

Amazon.com's Business Model and Its Evolution*

Overview

In July 2015, Amazon surpassed Wal-Mart as the world's largest retailer by market value after a surprise second quarter profit that led to a surge in the company's stock value. Amazon shares rose 17%, giving the company a market value of \$262.7 billion, compared to Wal-Mart's market capitalization of \$233.5 billion. After it posted two consecutive quarterly profits in 2015, analysts noted that Amazon was a company capable of both investing in itself and sustaining long-term profits. Going forward, the company planned to launch new digital products and service categories, build more fulfillment centers, power AWS, and expand the Kindle Fire Ecosystem. The company also planned to hire 100,000 people in North America for the holiday season.

According to some critics, if the huge investments made by Amazon in diversifying its business did not work out, investors' patience would finally run out and the company would be in trouble. Amazon would have to be selective about where it invested in order to maintain profitability. Moreover, some analysts felt that between price-match guarantees, free shipping, and plans to go multi-channel, other competitors were finally catching up with Amazon in the online retail market space. Amazon would need to work harder to meet the expectations of its customers to maintain its dominance in the highly competitive online retail sector, they added.

Although Amazon had a number of competitive weapons in its arsenal to drive customer loyalty and sustain market position, the battle would be tough as competitors were set to give the company a hard fight. The challenges that the company faced could severely threaten its business model. As the company commenced its 22nd year in operation, Amazon needed to be able to carve out a sustainable piece of the mobile device ecosystem where Apple and Google already had a head start, and where Facebook most likely would enter.

Suggestions for Using the Case

This is a high-interest case and one that will certainly trigger lively classroom discussion. Students are very interested in discussing the Amazon case, given the ubiquity of its services and products across many computing platforms. Many are likely to have read in the popular press about founding CEO Jeff Bezos and how he has inculcated and nurtured a unique culture at Amazon.

This case provides a unique opportunity for students to discuss Amazon's growing dominance in the e-commerce industry, and to compare its strong position in the cloud computing services industry to its much weaker position in mobile devices and their complement, the digital media streaming industry. Students should develop an appreciation of the need for companies to tailor a strategy and develop capabilities that fit the specific industry to build a sustainable competitive advantage.

*This teaching note reflects the thinking and analysis of Professor Armand Gilinsky, Sonoma State University. We are most grateful for his insight, analysis and contributions to how the case can be taught successfully.

We think Amazon.com's Business Model and Its Evolution is an excellent leadoff case for the course (other good choices are Robin Hood, Airbnb in 2016, and Mystic Monk Coffee—which also require that students draw upon the material covered in Chapters 1 and 2).

This case is also well suited for use in your business strategy module and has ample information for students to illustrate the following concepts and utilize the tools of analysis:

- Complete analysis of the company's strategy in the markets for e-commerce, cloud-based computing services (Amazon Web Services or AWS), mobile devices and other personal media players, and streaming of digital content (Chapter 5).
- Understand and appreciate the challenges associated with building organizational capabilities able to serve as the basis for developing a competitive advantage (Chapters 4 and 12) and then develop a strategy that successfully leverages these advantages (Chapter 5).
- Perform a thorough financial analysis of a company and understand the contribution of different product lines to a company's success. The financial ratio summary presented in Table 4.1 of the text should be a very valuable guide for students in doing the financial calculations to support their assessment of Amazon's financial performance. We strongly recommend that students use the ratios provided in the text Appendix to complete their financial analyses.

This Amazon case can also be paired with the material on diversification strategy, covered in Chapters 8.

- Establishing investment priorities that focus resources on the most attractive business units: (covered in Chapter 8)
 - Pursuing rapid-growth strategies via the most promising businesses
 - Initiating profit improvement / turnaround strategies in weak-performing businesses that have potential
 - Divesting businesses that are no longer attractive or that don't fit into management's long-range plans.
- Actions to boost the combined performance of a collection of businesses: (also covered in Chapter 8)
 - Sticking closely with an existing business lineup and pursuing opportunities presented by these businesses
 - Broadening the scope of diversification by entering additional industries,
 - Retrenching to a narrower scope by divesting poorly performing businesses
 - Restructuring by divesting some businesses and acquiring others so as to put a whole new face on the company's business lineup.
- Restructuring to improve performance and achieve economies of scope: (also covered in Chapter 8)
 - Overhauling and streamlining operations
 - Selling off underutilized assets
 - Reducing unnecessary expenses
 - Revamping product offerings
 - Consolidating administrative functions to reduce overhead costs
 - Enabling a portfolio of related businesses to share resources or to transfer them from business to business at a lower cost.

Finally, if used as a final review assignment prior to an examination or course project deliverable, the Amazon can also be useful to preview the strategy execution concepts in Chapters 10 and 12:

- Good strategy execution requires continuously building and upgrading the organization's resources and capabilities: (covered in Chapter 10)
 - Superior strategy execution capabilities may also enable a company to react more quickly to market changes and beat other firms to the market with new products and services.
- A company culture that is consistent with the requirements for good strategy execution can energize employees, deepen their commitment to execute the strategy flawlessly, and enhance worker productivity in the process: (covered in Chapter 12)
 - *A culture that is well matched to the chosen strategy and the requirements of the strategy execution effort focuses the attention of employees on what is most important to this effort.*
 - A corporate culture directs employees' behavior, serves as a guide to their decision-making, and can align the efforts and decisions of employees throughout the firm and minimize the need for direct supervision.
 - Some companies have so-called "high-performance" cultures where the standout traits are a "can-do" spirit, pride in doing things right, no-excuses accountability, and a pervasive results-oriented work climate in which people go all out to meet or beat stretch objectives.
 - Adaptive corporate cultures evince willingness on the part of organization members to accept change and take on the challenge of introducing and executing new strategies, i.e., company personnel share a feeling of confidence that the organization can deal with whatever threats and opportunities arise; they are receptive to risk taking, experimentation, innovation, and changing strategies and practices.

The case also provides students with the opportunity to make recommendations that will yield even stronger positions in its diversified services and products businesses, as well as specific action steps to improve Amazon's position in the rapidly-growing digital media streaming industry.

The assignment questions and teaching outline presented below reflect our thinking and suggestions about how to conduct the class discussion and what aspects to emphasize.

To give students guidance in what to think about and what analytical tools to utilize in preparing the Amazon's Business Model case for class discussion, we strongly recommend providing class members with a set of study questions and insisting that they prepare good notes/answers to these questions in preparing for class discussion of the case.

To facilitate your use of study questions and to make them available to students, we have posted a file of the assignment questions contained in this teaching note for the Amazon Business Model case in the instructor resources section of the Connect Library. (We should also point out that there is a set of study questions posted in the student section of the OLC for each of the 31 cases included in the 21st Edition.)

You may also find it beneficial to have your class read the Guide to Case Analysis that follows Case 31 in the text and is also posted in the instructor resources section of the Connect Library. Students will find the content of this Guide particularly helpful if this is their first experience with cases and they are unsure about the mechanics of how to prepare a case for class discussion, oral presentation, or written analysis.

Video for Use with the Amazon Case. There is a 10:49 minute video that you can show in class (or have students view on their own entitled "Amazon.com Business Strategy in the 2000s—Profit vs. growth—Long Runway for Success," that can be accessed at <https://www.youtube.com/watch?v=lvzrRx5-He4>

One option is to show the video right before you ask the class for action recommendations, but you can also show them at the beginning of the class period if you prefer.

This case is suitable for both written and oral presentations. Our recommended assignment questions are as follows:

1. As part of your internship requirements with Apple Inc., you have been asked to prepare an analysis of Amazon's competitive position in the markets for e-commerce, digital media players, cloud computing, and content creation and streaming. Your report should contain 2-3 pages of recommendations for sustaining the company's success in e-commerce and cloud-based computing, improving its position in portable media devices and streaming of digital media, and a recommendation about potential new areas for diversification. Write an executive summary of recommendations of no more than 2-3 pages, accompanied by supporting exhibits. These exhibits may include an overview of Amazon's strategy, a competitive strength assessment, and a financial analysis.
2. A key executive at Amazon has learned of your considerable skills in strategic analysis and has hired you to develop a strategic plan that will enable Amazon to improve its position in the e-commerce industry, continue to build a strong position in the market for cloud-based computing, and make a decision about its portable device and streaming media businesses. In developing your recommendations, you should assess the e-commerce, cloud computing, digital media streaming, and personal media player industries. You should also assess Amazon's competitive strength in its key product categories and analyze its recent financial performance. Finally, the plan should offer specific, actionable recommendations that will allow Amazon to further improve its position in all of its product categories. Your recommendations should be well supported with arguments and justifications for each recommendation. Your report should include 4-6 pages of recommendations and whatever supporting charts, tables or exhibits you deem useful.

Assignment Questions

1. What are the chief elements of Amazon's overall competitive strategy? How well do the pieces fit together? Is the strategy evolving?
2. What are the key elements of Amazon's strategy in e-commerce, cloud computing services, personal media players, digital media streaming? Are those strategies successful? Are they compatible? Explain.
3. What does a competitive strength assessment reveal about Amazon's e-commerce business, as compared to the leaders in the retail industry? Use the methodology in Table 4.3 to support your answer.
4. Does it appear that the company's competitive positions in personal media players and digital streaming are stronger or weaker than its position in e-commerce and cloud-based computing services? What steps should it take to ensure that the digitally streamed media—and mobile platforms to access that media—become a major contributor to the company's overall performance?
5. Does it make good strategic sense for Amazon to be a competitor in the e-commerce, cloud-based computing services, and personal media device industries? Which of its three principal product lines—e-commerce, cloud computing services, or personal media players—do you think is most important to Amazon's future growth and profitability? Why? Should any of the product lines be discontinued?
6. What is your assessment of Amazon's financial performance the past three years? (Use the financial ratios in the Appendix of the text as a guide in doing your financial analysis.)
7. What strategic issues confront Amazon in 2015? What market or internal circumstances should most concern Jeff Bezos and the company's senior leadership team?
8. What recommendations would you make to Amazon to address the strategic issues confronting it in 2015 and sustain its impressive growth in revenues and maintain its profitability?

Teaching Outline and Analysis

1. What are the chief elements of Amazon's overall competitive strategy? How well do the pieces fit together? Is the strategy evolving?

Students should recognize that Amazon has done a formidable job of developing and piecing together its very distinct “put long-term investment, market gains, and value creation ahead of short-term profits” strategy through effective innovation. As stated in the case, Amazon “constantly plowed cash back into the business and continued building new businesses in the hope of getting greater returns in the future.” This “invest and grow” strategy resulted in an increasing proliferation of new product and service introductions and the improvement of existing services.

Amazon has employed a broad low cost strategy linked to innovation with its three core products – e-commerce, web services for other businesses, and personal media players and mobile phones (and the content to be downloaded onto those devices).

More specifically, Amazon attempts to meet the needs of a global customer-market by introducing *innovative new products and improved existing products at cost or slightly above cost. Key pieces of its strategy have involved (1) meeting the needs of the converging online retail, entertainment, and computer markets and (2) developing one of the most advanced fulfillment and logistics networks in the world.*

Finally, students should be able to indicate that, to support Amazon's strategy implementation efforts, it has developed an adaptive, high-performance culture that entails:

- A virtuous circle called the “Amazon flywheel,” placing customer experience at the core of its business model.
- Decisions made by decentralized, streamlined “two pizza” -sized product development teams.
- A “working backward” approach to reduce cycle times from concept to delivery.

As technology has evolved rapidly, so has Amazon's strategy. Initially, Amazon initially focused on the book e-commerce (retail) industry by introducing innovative products like the handheld Kindle reader. Amazon continues to introduce innovative products in the mobile device industry but recently has focused a great deal of strategic attention and resources on meeting the needs of retail as well as small business customers in the converging retail, digital electronics, media entertainment, and computer markets. This, along with the introduction of the Fire TV and Fire Phone marks a clear evolution in Amazon's strategy to become a creator and distributor of digital media content via streaming to its own proprietary devices as well as to devices running its key competitors' operating systems (Google – android and Apple – IOS).

2. What are the key elements of Amazon's strategy in E-commerce, cloud computing and web services, and personal media players? Are those strategies successful? Are they compatible? Explain.

Students should be able to identify the following elements of Amazon's broad low-cost strategy utilized in its e-commerce, web services, and personal media players businesses.

Components of Amazon's Strategy in E-commerce

The four pillars of Amazon's business model in e-commerce were: low prices, wide selection, convenience, and customer service (via fast and reliable delivery and returns).

- **Low prices:** Reportedly, the prices of goods sold by Amazon were up to 13% lower than those prevailing in other online and brick-and-mortar stores.
 - The sales tax advantage it derived in some places where it did not have a physical presence also helped the company in keeping its prices low and gave it a cost advantage over brick-and-mortar stores.

- By purchasing large volumes of products directly from manufacturers, distributors, and publishers, Amazon received discounts from them.
 - Offering consistently low prices on the best-selling items supported a perception among consumers that Amazon had the best prices overall.
- **Wide selection:** As of 2015, the Amazon website had about 20 product categories including Books; Movies; Music; Video Games; Electronics & Computers; Home & Garden; Tools; Toys; Kids & Baby; Grocery; Health & Beauty; Clothing; Shoes & Jewelry; Health & Beauty; Sports & Outdoors; and Automotive & Industrial.
- Amazon adopted a three-pronged strategy in order to widen its selection of products: (1) for its own inventory of products, it set up special teams' category-wise, (2) for third party vendors, its appointed category managers who decided on the categories where they wanted sellers and subsequently invited them to do business; and (3) Product Ads, an advertising program that allowed sellers to promote their products on Amazon's website by uploading their catalogue.
 - Amazon also expanded into new categories like film streaming and cloud computing.
- **Convenience:** Amazon offered customers browser-friendly and easy-to-use websites, hassle free anytime, anywhere ordering by using modern technology and ensuring that any product could be delivered cheaply and reliably through a simple order process—accessible from customers' homes or offices.
- To conveniently ship items to customers, Amazon relied on an entirely automated order management system, closely linked to its suppliers and payment networks.
 - The website offered customers up-to-date inventory availability information, estimated delivery date, and delivery shipment notifications.
- **Customer service:** Customer service, loyalty, and retention were the three most important aspects of Amazon's service culture, which catered to an estimated 270 million worldwide.
- Amazon primarily focused on three primary customer groups: consumers, sellers, and developers.
 - Case Exhibit 6 lists 15 selected features offered to Amazon's consumer customers, few of which have yet been duplicated by rivals in e-commerce.
 - Amazon invested heavily in building advanced technological infrastructure and spent huge sums of money on customer service and loyalty programs, even though it affected the operating margins of the company (as will be shown in the coverage of Amazon's financial performance in Question 6).
 - Over the years, it had rolled out Amazon Prime, Mayday, One Day Delivery Service, Amazon Fresh, Amazon Dash, Amazon Lockers, and Automatic Refunds.

Students should be pressed to evaluate and reflect on case Exhibit 5, Amazon's Core Values, which supported the company's superior strategy execution efforts in e-commerce.

While there was very little to criticize or improve upon regarding these four pillars of Amazon's e-commerce strategy, other retailers were diversifying into multi-channel retail and appearing to be finally catching up with Amazon in the online retail game. Its biggest rival, Wal-Mart, was making online sales a high priority. Other large online retailers, such as Google Shopping and Chinese-based Alibaba.com, were building capacity and expected to capture some of Amazon's gargantuan online sales. Some experts felt that as the future favored multi-channel retail, Amazon would find it difficult to survive as a pure-play retailer.

That said, it remained to be seen whether or not Amazon's most recent foray (2015) into bricks-and-mortar retail — at its first physical store on the campus of Purdue University in West Lafayette, Indiana — will be

as successful and worthy of replication, particularly as it will compete head-to-head with other mass retailers as well as popular boutique computer retailers such as the Apple Store.

Components of Amazon's Strategy in Cloud Computing and Web Services

Students should be directed to case Exhibit 4, depicting Amazon's Business Model Evolution from retailer to e-commerce platform and web service provider to small businesses, self-publishers, and developers. Amazon Web Services (AWS) also provided marketing and promotional services for third-party retailers and web services for developers.

- AWS had grown into one of the largest computing services platforms in the world.
- Amazon had also expanded into new categories like film streaming and cloud computing.

Undoubtedly, Amazon faced formidable competition in the technology market from better capitalized rivals such as Apple, Google, Microsoft, and potentially even Facebook, as shown in case Exhibit 1. Amazon's lead in business-to-business customer service and the recruitment, training, and retention of seasoned IT developers probably could be trumped over time by rivals such as Google and Facebook, as it seems inevitable that those rivals will move from their primarily online advertising business models into Amazon's "customer data and ratings on products for resale" space.

Components of Amazon's Strategy in Personal Media Players

Students will observe that while Amazon had and continued to make it a priority to expand and upgrade its Kindle Fire Ecosystem, it had also made some serious stumbles in deploying integrating that ecosystem along the way.

- It continued to sell its now eight-year old Kindle e-book reader at cost.
- Its Kindle Direct Publishing platform provided authors with the opportunity to self-publish their books online and earn revenue, but the revenue return to Amazon was likely very small.
- Its Kindle Fire HDX tablet was launched into a rapidly maturing tablet market in September 2013. The tablet's Mayday button enabled customers to connect to a live customer support professional for help with any type of product query within 15 seconds, 24/7, free of charge, but usage and adoption rates of the device and its Mayday feature remained unclear.
- The year 2014 saw Amazon's ambitious attempt to roll out a series of devices to rival Apple's personal mobile device and content streaming (iPhone, iPad, and iTunes) ecosystem.
 - It debuted in the crowded smartphone market with the launch of Fire Phone, which met with lackluster sales and lukewarm reviews.
 - It introduced the Fire TV, a set-top box that plugged into HDTV for easy and instant access to Netflix, Amazon's own Prime Instant Video, Hulu Plus, and low-cost video rentals — but faced formidable direct competition from other set-top devices such as Roku and Apple TV.
 - It rolled out the Amazon Dash, a wand-like wireless device that includes a microphone and a barcode scanner allowed customers to add groceries and household goods to their shopping lists using the AmazonFresh service, but the adoption and penetration rates for this product as well as for the AmazonFresh grocery delivery service remained unclear.

Subsequent to setting out these three diversified lines of business with students, it is worthwhile to ask them whether they believe Amazon's relatively limited success in the mobile device industry has had any impact on its success in e-commerce or web-based and cloud computing services. Astute students are likely to realize that the rapid commoditization of the mobile device business and Amazon's late start and faltering steps in integrating those devices with its other businesses have largely negated any significant benefits Amazon could have gained from its innovative capabilities, even though these capabilities remain essential

in the personal media player industry. There is some credence in the statements in the case that, “Some critics felt that Amazon was too ambitious as it had been growing alarmingly and investing heavily. They felt that the strategy could backfire and that Amazon needed to be selective about the opportunities it pursued as it could not take customers and the competition for granted.” In sum, an argument could be made that although Amazon is investing in things that matter to customers, not all of that money has been well spent.

3. What does a competitive strength assessment reveal about Amazon's e-commerce business, as compared to the leaders in the discount retail industry? Use the methodology in Table 4.3 to support your answer.

Students should be able to prepare a competitive strength assessment for the major discount retailers. Although the students' strength measures, respective weightings, and ratings may vary, conclusions should be consistent with Table 1.

TABLE 1. Competitive Strength Assessment for the Leading Rivals in the Discount Retail Industry

Rating Scale: 1 = very weak; 10 = very strong

Key Success Factors/ Strength Measures	Importance/ Weight	Amazon		Walmart		Costco	
		Rating	Weighted Score	Rating	Weighted Score	Rating	Weighted Score
Customer service	0.20	8	1.60	6	1.20	6	1.20
Wide selection	0.10	9	0.90	8	0.80	7	0.70
Convenience	0.20	9	1.80	6	1.20	7	1.40
Low prices	0.25	7	1.75	10	2.50	9	2.25
Distribution	0.10	10	1.00	9	0.90	6	0.60
Reputation/Image	0.10	9	0.90	7	0.70	8	0.80
Market position	0.05	9	0.45	8	0.40	7	0.35
Total	1.00	61	8	54	8	50	7

The table above indicates that Amazon is the strongest player in the discount retail market space, which is supported by the market capitalization statistics presented in case Exhibit 1. Amazon's competitive strength is primarily a function of its superior customer service, distribution, and reputation for having a wide selection of products and a convenient ordering system. Students are likely argue either way regarding Amazon's rating with respect to “low price,” as the case presents differing points of view on this category.

The table above, however, does not compare Amazon to emerging players in the e-commerce space, such as Google and Alibaba, as the case presents very little information about those companies' efforts in that line of business. Similarly, if more information was available, students might also be pressed to compare Amazon's competitive strength versus its rivals in the web services business and mobile devices markets, analyses that might well lead to less favorable rankings for Amazon.

4. Does it appear that the company's competitive positions in personal media players and digital streaming are stronger or weaker than its position in e-commerce and cloud-based computing services? What steps should it take to ensure that the digitally streamed media—and mobile platforms to access that media—become a major contributor to the company's overall performance?

Based on the analyses above and a careful reading of the case, it should be quite obvious that Amazon is a late entrant into the mobile device and digital streaming markets. Unlike Apple or Google, Amazon has not yet enjoyed any experience curve benefits of being a late entrant into mobile phones, tablets, or streaming

media. There was no apparent direct linkage between those devices and its e-commerce platform, nor is proprietary software required for capturing the streaming content on those devices (or on any of its rivals' devices, for that matter).

A good argument could thus be made for Amazon to entirely exit (or at least reduce its investments in) personal media players and other electronic devices such as the Fire TV or Amazon Dash that are not essential to access the company's commerce or web services ecosystems. The case states that, "in the third quarter of 2014, Amazon spent about 12% of its revenues on technology and content including new-product development and licensing for music and video streaming. That led to the biggest quarterly loss the company had suffered in 14 years."

Development of streaming media (audio and video) content is also likely to remain capital and resource intensive for Amazon, but these investments are consistent with founder/CEO Jeff Bezos' "invest and grow the installed base while sacrificing profits" philosophy. They are also consistent with the company's superior capabilities to warehouse e-commerce content and inventory, as opposed to investments that would need to be made to push the envelope in device features and benefits. Wall Street investors have remained extremely patient with his philosophy over the 22 years Amazon has been in business, so there is little reason to expect that a major change in direction away from creation of content for digital streaming is likely to occur. Some students might even point to certain "halo" benefits to Amazon from creating award-winning television content like its recent "Transparent" series.

5. Does it make good strategic sense for Amazon to be a competitor in the e-commerce, cloud-based computing services, and personal media device industries? Which of its three principal product lines—e-commerce, cloud computing services, personal media players—do you think is most important to Amazon's future growth and profitability? Why? Should any of the product lines be discontinued?

Amazon has become the most disruptive force to emerge in retail in several decades. Its low-cost operations, network effect, and laser focus on customer service provide it with sustainable competitive advantages that traditional retailers cannot match; this should yield additional market share gains in the years to come. So, the answer is yes and no, it does make good strategic sense for Amazon to remain a competitor in the e-commerce and cloud-based computing services businesses, while the personal media player business remains a strong question mark or perhaps even a candidate for divestment.

■ **One of Amazon's key advantages is its low-cost operations.**

The cost to maintain its scalable fulfillment and distribution network is lower than having a large physical retail presence, allowing Amazon to price below its brick-and-mortar peers while still generating excess economic returns. Additionally, U.S. tax laws currently mandate that online retailers collect sales tax in states where they have a physical presence, with the tax responsibility falling to the end consumers themselves. As a result, Amazon currently collects sales tax in states where it maintains a physical presence--roughly half of the United States at present--providing some cost advantages. These allow Amazon to generate strong cash flow, which in turn can be reinvested in advertising, customer service, and website enhancements that keep its marketplace robust and customer loyalty strong.

■ **A shakeout among traditional brick-and-mortar retailers has long been underway, particularly in commoditized categories.**

With nonexistent customer switching costs and intense competition, we've already seen Circuit City, Linens 'n Things, Borders, and RadioShack effectively exit the marketplace, while names like Barnes & Noble, Sears, and the office superstores (OfficeMax/Depot and Staples) are struggling. Market consolidation among mass merchants like Wal-Mart and Costco has certainly played a role in this trend, as have direct-to-consumer investments in their own branded stores by technology original-equipment manufacturers like Apple and Samsung.

■ **A growth via acquisition strategy in e-commerce appears to be paying off.**

Amazon partnered with or acquired a number of companies across different sectors such as Zappos (shoes) Drugstore.com (pharmacy), Living.com (furniture), Pets.com (pet supplies), Wineshopper.com (wines), HomeGrocer.com (groceries), Sothebys.com (auctions), and Kozmo.com (urban home delivery). In some cases, Amazon purchased an outright equity stake in these partners, rebranded them, and also charged them a fee for placement of their products on the Amazon site to promote and drive traffic to their sites.

■ **Despite ongoing large R&D investments in fulfillment, technology (hardware devices and AWS), and content, we expect Amazon to continue generating positive cash flows, if not profits, for the foreseeable future.**

The shine may long be off its initial 2006 launch of the Kindle, which resulted in half a million devices sold, and although the Fire Phone and Kindle Fire and other devices have met with limited market acceptance to date, so Amazon should strongly consider abandoning the OEM business as it offsets any profits from the current fulfillment and content streaming businesses that remain in high growth markets.

■ **Amazon also benefits from a network effect.**

Since 2006, Amazon has been publicly sharing its business model with small enterprises through the Fulfillment by Amazon (FBA) program. That program, plus its low prices, expansive breadth of products, and user-friendly interface have attracted an estimated 270 million customers, which in return attracts merchants of all kinds to Amazon.com, including third-party sellers on Amazon's Marketplace platform (which according to the case represented 46% of total units sold in 2015) and wholesalers/manufacturers selling directly to Amazon. Customer reviews, product recommendations, and wish lists increase in relevance as more consumers and products are added to the Amazon platform, enhancing its network effect.

6. What is your assessment of Amazon's financial performance the past three years? (Use the financial ratios in the Appendix of the text as a guide in doing your financial analysis.)

Students should be able to use the financial information provided in case Exhibit 3 and the financial ratios provided in the Appendix of the text to make calculations similar to those shown in Table 2.

TABLE 2. Selected Financial Statistics and Ratios for Amazon Inc., 2010 – 2014

n/a = not applicable or impossible to calculate.

Performance Ratios	2014	2013	2012	2011	2010
Net sales growth %	19.5%	21.9%	27.1%	40.6%	n/a
Sales growth, products %	15.1%	17.7%	23.2%	36.4%	n/a
Sales growth, services %	39.6%	44.8%	54.0%	78.1%	n/a
Gross margin, %	29.5%	27.2%	24.8%	22.4%	22.3%
Fulfillment as % of sales	17.2%	15.8%	14.0%	12.3%	10.9%
Marketing as % of sales	16.5%	15.5%	15.9%	15.1%	13.5%
R&D as % of sales	13.2%	10.8%	8.8%	6.9%	5.6%
Gen'l & admin. as % of sales	8.2%	8.3%	9.6%	10.8%	13.8%
Operating profit margin, %	0.2%	1.0%	1.1%	1.8%	4.1%
Return on sales, % (ROS)	n/a	0.4%	n/a	1.3%	3.4%

Calculated from case Exhibit 3.

Students are likely to suggest that the strength of Amazon's strategy and products allowed it to withstand the effects of the recession much easier than competing bricks-and-mortar retailers.

Students should quickly recognize that, although Amazon's performance between 2010 and 2011 had been exceptionally strong with net sales revenues growing by 41%, the growth rate in that category weakened considerably in the succeeding years out to 2014. For purposes of comparison, revenue growth in services remained robust relative to revenue growth in products during that four-year period. As a result, gross margins widened considerably, from 22% to nearly 30%.

Students should also recognize that the company's operating profitability measures did not follow the same trend: operating profits as a percentage of sales decreased considerably since 2010, from 4% to just above zero percent. A major operating cost driver from 2010 to 2014, fulfillment costs, rose from about 11% of sales to 17% of sales. In response to rising fulfillment costs from other carriers such as the USPS, FedEx and UPS, Amazon was known to be investing in creating its own distribution system, e.g. deliveries from centralized warehouses to consumers via drones, for its e-commerce business. Another possible explanation for the decreasing profitability and uneven return on sales is the significant investments that Amazon made in R&D during the 2010 – 2014 period. Its R&D as a percentage of sales more than doubled, from 6% of net sales in 2010 to 13% of net sales in 2014.

In the third quarter ended September 30, 2015, Amazon's revenues increased by 20% to \$23.2 billion, while net income was \$79 million, compared with a net loss of \$437 million in the corresponding quarter of the previous year. The revenue growth was attributed to the company's rapidly growing cloud-computing business, higher sales in North America, and initiatives to attract more customers. On the back of these unexpected quarterly results, Amazon shares surged, making it the most valuable retailer in the world, surpassing Wal-Mart Stores, the previous global leader, in market value (\$263.7 billion vs. \$233.5 billion) as shown in case Exhibits 1 and 2.

7. What strategic issues confront Amazon in 2015? What market or internal circumstances should most concern Jeff Bezos and the company's senior leadership team?

We think it is always a good idea to push the class for their assessment of what issues management needs to address before proceeding to ask for action recommendations. Issue identification (or compilation of a "what I'd do if I were in her/his shoes" list) is a way for students to draw conclusions from all the preceding analyses, plus it sets the stage for what actions need to be taken.

In Amazon's case, we see several high-priority issues meriting priority consideration:

- How best to sustain long-term growth and profitability
- Despite apparent reductions in general and administrative overhead, how to stem the declines in operating profit as a percentage of total revenues
- Whether or not to reconsider its OEM strategy, which changed the company's focus from warehouse for other companies' products to manufacturer of its own products
- Whether to accelerate or decelerate its investments into logistics and fulfillment to escape the "price vise" of current fulfillment partners such as the US Postal Service, UPS, and FedEx
- Where to place future bets on international expansion, particularly as reception of its web services and streaming digital content in other countries and cultures is not automatically guaranteed, and stiff competition is expected from companies like Alibaba in Asia and Google everywhere on the e-commerce side.
- Whether to direct future capital investment — to opening bricks-and-mortar outlets domestically and internationally, or to continue building its direct-to-consumer portfolio of brands via acquisitions and partnerships

8. What recommendations would you make to Amazon to address the strategic issues confronting it in 2015 and sustain its impressive growth in revenues and maintain its profitability?

Although the major societal trends towards replacement of analogue media by digital media and the replacement of computers by larger-format smart phones are likely to continue unabated, Amazon must be more selective with its capital allocation into any OEM personal devices.

- That is, we believe the lack of consumer interest in the Fire Phone was a wakeup call for management's future capital decisions, as the company runs the risk of losing key personnel without stronger returns on invested capital, owing to the equity component of many employees' compensation structure.

However, the company should continue on its recent path with respect to acquisitions and investments in fulfillment and streaming content.

- These investments have been more directly aligned with Amazon's stable growth core e-commerce and higher growth AWS platforms.
- Continue to pursue small business customers for AWS by offering these customers high value-added services (such as a portal for their products and services), but avoid the temptation to go head-to-head with Google's Drive or Apple's iCloud that provide consumer data storage solutions, or head-to-head with Facebook or LinkedIn for network referral solutions.
- Amazon needs to stay a step ahead of current and potential rivals in e-commerce (Alibaba, Google, Facebook) and evolving rivals from traditional discount retail (Walmart, Costco, and possibly Target) by creating streaming content for entertainment that is directly linked to and informed by its extensive consumer and business customer networks.

Students should engage in an active and freewheeling discussion to defend their recommendation to Amazon to (1) continue building out its existing business model using big data, (2) propel growth and profitability forward via a strategic alliance or acquisition (previously covered in Chapter 6), or (3) cash out and exit the business via a sale to another IT provider. See Table 3 below:

TABLE 3. Selected Strategic Options for Amazon Inc.

Option	Pros	Cons
Continue	Preserves entrepreneurial can-do spirit, company culture, and investments in information technology and operating systems	Rival firms such as Google or Facebook may catch Amazon by developing similar or stronger data analytics, customer service & IT capabilities
Expand via JV or acquisition	Could involve strategic alliance with — or acquisition of — a large social media company with billions of users e.g. Facebook or Snapchat or LinkedIn, it may be able to achieve economies of scope to provide even greater service, bolt the higher margin advertising space on to its recommendation engines, and propel a return to profitability	Requires massive amounts of capital & cooperation to achieve Potential dilution of ownership & control Potential diminution of customer service & support turnaround times Cultures may not mesh well Loss of jobs as overlapping IT functions are streamlined No track record of joint venturing
Sell out	Bezos and very patient investors can cash out. Bezos can dedicate himself fully to the Washington Post, become more involved with charitable organizations, or engage in another start-up venture.	Google or Facebook (or other Internet firms such as Yahoo! or Alibaba) may be the only companies sufficiently large to attempt a buy-out of Amazon. The culture will change should Bezos depart.

Plans also need to be put in place to preserve Amazon's high-performance culture and assure a smooth succession in the event of Chairman/CEO Bezos' departure.

Wrapping Up The Class

The Amazon case can provide instructors with an important “bridge” to strategy execution concepts covered in later chapters, or it can even be paired with those chapters. We would encourage you to conclude by foreshadowing the material in those chapters and by making the following points:

- **Disruptive companies like Amazon that have superior competitive strength in one or two arenas—such as e-commerce or web service—typically have prioritized a few key success factors (KSF) that are necessary for industry dominance: (covered in Chapter 5):**
 - Develop a capability and a corporate culture to support superior customer service
 - Make massive investments in logistics and fulfillment, often to the detriment of profits
 - Adopt a virtuous circle that puts customers at the center, via a friendly, easy-to-use interface and policies that reward rather than punish customers
- **Companies like Amazon need to establish investment priorities that focus resources on the most attractive business units: (covered in Chapter 8)**
 - Initiate profit improvement / turnaround strategies in weak-performing businesses that have potential
 - Pursue rapid-growth strategies via putting resources into the most promising lines of business
 - Possibly divesting businesses or lines of business that are no longer attractive, that face intense head-to-head competition from its rivals, or that simply do not fit into management's long-range plans.
- **Amazon's development and deployment of big data is a good example of how companies get an important boost from investing in IT and operating systems: (covered in Chapter 11)**
 - It seems clear to us that Amazon's efforts to recruit and train IT employees in large numbers as well as creating an infrastructure that provides the capability to scale (handle growth) as it occurs, rather than having to scramble to catch up to consumer demand, have been worthwhile
 - Company strategies cannot be executed well without a number of critical internal systems for business operations
 - Amazon — whose business model is based on selling products, from books to shoes to e-readers to space on the “cloud” — possesses more data on consumer shopping habits than any other Internet company, whereas rivals Google and Facebook, have business models primarily based on advertising
 - If the systems a company employs are advanced systems, i.e. those that have not yet been adopted by rivals, these systems may provide the company with an insurmountable competitive advantage, at least so long as the costs do not continue to outweigh the benefits
- **Amazon's high performance, innovative culture is an excellent example of how companies get an important boost from a culture that promotes superior strategy execution and operating excellence: (covered in Chapter 12)**
 - Company strategies cannot be executed well unless you have inculcated a culture like Amazon's, that is, one highly conducive to adaptation and change.
 - Strategy-supportive cultures like Amazon's not only enable better execution, but also strengthen organizational capabilities, enough, in certain industries at least, to provide a substantial competitive edge over rivals

Epilogue

Sales increased 20%, 20%, and 22% in 2015, 2014, and 2013, compared to the comparable prior year periods. Changes in foreign currency exchange rates impacted net sales by \$(5.2) billion, \$(636) million, and \$(1.3) billion for 2015, 2014, and 2013. For a discussion of the effect on sales growth of foreign exchange rates, see “Effect of Foreign Exchange Rates” below.

North America sales increased 25%, 23%, and 26% in 2015, 2014, and 2013, compared to the comparable prior year periods. The sales growth in each year primarily reflects increased unit sales, including sales by marketplace sellers. Increased unit sales were driven largely by our continued efforts to reduce prices for our customers, including from our shipping offers, sales in faster growing categories such as electronics and other general merchandise, increased in-stock inventory availability, and increased selection of product offerings.

International sales increased 6%, 12%, and 14% in 2015, 2014, and 2013, compared to the comparable prior year periods. The sales growth in each year primarily reflects increased unit sales, including sales by marketplace sellers, offset by the unfavorable effect of foreign exchange rates. Changes in foreign currency exchange rates impacted International net sales by \$(5.0) billion, \$(580) million, and \$(1.3) billion in 2015, 2014, and 2013. Increased unit sales were driven largely by our continued efforts to reduce prices for our customers, including from our shipping offers, sales in faster growing categories such as electronics and other general merchandise, increased in-stock inventory availability, and increased selection of product offerings.

AWS sales increased 70%, 49%, and 69% in 2015, 2014, and 2013, compared to the comparable prior year periods. The sales growth primarily reflects increased customer usage, partially offset by pricing changes. Pricing changes were driven largely by our continued efforts to reduce prices for our customers.

AMAZON.COM, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS, 2013 – 2015

(in millions, except per share data)

	Year Ended December 31		
	2015	2014	2013
Net product sales	\$ 79,268	\$ 70,080	\$ 60,903
Net service sales	27,738	18,908	13,549
Total net sales	107,006	88,988	74,452
Operating expenses:			
Cost of sales	71,651	62,752	54,181
Fulfillment	13,410	10,766	8,585
Marketing	5,254	4,332	3,133
Technology and content	12,540	9,275	6,565
General and administrative	1,747	1,552	1,129
Other operating expense (income), net	171	133	114
Total operating expenses	104,773	88,810	73,707
Income from operations	2,233	178	745
Interest income	50	39	38
Interest expense	(459)	(210)	(141)
Other income (expense), net	(256)	(118)	(136)
Total non-operating income (expense)	(665)	(289)	(239)
Income (loss) before income taxes	1,568	(111)	506
Provision for income taxes	(950)	(167)	(161)
Equity-method investment activity, net of tax	(22)	37	(71)
Net income (loss)	\$ 596	\$ (241)	\$ 274
Basic earnings per share	\$ 1.28	\$ (0.52)	\$ 0.60
Diluted earnings per share	\$ 1.25	\$ (0.52)	\$ 0.59

Source: Amazon Inc. 10-K, filed 1/29/201