Has Amazon (Jeff Bezos) Taught This Old Value Dog a New Trick?

February 12, 2018
by Chuck Carnevale
of F.A.S.T. Graphs

Introduction

There is the old adage: "you can't teach an old dog new tricks." Well, I have been a "card-carrying" and fully committed value investor for more than 45 years now. I think that qualifies me as an "old" value investing dog. But more to the point, I have been consistently following and practicing the value investing principles as I was originally taught without exception for more than four decades.

As I have shared in the past, my initial introduction into value investing was inspired by my economics professor in college. When teaching us how to value a stock (publicly traded or private) he used to literally pound his desk with his fist as he shouted: "earnings determine market price." Importantly, he had research and supporting data to back up his statement. Consequently, I was so smitten with his logical-and-common-sense-based-lesson that I eventually named the money management firm I founded after graduation-EDMP, Inc. This was a simple acronym reminding me of his important lesson-**E**arnings **D**etermine **M**arket **P**rice.

This lesson has served me and my clients well over the years because in truth, and in the longer run, it is earnings and the rate of change of earnings growth that drives long-term price movement. However, I didn't simply take my professor's word for it. Instead, I developed the FAST Graphs fundamentals analyzer software tool that empowered me to evaluate the long-term functional relationship between earnings and stock price over the long run on thousands of US and Canadian-based companies.

So here I am more than 40 years later and after examining the longer-term relationship of price and earnings on literally tens of thousands of companies, I remain totally confident that the relationship between earnings and stock price over the long run is both profound and real. On the other hand, my experience has also taught me that there are exceptions to every rule. As it relates to valuation there is more than one way to ascertain the fair value of a company. Earnings remain a critical metric in this value investor's tool chest; however, earnings are not the only metric I consider. Valuation is essentially a puzzle. Like all puzzles, it takes all the pieces placed in the right order to make the beautiful picture.

Therefore, as time passed, and as my knowledge, education and experience grew and evolved, I expanded my valuation analytics to include other important fundamental metrics. Most prominently I began to evaluate cash flows in conjunction with earnings. This allows me the opportunity to segue into my title thesis as to whether or not Jeff Bezos (the vaunted founder of Amazon) actually taught this old value dog a new trick or not.

In truth, he did not, because I have now been studying the relationship between a business' value and its various cash flow generating capabilities for many years. So I won't be giving Jeff Bezos credit for my expanded understanding of valuation. However, he did provide me a perspective that I had not fully considered or perhaps even understood before. Therefore, I will give him credit for providing me a new and fresh perspective on valuation.

Here is an excerpt of what Jeff Bezos said in his (Amazon's) 2004 letter to shareholders that inspired me to broaden my perspectives on valuation. The complete 2004 letter also included a republishing of their 1997 (original shareholder letter) and can be found here:

"To our shareholders:

Our ultimate financial measure, and the one we most want to drive over the long-term, is**free cash flow per share.**

Why not focus first and foremost, as many do, on earnings, earnings per share or earnings growth?**The simple answer is that earnings don't directly translate into cash flows, and shares are worth only the present value of their future cash flows, not the present value of their future earnings.** Future earnings are a component—but not the only

© 2020 Advisor Perspectives, Inc. All rights reserved.

important component—of future cash flow per share. Working capital and capital expenditures are also important, as is future share dilution."

Later in the video portion of this article I will provide clear and undeniable evidence that Jeff Bezos more than accomplished his goal of driving free cash flow over the long term. And, to his credit, he has created quite a little business for himself and his shareholders as a result. But what I personally admire most about Jeff Bezos is that he and I both love and admire Frank Sinatra.

You see, both Jeff and I share the same favorite song Frank Sinatra's "My Way." Jeff Bezos is an out-of-the-box thinker who is not afraid of going against the crowd. Honestly, I don't know if Jeff Bezos actually likes Frank Sinatra or not. However, if you study Jeff's life and business practices at all, I think you will find the song "My Way" summarizes it nicely. Here are the lyrics enjoy:

"And now, the end is near
And so I face the final curtain
My friend, I'll say it clear
I'll state my case, of which I'm certain

I've lived a life that's full
I've traveled each and every highway
But more, much more than this
I did it my way

Regrets, I've had a few
But then again, too few to mention
I did what I had to do
And saw it through without exemption

I planned each charted course
Each careful step along the byway
And more, much more than this
I did it my way

Yes, there were times, I'm sure you knew
When I bit off more than I could chew
But through it all, when there was doubt
I ate it up and spit it out
I faced it all and I stood tall
And did it my way

I've loved, I've laughed and cried
I've had my fill my share of losing
And now, as tears subside
I find it all so amusing

To think I did all that
And may I say – not in a shy way
Oh no, oh no, not me
I did it my way

For what is a man, what has he got
If not himself, then he has naught
To say the things he truly feels
And not the words of one who kneels
The record shows I took the blows
And did it my way

Yes, it was my way"

Jeff Bezos has taken a path less traveled but one that he believed deeply in. It is hard not to admire a man and a company that has danced to their own drum while simultaneously disrupting numerous industries. But like him or hate him, I believe

© 2020 Advisor Perspectives, Inc. All rights reserved.

Amazon's record validates the value and importance of free cash flow generation. Jeff Bezos has definitely done it his way and – he has proven that his way works.

Is Amazon's Price Stupid or What?

Before I go on, please allow me to take this opportunity to clarify (and perhaps elaborate) on the important financial metrics that a company reports on their financial statements. For starters, it might be helpful to think of a company's financial reports as "scorecards." In sports it ultimately comes down to the final score posted when the game ends. In business, the equivalent of the final score in sports is ubiquitously referred to as the bottom line. However, in business the game never actually ends, but scores (their financial reports) are reported typically after each quarterly period of time.

Moreover, in business the bottom line is most commonly referred to as earnings. Earnings are also the most commonly focused on and reported on metric in financial news services and publications. Consequently, earnings tend to be what most professional and lay investors alike most prominently focus on, write about and/or talk about.

And as I previously indicated, earnings are a very important fundamental metric to analyze. However, earnings are not the only metric. Instead, it should be thought of as a very significant indicator regarding the business' overall financial health and future prospects for growth. To continue with my sports analogy, earnings represent a valuable checkpoint as to the company's overall strength and quality. But earnings are not necessarily the final word.

Therefore, you may be surprised to hear me say that the correct answer to the question posed by the heading of this section is-**or what**. In other words, Amazon's valuation may not in actuality be as crazy as it looks. Obviously, it is true that if you measure Amazon's valuation utilizing earnings and earnings growth as your yardstick, Amazon's valuation (measured by the P/E ratio metric) is insane. Moreover, as previously suggested, it is also true that earnings and earnings growth are the most ubiquitously utilized financial ratio by most investors-professional and lay alike. It is this last point that motivated me to give credit to Jeff Bezos for broadening and for even challenging my long-held and perhaps even sacred prior perspectives.

Is Free Cash Flow Per Share the True Bottom Line As Jeff Suggests?

Perhaps this section should start out with some discussion and even some color regarding what the concept "bottom line" really is or means. To give credit to Jeff's idea about free cash flow, I offer the following old adage: **"revenue is vanity and profit is sanity, but cash flow is reality."** I can't really attest to the original source of that old adage, but I can attest to the profundity of its message. Under the hypothesis of that old adage Jeff's focus on free cash flow gains credibility.

One of the simplest ways to define free cash flow is to think of it as the cash that a company has left over after spending the money required to operate their business. To me, this represents a quintessential definition of the bottom line. However, even though cash flow and earnings are related metrics, they are not the same metrics. Therefore, one could take the position that although earnings are commonly thought of as the bottom line, the true bottom line is free cash flow.

You see, the problem with earnings is that they are not always spendable. Earnings that are generated as a result of creative (albeit legal) financial engineering can be (partially at least) Illusionary. Which brings up another old adage: "earnings are optional but cash is cash." It appears that Jeff Bezos recognized early on that you can't spend depreciation or other non-cash earnings. However, he also learned early on that his checks would clear as long as there was cash in the bank.

Building Enterprise Value: Revenue Is Vanity and Profit Is Sanity, but Cash Flow Is Reality

While conducting research for this article I came across the following white paper produced by Berlin Packaging in 2010 titled "Building Enterprise Value: Revenue Is Vanity and Profit Is Sanity, but Cash Flow Is Reality" found here that I felt really addresses the drivers of company valuations. Additionally, I feel that the following excerpt speaks loudly to Jeff Bezos's notions about creating value:

"A company's value is a function of what someone is willing to pay for it. As an investor, you consider valuations all the time. If you buy a share of stock in a public company, you want the share price to represent a fair value and offer a fair return. If you invest in a private company – whether as an entrepreneur, through a private equity firm, or in some other manner – you also want to pay a price commensurate with the risk and return profile of the enterprise."

Is Amazon Dangerously Overvalued?

There are strong and divergent views on what Amazon's stock price is truly worth. Perhaps only Apple can match the

© 2020 Advisor Perspectives, Inc. All rights reserved.

emotional attachment that many investors have towards Amazon. You either love Amazon or you hate it. You either think it's insanely overvalued or you believe it's the greatest stock to own in the history of mankind. However, I ask that you carefully consider the first sentence in the above quote: **"A company's value is a function of what someone is willing to pay for it."** As a long time value investor, I have had this phrase thrown in my face many times over the years. Now the truth is, anything and everything in this world is only worth what someone else is currently willing to pay you for it.

However, that statement does not define intrinsic value, instead, it defines current market value. Nevertheless, if you are absolutely required or forced out of necessity to liquidate an asset, it is only worth what the market will bring at that moment in time. In order to put this into perspective, let's go ahead and review the historical performance of Amazon (AMZN) since December 31, 2001.

Had you had the foresight or luck to invest $10,000 in Amazon on that day and held it until yesterday's close, that $10,000 investment would be worth more than $1,333,000. The same investment made on exactly the same day in the S&P 500 index would have only turned $10,000 into a little more than $27,000. Rhetorical question: would you rather have $27,000 in the bank or $1,333,000?

Okay, here is the inarguable point. Had you bought Amazon on December 31, 2001 just as the recession was coming to an end and sold at yesterday's close you would be a millionaire today. That is real shareholder value, real actual results, and based on the definition stated above the real worth of Amazon to that shareholder. No philosophical debates can alter the factual reality of that transaction as described. Amazon was worth over $1 million to that investor – period – end of discussion and I'm done talking about it.

However, that logic only truly applies if you are forced or required to sell or liquidate your holdings. If not, you can simply hold on until your estimation of intrinsic value is inevitably realized. To summarize, there is a difference between intrinsic value and current market value. Sometimes that difference can be huge and at other times small. But in the real world, your investment will only sell for what the market is willing to pay at that moment. Therefore, at that precise moment in time, your stock was worth exactly what the other party was willing to pay you – nothing more, nothing less.

On the other hand, long-term investors planning for the future are not required to sell today. Instead, they are more concerned with what they believe the stock they are purchasing will be worth in the distant future. Therefore, they require strategies, skills and tools to help them ascertain what the future value of their stock will be and what rate of return that would represent to them.

Here is where the arguments, disagreements and heated debates are born. I see it in comments on articles of mine and others all the time. One person believes that free cash flow is the best metric to use to value a business, others think its earnings or EBIDTA – and the list goes on. The truth is, from my perspective at least, all of these investors are right and all of them are wrong. My point being, that each of the metrics cited above as well as many others are all important considerations towards determining a company's true worth value.

Here is some additional color on the subject taken from the white paper linked to above that provides additional insights on this multifaceted and confusing subject of how to value a business. I have summarized this excerpt by just listing the headlines, however, for those interested, the full text can be found by following the link above.

"Valuation is complex and is derived from a combination of objective and subjective variables. A company will have a higher valuation with:

- Higher profits.
- Higher cash flow.
- Robust cash flow.
- History of performance.
- Plan for future growth.
- Fewer assets.

All of the above are quantitative considerations that guide company valuations. But ultimately, it is people who get things done. All else being equal, a company with a stronger team will garner a stronger valuation."

The moral of the story is quite simple. Any reasonably intelligent human being with only modest math skills can become adept at determining the fair value of a business within a reasonable range of accuracy. It's important to add here that it is not required to determine fair valuation with perfect precision. You only need to be essentially correct to succeed. True worth valuation should always be thought of as a reasonable range of potentialities.

Furthermore, if you are going to succeed as an investor in the future, it is incumbent upon you to do your best in

© 2020 Advisor Perspectives, Inc. All rights reserved.

establishing a reasonable expectation of what the business you are considering is capable of generating on your behalf in the future. But most importantly, you must also come to grips with the reality that there is no perfect or single valuation metric. As previously stated, valuation is multifaceted; therefore, it requires the utilization of every tool and metric at your disposal.

Consequently, when I have subscribers to the FAST Graphs research tool I co-founded ask me what is the best metric to determine valuation with; my answer is always the same. **Use all of them!** Every company (and every industry for that matter) possesses characteristics that are unique to them. Some are capital intensive; some are high-margin low-growth – and every conceivable manifestation you can think of in between. Therefore, there are some companies where cash flow will be your best valuation metric and others where earnings might serve you best. But with that said, in all cases, the more metrics you review and analyze, the better chance you have of being essentially right.

What is Amazon Really Worth? Investing principle: "Your Margin Is My Opportunity"

As I previously indicated, Amazon has attracted both adoring and zealous fans and deriders regarding its stock price and current valuation. In the following video I will take a by-the-numbers fundamental look at Amazon, its growth and its fiscal strength. As an aside, there have been recent articles challenging whether Amazon is reporting free cash flow correctly or not. I will be elaborating on that subject in the video portion of this article.

FAST Graphs Analyze Out Loud Video: Amazon

There are many so-called investors who eschew reviewing historical fundamental operating results on the notion that history is merely rear-view mirror thinking or 20/20 hindsight. I believe they are drastically short-changing themselves. Although it is true that we can only invest in the future, it is equally true that we can learn a great deal from carefully examining the past. Because, as Sir Winston Churchill so eloquently put it:

Those who fail to learn from history are doomed to repeat it.

Furthermore, they say that a picture's worth 1000 words, but if true, then how many words is a video worth? I don't have an exact answer, but I assure you that a well-produced video analyzing a company's fundamental strengths and weaknesses is worth many many more. With the video format and the utilization of FAST Graphs (the fundamentals analyzer software tool) I know that I can provide a more comprehensive fundamental evaluation and analysis than I could with a long article comprised of thousands of words. Therefore, the following video will evaluate and illuminate the many facets of Amazons true value. This is where the fundamental analysis of Amazon is found with this article.

Summary and Conclusions

Earlier in the article I referenced the company's financial statements as the equivalent of a scorecard in sports. As a golfer, the parallels between a golf score and stock investing are very fascinating to me. Therefore, I would like to close this article by continuing my sports analogy utilizing the game of golf.

A professional golf tournament is typically comprised of four 18-hole rounds. At the end of each round, the scores and the player's rankings are posted. It is rare that the leader after the first round ultimately goes on to win the tournament. This relates to the similar fact that in business, one quarterly report does not define the winner from the loser.

Nevertheless, the scores and the leaderboard are posted after each round. Business results are posted usually every quarter. Furthermore (as it relates to my analogy), for every round of golf played, many other statistics are recorded, analyzed and reported on. Things like the number or percentage of fairway hits, number of greens hit, number of putts made from various distances and other statistics such as strokes gained on various aspects such as putting or driving, etc.

As the tournament unfolds, astute golf analysts will evaluate all of these various statistics in an effort to forecast who the ultimate winner might be. These analysts might focus on how well a player at the top of the leaderboard has been putting, or how close he's been hitting his approach shots to the pin or how straight and long he is driving the ball, etc. As these statistics are unfolding, the analysts are receiving information and clues as to who the ultimate winner might be. Financial analysts take a similar approach as they evaluate each published financial report.

The parallels to stock investing are very similar. A business typically reports their financial statements quarterly. As each quarterly report is published, investors are given the opportunity to evaluate the company's financial statements (its scorecard) in order to see how the business is performing. Of course, the very first place investors will look is at the so-called "bottom line" which is most commonly reported as earnings. In other words, the headlines will be reporting earnings and whether the company met, beat or badly missed analyst expectations.

© 2020 Advisor Perspectives, Inc. All rights reserved.

But here is the point. In sports such as golf, the tournament is played over four rounds and scores posted on each. After the fourth round, the final results are in and a champion declared. However, golf doesn't end with just one tournament. The same is true of business. Each quarter is important, and each final year is also important. But most importantly, the company's financial statements produce a lot more information than just the "bottom line." And finally, after each game a new one begins and the due diligence continues on, therefore, it's wise to take a long-term view.

Disclosure: No position.

Disclaimer: The opinions in this document are for informational and educational purposes only and should not be construed as a recommendation to buy or sell the stocks mentioned or to solicit transactions or clients. Past performance of the companies discussed may not continue and the companies may not achieve the earnings growth as predicted. The information in this document is believed to be accurate, but under no circumstances should a person act upon the information contained within. We do not recommend that anyone act upon any investment information without first consulting an investment advisor as to the suitability of such investments for his specific situation.

© F.A.S.T. Graphs