HollAnd Advisors

Holland Views: Reflections on a Mental Model

Scale Economics Shared

Many of you, we are sure, will have read Jeff Bezos latest Amazon shareholder letter[1]. We attach a few extracts from it below that those reading our own research might find interesting. Any of you that read our recent piece on JD Wetherspoon, we hope will notice very strong similarities in both Bezos' and our attempts to quantify a business moat! Neither of us were original but whilst we called-out the source of inspiration (Buffett's 2005 shareholder letter), Mr. Bezos did not. However, that Bezos chose to share this analysis and insight as he steps down as CEO of Amazon we think is very telling. Taking a step back to calculate the scale of benefits that have accrued to all different stakeholders in business is a very powerful way to demonstrate its moat we think. What Bezos is employing is a very powerful mental model that we have used for a long time.

"I want to invest in companies that are win-win *for their* entire ecosystem**"** **– Buffett**

Just a little reflection on so-called mental models

Much as we have made the following observations to some clients verbally, inside research pieces or on Twitter, we would like to be upfront on what could be described as a little 'style drift' at Holland Advisors (but in a good way we hope). As we now have worked our way through the analysis of thousands of companies over decades, we have developed many mental models along the way (Thank you, Mr Munger). As such, we know to look for Brands, Toll Road, Tipping Points and many more attributes that can create future value for investors.

We have also for many years used Buffett's great shortlist of **Dream, Compounders and Gruesome**[2] businesses to understand the types of companies we seek and just as importantly those we wish to avoid. That 'Dream' businesses (high ROIC + growing) are often statistically the best to seek out we of course can agree with. However, experience has taught us something that the modelling of these businesses does not show. This being that 'others' tend to find those companies too and thus they might not be mispriced in equity markets for long. Additionally, that cohort of 'others' can include new competitors. That Gillette was a high ROIC, low capital employed, growing business (i.e. a classic Dream model) was likely not lost on the founders of Dollar Shave Club and Harry's. In short, great branded companies are rarely mispriced.

The road less travelled – 'Scale Economics Shared (SES)'

What we have noticed along the way is that the shares of some great businesses price-in future growth somewhat efficiently. Efficient markets like the obvious, but that is not always the case in SES businesses. A simple contrast between the average branded company and the average EDLP (everyday low price) company might be instructive.

[1] https://s2.q4cdn.com/299287126/files/doc_financials/2021/ar/Amazon-2020-Shareholder-Letter-and-1997-Shareholder-Letter.pdf

[2] See Berkshire Hathaway 2007+ 2007 annual letters

We will not go into EDLP model specifics here, but just say that we think brands and their high ROIC's are relatively easy for investors to understand and identify. By contrast, companies that chose to invest in say, pricing and infrastructure over long periods to build long-term customer trust and thus future demand can find such a strategy to be costly in terms of short-term profits and thus investor support is not always assured. In high growth sectors, such as Tech there is a recent seemingly endless belief that blindly building such scale is a good thing. However, we think there are lots of other areas of the economy and investing where the same strategy is employed, but investors often fail to see the moat that is being built or widened.

One might put it this way: the well-worn phrase '*economies of scale'* is something every lay person understands in life and many companies pursue scale for the obvious benefits. The great companies however go a step further than just seeking scale. As Bezos puts it below, they create more than they consume. Which leads us to the phrase (a Mental Model) '*Scale Economics Shared'*. This is not just an attempt to bamboozle with jargon but is actually a really subtle way of describing a phenomenally powerful business strategy.

As the investor who coined the term, wrote:

"Most companies pursue scale efficiencies, but few share them."

Hopefully those that will have read many years of our work on JDW/Ryanair/Schwab/Greggs et al will have seen good evidence of this in our own thinking at Holland. So, you might say, what's new?

What is new is our increased conviction in this area and as a result the greater amount of time we want to spend seeking out these businesses.

For that we will call out and thank Messrs Nick Sleep and Qais Zakaria who ran the successful Nomad Investment Partnership and coined the SES phrase. We have never met either gentlemen, but reading their letters at Christmas was, for us, like looking in a rose-tinted mirror. Rose-tinted of course because they achieved not only great investment performance, but just as importantly they articulated perfectly, the business models of Costco and Amazon presciently many years before those businesses saw the full fruits of their labour that is today on display.

Those letters did not change our thinking per se but they clarified it in two ways.

1. Firstly, we credit the Nomad men for coining the great phrase 'Scale Economics Shared' in their beautifully crafted letters. In truth we think the phrase is better than Jim Collins' 'Flywheel' or Walmart's EDLP language that we had adopted. Nomad's phrase far better encapsulates what the best EDLP companies do… they *share* the benefits of their *scale*.

   <u>We might add that it this very sharing of scale is what can make the companies hard for investors to identify early-on/understand which offers opportunity to those that can.</u>

   "People who think well, write well" – David Ogilvy (the original "Mad Man")

2. Of far greater benefit to us personally however was the conviction and <u>clarity</u> reading these letters gave us in our own approach. As far back as 2012 we had identified Ryanair's and JDW's superb lowest-cost models but getting the right language to describe the true value of the model is extremely helpful in solidifying our thinking. Additionally, our EDLP views have been far from universally well received in the past.

As purveyors of our own investment research, we get lots of questions and feedback from other great investors. We are genuinely lucky and proud to have such talented investors as clients and have learnt a great deal from them. However, the danger perhaps in this is that we are encouraged to look for too many different types of value in too many places of the market. Indeed c.10 years ago we were proud to say that we did just that (i.e. we then sought-out 'deep value', 'work-outs', 'franchises' etc...).

There is of course nothing wrong with such a broad approach but there is a point when you have to establish what you are best at/where your niche is. Ours, we think, has always been as contrarian value buyers. <u>More specifically, it lies with buying owner-managed businesses that have shown past compounding potential but today for some reason are priced to fail/no longer compound.</u> But could we focus-in a little more?

Although the publication of Nomad's letters has developed a cult following in the last few months, we can honestly say our style drift was well under way before their publication. Never-the-less we thank the authors for helping solidify our thinking.

<u>You either 'get' deferred gratification or you don't.</u>

> *"Waiting helps you as an investor and a lot of people just can't stand to wait," Munger once said. "If you didn't get the deferred-gratification gene, you've got to work very hard to overcome that."* – **Munger**

Crucially we have <u>almost always</u> found value in EDLP businesses as rarely do we observe are they <u>all</u> priced for success (some are, some are not). In addition, we have often been surprised with the strength and reliance of their future growth (i.e. lack of 'fade' rate). This being a by-product of the unrecognised customer trust that today's low prices and great service builds over time. Investor reluctance we think comes from the difficulty in understanding the outsized reward of deferred gratification, low margins or long required investment cycles. Importantly it also comes we think from industry and sector-specific framing. By that we mean there might be only one true EDLP/'Scale Economics Shared' company in a region or sector thus making the understanding of the company hard both for local analysts and global franchise investors alike. JD Wetherspoons and AirAsia we think are both excellent examples of this.

Investors using Amazon or Costco as examples of this model should note that they have become in some ways exceptions to our rule, i.e. they are now widely recognised for the scale and power of business model they have built. We admire them both greatly, and realise that as early proponents of the power of this business model, that not buying Amazon shares was a <u>huge</u> error of omission on our part. However, at today's starting prices we can now often find better value in similar but less well understood Scaled Economics Shared companies elsewhere in the world.

Our experience has shown us how powerful these scale economics shared models are. It has also shown us that for some extended periods they can be mispriced. That is an opportunity we should not pass by. Recent pieces have already seen us spend more time in their area (JDW/AirAsia/Schwab). Followers of our work should expect more of the same.

Fig.1 below shows the excerpt from Bezos' letter where he articulates how Amazon 'shares the spoils' of its scale with each constituent stakeholders.

Fig.2 is a reminder that we had done this exact same analysis ourselves when assessing JD Weatherspoon's moat earlier this year.

Fig.1a: Amazon 2020 letter extract 1

Create More Than You Consume

If you want to be successful in business (in life, actually), you have to create more than you consume. Your goal should be to create value for everyone you interact with. Any business that doesn't create value for those it touches, even if it appears successful on the surface, isn't long for this world. It's on the way out.

Remember that stock prices are not about the past. They are a prediction of *future* cash flows discounted back to the present. The stock market anticipates. I'm going to switch gears for a moment and talk about the past. How much value did we create for shareowners in 2020? This is a relatively easy question to answer because accounting systems are set up to answer it. Our net income in 2020 was $21.3 billion. If, instead of being a publicly traded company with thousands of owners, Amazon were a sole proprietorship with a single owner, that's how much the owner would have earned in 2020.

How about employees? This is also a reasonably easy value creation question to answer because we can look at compensation expense. What is an expense for a company is income for employees. In 2020, employees earned $80 billion, plus another $11 billion to include benefits and various payroll taxes, for a total of $91 billion.

How about third-party sellers? We have an internal team (the Selling Partner Services team) that works to answer that question. They estimate that, in 2020, third-party seller profits from selling on Amazon were between $25 billion and $39 billion, and to be conservative here I'll go with $25 billion.

For customers, we have to break it down into consumer customers and AWS customers.

We'll do consumers first. We offer low prices, vast selection, and fast delivery, but imagine we ignore all of that for the purpose of this estimate and value only one thing: we save customers time.

Customers complete 28% of purchases on Amazon in three minutes or less, and half of all purchases are finished in less than 15 minutes. Compare that to the typical shopping trip to a physical store – driving, parking, searching store aisles, waiting in the checkout line, finding your car, and driving home. Research suggests the typical physical store trip takes about an hour. If you assume that a typical Amazon purchase takes 15 minutes and that it saves you a couple of trips to a physical store a week, that's more than 75 hours a year saved. That's important. We're all busy in the early 21st century.

So that we can get a dollar figure, let's value the time savings at $10 per hour, which is conservative. Seventy-five hours multiplied by $10 an hour and subtracting the cost of Prime gives you value creation for each Prime member of about $630. We have 200 million Prime members, for a total in 2020 of $126 billion of value creation.

AWS is challenging to estimate because each customer's workload is so different, but we'll do it anyway, acknowledging up front that the error bars are high. Direct cost improvements from operating in the cloud versus on premises vary, but a reasonable estimate is 30%. Across AWS's entire 2020 revenue of $45 billion, that 30% would imply customer value creation of $19 billion (what would have cost them $64 billion on their own cost $45 billion from AWS). The difficult part of this estimation exercise is that the direct cost reduction is the smallest portion of the customer benefit of moving to the cloud. The bigger benefit is the increased speed of software development – something that can significantly improve the customer's competitiveness and top line. We have no reasonable way of estimating that portion of customer value except to say that it's almost certainly larger than the direct cost savings. To be conservative here (and remembering we're really only trying to get ballpark estimates), I'll say it's the same and call AWS customer value creation $38 billion in 2020.

Adding AWS and consumer together gives us total customer value creation in 2020 of $164 billion.

Fig.1b: Amazon 2020 letter extract 2

Summarizing:

Shareholders	$21B
Employees	$91B
3P Sellers	$25B
Customers	$164B
Total	$301B

If each group had an income statement representing their interactions with Amazon, the numbers above would be the "bottom lines" from those income statements. These numbers are part of the reason why people work for us, why sellers sell through us, and why customers buy from us. We create value for them. And this value creation is not a zero-sum game. It is not just moving money from one pocket to another. Draw the box big around all of society, and you'll find that invention is the root of all real value creation. And value created is best thought of as a metric for innovation.

Source: Jeff Bezos, Amazon CEO 2020 letter to Shareholders

Fig.2: An assessment of JDW's moat. Great minds think alike?

Unfazed, we turn to Mr Buffett. Adopting a clever method he once employed in an analysis of Geico's moat shared in the 2005 Berkshire letter. We can look at the value accruing to each of JDW's stakeholders *as a proxy for the moat* that also gives context to JDW's 2010-19 investment period.

Looking at each of the three constituents in turn:

1. The **Happy Customers**. JDW's customers save -20% (vs. competitor prices) i.e. circa £500m in FY19 (20% of 2.5bn gross sales) in savings. Or more pertinently over £3.5bn in savings from 2010-2019!!
2. The **Happy Employees**. Employees now enjoy a premium working wage **plus** a £46m bonus scheme (c.10% of benefits) + job satisfaction (as per the 11y average tenure of pub manager) + growth opportunities as business grows.
3. **Happy Shareholders?** They certainly used to be. The share price cagr was 19% from 2012-19. Actually there might have been a yacht or two bought!
    - Clearly what can aid shareholder returns is great allocation of capital and JDW as a serial cannibal (purchaser of its own shares) is enhancing investor returns at rates in excess of simple EBIT growth

Source: Holland Advisors JDW, Walton on Thames, March 2021 Pg10

NB. The Nomad letters were distributed online without their authors permission or knowledge. Graciously however they have put an edited copy onto their own foundation's website. We encourage those interested to only look at this link and also read the touching preamble and post-amble that accompanies them. #ClassPersonified.

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