

Amazon.com Inc AMZN (XNAS)

Morningstar Rating	Last Price	Fair Value Estimate
★★★★	3,440.16 USD	4200.00 USD
30 Jun 2021 21:23, UTC	30 Jun 2021	30 Apr 2021 02:09, UTC

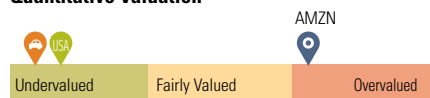
Price/Fair Value	Forward Dividend Yield %	Market Cap (Bil)	Industry
0.82	0.00	1,734.95	Internet Retail
	30 Jun 2021	30 Jun 2021	

Capital Allocation	ESG Risk Rating Assessment ¹
Exemplary	
	01 Jan 0001 06:00, UTC

Morningstar Pillars	Analyst	Quantitative
Economic Moat	Wide	Wide
Valuation	★★★★	Overvalued
Uncertainty	High	Very High
Financial Health	—	Strong

Source: Morningstar Equity Research

Quantitative Valuation



	Current	5-Yr Avg	Sector	Country
Price/Quant Fair Value	1.08	0.98	0.80	0.83
Price/Earnings	65.4	185.2	16.2	20.1
Forward P/E	57.5	—	12.3	13.9
Price/Cash Flow	26.2	30.6	10.2	13.1
Price/Free Cash Flow	80.8	63.4	17.7	19.5
Trailing Dividend Yield%	—	—	2.46	2.35

Source: Morningstar

Bulls Say

- ▶ Amazon is the clear leader in e-commerce and enjoys unrivaled scale to continue to invest in growth opportunities and drive the very best customer experience.
- ▶ High margin advertising and AWS are growing faster than the corporate average, which should continue to boost profitability over the next several years.
- ▶ Amazon Prime memberships help attract and retain customers who spend more with Amazon and reinforces a powerful network effect while bringing in recurring and high margin revenue.

Bears Say

- ▶ Regulatory concerns are rising for large technology firms, including Amazon. Further, the firm may face increasing regulatory and compliance issues as it expands internationally.
- ▶ New investments, notably in fulfillment, delivery, and AWS should dampen free cash flow growth. Also, Amazon's penetration into some countries might be harder than in the U.S. due to inferior logistic networks.
- ▶ Amazon may not be as successful in penetrating new retail categories, such as luxury goods, due to consumer preferences and an improved e-commerce experience from larger retailers.

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¹The ESG Risk Rating Assessment is a representation of Sustainalytics' ESG Risk Rating.

Amazon Expands Video Library With MGM Studios Acquisition; FVE Still \$4,200

Business Strategy and Outlook

Dan Romanoff, CPA, Eq. Analyst, 29 April 2021

Amazon dominates its served markets, notably for e-commerce and cloud services. It benefits from numerous competitive advantages and has emerged as the clear e-commerce leader given its size and scale, which yield an unmatched selection of low-priced goods for consumers. The secular drift toward e-commerce continues unabated with the company continuing to grind out market share gains despite its size. Prime ties Amazon's e-commerce efforts together and provides a steady stream of high margin recurring revenue from customers who purchase more frequently from Amazon's properties. In return, consumers get one-day shipping on millions of items, exclusive video content, and other services, which result in a powerful virtuous circle where customers and sellers attract one another. The Kindle and other devices further bolster the ecosystem by helping attract new customers, while making the value proposition irresistible in retaining existing customers. Through Amazon Web Services (AWS), Amazon is also a clear leader in public cloud services.

Additionally, the firm's advertising business is already large and continues to scale, thus offering an attractive option for marketers looking to access a vast audience with a variety of proprietary data points about those very consumers. AWS, advertising, and subscriptions are growing faster than e-commerce with the exception of the 2020 spike in online shopping. We expect these three areas to be the main growth drivers over the next several years. This is critical, as each of these segments drives higher margins than the corporate average, which in turn should allow both operating profit and EPS to outgrow revenue as margins continue to expand.

From a retail perspective, we expect continued innovation to help drive further share gains. We also look for continued penetration into categories such as groceries and luxury goods that have not previously translated into the same level of success as other retail categories. We also see technology advancements in AWS and a bigger push to service enterprise customers as helping to sustain

the company's lead there. Overall, we see strong revenue and free cash flow growth for years to come.

Analyst Note

Dan Romanoff, CPA, Eq. Analyst, 26 May 2021

On May 26, wide-moat Amazon formally announced the acquisition of privately held MGM Studios for \$8.45 billion; the deal had been rumored for several days. No timing has been provided, but we do not expect regulatory delays. While the deal is immaterial relative to Amazon's \$1.6 trillion market cap and we are not adjusting our \$4,200 fair value estimate, we see this move as strategically important as the company adds more content to its Amazon Prime Video library. MGM's content spans movies, scripted and unscripted television, video games, and podcasts. Notably, MGM owns a variety of franchises including James Bond, Rocky, Pink Panther, The Handmaid's Tale, and Real Housewives and boasts a catalog of more than 4,000 movies and 17,000 TV episodes. We think Amazon must continue to expand its content library to remain one of the relevant streaming players. We can envision the company justifying an increase in Prime membership prices next year based on the MGM acquisition.

We believe Amazon remains well positioned to prosper from the shift toward e-commerce during the COVID-19 pandemic in the near term, with particular strength in groceries and staples, but also from the secular shift toward e-commerce in the long term, and we see content as a differentiator for Prime members. We expect some content to be made available for free to Prime members, as Amazon has continued to expand benefits for this important group of consumers who shop more frequently on Amazon.com, purchase from more retail categories, and spend more overall with Amazon. Amazon's subscription services generated \$25.2 billion in revenue in 2020, representing 7% of total revenue and up 31% over 2019. We think most of this is Prime memberships, but we also see other paid subscriptions, including Kindle Unlimited, Prime Video, and Amazon Music Unlimited, as growing faster within the mix.

Research Methodology for Valuing Companies

Qualitative Equity Research Overview

At the heart of our valuation system is a detailed projection of a company's future cash flows, resulting from our analysts' research. Analysts create custom industry and company assumptions to feed income statement, balance sheet, and capital investment assumptions into our globally standardized, proprietary discounted cash flow, or DCF, modeling templates. We use scenario analysis, in-depth competitive advantage analysis, and a variety of other analytical tools to augment this process. We believe this bottom-up, long-term, fundamentally based approach allows our analysts to focus on long-term business drivers, which have the greatest valuation impact, rather than short-term market noise.

Morningstar's equity research group ("we," "our") believes that a company's intrinsic worth results from the future cash flows it can generate. The Morningstar Rating for stocks identifies stocks trading at an uncertainty-adjusted discount or premium to their intrinsic worth—or fair value estimate, in Morningstar terminology. Five-star stocks sell for the biggest risk-adjusted discount to their fair values whereas 1-star stocks trade at premiums to their intrinsic worth.

Four key components drive the Morningstar rating: (1) our assessment of the firm's economic moat, (2) our estimate of the stock's fair value, (3) our uncertainty around that fair value estimate and (4) the current market price. This process ultimately culminates in our single-point star rating.

1. Economic Moat

The concept of an economic moat plays a vital role not only in our qualitative assessment of a firm's long-term investment potential, but also in the actual calculation of our fair value estimates. An economic moat is a structural feature that allows a firm to sustain excess profits over a long period of time. We define economic profits as returns on invested capital (or ROIC) over and above our estimate of a firm's cost of capital, or weighted average cost of capital (or WACC). Without a moat, profits are more susceptible to competition. We have identified five sources of economic moats: intangible assets, switching costs, network effect, cost advantage, and efficient scale.

Companies with a narrow moat are those we believe are more likely than not to achieve normalized excess returns for at least the next 10 years. Wide-moat companies are those in which we have very high confidence that excess returns will remain for 10 years, with excess returns more likely than not to remain for at least 20 years. The longer a firm generates economic profits, the higher its intrinsic value. We believe low-quality, no-moat companies will see their normalized returns gravitate toward the firm's cost of capital more quickly than companies with moats.

When considering a company's moat, we also assess whether there is a substantial threat of value destruction, stemming from risks related to ESG, industry disruption, financial health, or other idiosyncratic issues. In this context, a risk is considered potentially value destructive if its occurrence would eliminate a firm's economic profit on a cumulative or midcycle basis. If we deem the probability of occurrence sufficiently high, we would not characterize the company as possessing an economic moat.

To assess the sustainability of excess profits, analysts perform ongoing assessments of the moat trend. A firm's moat trend is positive in cases where we think its sources of competitive advantage are growing stronger; stable where we don't anticipate changes to competitive advantages over

to decline (or rise) to its cost of capital. During the Stage II period, we use a formula to approximate cash flows in lieu of explicitly modeling the income statement, balance sheet, and cash flow statement as we do in Stage I. The length of the second stage depends on the strength of the company's economic moat. We forecast this period to last anywhere from one year (for companies with no economic moat) to 10–15 years or more (for wide-moat companies). During this period, cash flows are forecast using four assumptions: an average growth rate for EBI over the period, a normalized investment rate, average return on new invested capital, or RONIC, and the number of years until perpetuity, when excess returns cease. The investment rate and return on new invested capital

Morningstar Research Methodology for Valuing Companies



the next several years; or negative when we see signs of deterioration.

2. Estimated Fair Value

Combining our analysts' financial forecasts with the firm's economic moat helps us assess how long returns on invested capital are likely to exceed the firm's cost of capital. Returns of firms with a wide economic moat rating are assumed to fade to the perpetuity period over a longer period of time than the returns of narrow-moat firms, and both will fade slower than no-moat firms, increasing our estimate of their intrinsic value. Our model is divided into three distinct stages:

Stage I: Explicit Forecast

In this stage, which can last five to 10 years, analysts make full financial statement forecasts, including items such as revenue, profit margins, tax rates, changes in working-capital accounts, and capital spending. Based on these projections, we calculate earnings before interest, after taxes, or EBI, and the net new investment, or NNI, to derive our annual free cash flow forecast.

Stage II: Fade

The second stage of our model is the period it will take the company's return on new invested capital—the return on capital of the next dollar invested ("RONIC")—

decline until the perpetuity stage is reached. In the case of firms that do not earn their cost of capital, we assume marginal ROICs rise to the firm's cost of capital (usually attributable to less reinvestment), and we may truncate the second stage.

Stage III: Perpetuity

Once a company's marginal ROIC hits its cost of capital, we calculate a continuing value, using a standard perpetuity formula. At perpetuity, we assume that any growth or decline or investment in the business neither creates nor destroys value and that any new investment provides a return in line with estimated WACC.

Because a dollar earned today is worth more than a dollar earned tomorrow, we discount our projections of cash flows in stages I, II, and III to arrive at a total present value of expected future cash flows. Because we are modeling free cash flow to the firm—representing cash available to provide a return to all capital providers—we discount future cash flows using the WACC, which is a weighted average of the costs of equity, debt, and preferred stock (and any other funding sources), using expected future proportionate long-term market-value weights.

3. Uncertainty Around That Fair Value Estimate

Morningstar's Uncertainty Rating captures a range of likely potential intrinsic values for a company and uses it to

Research Methodology for Valuing Companies

assign the margin of safety required before investing, which in turn explicitly drives our stock star rating system. The Uncertainty Rating represents the analysts' ability to bound the estimated value of the shares in a company around the Fair Value Estimate, based on the characteristics of the business underlying the stock, including operating and financial leverage, sales sensitivity to the overall economy, product concentration, pricing power, exposure to material ESG risks, and other company-specific factors.

Analysts consider at least two scenarios in addition to their base case: a bull case and a bear case. Assumptions are chosen such that the analyst believes there is a 25% probability that the company will perform better than the bull case, and a 25% probability that the company will perform worse than the bear case. The distance between the bull and bear cases is an important indicator of the uncertainty underlying the fair value estimate. In cases where there is less than a 25% probability of an event, but where the event could result in a material decline in value, analysts may adjust the uncertainty rating to reflect the increased risk. Analysts may also make a fair value adjustment to reflect the impact of this event.

Our recommended margin of safety widens as our uncertainty of the estimated value of the equity increases. The more uncertain we are about the estimated value of the equity, the greater the discount we require relative to our estimate of the value of the firm before we would recommend the purchase of the shares. In addition, the uncertainty rating provides guidance in portfolio construction based on risk tolerance.

Our uncertainty ratings for our qualitative analysis are low, medium, high, very high, and extreme.

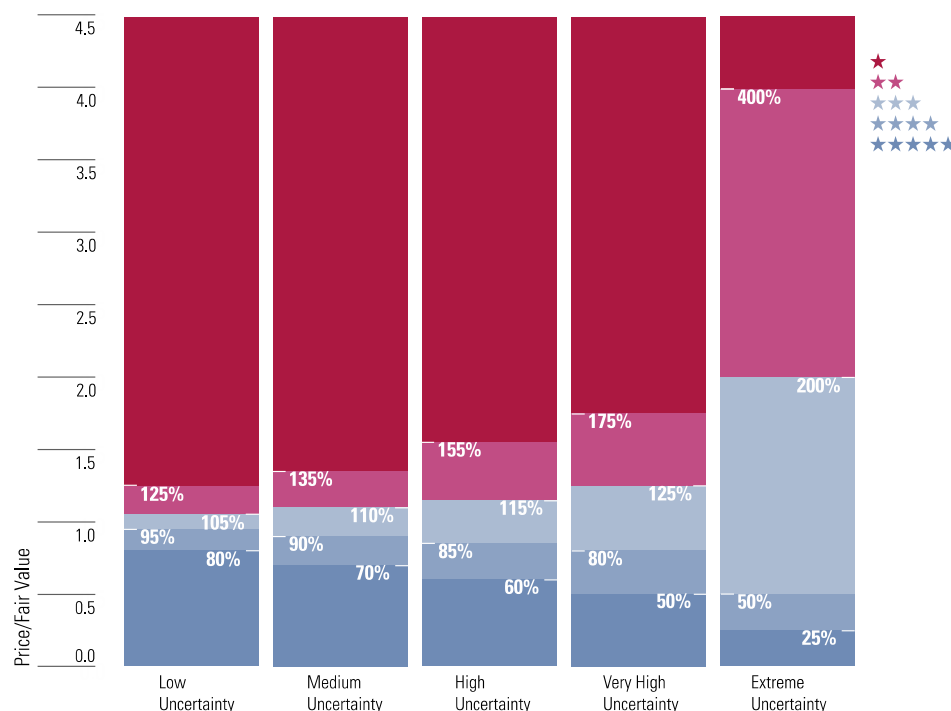
- Low—margin of safety for 5-star rating is a 20% discount and for 1-star rating is 25% premium.
- Medium—margin of safety for 5-star rating is a 30% discount and for 1-star rating is 35% premium.
- High—margin of safety for 5-star rating is a 40% discount and for 1-star rating is 55% premium.
- Very High—margin of safety for 5-star rating is a 50% discount and for 1-star rating is 75% premium.
- Extreme—margin of safety for 5-star rating is a 75% discount and for 1-star rating is 300% premium.

4. Market Price

The market prices used in this analysis and noted in the report come from exchange on which the stock is listed, which we believe is a reliable source.

For more details about our methodology, please go to <https://shareholders.morningstar.com>.

Morningstar Equity Research Star Rating Methodology



Morningstar Star Rating for Stocks

Once we determine the fair value estimate of a stock, we compare it with the stock's current market price on a daily basis, and the star rating is automatically re-calculated at the market close on every day the market on which the stock is listed is open.

Please note, there is no predefined distribution of stars. That is, the percentage of stocks that earn 5 stars can fluctuate daily, so the star ratings, in the aggregate, can serve as a gauge of the broader market's valuation. When there are many 5-star stocks, the stock market as a whole is more undervalued, in our opinion, than when very few companies garner our highest rating.

We expect that if our base-case assumptions are true the market price will converge on our fair value estimate over time, generally within three years (although it is impossible to predict the exact time frame in which market prices may adjust).

Our star ratings are guideposts to a broad audience and individuals must consider their own specific investment goals, risk tolerance, tax situation, time horizon, income needs, and complete investment portfolio, among other factors.

The Morningstar Star Ratings for stocks are defined below:

★★★★★ We believe appreciation beyond a fair risk-adjusted return is highly likely over a multiyear time frame. The current market price represents an excessively pessimistic outlook, limiting downside risk and maximizing upside potential.

★★★★ We believe appreciation beyond a fair risk-adjusted return is likely.

★★★ Indicates our belief that investors are likely to receive a fair risk-adjusted return (approximately cost of equity).

★★ We believe investors are likely to receive a less than fair risk-adjusted return.

★ Indicates a high probability of undesirable risk-adjusted returns from the current market price over a multiyear time frame, based on our analysis. The market is pricing in an excessively optimistic outlook, limiting upside potential and leaving the investor exposed to Capital loss.

Research Methodology for Valuing Companies

Other Definitions

Last Price: Price of the stock as of the close of the market of the last trading day before date of the report.

Capital Allocation Rating: Our Capital Allocation (or Stewardship) Rating represents our assessment of the quality of management's capital allocation, with particular emphasis on the firm's balance sheet, investments, and shareholder distributions. Analysts consider companies' investment strategy and valuation, balance sheet management, and dividend and share buyback policies. Corporate governance factors are only considered if they are likely to materially impact shareholder value, though either the balance sheet, investment, or shareholder distributions. Analysts assign one of three ratings: "Exemplary", "Standard", or "Poor". Analysts judge Capital Allocation from an equity holder's perspective. Ratings are determined on a forward looking and absolute basis. The Standard rating is most common as most managers will exhibit neither exceptionally strong nor poor capital allocation.

Capital Allocation (or Stewardship) analysis published prior to Dec. 9, 2020, was determined using a different process. Beyond investment strategy, financial leverage, and dividend and share buyback policies, analysts also considered execution, compensation, related party transactions, and accounting practices in the rating.

Sustainalytics ESG Risk Rating Assessment: The ESG Risk Rating Assessment is provided by Sustainalytics; a Morningstar company.

Sustainalytics' ESG Risk Ratings measure the degree to which company's economic value at risk is driven by environmental, social and governance (ESG) factors.

Sustainalytics analyzes over 1,300 data points to assess a company's exposure to and management of ESG risks. In other words, ESG Risk Ratings measures a company's unmanaged ESG Risks represented as a quantitative score. Unmanaged Risk is measured on an open-ended scale starting at zero (no risk) with lower scores representing less unmanaged risk and, for 95% of cases, the unmanaged ESG Risk score is below 50.

Based on their quantitative scores, companies are grouped into one of five Risk Categories (negligible, low, medium, high, severe). These risk categories are absolute, meaning that a 'high risk' assessment reflects a comparable degree of unmanaged ESG risk across all subindustries covered.

The ESG Risk Rating Assessment is a visual representation of Sustainalytics ESG Risk Categories on a 1 to 5 scale. Companies with Negligible Risk = 5 Globes, Low Risk = 4,

Medium Risk = 3 Globes, High Risk = 2 Globes, Severe Risk = 1 Globe. For more information, please visit sustainalytics.com/esg-ratings/.

Ratings should not be used as the sole basis in evaluating a company or security. Ratings involve unknown risks and uncertainties which may cause our expectations not to occur or to differ significantly from what was expected and should not be considered an offer or solicitation to buy or sell a security.

Quantitative Valuation: Using the below terms, intended to denote the relationship between the security's Last Price and Morningstar's quantitative fair value estimate for that security.

- Undervalued: Last Price is below Morningstar's quantitative fair value estimate.
- Fairly Valued: Last Price is in line with Morningstar's quantitative fair value estimate.
- Overvalued: Last Price is above Morningstar's quantitative fair value estimate.

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