

Retail: Thinking Outside the Big Box Store

In the 1996 comedy *Jingle All the Way*, Arnold Schwarzenegger plays a dad who has promised his son a Turbo Man action figure, the hottest toy of the season. On Christmas Eve, he finds himself competing against a deranged postal worker, con-artist Santas, the police, and almost every other parent in town, to get his son the coveted gift.

The shopping frenzy depicted in the movie isn't that far from the truth. Consumer spending accounts for more than two-thirds of the U.S. economy. We are possibly the only country in the world with an official day celebrating consumerism – Black Friday, the day after Thanksgiving in which up to 140 million people descend en masse on retailers to start the holiday shopping season.

At Baron, we have a long history of investment in the retail space. One of the first stocks covered by founder Ron Baron back in the 1970s was **Mattel, Inc.**, the maker of Barbie dolls and Hot Wheels cars. Today, we have numerous retail-focused investments. The stocks we favor typically have certain characteristics in common, including exceptional brands, unique product assortments, leading market share, and significant opportunities to build customer bases and expand margins. Our retail investments are predicated on a number of different themes, several of which we discuss in this piece.

Market Makers

Rather than competing in an established marketplace, some retailers create their own market niche. Companies such as **The Container Store Group, Inc.**, **Lumber Liquidators Holdings, Inc.**, **CarMax, Inc.**, **Dick's Sporting Goods, Inc.**, **Starbucks Corp.**, and **Under Armour, Inc.**, all pioneered their categories. Since then, each of these companies has been building on its first mover advantage to expand its business well beyond its initial customer base.

The story of CarMax is illustrative. This 20-plus-year-old company is transforming the used-car buying experience with superstores that feature the widest selection of late model, like-new cars; a transparent, no-haggle pricing approach;

and sales commissions based on units sold rather than dollars. The company also has a highly complementary auto-auction business that has grown into the third largest in the country. Consumers have embraced the CarMax business model, and the company has expanded from a single store in Virginia to more than 130 superstores nationwide, and has sold more than five million cars since its launch in 1993. Even given its impressive growth trajectory, CarMax has just 3% of the \$370 billion used-car market, suggesting considerable room for expansion going forward.

Around the same time CarMax was launched, former college football player Kevin Plank founded Under Armour as the first company to offer athletic wear using technical, performance enhancing fabric instead of cotton. Kevin started his business in his basement, selling t-shirts to amateur and professional athletes. Today, Under Armour has close to \$3 billion in annual revenues and a market cap north of \$12 billion. Other companies have since launched competing lines of technical performance wear, but Under Armour's first mover advantage has helped it create a brand with a loyal following. The company is expanding into other products, including footwear and full lines of athletic wear for men, women and children. Under Armour is also focusing on the international market and direct-to-consumer sales through its website, both of which offer substantial opportunities for additional growth.



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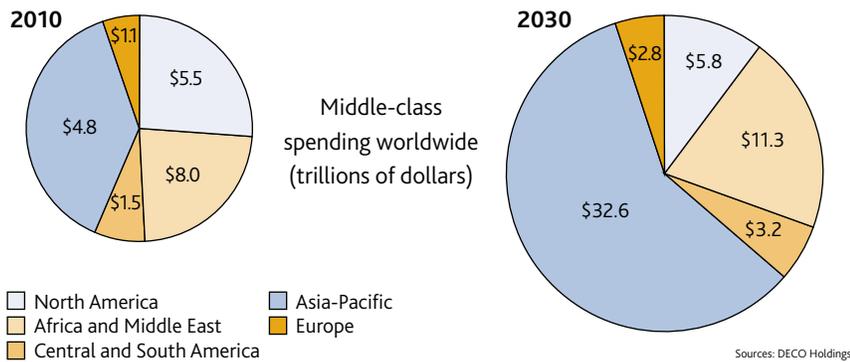


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Global Middle Class



Established Brands, New Growth

The rise of the middle (and upper) classes in emerging regions such as Greater China and Central and Eastern Europe offers compelling growth opportunities for U.S. retailers, especially the luxury and aspirational brands coveted by this status-conscious group. A number of long-established U.S. brands are setting their sights overseas, building their growth strategy around this lucrative market.

Tiffany & Co. has been a luxury jeweler for 177 years. For most of that time, it operated as a U.S. – and primarily New York City – based boutique business. About a decade ago, Tiffany embarked on an aggressive expansion strategy. Today, Tiffany has 125 stores in the U.S. and 177 stores overseas, and more than half of its sales are international. Tiffany's powerful luxury brand, which the company has diligently protected against discounting and counterfeiting, appeals strongly to the rising middle class in developing countries such as China, as well as aspirational consumers in developed countries. It has also brought new selling energy to stores through fresh merchandizing and new collections. In addition, to boost profit margins, the company has been implementing a vertical integration strategy, taking much of its manufacturing in house and investing in diamond facilities. We believe Tiffany still has a long runway for

growth, particularly in emerging markets, but also in affluent suburbs throughout the U.S.

Like Tiffany, **Ralph Lauren Corp.** is a well-established brand that has recently embarked on an ambitious international growth strategy. For much of its 46 years of existence, Ralph Lauren focused primarily on a menswear line constructed around its iconic polo shirt. In the early '00s, the company shifted gears, buying back rights from overseas licensees in a bid to expand its retail presence internationally. It started this initiative in Europe, where it has grown revenue six-fold over the past decade. Currently, one-third of Ralph Lauren's revenue comes from abroad; its goal is a revenue mix of one-third each from the U.S., Europe and Asia. The company has also added to its product lines for women, children, and accessories, and is expanding its overseas e-commerce capabilities. Ralph Lauren's carefully nurtured image of a classic American lifestyle brand resonates with aspirational consumers, and it has successfully built on that image without hurting the caché of its brand.

Consumer Staples

Although the food and beverage industry is not traditionally thought of as a growth market, there are exceptions. One such exception: natural and organic food, one of the fastest growing segments of the retail

grocery industry, growing about four times as fast as conventional grocery products. Yet this segment still comprises less than 10% of current grocery sales, providing substantial room for more growth. As the largest distributor of natural and organic grocery products to supermarkets in North America, **United Natural Foods, Inc.**, is benefiting from the growing numbers of natural food stores as well as the increasing adoption of natural and organic products by conventional grocers. United Natural Foods also benefits from its dominant scale – it is more than three times the size of its closest competitor – and its substantial investment in automation and logistics. Size and automation facilitate efficiencies in sourcing and distribution, which are key to the success of a distributor.

Craft beer is another fast-growing segment of the food and beverage industry. In recent years, while total beer sales have been flat or declining, sales from smaller regional breweries have been rapidly expanding as consumers seek out more flavorful, exotic and adventurous offerings. In 2013, the craft beer industry grew to \$14.3 billion in sales, up 20% over the prior year. Yet craft beer's share of the \$100 billion beer market is just 14%, providing a long runway of growth ahead of it.

As a pioneer of the craft beer movement, **The Boston Beer Company, Inc.**, in our view, is well positioned to benefit from this expected growth. This 30-year-old maker of Samuel Adams beer is a category leader, with a 20% market share, more than double that of the next biggest craft brewer. The Boston Beer Company is the only craft brewer with national advertising and distribution capabilities, a significant advantage since beer must be sold state-by-state through wholesalers. The company is driving growth through innovation, with 50 varieties of beer and a

recent introduction into hard cider, as well as a salesforce that in size rivals or surpasses the salesforces of the industry’s biggest brewers.

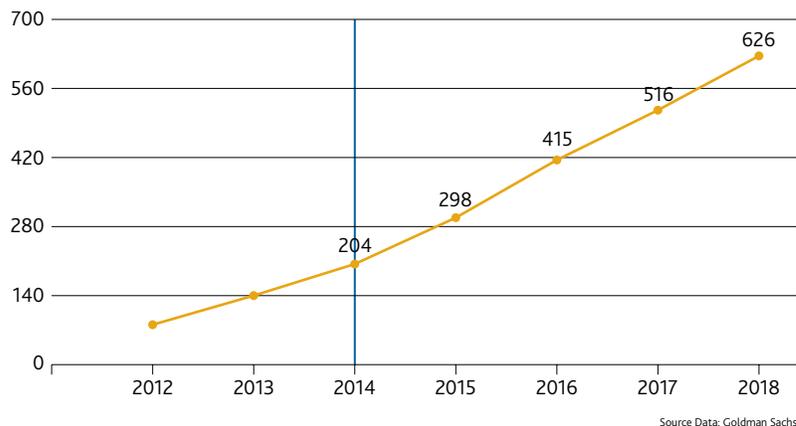
Point, Click, Purchase

Currently, 6% of total retail sales are online, up from 2% a decade ago. Over the next four years, this percentage is projected to increase to about 11%. These statistics, however, tell only part of the story. Today’s retailers are using online channels to connect with customers in multiple ways.

Online aggregators For retailers, perhaps the Internet’s greatest advantage is the ability to reach a vast number of people without leaving the store. The virtual marketplace is already an established online presence, with companies like **Amazon.com, Inc.**, Japan’s **Rakuten, Inc.**, and China’s Alibaba (which we own through our investment in **SoftBank Corp.**) operating in whole or part as retail platforms. In addition to providing retailers of all sizes with marketing platforms that are unparalleled in the brick-and-mortar world, these companies offer consumers a wide selection and competitive pricing, all from the convenience of their home (or pocket). The concept of the virtual marketplace is now being extended to everyday purchases like food (**OpenTable, Inc.**, which was recently acquired by **The Priceline Group Inc.**, and **GrubHub Inc.**) and transportation (privately owned **Uber Technology Inc.**).

Going mobile For retail companies, mobile represents an enticing proposition: an opportunity for consumers to shop whenever and wherever they are. The mobile market is also growing rapidly. It is predicted that the percentage of e-commerce retail activity conducted via smartphone or tablet will climb from 15% today to 27%, or \$278 billion in mobile sales, three years from now. In emerging markets where the percentage of PC users

Projected Global Mobile Commerce Spend (\$ Billions)



Source Data: Goldman Sachs

is typically far less than in developed markets – and in a number of countries, already surpassed by the percentage of smartphone users – many shoppers will likely go directly from offline to mobile shopping, bypassing desktops altogether.

Mobile shopping is still in its infancy. For instance, paying for a purchase can be cumbersome. A number of retailers (and others) are competing to come up with a faster payment process. Amazon.com recently acquired mobile payments startup GoPago and **Apple, Inc.**, recently filed a patent for a new iWallet system for mobile payments.

At the same time, mobile’s potential is vast. Not only does a smartphone allow consumers to pocket shop 24/7, but its ever present proximity to its owner means retailers can market their products with unprecedented precision. For instance, Apple’s new iBeacon technology allows retailers to send iPhone users in or near their stores location-aware notifications such as flash sales or deals and product information.

Small data Retailers are starting to leverage the “small data” they have (or acquire) to target customers. For example, Under Armour’s recent acquisition of the popular fitness app MapMyFitness gives the company unique access to billions of data points on

the work out routines of nine million active users. The app tracks where users work out, what they do, when they do it, and innumerable other traits, all of which provide Under Armour with the ability to target potential customers with ads and content precisely tailored to their work outs.

The growing adoption of online shopping means a long and lucrative runway of growth for retailers who are able to successfully leverage its advantages.

Conclusion

The appeal of retailers is that they are typically simple, easy to understand businesses. Investing in these businesses, however, requires a more nuanced approach. Shifting demographics, technological trends, consumer sentiment, management execution and a wide array of other factors can affect valuations. As with all of our investments, Baron takes a bottom up approach to investing in retail, looking for companies with open-ended growth opportunities, significant competitive advantages, visionary management, and attractive prices. For more than three decades, we have discovered and invested successfully in many such businesses in the retail space, and we expect that we will find many more in the years to come.

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Portfolio holdings as a percentage of net assets as of June 30, 2014 for securities mentioned in this newsletter are as follows: **The Container Store Group, Inc.** - Baron Growth Fund (0.7%), Baron Small Cap Fund (0.9%), Baron Discovery Fund (1.5%); **Lumber Liquidators Holdings, Inc.** - Baron Growth Fund (1.1%), Baron Small Cap Fund (1.3%); **CarMax, Inc.** - Baron Asset Fund (1.4%), Baron Partners Fund (4.9%*), Baron Opportunity Fund (2.5%), Baron Focused Growth Fund (4.2%*); **Dick's Sporting Goods, Inc.** - Baron Asset Fund (1.4%), Baron Partners Fund (4.6%*), Baron Growth Fund (2.3%), Baron Focused Growth Fund (3.5%); **Starbucks Corp.** - Baron Fifth Avenue Growth Fund (3.9%); **Under Armour, Inc.** - Baron Growth Fund (3.0%), Baron Opportunity Fund (1.0%); **Tiffany & Co.** - Baron Asset Fund (1.6%); **Ralph Lauren Corp.** - Baron Asset Fund (1.6%), Baron Fifth Avenue Growth Fund (2.3%); **United Natural Foods, Inc.** - Baron Asset Fund (0.6%), Baron Growth Fund (1.8%), Baron Small Cap Fund (1.6%); **The Boston Beer Company, Inc.** - Baron Growth Fund (0.5%); **Amazon.com, Inc.** - Baron Fifth Avenue Growth Fund (4.8%), Baron Global Advantage Fund (3.9%); **Rakuten, Inc.** - Baron International Growth Fund (1.5%); **SoftBank Corp.** - Baron Fifth Avenue Growth Fund (2.7%), Baron International Growth Fund (2.5%), Baron Global Advantage Fund (4.3%); **The Priceline Group Inc.** - Baron Asset Fund (2.8%), Baron Opportunity Fund (1.7%), Baron Fifth Avenue Growth Fund (4.2%), Baron Global Advantage Fund (3.3%); **GrubHub Inc.** - Baron Small Cap Fund (0.2%); **Apple, Inc.** - Baron Fifth Avenue Growth Fund (5.0%).

* % of Long Positions

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