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Daniel Rivet
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May 2017
Faculty Sponsor: Professor Andrew Earle

Amazon's Superior Innovation:

**A study of Amazon's corporate structure, CEO, and reasons behind why it has
become the most innovative company in today's market.**

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Introduction

Amazon is one of today's most powerful companies. The convenience of Amazon.com and the hot new products that Amazon is creating has skyrocketed Amazon to the top of the list of successful and innovative businesses. Looking at Amazon from the outside in, the question of "What drives Amazon to be so successful?" stands out. First thoughts are answers like "CEO, Jeff Bezos" or "it's ability to innovate". Yes, those are certainly major factors in the success of a company of this stature, but it is more complex than that. This study will answer the question, "How does Jeff Bezos' leadership style give him the ability to visualize the structure for success that he has implemented so well with Amazon?"

Literature Review

Structure of an organization is a crucial part of creating an innovation-focused company. Harvey M. Sapolsky conducted a study for the University of Chicago on Organizational Structure and Innovation. In this study, Sapolsky refers to the work done by James Q. Wilson about organizational innovation. Wilson states that, "task structures affect the rates at which an organization will generate and adopt innovations". Wilson also goes on to hypothesize that "the greater the diversity of the organization, the greater the probability that members will conceive major innovations". Amazon has an organizational structure that does just this. Bezos has implemented a structure of team processes where all teams are working on a diverse set of projects. These projects are all being worked on independently of

one another, which promotes the innovative atmosphere. The more diverse the organization is with these projects, the more innovations there will be.

A compelling article I came across while continuing my research on Amazon and Jeff Bezos was titled “Jeff Bezos, The Outsider CEO”, authored by Jon Allion from Seeking Alpha. Jon talks about a book written by William Thorndike called *The Outsiders*. William Thorndike is the founder of Housatonic Partners, an investment company that makes large equity commitments in companies ranging from \$10 to \$30 million. Thorndike published *The Outsiders: Eight Unconventional CEOs and Their Radically Rational Blueprint for Success* in 2012. The book covers eight CEOs that have an “unconventional” approach as a CEO and the reasons they have become so successful. Bill Ackman, billionaire CEO of hedge fund management company Pershing Square Capital Management, gave praise to *The Outsiders* at an event in April 2014. Ackman was giving a presentation that he ended up calling “The Outsider” and stated that, “the name of the presentation comes from a book which I highly recommend you read. I would say it is one of the most important investment books I have ever read” (Vardi).

The book covers eight CEOs including Tom Murphy (Capital Cities Broadcasting), Henry Singleton (Teledyne), Bill Anders (General Dynamics), John Malone (TCI), Katharine Graham (The Washington Post), Bill Stiritz (Ralston Purina), Dick Smith (General Cinema), and Warren Buffet (Berkshire Hathaway). The book realizes that each of the CEOs succeeded for a number of reasons, most importantly being that all of them were “masters of capital allocation” and preferred

cash flows to earnings. The Outsiders were all able to then redeploy that capital into more profitable projects.

Jon Allion compares Jeff Bezos to The Outsider CEOs and why he believes that Amazon still has plenty of room to grow. Allion provides side-by-side quotes from Thorndike in his book and quotes from Bezos' shareholder letters over the years to illustrate why Bezos is a modern-day Outsider CEO. On the left side of the following chart are Thorndike's quotes from the book and the right quotes are from Bezos over the years.

<i>"CEOs need to do two things well to be successful: run their operations efficiently and deploy the cash generated by those operations"</i>	<i>"We will balance our focus on growth with emphasis on long-term profitability and capital management"</i>
<i>"They were masters of capital allocation the process of deciding how to deploy the firm's resources to maximize shareholder returns"</i>	<i>"We will continue to measure our programs and the effectiveness of our investments, to remove those that do not provide acceptable returns"</i>
<i>"At the core of The Outsiders' shared worldview was the belief that the primary goal for any CEO was to optimize long-term value per share"</i>	<i>"I care very much about our share owners, and so I care very much about our long term share price"</i>

The similarities are astonishing. Bezos' state of mind regarding long-term profitability as well as maximizing cash flow goes hand-in-hand with Thorndike's theory of The Outsiders excelling in capital management. This theory goes on to prove that it is because of Bezos and the way he runs Amazon that the company has been superior than its competitors in innovation and long term performance.

Amazon's leadership principles

Amazon has a list of leadership principles that all employees follow, from executives to lower level employees. The principles are as follows: Customer Obsession, Ownership, Invent and Simplify, Are Right A lot, Hire and Develop the

Best, Insist on the Highest Standards, Think Big, Bias for Action, Frugality, Learn and Be Curious, Earn Trust, Dive Deep, Have Backbone; Disagree and Commit, and Deliver Results.

These leadership principles are a good overview of what the core of Amazon is really like. A few of the key principles listed above are Customer Obsession, Invent and Simplify, Insist on Highest Standards, and Deliver Results. Customer Obsession is Amazon's first leadership principle and for a good reason. The company strives to focus on the end consumer and work backwards from there. The Amazon Kindle tablet was created due to customer demand rather than an idea created from an engineer at Amazon. Bezos felt strongly about moving forward with the project to create the Kindle tablet due to the fact that it was clearly something that the consumers wanted. He made it clear that this project was a priority when an Amazon finance executive asked him how much he wanted to spend on the Kindle Project and Bezos responded with "How much do we have?" Employees dig into what the customer's wants and needs are, and from there come up with solutions or products to meet those needs. Bezos was quoted from an interview in 1999, just four years after Amazon was established, saying, "Our vision at Amazon.com is to be the world's most customer-centric company. We don't view ourselves as a bookstore or a music store. We view ourselves as a customer store" (Rey). This shows how limitless Amazon is as a company and has been from the beginning. It started with a demand for an online bookstore and has transformed into many different sectors because it has focused on what the customer wants. It is clear that this has been the focus since the birth of the company and to this day has worked

out for Amazon. This is the basis of why every new product or business aspect that Amazon comes out with is so successful. Bezos mentions in an interview with Adi Ignatius at Harvard Business Review that as things get complicated at Amazon, “We simplify by saying ‘What’s best for the customer?’” (Ignatius). When it comes down to tough decisions at Amazon, it always loops back to what is best for the customer.

Invent and Simplify is a leadership principle that defines Amazon’s business model. Amazon is constantly creating new lines of business that are disrupting sectors. Some examples are Amazon Prime Air, and Amazon Go. These are two new aspects of business that are going to completely change the way every individual does business. With Amazon Prime Air, customers will be able to order something on Amazon.com and have it delivered with Amazon Prime Air in 30 minutes or less via drone. Amazon Go is a grocery store with no checkout required. It will use a technology to track what customers put in their shopping carts and charge it to their Amazon accounts. These are just two of the projects that Amazon employees have created because of the Invent and Simplify leadership principle.

The executive members of Amazon hold their employees to the highest standards possible. The employees at Amazon have the mindset of being the best, and Bezos expects his employees to be the best they can be. The Insist on the Highest Standards principle ensures that all employees are constantly raising the bar and demanding the best ideas, products, and services possible. When Amazon employees are creating new products, they do not stop at a mediocre product. Because of this principle, employees are striving to make their products or services

the best that it can possibly be. This then creates a higher demand for the particular product or service because customers know the true quality of the product.

Combining the above three leadership principles will lead the company to the final one: Deliver Results. When a company is obsessing over customer needs, inventing and creating products to meet those needs, and constantly raising the bar to make those products better, it will always lead to results that are passed onto the consumer. Examples of successful “results” for Amazon would be Amazon Prime, Amazon Echo, and Amazon Web Services. These products/services are exactly the type of results that Jeff Bezos is looking to come from the use of his leadership principles.

These leadership principles have shown to lead to great success so far for Amazon. Jeff Bezos laid down these leadership principles in hope that it would establish an outline to follow to bring success to the company and it did just that. Because of Jeff’s ability to design these leadership principles and implement them into his company has been a direct correlation to how successful and innovative it has been.

Google, a major competitor of Amazon’s in technology advancements, has a list of “Eight Ideas that work at Google” that shows some similarities to Amazon’s leadership principles but also some key differences. Amazon’s “Think big” and “hire and develop the best” leadership principles are consistent with two of Google’s Eight ideas, “Think 10x” and “ Hire the right people”. Both organizations feel strongly in these principles and operate their businesses behind this logic.

Although there are these similarities, there are also a couple of key differences in the two company's principles that sets Amazon on a separate pedestal than Google. One of these differences lies in relation to Amazon's Invent and Simplify principle. Amazon expects and requires innovation and invention from their employees and urges them to "look for new ideas from everywhere" and explains that they are "not limited by 'not invented here'". Amazon will pursue all inventive and innovative projects no matter the idea as long as it will positively affect the consumer. 90 percent of Google's projects are dedicated or related to the company's core business whereas only 10 percent of projects are unrelated to the core business (G Suite). This puts limits on where Google employees can go with their ideas and what idea they can fully pursue. At Amazon, if an employee believes he or she has an idea that could be an innovative project that would positively affect the end consumer he or she can present it to Bezos and an executive board and they decide whether or not to pursue it right on the spot. Another difference in the two organization's principles is how they prioritize the consumer on their principles. Of Google's "Eight Ideas", the very last idea is to Focus on users, not the competition. Amazon's very first leadership principle is Customer Obsession. It is clear that Amazon's top priority is the consumer. Amazon's customer obsession principle as the first on the list allows its employees pursue any idea that would improve the life of the consumer.

What is amazon's structure?

Amazon has a unique structure to the organization. As most large, innovative companies, Amazon is very open to invention and ideas. Jeff Bezos likes to explain the environment of Amazon as “hospitable to experimentation”. Amazon’s culture is based entirely off of experimentation. Bezos knows and understands the importance of experimentation and how it leads to innovation. He also understands that to be able to experiment, you have to know how to fail, or how to accept failure. Jeff has implemented a belief in the company that it (as in Amazon) “must be willing to be misunderstood for long periods of time” (Ignatius). Experiments are crucial to innovation and Jeff thinks that, “Experiments are key to innovation because they rarely turn out as you expect and you learn so much” (Gregersen).

At Amazon, experimentation is always occurring throughout the company and ideas are constantly being presented to Bezos and a small executive committee to decide on which projects they want to pursue. When pursuing the selected projects, Bezos limits the size of the group that is working on each one. He uses the term “Two-Pizza Teams” to describe how big each group should be. Bezos’ thought process is that “No team should be so large that it cannot be fed with just two pizzas” (Soper). What is unique about Amazon’s team processes is the fact that they are completely independent of other teams in the company. Bezos has made the culture so that each team is working on their own projects with no knowledge of the other projects that are going on. Bezos believes that this independence allows the teams to use whatever technology or resources they need to make the project a success and do not have to rely on another team’s technology to help them. It allows

the groups to be more creative and expand on their ideas to help make them into reality.

Employees are able to stay focused on their experiments because they have adopted the mindset that they may be misunderstood for a distinct period of time. They understand that these ideas and projects are going to be altered in many ways, and in the midst of it all, they may not know exactly where they are going to end up, or even where they want to end up. Staying focused on the project at hand allows these employees to keep experimenting until they have a finished product that will positively impact the lives of the customer.

While other firms may acquire small startup companies to add to certain sectors of their business, Amazon tends to focus more on nurturing its entrepreneurial projects from within. This promotes innovation even more knowing that the company has faith in the employee's projects and wants to create those projects into large, disruptive innovations that will help the company flourish. Employees are motivated from this because they know that the executives of the company have faith in them creating new products or new sectors of the business that are going to disrupt new markets and lead to further success for Amazon.

How has Amazon's structure made them able to innovate?

Jeff Bezos has created a structure at Amazon that revolves around customer wants and needs. This revolving structure is accompanied with employees that maintain an "Explorer" mentality that they use to innovate new products. The "Explorer Mentality" is described as a mindset of employees that like to venture to

new areas of business or new products and attempt to create an idea or product that would be beneficial to the customers. As employees know this, it allows them to harness the experimentation mentality and use it to the best of their ability. Knowing that they are willing to be misunderstood, the employees can develop their ideas into disruptive, innovative products or business segments.

This structure that Bezos has used within Amazon has been a key factor in Amazon's ability to innovate and remain at the top of successful companies. Because of the idea that Amazon is constantly experimenting and always coming up with some innovative product or service, the company never has to play "catch up". In an interview with Business Insider, Bezos stated, "What really matters is, companies that don't continue to experiment, companies that don't embrace failure, they eventually get in a desperate position where the only thing they can do is a Hail Mary bet at the very end of their corporate existence" (Kim). Amazon is never behind the eight ball because of the structure of the company.

Jeff's vision for the company

Jeff Bezos started Amazon in 1994 after realizing that the Internet had grown at an astounding rate of 2,300% in the year prior. Bezos had the vision of creating an "everything store" online where he could sell numerous products in all different sectors. When determining what to sell first, he created a list of twenty things that he could sell on the store that later became Amazon, and he decided to sell books. At the time, there were only two other retailers that were selling books and Jeff believed that he could sell them to customers at a cheaper price. He also believed

that because no matter where you got the book, it was going to be the same thing, he had a leg up on the competitors. Jeff was able to find a loophole in the system that allowed him to buy books in bulk to get them at a cheaper price without having to get all of the books delivered. Jeff would order nine books that were out of stock and then the one book that he actually needed to sell and the distributor would only ship him the one book that he actually needed because the others were out of stock. This allowed him to charge his customers a lower price than his competitors and therefore created a competitive advantage for Amazon. This advantage led to more and more customers purchasing books from Amazon and this led to more cash flow coming into the business for Jeff to start selling other products. Fast forward some 15-20 years and Amazon is a site where a customer can pretty much buy anything they need. Bezos instituted the culture of giving the customer what they want and it opened horizons for Amazon.

When Amazon went public in 1997, Jeff wrote a letter to shareholders explaining that it's all about the long term. Jeff explains in a 2013 interview with Adi Ignatius from Harvard Business Review that he wanted to make it clear what the goals of the company were. Jeff knew that the company was going to be inventive and believed that that does not come in the short term. He understood that failures would happen but stressed to the shareholders that it is a long-term vision that he has for the business in hope that the shareholders would stay on board for the long haul. When Jeff came out with that statement, it aligns the interests of the shareholders and the customers knowing that they are focused on the long-term future of the company.

Jeff envisioned a company that could give the customer what they want and had a belief that they could create all of these products that people want, and/or create a way to give it to them. With this culture of the company, the future is limitless for Bezos and the Amazon team. The constant experimentation, willingness to fail and be misunderstood, and customer centric attitude are a few of the key factors of this company that allows them to produce innovative products at a constant rate. Because they are so focused on the end customer, there are no restrictions on what product or service the company should invent or introduce next. Bezos stated in the interview with Adi Ignatius, “We like to build innovative things. If we can find something that we think customers would like that would be differentiated, it would be super fun to do that” (Ignatius). This relates back to the theory of Bezos and Amazon continuously investing in new projects to sustain a disruptive, innovative force in the industry. The recent financials of Amazon prove the theory because of the mass amounts of money from earnings that Amazon is continuing to invest in new or existing capital expenditures.

Amazon’s Variety of Market Segments

As a customer centric company, Amazon has no limits as to what business segment it will enter next. The multi-billion dollar corporation does business in numerous different sectors that allows the company to compete with a variety of organizations that operate in different divisions. New ventures into different business sectors are developed starting with customer demand. Amazon not only listens to its customers, but also understands them. Amazon analyzes what the

customers have wanted, what they want now, and what they are going to want next. The customer obsession leadership principle that Amazon relies on so heavily has given Amazon the ability to succeed in many different business segments. Some of the different products and services that Amazon offers that allows it to compete in different segments are: Online retail, Amazon Prime, Amazon Web Services (AWS), virtual assistance products, consumer electronics, Amazon Fresh, Amazon Go, and clothing.

Amazon's e-commerce is a dominating force in today's market. According to *businessinsider.com*, "43% of all online retail sales in the United States went through Amazon in 2016". The e-commerce that Amazon was founded on has taken over how people do business in the United States. Modern day consumers do not see the need to go out to a store when they have the power to order any product they need at their fingertips. E-commerce has even transitioned into M-commerce, where customers are using mobile devices such as cellphones and tablets. In the e-commerce segment, Amazon competes with major retailers such as Wal-Mart, Target, Best Buy, and Home Depot to name a few. A second product/service that Amazon offers is Amazon Prime.

Prime is a segment of Amazon that allows consumers to subscribe to a membership that provides them with numerous exclusive benefits such as free, two-day shipping, Prime Video and Prime Music along with numerous other perks. Prime provides a convenience factor to customers of Amazon.com that more than an estimated 65 million users have subscribed to (Gustafson). Prime allows Amazon to venture into the video streaming market to compete with companies like Netflix and

Hulu. Prime Music is another benefit to the membership that draws consumers away from products like Apple Music and Spotify.

Amazon took a position in the virtual assistance business segment with its release of the Amazon Echo in June 2015. The Echo, better known as Alexa, is a smart speaker that is capable of voice interaction to act as a virtual assistant to the user. Amazon currently competes with Google (Google Home) and Apple (Siri) in the virtual assistance segment. The Echo is currently easily controlling market share over the Google Home according to *businessinsider.com* that shows a user share in the United States of 70.6% compared to a mere 23.8% for Google Home.

Amazon competes in a segment of “cloud-based products/services” with its subsidiary Amazon Web Services (AWS). The cloud service platform launched in 2006 and over the past ten years, has become the focal point of every tech company, according to *fortune.com*. AWS has sustained around 40 percent of the worldwide market share for cloud services providers while the next three competitors (Microsoft, Google, and IBM) retain about 20-25 percent combined. AWS offers users cloud-based database storage, analytics, content delivery, and security for users to scale and grow their businesses.

One of Amazon’s more recent ventures happens to be a grocery store called Amazon Go. This is a unique business endeavor for Amazon because it requires a physical store whereas all of Amazon’s other products and services are offered online or through the cloud. Amazon’s goal of being the most customer-centric company in the world could get a significant boost with the unveiling of these stores due to the almost mindless process that these Amazon Go stores will seem to

provide for its users. The organization will face many major competitors such as Wal-Mart and other grocery stores like Publix and Whole Foods.

The most recent move that Amazon has made has been into the fashion/clothing market. A 2016 article from *CNN Money* states that Amazon has released seven in-house clothing brands that the company is selling on the site. Analysts have projected that this engagement in new private brands could significantly increase Amazon's future earnings. Another recent move in the fashion industry has shown that Amazon is serious with this venture. In April 2017, Amazon was granted a patent for on-demand clothing manufacturing. The patent will "enable custom production of clothing after a customer has placed an order" (Sharma). Amazon's apparel business has been growing rapidly. Cowen analysts have projected that Amazon's clothing and accessory sales are expected to grow close to 30 percent throughout 2017. With this continued growth, Amazon is expected to surpass Macy's Inc. as the top clothing retailer in the U.S. by the end of 2017. This new patent can help Amazon's growth in this segment by "combining the manufacturing speed of fast fashion brands with its computing power".

These numerous different markets and business segments that Amazon competes in are all examples of how well this company can be a disruptive and innovative force in all industries. Understanding the customer and obsessing over their wants and needs have been at the roots of each of these product developments. It began with a demand for an online retail store in the 1990s, and has transitioned to the current demand for a better, faster, and easier way to purchase clothing and apparel. For the past 20 years, Amazon has met and exceeded these customer

demands in almost every business sector. The movements from sector to sector have proven to be successful on Amazon's financial reports and stock price.

Analysis of Amazon Stock

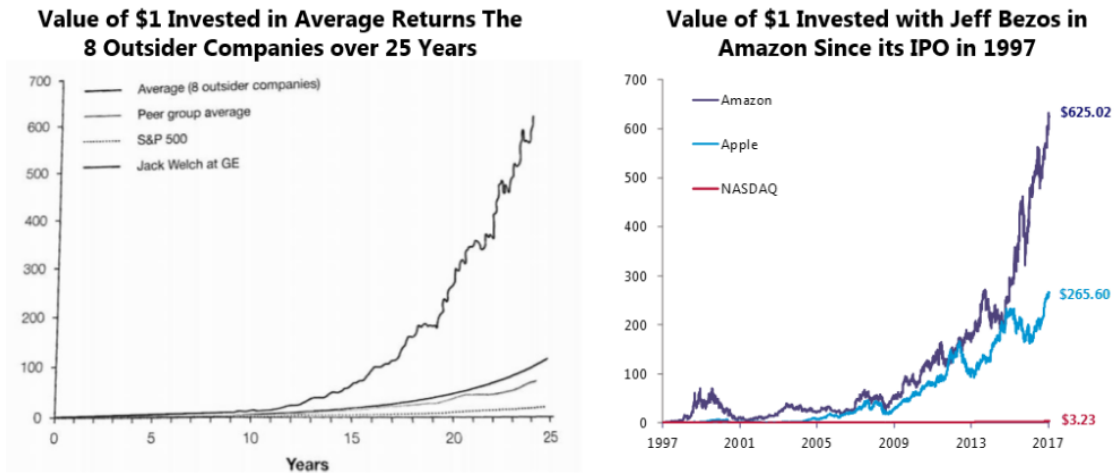
In May 1997, Amazon had its Initial Public Offering (IPO) of stock that sold for \$18.00 per share that raise an approximate \$54 million for the company. Twenty years later, the share price has appreciated to an astounding \$947 per share (5/11/17) and still rising day by day. In the last ten years, Amazon's stock has significantly outperformed all major indices as well as its major competitors.



The graph above is an interactive chart from yahoo finance that compare Amazon's stock (blue), with major competitors Apple (light blue) and Google (Orange), as well as the three major indices: Nasdaq (pink), S&P 500 (green), and Dow Jones

Industrial Average (purple). As seen in the graph, Amazon's stock has appreciated over 1,285% in the past ten years. Amazon's closest competitor pictured on the graph is Apple. Apple's share price appreciated about 783% over that same time period a mere 502 percent *less* than Amazon. This shows the true superiority of Amazon over its competitors. Google's stock price increased approximately 257% over the same ten years. From June 2007 to May 2017, Amazon's stock appreciated five times that of Google's stock and nearly double that of Apple's stock price. As seen in the graph, the three major indices have stay pretty level towards the bottom of the chart for the entire ten-year span. The best performing index of the three has been the Nasdaq, which appreciated 136% throughout the period. This comparison chart truly illustrates the dominance that Amazon has shown over the last ten years in the market.

Another comparison of Amazon's stock price was done in the article written by Jon Allion on *seekingalpha.com*. The graph on the left is from *The Outsiders* that was mentioned previously. This graph compares the average 25-year returns of the eight Outsiders' companies with the S&P 500, the peer group average, and also the returns of Jack Welch, CEO of General Electric.



Thorndike thought to include Welch’s returns because many people believed that Welch was the best CEO of that time. Allion created his own comparison graph to show the similarities of Amazon’s returns and Jeff Bezos to the returns of the eight Outsiders and those CEOs. In the graph on the right, Allion shows Amazon’s share price since the IPO in 1997 (roughly 20 years), compared to Apple and the Nasdaq. Allion explains that he chose to compare it to Apple because “many would say Apple (when asked what’s been the most dominant company over the past 20 years) and praise Steve Jobs in the process” (Allion). The two graphs are incredibly similar. The average return of the eight Outsiders’ companies and the Amazon share price lines are nearly identical. It is clear that Bezos has an enormous influence on the overall financial performance of Amazon. Even compared to a major competitor like Apple who has also seen “great CEOs”, Amazon has proved to outperform. The long-term oriented Bezos, whose primary focus has been the maximization of “dollar free cash flow per share”, is the reason for the overall success of company.

That dollar free cash flow has been on the rise and investors believe that Amazon is going to sustain that rate that the cash flows are growing at. The company’s earnings before interest, taxes, depreciation, and amortization has been

growing immensely over the past five years. Analysts have explained how with those earnings the company has continued to invest heavily in capital expenditures but the EBITDA is growing so fast that Amazon simply cannot invest in projects fast enough to soak up all of the earnings. This equates to a surge of free cash flow that totaled over \$10.5 billion over the last year according to *seekingalpha.com*. Once again Bezos is continuing to be a master capital manager and investing in many different capital expenditures to continue the high returns, but the company is performing so well currently that that cash flow just builds up.

Conclusion

A corporation built around the customer has created Amazon into the superpower company that it is today. CEO Jeff Bezos has implemented a structure into the company that allows innovation to prosper. The leadership principles that Bezos established provide guidelines and expectations for employees to follow and strive for. His vision of long-term success for the shareholders and the belief in maximizing dollar free cash flows are also reasons for companies overwhelming success. Because of Amazon's principle to remain "customer obsessed", the company has been able to disrupt multiple different business segments. Migrating to different business segments has allowed Amazon to compete with a multitude of organizations and show dominance in many sectors. The corporation has shown extreme performance over the past two decades and will continue to do so for many years to come.

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