RESEARCH REPORT

January 29, 2018

The Future of Brands

An Investor's Perspective

The Consumers & Healthcare sector team examines how to think about brands from the perspective of an investor. This exercise has proven to be quite helpful, considering many companies in our coverage universe derive their competitive advantage through their brand. Although there exists several complexities the evaluating brands and their implications for investors, we highlight three key trends we are observing in the market:

(1) The decline of search cost brands

(2) The rise of identity brands

(3) How identity brands can fail

Throughout the report, we will revisit the history of brands to determine how they initially materialized in the consumers sector. Additionally, we will highlight specific cases of Amazon, Canada Goose, Nike, and Under Armour and how they are benefitting from or losing from the reshaping of the branding landscape.

Consumers & Healthcare

Jon Allion
jallion@quiconline.com

Andrei Florescu
aflorescu@quiconline.com

Ioulia Malamoud
imalamoud@quiconline.com

Connor Steckly
csteckly@quiconline.com

Nick Gakena
ngakena@quiconline.com

Table of Contents

Why Brands Exist 2
The Decline of Search Cost Brands 3
Amazon's Benefit from the Death of Search Cost Brands 5
The Rise of Identity Brands 7
Where Identity Brands can go Wrong 9
References 10

Why Brands Exist

There is no question that strong brands can contribute to a defensible competitive advantage for a company. Contrarily, brands also have the ability to erode the perceived quality of the products and services a company offers. Before examining which types of brands are desirable from a business and investing standpoint, it is helpful to first learn how brands were initially created in the marketplace.

Prior to the 1950s, brands did not exist in the way we know today. At the time, products were easily distinguished on the basis of their true quality. A company could be successful just from having the best product or service offering. By the same token, companies with subordinate products would be easily identified and avoided. The reason why this held true is because products were not standardized as we are now familiar with. Automobiles could be horribly unreliable, toys could have atrocious quality control, tools could be flimsy, among other undesirable qualities. Most importantly, these differences could very easily be identified just by looking at them. In the middle of the 20th century, a trend of standardization took place, which made many products virtually indistinguishable from a surface level.

When this change in the industry took place, consumers entered a much more challenging shopping environment. Instead of easily being able to identify which products were worth their money and which were not, they had to do much more research. It is easy to imagine how difficult it would be to determine which products are superior in the absence of brands. For example, hair gel is nearly identical in looks no matter which two products you compare. The difference between an inexpensive gel and a salon-quality gel would become apparent only when the consumer tries each one. The process of finding a product that the customer likes would end up being quite costly, from both a monetary and time perspective. In the case of hair gel, the consumer would have to buy multiple products and try each one. Alternatively, the prospective buyer could go to the effort of finding current users and asking them about their experiences with the product. Regardless, the process of a consumer determining whether a product is good or not is considered a *search cost*.

The presence of search costs is ultimately what led to the introduction of brands in the middle of the 20th century. Through establishing a reputation for having quality products, brands reduced search costs for consumers. In doing so, these brands could charge higher prices to the consumer because of the reduced search costs the consumer had to incur.

Exhibit I

Examples of Traditional Search Cost Brands

Source(s): Company Reports

The Decline of Search Cost Brands

Over the past 50 years, consumer staples have been the top performing sector on an absolute and risk-adjusted basis. These companies pioneered modern marketing strategy, thus increasing their customers' perception of the value these companies offered. As long as the cost of building this reputable and well-articulated brand was less than the premium they were able to charge, companies would have a sustainable competitive advantage.

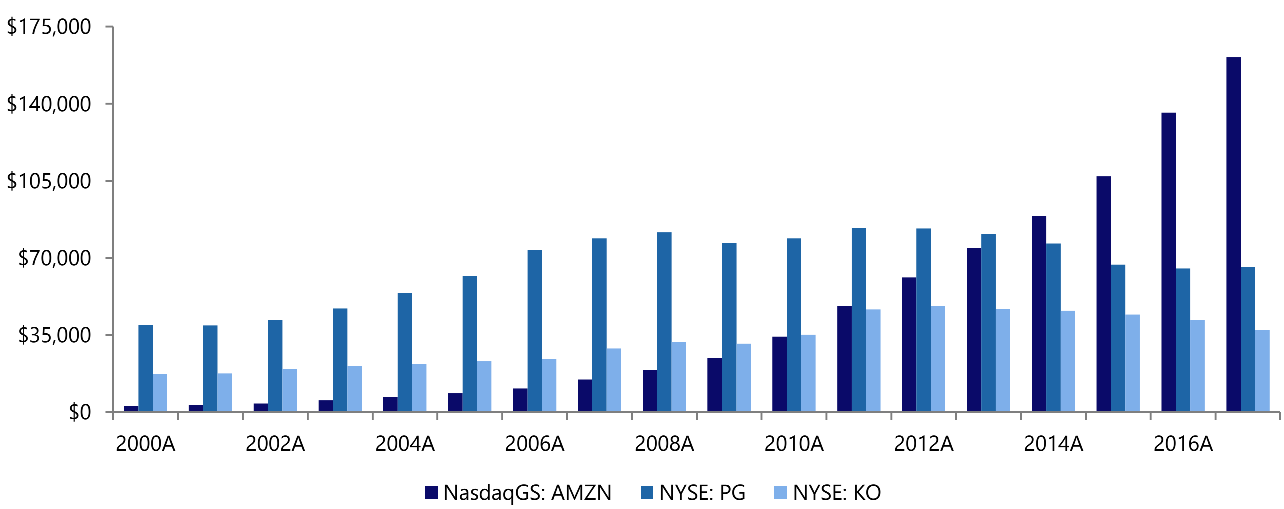
The outsized returns these firms were able to generate through charging a 'brand premium' offered innovative companies an opportunity to disrupt these once highly defensible profit streams. Costco is a great example. Costco customers are willing to pay membership fees to shop at its stores. Costco's size and scale allows them to consistently identify and sell high-quality products to its customers. This peace-of-mind justifies the membership fees, as it eliminates the need to buy name-brand products for quality assurance. Costco does the 'searching' for the consumer, and passes the cost along though its membership fee. This has allowed it to generate high returns on capital and grow its business rapidly, despite charging prices close to cost. By inserting themselves directly between the consumer and the brands, Costco has eroded the power of many historically strong brands and built a loyal customer base of its own.

Amazon is another example. Product reviews, ratings, and ranking systems have replaced brand name as key drivers of consumer choice. The uncertainty around a product's quality is largely eliminated when consumers are given access to hundreds of reviews from other consumers. Positive reviews can have an equally, or more powerful effect on consumer behavior.

The erosion of these brands' power has been accelerating in recent years. These disruptive consumer staples brands (e.g.. Costco and Amazon) have reduced the perceived benefits that search brands used to offer.

Exhibit II

Amazon Versus Procter & Gamble and Coca-Cola's Historical Revenue Trends (MM)



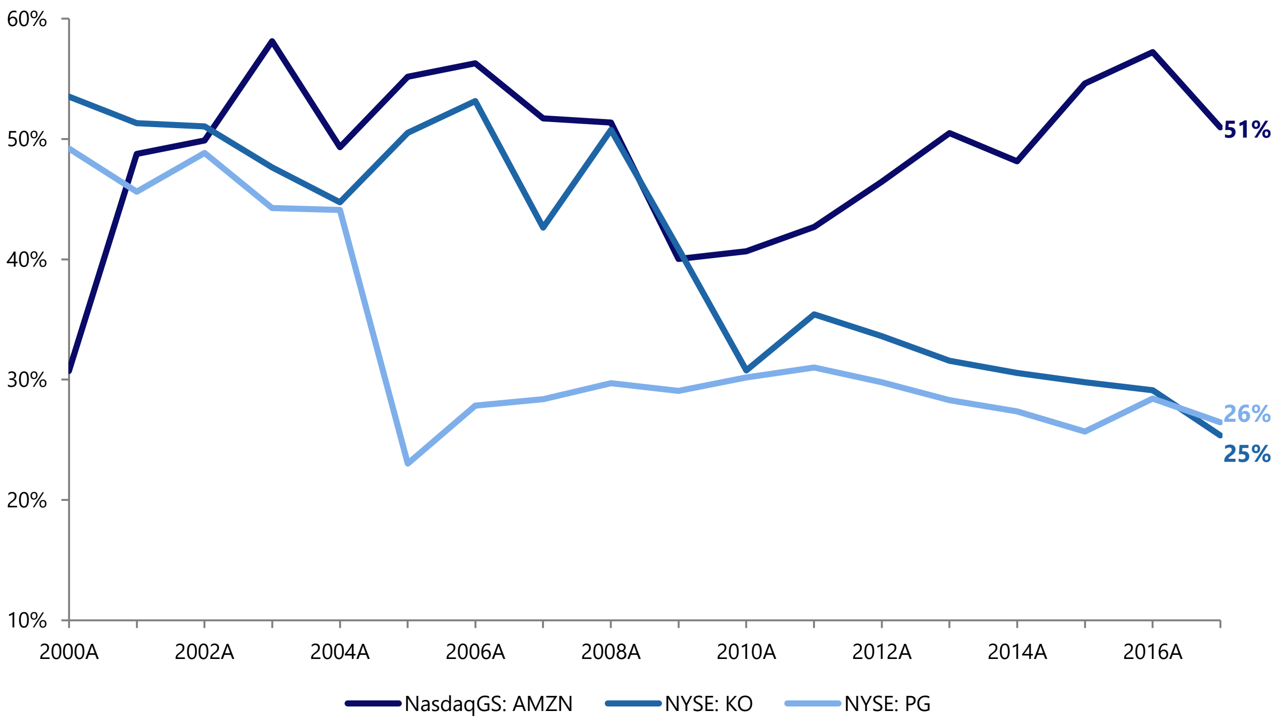
Source(s): Company Reports, Ensemble Capital, S&P Capital IQ

The Decline of Search Cost Brands (cont'd.)

Exhibit III compares the revenue growth of these historically strong brands like P&G and Coca-Cola to disruptors like Amazon. While revenue growth had been strong from 2000 to around 2010, sales have stagnated and begun declining slowly over the past seven years. This compares to companies like Amazon who have grown their revenue base by disrupting these companies' source of differentiation. While they are not direct competitors, these trends point to a broader shift in consumer preferences and behavior that should be concerning to companies who rely on their search cost brands. One way to measure how strong a company's set of competitive advantages are is the gross-profitability ratio (gross profit/total assets). The ratio uses gross profit because it is a 'cleaner' metric than net income or EBIT, as it is further up the income statement and not subject to line items that could distort the figure. Dividing by total assets shows how efficiently the company can utilize its asset base, while penalizing companies that hold excess cash. Since 2000, P&G and Coca-Cola have seen their gross profitability cut in half, while companies like Amazon have seen theirs steadily rise. This trend highlights how companies which have relied on search cost benefits to sustain their competitive position are now beginning to lose their edge.

Exhibit III

Gross Profitability Trends in E-Commerce Age



Source(s): S&P Capital IQ, Ensemble Capital

Amazon's Benefit from the Death of Search Cost Brands

Amazon Basics

Out of all the companies who can benefit from the death of consumer search-cost brands, Amazon will likely reap the biggest rewards in the long-term. This comes as the result of Amazon's launch of its own private brands category: Amazon Basics. While Amazon Basics offers hundreds of products to customers, currently its most popular products include batteries, iPhone chargers, desk chairs, paper shredders, pet supplies, and several other consumer goods.

Early Success in Basics – Batteries and Diapers

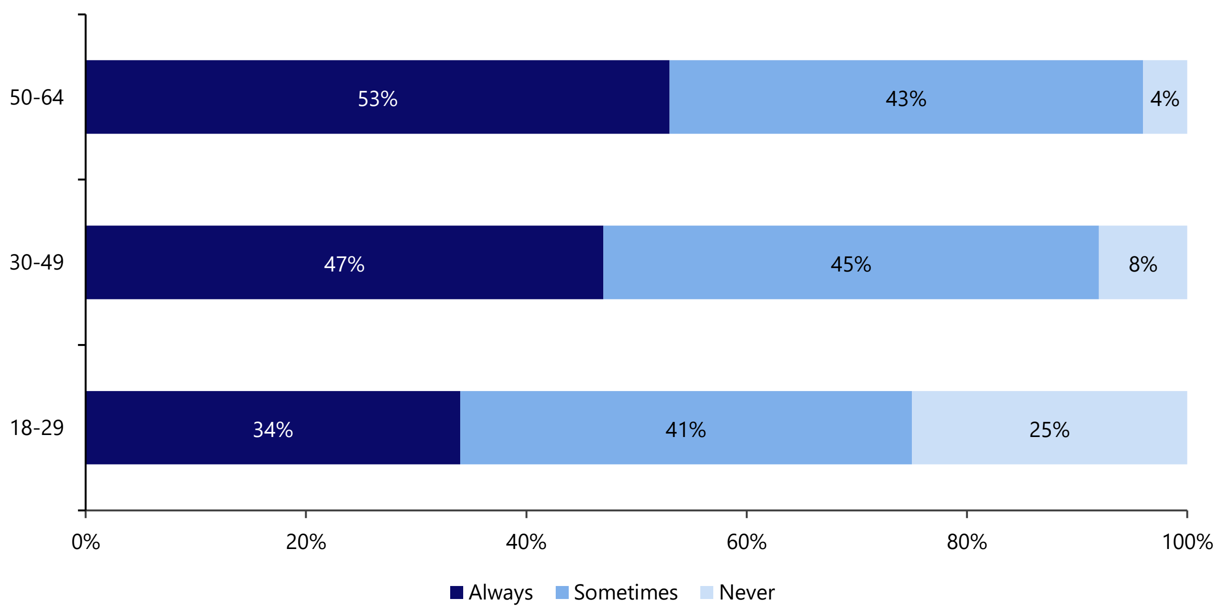
Out of all basics products that Amazon sells, its battery division has achieved the most success. Amazon Basics batteries are currently the most popular battery brand sold on the internet, outpacing both Duracell and Energizer with a 30% digital market share. The company's diaper division holds a 15% digital market share, only behind Pampers and Huggies.

The Future for Amazon Basics

A combination of factors will likely result in a widespread adoption of Amazon's Basic branded products. First, Amazon has built a strong brand that consumers trust. Amazon currently holds the sixth most valuable brand in the world, worth $54.1 billion. With retail sales topping $100 billion a year, while growing at 20% per annum, the company also benefits from significant size. Putting these two factors together provides Amazon with the scale to create its own consumer goods in house, under a branded name that customers trust.

Exhibit IV

Percent of U.S Adults who Read Ratings and Reviews



Source(s): Pew Research Center

Amazon's Benefit from the Death of Search Cost Brands (cont'd.)

Reviews

In addition, Amazon will benefit from a number of industry tailwinds. First, the rise of reviews and its adoption in consumer shopping is a massive benefit for Amazon. 1 in 4 shoppers check Amazon reviews, even while shopping in brick and mortar stores. 1 in 3 shoppers will refuse to buy a product unless it has positive reviews. More than 50% of the millennial demographic (ages 18-29), more than 50% of read ratings and reviews while shopping, while a meagre 4% never read reviews.

Branded vs. Non-Branded Trends

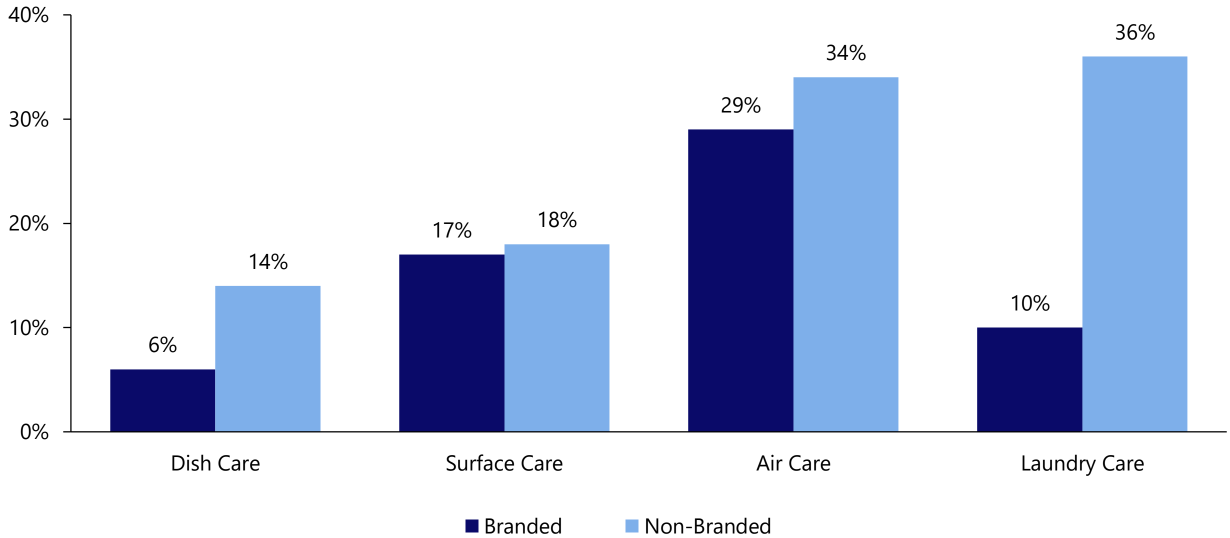
The search of branded vs. non-branded products is also heavily shifting in Amazon's favour. As opposed to searching Google for "Tide detergent" or "Swiffer mop pads", customers are cutting on keystrokes and now simply searching for "detergent" or "mop pads". From April 2016 through March 2017 non-branded search volume growth outpaced branded search growth for all major consumer products – dish care, surface care, air care and laundry care.

Amazon's Basics Brands Save Time and Money for Consumers

Amazon's retail operations success to date has come from the company's ability to save time and money for consumers. Amazon has strived to offer the lowest priced products while continuing to reinvest heavily in its operations to offer the fastest deliveries for consumers. This theme of a reduction in time and money is consistent with Amazon's private brands strategy. Amazon's Basics consumer goods will save time and money for consumers by being the cheapest products on the market that, which customers can easily distinguish from thousands of strong reviews.

Exhibit V

Branded vs. Non-Branded Search Volume Growth – April 2016 vs. March 2017



Source(s): L2

The Rise of Identity Brands

The disruption that traditional search cost brands have recently experienced has not rendered brands useless. There exists a different type of brand, an identity brand, that has resilient characteristics. From an investing standpoint, these brands have *economic moats* that develop extremely defensible business models.

Like search cost brands, identity brands also reduce search costs incurred by consumers when deciding which product to buy. However, identity brands also communicate something about the owner to either themselves, the outside world, or both. It is not the identity brand's reputation of quality that makes it a strong business, but the signal of one's identity that such brands give.

Case Study: Canada Goose

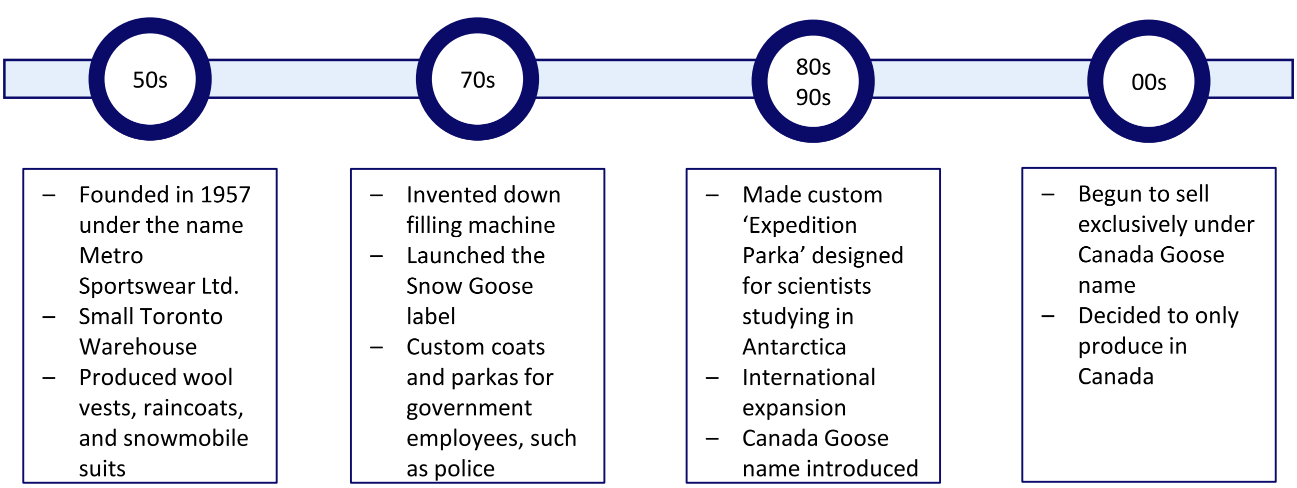
An excellent example of an identity brand is Canada Goose (TSX:GOOS-T). While Canada Goose sells quality parkas, that is not entirely what drives their steep price. A Canada Goose jacket emits an aura of status that a jacket from Eddie Bauer, The North Face, or Arc'teryx simply cannot match.

A Brief History

The deep history of Canada Goose dates back to 1957, when Polish immigrant Samuel Tick founded Metro Sportswear. At the time, the company specialized in wool vests, raincoats, and snowmobile suits. In the 1970s, Mr. Tick's son-in-law, David Reiss, joined the company and invented the down filling machine. Additionally, the label Snow Goose was established at this time. In the 1980s, the Expedition Parka was produced for scientists studying at Antarctica's McMurdo Station. The parka eventually became the standard jacket for this purpose, and was called "Big Red". Metro Sportswear further developed their reputation for purpose-built parkas when Laurie Skreslet climbed Mount Everest as the first Canadian to ever do so in the year 1982.

Exhibit VI

The History of Canada Goose



Source(s): Canada Goose

The Rise of Identity Brands (cont'd.)

In the 1990s, Metro Sportswear started to be trademarked as Snow Goose. However, the brand was then changed to what it is today, Canada Goose, when the company internationalized into Europe. The reason for this is because the Snow Goose name was already trademarked in Europe, so the company had to change their name. Under the Canada Goose brand, the parkas were used to set global dog sled race records, travel to the south pole, and are widely considered the unofficial jacket of film crews in the cold. In 2014, Canada Goose opened its global headquarters in Toronto. More impressively, the company employs 6% of the nations cut & sew labour industry. In 2016, Canada Goose opened its first two flagship stores in Toronto and New York City.

A True Identity Brand

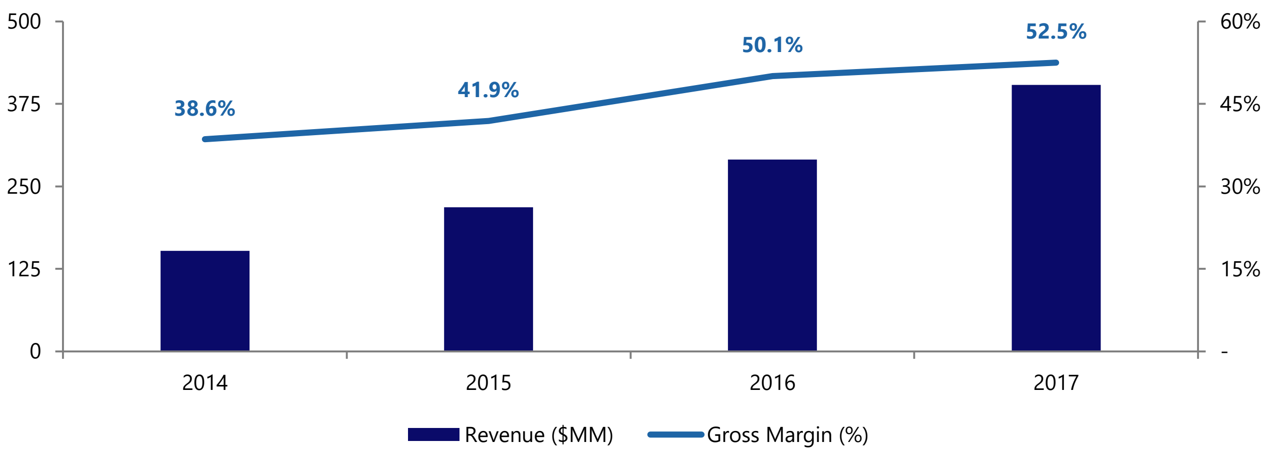
It is clear that Canada Goose has a rich past that cannot be replicated. The jackets being made only in Canada further adds to the national identity of this brand. In our view, the purposeful applications of a Canada Goose parka that have been shown in history strongly reinforce the identity this brand carries. Consumers are, at least, somewhat aware of the history of the brand, and want to align themselves with the authentic image of the company. This identity results in a strong moat because the brand has been cultivated for so long that it is relatively timeless, and less susceptible to changing preferences. Ultimately, consumers will look no further than Canada Goose when looking for a premium jacket that will communicate a certain level of status and authenticity.

Why Not Invest?

Considering the name is within our investable universe, it is important to have a reason why the name is not currently in our portfolio. Although Canada Goose is a great company, the valuation does not leave a reasonable margin of safety. At a forward year EBITDA multiple of 45.8x, we believe the current valuation is not justified, especially considering the discretionary and seasonal nature of this business.

Exhibit VII

Margin Expansion Through Canada Goose's Strong Brand



Source(s): S&P Capital IQ, Company Reports

Where Identity Brands can go Wrong

Faced with changing consumer tastes and increased competition, many identity brands have taken aggressive strides to prop up demand for their products. One tactic that brands have resorted to in recent years to stoke waning demand is discounting and promotional activities. These activities, while sometimes successful, are often bad for companies over the long term. **Discounting** and **nonexclusive distribution** through low-cost retail outlets such as Kohl's often decrease the perceived benefits that customers derive from these products. Under Armour serves as a case study in the harm that deep discounting can have on a company's brand sentiment and financial performance.

Under Armour was once a promising athletic apparel company, growing rapidly through international expansion and licensing deals. Waning demand in its domestic markets (Canada and US), prompted the company to pursue a promotional and discounting strategy. For these reasons, Under Armour has suffered a significant decline in share price as hopes of brand sentiment recovery fade. It has been lowering guidance amid falling revenues and narrowing EBITDA margins. Despite facing similar demand headwinds, Under Armour's largest competitor, Nike has weathered the storm quite well (**Exhibit VIII**).

The strength of Nike's brand and commitment to its core competencies have allowed it to outperform Under Armour. Well established companies that have built their brands over many decades and have learned the limits of their brands through experimentation are much harder to overthrow than many investors anticipate. Nike, having suffered from expansion failures of its own, has learned which markets it serves best and has focused its marketing efforts accordingly. Under Armour on the other hand has brought about its downfall by expanding too far too fast into non-core market segments. Facing competition from brands like Nike with much higher staying power, it is unlikely to recover from the loss of brand sentiment.

Exhibit VIII

Under Armour Versus Nike Historical Share Price Performance

Source(s): Company Reports, Ensemble Capital, Yahoo Finance, S&P Capital IQ

References

1. Business Insider
2. Canada Goose
3. Ensemble Capital
4. L2
5. Pew Research Center
6. S&P Capital IQ
7. The Atlantic
8. University of Rochester
9. Yahoo Finance