PETER SHAPIRO, CFA

WHAT'S NOT GOING TO CHANGE
BUSINESS MODEL STABILITY IN AN AGE OF DISRUPTION

Peter Shapiro, CFA
Analyst and Portfolio Manager

"I very frequently get the question: 'What's going to change in the next 10 years?' And that is a very interesting question; it's a very common one. I almost never get the question: 'What's not going to change in the next 10 years?' And I submit to you that that second question is actually the more important of the two – because you can build a business strategy around the things that are stable in time." – Jeff Bezos, Amazon.com CEO[1]

Change has been a human obsession for thousands of years. The fashion industry is built on change. The whole point of a New Year's resolution is to say that a changed version of you is better than the existing version. The concept of "planned obsolescence" intentionally pushes change on consumers whether they want it or not. Not surprisingly, thousands of people have written millions of pages on the topic; if you go to Amazon.com's website – Jeff Bezos's own company – and search for books on change, you get over 60,000 results.

And yet change is notoriously difficult to predict accurately. We've been expecting flying cars and teleporting since *The Jetsons* and *Star Trek*, and neither is around the corner. And we're no closer to nuclear-powered vacuum cleaners now than we were in the 1950s.[2] People have been making horrible predictions about change for as long as people have been making predictions.

For investors and markets this is extremely important, because stock prices reflect a set of beliefs about future events, discounted back to the present. If that set of beliefs is inaccurate, then so are stock prices. If we can't predict the Next Big Thing, how can we know where to invest?

— Investing in the Next Big Thing makes for a great story at a party. Not so for investing in businesses that resist change.

There's another way to think about this conundrum, and that's by turning the question on its head: Instead of asking what *will* change, think about what *won't* change. We're not alone in this approach. Warren Buffett said, "Our approach is very much profiting from lack of change rather than from change. With Wrigley chewing gum, it's the lack of change that appeals to me. I don't think it is going to be hurt by the Internet. That's the kind of business I like."[3] At Comgest we like that kind of business too, and we also like that it seems most investors don't think that way. Investing in the Next Big Thing makes for a great story at a party, but investing in businesses that

[1] https://www.goodreads.com/quotes/966699-i-very-frequently-get-the-question-what-s-going-to-change
[2] See article published by online magazine PCWorld: https://www.pcworld.com/article/155984/worst_tech_predictions.html
[3] Andrews, David. "The Oracle Speaks: Warren Buffett In His Own Words." p. 68

resist change doesn't. Our experience says that many investors get sucked in by the excitement of trying to forecast change, leaving those other opportunities for people like us.[4]

"AMAZONED" IS NOW A VERB

In 2017 around 7,000 brick-and-mortar retail stores closed in the US. That's a record and three times the amount in 2016.[5] A popular phrase has been coined to explain what's going on: physical retail is getting "Amazoned." More people are turning to e-commerce to fulfill their shopping needs, and fewer physical points of sale are now required. So how should we think about what Amazon is (and other e-commerce players are) doing that gives them the advantage in today's retail world?[6]

— Not surprisingly, retailers who can't compete with Amazon along the axes of speed, selection, and price have been left out in the cold

In fact, the Jeff Bezos quote I used to open this note is about Amazon's retail business. Here's the rest of what he said:

"… [I]n our retail business, we know that customers want low prices, and I know that's going to be true 10 years from now. They want fast delivery; they want vast selection. It's impossible to imagine a future 10 years from now where a customer comes up and says, 'Jeff I love Amazon; I just wish the prices were a little higher,' [or] 'I love Amazon; I just wish you'd deliver a little more slowly.' Impossible. And so the effort we put into those things, spinning those things up, we know the energy we put into it today will still be paying off dividends for our customers 10 years from now. When you have something that you know is true, even over the long term, you can afford to put a lot of energy into it."[7]

You can very easily square this with what Amazon does – for the retail side of their business everything is about improving Bezos's Holy Trinity of speed, selection, and price.

– With Amazon's Prime Now service, delivery times for some items can now be measured in minutes instead of days or weeks.

– Amazon itself stocks 12 million or so items (compared to fewer than 150,000 in a typical Walmart Supercenter), but when factoring in Amazon Marketplace, you can buy more than *half a billion* items through the company's website.[8]

[4] To be clear: We also love finding quality-growth companies that are disruptors and reasonably priced, and are thrilled to invest in them. We view investing in both what won't change as well as what will change as a method of diversification and risk mitigation that benefits our portfolios.
[5] See CNN article published on December 27, 2017: http://money.cnn.com/2017/12/26/news/companies/retail-toughest-year-store-closings/index.html
[6] Note that Comgest portfolios own positions in Amazon as of this writing.
[7] https://www.goodreads.com/quotes/966699-i-very-frequently-get-the-question-what-s-going-to-change
[8] According to ScrapeHero article published on January 10, 2018: https://www.scrapehero.com/many-products-amazon-sell-january-2018/

PETER SHAPIRO, CFA

WHAT'S NOT GOING TO CHANGE
BUSINESS MODEL STABILITY IN AN AGE OF DISRUPTION

– Amazon has made it simple when out shopping to know how much that same item retails for on Amazon's website. They know what their competitors' prices are and optimize their own pricing structure accordingly. Consumers have come to expect price transparency for transactions where opacity was previously the norm.

Not surprisingly, retailers who can't compete with Amazon along the axes of speed, selection, and price have been left out in the cold. High fixed-cost businesses don't do well with declining sales volumes, as department stores and other bricks and mortar retail concepts have been reminded in the past several years. Companies have been getting "Amazoned," where the value proposition they used to offer customers is no longer as relevant given the evolution of e-commerce.

— Is it still possible to compete with Amazon? We think the answer is "yes" but only for select business models

But what if you have a retail concept also built around some combination of speed, selection, and price? Is it still possible to compete with Amazon? Amazon doesn't have a monopoly on these ideas, after all. We think the answer is "yes," but only for select business models, and those usually focus on a subset of the Holy Trinity, looking to do one thing extremely well. One company we think is very well positioned relative to the threat posed by Amazon is long-term Comgest holding Costco, a warehouse club primarily in the US but also operating in Asia and Europe. For the uninitiated who haven't yet set foot in a Costco, its warehouse concept is like few others. The company spends next to no money merchandizing; items are simply left on the pallet, sometimes still partially covered in shrink wrap. There are also relatively few items stocked, with the average Costco having around 3,700 SKUs[9], compared to Walmart or Carrefour at well over 100,000. But what it does have is 1) extremely high quality and 2) extremely low price per measure (liter, ounce, etc.). Costco sells its items at an average gross profit of just 11 %, compared to other discount retailers at closer to 25 %. This means Costco's prices are noticeably lower than its competitors, which it makes back through an annual membership fee. With only 3,700 items to sell, Costco sells a ton of each, giving it substantial buying power with all its suppliers, even big multinationals like Unilever or Proctor & Gamble. And the quality is top notch: fresh meats, fish, and produce; premium home goods and clothes; and top beer, wine, and spirits. The only trade-off other than the membership fee is that customers usually need to buy in volume, meaning you may need a bit of cupboard

[9] Stock-keeping unit

space to store all that pasta, but you won't find it anywhere else for a better price per pound.

— Costco's low-cost/high-quality niche is valued by consumers, and that niche is naturally difficult for e-commerce to compete against effectively

Keep in mind, though, that Costco doesn't try to compete on speed (it's primarily a brick and mortar store, so it has no advantage there versus other physical stores), nor does it try to compete on selection, opting instead to offer few products and have buying power in all of them. Costco's low-cost/high-quality niche is valued by consumers, and that niche is naturally difficult for e-commerce to compete against effectively, most notably because selling at a low gross margin leaves little room to pay for shipping. If Costco were forced to compete on speed and selection, it will likely be in trouble, but so far the company's formula has worked exceptionally well, as Costco consistently posts same-store sales growth in the US several hundred basis points above personal consumption expenditures. We think that's because Costco doesn't try to be everything to everybody, nor does it try to compete head to head with strong competitors on things they do well. Instead, Costco has focused in an area where it does well, where it's hard for others to compete, and where consumer preferences are unlikely to change. We think that's likely to be a winning playbook for years to come.

BUT IS THERE EVEN ANYTHING THAT DOESN'T CHANGE IN TECHNOLOGY?

Even with its current turmoil, we believe retail is a relatively stable sector compared to one like information technology, where it's often said that the only constant is change. Just look at what's happened with the mobile handset market since Apple's iPhone was first introduced just over a decade ago – the device sparked a revolution in how personal computing is done. Here, as in retail, we aren't looking for specific products or technologies that don't change, but ways of doing business or mindsets that don't change over time. We'd point to several relevant to technology:

– Moore's Law, which refers to the historical tendency for semiconductor chip performance to double every two years. There are ongoing debates as to whether Moore's Law has played out, and we bring it up here as an analogy, not to predict anything about transistor density in integrated circuits. Instead, what we believe will not change is the trend for *the combination of hardware and software, working together, to continually get more powerful and faster* in ways that are meaningful for people running businesses. This is why we believe self-driving cars and robotic surgery are both possible and economic.

PETER SHAPIRO, CFA

WHAT'S NOT GOING TO CHANGE
BUSINESS MODEL STABILITY IN AN AGE OF DISRUPTION

- The desire to *get more value from fewer IT service providers.* Individual best-in-breed solutions will still have a place, but if you can make life easier on corporate IT departments, and help them limit their own costs, you play from a position of strength.
- Risk aversion of corporate IT departments. IT workers face an asymmetry when evaluating new tech offerings. If you select something other than the market standard, and it does well, perhaps you save your firm a few dollars and get a clap on the back. But if it does poorly, then expect to lose your job. With that incentive structure, it's no surprise that *the big incumbent players seen as "safe" choices have a built-in advantage* in maintaining their dominance.
- Network effects, where a product or service gets more useful the more people are using it. The beauty of a network effect is that the more entrenched the product or service becomes, the more difficult is then is to dislodge. A beautiful positive feedback loop, if ever there was one. We believe that, where they exist, *the strength of network effects is unlikely to decline and could even increase,* as tech seems to be moving even more in the direction of winner-takes-all markets.

Let's bring all of this back down to how we might use these ideas to look at companies and make investment decisions.

Flash back six years and look at where tech giant Microsoft, another long-term Comgest holding, stood. The longevity of its extraordinarily profitable Windows operating system and Office productivity software suite were both being questioned by investors, which is why the stock was trading at below 9x forward earnings. With device prices and sizes falling and becoming more focused on mobile – where Microsoft has been historically weak – there was no way people would pay for Windows in the same way they had historically. Combine that with the belief that free or substantially cheaper productivity software like Google Apps would eat Office's lunch and investors were willing to price Microsoft's stock in a way that discounted perpetual declines in free cash flow.

What happened since has been nothing short of breathtaking, both in terms of fundamental performance and the way the market has come to appreciate it, but the seeds were there to understand how this outcome could have happened, and they align with the technology "things that don't change" bullets mentioned a page ago. First, more powerful computing technology and improvements in telecommunications have allowed for the rise of the cloud. Second, Microsoft is uniquely positioned to benefit from the rise of the cloud, as it can offer a full-stack solution of IaaS, PaaS, and SaaS[10] in public, private, or hybrid format, thus becoming a one-stop shop for chief information officers. Third, Microsoft already had the relationships and infrastructure to service the corporate world. For instance, one often-cited reason why Google hasn't been more successful in its cloud efforts has been that the company is simply not set up for enterprise sales the way Microsoft is. And fourth, the network effects inherent in Office bought the company time to bring better and especially cloud-based solutions to market, and the success of those is evident in rising average selling prices as customers increasingly opt for a more feature-rich product. Windows remains an economic strength for Microsoft, but the company has transitioned away from measuring success by the number of personal computers and servers upon which its software was installed (an on-premise-based view of compute) to consumption of cloud capacity (a cloud-based view of compute). And this is the key point: the specific products may have changed, but *Microsoft's ability to respond to the needs of corporate consumers of technology has not*.

— The specific products may have changed, but Microsoft's ability to respond to the needs of corporate consumers of technology has not

This brings up an important point: a business model built around what won't change does not mean that a company shouldn't invest in R&D and try to innovate. Microsoft is a great example of that. The "what doesn't change" part of its business is not the products and services it offers; those develop at a rapid rate, and Microsoft continually invests billions of dollars per year to ensure its offerings are among the most innovative on the market. It's the *way* it does business that doesn't change, and considerable investment ensures that remains the case.

This idea of "what doesn't change" can be applied more broadly, of course. Take, for instance, French cosmetics and personal care company L'Oréal – one of our long-term portfolio holdings – which says in its values statement that its success for more than a century comes from its focus on "just one business – beauty."[11] It is certainly true that consumers wanted to look their best in the beginning of the 20th century, just like they do here in the 21st century. But beauty in 2018 has evolved from what it was in 1918, so the specific products have changed, but *L'Oréal's ability to respond to consumers' desire to appear beautiful has not*. To

[10] Infrastructure as a Service, Platform as a Service, Software as a Service
[11] https://www.loreal.com/group/who-we-are/our-values-and-ethical-principles

paraphrase Jeff Bezos: "It's impossible to imagine a future 10 years from now where a customer comes up and says, 'I want to look less than my best,' or 'I don't need to take pride in how I feel.' Impossible."

INCREASING CAP IS THE NAME OF THE GAME

Let's briefly move from the applied to the theoretical to see why focusing on what doesn't change can be so important to stock price performance.

— The Competitive Advantage Period (CAP) is the time over which a company will generate economic profit or Economic Value Add (EVA)

The Competitive Advantage Period (CAP)[12] is the time over which a company's returns on invested capital will exceed its cost of capital, before competitive forces in the market drive those returns down to the cost. Equivalently, this is the period over which a company will generate economic profit or Economic Value Add (EVA). This is where a company creates value, above the required return dictated by its cost of capital. All else equal, the market will pay more for this company the more value a company creates in a given time, or the longer the period during which the company can create value at a given level. I like this framework, because you can use it to create a good mental model about how the market values a stock.

Figure 1. Competitive Advantage Period (CAP)

Source: Comgest

Say, for instance, that a stylized company were expected to be able to generate above-cost returns on invested capital for a certain period. We could represent that graphically like figure 1, where zero on the y-axis represents the weighted average cost of capital (WACC), with the company's returns on invested capital (ROIC) some level above that, and the time over which the company can generate this economic profit shown on the x-axis. The boundary on the right is the end of the CAP, where the company's ROIC drops

[12] See http://people.stern.nyu.edu/adamodar/pdfiles/eqnotes/cap.pdf for an overview of CAP. Please also refer to our earlier White Paper: "Deconstructing the Comgest Quality Growth Approach" for our previous discussion of CAP's application to Comgest's investment philosophy, available on our website www.comgest.com.

PETER SHAPIRO, CFA

WHAT'S NOT GOING TO CHANGE
BUSINESS MODEL STABILITY IN
AN AGE OF DISRUPTION

— CAPs for various businesses can differ dramatically, but in "normal" conditions can be as short as a couple of years or less, or well over a decade

down to the WACC and the firm is no longer creating economic value.[13] CAPs for various businesses can differ dramatically and change over time, but in "normal" conditions can be as short as a couple of years or less (or even negative), which is often the case for more cyclical companies, or well over a decade.[14]

Figure 2. Increase in Return-Cost Spread

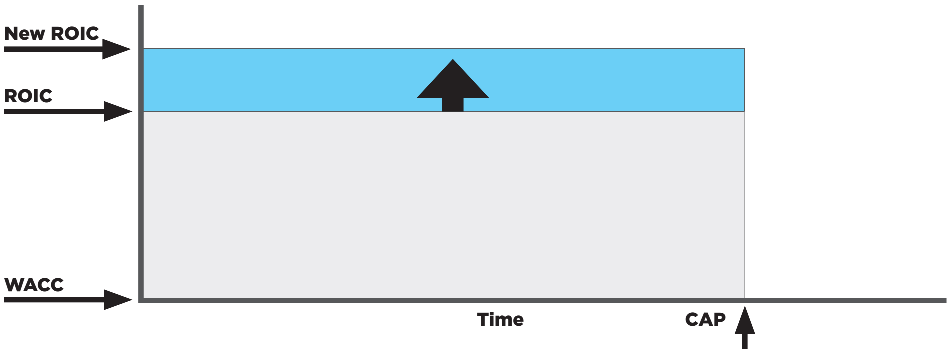

Figure 3. Increase in Duration of Return-Cost Spread

Source: Comgest

The extra value ascribed to the company by the stock market is represented by the shaded area, the amount of excess return multiplied by time over which the excess return is generated. For the value of a company to increase (*i.e.* for its value in the market to rise), that shaded area has to grow in size, which means one of two things has to happen – either 1) the return-cost spread increases though better economics for the company (*e.g.* faster sales growth, increased margin, better cash conversion, etc.) or 2) the duration over which this spread can be generated increases. These two possibilities are shown graphically above, where the gray area now becomes either the sum of the gray plus blue areas or the gray plus green areas.

[13] For this chart and the others in this note I've opted for simplicity and represented this boundary as a vertical line – competitive advantage dropping instantaneously from full down to nothing – but it's more intuitive to think of this as a downward sloping line as competitive advantage is progressively competed away. Right angles make conceptual charts simpler.

[14] For businesses not currently earning an economic profit (*i.e.* ROIC < WACC), this framework isn't particularly useful as presented because if the current business persists indefinitely, a rational equity investor would never buy the stock. If people want to buy the stock, it's because they expect a change in the business fundamentals.

PETER SHAPIRO, CFA

WHAT'S NOT GOING TO CHANGE
BUSINESS MODEL STABILITY IN AN AGE OF DISRUPTION

— **If we can be among that smaller group of investors looking to understand how a company can increase its CAP, this presents opportunity for us**

Here's where the power of this framework comes out. We believe most investors focus on the upper chart, or how a company's financials can improve. Just look at the questions corporates field on conference calls: "How have sales been for new product X?" "What do you expect full-year margins to be?" "How much will capital expenditures go up?" Relatively few people focus on the lower chart, how a company can make its advantages persist over a longer period. If we can be among that smaller group of investors looking to understand how a company can increase its CAP, this presents opportunity for us. And crucially, *we believe "what doesn't change" companies are among those most likely to be able to extend their CAPs.*

This mental model is not limited to retail or technology or personal care products, but is instead a blueprint to thinking about the long-term business model of any company. We are interested in whether a company can grow faster or operate more efficiently, which can increase the current economic profit generated and thus increase market value, but we also try to generate insight about what might help a company extend its CAP that can give us confidence that the market will eventually price that in over the longer term. Note that this doesn't mean we're looking only for companies priced by the market with a short CAP that we think can do slightly better – it can also be companies priced at a long CAP where we think it can be extended even more.

"PLUS ÇA CHANGE, PLUS C'EST LA MÊME CHOSE"

In early 1999, as the Internet bubble was going vertical, Jeff Bezos gave an interview[15] to Wired Magazine and made some predictions about the future of retail. Several of them turned out to be eerily accurate, but the article also noted the following Bezos prediction:

"Successful 'shoptainers' will be like the Gap, with its environment of music and youth culture, or Nordstrom, with its tinkling pianist and distinctive face-to-face service. They may be even more amplified, with personal service and showmanship turning every shopping trip into a Super Bowl-style destination event. 'That experience is what you get when you go to movie theaters, and why you don't always rent movies, right?' Bezos notes."

[15] https://www.wired.com/1999/03/bezos-3/

PETER SHAPIRO, CFA

WHAT'S NOT GOING TO CHANGE
BUSINESS MODEL STABILITY IN AN AGE OF DISRUPTION

It turns out that no one, even those who have hinted that predicting change is a "less important question," can resist the siren's song of offering up a view of what will change. We think financial markets are no different, with scores of talking heads giving their views about what will change in the future for every prognosticator who simply says, "this will persist." Because this simple, yet often overlooked, behavior is deeply rooted in human psychology, we think it's a durable source of market alpha and a key source of portfolio ideas.

Peter Shapiro, CFA
Analyst and Portfolio Manager

Peter Shapiro joined Comgest in 2013 and is an Analyst specialised in US equity. Peter began his career as an Analyst at Legg Mason Capital Management in Baltimore, Maryland and went on to hold a similar position at a boutique asset manager in Paris. He graduated from Colby College with a Bachelor's degree in Physics and holds Masters' degrees in Acoustics from The Pennsylvania State University and Applied and Computational Mathematics from The Johns Hopkins University. He is also a CFA® charterholder.

IMPORTANT INFORMATION – FOR PROFESSIONAL/QUALIFIED INVESTORS ONLY

Data as of 30 September 2018, unless stated otherwise. Product names, company names and logos mentioned herein are trademarks or registered trademarks of their respective owners. This document has been prepared for professional/qualified investors only and may only be used by these investors. This material is for information purposes only.

The information contained in this communication is not an 'investment research' and is classified as a 'Marketing Communication' in accordance with MIFID II. This means that this marketing communication (a) has not been prepared in accordance with legal requirements designed to promote the independence of investment research (b) is not subject to any prohibition on dealing ahead of the dissemination of investment research.

Past investment results are not indicative of future investment results. The value of all investments and the income derived therefrom can decrease as well as increase. Investing involves risk including possible loss of principal.

No discussion with respect to specific companies should be considered a recommendation to purchase or sell any particular security/ investment. The companies discussed do not represent all past investments. It should not be assumed that any of the investments discussed were or will be profitable, or that recommendations or decisions made in the future will be profitable.

The information and any opinions have been obtained from or are based on information from sources believed to be reliable, but accuracy cannot be guaranteed. No liability is accepted by Comgest in relation to the accuracy or completeness of the information or opinions contained in this document. The information in this document is not comprehensive and is presented for informational purposes only. All opinions and estimates constitute our judgment as of the date of this presentation and are subject to change without notice. Forward looking statements, data or forecasts may be not be realised.

Comgest does not provide tax or legal advice to its clients and all investors are strongly urged to consult their own tax or legal advisors concerning any potential investment. Before making any investment decision, investors are advised to check the investment horizon and category of the investment /fund in relation to any objectives or constraints they may have.

Investors shall undertake to respect the legal, regulatory and deontological measures relative to the fight against money laundering, as well as the texts that govern their application, and if modified investors shall ensure compliance.

The investment professionals listed in this document are employed either by Comgest S.A., Comgest Asset Management International Limited, Comgest Far East Limited, Comgest Asset Management Japan Ltd., Comgest US L.L.C. and Comgest Singapore Pte. Ltd.

Comgest S.A. is regulated by the Autorité des Marchés Financiers (AMF). Comgest Far East Limited is regulated by the Hong Kong Securities and Futures Commission. Comgest Asset Management International Limited is regulated by the Central Bank of Ireland and is registered with the U.S. Securities and Exchange Commission. Comgest Asset Management Japan Ltd. is regulated by the Financial Service Agency of Japan (registered with Kanto Local Finance Bureau (No. Kinsho 1696)). Comgest US L.L.C is registered with the U.S. Securities Exchange Commission. Comgest Singapore Pte Ltd, is a Licensed Fund Management Company & Exempt Financial Advisor (for Institutional and Accredited Investors) regulated by the Monetary Authority of Singapore.

www.comgest.com

COMGEST S.A.
17 square Edouard VII, 75009 Paris
France
Tel: (+33) 1 44 94 19 00
info@comgest.com

COMGEST ASSET MANAGEMENT INTERNATIONAL LIMITED

Dublin Office
46 St. Stephen's Green, Dublin 2
Ireland
Tel: (+353) 1 631 0100
info.camil@comgest.com

UK Representative Office
43 Brook Street, Mayfair
London, W1K 4HJ
United Kingdom
Tel: (+44) 20 3871 4109
info.camil@comgest.com

COMGEST FAR EAST LIMITED
Level 10, 28 Hennessy Road
Hong Kong
Tel: (+852) 3972 0200
info.asia@comgest.com

COMGEST ASSET MANAGEMENT JAPAN LTD.
1-8-2 Marunouchi, Chiyoda-ku
Tokio 100-0005
Japan
Tel: (+81) 3 4588 3640
info-jp@comgest.com

COMGEST SINGAPORE PTE. LTD.
8 Temasek Boulevard,
#20-01A Suntec Tower Three
Singapore 038988
Tel: (+65) 6672 7100
info.asia@comgest.com

COMGEST DEUTSCHLAND GMBH
Sky Office
Kennedydamm 24
40476 Düsseldorf
Germany
Tel: (+49) 211 44 03 87 0
kontakt@comgest.com

COMGEST US LLC
101 Arch Street, 8th floor
Boston, MA 02110
USA
Tel: (+1) 857 304 0135
info.us@comgest.com

COMGEST BENELUX B.V.
Gustav Mahlerplein 3-115
1082 MS, Amsterdam
The Netherlands
Tel: (+31) 6 229 20 612
contactnl@comgest.com