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Amazon: Is Profitability a Possibility?

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In today's society, companies seem to all be following the same trend; growth in profitability at all cost. Higher profits, for the most part, leads to more investors and more potential financing. Amazon.com appears to be breaking that trend, however. Their strategy seems to be growth, but not in profits. We would like to look into how and why Amazon is growing at such a fast pace, while their profits are staying steady at a very low level. Is profitability a possibility for Amazon? We believe that a marginal increase in price could accomplish just that, with a minimal impact to consumers.

***JEL Classification**: M16, M21*

1. Introduction

We are living in a time when businesses are focused on revolutionizing their core competencies in order to gain extraordinary profits. The idea of receiving higher profits has become such a dominant factor that businesses will go to great lengths, even to the point of committing fraud, in order to show the public they are profitable. Company's attempt this in order to gain further growth through investors and better reputation. In this mix of growth at all cost, there is a company that is breaking the mold. Amazon.com, an online retailer, is growing at an exponential rate, but they seem to have a different philosophy surrounding profitability. In fact, they make close to no profit while still increasing their business and their investors. To understand this accomplishment we are going to go over Amazon's history, what made them so successful and their strategy. In addition, we want to understand if their philosophy can be modified and therefore if Amazon can be more profitable. Finally, we would like to create a forecast to illustrate how much more profitable Amazon could potentially become.

2. History

"To be Earth's most customer-centric company, where customers can find and discover anything they might want to buy online, and endeavors to offer its customers with the lowest possible prices" (Amazon, 2014). This is the mission statement of Amazon Inc., and gives as good of a summary of the company as you could give. Amazon started as an online book retailer in 1994 in Seattle, Washington, and has since expanded into a Fortune 500 company. All along their rise, Amazon has stayed true to what they believe is the most important, becoming the largest and most efficient retailer in the world.

Amazon has evolved into a conglomerate of successful businesses that have stemmed from their revolutionary founder and CEO, Jeff Bezos. Bezos graduated from Princeton University with a degree in computer science and electrical engineering in 1986 (Biography.com, 2014). After working at several firms

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on Wall Street, Jeff Bezos saw an opportunity in e-commerce. By 1994, Bezos moved to Seattle and, with the help of a few employees, developed the software for Amazon.com (Biography.com, 2014).

Amazon was initially started as an online book store and had great success. "With no press promotion Amazon.com sold books across the United States and in 45 foreign countries within 30 days" (Biography.com, 2014). With their rapid success during the dotcom boom, Amazon was able to go public in 1997. The start of the transformation of Amazon into the company we see today didn't happen until 1998 when Amazon added clothes, electronics, toys, and many other products to their offerings (Biography.com, 2014).

In 1998, Amazon revolutionized how we view online retailing. Since then, they have added thousands of products under a dozen different categories to their offerings list. This not only includes items that Amazon itself sells, but also their successful idea to allow third parties to sell products using the Amazon platform as well.

As a whole, Amazon has changed how consumers shop for what they want and need. Their popularity has rapidly grown since its start, but there does seem to be only one matter that doesn't add up; profit.

3. Success Story

One of the key factors to Amazon's success is the implementation of their long-term strategy. The strategy includes low margins, high customer satisfaction, low prices, rapid shipment, and low profitability. With that said, we are going to identify the various sub-strategies to better understand how Amazon creates its success.

Low margins, and therefore low prices, have been a driving force to increase sales. This is illustrated very well in their revenue over the past ten years as shown in the graph below (MorningStar, 2014):

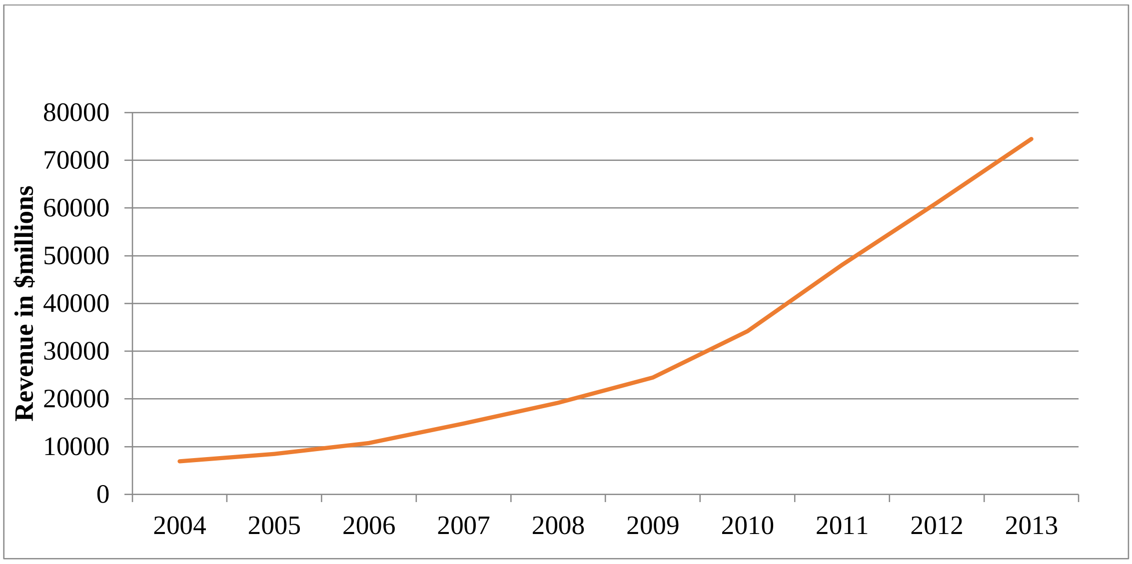

Figure 1. *Amazon Revenue Growth*

As we can clearly see, Amazon, in relation to revenue, has been extremely successful. Not only were they able to survive the dotcom bubble, but also thrive afterwards. Their commitment to low margins and low prices has allowed Amazon to become a viable and, in other ways, the go to retailer in today's society (Dediu, 2013). Furthermore, this has been backed up by the loyalty of Amazon's customer base as well as their investors. The low cost associated with their business has been partially possible due to Amazon's ability to maintain just-in-time inventory and the creation of economies of scale.

The effectiveness of Amazon's just-in-time inventory is greatly related to their logistics system. Currently, their inventory turnover lies around 8 turnovers per year, which implies that Amazon is able to maintain low on hand inventory (Wei, 2012). This is the benefit of being an e-commerce business rather than maintaining a store front. Amazon is able to maintain a customized inventory that allows them more flexibility based on the needs of their regional consumers.

Another major factor in Amazon's success story is their ability to create economies of scale, which is "the cost advantage that arises with increased output of a product" (Investopedia, 2014). In other words, Amazon is able to increase their economies of scale by increasing their output to their customers. This is shown in the graph above; as output increases year over year, revenue increases as well.

The last aspect of success that we desire to illustrate is Amazon's utilization of their website platform (Wei, 2013). The success derived from this section is based on the fact that Amazon split their platform into two sections. The first section is the division that Amazon uses itself. This is a low margin, low profitability section where Amazon sells goods directly to customers which reflects their long term strategy. The other division is the more profitable of the two, where Amazon allows outside businesses to sell their products through the Amazon platform. This allows Amazon to charge higher margins to the businesses since it is not a part of their core strategy.

As we have seen with the points discussed above, Amazon has established a variety of core competencies to become a successful company. Their low margins, logistics, and website platform have created a unique setting of sustainability that hasn't been able to be matched by any other competitor. Their continuous efforts to increase efficiency have led them to be the number one online retailer in the world. Although they have been successful, this has not directly correlated into profits.

4. Profitability?

It is no secret that Amazon is a successful company on the rise. It is also not a secret, however, that they have not been able to turn much of a profit since their inception. Matthew Yglesias jokingly commented that "Amazon, as best I can tell, is a charitable organization being run by elements of the investment community for the benefit of consumers" (Wei, 2013). Although Yglesias meant this as a joke there is some truth behind it, especially in the public's view. The company has been able to gain revenue at a steady growth rate year over year and has recently reached $74 billion. Though this is the case we can see in the flowing graph that this doesn't correlate with their net income-increasing year over year:

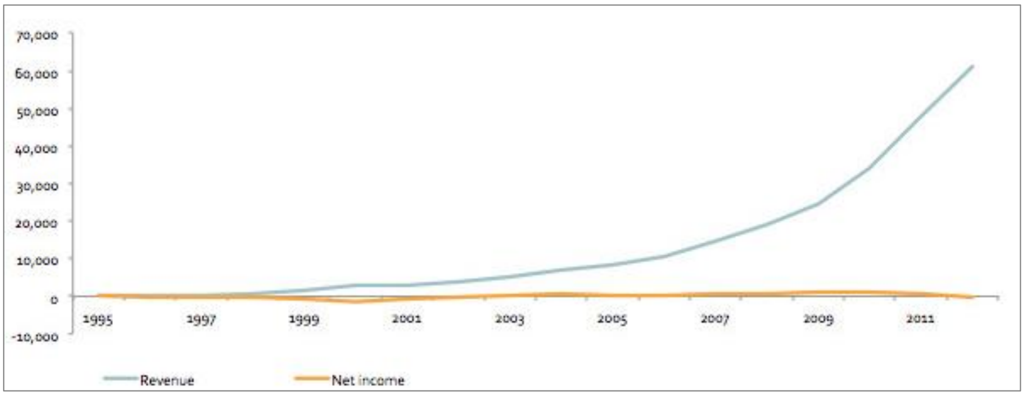

Figure 2. *Amazon performance since launch ($m)*
Source: Amazon, Enders Analysis, ben-evans.com

In fact, their net income, and therefore profit, has been an extremely flat line. This is made very clearly in comparison to their growth in revenue; therefore, let us identify the methods Amazon uses to create profit.

As mentioned by Yglesias it seems that Amazon is benefiting their customers by offering products at a low price. They achieve this feat by keeping their profit margins low, which establishes tough competition for other companies (Wei, 2012). The idea is to (1) draw in customers due to the low prices, (2) reduce competition, and (3) make higher profits by selling a lot of products. This strategy has proven to be successful as we can identify from the above graph. Another option that Amazon is offering customers is Amazon Prime, which allows free movie streaming, special deals, and most importantly free two-day shipping. Furthermore this benefits Amazon since it gives them constant yearly income.

The question that remains is why doesn't Amazon report higher profits in response to their Amazon Prime and its low margin but large quantity strategy. If we look at their gross profit on the other hand we can identify a different trend:

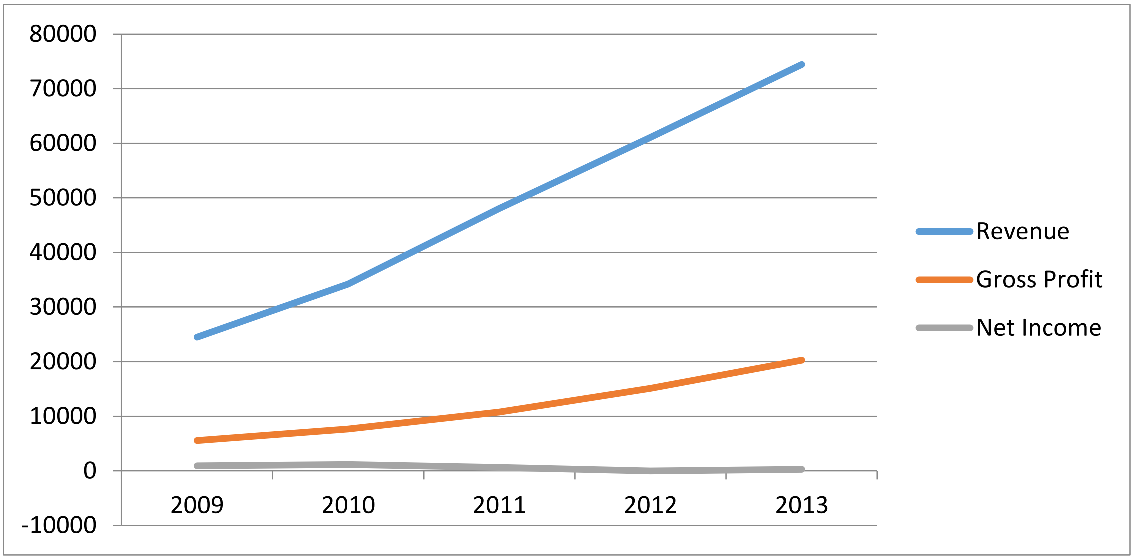

Figure 2*. Revenue, Gross Profit and Net Income*

As seen in the graph the gross profit follows a similar path as revenue, which finally shows a representation of what one thinks of Amazon's profit situation. But why don't they report numbers similar to the gross profit? The answer might seem blunt and almost too simple but they just don't want us to know (Evans, 2013). Also to successfully implement such a mindset it "requires a long-term willingness to be misunderstood", which is certainly the case with Amazon (Thompson, 2013). One of the reasons we identified Amazon reports less profits results from immediately reinvesting into the company, which makes them stronger for the future (Evans, 2013). In other words, they are "trading the present for the future" (Wei, 2013). This is something that has been reflected not only in profit but also in Amazon's stock price. Year over year Amazon has reported poor profitability but their stock price has increased 590% over the last 10 years (Yarow, 2013). This indicates that investors aren't worried about the lack of profit because they recognize the long-term vision of Jeff Bezos (Dediu, 2013). In addition, the reinvestment strategy makes sense since it allows Amazon to hide how much profit they actually make and it keeps the competition in suspense. Furthermore, the competition should be worried by this fact because they cannot estimate how far developed Amazon is nor can they assess which path Amazon will take next.

When summarizing this information we can identify that Amazon is better off than they are revealing to the public. Although that is true we believe that Amazon can create even more value by adjusting their prices.

5. Forecast

Throughout this paper we have illustrated why Amazon has been so successful but we have also shown that they underperform year over year in terms of profit. We were interested in whether there is a way for Amazon to increase their profit for investors. If this was possible, Amazon could use the extra profit to lure in more investors, from whom they could receive more investments. The easiest solution we found was to improve the profit margins by increasing prices of offered products. The created forecast illustrates price increases of 1% to 5% for the years 2013 through 2015. The results are as follows:

Table 1. Revenue estimation

Revenue	**2013**	**2014**	**2015**
Original	74,452	87,868	101,284
1%	75,197	88,747	102,297
2%	75,941	89,625	103,310
3%	76,686	90,504	104,323
4%	77,430	91,383	105,335
5%	78,175	92,261	106,348

Note: All values are in millions of dollars

If we decipher the above information we can identify that if Amazon would increase their prices by 1 percent, which would result in an increase of $745 million of revenue. Because they are functional with the amount they currently have, they could transfer the $745 million directly to the profit column. When we increase the price by 3 percent an increase of $2.234 billion can be identified and at 5 percent it goes up to $3.723 billion. Looking at the numbers, it is impressive how much a slight price increase could turn into for Amazon and more specifically their investors. Furthermore we believe that 1 percent is such a small difference in price that most customers wouldn't even recognize it while the effects of it are enormous for Amazon. An additional $745 million would most likely spike the interest of many investors, which would help Amazon with their general goal of reinvesting in the company. When we look ahead to a 1 percent increase of price, it would result in an $879 million increase in 2014 and a $1.013 billion increase in 2015. That is a lot of potential for any company and we believe that Amazon is in a unique position where it would benefit them greatly for the future without sacrificing future customers.

6. Conclusion

Throughout this paper we have discussed a lot about Amazon form their history, their success, their lack of end profitability, and their potential to generate greater profit. Amazon has definitely been one of the most rapidly growing companies over the last decade and their potential seems almost limitless. Every new platform creates more revenue, market share, and popularity. Although this is the case, we were able to identify a lack of profitability, especially in comparison to their highly increasing revenue. Still we believe that Amazon could be better off if they offered a little more profitability to their investors. They could accomplish it by increasing their prices by one percent, which would turn into a revenue increase of $745 million.

In conclusion, Amazon is a fantastic company with a lot of potential in the future, but one thing they could improve is their overall profitability by marginally increasing their prices.

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