

Amazon.com, Inc. (AMZN)

Positive on 4Q17 and Raising PT to \$1,600

INVESTMENT HIGHLIGHTS: Amazon is scheduled to report 4Q17 results at 5:30pm EST on Thursday, February 1. We expect the company to modestly beat on both revenue and profitability, driven by a strong holiday season, continued strength in AWS, as well as rapidly growing advertising revenue. We reiterate our BUY rating and increase our PT to \$1,600 based on sum-of-the-parts analysis on FY18 estimates.

- **Expect modest upside on 4Q17 revenue.** We expect 4Q17 revenue to come in at the high end of guidance and ahead of Street expectations due to a strong holiday season both on macro and micro level. We estimate total revenue of \$59.9B vs. guidance of \$56-60.5B and consensus of \$59.7B. Our estimate consists of \$37.5B N. America rev, above consensus of \$36.1B, \$17.5B Int'l rev, slightly below consensus of \$17.9B, and \$5.0B AWS rev, in-line with consensus.
- **Overall holiday sales exceeded expectations.** On the macro level, we believe 2017 holiday season exceeded expectations. NRF data shows that total retail sales increased 5.5% y/y in Nov and Dec, above forecast of 3.6-4%, representing best level since 2010. E-commerce continued to grow faster than broader retail, which, according to Adobe, increased 14.6% y/y, also ahead of prior forecast of 13.8%. NetElixir, a search marketing agency who analyzed e-commerce traffic data, estimated 13% y/y increase in holiday e-commerce sales, above its 10% initial projection.
- **Strong Prime growth.** We believe Prime continued to be key driver in driving revenue for the company. Amazon added more than 4 million Prime members in one week over the holiday season, above 3M that join over the same period last year. We believe Amazon adds at least 5M Prime members/quarter. Amazon doesn't disclose total count, but CIRP's latest estimate points to 90 million members in U.S. alone.
- **Higher conversion rate.** Amazon also leads other retailers in terms of conversion rate. According to Hitwise, Amazon enjoyed nearly 7% conversion rate during the holiday season, more than double its closest competitor, and conversion for most retailers were 1-3%. As a result, Hitwise data showed that Amazon accounted for 39% of total visits but over 69% of total transactions.

COMPANY UPDATE

Stock Rating	BUY Unchanged
Price Target	\$1,600.00 Raised from \$1,250.00

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Stock Price Performance



Market Data

Price (01/29/2018)	\$1,417.68
52-Week Range	\$1,431.39 - \$803.00
Shares Outstanding	481.87
Market Cap (MM)	\$683,140.6
Avg. Daily Volume	3,897,962.0
Total Debt/Cap.	51.42%

	FY 12/31/2016	FY 12/31/2017	FY 12/31/2018
	Actual	Old	New
Rev. (MM)	135,987.0A	177,318.2E	177,318.2E
Growth	27.1%		30.4%
EPS: 1Q	1.07A	1.48A	1.48A
EPS: 2Q	1.77A	0.40A	0.40A
EPS: 3Q	0.53A	0.52A	0.52A
EPS: 4Q	<u>1.54A</u>	<u>1.99E</u>	<u>1.99E</u>
EPS: Year	4.92A	4.39E	4.39E
Growth	293.6%		(10.8)%

- **Expect continued growth momentum in advertising business.** The company's Other revenue, which is comprised primarily of advertising and credit card revenue grew 58% y/y to \$1.1B in 3Q17. We believe the strong growth was driven mainly by its advertising business. For 4Q17, we estimate Other revenue to grow 60% y/y to \$1.7B. We estimate Other revenue should reach \$6.9B in 2018, representing 50% y/y growth and 3% of total revenue. We believe our estimate could prove conservative as three of world's largest ad agencies recently indicated to significantly increase spending with Amazon in 2018 (WPP +40-50% y/y, Omnicom +100% y/y, and Publicis +50% y/y). While still a relatively small percentage of total revenue, we believe Advertising revenue could meaningfully lift its N. America segment operating income given its high margin profile.
- **Profitability upside.** We estimate 4Q17 GAAP operating income of \$1.55B. at the high end of guidance and above consensus of \$1.50B. We estimate non-GAAP operating income of \$2.85B, also above consensus of \$2.75B. We believe Cloud contributed to most of the upside, although the rapidly increasing advertising revenue could modestly lift the overall margin as well.

Figure 1 *Sum-of-the-Parts Valuation Indicates Upside to Current Price*

Revenue Approach	Revenue 2018E	EV/Sales 2018E	Total Value 2018E
North America	143,320	3.0x	429,959
International	62,737	3.9x	244,676
EBITDA Approach			
	EBITDA 2018E	EV/EBITDA 2018E	Total Value 2018E
AWS	6,119	16.4x	100,356
Consolidated:			2018E
Total Enterprise Value			774,991
+ Cash and ST Investments			42,877
- Total Debt			24,710
Total Equity Value			793,158
÷ Shares Outstanding			498
= Price per Share			1,594

Source: Needham & Company, LLC

Figure 2 Projected Quarterly Income Statement**Amazon.com Quarterly Income Statement**

(in millions, except per share data and ratios)

	2016A				2017E				2018E			
	Mar-16 Q1:16A	Jun-16 Q2:16A	Sep-16 Q3:16A	Dec-16 Q4:16A	Mar-17 Q1:17A	Jun-17 Q2:17A	Sep-17 Q3:17A	Dec-17 Q4:17E	Mar-18 Q1:18E	Jun-18 Q2:18E	Sep-18 Q3:18E	Dec-18 Q4:18E
Total Revenue	29,128	30,404	32,714	43,741	35,714	37,955	43,744	59,905	48,488	51,289	56,784	73,383
Cost of Revenue	18,866	19,180	21,253	28,949	22,432	23,439	27,536	38,579	30,402	31,646	35,661	47,185
Gross Profit (Loss)	10,262	11,224	11,461	14,792	13,282	14,516	16,208	21,326	18,086	19,644	21,124	26,198
Gross Margin	35.2%	36.9%	35.0%	33.8%	37.2%	38.2%	37.1%	35.6%	37.3%	38.3%	37.2%	35.7%
Operating Expenses:												
Fulfillment	3,571	3,692	4,170	5,529	4,534	4,897	6,190	8,327	6,109	6,668	7,899	10,046
Marketing	1,380	1,466	1,653	2,411	1,826	2,096	2,344	3,235	2,424	2,770	2,953	3,743
Technology and content	3,209	3,461	3,701	4,052	4,372	4,916	5,349	6,013	5,867	6,462	6,814	7,118
General and administrative	442	497	554	624	709	755	848	899	970	933	1,022	1,027
Stock-based compensation	544	768	769	887	792	1,158	1,085	1,258	1,178	1,334	1,363	1,468
Other operating expense, net	45	55	32	34	44	66	45	45	45	45	45	45
Total Operating Expenses	9,191	9,939	10,879	13,537	12,277	13,888	15,861	19,777	16,594	18,212	20,096	23,447
Operating Income (GAAP)	1,071	1,285	582	1,255	1,005	628	347	1,550	1,492	1,432	1,028	2,751
Consolidated Segment Operating Income (CSOI)	1,660	2,108	1,390	2,176	1,841	1,852	1,477	2,853	2,715	2,811	2,436	4,264
CSOI Margin	5.7%	6.9%	4.2%	5.0%	5.2%	4.9%	3.4%	4.8%	5.6%	5.5%	4.3%	5.8%
Interest income	21	24	26	30	39	44	54	28	59	52	67	37
Interest expense	(117)	(116)	(118)	(133)	(139)	(143)	(228)	(199)	(245)	(245)	(245)	(264)
Other income (expense), net	81	(14)	8	14	48	137	143	143	143	143	143	143
Total Non-operating income (expense)	(15)	(106)	(84)	(89)	(52)	38	(31)	(28)	(43)	(49)	(35)	(83)
Income before provision for income taxes	1,056.0	1,179.0	498.0	1,166.0	953.0	666.0	316.0	1,522.1	1,448.9	1,382.7	993.1	2,667.8
Income tax expense (benefit)	475.0	307.0	229.0	414.0	229.0	467.0	58.0	532.7	507.1	484.0	347.6	933.7
Equity-method investment activity, net of tax	(68.0)	(15.0)	(10.0)	(3.0)	0.0	(2.0)	(2.0)	(2.0)	(2.0)	(2.0)	(2.0)	(2.0)
Reported GAAP Net Income	513.0	857.0	259.0	749.0	724.0	197.0	256.0	987.4	939.8	896.8	643.5	1,732.1
Pro Forma Net Income	904.0	1,480.7	705.4	1,346.0	1,359.1	564.7	1,180.6	1,836.3	1,736.9	1,794.8	1,560.6	2,717.3
Reported GAAP EPS	\$1.07	\$1.77	\$0.53	\$1.54	\$1.48	\$0.40	\$0.52	\$1.99	\$1.89	\$1.80	\$1.29	\$3.47
Pro Forma EPS	\$1.88	\$3.07	\$1.45	\$2.77	\$2.77	\$1.15	\$2.39	\$3.71	\$3.50	\$3.61	\$3.13	\$5.45
Basic shares outstanding	471.0	473.0	474.0	476.0	477.0	479.0	481.0	482.0	483.0	484.0	485.0	486.0
Diluted shares outstanding	481.0	483.0	485.0	486.0	490.0	492.0	494.0	495.0	496.0	497.0	498.0	499.0
EBITDA												
Depreciation and Amortization	1,827	1,909	2,084	2,297	2,435.0	2,633.0	2,912.0	3,560.0	3,561.7	3,478.9	3,470.9	3,469.4
Adjusted EBITDA	2898.0	3194.0	2666.0	3552.0	3,440.0	3,261.0	3,259.0	5,109.7	5,053.7	4,911.0	4,499.2	6,220.3
Adjusted EBITDA Margin	9.9%	10.5%	8.1%	8.1%	9.6%	8.6%	7.5%	8.5%	10.4%	9.6%	7.9%	8.5%
MARGIN ANALYSIS												
Gross margin	35.2%	36.9%	35.0%	33.8%	37.2%	38.2%	37.1%	35.6%	37.3%	38.3%	37.2%	35.7%
Fulfillment	12.3%	12.1%	12.7%	12.6%	12.7%	12.9%	14.2%	13.9%	12.6%	13.0%	13.9%	13.7%
Marketing	4.7%	4.8%	5.1%	5.5%	5.1%	5.5%	5.4%	5.4%	5.0%	5.4%	5.2%	5.1%
Technology and content	11.0%	11.4%	11.3%	9.3%	12.2%	13.0%	12.2%	10.0%	12.1%	12.6%	12.0%	9.7%
General and administrative	1.5%	1.6%	1.7%	1.4%	2.0%	2.0%	1.9%	1.5%	2.0%	1.8%	1.8%	1.4%
Operating margin	3.7%	4.2%	1.8%	2.9%	2.8%	1.7%	0.8%	2.6%	3.1%	2.8%	1.8%	3.7%
Tax rate	45.0%	26.0%	46.0%	35.5%	24.0%	70.1%	18.4%	35.0%	35.0%	35.0%	35.0%	35.0%
Pro forma net margin	3.1%	4.9%	2.2%	3.1%	3.8%	1.5%	2.7%	3.1%	3.6%	3.5%	2.7%	3.7%
YEAR OVER YEAR GROWTH												
Revenues	28.2%	31.1%	29.0%	22.4%	22.6%	24.8%	33.7%	37.0%	35.8%	35.1%	29.8%	22.5%
Gross profit	40.2%	39.9%	33.2%	29.7%	29.4%	29.3%	41.4%	44.2%	36.2%	35.3%	30.3%	22.8%
Fulfillment	33.8%	34.5%	34.2%	25.4%	27.0%	32.6%	48.4%	50.6%	34.7%	36.2%	27.6%	20.6%
Marketing	31.7%	33.3%	35.9%	42.0%	32.3%	43.0%	41.8%	34.2%	32.8%	32.1%	26.0%	15.7%
Technology and content	27.3%	28.1%	28.2%	26.3%	36.2%	42.0%	44.5%	48.4%	34.2%	31.5%	27.4%	18.4%
General and administrative	16.9%	22.7%	39.2%	82.5%	60.4%	51.9%	53.1%	44.0%	36.8%	23.6%	20.5%	14.3%
Operating income	320.0%	176.9%	43.3%	13.3%	-6.2%	-51.1%	-40.4%	23.5%	48.5%	128.0%	196.3%	77.5%
Pro forma net income	-180.4%	473.8%	142.9%	64.8%	50.4%	-61.9%	67.4%	36.4%	27.8%	217.8%	32.2%	48.0%
QUARTER OVER QUARTER GROWTH												
Revenues	-18.5%	4.4%	7.6%	33.7%	-18.4%	6.3%	15.3%	36.9%	-19.1%	5.8%	10.7%	29.2%
Gross profit	-10.0%	9.4%	2.1%	29.1%	-10.2%	9.3%	11.7%	31.6%	-15.2%	8.6%	7.5%	24.0%
Fulfillment	-19.0%	3.4%	12.9%	32.6%	-18.0%	8.0%	26.4%	34.5%	-26.6%	9.1%	18.5%	27.2%
Marketing	-18.7%	6.2%	12.8%	45.9%	-24.3%	14.8%	11.8%	38.0%	-25.1%	14.2%	6.6%	26.7%
Technology and content	0.1%	7.9%	6.9%	9.5%	7.9%	12.4%	8.8%	12.4%	-2.4%	10.1%	5.4%	4.5%
General and administrative	29.2%	12.4%	11.5%	12.6%	13.6%	6.5%	12.3%	6.0%	7.9%	-3.7%	9.5%	0.5%
Operating income	-3.3%	20.0%	-54.7%	115.6%	-19.9%	-37.5%	-44.7%	346.6%	-3.7%	-4.0%	-28.2%	167.5%
Pro forma net income	10.7%	63.8%	-52.4%	90.8%	1.0%	-58.4%	109.1%	55.5%	-5.4%	3.3%	-13.0%	74.1%

Source: Company reports, Needham & Company, LLC

Figure 3 Projected Annual Income Statement**Amazon.com Annual Income Statement**

(in millions, except per share data and ratios)

	2015A	2016A	2017E	2018E
Total Revenue	107,007.0	135,987.0	177,318.2	229,944.7
Cost of Revenue	71,651.0	88,248.0	111,985.9	144,893.4
Gross Profit (Loss)	35,356.0	47,739.0	65,332.2	85,051.4
Operating Expenses:				
Fulfillment	12,930.0	16,962.0	23,947.8	30,721.9
Marketing	5,062.0	6,910.0	9,500.9	11,889.3
Technology and content	11,317.0	14,423.0	20,650.3	26,261.8
General and administrative	1,523.0	2,117.0	3,210.6	3,952.7
Stock-based compensation	2,120.0	2,968.0	4,293.0	5,342.3
Amortization of other intangibles	171.0	166.0	200.0	180.0
Restructuring-related and other	-	-	-	-
Total Operating Expenses	33,123.0	43,546.0	61,802.6	78,348.0
Operating Income (GAAP)	2,233.0	4,193.0	3,529.7	6,703.3
Consolidated Segment Operating Income (CSOI)	4,524.0	7,327.0	8,022.7	12,225.6
Interest income	49.0	101.0	165.1	215.0
Interest expense	(460.0)	(484.0)	(708.6)	(997.8)
Other income (expense), net	(254.0)	89.0	471.0	572.0
Remeasurements and Other	-	-	-	-
Total Non-operating income (expense)	(665.0)	(294.0)	(72.5)	(210.8)
Income before provision for income taxes	1,568.0	3,899.0	3,457.1	6,492.5
Income tax expense (benefit)	951.0	1,425.0	1,286.7	2,272.4
Equity-method investment activity, net of tax	(21.0)	(96.0)	(6.0)	(8.0)
Reported GAAP Net Income	596.0	2,378.0	2,164.4	4,212.1
Pro Forma Net Income	241.6	4,436.1	4,940.8	7,150.5
Reported GAAP EPS	\$ 1.25	\$ 4.92	\$ 4.39	\$ 8.47
Pro Forma EPS	\$ 0.51	\$ 9.17	\$ 10.03	\$ 14.37
Basic shares outstanding	467.5	473.5	479.8	484.5
Diluted shares outstanding	475.3	483.8	492.8	497.5
EBITDA				
Depreciation and Amortization	6,281.0	8,117.0	11,540.0	13,980.9
Adjusted EBITDA	8,514.0	12,310.0	15,069.7	20,684.2
Adjusted EBITDA Margin	8.0%	9.1%	8.5%	9.0%
MARGIN ANALYSIS				
Gross margin	33.0%	35.1%	36.8%	37.0%
Fulfillment	12.1%	12.5%	13.5%	13.4%
Marketing	4.7%	5.1%	5.4%	5.2%
Technology and content	10.6%	10.6%	11.6%	11.4%
General and administrative	1.4%	1.6%	1.8%	1.7%
Operating margin	2.1%	3.1%	2.0%	2.9%
Tax rate	60.7%	36.5%	37.2%	35.0%
Pro forma net margin	0.2%	3.3%	2.8%	3.1%
YEAR OVER YEAR GROWTH				
Revenues	20.2%	27.1%	30.4%	29.7%
Gross profit	34.8%	35.0%	36.9%	30.2%
Fulfillment	24.4%	31.2%	41.2%	28.3%
Marketing	20.3%	36.5%	37.5%	25.1%
Technology and content	33.6%	27.4%	43.2%	27.2%
General and administrative	12.0%	39.0%	51.7%	23.1%
Operating income	1154.5%	87.8%	-15.8%	89.9%
Pro forma net income	-63.6%	1736.5%	11.4%	44.7%

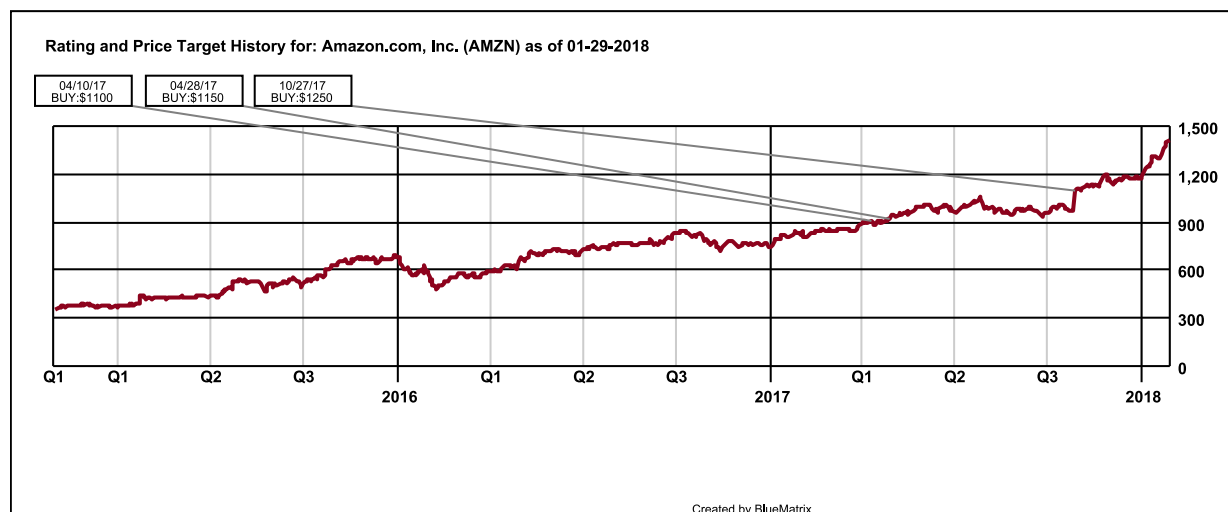
Source: Company reports, Needham & Company, LLC

Valuation (Price Target: \$1,600.00)

- Our price target of \$1,600 is based on the sum-of-the-parts analysis, which evaluates North America and International segments using EV/Revenue multiple, and AWS segment using EV/EBITDA multiple. Our price target is also below 7.3x FY18 sales multiple of its large-cap peers.

Risks to Target

- Risks to attaining our share price target include, but are not limited to: 1) a decline in discretionary consumer spending, 2) slow adoption of Prime membership internationally, 3) increased e-commerce competition both domestically and internationally, 4) slowdown of revenue and operating margin growth of AWS due to competition and continued pricing cuts, 5) lack of traction in new products, such as groceries and home services, and 6) potential regulatory changes and uncertainties particularly in international markets.



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Rating Suspended	< 1	0
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