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Don't Be a Consumer Dinosaur

December 2015

"The way I go through razors, I'll be extinct at these prices!"

The Consumer Staples sector logged solid stock market performance in 2015, outpacing the S&P 500 Index. Intra-sector performance, however, varied widely, even among companies we might consider similar blue chips. Clorox enjoyed double-digit appreciation, while Procter & Gamble saw a double-digit share price decline, and Church & Dwight came in between the two. Changes to the market landscape are forcing Home and Personal Care companies to evaluate past practices and develop new strategies to address the evolution of consumer preferences and purchasing behavior.

At the risk of stating the painfully obvious, the internet factors dominantly in the changes taking place in Home and Personal Care and has dramatically affected the way consumers compare, shop for, and receive products. Perhaps the least appreciated of these is the last one – distribution. Of course, there's the ubiquitous brown cardboard box with the Amazon logo on the side, but most people receive only one-off items: a book, some electronic gear, a toy, etc. Recently we have entered an era in which direct-to-your-door distribution has widened to encompass more prosaic goods, such as pet food, razors, and toothbrushes, replenished on a regular delivery schedule. Before long many more of us may switch from retrieving our consumer staples products at the supermarket or big box store to receiving them at our homes. This has significant implications for the businesses of many old-line consumer blue chip companies. Let's examine the most successful example to

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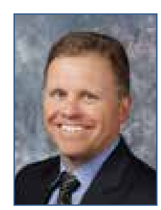

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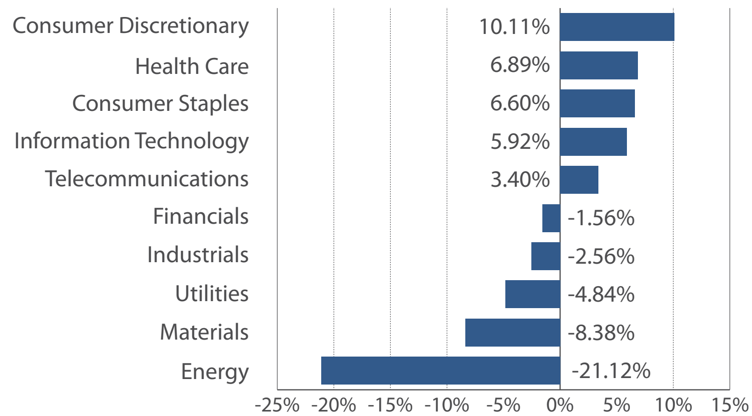
date of a new distribution model establishing a beachhead on long protected shores: the razor.

S&P 500 Sector Returns
(for the period 12/31/14 - 12/31/15)



Source: Bloomberg

For years disposable razor cartridges have been one of the great business success stories. We even speak of "The Razor Blade Model" as shorthand for a business that generates consistent sales and supernormal margins by supplying a consumable (cartridges) that the customer purchases because of sunk costs in a system (the razor handle). Constant "innovation" such as more blades, an aloe strip, vibration, etc., justifies the cartridge's steep price and leads to unique profitability. So valuable was the model that in 2005 Procter & Gamble paid $57 billion in stock to purchase Gillette. Today P&G's grooming division stands as its most profitable. A fundamental rule of capitalism proclaims that if you make a large enough profit on your business, eventually somebody will attack it. But, in this example, the attack couldn't come until the internet transformed consumer shopping habits, corporate marketing tactics, and distribution channels.

The attack arrived in 2012 with the launch of Dollar Shave Club (DSC). Today, DSC has over two million subscribers who purchase a razor handle and pay a modest monthly fee to receive a set of cartridges. DSC also provides shaving cream and other products. The razors are less complex than Gillette's, but they cost less. DSC never advertised during the Super Bowl or blitzed the airwaves during sweeps week, and you won't hear about it on drive time radio. Instead, DSC posted an entertaining YouTube ad that has pulled 21.5 million views. The products arrive at your door, so no more asking a sales associate at Walgreens to unlock the razor cabinet.

Meanwhile, another company has entered the fray. Harry's provides a slightly more upscale product, courtesy of the fact that the founders used part of their venture capital to buy a century-old razor blade factory in Germany. That makes the company unique in the industry as the only completely end-to-end supplier. At least it was until P&G finally realized what was happening and launched its own shave club, which isn't surprising considering that its grooming sales in the most recent quarter dropped -14%. In fact, P&G has now gone so far as to sue DSC for razor blade patent infringement. Suffice it to say "The Razor Blade Model"

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won't look the same going forward. Clearly DSC does not bear responsibility for P&G's quandary, but the fact remains that P&G's share price declined -12.82% in 2015. While those of us who have been paying egregious prices for razor blade cartridges may engage in a bit of schadenfreude at Gillette's expense, the key point is that the disruption could not have taken place absent a few technological and cultural shifts. DSC and Harry's needed a way to reach millions of consumers without spending much money (YouTube and website ads), an audience accustomed to ordering things online, and an inexpensive distribution system to get their products to customers cheaply and reliably (thanks to Amazon for forcing FedEx and UPS to invest).

Where might the new model strike next? Perhaps Quip has the answer; the question being, "Why did I pay $100 for an electric toothbrush and charger and then pay $30 for a set of two replacement toothbrush heads?" As with DSC, Quip offers a simplified product (electric toothbrush) and regular brush head replacements for a substantially lower price than one would typically find in Bed Bath & Beyond. Since Quip received its venture funding in early 2015, the company has yet to gain significant traction, but DSC's two million subscribers didn't arrive overnight either.

If your product is used on a regular schedule and your customers are taken aback by its replacement cost, your profit is at risk.

The message is clear: Companies that have enjoyed quasi-monopoly positions and supernormal profitability on daily use items should expect challenges, and successful challenges will affect the incumbent's sales, margins, and, for listed companies, share prices. If your product is used on a regular schedule and your customers are taken aback by its replacement cost, your profit is at risk.

Nor is this phenomenon restricted to the US, which we often think of as being at the forefront of the internet economy. Ever since the introduction of the iPhone, e-commerce has been migrating from the desktop to the palms of our hands through smartphones. In this instance, China leads the way. According to the US Census Bureau e-commerce accounted for 5.8% of total US retail sales in 2013, while the figure for China was 8.3%. Mobile or m-commerce alone held a 4.7% share in China in 2014. With less developed fixed-line, DSL, and cable infrastructure than in the US, Chinese consumers use their mobile devices as their primary source of internet access. As a result, e/m-commerce has boomed, and China has birthed such internet behemoths as search engine Baidu (market cap $68 billion), online gaming and instant messaging leader Tencent (market cap $182 billion), and online marketplace Alibaba (market cap $208 billion). Arguably, China's high population density will favor even more development of e-commerce and home delivery services for a wide variety of products.

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In short, the internet not only offers a convenient way to seek out and review a wide variety of products, it presents a significant threat to traditional companies that fail to anticipate or adapt to its potential. The internet also offers a means for start-ups to inexpensively broadcast their message and contributes to the development of distribution models that make it economical to receive regular, small volume packages. If there's another message, it's that consumers appear to be getting really tired of paying $30 for a set of five razor cartridges or two toothbrush heads.

(As of November 30, 2015)

Ownership of Publicly Traded Securities Mentioned	Amana Growth	Amana Income	Amana Developing World	Saturna Sustainable Equity	Sextant Core	Sextant Growth
Alibaba						
Alphabet, Class A (owns YouTube)	2.25			2.73%		1.81%
Amazon.com						1.43%
Apple	4.45%			1.86%		4.94%
Baidu			2.97%			
Bed Bath & Beyond						
Church & Dwight	3.69%			1.00%		
Clorox	1.94%					
FedEx						
Procter & Gamble		0.84%			1.87%	
Tencent			1.01%			
United Parcel Service, Class B	2.35%	2.30%				
Walgreens Boots Alliance						

Security weightings are shown as a percentage of a Fund's total net assets. Amana Participation, Idaho Tax-Exempt, Saturna Sustainable Bond, Sextant Bond Income, Sextant Global High Income, Sextant International, and Sextant Short-Term Bond Funds did not own any securities of the companies mentioned.

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