WILLIS INVESTMENT COUNSEL

Principled Investing

May 17, 2017

Adapt or Die

"What will the company look like in five years?"

TECHNOLOGY DISRUPTION IS ACCELERATING

When evaluating any company, a critical question that we try to answer is, "*what will the company look like in five years?"* For some companies, the answer is relatively straightforward. For example, a railroad company should closely resemble its current self in five years. Rail transportation is four times more efficient at moving bulk freight than trucks[1], is federally regulated, and the cost to build competing infrastructure is enormous. For other industries, creating or maintaining a "moat[2]" similar to a railroad company is becoming more challenging as technological innovation is altering the competitive landscape for many "non-tech" companies.

The most prominent example of a company changing the competitive landscape is Amazon. Twenty years ago Amazon's founder Jeff Bezos met with the owners of Barnes and Noble who reportedly told Bezos that while *"they admired him; they were going to launch a website that soon would crush Amazon[3]."* Obviously, they were wrong. Not only did Amazon use its online store model to disrupt the book business, they soon targeted small electronics, and then set their sights on anything that could be sold and shipped.

[1] http://business.tenntom.org/why-use-the-waterway/shipping-comparisons/

[2] Moat is defined as a sustainable competitive advantage for a company, allowing it to protect the company's profits.

[3] http://www.businessinsider.com/amazon-jeff-bezos-facts-story-history-2014-5?op=1/#azons-first-crazy-christmas-season-came-in-1998-6. Market Value Graphic: http://www.zerohedge.com/news/2017-01-09/extraordinary-size-amazon-one-chart

Over the past twenty years, Amazon customer accounts have grown from one million to more than three-hundred million today[4]. The recent mass adoption[5] of using Amazon to purchase items that range from fine jewelry to toilet paper has dramatically changed shopping habits and severely impacted many businesses once thought immune from its competition. As if Amazon's retail dominance wasn't enough, they also leveraged their massive computer server network and began renting-out their excess computing power and storage capabilities to become the leader in what is now known as cloud computing.

Amazon is not alone in their quest to fully utilize technology to gain a competitive advantage. As seen in the table below, *traditional* industries such as retail, hotels, taxis, cable television, electronic payments, and countless others are experiencing changes in consumer behavior that force companies to adapt or become obsolete.

Disruptive Technology	Disruptive Companies	Companies Negatively Impacted
Online Hotel Rentals	**Airbnb**	**Hyatt, Intercontinental, Marriott**
Online Retail Shopping	**Amazon**	**Kohl's, JCPenny, Macy's, Nordstrom, Sears**
Cloud (online data/computing)	**Amazon/Microsoft/Google**	**Cisco, IBM, Oracle**
Online Ride-sharing	**Uber/Lyft**	**Avis, Dollar Thrifty, Hertz, Taxis**
Streaming Media	**Netflix/Amazon/Roku/Apple**	**AT&T, Charter, Comcast**
Online Payments/Networks	**Bitcoin/PayPal/Square**	**Banks, Credit Card Companies**

While some of the "disruptive" companies are relatively new, many of them are companies that have existed for at least twenty years. For example, ten years ago Microsoft recognized that its software business would be entering a mature phase and began heavily investing in cloud computing. They were fortunate to have an incredibly profitable business to use as a springboard to develop the future of their business. Similarly, Google recognized in 2005 that cell phones could unlock huge potential for their users, so they purchased and developed Android. Netflix also used their highly profitable, but dying, video-by-mail business to fund the development of streaming technology. IBM is currently attempting to do the same by using profits from their declining mainframe business to support artificial intelligence (called Watson) and cloud technology.

MARKET LEADING COMPANIES

A common theme amongst successful companies is their ability to recognize the vulnerability of their existing products and services and invest for future… even if it means foregoing current profitability. While our decision to broaden and deepen our research efforts is important, we also have increased our odds of success by investing in market leaders. Somewhat contrary to the threat of new, tech-savvy companies taking over the world, a recently published study[6] identified a massive increase in market concentration for most industries over the past twenty years. The study also revealed that companies in the most concentrated industries experienced higher profit margins and positive abnormal stock returns. Said another way, *the strong companies got*

[4] https://www.statista.com/statistics/237810/number-of-active-amazon-customer-accounts-worldwide/ -Data as of end of year 2015

[5] 75% of Amazon accounts joined between 2007 and 2015.

[6] http://www.cicfconf.org/sites/default/files/paper_388.pdf

stronger; they were able to invest in technologies that could enhance[7] or replace their current products and further separate themselves from their competition.

While all companies are vulnerable to new technologies, market leading firms typically have higher levels of profitability and cash flow which allows them to make greater capital investments than their competitors. Additionally, when they are outmaneuvered by more nimble upstarts, they often make acquisitions which can enhance their capabilities, allowing them greater odds of surviving. However, our biggest concern with leading companies is that they fail to invest for the future, choosing complacency over innovation.

OUR RESEARCH PROCESS CONTINUES TO ADAPT AND EVOLVE

Similar to market leading companies that adapt to change, WIC recognized years ago that we also needed to update our research process to ensure long-term investment success. While our fundamental investment principles remain the same, we now place greater emphasis on the qualitative aspects of our companies and the industries in which they reside. This process is more time consuming and requires more analytical and creative effort but yields deeper insights, which is necessary to make prudent investment choices. The growth of our firm and our significant reinvestment in the analyst team over the past few years has enabled us to improve our research capabilities.

In addition to our research staff spending considerable time trying to understand the key drivers of a company, <u>we now place even greater emphasis on how technology can disrupt its business model</u>. This requires us to read more broadly about new and developing technologies so that we can understand how they might impact a company's profitability. Clever use of "big data," phone apps, mobile payments and cloud computing by upstarts and incumbents alike are changing the competitive dynamics, seemingly overnight. Before WIC's investment committee convenes to consider investing in a company, one of our analysts attempts to answer these questions:

- How does the company make money?
- How does the company differentiate itself with its products or services?
- What is <u>changing</u> within the industry that could <u>commoditize</u> a company's products?
- Is the company investing enough of its profits to increase its moat?
- Is there a <u>new technology</u> that could render its products less relevant?
- Are consumer preferences changing?
- Is a competitor developing or utilizing technology in a new way which could <u>upend</u> an industry?
- How confident are we about what this company will look like in five years?

Sometimes it becomes apparent that the future for a particular company is subject to so many unknowns – especially what it will look like in five years – we will not reach a sufficient level of conviction to own the subject company. Evaluating such uncertainty is an important aspect of risk assessment and risk management.

---

[7] "Enhance" could mean automating a manufacturing plant, using smart software to increase efficiency, or meaningfully engaging with current or new customers.

After several of these analyst meetings, the company is presented to our investment committee. At this point, we debate the prospects and predictability of the company, but we purposefully do not discuss valuation. This might seem counterintuitive given we are *value investors*, but we realize that if we spend more time understanding the nuances of a company and its industry, we will be less prone to buy a bad business that happens to be "cheap[8]." Finally, we estimate the company's *intrinsic value* using several valuation methods and apply a broad range of potential outcomes for each one, including stress-testing our assumptions.

The scrutiny that we apply to potential securities also applies to companies we own. To avoid complacency, we are always putting our existing companies *on trial* to determine if they meet our strict investment requirements. Our CIO routinely reviews and challenges our assumptions and analysis.

CLOSING THOUGHTS

All companies face the risk of obsolescence to varying degrees, so we can't go too far and assume all of them won't be able to adapt. Case by case, we must balance the unknowable future with our assessment of their ability to manage through the change. Many of the companies we own are market leaders, which increases the likelihood of success but doesn't guarantee it. Ultimately, investing is a balance of potential reward and potential risk. Regardless of our qualitative assessment, the valuation of a company needs to be attractive, as overpaying for a well-positioned company might be just as bad as buying a "cheap" but troubled company.

Brett M. Slattery, CFA

For more commentary, we invite you to visit our website at www.wicinvest.com.

Contact Information

WILLIS INVESTMENT COUNSEL
Principled Investing

710 Green Street
Gainesville, GA 30501
P: 770.718.0706 | F: 770.718.0805

[8] We define this as a value-trap. Buying a company in secular decline but with a low price/earnings ratio is a simplistic example of a value-trap.