

Global Equity Observer

Amazonians at the gate?

ACTIVE FUNDAMENTAL EQUITY | INTERNATIONAL EQUITY TEAM | INVESTMENT INSIGHT | JUNE 2017

CEO Jeff Bezos' vision of Amazon being 'The Everything Store' looks set to enter the next major phase as their assault on the grocery segment gains momentum, highlighted by the recent acquisition of Whole Foods. At 30%, grocery is the largest component of the \$2.5 trillion that U.S. consumers spend annually.¹ Looking back at where it all started for Amazon, i.e., with books, the smallest segment of U.S. consumer spending, and how the group has systemically gone on to dominate each segment it has targeted, the working assumption is that Amazon could succeed. Already today, Amazon accounts for 5% of U.S. personal expenditure, 33% of U.S. online expenditure and 50% of the growth in U.S. consumer expenditure.¹

For us, the interesting question here is how Amazon's move into grocery may impact Staples companies. Our conversations with CEOs of Staples companies have been dominated by the question of how this Seattle-based business may affect the way consumers shop and how the providers of branded products can adapt to this change.

AUTHOR



WILLIAM LOCK

Head of International Equity Team

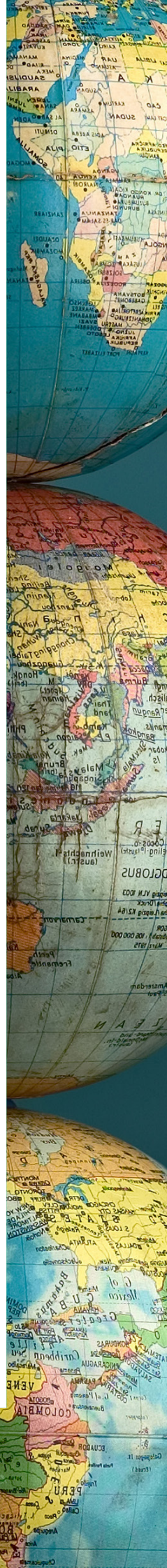


BRUNO PAULSON

Managing Director

"For us, the interesting question here is how Amazon's move into grocery will impact Staples companies."

¹ Source: U.S. Bureau of Economic Analysis, 2015.



We believe there are many U.S. Staples companies, particularly in Food and Household Products, which are ill-prepared for the retail website's push into grocery. We believe Amazon will expose these faults in the following ways:

- Targeting the centre of the store. The centre aisles are often populated with auto-replenished products such as detergents and cereals, products that lend themselves to online ordering and delivery. Relentless pressure from the online giant's price algorithms will, we suspect, lead to a rise in private label from the current 19% of the retail shelf in the U.S. toward the close to 40% of Europe.
- The arrival of voice control. This reduces the physical/visual part of branding, which will likely narrow the product range. Just think how many brands of shampoo one can remember compared with the number offered on a webpage or in a store. If voice is successful, the infinite shelf could become a very narrow one, threatening second tier brands in each category.

We believe that our portfolio is largely insulated, with only a small percentage of our Consumer Staples exposure, and total exposure, vulnerable to Amazon. As a result, we remain comfortable with Consumer Staples as the core element of our global portfolios:

- Tobacco cannot be dis-intermediated for regulatory reasons; alcoholic beverages are difficult for Amazon to sell in the U.S. Beauty is a brand-driven, limited, private label category, as are health, hygiene, personal care and spirits. We have just 3% portfolio exposure to U.S. food.
- 42% of our Staples exposure is in stocks that are much more geared to emerging markets (~50% of sales), rather than the U.S. (only 25% of sales), where Amazon is most active.
- Superior products and efficient marketing remain the best way to mitigate pricing pressure. We choose Staples companies where we believe management fosters an entrepreneurial and decentralised culture that pushes innovation, in turn helping drive pricing power.

“Skewed to what we think are the more agile and innovative companies in Staples, we believe that our portfolio is largely insulated.”

For several years, our focus has been on companies we believe are less vulnerable to the disruption of private label, changing distribution patterns and the challenges emerging from online marketing. This threat is just another variant of the same theme (albeit a very significant one). This is the reason we are underweight in the more exposed food and home care sectors. In particular, we have significantly reduced our weighting in food over the last three years in response to valuation and disruption risk. Our emphasis on the more agile and innovative companies in Staples versus the cost cutters and the food names has been reflected by our strong relative performance in Consumer Staples this year.

IMPORTANT INFORMATION**This material is for use of Professional Clients only.**

The views and opinions are those of the author as of the date of publication and are subject to change at any time due to market or economic conditions and may not necessarily come to pass. Furthermore, the views will not be updated or otherwise revised to reflect information that subsequently becomes available or circumstances existing, or changes occurring, after the date of publication. The views expressed do not reflect the opinions of all portfolio managers at Morgan Stanley Investment Management (MSIM) or the views of the firm as a whole, and may not be reflected in all the strategies and products that the Firm offers.

Forecasts and/or estimates provided herein are subject to change and may not actually come to pass. Information regarding expected market returns and market outlooks is based on the research, analysis and opinions of the authors. These conclusions are speculative in nature, may not come to pass and are not intended to predict the future performance of any specific Morgan Stanley Investment Management product.

Certain information herein is based on data obtained from third party sources believed to be reliable. However, we have not verified this information, and we make no representations whatsoever as to its accuracy or completeness.

All information, which is not impartial, is provided for informational and educational purposes only and should not be deemed as a recommendation. The information herein has not been based on a consideration of any individual investor circumstances and is not investment advice, nor should it be construed in any way as tax, accounting, legal or regulatory advice. To that end, investors should seek independent legal and financial advice, including advice as to tax consequences, before making any investment decision.

RISK WARNINGS

There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market value of securities owned by the portfolio will decline. Accordingly, you can lose money investing in this strategy. Please be aware that this strategy may be subject to certain additional risks. Changes in the worldwide economy, consumer spending, competition, demographics and consumer preferences, government regulation and economic conditions may adversely affect global franchise companies and may negatively impact the strategy to a greater extent than if the strategy's assets were invested in a wider variety of companies. In general, equity securities values also fluctuate in response to activities specific to a company. Investments in foreign markets entail special risks such as currency, political, economic, and market risks. Stocks of small-capitalization companies carry special risks, such as limited product lines, markets and financial resources, and greater market volatility than securities of larger, more established companies. The risks of investing in emerging market countries are greater than risks associated with investments in foreign developed markets. Non-diversified portfolios often invest in a more limited number of issuers. As such, changes in the financial condition or market value of a single issuer may cause greater volatility.

This communication is not a product of Morgan Stanley's Research Department and should not be regarded as a research recommendation. The information contained herein has not been prepared in accordance with legal requirements designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research.

This communication is only intended for and will be only distributed to persons resident in jurisdictions where such distribution or availability would not be contrary to local laws or regulations.

There is no guarantee that any investment strategy will work under all market conditions, and each investor should evaluate their ability to invest for the long-term, especially during periods of downturn in the market. Prior to investing, investors should carefully review the strategy's/product's relevant offering document. There are important differences in how the strategy is carried out in each of the investment vehicles.

EMEA

This communication was issued and approved in the United Kingdom by Morgan Stanley Investment Management Limited, 25 Cabot Square, Canary Wharf, London E14 4QA, authorized and regulated by the Financial Conduct Authority, for distribution to Professional Clients only and must not be relied upon or acted upon by Retail Clients (each as defined in the UK Financial Conduct Authority's rules).

Financial intermediaries are required to satisfy themselves that the information in this document is suitable for any person to whom they provide this document in view of that person's circumstances and purpose. MSIM shall not be liable for, and accepts no liability for, the use or misuse of this document by any such financial intermediary. If such a person considers an investment she/he should always ensure that she/he has satisfied herself/himself that she/he has been properly advised by that financial intermediary about the suitability of an investment.

Hong Kong

This document has been issued by Morgan Stanley Asia Limited for use in Hong Kong and shall only be made available to "professional investors" as defined under the Securities and Futures Ordinance of Hong Kong (Cap 571). The contents of this document have not been reviewed nor approved by any regulatory authority including the Securities and Futures Commission in Hong Kong. Accordingly, save where an exemption is available under the relevant law, this document shall not be issued, circulated, distributed, directed at, or made available to, the public in Hong Kong.

Singapore

This document should not be considered to be the subject of an invitation for subscription or purchase, whether directly or indirectly, to the public or any member of the public in Singapore other than (i) to an institutional investor under section 304 of the Securities and Futures Act, Chapter 289 of Singapore ("SFA"), (ii) to a "relevant person" (which includes an accredited investor) pursuant to section 305 of the SFA, and such distribution is in accordance with the conditions specified in section 305 of the SFA; or (iii) otherwise pursuant to, and in accordance with the conditions of, any other applicable provision of the SFA. In particular, for investment funds that are not authorized or recognized by the MAS, units in such funds are not allowed to be offered to the retail public; any written material issued to persons as aforementioned in connection with an offer is not a prospectus as defined in the SFA and, accordingly, statutory liability under the SFA in relation to the content of prospectuses does not apply, and investors should consider carefully whether the investment is suitable for them.

Australia

This publication is disseminated in Australia by Morgan Stanley Investment Management (Australia) Pty Limited ACN: 122040037, AFSL No. 314182, which accept responsibility for its contents. This publication, and any access to it, is intended only for "wholesale clients" within the meaning of the Australian Corporations Act.

Morgan Stanley Investment Management is the asset management division of Morgan Stanley.

All information contained herein is proprietary and is protected under copyright law.

Explore our site at www.morganstanley.com/im