HAMILTON POINT
Investment Advisors, LLC

100 Timberhill Place, Suite 120
Chapel Hill, NC 27514
(919) 636-3765

July 2017

Will Washington Drain the Amazon?

In our internet connected world, great ideas and dashes of capitalism are a recipe for rip-roaring increases in revenue, and few compare with ***Amazon****. With Amazon's proposed purchase of* ***Whole Foods****, we assess what investors might be thinking when owning companies producing little in cash profits, often with risks that aren't immediately apparent. At Hamilton Point we have done well sticking to businesses that produce sufficient cash to justify owning the shares, and Amazon is not one of them. Just-the-same, we mustn't ignore Amazon's disruptive approach and its potential effect on investment decisions we make.*

Let's Forget About Tomorrow

As background, Wall Street gives some companies a temporary pass on generating profits in hopes for gobs of future net income. Amazon redefines "temporary pass" since it has grown in market value to $480 billion but has produced a *cumulative* profit of just $7 billion in the last ten years.[1] In contrast, **Alphabet, Inc.** (a.k.a. Google, which we do own[2]) has produced net income totaling $105 billion over the same period, about $80 billion of which still resides on their balance sheet in cash. While both companies had revenues in the range of $15 billion ten years ago, Amazon now has $136 billion of revenue while Google's is $90 billion. It is their profits, however, that are important to us.

While Amazon is not earning much now, what does their market value imply about what investors *think* their future earnings power is? Well, using a pencil and legal pad (both purchased on Amazon Prime and delivered for free to our desk) we estimate investor thinking—hypothetically, anyway. Let's assume investors expect their shares to appreciate 10% per year for the next five years. Using this factor, Amazon's current market value would grow to $773 billion. If the company trades then at 20 times earnings, Amazon must be expected to earn about $38.7 billion by 2021 (up from $2.4 billion in 2016, or *only* a 1,500% increase in profitability).

Profits, Schmofits

We have nothing against Amazon's innovations and believe their customers are wise to receive free "concierge" delivery of goods to their front door. We wonder, however, that a giant company like Amazon enamors investors so with high revenue growth but decides, for now, to not make (much) money. Heck, lots of other companies could rapidly grow revenues if they stopped trying to make a profit. If **McDonalds** expanded offerings and reduced prices to where they operated at a near breakeven, their revenues would likely soar. If their investors rewarded paltry profits with a higher stock price, McDonalds could force competitors to close and later increase prices when customers had few options. This kind of predatory pricing is effectively a long-term "bait-and-switch" tactic—a marketing strategy that has probably existed as long as there has been bait.

On the topic of predatory pricing, a wonderful Yale Law Journal article discusses the prevailing philosophy of antitrust law and why Amazon has escaped serious scrutiny thus far: *"Due to a change in legal thinking and practice in the 1970-80s, 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 prices alone to be evidence of sound competition."*[3] You would think Amazon

1) Revenue and income figures based on year ending December 31, 2016.
2) For a free list of all recommendations made by Hamilton Point during the last year, please contact us.
3) Lina M. Khan, *Amazon's Antitrust Paradox.*, The Yale Law Journal vol. 126: 710.

CONTINUED ON REVERSE >

wrote this philosophy for their benefit. After all, if consumers are helped by Amazon today, what could possibly go wrong tomorrow? The Federal Trade Commission phrases its concerns this way, "*Pricing below one's costs is not a violation unless that strategy has a dangerous probability of creating a monopoly so that the discounting firm can raise prices far into the future and recoup its losses.*"[4] Hmmm. Can Amazon get to $38 billion in profits five years from now without increasing prices considerably? If they do so after their competition has been curtailed, will it draw the attention of antitrust regulators?

Feeling Used

In addition to potential antitrust concerns, Amazon's innovations also leave us wondering if all economic costs are loaded into the supplier relationships that Amazon maintains and, if not, what happens if those dynamics change? For example, let's drill down a bit on the suppliers who deliver Amazon packages—currently **UPS, FedEx** and the **United States Postal Service** (USPS). The USPS, desperate for relevancy it seems, expanded exclusive delivery services for Amazon but still lost over $5 billion last year.[5] Is each taxpayer unwittingly subsidizing Amazon customers by allowing losses to accrue at the Postal Service? What happens to Amazon if the government decides to stop enabling the Postal Service and its losses?

Meanwhile, UPS and FedEx (who are subject to taxes the Postal Service isn't) have been forced to respond with substantially increased capital expenditures. This strikes us as an odd dynamic to have Amazon cutting exclusive deals with the USPS, a government entity, to pose a competitive threat to UPS and FedEx. For example, UPS, a long-term Equity Income holding at Hamilton Point, has faced pricing pressure as evidenced by the addition of over $7 billion in annual revenue but hardly any earnings growth over the last five or more years—and a swelling pension liability. Accordingly, despite their dividend stability, we currently have UPS on our internal "probation" list for possible sale if their efforts to compete with the USPS falter further.

Last One Left…Turn Out the Lights

Amazon has long been destroying traditional brick-and-mortar retailers who pay property taxes and serve as showrooms for products bought on Amazon. Partly for that reason, Hamilton Point has had limited investments in the retail sector and has thus avoided the investment debacle that has been witnessed at Macy's, Sears, Target, Nordstrom and Kroger—to name a few—all of whom must examine their business plans through the relentless lens of Amazon. There are companies on our buy list who are directly impacted by Amazon, but have valuable brands or niche products and have performed relatively well thus far. Nonetheless, nearly every company—not just retail operations—deserves monitoring as so many are potentially in Amazon's disruptive sights.

The point here is not to say that Amazon is completely evil or is a bad business or that Hamilton Point knows exactly how this will shake out. Rather, it is to give a glimpse at how we evaluate risks in business plans and prefer the nimble selectivity that our individually-purchased equity strategies allow. We believe the best businesses—for long-term investors—make money, attract relatively little antitrust attention, have healthy supplier relationships and are not subject to Washington's whims. Time will tell how these factors are ultimately reflected (or not) in Amazon's stock price. In the meantime, come rain, sleet or snow, we look forward to having a letter carrier (or drone?) deliver us an organic tomato soon...on a Sunday.

Andrew C. Burns
ABurns@HamiltonPoint.com

Richard S. Woods, CFA, CPWA®
RWoods@HamiltonPoint.com

Hamilton Point Investment Advisors, LLC is an independent and independent-minded wealth advisory firm. Please contact us for a complimentary review of your portfolio. In addition, visitors to the firm's website, www.HamiltonPoint.com, can read past investment newsletters.

4) Federal Trade Commission Guide to Antitrust Laws: https://www.ftc.gov/tips-advice/competition-guidance/guide-antitrust-laws/single-firm-conduct/
5) USPS Annual Report for Fiscal Year 2016.