HollAnd Advisors

Holland Views: Amazon – Price $105 ($2,100 pre-split) Mcap $1.07tln

The one that got away… or did it?

We started researching this piece some weeks ago now. In truth we had not expected it to be actionable. A few things changed that. The falling share price of Amazon of course is one, but two others were more important. These were our findings as to the quality of the ethos and DNA that still drive Amazon's growth and innovation today. This added to existing scale and consumer and business' trust of the company we believe will likely result in little fade in the company's growth. Thinking harder about profit pools from places like subscription and advertising helped greatly too. We always admired Amazon from afar, but now feel we know it better. We think it should be a core holding.

The scale economy Gorilla

For some time now we have heralded the Scale Economy Shared (SES) model we so love. The evolution of our own approach to it and our learning from others we outlined in *Holland Views: Scale Economics Shared, April 2021*. Much as we pursued those with this model in our own backyard, favouring companies like JDW, Ryanair and Greggs, a glaring omission has always been our lack of writing on Amazon. As analysts that understand the SES model very well not analysing Amazon earlier in its life was likely the greatest mistake of our investing careers. We were just put off by the parabolic share price chart sadly. Always looking to right a wrong we recently sat down with Amazon Unbound by Brad Stone. We found it a compelling read. This prompted a re-read of some of Bezos' past letters and a closer look at its accounts. What follows is a summary of our reflections. We had seen little urgency to communicate these, but its falling share price has rather focused our mind.

The prettiest girl in the world

Before outlining some of our reflections we think a conclusion is worth stating upfront. We think Amazon is most likely the best business is the world. Why do we make that statement? We do so by joining a few simple dots i.e. if an investor were to believe as we do that a) Scale Economy Shared (SES) is the best business model/moat you can have. Also, b) Amazon looks clearly the best (and biggest) at executing that model globally. Then the conclusion of Amazon being the best business in the world should/could follow. Lovers of Google, Visa or Moody's may dispute this fact, and it is only our opinion. Whilst of course such other businesses are indeed wonderful, it must also be accepted that high margins often bring the attention of both competitors and regulators alike. Low margins do not. Sadly, the idea that Amazon had a powerful and impressive business model and a good runway of growth was not lost on our friend Mr Market for the last ten years. Just in the last few weeks however he is a little less sure. Maybe this represents our opportunity…? We are minded to recall Buffett watching Wal-Mart for a mere 20 years, buying only when the share valuation fell to an acceptable level. In truth we would be surprised if Buffett and team were not doing what we are right now, i.e. looking closely at Amazon.

Innovation – In the DNA

The time we have spent looking at Amazon in these recent weeks may or may not influence readers or us to invest in the shares. What it definitely has done however is help us see a clearer road map of what future growth companies we invest in should look and sound like. Of course, there is growth and a powerful use of the Scale Economy Shared (SES) model, but something else stood out to us more. **This being the phenomenal commitment to innovation and the relentless manner and speed with which Amazon approach it. It is written about, talked about and obsessed over by the company. The consistency of this message leads us to the clear conclusion that this is a lasting part of the company's DNA**. This is something that is not only evident in the book which looks back at the last decade at the company and all the innovations it released. It is also still highly prevalent in all the CEO letters that we read. Particularly so, in the most recent annual letter written by Bezos' successor Andy Jassy.

We suggest readers read and carefully consider the next passage of text. It is not written by a small cap growth company, dreaming of the stars. It is written by the follow-on CEO from the founder in what is probably one of the most powerful companies on earth. This is a CEO, who is only 54 and steeped in Amazon innovation culture.

> *"We spent Amazon's first 25 years building a very large fulfilment network, and then had to double it in the last 24 months to meet customer demand.*
>
> *It's* not normal *for a company of any size to be able to respond to something as discontinuous and unpredictable as this pandemic turned out to be. What is it about Amazon that made it possible for us to do so? It's because we weren't starting from a standing start. We had been iterating on and remaking our fulfilment capabilities for nearly two decades. In every business we pursue, we're constantly experimenting and investing. We're divinely discontented with customer experiences, whether they're our own or not. We believe these customer experiences can always be better, and we strive to make customers' lives better and easier every day. The beauty of this mission is that you never run out of runway; customers always want better, and our job is both to listen to their feedback and to imagine what else is possible and invent on their behalf.*
>
> *….People often assume that the game-changing inventions they admire just pop out of somebody's head, a light bulb goes off, a team executes to that idea, and presto – you have a new invention that's a breakaway success for a long time. That's rarely, if ever, how it happens. One of the lesser known facts about innovative companies like Amazon is that they are relentlessly debating, re-defining, tinkering, iterating, and experimenting to take the seed of a big idea and make it into something that resonates with customers and meaningfully changes their customer experience over a long period of time.*
>
> *….So, this capability to ship millions of items within a couple days (and increasingly one day) was not from one aha moment and not developed in a year or two. It's been hard-earned by putting ourselves in the shoes of our customers, knowing what they wanted, organising Amazonian's to work together to invent better solutions, and investing a large amount of financial and people resources over 20 years.*
>
> *…Albert Einstein is sometimes credited with describing compound interest as the eighth wonder of the world ("He who understands it, earns it. He who doesn't pays it").* ***We think of iterative innovation in much the same way. Iterative innovation creates magic for customers. Constantly investing and improving products for customers has a compounding effect on the customer experience, and in turn on a business's prospects."***

Source: Andy Jassy, President & CEO, Amazon 2021 Annual Report

This is a phenomenal way to think, and communicate, both for individuals and especially so for a maturing corporate of 1.6m employees! Those looking for examples of innovation at Amazon will find them aplenty. They include Alexa development (all the voice recognition experts Amazon hired said it couldn't be done). Or in the in-house chips they designed to faster power their AWS servers. [Each has a story behind it, often of many failures, before an ultimate success many years out].

> *"My life is based on a large series of mistakes…. every interesting thing I have ever done, every important thing I've ever done, every beneficial thing I have ever done has been through a cascade of experiment and mistakes and failures."*
>
> **Jeff Bezos, 2019 Portrait of Nation speech, Amazon Unbound**

Theory meets practice – What to seek in future growth companies

We have read many many investment and business books now, and learnt much. Arguably the most powerful ones are those that closely consider the culture that exists (needs to exist) inside great growth companies. The two that capture this best are Phil Fisher's, Common Stocks and Uncommon Profits and Jim Collins Good to Great. Reading Brad Stone's Amazon book and recent Amazon letters is like watching these two books come to life. Whilst we have no doubt that such texts likely influenced Amazon execs many years ago, retaining such an ethos when you employ 1.6m people and doubled your workforce in the last 24 months is quite different.

In essence this is what interests us about Amazon today. It has all the scale and power that comes with the most successful SES company ever built. Important however this still combines with 'Day1' ethos and a phenomenal commitment to innovation and investment. Experience has taught us not to underestimate such companies, the expected fade rarely occurs.

Here is our one-page summary of 'Built to Last' by Jim Collins. Below we list the four key traits he sought out in visionary companies. Each is easy to identify at Amazon:

Four key traits

1. Preserve a core ideology
2. BHAG (Big Hairy Audacious Goals)
3. Trying new things
4. Constant innovation in new products and services

Source: Built to Last: Successful Habits of Visionary Companies, Jim Collins and Jerry Porras (1994)

Saying and doing

The language in both Bezos and Andy Jassy writings clearly illustrate the above traits in Amazon's DNA, but any fool can aspire to achieve great things by their writing. Delivering upon them is far more difficult. Crucially the company's communication and aspiration are matched by many of its past achievements (and failures). This we will state is also unusual. There are plenty of companies with crafted investor messages who cannot deliver secular growth or much of a moat. There are also a few that may have a good business model, but it is sadly not ambitiously communicated to shareholders or employees by its founders (e.g. J D Wetherspoon). In short, we know of good companies that say good things, or do good things. Doing both we conclude is super-powerful for it creates a culture of not resting on your laurels and always thinking you can do more. This is evident in super-customer centric companies and arguably also in industrial businesses using the Kaizen (continuous improvement) method.

Whilst we had come across the Founder Mentality book, this video was new to us. Apparently, Mr Bezos recently pushed his senior executive team to study it:

https://www.bain.com/insights/what-is-founders-mentality-video/

Simple SES, but far from easy to value

We find Amazon in some ways a difficult company to analyse and in others it is simple. Having studied the type of books we list above it is self-evident to us that the company has/is still following the path to continuing success. Seemingly the following traits are ingrained:

- A relentless focus on the customer at almost all costs
- The ingrained culture of constant innovation and deferred gratification
- The latter evident in constantly building strong new legs of growth whether or not they are likely to be profitable in the short or medium term

These traits remain quite obvious to an outsider. It is important we think to conclude that just because Amazon is already very large that will not stop these forces working to drive future growth. Indeed, as we observed earlier the combination of today's scale advantages and a 'Day 1'/innovation culture is phenomenal.

> *"There is no company in the world that is more complex and difficult for outsiders to understand than Amazon. This is not a typical corporate conglomerate like Berkshire Hathaway or General Electric. Almost every aspect of Amazon is built around subtly increasing its connection to customers. The power of the business model is the combination of the sum of its self-reinforcing businesses and services, enabled by world-class technology, operational excellence, and a rigorous review and measurement process."* **Kurt Zumwalt - 15y Amazon Treasurer until 2019**

The quote above speaks to the difficulty in understanding the profitability of the different strands within the company. This is as a result of the company's decision to keep re-investing, i.e. that the company has clearly chosen to re-invest profits from divisions that easily have sufficient scale to be highly profitable into places that are not. For anyone wanting or needing analytical accuracy as to what the future of Amazon might look like this is a nightmare. A succession of guesses as to future growth and margin must be made. The vast majority of which might never actually materialise, depending on further future investment decisions. This in turn creates complexity for anyone wishing to understand the company's true profitability and thus its likely value.

> *"Risk and uncertainty are two different things."* **Mohnish Pabrai**

This quote always springs to mind in these sorts of situations. We don't think we have to be super-accurate about Amazon's future to assess or potentially invest in the company, we just need to be directionally and approximately right about growth and profitability. A first step towards such a conclusion would be to consider the DNA required inside an already dominant company for a high level of future invention/innovation so as to source new growth. Looked at via only that lens we would conclude that Amazon, irrespective of its size and age, is still in the very top tier of companies with great growth prospects.

> *"We seek to be Earth's most customer-centric company. We are guided by four principles: customer obsession rather than competitor focus, passion for invention, commitment to operational excellence, and long-term thinking."*
>
> **Source: Andy Jassy, President & CEO, Amazon 2021 Annual Report**

In turn we could then do as others do and make some margin assumptions to get a view for the potential earnings power of this business. For those that like to forecast and see such forecasts achieved this maybe a difficult process.

From our mindset if we can estimate and believe the likely look through earnings power of this business (even if that number is never actually reported) then we may be happy with our investment conclusion. When it comes to forecasting growth clearly, we and others will be guessing to an extent. Where we can have an edge maybe is the culture we see at the company gives us many reasons for the fade in growth that so often occurs at very large companies not to take place.

Deferred gravitation – or speculation

Assessing Amazon during the current market set back is particularly interesting. We believe passionately that companies like it, Costco, JDW, Greggs and Schwab are all 'deferred gratification' business models. As such if valued against a long runway of almost certain growth it is likely right that they should trade on higher than average multiples of today's earnings. However, a large proportion of the technology business that may well have been overpriced in the last 5 years and are now correcting might also claim to be deferred gratification plays. More likely, they are *"jam tomorrow"* stories! The crucial difference for us is the likely certainty of outcome. This rests on whether you have a genuine moat or not. Our definition of SES/deferred gratification investment is one where there is high recognition by the customer of the value being offered and where todays pricing given to the customer a) makes them likely to return and b) has the effect of keeping competitors away because they cannot match what you offer. To us the distinction between this proven model in the customers eyes and an unproven one that is just not profitable yet is super-clear. However, we are less sure if Mr Market is as clear on this distinction. That could give us wonderful opportunities in wonderful companies? **Put differently Mr Market today is treating Amazon as another technology company rather than a digital Costco.**

> *"It is obvious that deferred gratifiers do better over the long-pull, than these impulsive children who have to spend money on Rolex watches and other folly"* **Charlie Munger**

Not a two-foot fence in sight – Asset + problem heavy

In addition to the relentless focus on innovation, another factor stands out for us in our assessment of Amazon vs other business. This being their desire, and proven ability, to solve complex problems that others choose to pass on. In many cases the solutions are assets/resource heavy not light. This we think is important as it makes the company stand out in world of SAAS type start-ups looking for new capital and all chasing the nirvana of new high margin, low capital employed profit pools. Yes of course the company created AWS, but many other problems required time, money, commitment and often lots of staff and assets. The scale of the fulfilment logistics and delivery networks they have created and their constant re-investment to improve and deepen them is unmatched both by any competitor and in any historical period we can remember. These are very different challenges from those being tackled by Apple, Google or Facebook.

> *We spent Amazon's first 25 years building a very large fulfilment network, and then had to double it in the last 24 months to meet customer demand.*
>
> **Source: Andy Jassy, President & CEO, 2021 Letter to Shareholders**

Delivery/Prime/Marketplace/food delivery et al were all asset and labour heavy, complex logistical problems with unclear outcomes, even at scale. That Amazon chose to tackle such problems and, in many cases, made a commercial success out of them is a startling conclusion.

As investors reflect on the future moat of this business, we think this an important consideration. A company with high margin intellectual property can have it stolen. New competitors can also raise funding to target your profit pool. Additionally, regulation maybe a threat.

But if margins are very low there is less competitor targeting or regulatory pressure. Indeed, if returns are acceptable, but only at huge scale the temptation for targeting by competitor or regulators is very low. We have little doubt this is very well understood by Amazon execs. How well thought through it is by investors we are less clear on.

In 2021, despite still a huge level of investments and only making a 2.6% EBIT margin in its core North American market, Amazon still reported an after-tax RONTA of 30%. (NB this is $33bn of Net Income/on $111bn of Net tangible assets)[1] The scale of capital being still invested in the business is simply huge, and most of it invested (AWS excepted) in areas of expansion that whilst likely to drive good asset/turns and acceptable RONTA over time will likely not make any immediate contributions to returns or margins. **A better combined example of deferred gratification and moat building we think would be hard to find.**

Schwab and Amazon learnings

There are many aspects of Schwab that remind us of Amazon. (The "*through customers eyes*" approach and passing on of scale economies primarily). But do the two companies have still more in common? Schwab has also set about solving some very resource heavy problems. These include reducing trading commissions to zero and building a bank balance sheet for 20 years whilst its competitors enjoyed the benefit of asset-lite structures. But year after year the company has gained share and consolidated its industry.

"to the victor belong the spoils" **William L. Marcy**

Today Schwab is looking at the products it can overlay on this network. These include: does it charge the right amount for fund management companies to distribute their products to Schwab clients? Additionally, what add-on services can it now offer to HNW clients who have joined the platform? Whilst any new service will be added to the platform in a way that benefits Schwab customers, many new services are notably high margin due in part to their ability to be delivered on the already built industry dominant platform. Incrementally the new products that Schwab will sell to its customers in the future look to be a higher margin and lower asset intensity than some of those that came during the build-out phase.

Amazon to us today looks similar. **No company we can think of has <u>both</u> a digital and physical relationship with the customer (i.e. delivery and Prime login).** In the same way that Apple found itself in a strong position due to the stickiness of its IP/phone and was able to sell watches, ear pods and many other add on services, Amazon could be similarly positioned. Whilst it will likely still roll-out more last mile services in other countries across the world, it could also be set to benefit from other products or services distributed on its network that is already in place. Any higher margin products/services sold to customers we think will be done so at Amazon type prices, but that does not mean they cannot be significantly accretive to Amazon ROIC.

[1] This $111bn figure being reduced of course due to a massive $142bn of current liabilities). Like all scale economy businesses Amazon uses suppliers money very cleverly.

Esoteric as this maybe we ask readers to imagine investors' differing reactions to the following news: Microsoft announces an investment in last mile delivery. Now what about Amazon announces a new Consumer or B2B software product that it would deliver and maintain for free.

We also note from our work in the media/cable sectors that customers love bundles due to the value and simplicity they offer. Amazon's Prime entertainment and delivery bundle is a compelling offer and one that we think will grow in breadth. The recent Prime price raise and stickiness of the product (recent survey suggests Prime customers over 2 years have 98% retention rate) suggest it has strong pricing power.

Fig.1: First rise in US Prime pricing since 2018

Amazon Prime Price Increase History

Year	Annual Price for Prime	Percentage Increase
2005	$79.00	N/A
2014	$99.00	25.3%
2018	$119.00	20.20%
2022	$139.00	16.80%

Source: Amazon

The importance of 'Trust'

With Amazon US revenues now at c.1.7% of US consumer spending (and around half that level across Europe) it still has scope for growth into new or adjacent markets. With c.50% of household spending going on housing or transportation it will be interesting to see where the next focus/leg of growth comes from. Home security Amazon have already started expanding into, but what about financial services, health or even cars? Or expanding the digital entertainment service it already offers? Leaving regulatory hurdles aside for a moment there is good logic in Amazon buying a business like Netflix ($100bn) or Carvana ($10bn) or Spotify $20bn). Indeed even Disney (a JV with Berkshire Hathaway to split to physical assets from Disney+)…? These are all idle speculations, but they show what could be done with this physical/digital network and customer trust. What regulators let them do is a different question of course.

Customer centric (at scale) like we have never seen

We think Amazon's combination of a physical and digital network is powerful. However, it also has something perhaps even rarer – **consumer trust at massive scale.** We accept it is far from perfect and now at a size where some are questioning the effect of its dominance on other stakeholders (staff, suppliers and competition). However, the level of trust it has built amongst its global customers relative to its size is something we have never seen in business before. Most customers know that Amazon will deliver on its promises and do so at great prices and on time. They also know from either their own experience or that of others that when it does receive a complaint it is often fair, even generous and prompt in its solutions. It is important that we note that this is dramatic change from the days of large companies of the past.

Businesses like AT+T, BT, cable companies or any and all government departments more often come with poor customer service. They are just unable to keep any customer focus as they scale and bureaucracy booms. Arguably in most large companies' customer are not treated well, e.g. insurance price rises for renewal customers and cable price escalations and hard to cancel contracts. 27 years after its founding Amazon looks to be true to its promise of wanting to be the *world most customer centric company*. When talking to its customers as opposed to competitor it is rare to hear anything other than admiration. That is pretty impressive with 1.6m employees and counting.

A customer champion (not a supplier one)

The above points we think are all relevant ones when the spectre of potential regulation is considered. Has Amazon always treated all those sellers on its platforms perfectly? Probably not. Seemingly there have been periods when it might have used Marketplace sellers' data to inform its own Amazon Choice products. Such an area is for regulators to decide how platforms can and should operate when they both control the platform and are selling their own product own it (Ref Google flights travel). Whilst Brad Stone's *Amazon Unbound* has plenty of examples of resellers who felt their once dominance position of the Amazon platform was removed from them, there is not a single example of the end customer complaining about not being able to get such products. Simply put as niche positions in say paddle-boards were discovered by Amazon Choice or other Chinese based supplier they found alterative, usually cheaper products to offer in response. It is for regulators to decide how some of these issues should be addressed. However arguably Amazon's actions were/are mostly consistent with its customer first policy.

The Spectre of Regulation

> *".....This analysis reveals that the current framework in antitrust—specifically its equating competition with "consumer welfare," typically measured through short-term effects on price and output fails to capture the architecture of market power in the twenty-first century marketplace."* **Lina Kahn, 2017 Amazon Paper**

> *"When information advantages and bargaining power are so skewed towards a single player that unilaterally sets all the rules, it's no longer a 'market' in any meaningful sense.* **Lina Kahn, 2017 Amazon Paper**

Until we read *Amazon Unbound* we had unknowingly witnessed the *Antitrust Paradox* in action but we were not familiar with the term. We thank Brad Stone for setting us on a path of reading that helped our understanding of western consumer regulation.

We had watched the regulation of many different mergers and acquisitions over the years and noted a few patterns of our own. Tellingly we noted that as long as the customers were benefiting (or not disadvantaged) mergers were mostly allowed, even if the resulting party looked sizable in market power terms. We noticed this in both the Tesco/Booker merger in the UK and the Poundland/99p store one. Unknown to us was the existence of an important book on regulation in 1978 that informed such decisions:

> *"A seminal 1978 book by Robert Brook, the antitrust Paradox, which argued that regulators should curb market power only when it might result in higher price for consumers"* **Brad Stone, Amazon Unbound (emphasis ours)**

We have not read this book, but can see the blueprint of it across modern regulation today. Such thinking around the SES model which Amazon uses reasserts the view we have repeated many times in recent years, i.e. that the SES model is the most powerful moat because customers like it, employees and shareholders often do too, **but importantly regulators mostly do also**.

Taking this approach to regulation and assuming it remains this way it may be right to conclude that Amazon could expand into more verticals than investors might currently consider likely due to:

- Established and hard-to-match physical and digital network
- Consumer reputation for great service and value for money, i.e. few people are complaining to regulators about the company
- A believable reputation with regulators for lowering (not raising) prices in all market sectors they compete in
- Better behaviour towards other stakeholders like staff. A realisation by Amazon that it is being judged on many fronts and therefore a keenness to behave better

> *"What I teach and preach inside Amazon is [that] when you're criticised, first look in a mirror and decide, are your critic's right? If they're right, change. Don't resist."* **Jeff Bezos**

Regulation – Digging deeper

These conclusions maybe correct and/or logical, but there is much more going on behind the scenes. Those that want to understand how regulation may affect Amazon should read this excellent 2017 piece. https://www.yalelawjournal.org/note/amazons-antitrust-paradox

It is a tour-de-force explaining Amazon's market position and the complexities created by the *Antitrust Paradox* i.e. the conflict between regulators being relaxed as long as consumers are getting lower prices vs the market power that is accruing to a share winner like Amazon as a result. Its author was Lina Khan. The same Lina Khan who now, at the amazing age of 33 finds herself at the chair of the FTC. It was the publication of this report and its circulation that lead to the FANG CEO's having to testify before congress in 2020. The resulting remedies from which were detailed in the conclusion outlined in the link below. Most we note were pretty limited in their scope. Khan's position as now FTC chair suggests Amazon will likely have more regulatory battles ahead. https://judiciary.house.gov/uploadedfiles/competition_in_digital_markets.pdf

Amazon and Standard Oil

Having read it Ms Kahan report on Amazon and regulation we thought it fascinating she started it with the following two quotes:

> *"Even as Amazon became one of the largest retailers in the country, it never seemed interested in charging enough to make a profit. Customers celebrated and the competition languished."* **The New York Times**

> *"Mr. Rockefeller's most impressive characteristic is patience."*
>
> **Ida Tarbell, A History of the Standard Oil Company**

We have noted before from our reading of *Titan by Ron Chernow* that Standard Oil used its power to keep prices low not high, something that shows this is not a completely new phenomenon.

Our Observations

A number of further quotes from Ms Khan paper are included in Appendix 2. Summarising it is not easy, nor even likely helpful. We encourage all to read it. Having done so we will make only a couple of observations:

1. In order for regulation to change from the current (pro-consumer approach) to one more aware of market power as Ms Khan suggests there would have to be widespread change in law and ethos towards US competition policy, (e.g. Today in order to prove anti-trust abuses in the US court you have to prove harm to the consumer). Even with Ms Khan as head of the FTC, we see this change as highly unlikely
2. That there is a big difference between predatory pricing that is designed to kill off a competitor and a SES business model. One focused on hurting your competitor, the other on helping your customer and thus winning their long term loyalty

   > *"While there is no single seller online that can match Amazon, it's pretty hard under conventional antitrust to find someplace where Amazon has monopoly power."* **Jay Himes, Former anti-trust bureau chief, New York Attorney's office**

3. It is not only consumers that like deflation (i.e. lower prices) politicians and central bankers do too. Particularly in inflationary periods. To move to system that looks at wider market power would imply higher consumer prices

As such we think future regulation of Amazon likely takes one of the three courses below:

i. We don't see a likelihood of the US moves away from the current pro-consumer pricing regulation in favour of the market power one Ms Khan articulates

ii. Greater enforcements could made to potentially ensure better discipline/distance between how Amazon acts as a seller of its own products and those it sells for third parties

iii. A possible enforced break of the company could occur in time

On these points we note that a forced break up or spin-out of certain assets if forced by regulators in the future is not necessarily destructive to shareholder value. Hopefully Appendix 3 illustrates this. It shows the scale of assets that today would have to be recombined to make a modern-day Standard Oil.

Whilst we do not dismiss any regulatory threat, we think that Amazon's focus on the consumer and indeed the consumers enjoyment of Amazon prices and services along with low margins all suggest regulatory interventions will be difficult. **Investing in lower prices for the customers benefit and future trust is not an activity that cries out for new regulation. Equally investing the profit from one area of business into another unrelated area is rarely a matter of regulation, but corporate choice.** Regulating such a low margin, consumer focused business that genuinely invests for a better future is going to be hard. We suspect those with fatter margins will be easier targets. Even Ms Khan's view of market power assumes it is abused to hurt competitors. That an SES business like Amazon explicitly looks to delight customers and focus on the customers rather than competitors suggest she may have a very hard task ahead of her:

> *We're divinely discontented with customer experiences, whether they're our own or not. We believe these customer experiences can always be better, and we strive to make customers' lives better and easier every day* – **Andy Jassy, our emphasis**

> *"We seek to be Earth's most customer-centric company. We are guided by four principles: customer obsession rather than competitor focus* – **Jeff Bezos, our emphasis**

Amazon today

We are conscious that much of what is discussed above is neither an estimate of value nor a forecast of the company's future. This is intentional. As business and mental model observers we were keen to think harder about how intact the company's customer focused model was today. Also, how it was thinking post-Bezos' departure and what will affect its long-term value creating ability. On this combination of areas, we were frankly delighted with the qualities we found.

Before assessing (guessing!) what Amazon might be worth we want to look at a few other areas that we thought interesting in our research.

AWS/B2B

Much is written on this division and we have little to add. Clearly like others we are attracted to 30% organic growth and 30% margins. That the division is completely home grown is not lost on us. It suggests (ala Phil Fisher) that we should be aware of the company's ability to do this at points in time, i.e. create new legs of value. Whilst reading the annual reports we also stumbled across these quotes:

> *AWS sales increased 30% in 2020, compared to the prior year. The sales growth primarily reflects increased customer usage, partially offset by pricing changes. <u>Pricing changes were driven largely by our continued efforts to reduce prices for our customers</u>.*
>
> **Source: Amazon 2020 Annual Report-our emphasis**

> *AWS sales increased 37% in 2021, compared to the prior year. The sales growth primarily reflects increased customer usage, partially offset by pricing changes. <u>Pricing changes were driven largely by our continued efforts to reduce prices for our customers.</u>*
>
> **Source: Amazon 2021 Annual Report-our emphasis**

We thought these price-investment actions in AWS a telling test of the companies DNA. When a division of a business is growing at the rate AWS is, it points towards customers being very keen to sign up for the service. Most businesses would use such a strong demand environment to keep pricing firm, even maybe raise them. **That Amazon is doing the opposite we think speaks volumes.** This is not a Scale Economy business in one part and a profitable cloud business in another. Scale Economy runs though all its veins. This ethos also suggests to us other opportunities will emerge for the group in the B2B sector, where notably the Scale Economy Shared model is far less prevalent in competitor corporate suppliers currently.

Earlier in this note we raised (praised) the issue of the 'Consumer Trust' of Amazon. We think it important to observe that this trust also extends to business, large and small, and governments. **Some of the world's most influential organisations now trust Amazon to handle their servers and data – i.e. the very backbone of their existance. If they trust Amazon to do this and they are rewarded with lower, not higher pricing, much more can follow.** This trust is a crucial factor when add-on AWS services are sold today. As more products are developed for sale in the B2B sector as opposed to the B2C sector its value will only increase.

The China syndrome

When analysing Amazon there is an elephant in the room that should be briefly addressed: China. Last year we penned two notes on Alibaba, when its shares were disliked. Subsequently they have become reviled suggesting we should hide from such work. We will not. Our attraction to Alibaba was its Amazon-esq position in China.

We also saw in it the Scale Economy Shared model we so admire, but one operating at great speed in a fast-growing market. We noted how Charlie Munger was a great studier of successful businesses like Wal-Mart and Amazon. He also being a person with a well-informed, but pragmatic view on China. His decision to invest we thought telling as it combined these two areas of expertise.

When reflecting on Amazon's past it is interesting to note that:

- For all of the countries it has entered late or initially unsuccessfully (India and Mexico are examples) it still got to a good competitive position eventually. All except China. Here it underestimated local peers' competitiveness at almost every step – Alibaba being the prime protagonist. Notably Amazon chose not to back the advertising model Chinese competitors were using – a model it is now rolling out.
- Prime Day is effectively a copy of Alibaba 'Singles' day
- Alibaba's Cloud roll-out strategy in China is arguably an exact replica of Amazon's
- Reading and listening to Bezos and his team talk about long-term investing is almost identical to the same process pursued by Alibaba. Alibaba looks to make no money in the first c.5years of investing in a new sector. Then in years 5-10 it looks for market impact. Only after year 10 does it expect to be making good economic returns on capital.

> *"I will bet this will take you more than 10years to get this done" …"so you had better get started now."* **Source: Jeff Bezos/Amazon Unbound on addressing AWS team in 2010**

We conclude no more than to keep taking Alibaba seriously. We still believe it has an excellent Scale Economy business model. A model that after all was strong enough to keep Amazon at bay! Like Amazon it too has massive scale advantages already. This suggests future dominance if it continues to be leveraged intelligently.

Amazon as an investment prospect

Attached to this note is a very simple spreadsheet. It shows a few facts about Amazon:

- It North American e-commerce sales still grew at 18% in 2021
- In 2021, for the first year ever Amazon disclosed that adverting revenues were $31.1bn having risen 58% in 2021 and 57% in 2020
- Also, that Amazon subscription revenues (i.e. Prime) were $31.8bn in 2021, up 26%
- AWS sales continue to grow at 30-40% pa and have a stable EBIT margin of c.30% post giving customer price reductions

What does Mr Market think?

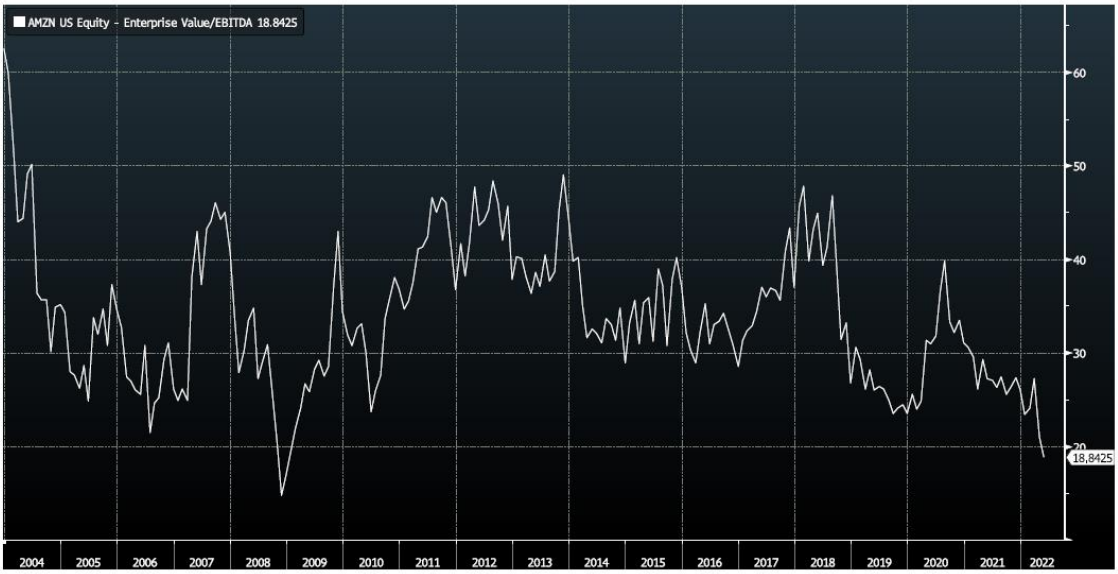
Before considering our own views on Amazon's likely long-term profitability we briefly consider others' views. Whilst the share price rose dramatically for many years, we assumed that the Amazon re-investment model was well understood, i.e. that Amazon could have made far more profit if it had chosen to, but instead re-invested so aggressively that these profits were not visible. The contrary opinion that was around in Amazon's earlier years being that Amazon was growing, but could not make a profit, thus was a likely a poor investment. Whilst we noted earlier a good understanding of the re-investment model by the FTC Chairwoman we recently read this second thesis re-aired by a respected writer in a book on the company. We were surprised by this.

As the share price is now falling rather than rising it will be interesting to see if this view is aired more widely once again...? **To be clear we are very much of the former view, the only debate for us being what would be an appropriate look-through earning power for us to use in evaluating the business.**

The Everyman approach

An EV/EBITDA chart for Amazon is shown below. Whilst illustrating the correction in Amazon's recent valuation we are not sure it is much more help.

Fig.2: Amazon EV/EBITDA multiple



Source: Bloomberg

The methodology which most investors use is just to make assumptions about the growth and likely margins of both AWS and e-commerce.

- We are happy to assume AWS growth continues are 30% pa and it maintains a 30% EBIT margin, especially when recent margins at this level are after significant investments in customer pricing and for future growth
- Equally with the more mature US e-commerce division still growing at 18% pa in 2021 we are happy to assume this division globally will continue to grow at 20%. This being partly driven by overseas growth and new category expansions

If we then had to choose a margin to use for e-commerce, we would likely opt for 4-5%. This being the range of margins the group achieved in its North American division in 2018-2019 when it had reached a point of some maturity. Whilst this is leap of faith maybe for overseas profitability, we note that a) the overseas divisions' sales is now at the scale that North America was in 2018 and b) we are not making forecasts that must be hit, but are trying to estimate underlying long-term earning power. I.e. we are looking through or past heavy and long investment phases. The scale and scope of current year drags on profits shouldn't be underestimated - hiring 275,000 more people as Amazon did in just the 2H of 2021 gives a small insight into this fact.

So, if we assume:

- AWS grows at 30% pa and has 30% EBIT margins in 3 years' time
- E-commerce grows at 20%pa and has 4.5% margins 3 years out

This produces a 3y-out EBIT of $73bn. Taxed this would result in PE of 21x vs today market cap.

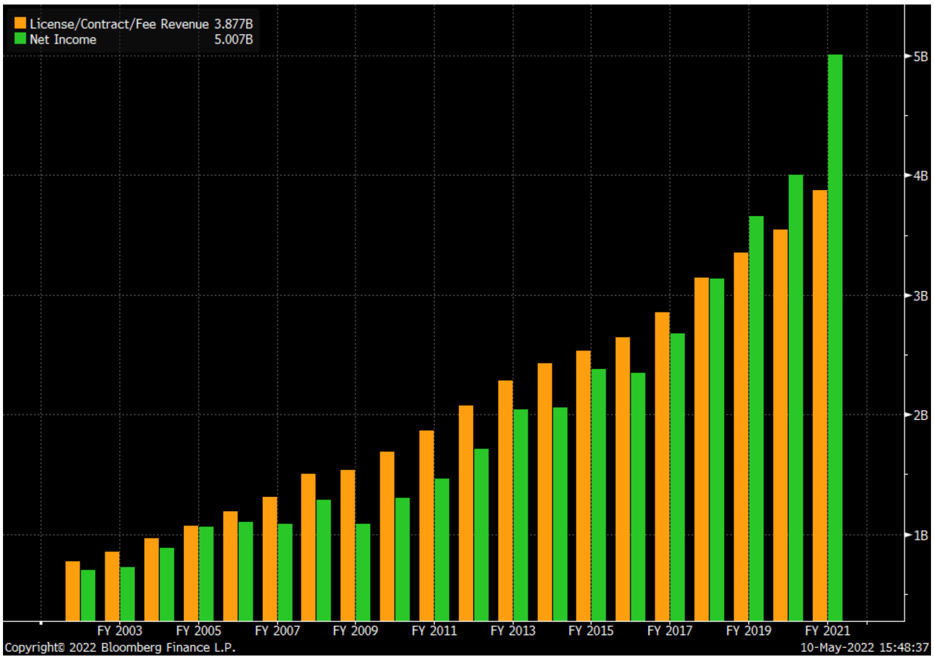
We look closer at the impact of Subscription (Prime) and Advertising revenues below. We note however that in 2018, when e-commerce North America reported a 5.1% EBIT margin, Subscription revenue was $14bn and Advertising revenue $9bn. In 2022 these are likely to be $38bn and $47bn respectively…

Can we do better?

Two factors stood out to us when we started to look closely at Amazon. The first was its increasing desire to accept advertising revenues on its platform in recent years. Also, their admission that these advertising incomes are very high in marginal profitability as the process to attract them is highly automated. The second was that it remains still very close to Costco in its ethos and indeed business model. When considering how to value Amazon we wonder if these factors can give us a better guide as to Amazon's true earning power.

Below is chart showing the correlation between Costco's net income and its club card fee income. We believe those that analyse Amazon need a good understanding of the Costco business model and culture. The customer centric way that Costco only takes a small markup (14-15%) ensures customers always get a great deal and thus return. Over time there has been a strong correlation between club card revenue and group profits as we show. The implication of which being that all other turnover is a wash-through, i.e., when fully costed customers are paying no margin on what they buy at all. With Amazon so closely following and admiring the Costco culture and model we think this interesting.

Fig.3: Costco Net Income via licence fee (club card revenue)



Source: Bloomberg

We think it interesting to consider that if Prime fees and advertising revenues were to make up the bulk of Amazon e-commerce profitability then, like Costco Amazon customers would be getting all other products at zero margin. We accept the cost to Amazon of producing Prime media content, so have used 50% of Prime income not 100%. That Amazon revenue also includes lucrative Marketplace fees we understand, but we are ignoring/assuming them to be cross subsidising something else.

As result of these thoughts, we did the following calculations:

1. We assumed 50% of Subscription revenue was e-commerce profit
2. …and 75% of Adverting revenue is also e-commerce profit

Adding this theoretical profit contribution to AWS EBIT in Dec 2021 gives an EBIT of c.$58bn. Taxed this would imply a PE of 27x on the share price at the top of this note. Thus far this is no Nirvana of value unearthing it seems.

Looking forward

Rolling this idea forward is revealing. If we grow subscription fees at 20%pa (i.e. in line with likely ecommerce growth – Prime prices just went up 18% in US!), and advertising income at +50%, +30% and +30% over the next 3 years. Assuming the same 50% and 75% contributions from these revenues contribute to EBIT and adding AWS division profits (i.e. +30%pa & at 30% EBIT margin). The result is as follows:

- 3y-out EBIT of $128bn and a **PE of c.12x vs Today's valuation**

Fig.4: Amazon splits out subscription and advertising revenue

	Year Ended December 31,		
	2019	2020	2021
Net Sales:			
Online stores (1)	$ 141,247	$ 197,346	$ 222,075
Physical stores (2)	17,192	16,227	17,075
Third-party seller services (3)	53,762	80,461	103,366
Subscription services (4)	19,210	25,207	31,768
Advertising services (5)	12,625	19,773	31,160
AWS	35,026	45,370	62,202
Other (6)	1,460	1,680	2,176
Consolidated	$ 280,522	$ 386,064	$ 469,822

Source: Amazon 2021 annual report

Valuing serial re-investors

What interests us about these assumptions is not so much the valuation conclusions they give. It is much more how such profit streams are derived. I.e. they are without any change in pricing or any need to give the customer a less good value proposition than Amazon does already today. This not only means today's low pricing and high service umbrella remains. It also means that almost all future economies of scale can be given back to the customer, i.e., pricing and service can improve still further. This is appealing to us and we suggest to Amazon managers also.

In our attached spreadsheet the outputs of these assumptions we are making on Subscription and Advertising profit contributions can be seen. The 50% of Subscription revenue and 75% of Advertising revenue profit contributions produce an implied EBIT margin in ecommerce of 9.6% in 2021. To some observers this will seem fanciful. Maybe it is. But we note that the 50% contribution from Subscriptions alone shows a c.4% margin. For reference Costco's EBIT margin is 3-3.5%. The remainder of profit is driven from advertising revenues which we all know from Facebook, Google and Alibaba studies are highly profitable.

NB. Were we to make the Subscription contribution to EBIT 30% (not 50%) and Advertising 50% (not 75%) then 3 years out EBIT would be c.$94bn (PE of 17x). The Subscription only margin would then be <2% of e-commerce sales vs Costco at 3-3.5%.

Signing off

We have admired Amazon for many years now. That said we had resigned ourselves to likely never being shareholders, sensing that the rapid appreciation of the shares discounted its future growth and the power of the company's business model.

We have been delighted to spend more time on the company and impressed that the 'Day 1' innovation and re-investment culture still comes across as strong as ever. We also think the combined power of physical and digital networks and consumer <u>and</u> businesses trust will open many future doors for add-on growth.

In truth when starting on this research we did not expect to uncover value, but we think we may have. Whilst in part the share price fall has helped this, in truth the bigger contributions likely come from our thinking above on the Costco model analogies and the profitability of advertising. We have little doubt that any projections we make of possible future profitability are likely very wrong as more future investment may come. That does not stop them being useful to help us get a feel for underlying earnings power.

As we started with the importance of ethos we will finish with it also. In Appendix 1 you will find two quotes from Jeff Bezos. The first talks to the power of constant innovation for survival. The second reminds investors that whilst this company has a super long term time frame, it knows what success look like, i.e. long term growth in free cashflow per share.

In signing off, we would like to thank the author of *Amazon Unbound,* Brad Stone. We have never met Mr Stone, but we stumbled across his book and it filled in many gaps in our understanding of this company. All should read it

Kind regards

Andrew **firstname@hollandadvisors.co.uk**

Contact:

HollAnd Advisors

Holland Advisors London Limited
The Granary, 1 Waverley Lane
Farnham, Surrey
GU9 8BB

Tel: (0)1483 449363
Mob: (0)7775 826863
www.hollandadvisors.co.uk

Appendix 1: A final insight into culture and ethos courtesy of Bezos

Here is a passage from Richard Dawkins' (extraordinary) book The Blind Watchmaker. It's about a basic fact of biology:

> *"Staving off death is a thing that you have to work at. Left to itself – and that is what it is when it dies – the body tends to revert to a state of equilibrium with its environment. If you measure some quantity such as the temperature, the acidity, the water content or the electrical potential in a living body, you will typically find that it is markedly different from the corresponding measure in the surroundings. Our bodies, for instance, are usually hotter than our surroundings, and in cold climates they have to work hard to maintain the differential. When we die the work stops, the temperature differential starts to disappear, and we end up the same temperature as our surroundings. Not all animals work so hard to avoid coming into equilibrium with their surrounding temperature, but all animals do some comparable work. For instance, in a dry country, animals and plants works to maintain the fluid content of their cells, work against a natural tendency for water to flow from them into the dry outside world. If they fail they die. More generally, if living things didn't work actively to prevent it, they would eventually merge into their surroundings and cease to exist as autonomous beings. That is what happens when they die."*

Source: Jeffrey Bezos, Founder & CEO, Amazon 2020 Annual Report

> Externally, one of the things that I would encourage you to look at is, this one you'll have to trend over a long period of time, but it's the free cash flow per share. I think that's kind of the final output metric. There are a whole bunch of inputs. The output metrics cannot be managed directly. They're kind of at the end of a chain of events and we work on the input metrics. Those are the things we can control. But as an external investor, watching that I think is very important. So you see things come out the end of the pipeline of our investments. So we are very focused on the long term but we also believe that the long term has to eventually come. And one of the things that we like to do is check in every once in a while. So we'll go through and we'll have a period where we invest very heavily. We started a period like that in 2005 where we decided very consciously we wanted to increase our investments in things like digital media, web services, category expansion, international expansion in China. There were several investment opportunities that we saw and we wanted to increase our investment level because we thought those were the right opportunities and the right time. But at the same time, I find that most of the

Source: Jeff Bezos 2007 Amazon AGM

Appendix 2: Extracts from FTC Chairwoman's 2017 report on Amazon

"Reporters and financial analysts continue to speculate about when and how Amazon's deep investments and steep losses will pay off. Customers, meanwhile, universally seem to love the company. Close to half of all online buyers go directly to Amazon first to search for products,

By some estimates, Amazon now captures 46% of online shopping, with its share growing faster than the sector as a whole"

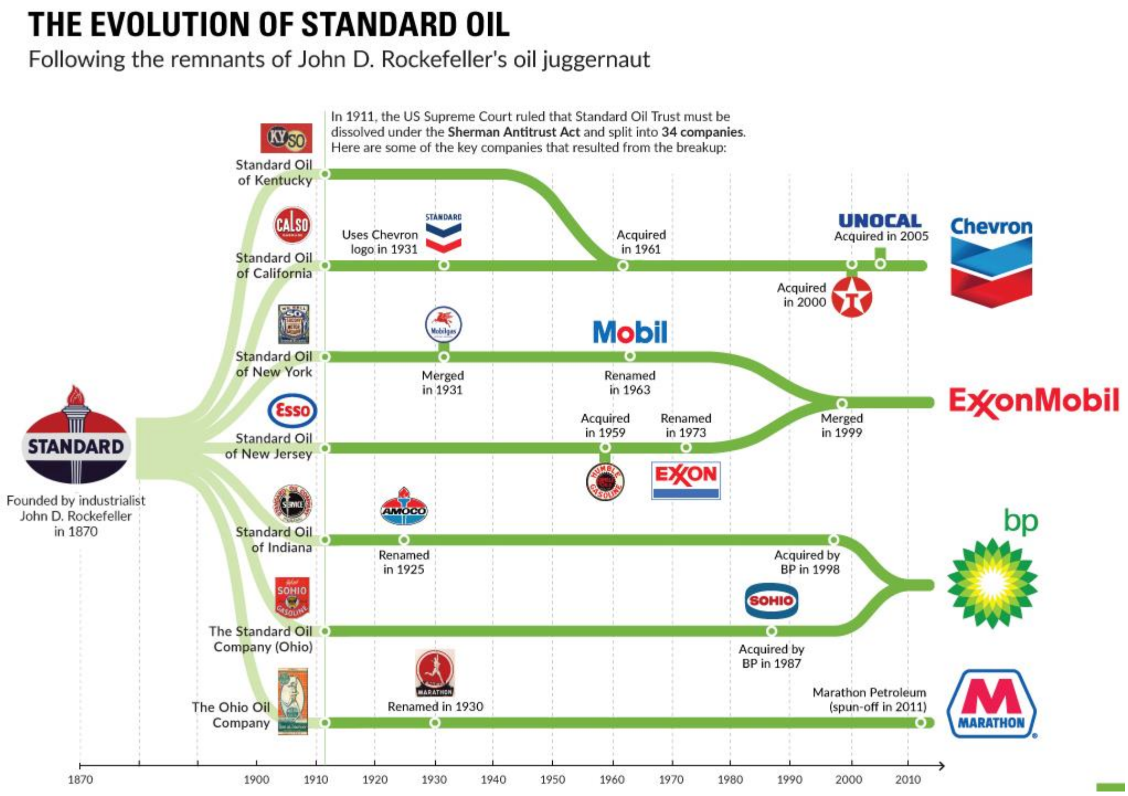
"In some ways, the story of Amazon's sustained and growing dominance is also the story of changes in our antitrust laws. Due to a change in legal thinking and practice in the 1970s and 1980s, antitrust law now assesses competition largely with an eye to the short-term interests of consumers, not producers or the health of the market as a whole; antitrust doctrine views low consumer prices, alone, to be evidence of sound competition. By this measure, Amazon has excelled; it has evaded government scrutiny in part through fervently devoting its business strategy and rhetoric to reducing prices for consumers."

"…..This analysis reveals that the current framework in antitrust—specifically its equating competition with "consumer welfare," typically measured through short-term effects on price and output fails to capture the architecture of market power in the twenty-first century marketplace".

Appendix 3: A Study of Standard Oil

In 1904, John D. Rockefeller's Standard Oil it controlled 91% of oil production and 85% of final sales in the United States. An antitrust case was filed against the company in 1906 under the Sherman Antitrust Act. It was broken up in 1911

The scale of today's assets that have been derived from the Standard Oil break-up in 1911 are shown below. Anyone wanting to understand John Rockefeller better we strongly recommend *Titan, by Ron Chernow*. Those looking into Standard Oil might find *A History of the Standard Oil Company by Ida Tarbell* useful.



Source: Wikipedia

	Year Ended December 31, 2019	2020	2021
North America			
Net sales	$ 170,773	$ 236,282	$ 279,833
Operating expenses	163,740	227,631	272,562
Operating income	$ 7,033	$ 8,651	$ 7,271
International			
Net sales	$ 74,723	$ 104,412	$ 127,787
Operating expenses	76,416	103,695	128,711
Operating income (loss)	$ (1,693)	$ 717	$ (924)
AWS			
Net sales	$ 35,026	$ 45,370	$ 62,202
Operating expenses	25,825	31,839	43,670
Operating income	$ 9,201	$ 13,531	$ 18,532
Consolidated			
Net sales	$ 280,522	$ 386,064	$ 469,822
Operating expenses	265,981	363,165	444,943
Operating income	14,541	22,899	24,879
Total non-operating income (expense)	(565)	1,279	13,272
Provision for income taxes	(2,374)	(2,863)	(4,791)
Equity-method investment activity, net of tax	(14)	16	4
Net income	$ 11,588	$ 21,331	$ 33,364

Net sales by groups of similar products and services, which also have similar economic characteristics, is as follows (in millions):

Disclaimer

This document does not consist of investment research as it has not been prepared in accordance with UK legal requirements designed to promote the independence of investment research. Therefore even if it contains a research recommendation it should be treated as a marketing communication and as such will be fair, clear and not misleading in line with Financial Conduct Authority rules. Holland Advisors is authorised and regulated by the Financial Conduct Authority. This presentation is intended for institutional investors and high net worth experienced investors who understand the risks involved with the investment being promoted within this document. This communication should not be distributed to anyone other than the intended recipients and should not be relied upon by retail clients (as defined by Financial Conduct Authority). This communication is being supplied to you solely for your information and may not be reproduced, re-distributed or passed to any other person or published in whole or in part for any purpose. This communication is provided for information purposes only and should not be regarded as an offer or solicitation to buy or sell any security or other financial instrument. Any opinions cited in this communication are subject to change without notice. This communication is not a personal recommendation to you. Holland Advisors takes all reasonable care to ensure that the information is accurate and complete; however no warranty, representation, or undertaking is given that it is free from inaccuracies or omissions. This communication is based on and contains current public information, data, opinions, estimates and projections obtained from sources we believe to be reliable. Past performance is not necessarily a guide to future performance. The content of this communication may have been disclosed to the issuer(s) prior to dissemination in order to verify its factual accuracy. Investments in general involve some degree of risk therefore Prospective Investors should be aware that the value of any investment may rise and fall and you may get back less than you invested. Value and income may be adversely affected by exchange rates, interest rates and other factors. The investment discussed in this communication may not be eligible for sale in some states or countries and may not be suitable for all investors. If you are unsure about the suitability of this investment given your financial objectives, resources and risk appetite, please contact your financial advisor before taking any further action. This document is for informational purposes only and should not be regarded as an offer or solicitation to buy the securities or other instruments mentioned in it. Holland Advisors and/or its officers, directors and employees may have or take positions in securities or derivatives mentioned in this document (or in any related investment) and may from time to time dispose of any such securities (or instrument). Holland Advisors manage conflicts of interest in regard to this communication internally via their compliance procedures.