Operator

Good day, and welcome to the Amazon Quarterly Conference Call. Today's conference is being recorded. At this time, I would like to turn the call over to Mr. Rob Eldridge, please go ahead, Sir.

Robert Eldridge

Hello, and welcome to our Q3 2010 financial results conference call. Joining us today is Thomas Szkutak, our CFO. We will be available for questions after our prepared remarks.

The following discussion and responses to your questions reflect the management's views as of today, October 21, 2010 only, and will include forward-looking statements. Actual results may differ materially. Additional information about factors that could potentially impact our financial results is included in today's press release and our filings with the SEC, including our most recent annual report on Form 10-K.

As you listen to today's call, we encourage you to have our press release in front of you, which includes our financial results, as well as metrics and commentary on the quarter.

During the call, we will discuss certain non-GAAP financial measures. In our press release, slides accompanying this webcast and our filings with the SEC, each of which is posted on our IR website, you will find additional disclosures regarding these non-GAAP measures, including reconciliations of these measures with comparable GAAP measures. Finally, unless otherwise stated, all comparisons in this call will be against our results for the comparable period of 2009. Now, I'll turn the call over to Tom.

Thomas Szkutak

Thanks Rob. I'll begin with comments on our financial results. Trailing 12-month operating cash flow increased 16% to $2.62 billion. Trailing 12-month free cash flow decreased 5% to $1.83 billion. Return on invested capital was 28%, down from 50%. 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 465 million shares compared with 451 million shares. Worldwide revenue grew 39% to $7.56 billion or 40%, excluding the $83 million unfavorable impact from year-over-year changes in foreign exchanges rates. We're grateful to our customers who continue to take advantage of our low prices, fast selection and free shipping offers, including Amazon Prime.

Media revenue increased to $3.35 billion, up 14% or 15% excluding foreign exchange rates. EGM revenue increased to $3.97 billion, up 68% or 71% excluding foreign exchange rates. Worldwide EGM increased to 53% of worldwide sales, up from 43%. Worldwide unit growth was 41%. Active customer accounts were approximately 121 million. Worldwide active seller accounts were more than 2 million. Seller units were 34% of total units.

Consolidated gross profit grew 39% to $1.77 billion, and gross margin was 23.5%.

Now, I'll discuss our operating expenses, excluding stock-based compensation. Fulfillment, marketing, technology and content in G&A combined was $1.37 billion or 18.2% of sales, up 120 basis points year-over-year. Fulfillment was $657 million or 8.7% of revenue, compared with 8.2%.

Tech and content was $386 million or 5.1% of revenue, compared with 4.9%. Marketing was $234 million or 3.1% of revenue, up from 2.6% in the prior year.

Now, I'll talk about our segment results and consistent with prior periods, we do not allocate the segments or stock-based compensation or other operating expense line item.

In the North America segment, revenue grew 45% to $4.13 billion. Media revenue grew 13% to $1.59 billion. EGM revenue grew 80% to $2.33 billion representing 56% of North America revenues, up from 45%. North America segment operating income increased 19% to $186 million, up 4.5% operating margin.

In the international segment, revenue grew 32% to $3.43 billion. Revenue growth was 35%, adjusting for the $86 million year-over-year unfavorable foreign exchange impact during the quarter. Media revenue grew 16% to $1.76 billion or 18% excluding FX. And EGM revenue grew 54% to $1.64 billion or 60% excluding FX. EGM now represents 48% of international revenues, up from 41%.

International segment operating income increased to 11% to $215 million, a 6.2% operating margin. Excluding the unfavorable impact for foreign exchange, international segment operating income increased 20%.

CSOI grew 15% to $401 million or 5.3% of revenue down a 112 basis points year-over-year. Excluding the $15 million unfavorable impact from foreign exchange, CSOI grew 19%. Unlike CSOI, our GAAP operating income includes stock-based compensation expense and other operating expense. GAAP operating income grew 7% to $268 million or 3.5% of net sales.

Our income tax expense was $79 million in Q3 or a 27% rate for the quarter. GAAP net income was $231 million or $0.51 per diluted share compared with $199 million and $0.45 per diluted share.

Turning to the balance sheet, cash and marketable securities increased $1.88 billion year-over-year to $5.88 billion. Inventory increased 56% to $2.52 billion and inventory turns were 11.8 down from 12.1 turns a year ago, as we extended selection, improved in-stock levels and introduced new product categories.

Accounts payable increased 38%, $4.61 billion and accounts payable days increased to 73 from 72 in the prior year. Our Q3 2010 capital expenditures were $315 million. The increase in capital expenditure reflects additional investments and support of continued business growth, including investment in technology infrastructure including Amazon Web Services, capacity to support our Fulfillment operations and investments in corporate office space. We expect this trend to continue throughout 2010.

I'll conclude my portion of today's call with guidance. Incorporated into the guidance of the order trends that we seen to-date and what we believe today to be appropriately conservative assumptions. Our results are inherently unpredictable and may be materially affected by many factors, including a high level of uncertainty surrounding exchange rate fluctuations, as well as 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 effect on guidance. Our guidance further assumes that we don't conclude any additional business acquisitions or investments, record any further revisions to stock-based compensation estimates and net foreign exchange rates remain approximately where they have been recently.

For Q4, we expect net sales of between $12 and $13.3 billion a growth between 26% and 48%. This guidance anticipates approximately 70 basis point of unfavorable impact from foreign exchange. GAAP operating income to be between $360 and $560 million between 24% decline and 18% growth. This includes approximately $140 million for stock-based compensation and amortization of intangible assets.

We anticipate consolidated segment-operating income, which excludes stock-based compensation and other operating expense to be between $500 million and $700 million or between 16% decline and 17% growth.

We remain heads-down 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. And with that, Rob, let's move to questions.

Robert Eldridge

Great. Thanks, Tom. Let's move on to the Q&A portion of the call. Operator, will you remind our listeners how to initiate a question, please?

Question-and-Answer Session

Operator

(Operator Instructions) Our first question comes from Scott Devitt with Morgan Stanley, please go ahead.

Scott Devitt – Morgan Stanley

One question please, the growth rates for the business on our segment sales basis described between North America and in international is about 10 percentage points and it's begun to work in favor of North America recently. I was just wondering if you could comment on the respective unit sales domestically versus internationally, and it's described as similar? Thanks.

Thomas Szkutak

Yeah, I can't – we are not breaking out the unit growth by segment, but we are seeing, very strong unit growth globally, it's up 41% which is certainly better than we've seen recently. Also keep in mind when you look at the difference between North America revenue growth and international, we do have the impact of Zappos included in the North American numbers this year, which we wouldn't have that in last year as well.

Scott Devitt – Morgan Stanley

Thanks.

Operator

And for our next question from Mark Mahaney with Citi, please go ahead.

Mark Mahaney – Citi

Thanks. I just wanted to ask a little bit more about the Q4 guidance, particularly on the CSOI line. Typically, you are able to generate in flattish margins sequentially that's not which you are guiding to at the midpoint, is that because some of the investments you wanted to rollout in the September quarter are being delayed? Are there new levels of investments that you are looking for in the December quarter? Are you rolling out more distribution centers there? Anymore color on why the sequential decline in margins is a little bit out of the norm? Thanks.

Thomas Szkutak

Thanks Mark. Yes, we have launched or opened about 10 performance centers right now. We have a couple more that are coming over the coming few weeks to get ready for our peak season. So certainly that's part of which we are seeing in Q4, obviously we have been incurring some cost on those three as well prior to Q4, but again you will see that ramping up.

The other thing too is we will continue to add capacity for infrastructure as well during Q4 and that's both for our retail business as well as our very fast growing AWS business, so those are impacting the guidance which you see there.

Mark Mahaney – Citi

Thanks Tom.

Operator

Our next question comes from James Mitchell with Goldman Sachs, please go ahead.

James Mitchell – Goldman Sachs

Great, thank you for taking the question. You are offering a range of free pass by to Amazon Prime such as Amazon Prime for students and Amazon Prime for mothers, how do you persuade the consumers to receive Prime for free-to-value and make full use of the service by purchasing more products as those consumers who are paying for Prime typically do?

Thomas Szkutak

Well, again it's a free offer, so that's something that we think is compelling and it follows really what we've done for Prime in general. We've offered free trials for Prime members going back to few years now, and the reason why we are doing that, again the free trials I'm talking about, not just in the Mom right now.

The reason why we were doing that was we wanted to make sure that customers could see the experience real time and we find that when customers see it real time, they become members and we've seen that consistently and so the other two programs that you mentioned, the Student and Mom, still very early and we are happy with what we see but we are still very early.

James Mitchell – Goldman Sachs

Thank you.

Operator

Your next question is from Brian Pitz with UBS.

Brian Pitz – UBS

Thanks. What percent of the increase in fulfillment was due to the shift of third-party fulfillment from COGS that you highlighted the last quarter? And then more a longer term question, can you talk about your strategy in online video distribution, does it make sense for be it a rollout of subscription streaming video product given competitors' success? Thanks.

Thomas Szkutak

We are not breaking out the change that you mentioned, but you can – the way you should think about it is would be a similar amount last year in Q3, as it was in Q2 in terms of basis points. In terms of the second, can you repeat the second part of your question on..?

Brian Pitz – UBS

Just in terms of your online video distribution, obviously you have VOD with over 65,000 titles, but migrating to a subscription streaming product, can you just give us a little thought on that given the success of some of your competitors?

Thomas Szkutak

Sure, I wouldn't speculate what we would do or not do in the future there, but now it's certainly and there room for a lot of innovation and we've got a great team in place that's working on that and we are going to try to do what's best for customers over the long term and try to continually improve our service there.

Brian Pitz – UBS

Great, thanks.

Operator

Our next question comes from Douglas Anmuth with Barclays Capital, please go ahead.

Douglas Anmuth – Barclays Capital

Thanks for taking the question. Thomas, I wanted to ask you about the media business and hoping you could give us a little bit more color in terms of the sub-segments, in particular I think you commented last quarter that physical books were still growing in a double-digit phase, if you could let us know if that's still the case? And then just one quick housekeeping thing, the equity income line basically was a lot higher than what we've seen in recent quarters, can you provide a little bit of color there and how we should think about that going forward? Thanks.

Thomas Szkutak

Sure. First, the media, in terms of – I'll take the North America, maybe we're seeing very good growth there, we're very pleased with the business that we have there. As it relates to books, we saw very strong revenue growth in the quarter, in fact from the unit perspective we saw accelerated growth in both physical and Kindle books in Q3 relative to Q2, so very strong growth during the quarter.

We did see in a couple of our categories some softness, particularly music and video as we overlap some higher revenue in last year Q3 specifically. In the music side, we had very strong growth last year with some of the Michael Jackson titles. We also had very strong growth with the Beatles Box and video games, specifically video game consoles.

There was very strong price reductions from the manufactures and which caused great growth last year and so we saw some softness that's in the North America media never succeed, but again we are very pleased with overall categories in media.

In terms of the equity income and in terms of how you should think about it, we did have included in our guidance and I will give you the total numbers, but excluded from the guidance that we gave approximately 90 days ago, we did not include Woot acquisition and the impact from the quarter is roughly 30 million in revenue. From a CSOI perspective, we had a few million dollar loss for the quarter.

And then because we had an investment in Woot, we had to step up that investment and fair value, so you have a gain that's included in the other income line, the equity income line that you're referring to, which brings our net down to about 15 million net or a little under $0.03 per share, so that's included in the numbers that you're looking at.

Douglas Anmuth – Barclays Capital

Okay, great, thank you.

Operator

Our next question comes from Gene Munster with Piper Jaffray, please go ahead.

Gene Munster – Piper Jaffray

Hey, good afternoon. If you can talk a little bit about your efforts in China, particularly you've rebranded Joyo as Amazon Joyo this spring and I think they are best picking up some traction. Is there any data points you can share with us in terms of number of distribution centers, just general outlook, at what point do you think China particularly can start moving the wheels for Amazon? Thanks.

Thomas Szkutak

Well, China is a very interesting long-term potential and we have businesses growing very fast there. We continue to add capacity there, we continue to work on trying to make sure we have a great experience of customers and so we're adding a lot of selection, we're making sure we have great prices. A lot of the things, same things that we're doing in all of our geography. So we'll continue to work hard on behalf of customers there and we think it's a very interesting long-term potential geography force.

Operator

Our next question comes from Colin Sebastian with Lazard Capital Markets.

Greg O'Shara – Lazard Capital Markets

Yes, hi. Greg O'Shara for Colin Sebastian. I was hoping maybe you could help provide some more color on the widening disparity between the electronics, the EGM sectors for North America and international.

I know Zappos and Woot are not included, but surely the widening disparity in growth rates can't be attributable to that entirely. Are there any fundamental differences that you're seeing from a trend perspective in that sector internationally versus the US?

Thomas Szkutak

Well, again, you did call out couple items that are rather sizable, particularly the Zappos piece is rather sizable, so that certainly is impacting the size and the growth, because we remember that Zappos isn't included in the last year's Q3 result.

But we're actually very, very pleased with EGM in both segments, they are both growing very fast and as you can see that even in Q3 for international grew 60% on local currency basis, so it's a very, very strong growth. We've added a lot of new categories over the past two years there and they have grown quite nicely. So we're actually very pleased with our international growth in EGM and very excited about the future there.

Greg O'Shara -- Lazard Capital Markets

Thanks.

Operator

And the next question comes from Youssef Squali with Jefferies, please go ahead.

Youssef Squali – Jefferies

Hi, thank you very much. Tom, you guys launched grocery delivery in the U.K., but it doesn't seem like you guys are doing your own delivery like some of the local competitors, can you speak the strategy there and any plans to launch a similar service in the U.S.

I know you are testing it in a couple of places, but maybe talk about more nationwide rollout? And then just a housekeeping item, how much revenue is baked in your Q4 guidance from the BuyVIP acquisition that you did this quarter? Thank you.

Thomas Szkutak

Okay, I'll speak to the second one first; BuyVIP hasn't closed and so it's not reflected in the guidance that we have given today. In terms of the first question, we think that grocery is very interesting. It's something that we are – there's not a lot I can comment about your question, specifically related to the U.K. It's something that we find it interesting, it's very early.

Think of it, you mentioned about a national rollout for the U.S., think of it as a test for the U.S. We are testing it currently and have been testing it for a few years in Seattle, and we think that it's interesting, but again it's for test and we'll see how it goes.

Youssef Squali – Jefferies

Okay, thanks.

Operator

Our next question comes from Jeetil Patel with Deutsche Bank Securities, please go ahead.

Jeetil Patel – Deutsche Bank Securities

Great, couple of questions. I guess, on the Prime side of the business, do you think you you've built great -- you've built great brand affinity with the Prime service as a whole.

Do you think there are opportunities to bundle or offer additional free products, programs and services within that Prime program? Will the consumer adopt it, and is there maybe different tierings that you can create off of that, in terms of $79 and $89 or $99 with additional products and services folder then?

Then second, around the Kindle side of the business, are there opportunities to leverage Whispersync across other forms of content, such as music and gaming or is there any sort of technical limitations around that? Thanks.

Thomas Szkutak

In terms of the opportunity for Prime, we like what we see in Prime, the way that we would try to expand the benefit to customers to-date has been to try to make sure that we have more selection available for Prime customers. We do that in a number of different ways, one is we add retail offerings, additional retail selection.

We've also been working very hard with our seller community filled by Amazon and when you list with fulfilled by Amazon and have availability and stock those products available for our free shipping programs, which is Super Saver Shipping in the US as well as Prime. So those are the things that we have been doing to try to make Prime better. We will continue to look at ways to make Prime even better for customers over time and we will have to wait and see on that. In terms of the second part of your question, I apologize not a lot I can add to answer that question. I apologize in terms of this technology and its use outside of Kindle.

Operator

Just a reminder, please limit yourself to one question. We'll go to our next questioner Jim Friedland with Cowen and Company, please go ahead.

Jim Friedland – Cowen and Company

Thanks. I have a question about the target deal that's coming to an end, I believe, its middle of next year. How should we think about modeling that business for next year? Any color you can give us into how it may impact the P&L, I think it's in the other line in the US? Thanks.

Thomas Szkutak

Yeah, it is, we as you can probably appreciate Jim, we haven't disclosed anything about any specific, our partnership that we have and this will be no exception. I guess one way to think about it though is with something like this, we continue to grow like we are growing, we will likely need more capacity going forward and so we will be able to use capacity for, in this type of an event.

Jim Friedland - Cowen and Company

Okay, that's great, thanks.

Operator

Our next question is Imran Khan with JP Morgan, please go ahead.

Imran Khan - JP Morgan

Yes, hi it's Imran. Thank you very much for taking my questions. Two quick questions; one, international gross margins were down 80 basis point year-over-year. Just trying to get a sense like where you stand in terms of ramping up the third party business or some of the new category launch, can you give us some sense what's driving this international gross margins down and how should we think about it?

And then secondly, the marketing costs were up 63% year-over-year basis. I start to think is it a new normal or is that like more of a one-time kindle marketing going on? If you can shed any light that would be very helpful? Thank you.

Thomas Szkutak

Sure. In terms of international gross margins, there is a number of dynamics there, certainly pricing is impacting it. We are getting very good traction in third party, continue to get good traction in third party within international.

Also keep in mind that we're talking about one of the earlier questions within EGM we've launched many new categories over the past few years that are growing, those categories growing very well as I mentioned the growth is up 60% year-over-year on local currency basis in total and what ends up happening when you launch new categories is many of those are low gross margins at the start and then we worked very hard overtime to be more efficient to buy better and so those categories improve over time. So again those are the things that are impacting gross margins.

In terms of marketing, a couple of things to think about; one, you are right we are a little over 3%, very similar to what we were in increase year-over-year last quarter, the primary area that we spend in marketing is web page search and associates still. Keep in mind that when you look at year-over-year, last year we didn't have Zappos and we continue to support the marketing efforts for Zappos which is included in that cost.

As you mentioned also, we are also doing some ads from a television standpoint for Kindle included in those numbers as well.

Imran Khan - JP Morgan

Great, thank you very much.

Operator

Our next question comes from Sandeep Aggarwal with Caris & Company, please go ahead.

Sandeep Aggarwal – Caris & Company

Alright, Tom, in your prepared remarks you did update us on the spending on procurement center et cetera. I guess the question is that you are spending on fulfillment and centers and as well as IT capacity. If Q4 will take care of most of the higher than norm spending or will you go beyond that? And secondly now that you have three years of history on selling Kindle, in long run will you think the 999 price plan will prevail or a $15? Thank you.

Thomas Szkutak

In terms of the capacity, again we are adding additional capacity in Q4, both from our fulfillment center and infrastructure standpoint, and beyond Q4 we are not commenting but certainly if we continue to grow you should expect like we are growing expect that we will add capacity next year. In terms of Kindle, we are trying to make selection available from a content perspective at great prices for customers and that's no different than any other product that we offer to customers, we think it should be very economic to customers and we will continue to work very hard on behalf of customers in that area.

Operator

And our next question comes from Spencer Wang with Credit Suisse, please go ahead.

Spencer Wang – Credit Suisse

Thanks, good afternoon. First question, I guess, Tom, can you just go back to your earlier comment about video on demand and I think you used a phrase "room for innovation," any more kind of color you could shed there in terms of how you are thinking about it, is it innovation in terms of pricing or selection or revenue model or UI? And then secondly just real quick any stats or data point you could give us in terms of sizing mobile commerce for you. Thank you.

Thomas Szkutak

In terms of video in demand, there is not a lot more I can add to that. I would say that I guess that where I would think about it is not a lot different than a lot of the things that we do on Amazon, we have a foundation of innovation everything that we do and we try to find creative ways and innovative ways to serve customers better and so that's grained very well in the culture, you have seen that in a lot of different ways in our various offerings and we will continue to do that as best we can on behalf of the customers over long term which includes Video On Demand. And then second part of our question, sorry was…

Spencer Wang – Credit Suisse

So any data point on mobile, sizing mobile for you guys commerce?

Thomas Szkutak

No, again I think I don't have any new data to share with you there. It is an interesting area for us, and if you think about just a growth in connected devices anytime, you can have a very fast growth in adoption of connected devices in around the world where customers can get easy access to amzon.com, we think it's a good thing to tail in for us and so what we are trying to do is try to make that as easy for customers with APIs and another ways so that we can serve customers well, so they get a great experience when they connect with their device. So that's something that certainly we are working and we find it interesting.

Spencer Wang – Credit Suisse

Thanks.

Operator

And for our final question from Justin Post with Bank of America.

Justin Post – Bank of America

Thank you. First on the Kindle, a lot of language in your press release about it, can you help us at all understand if it's margin accretive on the gross margin line when you think about the hardware and software or not and then secondly you are making a lot of infrastructure investments, a lot of headcount investments in the course of Fulfillment, can you give us any visibility if you think you're kind of caught up now this year given the spending last year or this is something that no idea of kind of wind, when you are kind of going to be caught up with what you need to be? Thank you.

Thomas Szkutak

Sure. The first part as you can probably appreciate, we don't break out any of our products or categories from a possibility standpoint and so we have a [Inaudible] doing that and so the details that we provided, to-data is just the North American International segment from a possibility standpoint.

So, I can't help you much there. In terms of infrastructure and capacity, just sort of - excuse me in terms of film capacity, you're right we added a lot of capacity to date, we have some more that we are adding in Q4 and that's the serve on demand that we think is in front of us and we will have to see, wait and see what happens over the coming quarters to see what capacity we need to have.

But what I can say is from our regional perspective; you can see our overall growth rates are very strong. And if they continue to be strong, we will have to add additional capacity. We are seeing very good traction fulfilled by Amazon which is also why we are also adding capacity for and we like that part of the business from a seller perspective a lot.

From an infrastructure standpoint, again just with the growth that we are seeing from a retail perspective, we are adding capacity to support the retail websites that we have around the world. In addition to that, we have a very fast growing web services business that has great traction, continues to grow well and certainly should expect that we will add capacity there over time to serves that growth.

Justin Post – Bank of America

Thank you.

Thomas Szkutak

Great. Well, thank you all for joining us today on the call and for your questions. The replay will be available on our industrial relations website at least to the end of the quarter. We appreciate your interest and look forward to talking with you again in next quarter. Thanks everyone.