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## Amazon.com (AMZN - NEUTRAL): Amazon Announces Prime Membership Increase of \$20 to \$99; Maintain NEUTRAL, \$330 PT

Price: \$370.78

12-Month Price Target: \$330

- **On Thursday, Amazon announced a price increase for Prime membership to \$99 annually.** The \$20 increase was at the low end of the \$20 – 40 increase Amazon suggested during its Q4:13 conference call. While the company did not specifically provide a reason for the increase when it discussed the notion with investors earlier this year, we believe that the price increase is intended to offset increased usage of Prime and higher fuel costs.
- **The price increase takes effect for existing members on renewals after April 17, and will apply to all new members.** We estimate that there are approximately 25 million Prime members; the price increase will add roughly \$500 million to annualized revenue and operating profit when fully implemented, as it would require no additional expense. However, we think that Amazon intends to redeploy the incremental revenue into an expanded service offering for Prime members, most likely in the form of additions to the content catalog for its Amazon Prime Instant Video offering (provided free of charge to all Prime members) or in the form of same-day or next-day shipping on some items. We think it is exceedingly unlikely that Amazon will increase price on Prime without offering something of value to its Prime members, and we do not expect the company to pass through any incremental profit over the near term to investors. We estimate that the average Prime member receives 20 packages per year, and we believe that the prior \$79 fee barely covered the incremental cost of expedited shipping. We estimate that Amazon spends in excess of \$1 billion per year on streaming content, or an estimated \$40 per Prime member, suggesting that even with the price increase, the company will not cover its direct costs in providing the service.
- **We estimate that Prime has 25 million members, and expect it to grow by at least 5 million annually, even with a price increase.** We had previously expected Prime membership growth to accelerate in the coming quarters on a year-over-year basis, and although the price increase may stifle a portion of that growth, we think that Amazon fully expects to continue the momentum it saw in 2013. Prime membership was so popular this past holiday season that the company limited new signups during peak periods to ensure that the surge in new membership did not impact current members' service.
- **Since introducing Prime nine years ago at \$79, Amazon had not increased prices (until today) while increasing the number of items available for Prime free, two-day shipping from one million to over 20 million.** We believe Amazon will see only limited attrition in Prime members from the price increase, as the value proposition of a Prime membership continues to grow as Amazon adds more digital content and Sunday shipping through its partnership with the U.S. Postal Service. In our view, Prime members perceive great value in the free shipping feature, and over time, we expect them to perceive incremental value as Amazon Prime Instant Video builds its content catalog.
- **Maintaining our NEUTRAL rating and \$330 price target.** Our PT reflects a P/E multiple of 50x our hypothetical FY:19 EPS of \$8.38, discounted back five years. Our rating is based on our assessment that Amazon is unlikely to provide investors with a strategy road map. While recent announcements have given us increased visibility into Amazon's revenue growth, we are not convinced that the company will share sufficient details about spending plans to allow us to accurately model profit growth, and it may take time before EPS grows sufficiently to justify its share price.
- **Investment Thesis:** Amazon is a dominant online retailer well on its way to becoming one of the world's largest retailers, in our view. We believe the company enjoys considerable advantages over its brick-and-mortar competitors, due to its low direct overhead. Amazon management is quite ambitious, expanding into expensive digital media through its Kindle hardware and Prime video streaming, depressing the company's earnings power. Similarly, the expansion of Amazon Web Services has thus far been quite costly, although we think that AWS is at a tipping point and will generate significant leverage going forward. In order to take a position in Amazon, we believe investors must make a leap of faith that its revenues will continue to grow and will generate high contribution margin; we have made the leap of faith on revenues, but the lack of visibility on contribution margin gives us pause, and we prefer to stay on the sidelines. Accordingly, we are maintaining our NEUTRAL rating.
- Risks to the attainment of our share price target include a lack of financial visibility, increasing competition, changes in consumer preferences, changes to the terms or economics of its agreements with its customers or suppliers, dependence on its shipping partners, macroeconomic factors, an evolving tax environment, and legal, regulatory, and security risks, among other factors.

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| Company    | Disclosure |
|------------|------------|
| Amazon.com | 1          |

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1) 09/10/13  
NEUTRAL \$330



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