Company Name: Amazon
Company Ticker: AMZN US
Date: 2018-02-01
Event Description: Q4 2017 Earnings Call

Market Cap: 669,802.32
Current PX: 1390.00
YTD Change($): +220.53
YTD Change(%): +18.857

Bloomberg Estimates - EPS
Current Quarter: 3.509
Current Year: 16.768
Bloomberg Estimates - Sales
Current Quarter: 48934.517
Current Year: 229414.465

Q4 2017 Earnings Call

Company Participants

- Dave Fildes
- Brian T. Olsavsky

Other Participants

- Mark Mahaney
- Douglas T. Anmuth
- Ross Adam Sandler
- Mark A. May
- Daniel Salmon
- Justin Post
- Brian Nowak
- Scott A. Mushkin
- Youssef Squali
- Ken Sena

MANAGEMENT DISCUSSION SECTION

Dave Fildes

Q4 Highlights

GAAP and Non-GAAP Financial Measures

- 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

Results

- 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 demand for our goods and services, and therefore, our actual results could differ materially from our guidance

U.S. Tax Reform Legislation

- I’d also like to update you on the impact of the recent U.S. tax reform legislation
- In our fourth quarter results, we recorded a provisional tax benefit for the impact of the new tax legislation of approximately $789mm, which is primarily driven by the re-measurement of federal net deferred tax liabilities, resulting from the permanent reduction in the U.S. statutory corporate tax rate to 21% from 35%
- As we complete our analysis of this new legislation, we may make adjustments to the provisional amounts
- Those adjustments may materially impact our provision for income taxes in the period in which the adjustments are made

QUESTION AND ANSWER SECTION

<Q - Mark Mahaney>: I’d like to focus on the North American retail operating margins. That 4.5% was the highest, I think, we’ve seen in a couple of years, maybe the highest since you’ve actually broken that segment out. So could you just go through the drivers behind that? I know you called out Alexa as being better than expected. Was that one of the factors? Was it the full quarter of the Whole Foods impact? Was it advertising revenue? Just what drove that result and how sustainable is it? Thank you.

<A - Brian T. Olsavsky>: Sure, Mark. Let me address your question by answering the entire company on noteworthy North America elements are strongest. So for the quarter, we came in at the highest end of our revenue range, $60.5B, 36% FX-neutral growth and 25% FX-neutral growth, excluding the Whole Foods acquisition. So the fact that we came in at the high end of the range, volume was high, especially in North America, and a lot of times in Q4 and other quarters actually, we see better efficiencies when the warehouses are busy. So it’s a very clean operational quarter, I would say.

The ops team did a great job handling record volumes in Q4 and also incorporating all the new capacity we had opened in 2017. If you’ll remember, we have added over 30% to our fulfillment square footage in 2017, coming off the similar increase in 2016. So amid all these opening of new buildings, many of them late in the year, the ops team did a fantastic job.

Advertising was also a key contributor as we’re continuing to make the offerings more valuable, both to customers and advertisers alike, and that was particularly strong in North America, although not in the North America segment. I would also point out, AWS had a strong quarter, accelerating growth vs. Q3 and also expanding operating margins by 100BPS. So particularly in North America, I would say, the strong top line volume combined with increased advertising revenues and also very clean operational performance.

Obviously, there’s a lot of things that can happen in Q4 from weather to demand patterns changing. We’ve seen additional costs creep in, in the name of customer experience in prior years, and this was, in hindsight, probably one of the cleaner Q4s recently.

<Q - Douglas T. Anmuth>: Brian, I was hoping you could talk about how you’re thinking about your primary investment areas in 2018 and perhaps if you could put it in context of 2017, are there things that are notably different this year relative to last year and also how you think about the margin trajectory relative to what we saw last year. Thank you.

<A - Brian T. Olsavsky>: Sure. I will be giving you guidance quarter-by-quarter, but I can talk to the general trends in the large investment areas. Let me start with AWS infrastructure and the growth in technical and sales teams, that will continue, [ph] we’re at a (7:08) $20B run rate in top line revenues for AWS, up from $18B last quarter. So we’re very happy with both the progression in new services and features that we’ve been able to bring to customers and also their response. We'll continue geographic expansion and continuing to, again, build on our tech teams and our sales teams.

So that expense is going to continue and likely increase. Prime benefits will continue to increase as well. Prime Video, Prime Now, AmazonFresh, all of our major Prime benefits, we continue to expand globally. Devices, as Jeff said in the press release, we are very happy with the results of Alexa. It's a very positive surprise for us both on a – adding a little bit more to that, we had record device sales with very high levels of customer engagement, including increased levels of voice shopping, growth in functionality, growth in our partners we work with, skills [ph] layer (08:20) we've increased rapidly, we're over 30,000 skills for Alexa. We've got 4,000-plus smart home devices from 1,200 unique brands.

So the relationships we're having with external companies is actually helping to accelerate the adoption of Alexa with customers. So really strong usage of – excuse me – Alexa with our devices. Obviously Echo, Echo Show, and the Echo family all directly tied to Alexa, but also Fire TV and tablets and we're seeing more and more engagement. Alexa usage on Fire TV is up 9x y-over-y. Music listening time on Alexa was 3x higher this holiday season.

So that's what we mean when we said far exceeding our expectations. Those are the things that I would point to. And that is an area again where we'll continue to invest heavily, and as you say, double down on that. Fulfillment, again, is – fulfillment capacity, especially [ph] the fuel (09:23) strong top line growth and growth in Amazon fulfilled units, which, again, is growing much quicker than our unit growth rate. We expect that and hope that to continue as well into 2018.

Video content, we spoke about on the last call. We do like the results we're seeing with engagement on customers, their buying habits, their engagement with the video content, their use of it on devices and we will continue to increase our budget in that area. But I'll be release – I'd incorporate that into the guidance each quarter as we move through the year.

<Q - Ross Adam Sandler>: Just two questions, AWS reaccelerated again this quarter. Can you just give us some color on what were the key drivers there? Was it lapping some of the price activity from a year ago? Was it higher utilization, moving up the stack? Any color there would be helpful. And then a question on shipping costs. So it looks like it grew about 31% up on shipping costs in the quarter, and that's been kind of moving in tandem with the Amazon fulfilled unit growth.

Is that the right way to think about it? It looks like it might be getting a little bit of leverage in the model right now is that – what's driving that, the shipping cost leverage? Thank you.

<A - Brian T. Olsavsky>: Sure. Let me start with that last one. Yes, the shipping costs are going to be very tied to AFN unit growth and also the impact of greater Prime adoption and faster shipping methods. So we consider that a very strong quarter as down sequentially in the growth that we've seen recently. That will fluctuate quarter-to-quarter. Again, it was a very strong operational quarter in Q4, and we've expanded the number of items that shipped free. There are now over 100mm items in the U.S. So shipping cost is always going to be a strong part of our offering, and it's going to be increasing due to our business model, and we, at the same time, look to minimize the cost by getting more and more efficient in that area.

AWS, yes, if you remember last year, we did have price increases in December of last year towards the end. So it had a partial impact on the quarter. But generally, just strong usage growth – usage growth continues to be strong growing at a higher rate than our revenue growth rate, and customers continued to add workloads and expand. And as I said, we're adding new services and features all the time, over 1,400 in 2017 alone. So it's a number of factors, I would say. It's not as simple as lapping a cost error – excuse me – price decrease last year, but very happy with the performance of the AWS business. Now over $20B run rate.

<Q - Mark A. May>: Brian, if you look back historically, your Q1 operating income guidance is typically about $300mm, $400mm lower than your Q4. Obviously, it's significantly greater than that this quarter. Maybe if you could shed a little light on why that is so and what are some of the key drivers there. And AWS and cloud pricing appears to have been more subtle in the recent quarters. Maybe if you could talk a little bit about the pricing environment and why that has been the case at least compared to trends from back in 2014, 2015, previously. Thanks.

<A - Brian T. Olsavsky>: Sure. Let me start with guidance. So, yes, the operating income guidance is $300mm to $1B. Operating income last year was $1B. Q1 is generally when we see the volume drop off from Q4 obviously, but a lot of the cost remain from the y-over-y build up in cost, particularly in the fulfillment network. So it's generally a headwind every Q1. It's – given the 30%-plus growth in square footage last year that we've built, that's one major headwind from Q4 to Q1. But we also continue to invest, particularly in Alexa and our device area.

As I mentioned in a number of comments earlier, we're very happy with the results, the customer adoption, the device sales that we're seeing and the general customer acceptance there. So we will continue to invest there. That's probably the two largest factors in Q1, I would say.

<A - Dave Fildes>: Yeah. This is Dave. Just on the second piece on pricing. I think in the pricing environment, I mean, nothing really to call out there. I guess, just a reminder on our pricing philosophy for AWS, I mean periodic price reductions are a normal part of our business where reduced prices more than 60 times with AWS since launching. So really, our kind of goal, philosophy here is to drive efficiencies in our ops and pass those savings on to customers, and some of that's through, again, the more than 60 price reductions, but also finding through new service and feature launches, better options for customers to present more efficient features for them to be able to run their businesses.

<Q - Daniel Salmon>: First, Brian, any comments on the impact of ASC 606 accounting changes on your first quarter guidance here? And then just second on the advertising business, in particular, the ads that we see in the search results on the site, the headline search ad sponsored product ads, do you aim for a certain particular ad load across the entire platform? Do you look at sort of tailoring it based on users' activity, maybe a combination of both? I would just be interested in your thoughts on that.

<A - Dave Fildes>: Yeah this is Dave. I'll take the first part of that question just around the new revenue recognition standard. We did adopt the new standard on January 1 of this year, 2018, and you'll see that reflected in our financials for Q1 coming up. There it touches on a number of different parts of our business in terms of how we recognize revenue in terms of any aggregate, the impacts to our expectations for the revenue guidance for Q1. It's not material.

There's a number of different areas, at least, that we've called out in our filings with the 10-Q in the past and the 10-K that will be on file shortly that talk about the different areas that are impacted us, but again, not material in the aggregate.

<A - Brian T. Olsavsky>: And on advertising, I would say our strategy is to make the customer experience additive by the ad process. We want customers to be able to see new brands and have easier time discovering products that they're looking for. For brands, we think the value proposition is that we can find ways for them, especially emerging brands, to reach new customers. So we're working with advertisers of all types and sizes to help them reach our customer base and the goal of driving brand awareness, discovery and better purchase decisions by the customer.

<Q - Justin Post>: Great. I think I have two questions. First, Whole Foods, you've got over a quarter under your belt. How's it going vs. your expectations? And what can Amazon really bring now that you've been there for a while, how are you thinking about that?

And then secondly, international decelerated a little bit this quarter, just wondering if there was any country to call out or anything going on there? And we know that you spent about $3B International investment, I guess, last year. Where do you think the high watermark is on that? So just maybe a little bit more color on your international business. Thank you.

<A - Brian T. Olsavsky>: Sure. Let me start with the Whole Foods question. We're continuing to be very excited about the opportunities we have to innovate with the Whole Foods and Amazon teams together. In our physical stores, if you look at our supplemental disclosure, that physical stores revenue was $4.5B in Q4, which is primarily comprised of Whole Foods and was slightly better than what was built into our guidance that I gave you last call.

So, so far, our focus has been on continuing to lower prices even beyond the initial ones that we discussed at the close of the deal in late August. We've launched Whole Foods products on our Amazon website, and the technical work continues to make Prime the Whole Foods customer rewards program and we expect to have more on that later in the year. We've also added Lockers, and much more to come. So we're very happy with the initial results out of the team in Whole Foods down in Austin.

Also, I will mention that we did see a small operating income loss for the quarter from Whole Foods. At the time of the acquisition, we had stepped up the fair market value of certain assets on the balance sheet. This is going to increase the amortization. It's a non-cash charge, but it will increase amortization over the useful life, and a lot of that is forward frontloaded, so we'll see higher amortization in the first few years, and then it reverses later. So excluding these non-cash expense items, Whole Foods had a positive operating income in Q4, but you'll see in the 10-K that the operating income, including the charges, was slightly negative in Q4.

International growth, your comment about slowing down, I think there's a slowdown vs. Q4 – Q3, if that was your point. 28% growth in Q3, FX neutral, was helped quite a bit by Prime Day and kind of the strengthening of Prime Day in a number of locales. Although we've had Prime Day in most of those countries, it's really starting to gain more and more traction there. So that is probably more of a help to Q3 than a discussion of any weakness in Q4.

So we're continue to be pursuing the same strategy as we have in North America, adding Prime benefits, adding devices, adding video content, adding AmazonFresh, Prime Now, giving a lot of value to the Prime customers in the international countries as well. And also in that number is India, and India continues to be a good story for us. We feel that it's had a lot of growth in the past year. In fact, more Prime members joined India's Prime program in the first year than we've seen in any other country in the history of the world, our world. So the selection is also increasing Prime eligible selection is up over 25mm items, launching Video there and also continuing to add other Prime benefits such as Prime Music will be coming soon, Amazon Family is there, as I said, Prime Video, and we had our first Prime Day in India. So that's a little bit on international growth.

<Q - Brian Nowak>: I have two. The first one, in the press release, you talked about the strength of the Prime member growth in 2017. Could you talk a little bit about to the – what you're seeing in growth in Prime subscribers in the United States at this point? And are you still seeing a similar tick up in consumer spending as they come into Prime as you have in the past?

And the second one, Brian, to go back to an earlier question on areas of investment this year, you didn't talk a whole lot about kind of new categories to expand into beyond the old retail business. I'd be curious to hear about your investment needed to go into logistics, health care and kind of new areas you haven't really cracked into as hard yet.

<A - Dave Fildes>: Yeah, this is Dave. Thanks for the question, Brian. Just on the first piece, in terms of just Prime membership and Prime behavior, we continue to see that we're seeing sign-ups for memberships at a strong clip. When we look at the y-over-y growth in paid Prime members on a global basis, it's been consistent in Q4 y-over-y, similar growth rates y-over-y to what we've seen in some of the earlier quarters of this year.

So that's, of course, a mix of strength in the U.S. and also strength in some of the newer markets that we've launched or introduced the Prime program in. We continue to see that as Prime members sign-up and engage into the program, their purchasing patterns change and they do spend more as they move into the program. And of course, our focus is – continues to be on adding some of the features around Prime that Brian's been talking about, but also importantly, making sure we're adding more selection to the offering through our own efforts, first party, but also programs like Fulfillment by Amazon, which is – continues to be a fast grower for us.

<A - Brian T. Olsavsky>: Yeah, and on new businesses or expansion of categories, as you discussed, I would not talk to anything that's not been publicly announced, but on some of the ones you mentioned, they are underway and are continuing.

I've said logistics, we will continue to build our logistics capability both – and that will be all the way to end delivery. We've been able to increase service levels in many of the cases by delivering it ourselves. And although we have a strong partner network here, we will always be able to leverage our strength and our knowledge about where shipments are going, both within our network and to final customers that will create opportunities for us there as we increase or better the customer experience as well.

We continue – I would say on the category side, the biggest effort will be on continuing to be on groceries and consumables with the Whole Foods acquisition. And again, we continue to look at our whole offering of AmazonFresh, Prime Now, Whole Foods, how can they work together to create better and better offerings for our customer base. And to a lesser extent, vs. grocery, I would say we continue to build our business, B2B businesses, and very happy with the initial performance there with a number of the companies and universities that we've been working with and their initial results.

<Q - Scott A. Mushkin>: So I want to go back to, and I think you said one of the big focuses of the year is going to be on the consumables, Now, Fresh, Whole Foods. There's been a lot of press on the Whole Foods front, the out-of-stock issue, and then clearly, the Now, as we've been testing it, and Fresh has the same issue.

So I was wondering if you guys could talk about what the company plans to do. I mean, there is obviously the reputational risk that could come from that to kind of correct some of these issues and, kind of, what the view of the company is on the out-of-stock issues. Not just at Whole Foods, but just generally across the consumables business in Fresh and Now. Thanks.

<A - Brian T. Olsavsky>: Yeah, I'm not – let me just back it to a more general statement. I'd say Whole Foods has not lessened their commitment to providing the best selection of high-quality products and having them in-stock for customers. We've made no changes post-acquisition that would have impacted anything related to in-stock, except perhaps the fact that the price decreases have brought up demand and there's amount of rebalancing related to that.

So I think the out-of-stock issues that may be getting press are tied more to the increased demand that we're seeing and also selective weather-related restocking issues. But stepping beyond any short-term issues, the commitment remains to have healthy, high-quality selection in-stock for products. That's what the Whole Foods team is committed to. That's what the Amazon team, with them, is committed to, and also across any delivery channel that we have, AmazonFresh, Prime Now or Whole Foods.

So where there's issues, they'll be corrected. Where there's areas we can improve our selection and delivery for customers, we'll do so. But it'd be something we're working on. So the immediacy, the perishability are all challenges everyone has in this area, but we're confident that we will have a good service and continue to delight customers.

<Q - Youssef Squali>: We've seen that the number of private label products on the site has increased pretty dramatically over the last 12, 18 months. Could you speak to your private label strategy, in general? How big is that segment today? How big can it become? And just broadly speaking, how are the margins in that segment vs. comparable third-party products? Thank you.

<A - Dave Fildes>: Yeah, thanks for the question. This is Dave. I think broadly, when we look at our strategy, it's focused on, number one, providing a broad selection for customers across a number of categories, so that they can find and buy exactly what they're looking for.

When you look at private brands, it's very much meant to supplement that great selection, and we look for ways to be able to find private label items that have a high-caliber of quality, but also can bring that selection and that convenience for customers and really supplement what vendors and sellers are already providing the customers in many cases.

We've not broken out kind of how significant or how large that is. I think for a lot of these initiatives, when you look across categories that would offer, many of them are still earlier stage and have been around even from kind of infancy for shorter period of time, a year, a couple of years, in some cases.

Amazon Fashion is one area where you're seeing us offer a number of private apparel brands, 52 some of the more popular lines with customers things like Goodthreads, Amazon's Essentials, which is men's and women's basics; consumables, is, of course, another big area where we have the benefit of working with some of the Whole Foods private label, but also doing some of our other Amazon brands, things like Happy Belly and Wickedly Prime and others.

So I think we'll continue to iterate on those and try to find different areas. And certainly there's other verticals that I didn't mention there that we're interested in continuing to kind of learn from customers what they want and what they're looking for there, and so we'll keep adding selection.

<Q - Ken Sena>: Maybe if you could just remind us of the thinking behind keeping AWS and Retail under one corporate structure, and does it make sense given the scale of where AWS is right now? And then – and I'm sorry I have a little bit of an echo, I don't know why, but – and we're hearing from marketers just how important Amazon is to their media strategy, so I don't know if you could just maybe talk about that a little bit more broadly in terms of the approach and your philosophy to that business? Thank you.

<A - Brian T. Olsavsky>: Sure. We see a lot of value in all of our businesses. And AWS is a key component, as is the physical consumer business. The – what I'll point out is, the management team is a common management team. The consumer business, if you will, is, if not the biggest, one of the largest customers of AWS. So we see a lot of commonality there where we, as depending on the position in the company, on the consumer side, the use of AWS has driven great infrastructure efficiencies just like other companies see when they use AWS, turning fixed costs into variable costs and pooling resources and not having a lot of trapped capacity throughout the company and taking advantage of all the new services and features.

So as an internal customer, the consumer business is very happy with AWS. And I think AWS is also very benefited by the fact that they have a large internal beta customer that tries out and uses a lot of their products and services. So it's a good combination for a lot of reasons, and we see no reason to change the structure that we have.

<A - Dave Fildes>: Yeah, and sorry, Ken, your second question was?

<Q - Ken Sena>: Yeah, the second question was just on the advertising side. And we're just hearing so much more how important Amazon is to broader media budgets. And so just hoping to get maybe a little bit more color just on your approach to the business right now, some of the drivers behind the recent success, and just maybe – just more of a sort of, as you look out over the next few years, kind of how important do you see this business becoming in the grand scheme of things?

<A - Dave Fildes>: Yeah, I mean, I think right now, we're really just focused on finding ways to work with those companies, whether it's vendors or sellers that are coming to us, and offer them a great experience on the website and ability to be able to reach customers. So I think there's more to come on that side.

As we said, we're definitely seeing some strong growth in our advertising revenue as part of the other revenue line item. And I think we're going to keep building more and new tools based on what we're learning from our customers there to better serve in the future.

<A - Brian T. Olsavsky>: Yeah, I think we're also part of a key lien in from brands and agencies into the e-commerce marketing space. So whether it's our site [ph] alongside (32:43) search or social marketing, it's really helping them engage customers on a highly efficient manner.