

Navigating the Amazon Risk in the Consumer Space

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By: Corbin Weyer, CFA, CPA, Research Analyst, Mid Cap Growth



Source: Business Insider, Twitter¹

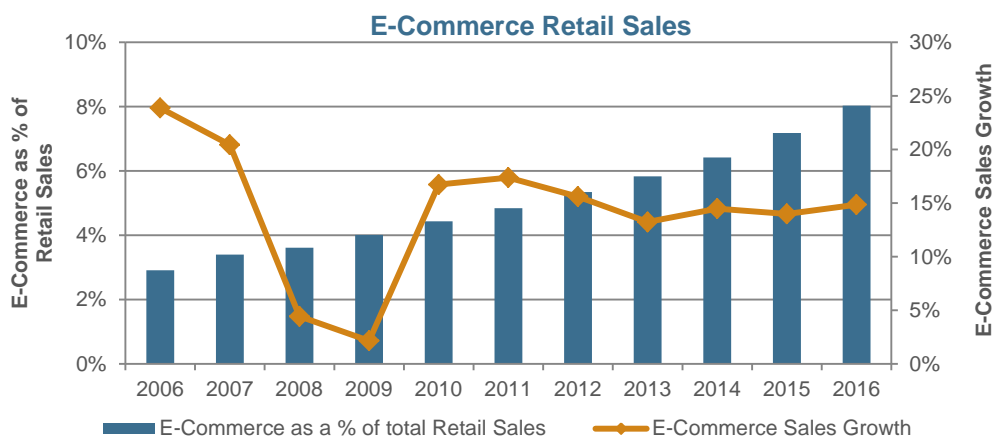
Well, no point in arguing – the market has already declared that Amazon is taking over the world while destroying direct and indirect competitors and entire business models along the way. It's hard to go a day without seeing the name plastered on the front page of newspapers and scrolled across television headlines.

How Did We Get Here?

The seminal event, which appeared to confirm Amazon's invincibility, was the surprise acquisition of Whole Foods, its first foray into traditional brick-and-mortar retailing – a concept it was methodically putting out of business from individual stores to entire malls. Investors and pundits appeared to blindly applaud the purchase, asking few questions about the financial or strategic rationale and getting no answers in return. Amazon could do no wrong, and the onus was on all other companies (in any remotely related industries) to vehemently defend to investors how and why they would survive in Amazon's world. Halfway through second quarter earnings season, Reuters reported that Amazon's name had popped up on roughly one of every 10 companies' conference calls (and this was before retailers began reporting!).

The market's increased aversion to questioning Amazon's actions stems from the business' demonstrated success in taking market share from traditional brick-and-mortar retailers in core categories including but not limited to books, electronics, sporting goods, apparel, pet products and personal care. Among other benefits to the consumer, Amazon offers convenience, price transparency and free and fast shipping (for Prime members). Consumers have migrated online to shop for these categories at an accelerated pace in recent years and Amazon, as the e-commerce market leader, is reaping the rewards via materially increased sales dollars.

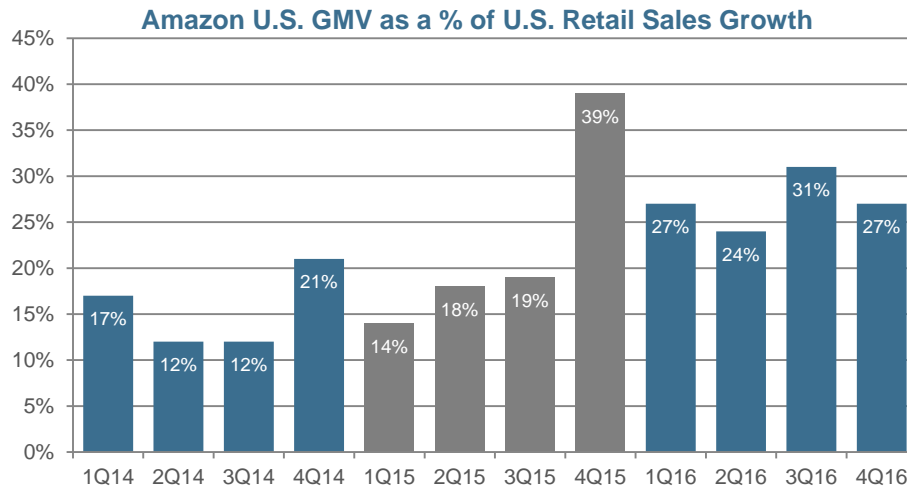
E-commerce retail sales in the U.S. grew 15% year over year in 2016 and have averaged 14% annual growth over the past five years. E-commerce penetration has increased from 5% of total U.S. retail sales in 2011 to 8% in 2016.



Source: Retail Indicators Branch, U.S. Census Bureau

¹ Business Insider. "Amazon billionaire Jeff Bezos' look has changed drastically since he started the company." <http://www.businessinsider.com/jeff-bezos-before-and-after>, July 28, 2017; <pic.twitter.com/NNA2LIFxy8>.

According to Slice Intelligence, Amazon accounted for 43% of all online retail sales in the U.S. in 2016 and captured 53% of online sales growth for the same period. Evercore ISI estimates that Amazon accounted for roughly 25-30% of total U.S. retail sales growth in 2016!



Source: Census Bureau, Company Data, Evercore ISI Research. GMV is sales grossed up for third parties.

On the other hand, traditional retailers have experienced deteriorating business results over the past few years due to a number of factors including the secular consumer shift from shopping at stores to digital, deflationary pressure across apparel and groceries, unfavorable weather during historically key seasonal sales periods, and the ever-competitive environment that is consumer retail. We have seen these challenges reflected in lower valuations for these businesses, while Amazon’s valuation over this period has marched up and to the right.

Looking back over the past two years, the combined market value for 40 of the largest public retailers has declined some ~\$70B to \$1.06T, while Amazon’s market value over this time has increased ~\$240B to \$530B. The market value decline looks even more startling if we exclude Home Depot and Wal-Mart (retailers some investors might deem Amazon resistant) – a loss of ~\$185B! These values do not include many of the retailers that have gone bankrupt over this time (e.g., hgregg, The Limited, RadioShack, Gordmans).²

Navigating the Amazon Effect

Will Amazon’s current success translate to other categories like grocery or previously unimaginable verticals like autos or healthcare one day? Maybe.

As mid-cap equity investors, we can leave the question of Amazon’s value to others. But we are left navigating this challenging competitive backdrop across the various consumer verticals that are or are not perceived to be within Amazon’s grasp.

Consumer industries have always been highly competitive, with low barriers to entry providing innumerable vendors and retailers to vie for the ever-fickle consumer’s dollar. Amazon has only intensified the competitiveness by lowering the switching and search costs for consumers. Moreover, as more consumers increase their search and shopping habits on Amazon, Amazon increases its leverage and extracts the economics from its own vendors. These threats and risks are real and we are investing accordingly.

To address the risk posed by Amazon’s ambitions, we have been and continue to be proactively avoiding Amazon competition where it is clearly evident. Department stores, specialty retailers and apparel/footwear vendors are highest on that list. Department store and specialty retailers’ sales and margins are susceptible to like-product being available on Amazon for a lower price and obtainable in a more convenient fashion (delivered to your front door). Apparel and footwear vendors distributing product across numerous channels risk pricing power given the increased transparency from the online channel. Over the past few years, we sold a number of long-term specialty retail and apparel vendor holdings due

² Comparison of market values of companies from 10/31/2015 to 10/31/2017.

to increased Amazon risk and overall disruption (and resulting decreased profitability) in these more traditional distribution channels. One possible exception to this is the vertical retailer that entirely controls its brand and distribution, provided the product remains proprietary.

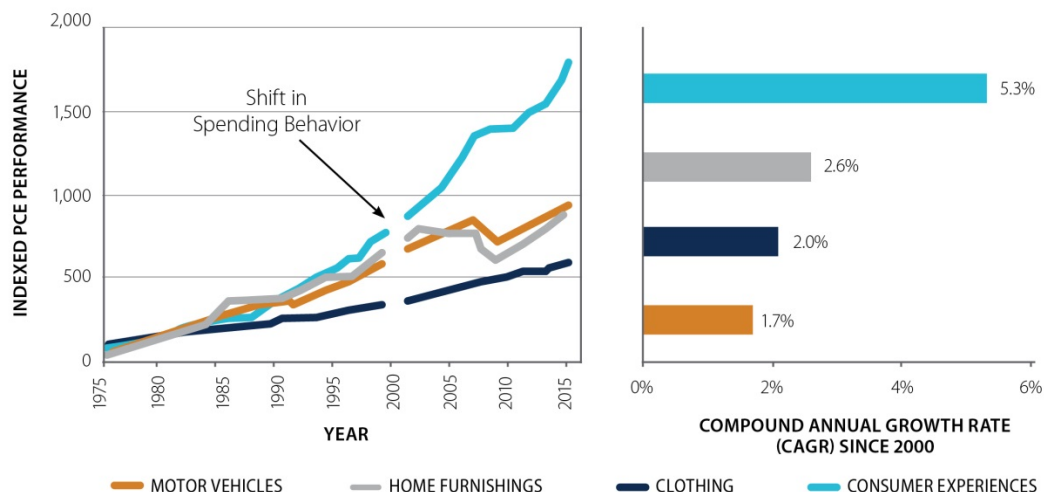
Consumer staples businesses, including food, beverage, household and personal products, have historically been a good safe haven. These businesses enjoyed years of stable sales and consistently high profit margins behind continued investments in their brands and uninterrupted shelf space at retail. But an influx of private label competition from retailers and consumers increased demand for healthier, more natural ingredients in their products have pressured these once stable, predictable businesses' profit streams and pricing power. Add to the mix consumers' increased willingness to buy many of these products online, particularly within the household, personal and beauty categories, and the headwinds mount. With this backdrop, we're looking to avoid many of these businesses due to the aforementioned concerns, which in aggregate result in a loss of bargaining power in the vendor/retailer relationship that the businesses commanded for so long.

Opportunity Lies Where Amazon Doesn't Dominate

We find ourselves gravitating toward the demographics underserved or unaddressed by Amazon – both low-income and rural consumers. For the 41 million Americans in poverty, the thought of spending \$99 for an annual Amazon Prime membership is out of the question. These consumers live paycheck to paycheck, suppressed by low wage growth against ever-rising consumer prices (notably healthcare and rent). Moreover, many of these cash-strapped, budget-conscious consumers historically have been late adopters to technology. For these consumers, price is the utmost determining factor when purchasing. Amazon has made recent attempts at attracting these consumers, including a discounted monthly Prime offer for customers receiving government assistance and Amazon Cash, which is meant to make it easier for customers who do not have credit cards or bank accounts to shop on Amazon, but we remain skeptical on material adoption of these offerings anytime soon. For many of the 60 million rural consumers in the U.S., the closest mass retailer, let alone an Amazon distribution center, is upwards of 40-plus miles away. These rural consumers have also historically been slow technology adopters. Without trying to talk out of both sides of our mouth, we believe a few retailers continue to serve these low-income and rural customers well and provide attractive investment opportunities – dollar stores, convenience stores, and off-price and closeout retailers.

Another pocket within the consumer sector where we have seen little Amazon encroachment would be leisure or “experience” related businesses including theme parks, sporting events, movie theatres, resorts and travel. We have seen these services comprise a growing share of the consumer’s discretionary wallet over the past decade at the expense of goods and possessions (clothes, vehicles, etc.). Catalysts for this shift include the rise of the millennial generation, which as a cohort instinctually favors experiences over goods more than baby boomers, as well as the proliferation of the smartphone and adoption of social media by all generations.

Shift in Consumer Spending Behavior



Source: William Blair, Bureau of Economic Analysis

Historically, we've had a harder time finding quality businesses in these industries, given the fixed cost nature of the models; many operate with lower quality balance sheets (higher debt) and overall earn lower returns on capital. However, a few investible opportunities exist and many of these businesses are getting better as more consumer dollars move to these channels and the businesses scale. Moreover, many of these companies are beginning to leverage their data to better attract and retain customers, extracting varying levels of price from customers across the loyalty spectrum.

Our consumer holdings and bench provide exposure to multiple consumer spending categories and good, secular growth end markets while balancing the inherent risk that is the fickle consumer and the now-growing risk that is Amazon. We look forward to what Amazon has up its sleeve next.

ABOUT THE AUTHOR AND TEAM

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Corbin Weyer joined Baird in 2010 and has over seven years of investment experience, all of which has been covering consumer stocks. Prior to joining Baird Equity Asset Management in 2014, he spent four years in Baird's sell-side equity research department covering the consumer sector. Corbin received a BSBA in accounting and finance from Marquette University.

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