

Operator

Thank you for standing by. Good day, everyone, and welcome to the Amazon.com Q2 2017 Financial Results Teleconference. At this time, all participants are in a listen-only mode. After the presentation, we will conduct a question-and-answer session. Today's call is being recorded.

For opening remarks, I will be turning the call over to the Director of Investor Relations, Darin Manney. Please go ahead.

Darin Manney - Amazon.com, Inc.

Hello, and welcome to our Q2 2017 financial results conference call. Joining us today to answer your questions is Brian Olsavsky, our CFO. As you listen to today's conference call, we encourage you to have our press release in front of you, which includes our financial results as well as metrics and commentary on the quarter. Please note, unless otherwise stated, all comparisons in this call will be against our results to the comparable period of 2016.

Our comments and responses to your questions reflect management's views as of today, July 27, 2017 only, and include forward-looking statements. Actual results may differ materially.

Additional information about factors that could potentially impact our financial results is included in today's press release and our filings with the SEC, including our most recent annual report on Form 10-K and subsequent filings.

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

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

Our guidance also assumes, among other things, that we don't conclude any additional business acquisitions, investments, restructurings or legal settlements and excludes the impact of our proposed acquisition of Whole

Foods Market. It is not possible to accurately predict demand for our goods and services, and therefore our actual results could differ materially from our guidance.

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

Question-and-Answer Session

Operator

At this time, we will open up the call for questions. We ask each caller please limit yourself to one question.

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

Heath Terry - Goldman Sachs & Co. LLC

Great. Thank you. I was just wondering if you could give us a sense on the investments that are planned in Q3. Previously, you've been willing to provide sort of some qualitative guidance around how you're rank ordering those or in terms of the ones that are the largest areas of investment in the quarter. I'm just wondering if you could update us on that given the guidance for Q3 and what we saw in investment in Q2.

Brian T. Olsavsky - Amazon.com, Inc.

Sure. Let me see what I can tell you on that. First of all, I want to remind you that Q3 is typically a lower operating income quarter as we're preparing for the Q4 holiday peak. The other dynamic is that, similar to last year, a large percentage of our new fulfillment centers are coming online in the second half of the year, a lot of them in Q3. So, to give that some perspective, the Amazon-fulfilled network, or the combination of retail and FBA shipments coming out of our warehouses has been nearly 40%. It was that last year, and it's continued through this year. Last year we added 30% additional square footage to handle that additional shipping volume, and about 80% of that went into service in the back end of last year. And that's what I mentioned about this time last year.

The similar dynamic this year, we are going to have about 80% of our increase in square footage for fulfillment and shipping coming online in the back end of the year, so that's a major increase. The other comment I would make is on the video content. Video content last year, I highlighted the fact that it was going to be a significant step up between second half of 2016 and the second half of 2015. We are still – we lapped that most of the first half

this year and we'll also be increasing video spend on a sequential and year-over-year basis in Q3, and that's included in this guidance.

Other than that, can't give much more specifics except to say that the large investment areas remain the increasing fulfillment capacity to service the strong growth of the FBA business. I will also point out that the strong usage growth in AWS has led us to a step up in infrastructure in capital leases to build the capital leases in the trailing 12 months. They've increased 71% through the end of Q2 versus last year. That is servicing – accelerating usage in our largest AWS services as well as geographic expansion. So that's additional factor sequentially in the quarter year-over-year.

Operator

Thank you. Our next question comes from Colin Sebastian with Robert W. Baird. Please proceed with your question.

Colin Alan Sebastian - Robert W. Baird & Co., Inc.

Great. Thank you. A question on the grocery category and the announcements that we have – that we heard recently. Specifically, does that imply that the strategy has changed around fresh, which was presumably replacing the trip to the grocery store? Or should we think about adding different modes such as pick up points and bricks and mortar as serving a distinct customer base or geared to reduce the cost bottleneck around home delivery? Any comments would be helpful. Thanks.

Brian T. Olsavsky - Amazon.com, Inc.

Sure, Colin. First, as far as Whole Foods is concerned, as Darin mentioned, it's not included in this guidance since it hasn't closed yet, but we are excited about that acquisition and looking forward to working with the team at Whole Foods. We think they are very customer-centric, just like us. They've built a great business, focus around quality and customer. So we're really glad to join up with them. On your larger question about what the place of Amazon Fresh, likely Prime Now and some of our other efforts, I would say we believe there'll be no one solution, so we're experimenting with a number of the formats from physical pickup points in Amazon Go to online ordering and delivery to your door through Prime Now and Amazon Fresh.

And we'll see how customers respond. We like the response that we've seen so far. We think it's a valuable – all those are valuable services, Amazon Go is not out of beta, but the other ones are. On top of that, we're looking forward to adding the Whole Foods team and their great reputation for quality customer service to this offering.

Operator

Thank you. Our next question comes from Justin Post with Merrill Lynch. Please proceed with your question.

Justin Post - Bank of America Merrill Lynch

Yes. A couple of questions. It definitely seems relative to your guidance, you may have stepped up spending in the second quarter. Anything in particular to call out, India or anything like that? And then just thinking bigger picture, I'm wondering why physical locations might make sense for Amazon. Why is that a positive use of capital going forward? Thank you.

Brian T. Olsavsky - Amazon.com, Inc.

Sure. As far as Q2 is concerned, we were very encouraged by the revenue and unit growth acceleration, particularly in North America. We see that tied to the Prime growth and the adoption of Prime and success of that program. Also point out that AWS stepped up its run rate from a \$14 billion run rate last quarter to \$16 billion. So we saw the largest quarter-over-quarter and year-over-year increase in revenue in that business as well. And gross margin expanded 130 basis points.

So as you point out, the year-over-year difference is primarily driven by investments, what we were within the guidance range and we continue to invest in, as I said, fulfillment capacity and logistics services, digital video, our Echo and Alexa, Echo devices and Alexa platform India, the buildup at the AWS infrastructure, all the things I mentioned not to mention Prime Now and Amazon Fresh and Prime benefits.

We did see a big jump in head count in year-over-year. You'll see it's 42%, and in the past, I'd say most of that is driven by operations hiring. I've even said that headquarters or office hiring many times in the past was below the level of revenue growth. Right now, what we're seeing is an accelerated growth rate in software engineers and also sales teams to support primarily AWS and advertising. So, yes, the growth rate of those two job categories actually exceeded the company growth rate. So we are adding – having success hiring a lot of people and pointing them at some very important programs and customer-facing efforts.

On the place of physical, again, as I mentioned in the earlier question, we are experimenting with a number of formats. You've seen the physical bookstores and I would say that the benefit there is again, we have a curated selection of titles and it's also a great opportunity for people to touch and feel our devices and see them, especially the new Echo devices. I went into the store in Seattle last week and I saw about a third of the people

were standing around the device table learning how they work, how they interact with devices. So, I saw firsthand the customer experience, I think, that's what we're seeing as a benefit to the physical stores right now.

Operator

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

Mark A. May - Citigroup Global Markets, Inc.

Thank you. A question on the comments around the fulfillment investments. Could you characterize or maybe even quantify how much of the fulfillment infrastructure investment that you're making is kind of incremental, is geared towards handling growth and sort of the existing business and infrastructure versus expanding your capabilities in fulfillment, like adding more inbound or last mile and/or from entering new international markets where you need to invest ahead of growth versus just sort of keeping up and maintaining growth within sort of your existing footprint? And then AWS, you had some price adjustments in May, yet the Q2 growth was quite good. Can you just comment about the impact that those cuts may have had in Q2 and if you're modeling those also in your Q3 guidance, maybe the impact there? Thanks.

Brian T. Olsavsky - Amazon.com, Inc.

Yes. Let me start with the second one. So, yes, we've had numerous price decreases, and we continue to have that in the AWS business, both absolute decreases in service costs and also rolling out new services that may be cannibalizing more expensive other services that we provide. So, nothing really to note on Q2 or Q3 from that standpoint. The fulfillment investments, I can't split it out for you between Amazon logistics support sort centers and fulfillment centers. What I can say, the biggest dynamic going on again is that Amazon fulfilled unit growth of nearly 40%, which was last year and carrying into this year.

It's a global number and we are very glad to have the success of the FBA program. We are matching that with just over 30% increase in square footage, and you're right, that does include some shipping sort centers and things that are incremental and new functions for us, if you will. But that's about all I can say on that right now. I think we're very happy with the FBA program. It's impact on Prime and we think Prime and FBA are self-reinforcing. We know customers really like it, the additional selection that FBA provides. So we like those combined, and we are working very hard to match that with capacity in an efficient manner.

Operator

Thank you. Our next question is from Douglas Anmuth with JPMorgan. Please proceed with your question.

Douglas T. Anmuth - JPMorgan Securities LLC

Thanks for taking the question. I just wanted to follow up on AWS, and just on the back of the price cut, obviously 1Q being the first full quarter, but it looks like 2Q, as Mark said, things did stabilize some. Can you just talk about whether you're seeing more of a volume pickup response here and companies kind of more actively moving volume into the cloud at these lower prices? And then just secondly, on Prime, the value of a Prime subscription for the consumer seems to continue to increase as you add more features in there. Can you just talk about your view around the flexibility of the price of annual Prime subscription? Thanks.

Brian T. Olsavsky - Amazon.com, Inc.

Sure. On the price of Prime, I have nothing to add at this time. We think that the – we are increasing the value of the Prime program every day. So it becomes more and more valuable and again, as we've said, it's the best deal in retail. On AWS, yes, we are seeing great customer adoption. Again, as I said earlier, the run rate's gone up from \$14 billion to \$16 billion in Q2, and also we had the largest sequential and year-over-year dollar rise in revenues. Our usage in all of our large services are actually accelerating and they're growing at a rate higher than our revenue growth. So, you're seeing great adoption. We are seeing AWS customers migrate more than 30 databases over the last year-and-a-half.

We signed some very big customer wins, like Ancestry, High Tail, California Polytechnic State University and others, that we're very proud to have. So, yes, the momentum in the business is very strong. We continue to open new regions. We'll be opening five regions in the near future in France, China, Sweden, Hong Kong and a second government cloud region in the East. So, yes, we like the momentum in that business. Stepping back, I would say that while pricing is important, again, we're generally being selected because of our functionality and pace of innovation, the innovation keeps accelerating. It did in the first half of this year, the pace of new services and features. We also know the customers value our partner and customer ecosystem and really the experience we've had, we've been at this longer than anybody else.

Operator

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

Mark Mahaney - RBC Capital Markets LLC

Hey. I want to stick with AWS, please. So the AWS revenue growth showed almost no change but the AWS operating margin was lower I guess than we've seen in, I don't know, six quarters or something like that. I find that a little surprising but then I also saw that the tech and content came in materially heavy, I think, versus our and I assume other expectations. So could you just talk about that a little bit, the profitability, if there's anything that's changed in the profitability of AWS? Thanks.

Brian T. Olsavsky - Amazon.com, Inc.

Sure. Those margins, as we say frequently, are going to fluctuate quarter-to-quarter and always going to be a net of investments, excuse me, price reductions and cost efficiencies that we drive. So I would say the biggest impact in the margin that you're seeing in Q2 is really around the 71% increase in assets acquired under capital leases. Most of that is for the AWS business. So we've really stepped up the infrastructure to match the large usage growth and also the geographic expansion. And that is showing up in tech and content. On the marketing, if you look under the marketing expenses, they are also up, and that is driven by the increases we're seeing in the sales team both in AWS and advertising. So I would point to those two as probably larger than normal impacts on Q2 operating margin.

Operator

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

Brian Nowak - Morgan Stanley & Co. LLC

Thanks for taking my questions. I have two. The first one, as you continue to add more Prime Now markets with one to two-hour shipping, can you just talk to some of the logistical challenges that you've already encountered and worked through? And talk to kind of if you really do see one to two-hour shipping become a larger piece of the business over the next year, what's the biggest challenge you have to make sure that you manage? And the second one on the subscription revenue, it looks like subscription revenue growth was strong again, over 50%. Could you just talk to what drove that acceleration? Was it Prime? Or is there something else in there? Thanks.

Brian T. Olsavsky - Amazon.com, Inc.

Sure. Let me start with your second question on the subscription revenue. It grew 53% year-over-year versus 52% in Q1. So, we continue to see strong Prime membership growth. That is the main thing. There's also – in that line item are also other monthly fees associated with some of our other subscription services like audiobooks, e-books, digital video and digital music. Again, I would say that we're very happy with the Prime membership growth and it has remained pretty consistent both in Q4 and then through Q1 and Q2 of this year.

On your second question on Prime Now, so Prime Now is now available in 50 cities across eight countries. We do learn. It's something to do in every city and have different – slightly different shapes and sizes of those buildings and different density profiles. And so we are learning as we go, learn as we grow internationally as well. That is a service that customers love. That's not an inexpensive service, though, and we also have – so we're constantly working on our cost of delivery and our route densities. And again, we like what we see and we'll continue to expand that and we'll be working very hard on making that not only a valuable Prime offering, a Prime benefit, but also a lower-cost operation as well.

Operator

Thank you. Our next question comes from the line of Dan Salmon with BMO Capital Markets. Please proceed with your question.

Daniel Salmon - BMO Capital Markets (United States)

Hey. Good afternoon, Brian. I think I heard you earlier say that your head count for advertising salespeople is growing faster than the company as a whole, or company's head count growth rate as a whole. I would just like to use that maybe as a springboard to talk a little bit about what you think the right mix is for how you sell in terms of self-service versus salespeople.

And then a second one would just be a quick one. I know it's early, but be curious to see what you're seeing with users of the Echo Show, with the screen on it, and if you're seeing any particularly different type of user behavior there versus the original devices with that one. Thank you.

Brian T. Olsavsky - Amazon.com, Inc.

Sure. Yes. It's early on the Echo Show. As you know, we just started shipping those in late June, but we're very excited about the potential and the addition of the video screen and the messaging capability and video capability. So it's – I've used mine, it's awesome. It's a big step up in my mind, but we'll get more customer feedback as we go along. On advertising, technically what I said is the sales force has grown higher than the rate of

growth in the business itself, which was 42% regular head count and that sales force is primarily AWS and advertising. So, we built self-service tools and obviously we want to make those as efficient as possible for customers and advertisers, but we realize that we will need actual sales contact with the accounts as well. So it's a mix. I can't get into the split, really, but I would see both growing.

Operator

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

Eric J. Sheridan - UBS Securities LLC

Thanks so much for taking the question. Maybe two. One, with respect to international margins, is there anything there you can give us in terms of rank order or color, whether it be geographies or category expansion that we should be thinking about that are driving some of the cost curve in the international side of the business? That would be number one. Number two, stock-based comps stepped up a lot, both quarter-over-quarter and year-on-year. Wanted to know if there was anything either organic or inorganic that was driving that step-up in stock-based compensation. Thank so much.

Brian T. Olsavsky - Amazon.com, Inc.

Sure. I'll start with the second one. Yes, as you noted in the press release or the 8-K, we had an absolute step-up from Q1 of \$792 million to Q2 of \$1.2 billion. So it increased 51% year-over-year in Q2 versus a head count increase of 42%. I'll also say that we generally see a step-up from Q1 to Q2 because we do our employee RCU grants in Q2 of each year. So that's a normal trend. But the 51% year-over-year is also – it's a combination of the hiring we've done but also an adjustment we made to our estimated forfeiture rate. We're seeing less forfeitures, which is a great sign for our employee retention, but you have to make adjustments to your reserves as you see that. So that was another influence in Q2.

On operating margins internationally, I would step back and say a lot of the investments we're making in North America we're also making in international. Prime benefits including Prime Video and remember we launched Global Video in Q4 of last year to 200 countries, Prime Now, Amazon Fresh, the general rise of FBA and added selection, both retail and FBA to make Prime more attractive, and the fulfillment and logistics costs that go with that, and the additional constant effort to reduce prices and accelerate shipping. So that all impacts both North America segment and international. The North America segment is a little further along in the Prime, excuse me, yes, the Prime membership growth curve. And so in some

respects we are giving benefits earlier in the lifecycle to international Prime customers than we did in North America just because it launched later.

And there's also India, as I mentioned, we continue to invest in India. We're very hopeful with the progress we've made with sellers and customers alike in India and we see great momentum and success there, so we continue to invest and we have some of our best people in that business.

Operator

Thank you. Our next question comes from line of Brian Fitzgerald with Jefferies. Please proceed with your question.

Brian P. Fitzgerald - Jefferies LLC

Thanks, guys. You mentioned before just stand of new fulfillment centers, it takes a bit of time for them to ramp optimization. How should we think about that path optimization over a year or so? As you continue to scale operations and you bring data to bear and robotics and Kivas and AI machine learning, are you finding that kind of new fulfillment center optimization curve is accelerating?

Darin Manney - Amazon.com, Inc.

Hi, Brian. This is Darin. Yes. We're getting more efficient every time we put new capacity into the network, whether that's through automation or just through the experience we've gained over the years. We still say it takes up to three years or three peaks to get to kind of network efficiency for a new particular facility, and that's about the same although the whole network gets sufficient over time. So there's a big mix going on, and we like the new innovation that we're bringing to the capabilities, but that ramp still stays about consistent as it was.

Operator

Thank you. And our final question comes from line of from Jason Helfstein with Oppenheimer and Company. Please proceed with your question.

Jason Helfstein - Oppenheimer & Co., Inc.

Thanks for taking my question. Just one, other slowed from 58% in the first quarter to 53% year-over-year. Anything to call out? And then just you made a comment about physical stores and reaction to one other question that was really about showcasing new devices. Is it fair to say that probably means locations would have small footprints versus large footprints if you're thinking about that? Thank you.

Brian T. Olsavsky - Amazon.com, Inc.

I'm sorry. What was the first part of your question?

Jason Helfstein - Oppenheimer & Co., Inc.

The other, other revenue slowed from 58% in the first quarter to 53%. Is there anything to call out around that?

Brian T. Olsavsky - Amazon.com, Inc.

No, nothing in that other line item. It's advertising and also other things like cobranded credit card agreements. I would say that advertising revenue growth has been strong and fairly consistent over the past three quarters. So that number will move around, but there's other things in it that more the variance and the volatility is in the other line items.

Your question on stores, we are – again, I personally think the new devices, the ability to see new devices is a great asset, but I don't want to shortchange the rest of the bookstore and the ability to have curated selection and the creativity we've had in taking new look at the bookstores. So we are experimenting with different formats, and we look at different sizes and we look at revenue cost per square foot just like any other physical retailer. So, we haven't essentially nailed the model yet, and we continue to experiment to see what works and how it differs by city or more suburban locations.

Darin Manney - Amazon.com, Inc.

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