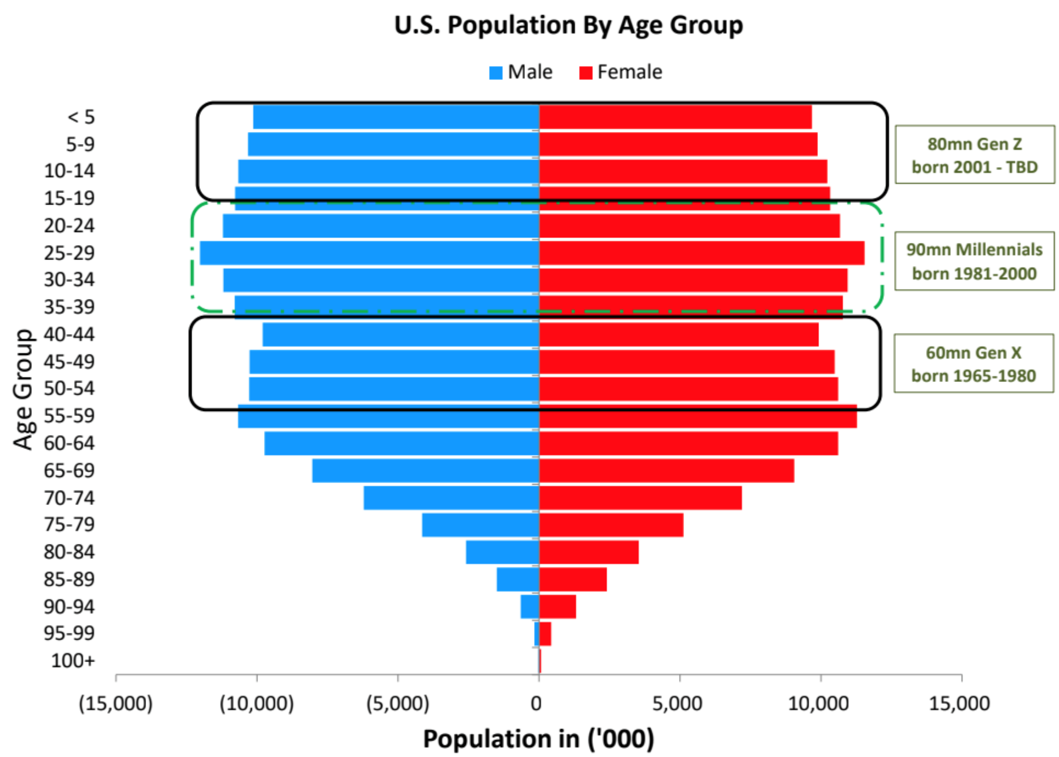
HOW MILLENNIALS' SPENDING PATTERNS COULD SHAPE THE INVESTMENT LANDSCAPE

October 31, 2019

Millennials, or those born roughly between 1981 – 2000, have received unflattering descriptions in the media, which has in the past labeled them 'entitled' or 'lazy.' But recent research suggests these stereotypes are not only inaccurate, they are also potentially inhibitive to understanding how millennials make – and will continue to make – investment and consumption decisions in the economy for decades to come.

The notion that millennials arrived into the adult world with a smartphone in hand and an elevated sense of entitlement – while also still being on their parent's health insurance – can prevent companies from adequately addressing the needs and wants of this massive wave of new spenders. We think misunderstanding Millennials' values, and how they spend money, has wide-ranging investment implications, a few of which we'll detail in this letter.

The reality: Millennials are participating in the labor force at close to record rates with rising wages[i], and the 90 million strong group is poised to become the most important consumer segment in the U.S. economy.



Source: Evercore ISI

Gaining a better understanding of what Millennials *value* arguably provides the greatest insight into how they shop and what they plan to buy—which in turn informs what industries, subsectors and companies stand to benefit most from this growing wave of new spenders. Millennials are a generation increasingly engaged with brands, often aligning their purchases with brands that tell a story Millennials identify with. It may be social purpose, responsible sourcing, environmental impact, trend-setting (social media), or some other quality that draws the Millennial consumer, and companies must increasingly adapt—and in some cases, reinvent themselves—to stay competitive.

The Boston Research Group (BCG) recently published research "debunking myths" about Millennials[ii], and some of their findings help frame an understanding of Millennials' attitudes and behaviors:

- The entire generation grew up with technology and are referred to by the BCG as 'Digital Natives.'
- They know exactly what they want, and they want it now. Millennials put a premium on ease, speed, and convenience. They place high value in eliminating friction in all areas of life.
- Trust their friends (and social media) more than corporate messaging. The definition of an 'expert' has shifted from a credentialed professional to anyone with firsthand experience, preferably a friend or peer.
- Act with a sense of purpose, often making consumption decisions based on how it might improve the world or reduce a carbon footprint. Want their values reflected in the businesses they buy from.

Here's how some of these attitudes and behaviors translate into economic and investment impact:

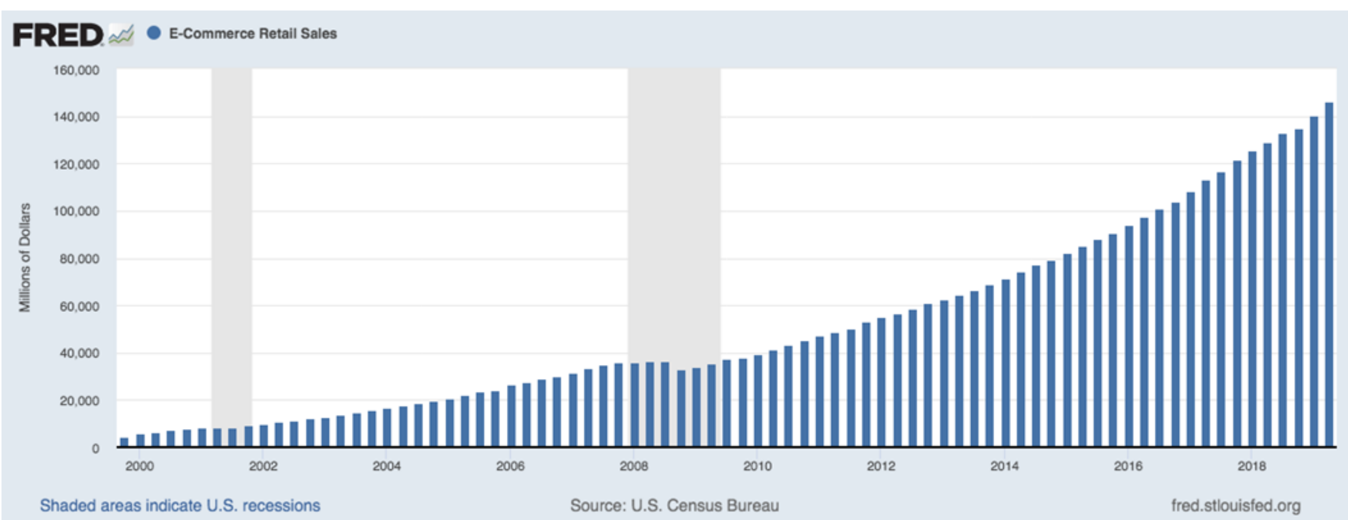
- More than any other generation, Millennials like to shop exclusively online for broad retail categories, like home goods, electronics, clothing, even groceries.
- Instagram, a social media app founded by and extremely popular with Millennials, has 1 billion active monthly users and generated $9 billion in ad revenue in 2018[iii]. In order to reach Millennial consumers, companies increasingly need to target them through social media channels like Facebook, Instagram, Snapchat, and Pinterest.
- According to research from Evercore ISI, home ownership is increasingly important to Millennials, with almost 80% saying they want to buy a home in the next 5 years. ***This data point largely goes against the popular narrative that Millennials prefer the flexibility of renting over owning.***

* Similarly, many believe that the rise of ride-sharing (Uber, Lyft) has reduced demand for car ownership. Over the last five years, however, Evercore ISI found that car ownership saw the biggest increase in the 18 to 34-year-old bracket (Millennials), and the number of cars per household has grown from 2.4 to 2.7 with 90% of American households owning at least one car. Millennials use ride-sharing apps, public transport *and* they want to own cars.
* Evercore ISI forecasts that steady demand for cars should sustain 1-2% growth in the auto market and 2-3% growth in aftermarket parts over the next 5 to 10 years.

This data provides myriad investment implications, as the companies best suited to meet future consumption demand are also those likely to create the most value and profit over time.

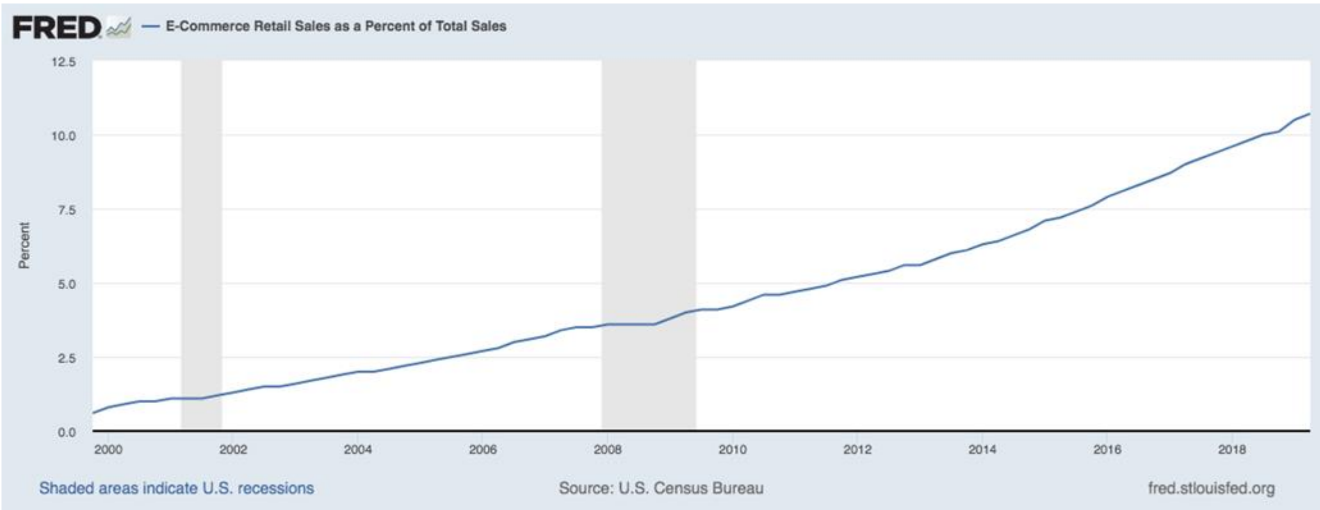
In the retail space, there is little doubt that the combination of Millennial spenders and Gen Z (the next in-line generation) spenders will drive e-commerce growth over the next decade and beyond. The current ~18% e-commerce penetration is likely to approach 40% by 2030, according to research firm Evercore ISI. The charts below demonstrate clearly how total sales, as well as e-commerce sales as a percent of total retail sales, have risen steadily since 2000. It's easy to imagine these trend-lines continuing apace given what we know about Millennials and Generation Z consumers.

Total E-Commerce Retail Sales (millions)



Source: Federal Reserve Bank of St. Louis

E-Commerce Sales as a Percentage of Total Retail Sales



Source: Federal Reserve Bank of St. Louis

In response, companies will need to continue committing capital to IT development and building e-commerce platforms; perhaps just as importantly, they will also need to continue to innovate around the way the consumers receive products. Because products ordered online often have high return rates—in addition to being environmentally unfriendly with packaging, logistics, and waste—the current retail models will undoubtedly be subject to evolution. Stores experimenting with the shop online, pick-up-in-store model have seen solid customer engagement. Going even further, Nordstrom, for example, is experimenting with a 'zero inventory' store, which would allow a customer to shop online and visit the store for the sole purpose of trying on and purchasing the specific item requested.

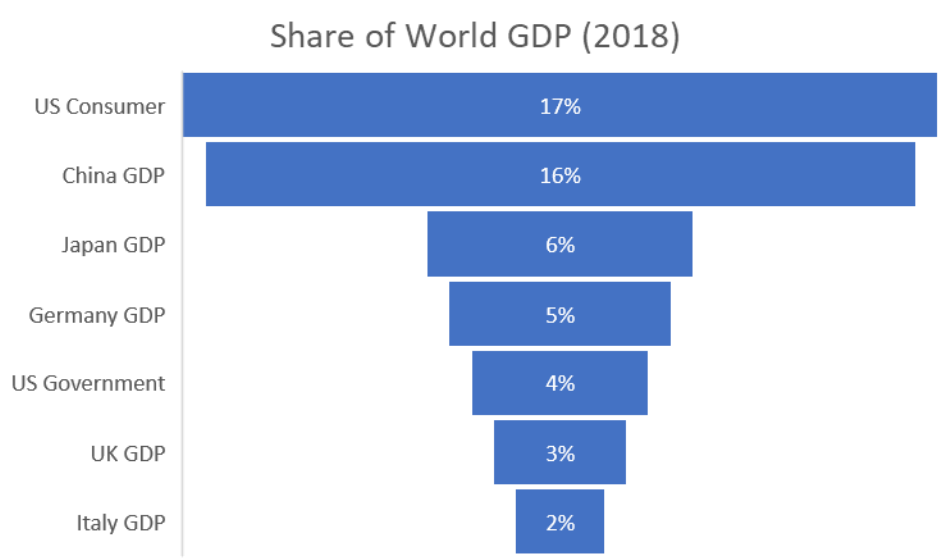
Big economic trends tend to create winners and losers, and in the realm of e-commerce, FedEx is a surprising example of a company that has arguably fallen behind. UPS was early to embrace e-commerce shipments and has invested heavily to upgrade its network, while FedEx has only recently turned focus to shipping online merchandise. And then there's Amazon, which has been aggressively building its logistics operations and now delivers almost half its orders, compared with less than 15% in 2017[iv]. Just five years ago, FedEx would not have considered Amazon a direct competitor, but today Amazon is a real threat to FedEx's market share. The market has seemingly taken note: since Jan 1, 2018, FedEx shares are down -40% while UPS is up +7% and Amazon is up +48%[v].

The home improvement market should also see measurable impact from shifting Millennial spending. Evercore ISI research suggests the industry could see 50-basis point boost over the next 3 to 5 years because of rising Millennial participation, with trend line growth expected to grow 4.5% per year. One example of a company that could sail in this tailwind is Trex.

Trex is a homebuilding product company that manufactures composite lumber, a material made from wood fiber, plastic, and a binding agent. When combined, these ingredients form a denser, stronger, and heavier material than wood. The product is innovative, practical, and durable. But Trex has another distinct advantage that makes them attractive to Millennials—every Trex board is made from 95% recycled material. The company pulls 400 million pounds of plastic and wood from landfills each year, making them one of the largest recyclers of discarded plastic shopping bags and polyethylene film wrap in North America. Every 500-square foot Trex deck contains over 140,000 recycled plastic bags, a meaningful quality for the conscientious shopper. The company is expected to see 10-12% sales growth in residential business in 2019[vi]. This is an example of multiple Millennial characteristics being reflected in a single product.

CONCLUSION

Examining trends in consumer spending is highly informative when it comes to making investment decisions. Consumer spending accounts for more than two-thirds U.S. economy activity, and as you can see in the graphic below, contributes more to global GDP than the entire Chinese economy!



Source: Strategas Research

Numbered at 90 million, Millennials represent the current and future wave of spenders poised to spend cash (for purchases big and small) across the economy. Research suggests that Millennials favor e-commerce, are eager to buy homes, and are likely to buy cars even as they increasingly use ride-sharing apps. The challenge for corporations – and investors alike – is identifying what millennials want to buy and how they want to buy it. Doing so means accessing the most powerful customer base in the world, likely driving revenue and profit growth over the medium to long-term.

[i] Source: Evercore ISI

[ii] Source: The Boston Consulting Group, “The Millennial Consumer: Debunking Stereotypes”

[iii] Source: Bloomberg

[iv] Source: The Wall St. Journal, “Fred Smith Created FedEx. Now He Has to Reinvent It.” October 17, 2019

[v] Source: Bloomberg

[vi] Trex company filings