

## Amazon.com, Inc. (AMZN)

## Channel Checks Highlight Positive Impact of WFM Price Cuts

**INVESTMENT HIGHLIGHTS:** We recently conducted price comparison checks at Whole Foods, Safeway, Trader Joe's and Costco, and came away incrementally more positive on the AMZN/WFM deal. We believe the recent price cuts have made WFM more price competitive on certain FMCG products, which we believe has lifted in-store foot traffic and turnover. We expect AMZN to continue strengthening WFM's value proposition as a destination to shop for high-quality grocery, and the price cuts should help gain consumer traction, particularly among Amazon's Prime members. We believe both organic and private label represent growth opportunities for Amazon to further penetrate the grocery market. In addition, we also expect further integration of WFM products online, as well as the roll-out Prime members benefits in WFM stores.

- Following the recent announcement of price cuts at Whole Foods Market (WFM), we conducted a price comparison exercise at WFM, as well as several other grocery chains (Figure 1). Among the items we surveyed, price cuts at WFM range from 11% to 38% with an average of ~16%. With these price cuts, we believe these items at WFM had become more price competitive against Safeway and Trader Joe's, whose prices now on average represent ~6% premium over WFM. On the other hand, Costco still holds the most competitive prices among most of the items we surveyed, although these prices require Costco membership and the purchase of larger quantities.
- We identify that price cuts at Whole Foods put particular emphasis on fast-moving consumer goods (FMCG), organic, and private label. While groceries are generally considered FMCG, we note that most promotions fall onto the most popular items such as eggs, milk, apples, and ground beef. We believe Amazon aims to increase WFM foot traffic, repeat visits, and customer loyalty with those competitively priced items, although we expect these price cuts could reduce profitability for these low-margin items.
- We believe the price cuts put emphasis on organic products, which should continue to strengthen Whole Food's value proposition as a high quality grocery outlet. We like the organic focus for two reasons. First, it represents a fast-growing opportunity. According to data from U.S. Consensus Bureau and Organic Trade Association, U.S. grocery sales totaled \$625B in 2016, an increase of ~2% y/y, while organic food sales grew much faster at over 8% y/y and less than 10% of market share. Second, we believe these products are well positioned to target Amazon's relatively affluent Prime member base, which should represent promising opportunity for Amazon to increase wallet share of their grocery budget.

## COMPANY UPDATE

Stock Rating	<b>BUY</b> Unchanged
Price Target	<b>\$1,150.00</b>

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## Stock Price Performance

Amazon.com, Inc. 09/07/17



## Market Data

Price (09/06/2017)	\$967.80
52-Week Range	\$1,083.31 - \$710.10
Shares Outstanding	480.38
Market Cap (MM)	\$464,911.3
Avg. Daily Volume	3,871,796.0
Total Debt/Cap.	51.42%

	FY 12/31/2016		FY 12/31/2017		FY 12/31/2018	
	Actual	Old	New	Old	New	
Rev. (MM)	135,987.0A	168,851.5E	168,851.5E	206,857.9E	206,857.9E	
Growth	27.1%		24.2%		22.5%	
EPS: 1Q	1.07A	1.48A	1.48A	1.68E	1.68E	
EPS: 2Q	1.77A	0.40A	0.40A	2.01E	2.01E	
EPS: 3Q	0.53A	(0.11)E	(0.11)E	1.66E	1.66E	
EPS: 4Q	<u>1.54A</u>	<u>2.08E</u>	<u>2.08E</u>	<u>4.09E</u>	<u>4.09E</u>	
EPS: Year	4.92A	3.85E	3.85E	9.45E	9.45E	
Growth	293.6%		(21.7)%		145.5%	

- We believe private label is another main focus for Amazon post its WFM acquisition. WFM has a well-established 365 Everyday Value brand, and many of these products are included in the recent price cut initiatives. We believe Amazon is uniquely positioned to penetrate the private label market as its extensive consumer data enables unparalleled expertise in product selection and pricing. Whole Foods' private label products are also the majority of SKUs that have become available on Amazon's website since the acquisition. As of Thursday, 365 Everyday Value brand comprises 166 out of 204 SKUs available on Amazon Fresh's Whole Foods store page, and 28 of 29 SKUs on Prime Now's Whole Foods store page. While this represents a very small selection of products and is still very early stage, we expect continued penetration of WFM's private label products on Amazon's website, as well as Amazon's private label products in Whole Foods stores. Ultimately, we believe the increasing penetration of private label products should help with Amazon's gross margin and profitability, in addition to gaining wallet share in the grocery market.
- We note that it has only been a few days since the rollout of these price cuts and the price cuts only concern a small selection of all products. Despite lack of official statistics disclosed by the company, we believe these initiatives are showing some early sign of effectiveness. Through several visits to the local stores, we noticed quite a few instances of empty shelves, particularly in the discounted item sections, likely suggesting higher turnover on these competitively priced items. We believe it is the company's intention to drive more foot traffic through these price cut initiatives, which could lead to consumers buying other items in-store.
- Apart from the price cuts, we also noticed that Amazon Echo devices are already available in WFM stores. We have not seen any Prime member specific discounts in-store, nor do we see the Prime-linked WFM loyalty program rolled out yet. We expect increasing synergy both on the consumer front as well as in the back-end operation as Amazon continued to integrate its e-commerce and WFM in-store businesses.

**Figure 1 Price Check Summary**

Item	Quantity	Whole Foods			Safeway		TJ's		Costco	
		Before	After	Discount	Price	vs. WFM	Price	vs. WFM	Price	vs. WFM
<b>Bananas</b>										
Regular	per lb	\$ 0.79	\$ 0.49	-38%	\$ 0.49	0%	\$ 0.57	16%	\$ 0.46	-6%
Organic	per lb	\$ 0.99	\$ 0.69	-30%	\$ 0.69	0%	\$ 0.75	9%	\$ 0.66	-4%
<b>Apples</b>										
Gala Apples	per lb	\$ 2.99	\$ 1.99	-33%	\$ 2.99	50%	\$ 2.07	4%	\$ 1.91	-4%
<b>Avocados</b>										
Regular	each	\$ 1.99	\$ 1.49	-25%	N/A		\$ 2.29	54%	N/A	
Organic	each	\$ 2.99	\$ 1.99	-33%	\$ 1.99	0%	\$ 2.69	35%	N/A	
<b>Large Brown Eggs</b>										
Private Label - Regular	dozen	\$ 3.66	\$ 2.79	-24%	\$ 1.67	-40%	\$ 3.29	18%	\$ 1.88	-33%
Private Label - Organic	dozen	\$ 4.49	\$ 3.39	-24%	\$ 3.99	18%	\$ 3.69	9%	\$ 3.50	3%
Branded - Regular	dozen	\$ 4.49	\$ 4.49	0%	\$ 4.99	11%	N/A		N/A	
Branded - Organic	dozen	\$ 6.49	\$ 6.49	0%	\$ 5.99	-8%	N/A		N/A	
<b>Butter</b>										
Private Label - Regular	1 lb block	\$ 3.49	\$ 3.49	0%	\$ 3.99	14%	\$ 2.99	-14%	\$ 3.00	-14%
Private Label - Organic	1 lb block	\$ 4.99	\$ 4.49	-10%	\$ 4.49	0%	\$ 4.49	0%	\$ 4.25	-5%
Branded - Regular	1 lb block	\$ 5.49	\$ 5.49	0%	\$ 4.99	-9%	N/A		N/A	
Branded - Organic	1 lb block	\$ 7.99	\$ 7.99	0%	\$ 7.99	0%	N/A		N/A	
<b>Milk</b>										
Private Label - Regular	1/2 gal	\$ 2.29	\$ 2.29	0%	\$ 2.49	9%	\$ 1.99	-13%	\$ 1.85	-19%
Private Label - Organic	1/2 gal	\$ 3.99	\$ 3.49	-13%	\$ 3.49	0%	\$ 3.49	0%	N/A	
Branded - Regular	1/2 gal	\$ 2.29	\$ 2.29	0%	\$ 3.29	44%	N/A		N/A	
Branded - Organic	1/2 gal	\$ 4.49	\$ 3.99	-11%	\$ 4.99	25%	N/A		\$ 4.99	25%
<b>Salmon</b>										
Wild Caught	per lb	\$ 12.99	\$ 9.99	-23%	\$ 9.99	0%	\$ 11.99	20%	\$ 9.99	0%
<b>Tilapia</b>										
Farmed Raised	per lb	\$ 9.99	\$ 7.99	-20%	\$ 7.99	0%	\$ 5.99	-25%	\$ 4.99	-38%
<b>Ground Beef</b>										
85% Lean Ground Beef	per lb	\$ 7.99	\$ 4.99	-38%	\$ 6.99	40%	\$ 7.99	60%	\$ 4.99	0%
<b>Almond Butter</b>										
Creamy or Crunchy	1 lb jar	\$ 13.99	\$ 9.99	-29%	\$ 9.99	0%	\$ 5.99	-40%	\$ 7.58	-24%
<b>Peanut Butter</b>										
Regular	per lb	N/A			\$ 3.01		\$ 2.29		\$ 1.66	
Organic	per lb	\$ 5.99	\$ 4.99	-17%	\$ 4.45	-11%	\$ 3.49	-30%	\$ 2.85	-43%
<b>Rotisserie Chicken</b>										
Rotisserie Chicken	each	\$ 8.99	\$ 7.99	-11%	\$ 6.99	-13%	N/A		\$ 4.99	-38%
Median				-17%		0%		6%		-6%
Average				-16%		6%		6%		-13%

\* Price at Safeway, Trader Joe's and Costco are based on price of most comparable products at equivalent quantity.

Source: Needham & Company, LLC

**Figure 2 Projected Quarterly Income Statement****Amazon.com Quarterly Income Statement**

(in millions, except per share data and ratios)

	2016A				2017E				2018E			
	Mar-16 Q1:16A	Jun-16 Q2:16A	Sep-16 Q3:16A	Dec-16 Q4:16A	Mar-17 Q1:17A	Jun-17 Q2:17A	Sep-17 Q3:17E	Dec-17 Q4:17E	Mar-18 Q1:18E	Jun-18 Q2:18E	Sep-18 Q3:18E	Dec-18 Q4:18E
<b>Total Revenue</b>	29,128	30,404	32,714	43,741	35,714	37,955	40,775	54,407	44,407	46,787	49,807	65,857
<b>Cost of Revenue</b>	18,866	19,180	21,253	28,949	22,432	23,439	25,852	35,147	27,754	28,400	31,050	41,819
<b>Gross Profit (Loss)</b>	10,262	11,224	11,461	14,792	13,282	14,516	14,924	19,260	16,652	18,387	18,757	24,038
Gross Margin	35.2%	36.9%	35.0%	33.8%	37.2%	38.2%	36.6%	35.4%	37.5%	39.3%	37.7%	36.5%
<b>Operating Expenses:</b>												
Fulfillment	3,571	3,692	4,170	5,529	4,534	4,897	5,448	7,073	5,595	5,942	6,226	8,127
Marketing	1,380	1,466	1,653	2,411	1,826	2,096	2,243	2,884	2,220	2,480	2,490	3,227
Technology and content	3,209	3,461	3,701	4,052	4,372	4,916	5,219	5,461	5,373	5,989	6,226	6,586
General and administrative	442	497	554	624	709	755	775	762	844	842	847	1,054
Stock-based compensation	544	768	769	887	792	1,158	1,223	1,415	1,243	1,497	1,594	1,778
Other operating expense, net	45	55	32	34	44	66	66	66	66	66	66	66
<b>Total Operating Expenses</b>	9,191	9,939	10,879	13,537	12,277	13,888	14,973	17,660	15,342	16,816	17,449	20,837
<b>Operating Income (GAAP)</b>	1,071	1,285	582	1,255	1,005	628	(50)	1,600	1,311	1,572	1,309	3,201
<b>Consolidated Segment Operating Income (CSOI)</b>	1,660	2,108	1,390	2,176	1,841	1,852	1,240	3,081	2,620	3,135	2,968	5,045
CSOI Margin	5.7%	6.9%	4.2%	5.0%	5.2%	4.9%	3.0%	5.7%	5.9%	6.7%	6.0%	7.7%
Interest income	21	24	26	30	39	44	30	23	51	44	36	29
Interest expense	(117)	(116)	(118)	(133)	(139)	(143)	(169)	(173)	(213)	(213)	(213)	(229)
Other income (expense), net	81	(14)	8	14	48	137	137	137	137	137	137	137
<b>Total Non-operating income (expense)</b>	(15)	(106)	(84)	(89)	(52)	38	(2)	(13)	(25)	(32)	(40)	(63)
<b>Income before provision for income taxes</b>	1,056.0	1,179.0	498.0	1,166.0	953.0	666.0	(51.5)	1,587.3	1,285.4	1,539.7	1,268.8	3,137.6
Income tax expense (benefit)	475.0	307.0	229.0	414.0	229.0	467.0	0.0	555.6	449.9	538.9	444.1	1,098.2
Equity-method investment activity, net of tax	(68.0)	(15.0)	(10.0)	(3.0)	0.0	(2.0)	(2.0)	(2.0)	(2.0)	(2.0)	(2.0)	(2.0)
<b>Reported GAAP Net Income</b>	513.0	857.0	259.0	749.0	724.0	197.0	(53.5)	1,029.8	833.5	998.8	822.7	2,037.5
<b>Pro Forma Net Income</b>	904.0	1,480.7	705.4	1,346.0	1,359.1	564.7	1,237.8	1,994.1	1,686.6	2,016.9	1,903.6	3,238.2
<b>Reported GAAP EPS</b>	\$1.07	\$1.77	\$0.53	\$1.54	\$1.48	\$0.40	(\$0.11)	\$2.08	\$1.68	\$2.01	\$1.66	\$4.09
<b>Pro Forma EPS</b>	\$1.88	\$3.07	\$1.45	\$2.77	\$2.77	\$1.15	\$2.51	\$4.04	\$3.41	\$4.07	\$3.83	\$6.50
Basic shares outstanding	471.0	473.0	474.0	476.0	477.0	479.0	480.0	481.0	482.0	483.0	484.0	485.0
Diluted shares outstanding	481.0	483.0	485.0	486.0	490.0	492.0	493.0	494.0	495.0	496.0	497.0	498.0
<b>EBITDA</b>												
Depreciation and Amortization	1,827	1,909	2,084	2,297	2,435.0	2,633.0	2,781.2	2,771.4	2,934.0	2,884.4	2,900.3	2,927.2
Adjusted EBITDA	2,898.0	3,194.0	2,666.0	3,552.0	3,440.0	3,261.0	2,731.5	4,371.4	4,244.6	4,455.9	4,208.9	6,127.7
Adjusted EBITDA Margin	9.9%	10.5%	8.1%	8.1%	9.6%	8.6%	6.7%	8.0%	9.6%	9.5%	8.5%	9.3%
<b>MARGIN ANALYSIS</b>												
Gross margin	35.2%	36.9%	35.0%	33.8%	37.2%	38.2%	36.6%	35.4%	37.5%	39.3%	37.7%	36.5%
Fulfillment	12.3%	12.1%	12.7%	12.6%	12.7%	12.9%	13.4%	13.0%	12.6%	12.7%	12.5%	12.3%
Marketing	4.7%	4.8%	5.1%	5.5%	5.1%	5.5%	5.5%	5.3%	5.0%	5.3%	5.0%	4.9%
Technology and content	11.0%	11.4%	11.3%	9.3%	12.2%	13.0%	12.8%	10.0%	12.1%	12.8%	12.5%	10.0%
General and administrative	1.5%	1.6%	1.7%	1.4%	2.0%	2.0%	1.9%	1.4%	1.9%	1.8%	1.7%	1.6%
Operating margin	3.7%	4.2%	1.8%	2.9%	2.8%	1.7%	-0.1%	2.9%	3.0%	3.4%	2.6%	4.9%
Tax rate	45.0%	26.0%	46.0%	35.5%	24.0%	70.1%	0.0%	35.0%	35.0%	35.0%	35.0%	35.0%
Pro forma net margin	3.1%	4.9%	2.2%	3.1%	3.8%	1.5%	3.0%	3.7%	3.8%	4.3%	3.8%	4.9%
<b>YEAR OVER YEAR GROWTH</b>												
Revenues	28.2%	31.1%	29.0%	22.4%	22.6%	24.8%	24.6%	24.4%	24.3%	23.3%	22.1%	21.0%
Gross profit	40.2%	39.9%	33.2%	29.7%	29.4%	29.3%	30.2%	30.2%	25.4%	26.7%	25.7%	24.8%
Fulfillment	33.8%	34.5%	34.2%	25.4%	27.0%	32.6%	30.6%	27.9%	23.4%	21.3%	14.3%	14.9%
Marketing	31.7%	33.3%	35.9%	42.0%	32.3%	43.0%	35.7%	19.6%	21.6%	18.3%	11.0%	11.9%
Technology and content	27.3%	28.1%	28.2%	26.3%	36.2%	42.0%	41.0%	34.8%	22.9%	21.8%	19.3%	20.6%
General and administrative	16.9%	22.7%	39.2%	82.5%	60.4%	51.9%	39.8%	22.1%	19.0%	11.5%	9.3%	38.3%
Operating income	320.0%	176.9%	43.3%	13.3%	-6.2%	-51.1%	-108.5%	27.5%	30.4%	150.2%	-273.7%	100.0%
Pro forma net income	-180.4%	473.8%	142.9%	64.8%	50.4%	-61.9%	75.5%	48.2%	24.1%	257.1%	-53.8%	62.4%
<b>QUARTER OVER QUARTER GROWTH</b>												
Revenues	-18.5%	4.4%	7.6%	33.7%	-18.4%	6.3%	7.4%	33.4%	-18.4%	5.4%	6.5%	32.2%
Gross profit	-10.0%	9.4%	2.1%	29.1%	-10.2%	9.3%	2.8%	29.1%	-13.5%	10.4%	2.0%	28.2%
Fulfillment	-19.0%	3.4%	12.9%	32.6%	-18.0%	8.0%	11.2%	29.8%	-20.9%	6.2%	4.8%	30.5%
Marketing	-18.7%	6.2%	12.8%	45.9%	-24.3%	14.8%	7.0%	28.6%	-23.0%	11.7%	0.4%	29.6%
Technology and content	0.1%	7.9%	6.9%	9.5%	7.9%	12.4%	6.2%	4.6%	-1.6%	11.5%	4.0%	5.8%
General and administrative	29.2%	12.4%	11.5%	12.6%	13.6%	6.5%	2.6%	-1.7%	10.8%	-0.2%	0.5%	24.4%
Operating income	-3.3%	20.0%	-54.7%	115.6%	-19.9%	-37.5%	-107.9%	-3319.9%	-18.1%	19.9%	-16.7%	144.6%
Pro forma net income	10.7%	63.8%	-52.4%	90.8%	1.0%	-58.4%	119.2%	61.1%	-15.4%	19.6%	-5.6%	70.1%

Source: Company reports, Needham &amp; Company, LLC

**Figure 3 Projected Annual Income Statement**

<b>Amazon.com Annual Income Statement</b>				
(in millions, except per share data and ratios)				
	2015A	2016A	2017E	2018E
<b>Total Revenue</b>	<b>107,007.0</b>	<b>135,987.0</b>	<b>168,851.5</b>	<b>206,857.9</b>
<b>Cost of Revenue</b>	<b>71,651.0</b>	<b>88,248.0</b>	<b>106,869.6</b>	<b>129,022.9</b>
<b>Gross Profit (Loss)</b>	<b>35,356.0</b>	<b>47,739.0</b>	<b>61,981.9</b>	<b>77,835.0</b>
<b>Operating Expenses:</b>				
Fulfillment	12,930.0	16,962.0	21,951.5	25,889.8
Marketing	5,062.0	6,910.0	9,048.2	10,417.4
Technology and content	11,317.0	14,423.0	19,968.6	24,173.5
General and administrative	1,523.0	2,117.0	3,000.4	3,586.3
Stock-based compensation	2,120.0	2,968.0	4,587.8	6,112.5
Amortization of other intangibles	171.0	166.0	242.0	264.0
Restructuring-related and other	-	-	-	-
<b>Total Operating Expenses</b>	<b>33,123.0</b>	<b>43,546.0</b>	<b>58,798.6</b>	<b>70,443.7</b>
<b>Operating Income (GAAP)</b>	<b>2,233.0</b>	<b>4,193.0</b>	<b>3,183.3</b>	<b>7,391.3</b>
<b>Consolidated Segment Operating Income (CSOI)</b>	<b>4,524.0</b>	<b>7,327.0</b>	<b>8,013.1</b>	<b>13,767.9</b>
Interest income	49.0	101.0	136.4	159.5
Interest expense	(460.0)	(484.0)	(623.8)	(867.3)
Other income (expense), net	(254.0)	89.0	459.0	548.0
Remeasurements and Other	-	-	-	-
<b>Total Non-operating income (expense)</b>	<b>(665.0)</b>	<b>(294.0)</b>	<b>(28.4)</b>	<b>(159.8)</b>
<b>Income before provision for income taxes</b>	<b>1,568.0</b>	<b>3,899.0</b>	<b>3,154.8</b>	<b>7,231.6</b>
Income tax expense (benefit)	951.0	1,425.0	1,251.6	2,531.0
Equity-method investment activity, net of tax	(21.0)	(96.0)	(6.0)	(8.0)
<b>Reported GAAP Net Income</b>	<b>596.0</b>	<b>2,378.0</b>	<b>1,897.3</b>	<b>4,692.5</b>
<b>Pro Forma Net Income</b>	<b>241.6</b>	<b>4,436.1</b>	<b>5,155.7</b>	<b>8,169.0</b>
<b>Reported GAAP EPS</b>	<b>\$ 1.25</b>	<b>\$ 4.92</b>	<b>\$ 3.85</b>	<b>\$ 9.45</b>
<b>Pro Forma EPS</b>	<b>\$ 0.51</b>	<b>\$ 9.17</b>	<b>\$ 10.47</b>	<b>\$ 16.45</b>
Basic shares outstanding	467.5	473.5	479.3	483.5
Diluted shares outstanding	475.3	483.8	492.3	496.5
<b>EBITDA</b>				
Depreciation and Amortization	6,281.0	8,117.0	10,620.6	11,645.8
Adjusted EBITDA	8,514.0	12,310.0	13,803.9	19,037.2
Adjusted EBITDA Margin	8.0%	9.1%	8.2%	9.2%
<b>MARGIN ANALYSIS</b>				
Gross margin	33.0%	35.1%	36.7%	37.6%
Fulfillment	12.1%	12.5%	13.0%	12.5%
Marketing	4.7%	5.1%	5.4%	5.0%
Technology and content	10.6%	10.6%	11.8%	11.7%
General and administrative	1.4%	1.6%	1.8%	1.7%
Operating margin	2.1%	3.1%	1.9%	3.6%
Tax rate	60.7%	36.5%	39.7%	35.0%
Pro forma net margin	0.2%	3.3%	3.1%	3.9%
<b>YEAR OVER YEAR GROWTH</b>				
Revenues	20.2%	27.1%	24.2%	22.5%
Gross profit	34.8%	35.0%	29.8%	25.6%
Fulfillment	24.4%	31.2%	29.4%	17.9%
Marketing	20.3%	36.5%	30.9%	15.1%
Technology and content	33.6%	27.4%	38.4%	21.1%
General and administrative	12.0%	39.0%	41.7%	19.5%
Operating income	1154.5%	87.8%	-24.1%	132.2%
Pro forma net income	-63.6%	1736.5%	16.2%	58.4%

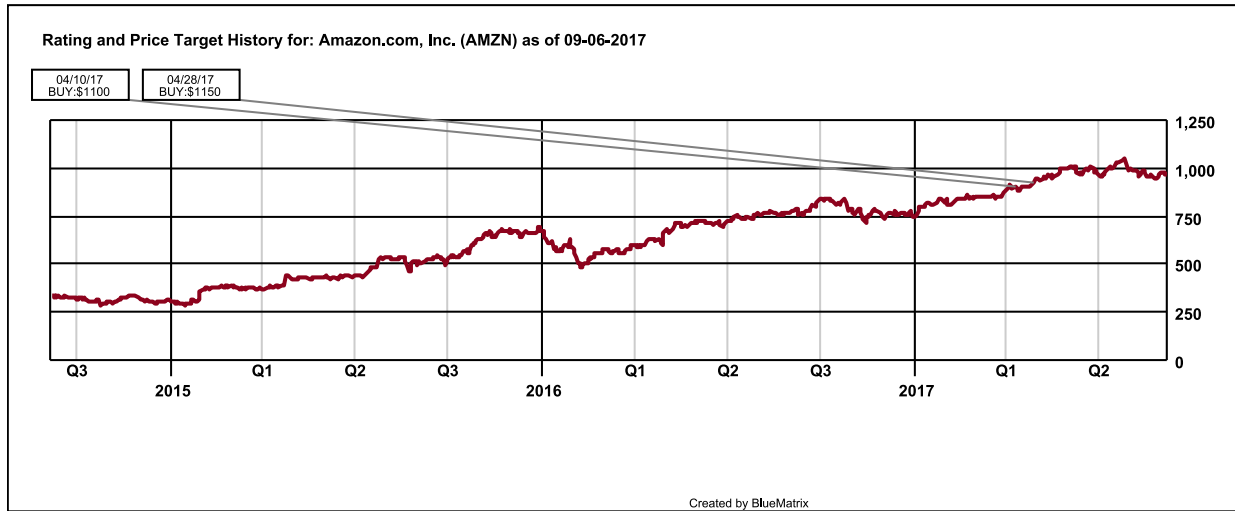
Source: Company reports, Needham &amp; Company, LLC

**Valuation (Price Target: \$1,150.00)**

- Our price target of \$1,150 is based on the sum-of-the-parts analysis, which evaluates North America and International segments using EV/Revenue multiple, and AWS segment using EV/EBITDA multiple. Our price target is also below 7.9x FY18 Sales multiple of its large-cap peers.

**Risks to Target**

- Risks to attaining our share price target include, but are not limited to: 1) a decline in discretionary consumer spending, 2) slow adoption of Prime membership internationally, 3) increased e-commerce competition both domestically and internationally, 4) slowdown of revenue and operating margin growth of AWS due to competition and continued pricing cuts, 5) lack of traction in new products, such as groceries and home services, and 6) potential regulatory changes and uncertainties particularly in international markets.



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I, Kerry Rice hereby certify that the views expressed in this research report accurately reflect my personal views about the subject company (ies) and its (their) securities. I, also certify that I, have not been, and will not be receiving direct or indirect compensation in exchange for expressing the specific recommendation(s) in this report.

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Buy	65	17
Hold	25	5
Underperform	1	0
Rating Suspended	< 1	0
Restricted	< 1	0

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