



The evolution of consumer shopping habits and growth of Amazon

Over the past four years, consumers were forced to rapidly change their shopping habits. Where do we stand now? Investment Analyst Jack McManus shares insights on trends in e-commerce growth and highlights how Amazon, the largest online retailer, continues to expand, adapt and innovate to market demands.

The arrival of the pandemic really accelerated home shopping and delivery. Now that we're post-pandemic, how is this trend playing out now?

The acceleration in e-commerce growth through 2020 was one of the biggest consumer trends that we saw at that time. When the world bunkered down and we couldn't or didn't want to interact with each other, we were forced to buy more of our products online almost overnight. Likewise, the businesses that we bought them from were forced to invest in their digital capabilities just to stay in the game. What resulted was a huge spike in e-commerce penetration, or the percentage of total retail sales facilitated online. Prior to the pandemic in the US, e-commerce penetration was around 16%, and it had increased at a fairly steady pace of 1% per year.

What we saw when Covid hit is that it spiked to 22%, effectively accelerating that trend by about five years in a matter of months. We and other observers at the time thought that this would be the new normal, and that e-commerce penetration would just go higher from there. However, what we actually saw was a period of reversion, as the lockdowns ended and people went back to shopping in person again, and then a period of consolidation, where it essentially went sideways for a couple of years. Today, we're pretty much back on that old trend line where we would have been without the pandemic, and e-commerce penetration is increasing at that steady 1% per year pace again.

How has Amazon managed to grow and respond to market demands, and are there any other competitors experiencing success in this sector?

Amazon have their own vertically integrated fulfilment network, distribution network, and last mile delivery logistics network. This means that in many respects they are self-reliant and don't rely on the success or failure of third parties. So going into the pandemic they were very well positioned to react and adapt to the changing environment quite quickly. They invested heavily to increase capacity and meet the demand, effectively doubling their infrastructure footprint in about 18 months. They built out a vast, delivery network and today they're delivering more packages in the US than the national giants like UPS and FedEx. Furthermore, they are delivering those goods faster than ever, which is helping them increase market share in those more time-sensitive, everyday essential categories like toothpaste and deodorant.

The other player we're seeing gain a lot of market share is Walmart. They invested heavily in what they call BOPIS, or buy online pickup in store, and they're increasingly automating their supply chain and getting very efficient at doing that. This is helping them gain share in online grocery. It's really those two players that we're seeing get the lion's share of growth in that market.

Amazon is known for their entrepreneurial culture. What opportunities are Amazon focusing on to continue to grow?

Amazon are an entrepreneurial company and like to characterise themselves as the world's largest start-up. In some respect this is true, they do have a very entrepreneurial culture which emphasises invention and experimentation. They have concepts like agility and flexibility codified in the company's principles and you can see this in how the teams are structured and operate. At the same time, Amazon is a very large company, so there's only so many markets out there that are worthwhile for them to pursue or ventures that will actually move the needle. A few of the bigger areas that we're keeping an eye on are advertising, where they're still growing very strongly in digital advertising.

This isn't only via the sponsored ads on their marketplace but also, they're increasingly leveraging their popular streaming service, Prime Video.

In health care, we are seeing them put together a patchwork of services through both acquisition and organically. They are increasingly leaning into logistics, and we expect that they'll externalise the capabilities that they've already built for themselves to third parties. Aside from that there's other experimental moonshots in satellite internet, driverless car, robotics, just to name a few. Some of those will be successful, but many will not. We often see press articles talking about something that didn't work or that Amazon shut down, painting the company in a negative light. But we believe that's proof of a positive, entrepreneurial culture in action. As an example, Amazon were famously lampooned for their attempt to launch a phone in 2014, the Fire Phone. Admittedly it wasn't a good phone, but they shut it down quite quickly, which shows capital allocation discipline, and the lessons they learned along the way from that saga were used to launch subsequent, successful devices like the Alexa and echo speakers and the Fire tablet, so it wasn't a lost effort.

Why is Amazon a holding in the Magellan Global Fund?

The investment thesis for Amazon is premised on four key pillars. Firstly, they're a dominant leader in multiple large, attractive, and growing end markets, the largest ones being e-commerce and cloud computing. Secondly, they benefit from a combination of multiple, strong self-reinforcing competitive advantages, such as economies of scale, branding, network effects and culture. This gives us some confidence that they'll be able to maintain their market positioning, and probably improve that over time.

Thirdly, we believe profitability is going to improve significantly over the medium term due to two key things. Firstly, we believe they'll get operating leverage as they grow into the infrastructure that they've built out in the retail business. Secondly, and probably more prominently, is the positive business mix, where the higher margin businesses in AWS, advertising, and the marketplace are growing the fastest, so over time they should become a bigger part of the pie and we should see profitability overall improve.

Fourthly, we like the optionality that's inherent in this business. Amazon have a good track record of entering and winning in new markets and we expect this to continue in the future. It's hard to put a quantitative estimate on the value of something like that, but we think it provides upside and skews the range of outcomes in our favour. Regarding valuation, Amazon has been on a strong run over the past year, up almost +70%, but we think it is still attractively valued to deliver double digit returns over the next 3 to 5 years.

By Jack McManus, Investment Analyst

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