COMMENTARY

GLOBAL ALPHA

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Dear clients and colleagues,

Stock investors seem to have anointed a victor that will win over the consumer: ***AMAZON***

Not a week goes by without Amazon announcing it will enter a new retail segment or a new country, and this usually has catastrophic consequences on the stock prices of incumbents in that segment or country.

The day Amazon announced its purchase of Whole Foods, the stock price of Kroger (KR US), the largest grocer in the US, fell by over 15% and United Natural Food (UNFI US), a competitor of Whole Foods, went down over 25%. Even Costco and Wal-Mart fell by more than 5%.

Another week, Amazon announced it would begin selling auto parts, and the market seemed to automatically assume it would dominate that industry. In the last year, the stock price of some of the major players in the industry has gone down. Autozone (AZO US) is down 28%, Advance Auto Parts (AAP US) is down 29% and Genuine Parts (GPC US), the owner of Napa which does not operate brick-and-mortar stores, is down 8%. Installers have also been impacted. For example, Monro Muffler (MNRO US) is down 33%.

Another week, Amazon announced it would enter the Australian market sometime in 2018. That announcement was sufficient to knock down every retail stock in Australia by an average of 15%, including our holdings, Greencross (GXL AU) and Bapcor (BAP AU).

Is the fear justified or overblown? Does it create opportunities for investors? Let us start by analyzing the threat from Amazon.

Since its founding in 1994, Amazon (AMZN US) has been an incredible grower. Sales in 2017 will be over US$160B. However, net income in the last 12 months was only US$2.6B, most coming from its AWS division (cloud hosting) and not from retailing. Actually, the company's total profit since its founding in 1994 is US$4.9B. This seems to be enough for investors to justify a market value of US$463B.

To put this value into perspective, it is more than Wal-Mart (WMT US) at $229B, Walgreens (WBA US) at US$83B, Costco (COST US) at US$68B, Target (TGT US) at US$39B and Kroger (KR US) at US$34B. These five companies have combined revenues of US$950B and combined net income of US$26.1B.

What is Amazon: Is it a retailer? Is it an IT firm? What is its competitive advantage?

In our opinion, Amazon's main competitive advantage is its analytical software and website. They have become the go-to site for shoppers looking to buy something, similar to the way Google has become the go-to internet search engine.

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It has analytical tools that predict what customers are looking for or might be interested in, and it offers to fulfill orders with great convenience (i.e. one-click shopping with quick and free delivery). And a better price?

Are they a better retailer, or are they just upending the industry by operating with much lower margins. Are we witnessing a race to zero profit?

All this may be good for consumers in the short term, but not for any retailer, Amazon included.

Let us look at Amazon's perceived competitive advantages, price and convenience.

- Price. There are two prices:

    - The Price paid by Amazon. Generally, the larger the purchasing power, the better the price paid. Amazon is not the largest buyer in most categories. The retailers listed earlier dwarf Amazon in their respective categories (general merchandise, drugs, food, etc.) and therefore pay a lower price for products — something Amazon acknowledges.

    - The price paid by an Amazon client. There is often a perception that Amazon offers lower prices. However, studies have repeatedly shown that more than 50% of the time Amazon prices are higher than other retailers. Amazon Prime customers think they are getting a better price and are less likely to compare prices because they like the convenience Amazon offers.

  Other retailers are taking notice and are fighting Amazon head-on on prices. Wal-Mart aims to have the lowest price on 80% of its sales.

  So what is Amazon's business plan: losing money or making a lower margin than its competitors? Is this a sustainable business model?

- Convenience. As discussed above, convenience is what draws many shoppers to Amazon. Convenience means easy ordering combined with mainly free and fast shipping. The enormous success of the Prime membership (free 2-day shipping for an annual subscription) has been key to Amazon's success.

Amazon has no competitive advantage when it comes to shipping. To try to capture more margin from this large cost item, Amazon is considering having its own assets (i.e., increasing the number of distribution centers, buying airplanes, trucks, etc.). Some retailers already have a more extensive distribution infrastructure, and everyone can offer free shipping.

Wal-Mart has an infrastructure that dwarfs Amazon. About 90% of the US population lives within 10 miles of a Wal-Mart store. The company now offers direct pick-up at stores and offers lower prices than Amazon. It is also tapping into its large employee base, allowing them to deliver packages to customers on their way home from work to earn extra money. A real game changer.

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In other industries, we believe that Amazon has no competitive advantage. Let's take the example of replacement auto parts. In the past 10 years, the "do-it-yourself" model, where you buy parts and fix your car yourself, has quickly been replaced by the "do-it-for-me" model, where you go to a garage to have your car maintained or repaired. Why? Cars are more complex, parts have been replaced by modules and environmental regulations are stricter.

In the "do-it-for-me" model, a mechanic will assess your car and perform the repair or maintenance using parts held in inventory or parts ordered from a "jobber". That "jobber" will be part of a network like Genuine Parts or Autozone. In this supply chain, delivery time is a maximum of a few hours, so overnight shipping will not do.

So, it appears that Amazon's only true competitive advantage is its search engine. The question is, how long will this advantage remain? As Google refines its shopping engine, as Wal-Mart improves its search engine, as Shopify and others help retailers build their own online tools, and finally, as customer become more confident about shopping online and skilled at finding what they want on the internet, Amazon's advantage will erode.

Additionally, consumer brands are developing their own direct-to-consumer platforms to avoid aggregators like Amazon, just as hoteliers are developing tools to become less reliant on Priceline.

Today over half of Amazon sales are fulfilled by third-party merchants using Amazon as a shopping portal. The challenge for Amazon will be to retain them as customers as they can easily switch to Wal-Mart, eBay or Alibaba.

In conclusion, we have no conclusion! It will be a few more years before we know if Amazon will emerge as a winner or a loser. Even worse, everybody could end up a loser.

In the meantime, the disruption caused by Amazon, real or imagined, and the impact on stock prices creates opportunities. Let's examine some of the consumer holdings in our portfolio:

We own Motorcar Parts of America (MPAA US). In the last year, its stock price has gone up 4% while sales and profit grew 15%. The company currently sells at 11.7x this year's earnings, a large discount to the market multiple of 21x. MPAA manufactures replacement alternators, starters and other parts and sells them to retailers, including Amazon. So in this case, Amazon's impact is positive as it is one more distribution channel for MPAA's products.

We also own MarineMax (HZO US). MarineMax sells new and used boats, parts and accessories from a network of stores that often include marinas. We see very limited impact on this company from Amazon and other online retailers.

In Australia we own Greencross Limited (GXL AU). Greencross is Australia and New Zealand's largest pet-care company with a network of 375 veterinary clinics and retail stores. GXL is down over 11% this year, and was down over 20% at one point, driven by Amazon fears. There is no doubt that Amazon will have an impact on

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some items Greencross offers, such as food and over-the-counter medication. However, as the company humorously noted, “our competitive advantage has four legs”. The Greencross model of offering a full suite of services (veterinary, grooming, boarding, food, toys and accessories), similar to PetSmart, provides it with a solid “moat”.

We also own L’Occitane (973 HK), a global cosmetics company whose products are created using natural and organic ingredients. In the last year, its largest growth came via online sales from its own e-commerce site as well from TMall (Alibaba’s site). We believe Amazon will be a positive for L’Occitane.

We own many other consumer-related companies and will be happy to give you an update on them if you wish.

We tend to avoid companies that will be direct competitors of Amazon, Wal-Mart.com or other e-commerce behemoths as we believe that they are not necessarily better, but they are changing the rules, and those new rules may very well create losers.

As such, we are avoiding department stores and retailers that sell other companies’ brands (i.e. shoe stores, clothing stores, etc.), unless they also retail their own brands. We are also avoiding retail-focused REITs.

Have a good weekend.

The Global Alpha Team

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