

Hyperion Asset Management

Company Profile Amazon.com, Inc.

Main Business Activities

Amazon Inc. (Amazon) has two primary businesses. Firstly, as a global e-commerce business and secondly, it has developed a dominant position by establishing a first mover advantage in the cloud computing industry. The majority of Amazon's revenues come from its e-commerce Marketplace businesses (comprising 88% of revenue), however the cloud computing business is a much higher margin business and as at FY20 contributed to 59% of EBIT (Earnings Before Interest and Taxes).

In terms of Amazon's e-commerce business, the company operates 19 marketplaces globally where it has a Prime membership in 22 countries. Amazon has established over 400 million square feet of logistics space to service its global marketplaces. Amazon has the dominant market share in U.S. e-commerce and has a fast growing footprint in International markets. Amazon's growth has been driven by its first mover advantage and its obsession with the customer. The continual improvement in the value proposition for customers has accelerated the structural shift of products sold online. On Amazon's marketplaces, it sells goods on both a first-party basis, as well as a third-party basis therefore allowing other parties to sell on its platform. Sales from third parties now make up over 55% of total paid units. Over 50% of these sellers use Fulfillment by Amazon (FBA), allowing merchants to outsource components of their operations. Amazon monetises sales from merchants through both a commission fee on sale as well as revenue for merchants who use their FBA services. Amazon also charge consumers a membership fee to become Prime members, which provides a number of benefits such as free one day shipping and free access to a library of music, movies, e-books and photo storage. There are now over 200 million Prime members globally which provides a large and growing high margin revenue stream for Amazon. Additional revenue streams for Amazon include their advertising business, allowing merchants to advertise on their marketplaces and leverage the significant consumer traffic.

Amazon Web Services (AWS) is a public cloud provider that enables companies of all sizes to outsource functions of their information technology (IT) (including servers, network hardware, software and most IT staff) as well as scaling both processing and storage capacity up or down as required. The costs incurred for AWS customers are predominately driven by usage.

Key Value Proposition to Customers

Amazon's marketplace businesses offer consumers the most convenient, cheapest and broadest selection of products a consumer can find (particularly in North America). For the cost of US\$119 per year (in North America), a Prime membership offers consumers significant value including free one-day shipping, Prime Video and Prime Music among others. The Amazon brand is trusted and they are known for their customer obsession. Customers have high confidence when shopping online that they will receive the correct products they purchased in the quickest time frame.

AWS is a public cloud provider that enables companies of all sizes to essentially outsource IT (including servers, network hardware, software and most IT staff) as well as scaling both processing and storage capacity up or down as required. The value proposition to customers is the flexibility, efficiency and cost effectiveness to spin up virtual networks rather than relying on on-premise hardware. AWS has developed a first mover advantage and has the broadest functionality and feature set that is available in the market. As with their e-commerce marketplace business, AWS offers customers a constant innovation and a strong product roadmap which is important for businesses when partnering with a cloud provider.

Sustainable Competitive Advantages and Outlook

The sustainable competitive advantage of the e-commerce Marketplace businesses is through offering the broadest selection of products a consumer can find, at attractive prices and with the most convenience. There are numerous aspects to Amazon's competitive advantage including the Amazon Prime offering, Fulfillment by Amazon (FBA) and the continual obsession to improve the value proposition to customers. Amazon's Prime membership model provides an incentive for consumers to keep shopping at Amazon due to their paid membership fee, as well as accessing benefits such as free shipping. The Amazon brand has strong consumer trust with Prime members not price matching, and simply searching for their product on Amazon without checking competitor prices. The FBA model allows merchants to solely focus on their product and allows them to outsource the customer acquisition and logistics component of their business. There is a strong network effect as the number of FBA merchants grow, which leads to consumer growth due to deeper product selection, leading to more merchants selling into a larger customer base. Amazon continue to improve the customer value proposition and reducing friction points for shopping online. This is evidenced by the introduction of free one day shipping for Prime members, which while costing Amazon billions in incremental cost, benefits the consumer which leads to strong top line revenue growth.

AWS enables companies to shift their workloads into the cloud. The value proposition to corporates includes:

- 1) The ability to reduce costs (less internal IT staff and lack of infrastructure required);
- 2) Increase productivity with variable processing and storage capacity immediately available; and
- 3) To always be using the most up to date technology.

Amazon have a first mover advantage in the cloud computing market and have a clear lead in terms of the level of features and functionality that they can offer customers. The industry is very capital intensive and has strong barriers to entry and therefore it is very unlikely that new entrants will be able to effectively compete. Hyperion expects Western markets will be dominated by AWS, Microsoft's Azure and Google Cloud.

Overall Company Growth Options

The overall growth opportunities in Amazon's marketplace businesses are high. Amazon has benefited from the structural shift to e-commerce which has led to a five year revenue compound annual growth rate (CAGR) of 30% to FY20 (in North America). The COVID-19 pandemic has accelerated the transition to online commerce though there still remains a long runway ahead. Online commerce penetration in FY19 was approximately 11% and this accelerated to 14% at FY20. There is substantial runway remaining, considering China's online retail sales penetration is over 30%. Global e-commerce makes up approximately 17% of retail sales (FY20). Hyperion believe e-commerce adoption is likely to accelerate near term driven by large reductions in friction (ease of use and payment innovations), increasing internet connectivity (particularly in emerging markets), growth in mobile phone usage and improved delivery times (with Amazon transitioning to one-day delivery). Outside of GMV growth, Amazon has a large market opportunity from seller services (FBA), subscription revenue (growth in Prime members) and advertising revenue. All of these divisions have been growing at faster rates than GMV. In terms of International markets, Amazon is at a much earlier stage than it is in North America, and Hyperion believe it is likely that revenue for the International division will grow at higher rates as the company's presence and product mix expands. Amazon's share of US retail sales is only approximately 7% while Amazon's share of global retail sales (excluding the U.S.) is approximately 0.8%.

In terms of cloud computing, the structural shift away from on-premise remains at an early stage. A Microsoft Corporation statement in 2020 revealed that as at FY20, there are only approximately 20% of workloads that have transitioned to the cloud. AWS' market share in the Internet-as-a-Service (IaaS)/Platform-as-a-Service (PaaS) market is 39%. The migration to public cloud computing will be a mega-trend over decades as enterprises slowly move off legacy systems. Hyperion believe the COVID-19 pandemic has accelerated this trend.

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