March to the Beat of Your Own Drummer: Amazon's Executive Compensation Practices

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Howard Berkower with assistance from Andy Tsang authored a column discussing Amazon's ongoing success and its unique executive compensation model for the *New York Law Journal.*

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I am honored and humbled to continue the column on executive compensation and corporate governance that Joseph E. Bachelder III wrote for the New York Law Journal for over 30 years. Joe was my esteemed colleague and dear friend at McCarter & English for more than eight years. His keen analytic mind, encyclopedic knowledge, attention to detail, concise writing skills, dogged work ethic and relentless pursuit of excellence greatly influenced me and all that knew him. He was a wonderful teacher and mentor who was always generous with his time. Joe Bachelder is and will always be sorely missed.

Earlier this year, in connection with Amazon's public announcement of its record-breaking annual financial results for 2020, Jeffrey P. Bezos, the company's founder and board chair, CEO or president since its 1994 inception, announced that he would be relinquishing those positions to become Amazon's executive chairman sometime this autumn. To say Amazon's 2020 financial results were "record-breaking" understates the matter: Assisted by the effects of the global pandemic, Amazon's sales of $386 billion represented a 38% increase from 2019 and its net income of $21.3 billion amounted to a whopping 84% increase from 2019. What an opportune time to announce an executive transition! In this article I trace Amazon's spectacular long-term success and examine its unique executive compensation practices.

Amazon went public in May 1997 when it raised $54 million by selling 36 million shares at $1.50 per share on a post-split basis. As disclosed in its prospectus, the company had no specific plan for its initial public offering (IPO) proceeds but was going public "to create a pubic market for its stock to facilitate future access to public equity markets," and "to provide increased visibility and credibility in a marketplace where many of its current and potential competitors are or will be publicly held companies." Upon completion of its IPO Amazon's market capitalization was about $430 million and Mr. Bezos and his family controlled about 48% of the outstanding shares.

Its IPO prospectus disclosed that Amazon was founded in 1994 "to capitalize on the opportunity for online book retailing" and its strategy was "to use technology to deliver outstanding service and achieve significant economies inherent in the online store model." Amazon sought "to build strong brand recognition, customer loyalty and supplier relationships, while creating an economic model that is superior to that of the capital and real estate intensive traditional book retailing business."

While you can still order books from Amazon today, online book retailing is, at best, a minute fraction of Amazon's business. Amazon is everywhere: It has revolutionized the retail market and has leveraged its online distribution network to process and fulfill the sale of products of third-party sellers. Its Amazon Prime memberships offer access to proprietary and third-party content of all kinds, including digital video. It also manufactures and sells electronic devices, including Kindle and Fire tablets. Amazon's most profitable business, however, is Amazon Web Services (AWS), the dominant cloud service business in the world. For 2020, while AWS generated only 12% of Amazon's annual sales, it was responsible for 59% of Amazon's annual operating income.

In its IPO prospectus Amazon warned that it "intends to invest heavily in marketing and promotion, site development and technology and operating infrastructure development," and expects to incur "substantial operating losses for the foreseeable future." Indeed, during its first six years as a public company, Amazon incurred more than $3 billion of cumulative net losses under U.S. generally accepted accounting principles (GAAP) before recording $35 million of net income for 2003. It took the company another six years to earn back the $3 billion losses to "break even." Amazon's annual income tends to fluctuate widely from year to year with large increases often followed by large decreases, as Amazon continues to evolve.

Amazon's $1.59 trillion market capitalization as of April 1, 2021, is surpassed only by Apple ($2.06 trillion) and Microsoft ($1.83 trillion). Interestingly, the price earnings ratio for the trailing 12-months (PE Ratio) for Amazon is 76 times earnings, more than twice as much as Apple (33 times) or Microsoft (36 times) as both companies continue to be substantially more profitable than Amazon.

To give some perspective to how profitable an investment in Amazon has been, had you been fortunate to have purchased 100 shares in its IPO at the IPO price of $18.00 per share, your $1,800 investment would now be 1,200 shares after giving effect to stock splits and, as of March 31, 2021, would be worth about $3.7 million. The compound annual growth rate (CAGR) of your investment would be about 37%. Were you to have invested at the same time $1,800 in the S&P 500 and reinvested the dividends earned thereon, the CAGR of your investment would be 8.6% and your investment would now be worth only $13,000. Significantly, Amazon achieved a 33% CAGR for 10-year period ending March 31, 2021, slightly less than the CAGR since its IPO. Furthermore, Amazon's CAGR exceeded the CAGR of an investment in either Apple or Microsoft for the recently ended 10-year period and the 24 years since Amazon's IPO.

Compensation Practices

Amazon recognized in its IPO prospectus that the Internet and online commerce industry is susceptible to rapid technological change and the importance of the need to continually evolve. Amazon acknowledged that its long-term viability depended on its ability to "identify, attract, hire, train, retain and motivate" its executive officers, key employees and "highly skilled technical, managerial, editorial, merchandising, marketing and customer service personnel." Amazon noted in its Compensation Discussion and Analysis section of its 2020

Proxy Statement that its compensation philosophy seeks to “encourage motivated, customer-centric employees to think and act like owners” and to provide “strong long-term incentives that align the interest of its employees with those of its shareholders.” Further, its compensation program reflects the company’s “core values, including customer obsession, invent and simplify, bias for action, acting like owners and thinking long term, hiring and developing the best, and frugality.” As a result, stock-based compensation comprises the overwhelming majority of an employee’s compensation package.

Base Salary. Salaries at Amazon are extremely modest. As disclosed in its IPO prospectus, Mr. Bezos, as Amazon’s principal executive officer, received compensation for 1996, the year prior to its IPO, of only $64,333 and no executive officer met the SEC’s definition of “highly compensated executive officer” for such year, meaning that no executive officer received compensation in excess of $100,000. In addition, Amazon disclosed in its IPO prospectus that it did not have long-term employment agreements with any of its key personnel or have any “key person” life insurance policies. Fast forward to today, Amazon continues to pay a very modest salary: for 2019 no named executive officer had a base salary of more than $175,000, including Jeff Bezos, who was paid only $81,840 and whose annual cash compensation has never exceeded $81,840.

Cash Bonuses. While from time to time Amazon has paid annual cash bonus particularly during the a few years following the burst of the “tech bubble” in 2000, it generally only pays a cash bonus in connection with the hiring of an executive officer a component of which is to replace compensation the executive forfeited to join Amazon and to cover relocation expenses. A signing bonus is usually paid over two or more years requiring the executive to remains employed by the company.

Stock-Based Compensation. Amazon employed stock option grants during the period from its founding through 2002, and in response to the significant market downturn that occurred during 2000-2001, like other companies, it exchanged “out of the money” options for new options exercisable for fewer shares at a lower strike price. However in November 2002, Amazon revamped stock-based compensation system by replacing stock option grants with restricted stock awards. Among the reasons given for this change was to limit overall shareholder dilution and the overall simplicity of restricted stock awards.

In connection with an executive’s annual review, the CEO and the head of human resources consider whether to recommend to the company’s compensation committee a restricted stock award, including the number of shares and the vesting criteria. Amazon avoids establishing pre-determined objective performance criteria as conditions to the award or its vesting. Instead, it focuses on subjective performance achieved and projected to be achieved which it believes provides flexibility and better fosters long-term growth, creativity and innovation. Among the factors considered are an executive’s level of responsibility, past contributions to the company’s performance, expected future contributions, the compensation of similarly situated executives at other companies and the expected value of the executive’s existing equity awards and the expected value of the proposed award. Awards typically vest over five or more years and are “back-end loaded” as vesting begins on the third or fourth anniversary of the award. Frequently, an executive may have to wait a few years to receive a new restricted stock award.

To illustrate, during the three-year period ending Dec. 31, 2019, Andrew Jassy, the chief executive officer of AWS who will be replacing Jeff Bezos as Amazon’s CEO later this year, received restricted stock awards only in 2018, but the value of those awards, that is, the total number of shares (assuming full vesting) times the average high and low trading share price on the date of the award was $19.5 million. Should Amazon stock continue to appreciate at the 33% CAGR it achieved for the 10-year period ending March 31, 2021, when the restricted stock awards begin to vest on the third anniversary, the shares would be valued at about $46 million. Indeed, as of Dec. 31, 2019, Mr. Jassy held 53,874 unvested restricted shares valued at $99.6 million (inclusive of his 2018 awards). In addition, during 2019 he benefited from the vesting of 28,326 restricted shares then valued at $50 million.

Other Compensation and Perquisites. While executive officers receive vacation, medical, 401(k) benefits and other benefits generally available to all Amazon employees, they are not provided with benefits under nonqualified deferred compensation or supplemental executive retirement plans or cash severance programs. In connection with perquisites, the bulk of Mr. Bezos' annual compensation every year is in the form of his security arrangements which in 2019 amounted to $1.6 million.

Bezos' Compensation. Any discussion of Amazon's compensation practices would be incomplete without addressing how it compensates Mr. Bezos in his capacity as the company's chief executive officer, or more accurately, that Amazon does not compensate Mr. Bezos for his services. As previously mentioned Mr. Bezos' annual cash compensation has never exceeded $81,840 since the company's inception. In addition, unlike other successful tech company founder-chief executive officers who periodically receive substantial stock-based grants, for example, Elon Musk at Tesla, (see Tesla's Stock Option Grant to its CEO, by Joseph E. Bachelder III, New York Law Journal (May 1, 2018 and Part 2 on June 22, 2018)), Mr. Bezos has never received any stock-based compensation from Amazon. Mr. Bezos has regularly sold Amazon shares under a 10b5-1 plan beginning in 2003 and based on his most recent Form 4 filed with the SEC, he now holds 53.2 million Amazon shares representing more than 10% of the total shares outstanding which as of March 31, 2021 are worth $164 billion.

Compensation Practices Employed Throughout the Company. Amazon employs its stock-based compensation practices widely throughout the entire company. Blogs can easily be found on the Internet for individuals seeking employment at various divisions of the company advising on what to expect the compensation package to look like and the extent to which these features can be negotiated: below market annual base salary, cash signing bonus payable over two years to ease the sting of the low annual salary and restricted stock award that starts to vest on the third anniversary of employment. Significantly, Amazon's directors do not receive cash compensation for their service but receive restricted share awards every few years.

Amazon's pervasive use of stock-based compensation is quantified in the company's annual reports and proxy statements filed with the SEC. For example, its 2020 annual proxy statement disclosed that "the total number of restricted stock units granted to our named executive officers during the three-year period from 2017 to 2019 represented (1) 0.27% of the total number of restricted stock units granted to all employees during the same three-year period and (2) less than 0.01% of the weighted-average number of shares outstanding for the same three-year period." An analysis of the notes to its audited financial statements contained in its most recent annual report reveals that for 2020 Amazon's stock-based compensation expense exceeded $9.2 billion and was allocated to its employees throughout its operations as follows: 55% to technology and content, 19% to marketing, 15% to fulfillment, and 11% to general administration and others. Furthermore, Amazon stockholders regularly approve the "say on pay" advisory vote on the compensation paid to is named executive officers with approval rates exceeding 95%, including most recently, 97% for its 2020 annual stockholders meeting.

Conclusion

Amazon has enjoyed phenomenal success during its 24 years as a public company. There are likely many reasons for the company's success and its ability to remain a leader on the cutting edge of the rapidly-changing technology revolution, however it is clear that Amazon's unique "eat your own cooking on steroids" compensation policy complements its outstanding historical long-term performance and bodes well for its future prospects.

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