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Amazon's Multiple Personalities

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Given the 86 million consumers that Jupiter Research predicts will be buying gifts online this holiday season, Amazon should be throwing off good cheer all around, right? Not exactly. Wall Street is acting like Scrooge as it frets about slowing revenue growth and diminishing profit margins in 2005. The big problem: Analysts are belatedly coming around to the idea that Amazon may be just a retailer, not some Internet high-flier that will dominate e-commerce. That means Amazon shares should be valued lower. Wharton experts, however, say these short-term worries are overblown although Amazon's business model does raise some concerns. Is being viewed as a retailer really so bad?

The bah-humbug crowd emerged shortly after the company announced its third quarter earnings in October. Amazon reported net income of $54 million on revenues of $1.46 billion, compared to net income of $16 million on revenues of $1.13 billion a year earlier. For the all-important fourth quarter, Amazon predicted revenue growth of at least 31% to $2.29 billion-$2.54 billion. For 2004, sales are expected to be up 32% to $6.67 billion-$6.9 billion.

While those results were strong, analysts panned the company's 2005 projections of sales between $7.4 billion and $8.15 billion, and operating income between $500 million and $625 million. The rub: Amazon's percentage increase of revenue growth falls "significantly to the mid-teens next year while the company increases its operating expenses to build up an even bigger infrastructure," wrote Piper Jaffray analyst Safa Rashtchy in a research report following Amazon's earnings report. "The result is that Amazon is making less money on each incremental dollar of sales."

On Nov. 18, Bank of America securities analyst Aram Rubinson did Rashtchy one better. He started coverage of Amazon with a "sell" rating and a price target of $26 at a time when Amazon shares were trading at $39.90. Calling Amazon a "mass market player in a niche market," Rubinson says Amazon is a mere retailer, and not an Internet stock that deserves a loftier valuation. To make matters worse, Amazon's product lineup is too broad, meaning it can't get economies of scale for any one category, states Rubinson, adding that if Amazon were more focused, say on just books and music, it would generate better returns .

According to William Cody, managing director of Wharton's Jay H. Baker Retailing Initiative, Amazon's department store approach could backfire, although he suggests that it's too early to determine how the Amazon saga will play out. "One-stop shopping works well in a department store. But online, another department store is just a click away."

For Wharton marketing professor Peter Fader, this angst over Amazon sounds familiar. In the heady dot-com era of the late 1990s, Amazon couldn't make money but still hit a $400 price target. Then the bubble burst and Amazon was allegedly washed up. Now it's a profitable semi-mature company that is expanding and facing slowing growth. "I don't put a lot of faith in the stock market to value Amazon," says Fader. "And if it is seen as a retailer - which it is, after all - I think that's great because Amazon stacks up well next to other retailers. Compare Amazon to Kmart and Sears with [their] aging companies and customer bases."

Wharton marketing professor Jerry Wind agrees, noting that Amazon still offers features other retailers can't or won't, including 24/7 shopping convenience, customized shopping lists and an easy-to-follow format. "Amazon can capitalize on" these capabilities, says Wind.

Does the Business Model Work?

The core concern about Amazon seems to be one of definition. What is Amazon? What are its core markets? Is it expanding too quickly and spending too much to get there? "I do think Amazon may have expanded too far, too fast," says Fader. "When you ask people what Amazon is, they will say it's a book and music store. I don't think Amazon is viewed as a broad retailer."

That confusion may be understandable given that Amazon has taken on two personalities. When it comes to books and music, the company is like any other retailer building fulfillment centers and distributing goods. Other parts of its sites are like a shopping mall, where one can buy goods from partners such as Target and Toys 'R' Us. Amazon also sells electronics, a cutthroat business, and apparel, often through partners. In the end, Amazon becomes a department store. "With Amazon there is always a danger that it is spread too thin," says Wind. "The company is definitely established in books and music, but whether it is viewed as a place for other products remains to be seen."

By offering so many products, many of them commodity purchases like diapers and music CDs, Amazon can rarely offer exclusives and volume discounts, says Cody. That hurts the company when it comes to selling electronics. "Amazon doesn't have the clout with vendors that a Wal-Mart or Best Buy has."

Meanwhile, Amazon keeps investing. Third quarter operating profit margins were 6.5%, lower than some Wall Street projections, because of spending on technology, content improvements and a new fulfillment center in Scotland. The company continues to fare well with consumers, earning a score of 88 out of 100 on the American Customer Satisfaction Index. "Amazon has made free shipping, low prices, good service and order accuracy a hallmark. Our decision to put dollars into lower prices and free shipping instead of TV advertising continues to be embraced by customers," said Jeff Bezos, founder and CEO of Amazon.com, in the company's earnings release. "Customer adoption of free shipping hit another record high this quarter."

Nevertheless, Amazon's business model appears jumbled compared to a competitor such as eBay, which facilitates transactions and takes a cut - a business model that is both profitable and relatively uncomplicated. Amazon, however, is part retailer, part shopping resource and part landlord to other retailers that utilize the e-tailer's platform. This plan has resulted in a large selection of goods, but plays right into Rubinson's criticism that Amazon is a mass market player with niche products. "Selection is vast, but it may be too vast," says Rubinson.

Fader and Wind agree. Both say it may be smart to drop certain lines of Amazon's selections, like sporting goods. Fader, who would like to see the company focus more on getting mileage out of its books and music business, questions whether Amazon is maximizing profit there or spending its limited time and resources looking for new markets to tackle. As Wind says: "Amazon needs to find out its target market ... It is competing with almost everyone in every market."

Less Is More?

One of the reasons experts like Wind and Fader suggest Amazon may be better off refocusing its efforts instead of expanding is its average order size. According to Rubinson, Amazon has an average order value of $54. Direct and catalog retailers focusing on just a few product categories average $150. The bottom line: Amazon is selling some products even though they aren't profitable. The tradeoff is growth for profits.

"In order to manage average order value, we suspect Amazon may need to cull the offering and sell only profitable SKUs (stock-keeping units)," says Rubinson. "That could come at the expense of growth.

Other retailers like Best Buy, Home Depot and Staples have opted to slow growth in order to improve profits. Amazon may ultimately need to make a similar choice." Fader agrees that Amazon could narrow its focus and boost profitability. "The expansion has been more successful than anticipated, but it still doesn't justify Amazon's need to offer everything. There is no reason that Amazon has to offer electronics when it's such a tough business."

Cody says pruning the list of items Amazon sells is unlikely as long as the company has growth as its biggest goal. "Obviously all of Amazon's moves are pegged to future growth," says Cody. "It doesn't see books and music as a growth industry."

Improving that average order size theoretically should be easier for Amazon than other retailers. But according to Fader and Wind, Amazon might not have the willpower to use its technology to boost profits. It's possible, for example, that Amazon could still grow even by paring back selection through dynamic pricing, suggests Fader. Dynamic pricing means that what a consumer pays for a product isn't fixed. For instance, a snow shovel in December will sell for more than one in September. And the price of that shovel in December during a storm at 2 p.m. may be more expensive. Characteristics such as loyalty to the store, time of day and most recent purchase could also be considered.

"Amazon was running experiments with variable pricing and stopped because of a backlash," says Fader. "That was a mistake. Amazon should be able to charge more for certain things at certain times. Dynamic pricing is the future and Amazon gave up too early." Consumers, he adds, would ultimately get used to dynamic pricing and Amazon probably wouldn't take a big hit on customer satisfaction because other retailers would quickly follow. "There are potentially more revenue dynamics. All that is involved is having a background and leveraging your information technology."

Cody agrees that Amazon is lagging on basic retail techniques. For instance, he receives weekly promotional emails from Target, Best Buy and Kohl's on sales and special offers. Email enticements from Amazon, however, are sporadic. "Other retailers have closed the gap with Amazon in the online channel," he says. Short of something like dynamic pricing, Wind suggests that Amazon could do better at offering gift ideas for other people. The company currently makes suggestions for customers, but that customer doesn't get help finding something for his or her mother. "What is unique about Amazon is the ability to target and initiate suggestions ... and thus stimulate buying."

While the current concerns are important, one needs to put the company's moves in context, according to Fader. Amazon could quickly win over Wall Street analysts like Rubinson by honing selection and delivering better profit and revenue growth. Amazon is distinct right now because "it is viewed as an online technology company," says Fader. "Sooner or later that distinction will fade and Amazon will be viewed by what it sells and how it does it."