Jeff Bezos looked out the open doorway of his office and stared at the "problem of the day," which his assistant Sarah had posted on the whiteboard in the hallway. It was Friday, September 13, 2002, and the whiteboard read: "You have 10 bottles with 100 pills each in them. In nine of the bottles, each pill weighs 10 mg. In one bottle, each pill weighs 9 mg. These pills are poisonous. You have a digital scale that reads out in mg. Can you determine which bottle contains the poison with only one weight measurement?"

Bezos—founder, chairman, and CEO of Amazon.com—normally enjoyed trying to solve these brainteasers. But today his mind was occupied with weightier concerns. Bezos had an unwavering vision that had guided the company’s efforts since its founding. In Bezos’s words, “We’re building a place where people can come to find and discover anything they might want to buy online.” Indeed, this vision of breadth and selection lay behind the choice of the name “Amazon,” the name of the world’s largest river. Yet, throughout its eight-year history, in the face of changing economics, uncertain financial markets, and a constantly evolving set of competitors, exactly how the company could best deliver on this vision remained a key question for Bezos:

We started with books, but our focus on serving the customer has led us to embrace selection, price, and convenience as the three key dimensions that define the customer experience. In order to fill out selection—and present our customers with a variety of price points, including used products—we have opened up our Web site to other sellers, including big companies, small businesses, and individuals.

Since its founding in 1994, the company’s business model had evolved through several stages. Initially, Amazon had been a pure online book retailer. Amazon had modest inventories and depended on a small number of large distributors to source its vast selection. Over time, however, this retail model evolved to incorporate a far wider variety of products, including music, video, electronics, and kitchen items, as well as deeper investments in physical distribution. By mid-1999, however, it was clear that if Amazon was to deliver on its vision of ultimate selection, it would have to augment its retail commerce model with a second strategy, the “marketplace initiative.”

The first manifestation of this model was Amazon auctions, launched in March of 1999. This was followed by several other initiatives, all of which were characterized by the feature that Amazon did not own the goods being sold and, in many cases, did not take responsibility for the tasks that comprised order fulfillment. Rather, the company had developed a wide variety of commerce
models in which it served as an e-commerce outsourcing partner for individuals as well as small and big companies. It earned fees for bringing buyers and sellers together and for providing a technology platform, distribution, and marketing services.

By the spring of 2002, Amazon had just completed its first cash-flow-positive 12-month period and was operating several distinct businesses under each of the "retail" and "marketplace" umbrellas. The reaction to Amazon's marketplace initiative in the financial markets had been generally positive. Indeed, Amazon's stock was up 52% for the year (as of mid-September 2002) versus a 35% drop in the NASDAQ index. Still, doubts clearly remained in some observers' minds. For example, Holly Becker, an equity analyst at Lehman Brothers, had reservations about Amazon's model. In a report issued in February 2002 she said, in part:

The used business appears to be an excellent complement to Amazon's core retail offering. The used business allows Amazon to participate in a growing market that leverages all of the inherent benefits of the Internet ... a truly virtual model, used eliminates a large portion of fulfillment costs and inventory risk, and therefore provides higher margins ... but ... we believe used is detrimental to Amazon's franchise in the long term. The company's point of difference, market share, and service capabilities are far greater in new products than used ... we believe cannibalization is likely in the longer term.¹

While the company had made dramatic strides in expanding the range of products it offered, there were still many categories in which it participated little or not at all. Thus, a key element of enhancing selection was to constantly expand the range of products sold on the site. In the fall of 2002, Bezos and his senior team were evaluating a proposal to dramatically expand the company's offerings in the apparel area. One option was for Amazon to buy directly from branded manufacturers (e.g., Levis) and to perform the same full range of functions that it did with respect to books, music, and videos. Another approach involved Amazon's approaching one or more retailers with the goal of operating their Web sites. A final option called for Amazon to strike partnership deals with a range of retailers and to provide their goods for sale in an apparel store on the Amazon Web site.

This would represent the next major step in Amazon's evolution and make demands on Amazon's scarce resources. Bezos explained:

Our typical model is to find a category that we want to be in and then decide how we want to participate. Once committed to a category, we seek a commerce model that makes sense given who our potential partners might be and given our ability to add value in that particular category. Apparel is a huge opportunity. It's a $203 billion U.S. market segment, almost 10 times the size of the U.S. book-market segment. But it is also a very complex business. Products come in sizes and colors. Products are branded. There is fashion risk and seasonal inventory issues. In many ways, the business is much more complicated than any of the categories in which we currently operate.

Background on Bezos and the Founding of Amazon

Bezos was a 1986 summit cum bade graduate of Princeton, with a B.S. degree in computer science and electrical engineering. Upon graduation, Bezos went to work at a telecom start-up. Bezos then went to work for D.E. Shaw a quantitative hedge fund, where he helped develop mathematical

models. Intrigued by the emergence of the Internet in the early 1990s, Bezos investigated 20 retail categories where he thought significant revenue might migrate to the Internet. After force-ranking these categories, Bezos focused on bookselling. He considered books an especially promising online opportunity in part because the vast number of stock-keeping units (titles) offered the possibility of compiling a vastly more extensive selection than that available in a traditional retail store. Bezos believed that this relative selection advantage was greatest in the books category.

In 1994, in one of the touchstone scenes of Internet lore, Bezos, his wife MacKenzie, and their dog left New York and set out west in a Chevy Blazer donated by Bezos’s father. As his wife drove, Bezos typed out a business plan. He decided to locate his business in Seattle, in part because of its proximity to software talent and the Oregon warehouse of the leading book distributor, Ingram Book Distributors.²

The Retail Model

Amazon opened for business in July of 1995 as “Earth’s Biggest Bookstore.” The company’s initial selection of 1 million titles increased quickly to 2.5 million. Amazon sourced the best-selling 35% of its titles, which accounted for 60% of its orders, from a single, large distributor, Ingram Book Distributors. Amazon sourced the remaining 40% of orders from other distributors and publishers. Amazon stocked relatively few titles, generally best sellers. Ordering its books on demand allowed Amazon to limit working capital and warehousing investments.³

By the end of the first quarter of 1996, Amazon had achieved $875,000 in sales. The company roughly doubled this volume during each of the next four quarters and reached approximately $16 million in sales during the first quarter of 1997. At this point, Amazon had nearly 340,000 unique customers and daily site visits of 80,000.⁴

Shortly after the first quarter of 1997, Amazon went public. The company raised $42 million in its IPO and ended its first day of trading with a market capitalization of $560 million. Bezos owned 42% of the company. At the time of the IPO, Amazon dealt exclusively in books. It carried no CDs or other products. A significant element of Amazon’s appeal to investors, one often highlighted by Wall Street equity analysts, was the remarkable cash flow cycle associated with its operations. (See Exhibit 1 for Amazon historical financials through the second quarter of 2002 and Exhibit 2 for perspectives on Amazon’s business model at the time of the IPO.) During the remainder of 1997, Internet usage and e-commerce penetration continued to grow. Amazon finished the year with $148 million in revenues and $31 million in losses. (See Exhibit 3 for e-commerce statistics.)

Expanding Its Product Range

In June of 1998, Amazon expanded beyond books and began selling music. Amazon’s entry was soon rewarded; within months, it became the largest online music retailer in the world. Continuing to grow, Amazon entered the video/DVD business in November 1998. (See Exhibit 4 for a timeline of Amazon’s entry into various categories.) In entering the music and video categories, Amazon


³ Ibid.

⁴ Ibid.
extended the fully integrated business model that it had developed in books. For both these categories, Amazon completed the full range of commerce functions, including buying, warehousing, merchandising, shipping, and customer service.

At year-end 1998, the company’s stock price stood at $53 per share, a 3,700% increase from the (adjusted) IPO price of $1.50. Amazon’s year-end market capitalization was $17 billion.\(^5\) (See Exhibit 5 for history of Amazon stock price and market capitalization.) On December 16, 1998, Henry Blodget, a well-known Wall Street equity analyst, called for Amazon’s stock, then trading at $40, to reach $67. Within weeks, the stock exceeded Blodget’s prediction and, as an emblem of the height of the Internet stock frenzy of the late 1990s, reached $105 in late April 1999 and again in December 1999. Blodget’s December 1998 report reasoned:

Amazon is in the early stages of building a global electronic retailing franchise that could generate $10 billion in revenue and EPS of $10 within five years. ... Although Amazon’s stock price is, in our opinion 1) incredibly expensive relative to near-term expectations and 2) scary to buy, we believe that the company’s opportunity is large enough to support a market capitalization much higher than the current valuation.\(^6\)

Through 1999, as the Internet continued to gather momentum, Amazon increased its commitments to new categories. As Amazon expanded, the private and public equity markets funded Internet-related companies to an unprecedented degree. (See Exhibit 5 for data on capital market activity.)

During the last half of 1999, Amazon launched toys, electronic products, tools, and software. During 2000, it added lawn and patio and kitchen products, as well as cell phones and wireless services. In addition, the company was also expanding overseas, adding dedicated sites for the United Kingdom, Germany, Japan, and others. (See Exhibit 4 for an outline of Amazon’s international expansion.)

Thus, by mid-2002, Amazon’s retail sales were spread among segments as follows:

<table>
<thead>
<tr>
<th>Category</th>
<th>% Sales Revenue 2Q 02</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. Books, Music, Video</td>
<td>51%</td>
</tr>
<tr>
<td>U.S. Electronics, Tools, Kitchen</td>
<td>16%</td>
</tr>
<tr>
<td>International</td>
<td>27%</td>
</tr>
<tr>
<td>Services</td>
<td>6%</td>
</tr>
</tbody>
</table>

Source: Company SEC filings.

**Investing in Distribution**

In preparation for the Christmas 1999 season, Amazon decided to invest in its warehouse and fulfillment capabilities. The company built five U.S. warehouse and distribution facilities and several customer service centers. (See Exhibit 4 for timeline of Amazon’s buildout of these facilities.) The investments were primarily designed to ensure that Amazon could meet its 1999 holiday volume:

All references to Amazon’s stock price have been adjusted to account for the three stock splits since Amazon’s IPO. These stock splits have resulted in an increase in the number of shares outstanding. The original Amazon stock offering price was $18.

moreover, the investments increased Amazon’s distribution capability in product categories where it could not rely on third-party distributors to the same degree that it did in the book business.

**Supporting the Business with Technology**

Throughout its evolution, one of the company’s key efforts was around technology. Bezos estimated that the company had invested $800 million in building out and integrating the technology that ran its Web site, customer service unit, payment processing systems, and warehouse operations. For example, Amazon had made a number of innovations in customer-facing technology. These included one-click buying, which it had patented, and "tabs," which had become the dominant user interface mode of organizing e-commerce on the Web. Amazon had pioneered the use of Web site personalization and customization so that, for example, customers were greeted by name when they arrived at Amazon.com, offered personalized special offers in their gold box, and presented with recommendations based on their prior purchases and predicted preferences. Additionally, Amazon’s technology stored customers’ addresses, credit card information, gift recipients, and payment preferences. These features made it easier for consumers to buy and raised the costs of their switching to competitors.

At the same time, Amazon had made deep investments in its e-commerce infrastructure, investments that allowed the company to operate a fully integrated e-commerce operation including payment processing systems and customer service operations. Amazon had also built an enormous database of product and customer information that supported many of its information-driven functions, such as customer service and Web site serving. In the words of one observer, “Amazon has built much of this on its own, to very high standards of security, reliability, and scalability. They run the largest, most sophisticated e-commerce operation in the world.”

**The Marketplace Model**

**Entering the Auction Space**

In early 1999, Bezos saw the potential power of auctions to expand the sources and selection of products available to Amazon customers: “As always, we were committed to selling a broad array of products, and auctions was a terrific way for us to partner with other sellers to expand selection.”

Bezos pushed his IT organization to develop auction capability, which debuted on the Amazon site in March 1999. While similar in some respects to eBay’s offering, Amazon’s auction site guaranteed buyers financial protection from fraud and also provided access to Amazon’s experienced customer service phone representatives. In November of that same year, Amazon launched a partnership with Sotheby’s oriented toward Web-based auctions of higher-end arts and antiques. (See Exhibit 6 for eBay financial data and Exhibit 7 for comparison of Amazon and eBay fee structure and for financial and operating comparison of Amazon and eBay.)

It was estimated that there would be approximately 450 million online auctions conducted in the United States in 2002, generating $12 billion in gross merchandise sales and $900 million in revenues for the companies that hosted these auctions. Further, analysts estimated that gross merchandise
sales would grow 42% between 2002 and 2003. Globally (including the United States), gross merchandise sales were estimated at $16 billion in 2002, growing to $23 billion in 2003.7

zShops

In the fall of 1999, Amazon introduced zShops, an area on the Web site that, like auctions, facilitated transactions between customers and third-party sellers. zShops offered small and medium-sized merchants the opportunity to operate storefronts within Amazon’s Web site. Within these stores, merchants could upload, maintain, and merchandise up to 40,000 items. Merchants that operated zShops sold goods at a fixed price.

Merchant Relationships

In early 1999, Amazon also began entering into a series of partnerships with other Internet retailers, including Drugstore.com, Living.com, Greenlight.com, and Wine.com. Generally, these firms became affiliates of Amazon and paid Amazon placement and referral fees for advertising themselves on the Amazon site. In many instances, these deals involved Amazon’s purchasing equity in the partner. Amazon generally referred to these early merchant relations as the Amazon Commerce Network.

Amazon also initiated a series of relationships with retailers that did not operate exclusively or primarily on the Web. While Amazon’s relationships with these merchants varied considerably, Amazon’s partnership with Toys “R” Us illustrated the degree to which Amazon was committed to partnering. Under a 10-year deal, Amazon agreed to house Toys “R” Us inventory, ship goods to customers, process payments, and perform post-sale customer service. Amazon developed and maintained the toys tab inside the Amazon Web site. Toys “R” Us retained responsibility for buying and pricing inventory.

Evolving Commerce Models

Bezos reflected on the growth and variety of Amazon’s relationships with other merchants and, generally, on the role of commerce partnerships at Amazon:

There are things we’ll never be able to do that partners can do effortlessly. Likewise, we bring certain skills and a customer base to the table that would be very difficult for partners to acquire. The toys category is a good example. The toy business is incredibly seasonal. You need to order your inventory in March, eight months before all the sales occur. Then, as Christmas approaches and a few toys get hot, a few privileged retailers get some of the last-minute shipments that come in from the overseas locations where most toys are manufactured. Toys “R” Us had a huge advantage in this inventory management and sourcing dynamic, and it became clear that our customers would be better off if we partnered.

As we began to look to partnerships in the toys category, Toys “R” Us was learning that it was much harder to operate a Web-based business than they thought. I have tremendous respect for the traditional retailing business. Good retailers are extremely skilled at picking real estate locations and figuring out how to get people to linger in their stores. Traditional

Steve Weinstein and Chad Bailer, *e3ei- wrHwafe’ ParsV* Crest Securities Research, October 1, 2002.
retailers focus on such fine-grained details as how many lumens of light they need to make
people feel safe in their parking lots.

But, doing business on the Web has its own difficult and distinct set of challenges that
we’ve worked hard to figure out. Technology is the backbone of it, and it is completely
different than what you need to be good at as a traditional retailer. Take fulfillment, for
example. Physical retail chains have multiple distribution centers that deliver pallets of
products to hundreds of stores around the country. Online, you don’t ship pallets to stores—
there are no physical stores. Instead, you have a few centralized distribution centers that pick
and pack millions of unique product combinations and ship them directly to millions of
customers’ homes. The technology, processes, and competencies needed to run this operation
differ fundamentally from traditional distribution functions.

Another difference is how to help customers find and discover products. It’s enormously
difficult to design and continually improve a Web interface that effectively helps customers
find, research, and buy a product online. Traditional retailers know how to solve these
problems in a physical store, but that knowledge does not translate directly to the Web.

We also believe that our brand has a lot of value in our partnerships with traditional
retailers. In the physical world, convenience equals location. You might believe that you run
the best taco stand in the world, and others might even agree. But if it sat at the top of Mount
Rainier, you just wouldn’t do a lot of business. In the online world, the importance of location
changes. Every place is equally convenient. So, you need more than mere convenience. Our
brand—more importantly the customer experience it stands for—is an advantage. It
differentiates our location from so many others.

In late 1999 and early 2000, traditional retailers began to realize how difficult it was to do a
good job on the Web. They also realized that, rather than accounting for half or more of their
business, the Web would perhaps account for 5% of their volume. With these insights, retailers
became more interested in outsourcing their online presence, and we began to do deals with
companies where we would be responsible for significant portions of their online operation.

Bezos reflected on what Amazon had learned from its early experiences with commerce
partnerships:

One of the things we had to learn through zShops and auctions was that we needed to
think of ourselves as serving two different sets of customers. We pride ourselves on being
customer-centric, but for years, “customers” meant “buyers.” As we began to operate auctions
and zShops, we realized that these third-party sellers were equally important customers. And,
it took a little while for the organization to learn what their needs were and how we could best
meet them.

Integrating the Businesses

Throughout 1999 and into 2000, the marketplace initiative operated as a separate business unit
within the company. The focus of the marketplace initiative on third-party sellers was a source of
tension in various parts of the organization. One observer commented:

From the beginning, Amazon was fanatical about creating a high-quality, Web-based
customer experience. Amazon invented one-click shopping, user-friendly browsing,
personalized recommendations, fully integrated customer service, and so on. Every employee
in the company spent most of December packing boxes in the warehouses to make sure no customer was let down. So, the premise of the marketplace initiative, this notion that a third-party seller would be responsible for significant parts of that customer experience, seemed to many in the company to run counter to Amazon’s core culture and customer orientation.

Amazon’s initial choice in organizing third-party commerce on its Web site was to contain it in distinct areas of the Web site, specifically in tabs titled “auctions” and “zShops.” To customers, Amazon’s traditional product lines remained distinct and separated from inventory and commerce related to third-party sellers. For example, to buy a book from Amazon, users continued to go to the books tab. Alternatively, to buy a used book from another merchant, customers visited the auctions or zShops tabs on the Web site.

In January of 2000, that changed. In a pivotal Saturday morning meeting, senior managers in charge of the marketplace initiative met with Bezos at his home to discuss what was working and what was not. The key insight that emerged in the discussion was the need to give Amazon’s third-party sellers access to the “product-detail” pages inside Amazon’s traditional stores for books, music, video, and other products. Bezos recalled: “At the end of the day, we realized that what was most important to the marketplace sellers was demand—access to prospective buyers. So, the idea of the single store was to give them a level of access equal to our own—listing their goods right alongside ours.”

As the place on the Web site where customers bought products from Amazon, these product-detail pages accounted for the large majority of Amazon’s traffic. The plan, all agreed, should be to let Amazon’s partner merchants sell their products on the same pages where Amazon sold its own goods. Bezos called this move the “single-store” strategy. Each store at Amazon—the boundaries of which were generally set by the tabs on the Web site—would have as its sole mission the delivery of selection, low prices, and high in-stock availability to its customers. The general managers of each of these “single stores” would display, in an integrated way, goods sold by all sellers with whom Amazon did business.

To implement the single-store model, Amazon developed a single product-detail page on which multiple sellers would showcase their goods. For example, a product page for a CD would include the permanent information related to a particular title, such as the artist, song lists, and cover art (which Amazon kept in an extensive database it had developed for all books, CDs, and video, as well as other products it sold). On that permanent page, various examples of that product could appear for sale. Some of these examples would be for sale by Amazon and shipped out of Amazon’s distribution centers. Third-party sellers would hold other examples for sale. In electronics, for example, a product page for a Palm Pilot would merchandise Amazon’s offering alongside offerings by J&R Electronics and used products by small businesses and individuals.

Bezos reorganized the company to support the new single-store strategy. General managers for each store would be accountable for store-specific income statements that reflected both commerce related to Amazon’s operations and commerce related to activities on Amazon’s platform of third-party sellers. Prior to this reorganization, Amazon’s general managers for certain categories had been responsible only for Amazon’s traditional retail commerce; separate management teams had run the auctions, zShops, and other third-party initiatives.

Bezos described the thinking that lay behind this organizational change:

When you have something big—our retail business—and something small—our then-emerging mar how strategic > hand to get people focused on the little thing, no matter t is. People ape incredibl busy, and they simply have bigger fish
to try most of the time. We couldn’t really integrate the businesses until the marketplace piece was big enough and demonstrably important enough to demand their attention.

In the wake of the changes in 2000, many in the organization began to think of Amazon as a platform for commerce rather than as a retailer. Bezos, certainly, was unequivocal in his determination to deliver price and selection to Amazon’s loyal customer base and willing, in the pursuit of that goal, to redesign Amazon’s business model accordingly. He spoke repeatedly of the need to manage for the long term and toward the vision of Amazon’s becoming the place for consumers to find and discover anything they might want to buy online.

In early 2001, the company announced it would lay off 1,300 employees, or 15% of its workforce. At the same time, the company announced the closing of one major distribution center and a customer service center. The company took a restructuring charge of more than $150 million to account for these and other moves.8

**Executing the Single-Store Vision**

Implementing the single-store vision required Amazon to develop multiple ways of partnering with and supporting the commerce of third-party sellers, which ranged from small merchants to large corporations.

**Small Businesses and Individuals**

In launching zShops and auctions, Amazon attracted thousands of small merchants and individuals to its site. The introduction of the single detail page offered to these merchants the opportunity to merchandise their products on the highly trafficked Web pages that historically had sold only Amazon products. The single detail page, in effect, invited Amazon’s base of small merchants and individual sellers to migrate from the auctions and zShops area of the Web site to the very core of Amazon’s site traffic and to display their products side by side with Amazon’s own merchandise. (See Exhibit 8 for example.)

zShop book merchants, for example, were given automated tools to migrate their catalogs of millions of used and out-of-print books onto the new single product pages inside the Amazon books tab. A similar transformation took place across all of Amazon’s stores where small merchants, many already active in the zShops area of the site, began to list used, refurbished, collected, and discounted products adjacent to Amazon’s product offerings. To serve individual sellers, Amazon introduced a feature that allowed individuals to list a single item for sale on Amazon’s product pages. (See Exhibit 7 for the fee schedules that Amazon offered to small businesses that wanted to sell products on Amazon’s detail pages, in zShops, and in auctions.)

**Large Business Sellers**

As the company pushed to continually expand its product lines and as the single-store strategy took shape, Amazon developed multiple partnership strategies with large companies. Most of Amazon’s commerce partnerships with large companies fell into one of four categories:

---

Merchants@Amazon.com Under this commerce arrangement, Amazon entered into partnerships with large retailers such as J&R Electronics, Office Depot, Circuit City, and Toys "R" Us. Under the terms of these arrangements, partners could sell their products on Amazon's Web site while still performing many of the commerce functions themselves. In these deals for example, merchants retained ownership and possession of inventory and set prices on their inventory. Merchants benefited from getting access to Amazon's customer base and from displaying inventory on Amazon's high-conversion site. In addition to improving its selection and customer experience, Amazon received a small fixed fee to cover oversight and setup expenses and a commission on items sold.

Merchants.com Under the merchants.com program, Amazon operated third-party Web sites on behalf of a variety of merchants. Thus, in contrast to the merchants@Amazon.com program, the goods were not merchandised on Amazon's site but appeared on the partner's own, separate site. For example, Amazon developed and maintained <www.target.com> on behalf of Target Corporation. In certain merchants.com arrangements, including the relationship with Target, Amazon took inventory into its distribution centers and completed most fulfillment functions, from shipping to customer service and returns. Merchants benefited under these arrangements, in part, from their use of Amazon’s infrastructure and technology platform. From its merchants.com partners, Amazon received a fixed fee—which varied in size depending on the scope of services performed by Amazon—as well as a commission on products sold.

Syndicated stores Like its merchants.com program, Amazon's syndicated-stores arrangements involved Amazon's operating Web sites on behalf of partners. However, unlike the merchants.com model, the syndicated-stores program charged Amazon with responsibility for all product development and operational tasks in support of the Web site, including buying, stocking, pricing, shipping, and servicing product. Amazon operated syndicated stores on behalf of Borders, Virgin Records, and Waterstones (the British version of Borders). Under this model, Amazon essentially offered its partners a fully integrated and completely outsourced commerce solution. In operating syndicated stores, Amazon's role was invisible to the customer, except for a "powered by Amazon" tagline at the bottom of the site's homepage. Initially, Amazon operated syndicated stores primarily on behalf of book and music retailers for whom Amazon could launch and operate a fully scaled and integrated online operation on the basis of its own experience in book and music online retailing. In this format, Amazon collected and booked all revenue and expenses associated with commerce in the syndicated store. Amazon's partners received a share of revenues generated by the syndicated stores. This arrangement generally allowed Amazon's partners to quickly reach profitability in their online efforts, since Amazon carried all significant expenses and investments associated with the operation.

Marketing deals Lastly, Amazon was involved in a number of marketing relationships. In these cases, Amazon promoted its partners' products or services on its Web site and, in some cases, allowed its customers to click over to its partners' Web sites. An example of such an arrangement was drugstore.com. Amazon charged its partners based either on the number of customers exposed to the partner's site or a commission on items sold.
inventory and completed fulfillment tasks) to a minimum of 5% of revenues (in partnerships where Amazon did not complete significant functions associated with inventory management and fulfillment). By the middle of 2002, Amazon generated significant business across all of its third-party commerce models, including both its individually negotiated relationships with large merchants and its general programs from small businesses and individual sellers. For example, Amazon reported that third-party transactions accounted for 20% of its North American units sold in the second quarter of 2002.

Bezos and his senior team had given considerable thought to the diversification of commerce models at Amazon and to the challenges of creating the proper internal incentives for Amazon’s general managers. (See Exhibit 9 for an analyst’s summary of the unit economics to Amazon of selling its own inventory versus enabling third-party commerce.) Bezos commented:

One of the keys to making this work is to try to get our economics to the point where we are agnostic about whether customers buy from us or from a third party. In the end, if we satisfy our customers and partners, they’ll remain loyal to us, and we should have no angst about cannibalizing our own business. To this end, we have tried to engineer fee structures for third-party transactions in such a way that they provide the correct incentives for the managers who are responsible for their own P&L. Our primary concern is the customer experience, not short-term economics. Our view is that a better customer experience will drive more people to our site more often, creating a larger absolute market.

The Apparel Opportunity

In the fall of 2002, against this backdrop, Bezos was juggling a number of proposals to take Amazon more deeply into the apparel business. Amazon’s only apparel offering was a small selection of goods offered by zShop merchants. Part of the impetus for Amazon’s interest in the apparel category was its size. Amazon estimated the U.S. apparel market segment at $203 billion per year. Various analysts estimated that the online component of the apparel business represented roughly 3% of the total market segment. Online apparel commerce was forecasted to grow at 34% from 2002-2007. (See Exhibit 3 for details of online spending forecast.)

<table>
<thead>
<tr>
<th>Market Segment</th>
<th>U.S. Market Segment</th>
<th>Amazon U.S. Market Segment Share</th>
</tr>
</thead>
<tbody>
<tr>
<td>Books</td>
<td>$23</td>
<td>-5 %</td>
</tr>
<tr>
<td>Books, Music, Video, and DVDs</td>
<td>$49</td>
<td>-3 %</td>
</tr>
<tr>
<td>Home</td>
<td>$109</td>
<td>&lt;1 %</td>
</tr>
<tr>
<td>Apparel</td>
<td>$203</td>
<td>-0 %</td>
</tr>
<tr>
<td>Home Improvement</td>
<td>$148</td>
<td>&lt;1 %</td>
</tr>
<tr>
<td>Electronics</td>
<td>$103</td>
<td>&lt;1 %</td>
</tr>
<tr>
<td>Total Retail</td>
<td>$1,628</td>
<td>&lt;1 %</td>
</tr>
</tbody>
</table>

Source: Casewriter analysis.

One approach to the category would be for Amazon to buy, stock, merchandise, and ship apparel in much the same way that Amazon ran its book, music, video, and electronics businesses. As an alternative to this integrated approach, Amazon could seek simply to manage Web sites on behalf of large apparel companies that, in many cases, struggled with the execution of maintaining large Web sites. A variety of other models, all of which involved Amazon’s completing some but not all of the functions required to sell apparel online, were also under consideration. One involved Amazon’s selecting and negotiating partnerships with significant apparel companies. (See Exhibit 10 for financial data on a variety of retailers.) The apparel industry was structured around a complicated mix of department stores (e.g., Macy’s and Nordstrom’s), integrated manufacturers and retailers (e.g., the Gap), and branded manufacturers (e.g., Levi’s). For any partners that fit Amazon’s chosen strategy for entering the category, Amazon would need to negotiate an operating and financial arrangement that met the needs of both parties.

Bezos reflected on the opportunities and challenges that apparel represented:

We are committed to expanding selection for our customers. Clearly, apparel is a large and growing category for online commerce, and thus, important for us to participate in. The hard question is how to go about sourcing, merchandising, and servicing an authoritative, large selection of merchandise. Conceptually, the answer is bounded, at one extreme, by a strategy of stocking a full range of products into our distribution centers and, at another extreme, by organizing a store exclusively around partnerships with various apparel players who, in combination, provide full selection.

Looking Ahead

As his team and he debated the apparel strategy, Bezos also reflected on Amazon’s long-term expansion strategy. Conversations about expansion criteria and the prioritization and sequencing of opportunities often occupied Bezos and his senior team. Some argued that Amazon, still only responsible for less than 1% of the U.S. market in its existing categories, should focus on domestic growth of its existing business lines. Yet others advocated a focus on international expansion, which by the second quarter of 2002 accounted for 27% of Amazon’s revenue. (See Exhibit 11 for data on international markets.) In all these conversations—and regardless of how they balanced domestic and international growth—Bezos and his team debated the criteria by which they would prioritize certain categories over others as targets for expansion. “We are committed to expanding across categories,” explained Bezos. “That’s not a hard issue. What is difficult is deciding which opportunities to pursue when.”
Amazon.com, Inc. (ʃˈæməzən/), is an American multinational technology company based in Seattle that focuses on e-commerce, cloud computing, digital streaming, and artificial intelligence. It is considered one of the Big Four technology companies, along with Google, Apple, and Microsoft. It has been referred to as "one of the most influential economic and cultural forces in the world" as well as the world's most valuable brand. Your Amazon Music account is currently associated with a different marketplace. To enjoy Prime Music, go to Your Music Library and transfer your account to Amazon.com (US). Fix in Music Library. Close. Sold by Amazon.com Services LLC. Additional taxes may apply. By placing your order, you agree to our Terms of Use. Check out 2002 on Amazon Music. Stream ad-free or purchase CD's and MP3s now on Amazon. Listen to over 60 million songs, anywhere with Amazon Music Unlimited. Renews automatically. Cancel anytime. Limited time offer. Terms apply. Learn More. Artist Overview.