The 4 As:

Aldi.
Amazon.
Apple.
Asos.

The future of retail.
Overview

The 4 As

In the second of our 4 As series, we take a look at Amazon. As we discussed in our opening article on Aldi, today’s consumers expect convenience, transparency and value for money.

They compare prices and product reviews on their smart phones, they search for the best deals in store and online, they shop anytime, anywhere and on any device. The best-performing retailers in this climate are those who have a rigorous focus on understanding their customer and apply that understanding through differentiation on price, product and/or convenience.

It will be no surprise then that we have picked Amazon as the next one of our four retail winners. Can they continue to grow at the expense of profit? And how should other retailers compete? Read on to find out.
The Amazon River is one of the largest in the world and part of the Amazon rainforest: home to over two and a half million different species of insect, more than forty thousand varieties of plant, one and a half thousand bird species and over two thousand fish species. However, human interference with this ecosystem puts its future survival into doubt. According to Jeff Bezos, the Amazon functioned as the inspiration for naming his business venture back in 1994.

Today the river’s business namesake is similarly vast, currently offering 120 million products and counting. It is set to overtake Walmart as the largest retailer in the world by revenue by 2025. Its growth over the last 20 years has been explosive, and yet it hasn’t even started to compete in emerging markets. The phrase ‘ahead of the curve’ could have been invented to describe Amazon. They were ready to lead the field as the technology disrupter who took advantage of globalisation, with their eye always on the customer. As Jeff Bezos said, “We innovate by starting with the customer and working backwards. That becomes the touchstone for how we invent.”

Not only has Amazon been the first to take advantage of the opportunities offered by technology and globalisation, they have shaped what the customer has come to expect from businesses in the internet era. If Amazon can guarantee next day delivery at the lowest prices, why can’t everyone else?

The valuation of the company has been exponential in line with their growth, with market capitalisation of the business growing to $143bn as of the end of May 2014. However, this valuation is based purely on the promise of future returns: historically Amazon has argued successfully with Wall Street that any profit should be re-invested to fund growth. In July Amazon announced a second quarter loss of $126m (following operating losses in April 2014), a net loss of nearly double than predicted. In addition, a 3rd quarter operating loss of up to $810m has been projected by the company whilst it continues with its investment programme.

Even though Amazon operates some very profitable segments as we will explore in more detail in this paper the pressure on profits is not likely to abate any time soon, as Amazon must continue to invest in its Fire Phone and TV boxes, expand its Web Services Division, TV shows and core distribution and delivery network in China, the US and UK, and as recently announced, in India. After the recent earnings update, Amazon’s share price (which still trades at 560 times earnings) fell by nearly 12%, indicating that some shareholders are beginning to question their strategy. For a long time, Wall Street has remained largely confident but the unanswered question still remains: can Amazon continue this growth at the expense of profit or will it, just like its rainforest namesake, become endangered? There are a number of possible factors: organisational complexity, new competitors such as Ali Baba (the 5th A in the making?), over-reach into new product areas (entering the mobile phone market has proved problematic for others before them), counter strategies from traditional competitors, backlash from its customers and impatience from its investors.

In our opinion, one of the biggest threats is organisational complexity, which brings with it high structural costs that cannot be offset by economies of scale. This is also the competition’s opportunity, of course. To understand whether this is a potential reality, we need to take a closer look at Amazon’s customer proposition and analyse the strengths and opportunities within its operating model.

Understanding this will also help us to outline potential scenarios for the future and suggest ways in which other retail organisations can compete against them.

“*If you’re long-term oriented, customer interests and shareholder interests are aligned.*”

Jeff Bezos
**Growth first, profit second**

Amazon is the e-commerce ‘one-stop-shop.’ Its proposition is clear and terrifyingly simple for its competitors (see Fig. 1). They offer convenience and choice, and they often equal the lowest prices. If you don’t know what you want, look on Amazon, find it, then choose the required delivery terms and the cheapest price. Simple. They target all customer segments and now have 120 million SKUs at prices in line with the market, but with market leading convenience. In today’s climate where differentiation on price, product or convenience marks out the retail winners, it’s obvious why Amazon is in our top four.

![Fig. 1](image)

**Convenience**

Amazon’s ‘customer obsession’ means that it is constantly looking for ways to increase convenience and improve the customer experience. It leads the market in leveraging the opportunities presented by disruptive technological advances and ‘wowing’ the customer with greater convenience. Platform innovations speed up the transaction process, while delivery times are among the shortest in the industry and supported by a variety of delivery options including ‘commuter lockers’ for customers who don’t want the hassle of missed deliveries. Amazon has set the standard for e-commerce convenience.

**Choice**

Amazon clearly represents the definition of customer choice. If you can’t find what you want on Amazon, it comes as a shock. Although it started as a book seller, the business has consistently extended its product range over more and more categories so that products as diverse as pet supplies, streaming videos, computer accessories and clothing are all available. A large proportion of products are offered through its Marketplace and are merely fulfilled by Amazon, but the key thing as far as the customer is concerned is that they found the product on Amazon. This diverse choice for the customer is increasingly extending into service offerings such as Amazon Prime, with the single objective of driving traffic through the Amazon platform. According to research firm Consumer Intelligence Research Partners, the average US Prime customer will spend $1,500 in 2014 - $800 more than non-Prime customers per annum.

**Price**

The final element of the value proposition is price. All this extra convenience comes at no extra price to the customer. Better than that, Amazon is very rarely found to be more expensive than the competition. Industry research has revealed that Amazon has a 5-13% price advantage over its competitors.

There are two consequences to this price limiting strategy – the first is that low prices set the standard for the market and increase the barriers to entry for would-be e-commerce competitors. The second, and an equally worrying consequence for its competitors, is that the low prices drive even more traffic and market share for Amazon.

So it’s a proposition that has significant appeal to customers, but just how appealing is it to investors? How will Amazon make a profit through this customer proposition?
The growth strategy

When Amazon was still in its infancy, Jeff Bezos drew a flywheel diagram on a napkin to explain Amazon’s growth strategy (see Fig. 2). That strategy hasn’t changed. A flywheel collects energy over time and then releases it quickly, at rates that exceed the ability of the energy source. So in Amazon terms, energy is collected from an improved customer experience, which drives traffic to the site, which in turn attracts sellers (either directly through Amazon or via Amazon’s fulfilment channel), which increases choice. This further enhances the customer experience, which drives traffic to the site and so on.

Through increased growth, so the argument follows, economies of scale lower the cost structure of the business, driving profitability and the ability to lower prices, further improving the customer experience. This, in turn, injects energy (growth) back into the flywheel.

The core principle behind this strategy is to continuously lower the cost per transaction which Amazon has successfully implemented for many of its longstanding categories, as we will describe later in this article.

These two complementary virtuous circles are essentially the promise that inspires the shareholder’s confidence in future returns. The key question to ask is whether growth will lead to a lower cost structure (especially the cost per transaction).

If so, then the model works. However, if increasing growth comes at the expense of higher complexity, then the promised economies of scale lowering the cost structure might never be realised. In this scenario, Amazon’s shareholders might never see a return on their investment. So just how complex is the Amazon operating model?

Fig. 2
Let’s take the three driving principles of Amazon’s value proposition - Convenience, Choice and Price - and understand how these are embedded into the operating model. A general observation is that, as simple as the model seems from the outside, the more complex it often is on the inside. Amazon is no exception. To achieve its simple, very appealing customer proposition of convenience, choice and low price, there is a huge and complex organisation responsible for delivery.

If Aldi’s stick of rock had ‘low cost’ written through its core, then Amazon’s stick of rock would have ‘customer obsession’. The business is firmly anchored and organised around this value proposition. But is it possible to be profitable when you are organised like this?

From the outside it seems that Amazon does not operate profitably, but it is definitely worth exploring this in a little more detail. Some propositions/business units are highly profitable – let’s take Amazon Prime as an example.

As Fig. 3 illustrates, Amazon Prime - a subscription-based service offering a mixture of services, content and products - delivered profitable returns for the company in 2012. Since then, further enhancements have been made to this offer to expand its attractiveness (and profitability).

**Convenience**

If we look at convenience to begin with, it’s clear that this is delivered principally through innovation and fulfilment. All innovations are religiously targeted at solving problems for customers. Amazon is set up to innovate with a scale and rapidity that others can only dream of. It helps, of course, that they are (relatively) unencumbered with legacy systems and so have less constraints to contend with than more established retailers.

That is only a small part of the jigsaw puzzle though. What sets them apart from others is their attitude towards innovation. It’s in their mindset, stemming from their start-up days, and it’s hard-wired into the organisational culture.

In order to be first to market in the digital age, it is important to get the right people together to work on a solution to an opportunity they see in the marketplace, then to test and launch very quickly. Amazon have retained this ability by keeping the platform development largely in Seattle, close to the leadership, where very bright people are able to produce mainly technology-based solutions which can be rolled out globally. It is the classic centre of excellence that holds the principal organisational power due to its proximity to Jeff Bezos.

Customer obsession permeates through into fulfilment. The operations teams work from huge purpose-built, semi-automated facilities, managing processes which are constantly redesigned to support the rapidly changing and expanding convenience proposition.

When exceptions to the processes occur, in order to maintain the mantra of customer obsession, those exceptions are dealt with at an individual transaction level. This is where theory and practical reality collide.

When things go wrong, dealing with these exceptions to the process result in a mountain of additional work: firstly to deal with the exception, and secondly to redesign and simplify the process to reduce these exceptions in the future with the goal of reducing cost. It is clear from customer review forums, however, that Amazon struggles to handle these exceptions both effectively for the customer and efficiently in terms of minimal cost for the business. The need to handle this increasing complexity results in large support teams (such as IT support, capacity planners, operations managers, customer experience teams and others) and subsequently higher rather than lower cost.

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**Fig. 3**

Amazon Prime Financials 2012
Choice
When it comes to choice, Amazon’s customer obsession drives a 'just do it' mentality. Local product managers are incentivised to expand their selection either through increasing the choice offered directly by Amazon or by increasing the number of SKUs offered through the Amazon marketplace (vendors who sell their products through Amazon’s platform with fulfilment carried out by Amazon). The first priority is to get the products and services in, the second priority is to worry about the consequences.

Since 1994 Amazon has expanded its assortment continuously. In recent years, more and more categories have been added to widen the choice. In mature categories such as books (the launch category), Amazon has collected a wealth of operational experience and perfected its operation, often destroying the competition and delivering healthy and sustainable profit margins. The rapid expansion of the assortment, especially in the last decade, has multiplied the complexity introduced by multiple categories in early stages of maturity. At an aggregate level, this has made it extremely difficult to maintain the profit margins (Fig. 4).

The resulting question is whether the relentless pursuit of broadening customer choice is sustainable in the long-term? A good example where the answer was clearly ‘no’ was when Amazon launched a white goods offer in the UK, only to withdraw the category due to the complexity involved in reverse logistics with its onerous legal requirements.

If sensibly applied though, expanding choice represents a powerful mechanism of growth. Success in the market has brought a war chest of capital that has enabled the senior team to enhance customer choice by acquiring start-ups and intellectual property, bringing new propositions to the market – focussing on delivery platforms, services and content. LoveFilm and Kindle are examples. These new businesses have been bolted on to the existing operations with varying degrees of synergy.

Once again though, the fulfilment operation is left to deal with this additional complexity and deliver customer choice while trying to prevent operational costs from spiralling out of control.

A traditional brick and mortar retailer will use category management techniques to enable customers to navigate the store and easily find the products they want. Amazon’s huge breadth of products and services makes it confusing for the customer unless they have a clear idea of what they want to purchase. The customer shopping experience can feel more like a visit to a car boot sale rather than the structured aisles of a physical store. Opportunities clearly exist here for Amazon to collaborate with tier one suppliers to improve their category management and move beyond product introduction, price and promotions.

In our opinion deploying category management processes for the online environment are an imperative for the future – not only for Amazon but for all retailers that offer choice. In this context partnering with data aggregators who can provide additional data points offering a holistic view of the customer represents a winning formula. A key question though will be how to incorporate this into the operating model.

Price
Finally, how does Amazon deliver either market leading (i.e. the lowest) price or a price matched with the lowest in the market? Amazon’s phenomenal growth can be attributed to the fact that the customer hasn’t had to pay for the market-leading choice and convenience that we have previously discussed.

The ‘just-do-it’ mentality is a strong driver behind price. Instead of linking price to the cost of production and fulfilment, price is matched to the market price. The local product manager retains accountability for volumes and margin, and uses a sophisticated price matching tool which automatically alters prices to match the lowest in the market. This keeps price and consequently margins low, but also highlights products where the margin has been eroded too much, enabling the product manager to manipulate manually.

The tool is self-teaching with the ultimate goal that it will not need human intervention. The strategic risk for Amazon is that a sustainable margin cannot be achieved given that Amazon itself is driving the market to offer cut-throat prices across many categories.
Returning to the flywheel, the key question was whether growth will lead to a lower cost structure, without which Amazon fails ultimately to make a profit. The growth aspect of the model is not in question: we agree that the strong focus on the customer proposition combined with the structure and mindset of the business will continue to deliver an enhanced customer experience through reduced prices, greater choice and greater convenience. This in turn attracts more vendors and more customers.

However, in the meantime, the business is ‘baking in’ complexity in pursuit of growth, raising the prospect that the costs associated with this complexity may outweigh the benefits of economies of scale in the future.

This raises two questions: will this ever-increasing complexity reach a point where it destabilises the ecosystem, and how long can Amazon maintain its focus on growth at the expense of profit? Until recently the shareholder community has been content that they offer such breadth and depth of choice and convenience at market leading prices that their growth seems unassailable. What is clear though, is that not many alongside Amazon can get away with such a strategy. So, if you can’t or don’t want to join Amazon, how do you beat them, or more realistically, make profit in their wake?

Our discussion so far raises a number of likely scenarios for the future with varying consequences for competitors. Examining these scenarios should be useful for competitors in planning where they ought to attempt to profitably compete in the future. In the short-term, the course is set: Amazon will continue to gain market share, specifically in many of their traditional competitors’ home markets. The majority of their traditional competitors have historically generated the lion’s share of their profits in their home markets in order to fund both overseas growth and the necessary infrastructure investments to develop their own omni-channel capabilities. Amazon will increasingly damage these domestic market profits with significant consequences for investment capital availability in the future.

However, over the medium-term, with the acquisitions and increased service and product offerings that Amazon has made in order to drive growth, there is a risk it will resemble the first 1980s style conglomerate of the internet age. Even though Amazon’s goal remains driving traffic to their platform, there are few synergies between the various business units, and where there are, these are outweighed by structural complexity that the business has been unable to streamline. In this scenario, the business’s investors are likely to eventually question and start deserting the business, potentially resulting in the need for the behemoth to dismantle itself. This may accelerate should customers also desert the business in the face of mounting stories in the press questioning their bullyboy tactics and poor service levels when dealing with the previously mentioned exceptions to the customer experience. However, waiting for a competitor to self-destruct (especially a behemoth like Amazon) is not a good starting point for any competitor strategy.

Amazon may not overcome the challenge of rising complexity but they may find a way to generate higher margins by shifting away from commodity products towards a greater focus on services, particularly subscription-based, thereby fulfilling the promise of the flywheel. In this scenario, the business is able to generate sufficient profit to be both reinvested and returned to shareholders and maintain its dominant market position. With such a breadth of products and services, Amazon will have the opportunity to develop real insight into customer behaviour by analysing data at an aggregated level. This represents a major opportunity for Amazon and it is part of the macro trend of power in the consumer sector moving away from the consumer and towards the data aggregator. The few players in the industry who are able to exploit customer information at this holistic level will derive much power as a result. Amazon is likely, in this scenario, to be one of them.

“The Internet in general, and Amazon.com in particular, is still in Chapter One.”

Jeff Bezos
What options are there for retailers to compete?

Competing on choice is unrealistic. It is impossible to recreate the Amazon Way (rainforest or business) overnight. The conundrum for many competitors is how to balance choice against the constant aim of lowering the cost per transaction. Adding choice will nearly always lead to added complexity. It is quite acceptable to have different business models - the key, though, is to manage that complexity and ensure costs do not spiral out of control. Increased investment in IT systems remains a must, but as we have analysed in our recent report ‘Digital Last’, these bets need to be carefully placed.

So what does that leave?

We do not believe that trying to create an exact replica of Amazon is the right answer. However, copying their philosophy of ‘customer obsession’ is an approach that can deliver success. We don’t mean customer obsession that generates internal complexity. We do mean customer obsession that sets out to really understand your customers, supported by an infrastructure that can deliver your proposition and generate profit. With clarity about who your customers are and what your winning proposition is, you will be able to provide the right (narrow) range of great products and services targeting specific customer needs. A key ingredient to underpin success is deploying a scalable and well architected operating model. This is something we have experienced extensively in other sectors such as IT services and Media.

A personalised service is a further option as it is something that the increasingly faceless Amazon fails to provide. As referred to earlier, the Amazon customer experience is akin to shopping in a giant car boot sale.

Where the necessity is to compete on convenience, retailers need to modify their operating model to enable the rapid designing and testing of new initiatives. To that end, data-driven A/B testing is an approach to adopt as standard.

Personalising the shopping experience, combining retail ‘theatre’ and personal interactions in store and the convenience offered by online is a powerful weapon. Will customers prioritise experience over convenience or price, or is it possible to combine? We believe if you get your business AND operating model right, it is.

One of Amazon’s attempts to move out of its cost conundrum is to branch out into subscription-based service offerings. As a number of retailers have already demonstrated, there’s an opportunity to offer subscription services for both commodity products such as mobile phones and premium content-based services like Tesco’s Blinkbox. Gazing into the future, could, for example, detergents be combined with the purchase of a washing machine on a subscription model?

So far, our focus has been on the customer, but at the other end of the chain, are the suppliers. Suppliers will be similarly unnerved by Amazon’s potential dominance of the marketplace – being the junior partner with an all-powerful future Amazon is not an enjoyable prospect. One can see that a competitive advantage for retailers is possibly working with a number of tier 1 suppliers in a win-win relationship where the supplier gets a preferential margin with a retailer who therefore has exclusive access to products Amazon doesn’t list. In addition, utilising supplier capabilities such as R&D, marketing and category management, and entering a ‘true’ collaborative relationship could represent a major defensive mechanism against Amazon.

Summary

“You want to look at what other companies are doing. It’s very important not to be hermetically sealed. But you don’t want to look at it as if, ‘OK, we’re going to copy that.’ You want to look at it and say, ‘That’s very interesting. What can we be inspired to do as a result of that?’ And then put your own twist on it.’” Jeff Bezos.

Amazon will continue to be one of the largest business disruptors and will remain a serious competitive threat for many organisations, but will also create growth opportunities and inspiration for others.

We predict continued rapid growth for Amazon for many years to come but the journey will not be plain sailing. With the ever-increasing complexity and the need to continuously invest in the organisation, the quest for profitability will remain challenging and the business will be required to constantly transform itself.

The initial fear, and in some cases even paralysis, of their competitors has largely been overcome and effective strategies are being put in place to co-exist alongside Amazon. That being said, understanding the Amazon operating model and constantly focussing on the customer will remain an imperative for every retailer. Those who do not transform to embrace this will be left behind and subsequently perish.

The final word should go to Jeff Bezos: “The Internet in general, and Amazon.com in particular, is still in Chapter One.”
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