Eidelman Virant
CAPITAL

11th of April, 2019

Dear Clients and Friends,

The S&P 500 Index recorded a 13% gain in the first quarter, the best start to a year since 1998. Many attributed the gains to the Federal Reserve pivoting from raising interest rates to stopping or potentially even lowering interest rates in the coming year. We believe the magnitude of this year's gain is mostly just a reversal of the pessimism surrounding the severe market decline experienced in Q4 of last year. The good news is historically when the S&P 500 got off to a robust start of 10% or more in Q1 of a year, it rose the remaining nine months of the year 85% of the time by a median of 7% per year.

While our portfolios experienced healthy gains in the first quarter, financial stocks lagged somewhat compared to the other sectors like technology and industrials. Bank stocks remain attractive from a valuation perspective, but concerns about loan growth, competition for deposits, and a flat yield curve have acted as a headwind. Weighing all the factors for banks going forward, we think the banks still offer superior potential risk-adjusted returns. We are also buying banks with the best management teams, motivated corporate cultures, strong balance sheets, valuable locations, and are attractive acquisition targets. Our top twenty largest bank holdings trade at an average valuation of 1.1x tangible book value and 11x estimated earnings, representing a roughly 25% discount from the industry average of similar sized banks. Last year, there were 260 bank buyouts at an average takeout price of 1.75x tangible book value and 24x earnings, representing a 50% appreciation potential for our banks in the event of a buyout.

We love buyouts, but we also love companies that can compound attractive returns over long periods of time. In the vast majority of cases, these compounders had magnificent corporate cultures driving such outperformance. Broadly, we define "great" corporate cultures as those that are the best places to work, have the most satisfied customers, and deliver superior long-term returns to shareholders. While most Wall Street analysts focus primarily on financial success, we've found corporate culture is the engine that drives sustainable outperformance.

One of the biggest challenges we face when looking for new investment ideas is reconciling our expertise in the power of corporate culture with our strict value discipline. While we have found some companies which neatly fit both criteria (particularly in the small banks I noted above), most companies with outstanding cultures aren't cheap on traditional metrics. These higher valuations previously dissuaded us from investing in some terrific opportunities.

"Value" has been and continues to be the bedrock of our investment philosophy. It is in our DNA to be attracted to underappreciated companies where simple math points to attractive returns with low downside risk. We often cite data supporting this approach such as from 1982 to 2018 the cheapest decile of stocks based on price/earnings (P/E) ratio have returned 11.4% per year versus just 6.8% for the most expensive decile. We have benefited greatly from beaten down companies outperforming after tough times like banks in the great recession and avoiding Wall Street darlings getting knocked off their pedestals by competition like we saw with technology stocks in the dot.com bust. However, the key factor we underestimated is the ability for top performing cultures to keep up their great performance versus reverting downward due to tough competition. Google (GOOG) is a great example.

Despite its legendary culture, delightful search technology, and tremendous growth potential, we thought Google stock was too high when it went public in 2004 at $85 per share. GOOG shares traded at 10x sales and 118x earnings, a valuation level about 5x higher than the average stock in the S&P 500 index at the time. However, Google went on to increase in value 28 times and is attractively priced today. How is that possible? Powered by their world-class workforce, Googlers innovated in their core search engine, ad platform, YouTube, android operating system and more, capitalizing on the secular trend of global advertising transitioning online. It turns out the company could have gone public at 1000x earnings and the stock still would have been a great value by outperforming the S&P 500 Index. Google is no isolated incident.

Stocks of the companies with the best corporate cultures have significantly outperformed the S&P 500 Index over time. As a proxy for culture, an equal-weighted portfolio of *Fortune* magazine's *100 Best Companies to Work For* returned 10% annually from 1998 through the end of 2018 compared to just 7% for the S&P 500 Index. Such ratios like P/E are short cuts which imply typical growth rates and competitive pressure. Companies with outstanding cultures have far exceeded growth expectations and thus have been underestimated by such metrics. Our investment analysis must evolve. I believe our biggest opportunity to improve future investment performance is to incorporate our knowledge that companies with great management cultures can still be great values without having below market P/E ratios. One current example is Amazon.com (AMZN).

Amazon was rated #1 in *Top Companies the US Wants to Work Now* according to Linkedin, #1 for nine consecutive years in customer satisfaction for the retail industry including the highest score ever recorded, and delivered shareholder returns of 37% compounded for the past 10 years vs the S&P 500 of 13%. Amazon is obsessed with customer service and their services are getting better every day. The biggest obstacle to overcome investing in Amazon is and always has been the valuation. Amazon shares currently trade at 68x next year's estimated earnings. On the next page, I'll detail why we think Amazon's position, strategy, and culture make shares undervalued and potentially worth $2,500 per share, a 40% premium to the current price.

I want to end by sharing the exciting news that Ben Weiss has joined the Eidelman Virant Capital team. Ben will work as an analyst as well as portfolio manager for 8th & Jackson Partners, a concentrated value-oriented hedge fund he founded in 2014. After working closely together, we agreed it would be mutually advantageous to work as one team to help all our investors generate superior investment returns. Ben graduated from Vanderbilt University and Washington University Law School and worked as a corporate lawyer in St. Louis and as an equity analyst at ADW capital, a value NY-based hedge fund. Ben is also a guest contributor on the media industry to Hollywood trade publications like Variety and Hollywood Reporter. We are thrilled to have him on board.

If you have any further questions, please don't hesitate to give me call.

Sincerely,

Tom Eidelman, CFA
Managing Director

**Amazon.com – (Ticker: AMZN) - Price $1,780, Target $2,500 (40% upside)**

Amazon.com is the world's largest online retailing company. Amazon also owns Amazon Web Services (AWS), the largest cloud infrastructure company. These are two of the largest and fastest growing industries in the world. Driven by their world class corporate culture and management, we think these businesses will continue to wow customers, develop breakthrough products and services, and compound profits at an extraordinary rate. The founder and CEO, Jeff Bezos, owns 16% of the company, perfectly aligning his financial interests with shareholders. To evaluate the whole entity, the two businesses are best analyzed and valued separately.

**Amazon Retail (Amazon.com) – Value $1,500 per share -** Amazon.com is an amazing shopping experience. Customers can buy nearly any product 24 hours a day, 7 days a week, at the lowest price, hassle free, and shipped to their doorstep. Amazon is obsessed with improving the customer experience and has been rewarded with a 49% market share of online retail sales.

With online still representing just 14% of retail sales in the United States (excluding gas, restaurants, and autos), Amazon's growth is expected to continue at 20% per year for the foreseeable future as a larger share of items are bought online. Amazon further leverages its online platform by selling its own propriety products, advertising, and allowing other businesses to sell their products on its website. In two years, the value of these combined profit streams could be $30B. At 25x operating earnings, Amazon.com would be worth roughly $1,500 per share.

**Amazon Web Services (AWS) – Value: $1000 Per share -** AWS is Amazon's cloud computing business. As Amazon was building its own data centers to manage its growing computing needs, they recognized early that as the internet grew, other businesses would need access to infrastructure, data storage, security, and a host of other applications in the cloud. Thus, AWS was born. Amazon invested aggressively to meet this need, building data centers around the world, and hiring software engineers and programmers to develop advanced web-based applications. Today, AWS offers over 125 fully featured services for computing, storage, databases, networking, artificial intelligence, and a variety of other web-based services. The breadth and quality of the AWS offering has led to capturing a 51% market share of this cloud infrastructure market.

While AWS already earns $25B in sales and $7B in operating profit, they are in the first inning of cloud growth. If Amazon can maintain their market position and margins into this forecasted opportunity, that would equate to $35B in profits in five years. Applying a market multiple of 25x for this dominant recurring revenue platform, AWS could have a future value of $1,000 per share.

**Alexa – Value: TBD -** Alexa is Amazon's AI-enabled voice platform that allows customers to search, explore, and buy products with voice commands. With 10,000 employees and more than 100 million voice-enabled devices sold, Alexa is a disruptive and delightful technological platform which will reward Amazon with more consumer spending.

## Conclusion

Amazon owns dominant businesses with outstanding growth, world-class management, and a culture of innovation and customer service. We think shares are undervalued based on our analysis that this team improve their products, competitive position, and profitability beyond expectations. Amazon is well known, but sometimes doing what is simple, and obvious, is most rewarding. Amazon shares represent an opportunity to own part of one of the great companies in the world at an attractive price.

**Disclosures**