Daiwa Securities

Amazon.com (AMZN US)

Profit margins peaking out?

- Q1 FY19 revenues up 17% y/y with AWS revenues up 41% y/y; impact from new e-commerce regulations in India was “minimal”
- Lower growth of costs led to sharp improvement of profitability in Q1 but expecting costs to increase going forward
- Strong market position in growing markets, improving profitability, excellent liquidity are credit positive; global increased scrutiny by regulators, aggressive competition are the main risk factors

Global Credit Research GCRE019

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Credit Opinion

Q1 FY19 results confirm Amazon’s strong credit profile supported by a strong market position in growing markets, improving profitability and excellent liquidity. Total revenues increased 17% y/y to $59.7bn with growth in all business segments. North America revenues grew 17% mainly due to increased unit sales, including third-party sellers. International sales increased 9% mainly due to increased unit sales, including third-party sellers. Amazon announced they adjusted their business structure in India to be in compliance with the new e-commerce regulations and the impact was “minimal” for the full quarter. AWS sales increased 41% mainly due to increased customer usage, partially offset by pricing changes. The growth rates are decelerating across all business segments as US consumer confidence declined sharply in the quarter and FY18 revenues had a positive impact from Whole Foods acquisition (August 2017, acquired for approximately $13.2bn, net of cash acquired).

EBITDA jumped 66% y/y and EBITDA margins improved 4.6pp to 15.5%. Lower growth of head count costs, fulfillment center capacity, finance leases continued from last year and growth of high-margin segments (advertising, AWS) contributed to the sharp improvement of profitability. However, going forward Amazon expects growth rates of certain costs like head count costs, fulfillment center capacity, finance leases to pick up in FY19. Amazon also announced it is working on evolving Prime free two-days shipping program into a free one-day shipping program that should put pressure on profitability in the following quarters.

Amazon has excellent liquidity supported by $12bn of adjusted FOCF (trailing 12 months) and $37bn of cash and marketables. Adjusted debt declined 2.4% y/y to $48bn due to principal repayment of finance leases. The negative working capital cycle is credit positive as Amazon’s e-commerce platform generally collects from consumers before payments to suppliers come due. Amazon has also a $7bn commercial paper program that could provide liquidity to make up for swings in working capital.

The main threats to Amazon business model are a high competition environment both in retail and cloud businesses, intensifying regulators scrutiny worldwide regarding data protection and market dominance of platform businesses and high dependence on third-party carrier to deliver its products. We view as positive the expansion of Amazon deliveries and Amazon Logistics as it reduces dependence on transportation firms, it gives Amazon more bargaining power in negotiating delivery prices and it is cost effective.

Prime free one-day shipping program

Amazon announced it is working on evolving its Prime free two-day shipping program to be a free one-day shipping program. The program will start in North America but it is intended to go global over time. The program is expected to make steady progress through FY19, using both Amazon operated shipping and third-party carriers. Amazon expects approximately $800m of incremental spending related to this investment in Q2.

Prime free one-day shipping program is in line with company's management strategy of the retail segment as Amazon targets to have the broadest selection, best available prices and most convenient options to receive the product. Uncertainty remains related to the impact of this program on Amazon's credit metrics as we don't have details on the total amount of required investments.

Highlights of Q1 FY19 Results

Amazon announced Q1 FY19 results on April 25th.
Total Revenues increased 17% y/y to $59.7bn with revenue growth in all business segments.
By business segment, North America grew 17% y/y, International grew 9% y/y and AWS grew 41% y/y. By product groups, Online stores grew 9% y/y, Third-party Seller Services grew 20% y/y, Physical Stores grew 1% y/y, Subscription Services grew 40% y/y and Other segment including advertising services grew 34% y/y.
Growth rates were slowing down in all product groups except Physical Stores and Subscription Services. Deceleration in Other segment including advertising services was particularly significant as Amazon is focused on operational improvements and making a balance between customer experience and relevant advertising at the moment.

EBITDA increased 66% y/y to $9.3bn as lower growth of hiring and fulfillment center capacity continued from last year and high-margin segments (advertising, AWS) showed strong growth. EBITDA margins increased 4.6pp y/y to 15.5%.
Amazon continues to improve its profitability by leveraging its large investments in people, warehouses, infrastructure put in place in previous years. Square footage for the fulfillment center and shipping areas increased over 30% in FY16 and FY17 and the growth rate went down to 15% in FY18. Head count costs increased 48% in FY16 and 38% in FY17 and the growth rate dropped to 14% in FY18. Financial leases for infrastructure, which are a good proxy for capital investment and infrastructure for data centers grew 69% in FY17 and the growth rate dropped to 10% in FY18. All these metrics stayed almost the same or slightly declined in Q1 FY19. However Amazon expects growth rates for these metrics to be higher for all FY19.

Adjusted free operating cash flow (=CFO- CapEx- assets acquired under capital leases) improved 49% y/y to ▲$3.4bn as cash from operations turned positive (cash from operations has been historically negative) and slow growth of adjusted CapEx.
Cash flow from operating activities were $1.8bn vs ▲$1.8bn in Q1 FY18 primarily due to increase in net income.
Adjusted CapEx (CapEx+assets acquired under capital leases) increased 6% y/y to ▲ $5.3bn primarily due to investment in fulfillment network and technology infrastructure to support AWS growth. Capital leases which show mostly the expenses for data centers increased 13% y/y. The investment growth rates are slowing down as Amazon benefits from heavy investments done in previous years (capital leases increased 69% in FY17).

Adjusted net debt increased 38% q/q to $11.1bn mainly due to decline in cash and marketables.
Current debt was made up of current portion of long-term debt and borrowings under credit facility that amounted to $1.6bn. Long-term debt was made up of $23.4bn of unsecured senior notes outstanding.
Finance leases decreased 5% q/q to $23.2bn due to principal repayment of finance leases.
Cash & marketables decreased 10% q/q to $37bn mainly due to principal repayment of finance leases, purchases of property and equipment and cash outlays for acquisitions.

Segment Information

North America

North America sales increased 17% y/y to $35.8bn mainly due to increased unit sales, including third-party sellers. North America sales accounted for 60% share in total revenues.
Operating Income increased 99% to $2.3bn primarily due to increased unit sales, including sales by third-party sellers, advertising sales and slower growth of fulfillment costs, partially offset by increased marketing costs. Operating margins improved 2.6 points y/y to 6.4%.

International

International sales increased 9% y/y to $16.2bn mainly due to increased unit sales, including sales by third-party sellers. International sales accounted for 27% share in total revenues.
Amazon made the necessary changes to its business structure in India to stay in compliance with the new e-commerce regulations and the impact was “minimal” for the full quarter.
Operating Losses decreased from ▲$622m (Q1 FY18) to ▲$90m primarily due to increased unit sales, including sales by third-party sellers, advertising sales and slower growth in operating expenses, partially offset by increased marketing expense.

AWS

AWS revenues increased 41% y/y to $7.7bn mainly due to increased customer usage, partially offset by pricing changes. AWS revenues accounted for 13% share in total revenues.
AWS operating income increased 59% y/y to $2.2bn primarily due to increased customer usage and cost structure productivity, partially offset by pricing changes and increased spending on technology infrastructure and payrolls to support the business growth.
AWS operating margins improved 3.2pp y/y to 28.9%.

Company Guidance for Q2 FY19

Net sales are expected to be between $59.5bn and $66.5bn, growing between 13%- 20% y/y. This guidance includes an unfavorable FX impact of approximately 150bps.
Operating income is expected to be between $2.6bn- $3.6bn, vs. $3bn in FY18 Q2. The guidance implies a decrease q/q from $4.4bn in Q1 FY19 for the following two reasons. First, Amazon is working on evolving its Prime free two-day shipping program to be a free one-day shipping program and it expects approximately $800m of incremental spending related to this investment. Second, there has been historically a step up in stock-based compensation expenses in Q2.

Chart 1: Financial results

($m) Period End	Q1 2018 03/31/2018	Q2 2018 06/30/2018	Q3 2018 09/30/2018	Q4 2018 12/31/2018	Q1 2019 03/31/2019	Y/Y	Q/Q
■P/L							
Revenues	51,042	52,886	56,576	72,383	59,700	17.0%	-17.5%
Gross Profit	20,307	22,254	23,573	27,597	25,780	27.0%	-6.6%
Gross margin	*39.8%*	*42.1%*	*41.7%*	*38.1%*	*43.2%*	*3.4*	*5.1*
Operating Income	1,927	2,983	3,724	3,786	4,420	129.4%	16.7%
Net Interest expense	250	249	241	237	183	-26.8%	-22.8%
Pretax Income	1,916	2,605	3,390	3,350	4,401	129.7%	31.4%
Net Income	1,629	2,534	2,883	3,027	3,561	118.6%	17.6%
EBITDA	5,598	6,613	7,502	8,048	9,274	65.7%	15.2%
EBITDA margin	*11.0%*	*12.5%*	*13.3%*	*11.1%*	*15.5%*	*4.6*	*4.4*
■C/F							
Cash from operations (1)	▲1,791	7,449	8,588	16,478	1,846	---	-88.8%
Depreciation & Amortization	3,671	3,630	3,778	4,262	4,854	32.2%	13.9%
Cash from investing	▲533	▲2,692	▲5,572	▲3,572	▲8,123	1424.0%	127.4%
CapEx (2)	▲2,727	▲2,949	▲2,527	▲3,119	▲2,721	-0.2%	-12.8%
Cash from financing	▲2,164	▲1,394	▲2,369	▲1,760	▲2,377	9.8%	35.1%
Net cash flow	▲4,488	3,363	647	11,146	▲8,654	92.8%	---
FCF	▲2,324	4,757	3,016	12,906	▲6,277	170.1%	---
Assets acquired under Finance Leases (3)	▲2,270	▲2,335	▲2,329	▲3,681	▲2,564	13.0%	-30.3%
Adjusted CapEx (2)+(3)	▲4,997	▲5,284	▲4,856	▲6,800	▲5,285	5.8%	-22.3%
Adjusted FOCF (1)-(2)-(3)	▲6,788	2,165	3,732	9,678	▲3,439	---	---
■B/S							
Assets	126,362	134,100	143,695	162,648	178,102	40.9%	9.5%
Current assets	50,829	54,481	59,885	75,101	69,431	36.6%	-7.5%
Cash&Marketables (4)	24,963	27,050	29,765	41,250	37,020	48.3%	-10.3%
Liabilities	94,899	99,105	104,570	119,099	129,692	36.7%	8.9%
Current liabilities	48,045	50,801	55,324	68,391	63,695	32.6%	-6.9%
Equity	31,463	34,995	39,125	43,549	48,410	53.9%	11.2%
Borrowings (5)	24,693	24,669	24,728	24,866	24,930	1.0%	0.3%
Finance Leases (6)	19,794	21,120	19,182	24,423	23,194	17.2%	-5.0%
Adjusted Debt (5)+(6)	44,487	45,789	43,910	49,289	48,124	8.2%	-2.4%
Adjusted Net Debt (5)+(6)-(4)	19,524	18,739	14,145	8,039	11,104	-43.1%	38.1%
■Financial Ratios							
Equity Ratio	24.9%	26.1%	27.2%	26.8%	27.2%	2.3	0.4
Adjusted NetD/E	0.62	0.54	0.36	0.18	0.23	▲ 0.4	0.0
Adjusted NetD/EBITDA	1.10	0.89	0.56	0.29	0.35	▲ 0.7	0.1
ROA	3.1%	4.8%	6.4%	6.6%	7.0%	4.0	0.5
ROE	13.3%	18.9%	24.0%	24.4%	26.1%	12.8	1.7

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)
Adjusted FOCF (free operating cash flow) = CFO (cash flow from operating activities)- CapEx (Capital Expenditure)- Assets acquired under capital leases
We are using last twelve months net income for ROA and ROE calculations.

Chart 2: Business Segments- Revenues breakdown

($m) 3 Months Ending	Q1 2018 03/31/2018	Q2 2018 06/30/2018	Q3 2018 09/30/2018	Q4 2018 12/31/2018	Q1 2019 03/31/2019	Y/Y	Q/Q
Revenue	**51,042**	**52,886**	**56,576**	**72,383**	**59,700**	17%	-18%
Retail	45,600	46,781	49,897	64,953	52,004	14%	-20%
North America	30,725	32,169	34,348	44,124	35,812	17%	-19%
International	14,875	14,612	15,549	20,829	16,192	9%	-22%
Amazon Web Services (AWS)	5,442	6,105	6,679	7,430	7,696	41%	4%
Operating Income	**1,927**	**2,983**	**3,724**	**3,786**	**4,420**	129%	17%
Retail	**527**	**1,341**	**1,647**	**1,609**	**2,197**	317%	37%
North America	1,149	1,835	2,032	2,251	2,287	99%	2%
International	-622	-494	-385	-642	-90	---	---
Amazon Web Services (AWS)	1,400	1,642	2,077	2,177	2,223	59%	2%
Operating Margin	**3.8%**	**5.6%**	**6.6%**	**5.2%**	**7.4%**	3.6	2.2
Retail	1.2%	2.9%	3.3%	2.5%	4.2%	3.1	1.7
North America	3.7%	5.7%	5.9%	5.1%	6.4%	2.6	1.3
International	-4.2%	-3.4%	-2.5%	-3.1%	-0.6%	3.6	2.5
Amazon Web Services	25.7%	26.9%	31.1%	29.3%	28.9%	3.2	▲ 0.4

Source: Company materials, Bloomberg; compiled by Daiwa.

Chart 3: Business Segments- Share in revenues

3 Months Ending	Q1 2018 03/31/2018	Q2 2018 06/30/2018	Q3 2018 09/30/2018	Q4 2018 12/31/2018	Q1 2019 03/31/2019
Revenue	**51,042**	**52,886**	**56,576**	**72,383**	**59,700**
Retail	89%	88%	88%	90%	87%
North America	60%	61%	61%	61%	60%
International	29%	28%	27%	29%	27%
Amazon Web Services (AWS)	11%	12%	12%	10%	13%
Operating Income	**1,927**	**2,983**	**3,724**	**3,786**	**4,420**
Retail	27%	45%	44%	42%	50%
Amazon Web Services (AWS)	73%	55%	56%	58%	50%

Source: Company materials, Bloomberg; compiled by Daiwa.

Chart 4: Business Segments- y/y growth

3 Months Ending	Q1 2018 03/31/2018	Q2 2018 06/30/2018	Q3 2018 09/30/2018	Q4 2018 12/31/2018	Q1 2019 03/31/2019
Revenue	**43%**	**39%**	**29%**	**20%**	**17%**
Retail	42%	38%	27%	17%	14%
North America	46%	44%	35%	18%	17%
International	34%	27%	13%	15%	9%
Amazon Web Services (AWS)	49%	49%	46%	45%	41%
Operating Income	**92%**	**375%**	**973%**	**78%**	**129%**
Retail	358%	---	---	108%	317%
North America	93%	321%	1714%	33%	99%
International	---	---	---	---	---
Amazon Web Services (AWS)	57%	79%	77%	61%	59%

Source: Company materials, Bloomberg; compiled by Daiwa.

Chart 5: Product Groups- Revenues breakdown

($m) 3 Months Ending	Q1 2018 03/31/2018	Q2 2018 06/30/2018	Q3 2018 09/30/2018	Q4 2018 12/31/2018	Q1 2019 03/31/2019	Y/Y	Q/Q
Revenue	**51,042.0**	**52,886.0**	**56,576.0**	**72,383.0**	**59,700.0**	17%	-18%
Online Stores	26,939.0	27,165.0	29,061.0	39,822.0	29,498.0	9%	-26%
Third-Party Seller Services	9,265.0	9,702.0	10,395.0	13,383.0	11,141.0	20%	-17%
Amazon Web Services (AWS)	5,442.0	6,105.0	6,679.0	7,430.0	7,696.0	41%	4%
Physical Stores	4,263.0	4,312.0	4,248.0	4,401.0	4,307.0	1%	-2%
Subscription Services	3,102.0	3,408.0	3,698.0	3,959.0	4,342.0	40%	10%
Other	2,031.0	2,194.0	2,495.0	3,388.0	2,716.0	34%	-20%

Source: Company materials, Bloomberg; compiled by Daiwa.

Chart 6: Product Groups- Share in revenues

3 Months Ending	Q1 2018 03/31/2018	Q2 2018 06/30/2018	Q3 2018 09/30/2018	Q4 2018 12/31/2018	Q1 2019 03/31/2019
Revenue	**51,042.0**	**52,886.0**	**56,576.0**	**72,383.0**	**59,700.0**
Online Stores	53%	51%	51%	55%	49%
Third-Party Seller Services	18%	18%	18%	18%	19%
Amazon Web Services (AWS)	11%	12%	12%	10%	13%
Physical Stores	8%	8%	8%	6%	7%
Subscription Services	6%	6%	7%	5%	7%
Other	4%	4%	4%	5%	5%

Source: Company materials, Bloomberg; compiled by Daiwa.

Chart 7: Product Groups- y/y growth

3 Months Ending	Q1 2018 03/31/2018	Q2 2018 06/30/2018	Q3 2018 09/30/2018	Q4 2018 12/31/2018	Q1 2019 03/31/2019
Revenue	43%	39%	29%	20%	17%
Online Stores	18%	14%	10%	13%	9%
Third-Party Seller Services	44%	39%	31%	27%	20%
Amazon Web Services (AWS)	49%	49%	46%	45%	41%
Physical Stores	-	-	233%	-3%	1%
Subscription Services	60%	57%	51%	25%	40%
Other	139%	132%	122%	95%	34%

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.

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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).

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■ 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)

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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.

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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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The information is posted under "Outline of Rating Policies" in the section of "Regulatory Affairs" on the website of Fitch Ratings Japan Limited (https://www.fitchratings.co.jp/web/)

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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.
Registered: Financial Instruments Business Operator
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