The rise of Amazon- What we can learn from the Tech giant

(Published on June 24, 2014)

The amazing success of Amazon easily ranks as one of the most important business phenomena in the past 20 years. This write up is inspired by a detailed article on Amazon in a recent issue of the Economist.

In the late 1990s, when the dot com boom started (and later went bust), it was not clear whether Amazon had the staying power to survive in the long run. The company was rapidly growing traffic on its site but was accumulating huge losses. At the same time, cash was running out. But now, as the Economist magazine points out, Amazon is one of the most formidable companies in the world. Consider the following:

- Amazon generated $75 billion of revenue last year.
- Amazon's market cap is about $ 150 billion.
- Amazon carries some 230 million items for sale on its website, 30 times bigger than the number sold by Walmart, the world's largest retailer.
- At one time, Amazon's trailing Price to Earnings ratio crossed 3500! (Today, it is around 500).
- The company has 96 fulfilment centres some of them being so large that they are the size of several American football fields. As a result of such investments backed by information technology capabilities, Amazon can offer same day delivery (the key to success in the huge grocery segment) to some 23% of the population in North America. Next year, that may become 28%. Amazon also looks well poised to leverage this infrastructure to enter new consumables (as opposed to consumer durables where delivery need not happen immediately) markets including grocery and toiletries.
- In the US, Amazon, despite its huge size, is still growing faster than the 17% rate at which the overall ecommerce market is growing. The global ecommerce market is estimated to be about $ 1.5 trillion.

- Currently, (in 2014) Amazon is the 9th largest retailer in the world by sales. By 2018, it may be the second largest, next only to Walmart.
- Amazon Web Services is a significant player in the rapidly growing area of cloud computing.

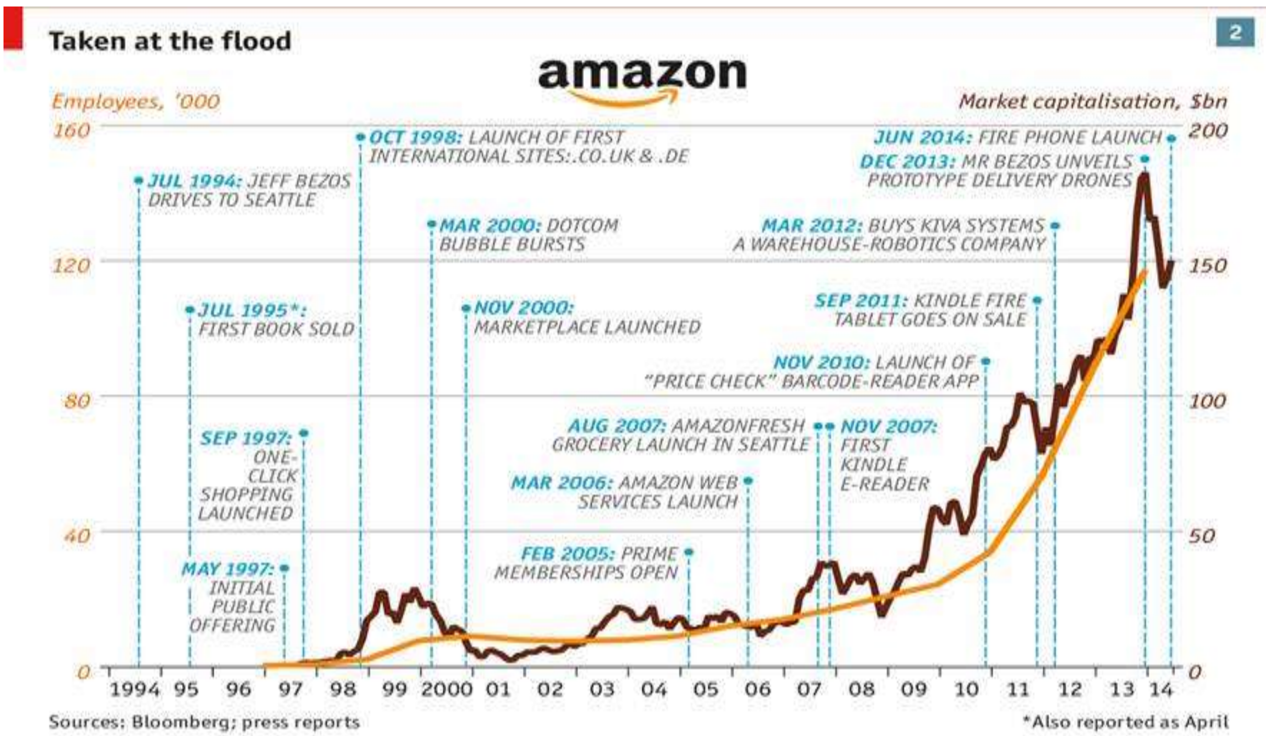
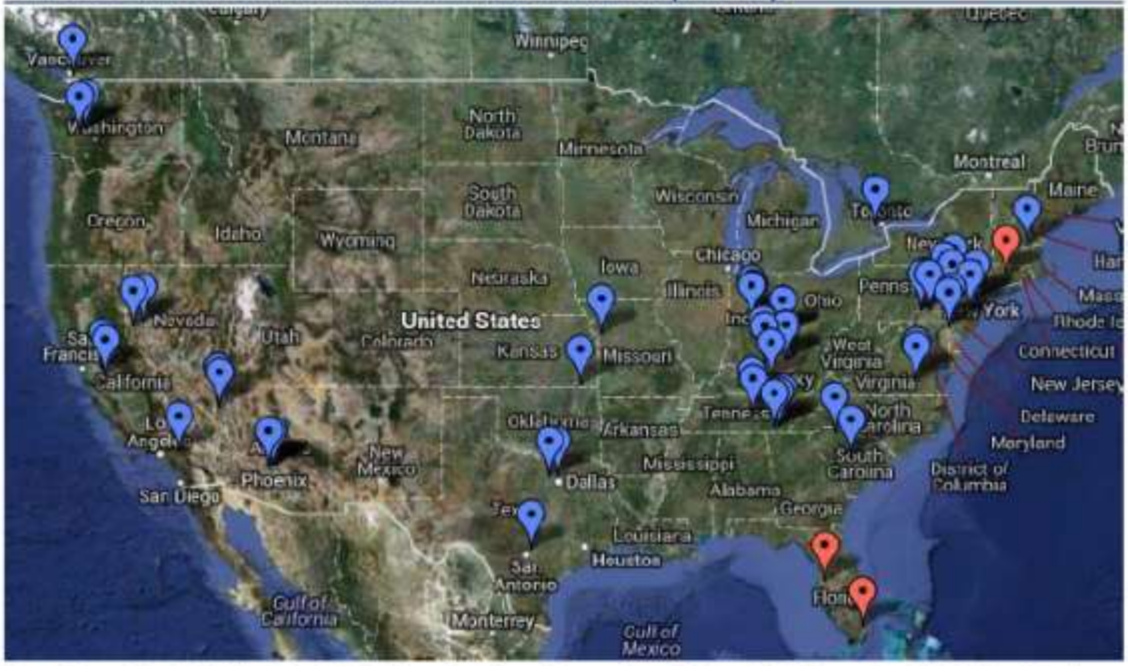


Chart 4: Amazon North America Fulfillment Center Footprint Map



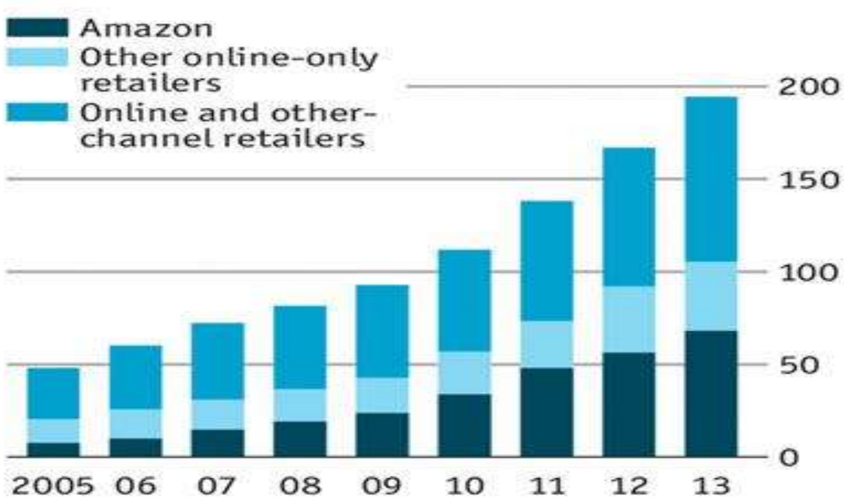
Source: Source: Google, BofA Merrill Lynch Global Research estimates, Amazon, ChannelAdvisor, Quidsi, Zappos, Supply Chain Asia, Wikipedia, American Independent Business Alliance, Auctionbytes, MWPVL International, and numerous online sources

Note – We expect Amazon to construct fulfillment centers in Florida and Connecticut (reflected in red)

The biggest play

1

Online retail sales in America, $bn



Source: Citi Research

	Year Ended December 31,				
	2013	2012	2011	2010	2009
	(in millions, except per share data)				
Statements of Operations:					
Net sales	$ 74,452	$ 61,093	$ 48,077	$ 34,204	$ 24,509
Income from operations	$ 745	$ 676	$ 862	$ 1,406	$ 1,129
Net income (loss)	$ 274	$ (39)	$ 631	$ 1,152	$ 902
Basic earnings per share (1)	$ 0.60	$ (0.09)	$ 1.39	$ 2.58	$ 2.08
Diluted earnings per share (1)	$ 0.59	$ (0.09)	$ 1.37	$ 2.53	$ 2.04
Weighted average shares used in computation of earnings per share:					
Basic	457	453	453	447	433
Diluted	465	453	461	456	442

What lessons can we learn from Amazon?

At a time, when most American companies attach the highest priority to meeting their quarterly earnings targets, Amazon has chosen to take a long term view. The company made only $ 274 million of net profit in 2013. Its core retail business probably just about breaks even. But founder Jeff Bezos is known for his stance that Amazon will continue to be customer focused rather than competitor focused. An integral part of that customer focus is the willingness to make the necessary investments without being worried about ROI in the short run. Despite its low margins, Amazon has a phenomenal market cap. This shows that investors may also be prepared to take a long term view provided the story is communicated well to them by the management.

Bezos, whose influence on the company remains strong, has all along believed that growth and market share hold the key to success. He mentioned in his 1997 letter to shareholders that aggressively investing to establish market leadership would pay off in the long run: **"We believe that a fundamental measure of our success will be the shareholder value we create over the *long term*. This value will be a direct result of our ability to extend and solidify our current market leadership position. The stronger our market leadership, the more powerful our economic model. Market leadership can translate directly to higher revenue, higher profitability, greater capital velocity, and correspondingly stronger returns on invested capital."** To this day, Amazon has been true to this philosophy. Indeed, Amazon publishes Bezos' 1997 letter in the annual report every year so that people do not forget the company's vision.

Paying less attention to profits has encouraged Amazon to develop a healthy risk appetite and move into areas that would be difficult for most other tech companies. As the Economist has put it: **"An almost perverse pleasure in low margins inspires ventures no one else would think of, like AWS."** At a time, when most Tech companies are sitting on piles of cash not knowing what to do with it, Amazon is not short of ideas on where to invest its money.

Amazon realized early on that with data management and analytics as core capabilities, it could enter just about any business. As more and more customers visit its website, leaving behind digital footprints, Amazon can anticipate what else they may like to buy and when. The recent launch of Fire Phone is only a culmination of this process. The Firefly button on the phone aims to provide users information (using the cloud) about virtually anything around and as the Economist has put it, essentially "turns the whole world into a shop window." Amazon looks well poised to sell just about everything!

Nothing can create more effective barriers to entry than a combination of scale and willingness to operate at close to zero margins. To use some Academic terminology from the world of Micro Economics, Amazon seems to be rapidly emerging as a natural monopoly that is prepared to operate at the low margins characteristic of a perfectly competitive market!

The only worry for Amazon at the moment is that as it grows bigger in scale, scope and market clout, it may attract the attention of antitrust authorities. There is a fear in some circles that the company after achieving an unassailable position may start raising prices. But for now this is only a vague worry. For the moment, nothing can take away credit from Bezos' vision and how he has gone about implementing it!