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**New Rec: Amazon.com (AMZN: \$40.94) September 26, 2004**

**Position: Sell Target: \$30.00 Timing: 2 (1=aggressive; 5=cautious)**

	3Q04E	4Q04E	1Q05E	2Q05E	F2004E	F2005E
<b>Rev (\$M)</b>	<b>1,434.8</b>	<b>2,396.3</b>	<b>1,842.9</b>	<b>1,638.5</b>	<b>6,748.8</b>	<b>7,895.5</b>
<b>EPS \$<sup>(1)</sup></b>	<b>0.18</b>	<b>0.39</b>	<b>0.31</b>	<b>0.22</b>	<b>0.97</b>	<b>1.21</b>
<b>Y/Y Gr</b>	<b>60%</b>	<b>32%</b>	<b>35%</b>	<b>22%</b>	<b>60%</b>	<b>24%</b>
<b>PE</b>	<b>na</b>	<b>na</b>	<b>na</b>	<b>na</b>	<b>42.1</b>	<b>33.8</b>
<b>PSR</b>	<b>na</b>	<b>na</b>	<b>na</b>	<b>na</b>	<b>2.6</b>	<b>2.2</b>
<b>Consensus</b>	<b>0.18</b>	<b>0.41</b>	<b>0.30</b>	<b>0.26</b>	<b>0.99</b>	<b>1.36</b>

(1) EPS excludes Stock-based Compensation, Other Operating Expense (Income), and Net Gains/Losses.

**Shares Out: 406.9M**

**Market Cap: \$16.7B**

**FYE: Dec**

Summary: Amazon.com, Inc. (AMZN) is the world's leading on-line retailer offering its 35M customers a place to find millions of new and used items at low

prices. AMZN classifies its worldwide business into North America (U.S. and Canada) and International (U.K., Germany, France, Japan and Canada). Within each region, AMZN further classifies its revenues into Media (books, music, DVD & Video, Magazine subscriptions, software and video games), Electronics and General Merchandise (all non-Media merchandise, including consumer electronics, apparel, toys, home/garden, sport/outdoors, jewelry, etc), and Other (non-Amazon.com sales such as Merchant.com and other promotional activities).

In July 2004, AMZN reported 2Q04 results that disappointed the “street.” AMZN’s reported revenues of \$1.4B revealed dramatic top-line growth deceleration, particularly in North America. Combined with management’s warnings about future margin pressure, the share price declined by 23% to a low of \$35.32 on 8/9/04 from \$45.82 before the earnings release. Since then, AMZN shares have regained some ground, settling most recently at \$40.94. Even at today’s lower price, AMZN’s 30x forward earnings multiple suggests it is still valued as a high-growth company. However, we think the recent quarter’s result may portend a trend of slowing growth rates and margin deterioration. We therefore think that AMZN’s current 30x F2005 EPS multiple may be too rich given our expectation that F2005 growth rates will be below consensus estimates.

During F2003, AMZN grew its revenues by 34%, mostly through geographic expansion, new product offerings and heavy discounting. However, during 2Q04, AMZN’s consolidated revenues growth slowed to only 26% y/y (22% excluding foreign currency adjustment) compared to growth rates ranging from 33% to 41% during the previous four quarters.

AMZN’s F2003 consolidated 34% revenue growth rate was comprised of 18% growth in North America and 71% growth in International. However, during 2Q04, North America revenue (57% of total revenues) grew by only 13% to \$792M. More specifically, AMZN’s largest business segment, North America Media, (39% of total revenues) fared the worst, growing only 9% (compared to growth rates of 14%-16% during the previous four quarters). AMZN attributed the slow growth to the 1.4M units of *Harry Potter and the Order of the Phoenix* that were sold during 2Q03. We think the decelerating growth cannot be solely attributed to Harry Potter. Comparisons for 2H04 will continue to be difficult given the strong sales during 2H03 as well.

Decelerating growth rates are also occurring in AMZN’s fast-growing International business. Q204 International revenue of \$595M grew by only 50% y/y compared to 61%-81% during the prior four quarters. The decline is even more dramatic in the International Media segment, which grew only 35% y/y (25% excluding foreign currency) compared to a range of 50%-75% over the past four

quarters. Management again attributed the International slowdown to Harry Potter, but we think there may be more to it. We also note that margins in the higher growth International business are substantially lower margins than in the domestic business. During 2Q04, gross margin for International was only 20% compared to 28% for North America.

Increased competition has forced AMZN to offer discounts on its products as well as free shipping over a minimum purchase level. AMZN began discounting during July 2001, and now offers year-round free shipping offers and lower price offers. We think that AMZN's impressive growth rates over the past year have been fueled by these promotions, and as each of these promotions come to its one-year anniversaries, the y/y comparisons will become increasingly difficult. Management warned that margin pressure should continue as it continues to offer price discounts and free shipping in order to compete. Management added that margins may be further affected by its plans to add a new development center and fulfillment center in Scotland, as well by its plan to hire more computer scientists and software engineers to improve its technology and content.

AMZN has long benefited from being a first-mover in the online bookselling business as well as from its brand value as one of the "founding fathers" of online retailing. However, as the internet becomes more ubiquitous, online shoppers have far more options and are inevitably taking on the characteristics of cost-conscious brick-and-mortar shoppers looking for the best deal. Also, as AMZN enters new product lines, it no longer has the first-mover advantage and must compete with established players (such as incumbent Blue Nile when AMZN entered the Jewelry business earlier this year).

AMZN faces increasing competition from mass retailers expanding their on-line offerings as well as from price-comparison intermediaries (e.g., shopping.com, pricescan.com, pricegrabber.com, etc.) that are gaining in popularity. While AMZN's July 2004 U.S. internet traffic declined 8% y/y to 33.8M visitors, mass retailers Wal-Mart attracted 16.5M internet users (24% increase y/y) and Target attracted 12.2M users (29% increase y/y). According to Media Metrix, about 38M internet users visited price aggregator sites during July 2004, a 13% y/y increase. Sites for leading price aggregator Shopping.com saw a 26% increase in its internet traffic during this same period. Also, Google is beta testing its price-comparison search engine called Froogle, and Yahoo recently purchased Kelkoo, a leading European comparison shopping engine. As the number of these shopping aggregator websites continue to grow, we expect AMZN will encounter further margin pressure and increased customer acquisition cost.

Bulls cite the improving internet usage fundamentals and broadband adoption trends. However, even in an environment where overall internet usage and on-line purchases have increased, AMZN has not seen increases in its internet traffic. Accordingly to Nielson NetRatings, AMZN's US internet traffic increased only 1% y/y for the twelve months ended August 2004, despite an 11% increase in total US internet users and a 15% increase in traffic to e-Commerce sites overall. We note that during this same period, eBay's US traffic increased by 35%.

Since AMZN has grown its revenues through geographic expansion, a risk to the bear story is that it continues to increase profits through entering new countries. AMZN has indicated that it will expand into new countries over time, and has also said that "China will be a prime focus for years to come." In August 2004, AMZN acquired Joyo.com in order to gain access to China's online market. Bulls believe the internet opportunity in mainland China will be tremendous given that the e-commerce market in China is still in its infancy, and China has already has 87M internet users. Also, the China Internet Network Information Center estimates that the number of internet users shopping online will increase by 190% in the coming year. While we agree that the Chinese e-commerce opportunity will eventually be huge, we think AMZN will be unable to realize material upside from China for some time. China currently does not have an adequate e-commerce infrastructure, and improvements will take numerous years to work out. China's postal service is unreliable, and China's banking system is not equipped for e-commerce. Cash is still king in China and credit cards are still not widely used. Currently, those with credit cards tend to be the older generation who do not use the internet. Also, the average income in China is minimal relative to that for the U.S., averaging \$1,062 annually compared to \$37,312 in the U.S., according to Morgan Stanley.

Given the structural problems described above, we think China represents a longer term opportunity that is not likely to contribute materially to AMZN's growth rate in the next couple of years. Joyo is expected to generate roughly \$35M of revenues this year. Even if Joyo's revenues double annually, we expect it would be many years before the upside makes any impact on AMZN's large revenue base.

Another risk to the bear story is AMZN's attempt to position itself as the platform for everything e-commerce. AMZN intends to spend millions more to hire computer scientists and engineers to improve its technology and content. The recent unveiling of A9.com is a product of this ongoing effort. This much anticipated search site gives users access to search results from Google, the Internet Movie Database, GuruNet.com, and also includes AMZN's own "Search Inside the Book." So far, we do not see A9.com as a technological breakthrough.

We wonder if many users will even switch from the search site they are currently comfortable with. AMZN has announced it will not push its Amazon.com retail sales on this search site. However, this week it has started offering 1.6% discounts for AMZN purchases. At this early stage it is still unclear what the money-making proposition of A9.com is.

If the grander goal of A9.com is to grab a piece of advertising revenues from the growing search market, we think AMZN still has a long road ahead. AMZN is only a tiny player now. And considering that A9.com utilizes Google's search technology, we do not think AMZN is a strong contender, since its reliance on Google's technology could cap any potential to grow.

AMZN currently trades at a 30x multiple of F2005 consensus EPS. We estimate AMZN's F2005 EPS to be \$1.21, which is 11% below consensus. If AMZN's 2005 growth rates come in below consensus expectations as we expect, AMZN's earnings multiple should contract. We therefore value AMZN at 25x our F2005 EPS estimate of \$1.21, a 24% EPS increase over F2004, which results in a \$30 share price.

AMZN stresses its focus on long-term, sustainable growth of free cash flow (FCF). We agree that FCF is the best measure of a company's profitability, and therefore also value AMZN on a FCF basis. Applying a 25x multiple to our F2005 FCF estimate of \$532M (\$1.25 per diluted share) results in a share price of \$31. Considering both the EPS and FCF methods, we are setting an initial target price of \$30, which represents a 27% downside opportunity.

#### Background:

Founded by Jeff Bezos in 1994, AMZN began selling books over the internet beginning July 1995. Since then, AMZN has become the world's largest online retailer, offering millions of books, CDs, DVDs and videos, as well as a vast assortment of consumer electronics and general merchandise such as tools/hardware, toys/baby, apparel, home/garden, jewelry, gourmet foods, health/beauty and more. AMZN completed its IPO in May 1997.

AMZN's mission is to offer its customers low prices, convenience and a wide selection of merchandise. AMZN strives to offer "Earth's Biggest Selection" and to be "Earth's most customer-centric company." AMZN attempts to build brand loyalty and repeat purchases by providing feature-rich content, a secure computer environment, fast and reliable fulfillment and timely customer service.

AMZN generates its revenues under the following business models:

a. *Amazon.com Retail.* Most of AMZN's revenues are generated through Amazon.com Retail, which sells a broad range of products purchased from distributors and manufacturers. AMZN is the seller of record, takes the inventory risk, and records revenue at gross retail price. Also, through its Syndicated Stores program, AMZN sells its products through other businesses' websites. As with Amazon.com Retail sales, AMZN owns the inventory, sets the prices, and is responsible for fulfillment and customer service. The referring business earns a sales commission on the sale. There are almost 1M websites that provide links to AMZN.

b. *Third-Party Sellers.* Through its Merchant@ and Amazon Marketplace programs, AMZN also enables businesses and individuals to sell virtually anything (new, used, refurbished and collectible items) to AMZN customers. AMZN is not the seller of record and earns either fixed fees, sales commissions, or per-unit activity fees. As the intermediary, AMZN recognizes revenues on a net basis (i.e., only the fees and commissions earned). Amazon Marketplace competes directly with eBay.

c. *Other Services.* Through Merchant.com, AMZN uses its e-commerce expertise to operate another business's website, sell its products under its brand name and URL, and sometimes offer fulfillment services (e.g., [www.target.com](http://www.target.com)). AMZN also provides technology services, such as search, browse and personalization, and other marketing and promotional services, such as its co-branded credit card. As with the Third-Party Sellers, AMZN earns and recognizes as revenue the fees and/or commissions associated with Merchant.com transactions. This business accounts for less than 2% of revenues.

AMZN operates its websites in six different countries and classifies its results into two geographic segments: North America, which consists of the U.S. and Canada, and International, which consists of the UK, Germany, France, Japan and Canada. Within each region, AMZN classifies sales into Media (books, music, DVD & Video, Magazine subscriptions, software and video games), Electronics and General Merchandise (all non-Media products), and Other (Merchant.com revenues, miscellaneous marketing and other promotional activities). Approximately 75% of AMZN's revenues come from Media items and about 43% of total revenues are International.

AMZN is headquartered in Seattle WA, and operates 11 fulfillment center locations (six throughout the U.S. and five internationally). AMZN also operates six customer service centers and has several co-sourcing centers and customer service locations. AMZN employs over 8,200 employees.

AMZN not only competes with other on-line e-commerce sites, but also competes with physical-world retailers, catalog retailers, publishers, distributors and manufacturers of its products. Like physical-world retailers, AMZN generates higher sales during the fourth quarter. AMZN's 4Q sales typically accounts for over 35% of the year's sales.

Discussion:

1. AMZN's 2Q04 results may be an indication of future decelerating revenue growth rates.

AMZN's 2Q04 revenues came in at \$1.39B, 4% below the consensus estimate of \$1.45B. Consolidated revenues grew by only 26% y/y compared to growth rates ranging from 33% to 41% during the previous four quarters. Excluding the impact of foreign currency translation, the 2Q04 growth rate was actually only 22%. We note that during F2003 and F2002, consolidated revenues grew by 34% and 26%, respectively (28% and 25% excluding foreign currency). The following table shows the annual and quarterly growth rates for AMZN by geography and by business segment:

Y/Y % Revenue Growth	F2002	F2003	3Q03	4Q04	1Q04	2Q04
NORTH AMERICA						
Media	10.2%	13.8%	15.3%	15.8%	15.7%	8.6%
Electronics and General Merchandise	17.9%	29.0%	35.3%	21.6%	33.5%	27.3%
Total North America	12.2%	18.0%	20.8%	18.1%	20.2%	12.8%
INTERNATIONAL						
Media	71.0%	61.2%	50.1%	58.5%	61.9%	35.4%
Electronics and General Merchandise	308.3%	240.9%	258.9%	290.4%	368.0%	218.3%
Total International	76.9%	71.2%	60.9%	74.0%	80.4%	49.8%
CONSOLIDATED						
Media	26.2%	30.7%	27.9%	32.8%	34.6%	19.9%
Electronics and General Merchandise	25.8%	47.7%	56.4%	47.6%	73.5%	55.7%
Total Consolidated	26.0%	33.8%	33.3%	36.2%	41.2%	26.1%

Note: The "Other" category comprises only 1.8% of revenues, and is therefore not shown in the above table.

AMZN's domestic business (57% of total sales) grew by only 13% in 2Q04, compared to quarterly growth rates ranging from 18%-21% over the past year. The most dramatic revenue deceleration occurred across AMZN's core Media business, which comprises 75% of sales. North America Media growth, in particular, slowed to only 9% compared to roughly 15% throughout the past year. AMZN attributed the slowing growth to last June's successful release of *Harry Potter and the Order of the Phoenix*, in which 1.4M units were sold. However, we note that the comps for the 2H04 will continue to be difficult given the strong book sales during the second half of last year. Growth in the International Media segment

also slowed from 62% the previous quarter to only 35% this quarter (25% excluding foreign currency translation). Management attributed the International slowdown to Harry Potter as well. However, we think that only explains a portion of the slowdown.

2. High growth rates over the past year were driven by expansion into new geographies and new merchandise categories, as well as through heavy discounting.

Over the past year, much of AMZN 33% growth has been powered by expansion into new product lines as well as by geographic expansion. For example, International growth was 71% during F2003 compared to 18% for North America). AMZN's aggressive expansion into new merchandise categories can also be seen from its 2Q04 results, where EGM grew 56% while Media grew only 20%.

During F2002, AMZN expanded into Canada with Media, and also launched two new U.S. merchandise categories, Merchant@Amazon in the U.S., and Marketplace in the UK, Germany and Japan. These new launches helped drive F2003 growth rates. In F2003, AMZN added six new merchandise categories (four in the U.S., one in Japan and one in Canada) and launched Marketplace in France and Canada.

Although the International business has fueled AMZN's recent growth, the margins for the International business are substantially lower than the North America business. The table below sets forth the Gross and Segment Operating Income Margins for the two segments.

	F2002	F2003	3Q03	4Q04	1Q04	2Q04
<b>GROSS MARGIN</b>						
North America	26.8%	26.6%	28.4%	25.3%	26.7%	27.7%
International	21.5%	19.5%	19.9%	17.2%	19.7%	20.4%
Consolidated Gross Margin	25.2%	23.9%	25.2%	21.9%	23.6%	24.6%
<b>SEGMENT OPERATING MARGIN</b>						
North America	6.5%	8.7%	8.8%	10.0%	8.9%	8.3%
International	0.0%	3.9%	2.6%	4.8%	6.1%	5.9%
Consolid. Segment Operating Margin	4.6%	6.9%	6.5%	7.9%	7.6%	7.3%

During Q204, gross margin for the International business was only 20% compared to 28% for the North America business, and Segment Operating Income margin was only 6% compared to 8% for North America. Bulls argue that AMZN has significant operating leverage. However, if growth continues to be driven by International business, further margin compression will eat into the potential operating leverage derived from the sales ramp-up. As of 2Q04, 43% of AMZN's

business is derived from International. By 4Q05, we estimate that the International business will account for about 49% of total sales.

AMZN has long benefited from being a first-mover in its books business. However, as AMZN grows through new product lines, it no longer has the first-mover advantage and must compete with established online retailers in that merchandise category. For example, AMZN entered the Jewelry business this April, competing with 5-year old online jeweler Blue Nile. AMZN intends to compete by offering extremely low prices, and has indicated that its gross margins in jewelry will be as low as 15% with diamond margins as low as 13%.

Increased competition has forced AMZN to offer significant discounts in its old and new markets alike. AMZN began its discounting campaign in July 2001, and now offers customers year-round free shipping and reduced prices. Super saver delivery was introduced in 2003 in the UK as well. Since many of AMZN's promotions would have already seen their one-year anniversaries, we think much of the incremental sales resulting from the promotions should have already occurred, and thus future comparisons will become more difficult.

3. Continued discounting and higher customer acquisition costs will drive margins down.

Gross margins declined 30 bps y/y to 24.6% due to lower pricing, free shipping and international expansion. Management warned that margin pressure should continue as it continues to offer price discounts and free shipping in order to compete. We agree this is necessary since AMZN's customers will expect low prices and free shipping to continue. However, continuing the worldwide, year-round free-shipping offers will further squeeze AMZN's margins. Management also indicated that the profit margins may be affected by its plans for a new development center and fulfillment center in Scotland. AMZN also intends to hire more computer scientists and software engineers to improve its technology and content.

During the last conference call, AMZN raised the upper range of its F2004 revenue guidance by \$75M, but did not raise the upper range of its earnings guidance, suggesting future margin compression.

4. Competition continues to intensify on multiple fronts.

As one of the early founders of e-commerce, AMZN benefits from a globally recognized brand name. However, we think the Amazon brand value carries less weight today than it did in the early days when online shopping was a

pastime for early adopters. As the internet becomes more ubiquitous, online shoppers have many more options and are inevitably taking on the characteristics of traditional brick-and-mortar shoppers seeking out the best deal.

AMZN is therefore facing increasing competition from mass retailers expanding their internet offerings, as well as from the increasing popularity of price-comparison intermediaries (such as shopping.com, nextag.com, bizrate.com, pricescan.com, pricegrabber.com and countless others). Accordingly to Media Metrix, while AMZN's July 2004 internet traffic declined 8% y/y to 33.8M visitors, mass retailer Wal-Mart attracted 16.5M internet users (24% increase y/y) and Target attracted 12.2M users (29% increase y/y). Also, approximately 38M internet users visited price aggregator sites during July 2004 (13% increase y/y). Shopping.com, the leading price aggregator site, saw a 26% increase in its internet traffic during this same period. Furthermore, Google is testing a price-comparison search engine called Froogle, and Yahoo has recently purchased Kelkoo, a leading European comparison shopping engine. On Froogle, even whimsical searches like "Easter Island moai statue" or "surfboard rug" instantaneously produced a nice assortment of options complete with photos. The increasing number of these websites will continue to put pressure on AMZN's gross margins as well as increase AMZN's customer acquisition cost.

Bulls point to improving internet usage and broadband adoption trends. During the twelve months ended August 2004, U.S. internet traffic increased 11% y/y and traffic to e-Commerce sites overall increased 15% y/y. However, we note that AMZN's U.S. internet traffic increased only 1% for this same period, whereas eBay's US traffic increased by 35%.

5. AMZN recently gained entry into China's e-commerce market, however, contribution to AMZN growth in the near term is likely to be inconsequential.

Entry into the mainland China online market is a critical component to AMZN geographic expansion strategy. In August 2004, AMZN made inroads into China through its \$75M acquisition of Joyo.com, China's largest online retailer of books, music and videos. Joyo will become AMZN's seventh global website. As online retailing in China is still a nascent industry, bulls think that AMZN will see increased growth rates because of this acquisition.

While we agree with the bulls that the Chinese e-commerce market will eventually become a huge opportunity, we think it will be many years before China's online retail market grows to become a meaningful opportunity. According to China Internet Network Information Center (CINIC), as of July 2004, China has 87M internet users (represents 28% y/y growth), of which 31M are broadband

users. The July 2004 growth rate has moderated from 49% as of July 2003 and 73% as of July 2002. CINIC also estimates that the number of internet users shopping online may increase by 190% over the coming year. Despite the healthy growth rate of internet users, we note that the primary goal of internet use in China is not for online shopping. According to CINIC's July 2004 sample study of 7,200 participants, 42% said their primary goal for accessing the internet was to "get information" and 35% said their primary goal was for "entertainment." Only 0.3% said their primary goal was for "online purchasing."

We think that online purchasing in China has not yet become mainstream because of the shortcomings of China's current e-commerce infrastructure. First, the country's mail delivery system is unreliable and the country has no credible nationwide alternative carrier like FedEx. Second, China's banking system is not equipped for online payment. Most Chinese still only use cash. Credit cards are not widely used, and the few with credit cards tend to be the older generation who do not use the internet. And finally, the average income in China is much lower than that in the U.S. According to Morgan Stanley, the average individual in China earns only \$1,062 annually on average, compared to \$37,312 per individual in the U.S. One of China's leading online retailer Dangdang.com has overcome China's structural obstacles by hiring a fleet of bicycle messengers to deliver the packages. The bike messengers receive either money order or cash on delivery and wire funds back to Dangdang. According to Dangdang, an average order is about \$10.

Because of the logistical problems described above, we think it will take several years before China has a nationwide infrastructure conducive to e-commerce. We think meaningful changes will take time to implement. In the meantime, Joyo is expected to generate up to \$35M of revenues this year, and revenues are expected to double in the next year. Even if we continue to double Joyo's run rate, it will be many years before volume from China generates substantial upside for AMZN.

Of course Amazon is not the first major player to enter China. At least two other Chinese Internet companies have been bought by a major U.S. player in the past two years. In June, Google bought a piece of Baidu, one of China's biggest search engines. Last November, Yahoo! acquired Chinese search outfit 3721, and eBay acquired Chinese auction site Eachnet in 2002. Previously, AMZN had unsuccessfully tried to purchase Dangdang.

6. AMZN's new A9.com search site is also unlikely to contribute significantly to near term revenue growth.

Last week, AMZN unveiled its A9.com search site which allows users to save past web searches and add personal notes, search Internet Movie Database, reference information from GuruNet.com, and use AMZN's "Search Inside the Book." We do not view A9 as any technological breakthrough, and wonder if users will even be inclined to switch from their current search sites (36% of searches are currently run on Google as of July 2004, according to Media Metrix). AMZN has been careful not to make A9.com appear predatory by pushing users to its AMZN retail sites. However, AMZN this week began offering 1.6% discounts on Amazon.com retail purchases.

Because the link to Amazon purchases from A9.com is currently planned to be subtle, and because it will be difficult to pull users away from the search sites they are already comfortable with, we do not expect A9.com to generate substantial incremental for AMZN in the near future. If the grander goal of A9.com is to grab a piece of the advertising revenues from the growing search market, we think AMZN still has a long way to go. AMZN is a tiny player, and considering that A9.com utilizes Google's search technology, we do not think AMZN is a strong contender. Its reliance on Google's technology could limit any potential significant growth in this market.

## 7. Risks to Bear Story.

*a. Improving free cash flow generation.* AMZN has historically been unable to generate free cash, and has cumulative FCF of negative \$471M from the company's inception to 2Q04. However, within the past year, AMZN has turned the corner. During the trailing twelve months (TTM) 2Q04, AMZN generated \$354M of FCF. This has steadily increased from F2003 FCF of \$346M. Because AMZN has very low inventory turns and negative working capital requirements, it can substantially add to cash flow as it ramps up revenue.

*b. Working capital is a source of cash.* AMZN generally receives cash from customers within 23 days of when product is received, and does not pay its suppliers until 44 days after product is received. This means that AMZN benefits from holding 21 days of operating cash. On average, AMZN inventory turns within 20 days.

*c. AMZN has considerable operating leverage.* Since AMZN currently only returns a 5%-7% operating margin, there is considerable operating leverage if AMZN grows its revenues and controls its costs. Every 1% additional operating margin results in \$0.16 of additional EPS. Alternatively, every \$43M of operating income results in an incremental \$0.10 per diluted share.

*d. Expansion into new geographies.* Aside from China, we do not know where AMZN intends to expand next. Successful entry into a new country could accelerate growth rates. However, we think a meaningful ramp-up will become increasingly more difficult since AMZN is already in many of the top e-commerce markets. According to Forrester Research, by 2006, North America will comprise 39% of the worldwide e-commerce market, Asia-Pacific will comprise 33% and Western Europe will comprise 25%. AMZN is already in three of the top four European markets (with the exception of Italy). As AMZN expands into smaller markets, incremental sales make less of an impact and the cost of build infrastructure may become disproportionately higher.

## 8. Financial Assumptions.

“Street” estimates for AMZN are based on “normalized” earnings, which exclude stock compensation expense, Other Operating Income/Expenses, and Non-Operating Gains and Losses. The normalized earnings are also tax-free estimates since AMZN has Federal NOL carryforwards of \$2.8B as of 6/30/04. We estimate normalized fully diluted EPS to be \$0.97 for F2004 and \$1.21 for F2005. Our earnings estimate is based on a revenue growth rate of 28% in F2004 and 17% in F2005, with operating margins of 6.4% and 6.7%, respectively (compared to 5.1% in F2003). These margins factor in some operating leverage gained from sales growth, offset by gross margin compression from discounting and cost increases in Technology and G&A.

We estimate free cash flow to be \$356M for F2004 and \$532M for F2005 (\$0.84 and \$1.25 per share, respectively). This assumes capex of \$80M in F2004 (in accordance with company guidance) and \$95M in F2005.

The following table shows our growth rate assumptions by geography and by product category:

<b>Y/Y % Revenue Growth</b>	<b>F2004E</b>	<b>F2005E</b>	<b>3Q04E</b>	<b>4Q04E</b>	<b>1Q05E</b>	<b>2Q05E</b>
<b>NORTH AMERICA</b>						
Media	10.3%	8.5%	9.0%	8.5%	8.5%	8.5%
Electronics and General Merchandise	25.5%	19.3%	27.0%	20.0%	23.0%	23.0%
Total North America	14.0%	11.3%	13.1%	11.6%	12.0%	12.2%
<b>INTERNATIONAL</b>						
Media	33.7%	14.5%	30.0%	20.0%	18.0%	15.0%
Electronics and General Merchandise	190.5%	58.1%	190.0%	150.0%	100.0%	80.0%
Total International	51.3%	24.0%	48.9%	39.6%	30.9%	25.9%
<b>CONSOLIDATED</b>						
Media	20.6%	11.4%	18.0%	14.0%	13.2%	11.6%
Electronics and General Merchandise	59.1%	33.7%	62.3%	53.2%	47.9%	40.4%
Total Consolidated	28.2%	17.0%	26.5%	23.2%	20.4%	18.1%

Note: The “Other” category comprises only 1.8% of revenues, and is therefore not shown in the above table.

*Gross and Contribution Margin.* We assume gross margins will be 23.3% and 22.9% for F2004 and F2005, respectively. We also estimate a Contribution margin that includes fulfillment costs, unlike the gross margin, and which we think is a better indication of true cost of sales. We assumed AMZN's contribution margin to be 14.9% for both F2004 and F2005. This compares to a contribution margin of 15.5% for 1H04. We have assumed a slight decline due to margin pressure as AMZN continues to offer free shipping and further discounts/promotions.

*Marketing.* AMZN's marketing expenses are primarily focused on improving the customer experience in order to drive word-of-mouth promotion and repeat customer visits. Marketing expense has increased substantially during 1H04, up 22% y/y. The fact that marketing expense has trended toward a new high is an indication of the increased marketing effort required of AMZN to acquire/retain customers against increasing competition. We project marketing expense will be 2.0% of revenues during 2H04, which represents an increase of 13% in dollars compared to the 22% increase during 1H04. We project F2005 marketing expense to be 2.1% of total revenues, a 14% increase in dollars from F2004 levels.

*Technology and Content.* Product development expenses increased by 11% from 1H03 to 1H04, at least \$5M per quarter y/y. For 2H04, we assume costs stay at 3.4% of revenues, consistent with 2H03. This represents \$25M more in costs, and is 23% higher compared to 2H03. We think this ramp-up is reasonable given management's guidance that its technology cost will continue to increase as it hires more computer scientists and engineers to enhance its technology and content. We project another increase of \$34M for F2005, which represents 3.5% of revenues compared to 3.6% of revenues of F2004. This is consistent with management's guidance that technology costs will increase in absolute dollars but will be the same or lower as a percentage of revenues.

*General and Administrative.* G&A increased 27% y/y for 1H04. As with marketing expenses, we note there is a ramp up in the average level of G&A expenses. During 1Q04, G&A increased by \$4M from a range of \$21-\$23M per quarter during the past year. We estimate that 2H04 G&A expense will similarly increase 27% from 2H03 levels. This represents 1.5% of revenues, as consistent with 2H2003. For F2005, we estimate G&A expenses will be 1.6% of revenues, compared to 1.7% during F2004. This represents a growth rate of 12% in dollars from F2004. Management indicated that G&A levels will be higher due to fixed costs associated with a new development center and a UK fulfillment center in Scotland. The fulfillment center will employ over 300 employees, and the new

“Amazon Development Centre” will house scores of computer scientist and software engineers focusing on building technological enhancements for AMZN’s website.

*Other.* AMZN intends to streamline its operations in France, and in doing so, expects to take a charge of \$5M in 3Q04. We have include this cost in our GAAP estimates but have excluded it from our normalized EPS estimates.

## 9. Valuation.

Despite decelerating growth and margin pressure, AMZN continues to be valued as a high-growth company. Subsequent to a disappointing 2Q04 earnings report, AMZN’s share price fell 23% to a low of \$35.32 from \$45.82 prior to the earnings release. Since then, the shares have regained some ground to \$40.94. Based on AMZN’s decelerating growth rate, as well as potential future margin compression, we argue that AMZN’s earnings multiple should contract in line with it decelerating growth rate.

AMZN currently trades at 30x consensus F2005 EPS of \$1.36. We expect that AMZN’s earnings and revenue growth rates will come in below consensus. If this occurs, we think AMZN’s multiple should contract slightly. We think a 25x multiple is a reasonable multiple given our estimated F2005 growth rate of 24%. This multiple is generous considering our estimate of AMZN’s long-term earnings growth rate is below 20%. Applying a 25x earnings multiple to our F2005 estimated EPS of \$1.21 results in a share price of \$30.

We also used FCF as a second metric for our valuation. AMZN management stresses its focus on long-term, sustainable growth in FCF, and we agree that FCF is the best measure of a company’s profitability. Applying a 25x multiple to our F2005 FCF estimate of \$532M, or \$1.25 per diluted share, results in a share price of \$31. Considering both the EPS and FCF methods, we will set our initial target price at \$30, which represents a 27% downside opportunity.

## 10. Financial Projections.

INCOME STATEMENT (\$M)	1Q04	2Q04	3Q04E	4Q04E	1Q05E	2Q05E	3Q05E	4Q05E
Net Sales	1,530.3	1,387.3	1,434.8	2,396.3	1,842.9	1,638.5	1,667.3	2,746.8
Cost of Sales	1,169.5	1,046.3	1,090.4	1,869.1	1,400.6	1,253.4	1,275.5	2,156.3
Fulfillment	127.7	122.7	120.5	198.9	147.4	131.1	133.4	219.7
Marketing	33.6	31.8	33.0	45.5	42.4	37.7	36.7	46.7
Technology and Content	55.1	58.5	63.1	67.1	68.2	70.5	70.0	68.7
General and Administrative	27.4	27.2	28.7	28.8	29.5	31.1	31.7	33.0
Stock-Based Compensation	7.1	21.7	21.5	24.0	20.3	19.7	20.0	24.7
Other Operating Expense (Income)	(0.5)	(7.2)	5.0	-	-	-	-	-
Total Operating Expense	1,419.9	1,301.1	1,362.3	2,233.4	1,708.4	1,543.4	1,567.3	2,549.0
Operating Income	110.4	86.3	72.5	163.0	134.5	95.0	100.0	197.8
Interest Expense	(27.7)	(26.1)	(26.3)	(26.7)	(27.2)	(27.6)	(28.0)	(28.5)
Interest Income	5.6	5.3	5.4	5.6	5.8	6.0	6.2	6.5
Other Income	2.5	(5.4)	-	-	-	-	-	-
Gains & Losses, Net	20.4	16.3	-	-	-	-	-	-
Net Income Before Taxes	111.1	76.5	51.6	141.8	113.2	73.4	78.2	175.8
Provision for Income Taxes	-	-	-	-	-	-	-	-
Net Income	111.1	76.5	51.6	141.8	113.2	73.4	78.2	175.8
Basic Weighted Average Shares	403.5	405.3	407.3	409.3	411.3	413.3	415.3	417.3
Basic EPS	0.28	0.19	0.13	0.35	0.28	0.18	0.19	0.42
Diluted Weighted Average Shares	424.5	424.7	426.7	428.7	430.7	432.7	434.7	436.7
Diluted EPS	0.26	0.18	0.12	0.33	0.26	0.17	0.18	0.40
Normalized Net Income <sup>(1)</sup>	97.3	74.7	78.1	165.8	133.5	93.1	98.2	200.5
Normalized Diluted EPS <sup>(1)</sup>	0.23	0.18	0.18	0.39	0.31	0.22	0.23	0.46

(1) Normalized Net Income excludes Stock-Based Comp, Other Operating Expense (Income), and Gains & Losses, Net.

Y/Y CHANGE	1Q04	2Q04	3Q04E	4Q04E	1Q05E	2Q05E	3Q05E	4Q05E
Net Sales	41%	26%	26%	23%	20%	18%	16%	15%
Cost of Sales	44%	27%	28%	23%	20%	20%	17%	15%
Fulfillment	23%	14%	13%	25%	15%	7%	11%	10%
Marketing	19%	26%	14%	13%	26%	18%	11%	3%
Technology and Content	10%	12%	17%	30%	24%	20%	11%	2%
General and Administrative	30%	25%	28%	25%	8%	14%	10%	15%
Stock-Based Compensation	-74%	-11%	3%	59%	185%	-9%	-7%	3%
Other Operating Expense (Income)	-159%	-883%	536%	Na	na	na	na	na
Total Operating Expense	36%	23%	26%	24%	20%	19%	15%	14%
Operating Income	182%	106%	40%	18%	22%	10%	38%	21%
Interest Expense	-24%	-24%	-12%	-9%	-2%	6%	7%	7%
Interest Income	-15%	-8%	25%	5%	4%	13%	15%	16%
Other Income	-12%	-245%	na	Na	na	na	na	na
Gains & Losses, Net	-192%	-127%	na	Na	na	na	na	na
Net Income Before Taxes	-1198%	-277%	232%	93%	2%	-4%	52%	24%
Provision for Income Taxes	na	na	na	Na	na	na	na	na
Net Income	-1198%	-277%	232%	94%	2%	-4%	52%	24%
Basic Weighted Average Shares	4%	3%	2%	2%	2%	2%	2%	2%
Basic EPS	-1033%	-273%	217%	93%	-2%	-6%	49%	22%
Diluted Weighted Average Shares	9%	8%	1%	1%	1%	2%	2%	2%
Diluted EPS	-967%	-264%	202%	95%	1%	-6%	49%	22%
Normalized Net Income <sup>(1)</sup>	141%	77%	61%	33%	37%	25%	26%	21%
Normalized Diluted EPS <sup>(1)</sup>	121%	64%	60%	32%	35%	22%	23%	19%

(1) Normalized Net Income excludes Stock-Based Comp, Other Operating Expense (Income), and Gains & Losses, Net.

% OF REVENUE	1Q04	2Q04	3Q04E	4Q04E	1Q05E	2Q05E	3Q05E	4Q05E
Net Sales	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Cost of Sales	76.4%	75.4%	76.0%	78.0%	76.0%	76.5%	76.5%	78.5%
Fulfillment	8.3%	8.8%	8.4%	8.3%	8.0%	8.0%	8.0%	8.0%
Marketing	2.2%	2.3%	2.3%	1.9%	2.3%	2.3%	2.2%	1.7%
Technology and Content	3.6%	4.2%	4.4%	2.8%	3.7%	4.3%	4.2%	2.5%
General and Administrative	1.8%	2.0%	2.0%	1.2%	1.6%	1.9%	1.9%	1.2%
Stock-Based Compensation	0.5%	1.6%	1.5%	1.0%	1.1%	1.2%	1.2%	0.9%
Other Operating Expense (Income)	0.0%	-0.5%	0.3%	0.0%	0.0%	0.0%	0.0%	0.0%
Total Operating Expense	92.8%	93.8%	94.9%	93.2%	92.7%	94.2%	94.0%	92.8%
Operating Income	7.2%	6.2%	5.1%	6.8%	7.3%	5.8%	6.0%	7.2%
Interest Expense	-1.8%	-1.9%	-1.8%	-1.1%	-1.5%	-1.7%	-1.7%	-1.0%
Interest Income	0.4%	0.4%	0.4%	0.2%	0.3%	0.4%	0.4%	0.2%
Other Income	0.2%	-0.4%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Gains & Losses, Net	1.3%	1.2%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Net Income Before Taxes	7.3%	5.5%	3.6%	5.9%	6.1%	4.5%	4.7%	6.4%
Provision for Income Taxes	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Net Income	7.3%	5.5%	3.6%	5.9%	6.1%	4.5%	4.7%	6.4%
Normalized Net Income <sup>(1)</sup>	6.4%	5.4%	5.4%	6.9%	7.2%	5.7%	5.9%	7.3%

(1) Normalized Net Income excludes Stock-based Comp, Other Operating Expense (Income), and Gains & Losses, Net.

INCOME STATEMENT (\$M)	F2003	F2004E	F2005E
Net Sales	5,263.7	6,748.8	7,895.5
Cost of Sales	4,006.5	5,175.4	6,085.8
Fulfillment	477.0	569.8	631.6
Marketing	122.8	144.0	163.4
Technology and Content	207.8	243.8	277.3
General and Administrative	88.3	112.1	125.3
Stock-Based Compensation	87.8	74.3	84.7
Other Operating Expense (Income)	2.8	(2.7)	-
Restructuring	0.1	-	-
Total Operating Expense	4,993.1	6,316.6	7,368.2
Operating Income	270.6	432.1	527.4
Interest Expense	(130.0)	(106.8)	(111.3)
Interest Income	22.0	21.9	24.5
Other Income	2.8	(2.8)	-
Gains & Losses, Net	(129.7)	36.7	-
Net Income Before Taxes	35.7	381.1	440.6
Provision for Income Taxes	-	-	-
Net Income After Taxes	35.7	381.1	440.6
Equity in Loss	(0.4)	-	-
Net Income	35.3	381.1	440.6
Basic Weighted Average Shares	395.5	404.0	414.7
Basic EPS	0.09	0.94	1.06
Diluted Weighted Average Shares	419.4	427.3	434.1
Diluted EPS	0.08	0.89	1.01
Normalized Net Income <sup>(1)</sup>	255.4	416.0	525.3
Normalized Diluted EPS <sup>(1)</sup>	0.61	0.97	1.21

(1) Normalized Net Income excludes Stock-Based Compensation, Other Operating Expense (Income), and Gains & Losses, Net.

Y/Y CHANGE	F2003	F2004E	F2005E
Net Sales	34%	28%	17%
Cost of Sales	36%	29%	18%
Fulfillment	22%	19%	11%
Marketing	-2%	17%	14%
Technology and Content	-4%	17%	14%
General and Administrative	12%	27%	12%
Stock-Based Compensation	27%	-15%	14%
Other Operating Expense (Income)	-50%	-198%	-100%
Restructuring	-100%	-100%	na
Total Operating Expense	29%	27%	17%
Operating Income	322%	60%	22%
Interest Expense	-9%	-18%	4%
Interest Income	-7%	0%	12%
Other Income	-50%	-201%	-100%
Gains & Losses, Net	35%	-128%	-100%
Net Income Before Taxes	-125%	967%	16%
Provision for Income Taxes	Na	na	na
Net Income After Taxes	-125%	967%	16%
Equity in Loss	-90%	-100%	na
Net Income	-124%	980%	16%
Basic Weighted Average Shares	5%	2%	3%
Basic EPS	-123%	948%	13%
Diluted Weighted Average Shares	11%	2%	2%
Diluted EPS	-120%	1015%	14%
Normalized Net Income <sup>(1)</sup>	1086%	63%	26%
Normalized Diluted EPS <sup>(1)</sup>	970%	60%	24%

(1) Normalized Net Income excludes Stock-Based Compensation, Other Operating Expense (Income), and Gains & Losses, Net.

% OF REVENUE	F2003	F2004E	F2005E
Net Sales	100.0%	100.0%	100.0%
Cost of Sales	76.1%	76.7%	77.1%
Fulfillment	9.1%	8.4%	8.0%
Marketing	2.3%	2.1%	2.1%
Technology and Content	3.9%	3.6%	3.5%
General and Administrative	1.7%	1.7%	1.6%
Stock-Based Compensation	1.7%	1.1%	1.1%
Other Operating Expense (Income)	0.1%	0.0%	0.0%
Restructuring	0.0%	0.0%	0.0%
Total Operating Expense	94.9%	93.6%	93.3%
Operating Income	5.1%	6.4%	6.7%
Interest Expense	-2.5%	-1.6%	-1.4%
Interest Income	0.4%	0.3%	0.3%
Other Income	0.1%	0.0%	0.0%
Gains & Losses, Net	-2.5%	0.5%	0.0%
Net Income Before Taxes	0.7%	5.6%	5.6%
Provision for Income Taxes	0.0%	0.0%	0.0%
Net Income After Taxes	0.7%	5.6%	5.6%
Equity in Loss	0.0%	0.0%	0.0%
Net Income	0.7%	5.6%	5.6%
Normalized Net Income <sup>(1)</sup>	4.9%	6.2%	6.7%

(1) Normalized Net Income excludes Stock-Based Compensation, Other Operating Expense (Income), and Gains & Losses, Net.