Operator

Good day, everyone, and welcome to the Amazon.com Second Quarter 2012 Financial Results Teleconference. (Operator Instructions) 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 Q2 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, April 26, 2012, 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'll 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'll turn the call over to Tom.

Tom Szkutak

Thanks, Sean. I will begin with comments on our second quarter financial results. Trailing 12 months operating cash flow was $3.22 billion compared with $3.2 billion. Trailing 12-months free cash flow decreased 40% to $1.1 billion. Return on invested capital was 11%, down from 21%. ROIC is trailing 12-months 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, stock-based awards outstanding, was

468 million share compared with 468 million shares. Worldwide revenue grew 29% to $12.83 billion or 32% excluding the $272 million, unfavorable impact from the 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 shipping offers.

Media revenue increased to $4.12 billion, up 13% or 15% excluding foreign exchange. EGM revenue increased to $8.16 billion, up 38% or 42% excluding foreign exchange. Worldwide EGM increased to 64% of worldwide sales, up from 59%. Worldwide paid unit growth was 43%. Active customer counts exceeded to 180 million. Worldwide active seller accounts were more than 2 million. Seller units were 40% of paid units compared to 36% of paid units in Q2 of 2011.

Now I will discuss operating expenses excluding stock-based compensation. Cost of sales was $9.49 billion, or 73.9% of revenue compared with 75.9%. Fulfillment, marketing, technology and content and G&A combined, was $2.99 billion or 23.3% of sales up approximately 307 basis points year-over-year. Fulfillment was $1.3 billion or 10.1% of revenue compared with 9.2%. Tech and content was $970 million or 7.6% of revenue compared with 6.3%. Marketing was $521 million or 4.1% of revenue compared with 3.3%.

Now I will talk about our segment results and consistent with prior periods, we do not allocate to segments our stock-based compensation or other operating expense line item. In the North America's segment, revenue grew 36% to $7.33 billion. Media revenue grew 18% to $1.87 billion, EGM revenue grew 41% to 4.94 billion representing 67% of North America revenues up from 65%. North America segment operating income increased 61% to $344 million a 4.7% operating margin.

In the international segment, revenue grew 22% to 5.51 billion adjusting for the $269 million year-over-year unfavorable foreign exchange impact, revenue growth was 28%. Media revenue grew 8% to 2.25 billion or 12% excluding foreign exchange. And EGM revenue grew 34% to 3.22 billion or 42% excluding foreign exchange. EGM now represents 59% of international revenues up from 53%.

International segment operating income decreased 91% to 16 million or 0.3% operating margin. Excluding the unfavorable impact from foreign exchange, international segment operating income decreased 74%.

Consolidated segment operating income decreased 7% to 360 million or 2.8% of revenue down approximately 109 basis points year-over-year. Excluding the unfavorable impact from foreign exchange CSOI decreased

4%. Unlike CSOI, our GAAP operating income includes stock based compensation expense and other operating expense. GAAP operating income decreased 47% to $107 million or 0.8% of net sales.

Our income tax expense was $109 million a 75% effective tax rate for the quarter and includes a one-time expense of $51 million related to the integration of Kiva Systems acquisition. Accordingly, our Q2 2012 effective tax rate is higher than both our current estimated 2012 annual effective rate and our 2011 effective tax rate.

GAAP net income was $7 million or $0.01 per diluted share compared with $191 million and $0.41 per diluted share. Q2 2012 net income includes $65 million of estimated loss related to the acquisition and integration of Kiva Systems.

Turning to the balance sheet. Cash and marketable securities decreased 1.39 billion year-over-year to 4.97 billion. Inventory increased 36% to 4.3 billion and inventory turns were 10.1 down from 11.3 turns a year ago as we expanded selection, improved in stock levels and introduced new product categories.

Accounts payable increased 24% to 7.07 billion and accounts payable days decreased to 68 from 69 in the prior year. Our Q2 2012 capital expenditures were $657 million, the increase in capital expenditures reflects additional investments in support of continued business growth consisting of investments in technology infrastructure including Amazon web services and additional capacity to support our funding operations.

I’ll conclude my portion of today’s call with guidance. Incorporated into our guidance are the order trends that we have seen to-date and what we believe today to be properly conservative assumptions. Our results are inherently unpredictable and maybe materially affected by many factors including a high level of uncertainties surrounding exchange rate fluctuations as well as the global economy 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 intercompany balances and foreign currencies among such subsidiaries, unfavorable resolution of legal matters, and changes to our effective tax rate can all have a material effect on guidance.

Our guidance further assumes that we don’t conclude any additional business acquisition, investments or settlement, record any further revision for stock-based compensation estimates, and that foreign exchange rates remain approximately where they have been recently.

For the Q3 2012 we expect net sales of between 12.9 and 14.3 billion or growth between 19 and 31%. This guidance anticipates approximately 425 basis points of unfavorable impact from foreign exchange rates.

GAAP operating income or loss to be between 350 million loss and 50 million loss down from 79 million income in the comparable prior year period. This includes approximately $275 million for stock-based compensation and amortization of intangible assets.

We anticipate consolidated segment operating income or loss which excludes stock-based compensation and other operating expenses to be between $75 million loss and $225 million in income, or between a 129% decline and 14% decline. We expect capital expenditures including capitalized software development to be approximately $0.8 billion to $0.9 billion. These anticipated investments are driven primarily by our expectations of a continued business growth consisting of investments in technology infrastructure, including Amazon web service and additional capacity to support our fulfillment operations.

We remain heads on focused on driving better customer experience through price, selection and convenience. We believe putting customers first is the only reliable way to create lasting value for shareholder. Thanks. With that, Sean, we will move 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 Spencer Wang with Crédit Suisse.

Spencer Wang - Crédit Suisse

Thanks, good afternoon. Just one question on Kiva and a couple of parts, Tom. Now that you have closed the acquisition, can you talk about how you will deploy the Kiva technology? Is that for new fulfillment centers only or can you use that in your legacy fulfillment centers and perhaps what type efficiencies that could gain. And then last part would be, is there any impact on your 3Q guidance from the Kiva acquisition specifically? Thanks.

Tom Szkutak

Sure. In terms of Kiva itself, we are very very excited to have Kiva as part of the Amazon team. You know we are looking forward to getting great productivity over time through the use. But again it's very early and you'll just have to stay tuned in terms of the plan. In terms of the impact, you mentioned Q3. Let me just provide a little bit of data on both Q2 actuals and Q3. In terms GAAP operating income in Q2, it was negative $25 million. For Q3 it's approximately negative $35 million. And then on the net income for Q2, it was a loss of approximately $65 million. And so those are the numbers for Q2 and Q3. But again we are very very happy to have them part of them and that we look forward to working with them going forward.

Operator

We will go next to Heather Bellini with Goldman Sachs.

Heather Bellini - Goldman Sachs

Question on the gross margin, continues to climb up, and I was wondering if you could give any commentary there around how agency versus wholesale and eBooks is contributing to that?

Tom Szkutak

Yeah, the bigger issue is not that, it's related to overall 3P, a number of factors of different factors certainly driving the improvement in product gross margins that you are referring to. But as it relates to 3P, it's on the broader 3P. So if you take a look at from a units perspective, third party was 40% of our total units in Q2. That's up from 36%. So it's approximately 400 basis points increase as a percentage of total units which is certainly one of the factors that you are seeing there.

Operator

We will go next to Herman Leung with Susquehanna.

Unidentified Analyst

This is [Deepak] sitting in for Herman. So the question I had was on the hardware business. So how important do you think is the hardware strategy to you for the digital content? Now given that Kindle Fire has been out there for a while, so could you discuss about the strategy on the business and how it's driving the digital content?

Tom Szkutak

Sure. You know we are very excited about both the hardware and the content of the business. We think if you take a look at our devices, certainly it's very integrated, which is great for customers. So we think it's incredible experience. And so we have been very excited about the progress we have made so far from both a device and content standpoint. And we are super excited about the road map that we have. So again, that's again, very, very happy with what the team is doing there.

Operator

And we will go next to Brian Nowak with Nomura Equity Research.

Aram Rubinson - Nomura Equity Research

This is Aram Rubinson sitting in for Brian Nowak. I notice your shipping cost was lower as a percent of sales for the first time in nearly three years. The driver it looks like it's shipping cost per unit which fell about 10%. Can you talk about how much of that might be attributable to proximity of distribution centers to metro areas, lower fuel, more favorable carrier pricing etcetera, and whether or not you see anything on the horizon that would change that course.

Tom Szkutak

Yes, we are seeing, there is a number of different factors, but certainly one of them is we are getting closer to customers and that's just with our wide [multitude of film] networks, so that's really having an impact on that. And again we have a lot of opportunities to improve that overtime, but again the team is making good progress and you are seeing that reflected in the results so far.

Operator

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

Paul Bieber - Bank of America/Merrill Lynch

This is Paul Bieber for Justin. Just going back for the gross margin question, I was wondering if you could give us some color on the relative impact of few different things; category, maturity, advertising, 3P, and maybe digital content on gross margins, which ones are impacting gross margins more than others. And then just quick question on the taxes. What were the impact of sales tax in Texas and California beyond gross margins?

Tom Szkutak

In terms of your question on gross margins, we are not breaking that up but certainly 3P is having the impact, mix of businesses having an impact. We continue to try to work with our partners to get even better prices on the goods that we provide for customers which is certainly impacting it. Mix of business things like [AWS] is certainly impacting that as well, given the growth rate there. So, again those are things that are impacting. In terms of sales taxes, any impact that we certainly would expect to see would be included in guidance that we are giving for Q3, but one thing to keep in mind as it relates to that is we right now approximately 50% of our business around the world, we either collect sales tax or value added tax. We have very good businesses in those jurisdictions and so [keep that in mind] you should think about any upcoming changes.

Operator

We will go next to Doug Anmuth with JPMorgan.

Kaizad Gotla - JPMorgan

This is Kaizad Gotla in for Doug. Just a couple of questions, can you discuss the international media deceleration, it looks like it decelerated from 22 to 12% on an ex-FX basis. And then can you maybe just give us an update on the fulfillment center plans for the rest of the year. Thanks.

Tom Szkutak

I'll take international in total first and then, you know that the same is true for media, and really I'll even start with the total business. Total business grew 32%. One thing to keep this on currency basis, one thing to keep in mind is for both the total business international growth and international media, we had a very, very strong growth last year Q2. In fact our total growth rate last year was 51% for the total business and on a local currency basis that was 44% growth, that's the highest growth quarter we've had in over 10 years. And so when you look at that, when you are comparing ourselves in Q2 this year, we had very good growth given that compare to last year, and that some of which we are seeing also in international media as you mentioned. So, international media was up 8%, on a local currency basis so it was up 12 and certainly it's a challenging compare.

Also there were some things just with, as we some timely things as we launched with the unfortunate events in Japan last year, we certainly did have some releases that with scope of relating the quarter obviously didn't happened, they moved into Q2 just from a supply standpoint those are certainly impacting that region and some other things. So it's, again, think of it in terms of the comparison point for last year is probably the best thing to do.

Operator

We will go next to Mark Mahaney with Citi.

Rohit Kulkarni - Citigroup

This is Rohit Kulkarni filling in for Mark. Couple of questions. Can you talk about, or disclose anything about mobile, how that's affecting your business. eBay talked about mobile affecting their growth rates quite materially, perhaps even by a few percentage points and accounting for almost 10% of their revenues maybe.

And second is, can you talk about the broad philosophy of management about short-term profitability versus long-term growth. Probably this is the first time in a while that you have bracketed negative pro forma operating income in your guidance. How should we view your short-term investment or the short-term profitability outlook.

Tom Szkutak

Sure. First in terms on mobile. Clearly, smartphones and tablets are a significant tailwind for our business. While we are not breaking out the numbers, it's a big tailwind on our business and it's going great. So we are seeing a very nice impact from that and again it's a tailwind that we expect that will continue. In terms of short term versus long-term, you know we are all about trying to make sure we do the right long-term things for both customers and shareowners. But more specifically around Q3, you know Q3 is similar to Q2 and other previous quarters and that we are investing certainly for the long term.

Yet, on the flip side, keep in mind, as you look at Q3 specifically, we are getting ready for a most seasonal quarter and we expect, given the growth that we have had, we are seeing very strong growth so we are investing heavily to get ready for that. In terms of capacity for example, we have announced 18 new fulfillment centers so far this year. We have actually opened eight of those already this year, out of the 18. And we are looking at potentially opening even more than that. I am sorry, six opened so far this year, out of 18. So those are certainly something are impacting the cost so far and you will be seeing that heavier in Q3 as we get ready for the most seasonal quarter.

Operator

We will go next to Mark Miller with William Blair.

Mark Miller - William Blair

Hi, I was hoping, you could share some perspective on your URL expansion strategy. I'd like to know, I guess some sense for the growth you are seeing there and how material it is in your overall numbers. And should we expect to see further expansion in those sites.

Tom Szkutak

Yeah. There's not a lot I can you know help you with there. We are certainly looking as you would expect us to do, ways to continue to grow and certainly that will be part of our strategy.

Operator

We will go next to Scott Tillman with Caris & Company.

Scott Tillman - Caris & Company

Tom, I was just curious, we have had a few quarters where operating income has far surpassed the upper end of your guidance range and we had a quarter here you definitely seemed to weaken as the months went by. Just wondering what you think is causing that divergence between sort of expectation at the beginning of the quarter and how things are playing out. Then just as a quick follow up to one of the other questions. You are looking at the fulfillment center network, just wondering if you are satisfied with the fee increases that were put in place in February that that business is now matching the margin for the rest of the business.

Tom Szkutak

I am sorry, could you elaborate on the months going by, I wasn't following your question.

Scott Tillman - Caris & Company

On operating income, we have had a couple of -- a few quarters here where the numbers have come in far better than guidance. And we actually had a situation where Europe actually got worst as the quarter went on. So wondering what is driving that out performance.

Tom Szkutak

Got it. You know we, certainly as you look at, I will talk to Q2 since it's the most recent quarter, but we had a lot of strength across many different areas. One of the ones I mentioned that certainly helped our operating profit as well as our gross margin with the third party business continued to be very very strong. And certainly that was a factor. Again, there was a number of factors. One thing too, you do see some timing differences to some extent between Q2 and Q3 in terms of our prep for Q4, you see that knowing our operating results, but you see that in our CapEx. In the last 90 days ago we said that we would spend approximately 800 to $900 million of CapEx for Q2, we spent little less than 700. You see that number for Q3 being 8 to 900 as well. It's 900 million. So, again those are things that you are seeing just a little bit of a shift between Q2 and Q3 there.

Operator

We will go next to Ron Josey with ThinkEquity.

Ron Josey - ThinkEquity

I wanted to ask you a quick on 3P and given it's around 40% of sale this year, item sold. What point you believe the customer experience on Amazon is at risk given the rise of third-party sales. And any insight in terms of adoption on FBA by third parties would be very helpful. And then one quick follow-up just on your comments on CapEx, I think you said, it came in lower in 2Q, guidance is for another 8 to 900 million, is that guidance sort of consistent maybe going out, going forward or is this sort of one-time build around technology. Thank you.

Tom Szkutak

In terms of the third party units, certainly FBA is having an impact on that, that's one of the drivers, certainly that's helping us have that percentage of total units go up. And we have looked at and we have been working very hard over a number of years on improving the experience for both customers and for sellers and FBA is an example of that. And what ends up happening is FBA sellers wants their part of the program, those units that FBA and our fulfillment network are eligible for all of our programs including free super saver shipping, prime. So, again those are great, certainly that’s a great program for our customers, it's great program for seller and it's great program for investors.

And I don’t of it as a bad thing at all, I think of it as a good thing. We have a lot of retail units that we send directly to customers, we are offering a great experience on third party units which includes FBA and a number of other programs that we have. So, again we will continue to try to make that even better for customers overtime, but it's working very well, and again those are the benefit of having third parties on a platform is we get to [equate] some new selection. We also have competing offers directly on our detail pages, so when customers come they get to choose in terms of who they want to purchase from. So, it's a competitive environment on our platform. So, we think that’s great for customers and for us.

Operator

We will go next to So Young Lee with SunTrust.

So Young Lee - SunTrust Robinson Humphrey

I was just curious about LivingSocial, it seem to be a bigger loss unusual, can you give us some color on what happened perhaps. And secondly, can you talk about the kind of traction you are getting with LOVEFiLM given all of the exclusive content you are getting there.

Tom Szkutak

LOVEFiLM business is doing very well. It's growing nicely as you mentioned we continue to add content there, and we plan on having more content there overtime. I’m very excited to have that business at part of Amazon and the team is doing great. In terms of LivingSocial there is a not a lot, I can add to it other than what we have disclosed.

Operator

We will go next to Ken Sena with Evercore Partners.

Andrew McNellis - Evercore Partners

This is Andrew McNellis in for Ken. Somewhat related to other questions that have been asked, could you provide any update to your same day shipping efforts and how that relates to sales tax and performance in your investment?

Tom Szkutak

In terms of delivery speed to customers, we are certainly trying to get geographically, always trying to get closer to customers, that's something that's not new, it's something we have been doing for some time. But in terms of same day, we don't really see a way to do same day delivery on a broad scale economically. But again we will continue to work on behalf of customers to try to figure out a way to serve them even better by getting product faster but in terms of same day, we don't see a way to do that on a broad scale economically.

Operator

We will go next to Anthony Diclemente with Barclays.

Perry Gold - Barclays Capital

This is Perry Gold on for Anthony. Can you please touch on the online sales tax issue and how it could affect your build out strategy for fulfillment centers?

Tom Szkutak

You know as I mentioned earlier, we have -- we do collect in several states within the U.S. We do collect in a number of geographies that have an equivalent value added tax, approximately half for our business. We actually sales tax, the value added tax. We do very good business in those geographies. Those geographies reflected, for the most part, if you go back on the last several years, most of them have been included. We have also certainly added some new geographies or new jurisdictions that we clocked during that time period. But you see that we have seen very very strong growth even while collecting. So we are very supportive of collecting. We think the best way to do that is through a federal solution and we keep working with Congress and others to try to get that passed.

Operator

We will go next to Kerry Rice with Needham & Company.

Kerry Rice - Needham & Company

Kind of sales tax issue again. Amazon signed a lot of bilateral agreements with several states on the collection of sales tax. And I know there is a federal effort also going on. Can you talk about if a federal sales tax is passed, how does that impact your bilateral agreements with the states. Does that supersede it or does that kind of have to continue to go on with those particular states and build those fulfillment centers and things in those states that you have agreed to.

Tom Szkutak

There is not a lot I can add to that. So I can't be that helpful with your question, I apologize. But again, you are right, we do support federal legislation, we are working very hard at that. One thing to keep In mind to, we price our products irrespective of what sales tax is, that’s a customer obligation and so we are pricing products very well. And so that’s not something that we just started doing, that’s something that we have been doing for a long time. And that’s why we have a good business in those geographies and jurisdictions where we do collect. And because customers are coming to us because they want to have value which we offer irrespective of tax, there has been a number of different third parties that have certainly reported on that. They come because they want great convenience, they want obviously great service, and those are things we are focused and those are the things that we believe customers will still want over the long-term and that’s why are focused on those areas.

Operator

We will go next to Matt Nemer with Wells Fargo Securities.

Matt Nemer - Wells Fargo Securities

The international segment operating income has been under a lot of pressure. Is that primarily related to existing markets, growth in new markets? And would that be on the merchandize margin side of the P&L or is it more of an operating cost issue.

Tom Szkutak

Keep in mind with international, it’s a mix of geographies and we are -- certainly there are some that we are investing in. We mentioned certainly in other calls, China is an area that is growing very fast but we are certainly in investment mode there. In recent years, we have launched Italy and Spain. We are certainly investing in those geographies and like what we see there. Those are certainly impacting. We are also adding a lot of fulfillment capacity. And so those are the things that are certainly impacting those numbers.

Operator

We will take our last question from Atul Bagga with Lazard Capital.

Atul Bagga - Lazard Capital

I have two questions. One on guidance and the other one prime members. Can you give us some color on guidance, what you are baking for growth in international versus domestic? And guidance implies there is some compression in margin. Is it again mostly the function of the sales mix or is something else going on there. And then a second on prime members. Can you remind us the profitability of prime members versus non-prime member and in the longer-term where do you think the penetration of prime members within your overall base?

Tom Szkutak

In terms of revenue, we don’t break out the segments in terms of the split. But if you take a look at our guidance, it’s to grow between 19% and 31%. And if you look at the impact of exchange, it’s a little over 400 basis points and so rounded it's just under 36% on the high end and 23% on the low end. And so that’s the range of guidance and so we are certainly pleased with what we saw in Q2 and certainly giving as we have in past quarters a wide range for Q3. In terms of the bottom line, in terms of operating income and CSOI guidance that we have given, as I mentioned earlier, certainly a number of different factors like the last several quarters, as we have been talking about we are certainly investing a lot in the business, but one thing to keep in mind is for the guidance in upcoming quarter to Q3. And we are certainly getting ready given the growth rates we had for our most seasonal quarter, that’s certainly impacting the bottom line in terms of our guidance and as I mentioned earlier we opened a lot of performance centers, adding a lot of capacity for both our web service businesses as well as infrastructure support. Our retail business, so again we are investing across the business which is like all the periods, but again we are getting ready for Q4.

Operator

That will conclude our question-and-answer session. I’ll turn it back over to our speaker’s for any additional or closing remarks.

Tom Szkutak

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.