

Amazon.com, Inc (NASDAQ: AMZN)

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Important Company Financial Data (October 30 th , 2012 from Ycharts.com)		
Share Price: \$238.24	Beta: 0.82	ROE: 0.52%
Market Cap: 107.70B	P/E: 3,403.43	ROA: 0.18%
52 Week: 166.97 – 264.11	EPS: 0.07	Net Profit Margin: (1.98%)

Thesis
 By shorting a company like Amazon, the risks are greater and therefore anything worth addressing must be considered. Although I do acknowledge that Amazon is a great company run by the extraordinary Jeffrey Bezos, Amazon's success has peaked already despite the public perception still running high. Unless Amazon decides to enter another market, Amazon will not find the same success it has enjoyed in its three areas: online sales, Kindles, and cloud computing.

- Key Points**
- Facing its first quarterly **net loss** in over five years, Amazon's price is not reflective of its financials and relative market position
 - With a simply unheard of P/E of over **3000**, Amazon's P/E is at least **135 times greater** than competitors such as Google and Microsoft (tablet and cloud), Wal-Mart and Target (retail), and e-Bay (online retail).
 - Amazon faced **decreasing net income** over the **past 4 consecutive quarters**, with Q3 bringing in a **net loss of \$274 million**
 - ❖ Also notice decreasing ROE and ROA (*Exhibit 1*)
 - Amazon's ROE is a mere **0.52%** with a net profit margin of **(1.98%)**
 - ❖ **MISPERCEPTION:** Amazon's low ROE and net profit margin stems from the fact that they are mostly an online retailer that acts as an intermediary between buyers and sellers
 - ❖ **CORRECTION:** e-Bay, a company with a similar business model, has a **ROE of 20.95%** and a **net profit margin of 17.54%**
 - Amazon's price has been rising consistently, a **37% increase** since January 2012, but **EPS** has been wavering (*Exhibit 2*)
 - Even ignoring the enormous loss in Q3, Amazon has been experiencing an average revenue **growth of 38.5%** but an average net income **decrease of 54%** over the past **5 quarters**
 - Amazon's massive online retail is slowing and its low profit margin is hurt by **increasing operating costs** YOY over the past **5 years** that reduces the revenue earned
 - Amazon continues to pump financial capital into different sectors for expansion, but ultimately **costs outweighs revenues**
 - Major factor for Amazon's loss this quarter was tied to **\$169 million of impairment losses** in LivingSocial, an online coupon provider. Notice how Amazon would still have suffered a loss without the goodwill charges.
 - ❖ Amazon is **not efficiently allocating its financial capital**, which reflects the continually increasing operating costs but declining net income
 - From Q3 of last year, Amazon has spent **34.8% more** on shipping and warehouses and **54.7% more** on technology and content spending, facing **increasing operating costs** over the past **3 quarters**
 - ❖ **MISPERCEPTION:** Amazon's increasing operating costs should not matter since they have no debt
 - ❖ **CORRECTION:** It is easy to have no debt when Amazon leases and amortizes a majority of what they use, however this problem translates into the lack of assets Amazon can use to borrow against in the future if prices dip and Amazon needs to support its shares
 - Amazon has been **incurring increasing fixed and variable costs** while facing **slowing growth**
 - ❖ Announced in Q3 Earnings Report, Amazon plans on adding 19 new fulfillment centers and 50,000 seasonal employees
 - ❖ **MISPERCEPTION:** Increasing fixed costs indicates investing in the future and potential greater margin efficiency
 - ❖ **CORRECTION:** Amazon has been increasing fulfillment spaces (warehouses) ever since 2007, yet since 2009 the profit earned per fulfillment space has been **decreasing** (*Exhibits 3 & 4*), thus **greater inefficiency** and **decreasing ROIC**.
 - Amazon is looking for new markets for their online retailer as their **total international sales** is only **43% of the total**
 - ❖ Looking for expansion, Amazon tried to tap into India with **Junglee.com**, a subsidiary, on February 2nd
 - ❖ Analysts placed India's e-commerce retail market around **\$10 billion**
 - ❖ On September 21st, India **forbade all FDI involvement in e-commerce**, forcing Amazon to completely abandon their efforts, **suffering opportunity losses and growth potential**; Amazon has to **reset their expansion efforts**
 - Amazon's competitive advantage in cheap online sales now face **competition** as well as **increasing hidden costs**
 - ❖ A key to Amazon's cheap items stems from not having a sales tax. However on September 15th, Amazon started to charge California a sales tax and plans to **double** the amounts of states taxed by **2016**, which would **triple** the population that can be taxed to **110 million**. This new sales tax would force many people to reconsider shopping at Amazon (see "**VAR 1**")
 - ❖ In order to reduce Amazon's advantage, both **Target** and **Best Buy** are trying to match Amazon's online prices, while **Target** is exclusively offering prices on some items that cannot be found cheaper anywhere else online
 - ❖ **Wal-Mart** is offering same day delivery for major cities in anticipation of the upcoming holidays
 - Amazon invests heavily in its Kindle, but it still remains **second** in the tablet market due to the Apple's daunting presence
 - Kindle sales are **facing less physical exposure** from brick-and-mortar stores
 - ❖ In May, **Target** announced that they will **phase out Amazon products** by Spring 2012

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- ❖ **Wal-Mart** announced it will **stop selling Kindles and Amazon products** on September 20th
- Apple, which owns at least **50%** of the tablet market share, has recently introduced a new iPad Mini, priced cheaper and will serve as **direct competition** to Amazon's Kindle
 - ❖ Amazon's efforts to compete has resulted in releasing **two versions** of the Kindle in the span of less than one month, which will ultimately be disadvantageous for Amazon (see "**VAR 2**" in *Exhibit 6*)
- Amazon Web Services (AWS), which has enjoyed very little competition since 2006, is now **facing fresh new competition** in a market that will be worth tens of billions in the future
 - AWS is an Infrastructure as a Service (IaaS) provider, a type of cloud computing in which users have more control over functionality (such as control over database and runtime) than Platform as a Service (PaaS) providers.
 - Recently, **3 giant technology companies** have entered the IaaS market (*Exhibit 7*) with obvious intentions to compete
 - ❖ Google, which owns the largest PaaS provider, has released Google Compute Engine on **June 2012**
 - ❖ Microsoft started offering IaaS from their Microsoft Azure, which was originally a PaaS released in 2010, on **June 2012**
 - ❖ HP launched their cloud in **September**, which is built on OpenStack (compatible with AWS). HP hopes its compatibility will steal some of the customers from AWS
 - These 3 upcoming IaaS competitors along with the Rackspace, which is behind Amazon in IaaS, will **start limiting the virtually uncontended growth** Amazon has been enjoying for the past few years
 - ❖ **MISPERCEPTION:** Since Amazon already holds the market share for IaaS services, it is hard for companies to enter
 - ❖ **CORRECTION:** Companies like Google and Microsoft have already established themselves as technology leaders. The clouding computing market has as much to do with brand name as any other market. Having already established PaaS services, the addition to IaaS is rather smooth.
 - One cloud computing specialist has told me that OpenStack could be a **long term threat** while another said AWS's **growth will be stunted** (see "**VAR 3**" and "**VAR 4**" for direct quotes)

VAR

- VAR 1: See *Exhibit 5*
 - A common pattern I noticed from those I polled was that a lot of people bought items from Amazon in bulk at once, which would turn the sales tax into a substantial amount
- VAR 2: See the "Case Study" in *Exhibit 6*
- VAR 3: A potential threat if "OpenStack **build[s] some momentum that [could] threaten** them [AWS]"
 - Ben Kepes, founder and principal of Diversity Limited, consultancy on cloud computing
- VAR 4: "[C]learly they [HP, Microsoft, etc.] will provide other alternatives to enterprises entering the market, and **thus AWS may not grow as fast as they have been growing**. That said, with the market sized at 15 – 20 billion dollars in a few years, there should be plenty of market to go around."
 - David L. Linthicum, CTO and founder of Blue Mountain Labs, a team of "cloud computing experts"

How It Plays Out

Amazon's main success as a company is due to its expansive online retail which has given it the opportunities to dive into clouding computing and the creation of the Kindle. However given its success, Amazon's exceedingly high operating costs has been an upsetting factor that diminishes its revenue. Amazon's competitors are now aware of its success both in retail and the cloud, and thus more companies are converging around Amazon, trying to eat up market share and imitate this behemoth. As seen in the poor results last quarter, Amazon is trying to find another area of potential growth, but LivingSocial proved to be a terrible bet. With more and more companies understanding Amazon's strategic advantage, it must find another source of revenue in order to maintain its high stock value. Amazon's stock value does not reflect its current position at this moment, and although the company will not die out or weaken substantially, **its value will drop once people realize Amazon has plateaued.**

Risks / What Signs Would Indicate We Are Wrong?

- No matter how I can analyze Amazon's stock, ultimately its stock price will reflect public perception. If the public still believes Amazon will grow substantially, the stock will rise.
- Jeffrey Bezos, Amazon's CEO, is one of the best. Simply put, we have to watch for any changes in the direction in the company that Bezos might want to initiate. Although there might not be any dramatic changes, even subtle ones should be accounted for.
- Amazon's stock is already trading at an extremely high price and higher priced stocks tend to be more fickle. These stocks can grow more since they have already experienced some momentum in the first place.

Signposts / Follow-Up

- Track the growth and market share of the new IaaS providers and their entry into the market
- Q4 earnings will be crucial as opinion on Amazon has been given a second chance after LivingSocial
- Monitor what Amazon is investing capital into since it would reflect attempts of growth or new ingenuity

Company Description

Amazon was originally an online bookstore founded in 1994 and became public three years later at a price of \$18. In 2002, Amazon launched their Amazon Web Services (contains EC2 and S3). Five years later, Amazon released their first Kindle and to this date, there are 5 generations with multiple versions. Amazon is the world's largest online retailer and has over 69,000 employees. The current headquarters is in Seattle, Washington and its CEO is Jeffrey Bezos.

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(Page of Exhibit/s)

Exhibit 1:

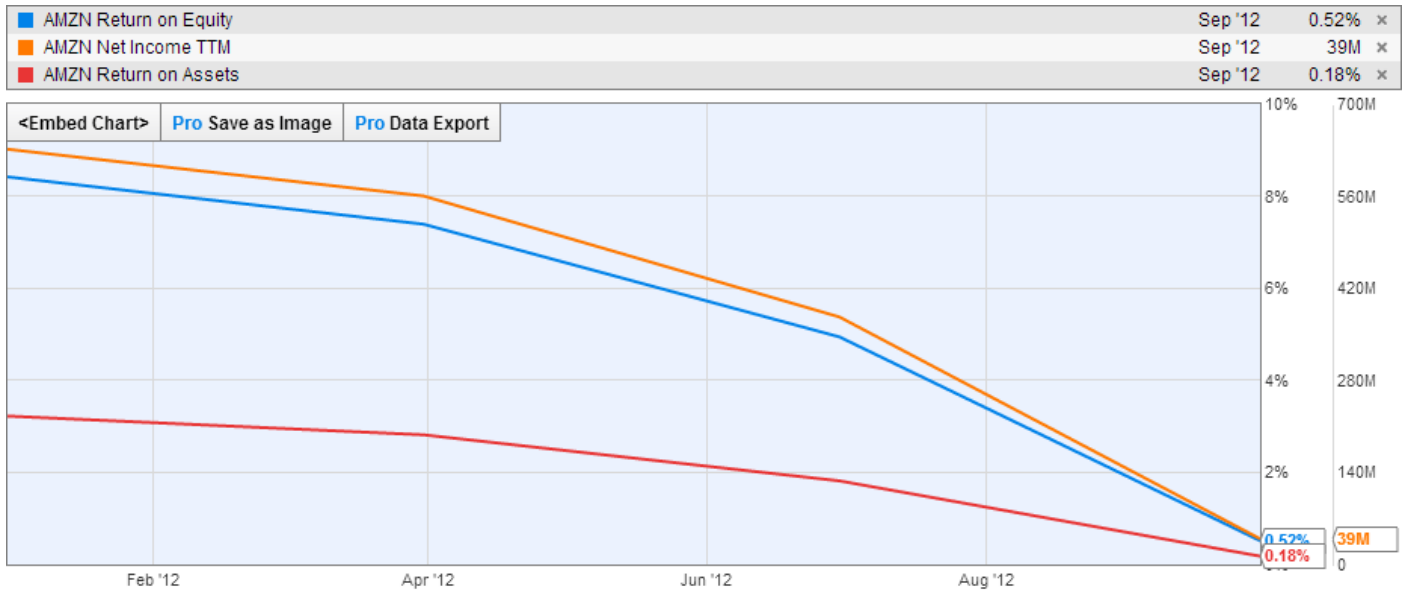


Exhibit 2

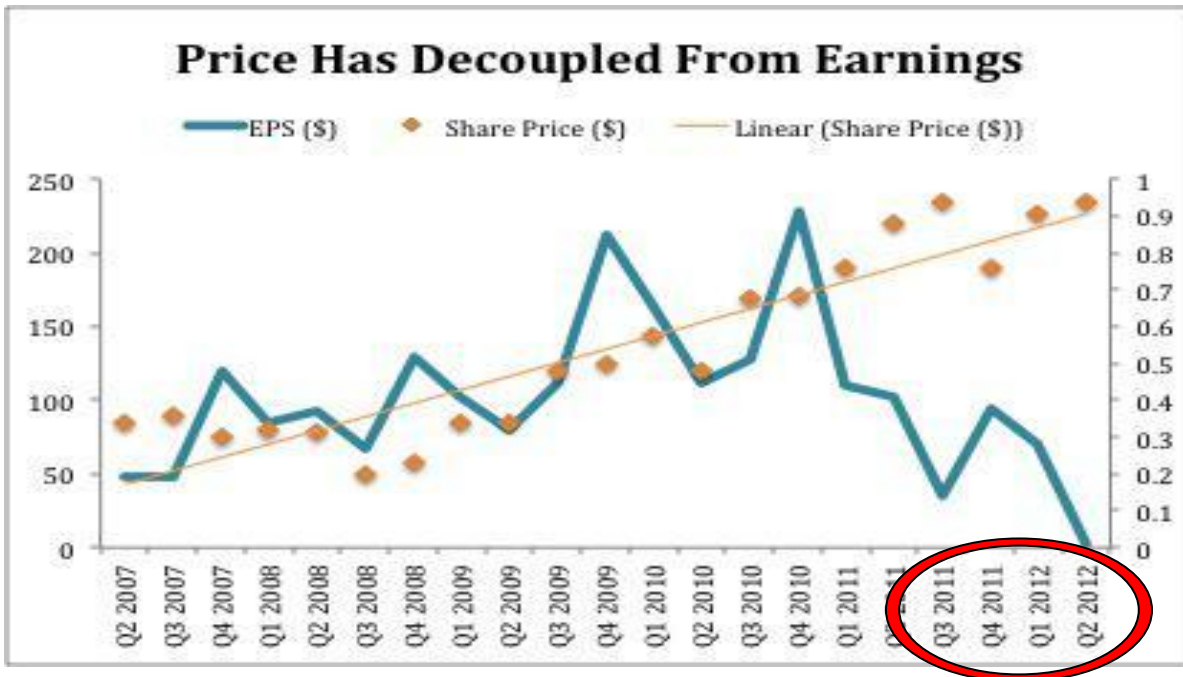


Exhibit 3:

	2007	2008	2009	2010	2011	TTM
Fulfillment , sqf in thousands	13,634	17,294	17,587	26,100	44,045	
% of Sales						
Fulfillment	8.45%	8.33%	8.05%	8.21%	9.24%	9.75%
Marketing	2.26%	2.45%	2.69%	2.93%	3.31%	3.57%
Technology and Content	4.82%	4.60%	4.32%	4.42%	5.44%	6.20%
General and administrative	1.35%	1.19%	1.09%	1.13%	1.18%	1.28%
Total Operating Expenses	16.88%	16.58%	16.15%	16.69%	19.17%	20.81%
Net Profit Margin	3.21%	3.37%	3.68%	3.37%	1.31%	0.69%
ROIC	22.90%	22.72%	21.36%	17.90%	7.57%	4.94%

Exhibit 4:

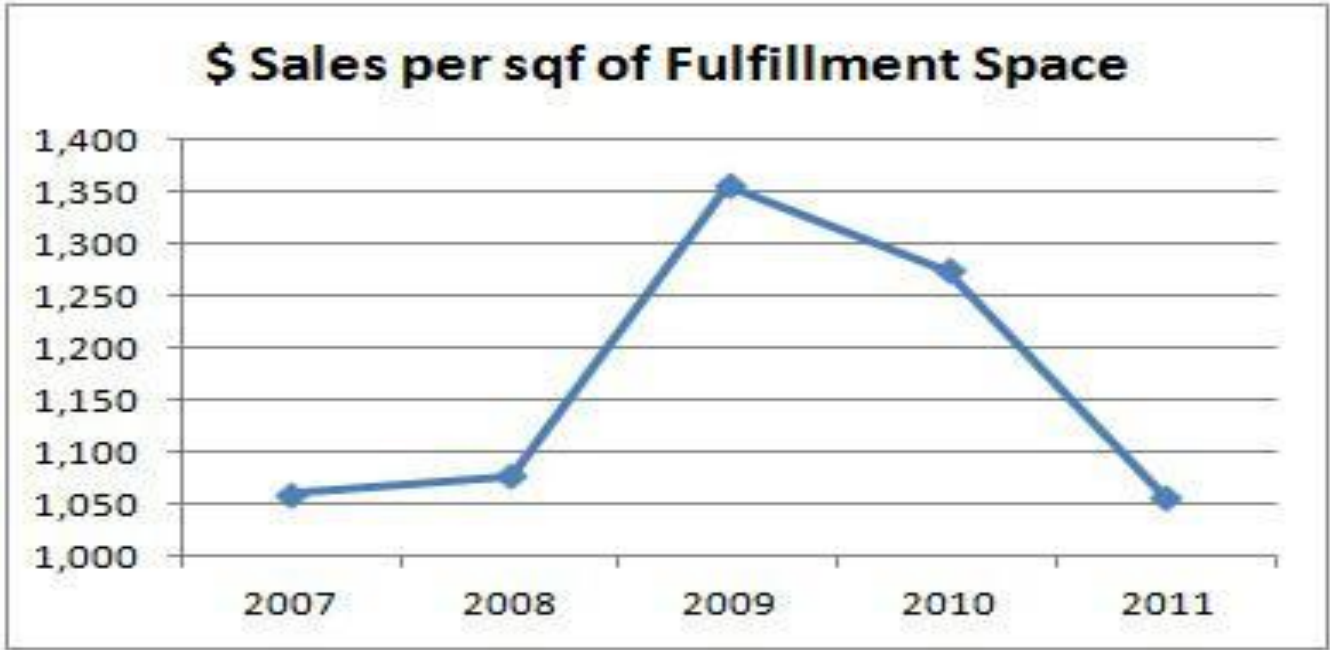


Exhibit 5:

Asked 73 people if they would consider shopping less from Amazon with a sales tax ranging from 5 to 10%:

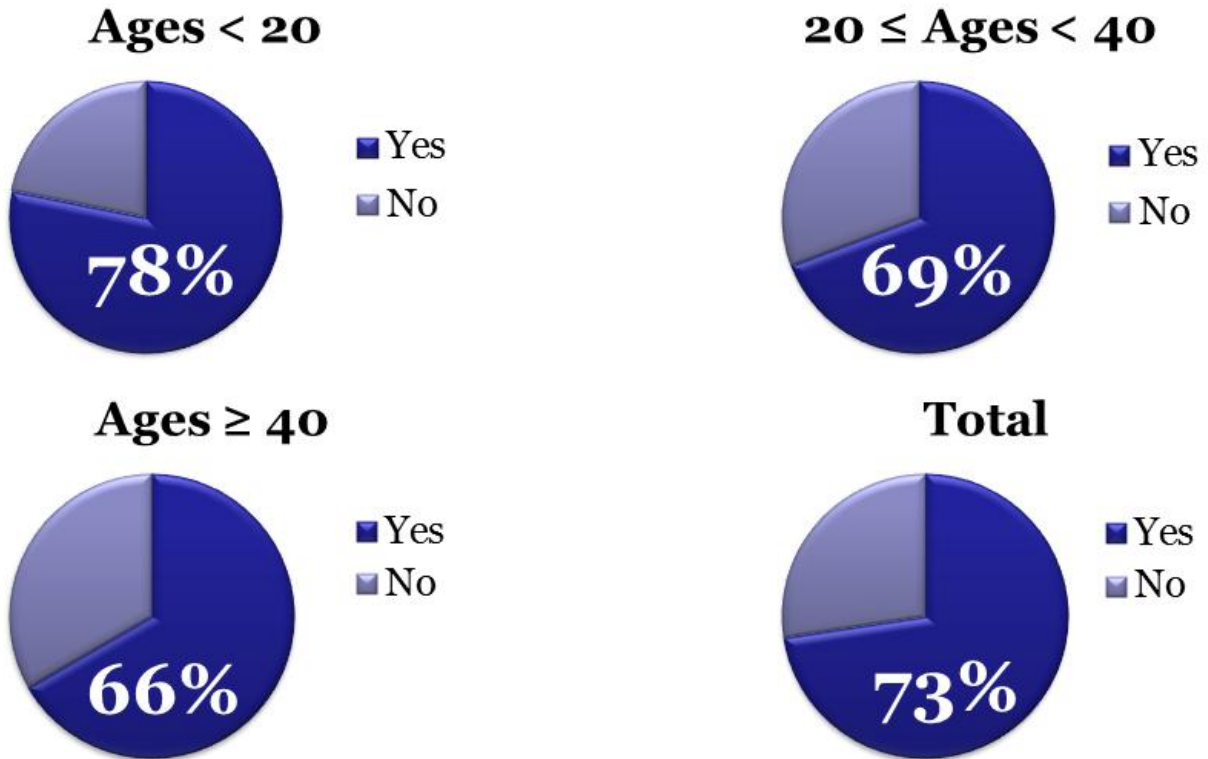


Exhibit 6:

Case Study: Smartphone Market

In the smartphone market, Apple’s iPhone is clearly dominant. In anticipation of Apple’s release of the iPhone 5, Nokia introduced 2 phones on the same day while Motorola released 3 phones all on another day. However, Apple’s competitive advantage lies in its ability to focus all efforts to perfect one single product (see *Quote 1*). This is due to the changing market in technology and its emphasis on brand names. Back when smartphones did not exist, companies like Verizon and AT&T flooded the market with hundreds of different phones, all of which had nothing unique branded onto them. However in today’s market, customers are more likely to get confused over various versions than a single icon like Apple. Also, investing in multiple products increases the costs dramatically. Shortly after, a senior vice president of Motorola admitted to the advantage of focusing on fewer products (see *Quote 2*). This case study perfectly reflects Amazon’s attempt to take some market share away from Apple’s tablet with introducing more versions of the Kindle. Also note that Apple has sold out 10 million iPad Minis with three days of its launch.

Quote 1: "Going all in on one product and executing flawlessly has certainly been a huge advantage" – Mr. Murphy, a partner at Silicon Valley venture capital firm Kleiner Perkins Caulfield & Byers.
Quote 2: "We believe in bigger launches with fewer phones" – Rick Osterloh, a Motorola senior vice president

* Quotes from WSJ article entitled "Nokia, Motorola Race Against Apple" – September 6th, 2012

Exhibit 7:

Google	Google Compute Engine (IaaS)	Release Date: June 2012
	Market Cap: 243.5B	
	Already has Google App Engine, leading PaaS on the Web	
	Incredible physical storage + highly utilized email (Gmail)	
Microsoft	Microsoft Azure	Release Date: February 2010
	Market Cap: 244.8B	
	Offering IaaS (original PaaS) to compete against Amazon in June	
	Working on integrating private and public clouds => hybrid clouds	
Hewlett-Packard	HP Cloud	Release Date: September 2012
	Market Cap: 28.3B	
	Built on OpenStack – Compatible with Amazon’s S3 and EC2	
	Converged Cloud => private cloud solution	
Rackspace	OpenStack	Release Date: 2006
	Market Cap: 9.1B	
	Second largest IaaS provider	
	150+ companies have joined, including Intel, Dell, IBM, Yahoo!	