Q2 2018 Earnings Call

Company Participants

- Brian T. Olsavsky, Chief Financial Officer & Senior Vice President
- Dave Fildes, Director, Investor Relations

Other Participants

- Brian Nowak, Analyst
- Douglas T. Anmuth, Analyst
- Eric J. Sheridan, Analyst
- Heath Terry, Analyst
- Jason Helfstein, Analyst
- Justin Post, Analyst
- Mark A. May, Analyst
- Mark Mahaney, Analyst
- Ross Sandler, Analyst
- Youssef Squali, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Thank you for standing by. Good day, everyone, and welcome to the Amazon.com Q2 2018 Financial Results Teleconference. At this time, all participants are in a listen-only mode. After the presentation, we will conduct a question-and-answer session. Today's call is being recorded.

For opening remarks, I'll be turning the call over to the Director of Investor Relations, Dave Fildes. Please go ahead?

Dave Fildes {BIO 20638976 <GO>}

Hello, and welcome to our Q2 2018 financial results conference call. Joining us today to answer your questions is Brian Olsavsky, our CFO. As you listen to today's conference call, we encourage you to have our press release in front of you, which includes our financial results as well as metrics and commentary on the quarter. Please note, unless otherwise stated, all comparisons in this call will be against our results for the comparable period of 2017.

Our comments and responses to your questions reflect management's views as of today, July 26, 2018 only, and will include forward-looking statements. Actual results may differ materially. Additional information about factors that could potentially impact our financial results is included in today's press release and our filings with the SEC, including our most recent annual report on Form 10-K and subsequent filings.

During this call, we may discuss certain non-GAAP financial measures. In our press release, slides accompanying this webcast and our filings with the SEC, each of which is posted on our IR website, you will find additional disclosures regarding these non-GAAP measures, including reconciliations of these measures with comparable GAAP measures.

Our guidance incorporates the order trends that we've seen to-date and what we believe today to be appropriate assumptions. Our results are inherently unpredictable and may be materially affected by many factors, including fluctuations in foreign exchange rates, changes in global economic conditions and customer spending, world events, the rate of growth of the Internet, online commerce and cloud services, and the various factors detailed in our filings with the SEC.

Our guidance also assumes, among other things, that we don't conclude any additional business acquisitions, investments, restructurings or legal settlements. It's not possible to accurately predict the demand for our goods and services, and therefore, our actual results could differ materially from our guidance.

With that, we'll move to Q&A. Operator, please remind our listeners how to initiate a question.

Q&A

Operator

At this time, we will now open the call up for questions. Our first question comes from the line of Justin Post from Merrill Lynch. Please proceed with your question.

Q - Justin Post {BIO 3469195 <GO>}

Great. Thank you. I guess, the standout metric of the quarter was the profitability and the margins. Both U.S. and International have improved year-over-year. Could you talk about (03:04) was it better than your expectations for the quarter? And then maybe reasons for the ad business to accelerate within the other line? Thank you.

A - Brian T. Olsavsky {BIO 18872363 <GO>}

Sure, yeah. Thanks, Justin. Yeah, for the quarter, so it was a strong quarter. We had – what I attribute it to is continued strength in our – some of our most profitable areas. AWS had its third consecutive quarter of accelerating growth, 49% FX-neutral growth. Advertising also had strong growth. Elsewhere we saw probably better than expected efficiencies in operations, our infrastructure costs, and generally all of our fixed costs.

You'll note that in the first half of the year capital leases were flat year-over-year, although we're up 20% for the full trailing 12 months, in the last 6 months it's been pretty flat as the team has really worked well to plan our data centers run our data centers more efficiently, even to meet again increasing usage at our customers; usage rates are exceeding our growth rate.

So that's what I would point to. Internationally, a lot of the same factors hold. I would say that, in addition to the operating efficiencies, advertising is also starting to make an impact on gross profit, although advertising is smaller in International segment than it's in North America, it's growing at a same rapid clip year-over-year.

Even while in International, we're continuing to invest in a lot of areas, we continue to frontload Prime benefits for the newer geographies, we continue to launch new countries as we launch Prime in Australia recently. We've launched devices in multiple countries, Echo and Alexa were launched in France. Echo Spot was launched in India and Japan in the last quarter. So continued – it's a mix of operating efficiencies as we grow, and then also continuing to invest on a lot of fronts.

Operator

Our next question comes from Mark Mahaney with RBC Capital Markets. Please proceed with your question.

Q - Mark Mahaney {BIO 3027058 <GO>}

Okay. Hey, maybe two things. Just a little bit of color on that unit growth, I think, it was 17%, any particular things to call out there as that would have stunted that growth or negatively limited? Or is that just kind of the new, new normal?

And then Brian, I'm sorry, you just talked better than expected efficiencies in operations, could I ask you to tease that out a little bit more, and a little more color particularly on the retail side of the business? Are there particular newfound efficiencies that are sustainable? Thanks a lot.

A - Brian T. Olsavsky {BIO 18872363 <GO>}

Sure. Let's start with unit growth. So I will note, we did a very strong unit growth rate last year in Q2, with 27%, so we're comping against that. As we look back on that, there were number of factors. I mean, in any quarter there can be product mix or ASP differentials which shift the unit growth figure, but if you also remember, we dropped our Super Saver Shipping threshold twice, the early part of last year from $49 to $35; and then down to $25.

So there was a bit of growth, particularly in lower ASP items from that, that we saw last year. So we're comping that. Another factor is digital content that moves to subscription. So Amazon Music and Kindle Unlimited, while they're very successful and it's a good transition, they just – the units do not count in this unit calculation.

So there's some things like that, that maybe obfuscate the numbers a bit, but we're really pleased with the retail growth. We think it's driven by again Prime, the Prime program, the engagement of Prime customers as well as increased selection, and particularly third-party selection.

On operations, if you look at probably the last 18 months, you're going to see a lot of different pace of increase in both infrastructure costs and capital costs, and the addition of fixed cost heads. So one thing that you'll notice is that, we've grown – we've stepped down our rate of growth of fixed head count, excluding the acquisitions we've grown 26% year-over-year at the end of June, on a trailing 12 month basis.

But 23% of that was in the second half of last year. So we are continuing to look at where we're investing head count. We're seeing a lot of our growth areas being fueled by head count that's moving within the company. There's a lot of movement of tech head count. And so there was less external hiring in the first half of this year. We don't think that, that's necessarily the long-term trend, but it certainly created a lot of operating efficiencies, and now we'll reset and evaluate where we need to still add people.

So I think the first half of the year could be a good test of where our cost structure is, coming off of the investment that leads up to the holiday. Last year, there was a lot of first half investment. If you look back on infrastructure and fixed head count that may be made that less pronounced. But this year it's a little more apparent.

Operator

Thank you. Our next question comes from the line of Douglas Anmuth with JPMorgan. Please proceed with your question.

Q - Douglas T. Anmuth {BIO 5591566 <GO>}

Thanks for taking the question. Wanted to ask two, if I could. First, 3Q is typically a heavy fulfillment center build out period ahead of the holidays, and then lower utilization, but obviously your profit outlook is good. Can you just give us a sense of how you're thinking about FC build out and square footage increases this year?

And then, secondly a lot of excitement around the pharmacy opportunity with the acquisition of PillPack. Can you frame some of the strategic rationale there around the acquisition, and how that helps advance your efforts, and how we should think about integration going forward? Thanks.

A - Brian T. Olsavsky {BIO 18872363 <GO>}

Sure. On the fulfillment center capacity, I don't have a number for you, today. I'll probably clarify that at the end of next quarter as we head into holiday, but if you think back, the last two years, we've added square footage that's exceeded 30% growth, both in 2016 and 2017.

We anticipate it's going to be lower this year as we get some efficiencies off what we've built over the last few years, but I don't have a number for you today. I will say that, the majority of it is being put in service in the back-end of the year, just like in the last two years. But I'll – we'll clarify that next quarter.

On PillPack, yes, the deal of course hasn't closed, yet. We expect to close it in the second half of the year, so I'll limit my comments right now. But we're excited. I think the company has a really highly differentiated customer experience, and they've done a great job getting to the size and scale that they're at today. We think that, working together with them we can expand on that in the future.

They're like a lot of the other acquisitions we've done. Recently, we're looking for well-run companies with highly-differentiated customer experience, and a real sense of customer obsession that matches ours. So we think PillPack has got all those traits, and we look forward to the deal closing and working with them.

Operator

Thank you. Our next question comes from Mark May with Citi. Please proceed with your question.

Q - Mark A. May {BIO 4280734 <GO>}

Thanks. On AWS, does the backlog there give you confidence in the ability for this business to continue to post the type of robust growth that you've seen of late? And on Alexa, now that you're reaching a meaningful number of Alexa users, I wondered if you could discuss a bit more about how Alexa is impacting retail business?

A - Brian T. Olsavsky {BIO 18872363 <GO>}

Sure. Let me start with AWS. Yeah, we're very happy with the results we're seeing, and the backlog that we see, and the new contracts and new customers and the expansion of existing customer business that we see. Again, the business has accelerated the last three quarters, and we're seeing great signs in a number of areas.

We've added 800 new services and features so far this year; that's an accelerated pace from last year, which was a record year. We see customers have migrated more than 80,000 databases using the AWS Database Migration Service.

And customers are just branching out to a lot of new products from us. There are new areas like machine learning, artificial intelligence, Internet of Things, serverless computing and database and analytics are really big. So we think that, when you look at it, why do people come to us? It's essentially set functionality and pace of innovation that we've demonstrated for multiple years. We've built a very strong partner and customer ecosystem. And frankly we've the most proven reliability of security and performance, and we've been at this longer than anyone else.

So again, we continue to deliver for customers. We continue to use feedback from customers to develop new services and features. The operating margin itself will fluctuate quarter-to-quarter, a very strong performance this quarter. Obviously, part of that was in the capital leases being flat year-over-year, and the team's ability to really run the data centers at a higher efficiency.

A - Dave Fildes {BIO 20638976 <GO>}

Yeah. And I think, the second question was just related to how is Alexa impacting the business, overall. And – hey, this is Dave. I mean, I think, we're having a lot of success with devices and customers are enjoying those. We talked to coming out of Prime Day, had some good success and happy customers enjoying some of the devices there. So I think, that's a lot of – the focus now is really having a good and exciting roadmap of recent revises and more to come ahead, and getting those into customers' hands.

Operator

Thank you. Our next question comes from the line of Heath Terry with Goldman Sachs. Please proceed with your question.

Q - Heath Terry {BIO 3406856 <GO>}

Great. Thank you. Just on the AWS point, as you're seeing customers to AWS, you're adding new customers to AWS, can you give us a sense of sort of where you're seeing customers spend focus. How successful – you mentioned database, but what other areas you're potentially seeing as customers move up the stack with you and grow?

And then, you flagged the flat capital lease growth on a year-over-year basis. In the past when you've talked about the growth in CapEx and capital lease, you generally referred to trying to grow those numbers or that infrastructure growth overall more or less with the business. Is there some level of efficiency breakthrough that you've gotten there where that's no longer the case? Or is it a function of timing? How should we think about what that CapEx and capital lease spend signals about your expectations for growth?

A - Brian T. Olsavsky {BIO 18872363 <GO>}

Sure. I would say it's just a demonstration of the very tight period where we – we've still added a lot, I mean, $4.6 billion is a lot of capital leases, but the rate of growth over last year is flat. So what I would say is, I'm not sure about the breakthrough element of it. We do spend a lot of time driving better efficiency in our data centers. We do see it; sometimes it is higher than other quarters. The starting point for our expectation would be, the usage growth would be very – that our growth in infrastructure costs would start with the growth in usage, which has been exceeding the revenue growth rate.

But we can drive more efficiently and we can sometimes bank the efficiencies of prior investments that we've made in other periods. So it will fluctuate quarter-to-quarter. I would say last year in the first half was a pretty large investment area. I'll lump it in with capital expenditures, but in the first two quarters, Q1 of last year, it was 82% growth year-over-year in capital expenditures, Q2 was 67%.

This year, those numbers are 33% in Q1, and 1% in Q2. So it's a – there's a bit of timing at play here, but I think overall, in the longer-term, we certainly work to drive efficiency in both AWS infrastructure capability, and also in our warehouse networks.

I don't have on the other piece, on product detail, I don't have anything more for you. I would just say that, our growth is coming from customers that span from start-ups to enterprise customers to government agencies, and they start small and then they continue to build and shift their businesses to us, and many of them have gone – a large number have gone all-in on AWS, and have had a chance to lower their cost structures as a result. I'd count Amazon in that category, because on the consumer side of the business, we increasingly see infrastructure savings due to the conversion to AWS resources.

Operator

Thank you. Our next question comes from Brian Nowak with Morgan Stanley. Please proceed with your question.

Q - Brian Nowak {BIO 16819013 <GO>}

Thanks for taking my questions, I have two. The first one on the ad business, Brian, I was just wondering, could you give us some examples of some products you've had particular success with on the ad side? And I know you guys are always focused on removing customer friction points and solving pain points for customers, maybe talk to us about some of the still existing pain points for your advertiser customers you're looking to address with the advertising product?

And the second one, I know it's an accounting question, but we're going to be asked it a lot. On revenue accounting, can you just sort of walk us through any of the accounting changes that any of the revenue lines had in the current quarter because of the multiple accounting moving pieces? Thanks.

A - Brian T. Olsavsky {BIO 18872363 <GO>}

Yeah, let me give Dave a chance afterwards to talk about that piece, but I'll start with advertising. So conceptually stepping back, it's now a multi-billion dollar business for us. We're seeing strong adoption across a number of fronts. Amazon vendors, sellers, authors as well as third-party advertisers who want to reach Amazon customers.

So we have hundreds of thousands of emerging and established advertisers. And they're using our services to achieve their marketing goals to – whether that's to drive new brand awareness, discovery or ultimately purchase decisions on our site.

Pain points and improvements, I would say, our priorities include improving the usability of our tools for advertisers, helping make smarter recommendations for customers. Automating, we're doing a lot of work on automating the activities that the advertisers need to do, and continue to invent new products for those advertisers.

We also think measurement is going to be important so we're focused on our measurement capabilities, so advertisers understand what outcomes they're driving on our properties. And we think that we're uniquely positioned to show them the direct benefit of their advertising.

A - Dave Fildes {BIO 20638976 <GO>}

Yeah. And Brian, this is Dave. Just on the accounting piece, specifically to Q2, the impact of the Accounting Standards Update, revenue recognition changes we did starting in the first part of year, it's a $640 million increase to other revenue, specifically related to how we treat some of the advertising service.

So you remember as part of the adoption beginning in 2018, certainly the advertising services were classified as revenue rather than cost of sales. So $640 million more is in other revenue this second quarter. You'd see that in that line item, which is about $2.2 billion here in the second quarter.

In addition to that, some of the other factors I talked about last quarter, some of the treatment of gross to net changes in some sales of apps and app content, digital media costs, some of that shift created a headwind for online stores revenue. So that year-over-year growth rate for that line item would have been higher, but for that change.

Operator

Thank you. Our next question comes from Eric Sheridan with UBS. Please proceed with your question.

Q - Eric J. Sheridan {BIO 17860961 <GO>}

Thanks so much. Two questions if I can. On Whole Foods, any update on the integration of Whole Foods within the broader Prime ecosystem, the way in which you're tying those assets and customer bases together to sort of promote the flywheel that you've talked about a fair bit?

And Prime Now, any update on the scale of markets globally, and what you're learning as Prime Now continues to scale in terms of how users adopt the service, putting SKUs closer to prem what that does to the velocity of purchasing? Thank you so much.

A - Brian T. Olsavsky {BIO 18872363 <GO>}

Sure. So, it was a big quarter for Whole Foods and Prime. We launched additional savings for Prime members at Whole Foods. If you go to Whole Foods store or Whole Foods Market 365 store, you see a lot of yellow stickers for 10% discounts of hundreds of sale items. You also see deep discounts on selected popular products. So Prime members have adopted this benefit, it's one of the fastest rates we've ever seen for a Prime benefit, and they've already saved millions of dollars on everything from seasonal favorites to as I said popular daily sales.

So in addition, we've expanded grocery delivery to 20 cities so that's picking up steam. During the Prime Day, we had some unique deals for Prime customers at Whole Foods. Actually, the deals lasted for a week at Whole Foods. And people had, again the ability to see the benefit that Prime membership save incremental dollars, because of it at Whole Foods. And the Prime Rewards Visa Card, which gives you 5% off on all purchases has been applied to Whole Foods' purchases as well.

So that is the second wave, probably after the first wave where we talked in previous calls about initial price drops, putting lockers in the stores, selling some of the Whole Foods' products on the Amazon site, and other things. So the invention level is still really high. We think it's a big milestone this quarter to launch Prime benefits with Whole Foods, and we'll keep going, we'll see how that develops.

Prime Now, I guess, my comments are that, it's in 50 cities worldwide, it's across 9 countries. It is different than – we have multiple options for you in grocery delivery. We have the delivery services – so AmazonFresh and Prime Now which serve a certain need. We have a traditional grocery store now with Whole Foods, and then we have the combination of those two with home delivery, and we're using Prime Now or Whole Foods products through Prime Now to make those deliveries as well as the new kind of stores with Amazon Go that we're experimenting with. So lots of innovation, invention on that front as well.

Operator

Thank you. Our next question comes from Ross Sandler with Barclays. Please proceed with your question.

Q - Ross Sandler {BIO 15948659 <GO>}

Good evening. Hey guys, I had two questions. First is on the Music business. So I think, you said recently you had tens of millions of paying subscribers. So are those paying music listeners coming from Prime, and using the mobile app, or they coming in from Echo? Any color on what's driving that uptake and converting users into paid members?

Then the second question is, you mentioned efficiency gains in retail and the improvement in retail operating margin. If we look at International, it's still negative, but it's also improving pretty meaningfully, so can you parse where that improvement's coming from between India and the other emerging markets versus some of the more mature markets in Western Europe?

A - Brian T. Olsavsky {BIO 18872363 <GO>}

Sure, let me start with that second question. So, yes, we have seen over the last few quarters, improved operating margins internationally. I would say in places like Europe and Japan, we're seeing many of the efficiencies I talked about earlier on fixed head count, operations costs, infrastructure costs, and also things like marketing working to be very efficient. I would also say that, although it's smaller internationally the impact of advertising is starting to show up more and more internationally. It's growing quite quickly just as it is in North America.

But you're right. We continue to invest. We're investing in India obviously, and have seen good traction there. We just passed our Fifth Year Anniversary – celebrated our Fifth Year Anniversary, as the most visited site in India. So we think there's a lot of great innovation that has continued to occur for Indian consumers and sellers, and that will continue.

But you're also seeing additional expansion. So we launched Prime in Australia; we're rolling devices out. We launched Echo and Alexa in France. The Echo Spot in India and Japan, and we announced that we're going to expand Echo and Alexa soon to Italy, Mexico and Spain. So I would say that we're continuing to frontload Prime benefits in the newer geographies. So that's one of the issues that we see with operating margin.

But we think it's the right thing to do. We are seeing strong traction in that front as well. We also like that the – on Prime Day, we were able to expand our list of countries that experience Prime Day; this year to Australia, Singapore, the Netherlands and Luxembourg. So we're very bullish on our International business. We do realize it's a period of investment and we're in different stages of growth in different countries.

A - Dave Fildes {BIO 20638976 <GO>}

Yeah, and this is Dave. Just quickly on Music, as you mentioned, tens of millions of paid customers are enjoying Amazon Music. When you look at the Amazon Music Unlimited subscription, it continues to grow very quickly. We've got those offerings in more than 30 countries now and the catalog there's tens of millions of songs, and a lot of rich playlists, personalized stations, those kinds of things.

Of course we started in Music with Prime Music, a little bit earlier in that space, and I think that's been a great way for Prime members to enjoy some of that catalog for free, and then as they enjoy that, be able to move into the Amazon Music Unlimited skill.

One of the great things that's also part of that, I think, you alluded to it is just Alexa, and one of the most popular features we see as you probably imagine for using those devices are just interacting with Alexa, wherever you may be is being able to listen to music. So that's proven to be a, I think, a good skill for folks to be able to enjoy in addition to a really kind of rich and growing Amazon skill set. We now have more than 45,000 skills available to customers.

Operator

Thank you. Our next question comes from Youssef Squali with SunTrust Robinson Humphrey. Please proceed with your question.

Q - Youssef Squali {BIO 1506420 <GO>}

Thank you very much. On the new Supreme Court decision, you guys have been collecting state taxes in all 45 states where it's applicable for a 1P. And for a 3P, I think, it was in two states. Have you seen any slowdown to growth in these two states since you began collecting taxes? I think, you started maybe last 12 months or so.

When will you start collecting taxes in the rest of the country, and will you charge for it? Because my understanding is that, in those two states you do not collect or you do not charge to help these 3P sellers file taxes or collect state taxes. Thank you.

A - Dave Fildes {BIO 20638976 <GO>}

Yeah. Hey, Youssef this is Dave. So right now, as you mentioned 45 states that have state-imposed sales tax, first-party products we do our own collection on that. For 3P sellers right now, it's three states. So Washington State started as of January 1, Pennsylvania as of April 1, and most recently Oklahoma on July 1. So those are the ones where we're collecting and remitting. We haven't said – and to your second point we've not talked about any kind of trends. As you could imagine some of these are still really early days.

Operator

Thank you. Our final question comes from Jason Helfstein with Oppenheimer & Company. Please proceed with your question.

Q - Jason Helfstein {BIO 2527987 <GO>}

Thanks. Given the focus in the press release about Alexa Voice Services, any thoughts about how you would monetize on third-party devices? And then just a follow up on Amazon Prime Video Channels, any plans to offer standard skinny bundles to become a cable replacement? Thanks.

A - Brian T. Olsavsky {BIO 18872363 <GO>}

Yeah, let me start with Alexa. So right now, our emphasis is around expanding the reach of Alexa and the usefulness. So as Dave mentioned, we're now up over 45,000 skills. We have a developer network of – that's expanded and we have over 13,000 smart home devices from 2,500 unique brands. You're seeing things like expansion into the hotel space where we're partnering with hotels to allow you to experience Alexa while you're traveling.

And you saw from the quote that was in our press release from Jeff, the number of Alexa-enabled devices has tripled in the past year, so – including some really large companies like Polk, Sonos, Acer, Hewlett-Packard, Lenovo, BMW, Ford, Toyota to name a few. So that's the biggest emphasis, is getting the expansion of Alexa to places where it can be useful. We also are developing new machine learning tools to help developers more easily build Alexa skills. We feel like we're getting great traction there.

So I think your original question was about monetization of Alexa, but right now the biggest thing we can do is to make it as useful as possible, and make devices that can use the skills.

A - Dave Fildes {BIO 20638976 <GO>}

Yeah, and then just on the second question. I mean, I can't speculate on what we might do in the future, but I'd say today, with Prime Channels, I think, we're really pleased with the growth we're seeing. We've seen some good channels come online over the last few quarters, and seen some good traction there. So we'll keep focusing on building out even better selection, because it's clear to us that customers want that option to be able to add that content as part of their Prime memberships.

Thanks for joining us today on the call and for your questions. A replay will be available on our Investor Relations website at least through the end of the quarter. We appreciate your interest in Amazon, and look forward to talking with you again next quarter.