Amazon: Friend or Foe?

This year marks the 20th anniversary of the founding of Amazon.com, the formerly humble online bookstore that grew to offer every product imaginable and in so doing changed retail forever. According to the National Retail Federation, at $44 billion in domestic sales ($77.5 billion globally), Amazon is now the ninth-largest retailer in America, online or otherwise, and by far the fastest growing in the top 20, up 27.2% year over year (see Figure 1). On Cyber Monday in 2013, worldwide customers ordered 36.8 million items from Amazon. Following Amazon's announcement to add 80,000 seasonal jobs for the 2014 holiday season (up from 70,000 in 2013), all signs point to another record holiday season for the giant e-tailer.

But is what's good for Amazon good for consumer products brands? It's a complicated question. For most brands, the short answer is: Yes. While the risks of partnering with Amazon are real and substantial, the potential rewards are enormous. Powerful brands that demonstrate true consumer pull and real differentiation, like Apple and Nike, are exceptions. For everyone else, to ignore Amazon is to cede sales at best, and court irrelevancy at worst. Amazon is already among the most powerful channels in the world, and it's growing stronger every day.

There are risks, clearly, but we know what they are and how to mitigate them. Of course, different products and brands require different solutions. There is no one-size-fits-all strategy. What's true for everyone, however, is that a successful digital strategy must address Amazon head-on. Only then can companies turn the online giant from a frightening foe into a powerful ally.

Digital Commerce Comes of Age

In the second decade of the 21st century, most people still buy much of what they want or need at brick-and-mortar stores. Even the best-performing online retail sectors – such as computers/electronics and apparel/accessories – derive only about 20% of total sales from online stores.

Amazon: Friend or Foe? was written by Jon Weber, a managing director in L.E.K. Consulting’s Boston office, and Chris Randall, a principal at L.E.K. Consulting's Boston office. For more information, contact retail@lek.com.
At the same time, all the key growth indicators are trending in digital’s direction. For instance, while mall traffic is down 20% since 2010, and will likely continue to decline, virtually all the growth in retail sales is being captured by ecommerce (see Figure 2). Plus, online retail sales are expected to continue double-digit growth through 2018. That’s why brands in all sectors have no choice but to develop a comprehensive digital vision and strategy.

The key questions you should be asking yourself are:

1. **What are my digital channels?** My website? Other websites? Mobile apps? Social networks? They’re all critical and they’re all unique.

2. **How do I drive traffic?** Customer acquisition strategies vary widely. Options are numerous, and include digital advertising, personalized emails, and online communities that build consumer knowledge, brand awareness and customer loyalty.

3. **How do I drive conversion?** Among the variables are website design, ease of navigation, customer service, shipping costs and return policies, and integration with other channels – both physical and digital.

4. **How do I structure merchandising and pricing?** What kinds of products sell best online? What should my assortment be, and how does this integrate with what my stores or wholesale accounts carry? What can I offer online that is unique? How do I handle pricing and promotions differently online than in physical channels?

5. **How do I expand beyond my proprietary channels in a way that is additive to my existing distribution ecosystem?** It’s this last, critical question that leads inevitably to Amazon.

**Winning with Amazon**

Amazon is a $77-billion global behemoth with 244 million registered users. Their customers are famously loyal, especially the more than 20 million who pay $99 per year for free two-day shipping with Amazon Prime. They have every incentive – price, selection, convenience, trust, customer service – to order from Amazon, even when they make their buying decisions someplace else. That’s why selling on Amazon is the 21st Century equivalent of selling on Main Street. You have to be there because that’s where the customers are.

But selling on Amazon carries its own challenges. Among them:

1. **Price scraping:** Amazon’s practice of deploying algorithms that scour the Web to ensure Amazon always offers the lowest possible price.

2. **Channel conflict:** No brand wants its relationship with Amazon to destroy established relationships with other important channels. It’s a delicate balance that requires elaborate planning and execution.

3. **Inventory markdowns:** Amazon enforces strict controls on inventory through aggressive automatic markdowns to reduce its inventory levels.
4. **Brand dilution:** This can be among the most damaging consequences of associating with Amazon, who may be recognized as a price leader and a “mass” retailer among certain customer segments.

5. **Amazon Marketplace:** It’s the Wild West of Amazon – a loosely managed network of third-party sellers who display their products to Amazon’s many eyeballs, but generally handle pricing, inventory and fulfillment themselves.

Again, these dangers can be managed, but only by engaging Amazon in different ways for different sectors, brands and products. For instance, high velocity core items should be treated differently than new products and still differently from closeout items. In short, there are different business models available to effectively manage risk while maximizing growth across all types of brands and products (see Figure 3).

For instance, a traditional wholesale relationship with Amazon can be a game-changing distribution channel for certain kinds of wholesalers, but it may work best for high-volume SKUs, core items and basics. Beyond those items, automatic markdowns and price scraping can create undue channel conflicts, margin pressure and consumer price confusion. Operating as a branded seller on Amazon generally mitigates these issues while creating the opportunity to showcase new, lower-volume products in addition to building brand awareness with millions of Amazon customers; however, realized margins will be lower.

Another example: While in most cases, brands are right to be wary of Amazon Marketplace, it can nevertheless be an effective closeout channel for last season’s items, and therefore a tool for managing working capital and freeing cash for reinvestment in new products.

<table>
<thead>
<tr>
<th>Business Characteristics</th>
<th>Traditional Wholesale</th>
<th>Branded Seller</th>
<th>Marketplace</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Product Type</strong></td>
<td>Core</td>
<td>New</td>
<td>Closeout</td>
</tr>
<tr>
<td><strong>SKU Velocity</strong></td>
<td>High</td>
<td>Low</td>
<td>Any</td>
</tr>
<tr>
<td><strong>Brand Dilution Risk</strong></td>
<td>Low</td>
<td>High</td>
<td>Low</td>
</tr>
<tr>
<td><strong>Channel Conflict Risk</strong></td>
<td>Moderate or Low</td>
<td>High</td>
<td>Low</td>
</tr>
</tbody>
</table>

Source: L.E.K. Consulting

Finally, even the most careful planning can be upended by third parties. Your brand can end up on Amazon despite your best efforts. How you manage that – by controlling who can and can’t sell your brand, defining which channels are acceptable, clearly specifying pricing, and enforcing consequences for breaking the rules – is key to building a holistic Amazon strategy that creates value.

**In Sum**

If done properly, integrating Amazon into your business can unleash potential that is thrilling and vast. Outside of brands with true consumer pull and loyalty, brands that choose not to engage with Amazon run the very real risk of becoming invisible to their customers, especially as digital commerce captures an ever-increasing share of consumer spending. Again, there is no magic bullet, no simple rulebook, for working with Amazon. Every case is different. But there are options for every product and every brand to make Amazon a friend, not a foe. Good planning to determine which ones make the most sense for your business could be the ticket to cashing in on a new friendship.
L.E.K. Consulting is a global management consulting firm that uses deep industry expertise and analytical rigor to help clients solve their most critical business problems. Founded more than 30 years ago, L.E.K. employs more than 1,000 professionals in 21 offices across the Americas, Asia-Pacific and Europe. L.E.K. advises and supports global companies that are leaders in their industries – including the largest private and public sector organizations, private equity firms and emerging entrepreneurial businesses. L.E.K. helps business leaders consistently make better decisions, deliver improved business performance and create greater shareholder returns.

For further information contact:

**Boston**
75 State Street
19th Floor
Boston, MA 02109
Telephone: 617.951.9500
Facsimile: 617.951.9932

**Chicago**
One North Wacker Drive
39th Floor
Chicago, IL 60606
Telephone: 312.913.6400
Facsimile: 312.782.4583

**Los Angeles**
1100 Glendon Avenue
19th Floor
Los Angeles, CA 90024
Telephone: 310.209.9800
Facsimile: 310.209.9125

**New York**
1133 Sixth Avenue
29th Floor
New York, NY 10036
Telephone: 646.652.1900
Facsimile: 212.582.8505

**San Francisco**
100 Pine Street
Suite 2000
San Francisco, CA 94111
Telephone: 415.676.5500
Facsimile: 415.627.9071

International Offices:
- Beijing
- Chennai
- London
- Melbourne
- Milan
- Mumbai
- Munich
- New Delhi
- Paris
- São Paulo
- Seoul
- Shanghai
- Singapore
- Sydney
- Tokyo
- Wroclaw

L.E.K. Consulting is a registered trademark of L.E.K. Consulting LLC. All other products and brands mentioned in this document are properties of their respective owners.

© 2014 L.E.K. Consulting LLC