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FANG Earnings Preview; Expecting Strong 4Q and Massive Secular Growth Tailwinds for 2018

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While Netflix kicked off 4Q tech earnings season with a bang earlier this week, we expect its FANG brethren to continue the "beat and raise" party next week by delivering stronger than expected earnings/2018 guidance based on our GBH Tech Tracker results and industry checks. Overall, we continue to be very bullish on secular tech themes for 2018 around streaming/content, e-commerce growth, online ad growth, and the transformational cloud shift among enterprises. While the regulatory environment, corporate tax changes (we estimate between $300 billion to $400 billion of large cap tech cash will be repatriated), and the macro backdrop create both opportunities and challenges for these FANG names as well as the rest of the tech sector, we believe the underlying fundamentals, spending environment, and consumer/enterprise landscape looks very healthy heading into 2018 as we expect a robust tech earnings season over the coming weeks. While we are maintaining our Highly Attractive ratings and bullish views on FANG stocks for 2018, we are raising our price targets on Amazon from $1,375 to $1,500 and Alphabet from $1,190 to $1,280 to reflect our increased confidence on these underlying fundamental growth stories playing out over the coming year.

Amazon (AMZN, Highly Attractive, $1,500 Price Target)

- ***Summary thoughts heading into earnings:*** We expect strength from Amazon across the board this quarter as our analysis indicates a better than performance on the North America retail channel as well on the AWS front, which should translate into 3%-5% top-line upside for 4Q in our opinion. While near-term there is a major focus on significant investments around fulfillment, Prime, Echo/Alexa, AWS, and integrating the Whole Foods acquisition into the fold which could depress margins over the next few quarters, we believe this is "near term pain for long-term gain" as Amazon has a unique window of opportunity to double down on its consumer and enterprise initiatives for 2018 and drive significant growth/cash flow for the coming years as Bezos & Co. further diversifies the Amazon franchise globally. More details around the Whole Foods acquisition strategy and cross-sell opportunities, AWS strength, HQ2 timing, and margin guidance will be focus areas for investors heading into earnings and could be a swing factor on the stock in the near-term with margins key. In a nutshell, Amazon remains one of our favorite secular tech growth stories for FY18 as our GBH Tech Tracker survey/analysis support the Amazon consumer growth thesis, coupled by cloud strength on the AWS segment which is still in the early innings of playing out among enterprises globally. Amazon/Echo and its white hot Alexa smart home ecosystem we also believe represents a $20 billion market opportunity for Bezos & Co. over the next three years with a robust holiday season kicking things off with strong smart speaker tailwinds heading into 2018.

- **Iron grip on e-commerce spending.** Amazon was the clear star of Cyber Monday and Black Friday as we forecast the company captured between 45-50% of all holiday online sales this year (vs 38% in 2016). As such, this should translate into an upside on the retail US channel in 4Q as Amazon looks to have "eye popping" momentum heading into 2018 in our opinion. While Amazon's biggest pure play competitor Walmart has done a commendable job beefing up its e-commerce strategy through organic (partner push, inventory expansion, offline driving online sales) and acquisitive means (Jet.com), Amazon continues to have an "iron grip" on the e-commerce market heading into 2018 despite a clear bullseye on its back from retailers around the world including Bentonville.
- **Alexa front and center.** Alexa, Amazon's next generation digital assistant, is the tip of the spear in our opinion that has spawned a white hot smart speaker market which is quickly becoming the core foundation of smart homes and opening up new avenues of consumer growth opportunities around retail, search, and advertising for years to come. With Amazon building out an unparalleled partner, app, developer, and skill set (30k+) network for its Alexa driven Echo devices coming off a banner holiday season, we believe a broader strategy around advanced AI, ad targeting,

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and further driving the "Amazon consumer flywheel" is the golden opportunity behind the Alexa ecosystem that is in the very early innings of playing out. In our opinion, the trifecta of Alexa, Echo, and Prime should enable Amazon to further penetrate the consumer, expand Prime membership and retail spending patterns, while widening the company's consumer competitive moat in our opinion for 2018 and beyond.

- **Prime membership growth is Amazon's key asset.** Bezos has built a Prime membership of over 88 million strong which is poised to increase spending another 20%+ this year and likely beat 4Q estimates handily and is on a stronger than expected organic growth pace for 2018 in our opinion. Prime growth remains the key jewel for Amazon going forward as cross-selling around Whole Foods customers and putting up more walls/barriers around its growing Prime customer base is a major ingredient in Amazon's ability to fend off competition. International growth on Prime will also be another catalyst that we expect to play out in 2018 and should help further drive better than expected e-commerce retail growth in the year ahead.
- **Driving the Amazon flywheel effect.** While near-term there is a major focus on significant investments around fulfillment, Prime, Echo/Alexa, AWS, and integrating the Whole Foods acquisition into the fold which could depress margins over the next few quarters, we believe this is "near term pain for long-term gain" as Amazon has a unique window of opportunity to double down on its consumer and enterprise initiatives heading into 2018 and drive significant growth/cash flow for the coming years as Bezos & Co. further diversifies the Amazon franchise globally.
- **Whole Foods synergies=tailwinds for 2018.** Strong customer overlap is a major synergy behind the Whole Foods acquisition and provides another avenue of growth into this key customer demographic to increase Prime membership and cross-sell over the next year in our opinion. We are encouraged by the early go-to-market techniques we saw during 4Q and cross-selling that Amazon has been deploying in Whole Foods stores, as with Prime members spending roughly 2x more than non-members

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increasing this customer base represents the holy grail. With Amazon's underlying goal to increase the average customer purchase/basket size, we believe further integration between Whole Foods inventory (recent price cuts in-line with Amazon's playbook) and the Amazon e-commerce machine is a great 1-2 punch that should drive increased sales/ramp in Prime members for 2018 and is still underappreciated by the Street in our opinion. We expect to hear more details about 4Q success and 2018 initiatives on the company's conference call. We also believe potentially aggressively betting on other consumer areas such as healthcare with the pharmacy segment front and center, despite recent noise, is a smart strategic move as Amazon looks to further spread its tentacles across the consumer landscape globally in 2018 and beyond.

Alphabet (GOOG, Highly Attractive, $1,280 Price Target)

- ***Summary thoughts heading into earnings:*** Our mobile search analysis/tracker this quarter continue to show strength from Google around its bread and butter search business, which should be a catalyst for modestly better than expected top and bottom-line results in 4Q as ad growth was the "star of the show" this quarter. We are also seeing accelerating ad momentum from search and YouTube yet again this quarter and heading into 2018 despite noise in the market. TAC trends will be a focus this quarter, as mobile advertising impression success remains a key going forward for Google in this very competitive land grab market opportunity. Overall, we believe solid 4Q earnings and strong enough 2018 guidance (expecting to be slightly ahead of Street expectations) could be a positive catalyst for shares with much fuel left in the growth tank in our opinion.
- **2018 is a "prove me" year for Google.** The main growth drivers and key monetization engine for Google/Alphabet into 2018 remain mobile search, YouTube, and overall advertising strength which have clear tailwinds

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heading into 2018 in our opinion based on recent results and our stronger than expected ad survey tracker work this quarter. To this point, we believe Google has a number of organic growth investments that will start to bear fruit in 1H2018 as ad growth, mobile impression strength, and a host of other initiatives lay out a compelling growth story for Google in 2018 in our opinion.

- **YouTube a major advertising asset and the golden gem.** We continue to believe YouTube is the major growth driver on the ad front, as this dominant platform now has north of 1.5 billion users watching on average 60 minutes per day. As Google further monetizes this "golden advertising gem" over the coming 12 to 18 months we believe this will be a major growth catalyst that is under appreciated by investors in our opinion and a key driver of ad growth for 2018 and beyond.
- **TAC remains the "banner on the airplane" that everyone is watching**. Importantly, Google's advertising business and trends are showing accelerating growth, as we saw TAC increase sequentially with mobile search driving this dynamic. We continue to believe that improving TAC trends into 2018 are a major part of the Google narrative going forward, as mobile advertising impression success holds the key to the advertising kingdom in our opinion. Overall while initiatives around Google Home and the fertile smart speaker market, hardware (Pixel), cloud (recent partnership with Cisco), AI, and Other Bets (Nest, Fiber) are all important growth initiatives to expand the company's growth tentacles on both the consumer and enterprise front for 2018/2019, it all comes down to stellar mobile search and advertising growth with YouTube remaining a key under penetrated asset in the Google product portfolio in our opinion. With the competition for mobile ad dollars becoming fiercer it is becoming incrementally important for Google to successfully monetize its search kingdom, YouTube asset, and mobile impression success in 2018 as the coming year could be a huge leap forward (or setback) for the company around monetization of its platform. However, this will not be an easy task

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as we believe Google has some more wood to chop ahead on its "bread and butter" advertising platform/AI capabilities as mobile remains the gateway to its next phase of growth with an increasingly more crowded and price competitive landscape abound which represents an ongoing lingering risk around the name.

Facebook (FB, Highly Attractive, $225 Price Target)

- ***Summary thoughts heading into earnings:*** While there continues to be evolution around Facebook's ad growth model and monetization strategy, it appears the company is executing extremely well in the field (e.g. engagement, MAU growth, ad growth) and all key metrics look healthy for 4Q with modest upside expected and "good enough" 2018 guidance based on our recent checks and GBH Tech Tracker survey work. We estimate Facebook is on a trajectory to have another solid quarter in 4Q on the MAU front and has strong momentum heading into 2018 on this all-important growth driver for the business, despite lingering clouds from the recent News Feed overhaul. To this point, we look forward to hearing more details about the News Feed strategic shift on the company's conference call as this remains a major near-term Street worry around the name given ad growth and potential engagement headwinds, which we ultimately believe will be short lived with minimal financial impact.
- **MAU growth story remains the fuel in FB's tank**. With MAUs currently north of 2 billion total users, Facebook will continue to grow its massive global installed base in our opinion while importantly monetizing users especially on the Instagram side of the house, which remains the "core 1-2 punch" that underlies our bullish thesis on the name. We note that Instagram already announced 800 million MAUs in September (vs. 700 million in April) as this platform remains a "golden jewel" in Facebook's platform in our opinion with healthy monetization and ad growth set to play out in 2018 based on our forecasts. With this platform on pace to be over 1

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billion MAUs by mid 2018 based on our estimates, we view this an underappreciated asset by the Street that could be a major growth catalyst for Facebook over the next 12 to 18 months on the advertising front. While the aforementioned News Feed changes recently announced could be worrisome in terms of an ad growth hiccup (that can be neutralized by stronger than expected monetization by the customer base), we believe this overhaul was the right move for longer term user engagement and driving "meaningful content", which remains the core ingredient in Facebook's recipe for success for the coming years. We also believe this will reduce ad load and ultimately in 2H18 enable Facebook to charge higher prices to advertisers once the dust settles from this News Feed change, a positive long term driver in our opinion.

- **Video Portal on the horizon out of Building 8.** Facebook must invest in newer growth initiatives in our opinion to further expand its drivers around ad growth rates, AR, mobile platform expansion, video, consumer engagement, and Instagram/Messenger monetization into 2018 and beyond. This is an integral part of Facebook's strategy that we expect to play out over the coming years despite worries on the Street around a stepped-up investment profile for the coming year. To this point, it appears Facebook will be releasing a video chat/Portal device at its F8 Developer Conference in May which will be the company's first in a line of new hardware products to get further entrenched in the consumer smart home/ecosystem in our opinion. While Facebook's brand and consumer success has helped create a tech titan, now it's about the company (with the help of Building 8) expanding its consumer reach and touch points through a myriad of next generation devices/wearables with the underlying goal of further building out its advertising and consumer kingdom vs. the likes of Amazon, Google, and others. This will not be an easy task and the jury is still out on how this premium video chat portal strategy will play out, although we believe it's a smart move for Facebook to expand its tentacles into this area of the fertile smart home market.

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- **2018 an investment year; driving future growth.** In terms of the year ahead, Facebook recently gave a FY18 outlook that is anticipated to be an "investment year" with forecasted total expense growth of 45%-60%. While the term "investment year" are never two words investors want to hear, we do believe this is a prudent strategy despite causing some heartburn for bulls on the name. The company is citing this significant increase in spending primarily to the hiring of more employees to work on security/safety along with payments Facebook is making for shows in its recently unveiled Watch tab as video remains a major "wild card" product initiative in our opinion. To this point, this higher investment profile could be a lingering cloud over Facebook's shares in the near term (further clarity expected on the 4Q earnings call) and a small speed bump until investors can get further comfort that these investments are fueling the next phase of the growth story for 2018 and beyond with margin improvement set to kick in for 2019.

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