Operator

Good day everyone, and welcome to the Amazon.com fourth quarter 2012 financial results teleconference. At this time, all participants are in a listen-only mode. After today's presentation, we will conduct a question-and-answer session. Today's call is being recorded.

For opening remarks, I will be turning the call over to the Vice President of Investor Relations, Mr. Sean Boyle. Please go ahead.

Sean Boyle

Hello and welcome to our Q4 2012 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, January 29, 2013 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 2011. Now, I will turn the call over to Tom.

Thomas Szkutak

Thanks, Sean. I will begin with comments on our fourth quarter financial results. Trailing 12 month operating cash flow increased 7% to $4.81 billion. Trailing 12 month free cash flow decreased 81% to $395 million. Trailing 12 months capital expenditures were $3.79 billion.

This amount includes $1.4 billion in purchases of our previously leased corporate office space as well as property for development of additional corporate office space located in Seattle, Washington which we purchased in the fourth quarter. The increase in capital expenditures reflects additional investments in support of continued business growth consisting of investing in technology infrastructure including Amazon Web Services and additional capacity to support our fulfillment operations.

Return on invested capital was 4%, down from 22%. ROIC is TTM free cash flow divided by average total assets minus current liabilities excluding the current portion of long-term debt over five quarter ends. The combination of common stock and stock-based awards outstanding was 470 million shares compared with 460 million shares one year ago.

Worldwide revenue grew 22% to $21.27 billion or 23% excluding the $178 million unfavorable impact from year-over-year changes in foreign exchange. We are grateful to our customers who continue to take advantage of our low prices, vast selection and shipping offers. Media revenue increased to $6.51 billion, up 8% or 10% excluding foreign exchange. EGM revenue increased to $13.93 billion, up 28% or 29% excluding foreign exchange. Worldwide EGM increased to 65% of worldwide sales, up from 63%. Worldwide paid unit growth was 32%. Active customer accounts exceeded 200 million. Worldwide active seller accounts were more than 2 million. Seller units represented 39% of paid units.

Now, I will discuss operating expenses excluding stock-based compensation. Cost of sales was $16.14 billion, or 75.9% of revenue, compared with 79.3%. Fulfillment, marketing, technology and content in G&A combined was $4.45 billion, or 20.9% of sales, up approximately 293 basis points year-over-year. Fulfillment was $2.2 billion, or 10.3% of revenue compared with 9.3%. Tech and content was $1.22 billion, or 5.7% of revenue, compared with 4.5%. Marketing was $833 million, or 3.9% of revenue compared with 3.3%.

Now, I'll talk about our segment results, and consistent with prior periods, we do not allocate segments, our stock-based compensation or other operating expense line item. In the North America segment, revenue grew 23% to $12.17 billion. Media revenue grew 13% to $2.9 billion. EGM revenue grew 24% to $8.5 billion, representing 70% of North America revenues, up from 69%. North America segment operating income increased 114% to $608 million, a 5% operating margin.

In the international segment, revenue grew 21% to $9.09 billion. Adjusting for the hundred $83 million year-over-year unfavorable impact from foreign exchange, revenue growth was 23%. Media revenue grew 5% to $3.61 billion, or 7% excluding foreign exchange and EGM revenue grew 35% to $5.43 billion, or 37% excluding foreign exchange. EGM now represents 60% of international revenues, up from 54%.

International segment operating income decreased 61% to $70 million a, 0.8% operating margin. Excluding the unfavorable impact from foreign exchange, International segment operating income decreased 56%.

CSOI increased 47% to $678 million, or 3.2% of revenue, up approximately 54 basis points year-over-year. Unlike CSOI, our GAAP operating income includes stock-based compensation expense and other operating. GAAP operating income increased 56% to $405 million, or 1.9% of net sales.

Our income tax expense was $194 million in Q4, resulting in a 58% rate for the quarter and 79% rate for the full year 2012. GAAP net income was $97 million, or $0.21 per diluted share, compared with $177 million and $0.38 per diluted share.

Now, I will discuss the full year results. Revenue grew 27% to $61.0 9 billion. North America revenue grew 30% $34.81 billion and International revenue grew 23% to $26.28 billion, or 27% growth excluding year-over-year changes in foreign exchange.

Consolidated segment operating income or CSOI increased 6% to $1.67 billion, or 7% excluding the unfavorable year-over-year impact from foreign exchange and operating margin decreased 54 basis points, 2.7%. GAAP operating income decreased 22% to $676 million, or 1.1% of net sales.

Turning to the balance sheet, cash and marketable securities increased $1.87 billion year-over-year to $11.45 billion. Inventory increased 21% to $6.03 billion and inventory turns were 9.3, down from 10.3 turns a year ago as we expanded selection, improved in stock levels and introduced new product categories. Accounts payable increased 20% to $13.32 billion and accounts payable days increased to 76 from 74 in the prior year.

In Q4 2012, we usually $3 billion of senior non-convertible unsecured debt in three, five and seven-year tranches with proceeds to be used for general corporate purposes. I will conclude my portion of today's call with guidance.

Incorporated into the guidance are the order trends that we have seen to-date and what we believe today to be appropriately conservative assumptions. Our results are inherently unpredictable and maybe 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 described in more detail in our public filings, issues such as settling intercompany balances and foreign currencies amongst our subsidiaries, unfavorable resolution of legal matters and changes to our effective tax rates can all have a material impact on guidance. Our guidance further assumes that we don’t conclude any additional business acquisitions, investments or settlements, record any further revisions to stock-based compensation estimates and that foreign exchange rates remain approximately where they have been recently.

For Q1 2013, we expect net sales of between $15 billion and $16.6 billion or growth between 14% and 26%. This guidance anticipates approximately 122 basis points of unfavorable impact from foreign exchange rates. GAAP operating income or loss to be between the $285 million loss and $65 million positive income compared to $192 million income in the prior period year.

This includes approximately $285 million for stock-based compensation and amortization of intangible assets. We anticipate consolidated segment operating income which excludes stock-based compensation and other expense to be between zero and $350 million compared to $390 million income in the prior period.

We remain head sound 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 for that. Sean, let's go to questions

Sean Boyle

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) We will take our first question from Scott Devitt with Morgan Stanley.

Scott Devitt - Morgan Stanley

Tom, it looks that you have successfully begin the transition of your logistics costs in the direction of being more of a fixed fulfillment cost with lower unit based shipping costs, given that the growth rate of about shipping now meaningfully below the fulfillment growth rate. So the question is, is this something that we should expect to continue now in the back of this meaningful fulfillment center expansion ramp?

Then separately, but on the same topic, we are also wondering, are there other parts of the business in which you can make this transition to more of a fixed cost in the future? Thanks.

Thomas Szkutak

In terms of the fulfillment question, you are right in terms of over the past few years, we have expanded in our fulfillment network pretty extensively to the point where we are closer to customers and you are seeing that reflected in our transportation cost, you can obviously see the fulfillment expense is certainly not fixed in terms of absolute terms but you can see that we had 20 fulfillment centers last year and that's reflected in the operating expense that you are seeing. But that is a benefit of having adding to our fulfillment center network. We get closer and closer to customers with a lot of great selection. So you are seeing that reflected in the individual of business gross margins, which shows up as benefits of transportation cost.

In terms of other opportunities, certainly there are a number of opportunities as we invest in individual customer experience areas across the business. Many of those would be on our website. We have a relatively fixed expense as we launch those and we amortize those costs over our full customer base. So as they grow to become more effective on a per unit or per customer basis. So there is a number of opportunities that we have had and will have going forward to do that.

Operator

Thank you. We will take our next question from Douglas Anmuth with JPMorgan.

Douglas Anmuth - JPMorgan

Great, thanks for taking the question. Just wanted to ask about the shift to third-party, I guess in particularly, I think last 4Q you talked about shifting more the business in the videogame space, in particular the third-party categories that you would specifically point to in this last 4Q, you already made sort of a similar shift. Thanks.

Thomas Szkutak

We did see, you know, a good expansion as you mentioned in 3P, a third-party units as a percentage of total units increased from 36% last year Q4 to 39% on expansion of approximately 300 basis points. Our overall unit growth rate for the quarter in total was 32%. Our third-party growth rate was in excess of 40%, so, again, nice growth. You are certainly seeing it in a number of areas.

You see it certainly in our EGM business look. If you look at our North America growth rates are unique and see that our revenues, up 23% but our third-party, our total unit growth rate was a substantially faster than that, and our third-party units were growing very fast there as well, so there's a number of differently that you are seeing that, but certainly you are seeing it there.

Operator

Thank you. We'll take our next question Brian Pitz with Jefferies.

Brian Pitz - Jefferies

Great. Thanks. Looks like you are moving more in the direction of same-day shipping. Would you provide any thoughts or insights here? Should we anticipate a significant ramp-up of fulfillment center build out, particularly in Q2, Q3? And, maybe, if you could just comment more generally on your FC built out plans U.S. versus international? Thanks.

Thomas Szkutak

There is not a lot I can comment on in terms of our plans similar to last year no as we progress through the year, we can give you further updates on what we plan to do there. Last year, we opened up 20 new fulfillment centers, and so we saw in a very rapid growth in fulfillment capacity last year, and stay tuned and we'll let you know more as the year progress there.

Operator

We'll go next to Mark Mahaney with RBC Capital Markets.

Mark Mahaney - RBC Capital Markets

Thanks. Two questions please. The paid unit growth deceleration to 32% there seems a bit of a disconnect versus an active customer growth that didn't decelerated as much on a per customer basis, are you seeing some sort of change in overall activity. Is that the impact of newer international markets?

Then just on the investment cycle, the last couple of calls, you've consistently called out future investments whether the $1.4 billion for Seattle or distribution center expansion. You didn't do it this quarter I don't over read into it, but does that we are at the end of a major investment cycle? Thanks.

Thomas Szkutak

In terms of unit growth, there's not a lot more I can add to it. We did see very strong, we saw substantially unit growth and revenue growth in terms of the paid unit growth in Q4 unit, which we are seeing very strong third-party growth as well, was up over 40%.

In terms of investment cycle, I wouldn't read into anything related to that. We will still be adding capacity during 2013 in terms of the levels of how much we'll add. As I mentioned earlier in the call, just stay tuned and we will let you know as the year progresses.

Operator

We'll go next to Heath Terry with Goldman Sachs.

Heath Terry - Goldman Sachs

Great, thanks. I was wondering if you give us just a bit of a sense of what you are seeing as you the rollout fulfillment centers into new state. Obviously the sales tax issue has been that's come up a good bit, but you touched on the impact of being closer with faster delivery in those same state. Net-net, what do you see as being the impact on not asking you to give us kind of a state by state breakdown, but the impact of rolling out the fulfillment center footprint taking both of those things into accounts.

Thomas Szkutak

I am not really sure how best to answer your question. I mean, we certainly have expanded pretty dramatically over the past really coming out of 2009 between 2010, 2011 and 2012. We've rapidly increase our footprint globally. Your comment was more directed towards the U.S., but we have also rapidly increased our footprint in the U.S.

As a result of that, your book category selection, a much broader selection closer to customers as you would expect with this rapid increase. We have also expanded selection during that time period. So we continue to be in the locations we would like to be in and we will continue to expand our footprint over time and become even closer and closer to customers. Beyond that there is not a lot I can add.

Operator

We will go next to Gene Munster with Piper Jaffray.

Gene Munster - Piper Jaffray

Good afternoon. Some high level query minus the margin difference between 1P and 3P. I know in the past you talked about you being agnostic between the two but the growth in 3P and what your CSOI margins imply that 3P has little bit higher margin. Is that the correct read through? Thanks.

Thomas Szkutak

There is some variation by business but certainly that we attempt to do as from my pricing standpoint, is to try to be agnostic. That is really how we run the business. Again, this is on a third-party versus retail. Then, we have also added certainly a lot of other services over the past year in terms of fulfillment. So it really depends upon where we are in the investment cycle, what our utilization is.

As you know, certainly as you look at the last few years, we have been in very heavily expanding in terms of fulfillment capacity because of the growth that we have been experiencing that certainly would put pressure on our overall cost structure. Certainly as a per unit basis because we are not giving the productivity. We don’t get the full productivity for a number of years after expanding.

So depending on what type of customer is, you know, whether it is a retail unit, a straight third-party units or NFPA unit but again we are certainly attempting this on a product basis to be roughly agnostic.

Operator

We will go next to Brian Nowak with Nomura.

Brian Nowak - Nomura

Thanks, guys. First, on the device strategy with Kindle and Kindle HD, can you help us at all what you are seeing with the attach rate trend on digital goods after people buy the Kindles. Then generally, do you see a higher overall GMV per customer on Kindle devices than users on Amazon Apps through other devices?

Thomas Szkutak

In terms of attach rates, we haven’t given a lot of detail but I think one thing certainly to look at, and it doesn’t give any attach rate, but it gives you at least a sense of the health of the business, the number that was in the release today. We sure have a multi-billion-dollar e-book business, growing approximately 70% year-over-year, total year last year. That’s growing at that rate after really just launching the business approximately five years ago. So it’s a pretty good healthy growth rate five years in.

We are seeing good, I can't give you specific numbers but we have seen very good progress on a number of our other digital media categories. Video, I talked about a little bit earlier, we are seeing Prime customers. Certainly the percentage of Prime customers who were watching free content through Prime Instant Videos has gone up dramatically year-over-year.

We have also increased Prime membership dramatically, year-over-year. They are also purchasing a paid content. Those customers that are using this, they watch free but they are also paying for new content which is great.

We have launched a number of new services on the music side. Most recently, our CD with free MP3, which we have on many titles. It's still very early but we certainly like that service and pleased to offer to customers. So I can't give you specific for attach rates but the business is making good progress on the video content side. Again it's still very early.

Operator

We will go next to Ross Sandler with Deutsche Bank.

Ross Sandler - Deutsche Bank

Thanks, guys. Just two quick questions. As you guys build out the Prime membership and the fees available through FBA, you run into this challenge of increase in your unit volume of tail items and at the same time we need to get products to customers in much shorter shipping cycle. So, can you talk about how the new fulfillments helps on that front? Is your reliance on air going down as a percent of total items shipped. Then if I remember correctly, you guys reclassified some FBA revenue in early 2012. Can you just remind how that flows through the shipping revenue line and what could happened as you count that in the beginning of '13. Thanks.

Thomas Szkutak

Sure. Just in terms of overall selection, as we added to Prime, what I was talking about earlier in terms of having a more expanded footprint is, there's no unit question that's helping us add additional selection more economically to Prime. And so on, that's both in terms of third-party selection as well as our retail selection and so that's something that we know continue to have the benefit of as we get more and more members in Prime and have the bigger, bigger concentration of two-day shipping U.S. for that.

So, we did add the shipping portion FBA fees in Q1 of 2012 and we see some benefit year-over-year, but we are still seeing leverage in terms of, you know, ex the FBA fees quite a bit leverage there, so we I do not have a specific number for you there, but yes we are still seeing quite a bit of leverage there, ex the re-class that you are referring to.

Operator

We'll go next to Justin Post with Merrill Lynch.

Justin Post - Merrill Lynch

Great. Thank you. Last year you reported 4Q in the lower half of revenue range and you were able to call out Taiwan and video games category. Any reasons why revenues were kind of in the lower half this quarter?

And then if you look at gross profit growth, it clearly has accelerated to 40% growth, but unit growth decelerated to 32%.Can you describe what's driving that kind of accelerating gross profit in the face of lower unit growth, and is it possible maybe you are letting the third parties handle some of the many less profitable categories for Amazon. Could you talk about that all? Thank you.

Thomas Szkutak

If you take a look at our growth rate, where we think the growth rate for Q4 was solid. It was up 23% on revenue basis quite a bit higher than on a unit growth basis up 32% year-over-year. In terms of some of the things that we saw and we again we saw solid growth across many different categories and geographies year-over-year.

Certainly some things to call out in terms of things that may have been a little bit softer. A few examples would be, we did see some of the higher average selling price items, particularly the items greater than $1,000 a little bit softer, a few of the consumer electronics, you subcategories like TVs, MP3 players digital cameras to some extent were softer. But, again, with the base that we have in Q4, still very solid growth.

Another one, certainly we are thrilled to have a Paperwhite in our lineup best e-reader that's out there and we are very pleased with it, but we couldn't keep up with demand. We would have had more sales in Q4 for able to keep up with demand and so the team is working very hard to make sure we have good in-stock going forward on that product, but we certainly could have sold more in Q4.

Operator

We'll take our next question from Tom Forte with Telsey Advisory Group.

Tom Forte - Telsey Advisory Group

Great. Thanks very much for taking my question. I want to ask you on Amazon Instant Video, how you thought about your current offering and your ability to add exclusive content in a cost effective manner through Amazon Studios, and what the relationship is between adding more titles and uses on your hardware such your Amazon Kindle devices? Thanks.

Thomas Szkutak

We will continue to expand our selection, both in terms of Amazon Instant Video as well Prime Instant Video and we will do that in a number of different ways. We think we have a very interesting selection right now and you should expect that will be spending more on content as it relates to Prime over time. We will continue to add selection on the Instant Video. Beyond that, you have to stay tuned.

Operator

We will go next to Ken Sena with Evercore Partners.

Ken Sena - Evercore Partners

Hi, I just had a question on your other segment line. Can you talk a little bit about the non-AWS drivers within that line as you are advertising? As you look out, are there advantages to you in terms of having AWS as far as offering things like buying, serving, analytics through the AWS platform to advertisers? Where are you in that rollout phase now? Thank you.

Thomas Szkutak

In terms of the AWS business, the business is growing very fast. We have increased the number of services pretty dramatically over the past several years. The team is doing a fantastic job there. We will continue to innovate on behalf of customers in that space. There is a number of other things that go into that line item. Some are credit card as well as other marketing revenue goes in there. But again, AWS is in that line item.

Operator

We will go next to Anthony Diclemente with Barclays.

Anthony Diclemente - Barclays

Hi, thanks. I wondered if you gave comment on the pace of business throughout the fourth quarter? Did you see a particular deceleration in the month of December? Then second question, on international, I am wondering, are there any call outs in terms of specific countries that may have been weighing on profitability? Countries where there is going to be outsized dollars of investment going on or accelerated investment at the current time. Thank you.

Thomas Szkutak

There are not a lot of specifics. We have long been in the practice of not talking about trends in within the quarter in terms of year-over-year growth or anything like that. Obviously the Q4 is very seasonal. December is, by far, the largest the month followed by November but in terms of individual growth rates, we don't have a lot of comments there.

In terms of international, yes, there certainly are geographies that we are investing in heavily. Certainly China would be one. Some of the European countries including some of the new launches that we are investing in. Those are certainly, you are seeing those represented in those segment results.

Operator

We will take our next question from Rohit Kulkarni with Citi.

Rohit Kulkarni - Citi

Okay, thank you for taking my question. In terms of your recent margin profile, actually comparing U.S. and international, I guess over the past four quarters, the vast majority improvement or rather the less worse margin trends that we have seen have been due to U.S. margins improving while international were declining in the range of 300 to 350 basis points. In Q4, international declined just 160 basis points. So my questions, should we read this as a beginning of a trend that we saw how domestic margins increased over the last four quarters and whether international should follow similar route over the next foreseeable future.

Thomas Szkutak

Yes, there is not a particular call out that I could make on that. The only thing that I would, in terms of the change I am referring to, but in terms of the difference between two, keep in mind that, a couple of factors. One, mix of business is a little bit different. Our AWS businesses is in North America segment. You also have some newer geographies. Or geography that I shouldn't say are necessarily newer but geographies that we are investing in heavily that have a longer-term horizon for returns, the ones I mentioned earlier. So those are factors as you look at the two different segments.

Operator

We will take our next question from Benjamin Schachter with Mcquarrie.

Benjamin Schachter - Mcquarrie

It looks likes the first-party gross margin is actually up fairly meaningful year-over-year. Wonder if you could talk about that within the context of Amazon Kindle hardware is impacting the gross margin. Then separately just any view on how videogames sales impact to the year-over-year growth rate for the quarter? Thanks.

Thomas Szkutak

Yes. It causes we haven't broken out the first-party versus third-party units since it's something we have done for that's only I am today or we have done in previous calls, so it's not I can help you with there.

Operator

We will take our next question from Jordan Rohan with Stifel Nicolaus

Jordan Rohan - Stifel Nicolaus

First just an accounting clarification, it should be pretty interesting, but the content cost for Prime Instant Video flowing to the cost of goods line even there is no direct revenue associated not into the tech and content line, right? Is that right?

Thomas Szkutak

That's correct.

Jordan Rohan - Stifel Nicolaus

Okay. So, gross margins would be even higher if those costs were included elsewhere or broken out separately? It also seems like it's becoming a separate question. It's something kind of common or to reduce the carrying value of your investment in LivingSocial. Give a feel on a broad strategic level as to whether the local deals business through Amazon local or through LivingSocial is something that you care to keep investing in? Thanks.

Thomas Szkutak

There's not a lot I can specifically talk about as it relates to LivingSocial beyond, what's on our result today and what we'll have in our 10-K, which we filed soon, and so I would encourage you take a look at in our full disclosures related to that. But in terms of local, there certainly is still a very interesting opportunity there. We do have a couple, we have an investment in LivingSocial, we also have a local business ourselves.

So, it's an interesting opportunity, it's a long-term opportunity in and we will continue to work on that customers to make that experience even better and you should think about it, not unlike a lot of the other businesses that we invest in with over long-term horizon and it's not very early there.

Sean Boyle

Okay. Thank you for joining us on the call today and for your questions. A replay will be available on 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.