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FEATURE

Amazon's Profits Are Soaring: Why That Could Be Bad for the Stock

As Amazon steamrolls traditional retailers, it must avoid becoming too profitable. Shares could exceed $1,000 by summer and gain 20% in a year.

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By JACK HOUGH
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As Amazon.com stock nears its 20th birthday, its long-term holders have already enjoyed many happy returns. The price has soared from $2 to $934, adjusted for splits, since the first day of trading on May 15, 1997. That puts Amazon's market value at $450 billion, making it the fourth-largest U.S. company, behind Apple (ticker: AAPL), Alphabet (GOOGL), and Microsoft (MSFT). No company has ever reached such a size with so little in cumulative profit—about $5 billion since going public. Alphabet, by comparison, has earned $90 billion over just the past five years. Apple has made more than that over the past two years. Amazon's ascent has made fuddy-duddies out of investors who pay attention to such things. *Barron's* went negative on the shares with a hyperbolic cover line during the dot-com stock bubble ("Amazon.bomb," May 31, 1999). Less than two years later, the stock had indeed fallen from nearly $60 to below $10, split-adjusted. But our call to buy at the bottom, or on the way back up, was deafeningly absent. (See sidebar: "The Amazoning of American Retail.")

Pari Dukovic/Trunk Archive

For some, Amazon's stock market success calls into question whether profit is still a relevant measure for growth investors, or even a worthy goal for growing companies. But for now, the outlook for the stock can be summed up with one word: higher.

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We think Amazon shares (AMZN) could reach $1,000 by summer and $1,100 within a year, for a gain of close to 20%, which, along the way, could make Amazon founder Jeff Bezos the world's wealthiest person. While earnings estimates have been sliding of late as the company ramps up spending, if history repeats, that means revenue growth is about to reaccelerate, leading investors to conclude that the cash was well spent, and that the shares are worth more.

Over the next few years, the operating environment will remain brutal for Amazon's victims, most recently clothing stores, and will become more challenging for consumer-goods companies that rely on brand-building and shelf space, rather than innovation, for pricing power. Amazon could even kick Alphabet in the shins in internet search. At the same time, there will be companies that, like remoras that attach themselves to sharks and feed on scraps, benefit from the bloodletting.

By the end of the decade, Amazon's profits will balloon, not because Bezos wants them to, but because it will be unavoidable, as revenues overwhelm costs and investments. That's the tricky part for long-term investors. A steady ramping of profits—or Bezos' preferred measure, free cash flow—lends itself to arithmetic, which is a lot less exciting than open-ended potential and narratives about market dominance. The next downturn for Amazon stock might not come when profits disappoint, but when they become too obvious. Forget Amazon.bomb, but Amazon.boring is a long-term risk.

TWENTY YEARS AGO, Amazon was a fairly easy company to describe. It sold books online, and was considering a move into music and videos, although in his legendary first letter to shareholders, Bezos made only limited mention of products, writing more broadly about online commerce, the need for sustained investment in systems and infrastructure, and the challenge of prioritizing those investments.

Today, Amazon remains, in part, a store. It recently cracked the top 10 list of worldwide retailers by revenue, and is still expanding sales faster than 20% a year, versus single-digit growth or declines for the others. But of course, the company is much more than that. It is a shopping club, Prime, with an estimated 80 million members who skew young and well-off. It is a vast marketplace for third-party sellers, whose data help tell Amazon which products to poach for its store, or even to begin making itself. It's an early leader in cloud computing for hire, where profit margins have proven so rich that Microsoft, Alphabet and others have piled in. It's an entertainment company that this year is expected to spend more on content than do NBC and HBO—and that's their main business, not a sideline. It makes gadgets, like the Kindle reader, Fire TV, and Echo voice assistant. And it's a recent entrant into online advertising, which should make Alphabet nervous. That's because while Google is still far and away the search leader, the most lucrative searches are those for products, two-thirds of which start on Amazon.

IN SOME WAYS, AMAZON IS LIKE Berkshire Hathaway, but with better returns. Berkshire sells insurance, where premium payments roll in long before claims are paid, allowing CEO Warren Buffett to invest other people's capital free of charge. Amazon sells inventory so quickly that it often collects from customers before it pays suppliers, creating an ongoing free float of cash to use.

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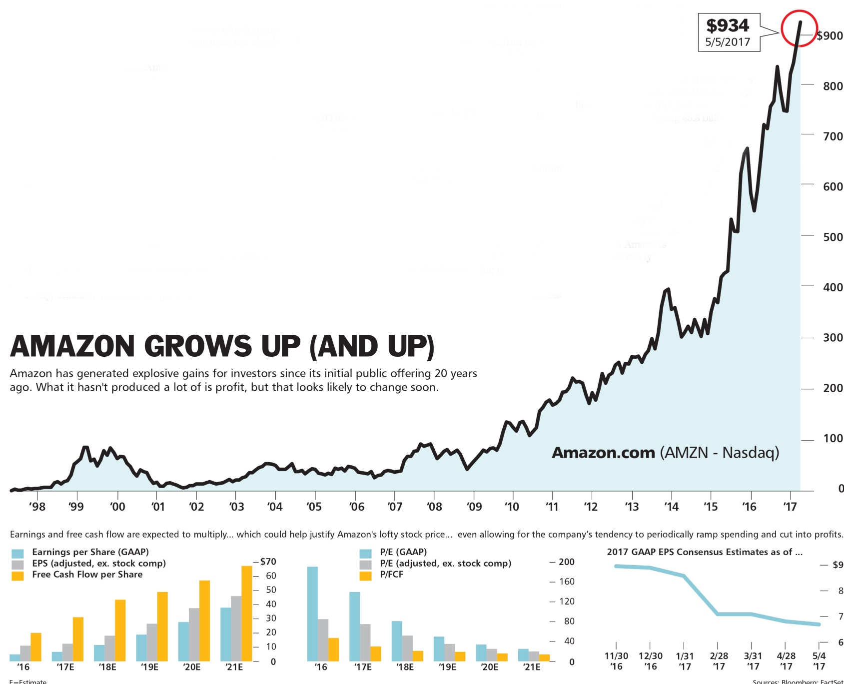

(**To see larger size image of chart, click here** .)

Last month, in his latest shareholder letter, Bezos continued to focus less on products than on investment, especially in artificial intelligence and machine learning. That spending will power better merchandise decisions for Amazon's store, and make Alexa, the voice of Echo, more lifelike; A.I. wizardry also can be resold to cloud-computing customers.

By double-dipping like that on its inventions, Amazon raises the potential payoff of its investments, which reduces risk. Its cloud infrastructure, for example, can cut operating costs for its own video-streaming business, while turning rival Netflix (NFLX) into a paying customer. The company further controls risk by moving quickly past flops. Its Fire Phone, launched in the summer of 2014, was laid to rest barely a year later. Microsoft, in comparison, stuck with its unloved Zune music player for more than five years.

CORPORATE INVESTMENTS are meant to build profits, or at least, that's the way it traditionally has worked. For Amazon, a familiar pattern is afoot. Last year, investment surged 47%, to $6.7 billion, and forecasts for this year's spending have been rising. Profit is expected to climb 40%, to $3.3 billion, far more than the company has ever earned. But just last fall, investors were predicting $5.3 billion in profit this year.

Shareholders aren't worried. "I don't think Amazon is a company that will ever go into harvest mode," says John Ettinger, a portfolio manager at Federated Investors, and an Amazon bull. "They're always going to want to experiment." In Amazon's latest quarterly report, Bezos called out spending in India, where Amazon is quickly adding to its Prime selection, as well as on television shows and its order-fulfillment network.

All of this is promising for investors. When Goldman Sachs analyst Heath Terry raised his price target on the stock late last month, he noted Wall Street tends to underestimate how Amazon's investment spurts lead to a pickup in revenue growth. Top-line forecasts have been rising. By next year, Amazon could top $200 billion in revenue, ranking it among the top five U.S. companies. Historically, Terry points out, Amazon stock has performed best during stretches that have started with a jump in spending.

AMAZON'S EXAMPLE MIGHT be helping to change investment analysis, and even stock performance. Baruch Lev, an accounting professor at New York University, has documented a long decline in the relationship between stock returns and upside earnings surprises, or even earnings growth. Traditional accounting, he says, fails to capture how spending on things like research and development adds to intangible assets that can power growth for years to come. Investors are left sifting for clues in

measures that don't necessarily show up in reports.

In a recent conversation with *Barron's*, Lev pointed to one such clue for Amazon: Though it holds fewer patents than Alphabet, its patents are cited more often in filings by others, suggesting they're more valuable.

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Amazon has changed the relationship between companies and investors by replacing profit with growth and vision, according to a colleague of Lev's, Scott Galloway, an NYU marketing professor and founder of digital-research platform L2. "Loss is the new black," he told attendees at a conference last month, citing the willingness of upstarts like Uber to lose steep and growing sums. "You can argue this might not end well…but the reality is retail investors love this model."

To Galloway, Amazon is not only dismantling retail, as evidenced by a sharp recent rise in store closings and bankruptcies, it also poses a long-term threat to brands. Brands serve as a signal to product quality, which manufacturers reinforce through advertising, allowing them to charge premium prices. Amazon can replace the role of brands by using one of its earliest innovations, unvarnished user reviews, combined with its search algorithms. The result is a better quality signal without the premium pricing, thus weakening the value of established brands.

IRONICALLY, NOW THAT Amazon has convinced the investing public of the unimportance of profits, its earnings are on the verge of soaring. Within five years, they could total $20 billion a year, a level only six U.S. companies are expected to reach this year. True enough, those forecasts have a way of coming down over time, but unless Amazon's next venture is launching a small nation-state, it will have a hard time investing away such a sum, not to mention its free cash flow, which is much higher. In five years, free cash flow is projected to reach $36 billion a year. That's enough money to make Amazon's current market value look almost modest, at less than 13 times 2021 free cash flow.

Of course, investors who buy today will want to see peppy stock gains between now and then. If Amazon's market value swells to $1 trillion within five years, and if that 2021 consensus holds, it will trade at 28 times free cash flow—a full price, but not a nutty one.

The pesky thing about profits and free cash flow is that once they are rich and rising, investors tend to get hooked, and they can begin asking more meddlesome questions about the latest investment spree, stock compensation, next year's bottom-line growth, and so on. Some are boorish enough to begin demanding dividends.

It's unclear how the world's biggest startup will handle that transition when it comes. In the meantime, Amazon stock at $934 looks poised for more youthful gains.

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