Digesting Digital Disruption

"I have been quoted saying that, in the future, all companies will be Internet companies. I still believe that. More than ever, really." Andy Grove.

If you're thinking that the above quote looks a little familiar, you're not wrong – in his January 2017 insight, "Success Breeds Complacency", Nick argued that it encapsulates the defining challenge for all investors today. I think it's worth repeating here because in our view Grove's proposition remains truer than ever. Perhaps the single most important thing we think about is the potential for technology to disrupt industries and erode moats, not just within the technology industry itself but across all the sectors we invest in. Keeping on top of tech changes is crucial for us so late February saw us return to San Francisco, attending Morgan Stanley's technology, media and telecom conference – four days of presentations from world leading companies, which built up to a fascinating snapshot of the most important technology themes.

Artificial intelligence was by far the biggest theme of the week. Most companies touched on it at least once and everyone seemed to be in agreement with Microsoft CEO Satya Nadella, who believes that this is the "next big shift" in tech development. Cloud computing company Salesforce went even further and argued that right now we are at an inflection point, "the dawn of a new era for AI" driven by the "explosion of data" in recent decades. Certainly the amount of data homo sapiens produces is rapidly accelerating: in 2016 we produced as much data as in the whole history of the earth until 2015, and each year the amount of data produced doubles[1]. The impact of this data on the growth and development of AI is tangible – in the past it was limited to small data sets and representative samples rather than real-time data but, now that data and data analysis has become much more sophisticated, AI is beginning to learn without human input. Recently Google's DeepMind algorithm taught itself how to win 49 Atari games[2].

The applications for this new breed of AI seem almost limitless, and in some areas commercial AI is already reaching critical mass – smart speaker and voice assistant Google Home has sold a total of 10m+ units, which isn't trivial. From our perspective as investors in consumer goods, we want to know that the likes of Diageo, Heineken and Unilever are alert to AI as a threat and an opportunity. We believe that these developments will "sort the men from the boys" in terms of brand quality: in exactly the same way as the infinite shelf space of ecommerce, this sort of AI has the potential to erode brand value quickly if the brand itself is not the default choice on, say, a voice-activated device which puts items into an e-shopping basket. Gillette's loss of share to Dollar Shave Club and other ecommerce razor suppliers is a cautionary story about tech disintermediation – the 115 year old Procter & Gamble ("P&G") mainstay lost US market share to online shaving subscription services for six years in a row, falling from over 70% in 2010 to 54% in 2016[3]. P&G responded by cutting prices by 12% on average but the hoped for turnaround hasn't yet happened.

Brands of course are of varying quality and we believe that the lowest of these are at serious risk of commoditisation or disintermediation. As the Gillette example shows, where exactly a brand falls in that continuum may not always be obvious. While Gillette undoubtedly remains resonant as a brand, the problem is its distribution: Dollar Shave Club has done so well because it offers a convenient way to buy a frequently purchased, essential and repeatable item without the need to visit the shops. We aim to invest in top tier brands which will hold onto value because their resonance and consumer loyalty makes them widely recognised and the first choice – and we expect our portfolio companies to remain alert to ways in which tech developments, including AI, can be beneficial for them. We were encouraged by Unilever's purchase of Dollar Shave Club in 2016 and regard it as an expression of Unilever's understanding of, and investment into, a future in which the old set-up of retailers as intermediaries is being disrupted by the internet. We also note that 25-30% of Diageo's media spend is now on digital (in the US it is up to 40%)[4], which shows that the company takes it seriously. Ultimately we want to be sure that consumers who want a bottle of whisky ask Alexa to order Johnnie Walker – and that Amazon can be persuaded to stock it like any other retailer.

Several companies highlighted the increasing tussle between advertising agencies and multinationals. Keith Block, CEO of Salesforce, described their newly developed suite of products backed by data and proprietary AI offering Einstein, which allows large multinational businesses (Unilever was the example mentioned) to talk directly to customers and essentially DIY their own social media campaigns. Large consumer goods companies such as Unilever and Diageo are traditionally B2B, but social media and tech changes mean that they're being given

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access to the B2C space, and Salesforce's platform enables them to do this – crucially, without the need to involve an advertising agency. Global advertising agency Interpublic countered by reiterating that nobody except an ad agency can offer a comprehensive creative campaign, and that multinationals have been trying to take advertising in-house for decades – with poor results. Perhaps that's still true, although there's an argument to be made that the new plethora of ways to communicate with the customer – gone are the days where the only advertising mechanism was mass media coverage – means that it's easier than ever to do things oneself. Whether advertising agencies find themselves disintermediated by these kinds of products or not, the key takeaway is that social media engagement and, in many cases, the transition to B2C status isn't optional. At Lindsell Train we remain alert to the changes large consumer companies must make in the light of this, and are encouraged by initiatives undertaken by our portfolio companies, such as Japanese personal care company Kao launching a set of haircare products specifically for marketing via social media, or changing the colour of certain skincare products to look more striking in Instagram photographs. We understand that these have proven to be a hit!

Another big theme was content – this is still king, whether the strategy is to develop an in-house direct to consumer ("DTC") platform like Disney or, like Comcast, to eschew exclusivity and try to be on as many platforms as possible. We broadly agree with CBS, which noted that although the content production space is increasingly crowded, excellent, high quality content will always find a way to reach the consumer "whether that's via Netflix, Amazon, Facebook or Apple". The consensus seemed to be that all content creators take DTC platforms seriously, but that truly compelling content is essential for this to work. Given Disney's recent announcement that it intends to launch its own branded streaming service in 2019 (plus an ESPN streaming service this year), we were encouraged to hear Activision Blizzard CEO Robert Kotick name Disney as "the best known Western brand in Asia" and to learn from Disney's own chairman Bob Iger that the company now boasts 11 franchises with sales of over $1bn each. Mr Iger also believes that the skinny cable bundle is the future – in his view consumers increasingly prefer to spend less on a smaller set of channels, many of which are supplied by providers unhampered by legacy technology and therefore able to offer more attractive ways to consume content, e.g. straight to mobile. He argues that most US households switching to a skinnier bundle will end up with savings of $50-75 per month, but they probably won't put the savings in the bank – they're likely to spend it on different ways to access content and Disney's direct to consumer platform should be a beneficiary of this.

Presenting at the conference was our portfolio company World Wrestling Entertainment (WWE). We have seen that it is transitioning into a DTC, media and social media company and becoming a "data powerhouse", underpinned by its unique content and global resonance. Last year WWE had 800m hours of live viewership in the US, which puts them in the same bracket as other sports leagues such as the NFL. Going forward there is scope to take the streaming product into multiple languages and currencies. Despite it being an English language, USD only product, 70% of video consumption and 27% of subscribers are outside the US – and because around 80% of all revenues come from the US, the gap between consumption and monetisation offers a real opportunity for revenue growth. We were also interested to learn that WWE is one of the earliest contributors to Facebook's new video on demand service, Facebook Watch. With 20bn video views globally across all platforms, WWE is the largest sports video service in the world (#1 on YouTube) so providing content to Facebook seems like an opportunity to extend their reach even further. Data is also increasingly important. WWE's 10m+ user accounts each generate 10,000+ data points and drive the continued uptick in digital advertising, a revenue stream that simply wasn't available previously. Perhaps the main point is the uniqueness of the content – advertisers view the WWE brand as something they want to be associated with because it's a uniquely family friendly, PG-rated sports entertainment property with very few peers. The digital and social transformation has changed the whole brand and illuminated the consumer affection for and engagement with the brand – WWE star John Cena has a decidedly non-trivial 50m Facebook followers!

We're always pleased to hear our portfolio companies being positively namechecked, so hearing Comcast call the theme park deal with Nintendo "a gigantic step forward" really underlined the value of Nintendo's IP. The aim is eventually to have Nintendo Lands in Osaka, Florida and California, which if realised would be a big change for Nintendo, which has traditionally avoided third party usage of its IP. Activision Blizzard also set out the case for video game franchises becoming "e-sports", and we wonder if Nintendo content such as Mario Kart or Splatoon might also be contenders. Comcast also highlighted the continuing appetite for sport. Advertising sales during the Winter Olympics totalled over $920m and the 2018 Super Bowl was probably the most profitable night for TV of all time – Comcast made more than $100m on one night and ad spots were sold for $5m each. In a world where advertising is becoming increasingly targeted (i.e. tailored to specific demographics via social media) sports also offer the opportunity for "old fashioned" blanket advertising coverage of consumer products, due to the sheer numbers of viewers tuning in. We anticipate increasing future competition for sports rights from the big tech players (early signs of this include the aforementioned Facebook Watch, which collects video together in an easy to find place) and we hope to participate in this with our investments in Celtic, Juventus, Manchester United, WWE and International Speedway.

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Two further important investment themes for us are a) the power of marketplaces and b) the power of eyeballs and ears. Etsy CEO Josh Silverman made the case that "there are very few two sided marketplaces at scale anywhere in the world, and they are all very valuable". While our portfolio company eBay wasn't explicitly named, it clearly falls into this category and we continue to value its powerful marketplace network effects (169m active buyers and over 1bn item listings) leading to economies of scale and excellent cash generation – compare eBay's 26% operating margin to Amazon's 3%. Just as the value of marketplaces derives in part from the power of having people congregate in one place, presenters at the conference widely acknowledged that having a huge number of eyeballs or ears on your product is an incredibly powerful proposition – even if products are as yet unmonetised or in the early stages of monetisation. The key strength of US-based music streaming service Pandora is the number of people that tune in: the data generated from being such a nexus is also very compelling, but there is still an enormous value to simply being the gathering place for millions of people. We take some comfort in this when thinking about MailOnline, which is the world's largest English-speaking newspaper website with more than 211m monthly unique visitors globally. It also comes first in the rankings of total minutes spent on UK newspaper sites, with around 1.4bn (the next are The Sun and The Guardian with c.200m each).

While I'm not sure that the likes of Unilever or Diageo are exactly what Grove would define as "internet companies", our week in San Francisco underlined the fact that whether the product is a website, a social media platform, a piece of content or a bottle of beer, digital is driving progress more than ever before. Furthermore, "digital" is bigger than just having a digital marketing strategy – of course, companies have to get this right, but they also have to think creatively and insightfully about the changing ways in which consumers access and interact with products, and tailor their approach accordingly. Certainly, there are risks in embracing technology changes, but at Lindsell Train we are sure that the bigger risk is to ignore them and miss out on the prospect of the phenomenal upside digital can offer.

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Footnotes:
[1]*Scientific American (https://www.scientificamerican.com/article/will-democracy-survive-big-data-and-artificial-intelligence/)*
[2]*Forbes (https://www.forbes.com/sites/bernardmarr/2017/06/09/why-ai-would-be-nothing-without-big-data/#7459a6144f6d)*
[3]*Wall St Journal (https://www.wsj.com/articles/gillette-bleeding-market-share-cuts-prices-of-razors-1491303601)*
[4]*Diageo*

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