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Extreme Competition Among Amazon and Other Large Retailers

Over the years, we have rarely commented on the retail industry. Currently, the intense competition among Amazon.com Inc. (NASDAQ:AMZN) and other large retailers is incredibly interesting and worthy of comment. There are large and disruptive changes happening in retail that can create investment risks and opportunities and can even affect parts of our daily lives. Therefore, we are going to devote much of this second quarter (Q2) 2017 edition of our Newsletter to the evolving competitive situation involving large retailers in North America.

Amazon-Whole Foods Merger Catches Many Off-Guard

On June 16, Amazon announced that it was buying grocery chain Whole Foods Market Inc. (NASDAQ:WFM) for US$42 per share, or US$13.7 billion including debt. The deal is expected to close later this year. Whole Foods shares surged in price, as would be expected. The more interesting market reaction was the strong selloff in the shares of a wide range of direct and indirect competitors to Amazon and Whole Foods. The affected companies included grocery retailer Kroger Co. (NYSE:KR) as well as other large retailers with significant exposure to groceries, such as big-box retailers Wal-Mart Stores Inc. (NYSE:WMT) and Target Corp. (NYSE:TGT) and warehouse club Costco Wholesale Corp. (NASDAQ:COST). Also trading lower in response to the merger news were drug store chains like CVS Health Corp. (NYSE:CVS) and Walgreens Boots Alliance (NYSE:WBA). To properly understand investors' reaction, we must understand Amazon's history and the intense competition among large retailers.

"Your Margin is My Opportunity"

Amazon CEO Jeff Bezos has been quoted as saying "your margin is my opportunity."[1] What he means is that Amazon can enter new lines of business where competitors have high profit margins and rapidly win new customers by lowering prices and by being efficient and customer-friendly. This rightly strikes fear into competitors and investors who own their shares, because the threat Amazon poses to competitors is real.

The company started in 1994 as an online bookseller and has successfully expanded into a diversified and multinational online retailer. Beyond retail, it owns Amazon Web Services, an enormous business in its own right that provides a subscription-based cloud-computing platform to its customers. Amazon's stock market capitalization is now approaching US$500 billion. In addition, it now ranks number three on consultant Brand Finance International's list of the world's most valuable brands. Brand Finance notes that Amazon may well become the world's most valuable brand in 2018.[2]

Reasons for Amazon's Success

Amazon has benefitted from the massive trend towards online retail over the past two decades. That trend is likely to continue. For example, U.S. online retail revenues are expected to grow by a compound annual growth rate of approximately 15% between 2014-2020. This compares to total retail sales, which are expected to grow by only 3% year over year on average, due to weak growth in brick-and-mortar retail sales.[3] Online retailers have capitalized on their structural advantage of lower costs due to not having physical stores. According to analysts at JP Morgan, online retail currently only represents around 12% of adjusted U.S. retail sales (not counting gas, food and autos) and is likely to rise to 30%+ over time.[4]

While it is clear Amazon has benefitted from overall growth in online retail, most of its success can be credited to its own customer-friendly strategy and business practices. Amazon has successfully implemented a low-price, high-volume strategy in order to win new customers and grow market share. Amazon has also vastly expanded the selection of products and services it offers while making the customer experience progressively more convenient. Its low-price strategy has occasionally attracted criticism from analysts and investors looking for better short-term profits. From today's perspective, judging by Amazon's market share and stock market performance, Amazon management was right all along to ignore them.

Amazon has constantly expanded its selection of products and services, both through its own efforts and by allowing third party sellers to sell through its websites. It consistently innovates to make shopping better for customers. A recent example is the launch of Amazon's Prime Wardrobe service, which will allow customers to order clothing and shoes at no upfront charge, take seven days to decide, and only pay for what they keep. Another example is the continuing rollout of the Amazon Fresh service, focused on grocery delivery. These services may be costly and risky to offer, but are convenient for customers. U.S. consumers recently ranked Amazon.com #1 in the American Customer Satisfaction Index, a 10,000-person poll that measures perceptions of quality and value across retailers nationwide.[5] This confirms that Amazon is actually customer-friendly.

Amazon Prime has become a huge part of the company's offering. Prime is a shipping service for products purchased through Amazon bundled with other offerings, including streaming video and streaming audio services. Amazon Prime membership has now reached 85 million in the U.S., according to a recent report, which represents around 63% of all U.S. customers who use the site. The number of Prime members has doubled since 2015, and members spend an average of US$1,300 per year on the site compared to US$700 for non-members.[6] A JP Morgan analyst recently commented:

> "Prime delivers such massive scale and features that we believe it would be very difficult for any company to replicate and compete against…. We believe there are no comparable shipping offerings available today at scale, with Amazon's large and growing infrastructure investments serving as a significant barrier to entry."[7]

To summarize, Amazon has arguably become the world's best retailer at a time when online retail is still growing fast. Amazon is out-competing a wide range of other retailers, and investors have taken notice.

Traditional Department Stores Struggling

Traditional department store chains have struggled to adapt to the changes in the retail industry. This category includes companies like Hudson's Bay Co. (TSX:HBC)[8] in Canada and Sears Holdings Corp.

(NASDAQ:SHLD), Macy's Inc. (NYSE:M) and J.C. Penney Co. Inc. (NYSE:JCP) in the U.S. Generally speaking, these companies are facing difficult decisions about closing underperforming locations and selling their real estate. Amazon has contributed to their struggles, but it is not the sole cause. The department stores have also been attacked on the low end by newer big-box chains with lower prices and on the high end by specialty and luxury retailers. Their core customers are aging. Their stores are often in dire need of renovations, but there may be no business case to invest the necessary capital. Many of them are very far behind on technology, both in their stores and in terms of any online strategy. To quantify their struggles, department stores' market share of all U.S. retail sales slid from 14.5% in 1985 to 4.4% in 2016.[9]

Leading Big-Box Stores Still Thriving

In some ways, the rise of the big-box store chains decades ago is similar to the rise of Amazon today. Big-box stores grew rapidly by pursuing a low-price and low-profit-margin strategy, wiping out many competitors along the way. The leading big-box store chains are well-managed and have eagerly adopted new technology, especially to improve their supply chain. Today there are many examples of failing big-box chains that have failed to differentiate themselves and lack a successful online strategy; however, there are some long-time industry leaders who are proving to be tough competitors to Amazon.

Wal-Mart started in the 1960s with Founder Sam Walton's vision of selling a high volume of products at low-prices and low profit margins. Costco started in the 1970s, also focused on a low-price, high-volume strategy. Costco distinguished itself by selling out of warehouses with minimal improvements, charging membership fees and selling items in bulk to large families and businesses. Home Depot Inc. (NYSE:HD) was founded in the late 1970s with the idea of building home-improvement superstores that were larger than their competitors' facilities. Low-prices, high volume and a large product selection have contributed to its success. Unlike most retailers, Wal-Mart, Costco and Home Depot have the necessary resources to compete with Amazon.

Leading big-box chains are investing heavily in online retail. A quick search for the most popular U.S. retail websites reveals that as of March 2017, Amazon is number one, but Wal-Mart, big box retailer Target Corp. (NYSE:TGT) and Home Depot are all in the top 10.[10] Wal-Mart in particular has not been content to grow its online sales organically and has acquired several online retailers and startups, including discount online retailer Jet.com for US$3 billion in 2016.[11] Its strategy is working, as it recently announced that its U.S. online sales grew 63% year-over-year.[12] In the U.S., Walmart.com now offers two-day free shipping with no membership fee and an extra discount for picking up orders in stores. Amazon cannot take Wal-Mart for granted as a competitor.

Nor can it expect to easily defeat Costco. Costco does not appear in the list of the top 10 U.S. retail websites, but a recent BMO Capital Markets study surprisingly found that prices on Costco's website were 17% lower than those on Amazon.[13] Meanwhile, Costco's traditional warehouse operations are thriving. Its June 2017 sales were recently reported as US$12.17 billion, up 7% from $11.33 billion the year before. Its same-store sales for the five weeks ending July 2 were up 6% in total, and 6.5% in the U.S.[14] Costco is still winning significant market share from other retailers even as investors worry about Amazon's effect on Costco.

The leading big-box retailers are far from dead. Some will manage to thrive, even in the face of competition from Amazon.

How Does the Future Look for Large Retailers?

In 10 years it will be 2027, and the business of retail will have significantly changed. Certain trends can reasonably be extrapolated into the future. First of all, more and more basic products will be purchased online. For many customers, online shopping means lower prices and convenient free shipping, so it makes no sense to travel to a store. The process of shipping goods purchased online has constantly improved. Whether package delivery drones proliferate as some have predicted, or shipping in 2027 is simply an improved version of the 2017 process, it will feel more convenient for the customer than it does today.

Many physical stores will still exist, but they will have to meet certain common-sense business tests. They will have to provide an enjoyable experience for customers, an immediacy unmatched by online retail, or very specialized merchandise. High-end physical luxury stores could still thrive, as the number of high net worth people increases globally. Many marginal physical stores will close, especially those situated in second and third tier retail locations or those that Amazon CEO Jeff Bezos once described as "the sort of bad stores that people go to because they don't have any alternative."[15] Automation technology will continue to roll out in physical stores in order to cut labour costs. Amazon is currently experimenting with an Amazon Go concept store that allows customers to make purchases without using a cashier or checkout.

Amazon's purchase of Whole Foods is a confirmation that there is a large role in the future for physical stores, especially in the perishable food category. Amazon likely concluded that it was easier to buy Whole Foods than build up a stronger grocery brand and a desirable set of physical locations by itself. In analyzing this transaction, we must note that Whole Foods is more than a random collection of grocery store locations. It is a high-end grocery chain with its stores strategically located in most of the wealthiest neighborhoods in the U.S. and Canada. These same areas tend to contain tech-savvy customers. Amazon clearly wouldn't have purchased just any grocery store chain.

It will be fascinating to observe how Amazon changes the day-to-day business of Whole Foods stores. How will the merchandise change? Will Amazon add pharmacies to stores? Will Amazon offer in-store pickup of items ordered online? Will the stores become more automated? Of course Amazon is not infallible, but its changes to Whole Foods could foreshadow future widespread developments in retail.

Investment Outlook for Large Retailers

Our investment strategy does not require us to have exposure to every sector. We always have the option of staying on the sidelines or allocating capital elsewhere. With the intense competition among large retailers, it is possible that customers may end up being the big winners rather than investors. Customers are getting rock bottom pricing on merchandise as retailers' low-price, high-volume strategies compress profit margins. They are getting limitless selection, as what's in stock in the store in their neighborhood no longer matters. Finally, customers are getting ever-increasing convenience, as their delivery options improve.

We evaluate the investment prospects of the large retailers in the same way that we look at other companies. We want to purchase high-quality companies at undervalued prices. Over time, that strategy has led to strong returns.

Amazon, Wal-Mart, Costco and Home Depot are all high-quality companies by our standards. Their individual characteristics vary, but they all have strong track records, good management, strong competitive positions in the industry and strong financial positions. Amazon has the best revenue growth prospects, while Wal-Mart is growing the slowest. Despite Wal-Mart's online strategy, it has a massive physical store network that is fairly mature in terms of growth potential. Wal-Mart's current annual revenue is still more than twice as large as Amazon's. Home Depot and Costco still have decent revenue growth potential despite their large size. Home Depot currently boasts the highest net profit margins of the group, but suffers from greater cyclicality than the others, as its revenues are linked to construction and renovation.

As we continually emphasize to clients, the quality of a business is different from its valuation in the stock market. It is always possible for a high-quality business to perform poorly in the stock market if its stock price starts at overvalued levels. We have always struggled with Amazon's high valuation. In hindsight, we would have been rewarded if we had focused solely on its fast revenue growth. However, our strategy has delivered strong returns over time without incorporating many high-valuation growth stocks.

Several years ago, we briefly made a profitable investment in Wal-Mart shares in our Total Return Portfolio after the share price had plummeted for short-term reasons, so we are no stranger to the stock. Priced around US$74 with a US$225 billion market capitalization and a 2.8% annualized dividend yield, Wal-Mart could potentially deliver annual total returns in the 4-7% range over the coming years. If the shares continue to decline due to concerns about Amazon, we may become more interested. Home Depot shares have provided excellent returns over the past decade, and the stock now seems a bit pricey relative to its growth prospects. We would consider revisiting Home Depot as an investment if the valuation comes down significantly.

Costco shares have declined by over 15% since the announcement of Amazon's Whole Foods purchase, from around US$181 to US$151 on July 11. Similar to our thoughts on Amazon, we have struggled with Costco's high valuation in the past. Its stock market capitalization is much smaller than Wal-Mart and Amazon, sitting at around US$66 billion. However, over the past 20 years, the shares have rarely traded at a valuation below 20 times earnings per share and are currently hovering around 25 times earnings. The annualized dividend yield has rarely climbed far above 1%. Earnings growth over the past decade has averaged around 10% per year, which is good (higher than Wal-Mart), but not exceptional.[16] Costco has been a difficult stock to justify buying, but it has performed well regardless. The current selloff in the shares is making us a bit more interested. There is definitely still room for Costco to add North American locations, as it hasn't blanketed the map as thoroughly as Wal-Mart. We are going to be following the company more closely now, especially if the valuation continues to drop.

Q2 Portfolio Highlights – Adding Canadian Western Bank

Our most significant transaction of Q2 was the purchase of Canadian Western Bank (TSX:CWB) shares in the Total Return Portfolio and the High Yield Portfolio at a price of $25.45 per share on June 6.[17] Its weighting is now approximately 2.0% in each portfolio. With a market capitalization above $2.6 billion, Canadian Western is the seventh-largest Canadian bank by that measure. Geographically its operations are primarily focused on the provinces of Alberta, British Columbia, Saskatchewan, and Manitoba. Its customers are small and medium-sized businesses as well as individuals, and it offers a wide range of commercial financing and retail banking services.

To date in 2017, Canadian Western's share price has underperformed the shares of its larger Canadian competitors. The underperformance can be attributed to oil price weakness as well as concerns about smaller mortgage lenders in the wake of the recent funding crisis at Home Capital Group Inc. (TSX:HCG). We believe Canadian Western's share price underperformance represents an investment opportunity. Historically the company has generally traded above 1.5 times its book value (assets minus liabilities) per share. At our purchase price, it was trading closer to 1.0 times book value, which was recently reported as $24.27 per share.[18] Alberta's economy has shown signs of improvement, with the unemployment rate coming down recently and the province returning to positive growth. Canadian Western Bank's historical loan losses on its mortgage business have been very low, so it is not entirely fair to associate the bank with problems at alternative lenders. In addition to decent potential earnings growth over the next couple of years, the Bank offers shareholders a dividend of around 3.5% annually.

Conclusion

We have devoted much of this Q2 edition of the Newsletter to developments in the retail industry. Our philosophy of buying high-quality businesses trading at undervalued prices has proven to be durable, and it applies to retail as well as to all other industries. We believe that this approach will continue to yield good results for clients over long periods of time. As always, we look forward to communicating with you and answering any questions you may have about your personal circumstances, our discretionary model portfolios or other topics of interest. Thank you for reading our Q2 Newsletter, and thank you for your business.

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APPENDIX "A"

DISCRETIONARY MODEL PORFOLIOS

We encourage clients to contact us for more information regarding our three fully discretionary model portfolios, namely the Total Return Portfolio, the High Yield Portfolio and the Balanced Portfolio. Our research efforts are now primarily devoted to finding investment ideas that will suit the criteria established for these portfolios and contribute to their returns.

1) Our Total Return Portfolio is focused on providing clients with an average annual return of around 8-10%, consisting mainly of capital gains and dividends.

2) Our High Yield Portfolio is focused on providing income-seeking clients with an average yield of 4%, plus around 2-3% of annual capital growth.

3) Our Balanced Portfolio is a more conservative portfolio that typically consists of approximately 50% fixed income investments and 50% equity investments.

[1] http://fortune.com/2012/11/16/amazons-jeff-bezos-the-ultimate-disrupter/
[2] http://brandfinance.com/images/upload/global_500_2017_locked_website.pdf
[3] Credit Suisse Equity Research. The Disconnect Between Merchandise and Logistics. June 29, 2017
[4] JP Morgan Amazon.com Research Report dated July 6, 2017
[5] Amazon.com First Quarter Earnings Press Release dated April 27, 2017
[6] https://seekingalpha.com/news/3277506-amazon-prime-now-85m-members-u-s
[7] JP Morgan Amazon.com Research Report dated July 6, 2017
[8] CIBC World Markets Inc. expects to receive or intends to seek compensation for investment banking services from this company in the next 3 months.
[9] https://www.drapersonline.com/retail/is-there-a-future-for-traditional-department-stores/7020618.article
[10] https://www.statista.com/statistics/271450/monthly-unique-visitors-to-us-retail-websites/
[11] http://fortune.com/2016/09/20/walmart-acquisition-jetcom/
[12] http://news.walmart.com/2017/06/16/walmart-to-acquire-bonobos-and-appoint-andy-dunn-to-oversee-exclusive-consumer-brands-offered-online
[13] http://www.marketwatch.com/story/costcos-online-prices-are-lower-than-amazons-study-finds-2017-06-15
[14] http://www.morningstar.com/news/market-watch/TDJNMW_20170706128/costco-shares-up-25-after-june-sales-rise.html
[15] https://www.wired.com/1999/03/bezos-3/
[16] Value Line Report on Costco Wholesale dated April 28, 2017.
[17] This company is a client for which a CIBC World Markets company has performed investment banking services in the past 12 months. CIBC World Markets Inc. has managed or co-managed a public offering of securities for this company in the past 12 months. CIBC World Markets Inc. has received compensation for investment banking services from this company in

the past 12 months. CIBC World Markets Inc. expects to receive or intends to seek compensation for investment banking services from this company in the next 3 months. CIBC World Markets Corp., CIBC World Markets Inc., and their affiliates, in the aggregate, beneficially own 1% or more of a class of equity securities issued by this company.
[18] CIBC Research Report on Canadian Western Bank dated June 1, 2017

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