

# Portfolio Watch

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## AMAZON: INVESTMENT PRECEDES GROWTH

Earlier this year, Amazon released its 2022 full year results and for the first time in nearly a decade, the business reported a net loss of US\$2.7bn. Although revenue grew 9.4% over the period, Amazon's profitability deteriorated, resulting in the company's share price and management team coming under significant pressure over the last few months. Given that Amazon is a key holding within our Global Equity Portfolio, we reviewed our long-term investment case for the business.

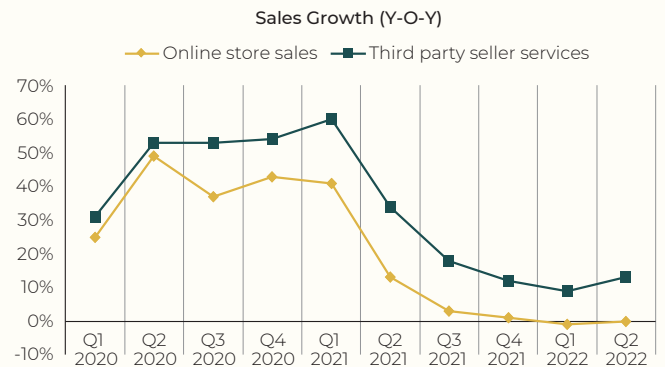
### HOW DID WE GET HERE?

Amazon was a key beneficiary of the unprecedented growth seen in online shopping during the COVID-19 pandemic, with its e-commerce sales volumes reaching record highs during 2020. However, as global lockdown policies were relaxed from mid-2021 onwards, consumers returned to physical shopping malls and started spending on leisure and entertainment services. As shown in graph 1, this saw Amazon's sales growth retreating from their 2020 to early 2021 peaks and normalising at pre-COVID levels.

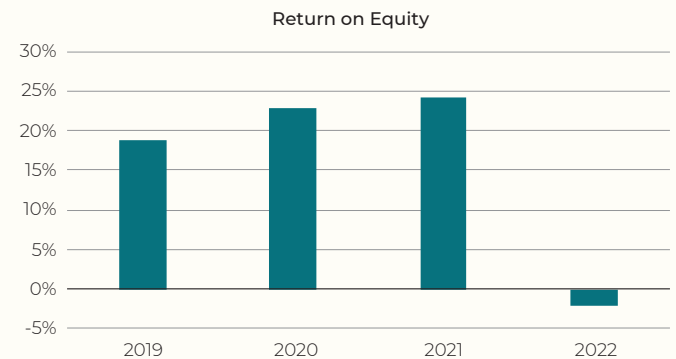
At the same time, Amazon's operating margins and profitability came under pressure following the significant capital investment made during the pandemic to double its fulfilment (i.e. delivery) network capacity. To place this into perspective, Amazon's capital expenditure increased from US\$16bn in 2019 to US\$40bn in 2020, US\$61bn in 2021 and US\$64bn in 2022. Consequently, as shown in graph 2, the company's return on equity (ROE)<sup>1</sup> declined in 2022. This ultimately saw Amazon's share price going from just under US\$145 in August 2022 to around US\$82 in December 2022.

<sup>1</sup>Return on equity (ROE) is calculated by dividing a company's net income by its shareholders' equity. ROE is a gauge of a company's profitability and how efficiently it generates profits.

Graph 1: Amazon's sales growth returns to pre-COVID levels



Graph 2: Fulfilment network expansion coincided with reduced sales growth driving profitability lower



### WHY THE INVESTMENT IN SCALE?

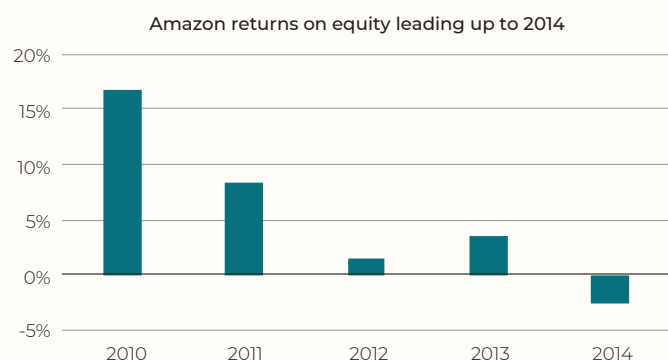
Amazon's focus on constantly enhancing its consumer experience and incrementally improving customer satisfaction have been key drivers of its e-commerce success. Amazon's paid subscription service, Prime offers members same-day delivery as its main value proposition. During the pandemic, the company was unable to fulfil this promise due to a rapid increase in demand and therefore invested capital to double its fulfilment network. At the same time, Amazon capitalised on the influx of customers to its e-commerce sites by further bolstering Prime with new streaming and sports content. As a result of the scale and pace of investment in both its fulfilment

network and Prime, Amazon's asset base increased faster than its ability to monetise the additional capacity, negatively impacting overall profitability and market sentiment.

## A CASE OF DÉJÀ VU?

Amazon found itself in a similar situation in 2014. At the time, it had bought Twitch (an online video game streaming platform); launched Fire TV; bungled the Fire Phone, reduced AWS prices by 43% following fierce competition; increased the price of Prime by 25% and massively expanded its office space in Seattle. This capital investment spree saw the company's ROE and share price plummeting. In his annual letter to shareholders, Jeff Bezos, who was CEO at the time, reiterated that "there is no invention, no innovation, no game changers without experimentation and the freedom to fail", and emphasised Amazon's culture of constant improvement and innovation. The rest is history and as we know, Amazon's returns gradually improved as the company's actions bore fruit.

Graph 3: Returns on equity fell off a proverbial cliff, dropping to (-3%) in 2014



## MAXIMISING ITS INVESTMENT

Acknowledging that there is a time to invest and a time to reap the benefits, Amazon's management team is now focused on improving operational efficiencies. This will be achieved by optimising the company's delivery routes and fulfilment centre capacity while growing into its scale. Market commentators have questioned whether Amazon's e-commerce penetration in the US could increase from its current market-leading position. Given that e-commerce penetration in the US is still relatively low at 14.7%<sup>2</sup>, we believe that just by maintaining its current market share, Amazon's e-commerce volumes will increase, and the excess fulfilment capacity will be utilised over the medium term.

<sup>2</sup>E-commerce penetration in the US was 14.7% in Q4 2022 or 22.7% excluding items that cannot be purchased online such as sit-down restaurants, bars and fuel.

In the interim, Amazon recently launched "Buy with Prime", allowing Prime members to shop on third party (affiliated merchants) e-commerce sites and have their orders delivered by Amazon. Participating merchants have already experienced a 40% increase in conversion rates on their e-commerce stores as a result of the affiliation with Prime and Amazon. Buy with Prime is essentially Amazon's monetisation of its fulfilment network, while simultaneously strengthening its Amazon Prime membership value proposition.

## NEW GROWTH FRONTIERS

Amazon is far from a one-stop shop and has many growth levers to pull. One example is advertising. In the digital advertising industry, Amazon's advertising division is relatively small, with 7% global market share. However, recent market leading sales growth indicates that Amazon has a very compelling value offering and is poised to take market share. Illustrating their competitive advantage in this arena, Amazon recently partnered with Pinterest, making them the first third party advertising platform to do so and enabling a seamless shopping experience via the Pinterest platform. Amazon advertising services extend beyond e-commerce, having spearheaded global advertising of Disney's Buzz Lightyear movie in 2022. With sales growth of 21% during the first quarter of 2023, a time when digital advertising is experiencing a cyclical growth deceleration, we have no doubt that advertising will become an integral part of Amazon's investment case in the future.

## SEEING THE WOOD FOR THE TREES

ROE is one of the financial metrics we use to assess the quality of a company, and we acknowledge and share concerns that ROE turned negative in 2022. However, ROE cannot be viewed in isolation and one must be careful not to mistakenly categorise a business as poor quality without understanding the underlying drivers.

In 2022, market declines triggered a material fall in most listed companies' valuations, ultimately affecting their profitability. In Amazon's case, this meant a US\$12.7bn fair value loss on its investment in electric vehicle manufacturer, Rivian. But more importantly, financial underperformance in any single period should not overshadow a company's long-term growth potential. Quality extends beyond financial statements. Amazon has grown substantially by reinvesting its own cash flow and has used very little – if any – debt. Current CEO, Andy

Jassy, has been with Amazon for 25 years and spearheaded the investment in AWS before it was fashionable to do so. He therefore understands the importance of capital allocation both in terms of sustaining returns and developing new capabilities. In his recent annual shareholder letter, he reiterated that no investment is made that is not aligned to Amazon's vision of the future. Investments that cannot demonstrate generation of the specified return hurdle rate are cancelled, but not before the team is allowed to experiment and fail. Without failure, there is no progress.

At Private Clients, we invest with a long-term perspective. We believe that the investments made by Amazon will allow it to remain a formidable competitor well into the future, serving both retail and corporate customers globally across its e-commerce, web services and advertising platforms. On this basis, our long-term investment case for Amazon remains intact and we view the company's current share price weakness as an attractive entry point to gain or increase exposure to a good quality business.

Graph 4: Amazon's market cap and return on equity since 2010

