"Story-Telling" in the Digital Age Brings Dramatic Changes to Consumer Markets

As Israeli historian from the Hebrew University of Jerusalem, Yuval Harari, explains in *Sapiens,* the human being is the only species that can "cooperate" in a flexible manner and in large numbers. This cooperation is enabled by our human capacity of "**story-telling**", as well as our ability to believe in "fictional beings" such as gods, nations, money and corporations. In his book "*Narrative and Numbers – The Value of Stories in Business*", NYU Stern's Professor Aswath Damodaran states that a company's value is a function of not only its "metrics" (like Sales, Cash Flows and EBITDA)[1], but of its "stories" (product, founder, business evolution).

The internet and the **rise of social media** have allowed humans to **leverage this "story-telling" ability** to **reach** greater numbers of people. If a story is compelling, it will typically be shared and disseminated to the masses. My childhood friend, Pipe Stein (an internationally renowned advertising guru and CEO of *Notable*), while presenting at the *2019 Future of Advertising event in Madrid* stated: **"We can measure "Likes", but we cannot measure love"**. We have plenty of data and metrics from the *Nielsens'* of this world. However, **do we know which are the right questions to ask ourselves?** At the end, it's the story and the content that "connects" or resonates with the target audience. Does it generate an **emotion**? If yes, then the story is effective and will surely make its way through the right access channels, also likely creating shareholder value!

The rise of social media has reduced the barriers to entry for smaller companies. In the old days, consumers would have fewer choices, always buying the same few brands as everyone else, since we all watched the same few television or radio broadcasts, most notably those offered during prime time. Today, shoppers learn about products online from friends, bloggers, *YouTube* celebrities and other influencers, where information and news are shared instantaneously often in real-time. The rise of "**niche markets**" has resulted in the **hyper-fragmentation of the consumer market.** "Blue-chip" brand names can no longer solely rely on their size and brand recognition for as long as they used to, as technology and the availability of information has leveled the playing field for large and small companies and **brand cycles** have **shortened**. Professor Damodaran states: "Brand Names last a long time, but nothing lasts forever."

[1] Defined as earnings before interest, taxes, depreciation and amortization.

The Thinking Man's Approach

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- Technology has reduced barriers to entry, resulting in the rise of new startups disrupting "old economies"
- Social Media has led to a hyper-fragmentation of the consumer market and to the shortening of brand cycles
- In order to survive, big brands can acquire these smaller companies. However, some of these have very strong valuations due to a "cult like" customer base
- Big brand companies that were considered defensive - especially in the U.S Big Food sector - are not anymore. Sectors like Software tends to demonstrate better defensive characteristics
- It is more important now than ever to focus on companies with robust technology platforms that can easily adapt to changing customer bases and consumer tastes.

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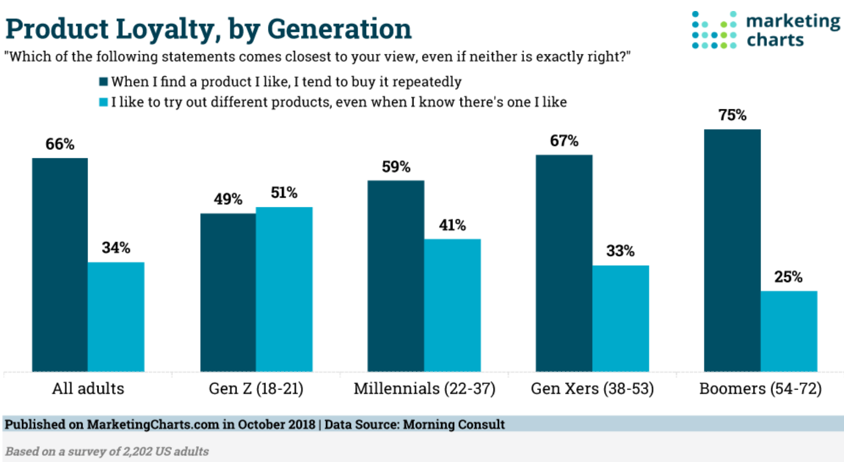
As the world moves from the industrial era to the **digital age**, power is shifting and fragmenting at greater speeds. Power in a digital world is about **access**. Existing "big brand" businesses need to understand this shift and position themselves to survive and thrive in an environment where **entrepreneurs** and **startups enabled by access to technology** are genuine threats. A great example is the U.S Food sector, where the top 20 manufacturers continue to lose market share to new startup food companies **in "niche" markets.** Such companies are able to grow quickly through the use of social media, starting off locally, then expanding to state, national, and even global levels.

Technology has reduced barriers to entry

Technology has **reduced barriers of entry for new companies**, providing them with an opportunity to expand and flourish in an expedited manner. Previously, customers were loyal to one brand, not only because few brands existed, but because the consumer "belonged" and was loyal to the few brands they were familiar with in the past.



Brand loyalty is undergoing a transformation – for example, the graph below shows how **product loyalty by generation has changed dramatically.** Baby Boomers (ages 54-72) "stick" to one product, while younger generations such as *Millennials* (ages 22-37) and *Gen Z* (ages 18-21), tend to be more open to trying new brands. This is also a result of the fact that ***Millenials* and *Gen Z*** have been exposed to a greater variety of brands and consumer experiences through new technological platforms (such as smartphones and the use of social media).

The internet has made it easy for consumers to **(1)** access brands from all around the world, **(2)** have more information about those brands from reviews and ratings, and **(3)** be exposed to digital market places where small "niche" producers can offer their products in a simple and less costly manner.

Startups have taken advantage of these lower barriers of entry enabled by technology to push their products to niche markets**. Customer tastes have fractured into diverse "niche markets",** and brands are focusing more on "values" than just product differentiation.

In the food space, some want gluten-free., while others seek low-carbohydrate or keto diets. Many want simpler ingredient lists and virtuous treatment of workers and animals. Those who can afford it look for artisan foods, in lieu of megabrands. Some examples of new startups which illustrate such growth include but are not limited to *Bulletproof 360* in the coffee space, or *Dirty Lemon* on the beverage side. Big food manufacturing firms can purchase these young startups, or they can build their own versions. However, **the window for acquisition and new brand creation can be limited.** Once startup brands like *Bulletproof* attract a cult-like following and build out their brand portfolios, it may be too late for the likes of *Coca-Cola, Nestle, or Dr. Pepper Snapple Group* to catch up.

As a consequence of this trend in the Fast-Moving Consumer Goods sector (FMCG), **$22 billion in industry sales has transferred from large to smaller companies** in North America between 2011 and 2016, according to the *Boston Consulting Group*. The market share of smaller companies in consumer goods grew from 23% to 26% over this period. As a result, 34 of the 50 biggest consumer companies have slower sales and profit growth according to *Bain*. However, this does not mean that global demand has stalled for consumer products; demand has increased, just not for the historical "big" brand names.[2]

Brand Cycles are Shortening

Some of the most recognized and valued brand names (like *Kraft-Heinz, Campbell Soup, Mondelez, Coca-Cola and McDonald's)* of the twentieth century are finding that **their magic is fading.** Professor Damodaran states: "Using my life cycle terminology, these companies are ageing, and no amount of financial engineering or strategic repositioning is going to make them young again."

The shift to online shopping has opened infinite shelf space for niche and entrepreneurial products. Reviews on *Amazon.com* and other online retailers are leveling the playing field. Thus, **it is very difficult for large corporate brands to sell a similar product at higher margins for longer periods of time.**

A major pillar of conventional value investing is that while technology, cost efficiencies and new products are all competitive advantages, brand name is the moat that can generate the most value. Again, that statement reflects a truth, which is that brand names last long (often stretching over decades), but **even brand name benefits fade as customers tastes change** and companies seek to go from local to national, from national to regional, and from regional to global.

Intellectual capital is the main value driver

Another critical trend is the **increasing importance of intellectual capital and applied Information Technology (IT)** to the operative structure of companies across all industries. And this applies just as much to the "old economy" as it does to "new economy" industries. Business spending on hard assets is generally larger, more cyclical, and more volatile than spending on soft assets. IT "soft" projects tend to be initiated when businesses are looking for increased security and / or efficiency, while brick-and-mortar projects tend to be put in motion when existing capacity is becoming strained.

For example, restaurants are seeing a huge shift to delivery, and as such have needed to incorporate more pieces of software than before. In addition to all the electronic order and delivery platforms they are now plugged into, they also need to deal with payments systems, HR software, and inventory management software. And right now, many of those applications do not interact or connect to one another. Thus for

[2] Daneshku, Scheherazade. "Consumer goods: big brands battle with the 'little guys'", *Financial Times*, (https://www.ft.com/content/4aa58b22-1a81-11e8-aaca-4574d7dabfb6).

example, a food tech company, *Ingest.ai* (created by a former *IBM Watson* engineer) promises to extract and connect the data from all of those disparate software pieces and tie them together to give restaurant owners a holistic, data-powered view of their business. Some large restaurants like *Domino's Pizza* are considered IT companies that sell pizza. *Domino's* is the envy of many across the space due to its proprietary, technology-driven, low-cost and top-of-mind delivery model. Companies like *McDonald's* are catching-up, while others like *Burger King* that had focused on cost-cutting and **not R&D, digitization and social media, have been sector laggards.**

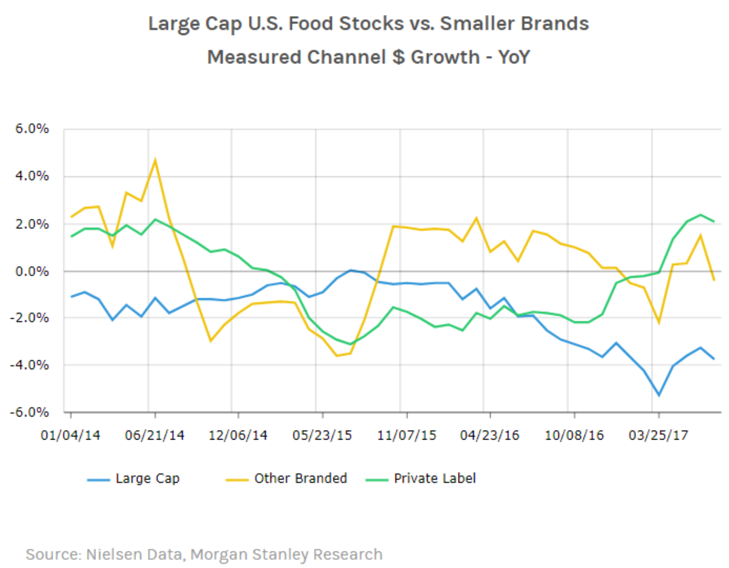
Conclusions and investment implications

As consumers change their tastes, their habits and their interaction with technology, **we detect a few trends with potential investment implications:**

1. **Hyper- fragmentation of product and consumer markets has significant investment implications**. While large companies still produce for the mass market, the world is increasingly attracted to smaller and unique brands. As a result, **Venture Capital - backed startups (and Private Equity - backed small food companies)** might provide an alternative investment opportunity to the old and under-performing public food companies and brands.

2. In the **supermarkets sector**, companies with a strong **private labelling** business have shown to be able to outperform. A company that has been in *BigSur's Equity Portfolio* for years and that we still like is *Costco Wholesale (Nasdaq: COST)*.

   Investment guru, Warren Buffett has commented on the popularity of *Kirkland*, *Costco's* private label. According to Nielsen Data, **Private-label brands have gained more than a full percentage point** of market share since 2011, reaching an estimated 19.5% last year.[3]



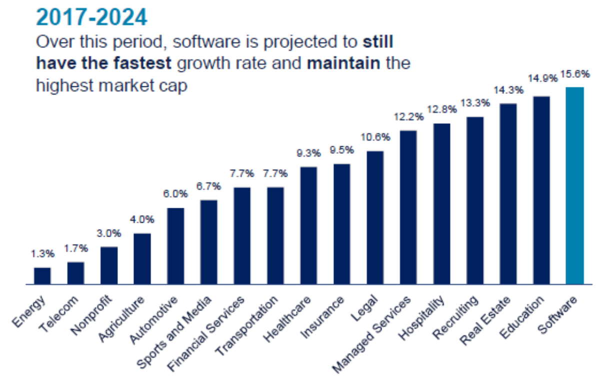
Source: Nielsen Data, Morgan Stanley Research

3. **Defensive sectors seem to be shifting** – for example **"Big Food" is not as defensive as it used to be**, while other sectors such as **Software** seem to be more "recession-resistant" and able to adapt to diverse economic cycles. The **digitization** of everything is causing the **4th Industrial Revolution,** and is disrupting all industries. We believe software is an interesting space because it **spans almost all major industries and sub-industries**. In an economic downturn, many companies shift to **digitizing**

[3] Please see "Important Disclosures & Disclaimers" section at the end of the materials.

and automating systems, which could continue to push software forward even through market turbulence.

Additionally, as per *Gartner Proprietary Research*, the software sector is already the **largest global sector of the global economy** (followed by the Financial Services sector), with over $7 Trillion in market cap; and is the **fastest growing global sector**, projected to reach $20 Trillion in market cap by 2024. For some analysts, even sectors as Artificial Intelligence/ Machine Learning, Robotics, Cloud Computing and Blockchain Technology could prove to be more "recession-resistant" than historic defensive sectors, like Big Food, Supermarkets and Restaurants.



Top Six Comparative Market Capitalization by Sector: 2017

Transportation	Automotive	Insurance	Energy	Healthcare	Financial Services	Software
$2.0TN	$2.2TN	$2.6TN	$4.5TN	$5.7TN	$6.7TN	$7.2TN

Projected Top Six Comparative Market Capitalization by Sector: 2024

Transportation	Real Estate	Insurance	Energy	Healthcare	Financial Services	Software
$3.4TN	$4.8TN	$4.9TN	$5.0TN	$10.7TN	$11.2TN	$20.0TN

Source: Gartner Proprietary Research

4. **Underweight Big U.S. Food Companies** – Technology has decreased the barriers of entry for new consumer products. Social media has allowed these products to reach their ideal consumers without massive marketing budgets. Shorter "brand cycles" have major implications for large multinational consumer companies. **The combined market share of the top 20 packaged-food companies fell to 42.4% last year from 46.8% in 2011.**

   Much of the lost share has gone to niche and entrepreneurial brands. The expected time horizon for big brands to generate outsized margins for new and existing products has shortened. Thus, the net present value of those cash flows gets reduced. As such, a company like *Kraft Heinz* recently took a charge of over $15 billion for impairment of goodwill, which can be interpreted as they having overpaid for the acquisition of a brand name years ago.

5. **In the Big Food Globalized Market: we tend to favor European over U.S. companies** – European food companies, including *Unilever and Nestlé*, we believe are better-positioned than their American peers for two reasons: (1) they originate from countries that are small relative to the U.S.—*Unilever* is Dutch and British, and *Nestlé* is Swiss, and were therefore forced early on to **expand into diverse markets with localized tastes**, which positions them well to operate in the current environment of fragmented

food demand; (2) they also have ample **exposure to emerging markets**, where growth is relatively fast.

6. **Focus on companies with a robust tech platform** – Take the example of *Costco Wholesale* in the supermarket sector, which deploys its **customer data** intensively to help drive more effective marketing and generate predictive analytics for customer demand through targeted e-mails and online advertising. *Costco* has achieved healthy same-store-sales growth numbers of above 5% by a concerted effort to **enhance its e-commerce experience and omnichannel capabilities**, highlighting the improvements it has made in its website to drive growth, and its partnership with Instacart.[4]

   Another example, in the restaurants sector is the leader in U.S. pizza delivery, *Domino's Pizza*. The company has focused in creating the best **IT platform in the industry which connects to its loyalty program** "Points for Pies" (loyalty points when customers submit pictures of pizzas from competitors). This program is a **catalyst to drive app downloads and brand participation**. The company is driving positive "same store sales" through innovative messaging, increased marketing, and new innovative products.

[4] "What's to watch for in Costco's Fiscal Q2 Results". *Forbes*. (https://www.forbes.com/sites/greatspeculations/2019/03/05/what-to-watch-for-in-costcos-fiscal-q2-results/#5d852bdc5cd1)

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