Amazon: The Everything Store
– a Review

It is hard to believe that Jeff Bezos founded Amazon in just 1994. With revenues of over $70 billion and a market value of over $130 billion today, its success has been so vast that the lexicon of modern finance has been expanded to accommodate a new verb - to be *"Amazoned"* is to have one's business model displaced by the online phenomenon. I admit to being both fascinated and (as an investor) terrified by Amazon. So I decided to read Brad Stone's, "The Everything Store". It's an excellent read, the main observations from which, as I see them at least, I will summarise below.

Narrative Fallacy

Stone recalls a discussion he had with Bezos as he sought the founder's cooperation with the project. Bezos asked how Stone would handle the "narrative fallacy" – a tremendously insightful question (reminiscent of Daniel Kahneman). The story behind Bezos' and Amazon's success is very complex. Bezos was an extremely gifted child (his mother clams he disassembled his crib with a screwdriver at aged three), whose family nurtured his talents and who attended a school program for gifted children. I have little doubt that even if Amazon never came to be, Bezos would have achieved great success in some other endeavour. Amazon, on the other hand, could easily have vanished before we ever came to know it. A few examples here indicate this point. It was seemingly at hedge fund D.E. Shaw that Bezos began to understand the extent of the potential of the Internet for new business opportunity. It was then Bezos decided to leave to start Amazon.com. Had Bezos not worked at D.E. Shaw, Amazon as a concept may never have been conceived. It is clear that Wal-Mart or Barnes & Noble could have strangled Amazon at birth had either management team had such an inclination (incidentally Amazon acquired various companies having seemingly employed such strangulation practices to submit its target). Perhaps the reluctance, commonplace amongst corporate managers, to impair one's own profitability, even for relatively short periods, may in-part explain why such a scenario never played out. Also, interestingly, Amazon seemed to come perilously close to bankruptcy in 2000 – a burning cash, it managed to issue a $670 million convertible bond in early 2000 just before the market closed to tech companies as the TMT bubble burst.

Personality

Bezos appears to be quite a unique individual: intellectually gifted with an irrepressible drive and a seemingly volcanic temper. He seems to have an almost instinctive opposition to conventional thinking and abhors inefficiency. However I can't help but notice one trait that appears in common with Howard Schultz (Starbucks), Sam Walton (Wal-Mart), Ray Kroc (McDonalds) and seemingly every successful entrepreneur I read about – an unshakeable belief in the project, even in the face of seemingly impossible odds. Bezos informed his family, the earliest investors in Amazon, that the company had a 70% chance of failure (he was still far too optimistic in this assessment in my opinion).

Bezos also made some very costly mistakes, but learned from them. For example, after IPO, with an expensive stock as currency, Amazon acquired a whole range of companies, almost all of which were disastrously unsuccessful and resulted in significant write-offs. Thereafter, Amazon's M&A endeavours were far more prudent, at least until the acquisition in 2009 of Zappos.com, a deal that totalled up to $1.2 billion. Amazon, as we know, started in books, but Bezos was actively looking for other categories that might also be suitably carried by the company. Toys was an area in which Amazon seemingly struggled badly. Unlike Books, there were no large wholesalers to accept unsold inventory. The industry seemingly had oligopolistic characteristics, was faddish and fast moving. Amazon's early foray into toys resulted in enormous inventory write-downs. Jewellery is another category where Amazon seems to have struggled.

Truly Long-Term

Having invested in public companies for almost twenty years now, I can confirm that very few are truly long-term. Amazon is definitively in the minority here. In fact Bezos claims what makes Amazon different is that it is truly customer centric and genuinely long-term. I must admit that, having read the book, Amazon does not sound like a place that I would like to work. There does not seem to have ever been any real respect for work and family-life balance and the managerial culture seems to be almost adversarial. In the early years, Bezos would not subsidise bus passes because he didn't want staff leaving to catch the bus. Rather than pay for air conditioning, ambulances were occasionally parked outside warehouses in the sweltering summer heat ready to take prostrate staff straight to the ER. However as a user of its services I can say that the customer experience is excellent.

Bezos has demonstrated a willingness to initiate seemingly crazy strategies – all in the interest of strengthening Amazon for the decades ahead:

- Amazon Marketplace: by allowing third party sellers to advertise alongside Amazon-owned inventory, Marketplace was seen by many insiders as very dangerous because it meant that competitors might make the sale rather than Amazon. Bezos pushed the idea believing that everything that enhanced the customer offering was as step in the right direction, and would force Amazon to improve their offering, even if at the expense of today's profits.
- Kindle: Bezos saw that e-books represented a threat to Amazon's core offering and must have found himself facing the same dilemma that Kodak, Barnes & Noble, Microsoft and countless others have faced in the past - how can you transition to a new model without killing the burgeoning profits of today? Bezos' answer was to appoint a secret team to try to "kill" Amazon's book business. This is another example of highly unconventional management in action. Bezos saw that Amazon would die anyway if it

stood still. This thinking absorbed from Clayton Christensen's *The Innovator's Dilemma* was the genesis of the Kindle.

- Amazon Prime: Prime would allow free, unlimited, expedited delivery in return for an annual subscription fee. Nobody at Amazon had any idea how popular the service would be and, as such, management could not cost the project properly. Bezos decided that the subscription fee would be $79 p.a. This seems to have been pure instinct – according to one insider, "every single analysis said we were crazy to offer free two day shipping".
- Bezos was famous for his "fever dreams": "Project Fargo" aimed to procure one of every single product ever manufactured and store it in a warehouse. As you might expect, nothing ever came of this.
- Reinforcing the point of long-termism: Bezos is involved in the "Clock of the Long Now" project, which plans to build a clock, to be located atop Mount Washington, that will operate with minimal maintenance for ten thousand years. The projects aims to encourage humanity to adopt a genuinely long-term perspective on its future.

The Flywheel

Amazon began to prosper almost from the very day it began. Bezos saw early on the potential of the 'flywheel', a concept developed by Jim Collins in his book *Good to Great*. Higher sales leads to lower unit costs (greater utilisation of fixed costs) and greater cash flow (favourable payments cycle), which leads to lower prices, which leads to higher sales, which further lowers unit costs and adds cash flow, and the cycle continues. Because of this effect, Bezos was convinced that time was of the essence – he needed Amazon to get big fast in order to gain a sustainable advantage over the competition. Bezos seems to have been influenced by Jim Sinegal, founder of Costco. Sinegal explained his view that low costs were key to success, with high margins proving an attraction to competition. Incidentally Bezos saw Apple's profit margins as a magnet for competition.

On this topic, one of the main criticisms the investment community has is that Amazon's profit margins are very low. In the period 2004-2007, Amazon reported operating margins of around 5% versus 0.2% in 2014. This may suggest that Amazon's current (low) profit margins are not reflective of its true earnings power, which is depressed by investment spending. On the other hand, only time will tell whether these "investments" are actually costs or not. Arguably the Amazon investment case hinges on this factor.

Fulfilment

The company seemed to struggle for years trying to improve and perfect distribution. Bezos saw prompt and efficient delivery as an essential skill set if Amazon was to prosper longer term. Early efforts were designed by former Wal-Mart staff, which ultimately proved highly unsuitable and required a complex rebuild. The new and ultimately successful approach was one that was tailored for Amazon's particular model.

The Future

Brad Stone's view is that Amazon will eventually offer free same day and next day delivery through Prime and will operate its own trucks (currently it relies on UPS, FedEx, etc). He also believes Amazon will eventually extend Amazon Fresh (groceries) beyond Seattle and parts of California. Bezos seems to believe that Amazon will have to master food and apparel retail if it is to become a $200 billion company. Amazon has already introduced its own mobile phone and Internet connected set top box and Stone expects Amazon to intensify its efforts on such hardware, as Bezos does not want customers to access Amazon through the devices of rivals.

There are elements of the story that remain somewhat inexplicable to me – for example, in what way does Amazon Web Services (an enormous cloud computing business which evolved out of a strategy to create best-in-class modules for Amazon infrastructure) fit in with the rest of the business? In this respect it would have been wonderful if the reader had been treated to direct commentary from Bezos on issues like this. Throughout the book we glean the interpretations of the Bezos strategy from those that have worked with Bezos. We are also given descriptions of many public statements that Bezos has made. However perhaps we could learn more if elements of his vision and strategy were articulated by Bezos himself for the specific purposes of this book. I suspect this is not his style however.

Amazon's history has been remarkable and I conclude that Amazon's future may remain as unpredictable as its past.

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