Amazon.com (NASDAQ:AMZN) Q2 2011 Earnings Call July 26, 2011 5:00 PM ET

Executives

John Felton -

Thomas Szkutak - Chief Financial Officer and Senior Vice President

Analysts

Scott Devitt - Morgan Stanley

Brian Pitz - UBS Investment Bank

Colin Sebastian - Robert W. Baird & Co. Incorporated

Spencer Wang - Crédit Suisse AG

Youssef Squali - Jefferies & Company, Inc.

James Friedland - Cowen and Company, LLC

Charles Munster - Piper Jaffray Companies

Justin Post - BofA Merrill Lynch

Douglas Anmuth - JP Morgan Chase & Co

Jeetil Patel - Deutsche Bank AG

Mark Mahaney - Citigroup Inc

Operator

Good day, everyone, and welcome to the Amazon.com Second Quarter 2011 Financial Results Teleconference. [Operator Instructions] Today's call is being recorded. For opening remarks, I will be turning the call over to the Director of Investor Relations, Mr. John Felton. Please go ahead.

John Felton

Hello, and welcome to our Q2 2011 financial results conference call. Joining us today is Tom Szkutak, our CFO. We will be available for questions after our prepared remarks.

The following discussion and responses to your questions reflect management's views, as of today, July 26, 2011, 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.

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.

During this call, we will 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.

Finally, unless otherwise stated, all comparisons in this call will be against our results for the comparable period of 2010. Now I'll turn the call over to Tom.

Thomas Szkutak

Thanks, John. I'll begin with comments on our second quarter financial results. Trailing 12 month operating cash flow increased 25% to $3.21 billion. Trailing 12 months free cash flow decreased 8% to $1.83 billion. Return on invested capital is 21%, down from 34%. ROIC is TTM free cash flow divided by average total assets minus current liabilities, excluding the current portion of long-term debt over 5 quarter ends. The combination of common stock and stock-based awards outstanding was 468 million shares compared with 465 million shares.

Worldwide revenue grew 51% to $9.91 billion or 44%, excluding the $477 million favorable impact from year-over-year changes in foreign exchange. We're grateful to our customers who continue to take advantage of our low prices, vast selection and shipping offers.

Media revenue increased to $3.66 billion, up 27% or 20% excluding foreign exchange. EGM revenue increased to $5.89 billion, up 69% or 62%, excluding foreign exchange. Worldwide EGM increased to 59% of worldwide sales, up from 53%.

Worldwide paid unit growth was 56% compared to 45% paid unit growth in Q1 2011. Active customer accounts exceeded $144 million.

Worldwide active seller accounts were more than $2 million. Seller units were 36% of paid units compared to 36% of paid units in Q1 2011 and 34% of paid units in Q2 2010.

Now, I'll discuss operating expenses, excluding stock-based compensation. Cost of sales was $7.52 billion or 75.9% of revenue compared with 75.5%. Fulfillment, Marketing, Technology and Content and G&A combined was $2 billion or 20.2% of sales, up approximately 190 basis points year-over-year.

Fulfillment was $909 million or 9.2% of revenue compared with 8.5%. Tech and content was $624 million or 6.3% of revenue compared with 5.3%. Marketing was $331 million or 3.3% of revenue compared with 3.1%.

Now I'll talk about our segment results, and consistent with prior periods, we do not allocate the segments or stock-based compensation or other operating expense line item.

In the North America segment, revenue grew 51% to $5.41 billion. Adjusting for the $3 million year-over-year of favorable foreign exchange impact, revenue growth was 50%. Media revenue grew 20% to $1.58 billion. EGM revenue grew 67% to $3.5 billion, representing 65% of North America revenues, up from 58%. North America segment operating income increased 7% to $214 million, a 4% operating margin.

In the International segment, revenue grew 51% to $4.51 billion, adjusting for the $473 million year-over-year favorable foreign exchange impact, revenue growth was 36%.

Media revenue grew 34% to $2.07 billion or 20%, excluding foreign exchange, and EGM revenue grew 71% to $2.4 billion or 53%, excluding foreign exchange. EGM now represents 53% of international revenues, up from 47%.

International segment operating income decreased 16% to $172 million, a 3.8% operating margin. Excluding the favorable impact of foreign exchange, International segment operating income decreased 34%. CSOI decreased 5% to $386 million or 3.9% of revenue, down 229 basis points year-over-year. Excluding the $28 million favorable impact from foreign exchange, CSOI decreased 12%. Unlike CSOI, our GAAP operating income includes stock-based compensation expense and other operating expense. GAAP operating income decreased 25% to $201 million or 2% of net sales.

Our income tax expense was $49 million in Q2, resulting in a 22% rate for the quarter and a 26% rate year-to-date. GAAP net income was $191 million or $0.41 per diluted share compared with $207 million and $0.45 per diluted share. Second quarter 2011 net income was positively impacted by equity method investment activity of $15 million, including the $49 million gain on sale of an equity position partially offset by $34 million in losses from equity method investments.

Turning to the balance sheet. Cash and marketable securities increased $1.25 billion year-over-year to $6.36 billion. Inventory increased 66% to $3.23 billion and inventory turns were 11.3, down from 12.5 turns a year ago, as we expanded selection, improved in-stock levels and introduced new product categories.

Accounts payable increased 61% to $5.72 billion and accounts payable days increased to 69 from 65 in the prior year. Our Q2 2011 capital expenditures were $433 million. The increase in capital expenditures reflects additional investments in support of continued business growth, including investments in technology infrastructure, including Amazon Web Services, capacity to support our fulfillment operations and investments in corporate office space.

I'll conclude my portion of today's call with guidance. Incorporated into our guidance are the order trends that we've seen to date, and what we believe today to be appropriately conservative assumptions. Our results are inherently unpredictable and may be materially affected by many factors, including a high level of uncertainty surrounding exchange rate fluctuations, as well as the global economy and consumer spending. It's not possible to accurately predict demand and therefore, our actual results could differ materially from our guidance.

As we describe in more detail in our public filings, issues such as settling inter-company balances and foreign currencies amongst our subsidiaries, unfavorable resolution of legal matters and changes to our effective tax rates can all have a material effect on guidance.

Our guidance further assumes that we don't conclude any additional business acquisitions or investments, record any further revisions to stock-based compensation estimates, and that foreign exchange rates remain approximately where they've been recently.

For Q3 2011, we expect net sales between $10.3 billion and $11.1 billion or growth of between 36% and 47%. This guidance anticipates approximately 450 basis points of favorable impact from foreign exchange. GAAP operating income to be between $20 million and $170 million or between 93% decline and 37% decline. This includes approximately $180 million for stock-based compensation and amortization of intangible assets. We anticipate Consolidated Segment Operating Income, which excludes stock-based compensation and other operating expense to be between $200 million and $350 million or between a 50% decline and a 13% decline.

We remain heads down focused on driving a better customer experience through price, selection, and convenience. We believe putting customers first is the only reliable way to create lasting value for shareholders. Thanks. And with that, John, let's move to questions.

John Felton

Great. Thanks, Tom. Let's move on to the Q&A portion of the call. Operator, will you please remind our listeners how to initiate a question?

Question-and-Answer Session

Operator

[Operator Instructions] And our first question today comes from Jim Friedland with Cowen and Company.

James Friedland - Cowen and Company, LLC

I wanted to ask a question about how you think about ROI and free cash flow, as you invest really aggressively to support this 50% growth. We are seeing free cash flow levels depressed in the near term. And how long can this -- do you expect this to continue? If you keep grabbing shares, should we continue to expect pressure, in terms of free cash flow? Just trying to get a sense of how we should think about incremental capital invested.

Thomas Szkutak

Sure. In terms of how we think about these investments. Our approach has been pretty consistent over the years. If you look at the, as you mentioned, the strong growth, this is the strongest growth we've had from a quarterly perspective year-over-year and over 10 years. And as a result of that, as we look forward, there's a requirement for a lot of capacity and it's something I talked about on previous calls. And if you think about our capacity, it comes in a number of different forms. First of all, our core Retail business. We need both fulfillment capacity, as well as infrastructure capacity. This is something that we've been doing really since our inception and I look at it as a high quality problem. We have a -- if you back out cash and marketable securities, you see that we have a high ROIC. I'm not saying that's really a historical performance, it's not necessarily a predictive performance, but I do feel very good about those investments. Those are something that we've done before. And it's something that we've been working to perfect really since we opened our doors back in the mid-90s. In terms of there's another set of investments certainly you're seeing we're investing in the conversion from physical to digital. We think we have good assets to do that. We're very focused on the customer experience. And that comes in a number of different forms. We feel very good about those investments in terms of the traction that we're getting from a customer standpoint. And we're certainly optimistic about our ability to generate good free cash flow while high returns on invested capital. Then we have some newer businesses. I say newer, they've been with us for several years, but at least they weren't since inception like beyond the digital initiatives like Web services. That's a business that we're investing in. We have great traction. The team has done a terrific job there. And we continue to improve that business, and it's growing very fast. And that's -- you're seeing capital requirements for that business. So that's a business that the team is operating very carefully. They're looking at best ways to improve return on invested capital over time, and we think that's a great big space to be investing in, and we think it's good for that customer set. And it's good for, we hope it to be good for customers over the long term.

James Friedland - Cowen and Company, LLC

And then just quickly on the investment in AWS it looks like the tech and content line has been accelerating and the q over q ramp was pretty meaningful again in Q2. Is that -- is the primary driver there AWS or is it a mix of things?

Thomas Szkutak

It's a mix of things but certainly AWS would be a big piece of that, along with our infrastructure to support our Retail business. When I say our Retail business, I mean everything but AWS. So again, think of it as the infrastructure cost to support those 2 businesses. There certainly are other investments we're making that are in that line item, but certainly, those are two big pieces.

Operator

[Operator Instructions] Our next question comes from Spencer Wang with Crédit Suisse.

Spencer Wang - Crédit Suisse AG

Tom, just a 2 part question on media and then a housekeeping question. On media, the revenue growth there reaccelerated pretty nicely from the last couple of quarters. Is there anything you would call out there, in terms of driving that reacceleration? Any sort of specific categories? And then the second part, I know it's still relatively early days for Prime Instant Video, but I was wondering if you could share with us some of the metrics you see and the impact on Prime membership. And then just last on the housekeeping question, how much were acquisitions to revenue growth in 2Q and in your 3Q guidance?

Thomas Szkutak

Sure. In terms of media, it was pretty broad across the board. Certainly, you're seeing great growth in our digital products, including Kindle that's represented there. The other thing to call out just from a sequential standpoint as you look at international specifically. We did see -- and this is reflected in the total growth rate for international, as well as the media growth rate. We did see an acceleration from Q1 to Q2 for our Japan business. We had talked about last time being soft given the events there, that our team there has done a terrific job serving customers, so we have seen the growth rates return more favorably from first quarter. They're not quite where they were last year but certainly they've -- we've seen an acceleration there, so that is also impacting our global media growth rates and it shows up in our International segment. In terms of Prime Instant Video, we're measuring, as you'd expect, a number of different things for that business. It's very early right now. There's not a lot I can share with you. What I can say though is we like what we've seen so far. We're continuing to invest there, and right now we're seeing customers love it, and it's early. So again, that's something that we'll continue to focus on. And then your third question in terms of acquisitions impact. For Q2, the most recent acquisitions for Quidsi and Lovefilm, that impact year-over-year for those two acquisitions, is a little over 200 basis points, approximately 220 basis points. We had a small amount in Q1. So if you're looking at it sequentially, assume it was about 30 basis points in Q1, and a little over 200 basis points in Q2. Again those are both year-over-year numbers impact for those acquisitions as Lovefilm was about half a quarter in Q1. In terms of bottom-line impact or CSOI and operating income for Q2, CSOI was about negative 19, for GAAP operating income, it was negative 27. That's for Q2. In terms of Q3, it's reflected in the guidance that we're giving today, and we're not breaking out those specific numbers.

Operator

And we'll go next to Mark Mahaney at Citi.

Mark Mahaney - Citigroup Inc

Tom, I want to ask about how you think through balancing margins and growth. I know you don't run the business per [ph] markets for free cash flow, but as you brought the margins down and investing aggressively to support what's this exhilarating 10-year high growth rates, I assume you're doing with a view not to just growth rate one quarter out or two quarters out, but for a full year out. Do you feel that you've got enough to grasp over the business such that when you see that growth rate slowing down, which it inevitably must, whenever that is in the year, that you can easily ramp-up margins? Do you really feel like you're at a point in the business model where that tradeoff is a very easy thing for you to manage?

Thomas Szkutak

Sure. The way you should think about it is first of all, the growth rates that you're seeing in Q2 really stem from investments that we've made over a long period of time. These aren't investments that we've made over the past few quarters. We have invested capacity over the last several quarters to help support that growth. And certainly that's one of the investments that's more recent. But again you should think about it as investments that we've made over a long period of time. For example, we've started investing in our Kindle business and AWS businesses several years ago now. And those have gotten great traction. We launched FBA several years ago. We launched Prime a few years back. We continue to launch new categories. We continue to add unique selections, so those of the things that have happened over an extended period of Time. We are also planting new seeds today. You see that Prime Instant Video as an example of that. Some of the -- a lot of the offerings that we have within AWS are examples of those. And again we have many examples of those across the business. So when we look at -- it was similar to the answer that I gave to Jim in the first question is again think about our business in a number of different pieces, but we have our Retail business that we've been offering in since inception. We continue to add capacity to support those. We continue to add selection and so those are the parts of the business that we feel very, very good about and the fact that we have to deploy more capital in terms of capacity we feel very good about. Again, our historical returns aren't predictive but we feel very good about it. And then we feel very good about the assets we have in our digital space as we convert from physical to digital, and then we talked about some of the newer investments as well that we feel very good that we're investing in today that we certainly hope and plan on getting good returns for shareholders. But our goal ultimately is, as you mentioned not to optimize for margins, but our goal is to maximize free cash flow and have high ROICs.

Operator

Our next question comes from Doug Anmuth with JP Morgan.

Douglas Anmuth - JP Morgan Chase & Co

I just wanted to ask two things. First, Tom it looks like you hired 5,300 people during the quarter. Can you give us some color on how they are spread out across the business? And then secondly, as you look at your margin outlook here for 3Q. Can you give us some color on the target roll-off and whether that's contemplated here in the outlook and how much of an impact that is?

Thomas Szkutak

In terms of the people and the quarter, keep in mind that we did acquire Quidsi at the start of the quarter, so that's included in the number. And so if you take Quidsi plus the operations in CS people that we added for the capacity that we've been talking about. The combination of those two make up the majority of those adds. Now we still had certainly adds across the business in a number of different areas. And particularly in some of the areas I mentioned, in some of the earlier questions. So again, the majority are of those 5,300, as well as actually the year-over-year increase, which is just under 15,000 is due to operations in CS and again, more recently, the acquisition of Quidsi. As for the margin, again, in terms of target, they've announced that they're going to be going to their new website in Q4 and we've had a very good relationship with them over the past several years. And we certainly wish them well with their new website. We were pleased to offer those services for them and again they've announced that they'll be switching to a new website in Q4.

Operator

We'll go next to Youssef Squali with Jefferies & Company.

Youssef Squali - Jefferies & Company, Inc.

Two quick questions please. First on the -- can you provide us an update on the distributed build out? How many distribution centers you have or you had by year-end -- I'm sorry, by quarter end. How many do you think you're going to have by year-end? I'm trying to figure out, where your capacity utilization today versus, say, 6 months ago. And second, can you talk about the strategy behind maybe the planned launch of the tablet products? Would you be able to looking to leverage in-store distribution channels for that product similar to what you've done with Kindle?

Thomas Szkutak

In terms of fulfillment centers. Last quarter, when we had our call, we had mentioned, or I had mentioned, that we had announced 9 fulfillment centers globally at that point. Right now, we've announced 15, and we are actually planning on a few more than that between now and the end of the year. So again if you look at where we're hiring for, we've announced, it's 15 today. And you should expect a few more. That compares to -- we added 13 last year. So it will be more than 15. 13 last year, it will be more than 15 this year...

Youssef Squali - Jefferies & Company, Inc.

And that's for a total of how many?

Thomas Szkutak

We haven't given the total for the year, but it's approximately in the low 50s adding 15 on top of that and then expect a few more. In terms of your other question, we have a long-standing practice of not talking about what we might or might not do. And so I can't help you with that question.

Operator

Our next question comes from Scott Devitt with Morgan Stanley.

Scott Devitt - Morgan Stanley

Tom, net shipping costs were up 110 basis points year-over-year. I just wondered if you could talk about the impacts on that from oil prices versus Amazon Prime adoption and other customer experience initiatives that you've been working on.

Thomas Szkutak

If you look at really our net shipping costs over the last several quarters, what you've seen is we've been shipping and certainly more free and that includes Amazon Prime. We've also certainly incurred some higher shipping costs as you mentioned with fuel prices, but that's something that we've been doing with, really, since we started offering free shipping back in the early 2000s. So that's something that we're used to dealing with and something that we have dealt with. So again what you're seeing again over the last several quarters is certainly the customers like our free shipping programs, including some [ph] prime and that's reflected and that number. That's also one of the inputs along with a lot of the other things that we've been talking about that's helping fuel our growth.

Operator

We'll go next to Colin Sebastian with R W. Baird.

Colin Sebastian - Robert W. Baird & Co. Incorporated

I guess first off going back, Tom, to what you mentioned earlier in the call and the drivers of accelerating growth. I wonder if you could talk about the relative importance of these factors, in particular the low prices. And then secondly, just curious in the progress you're making in growing the China business. I think you've added more fulfillment capacity there, e-commerce in general appears to be accelerating in that market. If you could talk about your position and the relative importance of that.

Thomas Szkutak

Sure. In terms of lower prices, it's kind of hard to describe, to answer your question actually. We view it as an extremely important aspect of our business. It's -- there's a number of different things that are important to customers and certainly are making sure that we have great prices for our customers and great values for customers is extremely important. It's something that we've been working on for a number of years, making sure that we know when we have great prices relative to others. And so that's something that we've continued to work on to make it a great experience for customers and we do that globally across all of our categories. In terms of your question on China. We're very pleased with our business in China. It's growing very fast. It's -- we are in investment mode in that country and -- but we think it's a very interesting long-term opportunity and the team's doing a very nice job there and we continue to invest, and we're seeing nice growth there.

Operator

Our next question comes from Brian Pitz with UBS.

Brian Pitz - UBS Investment Bank

Tom, maybe you could give us an update on affiliates and the sales tax issue that's going on. Any updates there? As you cut ties with affiliates and [indiscernible] collect sales taxes, how should we be thinking about the impact on both revenue and margin?

Thomas Szkutak

I think in terms of the sales tax issue in total, the way you should think about it is we support a federal simplified approach as we have more than 10 years. We think in the U.S., that the federal solution's a great way to solve this. Also keep in mind as you think about our global business, we already collect sales tax or equivalent to more than half of our business or approximately half of our business across the world, and again we think the right solution to the U.S. is the federal solution. In terms of beyond that, we continue to serve our customers globally and we continue to work through the issue that you described.

Brian Pitz - UBS Investment Bank

Should we think about any additional reductions in the number of affiliates going forward or are we at a stable point right now?

Thomas Szkutak

I really can't comment on that. We're incredibly pleased to have our affiliates. We continue to work with them and there's not much more I can add to that.

Operator

We'll go next to Jeetil Patel with Deutsche Bank Securities.

Jeetil Patel - Deutsche Bank AG

Two questions. In general digital content is becoming a growing industry theme as well as it seems like for Amazon. I guess curious as to whether you can comment on if there's a higher propensity for Prime customers to adopt digital content or is it broad-based among the customer base as a whole. And then second, a lot of the investments you're pushing through today, in terms of facilities, OpEx, et cetera. Can you talk about maybe what year are they typically geared for? How far out do you typically plan for in terms of investments today on products, new or existing? How far out do you typically think about from a planning standpoint that you're already absorbing in the model today?

Thomas Szkutak

In terms of digital content, it's -- we certainly have an offering right now. You asked the relationship between that and Prime. We certainly have a product with Prime is in video [ph] that we like. It's extremely early. We're learning, customers love it. What they're seeing so far we like what we're seeing so far in terms of some of the metrics but again it's very, very early. We do think that we are fortunate that we can offer such a service to customers, along with free shipping. We think that our good customers like both. They're both physical and digital customers. And so I'm not sure there's much more I can add to that. And then I'm sorry the second part of your question?

Jeetil Patel - Deutsche Bank AG

Yes just a lot of the expense build and investments that you're making today in the form of OpEx and CapEx. I guess, how far out do you typically think through some of these plans, in terms of today and what you're assuming in the model on kind of -- on these last couple of quarters relative to when you start to see kind of the fruits of the labor, some of the product start to commercialize in the marketplace?

Thomas Szkutak

Well we look at our overall investments, certainly not on a long-term basis, we have -- when we launch or invest in something new, it's usually a number of years before we're cash flow positive. And then in many cases, several years before cash flow positive. And so we do take a long-term view. That being said, we monitor those investments very carefully. So, for example, and we do it on a discrete basis, on an area-by-area basis in terms of our investment. For example, in our Web Services business. That team has done a very nice job of growing that business innovating on behalf of customers and we're also trying to see how do we get -- ensure we get higher ROICs on that business. And so they've been working on that for a number of years. And so they look at it on a service-by-service basis. And what they're trying to do is become not only great -- have great services for customers but to be as efficient as possible in terms of from an investment standpoint. And so those are -- that just happens to be an example. That happens across the business. And we continue to monitor those investments.

Jeetil Patel - Deutsche Bank AG

Can I ask it a different way? But the unit growth you're seeing this year of 50-plus percent. When do you think you put in kind of the investments or the plans in the P&L? Would you say it was back in 2008 or 2007, or would you say it was more recent than that?

Thomas Szkutak

Yes, yes, and yes. In terms of what enabled us to have the growth rate that we're experiencing today, I'll just take the retail part of our business for a second. There are many, many aspects of it, let me take just the retail part of it. We've continued to add great selection over a long period of time. And when I say great selection, unique selection. We've continued to get sharper and sharper arm pricing, understanding exactly where we are from a pricing standpoint. We've continued to launch new programs that get our product to customers quicker. We offered free shipping a number of years ago that made it more economical. We offer Prime to make it kind of quicker and more economical to get to customers, so it's a great service for customers. So all of these things have built upon themselves. We offer third-party offerings of [ph] 36% of total units. Several years ago now or a few years ago now, we'd launched Fulfilled by Amazon. It was a way to make that experience better for customers as well as sellers. So these things have built upon each other over a period of years. Now what you're seeing is there is a concentrated amount of investment that's going in, relative to capacity more recently. That really came out of -- you see different periods of growth that we've had where things have gotten softer, that we will absorb that investment and it becomes more productive. We saw that happen particularly in the U.S. when we had the downturn starting in late 2008. It kind of went through a portion certainly of 2009 even though our global growth was still in the high 20s. And that was a little bit softer in the U.S. for some of those periods. So we were able to add less fixed investment to support the capacity for that part of the business because of the growth. Now what you've seen is coming off of that through 2010, you saw very strong growth. We had 40% growth in 2010. You saw very strong growth in Q1. We had 36% growth on a local currency basis even with some of the softness in Japan. You've seen reacceleration in Q2 growth was 44% including a couple of hundred basis points of acquisition growth sequentially. So again it's, again these are building upon each other and some of the larger investments we've made to support capacity are more recent over the past 18 months now and that's continuing as you see from our Q3 guidance given the growth we're experiencing. So I'm trying to separate a little bit the growth to support the -- sorry, the capacity to support the growth but then we've made many smaller, some not so small investments over the past 10-years plus that have brought us to the growth rates on the customer experience that we have today.

Jeetil Patel - Deutsche Bank AG

But strategic versus tactical spend?

Thomas Szkutak

Correct. So tactical, some of the investments that's required to support from a capacity standpoint in the infrastructure, as well as FCs this quarter Retail business, for example, I would consider that tactical or running the business-type adjustment. And those have been sizable. You can see step change in our capital and part of it's for that growth for that reason, part of it's for growth in FBA and part of it's for growth in Web services as well as a few other areas.

Operator

[Operator Instructions] And we'll go next to Gene Munster with Piper Jaffray.

Charles Munster - Piper Jaffray Companies

Back to the tax question. It's inevitable that 100% of your business will be taxed. And let's fast-forward to that point. What message would you have for investors on how to think about the impact that will have on your business? And then a follow-up to that is there are some rumors that as you pull the affiliates out of California, you may actually have some sort of sales tax liability. Can you put any of those rumors to rest?

Thomas Szkutak

In terms of where we'll end up I'm certainly not going to speculate where we'll end up over a period of time, in terms of sales tax. And again, I'm talking the broader issue, not any particular state. The way I think about it I talked about our approach in terms of the U.S. of having a federal our national solution and I think that's the right approach. But in terms of the business itself, one thing to keep in mind is that we do collect, as a reminder, sales tax or equivalent tax at approximately half of our business today. And so when you look at the growth rates that we're experiencing, again half or a little over half of our business we're collecting that today. So that part of the base that we have -- in the end, customers really want is they want a great experience, they want -- certainly they want low prices. They want the selection that they're looking for. They want fast delivery. They want it to be as convenient as possible. That's true among certainly our retail customers. So we continue to work on that experience. We continue to work on trying to make the seller experience even better, FBA, Fulfillment by Amazon is another example of that. That happens to also have a customer benefit the consumer not just the seller, but again sellers like it as well as consumers. We continue to make sure that our experience is good for our Web Services business. So we take that, the customers experience extremely seriously, it's something they’re working on very, very hard. And our digital offerings, Kindle, we have a great team who's innovating on behalf of customers across the business including our Kindle business. And so they're trying to make sure they continue to innovate. And so all of these things that I had mentioned are things that we think are important to customers and ultimately why customers will purchase from us or not. Those are the things that we're going to continue to work on because we can't predict what will happen in some of these other things. But we can predict that customers will still want low prices, they'll still want great selection, they'll still want convenience, they'll still want innovative products and services, on every half. So those are the things that we're going to be continuing to work on and have worked on since our inception.

Charles Munster - Piper Jaffray Companies

And then the affiliates is there any sales tax? Are you guys liable for any past sales tax in California?

Thomas Szkutak

I can't -- I'm not to comment on that.

Operator

Our last question comes from Justin Post with Bank of America Merrill Lynch.

Justin Post - BofA Merrill Lynch

Two things. Talk about a lot of things, but not AWS. You still think that business -- I guess how's the trajectory? Do you still it still can be as big as retail? And any thoughts on what the margin profile of that business looks like relative to your core? So just thoughts on AWS in general. And then secondly, did you change the historical third-party unit forecast? I had a couple question on that. It looks like some of the historicals might have been higher than what you might have said in a couple prior quarters?

Thomas Szkutak

I'll answer the second one first. In terms of the unit growth and the third-party units, what we did this quarter, which is different than we have previously, we actually went with the paid unit growth as opposed to total units. So historically, we've been including -- there's been some amount of free units included in those numbers. And so for example, if you take a look at our current quarter, the number I mentioned was paid unit growth of 56%. That compared to again that's paid unit growth, that compared to 45% paid unit growth in Q1. The number that we reported in Q1 was actually

51% because that included free. So the comparable -- the 45% for Q1 and the 56% for Q2 are comparable. Again, those are just paid units. And then the third-party percentage of total units was 36% this quarter, up from 34% last year. And again those are paid units for the percentage of total units. And so we thought it would be an interesting, another interesting way of looking at it so we thought we'd provide it this quarter. In terms of the AWS business, it's certainly a very, very big space. Hard to say how big it will be for Amazon, but we're incredibly excited about that business. The team's done a terrific job and continue to innovate on behalf of customers. And we have just a great team of innovators and operators running that business, and we're very excited about it.

Justin Post - BofA Merrill Lynch

Can you say whether it's in investment mode or is it contributing at all to the bottom line at this point?

Thomas Szkutak

You should expect that we continue to invest in that business because of the high-growth nature of it. It's growing very fast. It is one of the reasons why you're seeing certainly a big contributor to our CapEx. It's also reflected in the tech and content line. And so again we're very excited about what we're seeing there. And the team is going to continue to stay heads down focused on their customer to drive that business.

John Felton

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

Operator

This concludes today's call. We thank you for your participation.