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Hosking Post
The Death of the Brand

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THE DEATH OF THE BRAND

"To me, consensus seems to be the process of abandoning all beliefs, principles, values and policies. So it is something in which no one believes and to which no one objects."

Margaret Thatcher

That the 'brand' is a core pillar of contemporary capitalism is something of a truism. Branded goods are ubiquitous and consumerism is perhaps the sole unifying global religion. The corporations that built and sustain branded goods remain hugely profitable, their products bought daily by households the world over. Branded companies are feted by investors and commentators. Business schools run classes on building branded 'moats'. When viewed generously, brands provide their customers with real utility: a mental short-cut for people drowning in choice. Moreover, at the higher, non-packaged end of the branded spectrum, lifestyle and luxury brands provide vehicles for aspiration. The purchase of a Ferrari, for instance, is for many a life-goal and will likely remain so. But the simple conceit of 'The Brand as King', particularly with reference to consumer packaged goods, appears consensual in Mrs Thatcher's definition of the term. Technology is changing everything. Many brands – as represented by Big Brand Inc, the large Consumer Packaged Goods (CPG) company – are struggling to keep pace with the digital revolution.

This writer's personal journey over the last five years has culminated in hyper-scepticism as to whether the 'twentieth century' model of Big Brand Inc remains relevant to the customer it purports to serve. Set against these business model question marks are near all-time high valuations for Big Brand Inc equities. The executives and activist shareholders who supposedly 'steward' these long-lived CPG companies have developed a theological focus on raising margins. This 'margin fanaticism' comes at a point in time when the established distribution mechanism for CPGs (physical retail) is undergoing emergency surgery and the rise of so-called 'weapons of mass discovery'[1] have provided instant access to cheaper, often times better-for-you alternatives at the touch of a button. The customer is becoming empowered with almost perfect information available instantaneously to the c.3bn people who own smart phones.[2] As we have seen in recent political 'events', established 'distribution channels' (linear media) are being challenged by disruptive incumbents, often with unpredictable consequences. The balance of power is shifting and the

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[1] A term used to describe mobile telephones. Scott Galloway, *The Four: The Hidden DNA of Amazon, Apple, Facebook and Google,* 2017
[2] Benedict Evans, partner at Andreessen Horovitz, see: https://www.ben-evans.com

individual is empowered. In the consumer world this sees power shift from company to customer, albeit in a relationship mediated by an uber-powerful tech platform. This tectonic shift in consumer economics, which did so much to upend speciality retail, bodes ill for Big Brand Inc.

A blank sheet of paper for the Great Restructuring

Brynjolfsson & McAfee, two MIT professors who popularised the concept of a 'Great Restructuring', hold that we are witnessing the third industrial revolution. The first, powered by steam, the second based on electricity and the third – now unfolding – fuelled by computers and networks.[3] The Moore's Law type-nature of this revolution – for example, the accumulated stock of digital information doubles every 1.2 years – is transforming traditional consumption patterns and redefining corporate winners and losers. In this context, investment thinking must be 'first principles' based. In other words, it should start with a blank sheet of paper. Historic conceptions of 'moats' and 'value' might well be mental dead weights. Much as it is set against basic human psychology, the speed of change we are witnessing makes it imperative to challenge received wisdom. One of the benefits of 'starting-over' in business, and indeed other areas of life, is the ability to re-examine cherished concepts, structures and constraints. A blank sheet of paper is, perhaps, one of life's great underappreciated advantages. With the right structure it should provide a canvass for 'Permissionless Innovation' - a buzz-phrase in technology and engineering circles used to describe the broad environmental factors that allow new ideas and businesses to flourish.[4] A culture of Permissionless Innovation does not, of course, always lead to the 'right' answers but it does encourage experimentation. Indeed, Richard Feynman held that "progress in science comes when experiments contradict theory."

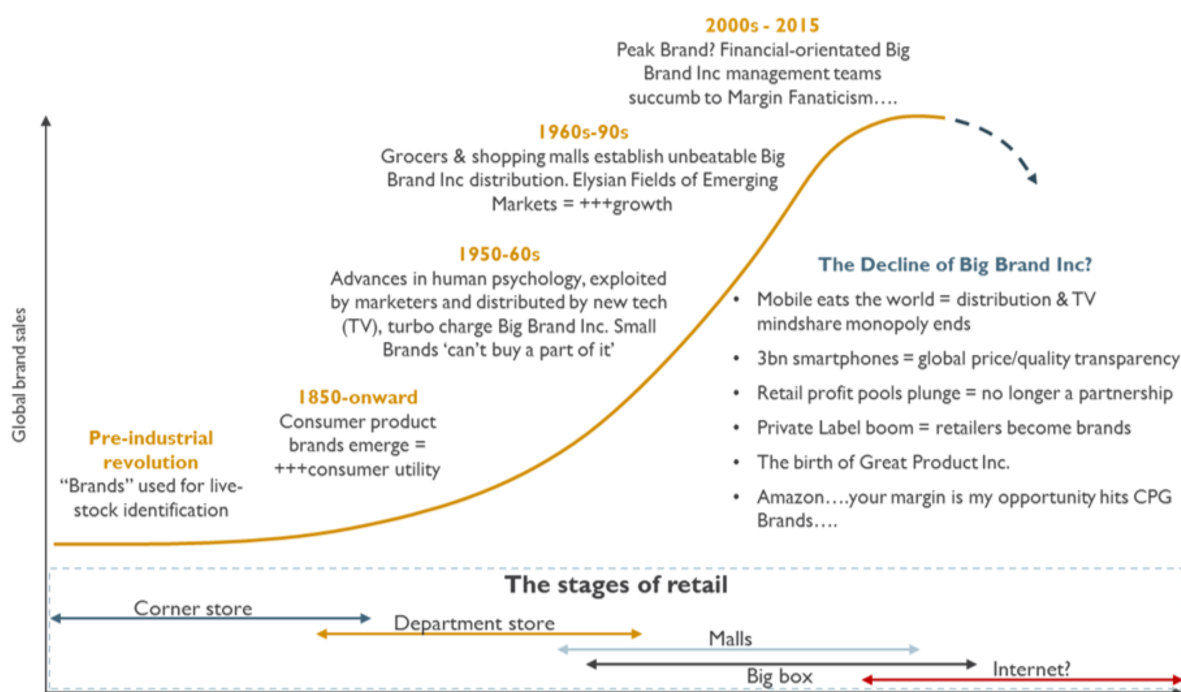
These experiments inevitably engender friction. By nature anti-status quo, they upset those for whom the status quo is 'just fine' - particularly those at the top of the pile! Hosking Partners' '30 year experiment', culminating in the go-anywhere, autonomous global generalist portfolio managers (itself not an entirely frictionless project!) provided us with a blank sheet to think and act in an unconstrained and unconventional fashion. At Hosking Partners we are unashamedly using this freedom to experiment.

[3] Brynjolfsson & McAfee, *Race Against The Machine: how the digital revolution is accelerating innovation, driving productivity and irreversibly transforming employment and the economy,* MIT Centre for Digital Business, 2011

[4] 'Permissionless Innovation' refers to the notion that experimentation with new technologies and business models should generally be permitted by default. Unless a compelling case can be made that a new invention will bring serious harm to society, innovation should be allowed to continue unabated and problems, if any develop, can be addressed later (see Adam Thierer, Fellow in Economic Policy at the Heritage Foundation and author of *'Permissionless Innovation: The continuing case for comprehensive technological freedom*).

The Hosking Partners ‘thought architecture’, together with this writer’s involvement in a challenger rum brand, gave perspective on the confident ‘moat’ assertions of Big Brand Inc and their cheerleaders in active fund management.[5] I hope to persuade the reader that this concept of the CPG-as-moat is essentially dated. A mental model that worked well in the post-WWII era is unlikely to produce similar results in the coming decades. Big Brand Inc is in some ways ‘dumb’, with very little idea of what a customer buys, when it is bought and in what quantity. By contrast the platform companies have this data in spades and, although unsettling at times, are better able to predict our consumption patterns. The technology which drove the astounding global adoption and loyalty towards certain CPG brands – essentially linear television advertising – is being replaced at speed. Concurrently, the physical distribution systems that facilitated CPG sales – big box retail and shopping malls – are also going through a traumatic period of mass closures and reinvention. All this as internet retail, a ‘private label boom’ and the mighty Amazon your-margin-is-my-opportunity model upend the consumer landscape. The upshot is that Big Brand Inc is losing customers, as seen in the declining revenue lines of these businesses. Moreover, it faces a permanent insurgency from, and is a forced buyer of ‘Great Product Inc’ – innovative challenger brands, who via the platforms offer the customer more ‘value’ than heavily advertised, high margin Big Brand Inc products.

Figure 1: Big Brand Inc: A very 20th century phenomenon?



[5] The Duppy Share, a disruptive rum brand that became profitable in 5 years with zero analogue media spend (see: http://www.theduppyshare.com)

Linear television, the ‘mere-exposure effect’ and the demise of old school retail

In April 1993, Phillip Morris cut the price of Marlboro cigarettes in response to generic competition. The stock fell 26% and commentators predicted the ‘death of the brand’. It wasn’t so. The reason to believe that ‘this time is different’, especially as regard CPG brands, is technology. The distribution media which provided Big Brand Inc with a near monopoly into forming human consumption habits – linear television advertising – is rapidly losing efficacy as a means to recruit new brand consumers. Broadly speaking, the post-war period saw a nuclear family sit down to watch evening television with the precious commercials between major TV shows (e.g. I Love Lucy or Coronation Street) the prime real estate of the advertising world. Big Brand Inc were the only buyers able to afford these prime slots and could therefore monopolise this beam into the viewers’ subconscious when, after a hard day at work and perhaps a drink or two, the psychological barriers of consumers (otherwise known as ‘people’!) were at their weakest. Many of the most successful post-WWII proponents of this new form of ‘brand propaganda’ were former intelligence officers (c.f. David Ogilvy) who had witnessed first-hand the ability of totalitarian regimes to manipulate popular will through propaganda. Daniel Kahneman observed that a “reliable way to make people believe in falsehoods is frequent repetition, because familiarity is not easily distinguished from truth. Authoritarian institutions and marketers have always known this fact.”[6] Indeed, Josef Goebbels held that, “*the common man is usually much more primitive than we think. Consequently, propaganda must always be simple and repetitive.*”[7]

Last century’s highly effective but manipulative model of customer recruitment and retention is becoming less effective. Traditional linear TV is being replaced by zero or low-advertisement binge-viewing (Netflix). It is difficult to underplay the importance of this shift: the ‘mere-exposure effect’, the psychological phenomenon whereby the more you see or hear something, the more you like it, is now not monopolised by Big Brand Inc.[8] It should be remembered that when TV advertising first hit the screens in the 1950s it was a tremendously powerful medium:

“…if you were Proctor & Gamble, you could afford to use this new method of advertising. You could afford the very expensive cost of network television because you were selling so damn many cans

[6] Daniel Kahneman, *Thinking, Fast and Slow,* 2011
[7] Pier Paolo Perdrini, *Propaganda, Persuasion and the Great War: Heredity in the modern sale of products and political ideas,* 2017
[8] In the late 1960s, Charles Goetzinger conducted an experiment using the mere-exposure effect on his class at Oregon State University. Goetzinger had a student come to class in a large black bag with only his feet visible. The black bag/student sat on a table in the back of the classroom. The students in the class first treated the black bag with hostility, which over time turned into curiosity, and eventually friendship. By simply presenting the black bag over and over again to the students their attitudes were changed, or as Zajonc states "mere repeated exposure of the individual to a stimulus is a sufficient condition for the enhancement of his attitude toward it." (Robert Zajonc, 1968)

and bottles. Some little guy couldn't. And there was no way of buying it in part." (Charlie Munger, 1994)

Today, a little guy can buy a part of it. The barriers to entry in advertising – the 'moat' – have collapsed. No longer does Big Brand Inc. monopolise eyeballs via the prime real estate of evening linear TV advertisements. With more than 1bn hours of content consumed per day, YouTube is now a more watched format than US television. Facebook has a quarter of the planet's population signed up. The scale and reach of these platforms is breath-taking – something the political classes are just waking up to.[9] Challenger brands can access huge audiences at low cost and the old world hierarchies that saw multiple layers of 'middle-men' mediate advertising content are being circumvented. As we have seen play out in recent elections, the playing field has, to a large extent, been levelled.

Moreover, as the Great Restructuring rolls on we purchase more goods online. Here customers 'search' and are provided with much simpler choices than in the 'physical' world. Rather than navigate the blinding array of choice in a grocery store aisle, typically stocked with c.650 stock keeping units (SKUs), online search sees three to four items displayed with clear price transparency. The impact of reframing customer decisions is having some radical implications. As humans we make more 'rational' decisions the less choice that we are offered. One of the effects of endless choice in the grocery aisle – Kroger, for instance stocks 400-plus varieties of salad dressing – is that it produces decision paralysis.[10] Marketers exploit this. Our minds rely on the availability heuristic – perhaps anchoring on a TV commercial we watched last night – to drive our consumption when we face this paralysis. In this vein, the work of psychologist Barry Schwartz shows us that more choice makes making choices harder.[11] The way in which we value things depends on what we compare them to and online search-based shopping reduces the number of comparisons. As a result 'choices' become starker. This gives the platform companies huge influence over our consumption decisions and power over Big Brand Inc. Whilst some Big Brands benefit, these trends make 'expensive' staple-type brands particularly vulnerable.

The second major facilitator of CPG sales in the twentieth century was a retail model designed for brands. The retailer and Big Brand Inc were partners. Grocery store layouts 'guided' (aka 'pushed'!) customers to the centre of the store layout, an area that still, for now at least, privileges brands. Wal-Mart described itself as a 'House of Brands' for much of the post-WWII period. But in 2016,

[9] See: https://www.intelligence.senate.gov/hearings

[10] See: https://www.instacart.com/kroger/aisles/9214-salad-dressing-toppings/page/4

[11] Barry Schwartz, *The Paradox of Choice: Why More is Less*, 2004

Wal-Mart - the largest retailer in the world - had an abrupt change of strategy that pivoted to its private label. The relentless success of Aldi and Lidl has normalised private label across the Western world. The retail landscape is physically changing. The 'temples of consumerism' aka shopping malls are, according to the CEO of one of America's largest private real estate companies, now "an historical anachronism – a sixty-year aberration that no longer meets the public's needs, the retailers' needs, or the community's needs."[12]

The results of all this are clear when viewed via the profit and loss accounts of Big Brand Inc. Branded CPG goods sales are declining and yet their valuations, in at least half of the major large CPG universe, are within 15% of peak.

Figure 2: Expensive stocks with declining sales

Ticker	EV/Sales	3 year sales CAGR (%)	% From Peak Sales	Market cap ($bn)
ABI BB	6.8x	1.8	-15%	235
KHC US	4.9x	1.6	-12%	97
CL US	4.5x	-4.5	-7%	63
PG US	3.7x	-6.9	-13%	224
MDLZ US	3.2x	-9.8	-8%	63
K US	2.4x	-4.2	-30%	22
CPB US	2.2x	-1.5	-49%	14

Source: Bloomberg

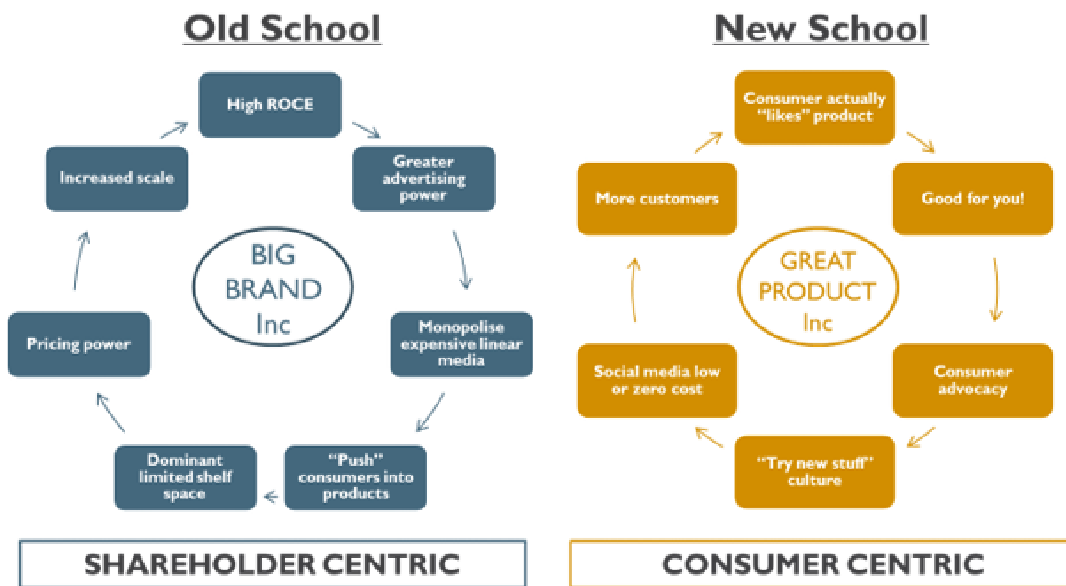
Realities must respect other realities

The doyen of this Brand New World is, of course, Jeff Bezos. He holds that:

"*The right way to respond to this [New World Order] if you are a company is to put the vast majority of your energy, attention and dollars into building a great product or service and put a smaller amount into shouting about it, marketing it. If I build a great product or service, my customers will tell each other.*"

[12] Rick Caruso, CEO Caruso Affiliated, National Retail Federation Convention, 2015

Figure 3: A Brand New World



Source: Hosking Partners

This 'Brand New World', as outlined by the contrast between 'Old School' and 'New School' flywheels above, sees the customer usurp the shareholder. The consumer business model has inverted. As this shift works its way through the consumer landscape, many decades of accumulated corporate learning are having to be unlearned, a challenge for the intergovernmental-sized bureaucracies of the large consumer goods companies (Unilever has nearly 4x the number of employees of the United Nations!).[13] But for these incumbents, there is no blank sheet of paper from which to 'start-over'. Permissionless Innovation and 'Proctoids' (the tongue-in-cheek appellation for P&G lifers) are not happy bedfellows! Simply being 'Big' and therefore able to monopolise customer 'mindshare' (i.e. manipulate customers into purchases via television advertising) is not the advantage it once was. According to Euromonitor, small branded goods companies with <$1bn in sales have been growing at a c.4x faster rate than larger manufacturers with sales >$3bn, leading to a slow but steady attrition of Big Brand Inc's market share.[14]

Meanwhile, Great Product Inc can now gain access to hundreds of millions of customers via platforms such as Instagram, Amazon/Alibaba's marketplace or YouTube. Here, customers will do much of the advocacy. The best recent example of Great Product Inc vaulting over the supposed 'moat' of Big Brand Inc is Dollar Shave Club's astonishing recomposition of the US razor market. In

[13] Unilever 169,000 employees, the UN 44,000 according to Google as of November 2017
[14] PWC Consumer Packaged Goods Trends, 2017

just five years two challenger brands, Dollar Shave Club (founded 2011) and Harry's (founded 2013), went from 0 to 12% market share and the incumbent – Gillette – lost nearly 30%. To paraphrase Lady Bracknell, losing one-third of market is neither careless, nor misfortune… but a damning indictment on a business model that put shareholders first.

The upward price treadmill of ever more (ridiculous?) 'shave technology' from Gillette lays testimony to the classic Big Brand Inc shareholder-first strategy. The shaving price umbrella became so high that it acted as a beacon for entrepreneurs. The Dollar Shave Club's 1 min 33 second YouTube clip is a collector's item of disruptive marketing.[15] It cost as little as $4,500 to produce and has been watched by over 25 million people, as of November 2017. Instead of being 'forced' to watch this advertisement – linear TV style – its humour actually draws people to seek it out and social media allows it to be readily 'shared' and 'liked'. The clip enlisted 12,000 customers in its first two days. That a company with seed funding and a handful of employees could achieve this level of disruption to a 'staple' market like razors should prompt a revaluation of the 'Old School' moat model.

Retailers as Brands

For much of the twentieth century retailers relied heavily on the advertising spend of Big Brand Inc to generate store traffic. Brands that did not spend on advertising were given less prominence than those that did. The grocers' incentive, therefore, was to promote Big Brand Inc over their own private label products – the offer to the customer was 'name-brands-for-less'. One former Wal-Mart executive, who spoke on condition of anonymity, claimed to this writer that when Wal-Mart launched a private label range in the late 1990s the brief was to ensure the packaging – the physical appearance of the Wal-Mart own brand – looked, "as much like 1950s Poland as possible!"

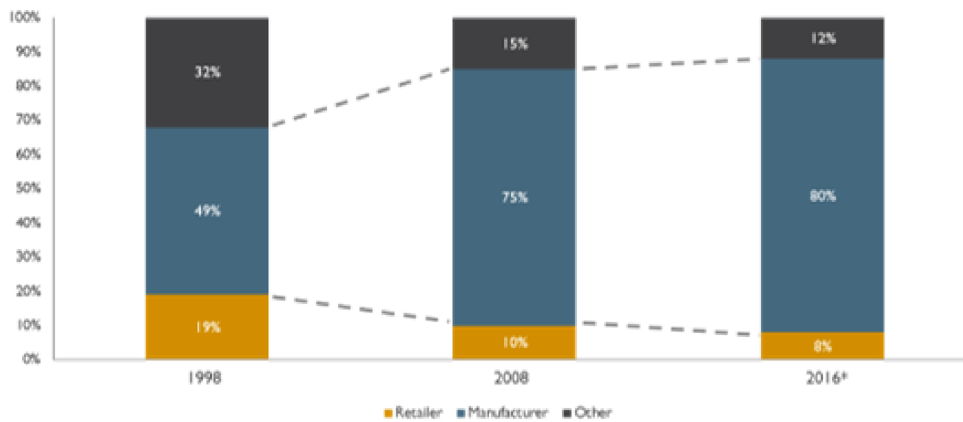
This mindset has now changed. Under huge pressure from internet retail and private label champions Aldi/Lidl, physical retailers are demanding more of the pie. In 2016, Wal-Mart dropped its 'House of Brands' tagline and is now heavily promoting its own brands. The world's largest retailer now demands that supplier brands prices should be 15% lower than the competitors 80% of the time.[16] Campbell's Soup (CPB), who have refused to yield to Wal-Mart's pricing demands recently issued their second profit warning of 2017 as Wal-Mart (who account for 20% of CPB sales) destocked CPB soup to promote their own private label. The results have been stark: CPB soup sales are declining in the US and grocers' private label sales of soup, led by Wal-Mart, are rising at 10% a year.[17] Sexy growth for an unsexy category! The potential positive change in earnings for

[15] The clip can be watched here: https://www.youtube.com/watch?v=ZUG9qYTJMsI
[16] See: https://news.walmart.com/events/2017-investment-community-meeting
[17] See: http://investor.campbellsoupcompany.com/

grocery retailers via even a small increase in share of wallet from Big Brand Inc is significant: food retailers' operating margins range from loss-making to 4% while those of Big Brand Inc can be over 30%. In a recent CNBC interview Warren Buffett noted, "right now, the retailers, they're doing better in this round of the fight."[18] Mr Buffett sits on the board of Kraft Heinz.

Figure 4: Big Brand Inc – just too greedy?

The brand-retailer operating profit split over 20 years has gone from 2.5:1 to 10:1



Source: Bernstein Research, Hosking Partners estimates

In the non-physical world the 'retailer as a brand' is even more powerful. The platform company can use accumulated data to set prices and promote products to individual consumers as well as manipulate displays to suit their economic interests. It should, therefore, come as no surprise that a third of all batteries sold over the internet are Amazon batteries. When Amazon offers us the stark on-screen comparison of prices between branded and non-branded goods, we often act rationally in favour of the cheaper, non-branded – or should that be Amazon-branded - good. As we move into a 'voice-first' world this trend is accentuated. Alexa, Siri and Google Assistant will likely further undermine the visual brand associations that are the product of multi-decade linear TV advertising campaigns.

[18] See: https://www.cnbc.com/2017/10/03/full-interview-warren-buffett-on-tax-reform-markets-and-much-more.html

Figure 5: Retailers are becoming the brands – at half the cost!

Source: Hosking Partners

What do to with all this?

Investment implications of the 'death of the brand' – or more specifically the unpicking of the CPG branded goods model – are broad. As the picture above demonstrates, perhaps the greatest long-term takeaway is that consumers are the main beneficiaries of this trend. As for individual stocks, there are perhaps some first, second and third order consequences.

First-order implication: avoid, or even sell-short, the most challenged Big Brand Inc companies. They are expensive. They have shrinking revenue lines. And they over-earn, encouraging constant attacks from Great Product Inc. Increasingly they become 'forced buyers' of these challenger brands at high/dilutive multiples.[19] In some but not all instances, Big Brand Inc is failing to recruit the next generation of under 30s customers, pointing to a worrying long-term future for supposedly 'bond like' long-duration equities.

Second-order implication: the platform companies ("The Four") will continue to benefit from the New School customer-centric world. They are in many cases the replacement 'brands' that, for now anyway, offer the 'trust architecture' for consumer purchases. Google and Amazon facilitate instant price and quality transparency. Facebook allows customer advocacy of Great Product Inc. Apple connects Great Product Inc with the 'shop in the pocket' of most of the world's high-income

[19] See Unilever's recent €2.3bn acquisition of Korean skincare brand Carver for 7x EV/sales vs ULV on 2.8x EV/Sales

consumers. Whether or not these factors are already 'in-the-price' – and then some – is, of course, the key determinate of whether the 'FANGs' represent good investments…

Third-order implication: grocery business/supermarkets/retail survivors, which are valued at close to historic lows, should start to re-earn more of the consumer pie. They have seen their profit pools shrink and are now demanding that 'price investment' falls on the shoulders of Big Brand Inc (see recent profit warnings from Campbell's Soup).[20] Private label offers the retailer a higher margin and the success of the private label-led Aldi/Lidl model is being cloned. Very small increases in profitability could see this sector – currently viewed as 'Amazon roadkill' – re-rate as the longevity and profitability of these businesses is reappraised. Perhaps Amazon's acquisition of WholeFoods was less a triumphant move to dominate food retail but born from weakness and a stark recognition of 17 years of failure to build any scale in the category?

Wal-Mart: profit pendulum, survival DNA and 'last-mover' advantage

Wal-Mart, perhaps more than any other stock, expresses the upside pregnant within the 'death of the brand' thesis. With the largest revenue line of any company in the world in 2016 – a title it has claimed every year this century - it is the world's largest buyer of 'Brands'. It runs, arguably, the world's most efficient supply chain at unrivalled scale and the Campbell's Soup profit warnings are a stark illustration of its market power. The global low-cost leader is a formidable competitor to Amazon and, almost certainly as a result of the long-term orientation of the Walton family (c.50% owners), exhibits an adaptive 'survivalist' corporate DNA. Given Amazon's 17 year 'failure' in food and subsequent (forced?) purchase of WholeFoods, perhaps Wal-Mart's 'late' arrival into grocery ecommerce appears serendipitous.

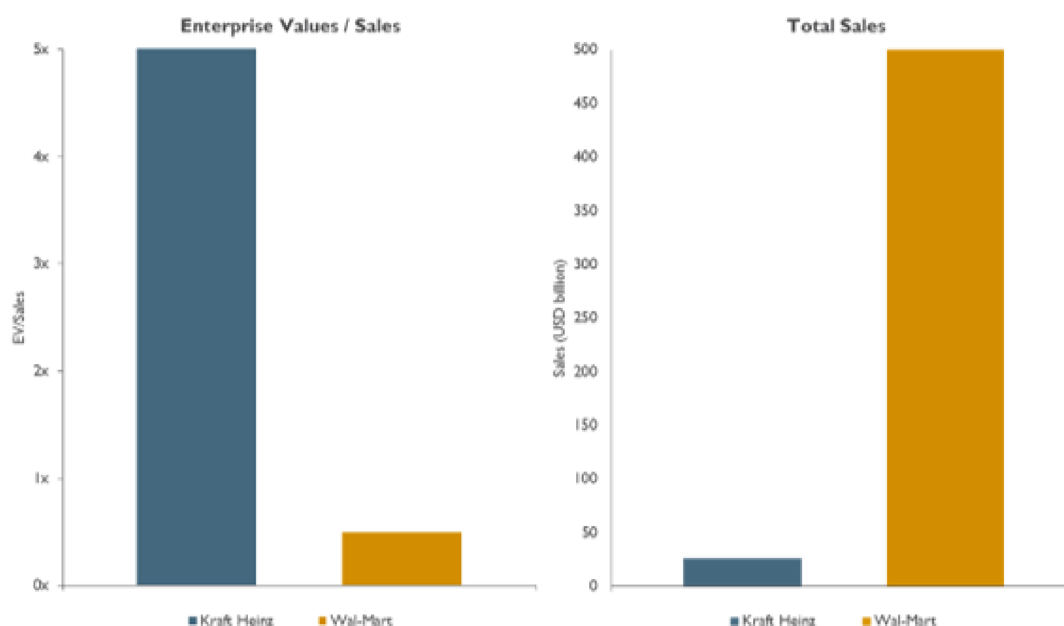
The $3bn acquisition of Jet.com, together with its founder Marc Lore, marked a sea change towards embracing the Permissionless Innovation type response to Amazon. Lore has been empowered to build an ecommerce business that will undoubtedly cannibalise existing store traffic but should nevertheless ensure the long-term survival of the company. Wal-Mart's 4,600 US stores now offer free two-day delivery as standard, in line with Amazon. Re-imagining the store as 'infrastructure' is a powerful competitive response: 90% of the US population live within 10 miles of a Wal-Mart store or, to use the promotionalist technology lexicon, 'distribution centre'. Order-on-line and pick-up-in-store is a highly convenient model for automobile centric US consumers. Customers like it. Importantly, when customers pick up their own shopping, rather than have it delivered, the

[20] In the October 2017 Q3 conference call Campbell's Soup CEO Denise Morrison commented that "the retailer landscape is changing dramatically"

economics of online grocery improve dramatically – an inescapable logistical truth that undoubtedly played a role in Amazon's WholeFoods purchase. Maybe stores have a value after all? With unassailable market share in middle and low income America – an area conspicuously avoided by WholeFoods – Wal-Mart's dominance appears undervalued. According to FDIC, 7% of Americans are unbanked and 19% 'underbanked', these customers are Wal-Mart customers and value the ability to, for instance, order online but pick up and pay cash in-store.[21] Among many of the underappreciated digital strengths of Wal-Mart – and this is an observation that speaks to its role as facilitator of the American middle-low income population - is that its Walmart Pay App (the no2 US payment app) is set to surpass Apple Pay's number of users by the year end.[22] Could Wal-Mart be Alibaba in mid-Western drag?

At just 0.6x EV/Sales Wal-Mart is valued at one-eighth of the value of Kraft-Heinz and generating twice the absolute level of free cash flow ($25bn vs $12bn) of Amazon. It will remain a formidable competitor.

Figure 6: Who owns the customer?



Source: Hosking Partners, Bloomberg. Values as of 31 August 2017

[21] See: https://www.fdic.gov/householdsurvey/
[22] See: https://www.bloomberg.com/news/articles/2017-11-07/walmart-pay-threatens-to-surpass-apple-in-u-s-mobile-payments

A redefinition of ‘quality’ stocks?

In addition to the potential stock moves outlined above, over the longer term much of the received wisdom present in investment literature, ‘twentieth century’ in origin, will need revaluation if the thesis holds. ‘Moat’ type investors will be required to ‘start over’ on a number of CPG brands and, perhaps, we will see a redefinition of what it means to be a ‘quality stock’. Could mining companies, for example, be perceived as ‘cyclical quality’? It is highly unlikely – at least anytime soon – that the platform companies commit significant capital to deep copper mining operations.

Figure 7: Great brands = great investments?

It took 18 years for KO to regain its 1998 high

Source: Factset

And for investors who believe that this is a second cry of “wolf!” for the ‘death of the brand’ which will, on the contrary, compound come what may, the above share price chart of perhaps the world’s most successful brand provides a salutary lesson. Valuation has a role to play in the Big Brand investment case as well as fundamentals. At the wrong price even the best brand was a poor investment.

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