GREENLEA LANE CAPITAL

Private Investment Partnership

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Investment Idea: Amazon.com (AMZN)

- Amazon.com (AMZN)
  - 2011 net sales of $48 billion
    - 40% y/y growth
  - $100 billion market capitalization (at 6/15/12)
    - $218.35 per share
  - 179x trailing GAAP EPS
- AMZN is the finest business of which I am aware, and I believe it is (very) cheap

AMZN is a mass merchant

- AMZN offers 14 million SKUs
- As a percentage of 2011 revenue:
  - 65% electronics & general merchandise (57% growth)
  - 35% media (16% growth)
  - 5% other (advertising, AWS) (72% growth)
  - 56% North American (43% growth)
  - 44% international (38% growth)

Strategy for mass merchants is simple

- Mass merchants compete on price, selection, and convenience
- Walmart is the dominant mass merchant, and its formula for success is straightforward
  - Scale efficiencies permit low prices, wide selection
  - Low prices attract more customers
  - More customers drive greater scale
  - Greater scale permits further price decreases
  - And so on…

AMZN possesses decisive advantages

- AMZN is structurally advantaged with respect to the key competitive factors in physical retailing:
  - Price, selection, and convenience
- Moreover, AMZN's business model affords it advantages that unavailable to physical retailers:
  - Personalization
  - Habit formation

Advantage #1: Cost structure / pricing

- Physical retailers' largest operating expenses substituted with technology
  - Labor and real estate are inflationary and largely variable
  - Technology is deflationary and largely fixed
- Inventory management is more efficient
  - Inventory need not be replicated over thousands of stores
  - Pulled by demand rather than pushed by merchandising
  - Inventory turnover: AMZN 12x; WMT 8x; TGT 6x
- Lower shrinkage
  - Most shrinkage occurs in-store

Advantage #2: No selection constraint

- Because physical store size must be finite, selection must be finite
- This creates a tradeoff between the number of categories in which a physical retailer can participate and the depth / specialization in each category
- No such tradeoff exists online

Advantage #3: Convenience

- Online, customers can shop anytime, anywhere
- They need not:
  - Travel to and from the store
  - Search the aisles
  - Wait in checkout lines

Advantage #4: Personalization

- Physical retailers cannot offer personalized experiences, because armies of customers must go to the same location and interact with a limited number of associates
- Online, customer behavior is automatically captured and used to for individualized merchandising
- Every customer’s Amazon.com is personalized

Advantage #5: Habit formation

- People form habits through repetition, and these habits are highly influential on shopping behavior
- Unlike physical stores, people can shop AMZN everyday / multiple times per day
  - When the need / desire for a product arises, it can be purchased on AMZN *immediately*
- AMZN's availability is analogous to Coca-Cola's ubiquity

<u>**Advantages widen *every single day***</u>

	Advantages To Scale
Cost structure / pricing	Price-volume-price virtous circle
Selection	Inventory turns permit more SKUs at attractive ROIC
Convenience	Investment in customer experience, more customer reviews
Personalization	Learning customer preferences, accumulated data, data mining
Habit formation	Habit becomes ingrained over time

Focused on the long term

We believe that a fundamental measure of our success will be the shareholder value we create over the long term. This value will be a direct result of our ability to extend and solidify our current market leadership position. The stronger our market leadership, the more powerful our economic model. Market leadership can translate directly to higher revenue, higher profitability, greater capital velocity, and correspondingly stronger returns on invested capital.

We will continue to make investment decisions in light of long-term market leadership considerations rather than short-term profitability considerations or short-term Wall Street reactions.

~1997 Shareholder Letter (reprinted in every annual report)

Focused on the long term (cont'd)

We all know in the physical world that whatever place has the best service can't have the lowest prices. Online, I think that's wrong. I think online you can have the best service and the lowest prices, if you have enough scale.

~Jeff Bezos on *Charlie Rose*, June 28, 2000

Focus on cost improvement makes it possible for us to afford to lower prices, which drives growth. Growth spreads fixed costs across more sales, reducing cost per unit, which makes possible more price reductions. Customers like this, and it's good for shareholders. Please expect us to repeat this loop.

~2001 Shareholder Letter

AMZN dominates online retailing

Rank	Company	2011 Web Sales ($ billions)	
1	Amazon.com	48.0	
2	Staples	10.6	
3	Apple	6.7	(estimated)
4	Walmart.com	4.9	(estimated)
5	Dell	4.6	(estimated)
6	Office Depot	4.1	
7	Liberty Interactive	3.8	(estimated)
8	Sears Holdings	3.6	(estimated)
9	Netflix	3.2	
10	CDW	3.0	(estimated)
11	Best Buy	3.0	(estimated)
12	OfficeMax	2.9	(estimated)
13	Newegg	2.7	
14	Macy's	2.2	(estimated)
15	W.W. Grainger	2.2	
16	Sony Electronics	2.0	(estimated)
17	Costco Wholesale	1.9	
18	LL Bean	1.7	(estimated)
19	Victorias Secret	1.6	(estimated)
20	J.C. Penney	1.6	

Source: *Internet Retailer* Top 500 Guide 2012 Edition

AMZN dominates web-only merchants

		2011	
		Web Sales	
Rank	Company	($ billions)	
1	Amazon.com	48.0	
2	Netflix	3.2	
3	Newegg	2.7	
4	Overstock.com	1.1	
5	Amway	1.0	(estimated)
6	Vistaprint	0.8	
7	Buy.com	0.8	
8	Gilt Group	0.5	(estimated)
9	Wayfair	0.5	(estimated)
10	Peapod	0.5	(estimated)

Source: *Internet Retailer* Top 500 Guide 2012 Edition

Historical growth

	Net Sales ($ millions)	Y/Y Growth
2002	3,933	26%
2003	5,264	34%
2004	6,921	31%
2005	8,490	23%
2006	10,711	26%
2007	14,835	39%
2008	19,166	29%
2009	24,509	28%
2010	34,384	40%
2011	48,077	40%

Growth is accelerating

- AMZN has a large marketplace (“3P”) business, in which it sells products on behalf of third-party merchants
  - Earns fees as a % of sale value (est. low-double-digit %)
  - These fees, as opposed to the gross sale value, are booked as revenue
  - 3P is similar to eBay’s marketplace business
- Operating profit dollars are similar regardless of whether AMZN sells a product itself or in its 3P business
- Therefore, AMZN’s unit trends are a better indicator of earnings power than revenue trends

Growth is accelerating (cont'd)

- 3P has been increasing in the mix
- Because 3P revenue-per-unit is a fraction of that in the retail business, this mix shift has depressed revenue growth relative to unit growth

	3P % Of Units	Revenue Growth	Unit Growth
2009	30%	28%	32%
2010	31%	40%	40%
2011	36%	40%	49%

The next decade looks promising

- Starting from today's 40%-50% unit growth rate, even a reversion to the mean would imply a high prospective 10-year CAGR

	1	2	3	4	5	6	7	8	9	10	10-Yr CAGR
AMZN revenue growth 2002-2011	26%	34%	31%	23%	26%	39%	29%	28%	40%	40%	**31%**
Reversion to the mean - A	45%	40%	35%	30%	25%	20%	15%	10%	5%	0%	**22%**
Reversion to the mean - B	45%	40%	35%	35%	30%	30%	25%	25%	20%	20%	**30%**

Dramatic mean-reversion seems unlikely

- I estimated AMZN possesses only 1% market share of the categories in which it competes
- Growth is accelerating
  - Active user accounts growing at 26%
  - Spend per active account growing at 12%
- Selection is wider than ever
  - Recent introduction of AmazonSupply
  - Push into apparel category
- Customer service ratings are setting records
- Advantages are wider than ever, and widening

E-commerce is an enormous tailwind

- Enabled by mobile devices, consumers are turning to the internet for their shopping needs
- Merchants of every stripe are responding by investing in their online offerings
  - Better websites, mobile sites, apps, free shipping and returns, etc.
- This constitutes a virtuous circle, whereby e-commerce adoption increases the incentives for further adoption
- Adoption also creates social proof and changes in consumers' habits

Historical e-commerce growth

$ millions							
	Total US Retail	Y/Y Growth		US E-commerce	Y/Y Growth		E-commerce % of Total
2001	3,067,965			34,448			1.1%
2002	3,135,269	2.2%		45,007	30.7%		1.4%
2003	3,266,790	4.2%		57,931	28.7%		1.8%
2004	3,467,850	6.2%		73,920	27.6%		2.1%
2005	3,693,913	6.5%		92,505	25.1%		2.5%
2006	3,885,877	5.2%		114,341	23.6%		2.9%
2007	4,008,096	3.1%		137,564	20.3%		3.4%
2008	3,945,364	-1.6%		142,508	3.6%		3.6%
2009	3,639,467	-7.8%		144,462	1.4%		4.0%
2010	3,887,725	6.8%		166,513	15.3%		4.3%
2011	4,195,820	7.9%		193,431	16.2%		4.6%

Source: US Census Bureau

Potential often underestimated

- I believe intuitions about the penetration potential of e-commerce are often overly conservative
- Intuitions and behavior are influenced by habit
- Habits die slowly, but ultimately people respond to incentives
- E-commerce offers the incentives of better prices, wider selection, and superior convenience

The facts are compelling

Intuition	Enjoyable shopping environments cannot be replaced by the internet
Fact	Bookstores are the quintessential experience-based retail destination,
	and books were the first category to move online
Intuition	People need to try on clothing
Fact	Apparel and accessories is the second largest e-commerce category,
	with 12% penetration of retail
Intuition	People need / like to buy their own groceries
Fact	Groceries are rapidly moving online in the UK, led by Ocado

The next decade looks promising

- E-commerce growth is accelerating
- Penetration, currently ~5%, could reach 20% within the next decade
- Assuming retail grows at 3-4%, if e-commerce reached 20% penetration in 10 years, it would grow at a high-teens CAGR
- AMZN should significantly outperform e-commerce
  - Currently growing at ~3x the industry

AMZN's profitability is misunderstood

- GAAP operating margins are lower than those of physical mass merchants, and have declined

	EBIT ($ millions)	% of Net Sales
2002	64	1.6%
2003	271	5.1%
2004	440	6.4%
2005	432	5.1%
2006	389	3.6%
2007	655	4.4%
2008	842	4.4%
2009	1,129	4.6%
2010	1,586	4.6%
2011	862	1.8%

AMZN has always been in hyper-growth

- AMZN has always been in hyper-growth mode, aggressively investing in:
  - New categories
  - New geographies
  - New customer acquisition
  - Price decreases
  - Customer experience improvements
  - Kindle
  - Amazon Web Services (non-retail)

Investing for growth depresses margins

- It would be illogical to believe that if run for current profitability (i.e., cancel new projects, shut off the growth engine), AMZN's margins would not be significantly higher than as reported under GAAP
- 1997 Shareholder Letter:

When forced to choose between optimizing the appearance of our GAAP accounting and maximizing the present value of future cash flows, we'll take the cash flows.

Investors anchor on GAAP…

- Fourth quarter 2005 earnings call:

Analyst: *Okay. My other question is for Jeff. Jeff, you have said for a long-time that your model is more efficient than the traditional retail model because you don't have to invest in real estate, which always goes up. Instead you can invest in technology, which goes down. But if I add up all of your expenses as a percent of revenue and add in free shipping, which you sort of view as a marketing expense, I think in 2005 it was a little over 20% and in the fourth quarter a little over 19, which is 200 or 300 basis points higher than a company like Walmart. So could you sort of just give us an idea why that is such a paradox? Why is it that we are not seeing more efficiency if, in fact, the model is more efficient?*

Jeff Bezos: *Well, I think one thing to keep in mind is that if we were not investing in some of these new initiatives such as digital and Web Services, our cost structure would be different today. So if we were totally optimizing our cost structure for a kind of a steady- state business, you would see a different cost structure. Other things that we talk about that you may remember are, if you look at the return on invested capital, the dynamics between our business and traditional retail are very different in large part because of the efficiency of our capital model, high inventory turns, low PP&E.*

…But should focus on normalized

- We can define “normalized operating income” as the pretax cash flow that would be available for distribution to shareholders, were AMZN to abruptly cut off its upward revenue trajectory
- The economic reality is that AMZN is *actually* generating this operating income, but is aggressively reinvesting in the business

AMZN versus WMT / TGT

- AMZN's normalized operating margins should be greater than WMT US and TGT's operating margins, which are 7% and 8%, respectively
  - AMZN has no stores and a fraction of the employees
  - AMZN has a far more efficient distribution system and virtually no shrinkage
  - 3P (>35% of units) generates far higher margins than a traditional retail business

Where are these growth investments?

- There are growth expenditures embedded in each I/S line, but we will focus on only two:
  - Advertising and other promotional costs (AOPC)
    - Targeted, revenue generating advertising (mostly online)
    - Contributed to ~30% average growth over past decade
    - ~2% of revenue over the past decade
  - Technology and content
    - Growth investments, largely akin to R&D, and including Amazon Web Services (non-retail)
    - ~5% of revenue over the past decade

Our growth add-back is conservative

- Together, AOPC and technology & content have averaged 7.5% of revenue over the past decade
- It is probable that a majority of these items is "growth" in nature, and should be added back to get to normalized operating income
- However, we need to add back only 1/3 of these expense lines to reach a 7% average operating margin (comparable to WMT US) over the past decade

Calculation of normalized margins

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	10-Yr Average
Net sales	**3,933**	**5,264**	**6,921**	**8,490**	**10,711**	**14,835**	**19,166**	**24,509**	**34,384**	**48,077**	
Y/y growth		*33.8%*	*31.5%*	*22.7%*	*26.2%*	*38.5%*	*29.2%*	*27.9%*	*40.3%*	*39.8%*	
Advertising and other promotional costs	**114**	**109**	**141**	**168**	**226**	**306**	**420**	**593**	**890**	**1,400**	
% of revenue	*2.9%*	*2.1%*	*2.0%*	*2.0%*	*2.1%*	*2.1%*	*2.2%*	*2.4%*	*2.6%*	*2.9%*	2.3%
Technology and content	**216**	**208**	**251**	**451**	**662**	**818**	**1,033**	**1,240**	**1,734**	**2,909**	
% of revenue	*5.5%*	*3.9%*	*3.6%*	*5.3%*	*6.2%*	*5.5%*	*5.4%*	*5.1%*	*5.0%*	*6.1%*	5.2%
EBIT as reported	**64**	**271**	**440**	**432**	**389**	**655**	**842**	**1,129**	**1,586**	**862**	
% of revenue	*1.6%*	*5.1%*	*6.4%*	*5.1%*	*3.6%*	*4.4%*	*4.4%*	*4.6%*	*4.6%*	*1.8%*	4.2%
Add back growth:											
Advertising / other promotional costs (1/3)	**38**	**36**	**47**	**56**	**75**	**102**	**140**	**198**	**297**	**467**	
% of revenue	*1.0%*	*0.7%*	*0.7%*	*0.7%*	*0.7%*	*0.7%*	*0.7%*	*0.8%*	*0.9%*	*1.0%*	0.8%
Tech / content (1/3)	**72**	**69**	**84**	**150**	**221**	**273**	**344**	**413**	**578**	**970**	
% of revenue	*1.8%*	*1.3%*	*1.2%*	*1.8%*	*2.1%*	*1.8%*	*1.8%*	*1.7%*	*1.7%*	*2.0%*	1.7%
Total growth investment	**110**	**106**	**131**	**206**	**296**	**375**	**484**	**611**	**875**	**1,436**	
% of revenue	*2.8%*	*2.0%*	*1.9%*	*2.4%*	*2.8%*	*2.5%*	*2.5%*	*2.5%*	*2.5%*	*3.0%*	2.5%
EBIT as adjusted	**174**	**376**	**571**	**638**	**685**	**1,030**	**1,326**	**1,740**	**2,461**	**2,298**	
% of revenue	*4.4%*	*7.1%*	*8.3%*	*7.5%*	*6.4%*	*6.9%*	*6.9%*	*7.1%*	*7.2%*	*4.8%*	6.7%
Plus: Other operating expense (income)	**47**	**3**	**(8)**	**47**	**10**	**9**	**(24)**	**102**	**106**	**154**	
Normalized EBIT	**221**	**379**	**563**	**685**	**695**	**1,039**	**1,302**	**1,842**	**2,567**	**2,452**	
% of revenue	*5.6%*	*7.2%*	*8.1%*	*8.1%*	*6.5%*	*7.0%*	*6.8%*	*7.5%*	*7.5%*	*5.1%*	6.9%
Implied maintenance:											
Advertising / other promotional costs	**76**	**73**	**94**	**112**	**151**	**204**	**280**	**395**	**593**	**933**	
% of revenue	*1.9%*	*1.4%*	*1.4%*	*1.3%*	*1.4%*	*1.4%*	*1.5%*	*1.6%*	*1.7%*	*1.9%*	1.6%
Technology and content	**144**	**139**	**167**	**301**	**441**	**545**	**689**	**827**	**1,156**	**1,939**	
% of revenue	*3.7%*	*2.6%*	*2.4%*	*3.5%*	*4.1%*	*3.7%*	*3.6%*	*3.4%*	*3.4%*	*4.0%*	3.4%

Sanity check

- There are several ways to sanity check our conclusion:
  - Total growth expenditures over the past decade averaged a not-unduly-large 2.5% of revenue
  - In our calculation, maintenance AOPC averaged 1.6% of revenue, which is similar to the advertising budgets of physical retailers
  - In our calculation, maintenance technology and content averaged 3.4% of revenue, which is significantly more than the IT budgets of most physical retailers (~2%)
  - In 2004, AMZN earned a 6.4% GAAP EBIT margin, which is direct evidence the business can be run with higher-than-recent margins

Normalized ROIC

- ROIC = NOPAT / (net fixed assets + net working capital)

	GAAP ROIC	Normalized ROIC
2008	138%	220%
2009	63%	96%
2010	62%	93%
2011	23%	91%

Valuation

Stock price	$ 218.35
Diluted shares	460
Market capitalization	100,441
Cash	5,715
Debt	0
Enterprise value	**94,726**
Retail revenue (excludes "other")	49,630
Normalized EBIT margin	7%
Normalized EBIT	3,474
Less: Taxes @30%	1,042
NOPAT - LTM	**2,432**
Assumed growth rate	40%
NOPAT - Forward	**3,405**
EV / NOPAT - LTM	**39x**
EV / NOPAT - Forward	**28x**

AMZN versus average

	Average Company	AMZN	AMZN vs. Average
ROIC	10%-12%	90%	8.2x
Earnings growth	6%-8%	45%	6.4x
P / E	15x	39x	2.6x

Prospective stock CAGR

- AMZN’s prospective stock CAGR is similar to its prospective revenue CAGR
  - Normalized EBIT margin is likely to expand from 7% (AMZN believes it can reach double-digits)
  - P / FCF multiple may contract
  - These two factors could roughly cancel out
- Therefore, I believe AMZN stock could return ~30% over the next decade
- This ignores excess cash generation

Why Now?

- AMZN trades at the low end of the historical range of 35x-65x trailing normalized NOPAT
- The market is penalizing AMZN for depressed margins (i.e., aggressive investment spending)
  - 2011 GAAP operating margin of 1.8% was the lowest in nearly a decade
- Aggressive investment indicates that AMZN sees opportunity….

<u>Thank You</u>

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