

Operator

Good day everyone and welcome to the Amazon.com Q3 2016 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 Q3 2016 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 metric and commentary on the quarter. Please note, unless otherwise stated, all comparisons in this call will be against our results for the comparable period of 2015.

Our comments and responses to your questions reflect management's view as of today, October 27, 2016, 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 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 are 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 segments. 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 now open up the call for questions. Thank you. Our first question comes from Douglas Anmuth with JPMorgan. Please state your question.

Douglas T. Anmuth - JPMorgan Securities LLC

Thanks for taking the question. The International retail segment margin was the lowest we've seen in quite a while. I was hoping you could provide some of the key drivers there in terms of the drag and any color on how to think about the incremental international investment that might be impacting the 4Q guide. Thanks.

Brian T. Olsavsky - Amazon.com, Inc.

Sure. Thanks, Doug. Yes, specifically to International, we are seeing expansion to support selection, expansion at fulfillment network increases. We're also investing in digital content and additional Prime benefits, fresh location Prime Now. But by far the biggest individual thing is the investment in India that we continue to make and very excited about it, the initial reaction in India from both the customers and also sellers. So that is essentially the International margin guidance in Q4.

Douglas T. Anmuth - JPMorgan Securities LLC

Thank you.

Operator

Thank you. Our next question comes from Gene Munster with Piper Jaffray. Please proceed with your question.

Eugene Charles Munster - Piper Jaffray & Co.

Great. Thanks. I guess when we think about the progression of margins in the second half versus the second half of 2015 and kind of the flat-lining of overall margin at this point excluding AWS, I guess should we think about this as being a temporary kind of plateau that will at some point resume once you start leveraging the fulfillment build-out? Or is there something structurally or philosophically changing with the way that you operate your business? Thanks.

Brian T. Olsavsky - Amazon.com, Inc.

Yes. Thanks, Gene. Well we will continue to invest in the business where we are seeing significant customer traction. And the things I'm about to mention fall into that category. But the largest individual reasons for the ramp-up in investment between first half and second half of this year and also second half of this year versus second half of last year are the things I mentioned on the call last quarter.

First, video content and marketing associated with that is nearly doubling year-over-year in the second half of the year. And it continues to be a large increase both Q3 and Q4. In the quarter, in Q3 we added 18 fulfillment centers and we've added five more in October. For the year we'll add 26. Most of those are in North America but that compares to 14 last year and I would look, looking back the last time we had double-digit increase in fulfillment centers was in 2012 when we added 11 in the third quarter.

So it was a rare aggregation of startups in Q3 and into Q4 that's helping us position better for Q4 volumes. Because paid unit growth continues to be strong and Amazon fulfilled unit growth which includes what we ship, includes FBA, is significantly higher than even that. So we continue to build for high AFN, or Amazon Fulfilled Network demand, including both retail and FBA. The number of warehouses that we added represents a 30% increase in square footage year-over-year. Last year we increased square footage by just under 20%. The definition of square footage in this case is all of our warehouses plus our sortation and delivery centers. So it's pretty much our customer service centers. So it's pretty much our full square footage that supports operation.

So those will dissipate as as they burn in. We've talked about fulfillment centers' initial startup costs include increase in fixed costs but also variable cost as we train workers and also bring in inventory. And there's a number of transportation costs also related to the startup of a new fulfillment center, both inbound and outbound. And they're inherently less efficient than more established mature buildings, so there will be a cycle where those will be more productive next year than they are this year and more productive in 2018 than they are in 2017.

So what you're seeing essentially in the second half of this year is a step-up investment primarily around digital content and also the fulfillment center investment, but also things like Echo and Alexa which we're adding a lot of resources to, India and AWS as we add people there to support additional service, think (7:54) rapid growth in that business.

Operator

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

Brian Nowak - Morgan Stanley & Co. LLC

Thanks for taking my question and I have two. The first one, just to go back, Brian, to the fulfillment build. In the past, I think you've talked about how it takes time to kind of get the fulfillment centers to peak efficiencies, so with these new FCs opening, could you just talk about it? Have you become more efficient so if you get into a lower volume quarter next year, there's less risk of deleverage? Or should we still kind of think about it's going to take time to get to up to peak efficiency?

And then the second one, AWS. Amazon is a company that is very good at removing friction in the purchase process. Could you just talk about some of the main hurdles you still have to overcome for large enterprises to really start using AWS more? Thanks.

Brian T. Olsavsky - Amazon.com, Inc.

Sure. So the fulfillment network as we built it, yes, they'll be more productive next year than they are this holiday peak and probably even more productive in 2018. So I can't forecast it for you into next year quite yet, but we certainly had productivity add additional cost to Q3 and even into Q4 of this year as we build the additional capacity. Again, the underlying reason for that capacity build is the strength in paid units and even more so in the units that we're fulfilling driven by our FBA program. The FBA program is a key pillar of our Prime offering. It adds selection. It makes Prime stronger and then that's a self-reinforcing where Prime then – the Prime success attract more sellers. So we're glad to have that problem. We are just working very hard to get capacity in place and in productive use for Q4 and beyond.

Darin Manney - Amazon.com, Inc.

Hi Brian. This is Darin. On the AWS question, yeah, we continue to invest in AWS on behalf of our customers in addition to the technologies that make integrations easier that helps companies move from an on-prem or a hybrid IT environment into AWS. So we're going to continue to do that, specifically things like the database migration tool that are helpful for customers when

they move production databases from on premises to the cloud with virtually no downtime.

And also many of our AWS customers are beginning to choose and continue to choose the AWS Schema Conversion Tool which really switches database engines to get out of old guard proprietary databases and onto AWS. And so we'll continue to react to customer needs and that will include opening up new regions. We've opened up Ohio this past quarter and we've highlighted that we'll have another number of regions coming online in a few months. So yeah, were doing a lot of things to help make it easier for all customers to migrate to AWS.

Operator

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

Mark Mahaney - RBC Capital Markets LLC

Okay. Hey, Brian. Would you give us any commentary on two categories, in particular groceries and fashion and apparel? And particularly on groceries, I know in the release there's a couple of data points about Fresh rolling out into newer areas like Maryland, great to see that. But could you just talk about that in the investment horizon? Is that moving the needle for you? And how big that, any way to help us quantify how big that already is to the revenue growth that you're seeing, particularly on groceries and any particular comments on fashion and apparel, same line of thinking? Thanks.

Brian T. Olsavsky - Amazon.com, Inc.

Okay. Sure. Thanks, Mark. I will start with Fresh and groceries in general. So yes, this quarter we launched in Northern Virginia, Maryland, Dallas and Chicago. We also launched a new pricing plan which is a monthly \$14.99 add-on to Prime in the U.S. and we've expanded, as you know, previously into London. We're very happy with the progression, both in the geographies that we've been in for a long time where we're at, continuing to add zip

codes and additional neighborhoods and also in these new cities. Certainly a business where we continue to work on costs and profitability, but we are finding it's a very attractive service to our customers, which is what we're after.

Similarly, but not exactly the same is the Prime Now business, which has similar overlap on things besides groceries. It's a slightly different model obviously where we're more about immediacy and a smaller list of items available in one to two hours. But there's certainly a lot of people who are using that for groceries and consumable items. And that is now up to 40 cities across seven countries versus 17 this time last year. We're also adding restaurant, Amazon Restaurant Delivery to the Prime Now offer in 19 metropolitan cities in the U.S. and that's up from two last year.

So we continue to believe consumables, groceries are a key part of the offer to customers and we are playing with very different models to see which works and for what needs. So we're very happy with the AmazonFresh and we've now expanded quite a bit as you see in this year. And Prime Now, we're also very happy with, although obviously the economics in that business are even tougher, but we do feel that our scale makes that possible because of the geographic footprint and how close we already are to customers.

Darin Manney - Amazon.com, Inc.

Hi, Mark. This is Darin. On fashion, yeah, fashion and apparel continue to be a large part of our EGM business and one that we're very excited about. We continue to make it easier for brands and manufacturers to come on board in that category. We continue to work with brands to come on board and we're happy with the traction we're seeing with those brands. And as we get more and more selection, we're really pleased with the customer engagement that we have there, both from the discoverability, the technology that goes behind making it easier to shop for fashion on our site as well as the increased selection by adding the brands.

Operator

Thank -

Brian T. Olsavsky - Amazon.com, Inc.

Sorry. To answer your question about was that part of investment. Yes, this is certainly part of our investment but the large ramp, if you will, in investment that we're seeing from the back end of last year and also the first half of this year is more related to digital content and the build in our fulfillment network, which I've already discussed.

Operator

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

Mark A. May - Citigroup Global Markets, Inc. (Broker)

Thanks a lot. In some of these incremental investment areas like warehouses, logistics and also content, I know in some cases you expense up front. In some cases you amortize over time. Just wondering if you could give us a sense of how much of the recent step-up is kind of being expensed. I'm particularly looking at your COGS as a percent of retail revenues which was up year-on-year for the first time in quite a while. How much of that was because of content that was expensed in the period? Just trying to kind of better understand that.

And I think also you've been changing around, and this is happening here shortly, FBA pricing including increasing your storage fees but also reducing your handling fees. I guess the question is, are these changes designed to just pass through kind of increasing shipping costs? Or is this more of a net-neutral change where really the goal is to try to free up capacity in some of your facilities? Thanks.

Brian T. Olsavsky - Amazon.com, Inc.

Let me start with your second question on FBA. So yes, we did make some changes to the pricing formula for this holiday season. They're essentially meant to incent the right behavior among sellers around holiday. And the biggest issue you're trying to get at is having the most valuable products for holiday in the warehouse in the Prime space and not having the warehouse filled with things that may not sell until after the New Year. So we are trying to incentivize that behavior. We're also trying to incentivize getting inventory into the warehouse quicker. So yes, the formulas were, or excuse me, the changing to the pricing formulas were really with that in mind to help the flow and the base utilization in Q4.

Darin Manney - Amazon.com, Inc.

Yeah, hi Mark. This is Darin. On the capitalization point, I'd say the things we capitalized are the core buildings and leasehold improvements in the buildings. But the things that we're seeing hit the P&L are the fixed and variable expenses that it takes to run the building and I think that's what Brian's pointing out most pointedly in terms of what is impacting the profitability of the second half. So yeah, the capitalization's relatively small in terms of, other than in the building itself.

Operator

Thank you. Our next question comes from the line of Youssef Squali with Cantor Fitzgerald. Please proceed with your question.

Youssef Squali - Cantor Fitzgerald Securities

Yes. Thank you very much. Two quick questions. With the step-up in investments in content from Prime Video that you mentioned before, would you also be stepping up the international expansion? Maybe you can just remind us how many countries you're in with Prime Video and whether there is a potential chance of maybe stripping Prime Video from Prime to allow it to be extended to other countries.

And then I know you're not guiding to 2017. But just looking at the capacity increases that you've had for FCs for 2016, should we expect kind of that as an ongoing expense going forward? Or is the current buildup enough to maybe give you some spare capacity to cool that down for 2017? Thanks.

Brian T. Olsavsky - Amazon.com, Inc.

Sure. So first on your video comment. We're in four countries right now, the U.S., UK, Germany and Japan. And we have stated that we will be in India soon. So the content that we are creating, especially through Amazon Studios, we are generally holding the worldwide rights to and can use that in other countries as well. And the cost of that then gets amortized to those countries. It becomes part of the International segment results. So yes, and we consider that to be very valuable as opposed to, versus licensing many times by country, the third-party rights to content that we don't create ourselves.

Your question on fulfillment expenses, I can't extend the guidance into next year. We will do that obviously at the end of next quarter. But I would say this was an extraordinary step up, as I mentioned, in Q3 that is tied to very rapid growth in not only paid units but Amazon fulfilled units. So really, our forecast for additional capacity additions and the rate of additions will be tied to those growth factors as well. So we'll have to see. We right now are working on getting the capacity in. It was very lumpy this time with 18 warehouses in one quarter and another five in the first three weeks of the next quarter. So ,and obviously we'll be working on the efficiencies of all the warehouses we have, including the ones we just started up this year.

Operator

Thank you. Our next question comes from the line of Colin Sebastian with Baird Equity Research. Please proceed with your question.

Colin A. Sebastian - Robert W. Baird & Co., Inc. (Broker)

Great. Thanks. A follow-up on the FC question, and I guess more specifically it sounds like you have enough capacity in terms of fulfillment centers for the holidays, but also wondering what your comfort level is in terms of your shipping partners to manage those deliveries. And then secondly, was wondering how you would characterize the pricing environment for AWS, in particular with more deep-pocketed competitors in the space now. Google in fact highlighted this on their conference call today. Thank you.

Brian T. Olsavsky - Amazon.com, Inc.

Sure. Let me start with transportation. So yeah, we looking forward to a great holiday and that includes working with our shipping partners both in the U.S. and globally. We've worked very closely with them to line up capacity, share capacity plans. We certainly have additional delivery capability of our own. But with all of our partners, we work well in advance of the holiday to get our plans in place. And we feel very confident. We're looking forward to a great holiday not only for customers but also for sellers.

On your question on AWS, I didn't listen to the Google call, but you'll have to fill me in on that later. The thing I can tell you about pricing is that our pricing is, price reductions are a core part of our philosophy, of course. We had a price decrease in Q3, and that was our 52nd since we started this business. So we are comfortable with price decreases. Not only did we lower the prices of our products but we also create new services that are cheaper that customers can switch to. So they can also benefit from that as well.

So if you step back and say why do people choose AWS, I'll give you the points I said last quarter. Basically what we hear are the functionality and pace of innovation is greater than our competition. We have added more new significant features and services this year already than we had all of last year when we added 722. We have a partner and customer ecosystem. You've read about the VMware deal that we signed this quarter. So we continue to extend with partners and build ecosystems that better can support customers. And finally experience. We've been in this business a

long time, longer than anyone else, and we've used that time to make our products and services better. So there was going to be a lot of winners in this space as we said, but we are very happy with our position and the customer reception to our products.

Operator

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

Justin Post - Bank of America Merrill Lynch

Great. Thank you. I guess when you look at fourth quarter guidance and you back out AWS, it suggests that margins are, on the core business, are going to be pretty down versus last year. Do you view this as a abnormal investment cycle, or just part of the overall kind of ebbs and flows of the business? And then long-term, I know several years ago you talked about maybe high single digit, low double digit margins long term. I wonder if you could refresh us on that, and also just let us know if you think International has structural margin differences than the U.S. in the core retail business. Thank you.

Brian T. Olsavsky - Amazon.com, Inc.

Sure. Yes. As far as the continuation of the investment into next year, I cannot give you much color on that today. What I can tell you again is that we've ramped up considerably. We've been investing quite openly in a lot of areas and continue to do so. We are experiencing a ramp-up, if you will, in the second half of this year particularly tied again to AWS, or excuse me, the fulfillment center spend and also the video content spend.

So we will continue to invest in video content. We'll continue to invest in fulfillment space to handle higher and higher paid unit volumes and shipped unit volumes. We'll continue to invest in things that we believe enhance the customer experience, particularly the Prime experience. Devices, we'll continue to invest in as particularly Alexa and the Echo products. We'll

continue to invest in getting faster and faster shipping methods for our consumers. We believe that's working. We're very happy with the results. We're very happy with all the customers we have but particularly the Prime customers that we have.

As far as long-term operating margins, I can't forecast that right now. I can't forecast that for our AWS business either. We are again working on two fronts. We are honing the businesses that we're in and making them as efficient, as profitable as possible while also investing very pointedly and very wisely, we believe, in things that will enhance customer experience and create lasting businesses for us down the line. We've said we want things that customers will love, can grow to be large, will have strong financial returns and durable and can last for decades. So that's still our mission. We have pillars of the business right now with Marketplace, AWS and Prime and we're actively looking for a fourth and fifth pillar.

Operator

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

Heath Terry - Goldman Sachs & Co.

Great. I was just wondering, there have obviously been some headlines since the call that you did earlier with the press on the scale of this investment cycle relative to other investment cycles that you've been through. With the 2014 cycle sort of being the most recent, could you quantify a little bit more how you would compare this investment cycle to that most recent one? And to the extent that we are in the midst of this investment cycle, would you say we're in sort of the earlier or later stages? Any sort of clarity around that would be useful. Thank you.

Brian T. Olsavsky - Amazon.com, Inc.

Sure. Yes. The word cycle, if I mentioned that, was a omission. It was a mis-speak. The investment that we are seeing is a step-up versus what we have

experienced in particularly the first half of this year and the last half, the second half of last year which I mentioned. But we have said investments are going to be lumpy. They are going to be high sometimes and they'll be moderated at other times. We are right now, the second half of this year looks like a big step-up compared to the first half and it is. But again, it's all areas that we will continue to invest in, some of which I just actually went through the laundry list. So I would not characterize it as a cycle. I would characterize it as continued investments. We make investments with the idea that they are going to pay off and they pay off in either directly in the business they're in or in their contribution to the total business many times as a part of the Prime program.

Operator

Thank you. Our next question comes from the line of John Blackledge with Cowen & Company. Please proceed with your question.

John Blackledge - Cowen & Co. LLC

Great. Thanks, just two questions. It seems you're increasing your efforts in the auto vertical with the recent launch of Amazon Vehicles. Just wondering if you could discuss some of the dynamics of the auto industry that make it attractive and maybe how it aligns with the Prime value prop. And also wondering if you had any plans to work directly with auto shops just given your ability to service most areas in one to two days. And then just the second question, on grocery would you consider physical locations in an effort to kind of expand and/or accelerate the growth in that vertical? Thank you.

Darin Manney - Amazon.com, Inc.

Yeah, hi John. This is Darin. On vehicles, Amazon Vehicles is really a car research destination and really builds the automotive community for customers and gets information they need when shopping for vehicles offsite or shopping for parts and accessories onsite. The features include research

tools, community engagement where you can talk to other customers, and certainly we'll try to build a one-stop shop for vehicles as an extension to the automotive store which engages customers to add information about their cars in their garage and which makes it actually easier to shop for parts and accessories for your particular vehicle. And so we think there's a lot of opportunity there to add convenience for customers. On the B2B side, certainly we do have a Amazon business offering. Businesses of all shapes and sizes can sign up to be a B2B customer and the selection that we have in our parts and in automotive categories are certainly open to that channel, but I wouldn't speculate on anything we might do in a particular vertical for those business customers.

Brian T. Olsavsky - Amazon.com, Inc.

Sure. And your comment on, or question on grocery and physical stores, I can't comment on any rumors or speculations there might be regarding that. But what I will tell you is we have experimented with physical stores. As you may know, we have three physical bookstores, one Seattle, one in San Diego and one in Portland and two more coming, one in Boston and one in Chicago. And what we're finding is they're great places for customers to browse what ends up being a curated selection of books and they also get to try out our devices, which is very beneficial. So they get to touch and try our eReaders, tablets, Fire TV and Echo. So we like what we see with that connection and we also have pop-up stores that you may see and also college pick-up points. So we will try different delivery methods or pick-up points or ways of getting product to customers, but nothing specific to point out on the grocery side right now.

Operator

Thank you. Our next question comes from the line of Ben Schachter with Macquarie. Please proceed with your question.

Ben Schachter - Macquarie Capital ([USA](#)), Inc.

Given the low unemployment rates that you're seeing in the U.S., do you expect any unusual impact on wages for seasonal workers this year? And are you seeing overall wage pressure in the fulfillment centers? And then separately, if you could just talk about trend lines you're seeing in paid units versus shipping units. Are they diverging meaningfully versus the past? Thanks.

Brian T. Olsavsky - Amazon.com, Inc.

Yeah, so on wages, nothing to point out for this holiday. Our challenge generally is the volume of head count that we're looking to hire and we work well in advance with agencies to help to get seasonal employees and many of them turn into full-time employees after the holiday. So nothing specific on the wage pressure front. As you probably saw, head count is up 38% year-over-year in Q3 and that is a continuation of a lot of ops roles they're supporting this high demand, the opening of the fulfillment centers we talked about, new Fresh locations, Prime Now. But also a lot of hiring in our tech areas particularly around AWS and also the Echo, Alexa areas.

Ben Schachter - Macquarie Capital ([USA](#)), Inc.

And the second, the second question?

Operator

Sorry. Go ahead. Okay. And our final question will come from the line of Neil Doshi with Mizuho. Please proceed with your question.

Neil A. Doshi - Mizuho Securities USA, Inc.

Great. Thanks. Can you just provide a little more color into the investments that you're making in India? What's driving that growth and what stage is India in today relative to some of the other large international markets that you've launched in the past?

Brian T. Olsavsky - Amazon.com, Inc.

Yeah, sure. So we are very encouraged by what we're seeing in India but it is certainly very early on still. Most recent highlights would be the launch of the Prime program in India this past quarter. It's now one of the top selling units based on Amazon.in. And so it's very been very well received by customers. It's hard to compare India to any other country. It's very different in its stage and structure. Being a third-party market has caused a lot of invention on our side. We're being creative. The team there in India has been very creative on whenever they find a roadblock or something that has not existed in another country, they create it themselves, whether that's from delivery stations to working with small merchants to, you name it. So we're very happy with both the customer engagement that we're seeing and also the seller engagement which is very important in India and very pleased with the team that runs it over there and the way they work with teams throughout the world.

Darin Manney - Amazon.com, Inc.

And Brian, to step back to Ben's other question on units. Ben, this is Darin. I will, so you know, paid units grew at 28% again this year as it did in the prior quarter. And as Brian pointed out earlier, our AFN unit, our Amazon fulfilled units, which include our first-party units as well as FBA units that go through our warehouses are continuing, are certainly higher than that 28%. And that's a result of the traction we're getting with our FBA sellers.

Darin Manney - Amazon.com, Inc.

So 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.