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# Allianz Europe Equity Growth Strategy vs. Business Disruption

AllianzGI Business Disruption Series



**Marcus Morris-Eyton**  
Portfolio Management  
European Equities

## Business Disruption—a threat or an opportunity?

One consequence of technological advances, and changing consumer expectations, is that almost all business models are inherently less durable than they used to be. Businesses are required to perpetually innovate, and can no longer rely on the best execution of a previously successful business model to survive.

Disruption is occurring all around us, to the extent that we now live in a world where the world's largest taxi company (Uber) owns no taxis, the world's most popular media site (Facebook) creates no content, the world's largest accommodation provider (AirBnB) owns no property, and one of the world's most valuable retailers (Alibaba) owns no stock. For business owners and investors, this creates both opportunities and risks alike, as many traditionally sound business models are turned upside down, and threatened with either disruption or outright extinction.

Investors – particularly long term investors – cannot afford to ignore disruption, as it threatens the existence of every successful company. As growth investors, our analysis often leads us to specific industries or companies experiencing high growth rates, but what distinguishes the good investment from the bad investment is not the level of growth per se but the sustainability of that growth. The biggest risk to growth stocks, where valuations are rarely cheap, is often the erosion of their market leadership or previous competitive advantages in the face of new competition. Such instances invariably lead to a swift collapse in the stock's multiple with share prices falling even faster than they rose. On the positive side, since almost all financial analysts incorporate fading growth rates into their valuation models, there are rich rewards for companies that can either sustain or further increase their growth rates over the longer term.

It is for this reason that we believe any company analysis should focus not purely on the financials, but crucially also on understanding the long term sustainability of a business model. This is gauged not through financial modelling but by analysing many of the softer factors that make a business unique. One must look for "the economic moat", or barriers to entry that can enable a company to sustain a competitive advantage, and maintain or ideally improve their market position over the long term. Such factors vary from industry to industry but include brand or product differentiation, economies of scale, access to distribution channels, supplier relationships, and customer loyalty. This competitive analysis is not new and is similar to what Michael Porter famously coined with his Five Forces, but becomes all the more relevant in this disruptive age, and is vital to any investment decision the growth team makes.

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**Understand. Act.**

Using barriers to entry to generate pricing power<sup>1</sup>**Product Value**

- Perceived product quality
- Pricing power supported by either cost of product failure or value added

**Customer Relationships**

- Strong and durable client relationships
- Generating customer loyalty
- Controlling distribution channels

**Industry Competitors**

- Fragmented and consolidating market
- Oligopolistic structures

**Supplier Relationships**

- Working with the supplier
- Supplier market structure, fragmented market, value added for supplier, economies of scale

**Barriers to entry / market leadership**

- Investing to raise barriers to entry
- Using size and continued investment to secure barriers to entry

Perhaps the clearest example of strong barriers to entry is through the creation of a brand. Brands, and the associated product reputation, generate barriers to entry and customer loyalty in almost any industry or product line. Perhaps most obvious in the luxury goods market, where the brand arguably assumes greater importance than the good itself. Take for example luxury brands like Louis Vuitton or Cartier – in many markets purchasing such a brand has become viewed as indicative of social status. This ensures consumers are usually willing to pay a premium above goods of a similar quality in order to own that brand, providing the luxury brand with not only pricing power and margin uplift, but also crucially barriers to entry. Since luxury brands take decades to build up and refine, the incumbents benefit from high barriers to entry, and a relatively low threat of disruption from new entrants.

Often the best defence against disruption is by making your product indispensable to your client. In technology this is increasingly done by no longer owning the good itself but by owning the customer interface (e.g. Uber or Facebook), whereas in industrials it is achieved through integrating a product/ solution within a supply chain. One company that does this successfully is the French industrial company Legrand, who sell electrical components (power sockets, circuit breakers etc) largely to professionals. In order to breed customer loyalty, Legrand have created free training seminars for electricians and engineers to enhance their skill set.

Naturally these training seminars are usually run with largely Legrand products, so when the electrician comes to practice, they find themselves reliant on the Legrand devices from which they learnt the trade.

Disruptive threats are not always easy to identify as an outsider, which is why it is important to analyse a business from all aspects of the supply chain. At Allianz Global Investors we benefit from the use of our Grassroots<sup>SM</sup> Research<sup>2</sup>, to understand the strength of relationship at both a supplier and end customer level. For example when one of our holdings within the hospitality industry decided to trial a coffee company spinoff in France (and thus become a disruptor), rather than wait for results, we were able to speak directly with the French store managers to gauge the customer reaction to the product offering, and likely sales trends.

Other examples of surveys we regularly run on our holdings include those designed to gauge the likelihood of a customer switching product/ supplier, or the impact of potentially disruptive new products or legislation (e.g. e-cigarettes or plain packaging for cigarette producers). This research and dialogue across the entire supply chain helps with early recognition of both disruptive threats and opportunities.

Despite all the attempts to disrupt or destabilise existing businesses models or industries, only a few succeed, and develop into interesting investment opportunities.

<sup>1</sup> Michael Porter Five Forces Model, for illustrative purposes only.

<sup>2</sup> Grassroots<sup>SM</sup> Research is a division within the Allianz Global Investors group of companies that commissions investigative research for asset-management professionals. Research data used to generate Grassroots<sup>SM</sup> Research reports are received from reporters and field force investigators who work as independent, third party research providers, supplying research that is paid for by commissions generated by trades executed on behalf of clients.

One industry that is clearly undergoing significant structural disruption at present is the autos industry, through megatrends such as fully autonomous driving, safety regulation and emission reduction etc. These trends are leading to greater component content in cars (the average car now includes more than 170 sensors and 150 actuators), which means it is not the car makers that are profiting but largely the auto suppliers, with the suppliers now building c.85% of a car's internal systems.

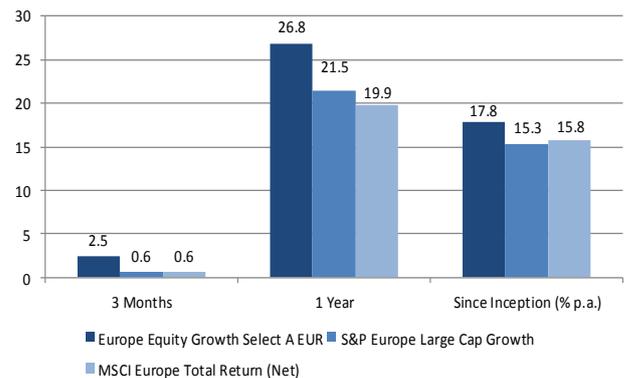
The challenge, as ever, for the suppliers will be to both substantially differentiate their product from the numerous other competitors and create barriers to entry. This is where companies such as Continental and Infineon appear to be succeeding by working in tandem, rather than against, the autos makers, by customising and integrating their software and systems into the cars. This inevitably makes the car makers more reliant than ever on their suppliers, tying them to their autos supplier in much the same way the electrician becomes tied to Legrand products. As Warren Buffet said, any company disruptor or not, needs to establish their own economic moat to survive.

## Allianz Europe Equity Growth Select | Fund Overview

- A high conviction strategy (30-45 stocks) based on the Europe Equity Growth team's best ideas
- Run by the experienced and award winning investment team, using their proven investment process
- Strong risk/reward profile, with the potential to outperform in both rising and falling markets

## Allianz Europe Equity Growth Select | Performance

Performance since inception (31.05.2013) in % as at 31.07.2015 for share class A-EUR (net of fees)<sup>3</sup>



Past performance is not a reliable indicator of future results.

## Allianz Europe Equity Growth Select | Disclosure

### Opportunities

- + High return potential of stocks in the long run
- + Investments specifically in the European stock market
- + Growth stocks outperform in some phases
- + Concentrated portfolio focusing on large-caps
- + Possible extra returns through single security analysis and active management

### Risks

- High volatility of stocks, losses possible. The volatility of fund unit prices may be strongly increased.
- Underperformance of the European stock market possible
- Growth stocks may underperform at times
- Restricted potential exposure to small caps
- Success of single security analysis and active management not guaranteed.

<sup>3</sup> Source: Allianz Global Investors, data as at 31.07.2015. Calculated at the net asset value, excl. front-end load, distributions reinvested. Calculation according to BVI method (German Investment and Asset Management Association). Any front-end loads (for this fund currently 5.00 %) reduce the capital employed and the performance. The fund unit price may be subject to increased volatility. TER (Total Expense Ratio): Total cost (except transaction costs) charged to the fund during the last financial year: 1.88 %. Past performance is not a reliable indicator of future results.

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