CAN AMAZON.COM BE PROFITABLE?

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EXECUTIVE SUMMARY

Amazon.com is a unique company because of the size and scope of its product offering – the days of characterizing Amazon as simply a bookseller are past. Today, 8 percent of all Internet commerce transactions are completed through Amazon. Profitability is closer than some may think; in 2002 Amazon experienced a loss of only $10m, however it spent $30m on free shipping. Though the internet retailing industry fundamentals may appear unattractive, Amazon is actually protected by its strong brand name, relationships with other retailers, sophisticated software, and distribution system. While the company's growth must continue in order to cover its fixed cost-structure and ward off a threatening WalMart.com, it appears that Amazon's business model and execution success will enable it to achieve profitability over the long-term.

INDUSTRY ANALYSIS

It is difficult to describe Amazon's business and industry using traditional models. What does Amazon sell? Just about everything. Who are its rivals? Wall Street analysts often compare Amazon to other Internet companies such as eBay and Yahoo! yet their services are all quite different. Finally, why do people use Amazon? Convenience, familiarity, and shipping drive busy consumers to Amazon, where they can find a wide variety of products that will be reliably shipped directly to their door, for free if the order is over $25, and typically without sales tax. Amazon is essentially a retail company with the same business risks and characteristics as a traditional retailer, though without the physical storefront presence. It is a brand name that draws consumers to its website and then strives to offer them everything that they need or want in one convenient location.

PORTER'S FIVE FORCES AND COMPLEMENTS

Threat of New Entrants. Most of the industries in which Amazon operates possess low barriers to entry. Except for modest capital requirements, there are no specific skills or permits required to enter many of the businesses in which Amazon competes. Indeed, books, electronic, apparel and toy stores are highly fragmented and have many "mom-and-pop" participants, indicating that entry is relatively easy. However, there have been recent trends toward consolidation. Internet retail sites serve as a "defragmenter" in several industries, and are an on-line version of these boutiques. Consequently, the internet model of one-stop shopping is a conundrum for the traditional defragmenter. Typically, a company that consolidates, or de-fragments, an industry does so at the expense of personalized service. However, the internet can actually offer *more* personalized service than some small independent retailers because of the sophistication of its software. Consequently, new entrants can easily offer the low-cost advantage of a large retailer combined with personalized service, and thus quickly compete with traditional brick and mortar shops.

Despite the low barriers to entry, the online ubiquity in the brand name gives Amazon.com a competitive advantage over potential entrants. Amazon's ability to store and recall customer billing and shipping information creates a minor form of lock-in for customers who can easily make a purchase with Amazon's "one-click" shopping. In addition, Amazon took advantage of the cheap financing opportunities of the late 1990's to raise over $1 billion in debt, which it used to build a vast distribution network. With today's capital markets being less friendly toward new internet start-ups, it would be difficult for a new company to effectively compete with Amazon's warehouses. In addition, Amazon's policy of offering free shipping on orders over $25 would be difficult for another company to imitate. Therefore, the threat of news entrants is relatively low.

Buyer Power. Amazon's business model includes two distinct groups of buyers, both of which have moderate power. The largest group of buyers is the traditional end consumer of Amazon merchandise. Serving end consumers, Amazon must compete with both 'brick and mortar' stores as well as other internet sites. While it would be very difficult for these buyers to collectively bargain with Amazon, it remains very easy to individually abandon the site and shop elsewhere.

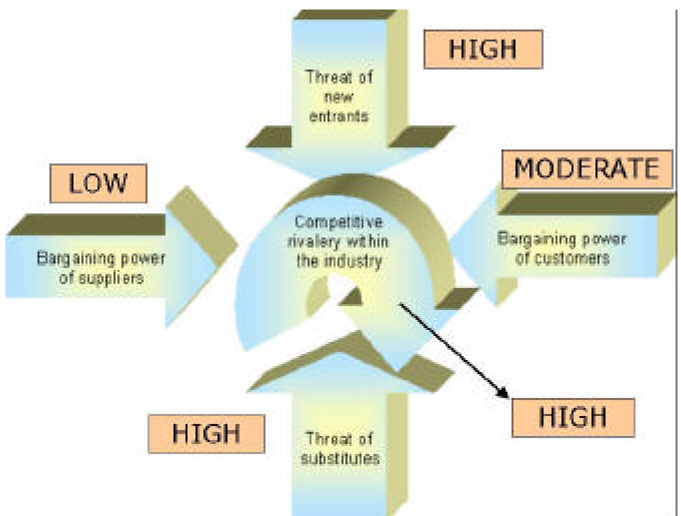
The second group of buyers include retailers such as Target and Borders, who hire Amazon to provide a web presence and/or distribution service. These "buyers" of Amazon's services have little holding them to Amazon. Their ability to switch providers and distributors is varied, and they can therefore demand good terms from Amazon. However, the relationship must remain mutually beneficial, and Amazon must get fair terms from any deal.

Supplier Power. Amazon has many suppliers representing brands across numerous product categories, and as a group they wield low bargaining power. Suppliers are eager to sell through Amazon and take advantage of its wide popularity with consumers. Currently, it is improbable that these suppliers could organize to bargain with Amazon on any meaningful scale. As Amazon continues to grow, its ability to bargain with suppliers will continue to increase. Its power could replicate the position now held by Wal-Mart, giving Amazon the ability to dictate terms and prices to its suppliers simply because of its enormous size.

Substitutes. Amazon's customers have other retailing options, making the threat of substitutes high. Brick and mortar stores constitute a substitute for an online shopping experience, and range from specialty boutiques to large specialty stores, such as Best Buy for electronics or Sam Goody for DVDs. Additionally, some products offered on Amazon are available directly from the manufacturer. Additionally, catalogs allow consumers to shop from their homes as conveniently as the Internet or Amazon and are an alternative to Amazon.

Rivalry. Amazon competes with small regional stores as well as large national chains. WalMart.com is emerging as a viable competitor. WalMart.com also has multiple product lines, and with outlets all over the country is equipped to handle the distribution challenge online retailers face.

Figure 1: Porter's Five Forces Analysis



Complements. There are three major complements to Amazon's business:

1. Internet access
2. Reliable shipping services
3. Lack of sales tax on Internet purchases

Amazon is clearly dependent on consumers' ability to access the internet. The market for Internet access is considered mature, with 56 percent of U.S. households currently online.[1] While this indicates that Amazon can be accessed by a large number of consumers, it also means that we will no longer see the explosive growth of the 1990's. However, the migration of consumers from dial-up to broadband enhances the prospects for online retailing in the near term.

Other complements include the availability of reliable shipping services and the availability of tax-free purchases on the Internet. While we can reasonably expect shipping services to remain reliable and competitive in the future, there is a strong possibility that all Internet purchases will be subject to sales tax in the future.

So what do these six forces tell us? Each force attempts to quantify "the ability of others to expropriate some or all of a firm's profits."[2] With low barriers to entry, moderate bargaining power of buyers, high threat of substitutes and high rivalry, the outlook for sustained profits is minimal. Amazon, however, has such a strong brand and predominates Internet retailing that it is very likely to reap any profits the industry is capable of achieving. The surreal days of the 1990's when companies could price, temporarily, below fixed costs are over, and Amazon has won this war of attrition.

MARKET

The current market for online retailing is estimated to be $50 Billion.[3] Amazon's 2002 sales of $3.9 Billion represent 8 percent of the total online market. Currently, Amazon operates in four major markets:

1) <u>Books, Music, Video, DVD (BMVD)</u>. This is Amazon's largest business segment,

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[1] Kaufman Brothers, Equity Research, 4 Apr 2003
[2] McAfee, R. Preston, Competitive Solutions, Princeton University Press, 2002.
[3] Soundview Technology Group, Equity Research, 19 Mar 2003

accounting for 48 percent of 2002 revenues. It also is a high margin business, with gross margins of 28 percent. The down side is that this segment is rapidly maturing. The BMVD market actually decreased 1 percent in 2001, and increased just 11 percent in 2002.

2) Electronics, Kitchen, and Tools (ETK). Along with BMVD, constitutes Amazon's core business. In 2002, ETK accounted for 16 percent of revenues, and is poised for significant growth. Gross margins are just 14 percent.

3) International. Constituted 30 percent of sales in 2002. Projected to experience highest growth in the next 3-5 years.

4) Services. Includes programs such as Merchant.com, whereby Amazon utilizes its expertise to operate other retailers' web sites in exchange for a fee or commission. This segment contributed just 6 percent to revenues. However, with gross margins of 50 percent, and operating margins of 17 percent, it contributed 23 percent to 2002's total operating profit. 2002 growth was 8 percent.

AMAZON TODAY

Amazon's vision is to be the lowest-cost provider of virtually all the merchandise a consumer could ever need. Clearly a bold vision, however Amazon's recent expansion into a broad range of markets suggests its strategy should be taken seriously. The more the company grows, the more they can leverage their operating efficiencies over their set fixed costs.

COMPETITIVE ADVANTAGE

In judging the attractiveness of Amazon.com, the size of the moat or competitive advantage that the company possesses is tremendously important. Increasingly, the Amazon name is becoming "the" site associated with online retailing. Though it was an overused phrase during the Internet boom, Amazon really does possess a 'first mover advantage' that has continued to provide the company with a competitive advantage. When Jeffrey Bezos started Amazon in 1994, the idea of selling books online was unique. However, Amazon was able to establish a name brand early and continue to expand the business. With Amazon's partnerships with other retailers, the Amazon name receives continued repetition and exposure. This continued exposure to in the minds of consumers has almost certainly limited the potential for another competitor to create a similar online service.

Amazon has also avoided some of the disadvantages associated with being a first mover. The company has not fallen victim to obsolete technology; indeed, the company has remained a leader in on-line innovation and continues to be the standard bearer for the industry. Amazon has a talented software staff that has designed one of the most consumer friendly websites and has been the source of many innovations including one-click purchases, secure payment systems, customer preference, and individual recommendations. Amazon also offers customers extensive ability to check on shipping status information. All of these features combine to increase customer loyalty.

The close integration on this technology into the daily business operations has over time produced efficiencies that are superior to those of the competition. Today, the company has the best online retail technology and has extensive experience with both distribution and infrastructure that will enable it to continue to expand the business.[4]

Another competitive advantage over brick and mortar retailers is the lack of taxation through the virtual Internet environment. Because of recent Supreme Court rulings, Amazon

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[4] Solomon Smith Barney Research Report, Mar 18, 2003

currently does not have to pay retail sales taxes except in North Dakota and Washington, states where it has a physical presence. However, a coalition of 38 states is working to enable the collection of taxes on out-of-state purchases, and Amazon.com needs to organize online retailers to counter the states' effort. This price differential can make a substantial difference when large purchases are involved.

AMAZON STRATEGY

The Amazon strategy is to leverage its competitive advantages to be the low-cost leader in the online retailing market. This strategy is heavily dependent upon sales volume. High sales enable Amazon to spread their high fixed costs over a greater number of units sold, thus improving net margins. In addition, as sales volume (and market share) continues to grow, Amazon's power in the value chain will grow accordingly. As such, it will be able to negotiate more favorable terms from suppliers, similar to strategies employed successfully by Wal-Mart and Dell.

Differentiation. At first Amazon.com would appear to operate in a commodity business with little differentiating characteristics. However, the technological advantage mentioned earlier allows Amazon to provide superior customer service and a product line that is much deeper and broader than its competitors. A small sample of recent product offerings include items as varied as electronics, software, wireless products, cameras, and tools and hardware.

Cooperation. Amazon has chosen to cooperate with mass merchandisers such as Borders, Circuit City, Office Depot, Target, and Toys R Us (Appendix A). This cooperation has developed so closely that Amazon has become a distributor for them through its development of the Merchants@ and Syndicated Store Program. Amazon has been extraordinarily successful, more so than most any other firm, in cooperating with other firms, even firms considered direct competitors. These relationships help Amazon avoid price wars with bricks and mortar retailers because they are actually partnering with the retail giants to sell their inventory. This cooperation can be linked to Amazon's openness to construct the arrangement so that both parties mutually benefit. It would be extremely difficult for a competitor to duplicate the efforts of Amazon in regards to its IT technology. Competitors would have high switching if they chose to abandon Amazon's integrated IT systems that already monitor inventory and supply capability information.

Amazon partners with Waldenbooks and Borders because it hopes to expand the pie of on-line BMVD sales, in this case books. Amazon achieves more BMVD sales while Waldenbooks and Borders benefit from their brand equity (Appendix B). Amazon assumes that the consumers that visit Borders.com or Waldenbooks.com would not necessarily visit Amazon.com. Thus any revenue that Amazon can receive from these customers is a gain. Additionally, perhaps the next time these customers purchase a book online they will use Amazon. It is beneficial to the booksellers as they create an online presence while avoiding the high costs of on-line sales, and can focus on their core competency, brick and mortar retailing.

Amazon is also competing with E-bay by cooperating with third-party sellers to sell their new, used, and collectible products. This cooperation with individuals has resulted in an increase in domestic share from 1% of units in 1Q2001 to 30% of units in 4Q2002. [5]

Pricing. Amazon has used price wars to attract consumers and prevent other uncooperative online retailers from becoming successful. Many of these online retailers were fighting for their survival, and thus had nothing to lose by participating in a full-scale price war. Consequently, there was no punishment Amazon could inflict that would correct the behavior of these non-cooperating competitors short of driving them out of business.

[5] JPMorgan Research Report, April 9, 2003

The Internet makes it difficult for Amazon to hide price changes from its competitors. Competitors cannot, however, undercut Amazon for long if they do not have a more efficient cost structure than Amazon.

FUTURE

INDUSTRY TRENDS

On an industry-wide level, the size of the online market will be determined in large part by Internet access. The home market is becoming saturated, however, the growth of wireless PC access and PDA Internet access will greatly influence the opportunities that consumers will have to make impulse purchases. Amazon's ease of use, its one-click purchasing, and its broad brand awareness make it well positioned to take advantage of the burgeoning mobile Internet market.

COMPETITIVE TRENDS

On the competitive level, there are three broad categories of competitors that could challenge Amazon's performance: new entries, existing online retailers, and successful brick and mortar retailers moving online.

New Entrants. As discussed earlier, despite the low barriers to entry for the online retailing industry as a whole, Amazon has developed substantial advantages over potential newcomers, thus making a direct attack unlikely. However, a more credible threat is the possibility of small online sites entering niche markets – specializing in very specific merchandise. Sites such as these could seek to differentiate themselves through broad selection, in-depth information, and extensive customer service. This is an example of the 'judo strategy' – Amazon's size and broad reach is such that it would not be economical to develop the expertise to compete in these niche markets.

Existing Online Retailers. The existing online retailers have three general options. First, they can choose to directly challenge Amazon for supremacy in the one-stop-shopping online market. Achieving success with this strategy will be difficult due to Amazon's size, experience, and brand awareness.

A second option is for these competitors to abandon the broad market, and focus on niche markets, similar to a new entrant. The disadvantage of this strategy is that the firm may not have the expertise or the resources to enter a specialty market. Even if an existing competitor was able to make a smooth transition into a niche market, their size might attract attention and a response from Amazon.

A third option is to partner with a larger firm to improve their chances for survival. Forming strategically sound partnerships might be the best strategy to avoid a full scale war with Amazon. One potential outcome of such a strategy could be an offer to partner with Amazon itself.

Successful Brick & Mortar Retailers Moving Online. Perhaps the most formidable competition will come from successful brick and mortar retailers moving into the online market. Success as a physical retailer is no guarantee of success as an online retailer, as many brick and mortar companies have discovered. In many respects, online retailing requires a very different business model. However, a large company such as Wal-Mart could leverage its brand name, supplier relationships, and inventory management processes to make a targeted move into the online segment. In addition, Wal-Mart's positive cash flow would be a huge strategic asset in financing early losses from the online division, thus allowing it to withstand years of unprofitable operations. A big question is how long would management and stockholders accept big losses from online operations. The online retail market could be profitable for one firm, but a disaster if two firms were to compete head to head on price.

AMAZON'S RESPONSE

Amazon can thrive in the near term by continuing to focus on its strengths: lowest cost and excellent customer service. A commitment to customer service will require Amazon to stay ahead of the growing mobile Internet technology, and thus ensure that Amazon is easily accessible and user-friendly regardless of where, when, or how a customer accesses the site. This will continue to broaden Amazon's user-base and increase volume, which in turn will allow for lower prices. Higher volume will also allow for increased bargaining power with suppliers, which will lead to even lower prices.

In response to competitive pressures, Amazon should seek to defeat all new competition in the general online market. Decisions regarding niche players will have to be made on a case-by-case basis, although Amazon cannot possibly attack every specialty retailer. In responding to medium-size competitors with established markets, Amazon should seek to form cooperative partnerships, just as it is doing now with Target.com, Toys 'R' Us, and Borders.com. Such a strategy leverages the strengths of all players, and increases the size of the pie while protecting each firm's primary market, at least for the short term. The movement into the online market by the Wal-Mart poses the biggest threat to Amazon. Amazon has two options: 1) It could partner with Wal-Mart (similar to Target), and insert itself into Wal-Mart's ecosystem. The risk is that Wal-Mart.com could eclipse Amazon. 2) Go to war with Wal-Mart.com and try to force them out.

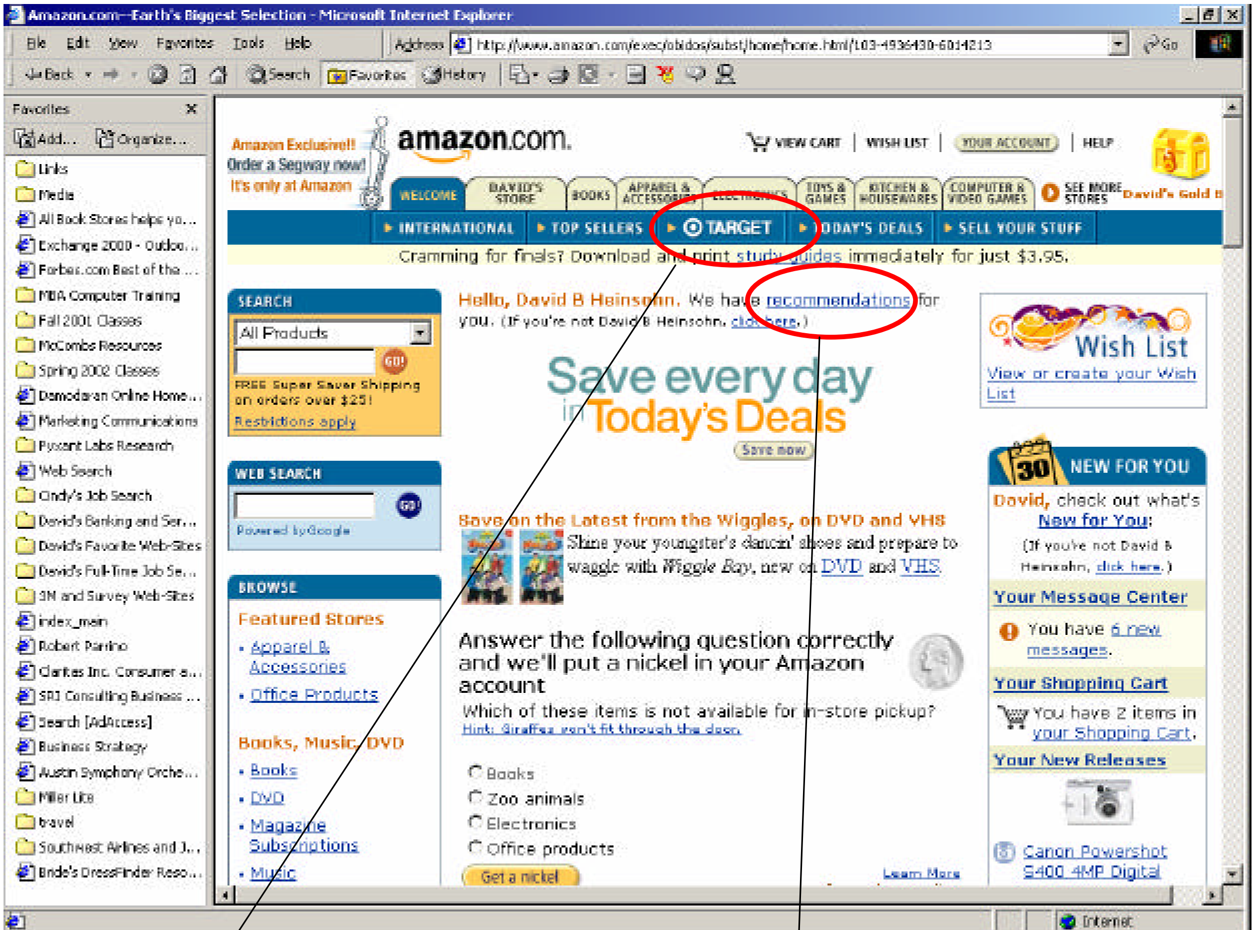
Amazon must pursue the second option and seek to defeat Wal-Mart head-to-head. Amazon currently has a competitive advantage over Wal-Mart.com because of their longer online experience and software expertise. If Wal-Mart is allowed to gain a foothold, they would likely gain the power to eventually run everyone else out of the industry (Target.com, Amazon.com, etc…), make Amazon fully dependent upon them, and then squeeze Amazon's profits.

Furthermore, Amazon should clearly signal its willingness to conduct an extensive price war if Wal-Mart institutes aggressive online pricing, and try to convince Wal-Mart's management and board that they will face extended losses if they seek to compete head-to-head. A clear, aggressive strategy on the part of Amazon will hopefully convince the Wal-Mart management, board of directors, and stockholders to abandon an uncertain future in the on-line field, and focus all of its resources on its highly successful brick and mortar business.

CONCLUSION

Despite the seemingly unattractive internet industry and year after year of losses, Amazon finally appears ready to reap the fruits of its labor and begin to earn profits. Amazon has to leverage its competitive advantages to offer both low-price and superior service. If it continues to stay on top of technological shifts in the industry and provide the end consumer with the best experience available in the marketplace, Amazon.com will be well positioned for future profitability as well as the opportunity to reshape the retailing landscape.

Appendix A: Amazon.Com Homepage (Demonstrates Partnership with Target)



Partnership with Target

Recommendation Program

Appendix B: Borders Homepage (Demonstrates Cooperation with Amazon)