AGF INSIGHTS

Surviving and thriving in the face of disruption

By Stephen Way and Sanjay Luthra

It was originally supposed to be called Cadabra with an ambition to become the world's largest bookstore, but when Jeff Bezos's lawyer said he thought it sounded like cadaver, Bezos set out to find a less sinister sounding name[1]. But for the corporate corpses felled in its wake, and the survivors still standing but as mere spectres of their former selves, Amazon has proven to be a lethal competitor.

Death by Jeff. Many never saw it coming. Disruption is at once destructive and creative, upending stalwart players while creating something utterly novel in its wake. Today, Amazon is not only the world's largest digital bookstore, its business runs the gamut--everything from streaming music and filmmaking, to selling diapers and furniture—making good on its messianic mission to change the very nature of commerce itself.

Disruption isn't new. However, its pace is accelerating, and current trends will only continue to hasten the speed with which it takes hold. And while disruptive innovators often seem to emerge from the shadows with little warning, companies that are able to withstand these tectonic forces share certain characteristics. A company's ability to create lasting economic value is intimately linked to building a sustainable competitive advantage for its product or services. Our investment process typically leads to companies with strong brands and pricing power, which we define as a "consumer advantage," as well as those companies which have a cost advantage due to high levels of productivity and efficiency, which we define as a "production advantage." While it is important to identify companies with these characteristics, in order to survive and thrive in an age of disruption, it has also become essential for companies to be willing to disrupt themselves, through innovation and targeted capital allocation.

The forces of disruption: deglobalization, demographics and the march of technology

Just as the rise of globalization following World War II increased liberalization and opened the world to emerging markets, it also challenged the status quo by creating new trading patterns and supply chain partners, giving rise to the multinational organization. Decades later, globalization is now in the midst of a profound change, its basic tenets undermined by the rise of populism and inward-looking policies in several developed economies, while shifting global supply chains.

Meanwhile, the ramped-up pace of technological innovation is creating new business models and digital ecosystems. Easy access to private capital that was once available only to upstarts, is now allowing them to scale rapidly, establishing alternative business models that challenge industry giants in ways that were simply not possible a decade ago. As digital natives, Millennials were born into the age of digital technology and particularly into the online shopping era. As such, they have a strong preference to interact with each other through more casual channels, which has resulted in the creation of vast social networks and well-established ecommerce platforms.

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Demographics are also helping shape disruptive forces. Global urbanization and the ascent of the Millennial workforce, combined with an aging population, will bring sweeping changes to market sectors and shift economic development.

Don't rest on your laurels or someone will undercut you

For the better part of a century, Proctor & Gamble's Gillette brand dominated the razor industry, with its utilitarian shavers and replacement cartridges. It did

[1] Shana Lebowitz, "How Amazon got its name." Business Insider, May 7, 2008.

so by investing heavily in research and development, as well as marketing and distribution, allowing it to charge customers a premium for its product.

Then along came Dollar Shave Club (DSC). Based in Venice, California, the brand with a quirky sense of humour, and a novel distribution idea set its sights on giving Gillette a run for its money. The company's vision? To take the thought and cost out of shaving.

The idea was simple: Instead of shopping at a store for replacement cartridges, a DSC subscriber could go online and set up a regular order to be shipped to his home monthly at a fraction of the retail cost, thanks to digital platforms that allowed customers new ways of shopping for the company's products. The company also utilized new technology, mainly through emerging platforms such as YouTube and Facebook, allowing them to reach a large market at a much lower cost than what traditional media advertising could have offered.

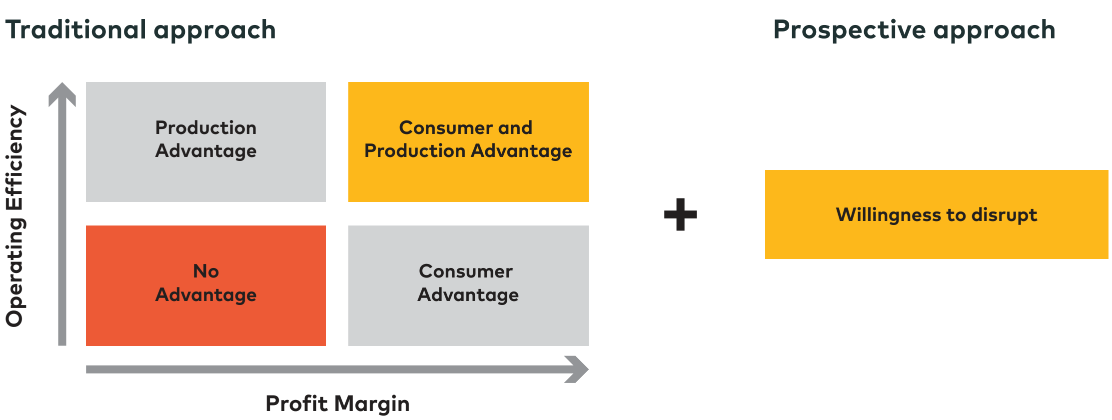
Ultimately, DSC's successful onslaught showed that Gillette's brand value had diminished. Gillette had not only lost touch with its customers, it stumbled because it was no longer able to offer meaningful innovation at an attractive price point to its customers. Meanwhile, new digital platforms also undermined the company's once dominant position in brick-and-mortar retail chains, demonstrating the importance of e-commerce in an age of disruption.

DSC ultimately disrupted the razor business by offering consumers not only lower prices but convenience by automatically restocking goods based on their consumption patterns.

Identifying the winners of tomorrow: Those companies able to weather the storm of disruption

Disruptive innovators often seem to arise from nowhere while wreaking havoc in their wake. In the past, identifying companies that would be able to thrive in an era of disruption consisted of seeking out "economic castles protected by unbreachable 'moats,'" according to Warren Buffet. A company with a sustainable competitive advantage would typically maintain a production advantage or a consumer advantage (Figure 1) and would grow within their moat. The wider the moat, the more likely it could stand up against peers and the test of time. However, as the pace of disruption has accelerated, the ability to survive has become increasingly difficult. At the same time, companies cannot afford to maintain the status quo. In order to maintain their competitive advantage, companies will need to disrupt themselves and potentially other industries to stay ahead. This will require a culture of innovation and bold decisions as well as investments in areas such as technology and research and development.

Figure 1: Companies able to create long-term economic value through a production or consumer advantage also need to disrupt themselves



Source: AGF Investments Inc.

The consumer advantage

We know that companies that have higher profit margins have a distinct consumer advantage, with strong brand names and loyal customers. This allows them heightened pricing power and therefore higher operating margins than their competitors. However, we believe that in light of disruption, there are additional dimensions with respect to the consumer advantage that need to be considered. In order for companies to protect their competitive moats going forward, they will also need to be more nimble, innovating faster and offering specialized or bespoke products.

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Nestlé SA is a great example of a company that continues to disrupt itself and the food industry, while leveraging the strength of its global brand to build on its consumer advantage. The 150-year-old company* launched "internal start-ups" within the organization, which encourages their scientists to think like entrepreneurs, by exploring novel ideas that lead to ground-breaking discoveries. This allows the company to evolve with the changing needs of its consumers, including the rapid development of new product lines, fast prototyping and quick in-market testing. As such, Nestlé has expanded into new higher margin areas such as natural, organic and plant-based offerings, focusing on a new strategy of on-trend nutrition, health and wellness categories, including their acquisition of plant-based food maker Sweet Earth.

Nestlé realized that while it maintained dominant brands in coffee with Nespresso and Nescafe, it was failing to keep up in the premium segment. Consequently, Nestlé did something inconceivable based on historical norms. It invested US$7.15 billion[2], creating a global coffee alliance with Starbucks in 2018 for the rights to sell the U.S. coffee chain's products around the world. A new range of 24 coffee products was launched under the Starbucks brand, including the first-ever Starbucks capsules developed using their existing propriety coffee and system technologies. Nestlé can now leverage its vast distribution network to market Starbucks branded coffee, which further bolstered its consumer advantage.

The production advantage

Meanwhile, companies with economies of scale and superior operating efficiency often have a production advantage. Historically, the classic example of a production advantage was exemplified by companies like Walmart Inc. that increased its moat due to its scale advantage. However, we believe that this production advantage alone is no longer enough to withstand disruption. Walmart has evolved by making significant investments into its business, including robotics, automation and artificial intelligence. Its online-to-offline business model also gives it an advantage relative to e-commerce peers that do not have the ability to integrate brick-and-mortar retail stores as part of their strategy.

Consider Waste Management Inc.,* the largest environmental service provider in North America. One may not think of innovation and disruption within the waste management industry but it certainly exists. What differentiates Waste Management from its peers is its production advantage, as it maintains significant economies of scale and continues to invest in the business. With the largest market share and the greatest number of landfills in the industry, its production advantage has led to regional and operational diversification, flexibility to invest in newer technologies and product categories and the capacity to absorb larger acquisitions.

Waste Management has continued to disrupt itself and the waste management industry with innovative technologies as digitization and convenience have become pervasive themes within the industry. Some of these

[2] Nestle, "Nestle enters agreement for the perpetual global licence of Starbucks consumer and food service products." May 7, 2018 press release

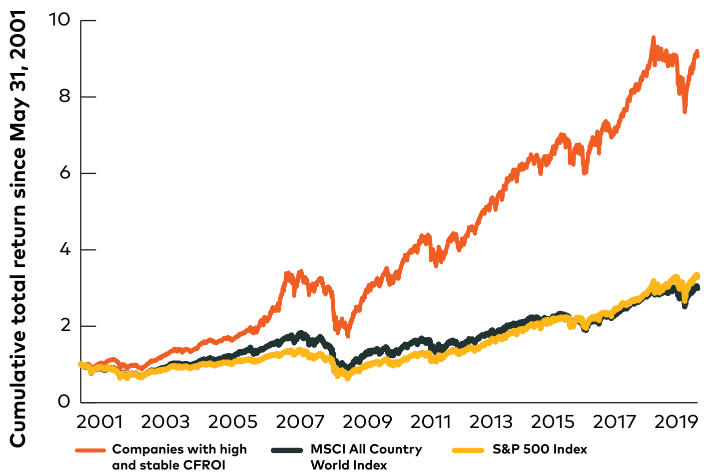
advancements include on-demand pick-up, which allows the company to respond to customer requests more quickly, efficiently and at higher margins. Also, a portion of the company's leading fleet of trucks is powered by compressed natural gas. Not only are these trucks quieter, less expensive to operate and better for the environment, they also provide a competitive advantage in communities that have strict emission initiatives.

Another way that Waste Management has improved operational efficiency and widened its moat relative to peers is through the use of "big data" to improve the utilization of its waste collection resources, such as more efficient routing, which can optimize waste collection based on the waste disposal patterns of its customers. The company is also investing in state-of-the-art technology and automation at its recycling facilities to improve its sorting technologies, where optical sorters extract recyclable items that otherwise would have been disposed of. Longer term, Waste Management has stated that autonomous vehicles will be part of their fleet that will require no operators. In addition to reducing costs and improving margins and operational efficiency, Waste Management's use of autonomous vehicles will help protect the company's sustainable competitive advantage against the threat of any potential disruption.

Creating long-term shareholder value

As previously mentioned, companies that have higher profit margins often have a distinct consumer advantage, while companies with superior operating efficiency often have a production advantage. Each of these on its own, or both, combined with the willingness and ability to disrupt themselves can lead to a company maintaining a sustainable competitive advantage over time. But how can an investor measure this? Both of these two factors help in determining a company's Cash Flow Return on Investment, or CFROI, a metric that we use to determine whether a company is earning a rate of return above its cost of capital. This is how we define quality. We are looking for companies that can generate a CFROI above their cost of capital over time. Why is this important to investors? Because companies that have earned high and stable levels of CFROI have dramatically outperformed the market over the long term.

Companies with high and stable CFROI tend to outperform the market over the long term



Source: Credit Suisse Holt, Bloomberg, AGF Investments Inc. Total returns. Rebased to 1 at May 31, 2001. Daily data to May 9, 2019.

Thriving in an era of disruption

Thriving in an era of disruption can be difficult, especially if a company has been successful and investors are content. Disrupting the status quo and introducing change within an organization can be uncomfortable, though bold decisions are required in order to thrive during a period of disruption. However, decisions can potentially be costly and not always the right ones. In fact, only one-third of companies have successfully navigated through change when industry disruption occurred . Those companies that have been successful have not only understood the magnitude of the change required to their business but have clearly articulated to investors the path they intend to take, made bold bets along the way and have invested meaningfully to get to where they need to be.

These days, the common wisdom is that the riskiest thing any company can do is to maintain the status quo. For companies to withstand the current pace of change, they will need to continuously improve upon their production advantage and/or consumer advantage if they are to maintain their competitive moats. They will also need to continuously innovate and disrupt themselves, ensuring they are ahead of future trends, while also adapting to the changing behaviours and needs of their customers.

Stephen Way, CFA

Senior Vice-President and Portfolio Manager
AGF Investments Inc.

Stephen Way leads AGF's global equity team in Toronto, while maintaining portfolio management responsibilities for their global equity and emerging markets mandates. As the architect of the EVA-based (Economic Value Added) investment process used for these industry-leading mandates, he is supported by a team that uses their collective industry experience and globally diversified cultural backgrounds to locate opportunities unrecognized by the market.Stephen is also a member of the AGF Asset Allocation Committee (AAC), which consists of senior portfolio managers who are responsible for various regions and asset classes. The AAC meets regularly to discuss, analyze and assess the macro-economic environment and capital markets in order to determine optimal asset allocation recommendations.

Stephen's industry experience began when he joined AGF in 1987. In 1991, he established AGF's wholly owned subsidiary AGF International Advisors Company Limited in Dublin, Ireland and ran the operations as Managing Director until 1994.

Stephen holds a B.A. in Administrative and Commercial Studies from the University of Western Ontario. He is a CFA® charterholder and a member of the Toronto CFA Society.

Sanjay Luthra, MBA, CFA

Associate Portfolio Manager
AGF Investments Inc.

Sanjay Luthra is an associate portfolio manager, responsible for Telecommunications and Information Technology.

He joined AGF from Ontario Municipal Employees Retirement System (OMERS) Capital Markets, where he specialized in Asia and Europe, covering the Technology, Media and Telecom sectors. Sanjay worked in the U.S. at Tata Consultancy Services, where he managed multi-million dollar projects for JPMorgan Chase & Co. and General Electric Plastics.

Sanjay earned an MBA from the Rotman School of Management, University of Toronto (Dean's list) and a B.Eng. from the Birla Institute of Technology, Ranchi, India. He is a CFA charterholder and is fluent in Hindi and Punjabi.

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*Nestle, and Waste Management Inc. are holdings of AGF Investments Inc. as of May 27, 2019.

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