*Investment Insight*

## BATTLE OF THE BRANDS: CAN UNLOVED CONSUMER STAPLES GIANTS KEEP PACE WITH NIMBLE CONSUMERS?

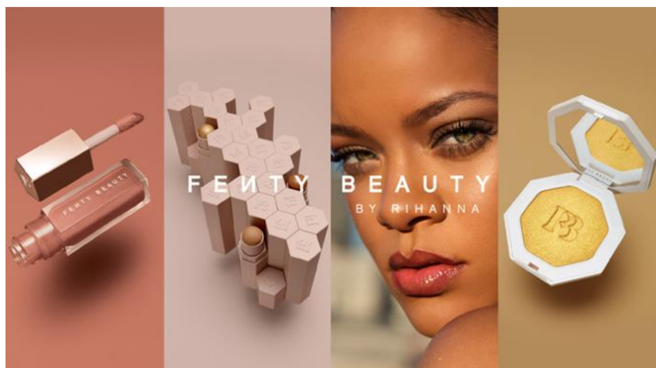
Big brands and the huge marketing machines that sit underneath them have found themselves under direct attack in recent years from agile upstart competitors.

From beauty products to biscuits, the stability and durability of long-term brands has been eroded by inertia on their behalf and also from changing consumer behaviour, with the way we shop now eliminating much of their competitive advantage over new entrants.

Brands that cannot adapt to changes such as Amazon's Alexa and the product placement challenges they create will, regardless of their size, succumb to those which can. But of course, the giants of the consumer staples world are not ones to lie down and accept their fate.

Below, three of our investment analysts look at the challenges facing consumer staples globally and how brands are fighting back.

### BIG IS STILL BEAUTIFUL




Walking along Knightsbridge on the way to lunch, I came across a long queue outside Harvey Nichols. Being curious, I stopped and asked, "what are you queuing for?" They replied "Fenty Beauty by Rihanna", they replied. In partnership with Rihanna, it is a new brand developed by the luxury powerhouse LVMH. It was launched in September 2017 and is distributed exclusively at Harvey Nichols and by LVMH's own beauty retail chain Sephora. The brand captures consumers' desire for celebrity endorsement and exclusivity. The queue continued for many weeks.

The rise of the internet and the popularity of social media have lowered barriers to entry for new products and enabled many local brands to reach consumers who were previously inaccessible because of high distribution and marketing costs. We have seen this more acutely in the mass beauty markets where the rapid uptake of e-commerce, coupled with changes in consumer preference, brought a shift in behaviour. Many local brands have gained momentum whilst big brands lost market share.

Faced with these challenges, the cosmetic giant L'Oréal carried out a detailed analysis of market trends a few years ago. They concluded that the success of local brands is less to do with their local origin and more to do with their product positioning, i.e. they fulfil a gap in emerging consumer trends that big brands do not offer. Years of success for big brands has made large companies somewhat complacent, and slow to react to new consumer phenomena. A lack of astute product innovation has exacerbated the impact, causing a loss of market share.

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But change is in the air. Big brands are fighting back. For example, to catch the consumer preference for natural ingredients, L'Oréal rolled out new products within its Garnier range. Garnier was born in 1904 and is already the second largest brand in L'Oréal. It is renowned for its know-how in harnessing nature through fruits, seeds, buds and flowers. The company also embarked on a huge digital effort from e-commerce to social media, to engage influencers with its army of 1,700 digital experts. Last year, online sales reached €2.1bn. The consumer division accelerated sales growth and regained market share.

Meanwhile in prestige beauty, where it is harder to replicate quality and authenticity, big brands are alive and well. Take Estée Lauder, for example, where sales have been growing at 7% compound annual growth rate for the past five years (faster than the wider market) with share gains. The company deploys an omni-channel approach for distribution, be it traditional department stores, mono-brand/multi-brand stores, or online or travel retail, with the latter performing particularly well in recent years.

I have always been a fan of travel retail and paid a visit to Estée Lauder's counter last month while at an airport. An enthusiastic sales rep greeted me. We chatted about product features then the question about price came up. She replied, "everything has gone up, they go up every year." Despite stagnant wage growth in the past several years, these big brands continue to exert pricing power.

Whether it is the long queue for Fenty Beauty, the turnaround from L'Oréal, or pricing power by Estée Lauder, one thing is clear; the big brand is not dead. The magic lies in finding the right formula for the product, pricing, marketing message and channel mix that satisfy today's consumers by providing what they want at the time and place they want it.

*Zhixin Shu, CFA*

## STANDING OUT ON THE SHELVES

Investment challenges and opportunities surround us in our daily lives. A casual walk to the local supermarket reveals the transforming landscape within the global consumer food industry. The yogurt aisle, once dominated by Actimel and Activia, is now being infringed by Greek, Icelandic, coconut, almond, soya and organic yogurt offerings. In the chocolate shelves artisan stories are appearing, featuring exotic roast varieties with the promise of ethically sourced beans. Ketchup is now beetroot based, breakfast cereal quinoa based, and smoothies are innocent.

Across categories innovative entrepreneurs are capturing the shelf space that was once the domain of the big brand goliaths, with the promise of local, authentic, natural, or socially responsible products.

Unsurprisingly, this has had an impact. In the period from 2010-15 the top 25 food manufacturers hardly grew their revenues, against a much more robust 6.3% p.a growth for

the smallest players. The sources of competitive advantage for these emerging players have been multi-fold, but include a consumer segmentation that translates into a higher requirement of tailored products and nuanced marketing messages, a savvier approach to utilising social media to get marketing leverage, and the use of e-commerce to reduce the requirement of deep investment in distribution.

Though these trends are real, the implications for the industry and key players are more nuanced. While some categories, like ketchup and canned food, have been challenged against the backdrop of declining volumes, others are still exhibiting robust growth: water, baby food, coffee and pet care are just some examples of this vibrancy.

Indeed, in many respects, these dynamics have defined the companies' responses. Amidst declining growth in its key categories, Kraft responded by opting for scale through its combination with Heinz, a failed bid for Unilever, and an aggressive rebasing of its cost base through zero-based budgeting. Campbell Soup, Kellogg, Hershey and General Mills have faced similar dilemmas in structurally challenged categories. Danone has been notable in trying to buy itself out of its problems by acquiring White Wave Foods, a leading plant based food and beverage provider. But for others, like Nestlé, the approach has been more subtle. There it has been about fostering growth areas, like coffee and pet care, while either divesting lower return assets -such as the US confectionary business - or opportunistically acquiring scalable, emerging franchises like Sweet Earth Foods, a plant based food producer.

More interestingly, investments in developing new categories like Nespresso, which have redefined at - home coffee consumption, or the Health Science business which challenges boundaries between the consumer and health industries by delivering personalised nutrition solutions, are providing whole new platforms that future - proof businesses. At the same time, early digital investments, whether to optimise internal processes and enhance corporate agility, tap into e-commerce opportunities, or leverage new marketing avenues like social media, further entrench the competitive advantage.

Indeed, in the end, for us as long-term investors, it has been a question of where the delicate balance lies between optimising the cost base whilst leveraging growth opportunities, and keeping the business agile. Scale matters. It gives R&D and A&P power, distribution clout, long-standing customer relationships, exposure to global markets leveraging innovation, and cash flow and a strong balance sheet. But whoever is best placed in this moving chess board requires a much more nuanced investment analysis than was historically the case.

*Katerina Kosmopoulou, CFA*

## ALEXA, ARE YOU LISTENING TO ME?

This time last year we predicted that voice would be the third wave of e-commerce, following the first wave of desktops and the second by way of smartphones. This was viewed with great scepticism in many quarters as voice was just a novelty fad at the time. It is surprising how quickly a year can change opinions.

Amazon sold tens of millions of the Echo Dot device last year, incorporating the intelligent personal assistant Alexa, with voice becoming a very important retail channel.

*"In a couple of years' time [Alexa] is going to be in every home more or less. The idea is a friction-free customer experience… Alexa can enable brands to connect with consumers in a unique way. The simplest way to think about it is the same way you thought about mobile a few years back – that is going to happen to voice."* Rahul Welde, Unilever Global VP October 2017.

Similarly, last year we highlighted that companies will have to place more importance on their brand recognition as Alexa could recommend other products to consumers if not asked for explicitly by name. The Alexa algorithm does incorporate your past order history into the recommendation, as well as those products which are eligible for Amazon Prime shipping and have good reviews. It results in a much-reduced selection when compared to the infinite shelf of online shopping, or even the in-store experience. Brands place great importance on their product image, packaging and logos but these could all be redundant as there are no visual clues on the Echo device. Similarly, price positioning of a brand is eroded, as is the chance to offer special promotions which can kick-start sales.

With the advent of voice technology, companies will have to think harder about how they promote brands. Some already have - perhaps unwittingly - included sound into their logo (think of "mmm, Danone" or the five note Intel jingle). The other important effect is that it can invite a brand to capture a category if it has enough mindshare and customers ask Alexa for it directly. Some brands become synonymous and genericize a product; for example, flying discs are 'Frisbees', and hot tubs are 'Jacuzzis'. However, in a highly competitive marketplace, it could be very difficult for some brands to attract their fair share of voice. This extends further into the realm of private labels. If you ask Alexa for batteries, then you might have expected to receive Duracell, Panasonic or Energizer batteries. However, in 2016, the most popular battery sold online in the US, with a 31% market share, was the AmazonBasics battery. Duracell had just a 21% market share.

Whilst Amazon and their private label ambitions pose a threat to established brands, we watch with great interest how companies will build new ones. In particular, we think about the next-generation products in the tobacco sector, such as heat-not-burn and vapes. Historically, the core value of the tobacco sector lies in their iconic brands such as Marlboro and Lucky Strike. It is these brands that underpin pricing power and allow companies to generate returns that are far in excess of the cost of capital.

Despite extensive advertising restrictions around the tobacco sector, these companies have become experts in developing strong and durable brands. However, they cannot use existing tobacco brands to market non-tobacco products. As we enter this era of next-generation products, these companies are all starting afresh and can potentially capture the entire category. As we doubt that Amazon will have ambitions to make private label e-cigarettes given all the regulations and complexity, the expert marketers will have free rein to build new brands. We just hope that they remember to include a catchy jingle.

*Giles Tulloch*

## INNOVATION WILL BE KEY

The current incumbents in the consumer discretionary space have survived many a challenge over their long histories. A shift to buying online, or via a voice-activated home computer should not, on the face of it, present any more of a challenge than previous technological advancements.

The danger that management fail to keep pace with change is ever-present in every business, and there may be times when these behemoths lag certain trends or shifts in consumer behaviour.

But, if they can innovate themselves, and rise to the challenges presented from an ever-changing consumer backdrop, there is no reason why these businesses, with their sprawling balance sheets and unrivalled branding arms, can continue to generate compelling returns for investors.

*Christopher Rossbach*
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