

SGH20 Insights

US TRAVEL DIARY

"We've had three big ideas at Amazon that we've stuck with for 18 years, and they're the reason we're successful: Put the customer first. Invent. And be patient." Jeff Bezos

Getting on the road and meeting with companies and industry contacts are important parts of our investing process. In March we ventured to the US on a research trip for a week. As the world's largest economy, the shadow cast by the USA economically, and in terms of secular trends and innovations driving industry change, remains very influential. Our trip centred on attending Treasury Wine Estates Investor Days in the Napa Valley, California, but we also took in the Montgomery Technology Summit in Los Angeles and met with some of the largest US consumer companies (including Home Depot, Sears, Coca Cola, Domino's Pizza, Amazon and Expedia).

Key insights

- US tax reform uncertainty prevails, but remains key to sustaining the reflation trade.
- Amazon's potential coming to Australia seems an opportunity as much as a threat.
- Large traditional retailers (like Home Depot) with differentiated offerings are adapting and thriving.
- Companies prescribing health and wellness solutions (like ResMed & CSL) are better positioned than those being forced to manage defensively their social license to operate (like Coca Cola).
- All company boards need relevant IT skills or risk falling behind in innovation and cyber security.
- Treasury Wine Estates has a significant opportunity to create further value as it leverages its brand strategy and distribution platform.

Trumponomics

There was general acceptance from the companies we met that there is a need for US tax reform, but more questions than answers remain about what the ultimate package will look like, how the cost of a corporate tax rate deduction will be funded, and how economic growth will be promoted without disrupting cross border activities and causing retaliatory measures from trading partners. Home Depot made the point that there are many proposals being discussed, including border adjustability, non deducibility of net interest expense, immediate expensing of US asset acquisitions, non taxation of foreign subsidiary profits and a reduced corporate tax rate, and it is hard to know what the package of changes might ultimately look like. The point is, it is not just about a cut in the corporate tax rate, but the package of reform and potential trade-offs. We continue to see tax reform as a top priority for the Trump Administration; however, our discussions coupled with the recent failure of Obamacare reform only reinforce the level of uncertainty around the

politics and timing. Given equities markets appear to have already embraced the idea of tax reform and that Trump's agenda can be implemented in a timely fashion; it makes markets increasingly vulnerable to any delays or disappointments.

The coming of Amazon

Since being founded in 1994 as an online book retailer, Amazon has transformed into an extraordinary company that now accounts for more than half of every dollar spent on-line in the US. Its category and geographic expansion, new standards in service and price, and mission to become "Earth's most customer centric company" has been nothing short of astounding. Amazon launched its digital offer in Australia in November 2013 (Kindles and ebooks only) and, subsequently, large web services business. Recent talk of Amazon entering Australia more broadly through its general merchandise and fresh offering, and implications for domestic companies has reached fever pitch - hence it was timely to meet with Amazon management in Seattle. Whilst they remain tight-lipped

on their expansion plans they made the points that when entering any new territory:

- local knowledge is required, and they look for strategic partnerships or acquisitions with local businesses;
- the customer proposition must be the same across everything they offer whether it is in Amazon Web Services, technology services or on line retail delivery; and
- the product/service must be differentiated from anything else available, and delivered consistently without exception.

In our view, it is this final point which stands out as one of the biggest hurdles for Amazon entering Australia.

Population densities are 3x higher in key US/ Canada/UK cities in which Amazon operates than in Australia and, although Australian logistics is well developed, it remains expensive. Importantly, Amazon mentioned that unless they can offer a truly “national” service, whereby all Australians receive a basic equivalent service, it would be unlikely to commit to an Australian launch of its full retail service.

With over 80% internet penetration and the third highest retail spend per capita globally, we believe Australia fundamentally remains an attractive retail destination, and the arrival of Amazon seems inevitable at some point. However, the current de-rate across the domestic retail sector on concerns around Amazon reminds us of 2010-12, the last time the threat of online retailing gained significant publicity and became an industry topic. Back then, it coincided with a material downturn in general consumer spending, but ultimately proved a good investment opportunity.

Adapting to on-line competition

Meeting with Home Depot provided some interesting insights into the risks for incumbent Australian retailers facing the growing threat from online. As the largest home improvement retailer in the US with ~US\$100bn in annual sales, Home Depot’s size and scale has assisted in helping defend its position against on-line competitors. But it has also been proactive in reshaping its business. Some years ago it identified approximately 25% of its product range as “at risk” to on-line competitors. Since then it has worked tirelessly on driving productivity improvements in both its physical supply chains and online order fulfilment capabilities. Together with targeting more and more exclusive supply agreements with suppliers to ensure its product range is strongly differentiated from its competitors, Home Depot has been

successful in combating online challengers whilst growing its online sales (inc. ‘click and collect’) to now be 6% of total sales.

This compares dramatically to Sears, the one time largest physical retailer in the US, and now a poster child of a bricks and mortar retailer decimated by online. According to Home Depot, Sears are donating around 50 basis points of sales per annum to Home Depot as a strategy of continuing to sell relatively generic branded goods from very large stores for decades has seen them savaged by changing consumer shopping trends.

In Australia, we see strong parallels between Home Depot and Bunnings and Sears and Big W and Kmart.

Risk and response to health and wellness

The paradox of deteriorating diets and growth in fast food consumption alongside the increase in expenditure on health from rising obesity and non communicable diseases like diabetes provides two different investment opportunities: invest in health or wellness companies providing prescribed solutions (where we tend to focus) or companies capitalising on the demand growth and falling real prices for processed foods. In our view, they carry very different longer term investment risks around the company’s social license to operate and, ultimately, regulatory risks. We believe fat and sugar taxes, a ban on trans-fats and more strident disclosure requirements are only likely to rise in response to foods that negatively affect consumer health and, with this, the risk of impairment to the longer term value of the companies that sell these products.

In meeting Dominos Enterprises and Coca Cola, it was interesting to contrast their approach to the health food debate and social responsibilities. Domino’s believe, by ensuring they have a wide range of topping for their pizzas and providing consumers with opportunity to eat healthily (or not), they are fulfilling their social responsibilities. Coca Cola, on the other hand, have taken a more proactive approach in openly recognising their social responsibilities. This includes publicly supporting the World Health Organisation’s ambition to see “added sugar” represent no more than 10% of a person’s average daily calorie intake - quite a change from Coke’s historical much more adversarial approach of spending considerable time and money countering public pressure to reduce sugar in their products. Interestingly, it is now providing new opportunities to expand their product range (through no/low sugar drinks) and smaller packaging sizes, and thus offset the impact of declining sales volumes. Despite these changes, we ultimately see them as defensive and

the carbonated soft drink market as being structurally challenged.

Our preferred way of playing the health and wellness theme is through ResMed, which addresses sleep apnea, and CSL which is currently developing CSL112, a reconstituted high-density lipoprotein (HDL), or in lay terms, cholesterol artery cleaner for preventing cardiac disease. CSL112 is currently a waste product of CSL's plasma product production process, and if the trials are successful, then the potential upside for CSL is large (c. US\$2bn market).

Technology insights and emerging trends

The Montgomery Summit is an eclectic gathering of 150 private companies, innovators and leaders in business and technology over 2 days in Santa Monica. Whilst providing great insight into emerging technology trends, it also provided interesting perspectives on what is important in investing in technology companies. Key take-aways included:

- Increasing evidence that the large scale adaptation of cloud-based services is growing as users become increasingly comfortable with concerns related to service levels, security and compliance. There has been a huge step-up in investment in cyber security by the largest players in the industry and step changes in technology reducing fears around the security of proprietary data. This supports the growing demand for computing as a service, and rapid growth in pooled hardware and data centres (a key part of our thesis for holding Next DC, the leading Australian listed data centre player).
- Evidence that the companies which best embrace technology in their businesses are those always looking externally for products and partners to enhance their offer. Paul Fipps, the CIO of Under Armour, highlighted how their investment in mobile app technologies and relatively low cost of sensors and microchips is making it likely they will soon be able to manufacture all shoes with microchips. Interestingly CHEP, Brambles' pallet business, is also looking to incorporate digital tracking technologies into its pallet supply chain solutions with customers. The cost-benefit trade-off of radio frequency identification (RFID's) has historically been the issue, but this is changing and being increasingly enabled with tools like CHEP-TRAC which is compatible with 2D scanning, RFID and GPS devices and is helping drive supply chain efficiencies and cost savings.

- The increasing importance of companies having technological expertise at all levels of their business and most importantly, at company board level. Failure to do this risks seeing companies falling behind in key areas like innovation and cyber security. Board skills diversity and whether companies have relevant IT experience is a question we are increasingly focused on as apart of our process of assessing management quality.
- The following is a checklist of issues to consider when investing in technology companies (which can be extended to most businesses):
 - the technology sector lends itself to a "winner take all" market or, at least, a select few survivors.
 - Succeed or fail quickly - speed remains the most important element in developing innovative technologies as the risk of spending too much money and ultimately being unsuccessful increases with time.
 - Be careful of investing in 'Mez' products that are neither unique nor offer users something of sufficient value. Without these features, survival is unlikely.
 - Identify the best talent in specific fields. This is a key ingredient for success.

Treasury Wine Estates - Leveraging the brand strategy and distribution platform

Treasury Wine Estates has been a long standing position in the portfolio. Ever since the business was demerged from Fosters in 2011, we have held the view there was the opportunity to enhance significantly shareholder returns if management could appropriately leverage Treasury's industry leading portfolio of brands and viticultural assets. Under Michael Clarke's stewardship over the last two years, the change in strategy from the company being operated as an order taking agricultural business to a marketing led consumer focused brand managed business has unlocked significant value. Notably, this has seen the company develop a direct distribution model in China and expand its portfolio through the acquisition of the majority of Diageo's US and UK wine portfolio in late 2015.

The investor day provided the first opportunity to visit the Diageo North American assets (including vineyards, wineries, production facilities and brands), meet senior management from across the Treasury business, and get an update on a number of new company strategic initiatives and targets for the coming years. Principal amongst these were:

- The launch of a new French wine portfolio from late CY2017 targeting the North Asian markets initially.
- Expansion of Treasury Wine's market share (both in terms of volume and value) from current levels of approximately 21% in Australia to a targeted 25% in near term.
- In addition, the previously stated supply chain cost savings in the US over the coming years (\$100m by 2020), re-establishment of key US national retail accounts and the taking back of considerable market share lost over the past decade.
- Commitment to optimising the wine portfolio by investing in vines (where previously the company had underinvested), including replanting select varietals to maximize yields in line with anticipated future demand.

We believe developing and re-establishing the customer relationships in the US will be a significant challenge, particularly given a number of major competitors such as Constellation and Gallo have strengthened their relationships with key distributors and retail customers in recent times. To this end, we see Michael Clarke's decision to relocate to the US as an important commitment around the company focus in getting this strategy right. We were also encouraged on the tour by our discussions with management, which provided us with increased confidence there are clearly defined priorities and a well defined pathway for achievement of the US objectives. In our view, this is a strong reflection of the culture of increased accountability and strengthened performance measures Michael Clarke has brought to the business.

Much of Treasury's success in recent times can be attributed to the company's successful establishment of direct sales channels into key customers in the Chinese market. Going forward, maintaining strong sales momentum is increasingly about supporting these sales relationships, which will require an increasingly sophisticated marketing program dependent on:

- Increased recruitment of staff from FMCG (Fast Moving Consumer Goods) backgrounds.
- Customising the marketing support and narrative for established heritage brands such as Wolf Blass as

compared to newly created 'native' brands such as the popular 19 Crimes.

- Aligning promotional activities with the company's global brand allocation policy for regional volumes to maximise yield per case of wine sold.

Treasury has stated a target for 5-10% of future annual sales growth to come from new products. The launch of the company's new French portfolio later in the year marks a new level of ambition in this regard, and while it will entail a relatively low fixed capital investment, it marks a new product extension and range for Treasury, that will test its distribution model and sales relationships. Beyond this, the ability to continue to secure adequate premium fruit supply going forward will be a key determinant of the company's ability to continue to drive new products and sales, and feed the increasingly broad number of markets and customers the company is cultivating.

Ultimately, the investor days reconfirmed in our view the significant opportunity that exists for Treasury Wines. While a lot has been achieved in repositioning the business in a relatively short space of time, when viewed against the global opportunity and their current footprint within this, we still believe there is significant opportunity to create further value for shareholders.

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