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Not quite everything

Evan Lorenz writes:

The day traders' verdict is in, and Amazon.com, Inc. is the undisputed champion of the coronavirus economy. With shares up 49.6% year-to-date, the Everything Store is the top performer among the five tech titans that now constitute 21.6% of the S&P 500. (For comparison, Microsoft Corp., Apple, Inc., Alphabet, Inc. and Facebook, Inc. have rallied by an average of 20.1%.) Following is an overview of America's post-quarantine economy and a bearish appraisal of Amazon (AMZN on the Nasdaq).

China instituted a strict lockdown in Wuhan, Hubei on Jan. 23, with various restrictions following in other cities and provinces, and then lifted the quarantine on April 7. Not until March 22 did the shelter-at-home order of New York Gov. Andrew Cuomo take effect, and the state is still in the process of re-opening. As a result, the experiences of the People's Republic may serve as a template for other economies now emerging from their own viral bunkers, last week's outbreak of Covid-19 in Beijing notwithstanding.

By some measures, at least, China is off to the races, with the Chinese manufacturing purchasing managers index jumping to 50.6 in May from 35.7 in February and the non-manufacturing PMI leaping to 53.6 in May from 29.6 in February.

"Everyone is focusing right now on the quarter-on-quarter improvement," Leland Miller, the CEO of China Beige Book International, a firm that surveys more than 3,300 mainland businesses, tells me. "Fair enough. You are seeing a slight expansion in our data from what was a nightmarish 1Q. . . . You are seeing a recovery, but the word 'recovery' has essentially lost all meaning because in February you had an economy that was shut down. . . . When you look at the year-over-year figures, the economy is still mired in a very deep recession. This quarter we saw services tick up into expansion, manufacturing tick up into expansion, retail is still in contraction. That is not nothing, [but] the recovery is much more muted than what people understand."

As every China watcher knows, the People's Republic has grown through debt-funded fixed-asset investment. But what's notable in recent surveys, China Beige Book reported last week, is how few businesses are taking on more debt: "A steep decline in credit costs seemingly didn't encourage struggling retailers to borrow. It's possible weak retailers are either already bankrupt or sufficiently worried about their prospects that borrowing to stay afloat has no appeal."

A similar pattern is emerging on this side of the Pacific. On June 16, the U.S. Census Bureau released its advance report on May retail sales: From the April doldrums, sales rose 17.7%, easily surpassing expectations of 8.4%. Yet, on a year-over-year basis, May retail sales fell by 6.1%, and those for the first five months, by 4.7%.

Ben Breitholtz, data scientist at Arbor Research & Trading who divines trends in business activity from online search-engine results, had been calling for a reacceleration in consumer spending. But lately he sees the strong month-on-month gains tapering off.

In particular, Breitholtz is concerned about what search intentions mean for employment. "The job market is sticking out still like a sore thumb," he tells me. So bad was the Great Recession that recruiters temporarily vanished even as job seekers persisted in the hunt. Now, says Breitholtz, both the recruiters and the seekers have gone quiet.

Retail property owners appear to be hunkering down for more bad news. On May 8, mall owner and pick-not-to-click Brookfield Property Partners, L.P. reported that only a fifth of retail tenants had paid April rent (*Grant's*, Nov. 29, 2019). On May 15, J.C. Penney Co., Inc. filed for bankruptcy protection. Last week came news that Property Partners, along with Simon Property Group, Inc. and Authentic Brands Group, were in talks to acquire the failed department-store chain.

Why? The shuttering of two or more anchor tenants can wreak havoc on a mall owner's income statement. This is because co-tenancy clauses typically grant rent relief to higher-paying inline tenants to compensate for the presumptive loss of revenue resulting from a decline in mall foot traffic. On May 27 Green Street Advisors predicted that more than half of mall-based department stores will close by the end of 2021. Thus, mall operators are preparing to buy up the ruins of those once thriving retailers to protect what remains of their rents.

Meanwhile, OK-grade economic releases, like the new retail-sales report and the May jobs report, are threatening to defund the national economic stimulus drive, in particular the weekly $600 supplemental unemployment payments that are slated to expire on July 31. "I mean, we're paying people not to work," Larry Kudlow, Trump's National Economic Council director, reminded viewers of CNN's "State of the Union" the other day.

Despite the record $2.5 million gain in payrolls last month, there were still 21.5 million fewer Americans employed in May than in February. To erase that deficit, you would need another nine months of job growth at last month's pace—not a rate that seems likely at the moment. "There will be targeted, but sizable reductions in our workforce across executives, managers and union-represented employees," AT&T, Inc. declared in a June 17 announcement. Hilton Worldwide Holdings, Inc., HSBC Holdings plc and Allstate Corp. are likewise axing jobs by the thousands.

Digging into the Bureau of Economic Analysis's April personal-income report, one finds that, while wages shrunk by 6.7% year-over-year, government transfer payments surged by 101.9%, to deliver an 11.7% jump in personal income. Nor, to judge by the 33% savings rate recorded in April, are households spending this windfall, at least not on merchandise. (Investing is another matter as the economic shutdown and stimulus have coincided with a riot of retail stock trading.)

"This shouldn't come as a surprise to anyone," a quartet of Barclays Capital, Inc. analysts led by Ross Sandler observed in April, "but Amazon is likely the most well-positioned company in our coverage universe (perhaps the whole market) to gain share during the current environment."

Each of Amazon's businesses seems almost custom-designed to exploit the various dislocations caused by Covid-19. The online store's gain is, at least in terms of revenue, the brick-and-mortar retailers' loss. Whole Foods Market, Inc. benefits from consumers loading up their pantries. And Amazon Web Services, the leading cloud brand by revenues, is poised to see more business as homebound employees log on to work and/or stream movies in lieu of going to the theater.

In the 12 months ended March 31, the three-legged Bezos empire generated $296.3 billion in sales and $14.1 billion in operating profit through its major divisions: North America ($181 billion in sales and $6.1 billion in operating profit); international ($77.6 billion and a $2 billion loss); and Amazon Web Services ($37.5 billion and $10.1 billion).

While the first quarter did deliver an uplift in orders—North American sales growth accelerated to 29% from 22% in the fourth quarter, both measured year-over-year—Amazon was not immune from virus-related difficulties. Thus, it was a problem, if a high-grade one, that a deluge of orders met a management team dealing with lower warehouse productivity on account of enhanced safety precautions. To cope, Amazon halted orders for nonessential goods for parts of March and April so that, in the first three months, revenues leapt by 26.5% but operating profit sagged by 9.8%. In normal circumstances, said Bezos, second-quarter operating profit would have weighed in at about $4 billion; in the reigning abnormality, break-even was rather the outlook.

In consequence, analysts pencil in an 18% slump in 2020 earnings per share. But because they expect a prompt return to normalcy, the same analysts project a 98% surge in next year's EPS and compound growth at a 31.3% annual clip between 2019 and 2023.

To its credit, Amazon has the balance sheet to allow it to do what it wants. At the end of the first quarter, cash and marketable securities of $49.3 billion were greater than $23.4 billion of debt. Add lease liabilities to the total, and net debt of $14.4 billion is 0.5 times trailing earnings before interest, taxes, depreciation, amortization and rental expense. Standard & Poor's rates Amazon double-A-minus.

At 132 times trailing earnings, 4.8 times enterprise value to sales and 34.9 times EV to Ebitda, the stock is hardly arithmetically cheap. Of the 55 analysts on the case, one calls it a sell, 50 a buy and four seem not to have made up their mind. After this year's rally, short interest comprises 0.8% of the float. However, insiders, including Bezos, have sold a net 2 million shares for proceeds of $4.2 billion at an average price of $2,039.63. Even so, the founding light and CEO is on track to become the world's first trillionaire in just six years, according to a May blog post on the software-review site Comparisun—that is, if Bezos can just continue to compound his wealth, as he has done for the past half-decade, by 34% per annum.

Obviously, no bear case on Amazon can rest on valuation, though this publication made a game try of it in the issue dated March 13, 1998. At the time, Southland Corp., owner of 7-Eleven convenience stores, traded at 0.1 times revenue and 12.8 times earnings, while Amazon changed hands at 119 times revenue and produced no earnings. "Almost certainly, it seems to us, the market is being overly credulous about the new bookseller and unnecessarily cynical about the old Slurpee purveyor," said we.

From then to Nov. 9, 2005, when Southland was acquired by its Japanese partners, the Slurpee stock produced a 44.3% compound annual return versus Amazon's 27.2% (the dot-com crash notwithstanding). Sometimes value wins.

But sometimes, it's a great entrepreneurial vision that prevails over a mere snapshot of price and value. Thus, over the next 14.5 years (a period when value investments lagged the market), Amazon generated a 33.3% compound annual return, helped in no small part by the 2006 launch of Amazon Web Services.

(Footnote: Frederick E. "Shad" Rowe was a leading bull on Southland in 1998, and so we quoted him then; today, the adaptive Dallas investor is among the prospering bulls on Amazon.)

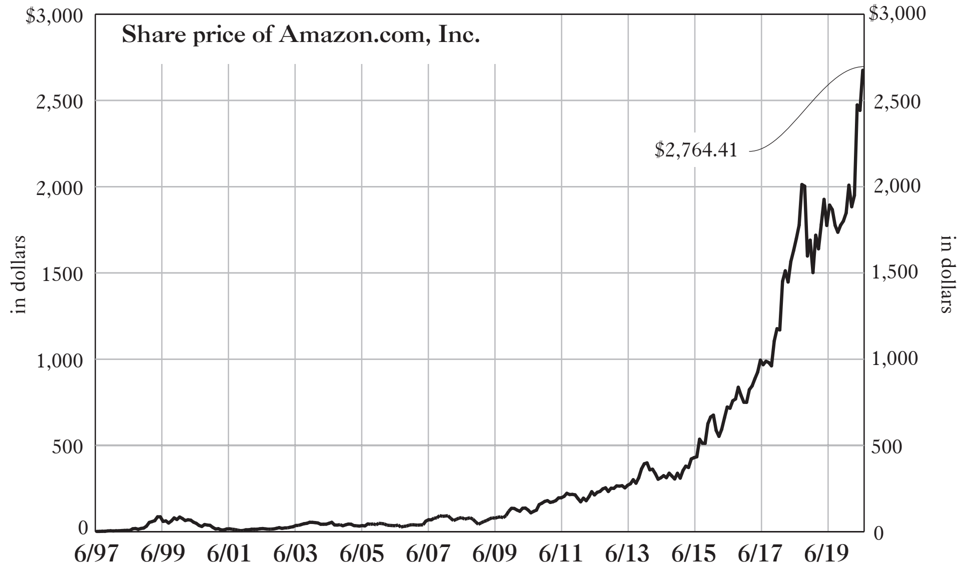
Still and all, Amazon is far from a scrappy underdog today, and it would be mathematically difficult to invent another AWS-size business. As mentioned, the company generated $296.3 billion in sales over the past 12 months (adding third-party sales on Amazon.com would raise the total to a half-trillion dollars). Strategically placed for growth Amazon may be, but not even online sales, and not even AWS, are likely to escape the recession, especially if fiscal stimulus is removed this summer. Besides, the law of large numbers says that Amazon will struggle to outgrow the industries in which it now competes.

The lone institutional bearish voice on Amazon, R5 Capital, a research boutique in New Canaan, Conn., spoke up in April, predicting a period of lackluster growth for Bezos & Co. Said the R5 analysts, Scott Mushkin and Matt Siler: "With our expected slowdown of the four large profit drivers, [third-party sales], subscription services, AWS and advertising, in conjunction with the cost of doing business increasing due to Covid-19, our outlook for profitability has . . . been reduced considerably. It is important to note that our forecast still calls for growth, but not at the heady levels prior to Covid-19 and the resulting economic slowdown. It is also important to note that we still view Amazon as well positioned to gain share over time."

Growth in AWS, the biggest profit center in the company, slowed to 33% year-over-year in the first quarter, following a tapering trend over the most recent four quarters: 34%, 35%, 37% and 42%. "When we talk to them," Michael Levine, who rates Amazon a buy at Pivotal Research Group, tells me, "they say, 'Look, the reality is we've got some clients who are really usage-based, and they're up like 300%. But we've also got exposure to travel and hospitality,' which I don't think [Microsoft] Azure and Google have as much of, just based on my chats with those guys. The reality is that they're so broad that anybody who's using public cloud is using them. I think there are very few people you would find who are just using Azure."

Then, too, competition is hotting up in the Cloud. Google, a distant number three to Amazon's pole position, named Thomas Kurian, a former president of Oracle Corp., as CEO of its cloud operations in January 2019. According to the must-read online tech paper The Information, Google has set 2023 as its deadline to surpass AWS. Kurian is doing this through a focus on basics ("Engineers were often more focused on projects they deemed interesting," *The Wall Street Journal* reported on Feb. 24, "rather than what customers were wanting") and through poaching talent from AWS.

More than a bookstore



source: The Bloomberg

On the latter point, Amazon filed suit last month against Brian Hall, a former AWS vice president who jumped ship to Google, to enforce an 18-month non-compete. This filing raised eyebrows in tech circles as Hall, a marketing man, had none of the deep technical knowledge of, say, an engineer.

A June 9 follow-up raised eyebrows here at *Grant's*. In the new filing, Amazon asks the Superior Court of the State of Washington to bar Hall from writing or editing speeches for Google's Cloud Next event that begins on July 14. "My team watches Google Cloud Next incredibly carefully as this conference has the potential to upstage our anticipated launches and interrupt our positive press for the next year," Matt Wood, an AWS vice president, addresses the court.

It scarcely sounds like Amazon. The Bezosian mantra, enshrined in the 1997 letter to shareholders (which document is still attached to every annual report issued by the company) is that it's all about the customers, not the competitors. At least in the AWS division, that may no longer be true.

Perhaps reports of proliferating numbers of no-pay cloud customers, whose ranks are said to include even Oracle and Slack Technologies, Inc., may explain the evident anxiety at AWS. "And we see that in almost every industry," Mushkin tells me. "You don't care about your competitors until the pie stops growing quite as fast."

Last year Amazon paid $881 million in taxes on $14 billion in pretax profits, a rate low enough—6.3%—to earn the booby prize of Fair Tax Mark, a British organization that rates companies on "good" tax conduct from a government's point of view. In the ranks of big tech, Fair Tax contends, none pays less of its fair share than the Everything Store.

Negotiations between the United States and the European Union on how better to tax the likes of Amazon broke off on June 18, but the European Union has announced it will levy its imposts even without a deal. Perhaps such taxes may take the form of the 3% levy on corporate revenue (as opposed to pretax operating profit) that France has enacted, but held in abeyance, pending a U.S.-EU meeting of the minds. A 3% tax on Amazon's $77.6 billion in international revenue would work out to $2.3 billion, or $4.60 a share, a material sum relative to the $13 billion, or $27.62 a share, in trailing 12-month pretax profits.

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Amazon has transformed itself from a seller of books into a seller of everything through the expedient of third-party sales. Such outside vendors accounted for 58% of gross merchandise revenue in 2018, up from 3% at the start of the millennium. (You can find the proportion of third-party sellers in Bezos's letter that accompanied the 2018 annual report.) In the 12 months ended March 31, 19%

Amazon.com at a glance
all figures in $ millions

	TTM*	2019	2018	2017	2016
revenue	$296,274	$280,522	$232,887	$177,866	$135,987
operating profit	14,110	14,541	12,421	4,106	4,186
net income	10,562	11,588	10,073	3,033	2,371
cash	27,201	36,092	31,750	20,522	19,334
marketable securities	22,091	18,929	9,500	10,464	6,647
debt	23,437	23,414	23,495	24,743	7,694
total assets	221,238	225,248	162,648	131,310	83,402
cash flow from operations	39,732	38,514	30,723	18,365	17,272
capital expenditures	20,366	16,861	13,427	11,955	7,804
free cash flow	19,366	21,653	17,296	6,410	9,468

* For the 12 months ended March 31, 2020.

source: company reports

of Amazon's overall revenue came from third-party sellers. While the profit on this revenue line is undisclosed, it's believed to be more lucrative than Amazon's own online sales, which produce 50% of corporate revenue.

This reliance on nonaffiliated merchants has created a set of problems that the coronavirus only made worse. Before the bug bit, journalists on both sides of the Atlantic were describing how counterfeits, knockoffs, products declared unsafe by national regulators and lead- and cadmium-laced toys had wheedled their way into the Amazon bazaar. On April 29, American regulators branded Amazon's websites in Canada, France, Germany, India and the United Kingdom as "notorious markets" on account of alleged intellectual-property violations.

Price gouging, an offense as much against propriety as the law, is a headache that Amazon has addressed by admonishing its merchants to stop doing it—but without providing a hint as to what might qualify as a fair price. Facing the threat of eviction, not a few of the offending merchants responded by pulling their products from Amazon websites, thus exacerbating shortages of hand sanitizer, toilet paper, disinfectant wipes and the like.

Despite its investments in people and processes to meet the wave of lockdown-induced demand, Amazon still struggles with longer shipping time and delays. Mushkin tells me via email that stated delivery times for goods ranging from shoes to TVs are quoted as a week or longer, perhaps indicating that the virus is causing more problems in Amazon's distribution centers than is widely appreciated. For their part, consumers are trying different online vendors, the biggest beneficiaries, according to R5 Capital, being Walmart, Inc. and Target Corp.

Last week, Shopify, Inc., which provides retailers with the tools to compete online, signed deals to put its clients on Walmart's online store. In contrast to the laissez-faire Amazon, Walmart spends time vetting each merchant, perhaps reasoning that the potential savings in reputational troubles are worth the effort.

Until recently, Jeff Bezos appeared to be living life as large as perhaps any other middle-aged prospective trillionaire would choose to live it. However, the world's richest man seemed suddenly to refocus in March, at least by the *New York Times*'s telling, and today Bezos is again directing day-to-day operations in Seattle. Last week he agreed to appear before Congress to answer allegations that Amazon is abusing its dominant position to squash competition. He may find his schedule filling up fast. New antitrust investigations span from the EU to California. New class actions from workers, contending that Amazon did not do enough to protect against the virus, are also on the docket—which docket may or may not grow even longer as a result of the autumn's elections. Not everybody loves a winner.

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