

trust factor

HOW **AMAZON** IS GETTING **BIGGER, FASTER AND MORE PROFITABLE.** > By Mike Troy

The retail industry has never seen anything like Amazon. It is a search engine that rivals Google in terms of locating products, a platform for user-generated content with reviews, a third party marketplace provider, a media powerhouse producing award-winning original programming and a leading provider of cloud computing services.

The company's unconventional business model and unique value proposition for shoppers has earned Amazon a level of trust and loyalty not seen in the retail industry. Amazon, and by extension founder and CEO Jeff Bezos, consistently ranks at or near the top of various measures of trust, reputation and brand value. It was the top-ranked company in the 2016 Harris Poll Reputation Quotient survey of more than 23,000 U.S. respondents, marking the eighth consecutive year it has been in the top 10. An organization called the Reputation Institute listed Amazon first in its annual RepTrak 100 listing of the most reputable companies in America. Amazon now ranks third on Fortune's listing of the World's Most Admired Companies, behind only Apple and Google. And in terms of the world's most valuable global retail brands, Amazon is tops



Jeff Bezos, Amazon founder and CEO

based on the most recent BrandZ report from WPP's Millward Brown division.

"Amazon overtook Walmart three or four years ago to become the most valuable retail brand on the planet in a shift that is reflective of the changing mindset of the consumer," says David Roth, co-CEO of the The Store, WPP's retail practice. "Amazon has been very clever about removing friction from the shopper's process of being interested in buying something to actually completing the transaction."

That cleverness shows up in the company's steadily climbing sales numbers, stock price and brand value, a metric Millward Brown seeks to quantify in the BrandZ report. Last year, Amazon's brand value surged 59 percent,

roughly double that of Alibaba, the next closest retail company. Amazon advanced seven spots this year to rank seventh on the full list of the most valuable brands at \$99 billion, while Walmart declined six spots to rank 32nd with a brand value of \$27.3 billion.

The brand value, respect and trust accolades being heaped on the company stem largely from the pursuit of one of Bezos' foundational principles: to be customer-obsessed as opposed to competitor-focused. It is an important distinction and key to understanding Amazon's actions and experiments. For example, the Dash button seemed like an oddity when first introduced, but now more than 150 brands participate in the program. Offering free unlimited two-day delivery as a benefit of Prime was a pretty sweet deal, but then Amazon began offering same-day



Amazon One is the first of a fleet of 40 aircraft that will facilitate cross-border delivery.



or one-hour Prime Now delivery. Now the Amazon Echo device and virtual assistant Alexa make ordering products even easier.

THE POWER OF PRIME

A Prime membership is already the best deal in the history of shopping, if Amazon does say so itself, and Bezos wants Prime to be such a good value it would be irresponsible to not be a member.

A lot of people already agree. Amazon doesn't disclose the total number of Prime members, only that paid Prime memberships increased 47 percent in the U.S. last year. Analysts put the number of Prime members in the vicinity of 70 million.

The core value proposition of Prime and the reason most people first agreed to pay a \$99 annual fee was unlimited free two-day shipping enabled by steady expansion of distribution capacity. The other major benefit of Prime is content in the form of movies and award-winning Amazon original programming.

"Satisfaction with Prime membership is insanely high," says Rich Ratcliff, senior vice president with the Carbonview Research division of EnsembleIQ. A survey of 1,015 consumers conducted in May showed that among primary grocery shoppers in a household, 97 percent shop at Amazon at least occasionally; 74 percent do so multiple times a month; and 35 percent several times a week. In addition, 55 percent of these shoppers are members of Amazon Prime and of those, 97 percent said they are happy with the service Amazon provides. Millennials in particular love Prime, with Carbonview's data showing that 63 percent are already Prime members compared to 45 percent of Baby Boomers.

"Through a bundling of Prime services and content they have sucked people into to an Amazon-first mentality. It has become the brand of first preference, which is a significant challenge to anyone in the retail space," says The Store's Roth.

To ensure it maintains preferred status, customer obsession means continuing to elevate delivery expectations through expansion of fulfillment capabilities. It has become an almost monthly occurrence for Amazon to announce the opening of a fulfillment center somewhere in the U.S. In August, the company said it would open a second fulfillment center in the northwest Dallas suburb of Coppell, marking the eighth Texas location to be added in three years. Expansion has been even faster in California, where four fulfillment center locations were announced in four months this year,

giving the company a total of 10. In June, two facilities in Illinois were announced after two locations had been announced in April in New Jersey.

Amazon now has a fulfillment center or delivery capability within 20 miles of 44 percent of the U.S. population, compared to 26 percent in 2014, according to Gene Munster, an analyst with Piper Jaffray.

That means the company can offer two-day shipping on more than 30 million items, same-day delivery on more than 1 million items in nearly 30 metropolitan areas, and one and two-hour Prime Now delivery on a more limited assortment in 25 major markets.

However, the biggest news on the fulfillment front this year was the addition of a fleet of 40 aircraft through a lease deal with air cargo provider Atlas Air Worldwide. The aircraft, the first of which is named Amazon One, contribute to the company's ability to offer Prime service worldwide as cross-border commerce continues to grow.

THE GOOD FIGHT

The trust and reputation factors are huge advantages for Amazon, and a major concern for competitors, because they give Amazon license to extend its brand and value proposition into huge new areas such as food and consumables, private label and apparel. That said, leading food and consumable retailers aren't ready to cede share to Amazon just yet. Many are rolling out click-and-collect capabilities that leverage their physical footprint while simultaneously understanding that the store experience must improve to give shoppers a reason to come inside.

"We are going to play with Amazon in the two-day game and one-day game as appropriate, and we've built about six very large fulfillment centers which now gives us two-day service anywhere in the United States, with hundreds of thousands of SKUs," Brent Beabout, senior vice president of e-commerce supply chain at Walmart, said earlier this year during a panel presentation at the Grocery



Manufacturers Association's Executive Forum. "More importantly, we have stores. This is a place where Amazon is going to struggle, because it costs money to go local and build the stores and locate inventory that is close to the customer. We have that mass already. We can put almost all the inventory for 150,000 SKUs within a few miles of customers."

Proximity of inventory is a potential advantage for conventional retailers when done right, according to Barry Clogan, a senior vice president with MyWebGrocer, a provider of digital grocery services.

"At a bare minimum, to remain relevant grocers need to offer pickup," Clogan says. "If they don't, they are going to fall so far behind they are going to miss a whole generation of shoppers."

That may sound like a dire prediction, but Clogan has, in a sense, lived in the future where the U.S. is headed. Before joining MyWebGrocer a year ago, he spent five years with Tesco, the world's most successful online food retailer, leading the rollout of online grocery to eight international markets. In Tesco's home market

The TOP 20 most valuable global retail brands

Rank	Company	Brand Value (in millions)	Percent Change
1	Amazon	98,988	59%
2	Alibaba	49,298	-26%
3	The Home Depot	36,440	32%
4	Walmart	27,275	-23%
5	IKEA	18,082	6%
6	Costco	14,461	29%
7	Lowe's	13,001	21%
8	ALDI	12,077	4%
9	CVS	12,074	17%
10	Ebay	11,509	-19%
11	JD.com	10,496	37%
12	Walgreens	10,364	22%
13	7-Eleven	9,360	25%
14	Target	9,301	11%
15	Tesco	8,923	-5%
16	Kroger	7,905	N/A
17	Carrefour	7,736	-3%
18	Woolworths	7,459	-37%
19	Lidl	6,846	14%
20	Macy's	5,419	-24%

Source: BrandZ report from Millward Brown

of the United Kingdom, the retailer is capable of serving nearly 100 percent of the population with a one-hour delivery window by picking orders from 330 stores. It is still growing by double digits after launching 17 years ago, according to Clogan.

E-commerce is less developed in the U.S. than in the UK, but it offers an indication of where things are headed over time as Amazon grows and other retailers elevate their digital game.

"While we believe that Amazon will remain the uncontested winner of the online retail space, the pitched battle between it and the big brick-and-mortar competitors is still in its early stages," according to Charlie O'Shea, a vice president and senior credit officer with Moody's Investor Service. "We expect online retail sales will eclipse 20 percent of total retail sales in

seven years, more than double today's roughly 9 percent."

O'Shea believes that well-run brick-and-mortar retailers will not only survive online, but can thrive there and already are, thanks to their considerable physical assets as they ride the

Making Sense of Amazon's Financials

Amazon impacts the retail industry in many ways, but its full impact on the market is distorted by how it reports sales.

Amazon's net sales increased 20 percent to \$107 billion last year, even with a \$5.2 billion headwind from the weak U.S. dollar. The momentum continued and accelerated during the first half of 2016 with sales up 29.7 percent to more than \$59 billion. A key driver of the sales growth is Amazon's marketplace, where a wide range of third-party sellers leverage the Amazon platform and account for approximately 40 percent of sales.

"Most people see that Amazon reported 2015 revenue of \$107 billion and consider that to be Amazon's top line. However, that's not the full picture," says David Spitz, CEO of ChannelAdvisor, a leading cloud-based e-commerce solutions provider that helps companies sell on Amazon and other marketplaces. "When Amazon sells a product first-party, \$100 in revenue is the same as \$100 in retail sales. However, when Amazon sells a product on its third-party marketplace, it records only the commission as revenue. In other words, reported revenue could understate Amazon's third-party retail sales volume by 90 percent."



That means if Amazon sells two products for \$100 each—one through a first party and the other through a third party—it may report only \$110 in revenue, but it represents a \$200 retail sales impact.

The bottom line, according to Spitz is, "you think Amazon is big, but it's probably twice as large as you originally thought."

Perhaps even more disturbing for competitors is that Amazon is gaining a disproportionate share of the fast-growing segment of the overall retail market, and for the past 18

months has been doing so while accelerating profitability. In 2015, net income surged to \$596 million, or \$1.25 per share, sharply reversing a prior year net loss of \$241 million, or \$0.52 per share. Through the first six months of 2016, profits of nearly \$1.4 billion are more than double all of last year and up from an inconsequential \$35 million profit in the first half of 2015.

Lastly, helping to underwrite the entire enterprise is the company's hugely profitable cloud computing division known as Amazon Web Services, or AWS. For example, AWS accounted for only 9.2 percent of sales in 2015, but its operating profit of \$1.3 billion represented 56 percent of total operating profits. Amazon's North American division accounted for 58.2 percent of 2015 sales, and its \$1.29 billion operating profit accounted for 55 percent of total operating income.

online wave generated by Amazon.

"A compelling part of this strategy is buy online, pick up in-store, which is effectively a same-day availability option for consumers, which we estimate facilitates 40 percent to 50 percent of all online sales by brick and mortar retailers," O'Shea SAYS.

WHAT'S NEXT

"The food and consumable world has been a bit of a safe haven from digital disruption relative to other categories," Kelly Ungerman, a partner at McKinsey & Co. who leads the firm's Americas consumer digital practice, said at the Category Management Association's recent annual meeting.

She believes Amazon's impact is over-hyped in the near term, but under-hyped in the long term. That's because most product searches begin online, mobile has become the gateway to online and Amazon dominates in mobile.

"In most categories they have become the first screen of product search," Ungerman said.

So far, Amazon has had limited success offering fresh food. This year it added Boston, Baltimore and Sacramento to the handful of markets including areas of northern and southern California, northern New Jersey, New York, Philadelphia and Seattle to areas where the service is available for a \$299 annual fee.

Despite the limited availability, Amazon knows how to scale offerings quickly, which it did with the Prime Now service. Launched in Manhattan in December 2014, Prime Now is available in more than 40 metropolitan areas worldwide.

Should Amazon suddenly get more aggressive with its pursuit of food and consumables, it is likely to grow quickly because of the trust factor, according to Carbonview's Ratcliff. The firm's research bears out the high level of trust consumers place in Amazon. Earlier this year, when Amazon announced plans to enter the private label world, Carbonview research showed that consumers rated Amazon's products as more trustworthy and innovative than national brands and as strong in quality—and that was before they were available.

It is a sobering reminder to a food and consumables industry that has been lulled into believing that its market share was less vulnerable to the impact of Amazon.

"More often than not, large incumbents are replaceable, yet they fall into the trap of believing past loyalty is a guarantee

of future loyalty," according to a KPMG white paper authored by Matt Hamory, strategy leader for consumer markets, and Scott Rankin, managing director of strategy. "In fact, too many companies mistake current market share for ongoing market relevance." **RL**