



To our shareholders:

Our ultimate financial measure, and the one we most want to drive over the long-term, is free cash flow per share.

Why not focus first and foremost, as many do, on earnings, earnings per share or earnings growth? The simple answer is that earnings don't directly translate into cash flows, and shares are worth only the present value of their future cash flows, not the present value of their future earnings. Future earnings are a component—but not the only important component—of future cash flow per share. Working capital and capital expenditures are also important, as is future share dilution.

Though some may find it counterintuitive, a company can actually impair shareholder value in certain circumstances by growing earnings. This happens when the capital investments required for growth exceed the present value of the cash flow derived from those investments.

To illustrate with a hypothetical and very simplified example, imagine that an entrepreneur invents a machine that can quickly transport people from one location to another. The machine is expensive—\$160 million with an annual capacity of 100,000 passenger trips and a four year useful life. Each trip sells for \$1,000 and requires \$450 in cost of goods for energy and materials and \$50 in labor and other costs.

Continue to imagine that business is booming, with 100,000 trips in Year 1, completely and perfectly utilizing the capacity of one machine. This leads to earnings of \$10 million after deducting operating expenses including depreciation—a 10% net margin. The company's primary focus is on earnings; so based on initial results the entrepreneur decides to invest more capital to fuel sales and earnings growth, adding additional machines in Years 2 through 4.

Here are the income statements for the first four years of business:

	Earnings			
	Year 1	Year 2	Year 3	Year 4
	(in thousands)			
Sales	\$100,000	\$200,000	\$400,000	\$800,000
Units sold	100	200	400	800
Growth	N/A	100%	100%	100%
Gross profit	55,000	110,000	220,000	440,000
Gross margin	55%	55%	55%	55%
Depreciation	40,000	80,000	160,000	320,000
Labor & other costs	5,000	10,000	20,000	40,000
Earnings	\$ 10,000	\$ 20,000	\$ 40,000	\$ 80,000
Margin	10%	10%	10%	10%
Growth	N/A	100%	100%	100%

It's impressive: 100% compound earnings growth and \$150 million of cumulative earnings. Investors considering only the above income statement would be delighted.

However, looking at cash flows tells a different story. Over the same four years, the transportation business generates cumulative negative free cash flow of \$530 million.

Cash Flows				
	Year 1	Year 2	Year 3	Year 4
	(in thousands)			
Earnings	\$ 10,000	\$ 20,000	\$ 40,000	\$ 80,000
Depreciation	40,000	80,000	160,000	320,000
Working capital	—	—	—	—
Operating Cash Flow	50,000	100,000	200,000	400,000
Capital expenditures	160,000	160,000	320,000	640,000
Free Cash Flow	\$(110,000)	\$(60,000)	\$(120,000)	\$(240,000)

There are of course other business models where earnings more closely approximate cash flows. But as our transportation example illustrates, one cannot assess the creation or destruction of shareholder value with certainty by looking at the income statement alone.

Notice, too, that a focus on EBITDA—Earnings Before Interest, Taxes, Depreciation and Amortization—would lead to the same faulty conclusion about the health of the business. Sequential annual EBITDA would have been \$50, \$100, \$200 and \$400 million—100% growth for three straight years. But without taking into account the \$1.28 billion in capital expenditures necessary to generate this ‘cash flow,’ we’re getting only part of the story—EBITDA isn’t cash flow.

What if we modified the growth rates and, correspondingly, capital expenditures for machinery—would cash flows have deteriorated or improved?

Year 2, 3 and 4 Sales and Earnings Growth Rate	Number of Machines in Year 4	Year 1 to 4 Cumulative Earnings	Year 1 to 4 Cumulative Free Cash Flow
	(in thousands)		
0%, 0%, 0%	1	\$ 40,000	\$ 40,000
100%, 50%, 33%	4	\$100,000	\$(140,000)
100%, 100%, 100%	8	\$150,000	\$(530,000)

Paradoxically, from a cash flow perspective, the slower this business grows the better off it is. Once the initial capital outlay has been made for the first machine, the ideal growth trajectory is to scale to 100% of capacity quickly, then stop growing. However, even with only one piece of machinery, the gross cumulative cash flow doesn’t surpass the initial machine cost until Year 4 and the net present value of this stream of cash flows (using 12% cost of capital) is still negative.

Unfortunately our transportation business is fundamentally flawed. There is no growth rate at which it makes sense to invest initial or subsequent capital to operate the business. In fact, our example is so simple and clear as to be obvious. Investors would run a net present value analysis on the economics and quickly determine it doesn’t pencil out. Though it’s more subtle and complex in the real world, this issue—the duality between earnings and cash flows—comes up all the time.

Cash flow statements often don’t receive as much attention as they deserve. Discerning investors don’t stop with the income statement.

#### *Our Most Important Financial Measure: Free Cash Flow Per Share*

Amazon.com’s financial focus is on long-term growth in free cash flow per share.

Amazon.com’s free cash flow is driven primarily by increasing operating profit dollars and efficiently managing both working capital and capital expenditures. We work to increase operating profit by focusing on improving all aspects of the customer experience to grow sales and by maintaining a lean cost structure.

We have a cash generative operating cycle<sup>1</sup> because we turn our inventory quickly, collecting payments from our customers before payments are due to suppliers. Our high inventory turnover means we maintain relatively low levels of investment in inventory—\$480 million at year end on a sales base of nearly \$7 billion.

The capital efficiency of our business model is illustrated by our modest investments in fixed assets, which were \$246 million at year end or 4% of 2004 sales.

Free cash flow<sup>2</sup> grew 38% to \$477 million in 2004, a \$131 million improvement over the prior year. We are confident that if we continue to improve customer experience—including increasing selection and lowering prices—and execute efficiently, our value proposition, as well as our free cash flow, will further expand.

As to dilution, total shares outstanding plus stock-based awards are essentially unchanged at the end of 2004 compared with 2003, and are down 1% over the last three years. During that same period, we've also eliminated over six million shares of potential future dilution by repaying more than \$600 million of convertible debt that was due in 2009 and 2010. Efficiently managing share count means more cash flow per share and more long-term value for owners.

This focus on free cash flow isn't new for Amazon.com. We made it clear in our 1997 letter to shareholders—our first as a public company—that when “forced to choose between optimizing GAAP accounting and maximizing the present value of future cash flows, we'll take the cash flows.” I'm attaching a copy of our complete 1997 letter and encourage current and prospective shareowners to take a look at it.

As always, we at Amazon.com are grateful to our customers for their business and trust, to each other for our hard work, and to our shareholders for their support and encouragement.



Jeffrey P. Bezos  
Founder and Chief Executive Officer  
Amazon.com, Inc.

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<sup>1</sup> The operating cycle is number of days of sales in inventory plus number of days of sales in accounts receivable minus accounts payable days.

<sup>2</sup> Free cash flow is defined as net cash provided by operating activities less purchases of fixed assets, including capitalized internal-use software and website development, both of which are presented on our statements of cash flows. Free cash flow for 2004 of \$477 million is net cash provided by operating activities of \$567 million less purchases of fixed assets, including capitalized internal-use software and website development costs, of \$89 million. Free cash flow for 2003 of \$346 million is net cash provided by operating activities of \$392 million less purchases of fixed assets, including capitalized internal-use software and website development costs, of \$46 million.