

Amazon 2018

Business Strategy and Financial Strategy

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Introduction

With sales of \$178 billion, Amazon.com, Inc. was the biggest internet retailer in the world in 2017, and with around 250 million items in its catalogue it was considered to be the biggest general store worldwide.

Amazon's annual growth (average 36% in the last decade), in spite of its big size, was striking. In comparison, the average annual growth rate of the retail business in the U.S. was only 2% in the last decade. Amazon was expected to reach \$250 billion in sales by the end of 2018, driven by low prices, its wide range of products, and its positive customer experience.

As a result of Amazon's strong growth, the market capitalization of Amazon had tripled in the last 4 years (2013-17) reaching \$566 billion. All these factors attracted the interest of investors, analysts, regulators, and the public.

In February 2018, John Allen, a fund manager, was considering the possibility of buying shares of Amazon. John collected the financial statements of Amazon from 1995 to 2017. The first step was to simplify the financial statements so that he could get clear conclusions out of the numbers (see **Exhibits 1 and 2**).

John also gathered plenty of information available on the web but relied mainly on the Annual Report Form 10-K,¹ submitted to the Securities and Exchange Commission (SEC) for the fiscal year of 2017.

¹ A 10-K form gives a comprehensive summary of a company's financial performance: audited financial statements, company history, organizational structure, executive compensation, equity, subsidiaries, among other information. Form 10-K, as well as other SEC filings, can be searched using the EDGAR database on the SEC's website. Although similarly named, the annual report on Form 10-K is distinct from the "annual report to shareholders".

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Remembering his time as an MBA student, John summarized the main facts in a case study that could be discussed afterwards. In fact, the case would be a summary of the 10-K Form in a more palatable format.

Prior to the valuation process, John wanted to understand the business, its past, present, perspectives, and risks. He wanted solid opinions based on data. Afterwards, he would do the valuation to decide whether to buy Amazon's shares or not.

Now, take the role of John and do your own analysis of Amazon.

Amazon's Mission and Principles

Amazon is guided by four principles: *"customer obsession rather than competitor focus, passion for invention, commitment to operational excellence, and long-term thinking."*²

Amazon's Main Businesses (Products and Customers)

Amazon's customers consist of retail consumers, sellers, developers, enterprises, and content creators. Amazon operates in many businesses, which can be summarized in the following five categories.

Online retailer. Amazon sells virtually everything (250 million references in its catalogue) to hundreds of millions of customers in the entire world. Sales of products reached \$108 billion, or 61% of Amazon's total sales. Accumulated growth in the last three years (2014-17) was 58% (see **Exhibit 3, Table 1**). Cost of goods sold were reported in the P&L as 94% of sales. Many analysts attributed the growth to the success of the Amazon Prime program.³ The investments (and expenses) in logistics and web development, required for this business, were huge.

Amazon also manufactures and sells electronic devices, including Kindle e-readers, Fire tablets, Fire TVs, and Echo, and develops and produces media content. Their retail strategy focuses on selection, low prices, and convenience.

Marketplace or Third party seller services. Around 2 million sellers from 100 countries sell their products through Amazon Marketplace. These sales represent around half of the 4 billion items sold by Amazon. For this service Amazon charges a fixed fee and/or a percentage of sales that are accounted in the P&L as services. Amazon offers all type of services to third party sellers, like web, marketing, fulfillment (logistics, transportation, customer services, etc.).

Revenue from third party seller services reached \$32 billion or 18% of Amazon's total sales and this business was growing very fast. Accumulated growth in the last three years (2014-17) was 171% (see **Exhibit 3, Table 1**). Estimates suggest that Amazon has a higher operating profit in its marketplace than with its own products sold.

Subscription services. Includes annual/monthly fees associated with the Amazon Prime membership, audiobooks, e-books, digital video, digital music, etc.

² Phrases in italic format are taken literally from Amazon's 10-K Form.

³ Prime subscriptions are estimated to be at around 60 to 90 million in the U.S. alone. According to Amazon, these customers spend twice as much as other regular customers (around \$1,200/year).



Amazon web services (AWS). Amazon offers a broad set of global computing (cloud service), storage, database, and other services to companies and institutions. In 2017, AWS represented 10% of total revenue (\$17 billion), with an operating profit (EBIT) of \$4.3 billion, (105% of total EBIT of Amazon). It was also the segment with the highest growth, that is, 122% from 2015 to 2017 (see **Exhibit 3, Table 3** and **4**).

Content creators. Amazon offers programs that allow authors, musicians, filmmakers, app developers, and others to publish and sell content (Kindle Store, Amazon Publishing, etc.).

Physical stores. This segment was created in 2017 and it includes bookstores, pop-ups, and *amazon 4-stars*,⁴ which together represent 3% of Amazon's sales mix and \$6 billion (see **Exhibit 3, Table 1**). With the acquisition of Whole Foods, Amazon is also moving into grocery stores.

Other. Represents sales not otherwise included in the previous business categories, such as certain advertising services and the co-branded credit card agreements.

Sales of each business category are presented in **Exhibit 3, Table 1**; the geographical distribution of sales is shown in **Table 2**. Amazon does not provide information about profitability of its businesses; all the information is related to what Amazon calls "segments".

Market Segments

Amazon has organized its operations into three market segments: North America, International, and AWS.⁵ See **Exhibit 3**, with the following information:

- Sales by market segment (**Table 3**).
- Operating income (EBIT) by market segment (**Table 4**).
- Total assets by market segment (**Table 5**).
- ROA (return on assets) by market segment (**Table 6**).
- Retail industry and competition (**Table 7**).

P&L Comments

Amazon's P&L and balance sheet for years 2013-2017 are presented in **Exhibits 1** and **2**.⁶

- Net sale of products refers to sales in the retail business; net sale of services refers to the revenue from all other business segments (third-party seller or Marketplace, AWS, etc.). The breakdown of revenue by business segments is shown in **Exhibit 3, Table 1**.
- Amazon reports that usually 33% of annual sales are generated in the fourth quarter.
- Cost of revenue refers to the purchasing price of products from suppliers plus shipping costs; it is mainly part of the retail business.

⁴ Amazon 4-stars are physical supermarkets located in big cities. They sell the best-rated and the best-selling products from amazon.

⁵ Annual report 2017, page 68, Note 11 Segment information.

⁶ In the Excel doc (available on the web), you may see the P&L and balance sheet from 1995 to 2017.