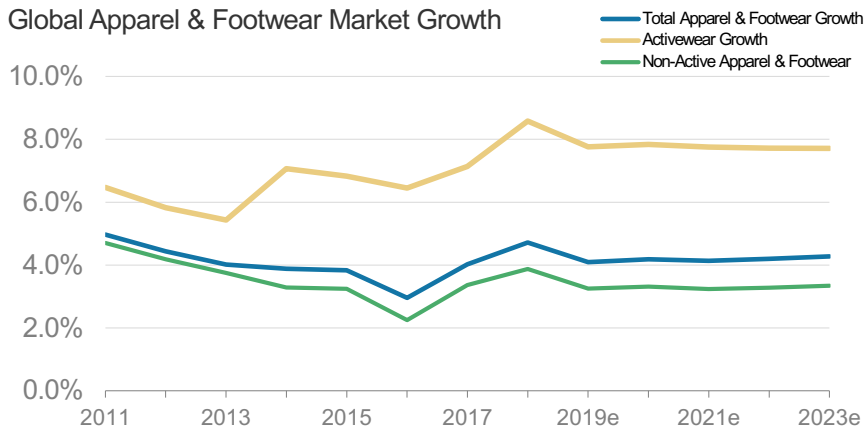
Source: Euromonitor, Morgan Stanley Research

Exhibit 58: We forecast activewear to represent ~37% of total North America apparel and footwear sales by 2023



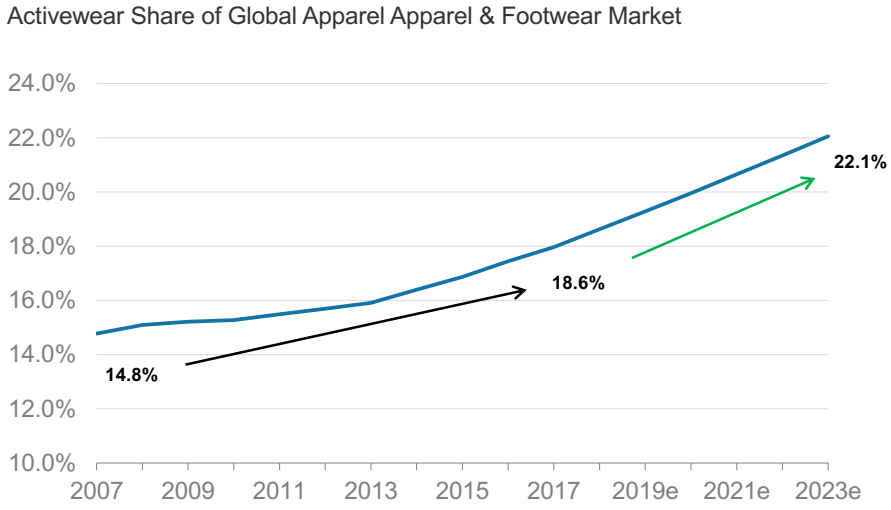
Source: Euromonitor, Morgan Stanley Research

Exhibit 59: We forecast a +7.5%+ activewear market CAGR through 2023, above the 6.5%+ 2010-2018 CAGR



Source: Euromonitor, Morgan Stanley Research

Exhibit 60: We expect activewear to represent ~22% of overall global apparel and footwear sales in 2023



Source: Euromonitor, Morgan Stanley Research

Investment Thesis: We believe NKE is in the early innings of transition from a traditional wholesale business to a digitally-driven, direct-to-consumer ("DTC") brand. The business

appears positioned to take share in the high-growth, global activewear market (where it already ranks as the #1 brand) as well as increase profitability (from FY 2019 +HSD y/y to +mid-teens y/y by 2022E). This should make it one of the highest-growth consumer names, as well as one of the few to potentially benefit from the shift to digital (~10% of FY 2019 sales). We believe its "Consumer Direct Offense" strategy will ignite the next phase of margin accretive revenue growth for the brand, driving our ~18% base case 5-year EPS CAGR. Its recently-announced Hurley divestiture (please see our note Benching Hurley to Step Up Consumer Direct Offense) and John Donahoe CEO appointment (please see our note It Was a Good Run: Expect a Seamless CEO Transition) represent further evidence of the company's digital transformation commitment as well as its ongoing, strategic portfolio evaluation. Additionally, NKE's investments in technology, supply chain innovation, and ESG efforts are creating underappreciated longer-term competitive advantages, supported by an industry-leading balance sheet, $4B+ free cash flow, and ~33% ROIC. These advantages will likely drive further margin expansion over time. All in, we see the likelihood of NKE's bull case playing out as among the highest in our stock coverage universe.

High-margin DTC sales are the North American athleticwear market's major growth engine, and we believe NKE's DTC strategy and innovation pipeline will be a key enabler of its market share gains. NKE has historically been viewed as a wholesaler, but we increasingly view it as a play on global eCommerce and technology. We expect NKE to continue to allocate its best SKUs (newest launches and premium products) to DTC, leading the most profitable customers to the channel. NKE's digital commerce expansion is being driven by Nike+ members, who spend 3x more through NKE DTC than non-members, and apps like SNKRS, which have quickly become the leading destination for high-heat footwear launches globally. As DTC becomes a larger piece of NKE's revenue pie, not only does NKE recognize the full wholesale to retail markup for itself, benefitting sales, but it also realizes a ~25% higher gross margin, by our estimates (Exhibit 61). In the near-term, NKE is continuing to invest in its DTC business, limiting EBIT margin accretion. However, over the medium to longer-term, DTC EBIT margins should be accretive to total company margins, especially online, which we estimate is ~900-1000 bps higher than wholesale.

Exhibit 61: Over the medium to longer-term DTC EBIT margins should be accretive to total company, especially online, which we estimate is 900-1000 bps higher than wholesale

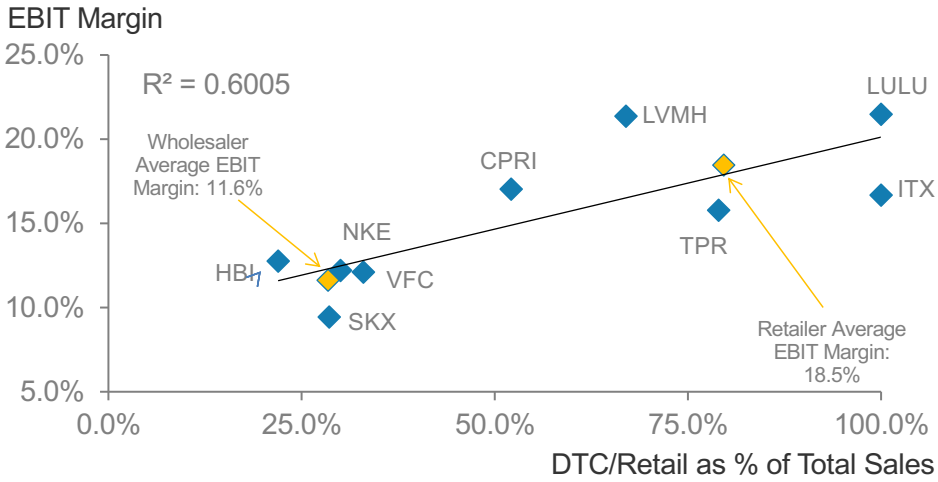
Wholesale		Stores		Online	
Wholesale Price	$50	Retail Price	$100	Retail Price	$100
- COGS	30	- COGS	35	- COGS	35
Gross Profit (~40%)	20	Gross Profit (~65%)	65	Gross Profit (~65%)	65
- SG&A	14	- SG&A	51	- SG&A	25
				- fulfillment cost	18
EBIT	$6		$14		$22
Operating Margin	**13%**		**14%**		**22%**

Source: Company Data, Morgan Stanley Research

As DTC, or retail, becomes a larger piece of NKE's business, we expect its EBIT margin to move higher over time, in-line with global retailer peers (Exhibit 62)**.** Global brands that generate more than half of sales from retail (e.g. LULU, TPR, ITX, LVMH, and CPRI) produce ~18% EBIT margin on average, with some as high as ~21%. On the other hand, wholesalers (e.g. NKE, SKX, HBI, and VFC) generate a ~12% EBIT margin on average, 6 points below the retail peer average. In our base case, as NKE increases its DTC sales, we see NKE achieving a ~15% EBIT margin by FY 2022 from 12.2% in FY 2019, just below its retail peers. In our bull case, where NKE accelerates its DTC transformation at a faster

rate (to ~16% margin by FY 2022), we think NKE could achieve ~17%+ EBIT margin over the long-term (FY 2024).

Exhibit 62: As DTC, or retail, becomes a larger piece of Nike's business, we expect its EBIT margin to move higher over time, in-line with global peers

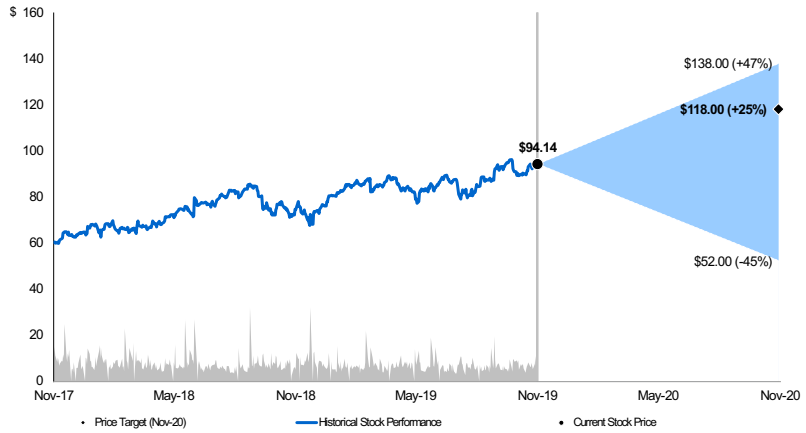


Source: Company Data, Morgan Stanley Research

Notably, we see NKE's bull case playing out as among the highest in our stock coverage universe. In our bull case, NKE delivers a 24%+ 4-year EPS CAGR driven by a 9%+ 4-year revenue CAGR as its DTC strategy and innovation pipeline drive greater than expected market share gains. Gross margin expands 70+ bps annually as DTC growth accelerates and NKE's "manufacturing revolution" benefits, including initiatives like its Express Lane, materialize more quickly than anticipated. This coupled with ~30 bps of annual SG&A leverage on a stronger than expected top-line leads to ~100 bps of annual EBIT margin expansion and low-20s percent EPS growth. In this scenario, we see a $138 stock, or ~45%+ upside.

Nike Inc. Risk Reward

We see an increasing likelihood of our DTC-driven Bull case playing out; our $118 price target represents the midpoint of our Base and Bull cases



Source: Thomson Reuters, Morgan Stanley Research

Price Target **$118**

Our price target reflects the midpoint of our $98 base case and $138 bull case, both of which are derived from our DCF analysis and supported by P/E multiples. Our base case DCF uses a 7.3% WACC and a 2.5% long term growth rate in our base case (3.5% in our bull case / 2.0% in our bear case). The growth rate is based on our bullish global athleticwear view.

Bull **$138**

41x Bull case FY20e EPS $3.37

"G.O.A.T." NKE delivers a ~10% 4-year revenue CAGR as the global activewear market grows faster than anticipated, and Adidas momentum slows globally. DTC growth accelerates and "manufacturing revolution" benefits materialize more quickly than anticipated. ~15% medium-term EBIT margin business. Virtuous cycle of stronger ROIC and cash flow drives stronger innovation and moat around the business.

Base **$98**

33x Base case FY20e EPS $3.02

Slam Dunk.8%+ 4-year revenue CAGR, ~60 bps of annual gross margin expansion driven by a mix shift to DTC and supply chain innovation (lower product costs, shorter lead times, and greater full price selling) leading to ~75 bps of annual EBIT margin expansion.

Bear **$52**

20x Bear case FY20e EPS $2.55

Cool Down.5-6% 4-year revenue CAGR, below management's +HSD plan, as North America returns to declines as it anniversaries tough compares and innovation slows. International grows slower than expected as the sportswear trend cools off globally. ~11% long-term EBIT margin business. NKE trades at the low end of its five year historical P/E.

Why Overweight?

- We believe NKE is in the early innings of transition from a traditional wholesale business to an emerging retail technology company.
- Nike appears positioned to take share in the high-growth, global activewear market as well as increase profitability, which should make it one of the highest growth consumer names and one of the few to benefit from the shift to eCommerce.
- Nike's "consumer direct offense" lead through its direct to consumer (DTC) business is set to ignite this next phase of margin accretive revenue growth for the brand, driving our ~18% 5-year EPS CAGR
- Our out year EPS estimates are above consensus, and we see the likelihood of NKE's bull case playing out as the highest of all our coverage stocks.
- What's more, Nike's investments in technology, supply chain innovation, and ESG efforts are creating underappreciated longer-term competitive advantages, supported by an industry-leading balance sheet, ~$4B free cash flow, and ~32%+ ROIC. These advantages are likely to drive further margin expansion over time.

Key Value Drivers

- Total sales growth — North America, EMEA, China, and APLA are NKE's major reporting buckets
- Gross Margin — Product input costs (mainly raw materials, labor, and overhead), channel mix, product mix, foreign exchange, warehousing, distribution, and inventory management
- Operating margin — Marketing expenses, R&D, owned retail store operational expenses, and eComm fulfillment costs all impact EBIT margin.

Risks to Achieving Price Target

- Tariff Risk — The recent 10% tariff announcement could drive lower earnings

results through either or a combination of gross margin headwinds and/or softer demand given higher consumer prices. We estimate ~10-15% of US merchandise is imported from China (total company China manufacturing exposure = 24%).

- Adidas (covered by Elena Mariani) — Competitors have taken share from Nike in the past in key categories, and this trend could reemerge.
- China — If macro slows, it could stymie Nike's sales growth rate in this key region.
- US Sporting Goods Retail — Consolidation could cause inventory destocking and elevated clearance selling.
- FX — Unanticipated swings in FX create some risk to EPS given Nike is nearly 60% international.
- Environmental, Social, and Governance — Mismanagement of ESG issues could lead to business or reputational risk, which could hurt cash flow or valuation.

Penn National Gaming (PENN): Overweight, PT $27

Thomas Allen, Gaming & Lodging

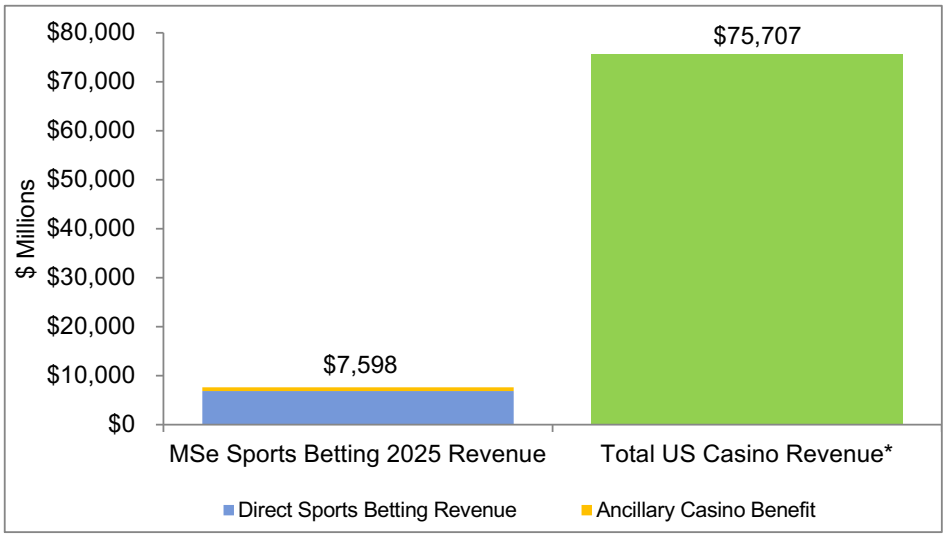
Industry View: We are positive on US regional gaming stocks as the market in our view doesn't fully appreciate the opportunity from legalized sports betting's proliferation. In fact, since the Federal ban on sports betting was repealed in May 2018, gaming stocks have de-rated compared to the broader market, despite US regional gaming revenue accelerating 100bps from growing 3.9% in 2018 to 4.9% YTD. From only Nevada having legal sports betting in May 2018, 20 states have now legalized, with 14 live. We expect US sports betting revenue to increase from ~$850 million in 2019 to >$2 billion in 2021 and $7 billion in 2025. We have found that retail sports books have attracted new customers to casinos, supporting table games (20% of market revenue) while not really affecting core slot trends (stable at up 1% YTD). We continue to see industry EBITDAR margins expanding, supported by more sophisticated marketing strategies and efficiencies due to industry consolidation.

Investment Thesis: Our top pick to play this theme is PENN as we see significant upside relative to the size of the company, 2% upside to 2020e consensus EBITDAR driven by synergies and organic growth, and an attractive risk-reward with the stock trading at just 6.6x '20 EBITDAR, near trough levels and a >1x discount to every other operator in our coverage, suffering from high (5.6x) financial leverage. Regarding sports betting, PENN is arguably best positioned in our coverage to capitalize given its partnerships (with DraftKings, FOX Bet, theScore, and PointsBet) and broad retail presence (in 19 states, more than any other operator).

How large is the US sports betting opportunity? We expect the legal US sports betting market to be $7 billion in 2025, with 79% of revenue online / 21% onground and 36 states legalizing. We see a bull case market size of $15 billion, assuming all states legalize, and a bear case market of $2.5 billion, assuming regulatory momentum slows and spend per adult isn't as strong. For more detail on the build-up of our estimates, see our 11/1/19 report, Raising 2025 US Sports Betting Market Forecast from $5B to $7B.

Adding the incremental traffic that we expect sports betting to bring the US casinos (our analysis concluded a ~1% indirect tailwind to existing casino revenue), we see legalized sports betting adding ~10% to US casino gambling revenue, though much will be online.

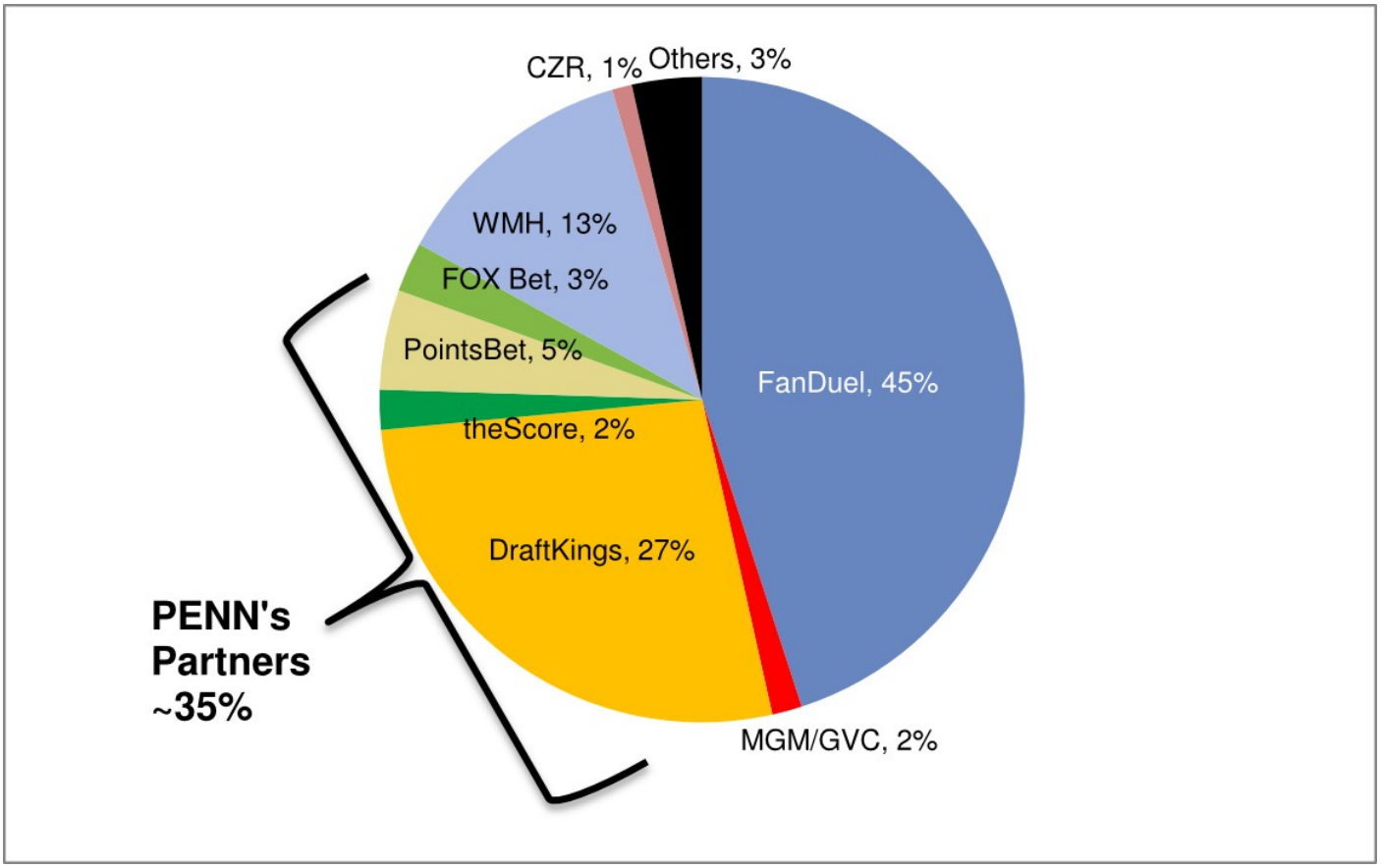
Exhibit 63: We expect US sports betting to add 10% more revenue to US casino gambling by 2025



Source: American Gaming Association, H2 Gambling Capital, State Gaming Revenue Filings, Morgan Stanley Research *Including pro forma 2020 (MSe) casino revenue in Massachusetts

Why is PENN the best way in our view to play legalized sports betting (among casinos)? PENN has signed agreements with online partners, DraftKings, FOX Bet, PointsBet, and theScore, to receive 5-15% of the sports betting revenue of states where they achieve market access through PENN's casinos. Together these operators have ~35% online revenue market share in NJ, and our analysis suggests nearly 50% of recent US betting app download market share. Online market aside, PENN has properties in 19 states, positioning it to: 1) monetize market access (i.e. sell additional online licenses), 2) launch profitable onground sports books, and 3) attract incremental casino customers by offering sports betting. PENN will eventually likely also partner with a media company to deliver a direct online sports betting product.

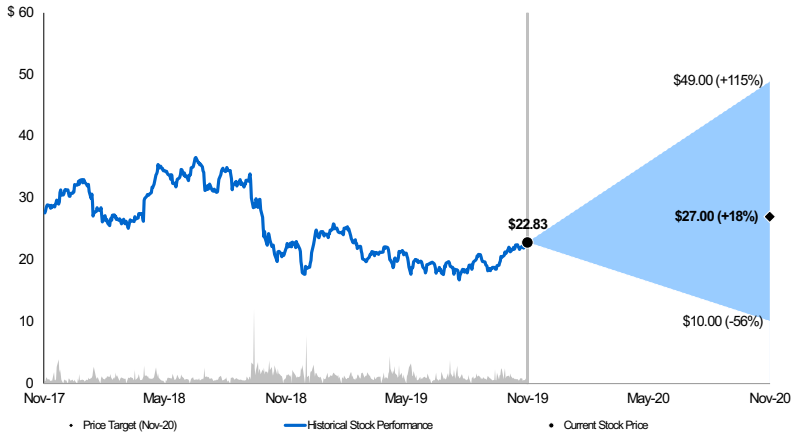
Exhibit 64: We believe PENN's partners (DraftKings, Pointsbet, FOX Bet, and theScore) have ~35% online sports betting market share in NJ



Source: NJ Division of Gaming Enforcement, Morgan Stanley Research Estimates

Risk Reward: Penn National Gaming (PENN)

High Leverage Drives a Wide R/R but Regional Tailwinds / Low Valuation Drive Upside



Source: Refinitiv, Morgan Stanley Research estimates

Price Target **$27**

Based on sum-of-the-parts analysis using 6.9x blended multiple (roughly in line with current NTM consensus EBITDAR multiple), plus value for sports betting.

Bull **$49**

7.4x 2020e Bull EBITDAR

1) 3% organic net revenue growth in 2019e / 2020e; **2)** 2019e / 2020e Adjusted EBITDAR $1.645B / $1.788B; **3)** $16 / share for sports betting including incremental traffic.

Base **$27**

6.9x 2019e Base EBITDAR

1) 1% average organic net revenue growth in 2019 / 2020; **2)** 2019e / 2020e Adjusted EBITDAR $1.601B / $1.726B; **3)** $5 / share for sports betting including traffic.

Bear **$10**

6.4x 2019e Bear EBITDAR

1) 2% net revenue decline in 2019 / 2020e; **2)** 2019e / 2020e Adjusted EBITDAR $1.550B / $1.647B; **3)** Minimal dilution from sports betting

Investment Thesis

- PENN has been one of the worst performing gaming stocks YTD despite positive estimate revisions, healthy regional gaming trends, and raising its Pinnacle acquisition synergies target, just suffering from high leverage
- While PENN has some idiosyncratic property-level risks, including new CO / MA competition, and VGT /expansion headwinds in IL and PA, we believe these risks are in expectations and manageable
- PENN has an underappreciated opportunity from US sports betting legalization given it has the most market access of any casino operator, and arguably some of the best partners
- Our 6.9x valuation multiple is close to the middle of PENN's historical range (6x-8x). PENN currently trades at a steeper than history and in our eyes unwarranted discount to peers. PENN is trading at a 17% '20e FCF yield.

Key Value Drivers

- Regional gaming trends
- Synergies from PNK acquisition
- Sports betting
- Returns on new projects

Potential Catalysts

- Sports betting ramping
- Synergies and new assets ramp quicker than expected
- Consolidation / M&A opportunities
- Macro tailwinds

Risks to Achieving Price Target

- Weaker regional gaming trends
- High (nearly 6x) implicit leverage given fixed rent expense
- Greater than expected competitive and other idiosyncratic risk
- *Note PENN has spun out its real estate into a REIT so should trade at a discount to

owner operator peers

Philip Morris International (PM): Overweight, PT $92

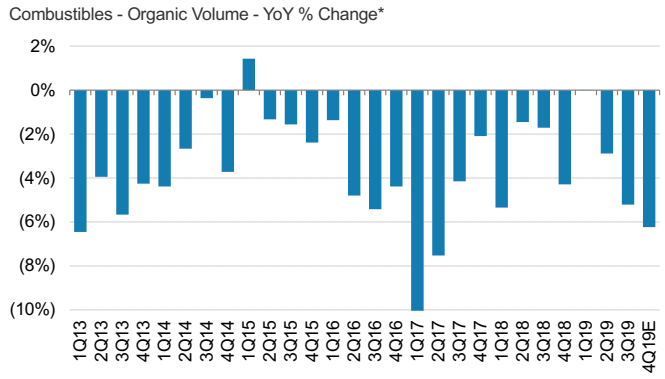
Pamela Kaufman, Tobacco & Packaged Food

Industry View: We are generally guarded on tobacco stocks as a firm due to deteriorating US fundamentals, regulatory uncertainty in the US, and higher leverage across the industry. We are Equal-weight MO and our European Tobacco counterparts rate both BAT and IMB UW. Relative to the peer group, we believe PM is well-positioned given its solid cigarette fundamentals, high Emerging Markets exposure (+50% OCI), strong heat-not-burn offering, and lower leverage.

Investment Thesis: We believe PM should deliver upside to its 8% EPS growth algorithm due to stable cigarette fundamentals and improving IQOS momentum. IQOS adoption is accelerating across several key European markets, which should support midterm topline growth ahead of peers. In addition, PM should be able to deliver peer-leading EPS growth over the next several years, and valuation is attractive relative to staples peers.

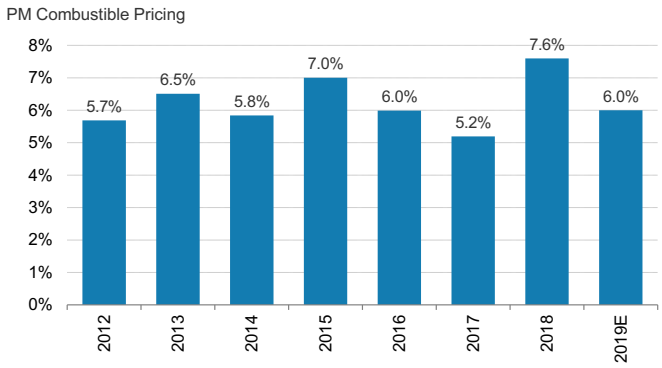
PM is delivering solid cigarette fundamentals. PM's combustible business is delivering consistent growth, with organic sales +1.2% in 2019 YTD, following +2.2% in 2018. Volumes have surprised to the upside in the European Union (-2.0% YTD), offsetting weaker performance in Eastern Europe and East Asia and Australia. Importantly, PM has delivered strong price realization +~5.5% YTD and margins have benefit from a shift in mix towards higher margin geographies. Looking toward 2020, we expect the company to deliver ~0.5% organic revenue growth in combustibles, reflecting volumes -3.6% and price/mix +4% as we expect topline to moderate due to PM will likely face headwinds due to excise tax increases in Indonesia and the Philippines

Exhibit 65: PM Combustible Volumes



Source: Company data, Morgan Stanley Research

Exhibit 66: PM Combustible Pricing

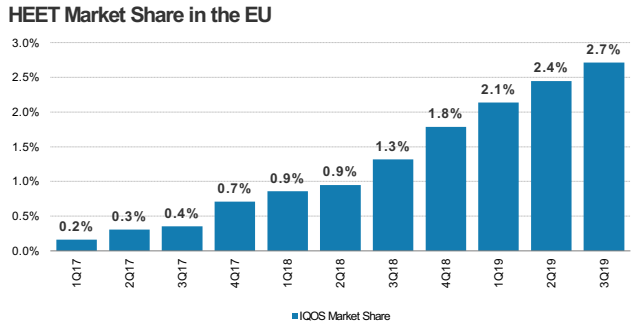


Source: Company data, Morgan Stanley Research

We expect IQOS momentum to continue, benefiting from PM's new product launches and marketing investment. IQOS is experiencing favorable trends across key European markets, such as Italy and Russia, increasing our confidence in continued strong growth. IQOS market share in the EU was 2.7% as of 3Q19, up ~130 bps YoY. In Italy, IQOS share was 4.6% in 3Q19, underscoring its ability to achieve a critical mass in markets outside of Japan. We believe IQOS adoption should continue to grow due to PM's initiatives such as

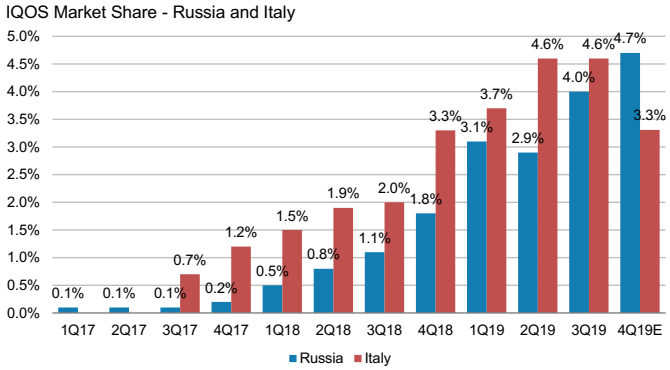
launching new devices (IQOS 3, Multi, Duo) which allow for consecutive heatstick uses and improved battery life/charging time. In addition, PM is adjusting its marketing message based on its earlier learnings. In Japan, PM reduced the ASP of its IQOS devices by 30% in order to better align with competitor pricing, which should drive further IQOS adoption among late adopters. We believe PM is on track to deliver on its 90-100 bn HTU target by 2021, but conservatively model 86 bn HTUs.

Exhibit 67: IQOS market share momentum picked up in the EU over the last several quarters



Source: AlphaWise, Morgan Stanley Research

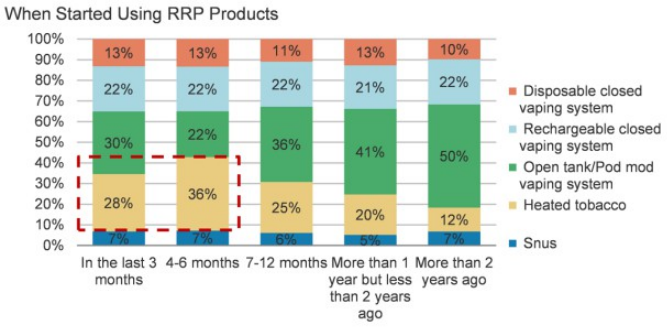
Exhibit 68: IQOS market share momentum picked up in the EU over the last several quarters



Source: AlphaWise, Morgan Stanley Research

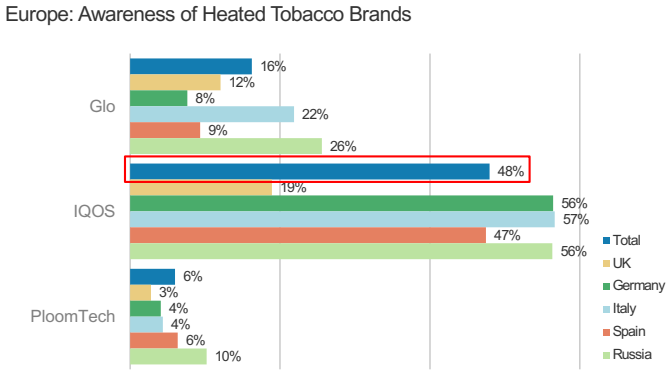
Moreover, our recent AlphaWise of 3,000 European nicotine users reinforces IQOS leadership in Europe. Our survey indicated that HNB adoption is increasing as ~50% of HNB users in Europe entered the category within the last six months compared to 15% who initiated 1-2 years ago. IQOS is benefiting from this trend as 38% of reduced risk users in our survey use IQOS, while 19% said it is the product they use most. IQOS also has high brand awareness, as 48% of respondents heard of IQOS while only 16%/6% heard of competitor products Glo (BAT) /Ploom Tech (JT). IQOS also exhibits the highest user satisfaction and consideration relative to other HNB products, and is best positioned to benefit from HNB tailwinds.

Exhibit 69: HNB saw an increase in new users in the last three months



Source: AlphaWise, Morgan Stanley Research

Exhibit 70: IQOS has 48% awareness vs. Glo/Ploom Tech of 16%/6%

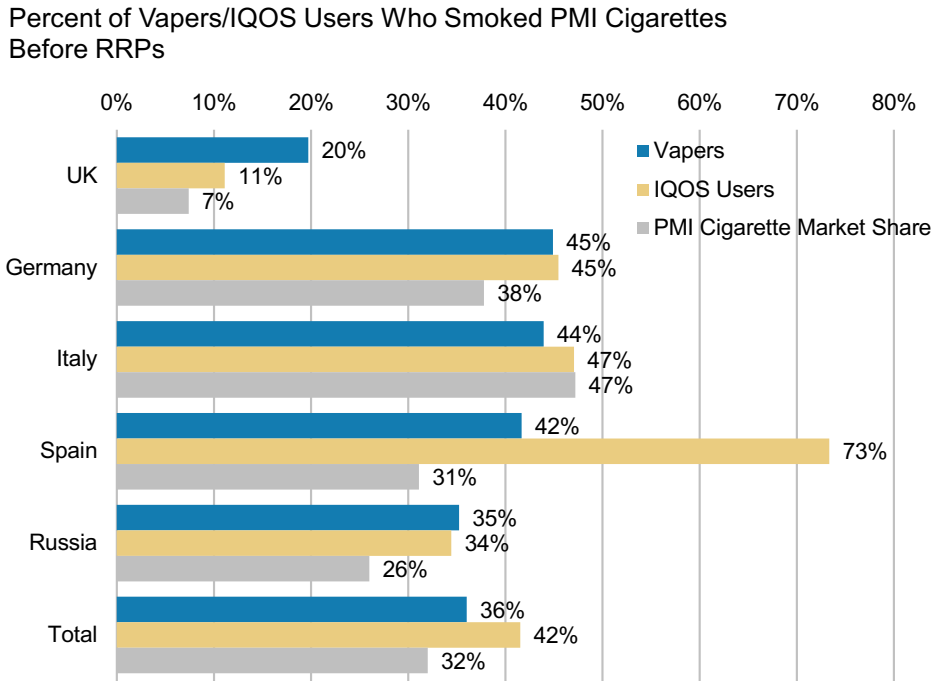


Source: AlphaWise, Morgan Stanley Research

Moreover, IQOS should be accretive to PM's volumes as it is drawing in new customers. Our survey results support PM's prior estimates that while IQOS is sourcing some of its customers from PM's current smokers base, it is also drawing in new users. In our survey, IQOS cannibalization rate exceeds its cigarette share in a market by ~10%. We found

varying IQOS cannibalization rates across countries, with a high share of IQOS users in Spain (73%) sourcing from PMI brands while in Russia and Germany, IQOS is expanding PMI's customer base by sourcing a more significant percentage from other cigarette manufacturers. However, vapers are sourcing from PM's brands as well, slightly ahead of its market share in most countries, highlighting PM's need to build out its vaping portfolio to retain those customers as they switch.

Exhibit 71: IQOS is sourcing a high share of its customers from non-PMI cigarette brands



Source: AlphaWise, Morgan Stanley Research

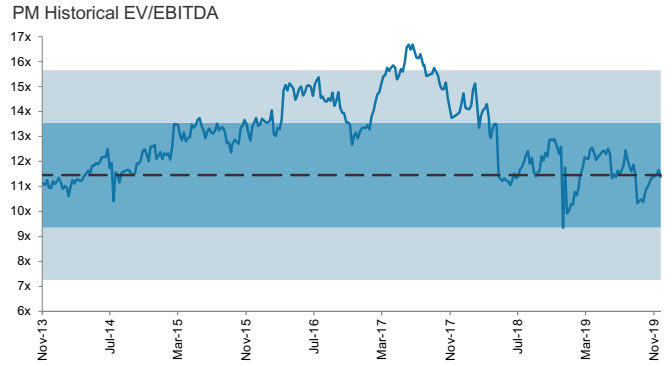
US is a source of upside for IQOS. While our model does not currently explicitly assume IQOS volumes in the US, this is a potential source of upside to our forecasts. IQOS received PMTA approval from the FDA in April 2019 and Altria has started to sell IQOS in a test market in Atlanta, Georgia, with plans to expand to a second test market in Virginia by the end of this year. We believe IQOS will gradually expand its market share in the US as we do not anticipate a national launch prior to 2021. However, we estimate that by 2025, IQOS could capture 5.5% of the US market.

We believe PM's mid-term guidance for +5% organic revenue growth and at least 8% constant currency EPS growth is achievable. We believe that PM should continue to deliver peer-leading results, driven by stable cigarette fundamentals and IQOS upside. The combustible business remains in tact as PM should benefit from a rational competitive environment, which should support continues strong pricing. We also expect continued growth in IQOS (HTU +32.4% YoY in 2020) driven by further gains in Europe. We also expect continued margin expansion as PM executes on its $1 bn cost savings program and IQOS sales increasingly shift towards higher margin geographies.

We believe PM's advantaged positioning warrants a premium valuation. PM is trading at 11.4x 2020E EV/EBITDA vs. peers at ~8.5x EV/EBITDA, but is trading at a 30% discount to consumer Staples compared to trading at a ~15% discount to Staples over the last five years. At 11.4x 2020E EV/EBITDA, PM is trading below its 13.3x average multiple over the

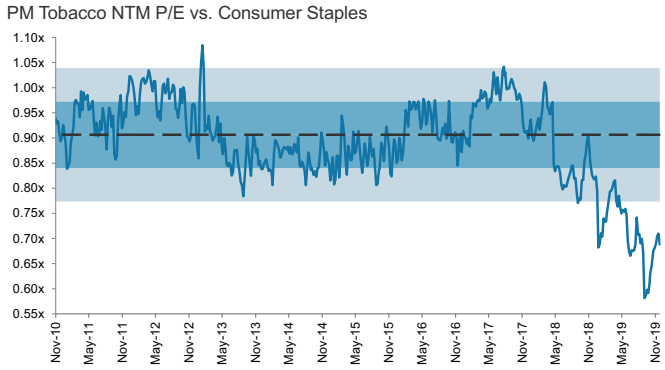
last five years.

Exhibit 72: PM is trading at 11.4x 2020E EV/EBITDA, in-line with its historical average multiple



Source: Company data, Morgan Stanley Research, Eikon

Exhibit 73: PM is trading at 14.8x PE, a 30% discount to consumer staples



Source: Company data, Morgan Stanley Research, Eikon

Risk Reward: Philip Morris International (PM)

Attractive fundamentals and IQOS growth opportunity

Source: Thomson Reuters, Morgan Stanley Research

Price Target **$92**

Based on our DCF valuation, which reflects a WACC of 6.5% and -0.5% terminal growth.

Bull **$125**

Supported by our Bull Case DCF.

Solid combustibles performance with IQOS over-delivery. LSD total volume growth driven by moderate combustible declines (-2.5% annually) combined with IQOS results above the high end of company guidance (102 bn HTU in 2021). Solid margin expansion contributes to HSD-LDD EBIT growth.

Base **$92**

Based on our DCF valuation which reflects a 6.5% WACC and -0.5% terminal growth.

Delivering on plan. PM delivers on current 2018-2021 growth objectives, with a 2% overall volume decline, 7% cigarette price/mix, and EPS slightly above the company's 8% outlook. Cigarette volume declines fall to -4% annually as IQOS momentum grows. IQOS continues to gain share sequentially, with IQOS reaching 85 bn HTU in 2021. Solid ongoing fundamentals and continued momentum for IQOS support peer leading valuation.

Bear **$70**

Supported by our Bear Case DCF reflecting -2% terminal growth.

Fundamentals weaken due to accelerating shift towards alterative products; IQOS momentum slows. Local-currency operating income growth slows to up LSD-MSD as combustible volumes decline 5% annually, IQOS disappoints with 2021 volumes of ~66 bn units due to a shift towards competitive products. Margins contract due to greater investment in RRPs.

Investment Thesis

- Philip Morris operates in an attractive industry, with high profit margins & substantial free cash flow.
- The company benefits from significant geographic diversification, with good exposure to EMs (growth) and Developed Markets (high margins).
- We anticipate continued delivery on PM's mid-term targets for +5% constant currency revenue and +8% EPS growth due to a rational competitive environment, an absence of excise tax shocks and solid industry pricing.
- IQOS provides an incremental source of volume and profit that should support MSD long-term OCI growth.
- Increasing competition in vaping, which we expect to sustain a lower margin profile relative to cigarettes could impact increases uncertainty around PM's long-term outlook.
- Valuation looks fair relative to Staples peers.

Key Value Drivers

- IQOS market share momentum and consumer adoption
- Combustible pricing power
- Reduced prevalence of illicit trade
- New product innovation

Potential Catalysts

- Short term: Stronger-than-expected EPS and operating profit growth; Relative value of the US dollar; IQOS market share trends
- Medium term: Dividend growth and share repos; potential for increasing competition from redued-risk alternatives; IQOS US adoption
- Long-term: Potential expansion into new reduced-risk tobacco products.

Risks to Achieving Price Target

- Strength of US dollar
- Large-scale excise tax increase
- Shortfall in IQOS expectations

Procter & Gamble (PG): OW, PT $134

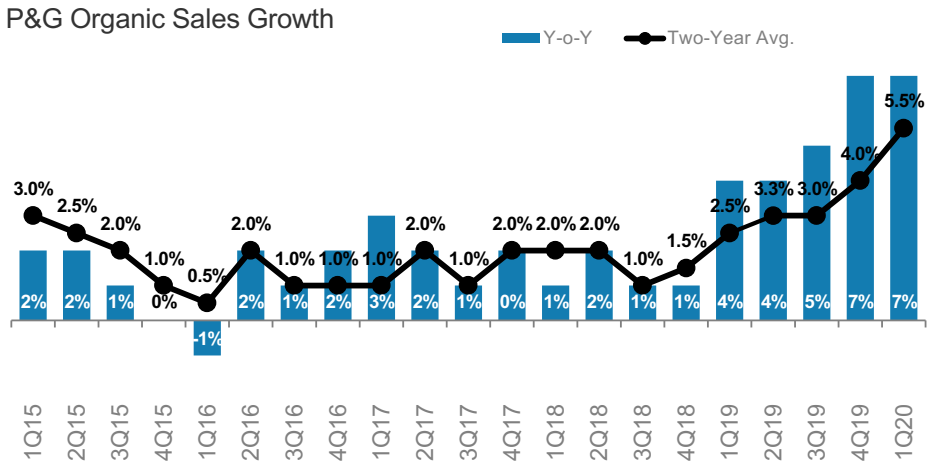
Dara Mohsenian, Household Products, Beverages, & Food

Industry View: We are cautious on the Household Products & Personal Care group, as we expect HPC topline growth will materially decelerate as HPC companies cycle large US price increases and comparisons become more difficult. Due to worsening commodity prices last year, HPC companies announced price increases to offset margin degradation in the US, but going forward we expect US pricing to dissipate as increases are cycled and commodity prices are now benign. We remain the most concerned about the HPC group across the CPG sector given the incremental US price increases were most pronounced sequentially, and we are concerned that as pricing dissipates, volume will not proportionally recover, resulting in a topline deceleration. We have already seen this occur with a few HPC companies, namely CLX, where we are UW. Additionally, more difficult comparisons should add to a forward topline deceleration.

Investment Thesis: PG is our top pick in HPC, as we believe PG's organic sales growth trajectory has sustainably improved, with ~7% organic sales growth in the past two quarters, driven by strong breadth of improvement across the portfolio and expanding PG market share despite greater pricing/less promotion than peers, which were enabled by organizational changes. Combined with inflecting and above consensus gross margins based on our detailed GM build, we expect higher PG topline/EPS growth than peers, which should drive premium PG valuation vs. in line relative levels today.

Momentum Behind Topline Recovery is Sustainable: PG reported 7% organic sales growth in 1Q20 and 4Q19, which was PG's best organic sales growth in 13 years, highlighting strong momentum. PG's +5.5% 2-year average Q1 organic sales growth was also the best result in a decade and the third consecutive quarter of sequential 2-year average organic sales growth improvement, well-above +4% in 4Q19 and +3% in 3Q19. We see higher organic sales growth as sustainable long-term at PG with strategic and organizational changes put in place in recent years bearing fruit, and strong breadth and magnitude of recent market share improvement. We also see future potential topline benefits (and PG market share gains) from a large 120 bps of opportune margin reinvestment back behind the business in Q1 as a % of sales and 190 bps in Q4 of FY19.

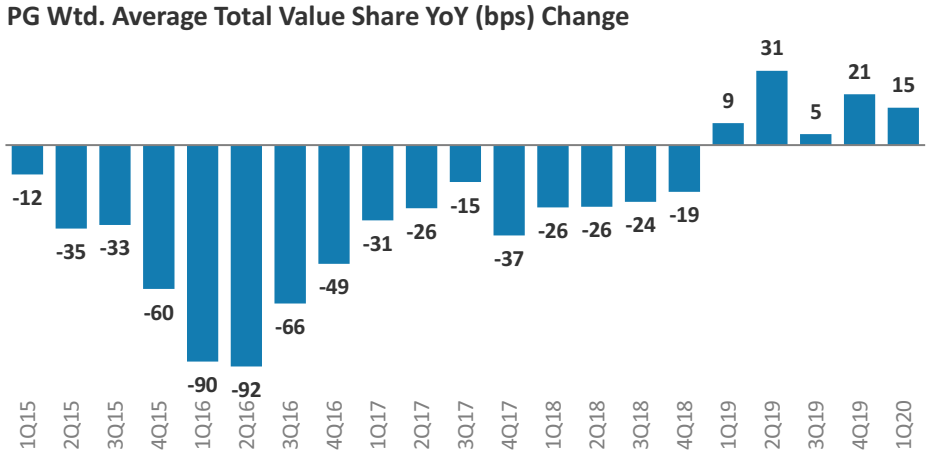
Exhibit 74: PG Organic Sales Growth Has Continued to Accelerate



Source: Company data, Morgan Stanley Research

Broad Corporate Market Share Improvement: PG's corporate weighted average market share has been up y-o-y for five straight quarters, a significant improvement from years of substantial market share losses.

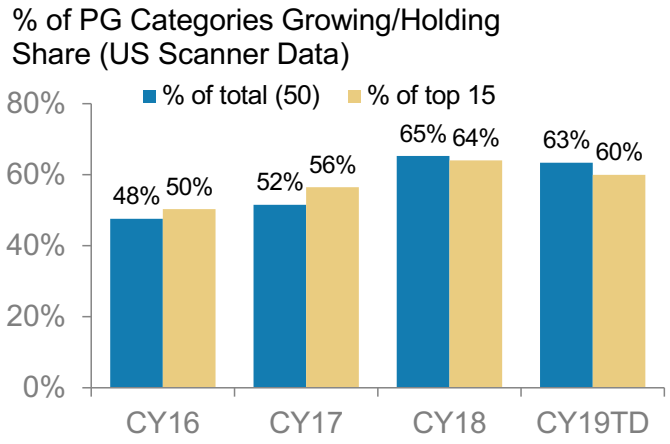
Exhibit 75: PG Corporate Market Share Results Have Inflected Positively



Source: Company data, Morgan Stanley Research

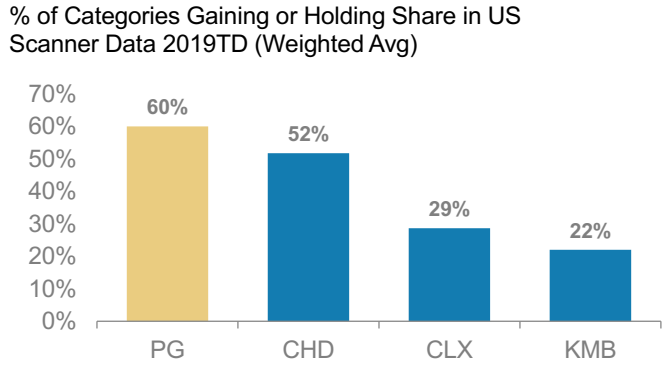
Breadth of Improvement: PG market share improvement has been broad-based, with ~60% of PG's corporate top 15 categories gaining/holding share in CY19TD, up from ~53% in CY17/16. Analyzing PG's 50 total categories tracked by US scanner data we see a similar picture, with ~60% of PG's categories gaining/holding share in CY19TD, up from ~52% in CY18, ~40% in CY17/16, and ~32% in CY15. Compared to other large cap HPC peers, PG's breadth of overall market share is far above CHD at 52%, CLX at 29%, and KMB at 22%.

Exhibit 76: The % of PG Categories Gaining/Holding Share Has Steadily Increased



Source: Nielsen xAOC + C, Morgan Stanley Research

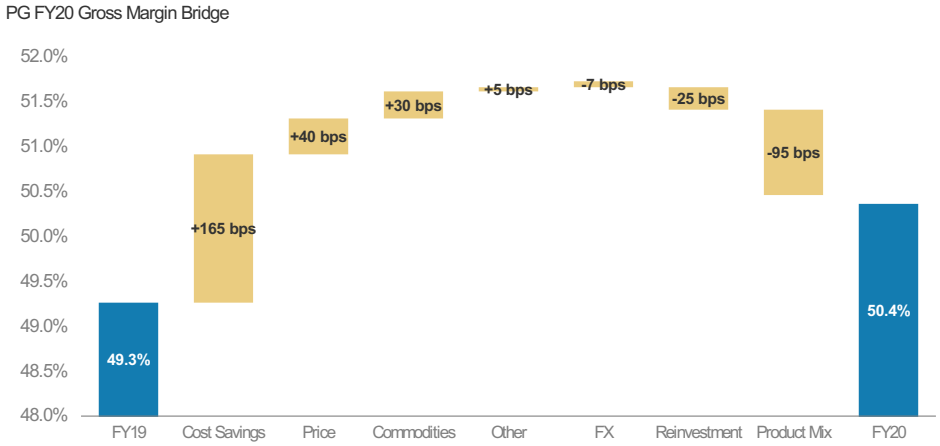
Exhibit 77: PG Has Stronger Market Share Growth Than Peers 2019TD



Source: Nielsen xAOC + C, Morgan Stanley Research

We expect above consensus GM expansion at PG in FY20, with the highest level of y-o-y expansion in the group, which should allow PG the opportunity to further reinvest behind the business and drive further topline growth. Below we break out our detailed gross margin build that points to ~20 bps of FY20 upside vs. consensus.

Exhibit 78: We Forecast +110 bps of Gross Margin Expansion in FY20



Source: Company data, Morgan Stanley Research estimates

Our outlook for +110 bps of PG gross margin expansion in FY20 is above consensus by ~20 bps and driven by the following items:

- **Cost Savings:** PG has guided to $1.2bn-$1.6bn in annual COGS savings longer-term; we conservatively forecast PG to come in below that range in FY20 at $1.1B. This implies a +165 bps gross margin impact from cost savings in FY20, but would be +210 bps at PG's LT guidance midpoint.

- **Commodities:** We anticipate a commodities tailwind of ~$150mm in FY20, or +27 bps, a large improvement vs. a -80 bps headwind from commodities in FY19 and a -92 bps headwind in FY18. PG publicly confirmed commodities is expected to be a slight tailwind for FY20 on their 4Q19 call, but our detailed commodity tracker (which has an 83% historical r-squared for PG) now points to a more substantial

tailwind of $300M. To be conservative given timing lags/pressure from non-tracked commodities (such as labor and specialty chemicals), etc. we assume $150M.

- **Product Mix:** We assume product mix will continue to be a negative impact of ~95 bps to FY gross margins, in line with recent results (FY19 was -103 bps and FY18 was -88 bps), although we conservatively assume it will be -100 bps in the balance of the year vs. -50 bps in the reported Q1.

- **FX:** We estimate that FX will be slightly negative to gross margin in FY20 at -7 bps, in line with PG's Q4 guidance and our spot FX model.

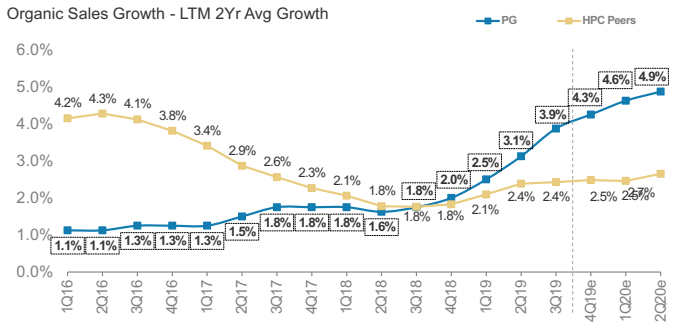
- **Price:** We forecast that PG's pricing will be a +42 bps GM tailwind in FY20 based on 0.8% FY20 yoy pricing due entirely to price increases already in place. Pricing has already started to moderate at PG, with the 1.0% result in 1Q20 (+1.3% unrounded) a sharp drop off from 3% in 4Q19, and we anticipate that it will take another step down to 0.5% in 2H20.

- **Reinvestment:** PG has been reinvesting behind the business in FY19, with a -33 bps impact from the reinvestment line-item. 1Q20 was a light reinvestment quarter on gross margin, with less than 10 bps of impact, but we conservatively estimate -25 bps of reinvestment in FY20 with -30 bps in the balance of the year.

- **Other:** We estimate that the other line (including tariffs, fixed cost leverage, and other items), will be a +5 bps tailwind for FY20 gross margin, driven by a -9 bps BOY forecast vs +40 bps in Q1.

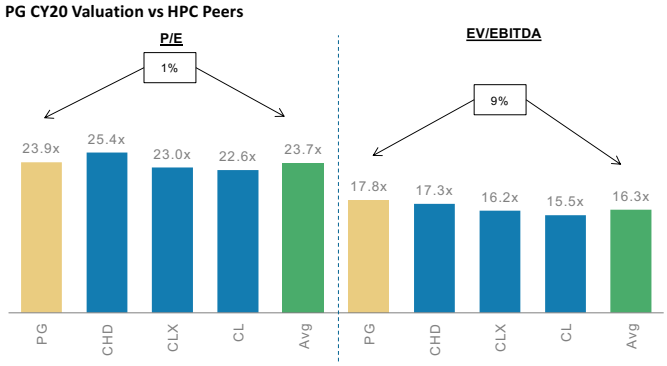
Compelling Relative Valuation: Despite PG posting clearly superior LTM 2-year average organic sales growth vs. HPC peers, with the gap vs. peers widening for 13 straight quarters, PG's CY20 NTM P/E is trading roughly in line with HPC peers. We believe this valuation is unfair given greater PG topline/EPS growth, with superior topline growth, as well as greater gross margin expansion, as detailed above.

Exhibit 79: We Expect PG Underlying Organic Sales Performance to Outpace HPC Peers



Source: Company data, Morgan Stanley Research

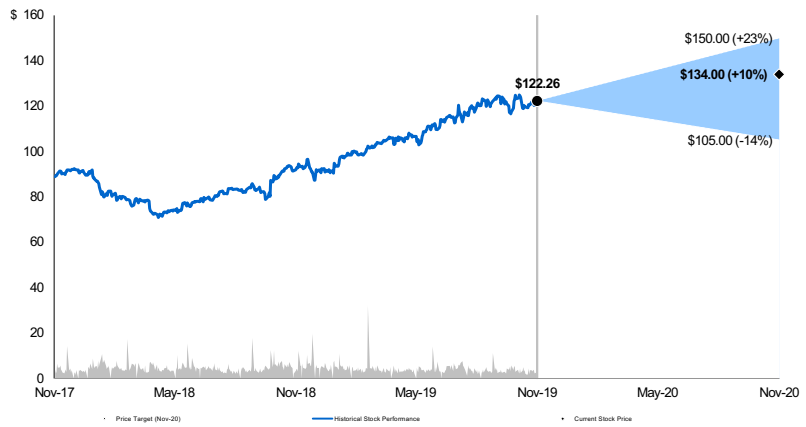
Exhibit 80: PG CY20 P/E Trades In Line With HPC Peers



Source: Refinitiv, Morgan Stanley Research

Risk Reward: Procter & Gamble (PG)

Procter & Gamble (PG): Risk-Reward Remains Favorable



Source: Thomson Reuters (historical share price data), Morgan Stanley Research estimates

Price Target **$134**

Derived from base case scenario

Bull **$150**

28.5x Bull Case CY20e EPS

Topline sustains >4.0% organic sales growth. Revenue upside (~125 bps int'l upside and ~100 bps US upside) as PG's marketing/innovation focus drives market share improvement. Cost cutting above our forecast and better than expected price realization drive margin upside, and in turn ~10% EPS growth. Valuation expands to 28.5x CY20e EPS

Base **$134**

26.5x Base Case CY20e EPS

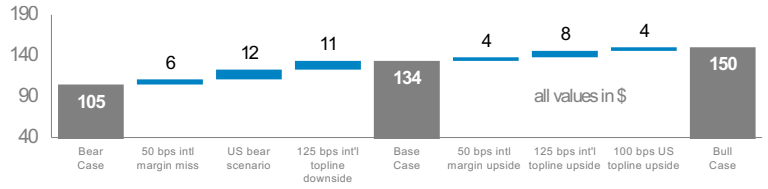
Strong sales growth + margin expansion. We forecast organic sales growth of ~4.0% going forward (above HPC peers) led by improving US results on building market share momentum. Better price realization and continued cost savings support ~70 bps of OM expansion/yr, driving HSD% EPS growth. We apply a multiple of 26.5x to CY20e EPS, a slight premium to PG's 3-yr avg given accelerating fundamentals.

Bear **$105**

22x Bear Case CY20e EPS

US led topline/margin downside. Our US bear case scenario plays out: -80/-50 bps pricing/volume downside along with ~20 bps of margin downside on greater reinvestment. Outside the US, ~125 bps of topline downside and ~50 bps of margin downside drive muted LSD% EPS growth. Valuation contracts to 22x CY20e EPS.

Exhibit 81: Bear to Bull: Topline Trends Should Be the Key Stock Driver



Source: Morgan Stanley Research estimates

Investment Thesis

- **Topline Momentum Looks Sustainable:** We believe strategy tweaks put in place in recent years are bearing fruit and can accelerate PG topline growth back to the ~4% range. In the US, improving breadth of performance and reduced promotional intensity give us confidence that market share momentum is sustainable, which, combined with an improving price outlook and greater agility as organizational changes are implemented, supports topline growth above HPC peers.
- **Improving Margin Outlook:** Following 2 years of FY gross margin declines, we see a FY GM inflection led by improving price realization and a commodity tailwind. When combined with a sizable cost savings program (worth ~15% to annual profit), we see scope for ~120 bps of annual margin expansion in FY20, and in turn HSD% EPS growth delivery over the next several years.
- **Valuation Looks Compelling on a Relative Basis:** With PG trading at ~24x CY20e EPS, close to peers, relative valuation looks compelling considering our call for PG fundamentals to positively inflect after years of underperformance vs. more expensive HPC peers.

Risks to Achieving Price Target

- Risks include macro pressures, pricing fluctuations, cost-cutting, execution issues, market share vacillations, and currency & commodity volatility.

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Global Stock Ratings Distribution

(as of November 30, 2019)

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STOCK RATING CATEGORY	COVERAGE UNIVERSE COUNT	COVERAGE UNIVERSE % OF TOTAL	INVESTMENT BANKING CLIENTS (IBC) COUNT	INVESTMENT BANKING CLIENTS (IBC) % OF TOTAL IBC	INVESTMENT BANKING CLIENTS (IBC) % OF RATING CATEGORY	OTHER MATERIAL INVESTMENT SERVICES CLIENTS (MISC) COUNT	OTHER MATERIAL INVESTMENT SERVICES CLIENTS (MISC) % OF TOTAL OTHER MISC
Overweight/Buy	**1150**	**36%**	**287**	**42%**	**25%**	**515**	**36%**
Equal-weight/Hold	**1452**	**46%**	**317**	**47%**	**22%**	**692**	**48%**
Not-Rated/Hold	**1**	**0%**	**0**	**0%**	**0%**	**1**	**0%**
Underweight/Sell	**563**	**18%**	**73**	**11%**	**13%**	**222**	**16%**
TOTAL	**3,166**		**677**			**1430**	

Data include common stock and ADRs currently assigned ratings. Investment Banking Clients are companies from whom Morgan Stanley received investment banking compensation in the last 12 months. Due to rounding off of decimals, the percentages provided in the "% of total" column may not add up to exactly 100 percent.

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Overweight (O). The stock's total return is expected to exceed the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.
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Underweight (U). The stock's total return is expected to be below the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.
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INDUSTRY COVERAGE: Gaming & Lodging

COMPANY (TICKER)	RATING (AS OF)	PRICE* (11/29/2019)
Thomas Allen		
Boyd Gaming Corporation (BYD.N)	O (12/20/2018)	$29.41
Caesars Entertainment Corp (CZR.O)	E (06/25/2019)	$13.04
Choice Hotels International Inc (CHH.N)	E (05/05/2017)	$97.25
DiamondRock Hospitality Co (DRH.N)	U (09/26/2016)	$10.30
Eldorado Resorts Inc. (ERI.O)	O (11/18/2019)	$53.51
Extended Stay America Inc (STAY.O)	E (08/09/2019)	$14.76
Gaming and Leisure Properties Inc (GLPI.O)	O (07/24/2018)	$42.20
Hilton Worldwide Holdings Inc (HLT.N)	E (01/17/2018)	$105.00
Host Hotels & Resorts, Inc. (HST.N)	U (12/20/2018)	$17.49
Hyatt Hotels Corporation (H.N)	E (03/07/2017)	$80.80
Las Vegas Sands Corp. (LVS.N)	O (11/07/2017)	$62.75
Marriott International Inc. (MAR.O)	E (07/24/2018)	$140.36
MGM Growth Properties LLC (MGP.N)	++	$30.99
MGM Resorts International (MGM.N)	++	$31.95
Penn National Gaming, Inc. (PENN.O)	O (05/09/2019)	$23.03
Stars Group Inc (TSG.O)	E (05/01/2019)	$24.29
Sunstone Hotel Investors Inc (SHO.N)	U (09/26/2016)	$14.00
VICI Properties Inc (VICI.N)	O (08/26/2019)	$24.73
Wynn Resorts, Limited (WYNN.O)	E (02/09/2018)	$120.85
Xenia Hotels & Resorts Inc (XHR.N)	U (12/20/2018)	$21.06

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* Historical prices are not split adjusted.

INDUSTRY COVERAGE: Branded Apparel & Footwear

COMPANY (TICKER)	RATING (AS OF)	PRICE* (11/29/2019)
Kimberly C Greenberger		
Foot Locker Inc (FL.N)	E (08/08/2019)	$40.05
Levi Strauss & Co (LEVI.N)	E (04/15/2019)	$16.78
Nike Inc. (NKE.N)	O (08/01/2018)	$93.49
PVH Corp. (PVH.N)	O (04/09/2019)	$96.96
Skechers USA Inc. (SKX.N)	E (08/01/2018)	$40.22
Under Armour Inc. (UAA.N)	E (08/01/2018)	$18.89
Yeti Holdings Inc. (YETI.N)	E (03/29/2019)	$31.82

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INDUSTRY COVERAGE: Hardline/Broadline/Food Retail

COMPANY (TICKER)	RATING (AS OF)	PRICE* (11/29/2019)
Simeon Gutman, CFA		
Advance Auto Parts Inc (AAP.N)	O (06/23/2014)	$157.08
At Home Group Inc (HOME.N)	E (06/10/2019)	$8.58
AutoZone Inc. (AZO.N)	E (07/06/2017)	$1,177.92
Bed Bath & Beyond Inc. (BBBY.O)	E (04/05/2019)	$14.58
Best Buy Co Inc (BBY.N)	E (01/19/2016)	$80.64
BJ'S Wholesale Club (BJ.N)	E (07/23/2018)	$23.70
Costco Wholesale Corp (COST.O)	E (10/06/2017)	$299.81
Dick's Sporting Goods (DKS.N)	E (05/20/2016)	$45.81
Dollar General Corporation (DG.N)	O (02/16/2016)	$157.36
Dollar Tree Inc (DLTR.O)	E (02/16/2016)	$91.46
Five Below Inc (FIVE.O)	O (06/30/2019)	$123.71
Floor & Decor Holdings Inc (FND.N)	E (11/12/2018)	$48.01
Grocery Outlet Holding Corp (GO.O)	E (07/15/2019)	$33.13
Home Depot Inc (HD.N)	O (02/23/2017)	$220.51
Kroger Co. (KR.N)	E (06/19/2017)	$27.34
Lowe's Companies Inc (LOW.N)	O (01/21/2015)	$117.31
Lumber Liquidators Holdings Inc (LL.N)	E (03/02/2015)	$8.91
National Vision Holdings Inc. (EYE.O)	O (11/20/2017)	$30.20
O'Reilly Automotive Inc (ORLY.O)	E (07/06/2017)	$442.28
Ollie's Bargain Outlet Holdings Inc (OLLI.O)	E (09/25/2017)	$65.40
Party City Holdco Inc (PRTY.N)	E (01/19/2016)	$1.93
Sally Beauty Holdings Inc (SBH.N)	U (11/08/2017)	$18.43
Target Corp (TGT.N)	E (05/20/2019)	$125.01
The Michaels Companies, Inc. (MIK.O)	E (05/20/2019)	$8.18
Tractor Supply Co (TSCO.O)	E (06/23/2014)	$94.44
Ulta Beauty Inc (ULTA.O)	E (08/29/2019)	$233.86
Valvoline Inc. (VVV.N)	E (10/18/2016)	$22.65
Walmart Inc (WMT.N)	O (01/23/2019)	$119.09
Wayfair Inc (W.N)	E (04/25/2018)	$84.92
Williams-Sonoma Inc (WSM.N)	U (01/23/2019)	$69.40

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INDUSTRY COVERAGE: Beverages

COMPANY (TICKER)	RATING (AS OF)	PRICE* (11/29/2019)
Dara Mohsenian, CFA		
Brown-Forman Corporation (BFb.N)	E (06/28/2018)	$67.82
Coca-Cola Co. (KO.N)	O (05/14/2019)	$53.40
Coca-Cola European Partners PLC (CCEP.AS)	E (06/12/2019)	€45.80
Constellation Brands Inc (STZ.N)	E (05/24/2019)	$186.06
Keurig Dr Pepper Inc (KDP.N)	U (04/11/2019)	$30.94
Molson Coors Brewing Co (TAP.N)	E (01/09/2018)	$50.48
Monster Beverage Corp (MNST.O)	E (11/08/2018)	$59.82
PepsiCo Inc. (PEP.O)	O (05/06/2012)	$135.83

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INDUSTRY COVERAGE: Tobacco

COMPANY (TICKER)	RATING (AS OF)	PRICE* (11/29/2019)
Richard Taylor		
British American Tobacco PLC (BATS.L)	U (06/16/2019)	3,060p
Sanath Sudarsan, CFA		
Imperial Brands PLC (IMB.L)	U (09/18/2018)	1,703p
Swedish Match AB (SWMA.ST)	O (09/18/2018)	SKr 458.70

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INDUSTRY COVERAGE: Tobacco

COMPANY (TICKER)	RATING (AS OF)	PRICE* (11/29/2019)
Pamela Kaufman, CFA		
Altria Group, Inc. (MO.N)	E (08/23/2019)	$49.70
Philip Morris International Inc (PM.N)	O (03/31/2008)	$82.93

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INDUSTRY COVERAGE: Food

COMPANY (TICKER)	RATING (AS OF)	PRICE* (11/29/2019)
Dara Mohsenian, CFA		
General Mills Inc (GIS.N)	E (09/17/2018)	$53.32
Kellogg Co. (K.N)	E (09/17/2018)	$65.12
Kraft Heinz Co (KHC.O)	E (03/03/2019)	$30.50
Mondelez International Inc (MDLZ.O)	O (08/07/2019)	$52.54
Pamela Kaufman, CFA		
BellRing Brands Inc. (BRBR.N)	O (11/11/2019)	$20.03
Conagra Brands (CAG.N)	E (05/20/2019)	$28.87
Hostess Brands Inc (TWNK.O)	E (09/25/2017)	$13.45
J. M. Smucker Co (SJM.N)	E (04/18/2019)	$105.09

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INDUSTRY COVERAGE: Household & Personal Care

COMPANY (TICKER)	RATING (AS OF)	PRICE* (11/29/2019)
Dara Mohsenian, CFA		
Church & Dwight Co., Inc. (CHD.N)	E (02/05/2019)	$70.24
Clorox Co (CLX.N)	U (04/19/2018)	$148.23
Colgate-Palmolive Co (CL.N)	E (04/30/2018)	$67.82
Coty Inc (COTY.N)	E (11/07/2018)	$11.54
Edgewell Personal Care (EPC.N)	E (06/04/2015)	$31.16
elf Beauty (ELF.N)	E (06/04/2019)	$16.57
Energizer Holdings Inc. (ENR.N)	E (04/18/2017)	$49.89
Estee Lauder Companies Inc (EL.N)	O (08/28/2018)	$195.47
Kimberly-Clark Corp (KMB.N)	E (01/24/2019)	$136.34
Newell Brands Inc. (NWL.O)	E (01/25/2018)	$19.22
Procter & Gamble Co. (PG.N)	O (12/13/2018)	$122.06

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INDUSTRY COVERAGE: Restaurants

COMPANY (TICKER)	RATING (AS OF)	PRICE* (11/29/2019)
John Glass		
BJ's Restaurants, Inc. (BJRI.O)	E (09/16/2015)	$41.15
Bloomin' Brands Inc (BLMN.O)	E (12/19/2018)	$24.05
Brinker International Inc. (EAT.N)	U (01/17/2017)	$44.80
Chipotle Mexican Grill, Inc. (CMG.N)	E (04/17/2019)	$813.92
Darden Restaurants Inc. (DRI.N)	E (10/30/2014)	$118.44
Dominos Pizza Inc. (DPZ.N)	O (04/17/2019)	$294.30
Dunkin Brands Group Inc (DNKN.O)	E (09/06/2011)	$76.55
Jack in the Box Inc. (JACK.O)	E (05/21/2019)	$79.29
McDonald's Corporation (MCD.N)	O (11/29/2018)	$194.48
Red Robin Gourmet Burgers, Inc. (RRGB.O)	E (01/09/2013)	$27.27
Restaurant Brands International, Inc. (QSR.N)	O (03/26/2018)	$65.63
Shake Shack Inc (SHAK.N)	E (12/07/2017)	$61.98
Starbucks Corp. (SBUX.O)	E (06/20/2018)	$85.43
Texas Roadhouse, Inc. (TXRH.O)	E (01/17/2017)	$57.90
The Cheesecake Factory, Inc. (CAKE.O)	E (03/27/2008)	$43.61
The Wendy's Company (WEN.O)	E (01/08/2015)	$21.44
Wingstop Inc (WING.O)	E (10/18/2018)	$80.00
Yum! Brands, Inc. (YUM.N)	E (01/09/2014)	$100.67

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