

## How Amazon.com survived, thrived and turned a profit

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[http://seattlepi.nwsourc.com/business/158315\\_amazon28.html](http://seattlepi.nwsourc.com/business/158315_amazon28.html)  
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### ***E-tailer defied predictions it would do none of those***

Unfettered by the rules of the old economy -- that profits drive stock value -- Amazon.com Inc. was the poster child for the new Internet economy with its dynamic, young chief executive and highly valued stock. But when the technology bubble burst, the company quickly morphed from poster child into punching bag, an example of Internet economics and excess.

Unlike many of its e-commerce counterparts, however, Amazon survived. And yesterday the company posted its first annual profit, a milestone that many analysts and observers never thought it would reach.

Now the company is more than just surviving, it's made itself the undisputed leader of Internet commerce. Taking its cue from old and new ways of doing business, its model today has helped the company to grow into a multibillion-dollar business -- more important, one that can turn a profit.

Nearly a decade after Jeff Bezos founded Amazon in a Bellevue garage, analysts again are predicting good things from Seattle's biggest Internet venture, from new online stores to international expansion, even further strengthening its dominating presence on the Web.

Seattle businessman Nick Hanauer, an early investor who is credited with persuading Bezos to move to Seattle in the summer of 1994, knew the company would one day turn a profit.

"What few people understood was that the reason that they didn't make money was that for the previous five years every time there was a trade-off between making more money or growing faster, we grew faster," said Hanauer, whose \$40,000 investment in Amazon once was valued at \$250 million. "It wasn't that there weren't lots of opportunities to make money. It was just that we had consciously foregone those opportunities to reach scale and make it impossible to duplicate what we had done. And voila!"

Yesterday's earnings report isn't the only upbeat news. Its stock has more than doubled in the past year. And some analysts expect the company to be continuously profitable from now on.

A few years ago that wasn't the case.



## **The dark ages of e-commerce**

After Bezos founded Amazon in 1994, he launched the Web site the following July with the idea of selling books to a mass audience through the Internet.

The Web site -- text heavy and gray -- wasn't pretty.

But that didn't concern Madrona Venture Group's Tom Alberg, who invested \$100,000 in Amazon in 1995.

"Even though it was the dark ages in terms of what everybody was doing, it worked and it worked pretty well," said Alberg, who recalls the site not listing book publication dates and other key information.

By the fourth month in business, the company was selling more than 100 books a day. That impressed Alberg -- who introduced Bezos to venture capitalists at Kleiner Perkins Caufield & Byers.

"I remember Jeff would call and say they got sales from New Hampshire and Florida," recalls Alberg, who continues to sit on the board. "It sounded pretty good, you know. Somebody from New Hampshire bought a book."

But Bezos created more than a bookstore; he created an online community. The site was revolutionary early on for allowing average consumers to create online product reviews. It not only drew people who wanted to buy books, but also those who wanted to research them before buying.

"Amazon was probably the first truly worldwide community that was built online," said Scott Lipsky, a former Amazon executive who now runs Seattle start-up RGB Labs. "They happened to sell books. But the simple fact that everyone was sharing their thoughts and book reviews made it a community unto itself, very much like eBay." Today, Lipsky -- who left Amazon in 1997 -- thinks the community of more than 39 million customers will help the company retain its lead over Wal-Mart, Barnes & Noble and others.

## **'Get big fast'**

In 1996, its first full fiscal year in business, Amazon generated \$15.7 million sales -- a figure that would increase by 800 percent the following year.

A year after going public in 1997, Amazon added music CDs and movie videos to the Web site, what many considered to be a wise move designed to complement the company's expansive book collection. Then the company, which touted itself as "Earth's biggest bookstore," demonstrated it had much bigger plans.

Amazon added five more product categories -- toys, electronics, software, video games and home improvement -- just a year later in time for the Christmas holiday.

It was an era of hypergrowth -- one later ridiculed by onlookers who believed Amazon's "Get Big Fast" strategy was doomed. But early investors and executives point to the rapid growth as a key to its success.

Hanauer to this day keeps a remnant of that period, an old T-shirt from an Amazon summer picnic that says: "Eat another hot dog, get big fast."

"That relentless focus on doing whatever it took to get to scale, understanding that turning profitable would not be easy but would have to follow that, was a brilliant insight," said Hanauer.

As a venture capitalist, Alberg has taken some heat for helping to create an atmosphere that led to the skyrocketing valuations of companies such as Amazon. But he, too, said Bezos -- who originally forecast profitability in the second or third year of existence -- seized an opportunity.

"The revolution in thinking was everybody saying you have a great opportunity to grow quickly here, money is available, so let's take advantage of it and use that money to grow quickly even if we lose money," said Alberg.

By the end of 1999, sales for the year surpassed the billion-dollar mark to \$1.6 billion. Investors had driven the company's stock to close at an all-time high of \$106.69 on Dec. 10. And that same month, Time magazine named Bezos "Person of the Year," calling him the "king of cybercommerce."



In just a few months, the king's crown would become tarnished.

### Amazon.toast

A month following Bezos' crowning in Time, the company fired 150 workers, mostly employees at its Seattle headquarters, as part of an internal reorganization. Just five days later, Amazon reported a loss of \$323 million for the holiday fourth quarter and promised that future losses would be lower. (The company, however, would later exceed that amount by more than \$200 million the following fourth quarter.)

By the summer of 2000, Amazon's stock price had dropped by more than two-thirds and analysts began to criticize the retailer for venturing into too many product categories and spreading itself too thin. One much publicized report by Lehman Brothers warned investors that the company might run out of cash and advised them to avoid its stock. Some on Wall Street speculated that Amazon would file for bankruptcy or that another company would buy it.

Naysayers nicknamed the company everything from Amazon.bomb to Amazon.toast as they predicted the collapse of the world's largest e-tailer.

In early 2001 -- when Amazon reported a whopping fiscal loss of \$1.4 billion, which remains the company's worst annual performance -- Bezos finally had an answer.

### Changing focus

The chief executive told analysts in January 2001 that Amazon would report a profit by year's end. But to do so the company had to cut expenses and restructure its business model.

Amazon started the new year by laying off 1,300 workers (about 15 percent of its work force), closing two warehouses and shutting down a Seattle customer-service center.

Bezos followed with a memo calling for the company to "get the crap out" and stop selling products that weren't profitable.

At the same time, Amazon concentrated on better managing the merchandise it would carry, from delivering packages presorted by geography to postal hubs to developing complex algorithms that analyze relationships between items that people buy so they could be grouped in the same warehouse.

The company also looked to bolster its offering online -- not by expanding its own warehouse inventory but by selling products in other companies' warehouses.

Amazon transformed itself from a specialty retailer into an online shopping portal, taking a cue from auctioneer eBay, which set itself up as a mediator between buyer and seller. It started selling products

from companies such as Toys "R" Us and Target on its Web site. It added merchandise from smaller retailers in its zShops. And it competed directly with eBay through its Amazon Auctions.

Most recently, Amazon launched product categories with merchandise from other retailers. Its apparel store, for instance, debuted in the fall of 2002 stocked with underwear, sweaters and jeans from companies such as Nordstrom and Gap.

Although Amazon lists the merchandise on its Web site, it does not actually take control of the inventory; the individual vendors are responsible for fulfilling their orders. Amazon, however, receives a cut from the sales. Amazon's sales from third-party vendors are still a small percentage of its total revenue, but the margins are higher.

"The more things they can sell to (customers) and not do the dirty work, the better the business grows," said Kate Delhagen, a retail analyst with Forrester Research.

And by the end of 2001, Bezos came through on his word -- in fact, he did even better. The company reported its first profit -- based on generally accepted accounting principals and not on a pro forma basis as expected -- with fourth-quarter earnings of \$5 million.

### **New technology and partners**

But the company knew that one quarter of profits -- especially one that eked out earnings of just 1 cent a share -- wouldn't be enough.

Amazon has since posted quarterly profits in the fourth quarter of 2002 and in the third quarter of 2003, the first non-holiday quarter to post earnings. And yesterday's fourth-quarter profit report is the first time that Amazon has reported two quarters of earnings back to back.

But to do so, it has had to continually drive sales and refine its changing business. The company launched a free shipping promotion that eliminated the fee for orders of more than \$99. After several tests, the company settled on a \$25 price point last year. And it continues to offer discounts on merchandise, offering consumers personalized daily deals on everything from kitchenware to computer hardware.

In the past few months, Amazon has rapidly expanded the number of product categories on its site. It added four new stores, currently in beta, just before the holiday season: sporting goods, gourmet foods, jewelry, and health and beauty. Customers can now buy everything from soccer balls to Alaska smoked salmon to three-stone sapphire rings.

The company will also likely unveil new technology developments. One of its most recent, which debuted in November, lets customers search for words that appear in books and view the text. Amazon has been reported to be working on its own search engine that would possibly compete with Google.

The company might also look overseas to grow its business, opening new stores on its international Web sites or launch Amazon in other Asia-Pacific and European countries where it does not currently exist.

"I think what's key here, the company is always thinking about changes in the marketplace dynamics, consumers' behavior and how they can best be relevant and address consumers," said Jeetil Patel, senior analyst at Deutsche Bank Securities, which has an investment in Amazon.

### **'An alien life form'**

Nearly 10 years after Jeff Bezos founded Amazon in Seattle, his name remains synonymous with the company. The 40-year-old, known for his trademark laugh, has been the face of the company since its inception.

Hanauer doesn't get the sense that his longtime friend -- who he describes as "the smartest man in the world" -- is getting ready to turn over the reins anytime soon.

"He is absolutely as single-mindedly focused now on Amazon as he ever was. He works just as hard today as he did on the first day. He has lost none of his enthusiasm," said Hanauer. "He is an alien life form. I am serious, honestly. He is wired different than any other human I know."

At a lunch two months ago, Lipsky -- the former Amazon executive -- asked Bezos whether he would consider doing another start-up. The answer was a resounding no.

"He really doesn't miss being the small company entrepreneur," said Lipsky. "He seems very comfortable being the king of a very successful and growing empire."

That may be the case. But some believe Amazon needs to do more to build executive management bench strength. For now, though, Bezos is still firmly in control.

And he has not lost his passion for making the online consumer's experience better. That's the mantra he used to build Amazon over the past decade. And it's something that he still preaches to this day.

"The better you can make your customer experience ... the more customers you'll attract, the larger share of that household's purchases you will attract," Bezos said during a conference call after yesterday's earnings announcement. "You can become a bigger part of a customer's life by just simply doing a better job for them. It's a very, very simple-minded approach."

## **AMAZON.COM TIMELINE**

### **1994**

**July:** Amazon.com is founded by Jeff Bezos after the former investment banker leaves New York for Seattle with the idea of creating an online bookstore.

### **1995**

**July:** Web site launches and by the end of the month books are shipped to 50 states and 40 countries.

**October:** First 100-order day.

### **1997**

**May:** Amazon.com raises \$54 million in an initial public offering -- the same month that it is labeled Amazon.toast and Amazon.bomb by Forrester Research and Barron's.

**October:** Bezos hand delivers the company's 1 millionth order to a customer in Japan who buys a Windows NT manual and Kitty Kelly's "The Royals."

### **1998**

**June:** Amazon.com opens its music store.

**August:** Lease signed for 186,000 square feet of office space at the old veterans hospital on Beacon Hill.

### **1999**

**February:** Amazon.com buys a 46 percent stake in Bellevue-based drugstore.com.

**March:** Trying to keep up with eBay, Amazon.com opens its auction business.

**April:** Amazon.com settles a lawsuit brought by Wal-Mart, agreeing to reassign employees who had knowledge of the Arkansas retailer's computer systems.

**July:** Amazon.com opens its electronics and toy stores.

**October:** Jeff Bezos says it would be a mistake to press for profits too quickly at the expense of new investments that could draw customers.

**November:** Cumulative losses now exceed \$550 million. For the first time, analysts express frustration and lower ratings on the stock. Customer growth and revenues per customer decline.

**December:** Bezos is chosen as Time magazine's person of the year.

## 2000

**January:** Amazon.com invests about \$60 million in Kozmo.com, an online service that delivers snacks, videos and other items to homes and businesses. Kozmo.com closes less than a year and half later after it runs out of money.

**February 2000:** After losing \$390 million in the previous year, Bezos declares that "driving toward profitability" is a top priority.

**June 2000:** Suffers its second-largest stock drop -- 19 percent -- as investors reacted to an analyst report that said the online retailer could run out of cash by the end of the year. An Amazon.com spokesman calls the report "pure hogwash."

**November:** Amazon.com opens its Japanese site -- the company's fourth international Web site.

## 2001

**January:** Amazon.com announces plans to cut 1,300 workers, or 15 percent of the 8,500-employee work force.

**February:** An analyst with a history of tackling Amazon.com filed the company with a report warning that the Internet retailer will run out of money this year. Amazon spokesman calls the report "silly" adding, "We have plenty of moolah to pay our bills."

**April:** Amazon.com partners with Borders to run the company's online bookselling business.

**April:** "Ouch," begins Bezos' annual letter to shareholders this year, which notes "it's been a brutal year."

## 2002

**January:** Amazon surprises critics -- and some fans -- by reporting a fourth-quarter profit of \$5 million, the company's first.

**August:** Customers who spend more than \$25 on Amazon.com qualify for free shipping.

**August:** Former General Electric executive Thomas Szkutak, at left, joins Amazon.com as chief financial officer, replacing Warren Jenson.

## 2003

**January:** Amazon.com records its second profit.

**September:** A9 -- Amazon.com's online search engine subsidiary -- is established in Palo Alto, Calif.

**October:** Amazon.com unveils a new technology called "Search Inside the Book" that allows consumers to preview text of 120,000 books.

**October:** Amazon.com posts its first non-holiday profit of \$15.6 million.

## 2004

**January:** Amazon.com posts its first-ever annual profit.

## INNOVATIONS

Over the years, Amazon.com has invested in a number of e-commerce companies, partnered with other retailers and developed new technology. While some of its innovations have improved the online consumer experience and generated sales, some of its attempts have failed. Here's a look at a few of them.

### Hits

- **Online reviews:** Amazon lets customers submit feedback on books and other products sold on the site. It becomes a popular online feature as consumers flock to share their thoughts with millions.
- **zShops:** Amazon charges other merchants a monthly fee to sell their wares on the Web site. zShops have higher profit margins than the company's own direct sales. Merchants who sell their products through zShops pay Amazon a monthly fee of \$39.99 and a closing fee of 5 percent on items sold for \$25 or less.
- **Wish Lists:** Customers can create lists of the products that they want from Amazon.com and save the list for online viewing by others.
- **Free shipping:** After testing several price points, Amazon eliminates shipping fees for orders of more than \$25, its lowest price point yet. Although it costs the company in additional shipping expenses, the move boosts sales and Amazon decides to maintain the offer indefinitely.

### Misses

- **Charging for book recommendations:** Amazon charges publishers for placement of books on the Web site. After media reports disclose the practice, Amazon says it will tell customers when publishers have paid for its recommendation.
- **Pets.com:** Amazon agrees to buy 50 percent of the online pet supply store. Less than two years later, Pets.com says it will close after failing to raise additional financing. Its stock is worth 22 cents a share after it announces its closure.
- **Kozmo.com:** Amazon invests \$60 million in the company, which home delivers videos and snacks ordered on the Internet. (Fellow Seattle company Starbucks Corp. is also an investor.) Kozmo.com announces it will close less than a year-and-a-half later after it cannot obtain additional funding.
- **Living.com:** Amazon invests in the online home furnishing store and agreed to add a Living.com tab on its Web site in return for \$145 million over five years. Just six months later, Living.com announces that it would file for Chapter 7 bankruptcy protection. Living.com is now the Web site for the Fine Living television channel.

**Sources:** Amazon.com, IPO Monitor and Forrester Research Inc.