HollAnd Advisors

Holland Views: Amazon – Price: $140; MCap: $1.4tn

Reflections on the SES Gorilla

Since our piece on Amazon last year, we have had little to add. In it we tried to think hard on subjects like the power of its reinvestment model when applied not just to consumers, but to businesses also. In addition we considered the potential implications of regulatory efforts against the company. Being very long tail issues all of these areas take time to unfold. Our conclusion on the company's culture and the ultimate power of its business model are unchanged so please do relook at the piece we wrote last year. In areas where our thinking has evolved, we comment below.

Regulation: The wrath of Khan…

When we investigated the history of Lina Khan and her ideas of regulating Amazon a few things struck us. First was her intelligence and incisiveness. She was unlike any regulator we have come across in that she really understood the power of the Amazon business model in its use of scale and efficiency. Initially this made us apprehensive towards what a newly promoted Khan as head of the FTC could accomplish with such intelligence and power.

On reading further however we realised the scale of the task that confronts her. Almost all antitrust regulation set by the US for the last 50 years has been determined by a test of what is good for the customer. If customer outcomes are judged as better, or at least as good, a merger may be waved through, or market position seen as reasonable. This was an important precedent set many decades ago and the same test is used in UK regulation also. It means that regulation is consumer/user facing rather than decided on a company being considered as having too much market share.

That Amazon works very very hard to save its customers money/give them great outcomes of better service and lower prices we are convinced of. Indeed, its passion for this approach shows no sign of easing up at all. As such it is almost impossible to claim that Amazon does anything other than bring better, rather than worse consumer outcomes. This is an ethos it has brought to its business offerings now as well, most notably via AWS. Thus, in order for regulators to claim Amazon's scale is a bad thing, such regulators will need to change the basis on which all regulatory decisions have been made in recent decades, i.e., to row back from what is best for the consumer, to instead a more trust-busting agenda, that just observes scale as bad. This we think a very very unlikely change to be agreed to amongst US elected officials of any political persuasion, however convincing Ms Khan may be. Also, to this point part of our attraction to the Scale Economy Shared model is it gets so few customer complaints as it offers great service and value. As such which Amazon user will be complaining to the FTC about it abusing its monopoly power…? Consumers are happy with the service/price offering. More and more businesses and Government departments are also now benefiting from Amazon's passed-on efficiency too. This being most evident in the passing on of cost savings it gives to its AWS customers.

Ms Khan and her team may be able to find areas where they think a network of such scale is being not run correctly. Indeed, they might even win an argument that forces Amazon to spilt out its third party seller network which is now 30% of non-AWS sales. But if this were forced upon Amazon what might the implications be? We suspect it would only be enhancing to profits as such a hugely profitable third party network is hidden inside an only moderately profitable core. As we observed in our original piece, Amazon is totally obsessed with what is best for the end customer. Do suppliers get squeezed in pursuit of that objective? Yes. If the regulators think such supplier/Amazon relationships need to be better regulated it is up to them to enforce the necessary actions/split of this company. In the first hand we think they will have their work cut out in trying to do so, with so few Amazon customers complaining. On the second, even were they successful we think in time Amazon shareholders might celebrate such a forced change.

A trusted global supplier of AI

One of the reflections that came to us as we researched Amazon last year was of the huge potential of what using a Scale Economy Shared model might yield in the business-to-business sector. All the companies we have studied globally using this business model do so in the B2C arena. Except for TSMC we could not think of another using it in the business-to-business arena. This intrigued us and suggested a potential huge future opportunity for AWS. With AWS providing critical functionality to many of the world's biggest and most important organisations, Amazon has become a highly trusted business partner. That it shares its efficiency in a way so few suppliers do is also a dramatic change in how government departments for example are used to engaging with those they outsource to. This we observed was crucial relationship building at multiple levels in an unprecedented way. We suggested this could mean that one day Amazon would be set to sell more B2B services which if in demand and offered at the right price those customers would quickly trust it to supply.

What those future products were going to be we had little idea when writing last Spring. Listening to Andy Jassy on the company's most recent investor call leads us to think that AI might be one such product area. We are likely to be the last people to understand what and how AI can be deployed globally, but even we can see its potential in the business sector in problem solving and customer handling etc. Andy Jassy's comments we thought revealing. Yes, we can all see/read that Nivida has complex AI chips that the world wants today but is Ryanair going to order those chips and start building its own AI functions in house from scratch? No, they are either going to outsource such functions to other companies that most likely will run the programming though AWS cloud data system. Or they are going to wait until easier to use off the shelf products are provided to them by a corporate they already trust to innovate, and supply needed functionality at great prices. Enter Amazon. That AWS has already shown its ability to develop its own chips (Graviton) in the past, passing on the achieved efficiency to AWS customers is a blueprint for what might come next for AWS and AI.

Imagine for moment as an AI start up trying to convince the Department of Defence, the World Bank or CIA how they should use you as their preferred supplier of AI tools and functionality. When you are only amongst a small handful of companies in the world with such knowledge maybe they will listen to you. The moment such skills become a little more widely spread they will use a trusted supplier, and no-one is more trusted that AWS.

Valuing Amazon

Valuing Amazon is a feat that has defeated better brains than ours. We gave our best estimate of value in our first piece, suggesting the price had fallen enough as it approached 15-20x PE multiples a few years out on our look though earnings. Those past calculations are re-attached and unchanged (warts and all) for readers to see.

We thought the recent quarter profitability of the North American eCommerce business was helpful to those of us seeking to value the company. Also too was Andy Jassy's commentary when asked about this issue:

> *"North America will get back to the margins like we had before Covid. I don't think that's the end of what's possible for us there"* ***Andy Jassy, Amazon CEO July 2023 Analyst call***

North America – eCommerce

For the record NA EBIT margins were 4.1% in 2019 and 5.1% in 2018. If this divisions sales are assumed to keep growing at 12% pa then NA sales two years from now will be c.$415bn.

- A 5% Margin applied to this = **$21bn of EBIT (Calc A we will call this)**

AWS

Additionally, AWS sales growth today seems depressed as do its margins. Two years from now AWS might have a c.$125bn sales run rate and say 30% margin again.

- This would produce an **EBIT of $37bn (Calc B)**

This makes no assumption about any AI growth potential in this division.

Combined, these figures = $58bn of EBIT, say $43bn profit after tax. This implies a PE of 32x. Plausible but hardly a giveaway valuation. More interesting for us than such calculations (that many other analysts also undertake) is what is not included. The two notable exceptions for us are **Subscription revenues and Advertising revenue.** Rolling Amazon Prime's revenue forward two years, it will likely be c.$50bn pa. We noted in our 2022 note how Amazon's business model has closely copied that of Costco. We noted how Costco's profits closely mirrored its subscription revenue with all other transactions arguably happening at 0% net margin to the company as a result. Were Amazon to consider its profitability in this way maybe **its consumer segment profits are better represented by the $50bn (C) of subscription revenues instead of $21bn** that derives from our 5% margin?

Advertising

The other issue that must be considered is advertising. Whilst it is hard to disaggregate the cost of running the group's delivery network from say the profits derived in eCommerce or third party sales, advertising revenue is clearly a separate line item. It requires little incremental capital and arguably has limited effect on the core business. It is popular however as advertisers wanting to reach their target market are keen to use Amazon's eyeballs to do so. Assuming this offering is managed sensibly, so as not to distract from the core eCommerce user experience then it is genuinely incremental revenue. It is also very likely to be high margin revenue. When Amazon reported a 5.1% NA eCommerce EBIT margin in 2018 it had advertising revenue of c.$9bn pa. In two years' time these advertising revenues are likely to be $62bn. Surely these in any other company would be reported at c.50% margins. If we assume a 40% EBIT margin on the incremental sales added since 2008 this would result in an additional **EBIT of $16bn (D)** – ($62-$9bn*30%).

A few sums

A+B = $21bn+ $37bn= $58bn
A+B+D = $21bn+ $37bn +$16bn= $74bn
B+C+D= $37bn+$50bn+ $16bn= $103bn
Current market cap = $1,300bn

None of these calculations assume any step change in the size of AWS/AI type incomes, which as likely high in margin could have a big swing factor driving the future visible profits of Amazon.

We don’t feel a need to spin these arguments out further. All readers can make up their own minds as to what this company’s underlying earnings power is/could be in a more steady state environment. The tricky bit of course is that such a steady state is unlikely to materialise any time soon!

Hopefully, readers purchased shares in arguably the world’s best Scale Economy Shared company during last year’s share price fall. If so, today they should be happy holders.

With kind regards

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