DIAMOND HILL
INVESTED IN THE LONG RUN

The Phenomenon That Is Amazon

Nov 2022

Near-term uncertainties and heightened volatility have clouded equity markets for the past six months or so, leading to a drawdown in US stocks of 20% to 30%. During market drawdowns, it's not uncommon for sectors that have led for an extended period to then lead the market downward. And this is what we've seen in the technology space. Using the Russell 3000 Index as a proxy, the technology portion of the index advanced more than 150% from its low in March 2020 to its high in December 2021 (Exhibit 1). Subsequently, we witnessed a 34% decline in tech stock prices in the first half of 2022. For price-conscious investors like us, this provides opportunities to redeploy capital toward areas of the market that we believe are most attractive today and in high-quality companies that we believe can compound growth over the long term.

Austin Hawley, CFA
Portfolio Manager: Large Cap, Large Cap Concentrated and All Cap Select

Rick Snowdon, CFA
Portfolio Manager: All Cap Select

Exhibit 1: Russell 3000 Index — Technology Sector ($)

Source: FactSet.

One such opportunity is Amazon. Amazon is a business that we've looked at in prior years as a potential investment, but the company's trajectory was never clear enough for us to estimate intrinsic value with a high level of confidence. Fast forward to 2022, and things have changed. Namely, Amazon's Web Services, which is its cloud infrastructure business, has continued to outgrow the rest of the business significantly in terms of revenue and profitability. And it has become significant enough to provide an anchor to our estimate of intrinsic value. In fact, we think Amazon Web Services (AWS) represents roughly half the value of the entire company.

Another significant development is that Amazon started enhancing some of its disclosures, particularly around the advertising business, which has been incredibly helpful in understanding that portion of Amazon's business. The enhanced advertising disclosures, along with its third-party seller services, allowed us to gain clarity on the large pieces of its retail business so that we could confidently estimate an intrinsic value. Combine these fundamental developments with the fact that Amazon's stock sold off as much as 18% in Q1 alone this year and it made for an interesting opportunity.

One of the unique things about Amazon is that on the way to becoming one of the largest retailers in the world, and certainly the largest online retailer in the world, it built scale capabilities that it was able to sell to others which are now big businesses all unto themselves. As previously mentioned, AWS is highly profitable and quarterly growth has been as robust as 30% in recent months. We know the growth is going to slow, but there's still a lot of runway for commercial adoption of public cloud infrastructure, so we believe there will be solid growth for a significant period of time.

Amazon's Third-Party Seller Services has also been highly profitable. These are services offered to other sellers — the ability to list products on Amazon's website, accessibility to Amazon's warehouse and distribution centers, ability to collect payment via Amazon payment services, and delivery services, including expedited delivery via Prime. We estimate that its third-party seller services represents roughly $450 billion in gross merchandise value — that's nearly twice as big as Amazon's online sales of its own products and maybe 75% of the size of Walmart — and makes up about 20% to 25% of the total value of Amazon's business.

Another valuable piece of Amazon's business is its advertising platform where it sells ad space on its own retail platform. Online advertising is a great business — if you think about a big online advertising company such as Alphabet (Google's parent), they know your search history, your interests, what you click on. Now think about Amazon, it knows what you've bought and products that you've searched for in the past. Chances are if you're searching for a product on Amazon right now, you are probably ready to purchase. It's like being in a store with money in your pocket. So advertisers can serve up ads tailored to your specific interests. There are also positive industry tailwinds for online advertising as marketing dollars continue to shift online. We estimate Amazon's online advertising platform is worth about 12% to 15% of the total value of the company.

The remaining pieces of Amazon's business include Amazon Prime (subscription revenue that it gets from Amazon Prime customers) and first-party sales (sales of its own products). Together, we believe these revenue streams make up roughly 12% to 15% of the business and have an attractive long-term growth trajectory. Overall, Amazon has done a remarkable job of scaling and monetizing its capabilities over the years, and we believe it has tremendous growth potential over the long run. Most importantly, we were able to invest when the stock price represented an attractive discount to our estimate of intrinsic value.

As of 31 October 2022, Diamond Hill owned equity shares of Amazon, Inc. and Alphabet, Inc.

Russell 3000 Index measures the performance of roughly 3,000 of the largest US companies.