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INVESTMENT MANAGEMENT

Global Equity Observer

Rebuilding Moats in the Digital Age

ACTIVE FUNDAMENTAL EQUITY | INTERNATIONAL EQUITY TEAM | INVESTMENT INSIGHT | JUNE 2019

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Over the last 50 years, the leading staples companies have prospered in an analogue world. This was evident from their dominant market shares, compounding sales growth and sustainably high returns on operating capital. But, the digital age has presented two key challenges to this prosperity: e-commerce and new marketing platforms, including social media/search.

It is fair to suggest that the consumer staples industry has been slow to adapt. Growth rates have slowed from mid-single digit rates to low-single digit. There has been talk of "the end of big brands." However, we see evidence that the leading consumer staples companies are starting to crack the digital code. A combination of scale and skill is allowing such leading brands to thrive, and sales growth is picking up again.

Let's start with e-commerce in China, where a domestic e-commerce company is at the technological and innovative cutting edge, providing an online ecosystem with arguably the world's best digital brand-building platform. Unlike elsewhere in the world, brands have their own virtual stores featuring services such as loyalty programs and livestreaming. These virtual stores are segmented by the platform provider, for example 'The Luxury Pavilion,' which gives prestige beauty brands their own section. This avoids these brands being crowded out by mass-market offerings or being placed next to household cleaner products. Data on consumer habits is shared with the branded companies by the platform provider, helping to accelerate product innovation. The platform dramatically expands the reach of a brand beyond Tier 1-2 all the way down to Tier 4-5 cities, adding a potential 600 million consumers.[1]

"The digital age has presented two key challenges to consumer staples' prosperity: e-commerce and social media"

[1] Holding Annual Reports.

Leading staples companies in China, including those from Europe and the United States, are seeing the payoff from their digital investment, evident in a sharp acceleration in Chinese sales. For instance, a large French beauty company we own in the portfolio posted 26% year-on-year growth in Asia Pacific in 2018, up from 11% in 2017 and less than 5% in 2015 and 2016.[1]

Outside China, a well-known American e-commerce site dominates the digital retail space but, in sharp contrast to its Chinese counterpart, it doesn't share its consumer data, focuses on price rather than brand building and uses its own label as a direct competitor. This drives the consensual view that the company is out to destroy brands, whereas in reality, most of its own brands have failed against the leading consumer staples companies, which have learned how to compete on the platform effectively. Such companies make sure they are at the top of key word searches (crucial now that 55% of all product searches in the U.S. occur directly on this platform[2]) and work to gain top customer rankings and reviews for their products. These companies also benefit from there being more than one e-commerce operator in the U.S. – traditional retailers have invested heavily in their own e-commerce offerings. In 2018, the number one traditional retailer grew e-commerce sales by 40% while the top discount retailer grew its sales by 36%.[3] This broader digital opportunity enabled the leading consumer staples companies to grow their own global and U.S. e-commerce sales by approximately 40% in the same period,[4] well ahead of both the leading U.S. e-commerce platform and the industry growth rate.

"The digital opportunities in the U.S. enabled leading consumer staples companies to grow e-commerce sales by approximately 40% in 2018"

Today, e-commerce generates between 5-10% of the leading consumer staples companies' sales, versus 1-2% five years ago.[4] Importantly for consumer staples companies, e-commerce has similar operating margins to selling in brick and mortar stores and e-retailers make more profit selling large rather than small brands.

On the digital marketing front, Silicon Valley's key advertising platforms (in the guise of search engines and social media sites) have effectively acted as a tax on consumer staples companies. Over the last five years, consumer staples executives have reallocated 30% to 50% of marketing budgets[4] from traditional media to digital marketing on the promise of higher returns on investment and have instead been rewarded with slowing sales growth rates.

"If you want to make digital work, you have to retool and retrain"

Consumer staples companies now seem to recognise that they need to retrain and transform their marketing departments – it is not as simple as just throwing money at digital marketing. Historically, a company would brief an advertising agency up to a year in advance to come up with the creative content for a global advertising campaign as well as the tactical execution of said campaign, such as the best time of day to show the newly created advert. Today, consumer staples marketing teams have social listening teams that pick up on the latest trends among 'influencers'. They have in-house creative teams to produce a constant stream of content for social media sites. Specialist teams mine data and monitor in real time the performance of digital spend. For example, does targeting a deodorant campaign at men aged 20-30 and who play sport produce a better hit rate than targeting men aged 20-30 who smoke? As the leading consumer staples companies gain greater know-how, from mastering the basics (clean data, buying the right key words, speeding up loading time to their websites) to producing high-quality digital content (two seconds rather than six seconds for an advert), we believe the current digital marketing platform 'tax' will diminish.

So as investors, how do we gauge who is doing a good job? We have also had to go back to school. In the last few years, a host of consumer staples companies cut their advertising and promotion (A&P) costs as a percentage of sales, claiming digital spend had a higher return on investment. But, there is no such thing as a free lunch. If you want to make digital work, you need to retool/retrain. This means hiring hundreds – or thousands – of digital

[2] L2 Consulting, 2019.

[3] Holding Annual Report 2018.

[4] Holdings Annual Reports.

experts. The cost of this investment sits in the selling, general and administrative (SG&A) line of the profit and loss account rather than the A&P line. Once an organisation has retooled and hired the digital experts, these experts then start asking for more money to spend on digital content, so A&P spend goes back up. If successful, sales growth then reaccelerates and brings down SG&A costs as a percentage of sales.

One of the companies in our portfolio, a global leader in beauty brands, is at the forefront of this digital evolution and we believe provides a useful guide to measure where on the journey other consumer staples companies are. The consultant Gartner L2 ranks 1,872 brands on their expertise across the digital landscape. In 2018, 57 of these brands earned the title 'Genius' or best-in-class. The beauty holding in question owned the greatest number of Genius brands (seven) as well as reporting sales growth of 7%, its fastest growth in over 10 years and close to 1.5x the beauty market as a whole's growth.[5]

"Consumer staples that crack the digital code can reinforce moats, compound sales growth and sustain high returns on operating capital"

We believe consumer staples companies that crack the digital code can reinforce their moats, continue to compound their sales growth and sustain a high return on operating capital for years to come. Big brands in the new digital world can thrive if they combine scale and skill. As investors, when assessing a company's attributes, in addition to being well invested, decentralised and entrepreneurial, we want to see digital expertise.

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[5] Holding Annual Report 2018.

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