Does Wall Street buy your growth story? For how long?

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Amazon's stunningly successful growth strategy has created a context in which, as one observer put it, "no profits, no problem." But is this strategy just valid for this moment in history, a consequence of a brilliant innovator surfing the economic tsunami of this digital era? Is it imitable by other disruptive innovators? Is there a way to model how investors interpret whether such a strategy is sustainable? And what events might cause investors to rethink their unmitigated admiration of Amazon?

For years founding CEO Jeff Bezos has convinced investors that profits should be immediately invested for even more growth. Some pundits, however, are vexed to explain why Amazon isn't punished by investors for being a perpetual adolescent, promising innovation and growth but not conventional returns. Even growth companies, they argue, must eventually turn a profit.

On the other hand, Amazon's strategy has rewarded investors with a steadily soaring stock price and ever-increasing market capitalization. Indeed, Amazon today is worth more than Walmart, Costco and Target – combined. Amazon's growth in value since its diversification into formerly unrelated fields such as selling computing capacity via its Amazon Web Services business has been remarkable (see Exhibit 1).

Bezos has been clear from the time of the company's founding that his intention has always been to build an organization that approaches every day as though it is "Day 1," referencing a startup mindset. Companies in Day 1 are disruptive, innovative, risk-taking and fast. Indeed, he regularly references Day 1 in his annual report, for example:

> Day 2 is stasis. Followed by irrelevance. Followed by excruciating, painful decline. Followed by death," he said. "And *that* is why it is *always* Day 1.

Bezos even works in an office building named "Day 1." And he has been pursuing this profitless, but growth-driven philosophy relentlessly. Indeed, his ability to persuade investors to give him lots of cheap capital has become legendary. Amazon's disruptive swath – bookselling, web services, shoe shopping and lately even groceries – does not appear to be slowing down, even though a typical quarter is profitless.

Amazon defies conventional investment wisdom in other ways. For example, investors don't seem to care if the company strays from industry boundaries. This gives it the license to compete not only in its core retail operations but in cloud-based computer services, movie and television production, video streaming, third-party selling and myriad other lines of business. When something doesn't work out – for instance, the Fire cell phone – the management team simply declares the market entry to have been a learning experience and moves on.

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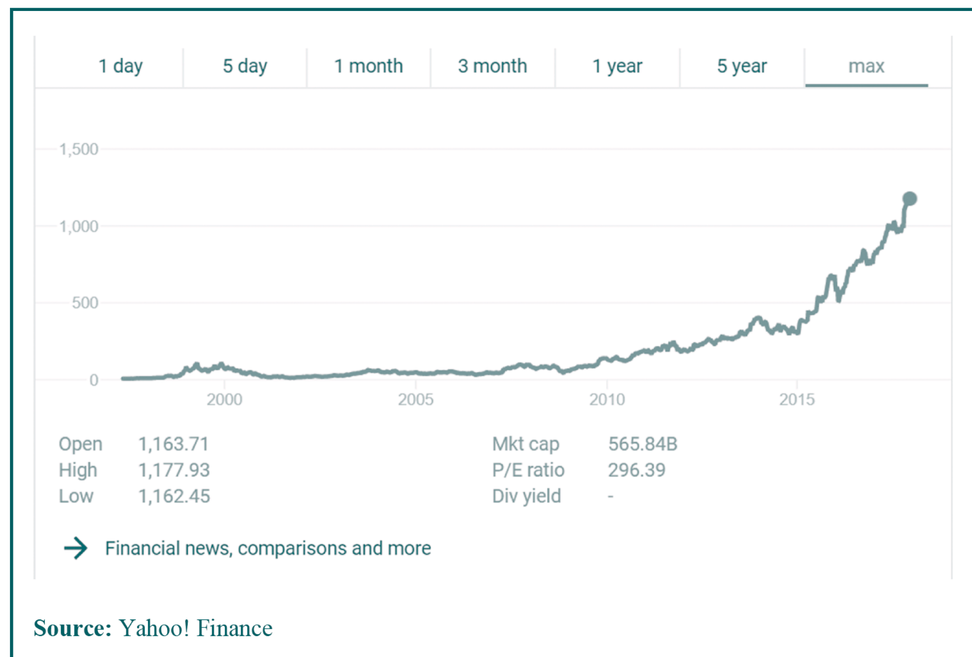
Amazon is a prototypical example of a company that is built to thrive in the “transient advantage economy.”[1] Companies that compete this way learn to seed many small innovations, nurture them, rapidly scale the ones that get traction in the marketplace, extract value from them as long as possible and disengage when their advantages decline. Instead of building “moats” around existing businesses, they use their speed and customer-centricity to make competing with them either unattractive or impossible. And investors seem eager to buy this approach. Even granting their success, the question remains, “How much of a premium are investors wagering on future growth rather than present profits?”

The Imagination Premium™: a measure of confidence in a growth strategy

The answer can be measured in the Imagination Premium™ metric. It assesses the confidence of the investing community in a business’ growth strategy. Here’s how it’s calculated. Firstly, look up the “beta” of a company’s stock, which is a measure of how volatile the price of a stock is relative to the overall market. Investors use this number to estimate how much return they should expect. In general, stocks that have higher beta values need to provide better returns to investors than those with low values because they represent riskier bets. From this, a firm’s implied cost of capital can be calculated. By comparing this value with the actual cash flow thrown off by the firm, the Value of Operations (VO) can be derived. By comparing this value with a firm’s market capitalization, it is then possible to determine whether the firm is valued strictly on the basis of its current operations, or whether the investing community is seeing more, or less, value potential.

Exhibit 1 The stratospheric rise of Amazon’s stock market value



Source: Yahoo! Finance

> **“Bezos has been clear from the time of the company’s founding that his intention has always been to build an organization that approaches every day as though it is ‘Day 1,’ referencing a startup mindset.”**

This is where the model gets interesting. Depending on the difference between the value from ongoing operations and the firm’s actual market cap, we can tell if observers have judged the firm to be poised for growth or not. When market capitalization is greater than the value of operations, we call this the Value of Growth (VG). This is the value that investors are placing on the company that can’t be explained by its current performance. By dividing this growth value, VG by VO, we derive a number for the Imagination Premium™. As the name suggests, this is the additional value investors are placing on a firm because they believe in its potential for growth and consequent share price appreciation.

Amazon’s “Imagination Premium”

According to this model, Amazon’s Imagination Premium is 2.92. The company’s implied value of growth was nearly four times its value from operations, a result completely consistent with Amazon’s “profits are optional” motto. Jeff Bezos’ ability to simply and credibly paint a vision of the “World’s Biggest Store” and deliver on making that vision a reality, year after year, has earned him the trust of investors, despite the company’s lack of interest in throwing off profits. It has created a competitive advantage and a set of permissions which few other firms have been able to duplicate.

The collapse of a high Imagination Premium: Tesla

Tesla’s bright future as the premier electric car maker is another story that entrances investors. Nonetheless, the company is still losing money, and hasn’t been able to manufacture at scale. There is no value of operations in this venture. Tesla’s market capitalization, however, exceeded that of both Ford and General Motors for a period in 2017. CEO Elon Musk so effectively portrayed the firm as the harbinger of the next big thing in the car business that investors crowded into the stock.

And then came a surprise announcement from Volvo: it would leave the internal combustion engine behind. Every new car it would make from 2019 onward would be either electric or hybrid. Other car companies followed, suggesting to observers that the internal combustion engine has an expiration date. What this signaled to investors was that despite Musk’s missionary zeal to make electric cars cool, his company would face formidable competition from well-funded firms who know how to make cars at scale. Moreover, doubts are increasing about the sustainability of Tesla’s lead in battery technology and software as competitors catch up. Cheap exports from China, for instance, could undermine Tesla’s investments in mass production plants in the United States.

It didn’t help that Tesla’s launch of its hoped for mass-market car was plagued with manufacturing difficulties. As one investor envisioned the company’s future:

> To own Tesla stock at these valuations, one must believe that a company that has never hit an earnings milestone in its history can suddenly solve their production problems, solve their technology scaling challenges, stem their massive cash burn rate and hope that no other luxury car maker ever offers a competing EV.[2]

A widespread loss of faith caused Tesla’s stock to suddenly shed some $10 billion in market capitalization by the end of 2017.

In the case of Tesla, this value was all imagination premium, inspired by Musk's ability to paint the picture of a total transformation in the automotive space in which his company would be the undisputed market leader. Unlike Amazon, however, Tesla has failed to deliver on its growth story due to its inability to generate positive operating cash flow.

The markets don't like a lack of imagination either

For most companies, having a high imagination premium would be a dream come true. In many sectors firms are hobbled by an imagination premium number that is low or even negative. The entire casual dining sector faces this challenge, as it confronts a generational shift in eating habits away from sit-down restaurants, a massive amount of competition from so-called fast-casual establishments and the rise of new offerings that make food preparation at home more convenient, such as meal kits.

The case of Buffalo Wild Wings offers an example. This casual dining and sports bar chain had grown substantially since its 1982 founding. With a mix of company-owned and franchised restaurants, the chain grew to over 1,200 eateries by 2017. In 2015, however, sales began to decline, even as the cost of ingredients of its Buffalo chicken wings increased.

In Imagination Premium terms, the firm actually had a negative premium of 0.6, meaning that not only were investors doubtful of the company's growth story, they actively expected the market cap to shrink! At the time of this analysis, its market capitalization was $2 billion and it was generating over $280 million in free cash flow. An activist investor, Marcato Capital Management, pounced in the summer of 2017, demanding board seats, the dismissal of the company's longtime CEO, and a shift in strategy to increase ownership of restaurants by franchisees. The activists got some of what they wanted – the CEO has agreed to retire and there are efforts to diversify the format to appeal to cost-conscious customers.

The latest turn in the Buffalo Wild Wings saga is that a buyer, Roark Capital, has emerged. Roark also owns Arby's and other restaurants in the fast-casual and casual dining sectors. The firm offered a modest premium of $2.4 billion for Buffalo Wild Wings, which will result in its going private. Given the fresh thinking and experimentation needed to overcome a negative imagination premium, Roark recognizes that a Buffalo Wild Wings turnaround will be far easier to accomplish outside the glare of the public markets.

Balancing innovation and execution

As these cases suggest, The Imagination Premium™ offers a potentially forward-looking metric for evaluating a firm's growth strategy by breaking its market cap into its component elements. Too high, and a firm risks a bubble-bursting punishment. Too low, and a firm doesn't have a convincing growth story, and as a consequence may face acquisition, activist actions or a shift in leadership.

Traditional metrics used to evaluate investment proposals can lead firms to over-invest in existing businesses that show more predictable cash flows than innovative new ones can.

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Firms without solid innovation portfolios can easily be lured into using share repurchases or other financial maneuvers to increase the price of the stock, even if only for a brief period.

Part of the difficulty is that conventional metrics for investing in new opportunities are dangerously flawed. Consider one popular metric, the Net Present Value [NPV] calculation. NPV theory suggests that firms forecast their cash flows into the future, discount them back to today’s dollars and invest in those ideas that promise to return more than an additional investment in the base business would return. The dilemma is that this way of thinking does not take account of transient advantage. It presumes predictable cash flows and does not generally allow for the erosion of profitability in the base business. In effect, net present value incents investment in core operations that may not drive the future of the company. To get greater value from growth, a different way of thinking about value creation is needed.

The power of optionality

When uncertainty is low, it is possible to calculate a credible net present value with predictive potential. Consider, for instance, the value of cash flows derived from enrolling students in a prestigious MBA program. Next year’s numbers are going to be quite predictable as are the numbers for the year after that, unless the sector experiences discontinuity. Few businesses today, however, have that much predictability.

As uncertainty increases, as it will with investments in innovations, the value that is being created is increasingly that of option value, which is the value created by small investments made in one point in time that open potential opportunities later on. Options come in many forms, but for purposes of increasing a company’s Imagination Premium, those that matter the most are those that increase customer willingness to pay, launch an entirely new category or create a new source of cash flow for the firm.

Amazon’s chief rival figures out The Imagination Premium

When discussing barriers to growth with executives, their frequent lament is that their investors punish them for either straying beyond their traditional business boundaries or investing in projects with uncertain outcomes. Investors complain that the cash flows from such ventures are not predictable and existing metrics might suffer. If these complaints resonate, it’s because the company has either not done a good job of communicating the value of its growth investments, or investors simply don’t believe what they are being told.

Amazon’s chief rival, Walmart, provides an example of how this works. Walmart had attempted for years, without much success, to gain traction in the e-commerce business, even as Amazon enjoyed torrid 20 percent or more annual growth. Walmart faced myriad internal problems, including hostility regarding e-commerce ventures from store managers and weak technological infrastructure.

In what some describe as a major inflection point, and “Walmart’s last shot”[3] at gaining an e-commerce foothold, the company announced its decision to buy startup Jet.com on August 8, 2016. It offered a stupendous price - some $3.3 billion for the fledgling e-commerce firm. Until that point, Jet.com had raised about $500 million and was valued at about $1 billion. A large part of the valuation premium was due to the reputation of their founder, Marc Lore. Lore was an extraordinarily successful first-time entrepreneur. His former company, Diapers.com rocketed to a competitive position with Amazon, eventually being acquired by it for $550 million in 2010.

Diapers.com began modestly. The founders reportedly spent three years designing a highly functional web site before actually beginning operations. The original warehouse was a garage. It was a focused, Spartan operation. With costs low, and a clear line of sight to what customers wanted, the young company found a promising niche and exploited it effectively – drawing on their own experience of what parents really need and building customer-centricity into its very fiber. Indeed, their effectiveness in competing against Amazon, which ended up abandoning its own diaper brand, gave the new company considerable credibility.

At the time of Walmart's acquisition of Jet.com, the investing community was skeptical. Lore's new company was losing money, it struggled to capture and retain customers, and some pundits predicted that Walmart's bureaucracy would ultimately strangle the startup. But Lore and Walmart's CEO Doug McMillon, told a different story. Walmart would give Jet.com investment capital and scale. It would allow them to serve customers the way customers wanted to buy. This would position Walmart in growing new markets, particularly among upscale shoppers. It would play to Walmart's strengths, in which selling baskets of items generates better margins for the firm and cheaper prices for customers – consistent with Walmart's long-time brand presence.

The commitment was all in –Walmart put Lore in charge of its entire e-commerce operation with the mandate to, this time, "get it done." The deal even included an agreement to leave Jet.com at their headquarters in New Jersey and put Lore in charge of Walmart's other geographically dispersed digital outposts.

A year and a half later, the naysayers are being proven wrong and Walmart's bet on Lore and the additional acquisitions are bearing fruit. The outcome is summed up by a reporter's observation about the deal:

> [. . .] had it not spent that $3.3 billion on the acquisition, that money likely would have gone to share buybacks, on which the company has spent $8 billion over the last year. Though investors cheer buybacks, they do nothing for the long-term health of the underlying business. –Jeremy Bowman of the Motley Fool.[4]

This observation nicely sums up our argument about the different kinds of value that investors are looking for. On the one hand, cash from operations that can go to buybacks offers short-term rewards. However, without an investment in growth opportunities, eventually investors will lose patience with existing management.

In January of 2016, Walmart traded at $61.46 per share. At the time of the Jet.com acquisition, its shares were worth $73.34. Today, they are worth $97.13. This is reflected in the company's Imagination Premium (see Exhibit 2).

As of 2014, Walmart investors were clearly valuing its operations (dashed line) more highly than its growth prospects (green line). As the company struggled with its e-commerce strategy throughout the 2014-2016 period, the value of growth (VG,) began to plummet, despite the fact that the value of operations held steady. After the 2nd quarter 2016 acquisition of Jet.com, VG began to stabilize, and a few quarters later as the e-commerce strategy began to bear fruit, VG increased and Walmart's total market capitalization began to increase as well.

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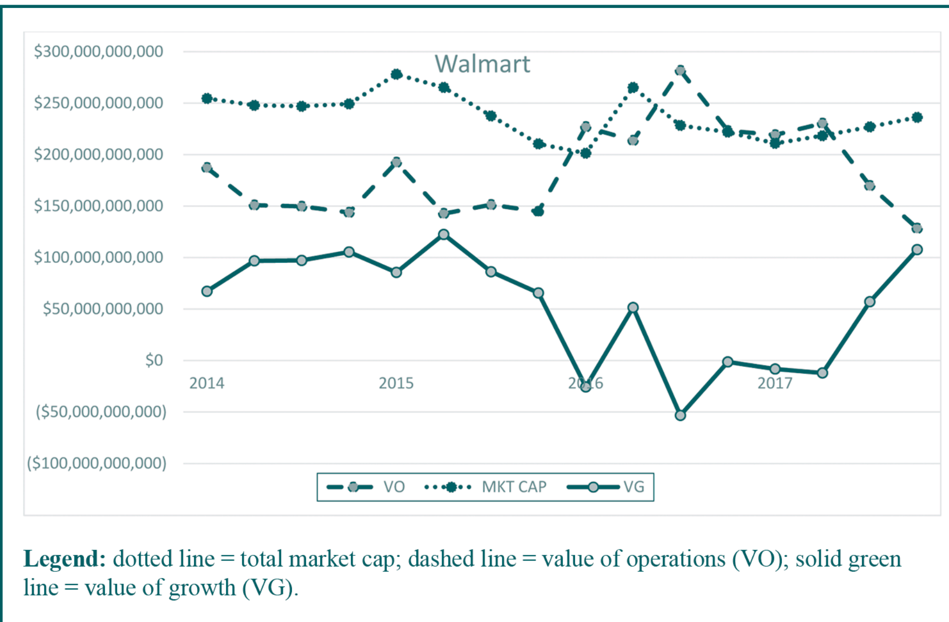
Exhibit 2 How investing in growth lifted Walmart's Imagination Premium



Legend: dotted line = total market cap; dashed line = value of operations (VO); solid green line = value of growth (VG).

Amazon vs Walmart: implications for executives

Jeff Bezos' vision and relentless execution has kept Amazon's market cap astonishingly high for two decades now. He and Amazon have been given permission by the markets to pursue growth because he has captured their imagination. Yet, we know that companies with extraordinarily high Imagination Premiums are highly vulnerable to shifts in investor sentiment.

It hasn't ever been smart to bet against Jeff Bezos. But Walmart's resurgence brings into sharp relief potential negative scenarios for his firm. For many investors, Walmart's taking out options on getting Internet retailing right by acquiring Jet.com have led them to start thinking of it more as a growth stock than its traditional play as a value investment. This is evident in Exhibit 2 where the green VG line is ready to cross the dotted VO line as the largest component of Walmart's market cap.

Walmart not only has huge, existing cash flows but now has a compelling e-commerce growth story – both strong value from operations and value from growth. Amazon, with over $135 annual billion in sales and a market capitalization of over $546 billion, will require adding vast new territories to keep up its torrid growth rate.

We'll go out on a limb here. Based on its proven strengths and growth strategy, we suspect that investors will begin to see a resurgent Walmart as a competitor that can challenge Amazon, and as a result deflate some of its perceived value from potential growth.

There are several essential implications for leaders. The first is that when investors believe your growth story, your Imagination Premium will increase, lifting your market cap along with it. We believe this offers a counterweight to those who argue that companies should not make investments in uncertain, new territories. While the benefit may not show up in net present value analysis, we find that it definitely can increase the Imagination Premium, and thus can be analyzed as a benefit to investors in terms of total market capitalization.

If, on the other hand, either the growth story is not compelling or credible, the portion of your company's market capitalization represented by your value from growth will shrink. This is the situation Buffalo Wild Wings found itself in – despite management protestations to the contrary, Marcato Capital Management and fellow investors simply didn't believe that the existing strategy

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of the firm would lead to growth. As with Buffalo Wild Wings, our research finds that firms with low Imagination Premiums tend to invite interest from activist investors, criticism from shareholders and often, a Board decision to fire the incumbent management team.

A second learning implication is that a high Imagination Premium is not always a good thing. As we saw in the case of Tesla – and many other high-flying firms before it – sky-high expectations for growth can be dashed by external events over which businesses have little control. Unless a business can show, as Amazon has historically done, that it can turn expectations into gold-spun reality, lofty investor expectations can become a liability.

In contrast to those managers who complain that quarter-by-quarter market demands constrain their ability to innovate, our research adds a different nuance. Granted, investors appreciate the short-term lift of activities such as share repurchases. However, what they appreciate even more is for a management team to find the right balance between delivering results today and investing in future growth, even if it means being brave enough to face the resulting uncertainty.

Notes

1. McGrath, Rita, "Continuous reconfiguration in the transient advantage economy," *Strategy & Leadership,* Vol.41, No. 5, 2013.
2. CNBC online www.cnbc.com/2017/10/10/investors-giving-cash-incineration-engine-tesla-a-lot-of-rope-but-may-soon-lose-patience.html
3. Bloomberg online www.bloomberg.com/news/features/2017-05-04/can-wal-mart-s-expensive-new-e-commerce-operation-compete-with-amazon
4. Jeremy Bowman of the *Motley Fool*, cited at *Business Insider* www.businessinsider.com/walmart-stock-price-jet-acquisition-one-year-later-2017-10

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