Hey, You, Get Off My Cloud

June 27, 2017
by William Smead
of Smead Capital Management

Walmart (WMT) recently made it clear to vendors that they should “get off” Amazon’s Cloud. This was one of two announcements which speak to the competitive landscape of business in the U.S. The other announcement came earlier when Amazon (AMZN) disclosed an agreement to buy Whole Foods (WFM) for $42 per share in cash. With a little help from the Rolling Stones¹, we will unpack these announcements and see if there is historical evidence to guide us on the consequences.

I live in an apartment on the ninety-ninth floor - of my block
And I sit at home looking out the window
Imagining the world has stopped

When Amazon disclosed their purchase of Whole Foods, the investment world “stopped” wanting to own anything which in some way could be negatively impacted by Amazon’s empire. Obvious competitors like Walmart, Target (TGT) and Kroger (KR) suffered deep price slumps. Unlike other recent Amazon fear episodes, even a golden child like Costco (COST) saw shares fall 6%. The “imagining” worked its way to Walgreens (WBA) and CVS (CVS), as investors looked out their “99th floor window” and saw Amazon taking over the retail prescription market in the U.S. The stock market has spent the last week contemplating a world nearly identical to the TV cartoon, The Jetsons, and the heat got very hot in the retail world’s kitchen.

Then in flies a guy who’s all dressed up - like a Union Jack
And says, I've won five pounds if I have his - kind of detergent pack
I says, Hey! You! Get off of my cloud

Amazon’s Jeff Bezos flew in “all dressed up,” but Walmart wasn’t going to take the new competition laying down. Walmart has told vendors to avoid Amazon Web Service’s cloud, the only part of Amazon’s business which consistently produces net income.

Don't hang around 'cause two's a crowd
On my cloud, baby
The telephone is ringing

As long-duration owners of high quality businesses purchased when they are deeply out of favor, we love the fact that “the telephone is ringing.” There are several companies with long histories of success
and balance sheet strength which are being trounced by the fear that Amazon will crush everything in their path. We are happy to “hang around cause two’s a crowd.” Since tech stocks and FANG stocks have dominated the stock market for the last two and one half years, a real effort is being made to discount a business world looking more like The Jetsons than where we will be in 10 years.

He says, "It's three a.m., there's too much noise
Don't you people ever want to go to bed?
Just 'cause you feel so good,
Do you have to drive me out of my head?"
I says, Hey! You! Get off of my cloud

Since there is “so much noise” and Amazon shareholders “feel so good,” we thought we’d weigh in on both sides of this issue.

1. Whole Foods is an appetizer for a company the size of Amazon and the limited exposure looks like risk aversion to us.
2. Amazon is paying cash for WFM and this tells us that most of Whole Food’s shareholders are willing to pay 23.8% of their capital gains to the U.S. Treasury, in lieu of receiving shares of Amazon stock.
3. The CEO of Whole Foods made silly dating references (“It was love at first sight.”) to the transaction very much like the teenage "love-making" references Ted Turner made when AOL bought Time Warner (TWX, owner of Turner's CNN) in the last tech boom. AOL was a disaster for TWX.
4. Grocery delivery has been tried for over twenty years and has been a graveyard for everyone including Amazon during that time. As an example, our local Amazon Go location is lucky to have one car picking up groceries when we drive buy, even during rush hour!
5. The decline in the share prices of the companies perceived as damaged by the announcement was more than $25 billion. The gain in AMZN and WFM was on the order of $15 billion.

The Walmart announcement comes from a highly-profitable company which competes head-to-head with Amazon. It came soon after Nordstrom (JWN) announced that the family would like to take the company private and get out of the trap which Amazon has laid in this frenzy. We believe...

1. Investors shouldn't be interested in a business because of Amazon, they should be interested if one meets an economic need in the Amazon era.
2. Competitive practices and regulatory scrutiny could be headed toward the FANG companies and Amazon is not the biggest offender among their brethren. Amazon is attempting to consolidate economic power in the Whole Foods acquisition. We are convinced the issue of concentrated economic power in the U.S. will only getting hotter, even if you don’t have a “99th floor” view!
3. Walmart is huge in relation to Amazon in sales and profits and has power with its vendors.
4. The history of the investment markets shows that when the future looks the most exciting for a company or an industry, prices are typically peaking. The power Amazon is showing in the stock market is common to glamour tech stocks of the past like IBM (IBM), Microsoft (MSFT) and Cisco (CSCO).
5. There is a big difference between the relatively unregulated world of groceries and the highly regulated world of prescription pharmaceutical wholesaling and retailing. Walgreens looks very
interesting to us at these prices.

In conclusion, the recent announcements related to Amazon have been very entertaining and could possibly open doors for value buyers like us. History would argue that the market’s reaction tells us that “imagining” might have become too popular. We are reminded that on our long-duration value investing “cloud,” only the lonely can play.

Warm regards,
William Smead

1 Source: “Get Off My Cloud” by the Rolling Stones (http://www.azlyrics.com/lyrics/rollingstones/getoffofmycloud.html)

The information contained in this missive represents Smead Capital Management's opinions, and should not be construed as personalized or individualized investment advice and are subject to change. Past performance is no guarantee of future results. Bill Smead, CIO and CEO, wrote this article. It should not be assumed that investing in any securities mentioned above will or will not be profitable. Portfolio composition is subject to change at any time and references to specific securities, industries and sectors in this letter are not recommendations to purchase or sell any particular security. Current and future portfolio holdings are subject to risk. In preparing this document, SCM has relied upon and assumed, without independent verification, the accuracy and completeness of all information available from public sources. A list of all recommendations made by Smead Capital Management within the past twelve-month period is available upon request.

© 2017 Smead Capital Management, Inc. All rights reserved.

This Missive and others are available at www.smeadcap.com

Follow us on Twitter @SmeadCap