



THE ALCHEMY OF AMAZON



By Allison Enright

In his 2015 letter to shareholders, Amazon.com Inc.

CEO Jeff Bezos described some of what's at the heart of Amazon's success this way: "Failure and invention are inseparable twins. To invent you have to experiment." He went on: "We all know that if you swing for the fences, you're going to strike out a lot, but you're also going to hit some home runs." And Bezos has shown he's more than willing to use money and manpower to propel this business philosophy.

To wit: When Amazon issues a press release announcing financial results, it includes a bullet-point list of business highlights it deems noteworthy. Its fourth quarter release last month summarized 2017 highlights. Those highlights ran seven pages, and the word "launched" or a synonym of launched appeared at least 32 times.

Among the highlights: New developer tools to extend the growth of its intelligent personal assistant Alexa's voice-activated skill set within Amazon devices. The Alexa software is also being integrated by companies like Toyota, which will add the software to some car models this year. The launch of two private-label furniture brands. The release of 1,430 improvements to Amazon Web Services, Amazon's high-growth (revenue was up 43% in 2017) and most profitable business segment, which sells computing services. The company also slipped in the nebulous announcement that it, Berkshire Hathaway Inc. and JPMorgan Chase & Co. are going to work together to reduce health care costs and improve employee satisfaction with healthcare. You know, no big deal; it's on page four.

The drive to experiment is central to Amazon's business strategy. Those experiments have it expanding in virtually all directions—and far beyond e-retail.

“Amazon likes to experiment and see where there is demand,” says Colin Sebastian, managing director and senior equity research analyst at investment firm R.W. Baird & Co. Sebastian sees no end to Amazon's willingness to explore new areas, and he is bullish on Amazon's ongoing push into delivery and logistics services. As this issue went to press, the Wall Street Journal reported the imminent launch of Shipping with Amazon, a delivery service where Amazon would pick up packages from businesses and deliver them to customers. The program is widely viewed as a challenge to UPS Inc. and FedEx Corp.'s delivery services. Amazon declined to comment about the program.

The initiatives on the earnings highlight reel are a fraction of what's in play. For instance, Amazon's advertising business, which includes display and pay-per-click ad products where brands and marketplace sellers can advertise, didn't make the highlights. But Amazon's been investing in its ad platforms and adding new ways for brands and marketplace sellers to advertise across Amazon's websites, contributing to an explosion in high-margin, high-profit revenue flowing to Amazon.

“Amazon is in an extraordinarily established position right now,” says Rebecca Lieb, analyst and founding partner of research and advisory firm Kaleido Insights. “It is [focused on] innovation and continual expansion, and its numbers are very, very good. It seems like there's nothing it can't do, and it is well financed to do it.” And it's increasingly profitable; Amazon generated \$3.03 billion in profit last year on \$177.87 billion in revenue.

While Amazon seems omnipresent in online retailing—accounting for about \$4 in every \$10 spent online in the U.S.—it accounts for less than 3.0% of retail spending, second to Walmart Inc.'s 6.3% share, according to Internet Retailer's “2017 Amazon Report.” That leaves a lot of retail runway for Amazon to eat up not only by growing its core retail businesses, but to dive into others, like grocery stores and possibly pharmaceuticals and health care, and into adjacent business areas that leverage its infrastructure, such as fulfillment, advertising and voice-activated programming.

Amazon's philosophy starts and ends with satisfying customers and, for Amazon, this includes customers it may not yet have, in just about any market space. “Amazon starts with the customer and works backwards and it continues to invest to get it right,” says Eric Heller, founder of

Marketplace Ignition, a digital marketing consultancy specializing in Amazon.

In doing so, Amazon is becoming defined less as an e-retailer and more as a force for businesses and industries of all kinds to reckon with.

GROCERY GAINS

No Amazon experiment personifies the test-and-learn-and-try-again ethos better than its attempts to maneuver into the grocery category. Amazon launched AmazonFresh, a service that offers home delivery of perishable groceries, in 2007 in Seattle. It did not expand the service beyond Seattle until 2013. The next year it launched Amazon Prime Pantry, a service that ships shelf-stable food and household staples nationwide. Throughout 2015 and 2016, Amazon expanded AmazonFresh in at least a half dozen markets. It currently offers AmazonFresh in 13 markets.

Amazon in March 2017 opened two pickup points in Seattle for groceries ordered through Fresh where consumers pull in, pop their trunk and an employee loads the groceries. Industry watchers heralded the move as Amazon's big break into bricks-and-mortar retailing. In August, the pickup points seemed like a minor divergence when Amazon bought Whole Foods Market Inc. and its fleet of grocery stores for \$13.7 billion. In November, Amazon killed Fresh in some ZIP codes—representatives say the purchase of



CURATED PICKS - SHOP BY CATEGORY SOFAS ACCENT CHAIRS PILLOWS OTTOMANS RUGS LIGHTING WALL ART

MODERN

Home furnishings is a high-growth category for Amazon. It launched two private label furniture brands—Stone & Beam and Rivet—to Prime members last fall.

Whole Foods didn't relate to the change at Fresh—and in February it announced that Prime members can shop for Whole Foods groceries online and have them delivered for free in under two hours through Prime Now in four metropolitan areas. Amazon, which will fulfill these grocery orders directly from Whole Foods stores, plans to expand the offering to more markets this year.

Despite the mixed bag of Amazon's grocery offerings, consumers consider Amazon a go-to spot to buy groceries. 42% of U.S. consumers who bought groceries online last year did so with their local grocers, 34% ordered from Amazon and 32% chose Walmart.com, according to a recent survey of 1,000 U.S. consumers from online grocery technology firm Unata and order fulfillment platform ShopperKit. Other choices included Instacart (12%), Peapod (8%) and FreshDirect (6%). All these competitors will face even stiffer competition from Amazon for consumers' online grocery dollars as the Whole Foods/Prime Now service rolls out. Amazon Prime Now delivery is available in 34 metropolitan areas, which collectively reach 42% of the U.S. population, according to an Internet Retailer analysis.

Estimates from Internet Retailer's "2017 Online Food Report" bear out the progress Amazon's made in selling food online. It estimates Amazon had 39.3% market share of online groceries sold in the U.S. in 2016—and that's prior to the acquisition of Whole Foods. Walmart is the next-largest for groceries online with 24.0% share. The wind with online grocery is at Amazon's back. 36% of respondents to the Unata survey plan to shop online for groceries this year, up from 22% in 2017. 54% of online grocery shoppers said they are likely to try ordering Whole Foods items through Amazon.

HEALTHY DIRECTIONS

Are pharmaceutical sales and health services on Amazon's near-term experiment list? The retailer won't say much, but its public moves suggest it may be heading this way. Amazon has been approved for wholesale pharmacy licenses in at least 13 states.

It's also hired a handful of healthcare policy experts and executives from health insurance companies—perhaps in preparation for the recent Amazon/Berkshire Hathaway/JPMorgan Chase vague-on-the-details announcement that the trio intends to take on rising health care costs. The consortium says it will apply technology to lower healthcare costs for its employees while also improving the care employees receive. At the time of this story's publication, Amazon has 280 active job listings seeking employees with healthcare expertise.

Amazon also reportedly has several under-the-radar labs believed to be working on health-related experiments, such as using Alexa software in health settings like doctors' offices.

POWERED BY VOICE

One Amazon experiment that's already starting to pay dividends is its investment in interacting with consumers via voice. Since 2015, Amazon has embarked on a marked push to offer smart devices powered by its Alexa software, which recognizes and responds to queries asked vocally. The rapid growth of those devices has quickly transformed the way many consumers seek information—whether they are shopping for a product, seeking a news update or looking for entertainment.

Amazon makes Alexa voice services available on a range of products, but the primary touch point is with its line of Echo speakers. Amazon says it sold "tens of millions" of them during 2017, and estimates from other sources show how adoption is snowballing. Consumer Intelligence Research Partners (CIRP) estimates in January there were 31 million units in use in the United States, up from 8 million a year earlier and 3 million in January 2016. CIRP also estimates Amazon, as of September, had 76% of U.S. market

share for such devices, compared to 24% for Google, which offers Google Home devices.

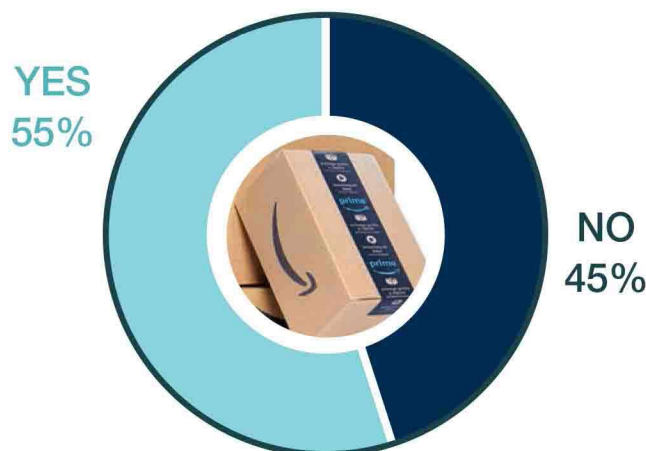
Amazon is also pushing Alexa's capabilities beyond its own hardware. 2018 and 2019 Toyota models will have Alexa in car as an option. Some Ford models have Alexa software, too. Consumers also can hook up devices around their home to activate when instructed to through Alexa. For instance, the command, "Alexa, preheat the oven to 350 degrees" works with a line of GE smart appliances. Consumers can now control more than 4,000 household devices through Alexa, Amazon says.

Already roughly one in three (37%) consumers have an Alexa device in their household, according to a January Internet Retailer survey of 500 online consumers fielded by research firm Toluna. That suggests that, while many consumers have embraced the technology, there's plenty of room for growth. "Amazon's voice shopping and voice search is very embryonic," Kaliedo's Lieb says. "It is being adopted in the home, but the real potential is in people who are offline and when their hands are occupied, such as drivers."

Amazon's voice-based advances could help it play a critical role in how consumers access information, Sebastian says. "It is more than just capturing the way people will be searching in the future," he says. "It is an extension of the platform, connecting Amazon to all the automation of internet of things in the home and office. If you think ahead to the world where we always have access to this intelligent assistant, Amazon wants Amazon to be everywhere.

PRIME

Do you have an Amazon Prime membership in your household?



Source: Internet Retailer/Toluna survey of 500 consumers, January 2018

Just ask Alexa for whatever you want or need, and Alexa—or 'She' as I call it—can give it to you."

The growing ubiquity of this interactivity is showing positive results for Amazon. Shoppers who own an Echo spend an average of \$1,700 annually with Amazon—a 30% premium on spending by Prime members, according to CIRP.

FURNITURE IN FASHION

Amazon has been pushing furniture and home goods in a big way in recent months, perhaps inspired by the growth of e-retailer Wayfair Inc., whose five-year compound annual growth rate is more than double that of Amazon's. Wayfair is the No. 1 e-retailer explicitly focused on home goods, according to Internet Retailer's "2017 Online Home Goods Report," but is second to Amazon in sales in the category. A separate study from One Click Retail shows Amazon and its marketplace sellers sold nearly \$7 billion worth of home goods to U.S. consumers in 2016, a 33% jump from 2015, and accounted for about 28% of the online home goods and housewares market.

When Amazon in November debuted two Amazon private label brands of furniture and home goods—Stone & Beam and Rivet—it said home furnishings was one of its fastest-growing product categories. The private label collections—Rivet offers a midcentury modern look while Stone & Beam is geared toward families—include items ranging from wall art and lamps to \$1,000-plus sofas.

Last spring, an Amazon representative pitched dozens of furniture brands and furniture store retailers attending High Point Market, the largest furniture industry trade event, to sell through the Amazon marketplace. Amazon's efforts helped it grow the number of home and kitchen SKUs available for Prime shipping 76% year over year, according to a fourth quarter Baird assortment analysis.

Only one in three (34%) Amazon shoppers have purchased a large-sized item like furniture or exercise equipment on Amazon, according to the Internet Retailer/Toluna survey. But there is latent interest: a further 44% said they'd seriously consider doing so.

Amazon is marketing to such consumers with Google Product Listing Ads—the pay-per-click ads on Google that include product photos and pricing. Amazon made its first investments in PLAs in or around December 2016—and the ads it bought were for home goods. That activity in the home goods category increased throughout 2017, according to Mark Ballard, senior director of research at Merkle, a digital marketing agency.

MARKETING MATTERS

While Amazon is the biggest e-retail spender on paid search advertising—it spent about \$37.6 million a month on it in 2017, according to Adgooroo—Amazon too has created its own burgeoning revenue stream from advertising it offers on its own network of sites and apps. EMarketer Inc. estimates Amazon's advertising business will capture \$2.35 billion in U.S. marketers' dollars this year, up 42.4% year over year, making Amazon the third-largest digital advertising network in the U.S. (after Google and Facebook) in terms of ad sales. Amazon categorizes income generated from advertising under "other" in its financial filings, mixed in with some other revenue streams. "Other" revenue totaled \$4.65 billion and grew 58% in 2017.

The retailer has made a number of improvements to its advertising offerings over the last year, including more rigorous reporting, which are making them attractive to brands and marketplace sellers.

"My perspective a year ago was [Amazon's ad] environment was 10-15% optimized, if you are using Google as the high water mark at 100% efficiency," Marketplace Ignition's Heller says. "There was no real API interface, no way [to] automate your actions with the platform. It was just brute force with spreadsheets." Improvements introduced over the last year have now doubled that to about 25-30% efficiency, Heller estimates. And that's drawing more marketers to buy among the pay-per-click ad formats Amazon offers.

"Today, when brands launch on Amazon, the No. 1 thing people talk about is the pay-per-click levers at their disposal to grow on the platform," says Fahim Naim, founder and CEO of eShoppportunity, a marketing consultancy specializing in Amazon. "It's gained a lot of steam over the last year. Now, it is almost compulsory for brands to run ads."

Amazon Marketing Services, the self-service part of Amazon's advertising business, offers four primary forms of ads: sponsored products, headline search, product display ads and Amazon store pages. Headline search ads are banner ads that appear at the top of search results. Product display ads can appear in multiple locations, including search results and product detail pages. Store pages, where brands can showcase their products with marketing content like photos and videos, are free to brand owners. Sponsored product advertisements, which appear on search results pages and product pages, account for the bulk of marketers' spending on Amazon. In the fourth quarter, sponsored product advertisements on Amazon accounted for 85% of brand marketers'

VOICE

Do you have a device in your household that uses Amazon's voice-based search program Alexa, such as an Echo, Echo Dot, or Fire TV?



"No, 63%"

"Yes, 37%"

IF YES,

how often do you interact with the Alexa device by voice?

4% "Less than once a week"

10% "Weekly"

14% "A couple times a week"

32% "Daily"

40% "Multiple times a day"

Source: Internet Retailer/Toluna survey of 500 consumers, January 2018

spending with Amazon, according to a Merkle analysis of 100 brands.

Other ad formats, like sponsored links, are aligned with product search results on Amazon, but take shoppers to other sites off Amazon. "Amazon might make more money if you buy the product from Amazon, but it's not going to turn its back on a chance to make money if you don't," Lieb says. "Amazon makes money either way."

And that's the rub. Amazon's propensity to dive in when it sees a need or opportunity, its willingness to invest in experiments—and to learn and iterate on those experiments—demonstrates to the rest of the business world that Amazon does not see any boundaries to its business. It sees only possibilities. ●