RESEARCH REPORT

March 26, 2018

Consumers Sector

Key Trends Update

The Consumers & Healthcare team evaluates key trends that are affecting the consumers space. While each brand faces its own unique set of challenges, the following changes within the space are affecting a wide variety of players and are forcing them to adapt:

1. The disparity of success between high, mid and low-price brands and trends unique to the low-end and the luxury spaces

2. The rise of fee-based loyalty programs, similar to Amazon Prime.

This report has reinforced our confidence in both the low-price and the luxury markets. When evaluating companies in these spaces moving forward, we should consider the company's ability to adapt to different trends shaping their separate environments, nimble disruptors in the low-price space and experiential, personalized luxury, on the high-price side. Additionally we will continue to monitor the growth of fee-based loyalty programs, as we believe in their ability to grow sales when executed effectively.

Consumers & Healthcare

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Trend I: Mid-Priced Products Suffer, High & Low-Priced Products Thrive

The first key trend we are monitoring within the consumers sector is the polarizing levels of success between mid-priced products and products produced priced at the extreme high and low end. In our view, mid-priced products, namely 'traditional' consumer packaged goods (CPG) from legacy brands like Gillette, are being disrupted by low-priced products that satisfy the core aspects of the legacy brand and add superior features in addition to the primary function of the product.

Although private label brands act as a large threat to mid-priced consumer goods, this analysis will focus on smaller start-ups because private label brands have already been discussed in our previous report, *The Future of Brands*.

Nimble Disruptors: Their Competitive Advantage

Innovative supply chains are ultimately what has allowed small players in the CPG space to penetrate the fortress-like business models that consumer giants have enjoyed for decades. First, more accessible outsourcing capabilities remove the capital expenditure barrier that previously existed for small companies, leading to an attractive asset-light business. This is exactly what Dollar Shave Club did, which allowed them to profitably operate at low volumes in the beginning and add scale as they grew.

Smaller players in the CPG industry are also leveraging premium, convenience, and e-commerce retail platforms to achieve a nimble and affordable distribution channel. From a brick-and-mortar standpoint, nimble disruptors distribute through retailers that focus on carrying small brands, such as Whole Foods. From an online standpoint, Amazon.com gives them the 'shelf space' they need to grow, as do sophisticated e-commerce solutions like Shopify.

There is evidence that disruption from nimble businesses is real. In 2016, CPG giant Unilever bought Dollar Shave Club. Following this news, Gillette launched their *On Demand* service, which mimicked the direct-to-consumer business model of Dollar Shave Club. Not only does this suggest that nimble start-ups are disrupting CPG giants, but it also suggests that the days of organic growth from these large brands are over.

Luxury Goods: Chugging Along

Though mid-cost consumer products have an unfavourable outlook, our view is the opposite for luxury goods. The luxury goods market remains consolidated, with the ten largest companies holding over 48% market share, reinforcing confidence in the sustainability of their economic moats. The primary driver of luxury market growth are consumers in emerging markets. 70% of consumers in emerging markets have become more inclined to purchase luxury goods, compared to 53% in more mature markets, in the past five years. Two trends which are affecting the luxury space are: an increased focus on experiential luxury and a shift towards personalization.

The Shift Towards Experiential Luxury

The idea of luxury has evolved past being purely physical. Consumers are now more focused on the experiential side of luxury, that being intangible product attributes. Such intangible attributes could include the status that a product represents, a quality which over half of luxury good consumers have admitted to being a defining decision making variable in the purchase process. The nature of the status that consumers are searching for has also changed. Rather than just using luxury goods as a means to represent wealth, consumers have begun to buy products which reflect values that they wish to emulate. For example, some purchases, especially those made by millennials, are made to show that the consumer values sustainability. The positive values reflected by these purchases are meant to enhance the consumer's status. Experiential luxury has been further affected by the rise of digital technology. Many brands are implementing technology (e.g. virtual reality) into their consumer experience. For example, Dior offers a virtual reality fashion show to consumers, which allows them to watch the show from the virtual "front row".

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The Move from Standardization to Personalization

For many years, distribution within the luxury sector has been characterized by brands building premium, but generic, stores and experiences – this is changing. 45% of consumers are now demanding more personalization and 39% are asking for home delivery. Overall, consumers are demanding a more personal experience throughout the buying process.

Companies are responding to this by creating customized online content to engage consumers. This online content is vital to the success of luxury brands as nearly 50% of luxury buying decisions are influenced by what consumers see or hear online. As of now, third party distributers (e.g. Yoox Net-A-Porter) have been dominating the online luxury space, so much so that multi-brand stores account for 78% of online purchases. Luxury brands have, generally, been underinvesting in online channels, which has given rise to the dominance of these multi-brand online stores.

Brands who have invested in online distribution are struggling to create a high-end consumer experience, which is comparable to that which the consumer would find in-store. To combat this issue, Burberry now offers a collect-in-store service, which gives consumers the opportunity to buy goods online and pick them up in-store, exposing them to the in-store experience they would have received by shopping in person. Chanel, has taken a different approach by partnering with Farfetch, an e-commerce platform, to develop an app which provides consumers with pre and post-purchase support, but does not offer online purchase options. Bruno Pavlovsky, Chanel's President of Fashion, stated that the goal of the app was to create a "hyper-personalized experience for shoppers".

The Risk of Indebted Consumers

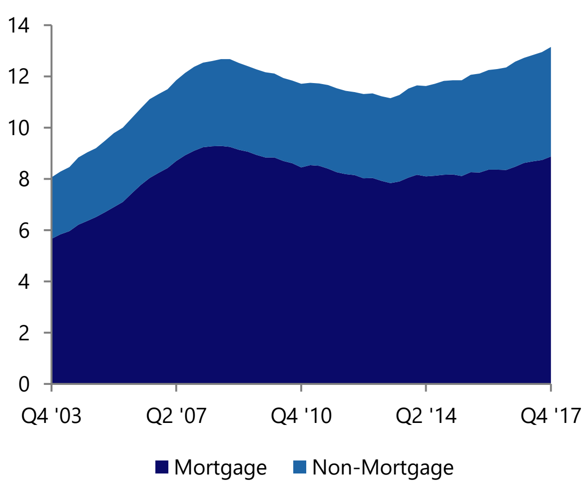
One concern when evaluating the longevity of the success of the luxury goods space is consumer debt levels. Canadian consumer debt has reached historic highs, with debt to disposable income levels at 173% in Q3 2017. American consumer debt is also high, recently reaching 141% of disposable income. It is possible that consumers, faced with this excessive leverage, will reduce their spending on luxury goods in order to pay their debts, especially in an environment of rising interest rates.

Portfolio Implications

We are confident in both the high and low-end sides of the consumer products space. We are, however, concerned about consumer debt levels, which could threaten the longevity of luxury good growth. Moving forward we are particularly interested in investing in companies which can be classified as 'nimble disruptors", as we believe in their growth potential. However, it can be difficult to find investable companies who fit this description. In the luxury space, we will look to invest in companies who are adapting to consumer needs of experiential luxury and personalization. We are bearish on the mid-priced space.

EXHIBIT I

American Consumer Debt ($Tn)



Source(s): Federal Reserve Bank of New York

Trend II: Fee-Based Loyalty Programs – A Survival Strategy

The second trend we are monitoring is growing use of fee-based loyalty programs. Retailers are increasingly looking at subscription based membership platforms to bolster razor thin margins, encourage repeat visits, and keep pace with rapid changes in consumer expectations. Loblaws' "PC Insiders" program will be used to examine this trend among grocers.

As recently as 2016, value in the grocery industry was derived primarily from cost competition and ability to meet a wide range of needs. Recent implementation of fee-based loyalty programs from Walmart, Jet.com, and Loblaws show that incumbent grocery giants are dedicating significant resources to meet changing consumer expectations. New loyalty programs allow firms to differentiate on service and convenience, providing options like curbside pickup or home delivery to satisfy affluent, time-conscious customers. Their existing network of locations allows for seamless omnichannel shopping - a significant advantage against online retailers without a nationwide physical footprint.

Home delivery represents a particularly attractive prospect for retailers, as it allows for routine purchases to become automated. Frictionless re-ordering of household staples signifies retailers penetrating "the home" and bypasses traditional barriers to purchase like bad weather or proximity to competitors.

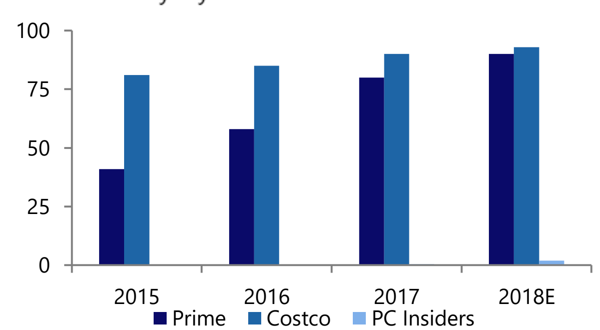
Loblaw's *Insiders* program is currently in the pilot stage, with a full rollout expected in the coming months. For an annual fee of $99, *Insiders* will receive free "click & collect" service, free shipping on certain goods, 20% back in PC points on purchases of baby essentials, cosmetics, or Joe Fresh merchandise, and a $99 PC travel credit. The *Insiders* program is a direct response to the changing grocery landscape and a countermove to prevent convenience-focused customers from fulfilling their needs elsewhere.

The success of Loblaw's move into fee-based loyalty will hinge greatly on their ability to capitalize on existing customer relationships. *Insiders* is constructed similarly to *Prime*, though with less diversity regarding what can be delivered due to Loblaw's limited arsenal of grocery products and clothing staples. Amazon customers can purchase electronics, stream music or video, and borrow books in addition to the grocery catalogue already available. Loblaws will face headwinds from competing against a "one-stop shop" and must convince consumers that *Insiders* is a significantly valuable offering for their grocery needs. With *Prime* penetrating a vast share of the market already, justifying a second $99 yearly fee will require significant emphasis of omnichannel benefits.

A survey by LoyaltyOne revealed that 62% of millennials would consider joining a fee-based loyalty program if their favorite retailer offered one, citing the belief that increased benefits in these types of memberships justify the cost. Loblaws is offering the bulk of reward points on clothing, cosmetics and baby products - showing that they are aggressively targeting millennials. McKinsey finds millennials to be the most profitable group to establish a long-term relationship with because of their dual incomes and willingness to pay a premium for convenience. If Loblaws can portray a compelling value proposition to millennials with their new program, the C&H team believes that *Insiders* will be successful enough to prevent significant customer turnover as Amazon enters the market.

Exhibit II

Millions of Loyalty Subscribers



Source(s): Company Reports

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