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ZAPPOS.COM: DEVELOPING A SUPPLY CHAIN TO DELIVER WOW!

Our decision was always to focus on service because we got instant feedback whenever we upgraded delivery. Customers were wowed by the experience, and then they told a bunch of people. And word of mouth works a lot faster on the Internet than it does person-to-person because you can just e-mail out a bunch of your friends and say, 'hey I just had this amazing experience.' That was one of the reasons that we wanted to keep upgrading shipping.

—Alfred Lin, Chairman, COO, and CFO of Zappos[1]

In late 2008, less than 10 years after its founding, Zappos anticipated reaching annual gross sales of $1 billion. When its founder first proposed the idea of selling shoes online, the concept was greeted with intense skepticism. Despite the challenges, the company had achieved dramatic success. It was the world's largest online retailer of shoes, was profitable, growing rapidly, and had an outstanding reputation for customer service. Its employees were passionately, engaged in their work. While shoes still provided the vast majority of revenues, Zappos had expanded its product offerings based on feedback from customers and the enthusiasm of employees. There was still a huge untapped customer base—only 3 percent of the U.S. population were Zappos customers—suggesting that the company was not close to saturating its opportunities in the U.S., let alone other international regions.

However, the collapse of the financial markets, and the prospect of a prolonged recession, created new challenges. Zappos had never been lavishly funded—it had always been intensely conscious of cash. Unlike most retailers, it was continuing to grow, but early signs were that the rate of growth was slowing. As the company's leadership looked forward, it considered ways that Zappos could sustain the high quality experience that it was known for—to deliver "wow" to its customers, suppliers, and other affiliates. The company's supply chain management had evolved as Zappos had grown, and was one of its sources of excellence. Yet, perhaps there were opportunities for continued improvement.

[1] Quotations are from interviews with the author, unless otherwise specified.

David Hoyt prepared this case under the supervision of Michael Marks, Lecturer in Operations, Information, and Technology, and Professor Hau Lee as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

ZAPPOS.COM

In 1999, Nick Swinmurn was frustrated in finding the right size, color, and style of shoe. After trying several stores, he felt there must be a better way. Stores carried a relatively small selection of styles, and usually did not have a full complement of colors and sizes even for the styles they did stock. This was not surprising considering the physical constraints of shoe stores, the limited number of shoes that an average store could stock, and the small local population served by individual stores.

But this was 1999, and the Internet boom was in full swing. If Swinmurn, who was an ordinary shoe customer (not a shoe fanatic), was frustrated, it seemed likely that many others must be feeling the same way. What consumers needed was a way to access a huge selection of styles, colors, and sizes. Since none existed, Swinmurn decided to create one, using the Internet to address the selection problems faced by traditional shoe retailers—despite having no experience in retail, let alone the shoe industry.

Raising Capital

Swinmurn raised $150,000 from family and friends and recruited Fred Mossler, a senior shoe buyer at Nordstrom, to join him. Swinmurn tried to raise venture capital, but had difficulty finding investors willing to put in large amounts of money.

One of the venture firms that he approached was Venture Frogs, founded by Tony Hsieh and Alfred Lin. Hsieh was a young Harvard graduate, who had cofounded an Internet advertising firm called Link Exchange with Sanjay Madan, a college roommate. They sold the company to Microsoft for $265 million in 1998, when Hsieh was 24. Lin had been a friend of Hsieh's at Harvard (and a customer of Hsieh and Madan's college pizza-making business), who left a PhD program at Stanford University to join Hsieh at Link Exchange. Hsieh and Lin then founded Venture Frogs, which funded Internet start-ups, including companies such as AskJeeves, Tellme Networks, and Zappos.

In 1999, at the height of the Internet boom, Swinmurn left a voicemail with Venture Frogs, explaining that he had started a company to sell shoes on the Internet. As Hsieh and Lin were about to hit the delete button, thinking that this "sounded like the poster child for bad Internet business ideas,"[2] Swinmurn said that the shoe market in the United States was $40 billion, and that 5 percent of this business was being done by mail order. Hsieh and Lin realized that if people bought $2 billion of shoes from catalogs, the Internet—with its capacity to reach large sections of the population and to provide detailed information vastly better than a catalog could—was going to be a substantially larger market. They decided to invest, putting about $2 million into the company over the next few years. Hsieh also invested personally in Zappos (whose name was an adaptation of the Spanish word for shoes, "zapatos"). Later, Sequoia Capital, a premier Silicon Valley venture firm, also invested in the company.

While Hsieh, Venture Frogs, and Sequoia put money into the company, Zappos was never funded on the lavish scale of Internet start-ups such as WebVan—the total investment in the

[2] Hsieh quoted in Duff McDonald, "Sole Purpose," *CIO Insight*, November 2006, p. 45.

company was less than $10 million for the first five years of the company's existence. Sequoia Capital would later lead an investment round of $54 million, some of which was used to buy out early investors. In the long run, the lack of substantial funding was a benefit—Zappos was forced to focus on those factors which were essential to success, operate efficiently, and avoid the excesses that led to failure for many other Internet start-ups. The difficult challenge of creating a successful online shoe retailer, which inhibited access to large-scale investment, had another advantage—lack of competition. As Lin said, "It was actually tempting to invest in a company where everyone thought this couldn't be done, because you knew that in the early stages, you were not going to have a lot of competition."

However, in the short run the relatively low funding raised by the company was painful—there were times when employees worked for months without paychecks in order to help the company survive.

Financial Success

After investing, Hsieh began to work closely with Swinmurn, and in 2000 they became co-CEOs. Lin joined as CFO in 2005, later adding the roles of COO and chairman. Swinmurn left Zappos in 2006, and Hsieh became the sole CEO. Zappos had strong growth from its first sales through 2008, when it expected gross merchandise sales of $1 billion (**Exhibit 1**).

This strong growth was largely dependent on a happy, loyal customer base. As the company developed, the percentage of repeat customers grew—from 40 percent in 2004[3] to 75 percent in 2008.[4] Hsieh viewed this as essential for sustained success, saying, "You can get anyone to buy from you once…. The hard part is getting people to buy from you again and again."[5]

Zappos became profitable in 2006, but did not have an objective of maximizing profit, preferring to invest in growing the company. That year, Zappos was able to achieve gross margins of 31 percent, even after shipping and returns (with more than one in four orders returned).[6] Shipping, both outbound and for returns, was a substantial part of the company's cost structure, at about $100 million,[7] or almost 17 percent of the company's gross sales of $597 million in 2006. This percentage had remained relatively constant over time, despite increasing return levels and decreasing delivery times.

In late 2008, Zappos had about 9 million customers—a large number, but just 3 percent of the U.S. population, leaving plenty of room for continued growth. It had about 1,500 employees, half in its Nevada headquarters and call center, and half in its Kentucky fulfillment center. The company was still private, with no immediate plans for an IPO.

[3] Richard Waters, "Trial and Error Shows the Path to Success," *The Financial Times*, March 9, 2005, p. 9. Zappos defined repeat customers as any customer that had previously purchased from the company.
[4] Jeff Morris, "Service a 'Shoe-In' for Zappos.com," *Multichannel Merchant*, April 2008, p. 7.
[5] Arthur Zaczkiewicz, "Zappos Sells Service," *Women's Wear Daily*, November 15, 2006, p. 24.
[6] Waters, loc. cit.
[7] Sidra Durst, "Shoe In," *Business 2.0*, December 2006, p. 54.

Corporate Culture and Values

Zappos had a strong company culture, which was developed and nurtured by management. This culture, together with company values, was a strong influence on all aspects of the business, including the supply chain. Hsieh and Lin recalled that the strong culture that existed in the early days of their first start-up, Link Exchange, had disappeared as the company grew. As Lin explained, "At the end of the day, one of the reasons we sold the company was because it was no longer a fun place to work." They were determined that this would not happen at Zappos.

As a result, when Zappos leadership considered what it needed in order to meet the next year's business objectives, the question "How are we going to grow the culture?" was as important as issues such as "How many people do we need to hire, how many more servers, or how much more office space do we need?"

Hsieh described what the culture meant to him in 2008:

> To me, the Zappos culture embodies many different elements. It's about always looking for new ways to WOW everyone we come in contact with. It's about building relationships where we treat each other like family. It's about teamwork and having fun and not taking ourselves too seriously. It's about growth, both personal and professional. It's about achieving the impossible with fewer people. It's about openness, taking risks, and not being afraid to make mistakes. But most of all, it's about having faith that if we do the right thing, then in the long run we will succeed and build something great.[8]

Hiring and training were particularly important in maintaining and growing the culture and the company's values. Hsieh said, "We want people who are passionate about what Zappos is about—service. I don't care if they're passionate about shoes."[9] (Zappos' culture and values are discussed in detail in the **Appendix**.)

THE ZAPPOS SHOPPING EXPERIENCE

From the beginning, Zappos set out to provide an exceptional shopping experience for its customers. It wanted customers, after any interaction with the company, to say "Wow!" To illustrate the priority placed on serving its customers, Hsieh referred to Zappos as "a service company that sells shoes," which he later amended to include the wide range of other products sold by the company. Hsieh elaborated on the importance of customer service: "It's not really a secret…. People have known for a long time that companies that provide good service do really well. Yet no one does it."[10] Hsieh saw customer service as an investment rather than an expense.

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[8] "2008 Culture Book," Zappos.com, p. 12.

[9] Christopher Gergen and Gregg Vanourek, "Zappos Culture Sows Spirit," *The Washington Times*, July 16, 2008, p. B2.

[10] Waters, loc. cit.

The drive to provide a "wow experience" informed every aspect of the company. The Zappos website loaded faster than any other retail website. While most orders were made online, telephone support was essential for maximizing the customer experience. Unlike other popular retail sites, he company's toll-free phone number was prominently displayed on all its web pages, the average phone call was answered in less than 20 seconds, and call center operators had the authority to resolve virtually any issue.

Zappos knew that its primary competition in the shoe business was brick-and-mortar stores, and that in order to be successful, customers needed to be comfortable buying shoes online. The company addressed this challenge in a number of ways, including free returns, providing extensive online product information, maintaining a call center, and free overnight shipping.

Fit, and the Return Policy

A key aspect of making customers willing to buy shoes online was dealing with the issue of fit—customers needed to feel comfortable that they would receive products that fit, and that they could return those that did not. Zappos quickly realized that this could be best addressed by providing free returns, initially for 60 days, later extended to 365 days (although most returns came back within 60 days). Customers could thus purchase several pairs of shoes, of different styles and fits, keeping those they wanted while returning those that did not fit.

Zappos closely monitored customer behavior. It found that the most profitable customers were not those that returned the fewest products. Customers who made use of the free return policy tended to experiment with different brands and styles—while they had a higher return rate, they also made more net purchases. Overall, returns were about 35 percent of gross sales.

Online Product Information

It was also essential to provide as much information as possible to customers as they made their purchasing decisions. This was done in several ways. Retail websites typically had small photographs of products, with swatches of the available colors. The pictures were generally from only a few angles, and often did not show important details. Zappos provided substantially better information to customers. When new models (or models with new colors) arrived at the Zappos warehouse, a photography team took pictures from several angles (by 2008, eight photos were taken of each style and color). Customers interested in a particular item could easily see large pictures, in the desired color, from multiple perspectives.

The site also included detailed descriptions of the shoes, as well as information that would ordinarily be provided by experts at a brick-and-mortar shoe company. For instance, a person's gait (the way that they ran or walked) was important in finding the proper running shoe. The Zappos site had a detailed discussion of gait, and how customers could determine which type of shoe was appropriate for them.

The site also provided customer feedback. Customers could write comments on the shoes they purchased, which Zappos did not edit (except to remove profanity). The most recent customer comments were displayed for each type of shoe.

The Zappos Call Center ("Customer Loyalty")

Most customer interactions were through the website, which handled about 95 percent of orders. The rest of the orders, plus questions about products, returns, or other issues, were handled by the call center. In 2008, this was staffed 24/7 by about 400 people in the Las Vegas headquarters.

As described in the Appendix on company culture and values, all Las Vegas employees went through the same 4-week new-hire training course. At the end of the course, regardless of the job that they were hired for, they spent at least two weeks in the call center working with customers.

Zappos measured most every aspect of its business, including the call center (or "customer loyalty" in Zappos terms). It measured how long it took from the time a customer called to the time the call was answered by a call center operator—in 2008 this number was astonishingly low, consistently averaging less than 20 seconds. It did not, however, measure call center operators on metrics of efficiency, such as how many calls they took. The objective was to provide the customer with the best possible experience. If that meant having an extensive conversation with a customer about his interest in running, the call center operator was encouraged to have the conversation. If the customer was looking for a specific shoe that was not available at Zappos, the call center operator was trained to look on at least three other Internet websites to find what the customer wanted, and then talk the customer through finding the product on the competitive website. Zappos would lose that order, but the customer would likely return to Zappos in the future. Hsieh commented, "We score [call center operators] based on whether or not they went above and beyond for the customer…. We don't care if they made the sale or how 'efficient' they were…. For us, every interaction is a branding opportunity."[11]

One widely cited example of a call center operator going above and beyond customer expectations took place in July 2007. A call center operator was following up on shoes that should have been returned, and e-mailed the customer. The customer replied that she was very sorry—she had bought the shoes for her sick mother, who had since passed away, and had not gotten around to returning the shoes. The call center operator arranged for UPS to go to the customer's house to pick up the shoes, then sent a flower arrangement and condolence card to the customer. Needless to say, the customer was overwhelmed by this concern on the part of a company, and posted comments about her experience on a blog, which were widely circulated.[12]

Call center operators were trained to handle most any situation by themselves. They were given the authority to do so using their best judgment without needing to escalate the matter to a supervisor or manager. For quality control purposes, calls were monitored by Zappos employees, not by an outside agency. Monitors listened to ensure that the operator had exceeded customer expectations, and that the customer's experience had been excellent.

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[11] Ken Magill, "Workers Paradise: Zappos.com Believes Happier Staffers Lead to Happy Customers," *Direct*, October 2007, p. 35.
[12] Brian Morrissey, "These Brands Build Community," *Adweek.com*, May 12, 2008.

In late 2008, the call center received about 5,000 calls daily. Zappos viewed each of these as a chance to "wow" a customer in a personal way. As Hsieh said, "At that point, you have the full attention of the customer…. That's the time where you have a huge opportunity … to shine."[13] A customer that had an exceptional experience was likely to tell friends about it. With the ease of e-mail communication, positive or negative customer experiences could be rapidly spread to large numbers of people. Zappos wanted to ensure that its word-of-mouth testimonials were overwhelmingly positive.

Free, Rapid Delivery

The final aspect of providing exceptional service was rapid delivery at no additional charge. Zappos always tried to beat customer expectations, under-promising and over-delivering. Ultimately, this meant operating the warehouse around the clock, every day, with deliveries made overnight by UPS. An order received in the evening would usually be delivered the next day, even though the standard delivery terms were for UPS Ground, which had a 4-5 day delivery expectation. Lin elaborated:

> I guess in the early days we didn't really have a choice; we couldn't afford anything else except ground shipping. Then we started understanding that whatever money we had left over we wanted to reinvest in the growth of the company. We can either spend it on marketing, trying to get new customers, or we can spend it on our existing customers and let them drive the word of mouth, and let them drive the "come back." You know these customers are going to buy shoes at a later date, so our decision was always to focus on service because we got instant feedback whenever we upgraded someone. They were wowed by the experience, and then they told a bunch of people. And word of mouth works a lot faster on the Internet than it does person-to-person because you can just e-mail out a bunch of your friends and say, 'hey I just got this amazing experience.' So that was one of the reasons that we wanted to keep upgrading shipping.
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> The other reason is that we've always thought about our real competition as the instant gratification you can get walking into a brick-and-mortar store, trying on some stuff, and walking out with the stuff you like. Our idea was that over time, we were going to get as close to that as possible, and that would really bring the store to your home.

During the 2006 holiday season, Zappos guaranteed next-day delivery for all orders, and continued the policy through 2007. However, since customers expected next-day delivery, "they were no longer as wowed as before, when it was a 'surprise' upgrade," according to Lin. Furthermore, guaranteeing next-day delivery set customers up for disappointment on those rare occasions when the delivery was late due to unavoidable problems such as weather impacting plane schedules, or if communications lines were down and Zappos was unable to communicate orders to the warehouse. Overall customer satisfaction decreased very slightly in 2007, and the company decided to no longer advertise overnight delivery. It provided the same level of service, but only guaranteed 5-day ground shipping. Zappos found that when customers no

[13] Michael Bush, "Customer Service a Branding Opportunity," *Tire Business*, May 12, 2008, p. 35.

longer expected next-day delivery, they were again surprised when packages arrived the next day, especially when they had placed their orders late at night.

As Zappos continued to increase delivery speed, shipping cost as a percentage of net sales (after returns) remained constant, even though the percentage of returns increased. By 2008, Zappos was one of the top three UPS overnight shippers, and worked closely with UPS to increase efficiency and drive down shipping costs. If Zappos decided to back off from its desire to ship all orders for overnight delivery, for instance, using ground delivery for all customers that were within a two-day delivery from its warehouse, it estimated that savings could be significant. UPS estimated UPS Ground could reach 11 percent of Zappos customers within one day, 49 percent within two days, 18 percent within three days, 21 percent within four days, and the remaining 1 percent would take five days.

THE DEVELOPMENT AND EVOLUTION OF ZAPPOS' OPERATIONS

Zappos began in San Francisco, in the second floor of a Victorian house, with the founder of Craig's List living downstairs. By 2004, the company needed to expand, with particular emphasis on its call center. Hsieh and the senior management believed that it was important to have the call center as part of corporate headquarters, rather than outsource or remotely locate this function—after all, the company's primary focus was on providing the very best customer experience, and the call center was central to achieving this objective. The Bay Area was expensive, but it also did not have the right environment, nor access to suitable employees to staff the type of call center that they believed was essential to the company's success.

They decided to move Zappos to Henderson, Nevada, on the outskirts of Las Vegas. Las Vegas was a service-oriented city that operated on a 24-7 schedule, was already home to many call centers, and had extremely good Internet connectivity. Of the 90 employees in San Francisco, 70 moved to Las Vegas.

Attracting Brands

In the early years of the company, it was difficult to get brands to sign up for online distribution. Shoe companies had made huge investments in their brand equity. In 1999, Zappos was an unknown start-up, and established retailers viewed the Internet as, in Mossler's words, "kind of a flea market…. They saw the Internet as a place where everything would be discounted, and their brand would be ruined." In addition, the existing retailers pressured the brands to resist online sales, as they did not welcome the new competition.

An additional complication was that brands were more successful when grouped—athletic shoe brands, for instance, fared better when grouped with other athletic shoes. If a retailer offered only one athletic shoe brand, there would not be enough selection to attract customers. Thus, it was difficult to convince companies to be the first brand of a category to be carried by Zappos. Once the first brand signed on, however, subsequent brands were easier to attract. In its first year of operation, the company signed up 60 to 70 brands.

Zappos focused its attention on signing brands that customers searched for or asked for when talking to call center operators. The company reviewed logs of customer searches for brands that were not on its site, and its buyers investigated those brands and evaluated whether they would be valuable additions to the Zappos offering. As the company grew and became well known within the industry, brands began to contact Zappos about being sold through the site. As Steve Hill, the company's vice president of merchandising in 2008, said, "[The buyer] will get in touch with the brand, talk to them, and look at the product. If there's a compelling reason to have the product, then we'll go ahead and open the brand. In a lot of cases, it would be duplication of something we already have, so we may not go down that road."

High-end brands, initially reluctant to partner with online retailers such as Zappos, eventually came on board for several reasons. First, as consumers became comfortable buying online, this became an important distribution channel. Second, they began to realize that if customers could not purchase authentic high-end brands, it made it easier for counterfeiters—customers searching for their brands on the Internet would end up on sites that sold fakes.

A third incentive for high-end brands arose when Zappos began creating "vertical" sites within Zappos.com. The first such site, "Couture," was created in 2003, and featured high-end fashion products (initially shoes, later expanding to clothing and accessories). By 2008, Zappos had added verticals for running, outdoor activities (such as hiking), and a "RideShop" featuring products for skiing, skateboarding, surfing, and off-road bicycling. Brands were eager to participate in vertical sites, since those visiting the sites would be passionate consumers—the types of customers that wanted high-end brands, and that those brands wanted most to attract.

As customers were wowed by the company's high level of service, they began asking Zappos to carry products beyond shoes. Zappos added additional products based on the passion displayed by customers or employees. Lin explained:

> A lot of companies look at [product] categories from a market point of view, and chase after big markets—they think a market is strategic and want to go into that market. We have tended to look at things as: 'if we want to get into this product category, do we have passionate people, whether it's a customer, or an employee, or a partner, that would love for us to be in that product category?' It's actually worked out very well in those situations. So, if customers want us to get into handbags or accessories because we sell shoes, we go into that category.

Zappos began selling electronic entertainment products because some of its employees were passionate gamers, and wanted to sell gaming equipment. Lin observed, "We found that people who are passionate about a product category tend to run it much better and much more efficiently than people who just think, 'this is a big market, I want to get into that business.'"

By late 2008, some of the non-shoe products that Zappos sold included: handbags, luggage, clothing, eyewear, electronics (cameras, computers, video games, phones, and GPS devices), watches, houseware, and jewelry. Its outdoor vertical site also included items such as tents, stoves, water filters, lanterns, and other items important for outdoor enthusiasts—these customers were not just interested in hiking boots, they were passionate about the outdoors, and wanted to be able to get a wide range of products. Other vertical sites included a range of items important to customers interested in those sites areas of focus.

Evolution of the Operational Model

The original Zappos business model was to provide exceptional product selection by partnering with shoe companies, which would hold the inventory and fulfill orders. Customers would order shoes from the Zappos website,[14] and the orders would be forwarded to the shoe companies, which would fulfill the orders. Thus, Zappos would not incur inventory or fulfillment costs. Zappos charged customers the retail price, and paid its vendors the wholesale price. Over time, this model changed, until by 2003, all Zappos shipments were from its own inventory. This evolution was primarily driven by the company's focus on customer satisfaction.

The Drop-Ship Model

The original "drop-ship" approach had two major problems. First, inventory information on the website was only about 95 percent accurate. The company received this information from its vendors in many ways, including fax, phone, and email. The update process was essentially manual, and was unreliable both due to uncertainties in the vendors' inventory records and poor timeliness of information updates. This led to frustration for customers, since they could place orders for products that were not in stock, leading to cancellation or long delivery times.

The second problem with the drop-ship approach was that Zappos did not know when a customer order had been shipped. The vendor might promise to ship an order within a few days, but if it received a large order from a major department store, the Zappos customer's order might be delayed. The customer was unhappy, and Zappos would not know that there was a problem until the customer called to inquire about the order.

Bringing Inventory In-House

In response to these problems, in November 2000 Zappos began to stock its own inventory. One of the requirements of some of its vendors had been to have a physical store before they would sign up to be online suppliers (this was in the early days of Internet retailing, and manufacturers were unsure about the effectiveness of online selling). In order to meet this requirement, Zappos had purchased a shoe store in Willows, California that was going out of business but carried the appropriate brands.

One of the attractions of Willows was that it was much less expensive than the San Francisco Bay Area, so when the company decided to carry its own inventory, it purchased an abandoned department store across the street from the shoe store, and turned it into a warehouse and distribution center. However, Willows, about 100 miles north of Sacramento, was not ideally located to be an Internet distribution center. There was no major airport nearby, and shipments were made by UPS Ground. The warehouse was a manual operation.

While bringing some inventory in-house, Zappos continued to use the drop-ship approach with many of its vendors.

Experimenting with Third-Party Fulfillment

Zappos quickly outgrew its Willows distribution center, which had only 30,000 square feet. UPS approached the company to manage its inventory and fulfillment. Under this program, Zappos

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[14] The company's original website was shoesite.com, but this was later changed to Zappos.com.

would continue to own the inventory, but it would be stored in a UPS facility near its hub in Louisville, Kentucky. Order fulfillment would be handled by a third party. The proposal offered several advantages, the most significant being that about two-thirds of customers could receive deliveries within two days using UPS Ground—and at a lower cost than shipping from Willows. Inventory and fulfillment would be managed using automated tools, which would be more efficient than the manual methods used at Willows, but without Zappos having to make a major capital investment. In 2001, after performing a detailed analysis, Zappos moved its inventory to the UPS facility.

Within 6 to 8 weeks, however, it was clear that this approach would not work. The Zappos business involved more stock-keeping units (SKUs) than the system could handle, since each shoe style/size/color combination was a separate SKU. Thus, an individual style of shoe could require many SKUs. At the time, Zappos had about 70,000 to 80,000 SKUs.

Developing the Zappos Distribution Center in Kentucky

Zappos decided that in order to provide exceptional service to its customers, it would need to develop its own distribution center, designed to meet the high-SKU needs of its business. They found an inexpensive building in Shepherdsville, Kentucky, less than 30 minutes from the UPS hub in Louisville. Due to a lack of capital, the company needed to build its warehouse as inexpensively as possible. As a result, they used static inventory shelving and hand-held bar code scanners, which stored information that was later uploaded to the inventory management servers—the cost of wireless communication between scanners and servers was beyond the company's budget constraints.

The Zappos team did not have previous experience in developing complex inventory management systems. Furthermore, they did not find other companies that had addressed problems similar to theirs, so they developed their systems in-house. As a result, the company developed its own systems and procedures focused on a highly SKU-intensive business that required virtually perfect inventory accuracy. To help bring up the new warehouse, Hsieh moved to Kentucky for five months, doing much of the software coding himself.

From the company's earliest days, Zappos had developed its own software, optimized to meet its needs, using open source programs in order to minimize costs. This practice was still in place in 2008. The company's rapid growth required continual upgrading of both hardware and software in order to keep up with the escalating volume and to deliver a superior customer experience. At the end of each year's holiday selling season, the IT group (always small, considering the company revenue, and numbering about 30 people in 2008) would make plans to provide double the capacity of the just-finished holiday season for the following year's holiday season. They implemented these plans by mid-year, so that all systems could be thoroughly tested before the new capacity was required.

In its new warehouse, stock locations were randomly assigned. A given stock bin might hold up to 20 pairs of shoes, but these would not be the same style, or even the same brand. The random stocking approach had a number of advantages—while keeping all shoes from a given brand together sounded like good organization, it created problems when they started shipping, and creating missing spaces in stock bins. Using random stocking, when a shipment arrived, it was separated into pairs of shoes, which were placed in the nearest available bins. The stock worker scanned the shoe box and location when placing the box into a bin, telling the system the location of that particular item. When a stock picker went to get a box that had been ordered, it was easy to find the appropriate box in the bin, since it would be located with different styles of shoes from different manufacturers—the worker did not need to distinguish between the size 8 shoes stocked next to the size 8½ shoes of the same model sitting next to it.

As its business grew, Zappos increased its warehousing capacity. The initial 265,000 square foot facility was filled to capacity by 2006, and the company opened a new 832,000 square foot facility, of which half was retained for future growth. Warehouse operations also became more sophisticated. The initial warehouse consisted of static shelving and simple conveyors. The new facility had some static shelving, but with automated conveyors. It also had automated carousels that spun until they reached the needed item, much like systems commonly used in dry cleaners—except that each of the 128 carousel loops in place by 2008 contained 32 units per floor and were stacked four stories high. In 2008, Zappos added more automation to its warehouse operations by installing a robotic system in which robots picked up shelves that contained the items to be picked (or empty places for items to be stocked), and brought the shelves to the workers. This greatly increased worker efficiency—in the first year it was more than twice as efficient as either the static or carousel methods. It was also more scalable, since new shelves and robots could be easily added when needed. (See **Exhibit 2** for photographs of the Zappos distribution center.)

The End of Drop-Shipments

Until 2003, Zappos was still sending orders to its vendors for drop-shipping, although the percentage of shipments from the company's own inventory increased as it grew. The source of the delivery, whether from the Zappos warehouse or drop-shipped from the vendor, was transparent to the customer. However, evaluation of customer satisfaction showed that customers served by the Zappos warehouse were happier than those whose orders were drop-shipped.

By March 2003, about 75 percent of orders were being shipped from the Zappos warehouse. The company decided that it could not provide customer service that lived up to its own standards by continuing the drop-ship business. The company leadership evaluated the situation, and decided that it should define itself not as a shoe company, but as a "service company that happens to sell shoes." Hsieh explained, "We decided that we wanted to stand for something more than just making money selling shoes." The service results at that time were not what Hsieh and the other leaders wanted them to be, but the revised focus helped concentrate attention on what the company needed to do in order to be recognized for superior service.

Zappos immediately stopped using drop-shipments, cutting off 25 percent of its business in the short term. Zappos built this business back up as it increased its inventory to include those items that had previously been drop-shipped.

The decision to bring all inventory in-house allowed Zappos to take those systems and procedures improvements required to increase inventory accuracy to nearly 100 percent. When the last item of a particular style/color/size was sold, that item no longer appeared on the website. Thus, any item that a customer selected online was in stock—the only exception being when there was just one left in inventory, and two customers had that item in their shopping carts at the same time. The first one to check out would receive the item. As with all Zappos activities, providing outstanding customer service drove the company's operations—in this case, the requirement for exceptional inventory accuracy, with an objective of 100 percent accuracy.

Zappos showed inventory statistics on its home page. On November 25, 2008, for instance, the warehouse had 1,417 brands, 152,677 styles, 824,277 UPCs, and 2,851,610 total products available for shipment.[15]

SUPPLY CHAIN MANAGEMENT

Buying

The traditional practice followed by shoe manufacturers was to develop new shoe styles that would be introduced at trade shows. Retailers would place orders for the upcoming selling season for delivery throughout the season. The manufacturers built to these orders, with a relatively small surplus available in case the styles became highly popular.[16] If a retailer ordered too many units, it would have excess inventory that had to be disposed of, generally by selling at a steep discount. However, if a style became a huge hit, the manufacturer would not be able to increase deliveries, as it could not restart production, and the retailer would lose potential sales.

Each brand had a monthly availability schedule, and retailers would place orders for specific numbers of units to be delivered each month. Making optimal purchasing decisions was based on setting the right delivery schedule—both the number of units and delivery timing. These decisions required experience on the part of the buyers, and a good sense of the market. This was particularly true in Zappos' early days. Selling shoes over the Internet was new, and the most relevant model was catalog mail order sales. Mossler's experience in the industry was particularly critical during this time. He explained, "It's about your feel. You got a sense for the brands that were currently selling on the site, and how they were doing. You had a sense for how big a potential a new brand could have…. You just made your bets."

By 2008, the merchandising department had about 100 employees, about half of whom were buyers and assistant buyers. These were the primary points of contact for vendors. Zappos had an Extranet, which vendors could use to see the same information that the Zappos buyers saw, such as on-hand inventory, sales, pricing, and margins. This enabled Zappos to benefit from having thousands of buyers (both Zappos and vendor personnel) evaluating the inventory. If a vendor saw that a product was selling well, and the vendor had additional stock, s/he might call the appropriate buyer and suggest that Zappos purchase more inventory. On the other hand, if an item was selling slowly at Zappos, but the vendor needed more product for other distribution channels, s/he might suggest that Zappos reduce future scheduled deliveries.

[15] Zappos.com homepage, http://www.zappos.com (November 25, 2008).

[16] An exception to this practice was Crocs, the manufacturer of plastic shoes and sandals. For a description of the Crocs supply chain, see the Stanford GSB case, "Crocs: Revolutionizing an Industry's Supply Chain Model for Competitive Advantage," GSB No. GS-57.

"Powered by Zappos": Operating a Supply Web

The Zappos supply chain was not as simple as the linear process of placing orders with its suppliers, stocking inventory, and shipping orders to customers. For instance, in 2007, Zappos purchased 6pm, a discount online shoe retailer (described in more detail below). When 6pm was integrated into Zappos, the 6pm.com website sold product that was in the Shepherdsville warehouse, exactly in the same way as the Zappos.com website—the products were handled in exactly the same way, and a product on the 6pm.com website might be sitting in an inventory bin next to a product on the Zappos.com website, even though each website displayed different products.

The capability that Zappos created to sell online to individual customers was also valuable to its vendors' direct sales initiatives. Most manufacturers of retail products had distribution systems that were built around shipments of relatively large numbers of goods to retail stores, or to distribution centers operated by large store chains. For instance, a manufacturer selling shoes to Nordstrom would deliver large bulk orders to a Nordstrom distribution center. Nordstrom would then supply a relatively small number of stores from this distribution center. The transfer of individual pairs of shoes to customers would occur at the Nordstrom retail store.

As the Internet developed as a credible, popular, way of selling to the public, some manufacturers wanted to be able to sell directly to customers. To do this, they needed to develop websites to sell products, and a distribution network to deliver products directly to customers—in small shipments to large numbers of destinations. For companies that had previously sent large shipments to relatively few destinations, this was a difficult challenge—to say nothing of the new requirement to process lots of orders for single units of the products, handle billing to individual consumers, and deal with individual returns. The companies would have to develop several areas of competence: the technology to design and run a retail website, a call center to deal with customer questions and problems, and a distribution system optimized for delivery to retail customers.

These were all areas in which Zappos excelled. In order to help manufacturers sell directly to consumers, Zappos developed a program called "Powered by Zappos." Under this program, Zappos developed and ran the website for these companies, ran the call center, and distributed directly to customers. Suppose the manufacturer was the hypothetical "Smith Shoe Company." Customers would go to the company website, smithshoe.com, which would display all the available shoes. The Smith Shoe website included a prominent "Powered by Zappos" logo. The customer ordered a shoe, and the order was sent to the Zappos distribution center, where it was handled just like any other order. Customers that had a question or problem called the number on the Smith Shoe website, which was answered by an operator at the Zappos call center. Smith Shoe paid Zappos to develop and run the website, and to handle its customers at the call center. Zappos purchased inventory that was sold on the Smith Shoe website, as it did for items sold on the Zappos website—in fact, the inventory was the same, even though it was offered on two websites. In all cases, regardless of which website a customer used to place an order, Zappos bought products from its supplier at wholesale prices, and sold to the customer at retail prices.

Lin observed one of the benefits of having a single inventory serving multiple online stores:

> One interesting aspect of our business from a supply chain perspective is that in the brick-and-mortar world, every time you open a store it has to have its own display space, its own shelf space, and its own inventory space. The way we've opened up these stores online, you can have different windows to access the same inventory; you can just create verticals. Our main site has access to the same inventory, or we have a limited selection of our verticals related to running, for example. Or, I can show you a specific brand through our Powered by Zappos site, or through letting other people sell our products, as in Overstock or on the 6pm site. It's accessing the same inventory, so over time it will be much, much more efficient than in the brick-and-mortar world.

Thus, Zappos created a supply web, in which the same inventory could be accessed through many websites (**Exhibit 3**). In 2008, several companies sold shoes through the Powered by Zappos program.

Scheduling Product Delivery

One of the challenges facing Zappos was scheduling deliveries from its suppliers to the distribution center. In 2008, the company placed orders with more than 1,400 different brands. Orders typically involved multiple delivery dates. Zappos gave suppliers delivery windows to help schedule when products arrived at the distribution center, and to try to smooth the receiving schedule. Zappos received products five days a week, even though the warehouse operated around the clock, seven days a week for shipping products to customers—the company's primary objective was getting products on a truck to go to UPS within four hours of a customer order.

The large number of shipments from its vendors led to traffic management difficulties for the warehouse. One of the challenges Zappos faced was that it had limited visibility into the manufacturers' supply chains, and there was a high degree of uncertainty as to the actual day that a shipment would arrive at the warehouse—while a manufacturer might state availability on August 1, and Zappos might specify a quantity to be delivered from that availability, in practice, the shipment might arrive any time in August. As a result, there were days in which traffic at the warehouse was backed up waiting to be unloaded, and other days in which relatively few shipments arrived.

This created inefficiencies within the warehouse operation, but was an issue that was difficult for Zappos to address. Lin observed: "[We want] to wow not just our customers and our employees, but also our partners. We give them a pretty wide window, don't ask them to change that, and don't hold them [to specific requirements]."

Dealing with Excess Inventory

Brick-and-mortar stores had to clear space to prepare for the new products that arrived each selling season. For instance, a store would have to clear shelf space used for sandals by August or September, in order to make space available for boots, which would sell during the fall and winter season. To do that, the store would have to drop prices starting in July until the end-of-season inventory was depleted.

Zappos was not constrained by the need to clear space to make room for each season's incoming new inventory. It did not need to begin trying to get rid of stock until customers reduced demand. For instance, it found that customers bought sandals well into the fall. When customers slowed their purchases, Zappos would reduce prices—but the reductions were based on customer behavior, not on the need to make room for the next season's products. Conversely, if a model sold slowly, the price could be lowered well before the end-of-season—again, these decisions were based on customer demand. As Hill explained, "When we make a decision to mark something down, it's because customers are telling us that they're no longer interested in this product at that price, so we lower the price to a point at which they say, 'Hey, now I'm ready to buy it again.'"

In Zappos' early days, decisions to reduce price in order to clear slow-moving stock were made manually. If a shoe style was in stock for 60 days, and no sales had been made, they would lower the price. As the company grew, this process was automated. The company assigned sell-through percentages to each product. For instance, it might expect a given style to sell-through at 25 percent per month. For an initial period, such as the first 60 days, it would maintain the price regardless of sales. After that, if the product did not achieve its target sell-through, the system would automatically mark down the price until it achieved the sell-through plan. If sales picked up to the point where they exceeded the plan, the price might be adjusted back up.

Zappos did not want its success to be based on discounting, however. The basic operating principle of the company was to deliver the very best service. Thus, with respect to disposing of excess inventory, the primary focus was on the buying decision. Zappos wanted to have the right products, in the right quantities, at the right time. To the extent that it made these decisions correctly, it would have less slow-moving inventory to deal with.

However, it was inevitable that there be some excess inventory, and the company adopted a number of approaches to address the issue. It would only discount to a limited degree on the Zappos.com website—as a full-service site, with free shipping and returns, there was not enough margin to support deep discounts. Furthermore, deep discounts on the site would dilute the Zappos brand and inhibit sales of new models. For instance, if a runner needed new shoes, and the site had both this year's model and last year's model, it would be difficult to sell the new model if the old one was heavily discounted.

To supplement the automated discounting program for selling excess inventory, Zappos opened several outlet stores. The first, adjacent to the company's Kentucky warehouse, opened in 2004. Beginning in 2006, the company opened stand-alone outlet stores in four other locations. In 2007, Zappos bought the online shoe company 6pm, a discounter that sold surplus or end-of-season shoes to a different customer base. Zappos customers typically viewed service as very important, and were extremely loyal, while 6pm customers were looking for the best price, thus tended to shop around for the best deals. With the 6pm purchase, Zappos now had an online outlet for slow-moving inventory—it could move these products to the 6pm site, where they could be discounted as much as necessary without damaging the Zappos brand. 6pm customers also paid for shipping (both for delivery and returns). Thus, Zappos could be preserved as a full-service, full-margin operation, while prices on the 6pm site could be discounted as required to move inventory.

After 6pm was integrated into the Zappos operation, all the inventory was held at the Zappos warehouse in Shepherdsville. Orders from the Zappos.com and 6pm.com sites were handled identically at the warehouse, except that Zappos orders shipped in Zappos-branded boxes, and 6pm orders were shipped in ordinary brown corrugated boxes.

In 2008, Zappos also initiated a relationship with Overstock, an online discount retailer, as a way to liquidate excess inventory. In this arrangement, Zappos drop-shipped from its Shepherdsville distribution center to Overstock's customers.

Opportunities for Improvement

Hsieh realized that the supply chain still contained inefficiencies. One, as discussed earlier, was the problem of inbound freight, which was difficult to coordinate and resulted in uneven deliveries. There was also inefficiency in the overall supply chain reaching back to the shoe production. Most shoes were manufactured in China, then sent to the shoe companies in the U.S., where they were stored. The shoes were then sent to Zappos in Kentucky. Shipping some or all of those shoes destined for Zappos directly to the Zappos Kentucky distribution center would increase overall supply chain efficiency.

Many of the deliveries to Zappos also were made with partial truckloads ("less than truckload" or LTL). These LTL shipments came from the warehouses of individual suppliers, resulting in a larger-than-necessary number of trucks arriving at the Zappos distribution center (creating traffic problems), as well as the economic inefficiency of transporting partially full trucks. At some volume, it might be more efficient for Zappos to have its own truck fleet that could make pickups from supplier warehouses and optimize cargo capacity. There was a high concentration of supplier warehouses in southern California, particularly in the areas around Ontario and Long Beach, as well as in a few locations on the East Coast.

There were also possibilities for increasing the efficiency of outbound freight, even if the overnight objective was still retained. Many customers could receive shipments within one day, using UPS Ground. Even more of the country could be served overnight by less expensive ground shipment over weekends, where "overnight" was considered to be the next business day.

THE QUESTION OF INTERNATIONAL EXPANSION

Zappos had a passionate customer base in Canada. Initially the company shipped to a freight forwarder in the U.S., who would then ship to Canada. Eventually, Zappos set up a Canadian website, which handled only Canadian orders and simplified the customs issues for customers. Many brands had sold Canadian distribution rights to other partners, so Zappos could not sell these brands on its Canadian site. With an existing customer base, it was possible for the company to establish a Canadian call center and distribution center, but to achieve substantial volume would require negotiating Canadian distribution agreements with many brands.

The company periodically considered further international expansion, but the opportunities in the U.S., and the costs of moving into other countries, had never favored expansion outside North America. Lin explained:

> The debate has always been, 'Can we be consistent to our brand, providing great service in the other country without having a distribution center or call center?' The answer is, 'No.' If you're going to go to another country and establish [a distribution center and call center], not only do you have to put in a bunch of money, but you also have to understand the culture there. [An equivalent size market to the U.S.] is to serve all of Europe. Europe is fragmented with different layout issues and different cultural issues, and different levels of understanding of the desire for service.

With substantial opportunities still to be tapped in the U.S., and significant challenges and costs required to replicate the company's success in foreign markets, Zappos had rejected major international expansion each time it had been considered. The company did sell footwear and bags to international customers, but charged for shipping and returns, and required that customers take care of taxes and duties themselves. Orders from customers outside the U.S. and Canada were accepted only by phone, not on the Zappos.com website.

THE ECONOMIC CHALLENGES OF 2008

As of November 2008, Zappos had not yet seen a major impact from the financial market collapse and economic slowdown. The company had recorded significant revenue increases through the first three quarters of the year. While high-end brick-and-mortar retailers reported double-digit sales decreases in September and October, Zappos continued to grow, albeit at a somewhat slower rate.

Margins were decreasing, however. In addition to the immediate impact, this brought into question an issue that would eventually need to be considered even in good economic times—scalability. Some of the "wow" factor important to the customers and to the company resulted from labor-intensive activities which might eventually become unwieldy or unaffordable as the company grew. Would Zappos have to make process and organizational changes in order to successfully grow to $2 billion, or $20 billion in sales? (See **Exhibit 4** for 2007 sales of the top ten Internet retailers. See **Exhibit 5** for financial results of Zappos and other retailers.)

Customer behavior also seemed to be changing. Traditionally, customers came to the Zappos.com site and purchased directly. However, as the economy struggled, Zappos noticed that customers came to the site many times, through multiple channels, before finally placing orders. They might view the site directly, come through affiliate sites, through comparison shopping engines, through a Google ad, and then finally buy.

The changing economy posed challenges on many fronts. In looking at how best to prepare for difficult economic times, the company looked at all aspects of its business for improvements and efficiencies, including its supply chain.

STUDY QUESTIONS

1. What are Zappos' core competencies and sources of competitive advantage? How sustainable are they? What role does corporate culture play in these questions?
2. How important is next day air shipment to the customer experience? Is it worth the cost? How might you change it in the cost-conscious environment facing the company in late 2008?
3. How would you expand the business? Would you add more products, more geographies, or by selling private labels? As you expand the business, how can the company become more profitable, particularly in light of the costs associated with the focus on service?
4. How would you expect the environment of a more cost-conscious consumer to affect Zappos' business? What can Zappos do in such an environment to maintain sales growth?

Appendix
Zappos Culture and Values

Step into the lobby of Zappos' headquarters outside Las Vegas, and you know you are visiting a company with a unique culture. The room feels like a well used (but well cared for) college dorm activity room. The lights are low and the aroma of popcorn wafts from a popper sitting on the receptionist's desk. There is a large video dance game, "Dance Dance Revolution" awaiting both visitors and employees. You wait on a comfortable sofa. There are bookshelves filled with many copies of popular business and motivational books. The rules for this library are simple: you can take any book you want, you do not need to return it, but you must read it.

The unique nature of the company culture does not end at the lobby. Each work area in the building is highly decorated. Employees work in an open office environment, but not in conventional, discrete cubicles. Instead, aisles are denoted by low (four foot) modular walls. Divisions between adjacent employee workspaces are low. There is no dividing wall between workspaces on one side of the aisle and those on the other. The company's senior executives, including Hsieh, Lin, Mossler, and Hill, are located in the middle of such an aisle, indistinguishable from any other employee. In short, the working environment reinforces a belief that employees do not operate as individuals, but are part of a team, and teams are part of a larger organization—everyone involved plays an important role, and everyone contributes together.

As a visitor tours the offices, the employees in each aisle give a warm welcome—sometimes by giving a big smile and waving, sometimes by other forms of recognition. In one case, one employee starts a recording of music, at the end of which the entire group rings cow bells. Clearly, these people are happy to be where they are, doing what they are doing, and working with their colleagues.[17]

Like many start-up companies, Zappos culture and values began to develop at the company's formative stage. There were relatively few employees, and many of them were involved with each new hire. As companies grow, the culture generally evolves to be more formal, losing the highly collaborative, family atmosphere. Hsieh and Lin had seen this at Link Exchange, where the company had been a financial success, but had ceased to be a fun place for employees to work and spend their time.

Following the Link Exchange experience, Hsieh and Lin believed that it was just as important to grow the culture every year as it was to grow revenues and other business metrics. In 2004, Hsieh sent an e-mail to all employees asking "What does the culture mean to you?" The responses were then distilled down to 10 values:

1. Deliver WOW Through Service
2. Embrace and Drive Change
3. Create Fun and a Little Weirdness

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[17] Zappos provides tours to anyone who requests them. For information, contact tours@zappos.com. To see a video of the Zappos environment, including interviews with Tony Hsieh, see an ABC Nightline segment available at the bottom of the Zappos.com homepage (November 24, 2008).

4. Be Adventurous, Creative, and Open Minded
5. Pursue Growth and Learning
6. Build Open and Honest Relationships with Communication
7. Build a Positive Team and Family Spirit
8. Do More with Less
9. Be Passionate and Determined
10. Be Humble

These values played an important role in new employee hiring decisions, in training, and were reinforced by everyday actions throughout the organization. In the recruiting process, potential employees were interviewed in a traditional fashion regarding their ability to do the work. The human resources department then intensively interviewed them to ensure that they were compatible with the company values. Take, for instance, the value "Be Humble." When interviewing experts for senior positions, if the recruit exhibited excessive ego or arrogance, that person would not be hired. For this reason, the company preferred to train employees to take higher-level positions than to bring in experienced outsiders.

Another value was "Create Fun and a Little Weirdness." Potential employees might be asked to rate how "weird" they were on a scale of 1-10. Hsieh observed, "If they say 'one,' we won't hire them…. If they're a 10, they're probably too psychotic for us. We like 7s or 8s."[18] One example of "fun and a little weirdness" was the weekly practice of a department (varying from week to week) dressing in costumes and parading through the office.

Hsieh described the Zappos culture as follows:

> To me, the Zappos culture embodies many different elements. It's about always looking for new ways to WOW everyone we come in contact with. It's about building relationships where we treat each other like family. It's about teamwork and having fun and not taking ourselves too seriously. It's about growth, both personal and professional. It's about achieving the impossible with fewer people. It's about openness, taking risks, and not being afraid to make mistakes. But most of all, it's about having faith that if we do the right thing, then in the long run we will succeed and build something great.[19]

One might expect that the exuberance of the workforce, and the strong, cohesive, fun-loving culture emanated from a rowdy, boisterous, over-the-top, leader. Nothing could be further, however, from Hsieh's personal style, or that of the other senior leadership. Hsieh was quiet, humble, and extremely soft spoken. The other senior leaders were mature, calm, and professional. The specific culture was not dictated from the top, but rather grew from the employees. The role of the leaders was to cultivate it, reinforce it, and ensure that those attributes that fostered passion and joy among the employees were not casualties of the company's success and continued growth.

[18] Helen Coster, "A Step Ahead," *Forbes*, June 12, 2008, pp. 80.
[19] Zappos.com 2008 Culture Book, p. 12.

Lin described what the executives told new employees during their initial training:

> We tell all the employees, 'This cannot be just me, or Tony [Hsieh], or Fred [Mossler], or Steve [Hill], or anybody else who's on the management team's culture. It's everybody's culture here and it's important that you live, breath, inspire the culture, and build upon it. All this is user generated. We don't ask people to do any of this stuff, it just builds upon itself. If you're passionate about it, please build upon it.'

Mossler observed that the Zappos culture fostered excellence:

> Everyone's focused on just being the very best at whatever particular department they are in. I'd say that's definitely a thread that runs throughout the company. It's a lifestyle…. They're always living, breathing, and thinking about the company. After work, people don't go home and forget about what happened at Zappos. They go out with other Zappos employees, and they have fun, they bond and build relationships, but they're always talking about, 'How can we move the business forward? How can we innovate? How can we make it better?'

Every new employee, whether entry level or senior manager, went through the same four-week training program. Midway through the training, Hsieh offered the new hires a bonus, plus pay for the time they have been with the company, to quit. The size of the bonus had increased over time, and in 2008, was $2,000. The objective was to ensure that any new employee who stayed was passionate about the company and its values, and to identify those who were not as soon as possible. Throughout the company's history, the acceptance rate for these bonuses was just 2-3 percent. Since the call center turnover rate was higher than 2-3 percent, Hsieh commented that, "To me, it says that the offer is not high enough." Either the hiring process was not matching the company and employee properly, or "We didn't do a good enough job of training them on an ongoing basis after the initial couple of weeks. Or sometimes other stuff happens in their lives that makes them less focused on work." Employees who stayed more than 90 days, however, generally stayed for the long term.

At the end of the training, all Las Vegas new hires, regardless of the job they were hired for, worked for at least two weeks as call center operators, interacting with customers. At some point in their first year, they would also spend at least a week working at the Shepherdsville warehouse, learning how orders were fulfilled. Zappos believed it was important that all employees have a full understanding of the business. Many employees hired at Shepherdsville, particularly those at supervisory or higher levels, went to Las Vegas to participate in the new hire training, if possible during their first year with the company.

Each year, Hsieh sent an e-mail asking each employee, as well as the company's affiliates and business partners, to write a few lines describing what the Zappos culture meant to them. They were not to discuss this with their colleagues. If they had been employees the previous year, they were not to look at what they had written before until they had made their new submission. These were put into a book, which was published. The 2008 edition was about 475 pages long. While no entry could be characterized as "typical," there was definitely a common feeling among them as contributors told stories of the importance of Zappos in their lives, and what the company culture meant to them. The following comment by one employee is representative of the sentiment expressed by many:

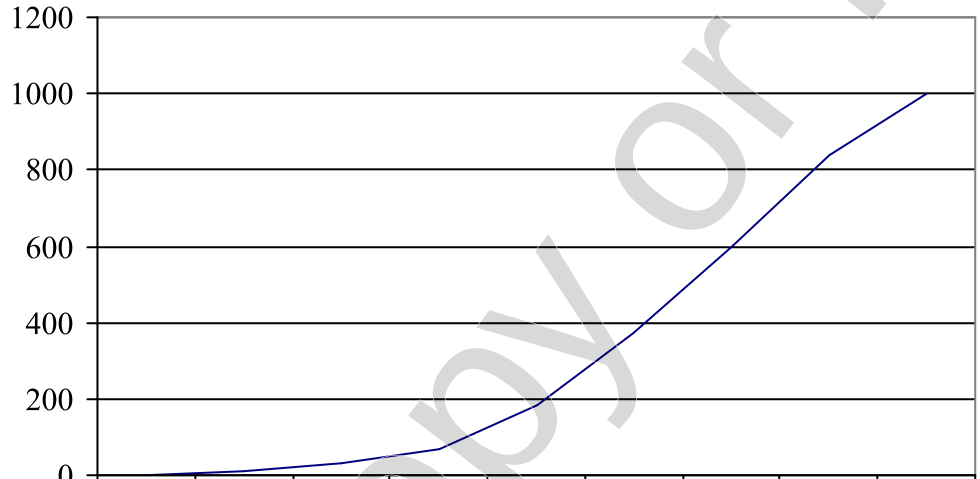
> I am truly grateful each day I walk through the doors that I can be challenged, encouraged, and grow; I can laugh and play. I am able to spend my days in an environment that operates with and supports the same beliefs I hold close to my heart. There is really no place like zome.[20]

Company partners were also asked to contribute. One commented on the relationship between culture and company success:

> From the moment that I first researched Zappos I knew there was something special happening within the company. I wanted to know how a company could successfully grow as quickly as Zappos. I found the answer to my question as soon as I walked in the door of the Zappos campus. I felt welcomed and the campus was buzzing with friendly people. As I toured the campus, almost everyone introduced themselves by name and gave me a brief description of their job. I could tell everyone was proud of their careers and enjoyed being part of the Zappos team. I believe that the positive energy that's being unleashed by the Zappos team is the key to Zappos' success.[21]

[20] Quote from Kelly D., Merchandising Department, in "2008 Culture Book," *Zappos.com*, p. 221.
[21] Quote from Leslie W., of Zappos.com partner Fleur't, in "2008 Culture Book," *Zappos.com,* p. 457.

Exhibit 1
Zappos Gross Revenue Growth



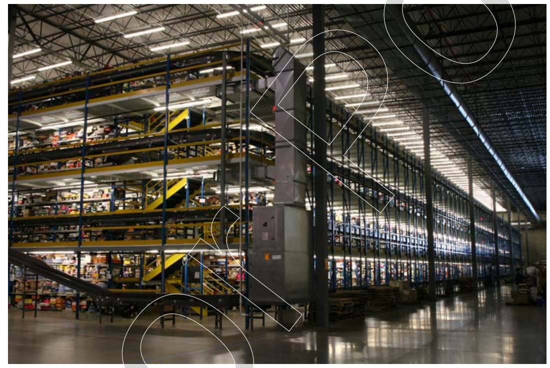
	2000	2001	2002	2003	2004	2005	2006	2007	2008 (est)
$Million	1.6	8.6	32	70	184	370	597	840	1000

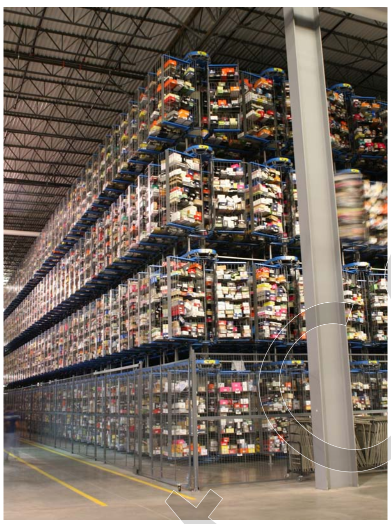
Zappos growth in gross revenues, 2000-2008. Returns typically ran in the range of 35-37 percent of gross revenues.

Source: "2008 Culture Book," *Zappos.com*, p. 9.

Exhibit 2
Zappos Distribution Center, Shepherdsville, Kentucky

Shepherdsville Distribution Center


Static Shelving

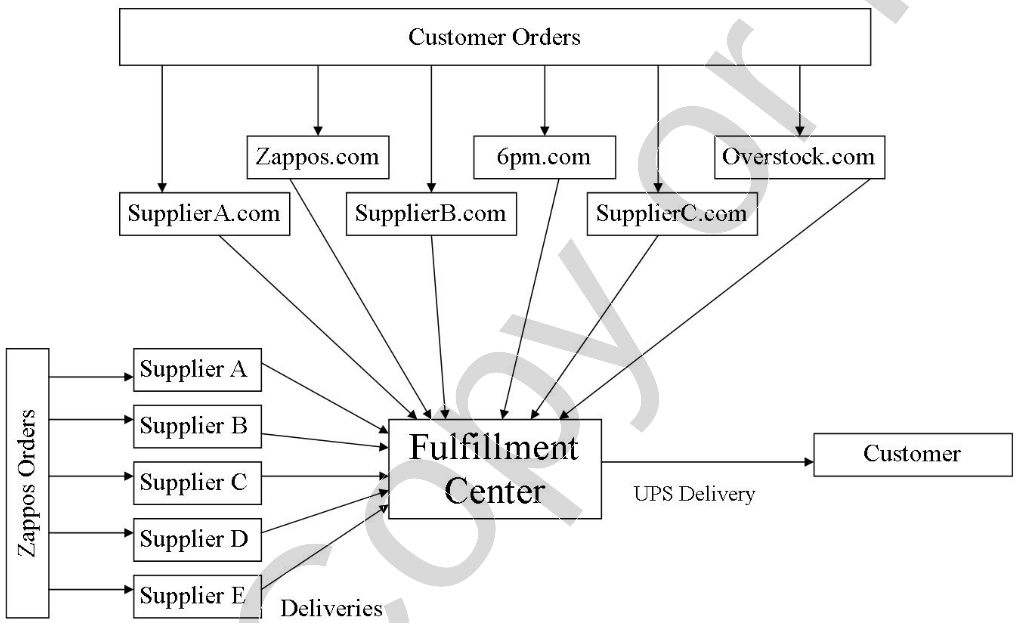

Carousel


Robots (and operator) with shelves at work station.


Robotic inventory area.

Source: Zappos.com (with permission).

Exhibit 3
Zappos Supply Web



SupplierA.com, etc. are "Powered by Zappos" sites.

Exhibit 4
Top Internet Retail Businesses in 2007

The top ten Internet retail companies in 2007, according to *Internet Retailer*, were:

Rank	Company	Web Sales Volume ($ billion)
1	Amazon.com	14.8
2	Staples Inc.	5.6
3	Office Depot Inc.	4.9
4	Dell Inc.	4.2
5	HP Home and Home Office Store (Hewlett-Packard Co.)	3.4
6	OfficeMax Inc.	3.2
7	Apple Inc.	2.7
8	Sears Holding Corp.	2.6
9	CDW Corp.	2.4
10	Newegg.com	1.9

Source: "America's Top Ten Retail Businesses," *Internet Retailer Top 500 Guide, 2008 Edition*, online summary (http://www.internetretailer.com/top500/list.asp, accessed January 23, 2009).

Exhibit 5
Income Statement Data for Zappos, Amazon, and Nordstrom

	Zappos 2008	Amazon 2008	Amazon 2009	Nordstrom YE 1/31/2009	Nordstrom YE 1/31/2010
Revenue	$635M	$19B	$24.5B	$8.6B	$8.6B
Gross Margin %	35%	22%	23%	37%	38%
Operating Income %	3.4%	4.4%	4.6%	9%	10%
Annual Revenue Growth	20%	29%	28%	(6%)	1%
Market Capitalization	n/a	$22B	$59B	$2.9B	$8.3B

Sources: Zappos data from Amazon.com Amendment Number 1 to SEC Form S-4 Registration, dated September 14, 2009, p. D-3. Amazon and Nordstrom data from company annual reports. Stock prices (for market capitalization) from BigCharts historical quotes (http://bigcharts.marketwatch.com).