Fixed costs and operating leverage

Amazon letters: 2002, 2001 · Difficulty: Intermediate

Summary

When most costs are **fixed**, they shrink as a percent of sales as the business grows, so operating income grows faster than sales (**operating leverage**). Bezos explains that Amazon's software and customer-experience costs are largely fixed, "more like a publishing model than a retailing model."

2002 letter

How can Amazon.com be trying to do both? The answer is that we transform much of customer experience—such as unmatched selection, extensive product information, personalized recommendations, and other new software features—into largely a fixed expense. With customer experience costs largely fixed (more like a publishing model than a retailing model), our costs as a percentage of sales can shrink rapidly as we grow our business. Moreover, customer experience costs that remain variable—such as the variable portion of fulfillment costs—improve in our model as we reduce defects.

2001 letter

Focus on cost improvement makes it possible for us to afford to lower prices, which drives growth. Growth spreads fixed costs across more sales, reducing cost per unit, which makes possible more price reductions. Customers like this, and it's good for shareholders.

…

Ultimately, your determination of cash flow per share will be a strong indicator of the price you might be willing to pay for a share of ownership in any company. Since we expect to keep our fixed costs largely fixed, even at significantly higher unit volumes, we believe Amazon.com is poised over the coming years to generate meaningful, sustained, free cash flow. Our goal for 2002 reflects just that.

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