Amazon.com, Inc. (NASDAQ:AMZN) Q1 2010 Earnings Call April 22, 2010 5:00 PM ET

Executives

Rob Eldridge - IR

Tom Szkutak - SVP and CFO

Analysts

Colin Sebastian - Lazard Capital Markets

James Mitchell - Goldman Sachs

Douglas Anmuth - Barclays Capital

Youssef Squali - Jefferies & Co.

Brian Pitz - UBS

Mark Mahaney - Citi

Scott Devitt - Morgan Stanley

Jeetil Patel - Deutsche Bank Securities

Steve Weinstein - Pacific Crest

Imran Khan - JPMorgan

Ben Schachter - Broadpoint AmTech

Justin Post - Bank of America/Merrill Lynch

Spencer Wang - Credit Suisse

Operator

Good day everyone and welcome to the Amazon.com First Quarter 2010 Financial Results Conference. (Operator Instructions) At this time I would like to turn the call over to Mr. Rob Eldridge. Please go ahead sir.

Rob Eldridge

Hello, and welcome to our Q1 2010 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 or responses to your questions reflect management's views as of today, April 22, 2010, 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 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 2009. Now, I'll turn the call over to Tom.

Tom Szkutak

Thanks Rob, I will begin with comments on our financial results. Trolling 12 month free cash grew 62% to $2.32 billion. Return on invested capital is 45% up from 41%. 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 towards outstanding 463 million shares compared with 447 million. World wide revenue grew 46% to $7.13 billion or 42% excluding the $185 million payable impact from year-over-year changes in foreign exchange rates.

We are grateful to our customers who continue to take advantage of our low prices, vast selection and pre-shipping offers including Amazon Prime. Media revenue increased to $3.43 up 26% or 22% excluding foreign exchange rates. ETM revenue increased to $3.51 billion of 72% or 68% excluding FX. World wide EGM increased to 49% of world wide sales up from 42%.

World wide unit growth was 40%; active customer accounts exceeded a 114 million. And for the first time this number includes our Amazon China customer accounts. World-wide active seller accounts were approximately $2 million of 22%. Sold units were 31% of total units. Consolidated gross profit grew 42% to $1.63 billion and gross margin decreased 62 basis points up to 22.9%.

We no longer present gross profit as our consolidated statement of operations as we believe income from operations is more meaningful measure due to the diversity of our product categories and services. Our focus is on growing operating profit dollars rather than maximizing margin percentages.

Now I will discuss operating expenses, excluding stock based compensation. Fulfillment in marketing tech and content and G&A combined was $1.12 billion or 15.8% of sales down 115 basis points year-over-year. Fulfillment was $528 million or 7.4% of revenue compared with 8.3%.

Tech and content was $319 million or 4.5% of revenue compared with 4.9%. Marketing was $196 million or 2.7% of revenue, up from 2.5% in the prior year. Now I will 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 items.

In North America segment, revenue grew 47% to $3.78 billion. Media revenue grew 22% to $1.6 billion. EGM revenue grew 72% to $2.02 billion, representing 54% of North America revenues, up from 45%. North America segment operating income increased 81% to $273 million, or 7.2% operating margin.

In the international segment, revenue grew 45% to $3.35 billion. Revenue growth was 37%, adjusting for the $175 million year-over-year favorable FX impact during the quarter.

Media revenue grew 29% to $1.83 billion or 23% excluding FX. And EGM revenue grew 68% to $1.49 billion or 61% excluding FX. EGM now represents 44% of international revenues, up from 38%.

International segment operating income increased 37% to $234 million, a 7% operating margin. Excluding the favorable impact from foreign exchange rates international segment operating income increased 26%. CSOI grew 58% to $507 million or 7.1% of revenue up 53 basis points year-over-year. Excluding the $15 million favorable impact from foreign exchange rates, CSOI grew 53%.

Unlike CSOI, our GAAP operating income includes stock-based compensation expense and other operating expense. GAAP operating income grew 62% to $394 million or 5.5% of net sales. Our income tax expense was $100 million in Q1 or a 25% rate for the quarter. GAAP net income was $299 million of course, $0.66 per diluted share compared with $177 million and $0.41 per diluted share.

Turning to the balance sheet, cash and marketable securities increased $2.33 billion year-over-year to $5.06 billion. Inventory increased 44% to $1.82 billion and inventory turns were 12.6 up from 12.5 turns a year ago, even as we expanded selection, improved in-stock levels and introduced new product categories.

Accounts payable increased 52% to $3.62 billion and accounts payable days increased to 59 from 57 in the prior year.

Our Q1 2010 capital expenditures were $140 million, the increase in capital expenditures reflects additional investments in technology infrastructure including Amazon web services, additional investments and support of continued business growth including capacity to support fulfillment operations and investments and corporate office-base which we expect to continue throughout 2010.

I will conclude my portion of today's call with guidance. Incorporated into the guidance of the order trends that we've seen to date and what we believe to date 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 global economy and consumer spending.

It’s not possible to accurately predict and end 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 currency 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 or stock based compensation estimates and that foreign exchange remained approximately where they have been recently.

For Q2 we expect net sales of between $6.1 and $6.7 billion or growth of between 31% and 44%. This anticipates approximately 100 basis points of positive impact from foreign exchange. GAAP operating income could be between $220 and $320 million or grow between 39% and 102%.

The second quarter 2009 results include the impact of our settlement with Toys “R” Us for $51 million substantially all of which was expensed during the quarter. This includes approximately $130 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 $350 and $450 million, a growth of between 15% and 48%. We remain head strong focused on driving a better customer experience through price, selection and convenience. We believe the prudent customer first is the only reliable way to create lasting value for shareholders. Thanks and with that Rob let's move to questions.

Rob Eldridge

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 we will go first to Colin Sebastian with Lazard Capital Markets.

Colin Sebastian - Lazard Capital Markets

Thanks, and congratulations on a very strong quarter. I wonder if you could talk a little bit about the same day delivery program, how that's playing out in cities where it's offered and if there is something that could be rolled out more broadly amid successful testing in the existing markets? Thanks.

Tom Szkutak

Sure and probably the best way to describe it is similar to other programs that we have related to past shipping in prime. We are finding that customers like it, we certainly think that new customers like the reliability of getting their products so efficiently, so quickly and hard to say what we do beyond what we are doing today with same day but we certainly think that getting product to customers fast is important.

Operator

We will go next to James Mitchell with Goldman Sachs.

James Mitchell - Goldman Sachs

I have two question, one is with regard to the very large active customer number that include China but with Zappos I assumed I would like may 5 million each from China and from Zappos if you did include Zappos. And then secondly even I look at the expansion in North America and operating margins in the quarter. With that helped by sales of digital media and also of Amazon web services thank you?

Tom Szkutak

I will take the second part first, you know the North America expansion was driven by you know a number of things certainly the very strong growth and then it was also driven by you know us being able to leverage raw expenses if you take a look at our global fulfillment type cost as a percentage of revenue you can certainly see a lot of leverage there and that's also true when you look at North America.

We haven't added you know any significant capacity in North America since Q3 of 08. You know certainly with growth rates that you are seeing, you should expect that we will be adding capacity over time there. But again it was driven by a lot of different factors and you know with a lot of different product categories are growing very strong and thus being able to leverage those expenses. In terms of the first part can you repeat the first part again it was related to?

James Mitchell - Goldman Sachs

On the customers does that include China and also Zappos or just China and is it fair to assume that each of China and Zappos which contribute about 5 million active customers?

Tom Szkutak

Yeah James you are correct the active customer does not include Zappos but it does include China this quarter for the first time. And we are not at this point breaking out the addition of China at this point. So it is 114 million active customers world wide at this point.

Operator

We'll go next to Douglas Anmuth with Barclays Capital.

Douglas Anmuth - Barclays Capital

Thanks, just two quick questions, can you comment on the head count when you went about 1800 people on a sequential basis certainly larger number then we would have expected. And then the second one is just the tax rate being a little bit higher at 25% and is that purely just a function of higher North America profit?

Tom Szkutak

The first part in terms of head count, the biggest piece of that is related to fulfillment. You know when we coming out of Q4 we always have a certain people additions related to that and so again a sizeable piece of that incremental headcount was due to operations in the rest was you know certainly in the areas to help us grow as we move forward. In terms of the effective tax rate certainly the mix of our geographies are certainly what's making that change.

Operator

We will go next to Youssef Squali with Jefferies & Co.

Youssef Squali - Jefferies & Co.

First one of your competitors talks about seeing some weakness in Europe. Ex-UK and looking at your international margins it looks like they came little bit under pressure. They were down by 40 or 50 bps year-on-year. Is that something you guys saw as well and then by our estimates are the change in accounting for Kindle that you instituted in Q1 resulted, again by our map in somewhere between $80 and $100 million of additional revenues for the quarter, can you maybe just help us understand if we are in the right zip code there?

Tom Szkutak

The first question, we are not bringing out individual geographies within the international segment but what you are seeing in the international is you know very strong growth and we were pleased across all of our geographies we saw excluding the impact of foreign exchange rates we saw growth of 37%, you know, which is certainly very good and it was driven by a number of things certainly we have added many new categories and a lot of selections over the past few years and we certainly have or focused on making sure that we have great and a competitive low prices and that would certainly fuel in growth prime is also a factor and third-party growth, continues to be very strong and so those are the factors that are driving the international growth.

In terms of the change in accounting for Kindle, we are not breaking out any precise numbers on that but the way you should think about it is, may be a few (inaudible) one is if you look at our overall growth rate and you look at on a local currency basis and we certainly have for the first time of four quarter of Zappos included in those numbers as well as the change in accounting for Kindle and if you back off, exchange in those two items and compare it to the equivalent growth rate in Q4, you did see, a few hundred basis points, acceleration and growth from Q4 to Q1.

So, it can be much more of a breakup than that but you can see that, we did an acceleration growth there.

Operator

We'll go next to Brian Pitz with UBS.

Brian Pitz - UBS

It was your comment on the impetus to begin selling the Kindle through brick-and-motor stores, then do you expect to make the device more widely available? Also, I'm just curious why the rollout is limited to so few stores, thanks.

Tom Szkutak

Well it's starting with a small number of stores but we are very pleased to be working with Target and we think we are very pleased to have even more customers see Kindle and have the opportunity to purchase Kindle. So that's why we are doing it and we are very excited to do it.

Brian Pitz - UBS

Right.

Operator

We will go next to Mark Mahaney with Citi.

Mark Mahaney - Citi

I know why you may not want to talk so much about gross margins. I understand you're running the business for operating profits and then cash flow. But could you provide a little bit more color on the gross margin trends, particularly in international markets, given what should be some pretty positive mix shifts and scale factors, but mix shifts towards the digital goods and AWS and things like that. The trends seem a little surprising.

Anything in terms of vendor terms, product mixes that may have explained the gross margin trends. Thank you.

Tom Szkutak

In terms of international it was primarily driven by a certainly number of factors we continue to have lower prices and make sure we have great competitive prices and a challenging environment which includes free shipping offers and it was on prime included in that and keep in mind that we’ve launched many new categories over the past few years and so as we talked about in the past it takes sometime to get the scale in those categories and we are seeing very broad growth across many categories including the new categories and so that’s certainly that mix is having an impact and that means all those factors have been partially offset by very strong solid third-party growth as well as the savings that we will get from our vendor partners so again those are the key drivers.

Mark Mahaney - Citi

And one quick follow up on marketing for the Kindle, is there any change in your thinking of the level of marketing support you want to provide given obviously a much more competitive environment?

Tom Szkutak

Well in terms of marketing itself you saw that it increased a little bit as a percentage of revenue year-over-year and we are doing advertising for Kindle, it's certainly a product and an area that we are very excited about. You probably seen some of the ads that we are doing as well as doing on my marketing.

Operator

We will go next to Scott Devitt with Morgan Stanley.

Scott Devitt - Morgan Stanley

Great, thanks for taking the question. The first quarter operating margin was 7.1% and at the midpoint of revenue and operating margin on a cash basis in Q2 I think it's 6.3% so Tom could you just talk through what the factors are that would drive operating down sequentially that order of magnitude and then secondly, stock based compensation I think you guided to $110 million and did $87 million and then guided to $130 million in 2Q, so what's the volatility in that line item -- in the first quarter and going forward, thanks.

Tom Szkutak

Sure, I will take the second part first. The 87 is actually the equivalent of stock based compensation amortization intangibles which is one 113. And so it's come from 113 to 130. In terms of the operating margin, we are not giving operating margin guidance for Q2 but implied operating margin and we do have a consistent what we have done in prior periods. We have a range of operating income and that range is 350 to 450 at the low end of the range it's 5.7% of implied operating margin and 6.7 on the high end. On the high end you would see an expansion of operating margins of approximately 20 basis year-over-year and so that's the guidance based upon what we see if by looking at all the factors and there is not much I can help you with that. I would one thing to keep in mind those I mentioned in one of the earlier questions, with growth we are experiencing, we need to make sure we support that growth. And what that means is we will continue to add capacity at our various businesses to support that growth whether it be our retail business or AWS business or third-party seller business including FBA.

And so those are things that we certainly are supporting giving the growth that we are having. The other thing is we will continue as we haven't in prior years. We still think there is a lot of opportunity in front of us and so as we haven't prior years. We'll make sure that we are judicious about where we make those additions. But we will add resources to make sure that we capitalize on those growth opportunities. So those are the things that we are thinking about.

Operator

We will go next to Jeetil Patel, with Deutsche Bank Securities

Jeetil Patel - Deutsche Bank Securities

And thank you. Two questions. I guess the unit growth nicely accelerated from the fourth quarter levels, and the trend line you have been seeing historically, I guess can you talk about whether that is more of a function of the domestic business and still seeing very good purchase frequency or international now participating as Prime has now been out there for well north of two years? And then second just broader question, but in a world where we are going towards mobile and smartphones from an immediate consumption standpoint, can you, I guess, talk about what is the opportunity from an e-commerce standpoint? Do you think that it will be just as good of an e-commerce-oriented environment on a mobile device as you see in a desktop internet world since it's a smaller form factor, smaller screen? How do you have to change if you have to in terms of how you present information to consumers? 14th file

Tom Szkutak

Jeetil, I will take the second part of your question first. We are excited about the idea that the world may shift to a place where 3G connected devices are available to browse net and our view is that the more of web connected devices whether be tablets or smartphones, the better that is for our retails business as you are suggesting and we will figure out the best way to make sure that we may get as easy as possible for customers to purchase from those devices but we think that that's an exciting opportunity to have a world that looks like that.

In terms of your unit question, as you can probably expect, given the growth that we are seeing both in North America and in international from revenue prospective. We are seeing very good growth in units as well and so we are very pleased with the unit growth we are seeing in both segments.

Jeetil Patel - Deutsche Bank Securities

I guess on the former question that I asked about how mobile changes the world, does that give you an advantage as you look at your recommendations capability, what you have been building in terms of that database and kind of cross-comparison of what people are buying in terms of the cross categories and products. And then I guess is it international growth that is incrementally much better on units that's driving it. It seems like domestic has been good, but international seems to be kicking in even more so these days than ever before?

Tom Szkutak

Again your unit question is related to Mobal or it's related to total?

Jeetil Patel - Deutsche Bank Securities

Total.

Tom Szkutak

Again that the unit growth is very broad and so again when you see the results that we had with, at local currency basis international being up 37%, this is revenue I'm speaking as well as, North America again was a 47%, 46% on a local currency basis that you're seeing very revenue growth. You're also seeing very strong unit growth in those two segments. And in terms of again, in terms of Mobal, we're going to use obviously try to make sure that we learnt as much as we can and try to serve our customers the best we can in that environment but it's an environment that we like.

Again, the idea of having easy access from a web perspective on a wireless devices, as a world that we like, so again we're going to do, whatever we can to make sure it's easy for customers to get access.

Operator

We'll go next to Steve Weinstein with Pacific Crest.

Steve Weinstein - Pacific Crest

Great, thanks. I don't know if you would be willing to disclose it, but I'm trying to get a better understanding of how much Zappos impacted the quarter. If you could at least give us a sense of what the organic growth would have been without that. But I also would love to know if there is any other impacts to the P&L. I just wanted to make sure the worldwide unit growth of 40% that is excluding Zappos, correct?

Tom Szkutak

No, the worldwide unit growth includes Zappos and the impact, someone had asked a similar question earlier. We are not breaking out Zappos results specifically as part of our total, but what I had mentioned was, if you take a worldwide results on a local currency in a growth basis and you back out Zappos and the Kindle accounting change, you see a growth rate that accelerated from Q4 and that accelerated versus what we saw in Q4 excluding exchange and excluding Zappos.

Operator

We will go next to Imran Khan with JPMorgan.

Imran Khan - JPMorgan

I have two quick modeling questions and then one more of a big picture question. In terms of modeling questions, I think on your other operating expenses/income net was $26 million, could you explain what that was, please? And secondly, fulfillment seems like it came down quite a bit at 7.4% of revenue. Is that sustainable? How should we think about that? And the long-term question is, I think the shareholder letter Jeff talked about how you launched 21 categories worldwide. Can you give us some sense how long it takes to ramp those categories, how long it takes to get to the peak margins now that we have the experience of launching many different categories over the last many, many years?

Tom Szkutak

Can you just repeat there was a part in the middle there that I missed, you said something about 7.4% I didn't hear.

Imran Khan - JPMorgan

That is the fulfillment. Fulfillment as a percentage of revenue, I believe, was 7.4%?

Tom Szkutak

Is your question is related to that.

Imran Khan - JPMorgan

Yes, so that is down 80 basis points year over year. So I was trying to figure out if that is a one-time thing or how should we think about it? Is that sustainable, trying to figure out what is driving that leverage?

Tom Szkutak

I start with the fulfillment one first, what you are seeing there is, we saw accelerated growth and when you see accelerated growth we're able to leverage that in our fulfillment capacity and a great way from a productivity standpoint. Also what I had mentioned was we have added capacity, but specifically in North America we haven't added in a meaningful capacity since Q3 of '08 and if you recall we were building capacity and then we had a financial disruption in the market, so we ended up having some excess capacity in Q4 of '08. We've been to leverage that capacity throughout and so that's resulting in the productivity that you are seeing. Now with the growth that we are experiencing, you should expect that we will have to add capacity overtime here to satisfy that growth.

In terms of your category question, we have learned a lot over the years, but it still takes us a number of years to get to scale when we launch new categories. One of the things we've learned over the past several years is, we need to make sure that we have great selections day one. We need to make sure that we are pricing very competitively day one. Even though we don't have necessarily the scale or the buying tools to purchase well day one and so what that means usually is that will have lower contribution profit per unit generally early on and as we learn you know those categories we get better and better at you know sourcing and make sure we have the right inventory in place and all that. So it takes a number of years before you know we get those scale in those categories and get meaningful free cash flow out of them.

Rob Eldridge

Imran, in regards to your question on what's behind the $26 million of the operating expense. Remember that we are amortizing intangibles in that line I mean there is a number of things that go into that but it really is predominantly amortization intangible assets.

Operator

We will go next to Benjamin Schachter with Broadpoint AmTech.

Ben Schachter - Broadpoint AmTech

Well if you could discuss some initiatives around used products and particularly in EGM and what the strategy is there going forward? Another question would be discuss your private label strategy. Are there any new trends there, any new categories that we should know about? And then finally, just for the modeling, was there any meaningful impact from videogame hardware shortages this quarter?

Tom Szkutak

In terms of used products, our strategy there has been you know pretty consistent. We have a platform that is available for sellers to sell used product which is predominant use and we try make that experience as good as we can, both for the sellers and for customers so they can understand you know what the quality of the good is before making a purchase decision. We have done some private label as you mentioned and you know there is not really a lot really to speak of today about that, but again we have, do have some private label product that we sell, but you know the vast majority of the products we sell are not private label.

Operator

We will go next to Justin Post with Bank of America/Merrill Lynch

Justin Post - Bank of America/Merrill Lynch

A couple of things. First, I know your company does not like to waste money. Usually you have a revenue decline into the summer, and you ramp up your facilities and your people kind of in the third quarter. Why earlier this year? Do you feel really bullish as we go into the summer period? And then just to clarify, are you saying all of the acceleration on an ex-currency basis from 1Q versus 4Q is due to Zappos and Kindle amortization?

Tom Szkutak

On a global basis excluding exchange Kindle and the accounting change, we saw a few 100 basis points acceleration and growth so we did accelerate excluding those items. In terms of capacity we do have high growth rates right now. We have 40% unit growth, 46% revenue growth in Q1, you see the guidance for Q2 and so as you would expect with that growth rate we need to make sure we have the right amount of capacity and people on hand to serve. As part of that from a fulfillment perspective, we are growing our fulfilled by Amazon, our FDA business which also requires capacity to do so. So those are things we view as high quality problems but those are things that we certainly will have to add as we move forward as well as other areas, other parts of our business that are growing in addition to those two.

Justin Post - Bank of America/Merrill Lynch

But you said that you are investing earlier this year than normal, or is it just maybe a little bit of a catch-up to last year? How would you phrase that, would you say?

Tom Szkutak

I guess I would characterize as it is, we're trying to make sure we, satisfy demand in our retail business and our third party business that we fulfill as well as web services businesses, so those are the things we're trying to do and making sure that we have the right capacity on hand.

Operator

We'll take our final question from Spencer Wang with Credit Suisse.

Spencer Wang - Credit Suisse

A question on e-books. I guess, as you and the industry move more towards the agency model for digital books, it shifts the ability to set pricing to publishers. I guess our understanding is you also have to charge sales tax, also. So it would seem that your ability to leverage low price maybe mitigated a little bit. So I was wondering if you could just talk about how you would adjust your model to differentiate Amazon versus some of the other players in the context of the other two pillars, I guess, convenience and selection that you are focused on?

Tom Szkutak

One of the things that we're doing is we are expanding selection, pre-dramatically. When we launched two plus years ago, with Kindle we had approximately 90,000 titles. Just recently we passed over 500,000 titles and so our vision is, as we stated when we launched Kindles to have every book ever published in any language available for customers in under 60 seconds and that's still our stated long-term goal and so we're going to continue to add selection in support of that vision.

Operator

And that does conclude our question-and-answer session. I would now like to turn the call back over to Rob Eldridge for any additional or closing remarks.

Rob Eldridge

Great. Thank you for joining us on the call today 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.com and look forward to talking with you again next quarter.

Operator

And that does conclude today’s call. We appreciate everyone’s participation.