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Taking Stock with Steele

Your Monthly Newsletter

The purpose of this newsletter is to share insights and expertise. Our goal is to ensure that our clients are well informed of changes affecting local business decisions and our investment recommendations. We believe Knowledge Pays and we want our knowledge to help pay for you.

AMAZON BUYS WHOLE FOODS BEGINNING OF THE END FOR BRICKS AND MORTAR?

In June, Amazon announced that it would buy Whole Foods Market for $13.7 billion, its largest acquisition ever. Grocery and other retail and consumer products stocks fell significantly after the news broke. The stocks that fell the most have operations concentrated in the US and Europe, where Whole Foods has the greatest presence. Canadian retailers (e.g. Loblaw Cos, Empire Co and Metro) fared relatively well.

Why Did Amazon Buy Whole Foods?

Grocery delivery as a long-term play.

We believe that Amazon wants to do for grocery what it did for general retail; **automate warehouses to provide products at rock bottom prices so that physical stores cannot compete on price**. We believe the currently very low online grocery adoption rate is a major opportunity for companies looking to expand online offerings. Currently, **only ~0.7% of total North American grocery sales occur online despite roughly one in four North Americans buying some groceries online each year**. In contrast, consumers in the UK now source over 7% of their groceries online, much of which is delivered, and online grocery sales have recently been growing at a rate of 10% per year in the UK.

The grocery delivery model has inherent efficiency gains that many do not realize. In addition to a material reduction in labour and real estate costs, if groceries were delivered directly from warehouses, both consumers and retailers would benefit from the longer shelf life of fresh products as they do not sit in open air for long before reaching the consumer. Additionally, as more people adopt grocery delivery, consumers and retailers would benefit from transportation cost savings as trucks driving to and from distribution centres and individuals driving to and from the grocery store are replaced with delivery trucks fulfilling multiple orders per trip.

In 2012, Amazon purchased a company called Kiva Systems, a provider of automated storage and retrieval robots for use in warehouses. Kiva was miles ahead of its competition at the time and Amazon aimed to keep that technology all for itself. Amazon bought Kiva and did not renew all of Kiva's existing contracts with other retailers. Keeping this technology to itself has worked out well for Amazon so far.

Kiva robots move shelves of product around a warehouse to human packagers. Creating grocery warehouses with **Kiva robots would allow for grocery order packaging that is many times faster than human alternatives and at a fraction of the cost**. Currently, all grocery delivery services involve an employee walking around a grocery store shopping for a customer. Amazon's grocery fulfillment system would likely be as efficient as its

Current Rates & Data

Govt of Canada	
90 day	0.75%
1 year	1.06%
2 year	1.23%
5 year	1.55%
10 year	1.91%
30 year	2.25%

U.S. Treasury	
90 day	1.04%
1 year	1.20%
2 year	1.36%
5 year	1.89%
10 year	2.34%
30 year	2.90%

Canada Prime Rate

2.95%

U.S. Prime Rate

4.25%

Exchange Rates	
CAD/USD	0.785
USD/EUR	1.140
JPY/USD	113.2

general product fulfillment system. Like general retail, Amazon would also retain a cost advantage due to a lack of consumer facing real estate.

Any Other Reasons?

Whole Foods has **significant underutilized distribution capabilities** relative to its retail footprint. Just prior to putting itself up for sale, Whole Foods was preparing to rapidly increase its store count. The company had been building out distribution capabilities in anticipation of this growth. This distribution capability combined with a small store footprint is ideal for Amazon as it allows Amazon to use this excess distribution capability for its grocery delivery business.

Whole Foods has a **premium private label brand and good relationships with farmers**. These are two things that Amazon does not have. Amazon has the capability to create and source its own products in various product segments but creating a premium private label brand and establishing relationships with farmers would take a lot of time and investment. Why not buy one of the best private labels brands in the world?

Whole Foods customers are often Amazon customers. According to 1010data, over the 12-month period ended May 2017, 81% of Whole Foods' customers are also Amazon customers. Whole Foods and Amazon both cater to the high-spending middle and upper middle class. The majority of Whole Foods customers are already familiar with Amazon's product offering and services. Amazon should be able to capture more of these customers' total spending. Additionally, Amazon will be able to introduce Whole Foods to its customers that do not currently shop at Whole Foods without having to coax these customers into stores.

Why Would Amazon Buy a Bricks and Mortar Store Rather than Going All-In on Delivery?

We believe **in the short-term Amazon will set up a click and collect program operating in Whole Foods stores** while it develops its grocery delivery capabilities. A click and collect program is where users order groceries online, an employee walks around the store fulfilling the order and the user later picks the order up in-store. Creating a click and collect program first would allow Amazon to cultivate a large user base, get users used to ordering groceries online and then eventually convert them to a delivery model.

What Happens to Incumbent Grocery Stores?

The question below is why we think the shift to grocery delivery will come faster than expected.

"If the grocery store closest to home closes, how far would you be willing to drive to buy groceries in-store when you can get them delivered for less at every price point you wish?"

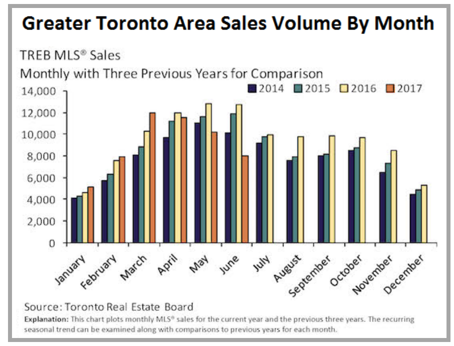
Grocery consumers are notorious for choosing the closest store over a preferred setting or brand.

Ultimately, we believe grocery stores will face a long and slow decline. Because of the way consumers adopt new technology incumbent stores should be mostly unaffected for a few years. This is particularly true for Canadian grocery stores that operate in a region where Whole Foods has an immaterial footprint and where Amazon Fresh, Amazon's grocery delivery business, is not yet established. We think Canadian stores have a better chance than most to get ahead of Amazon and compete online. For example, Loblaw and Wal-Mart have already rolled out their own click and collect programs across much of Canada.

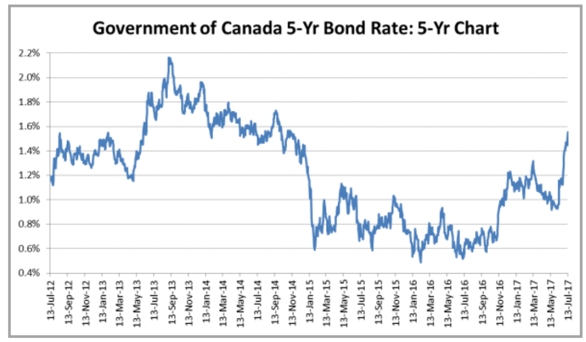
In the long run, Amazon will prove to be a formidable competitor globally in the grocery space because its shareholders are happy without dividends, happy without earnings and happy to see cash flow reinvested in the business to increase market share. Amazon has a debt-to-market cap ratio of 0.04x versus major North American grocery stores at 0.4x-1x. As a result, **Amazon already has a ~10% cost advantage over grocery stores due to its smaller debt load and no profit constraint. If Amazon develops a further 10%+ cost advantage in distribution using automation, how long can the traditional grocery store model last?**

ECONOMIC TIDBITS ONTARIO HOUSING MARKET ACTIVITY PLUMMETS & THE BANK OF CANADA RAISES RATES

• New housing market rules in Ontario have put a damper on sales activity, particularly in the Greater Toronto Area (GTA). According to the Toronto Real Estate Board, home sales declined 37% in the GTA year-over-year. More reasonably priced Kitchener-Waterloo saw sales activity fall just 3% so it is not doom and gloom everywhere just yet. Prices are starting to fall but are still near peak levels.



• On July 12, the Bank of Canada raised the key interest rate by 0.25% to 0.75%, the first hike in seven years. The bank expects the Canadian output gap to close by the end of 2017 due to strong economic and employment growth. While inflation is below the 2% target, the bank expects inflation to trend toward 2% as the output gap closes. This rate hike will raise the cost of consumer lending.



LE JIT A "JUST-IN-TIME" RUNDOWN OF OUR CURRENT INVESTMENT THEME

Companies That Are Quite Immune From Interest Rate Hikes and Not Reliant on Rip-Roaring Growth

- **Open Text Corp (OTEX)** and **Jean Coutu Group (PJC.A)** are two ideas related to this theme.
- **Open Text** is a leading provider of enterprise software. Open Text trades at ~11.5x forward EV/EBITDA, a discount to its peers at an average of ~14x. On the surface, this discount could be reasonable due to Open Text's higher debt load. That said, Open Text's earnings have been relatively depressed over the past year due to its above average exposure to currency fluctuations and relatively unfavourable product cycle timing. Management has stated that it is looking to deploy ~US$3 billion for acquisitions over the next few years. After a period in which the company made only a few minor acquisitions, we can see an acquisition renaissance on the horizon following four $100M+ acquisitions in the past eight months.
- **Jean Coutu** is a Quebec-based drugstore chain and generic drug manufacturer. Jean Coutu has meaningfully underperformed its consumer staples peers as a result of its limited growth and the looming effects of Quebec's Bill 81 (which allows government to initiate tendering processes for generic drugs) which is expected to pressure PJC.A's margins. We believe Bill 81 will be scrapped in line with similar bills in Ontario and Saskatchewan. If Jean Coutu monetized its assets, boosted its debt load to match that of its peers and uses those funds to buy back stock, it is our view that the shares could trade at close to 10x earnings. This compares to consumer staples and pharmacy peers at 12x-24x earnings.

JEANNINE'S TIP O' THE MONTH Save the Date

Tuesday, September 19, 2017 @ 6:30pm

Raymond James Ltd. invites you to an exclusive presentation featuring:

Dennis Mitchell, Senior VP, Senior Portfolio Manager, Sprott Asset Management.

Watch for more details from us regarding this presentation to be held at Westmount Golf and Country Club.

Feel free to express your interest in this event to us.

This newsletter has been brought to you by Steele Wealth Management

Brian Steele, CA, CPA, CFA | Jeannine Campbell | Laura Prust, CIM, CPCA
Kelly Edmonds | Matthew Bell, CFA

Phone: (519) 883-6030 Toll-Free: 1 (877) 642-6408

Email: steelewealthmanagement@raymondjames.ca

Address: Unit #1 595 Parkside Drive | Waterloo, Ontario | N2L 0C7

Website: www.steelewealthmanagement.com

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