Amazon in 2017

In June 2017, Amazon shocked the retailing industry by acquiring Whole Foods, an upscale grocery chain in the U.S., for $13.4 billion, a 27% premium over its trading value. Grocery industry, a large market with an estimated annual spending of about $800 billion in the U.S, was not new to Amazon. Almost a decade ago Amazon introduced AmazonFresh, but until now it had achieved limited success. Was Whole Foods going to help Amazon become successful in the grocery market, or was this another gamble of Jeff Bezos?

Although Amazon had posted record sales growth since its inception 20 years ago (Exhibit 1), its profitability had been uneven (Exhibit 2). Operating margin of 2.8% and net income of 2.0% in the first quarter of 2017 reflected Bezos’ philosophy of investing for the long run. So far the financial markets had rewarded Amazon for its long-term vision and bold moves – Amazon’s stock had risen over 56,000% since the company went public. This allowed Bezos to diversify into what some saw as somewhat unrelated and risky businesses. Was Amazon spreading itself too thin or were its investments positioning the company for the future?

Evolution of Amazon

Amazon launched its website in July 1995 to sell books online. Bezos’ idea was to provide low prices, vast selection, and convenience to customers by creating a virtual store with unlimited inventory and low fixed costs. Soon it expanded its product line into music, movies, electronics, and general merchandise. In November 2000, Amazon launched its marketplace to allow third-party merchants to use its platform to sell their products. At the end of Q1 2017, sellers on marketplace accounted for 50% of the units sold by Amazon. Amazon also started setting up its packing and distribution system inside the warehouses of a number of its important suppliers like P&G and Kimberly Clark.

In 2002, the company launched Amazon Web Service (AWS) to provide cloud-computing services to a large number of companies. AWS provided firms an elastic information technology infrastructure that could be expanded at a low cost on a need basis. Bezos continued to invest heavily in AWS, which in Q1 of 2016 generated $2.6 billion in revenue and $604 million of operating income. The cloud computing market was growing rapidly and it was highly competitive, with large technology players such as IBM vying for a dominant share.
In 2005, Amazon launched Prime, which offered free two-day shipping for a $79 annual subscription fee. In 2014, Amazon launched Prime Music, an ad-free music streaming service for Prime subscribers. That same year, Amazon raised the price of Prime for the first time, from $79 to $99. Despite the increase, Prime membership grew 53% in 2014 and 35% in 2015. By 2017, Amazon had an estimated 80 million Prime subscribers globally who spent four times what non-Prime customers spent, and accounted for almost half of all spending at Amazon.

In 2006, Amazon launched Unbox, later called Video-on-Demand, which allowed consumers to instantly stream videos on their laptops and tablets. By 2013, Amazon Instant Video offered a large selection of movies and TV shows to consumers, and was catching up with competing services from Netflix and Apple. In 2011, in partnership with Warner Brothers, Amazon launched Amazon Studios to produce original content for movies and shows. Later, it formed multi-year, multi-billion dollar licensing agreements with Viacom to bring hundreds of TV shows to its Instant Video service. In 2014, Amazon paid HBO over $200 million to make select shows available on Prime Instant Video; it also paid nearly $1 billion to acquire Twitch, a live-streaming site for gamers. A year later, Amazon announced that its Studios would begin making feature films.

In 2007, Amazon introduced Kindle and other tablets. Kindle was priced significantly lower than the iPad and other competing tablets, and provided a convenient device for consumers to shop and download digital books and movies from Amazon’s store. In July 2012, Amazon acquired UpNext, a 3D mapping company, which put it on a collision course with Apple and Google Maps. Amazon had already built an AppStore that was available to millions of consumers in nearly 200 countries and which rivaled Google and Apple’s AppStores for apps and games. In July 2014, Amazon launched its Fire phone, which included 3D-like images and a “Firefly” button that identified objects in the vicinity that could be purchased from Amazon. Only three months later, disappointing sales led Amazon to announce that it would take a $170 million write-down on the Fire Phone.

In November 2014, Amazon launched Echo, a device with a voice-activated virtual assistant who answered questions and placed orders on Amazon. Few months later, Amazon introduced Dash Replenishment Service that enabled connected devices to order goods when supplies were running low, e.g., a coffee maker could automatically order more coffee beans. The same quarter, the company also launched Dash Button - a small button that Prime customers could place in their homes to reorder frequently used household items. Customers could choose from 18 popular brands and Amazon was working aggressively to increase the number of available brands. In several U.S. cities, Amazon also introduced Prime Now, a free delivery service that would allow Prime members to choose from tens of thousands of daily essentials through a mobile app for delivery within two hours. In March 2015, the U.S. Federal Aviation Administration allowed Amazon to begin outdoor testing of drones to make deliveries.

In its early days of e-commerce, Amazon had pioneered the recommendation system that allowed it to suggest books, music, and videos to its customers based on the purchases of other customers with similar preferences and buying patterns. In 2011, Amazon launched its own advertising network to serve targeted ads to customers. A customer who visited Amazon for, say, a camera, but did not buy, could be tagged and served a camera ad later when that customer visited a camera- or photography-related site. In 2015, Amazon generated an estimated $1.26 billion in ad revenue from its ad network.

In 2012, Amazon entered the $7.2 trillion U.S. wholesale and distribution market with AmazonSupply, which offered products for business clients (including janitorial supplies, medical supplies, and mechanical parts). Amazon’s easy-to-use website, 24-hour delivery, and low prices were relatively unique in the wholesale business, which was primarily composed of regional, family-run businesses that boasted superior client relationship through personal selling. By 2014, AmazonSupply’s catalogue had increased to
2.2 million items – impressive when compared against the catalogue of market-leader, W.W. Grainger (6% share and $9.4 billion in sales), which contained 1.2 million products.\textsuperscript{13}

In March 2015, Amazon announced its new \textit{Home Services} business for Amazon consumers to select vetted and insured professionals to perform plumbing, electrical, pet care, and other home services. Amazon consumers could view price and scheduling information for those services during the regular checkout process.\textsuperscript{14}

In June 2016, Amazon launched \textit{Amazon Inspire}, an online marketplace with free lesson plans, worksheets, and other instructional materials for school teachers. Rohit Agarwal, general manager of Amazon K-12 Education said, “Every teacher should be able to use the platform with zero training. We are taking a big step forward to help the educator community make the digital classroom a reality.”\textsuperscript{15}

In June 2017, Amazon made news with its acquisition of Whole Foods. With this acquisition, Amazon would get access to Whole Foods’ 460 stores and high-income customers. Many experts believed that this would help Amazon penetrate the $800 billion grocery market where it had limited success until now. However, Whole Foods had only 1.2% share in this market that was dominated by Wal-Mart with 14.5% share. Grocery industry was highly competitive and even Amazon could not get more than 0.2% share in the last ten years.\textsuperscript{16} Lidl, the German discount supermarket chain, was also planning to enter the U.S. grocery market in 2017. As a result of intense competition and razor thin margins, most grocery retailers including Whole Foods were struggling. Did it make sense for a technology company with stratospheric stock price to enter this thin margin industry?

\textbf{Impact on Retailers}

Amazon had become the digital giant, with nearly $136 billion in revenue, over 300 million active customer accounts, and a workforce of 341,400 full- and part-time employees.\textsuperscript{17} Brick-and-mortar retailers continued to lose business to Amazon and were fighting for their survival. Traditional bookstores like Barnes & Noble or electronic chains like Best Buy were becoming Amazon’s \textit{showroom}, such that customers would see, say, a television in Best Buy, get all the advice and information from Best Buy’s sales person, but later buy it at a cheaper price at Amazon. In 2010, Amazon launched a \textit{Price Check} app for smartphones that customers could use to scan the barcode of a product in a store and immediately see the comparable price for the same product on Amazon. In 2014, Amazon even opened its first brick-and-mortar store in Manhattan for the holiday season that served as a mini warehouse for local deliveries, accepted returns, and allowed for pick-up of online orders.\textsuperscript{18} Was this the end of traditional retailers, or could they find a new strategy to survive?
Exhibit 1  Amazon’s Revenue 1995 – 2016 ($ millions)

Source:  Compiled from company annual reports, accessed July 2017.

Exhibit 2  Amazon’s Net Income 1997-2016 ($ millions)

Source:  Compiled from company annual reports, accessed July 2017.
Endnotes

13. O’Connor, “Amazon’s Whole Slaughter.”