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# Amazon: The Most Undervalued Company, But Only For Long-Term Investors

Nov. 09, 2021 2:57 PM ET | [Amazon.com, Inc. \(AMZN\)](#) | 18 Comments | 15 Likes

## Summary

- Amazon's free cash flow has been steadily declining for the last three quarters. For the short-term investor, this is a problem.
- Roughly speaking, there were two alternatives: to worsen either the quality of service or free cash flow. The company chose the second option, and long-term investors should welcome this.
- Amazon is actively investing in its future and its key high-margin directions are demonstrating accelerating exponential growth.
- Despite the mixed quarterly results, the company's capitalization will grow.



AdrianHancu/iStock Editorial via Getty Images

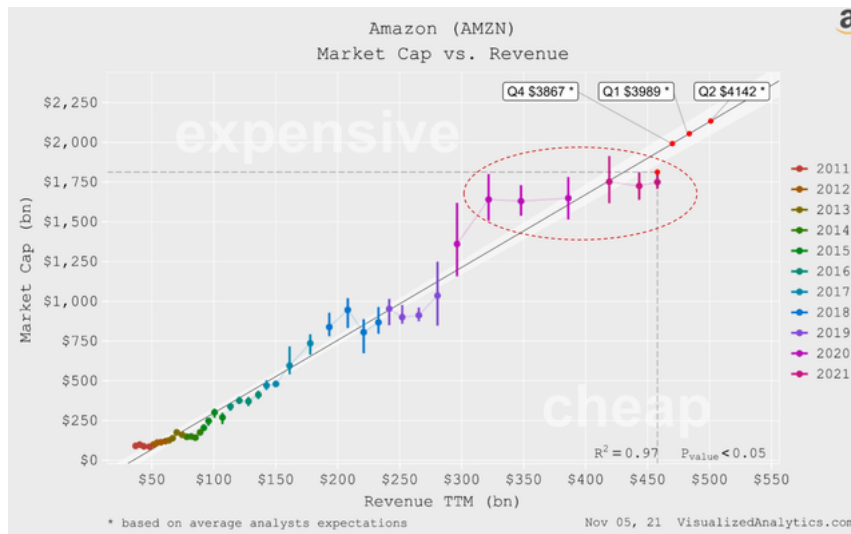
## Thesis

Amazon (NASDAQ:[AMZN](#)) missed revenue and EPS estimates, dropping the stock down on earnings day. In addition, the company's free cash flow turned negative. But by and large, this should be of interest only to short-term investors. From the perspective of a long-term investor, the last quarterly report was just superb.

## A rough look at Amazon's financial results

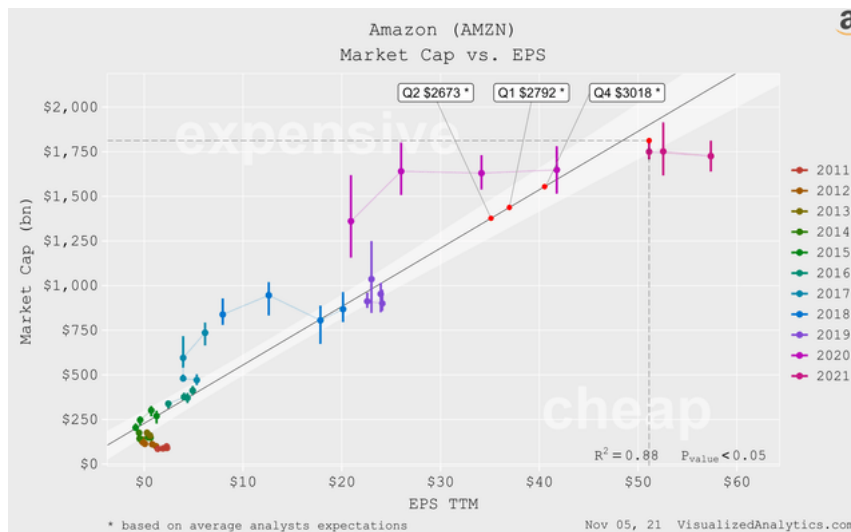
Quarterly financial results are difficult to assess correctly outside the context of their impact on the company's market price. Therefore, personally, every time I first look at the following three graphs.

Considering the nature of the long-term relationship between Amazon's capitalization and revenue, the last quarter's result only confirmed the company's undervalued state. Moreover, an interesting detail catches the eye. The company's revenue TTM in absolute terms for the last six quarters grew by 42%. *During the same period, the capitalization of the company showed practically no growth. Given that the current forecast suggests further revenue growth, the idea that Amazon is undervalued seems realistic.*



Source: [visualizedanalytics.com](https://visualizedanalytics.com)

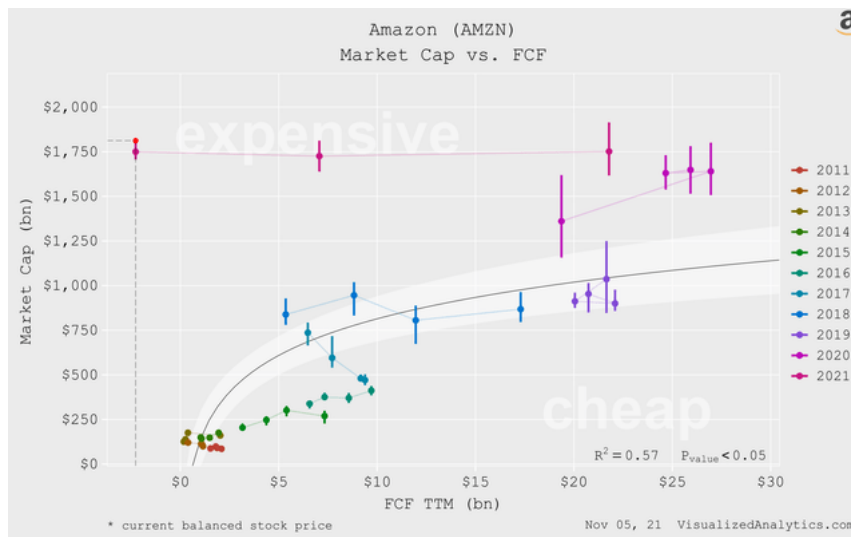
Based on the long-term relationship between the EPS TTM absolute size and the company's capitalization, Amazon's current price is balanced:



Source: [visualizedanalytics.com](https://visualizedanalytics.com)

But, if we take the analysts' average expectations as a basis, within the bounds of this model the company's balanced price per share in Q2 2022 will be around \$2700. However, don't take this number literally. At the very least, it should be noted that the quality of this model is worse than the previous one. *But the very fact that EPS is expected to decline amid rising revenues indicates a decline in margins. We'll come back to this later.*

And finally, let's consider the third model, in which FCF plays the role of an independent variable:

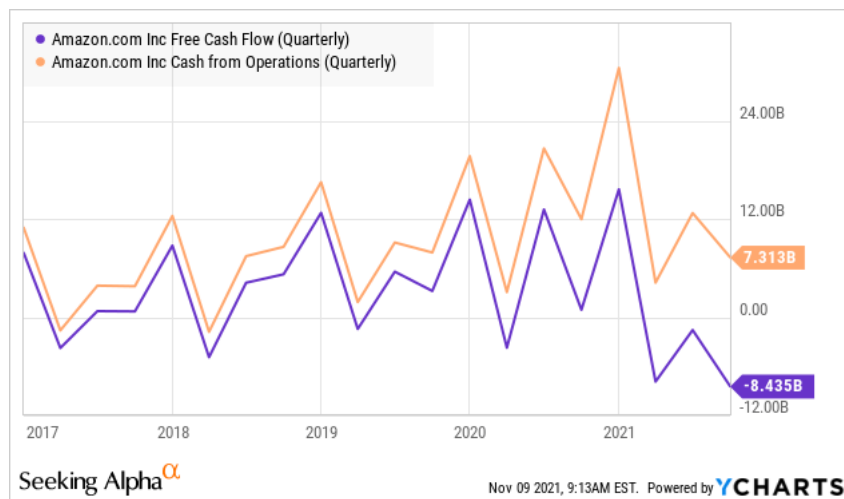


Source: [visualizedanalytics.com](https://visualizedanalytics.com)

As you can see, in this case the situation is quite negative. The company's free cash flow has been steadily declining for the last three quarters, and this already requires a separate study.

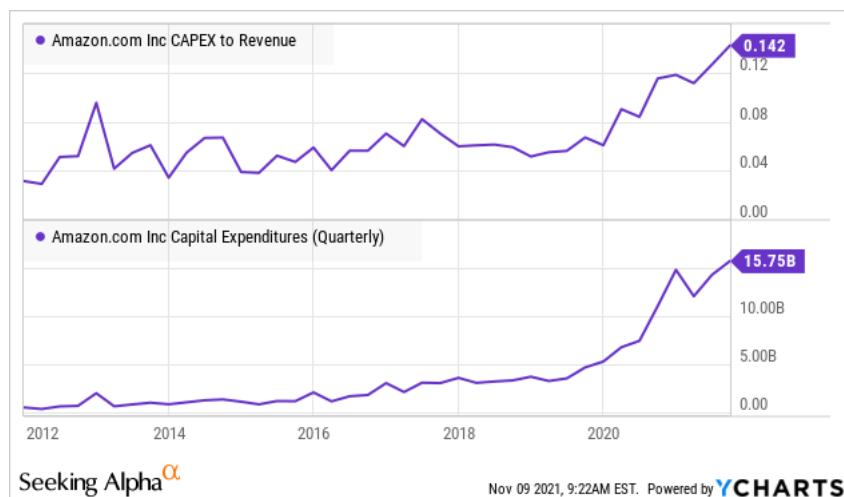
### What's wrong with FCF?

We should start with the fact that operating cash flow, in contrast to free cash flow, in the last quarter was generally at an acceptable level. The difference between the two is capital expenditure. This is the first reason for the decline in free cash flow.



Data by YCharts

Indeed, since 2020 (actually since the beginning of the pandemic) the company has shown an unprecedented increase in capital expenditures, which accounted for 14.2% of revenue in the last quarter:



Data by YCharts

Here's how the CFO comments on this process:

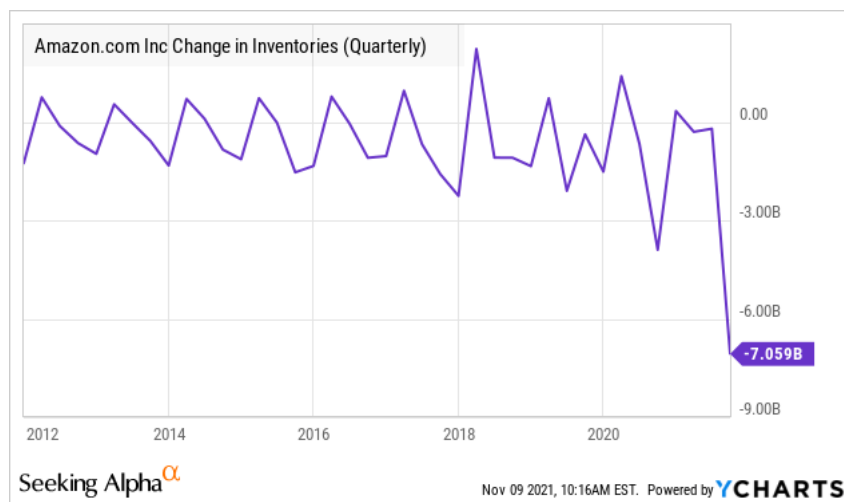
...We made strong progress in Q3 to build and open new facilities. And as a result, for the first time since the pandemic began, **we're no longer capacity constrained for fiscal space in the network.** September alone, we brought online more than 100 new buildings in the United States, including fulfillment centers, source centers, and last-mile delivery stations.

For the year, we expect our 2021 footprint additions to exceed last year's buildout, which was also significant. Put this in perspective, we are on track to double our fulfillment network over the two-year period since the pandemic's early days...

Source: *Amazon Q3 2021 Results - Earnings Call Transcript*

So, the rise in capital spending was the company's natural response to the challenges posed by the pandemic. This is a compulsory measure designed to ensure the maintenance of a high level of customer service in the changed conditions. *Roughly speaking, there were two alternatives: to worsen either the quality of service or free cash flow. The company chose the second option, and long-term investors should welcome this.*

The next factor that put pressure on free cash flow is inventories. In the last quarter, this indicator in the structure of cash flow provided a decrease of \$7.05 billion, which is also significantly beyond the average values.



Data by YCharts

The CFO commented on this result as well:

...We are just now getting caught up on space for inventory and inventory is being brought in to support the holiday. And if you look year-over-year, well, unit's growth is, as you say, closer to 8% in Q3. The cubic - inventory cube is up close to 40%, both in North America and internationally.

So, there's like the second shoe that's dropping of getting the fulfillment centers back in stock, especially for sellers and especially as we head into holiday...

Source: *Amazon Q3 2021 Results - Earnings Call Transcript*

Cyber Monday and Black Friday is coming. This will be followed by a period of holidays. The company is ready for this. Against the background of this fact, the temporary deterioration in free cash flow is practically irrelevant.

## What a long-term investor shouldn't forget

Amazon's retail business is traditionally low-margin. It has been losing money for years and probably in the future it is not worth expecting that the situation will change dramatically. But this business has spawned two areas that will ensure Amazon's profitability in the future. These are AWS and digital advertising. I will not develop this topic in detail, but I will give two graphs that give an unambiguous answer, what was the last quarter for Amazon.

Comparing the current and previous revenue growth trends of the company's cloud division, it should be noted that the result of the last quarter confirmed here the acceleration of exponential growth:

Source: [visualizedanalytics.com](https://visualizedanalytics.com)

Let me remind you that this direction brings more than half of the company's operating income.

Source: [Amazon Q3 2021 Results](#)

And here is the second graph. The 'Other' (advertising services) segment has also showed acceleration:

Source: [visualizedanalytics.com](#)

Generally speaking, advertising is a high-margin business, and judging by Meta (FB) and Google (GOOG/GOOGL), the average size of the operating margin of the industry fluctuates around 30%. But Amazon has the ability to save on operating costs by sharing their value with the company's main business. Therefore, the operating margin of Amazon's advertising segment has a high chance of being at the level of 35%-40%. But the most important thing is that this direction is accelerating.

## The final touch - DCF model

Last month I [posted](#) a detailed, step-by-step construction of the DCF model for Amazon. This time I will only make the necessary changes related to the increased capital expenditures of the company in the medium term.

Here is the calculation of the Weighted Average Cost of Capital:

Source: [visualizedanalytics.com](#)

And here is the Discounted Cash Flow Model itself:

*The DCF-based target price of Amazon's shares is ~\$4,450, offering 25% upside.*

## Bottom Line

So, the fact that the quarterly results of Amazon fell slightly short of analysts' expectations, and the free cash flow went into the negative zone, on a large account is a noise for short-term investors. The company is actively investing in its future and its key high-margin directions are demonstrating accelerating exponential growth. This is the main thing to note from the entire array of numbers.

But there is more. The market is a reflection of human psychology and therefore it has a pendulum nature. It's rarely balanced, but inevitably comes back to the balanced state from time to time. Approximately it looks like this:

Source: *Author*

As I noted at the very beginning, the company's capitalization has remained practically unchanged for six quarters. But during this period, Amazon continued to grow. As a result, now, in my opinion, the market has reached a state where the company's fundamental value has exceeded its price. Therefore, even despite the mixed quarterly results, the company's capitalization will grow.

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This article was written by



**Oleh Kombaiev**  
13.58K Followers

Commodities and tech stocks. Deep Value.

**Disclosure:** I/we have no stock, option or similar derivative position in any of the companies mentioned, and no plans to initiate any such positions within the next 72 hours. I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it (other than from Seeking Alpha). I have no business relationship with any company whose stock is mentioned in this article.

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