VENATOR
CAPITAL MANAGEMENT LTD.

AMAZING AMAZON AND THE CULT OF EVERYTHING ELSE

Instrument (Inception)*	July 2017 Return	Year-to-Date Return	Compound Growth
Venator Founders Fund (March 2006)	**0.9%**	**-3.6%**	**11.3%**
Venator Investment Trust (September 2007)	**0.9%**	**-3.7%**	**7.7%**
Venator Income Fund (August 2008)	**0.0%**	**4.1%**	**11.9%**
Venator Select Fund (September 2013)	**-1.8%**	**-10.2%**	**11.3%**
S&P/TSX Total Return (March 2006)	-0.1%	0.7%	5.3%
Russell 2000 (March 2006)	0.7%	5.8%	7.5%
S&P Toronto Small Cap (March 2006)	0.0%	-4.1%	2.1%
S&P 500 (March 2006)	2.1%	11.6%	8.2%
Merrill Lynch High Yield Index (August 2008)	1.2%	6.1%	9.1%

We thought it would be a good exercise to share our views on Amazon and its wide-ranging impact (both real and imagined) on the various industries and investments that we look at on a day-to-day basis. We aren't talking about the stock mind you; Amazon is an incredible business and its high stock price reflects that quality. Instead, we are focusing on how to best navigate its effects on the rest of the businesses within its sphere of influence. That sphere currently encompasses third party consumer goods (books, toys, etc.), private label (batteries, pet products), shipping, payments, advertising, corporate computing, home automation (Echo/Alexa), physical retail, grocery, and media (Amazon Prime); and it appears to be ever expanding.

I have been around long enough to remember Amazon's start as a humble, money-losing internet retailer of books. This model was presumably chosen in part due to the cost and ease of shipping but, more importantly, the point that the book industry works on a unique working capital cash conversion cycle. A book retailer gets the books without paying for the inventory first, sells them, and then pays the publisher afterwards, which creates a self-funding model unlike other products where a retailer pays for inventory up front. In the end, this probably wasn't a great business, and hardly justified Amazon's lofty valuation going into 2000 (before the stock fell by 90%, taking 10 years to fully recover and permanently break out from its dot-com-bubble high in 2010).

However, Amazon evolved expanding into toys, DVDs, and electronics to name a few items. Again, internet retailing is a marginally profitable business, if at all. But along the way Amazon started selling other people's stuff, allowing companies to leverage its logistics, distribution and warehousing network, and taking a slice/toll from every sale, a segment that was guaranteed to be profitable. Two other major business initiatives then came along in the form of Amazon Prime subscription services (the best deal in retail/entertainment content), and Amazon Web Services (corporate network hosting). The latter, which basically has Amazon acting as the backbone for other companies' technology platforms, is currently believed to account for nearly 50% of the company's total value at this point.

Witnessing the continuous evolution of Amazon, and how it has happened more-or-less organically, speaks to the vision of its founder Jeff Bezos. Amazon version 1.0/2.0 (selling stuff) really wasn't worth much in hindsight, but version 3.0 (selling other people's stuff) solidified the platform, while version 4.0 (Amazon Prime) and 5.0 (Amazon Web Services) together easily represent two-thirds-plus of the value of the business today. We shall

see where Echo/Alexa (version 6.0) takes them as it seems to be off to a better start than Amazon's previously failed forays into consumer electronics (I have yet to meet anyone that owned a "Fire" phone or tablet).

It's also worth noting that Amazon has left a sea of weakened or destroyed companies in its wake, especially in retail, as a result of its growth process. A wave of retail bankruptcies and vacancies is part of the legacy of Amazon, as leveraged competition couldn't handle the shifting ground (see Circuit City and Chapters). Those without leverage have been weakened and their growth prospects have been severely curtailed as physical location and margin expansion are near impossible now (see Best Buy and Walmart). It's interesting to hear the views of retailers regarding the current landscape. One consumer products company recently said to us "if you think you are ever going to raise money on a toaster again, your business model is flawed", while another retailer complained that "Amazon sells the same stuff as us, for the same price, with the same shipping terms, and yet makes one-third the margin; why then, is it considered such great retailer?". You can feel the frustration as the brand itself starts to take over from reality. Ordering is simple with a Prime Account already set up, and people trust they are getting competitive prices even though this is often not the case (tip: always start your search by checking the "Prime" box on the left column to make sure you don't get ripped off on shipping costs from third-party sellers).

One lesson to be learned from the wreckage Amazon has left behind is that there is no more dangerous a competitor than one that can lose money without consequences. This is a tough luxury to achieve, especially in supposedly competitive marketplaces, with already established large and profitable competitors. Barnes and Noble could not declare that they were going to start losing money to fend off Amazon, any more than BMW can start losing billions of dollars on cars and a charging network to fend off Tesla. A CEOs tenure simply isn't long enough to afford a 50% haircut to its stock price, in hopes of taking a currently profitable business into a multi-year loss scenario, especially since most money losing, high growth upstarts end up going out of business.

The natural fallout from Amazon's growing sphere of influence is the knee-jerk reaction of any business Amazon might one day be competitive with. No one wants a competitor's CEOs personal slogan to be "your margin is my opportunity", much less a well-capitalized one with unlimited funds to make it happen. The narrative of Amazon has inevitability done an incredible amount of damage to shopping mall REITs (foot traffic), retail (foot traffic, margins), industrial distributors (margins), automotive parts, sporting goods, pet supplies, data centers (margins), consumer products (margins, channel dislocation) and, most recently, grocery.

Just the mere mention that Amazon may peripherally enter a market can create havoc with speculative sentiment alone. Recently, we saw home improvement leaders Home Depot and Lowes fall precipitously on news that troubled retailer Sears was going to sell their dying appliance brand Kenmore on Amazon.com. Several days later, a small article pointing out that there was a healthcare division inside Amazon looking at telehealth sent market leader Teledoc's stock down 10%. While this was bad short-term news for Teledoc shareholders, the decline gave us an opportunity to pick up some of its convertible bonds, which we had been eyeing for some time.

Below we have highlighted some investments that we have made with Amazon-ish factors in mind. There are others we own or are looking at, but the bottom line is that for anything which Amazon can have a real or perceived influence on, the short-term reality is that the market makes it real, so you need to have a strategy for how the presence of Amazon can, will or is effecting your investments.

GAP (long): The Gap is something of a poster child for a post-Amazon narrative: even if Amazon can't sell the same product as you, they will mess with your mall traffic. The Gap is also seen as stale from a fashion

standpoint. That said, we believe that at a low multiple of less than 10x free cash flow (soon to benefit from US corporate tax cuts) and a clean balance sheet, the complacency/bear thesis has the potential to be turned on its head. Yes, Amazon can steal mall traffic, but the Gap can sell online too. Furthermore, unlike a department store, Amazon can't sell Gap brand items; if you want the Gap, Old Navy or Banana Republic, there is only one place to get it. Financially, the Gap appears to be stabilizing, with Old Navy growing at a healthy clip (children's clothing is a strong market in general), although the smaller Banana Republic brand is admittedly struggling. Gross profit has stabilized and is growing, and the company is likely looking at favorable lease negotiations in the future due to a sea of private-equity sponsored retail bankruptcies, which could possibly lead to more traffic for surviving retailers, even if overall mall traffic declines (bigger slice of a smaller pie). That said, the quickest road to stock price increases could be following Restoration Hardware's recent model of a public leveraged buyout. Restoration Hardware managed to buy back 50% (!) of its stock in six months. If the Gap, which is in a far more stable financial position than Restoration Hardware, were to follow suit its end-game debt levels would still only be 5x its free cash flow, which we consider very manageable (we have no idea if this is about to happen, but the company has recently reinitiated its stock buyback program which was dormant for twelve months).

TESLA (long convertible bonds): Tesla, like Amazon ten years ago, is a great company whose future profitability is still up in the air, which makes the stock appear expensive. But unlike Amazon, we can own Tesla's convertible debt which rewards us with nearly all the upside over the next five years, with very little downside. Like Amazon, Tesla can operate without regard to profitability in the name of growth, while more established competition does not have that luxury. This is what gives Tesla the ability to disrupt the auto industry with marginally profitable cars, and billions of dollars spent on gigafactories and charging networks. I am quite certain that competitive executives are reluctant to declare that they have decided to become unprofitable for the next five years, and are going on a debt-financed infrastructure spending spree to compete with Tesla. The Model 3 is gaining great reviews, and is quite possibly set to take up to one-third market share in cars over US$30,000 over the next two years. Another parallel to Amazon would be its Solar City subsidiary. This would be akin to Amazon Web Services, as a seemingly unrelated but potential game changer within its sphere of influence. Solar City's next big thing is good-looking solar roof tiles that can take a home totally off the grid. While Tesla is not even remotely within Amazon's sphere of influence, the parallels of its evolution vs Amazon's cannot be ignored.

ENERGIZER (short): Energizer is a curious company in that there can be no doubt that their overall volumes of batteries sold are in permanent decline, and yet the stock trades at a market multiple. Battery volumes have been under pressure for many years now, a condition that is expected to persist into the future. Exasperating matters now is the "Amazon Basics" line of batteries which is likely set to grab nearly all battery volume on its website (Amazon's Echo/Alexa home AI product doesn't even give you the option to buy a brand of battery other than Amazon Basics). While Amazon's batteries may be inferior in terms of performance, I doubt most people will care given the severely discounted price, even if they are aware of the performance differential. Most of the stock's movements are based on inventory shuffling within its customer base and promotional activity, but there is still a long-term and accelerating deterioration the company can't escape from.

WALMART (short): Walmart's stock, trading at market multiples, continues to defy logic relative to every other company that finds itself directly in Amazon's line of fire. The global retail behemoth is now in the middle of its fourth year of declining earnings on flat organic revenues. The upward wage pressure they have been experiencing is not in their control, even if they want to pretend it is voluntary. I would also argue that price deterioration is a competitive response; again, this is forced, not voluntary. With Amazon now targeting grocery

through its purchase of Whole Foods, as well as lower income families, they will now be going after the two segments that were previously Walmart's Amazon-dodge, which currently represent well over 50% of Walmart's business. Given Walmart's slim 5% operating margins, and Amazon's possible willingness to operate Whole Foods below this level (Whole Foods is only a 5% operating margin business currently), coupled with a likely willingness to operate the low-income part of the business at near breakeven levels, we would look to more downward earnings revisions for Walmart in the coming years.

As always, we reserve the right to change our mind!

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