
# Amazon: A Not-for-Profit Organisation?

**The subject rears its head every time that Amazon releases financial results: the company is not making any profits.**

July 2014 was no exception to this rule. Quarterly sales (April-June 2014) rose 23% from the same period of 2013 to $19.34 billion, but it still managed to lose a hefty $126 million (compared with $7 million a year earlier).

This phenomenon continues to recur, so much so that Amazon has become the object of mockery by certain commentators that pull out all the stops when they describe the firm:

*"Amazon, as best I can tell, is a charitable organisation being run by elements of the investment community for the benefit of consumers."* (Matthew Yglesias, *Slate*).

Kurt Salmon

**Delving deeper, how much of this is reality and how much is exaggeration? How can one explain such a situation? Is it a serious problem? And what are the options—and the risks—facing Amazon?**

A look back at the progress of revenue and net income over the past 16 years paints a seemingly inescapable picture (see Exhibit 1):

» Sales have gone through the roof while profits have remained rooted to the floor

» Over the past three fiscal years (2011 to 2013) the average net return was just 0.5%

» It is therefore fair to say that Amazon makes no, or very little, profit

But what do these numbers really mean? At the end of the day, not a lot.

To draw conclusions from this would be premature, as this picture is pretty much a helicopter view and the "net income" number is not really relevant to a company like Amazon.

At this point in the analysis it seems like a good time to ask: How come profits have stalled while revenue has increased so quickly?

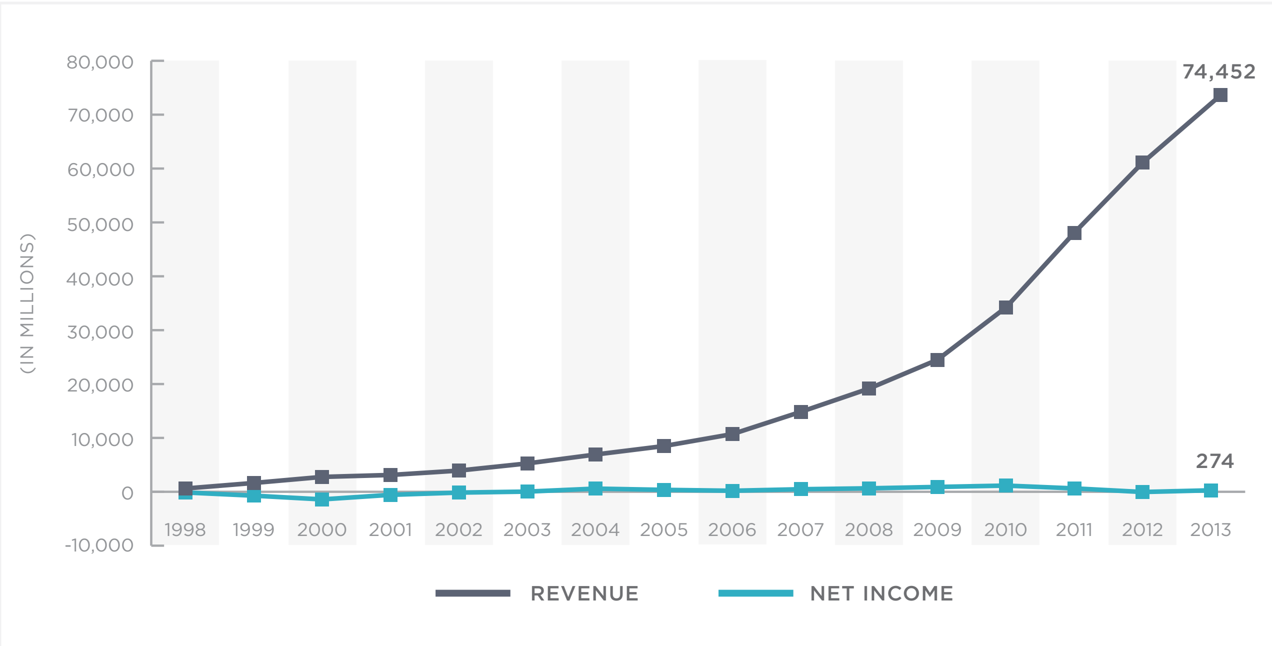
The only possible answer is that P&L components such as COGS, cost of operations and amortisation have increased.

To identify the costs in question, we can test three theories:

1. Amazon is obliged to sell at ever-smaller margins to sustain its growth.
2. Keeping customer service-related promises, Amazon's key strength, has become increasingly expensive.
3. Amazon deliberately invests in a way that results in either no profit or an insignificant one.

It should be noted that Amazon deliberately refuses to reveal the granularity of data needed to answer these questions beyond any doubt. The analysis presented in the remainder of this article seeks to

**Exhibit 1:** Amazon's revenue and net income



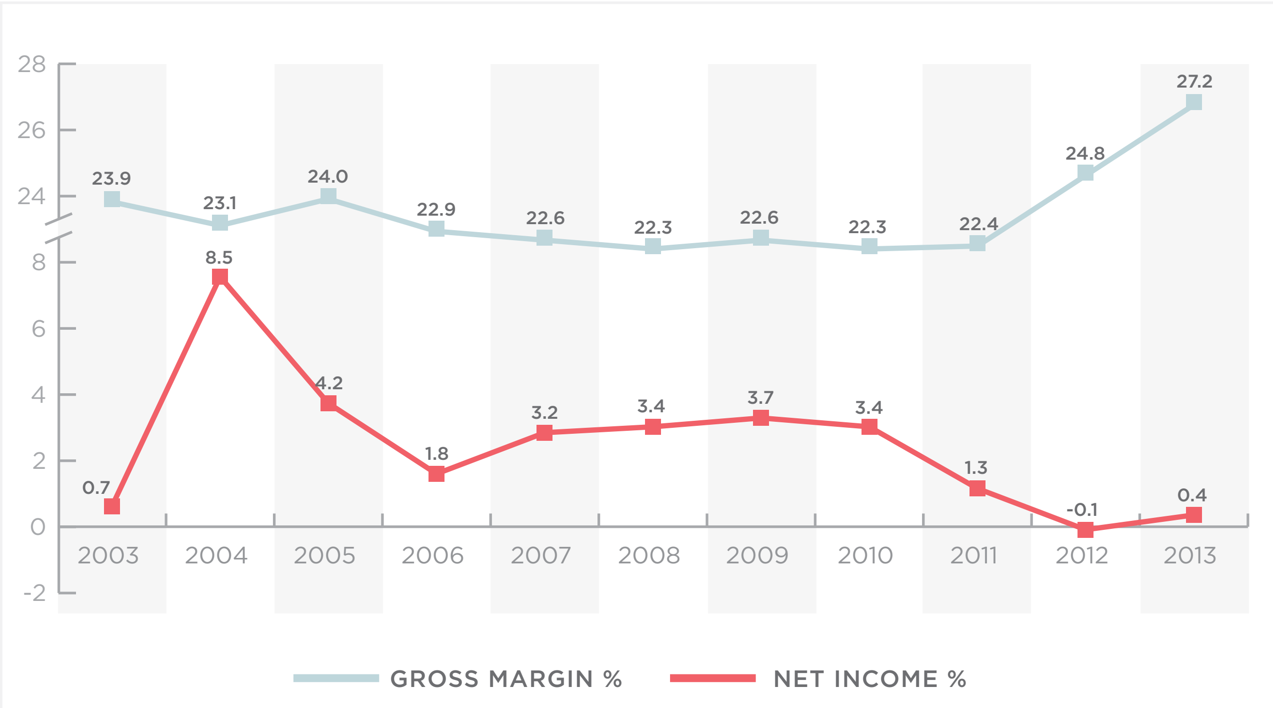



**Exhibit 2:** Amazon's Gross Margin and Net Income as % of Total Revenue

shed some light on these issues, but cannot deliver a definitive answer.

## THEORY 1: AMAZON IS OBLIGED TO SELL AT EVER-SMALLER MARGINS TO SUSTAIN ITS GROWTH.

First, a comparison of the evolution of gross margin (revenue minus cost of sales, which includes price effect) and net income over the past 10 years reveals the following, as shown in Exhibit 2:

- These two indicators do not seem correlated at all
- Over the past three years (2011 to 2013) Amazon has significantly increased its gross margin while its net income has dropped markedly

This analysis alone seems to refute the first theory.

But if Amazon's gross margin has improved, does that mean that the company is repositioning itself and increasing its prices (the scorched earth strategy identified by some observers)?

This seems highly unlikely. What is the explanation, then?

Before answering, one needs to take a close look at Amazon's sources of revenue. Amazon has revealed very few details about this, simply dividing them into three business lines in its financial statements:

- **Media:** books, DVDs, music, computer software, etc.
- **Electronics & General Merchandise (EGM):** all physical goods sold by Amazon or by third parties (in its Marketplace) that do not fall under Media
- **Other:** mainly Amazon Web Services (AWS)

Let's take a look at the annual revenue of each of these three categories:

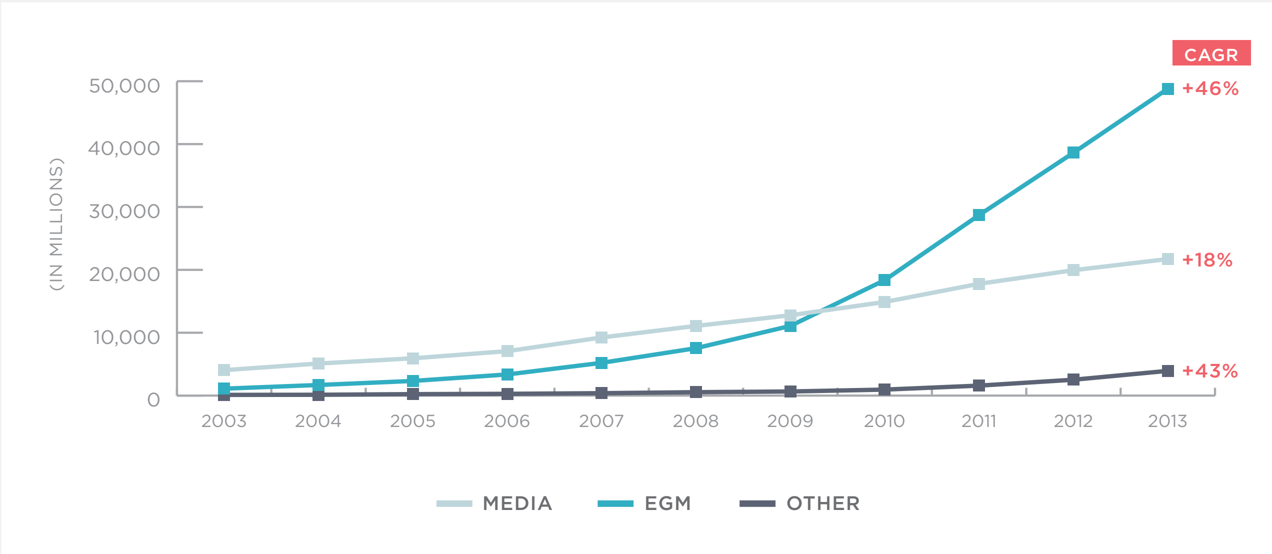



**Exhibit 3:** CAGR of Amazon's Three Major Revenue Sources

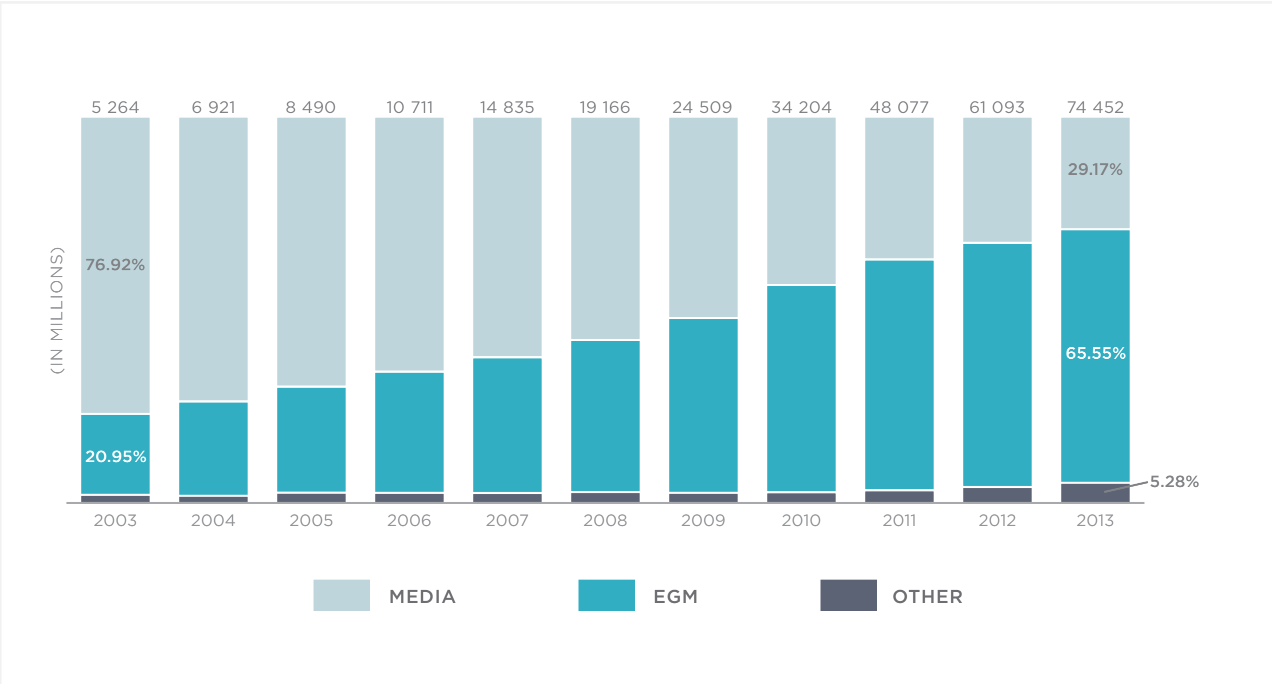



**Exhibit 4:** Breakdown of Total Revenue

» All three are growing
» With compound annual growth rates above 40%, EGM and Other (AWS) are the two parts of Amazon's business that are expanding significantly
» Media generated close to 77% of Amazon's revenue in 2003, but represented just 29% in 2013 (remember the depiction of Amazon as an online bookseller, now just a small part of its business?)
» Amazon currently generates two-thirds of its revenue from EGM

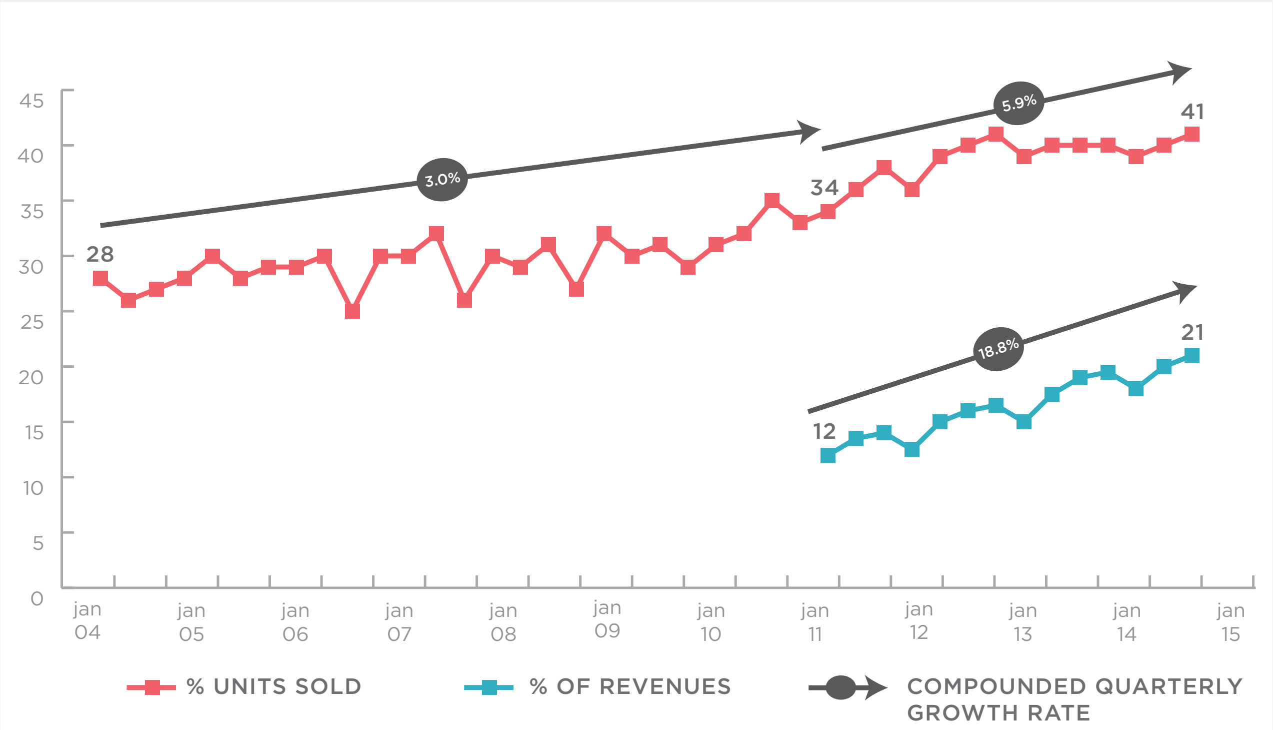
Notably, Amazon is not just a retailer; it is also a service provider for third-party companies, making its logistics and web platform (AWS) expertise available to other firms, with the dual benefit of spreading investment costs and generating additional revenue.

It is perhaps here that the reasons behind the improvement in Amazon's gross margin can be found.

A comparison of the number of third-party items sold via the Marketplace and the income from these activities sheds light on this. As seen in Exhibit 5:

» Third-party products now make up over 40% of Amazon's total sales volume
» The volume of third-party products sold on Amazon has risen steeply since 2011, with average quarterly growth of nearly 6%
» Third-party products represent over 20% of Amazon's total revenue
» This revenue has increased by a quarterly average of almost 19% since the beginning of 2011

**Exhibit 5:** Marketplace Sales as % of Total Units Sold and Overall Revenue



The revenue that Amazon earns from its Marketplace has therefore increased three times faster than the volume sold.

Amazon Marketplace revenue is based on sales fees made up of a fixed part (subscription for professional vendors and fees per item for individuals) and a variable part (sales management fees) that varies according to the product category and is indexed to the items' sales prices.

If Marketplace revenue has increased three times faster than the volume sold, it's either because the average price of items is rising substantially (highly unlikely at this level) or Amazon is regularly increasing its sales fees. This is in fact the case: for example, Amazon unilaterally upped commissions on the sale of cultural goods by 50% in February 2013.

Thus Amazon uses its Marketplace (among other things) as a tool to maximise its gross margin.

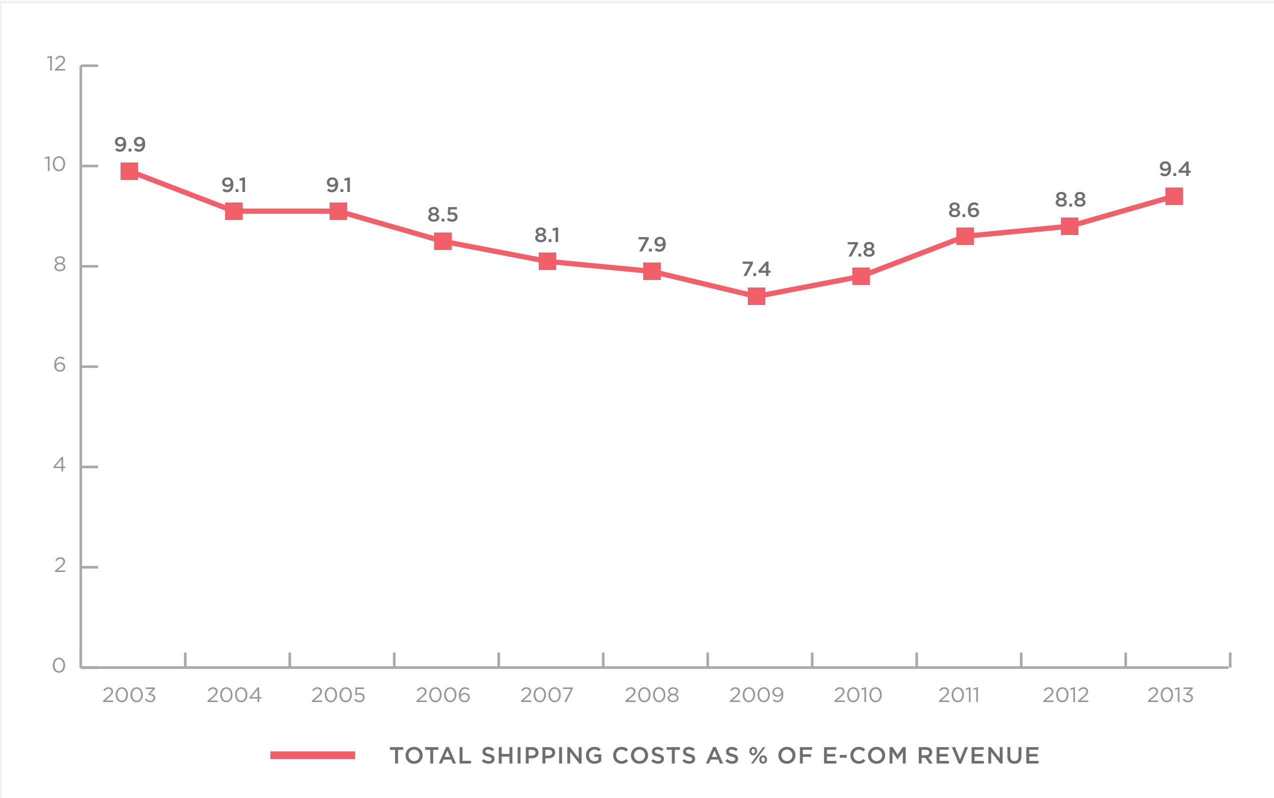
## THEORY 2: KEEPING CUSTOMER SERVICE-RELATED PROMISES, AMAZON'S KEY STRENGTH, HAS BECOME INCREASINGLY EXPENSIVE.

In other words, is one of Amazon's key success factors—delivery times and free delivery for part of its customer base (Prime)—becoming more costly to sustain as time goes by?

To answer this question, let's look at total shipping costs, as demonstrated in Exhibit 6:

» Despite fluctuations, shipping costs have not changed substantially over the last decade

**Exhibit 6:** Total Shipping Costs as % of E-Commerce Revenue



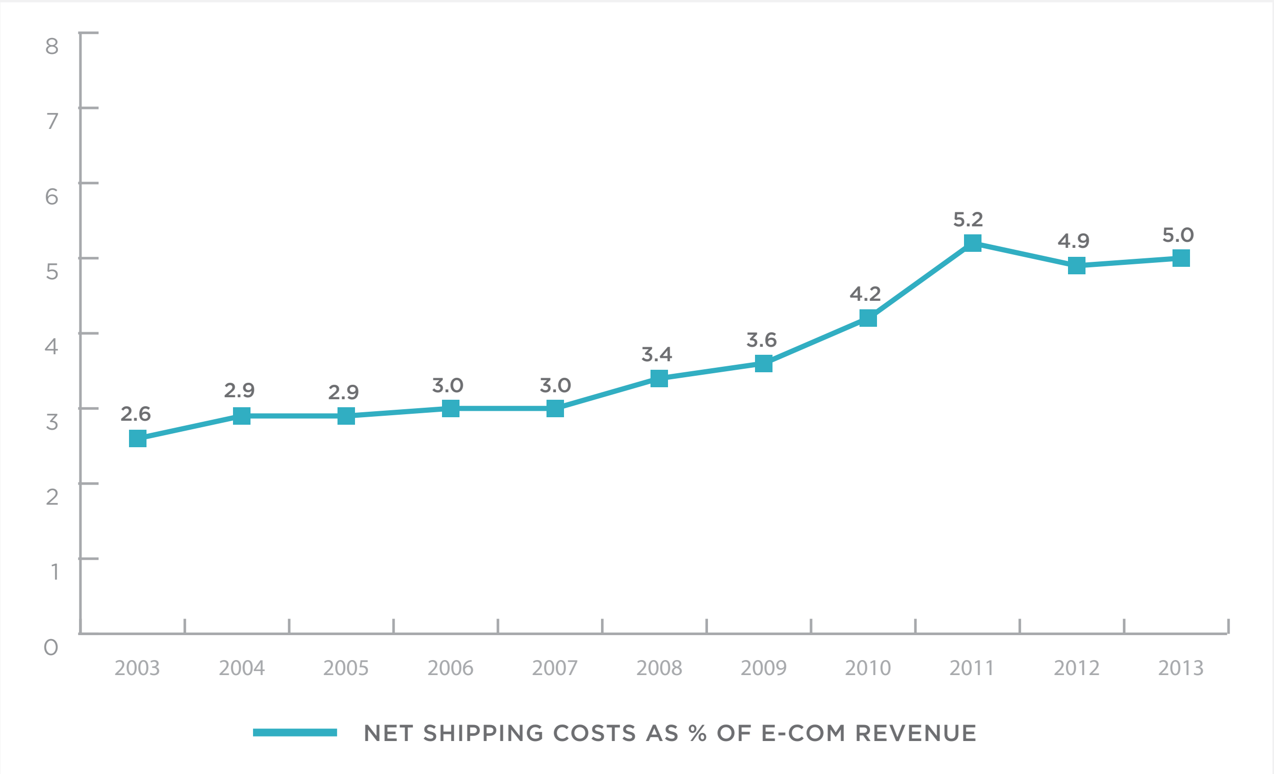



**Exhibit 7:** Net Shipping Costs As % of E-Commerce Revenue

- There has been, however, an upward trend since 2009

However, these figures do not reflect the real financial impact of shipping costs on Amazon because they do not take into account the shipping revenue Amazon receives (Amazon Prime and costs rebilled to customers).

The net shipping cost (total cost minus shipping revenue) is as follows (see Exhibit 7):

- Net shipping costs have almost doubled over the past decade
- Keeping its customer promise has therefore cost Amazon more over time

It is worth bearing in mind that Amazon is perfectly comfortable with this situation, explaining it by the fact that its product mix has shifted toward more electronic goods that are more expensive to ship, that it uses more costly preparation methods (not hugely so, judging by the total shipping cost figures), and that—most importantly—it has been trying to reduce customer rebilling rates to maintain low (overall) prices for its customers.

## THEORY 3: AMAZON DELIBERATELY INVESTS IN A WAY THAT RESULTS IN EITHER NO PROFIT OR AN INSIGNIFICANT ONE.

Let's forget about the notions of revenue and profit in favour of cash flow (free cash flow and operating cash flow, with the difference between the two representing capital expenditures), which is more relevant (and preferred by Amazon).

» Amazon's operating cash flow has changed over time, but it still demonstrates a stable trend at an average of nearly 8% of total revenue. For example, it was 7.5% in December 2013 and 6.4% in June 2014

» Free cash flow, meanwhile, has followed a broad downward trend. Overall, it has dropped from more than 6% in December 2003 to just over 1% in June 2014

Amazon's operations are therefore generating a steady level of cash while the entire Amazon business is generating less and less. And as Exhibit 9 shows, Amazon's capital expenditures appear to be increasing:

» Amazon has indeed increased its capital expenditures, both in absolute terms and as a percentage of sales

» A clear upward shift dating from the start of 2010 is noticeable, coinciding with the ongoing drop in free cash flow

Theory No. 3 does seem to be the right one. While its sales and operating cash flow have been increasing, Amazon has been making ever more massive investments that largely explain the lack of profit.

## WHAT IS AMAZON ACTUALLY INVESTING IN?

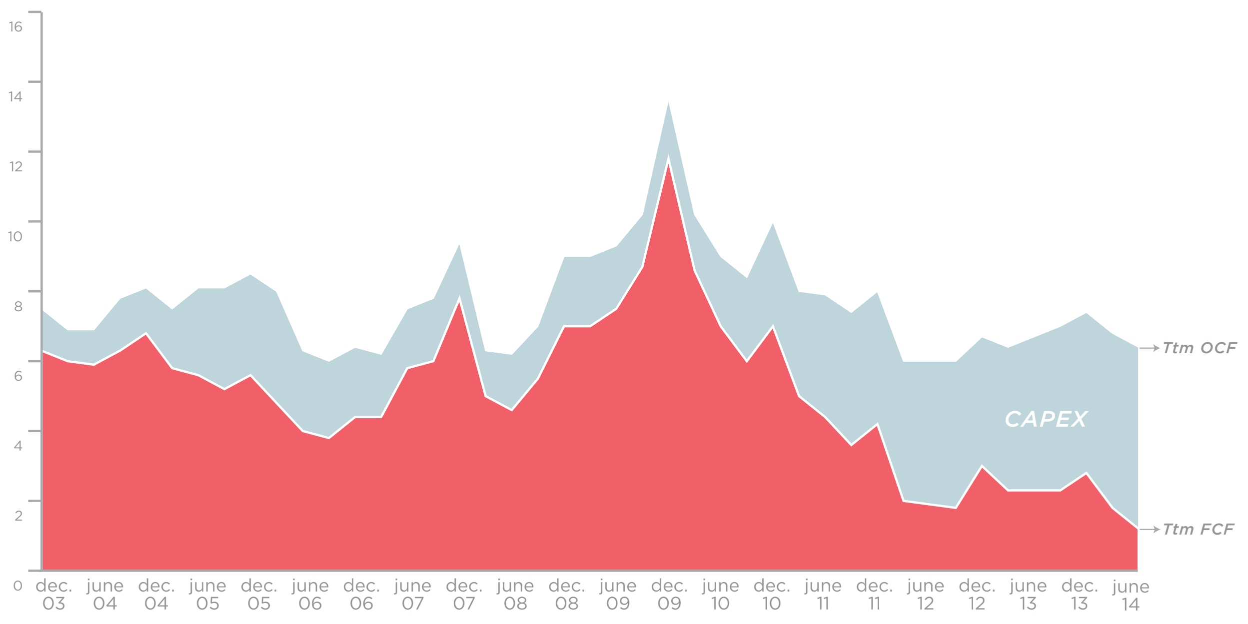
Again, Amazon discloses few details about this, for example refusing to separate out investments in warehouses and AWS data centres.

A look at the amount of building surface area owned by Amazon reveals a 20-fold increase over the past 10 years.

» Amazon is therefore investing hugely in logistics facilities

» There has been a substantial increase in the amount of square footage owned since 2010, again coinciding with the growth in capital expenditures

**Exhibit 8:** Free Cash Flow and Operating Cash Flow As % of Total Revenue




*N.B. Investment relating to Amazon's future headquarters in the fourth quarter of 2012 has been omitted from the analysis.*

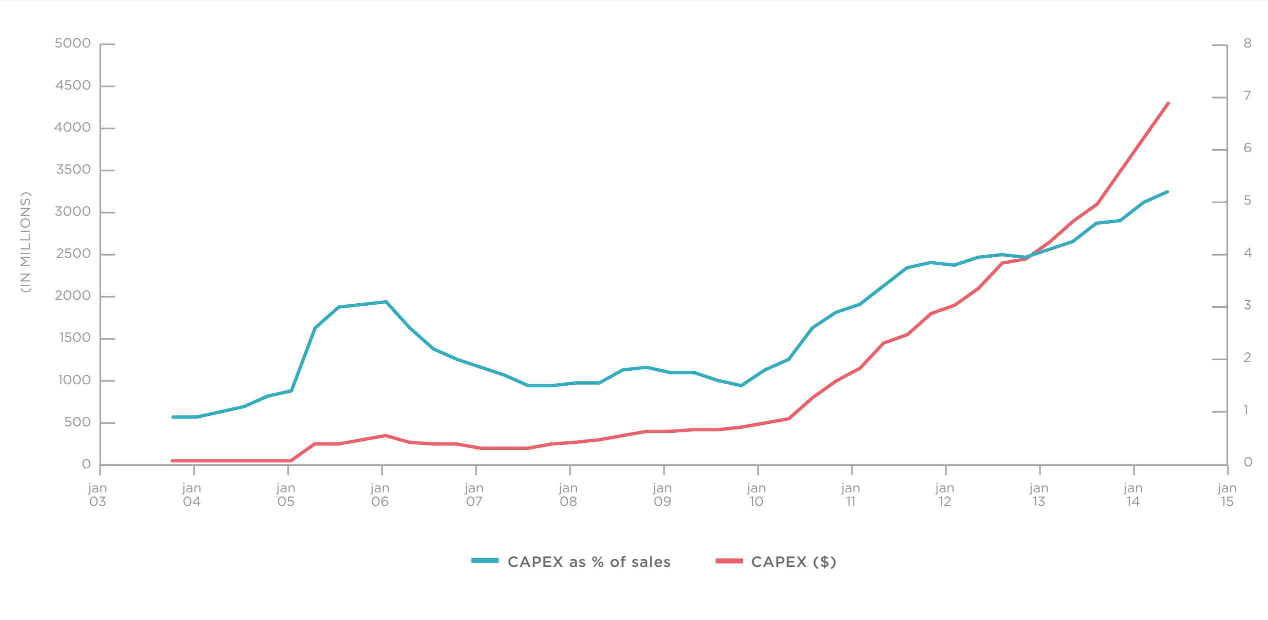



**Exhibit 9:** Capital Expenditures As % of Total Revenue

## WHY IS AMAZON INVESTING SO MUCH IN LOGISTICS?

This question goes back to theory No. 3. Quite simply, Amazon invests in customer satisfaction. It's no secret that Amazon's success is largely due to the quality of service provided to its customers in the form of very short delivery times at low cost.

To keep that promise, Amazon needs to be as physically close to its customers as possible, which means multiplying its storage facilities, resulting in the large increase in storage space.

This analysis makes clear the entrepreneurial philosophy of Jeff Bezos. Instead of increasing the wealth of shareholders and stakeholders, he continues to develop his business further.

He continually invests and reinvests the cash generated by his company with the goal of developing it rather than maximising profit.

It now appears that the original questions have largely been addressed.

1. Yes, it's true to say that Amazon makes no, or very little, profit.
2. No, this is not due to some flaw in Amazon as a business.
3. Amazon does not generate profits because that is not its goal. Any profits are reinvested to develop the company further.

There are, however, two additional questions that may be asked:

The first is, can Amazon generate profits?

Yes. All Amazon would need to do to make a profit is reduce its investments.

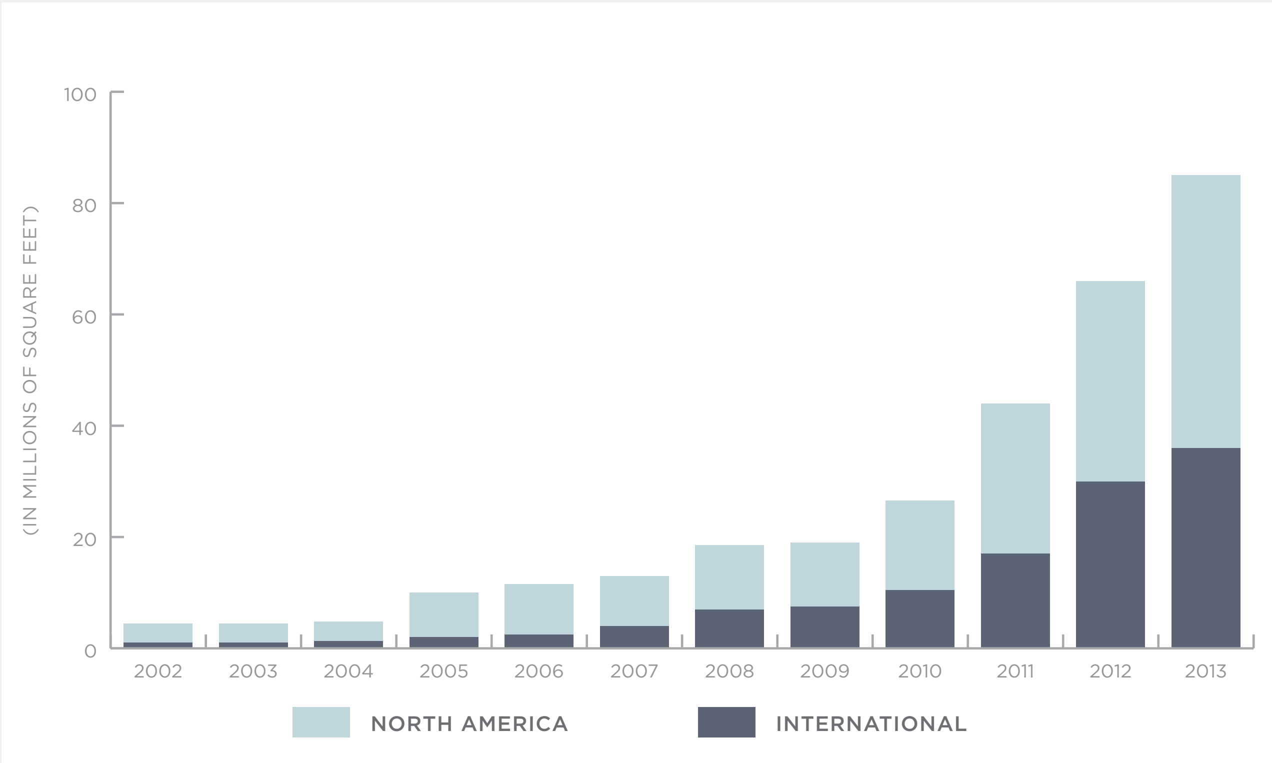



**Exhibit 10:** Building Surface Area (Storage Facilities and Data Centres) Owned

For example, if Amazon had kept its investments (capital expenditure/sales) at 2009 levels (before their rapid build-up), it would have generated $3 billion in additional profit over the past 12 months.

And finally, is there a risk in running a business in this way?

Amazon is unavoidably risking its shareholders becoming fed up and dissatisfied. There is evidence of this in the sharp correction in its share price following the publication of its latest results (-15% in the following week). However, the share price has since rebounded and more than recouped the temporary downturn.

But if pressure from shareholders became too strong, and Amazon was forced to maximise profits to distribute more generous dividends, what would this actually mean?

» Amazon would have to reduce its investments, which seems necessary to meet its goal of continuing growth

» Amazon would see its growth slow down, and could lose not only its ability to remain one step ahead of its rivals but its customer appeal as well. ❖

*Sources: Amazon / Kurt Salmon Analysis / a16z*

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