Analysis: As growth wanes, Amazon begins to show Wall Street the money

Alistair Barr, Reuters

(Reuters) - After a spending spree in recent years pushed Amazon.com Inc's net results into the loss column, investors are betting that the company is tightening the purse strings and focusing on delivering a solid profit.

Investors have watched with growing consternation since 2010, as the world's biggest online retailer spent billions erecting warehouses, amassing computer servers, buying video content and manufacturing tablets. Analysts say Amazon is emerging from that supercharged investment phase just as growth of its core retail [1] business [2] slows.

On Tuesday, it blew past expectations for quarterly operating income and gross margins. That propped up the bull case that the company has put in place many of the necessary pieces to its profit puzzle.

Despite missing revenue expectations for the crucial holiday season, Amazon shares set a record in late trading on Tuesday after the results. The stock was up almost 5 percent on Wednesday and down 1 percent at $270.17 in morning action on Thursday.

"When the investment phase winds down, there will be dramatic room for margin expansion," said Mark Mahaney, an analyst at RBC Capital Markets [3]. "Whether we're at the end I don't know for sure, and the company is not signaling that. But my guess is that we are."

Year-over-year expense growth peaked in the middle of 2011 at 64 percent. In the fourth-quarter of 2012, expenses were up 42 percent compared to a year earlier, according to Matt Nemer, an analyst at Wells Fargo.

Tellingly, fourth-quarter 2012 expenses grew more slowly than gross profits for the first time in 10 quarters, he noted.

"What investors are buying now is the profit that will come as Amazon comes out of its current investment cycle," he said.

LEVERAGE

What gets Wall Street excited about Amazon is leverage - the word analysts use to describe earnings [4] growth that's possible once a company has finished building a business and is ready to funnel more revenue through it.

"They've made these investments in front of the growth and now they can grow into the infrastructure that they've built," said Steve Weinstein, senior Internet analyst at ITG Investment Research. "For each extra dollar of revenue, the profitability will increase."

Amazon's Kindle e-book business is a good example.

It had to spend heavily to develop software [5] and hardware to make the e-book buying experience quick and seamless for customers. It also had to invest in data centers and lots of servers to process e-book purchases and send digital copies to millions of devices, Weinstein explained.

Much of this leg work was complete and it will cost relatively little to handle higher e-book volumes, he said.

The process may be similar with other Amazon businesses, such as the online marketplace for third-party sellers called 3P, and AWS, which are growing rapidly, Weinstein added.

A comparison of Amazon's North American business with its younger international operations shows the potential for profit. In North America, operating profit margins reached 9 percent in 2003, but then fell as the company spent heavily to build a big network of fulfillment centers.

Now that Amazon has fulfillment centers closer to more customers, the cost of shipping is falling, boosting profit again. In the fourth quarter of 2012, operating margins were at 5 percent, almost double a year earlier.

"This part of the business could get to 7 percent operating margins in the future," Nemer said.

Amazon's international operations generated operating profit margins of more than 7 percent in 2009, but last year the company barely broke even overseas as the company expanded into new countries such as Brazil [6] and Spain, Nemer said.

"Amazon is investing a lot of money upfront to build new websites and distribution in these countries," Nemer said. "It's amazingly costly and dilutive to earnings [7] initially."

He estimated that older overseas markets [3] such as Britain, Germany [8] and Japan [9] still generate margins of 6 or 7 percent.

Still, Amazon's valuation is a lot higher than other major technology companies, notably longtime investor darling Apple Inc. That gives some investors pause.

Amazon shares recently traded at a whopping 156 times forecast 2013 profit, while Apple stock sold for just 10 times estimated earnings this year, according to Thomson Reuters data.

But such metrics rely on net income, which for Amazon is depressed by its huge investments in recent years.

"With that in mind, the valuation all of a sudden looks pretty reasonable," Nemer said.

(Editing by Edwin Chan and David Gregorio)

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