



November 17, 2017

Q3'17 Investment Commentary

One of our biggest mistakes was not investing in Amazon shortly after reading Josh Tarasoff's 2012 VALUEx presentation, instantly recognizing the appeal and dismissing a potential purchase on account of the stock being "too expensive."¹² We will forever hold ourselves accountable for this mistake, while simultaneously self-reflecting on what we can do to avoid this mistake in the future and figure out where and how value does accrue in commerce today. In considering Amazon today, especially the stock, we all need to recognize that the perception pendulum has swung from perhaps "neutral" to exceedingly bullish. The fear of Amazon is so acute across various sectors that merely the whisper of Amazon's encroachment in a given vertical moves market caps billions of dollars in a matter of seconds. As such, it is imperative that every investment manager and corporate manager recognize where and how their business does and might compete with Amazon in the future and consider what can be done to entrench any advantage that may exist as of today. Further, all stakeholders need to consider what their markets might look like over the course of five to ten years down the line since this is the playing field upon which Amazon's shareholders afford it the right to compete.

In reflecting on our experience (or lack thereof) with Amazon, we think one of the company's biggest successes is how they have changed consumer behavior and made buying online easy. With Prime, consumers know that whatever they may want can be bought and received within two days—Amazon has literally become the "Everything Store." While Amazon was the first to drive this change in behavior, and has been the primary beneficiary thus far, they did something else at the same time: they opened the door to other different mediums for transactions and opened consumer minds to exploring more online consumption opportunities. Changing behavior from offline to online was the seminal achievement of Prime. Incumbents and upstarts alike cannot at this point displace Amazon; however, in the right situations, they can defend their own turf or forge new paths for themselves. If it sounds like we are anti-Amazon, let us clarify: we are not. We are Prime members, habitually ordering a variety of products from Amazon, but we are also bargain hunters. As bargain hunters we both scour for the best combination of quality and price when in the market for a product purchase, and we look for situations in markets where there is a disconnect between sentiment and reality. There is no larger disconnect in our assessment of the market today than the implicit inevitability of Amazon's dominance across a host of domains. When Amazon sneezes interest, the target sector immediately catches a bad cold. It has

¹ <https://twitter.com/ElliotTurn/status/297072766518177792>

² <https://www.scribd.com/document/98208572/ValueXVail-2012-Josh-Tarasoff>



reached a point where even if Amazon does fulfill its rhetorical predestiny, there is ample room for others to succeed. In fact, we see several unique niches being carved out or already dominated by competitors whose servings meet a balancing of demands between quality, price and convenience.

While Amazon has been conscious of vast potential future profit pools and willing to forego short-term profits for long-term potential, its scale and many simultaneous efforts will leave room for competitors to carve out enough of their own scale within niches to create their own offering premised on something other than mere convenience. We see the following opportunities for companies differentiate their offerings from the acknowledged leader:

- Higher touch, service and education element
- Smart curation in areas where selection matters
- Trade away the convenience of fast shipping for even lower prices
- Immediacy that next day is not enough for
- Low volume, high price
- Quality that inspires passion and a direct brand relationship
- Unbiased openness

Acquiring customers isn't necessarily easy, but cheap capital has afforded these nascent startups the opportunity to offer meaningful subsidization of everyday products. We initially mocked the idea of Jet when the company was featured in the Wall Street Journal for its negative gross margins--in other words, the more product Jet sold at the time, the more money they lost.³ At the same time, we were cognizant that Marc Lore is a force to be reckoned with and he had a sensible idea for incentivizing optimized shipping structures while kicking back the savings to customers. Immediately upon the Walmart acquisition it struck us that perhaps Jet, Lore and the VCs involved knew of Walmart's interest and merely needed to prove concept in order to bring about a swift acquisition and meaty IRR.

This Amazon prelude offers the opportunity to visit one of our best (PayPal) and one of our worst performers (Walgreen's) so far this year.

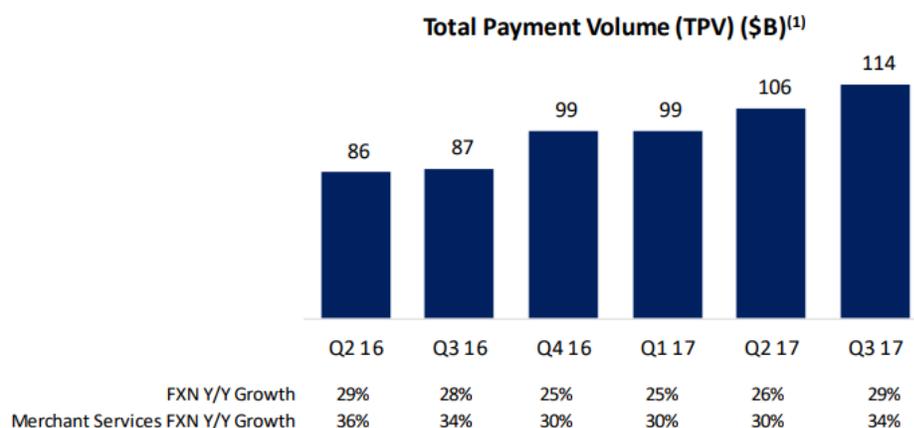
1 - Amazon's share of e-commerce = PayPal's opportunity

³ <https://www.wsj.com/articles/jet-com-runs-into-turbulence-with-retailers-1438899476>



One of our theses behind PayPal has been how significantly the company stands to benefit for online consumption outside of the Amazon ecosystem.⁴ To that end, their growth in Total Payment Volume (TPV) is a great proxy for the growth in online sales-ex Amazon.

Gaining Share



- Merchant Services (non-eBay related) volume represented 86.5% of TPV in Q3-17. 34% growth on an FX-neutral basis driven by core PayPal and Braintree
- Mobile volume growth of 54% in the quarter. Mobile TPV was approximately \$40 billion in Q3-17, representing 35% of TPV
- Approximately 21% of TPV in the quarter came from P2P, which includes core PayPal, Venmo and Xoom. Venmo volume was up 93% to \$9.4B in the quarter



⁽¹⁾ Definition included in Supplemental Information.

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As the chart above and PayPal’s stock’s price clearly indicates: e-commerce outside of Amazon has been vitally strong this year.⁵ Stated differently: there are beneficiaries other than Amazon of this sweeping change in consumer behavior, though this is not a story we often hear. Amazon created the “1-click” buy button, but PayPal has made the login-free “One Touch” buy button ubiquitous on every non-Amazon

⁴ For our fuller PYPL thesis, check out the presentation from 2015 <http://www.rgaia.com/ebay-paypal-split-analysis-buy-two-moats-for-the-price-of-one/>

⁵ http://files.shareholder.com/downloads/AMDA-4BS3R8/5421520140x0x960247/15B1F272-F94C-4743-84BB-A36C509F557C/Investor_Update_Third_Quarter_2017.pdf



shopping experience and in virtually all important mobile apps. In fact, offering this as an “open-source” payment stack has been one of the key drivers of the explosion in innovative apps. For retail, it has been a key tool to foster improving shopping cart conversion rates. For consumers, PayPal has been a secure, easy payment platform that facilitates less sharing of sensitive financial information, ultimately creating fewer points of failure for credit card or identity theft.

PayPal itself is a key player behind behavioral change in commerce as well: PayPal was early to pointing out how the lines between a point-of-sale transaction and an online transaction are blurring. An oft-repeated example is how someone can buy goods online at Home Depot and pick up in-store. This is happening with increasing frequency. Similarly, in the past, when you ordered Chinese food from the local restaurant, this was registered as a “POS” payment, but now the same transaction made on Grubhub is recorded as “online.” As consumer behavior continues to evolve, the variety of offerings catering to this new demand is growing.

Amazon has not hid its ambitions of capturing more payment share, yet merchants need to think hard about whether they truly want to share key data with a company that could inevitably turn into a competitor.⁶ While Amazon claims merchant data is anonymized, Amazon has not been shy about competing directly with companies who were customers of Amazon platforms. PayPal is the only truly open, unbiased end-to-end solution for e-commerce and we think it has a long runway for future success.

Walgreen’s: delivering on better outcomes at a lower cost

While PayPal is a new ecommerce company of similar vintage to Amazon, Walgreen’s is an old-world, century old stalwart. In further contrast to PayPal, Walgreen’s stock has been our weakest holding thus far this year. Given the weakness in Walgreen’s stock, one would assume from the look of things that Amazon is already competing with the company and inflicting considerable damage. That assumption would be wrong. Evidence of the zealotry behind the Amazon fear is all over Walgreen’s stock. Starting with Amazon’s acquisition of Whole Foods in mid-June, there have been three further instances of Amazon-related headlines leading to 5% or greater drops in Walgreen’s stock.

⁶ <https://www.cnbc.com/video/2017/10/23/amazon-pay-vp-on-amazons-push-into-payments.html>



It has reached the point where outside of the financial crisis and the company's dispute with Express Scripts (during which we commenced our position), Walgreen's has never seen such lush free cash flow yields:



Meanwhile, in Walgreen's own business they continue to take share from other pharmacies (CVS included) on prescriptions and have finally completed a complex and drawn out regulatory process for the acquisition of a large swatch of Rite-Aid stores. The delay in completing this acquisition was no doubt a sore point for Stefano Pessina in pursuing his typically aggressive M&A strategy, though it has not hindered Pessina's fostering of new partnerships to position the company for success in an evolving healthcare landscape (look no further than the creation of a strategic alliance with Prime Therapeutics for a new kind of PBM).⁷

Amazon's ability to compete on a longer timeframe than competitors has been a crucial source of advantage and thus for Walgreen's, Pessina himself is a key competitive advantage the company has that others have not. In many respects, Pessina should be the next chapter in William Thorndike's acclaimed "The Outsiders" exploring CEOs with non-traditional backgrounds who built incredibly successful businesses and wealth for themselves and their shareholders. Pessina is a self-made billionaire who after having finished his academic career in nuclear engineering took over his family's small pharmaceutical wholesaler. At the small family business, Pessina commenced a string of

⁷ <http://news.walgreens.com/press-releases/general-news/walgreens-and-prime-therapeutics-agree-to-form-strategic-alliance-includes-retail-pharmacy-network-agreement-and-combines-companies-central-specialty-pharmacy-and-mail-service-businesses.htm>



acquisitions—both vertical and horizontal in nature—ultimately building the most formidable global pharmaceutical organization. Pessina’s vision and large ownership stake insulate him from the short-term pressures that so many of Amazon’s competitors have succumbed to.

Importantly, there are no signs in any financial performance to-date that Walgreen’s is in fact vulnerable; however, from the outside, the company’s US-heavy retail footprint appears primed to lose business to Amazon. Pharmacies in the US are a complex, highly regulated business with multifaceted relationships. In most cases, the person purchasing a drug at the pharmacy counter is not the person paying for it—that would be the PBM. Deals with PBMs can be complex (as was evidenced by the past Walgreen’s/Express Scripts problems) and competitive. Even were Amazon to make inroads in pharmaceuticals, the shape of the competitive market needs to be contextualized: Walgreen’s retail foot-print has already withstood competition from “convenience” and “price sensitive” mail order business driven by PBMs. Global scale at Walgreen’s is a crucial driver of a cost advantage that has led to the capture of share from peers. This has been aided by the company’s growing stake in AmerisourceBergen. Moreover, Walgreen’s has key profit-pools that are largely immune to Amazon’s foray into pharmaceuticals including, but not limited to same-day needs, vaccinations, a European wholesale and distribution business, and a thriving portfolio of proprietary cosmetics mainly sold in Europe.

With all this said, it’s worth concluding by pointing out it remains uncertain if, or even how Amazon will try to compete in this industry. If they do, there will be losers, but Walgreen’s will be fighting from a strong, defensible position. Alternatively, should Amazon opt not to compete, it would be but one more indication that Walgreen’s is a truly special business.

What do we own:

The Leaders:

Investnet, Inc (NYSE: ENV) +30.40%

GrubHub Inc. (NASDAQ: GRUB) +20.78%

PayPal Holdings, Inc. (NASDAQ: PYPL) +19.86%

The Laggards:

AmerisourceBergen Corp (NYSE: ABC) -12.06%



Twitter, Inc. (NYSE: TWTR) -5.60%

The Howard Hughes Corp (NYSE: HHC) -4.00%

Thank you for your trust and confidence, and for selecting us to be your advisor of choice. Please call us directly to discuss this commentary in more detail – we are always happy to address any specific questions you may have. You can reach Jason or Elliot directly at 516-665-1945. Alternatively, we've included our direct dial numbers with our names, below.

Warm personal regards,

A handwritten signature in red ink, appearing to read "Jason Gilbert".

Jason Gilbert, CPA/PFS, CFF
Managing Director
O: (516) 665-1945
D: (516) 665-1940
M: (917) 536-3066
jason@rgaia.com

A handwritten signature in dark blue ink, appearing to read "Elliot Turner".

Elliot Turner, CFA
Managing Director
O: (516) 665-1945
D: (516) 665-1942
M: (516) 729-5174
elliott@rgaia.com

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