What Happens Next – Sunday June 20, 2021
Writing Fiction, Raising a Thief, Internet Stocks
Mark Mahaney QA

Larry Bernstein:

Fantastic. All right. I want to start with Amazon. We had Brad Stone speak on our program a few weeks ago. I I want to ask about Amazon as an advertiser. One of the things that's interesting is that when someone wants to buy something, you think they would go to Google first, but lately there's a trend to go to Amazon to find that product, and there we are already on their site and ready to buy. How do you think about Amazon as an internet advertiser competitor?

Mark Mahaney:

Okay. Well, first Brad Stone, I'm a huge fan. I've read all of his books, and I also hosted a call with him too. So, he's written two books on Amazon, one on Airbnb. I think if you want to understand Amazon as an investor, as an individual, I don't think you could find a better book than first The Everything Store, which he wrote, I forget, 5, 6, 7 years ago. And then most recently Amazon Unbound, which is the history of Amazon over the last five years and particularly a history in which more of a personal deep dive into Bezos himself. So, I think the world of him.

I've referred to Amazon as the best mix shift story in tech as a stock. I've been referring to it that way for a couple of years. And what I mean by that is it's great to have your core business, which for Amazon is retail, and it's got good, solid growth. It's had 20% revenue growth for more than a decade. That's extremely rare-air, but they've done that. It's a very low margin business. Low single digit operating margins. We're talking 2, 3, 4%. But then the faster growing businesses, that's cloud and that's advertising, they are growing two to three X faster than that core retail business, and they've got dramatically better margins. Both of those are 30% operating margin businesses. So, their operating margins are maybe as much as 10 times higher than the margins of the core business, which means you've got this mix shift. You're going to have the structural rise in Amazon's operating margins for the next five to 10 years as the more of the revenue comes from these higher margin businesses.

It's a wonderful position to be in. It's like the opposite of Google, which started off with this hugely high margin search revenue. Everything they went into after that had lower margins. And it meant that the margins for the business as a whole kept coming down over time anyway. Amazon is the opposite and they've now become ... I used to think about internet advertising as a duopoly. Google, Facebook duopoly. I think Amazon has inserted itself in there. And the big advantage Amazon has is that it's the marketplace. They can close the loop for marketers. Like you know how your ads do because you know when somebody clicks on your ad, whether they actually bought the product, because it's all on Amazon. They have really well positioned themselves in this.

Now I do wonder a little bit, and this also came up in Brad's book about whether they've been a little bit overly aggressive with some of these ads. Maybe there are too many ads. There's a risk that they've eBay-ed their shopping marketplace. We've seen slightly declining or declining customer satisfaction scores at Amazon over the last, I'd call it five, six years. And I think a little of that is due to the cluttering of the Amazon marketplace with some of these ads. I think that is a risk for Amazon and I think that's something they need to correct. But there's no question, they are a target rich environment for anybody who wants to advertise. And who would want to advertise on Amazon? All those companies that are selling products on Amazon. It's a natural commerce marketplace and advertising marketplace, and it has wonderful benefits for Amazon's P and L, and therefore for Amazon's shareholders.

Larry Bernstein:

Jeff Bezos is taking a smaller role. In Amazon Unbound, Brad Stone also focused on how important Jeff was to going into all these new businesses. He gave an example of Alexa specifically, where he actually designed the product and sent them off on their way. You mentioned the importance of management teams in your previous discussion of Wix, for example, which you thought they had a tremendous management team. How central has Bezos been to Amazon's success and how good is that next layer of management to push Amazon into new businesses to really allow for further take off?

Mark Mahaney:

One of the key points I have in my book Nothing but Net is the importance of management teams. There's a couple of screens that I try to get people to focus on, level of product innovation at a company. Most consumers, they'll have a sense of that. It's almost like if I can steal from Peter Lynch, like the coffee, buy the stock, and that was Dunkin Donuts. To ruin the analogy, if you see that company rolling out a bunch of different types of coffee in different sizes and different flavors, that's product innovation in coffee land. So anyway, I focused on how innovative companies are in terms of product innovation, how large their market opportunities are. And I look for consistency in management team. I think I mention management team first. That's probably the single most important factor.

I've referred to a four M framework when I look at companies, markets, business models, competitive modes and management teams, but the most important M of those four M's has always been management team in my book. So what I find interesting about Amazon is this S committee, there's 20 to 25 senior execs that the longevity, the consistency in that management team has been extraordinary. I don't know why. I have a couple of theories on why it is, but that committee, the top lieutenants, the top executives, I mean, they've been with that company for over 15 years. You rarely see that now. You want that if those are good executives, but Amazon's shown some pretty rare-air type of skills, the ability to succeed in vastly different businesses, retail, advertising, cloud computing, three businesses with vastly different core competencies, very different types of business models, very different types of skill sets, different types of managerial skills required to run these businesses.

Mark Mahaney:

So that's just really impressive all under one roof by one management team. So, the fact that that team has been very consistent. Andy Jassy is an ex-CEO. If you had any time in the last five years said, "Well, who'd be the best person to replace Bezos?" You would have said one of two people, either Jeff Wilkie who ran the retail business, has run it for 20 years, but is retiring. Or Andy Jassy, who's been with Bezos for 20 years as well. It may have been 19, but it's close enough to 20. And he ran AWS for the last 10 plus years. You got exactly the right person running the business going forward. I don't think there's going to be any slip up at all in terms of the operational excellence of Amazon, because Jeff now is going to become the executive chairman.

Whether there's a slip-up in product innovation, that's the question. That doesn't impact earnings in the next 2, 3, 4 years. It could impact earnings years 5 from now, years 10 from now. Of course, is somebody else at Amazon going to come up with that aha moment, that aha discovery, that aha new product innovation? My guess is that somebody will be able to do that. They've got enough senior talented execs and no one person can ever have everything figured out. There are also other risks with Amazon. I think regulation is near the top of that list, especially-

Larry Bernstein:

Yeah, let's talk about that next.

Mark Mahaney:

Okay. Let's do it.

Larry Bernstein:

Let's talk about antitrust. We had Fiona Scott Morton, Josh Soven, and Doug Melamed on an antitrust panel back in February. And the focus there was on big tech. What's interesting is that it seems to be almost bipartisan in their antipathy towards big tech power. Republicans don't like the fact that the management teams hate and undermine Republican efforts and speech and support. And the Democrats just don't like big, powerful corporate institutions. So, we have this unique combination of political forces opposed to big tech. Who do you think is most exposed? How do you think it will play out? And the Biden administration seems to have picked some of their most progressive antitrusters to be in a management team in this area. Your thoughts?

Mark Mahaney:

Your last statement is factually true. If you were going to pick one person to head the FTC, that was most on the record in terms of being critical of big tech, they picked her. That's Lena Khan. she's done great groundbreaking work on the antitrust challenge, paradox of how do you regulate companies that clearly provide great consumer benefits? Facebook, Google. It's free, and Amazon, not free, but clearly cheaper than most mainstream retail options. How do you regulate companies like that that clearly show great consumer benefits, but also because of their size have such potential for acting monopolistically whether they do or not? So anyway, she wrote one of the definitive pieces on that. So they clearly have somebody who's on the record as being very pro-regulation for these companies.

So yeah, it is a risk. I guess at the end of the day, I think that risk has already been priced in. This isn't new. This has been a rising concern for these companies for years. We've already gone into the 15 billion plus in fines paid by Google and Facebook to regulators for certain actions that they've taken in the past. And there's no question these are aggressive companies. The real conflicts of interest in these new bills that were just introduced are really focused on the conflict-of-interest areas. Now that's less of an issue for Facebook, but clearly, it's an issue for Amazon, which runs an e-commerce marketplace and competes in said marketplace. And for Google that runs an online advertising network and competes in that online advertising network.

So that's where the conflict-of-interest issues arise. I doubt that there'll be a forced breakup of these companies. Think it'd be very hard to do. I think at the very least you've cut off the opportunity for them to do large strategic acquisitions. I think that's just completely off the table. At some level, that probably dings the growth outlook for these companies. That's why investors have taken their multiples down a couple of turns. I think Google would probably trade at 28 times earnings rather than 25x, if it wasn't for this regulatory risk overhang.

So, investors need to be careful about it. I don't think it'll affect the E for these stocks, the earnings, the earnings growth. I don't think it will materially, at least not in the next two to five years. But it has impacted and will continue to impact the PE, the multiples that investors are willing to put on those earnings.

Larry Bernstein:

I invest a substantial portion of my net worth in the S&P 500 and then dabble in individual stocks on the side. And one of the most extraordinary aspects of investing in the S&P 500 is the amount of exposure I already have to Amazon, Google, Microsoft, Facebook, etc. It's incredible. I think Amazon is more than 5% of the S&P 500. When you think about that, I'm already so heavily exposed to Amazon as it is. What do you think the right portion of your portfolio should be in Amazon given your incredibly positive outlook on the stock? Is it a market weighting? Is it less, is it more?

Mark Mahaney:

It should be more than a market weighting. I think if you want exposure to the internet, if you want exposure to a company that's a leader in online advertising, online retail and cloud computing, you can do it with a very seasoned management team with an extremely good track record. In outlook, I think that's rare air. In my book, Nothing but Net, I talk about the 20% rule. I love to see companies that can generate consistent 20% revenue growth. I prize that over almost anything else because in the history of the internet is I've learned scale eventually begets profits. You can't generate earnings if you can't generate revenue. And companies that can grow 20% year in and year out, or greater, they will scale their selves to profitability.

And by the way, Amazon now in the next five years is probably going to be the world's single largest generator of cashflow on an annual basis. I was tracking Amazon early on when nobody thought it would ever generate a single penny of profits. Well, they're doing it now, and they're doing it in spades. So anyway, I think you want to have exposure to Amazon. If you want growth in your portfolio, you want a name like Amazon. Amazon's underperformed or traded in line for the last nine months. And that's because the stock outperformed so much last year, so you're going through a consolidation phase. But because the market swung over the value.

Why did it swing the value? Because when you're coming off of these terrible COVID comps from last year, Caterpillar and other cyclical companies are growing just as fast as Amazon. But that's not going to be the case when we go deep into '22 and into '23. Then the secular growth premium of Amazon is going to reassert itself. And the market is going to want to bid up more for a company that can grow not off of easy COVID comps, but in a regular market can grow 20% top line. You just don't get that with the S&P 500.

The number of S&P 500 companies that can grow consistently 20% year in, year out, year in and year out, it's small single digit percentage of them. I'm highlighting for you one of those companies. That's Amazon. Great management team, large market opportunities, and it's trading it, I think, at a very reasonable valuation. It's actually a slight discount to its historical average. This is when you step in on Amazon.

Larry Bernstein:

All right. Let's move to Uber for a second. When I think about Uber, I think of it as really two things. I think of it as labor cost and cost of an automobile. And lately, if you look at and try to get an Uber, the prices are much higher to get an Uber than previously, pre-COVID.

We have just tremendous demand for labor right now, all over the economy. And Uber takes advantage of labor markets where they're not completely in sync, where people looking for in between jobs, the marginal labor user. How do you think about Uber's ability to participate in a market where labor is in tremendous demand and where car prices are through the roof?

Mark Mahaney:

Okay. Let's see. Uber's our number two pick in mega cap space. Why is it going to work from here? Well, because it's drive business, it's ride sharing business. What they call Uber Mobility, I think it's a COVID recovered recovery play. It's still on a year-over-year decline, but the clients are getting less and less. So, the fundamental outlook is for a recovering Uber on the ride sharing side, on the mobility side, and then on the delivery side, the Uber Eats side, that is just a structural winner from COVID.

Then I've got a company, an asset, that I think is going to finally reach EBITDA breakeven in the back half of this year. And I know what Charlie Munger says about EBITDA, but still, you get positive EBITDA and then eventually it leads to positive earnings, and positive free cashflow. Like it's a trigger, it's part of the earnings process. And when they start showing consistent profitability, I think they're going to show this in 2020, you're going to expand the group of investors that get interested in the stock so that you can get ahead of that.

I still think that the percentage of people in the U.S. that use ride sharing, I think that penetration can double, it's about 36% of the population based on survey work we've done has used ride sharing. And I think that number, given the value proposition of ride sharing, I think that penetration can double over the next five to 10 years. It saves money, it saves time, maybe not in this environment, but I'll explain how that's going to change. It's more reliable than taxis or public transportation.

I think that can double, and then I think the frequency of usage, the people who use Uber now, there's only about a quarter of them use it on a weekly basis. I think the value prop is so strong that the percentage of people that use ride sharing on a weekly basis can at least double to get the 50% or higher.

I just really like this long growth runway. Near term, there are problems with prices of Uber's, particularly in places like New York City. And that's because they're not enough drivers. Why aren't there enough drivers? I think there's four factors here. First are the stimulus checks have been a bit of a disincentive to get riders in the cars, but that's going to end by the end of this September. This is a problem that gets resolved in three or four months.

Secondly, there were concerns about letting strangers in your car during COVID. Well, as vaccination rates rise, that problem is going to get solved.

Third, is that they had competition from some of the food order deliveries, the Instacarts and the DoorDashes, that'll remain a factor, but at the end of the day, you'll probably be able to make more per hour driving for ride sharing than you will for food. It's just, people pay more to have their bodies driven rather than their burgers driven.

And then finally there is some friction involved with setting back up on Uber. Like for you and I to go use Uber again, all we have to do is open the app and click, and we're back on as riders. As drivers, if you haven't been driving for a year and a half, you've got to get your vehicle inspected again, you got to go through background checks again. So there's a little bit of friction, but that will be worked through. I think you'll see the supply ramp up pretty aggressively through the back half of this year, and I think you'll see pricing come down. The value proposition is going to get stronger for Uber. I like buying Uber here before all of that's priced into the stock.

Larry Bernstein:

I want to talk about Spotify next. I worry about the moat. They have all this content, but how do they prevent others from taking that exact same content and providing it on a platform that works?

Mark Mahaney:

And I'd say of our top picks, this is probably our most contrarian call, Spotify.

And the stock, for what it's worth for bulls, it's off 30% plus, at least from its peak earlier this year. Let's see, why I like Spotify, you've got a large end market. I think it's $100 billion, $125 billion and market. And you can think about the 3 billion smartphones. If you were to pull a thousand smartphones worldwide, what percentage do you think would have some sort of music app on that front screen? 99% or something like that. People probably listen more to music on their phones then they do talk with people on their phones. So it's a large end market.

And this is the global streaming leader. Based on survey work we've done, they have far surpassed Apple Music, Pandora, Amazon Music, Google, YouTube Music, like this is the global leader both on the subscription basis, the number of subscribers, they got 200 million paid subscribers worldwide. And I think that number can double or triple in the next five to 10 years. I just think there it could.

And then they also have 2 million other people who are ad-supported now, so I also think that number can double or triple in the next five to 10 years. I just think there's a lot of growth ahead of them. It's a large market, they're the leader in the market. The pushback on it is the business model and the business risk is this isn't Netflix where there's just a whole bunch of different video operators or film producers, TV series producers, et cetera.

This is music where there are four major labels, and they have a choke hold on industry economics. And that's why gross margin at Spotify is 25%, that's an issue. But the advantage that Spotify has is as they get bigger and bigger, their leverage versus the labels is going to expand. And then as they become bigger and bigger, they get to layer in more products and services, and they'll get better economics on them.

And the great example of that is podcasting. This company invested aggressively in podcasting two years ago before the market really understood just how big podcasting could be. And now when they get ad revenue on podcasting, they don't have to share that ad revenue with the labels.

So, you're going to see gross margins start to rise here. This is a little bit akin to Amazon. I think that there's just a lot of room. Every new product and service that Spotify is rolling out is accretive to gross margins, that's going to directly upset the bear argument that this is a structurally low margin business.

And by the way, you can make money with structurally low margin businesses as long as the trend is going the right way on those gross margins. I think you're going to see Spotify gross margins go up. And then are three things going on with Spotify this year.

Again, they're rolling out a price increase globally. I think it's going to be successful. I don't think churn is going to rise. I think the value proposition is strong enough for Spotify.

Secondly, they've launched into 86 new country markets, some of them which are very small countries, but there are some big ones in there like Nigeria, and music is really a global market.

And then a third is they've launched some really nice product innovation, even on the advertising side, what they call streaming ad insertions in the podcasting to make the ads more personalized, better targeted. And anyway, I just like the level of product innovation at this company.

I like Spotify just like Uber. I think this multiple; I think there's a real rerating opportunity. It trades a 3x enterprise value to sales, I think that multiple can go to four, to five. And so I'm saying the stocks go up because the earnings go up over time as earnings grow. But then if you also tell me that the stock can rerate, that the multiple on said earnings can go up, that's a two barreled approach to stock price appreciation, which is what we're all trying to get.

So, when I get those opportunities, like I like to find stocks that can double in the course of three years. That means if you keep your PE, or your valuation multiple, you need kind of compound at 25% growth. But if I can show you compound at 25% growth and a multiple that can go up higher, then you can get a double in two years, and that's where I get super excited about stocks.

And I think Spotify is exactly at that position now. And again, this is a contrarian call, that's what allows the stock to double in two years if I'm right on the fundamentals. So Spotify is one of our top picks, and it's probably amongst the largest cap stocks, it's probably our most contrarian long.

Larry Bernstein:

Thank you so much, Mark I appreciate it.