Daiwa Securities

Amazon.com (AMZN)

Global Credit Research GCRE009

FICC Research Dept.

Profitability continues to improve

- Total revenues up 29% y/y to $56.6bn, EBITDA up 130% y/y to $7.5bn, EBITDA margins up 5.8 points to 13.3%
- FOCF increased 7.4 times to $5.2bn due to strong cash from operations and slower growth in CapEx
- Good liquidity profile given current levels of free operating cash flows and cash & marketables holdings of $29.8bn

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Daiwa Securities Co. Ltd.

Credit Opinion

Amazon announced Q3 FY18 results on October 25th.
We view as positive Amazon's strong revenues growth in all business segments, improving margins and the strong liquidity profile despite continuous losses in International segment due to aggressive investments.
Retail revenues (including both North America and International segments) increased 27% y/y to $49.9bn supported by strong growth rates in advertising and Prime services. AWS revenues increased 46% y/y to $6.7bn as the overall cloud market is growing and due to the proven reliability and the fast pace of innovation of Amazon's system. EBITDA margins improved 5.8 points to 13.3% due to strong growth of high-margin segments (advertising, AWS), increased efficiency in operations and infrastructure costs and slower growth of head count costs.

Amazon's strong liquidity profile is supported by its strong free operating cash flows, rich amount of cash, cash equivalents and short-term investments ($29.8bn) and its negative working capital cycle as it generally collects from consumers before payments to suppliers come due. Free operating cash flows increased 7.4 times y/y to $5.2bn mainly due to increased revenues and better margins across all business segments. Amazon has also a $7bn commercial paper program that could provide liquidity to make up for swings in working capital.

We believe the strong market position of the e-commerce platform, proven reliability and functionality of the cloud business and good liquidity to support Amazon's credit profile in the future. The cloud market is expected to grow at CAGR of 18% to reach $278.3bn by 2021 according to Gartner. Amazon is leading the market with AWS revenues growing 46% y/y to $6.7bn this quarter.

The main threats to Amazon business model are a high competition environment both in retail and cloud businesses, online data security and increasing scrutiny by regulators.

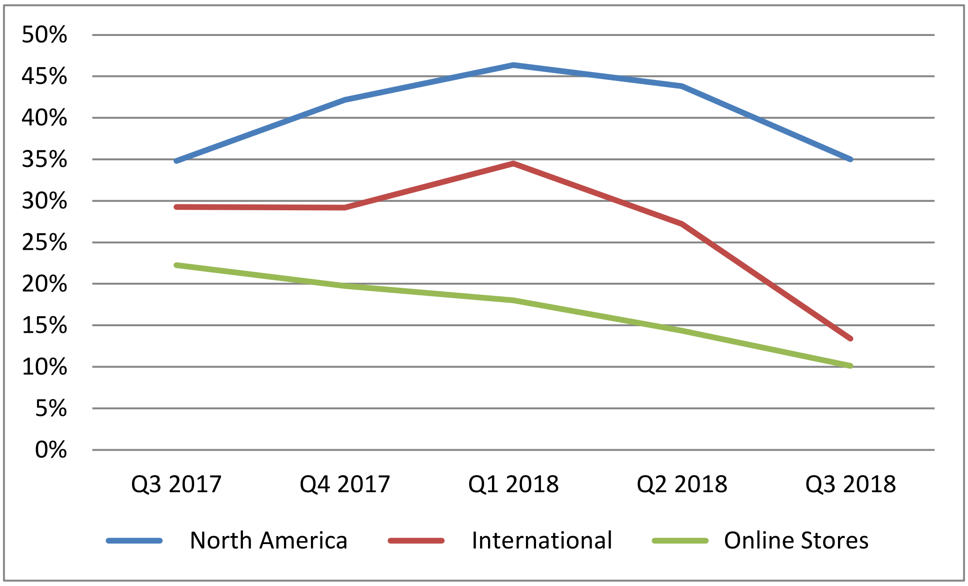
Profitability

Highlights of Q3 Results

Total Revenues increased 29% y/y to $56.6bn with growth in all business segments. FX had a negative impact on sales of ▲$260m.
Total revenues in retail business (including North America and International segments) increased 27% to $49.9bn, having a share of 88% in total revenues.
AWS revenues increased 46% y/y to $6.7bn mainly due to increased customer usage, partially offset by pricing changes.

Online Stores revenues increased 10% y/y to $29.1bn. The deceleration in growth rates is mainly due to aggressive campaigns in the first part of the year (Super Saver Shipping) and a change of revenue classification. Digital content like Amazon Music Unlimited, Kindle Unlimited was moved from Online Stores segment to Retail Subscription Services segment.

Chart 1: Decelerating growth rates of Online Stores



Source: Company materials, Bloomberg; compiled by Daiwa.

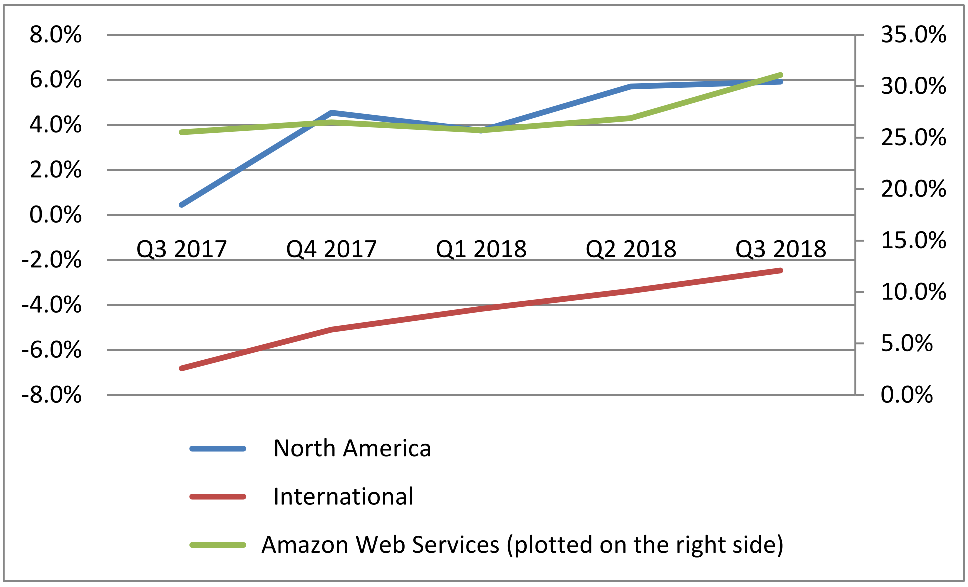
Revenue of Retail Subscription Services was up 51% y/y to $3.7bn due to its strong content offerings, synergies from the acquisition of Whole Foods Market and a change of revenue classification. Subscription sales include fees associated with Amazon Prime membership and access to content including audiobooks, e-books, digital video, digital music and other non-AWS subscription services. Prime members (over 100m members) can enjoy savings at Whole Foods store, fast delivery of groceries to more than 60 cities in the US and can build their Whole Foods grocery cart using Alexa.

Other segment which includes advertising services increased 122% y/y to $2.5bn due to strong adoption across a number of groups, Amazon venders and sellers, authors as well as third party advertisers who want to reach Amazon customers. Revenues include a one-time revenue of about $750m due to the reclassification of certain advertising services that were previously classified as a reduction of cost sales. If we exclude the one-time revenue, y/y growth rate in other segment was 55%.

EBITDA jumped 130% y/y to $7.5bn mainly with EBITDA margins up 5.8 points y/y to 13.3%.
Profitability continues to improve mainly due to strong growth of high-margin segments (advertising, AWS) and increased efficiency in operations, infrastructure costs.
Amazon had a slower growth in head count costs due to less external hiring this quarter and movement of personnel within the company. Head count increased 13% y/y in the nine

month of FY18 vs head count growth of 48% in FY16 and 38% in FY17. Square footage for the fulfillment center and shipping areas increased about 15% in FY18 vs growth of over 30% in FY16 and FY17 due to automation and increased operational efficiency. Capital leases which show the expenses for data centers increased 9% y/y (trailing 12m) vs 69% at the end of FY17 due to increased efficiencies in the data centers.

Chart 2: Improving margins across the board



Source: Company materials, Bloomberg; compiled by Daiwa.

Segment Information

North America

Sales in North America were up 35% y/y to $34.3bn (61% share in total revenues) mainly due to increased unit sales (including third-party sellers) and impact of Whole Foods Market acquisition (August 2017, $13.2bn net of cash acquired).
Op Income increased from $112m (FY17 Q3) to $2.0bn (FY18 Q3) primarily due to increased unit sales (including sales by third-party sellers), advertising sales and slower growth in certain operating expenses, partially offset by costs to expand the fulfillment network.

International

International sales were up 13% y/y to $15.5bn (27% share in total revenues) mainly due to increased unit sales (including sales by third-party sellers). Growth rates are decelerating as FY2017 sales included an acquisition (Souq) and Diwali sales will be fully recorded in FY18 Q4 (In FY17, about half of Diwali sales were recorded in Q3). Growth in new customers was 60% as Amazon launched Turkey website in the quarter.
Op Loss decreased from ▲$936m (FY17 Q3) to ▲$385m (FY18 Q3) primarily due to increased unit sales (including sales by third-party sellers), advertising sales and slower growth of certain operating expenses, partially offset by costs to expand the fulfillment network.

AWS

AWS revenues increased 46% y/y to $6.7bn mainly due to increased customer usage, partially offset by pricing changes.
AWS operating income increased 77% to $2.1bn primarily due to increased customer usage and cost structure productivity, partially offset by pricing changes and increased spending on technology infrastructure, payrolls to support the business growth.

Liquidity

Free operating cash flow (FOCF= Cash flow from operating activities- CapEx) increased 7.4 times y/y to $5.2bn.
Cash flow from operating activities increased 127% y/y to $8.6bn due to increased revenue and improving margins across all the business segments.
CapEx increased 9% y/y to ▲$3.4bn primarily due to investment in fulfillment network and technology infrastructure to support AWS growth.

Cash holdings, $7bn commercial paper program and $600m credit facility improves Amazon's liquidity profile.
Cash, cash equivalents and short-term investments increased 10% q/q to $29.8bn.
In April 2018, Amazon established a commercial paper program of $7bn with a term of three years, but it can be extended for up to three additional one-year terms if approved by the lenders. There were no borrowings outstanding under the Credit Agreement as of September 30, 2018.
Amazon has also a credit facility of $600m available for three years from October 2016. There were $535m borrowings outstanding under the Credit Facility as of September 30, 2018.

A program of $5bn stock repurchase with no fixed expiration was approved by the Board of Directors in February 2016, but no stock repurchases so far.

Company's guidance for Q4

Net sales are expected to be between $66.5bn and $72.5bn, growing between 10%- 20% y/y. Operating income is expected to be between $2.1bn- $3.6bn, vs. $2.1bn in Q4 FY17.

Chart 3: Summary of financial statements

($m) Period End		Q3 2017 09/30/2017	Q4 2017 12/31/2017	Q1 2018 03/31/2018	Q2 2018 06/30/2018	Q3 2018 09/30/2018	Y/Y	Q/Q
■P/L								
Revenues		43,744	60,453	51,042	52,886	56,576	29.3%	7.0%
EBITDA		3,259	5,625	5,598	6,613	7,502	130.2%	13.4%
	EBITDA margin	*7.5%*	*9.3%*	*11.0%*	*12.5%*	*13.3%*	*5.8*	*0.8*
Operating Income		347	2,127	1,927	2,983	3,724	973.2%	24.8%
Pretax Income		316	1,872	1,916	2,605	3,390	972.8%	30.1%
Net Income		256	1,856	1,629	2,534	2,883	1026.2%	13.8%
■C/F								
Cash from operations		3,777	12,344	▲1,791	7,449	8,588	127.4%	15.3%
	Depreciation & Amortization	2,912	3,498	3,671	3,630	3,778	29.7%	4.1%
Cash from investing		▲18,478	▲2,032	▲533	▲2,692	▲5,572	-69.8%	107.0%
	CapEx	▲3,074	▲3,619	▲3,098	▲3,243	▲3,352	9.0%	3.4%
Free cash flow (FCF)		▲14,701	10,312	▲2,324	4,757	3,016	---	-36.6%
Free operating cash flow (FOCF)		703	8,725	▲4,889	4,206	5,236	644.8%	24.5%
Cash from financing		14,662	▲2,647	▲2,164	▲1,394	▲2,369	---	69.9%
Net cash flow		▲39	7,665	▲4,488	3,363	647	---	-80.8%
■B/S								
Assets		115,267	131,310	126,362	134,100	143,695	24.7%	7.2%
	Current assets	48,578	60,197	50,829	54,481	59,885	23.3%	9.9%
	Cash&Marketables	24,310	30,986	24,963	27,050	29,765	22.4%	10.0%
Liabilities		90,609	103,601	94,899	99,105	104,570	15.4%	5.5%
	Current liabilities	47,072	57,883	48,045	50,801	55,324	17.5%	8.9%
	Total Debt	24,710	24,743	24,640	24,638	24,684	-0.1%	0.2%
	Adjusted Net Debt (*)	400	▲ 6,243	▲ 323	▲ 2,412	▲ 5,081	---	---
Equity		24,658	27,709	31,463	34,995	39,125	58.7%	11.8%
■Financial Ratios								
Equity Ratio		21.4%	21.1%	24.9%	26.1%	27.2%	5.8	1.1
Adjusted NetD/E		0.02	▲0.23	▲0.01	▲0.07	▲0.13	▲ 0.1	▲ 0.1
Adjusted NetD/EBITDA		0.03	▲0.40	▲0.02	▲0.11	▲0.20	▲ 0.2	▲ 0.1
ROA		1.9%	2.5%	3.1%	4.8%	6.4%	4.5	1.6
ROE		8.0%	11.6%	13.3%	18.9%	24.0%	16.0	5.1

Source: Company materials, Bloomberg; compiled by Daiwa.
(*)Adjusted net debt = total debt- cash- marketables
FCF (free cash flow) = CFO (cash flow from operating activities)- CFI (cash flow from investing activities)
FOCF (free operating cash flow) = CFO (cash flow from operating activities)- CapEx (Capital Expenditure)
We are using last twelve months net income for ROA and ROE calculations.

Chart 4: Revenues breakdown by business segments

($m) 3 Months Ending	Q3 2017 09/30/2017	Q4 2017 12/31/2017	Q1 2018 03/31/2018	Q2 2018 06/30/2018	Q3 2018 09/30/2018	Y/Y
Revenue	**43,744**	**60,453**	**51,042**	**52,886**	**56,576**	29%
Retail	39,160	55,340	45,600	46,781	49,897	27%
North America	25,446	37,302	30,725	32,169	34,348	35%
International	13,714	18,038	14,875	14,612	15,549	13%
Amazon Web Services (AWS)	4,584	5,113	5,442	6,105	6,679	46%
Operating Income	**347**	**2,127**	**1,927**	**2,983**	**3,724**	973%
Retail	**-824**	**773**	**527**	**1,341**	**1,647**	---
North America	112	1,692	1,149	1,835	2,032	1714%
International	-936	-919	-622	-494	-385	---
Amazon Web Services (AWS)	1,171	1,354	1,400	1,642	2,077	77%
Operating Margin	**0.8%**	**3.5%**	**3.8%**	**5.6%**	**6.6%**	5.8
Retail	-2.1%	1.4%	1.2%	2.9%	3.3%	5.4
North America	0.4%	4.5%	3.7%	5.7%	5.9%	5.5
International	-6.8%	-5.1%	-4.2%	-3.4%	-2.5%	4.3
Amazon Web Services	25.5%	26.5%	25.7%	26.9%	31.1%	5.6

Source: Company materials, Bloomberg; compiled by Daiwa.

Chart 5: Revenues breakdown by product

($m) 3 Months Ending	Q3 2017 09/30/2017	Q4 2017 12/31/2017	Q1 2018 03/31/2018	Q2 2018 06/30/2018	Q3 2018 09/30/2018	Y/Y
Revenue	**43,744.0**	**60,453.0**	**51,042.0**	**52,886.0**	**56,576.0**	29%
Online Stores	26,392.0	35,383.0	26,939.0	27,165.0	29,061.0	10%
Third-Party Seller Services	7,928.0	10,523.0	9,265.0	9,702.0	10,395.0	31%
Amazon Web Services (AWS)	4,584.0	5,113.0	5,442.0	6,105.0	6,679.0	46%
Physical Stores	1,276.0	4,522.0	4,263.0	4,312.0	4,248.0	233%
Subscription Services	2,441.0	3,177.0	3,102.0	3,408.0	3,698.0	51%
Other	1,123.0	1,735.0	2,031.0	2,194.0	2,495.0	122%

Source: Company materials, Bloomberg; compiled by Daiwa.

Explanatory Document of Unregistered Credit Ratings

In order to ensure the fairness and transparency in the markets, Credit Rating Agencies became subject to the Credit Rating Agencies' registration system based on the Financial Instruments and Exchange Act. In accordance with this Act, in soliciting customers, Financial Instruments Business Operators, etc. shall not use the credit ratings provided by unregistered Credit Rating Agencies without informing customers of the fact that those Credit Rating Agencies are not registered, and shall also inform customers of the significance and limitations of credit ratings, etc.

■ The Significance of Registration

Registered Credit Rating Agencies are subject to the following regulations:
1) Duty of good faith.
2) Establishment of control systems (fairness of the rating process, and prevention of conflicts of interest, etc.).
3) Prohibition of the ratings in cases where Credit Rating Agencies have a close relationship with the issuers of the financial instruments to be rated, etc.
4) Duty to disclose information (preparation and publication of rating policies, etc. and public disclosure of explanatory documents).

In addition to the above, Registered Credit Rating Agencies are subject to the supervision of the Financial Services Agency ("FSA"), and as such may be ordered to produce reports, be subject to on-site inspection, and be ordered to improve business operations, whereas unregistered Credit Rating Agencies are free from such regulations and supervision.

■ Credit Rating Agencies

[Standard & Poor's]

The Name of the Credit Rating Agencies group, etc

The name of the Credit Rating Agencies group: S&P Global Ratings ("Standard & Poor's")
The name and registration number of the Registered Credit Rating Agency in the group: S&P Global Ratings Japan Inc. (FSA commissioner (Rating) No.5)

How to acquire information related to an outline of the rating policies and methods adopted by the person who determines Credit Ratings

The information is posted under "Unregistered Rating Information" (http://www.standardandpoors.co.jp/unregistered) in the "Library and Regulations" section on the website of S&P Global Ratings Japan Inc. (http://www.standardandpoors.co.jp)

Assumptions, Significance and Limitations of Credit Ratings

Credit ratings assigned by Standard & Poor's are statements of opinion on the future credit quality of specific issuers or issues as of the date they are expressed and they are not indexes which show the probability of the occurrence of the failure to pay by the issuer or a specific debt and do not guarantee creditworthiness. Credit ratings are not a recommendation to purchase, sell or hold any securities, or a statement of market liquidity or prices in the secondary market of any issues.

Credit ratings may change depending on various factors, including issuers' performance, changes in external environment, performance of underlying assets, creditworthiness of counterparties and others. Standard & Poor's conducts rating analysis based on information it believes to be provided by the reliable source and assigns credit ratings only when it believes there is enough information in terms of quality and quantity to make a conclusion. However, Standard & Poor's does not perform an audit, due diligence or independent verification of any information it receives from the issuer or a third party, or guarantee its accuracy, completeness or timeliness of the results by using the information. Moreover, it needs to be noted that it may incur a potential risk due to the limitation of the historical data that are available for use depending on the rating.

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[Moody's]

The Name of the Credit Rating Agencies Group, etc

The name of the Credit Rating Agencies group: Moody's Investors Service ("MIS")
The name and registration number of the Registered Credit Rating Agency in the group: Moody's Japan K.K. (FSA commissioner (Rating) No.2)

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The information is posted under "Unregistered Rating explanation" in the section on "The use of Ratings of Unregistered Agencies" on the website of Moody's Japan K.K. (The website can be viewed after clicking on "Credit Rating Business" on the Japanese version of Moody's website (https://www.moodys.com/pages/default_ja.aspx)

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Based on the information received from issuers or from public sources, the credit risks of the issuers or obligations are assessed. MIS adopts all necessary measures so that the information it uses in assigning a credit rating is of sufficient quality and from sources MIS considers to be reliable. However, MIS is not an auditor and cannot in every instance independently verify or validate information received in the rating process.

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[Fitch]

The Name of the Credit Rating Agencies group, etc

The name of the Credit Rating Agencies group: Fitch Ratings ("Fitch")
The name and registration number of the Registered Credit Rating Agency in the group: Fitch Ratings Japan Limited (FSA commissioner (Rating) No.7)

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Assumptions, Significance and Limitations of Credit Ratings

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In issuing and maintaining its ratings, Fitch relies on factual information it receives from issuers and underwriters and from other sources Fitch believes to be credible. Fitch conducts a reasonable investigation of the factual information relied upon by it in accordance with its ratings methodology, and obtains reasonable verification of that information from independent sources, to the extent such sources are available for a given security or in a given jurisdiction. The assignment of a rating to any issuer or any security should not be viewed as a guarantee of the accuracy, completeness, or timeliness of the information relied on in connection with the rating or the results obtained from the use of such information. If any such information should turn out to contain misrepresentations or to be otherwise misleading, the rating associated with that information may not be appropriate. Despite any verification of current facts, ratings can be affected by future events or conditions that were not anticipated at the time a rating was issued or affirmed.

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May 2018

IMPORTANT

Notification items pursuant to Article 37 of the Financial Instruments and Exchange Law

If you decide to enter into a business arrangement with our company based on the information described in this report, we ask you to pay close attention to the following items.

• In addition to the purchase price of a financial instrument, our company will collect a trading commission* for each transaction as agreed beforehand with you. Since commissions may be included in the purchase price or may not be charged for certain transactions, we recommend that you confirm the commission for each transaction. In some cases, our company also may charge a maximum of ¥ 2 million (including tax) per year as a standing proxy fee for our deposit of your securities, if you are a non-resident.
• For derivative and margin transactions etc., our company may require collateral or margin requirements in accordance with an agreement made beforehand with you. Ordinarily in such cases, the amount of the transaction will be in excess of the required collateral or margin requirements**.
• There is a risk that you will incur losses on your transactions due to changes in the market price of financial instruments based on fluctuations in interest rates, exchange rates, stock prices, real estate prices, commodity prices, and others. In addition, depending on the content of the transaction, the loss could exceed the amount of the collateral or margin requirements.
• There may be a difference between bid price etc. and ask price etc. of OTC derivatives handled by our company.
• Before engaging in any trading, please thoroughly confirm accounting and tax treatments regarding your trading in financial instruments with such experts as certified public accountants.

* The amount of the trading commission cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

** The ratio of margin requirements etc. to the amount of the transaction cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

When making an actual transaction, please be sure to carefully read the materials presented to you prior to the execution of agreement, and to take responsibility for your own decisions regarding the signing of the agreement with our company.

Corporate Name: Daiwa Securities Co. Ltd.
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Chief of Kanto Local Finance Bureau (Kin-sho) No.108
Memberships: Japan Securities Dealers Association
The Financial Futures Association of Japan
Japan Investment Advisers Association
Type II Financial Instruments Firms Association