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Amazon's Achilles' heel

Evan Lorenz writes:

"The underlying cause was malinvestment caused by too low interest rates," recalls Martin Fridson, CIO of Lehmann Livian Fridson Advisors, LLC, of the dot-com bust of yore. Amazon.com, Inc. (AMZN on the Nasdaq) is the subject at hand, and the tech wreck of 2000–02 is a principal point of reference. In preview, we're bearish—still—on the Everything Store.

Did anyone have a better pandemic than Jeff Bezos? It would be hard to imagine it. Amazon's revenues leapt by 73%, to $485.9 billion, in the 12 months ended June 30, from $280.5 billion in 2019. The CEO stepped down on July 5, 2021, handing off the top role to Andy Jassy, the former chief of Amazon's cloud division. Yet, for all the upheaval, Amazon's share price has returned to the point at which we said it was too high (see the issue of *Grant's* dated June 26, 2020): from $134.64 to a split-adjusted high of $186.57 on July 8, 2021 and now, virtually, back again.

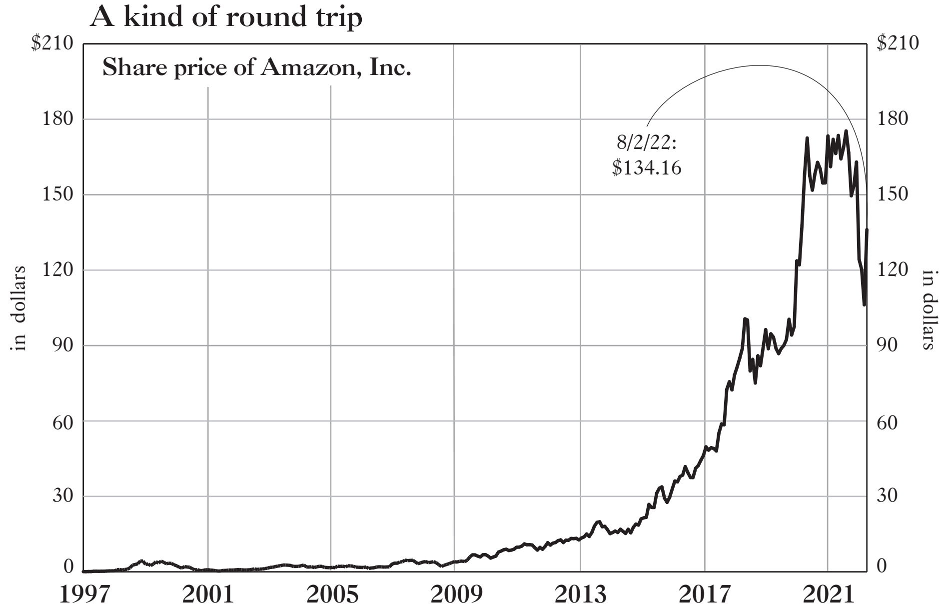
Amazon divides itself into three units: North America (60% of revenue in the 12 months ended June 30), International (25%) and Amazon Web Services (15%). The North American and International units comprise the online store, the brick-and-mortar sales from Whole Foods Market, Prime subscriptions, logistics and business services sold to third-party merchants, advertising revenue, video streaming, movie studios and more.

Just describing Amazon's Prime subscription service takes some doing. It is free two-day delivery, access to streaming videos and music, a photo storage site, and free e-books. Subscribers are entitled to a year of free food delivery from Grubhub, Inc., and Prime students to a six-month premium membership on LinkedIn. Starting Sept. 2, Prime customers will be able to stream the brand-new *Lord of the Rings: The Rings of Power* series. Thirteen days later, Prime will become the exclusive broadcaster of NFL Thursday Night Football. The annual cost to purchase separately each of the many bundled Prime services? JPMorgan & Chase Co. analysts Doug Anmuth and Bryan Smilek come up with $1,104. Compare and contrast Amazon's price tag of $139.

Whatever else Amazon does, it grows. Witness its recently announced, $3.9 billion acquisition of 1Life Healthcare, Inc., operator of primary-care practices under the brand One Medical. The completed transaction would give Amazon an entrée into U.S. healthcare, i.e., a 19.7% slice of America's GDP.

It would take an acquisition both large and lucky to match the profit dynamo called AWS, which delivered $22.4 billion of the $15.3 billion in second-quarter trailing operating income. The reason the first-named figure is bigger than the second is that the two retail divisions made losses. AWS revenue spurted by 33.3% from the year-earlier period, outpacing the 10.2% expansion in North American sales and an 11.9% contraction in International sales.

A kind of round trip



source: The Bloomberg

Amazon.com, Inc. at a glance
all figures in $ millions except per share data

	TTM*	2021	2020	2019	2018
North America	$291,591	$279,833	$236,282	$170,773	$141,366
International	122,241	127,787	104,412	74,723	65,866
Amazon Web Services	72,070	62,202	45,370	35,026	25,655
total sales	485,902	469,822	386,064	280,522	232,887
North America	-1,521	7,271	8,651	7,033	7,267
International	-5,590	-924	717	-1,693	-2,142
Amazon Web Services	22,409	18,532	13,531	9,201	7,296
total op. income	15,298	24,879	22,899	14,541	12,421
net income	11,607	33,364	21,331	11,588	10,073
earnings per share	1.09	3.24	2.09	1.15	1.01
shares outstanding	10,175	10,300	10,200	10,080	10,000
cash	60,710	96,049	84,396	55,021	41,250
debt	58,053	48,744	31,816	39,791	9,650
operating leases	66,524	67,651	52,573	39,791	9,650
total assets	419,728	420,549	321,195	225,248	162,648

*Trailing 12 months ended June 30, 2022.

source: company reports

"We believe we're still in the early stages of enterprise and public-sector adoption of the cloud," CFO Brian Olsavsky told his earnings-call audience on July 28. "We see great opportunity to continue to make investments on behalf of AWS customers. We continue to invest thoughtfully in new infrastructure to meet capacity needs while expanding AWS to new regions, developing new services and iterating quickly to enhance existing services."

The share price is another story, down 19.5% in the year to date but with a big and loyal fan base still behind it. "Amazon Stock Has Gotten Crushed. There's a Case It Could Double, or Even Triple, from Here," was the headline hung over a July 22 *Barron's* article, which found that the sum of Amazon's parts was greater than the currently valued whole. Who knew that the great growth name had become a value stock?

Gene Munster, portfolio manager at Loup Ventures, told *Barron's* that AWS will generate $45 billion in operating income this year. Slap a 25 times multiple on that figure, and the cloud business alone, at a hypothetical value of $1.1 trillion, would come within $300 billion of matching Amazon's $1.4 trillion total market cap. "That means investors are currently getting everything else free," *Barron's* explained. "Online stores, Prime, logistics, Whole Foods Market, and a host of other businesses that Amazon has acquired over the years."

The balance sheet, too, supports the bull narrative. On the June 30 statement date, Amazon showed $60.7 billion in cash, $58.1 billion in debt and $66.5 billion in operating lease liabilities. Moody's Investor Services (which rates Amazon A1) and S&P Global Ratings (double-A) agree that Bezos has built himself a solid investment-grade credit.

Of the 60 analysts on the AMZN case, 58 say buy, so it's no surprise that the short interest amounts to less than 1% of the equity float. It's the insiders who see the situation our way. Over the past 12 months, Amazon executives (Bezos excluded) unloaded a split-adjusted 469,640 shares for proceeds of $71.9 million.

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If Amazon is a value stock, it's the unusual kind that trades at 121.8 times trailing earnings per share and 25.6 times enterprise value to trailing Ebitda. One wonders, then, how to characterize Walmart, Inc., at 21.4 times trailing EPS, and cloud peers such as Microsoft Corp. (30 times) and Alphabet, Inc. (22.3 times). Remnant-deep value?

The One Medical acquisition isn't Amazon's first foray into healthcare, though it wouldn't take much to make it the most successful. Preceding One Medical was the forgettable 2018 purchase of online pharmacy PillPack, Inc., for $753 million, and the ballyhooed joint venture with JPMorgan Chase & Co. and Berkshire Hathaway, Inc. to tackle runaway medical costs and improve patient outcomes, also in 2018. The blue-chip partners abandoned their project last year.

Altogether, Amazon's record with acquisitions is an undistinguished one, with the 2017 purchase of Whole Foods Markets, Inc., for $13.6 billion, serving as a case in point. In fiscal 2017, the up-market grocer booked $16 billion in sales at 470 stores. Last year, its fourth under the Amazon banner, Whole Foods booked $17.1 billion in sales at more than 570 locations. Inflation's gift to the top line notwithstanding, same-store sales appear to have declined under Amazon's ownership.

Two years ago, citing multi-week delivery times for consumer electronics, we fretted that Amazon would fail to keep up with the surge in pandemic-driven demand. Amazon rose to the occasion and then some. From year-end 2019 to 2021, it doubled its head count to 1.6 million and increased its real estate footprint by 81.1%, to 605.4 million square feet.

Today's headache is too much capacity. To Amazon's redundant warehouses, which featured in the May 27 issue of *Grant's*, add the new halt in construction of Amazon office buildings in Bellevue, Wash., and Nashville, Tenn., and management's evidently strategic retreat from its pre-pandemic plan for more office leasing in Manhattan's Hudson Yards. Of course, Amazon was hardly alone in betting that the lockdown boom would continue long after the virus receded. Shopify, Inc., which helps brick-and-mortar merchants compete online against such behemoths as Amazon itself, says it's reducing head count by 10% following its own belated reappraisal of the Covid boom.

The downturn in merchandise sales that's hurt Walmart, Inc., Best Buy Co., Inc. and Aaron's Co. (the rent-to-own furniture and consumer-electronics vendor) has certainly not passed by the Everything Store. In the second quarter, a 10.2% North American revenue surge translated into an operating loss of $627 million versus a profit of $3.1 billion in the year-earlier period. In the same quarter, the International division reported a sales decline of 11.9% and an operating loss of $1.8 billion compared with an operating profit of $362 million the year before. Without AWS, Amazon would be hard to distinguish from another money-losing retailer.

As it is, according to a first-quarter calculation by research firm Canalys, AWS commanded 33% of cloud market share, followed by Microsoft's Azure unit (21%) and Google Cloud (8%). Even so, faltering momentum at the essential web unit presents the biggest risk to the Amazon share price. Measured year over year, AWS's top-line growth decelerated to 33.3% in the second quarter, from 37% in the first quarter and 40% in the fourth quarter.

It happens that AWS's 2006 founding marked the start of the cloud revolution and the liberation of early-stage technology companies from the costly necessity of buying their own servers and data-center space. In part for this reason, startups, profitless technology businesses and cryptocurrency projects are heavily represented on the AWS client roster. Not that you could prove it from Amazon's SEC filings; management began breaking out AWS revenue separately only in 2015 and stays as mum as it decently can on the size of its Prime subscriber population.

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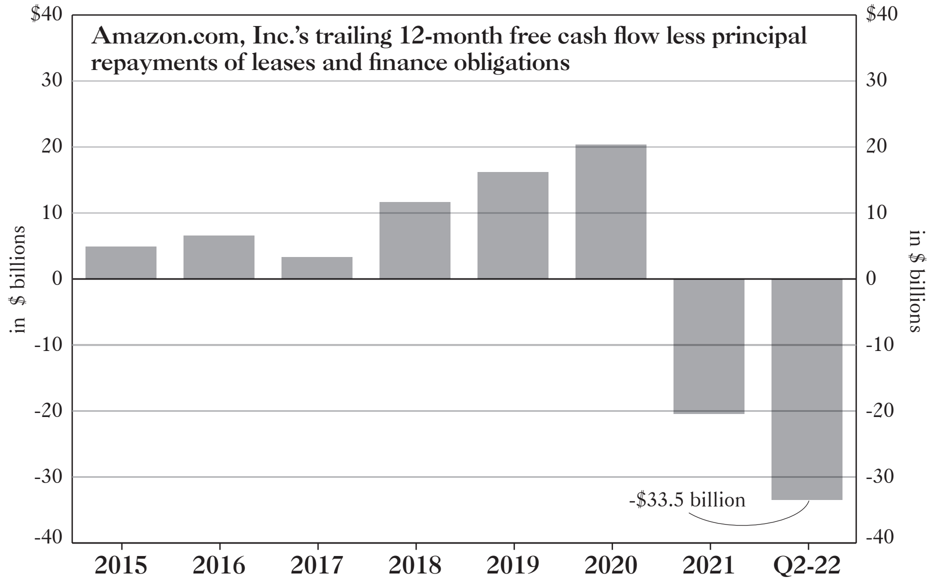
Research boutique Apps Run the World, which identifies which cloud customers deal with which web service vendors, finds that 34.5% of Amazon's customers employ fewer than 100 people. That arresting figure compares with exactly zero percent for Microsoft. "Microsoft and Google primarily serve enterprise [customers]," Fred Hickey, proprietor of *High-Tech Strategist*, tells me. "Amazon Web Services is the one that sells to all of these crazy companies that come out of the blue, whether it is NFT companies or crypto companies."

On one of its marketing pages, AWS has this to say about its fashion-forward customer base: "More customers trust AWS for their blockchain and ledger technology workloads than any other cloud vendor. 25% of all Ethereum workloads in the world run on AWS." (So much for decentralization.)

Another kind of cloud



source: company reports

In 2015, AWS published a case study on Coinbase Global, Inc., the first regulated cryptocurrency exchange in America. "As a startup company that built its bitcoin exchange in the cloud from day one, Coinbase has more agility than it would have had if it created the exchange internally," notes the report. " 'By starting with the cloud at our core, we've been able to move fast where others dread,' says [Coinbase director Rob] Witoff."

Fast forward seven years. In May, Coinbase announced a hiring freeze and plans for slashing costs, including outlays on AWS. As *The Information* helpfully explained, "Fast-growing companies like Coinbase often let their numerous teams handle their own cloud spending, so cutting costs usually means appointing someone or a group of people to oversee and control those expenditures companywide." Given the steady drumbeat of tech layoffs, Coinbase is unlikely to be alone.

It's here that comparisons to the tech bust of a generation ago come into practical play. In the late 1990s, growth in internet usage seemed limitless. To meet projected bandwidth needs, telecommunication firms laid down millions of miles of fiber-optic cables complete with network switches, routers and other such impedimenta.

In the way of a speculative boom, the futurists overdid it, as a 2002 post mortem in *The American Prospect* details: "Many companies have built networks and burned cash. Fiber-optic networks costing billions of dollars remain unused because there is no prospective demand for them, and the companies that built them are broke. And partly because much of this investment was vendor-financed—that is, capital came from manufacturers such as Lucent, Nortel, Motorola, Alcatel and Cisco, which were anxious to sell their products—the collapse has extended to the equipment sector."

And so, we submit, today: Amazon is probably putting into place more capacity for cloud services than the world needs, or may need for many a moon.

Management funds this growth through leases and the outright purchase of servers and data centers. Leases outstanding increased to $66.5 billion on June 30 from $39.8 billion in 2019. Amazon does make a clean breast of these facts. On the second-quarter call, Olsavsky told analysts that capital expenditures plus equipment finance leases will be up slightly from the $60 billion or so it spent last year, but that the proportion supporting tech infrastructure (mostly AWS) will rise to over half from around 40% last year.

That means Amazon will spend more than $30 billion on technology infrastructure alone this year. In 2019, total capital expenditures plus lease repayments summed to $22.3 billion. Note that Amazon will spend more on AWS in 2022 than it did on the entire company in the year before the bug hit.

It can take an awfully long time for the market to absorb the capacity thrown up in the heat of a bull market. In 1999, telecom companies laid down 3.9 million miles of fiber, boosting the nationwide total to a little more than 16 million miles. "Today," a September 2018 article in *Microwave Product Digest* related, "much of that fiber remains unused."

These facts help to explain the curiously high cost of the post-dot-com recession. It was shorter than the 2007–09 affair (8 months versus 18 months) and, by the numbers, much less severe (measured in terms of peak-to-trough decline in real GDP, 0.1% versus 3.8%). But the tech wreck dealt more pain to credit investors than the Great Recession did.

For perspective, according to Moody's Investors Service, the 12-month default rate for sub-investment-grade U.S. loans and bonds has averaged 3.98% since 1970. While the Great Financial Crisis produced a higher peak default rate—14.68% in November 2009 versus a high of 11.13% in January 2002—the post-dot-com bust lingered longer. Driven by telecom defaults such as those at Global Crossing Ltd., Williams Communications Group, Inc. and Genuity, Inc., the post-dot-com trailing default rate held above its 52-year average for 62 long months between 1999 and 2004. In contrast, the housing bust produced 22 months of defaults above the long-term average.

Amazon is hardly a bankruptcy candidate, even if trailing 12-month free cash flow less finance lease payments did fall to a deficit of $33.5 billion in the second quarter from positive $4.2 billion a year ago. However, the one and only reason the market confers a trillion-dollar-plus valuation on AMZN is its continued faith in the rapid revenue and profit growth of AWS. Let the top line slow to even single-digit growth (which, given current capital spending plans, would leave Amazon with a great deal of excess overhead to absorb), and the shares would almost certainly re-rate lower—we will venture sharply lower.

"We saw what happened to the people who were providing the back-end services to all of the dot-com players in 2000 and 2001," Hickey observes. "That business crashed once the funding dried up. What are we seeing now? We are seeing funding dry up. The IPO market is almost nonexistent at the moment. The junk-bond market has tightened considerably. Rates are higher. And we've seen lots of these venture capitalists, Bill Gurley being one of the examples, saying you better cut back. Rough times are ahead."

However, if history is any guide, investors will be astounded. "From all of my studies," Fridson tells me, "I've found no evidence of learning in the financial markets."

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