

QV UPDATE

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Disruption

One of the key business buzz words we hear these days is disruption. The question typically asked is, how will XYZ Inc. be disrupted by <insert here>? For example, if we are talking about autonomous driving, the question might be in relation to potential disruption in the autobody or auto insurance businesses due to less car accidents.

As investors, we have always asked ourselves how a business generates its profits and how those returns may change over time. In today's language, how will they be disrupted? An example is our investment in Canadian Tire. When Target entered the Canadian market in March 2013, it was speculated that the franchise and profitability of Canadian Tire would be impaired. Target is a strong competitor in the US and its entry into Canada was a concern for those with overlapping products. Prior to Target's arrival, Canadian Tire did a deep dive on all products that overlapped. For instance, Canadian Tire slimmed down its offering of small appliances and focused more on areas such as camping and fishing. In this case, Target Canada, the "disruptor", lost \$2 billion on its failed attempt to enter Canada and quickly retreated.

Banking is an industry currently navigating the threats and opportunities from significant disruption. Fintech, short form for financial technology companies, is now used to describe any technological innovation in the financial space, including retail banking. Accounting and consulting firm Deloitte highlights that "pure digital players armed with new ways of working and real time analytic insights can find a niche, scale, and disrupt the model of legacy companies." Articles have been written suggesting companies like Facebook, Apple and Amazon would be interested in using fintech to provide financial services to their customers. This is a very profitable business, so we can understand the interest. However, how easy will it be to disrupt large franchises such as the Canadian banks?

We will meet often with management, read various publications and speak with industry analysts to help quantify the probability and potential effect of new competitors.

This week we met with Bharat Masrani, CEO of the TD Bank Group, which is a holding in our large cap and balanced strategies. Bharat talked about some of the advantages TD has over these potential entrants.

TD has 15 million customers in Canada and 9 million in the United States. This is an enormous base of clients on which to test and launch new products that can be rolled out across TD's footprint. An example given during our meeting was an app they launched called TD My Spend. This tool links a family's TD bank accounts and TD credit cards allowing customers to track their spending. Throughout the month, the app categorizes your spending and lets you know if you are within your budget and how your current spending compares to your historical patterns.

TD licensed the app from developer Moven. TD made some adjustments to tailor the offering to its clients, then launched it for its Canadian customers. The take up in one year was many multiples of what Moven achieved over five years. Currently, TD has over one million customers using the app. One of the key reasons for success is likely the trust 15 million Canadian customers have in TD Bank. TD's existing customer base and technology budget allowed it to create a product that builds loyalty to the brand while potentially drawing in new customers.

Another advantage TD believes it has versus some of the newer competitors is its vast amounts of data. Earlier this year, TD acquired Layer 6, an artificial intelligence company. The rationale for the deal was that an AI specialist can use the massive amounts of data within the bank to improve processes and predict the best products and services to recommend to its customers.

Facebook, Apple and Amazon also have many customers that access their sites frequently, so from that perspective they seem like a serious threat. However, the hesitation for some potential customers might be around privacy and trust. As an example, Facebook disclosed earlier this year that millions of users had their data harvested by Cambridge Analytica as a result of a data breach.

There will always be new businesses or technologies entering the markets of existing companies. The role for us as investors is to determine how much of a threat the disruptor is and how well prepared the existing company is to defend its business. We feel the Canadian banks we own are following the right strategy to limit the impact from potential new entrants.