

SHOE-ING

Zappos.com's commitment to service has inspired cultlike devotion among its online customers and employees. But can this Internet shoe retailer stay private much longer?

What began as an unsuccessful attempt in 1998 by Nick Swinmurn to find a pair of Airwalk desert boots—first at San Francisco's Stonestown Galleria (“They didn’t have my size”) and then online (“Still no luck”)—led to an Internet start-up the following year that has attracted some of the smartest investors in Silicon Valley. Its product, obviously: shoes.

Zappos.com operates a giant call center in Las Vegas and sells millions of shoes and hundreds of brands out of its 260,000-square-foot warehouse in Shepherdsville, Kentucky. Revenues have either doubled or tripled in each year of business and were on track to top \$350 million in 2005. In terms of profits, the company just breaks even—but that’s partly because it has plowed all it could into expanding the business. Its more than 700 full- and part-time employees enjoy many benefits too. At Zappos everybody gets a free lunch, including the graveyard shift in Las Vegas, though those folks have to eat it at midnight. Little is wasted on management perks, however. Along with other executives, Swinmurn and CEO Tony Hsieh, both 32, work in the same poky cubicles as the rest of the Las Vegas staff and have no secretaries. When *Corporate Board Member* asked Hsieh for material on

the company, he offered to overnight it. Personally? “Well, the UPS machine is right outside my cubicle, so yeah,” he said.

Since Swinmurn’s idea about selling shoes online came at the height of the dot-com boom, he saw no reason why he shouldn’t be the next Jeff Bezos. He had online experience—he was a marketing manager for Autoweb, an Internet car retailer, at the time of the start-up—and his search for those Airwalks had left him convinced that selling shoes online could fill a gap. “I thought, ‘Wow, this is weird; this is an area no one has really gone after,’” he recalls. He quit Autoweb, did some research, and in February 1999 launched a test website. A few months later he raised \$150,000 from friends and family to form Shoesite.com, his first name for the company. He needed more funding, of course, but couldn’t persuade any venture capitalists to invest. “They thought shoes would be hard to sell online because people would want to try them on, meaning lots of returns,” he says.

But then Swinmurn was able to recruit a veteran Nordstrom buyer, Fred Mossler, to join the company as its senior vice president of merchandising, a position he still holds. Other outfits rapidly began to set up online shoe-retailing businesses, among them

by Bonnie Azab Powell



AT THEIR LAS VEGAS HEADQUARTERS, FROM LEFT: TONY HSIEH, NICK SWINMURN, AND ALFRED LIN

Nordstrom and a number of Internet-only concerns, including Shoes.com. Swinmurn lost his exclusivity, but the presence of competitors—and the arrival of Mossler, who had extensive industry experience and contacts among manufacturers—gave his start-up just enough credibility to land an investor: a small San Francisco company called Venture Frogs.

Venture Frogs' principals and founders were Hsieh and Alfred Lin, 32, former Harvard classmates whose dormitory businesses as budding pizza barons had overlapped. Hsieh bought whole pies and sold them at a profit to fellow students—including Lin, as it turned out, who resold the individual slices at even greater markups. In 1996, when Hsieh co-founded LinkExchange, a cooperative advertising network for small websites, he brought Lin in as vice president of finance. Microsoft bought LinkExchange two and a half years later for \$265 million, and the two used some of that money to launch Venture Frogs.

"The numbers Nick was talking about intrigued us," recalls Hsieh. In 1999 shoe sales in the United States amounted to \$40 billion, \$2 billion of which was handled by mail-order catalogs. "It seemed like

provide cash infusions in times of need, and Hsieh has also put in some of his own money, for a total of around \$10 million.

"Looking back, not getting more outside funding was a blessing in disguise," he says. "We couldn't go out and blow \$50 million on advertising"—as now-defunct Pets.com did, mostly on a Super Bowl ad starring a sock puppet—"or on a completely automated distribution center. It forced us to be creative."

Swinmurn's original idea had been to offer more inventory than brick-and-mortar retailers could, but at first it was a struggle to sign big-name brands, which didn't want to be associated with what they saw as an Internet fly-by-night. As a result, Zappos debuted with fewer than 20 shoe styles—not quite the mall-busting selection Swinmurn had envisioned. Unable to offer much in the way of inventory, "we just decided to make sure we took care of the customers we did have to keep them coming back," he says. "As we added more selection, we hoped they'd tell their friends. We couldn't afford advertising, so we needed good word of mouth.

It wasn't rocket science."

Nobel-worthy or not, the company's focus on service is undoubtedly the key to its success. Early on, after suppliers fumbled Zappos' customer orders—shipping the wrong shoe or, worse, running out of an item—Zappos switched to holding and shipping its own inventory. As it streamlined the delivery system, it started trying to beat its own promises, getting shoes to repeat customers in two days

instead of the four to five it had specified. The company instituted a generous 365-day return policy, complete with postage-paid return shipping that customers can print out instantly from their computers. Its website provides photographs of each shoe style from six angles and also posts customer feedback, such as whether a style runs smaller than usual, to help cut down on those returns.

Most important, Zappos has hired the best customer-service representatives around. Two years ago Hsieh and Swinmurn moved the company to Las Vegas. "In San Francisco we just couldn't find people who would treat call-center work as a career," says Hsieh. "And that was critical." In Las Vegas, apparently, they could. The 800 number is manned 24 hours a day, seven days a week; so is the Kentucky warehouse. Round-the-clock service does not come cheap, Hsieh admits, but it's the only way to get shoes to a customer overnight. As the comment sections posted on the company's site

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the online version of that would do at least as well, if not better," Hsieh says. Venture Frogs put \$500,000 into Swinmurn's enterprise. Hsieh was less confident about its name, though. Shoesite.com was "kind of like calling your store Store," he jokes, so he and Swinmurn asked the handful of employees the company had at the time to brainstorm a new name. The result was a catchy riff on *zapatitos*, Spanish for shoes.

Zappos had been open barely a year when technology stocks crashed. Scores of Internet companies began pink-slipping their fresh-faced employees and auctioning off their Aeron chairs. But instead of panicking, Hsieh decided to take a more hands-on role at Zappos and eventually became CEO and a board member. Swinmurn was chairman at the time. Lin signed on as CFO in 2005, after getting another Venture Frogs investment, Tellme Networks Inc., an Internet communications company, on its financial feet. Venture Frogs has continued to

show, customers respond with fanatical gratitude. The site abounds with exclamation-point-studded paeans like this one: "Zappos was great to do business with—I had my shipping expedited at no charge and they arrived in perfect condition and were exactly what I'd ordered and they came so quick!!" More than 60% of sales are now to repeat customers.

These include Deborah Stalford, 33, a graphic designer in Berkeley, California, who estimates that she ships back four pairs of shoes to Zappos for each one she keeps. "I don't really think of it as returning them. It's more like sending the shoe-store guy into the back to get another style or size," she says. She's not alone. Between 20% and 30% of orders get returned, depending on the brand. This, admits Hsieh, "does cut into our margins, but that's just another cost we'd rather bear than decrease the customer experience or spend the money on marketing."

Hsieh likes to point out that Zappos' unofficial motto is, "We're a service company that just happens to sell shoes." Cynical readers may be forgiven for thinking they've heard that, or something like it, many times before. But in this day of frustrating voice-activated phone trees and surly store clerks, big companies that reliably offer good customer service are few and far between. Asked for a role model, even Hsieh struggles. "There are some that provide great service to wealthy customers, but not to the masses. Maybe Starbucks or In-N-Out Burger does," he hedges. "Basically, everyone says customer service is important, but they don't actually put their resources behind it when it comes down to making a choice between short-term profit and better service."

Zappos has. Since mid-2005, every Las Vegas employee—from executives and buyers to accountants, programmers, and call-center operators—has had to go through a lengthy training course: two weeks of learning about Zappos' culture and call-center system, two weeks of answering the phones, and then a week of racing sweatily around the warehouse.

Zappos' employees are almost creepily enthusiastic about the company. The slim paperback given to new hires by way of an employee manual contains a few paragraphs, signed or anonymous, from every employee about what the Zappos culture means to him or her. In the introduction to the latest edition, Hsieh writes, "Customer service shouldn't just be a department. ...[I]n addition to trying to wow our

customers, we also try to wow our employees and the vendors and the business partners that we work with." If the manual is any indication, Zappos has certainly succeeded in wowing its workers. Here's



what came from the warehouse, for example: "Two years and a million shoes later, I've seen that what I do is important and I never thought a job could be so satisfying."

"I know, I know, it seems like a cult," laughs Catie Fahrner, a Zappos assistant buyer whose name and contact information were not supplied by the company. Fahrner, 25, has worked for Zappos since June 2000, starting as an intern while in college and moving through three or four departments before settling happily in her current one. Reached by phone on her way to work, she claims not to mind that it's a Saturday: "Going to work does not feel like work. It's fun." She says she and other employees "really want Zappos to succeed, because we hope it will be the last job we'll ever have."

Coleman Horn, chief design officer at Medium, a manufacturer of über-hip men's and women's shoes, is another big fan. Not only does Zappos sell more Medium shoes than any other U.S. retailer, but its customer feedback, which Horn reads avidly, helps him put out a better product. "I've caught a lot of stuff that way—for example, that certain shoelaces were fraying, so we upgraded them." Using Web-based tools provided by Zappos, Medium tracks its inventory on the site daily to see what's selling and what's not. Other retailers offer similar tools, "but not with the anal level of detail that Zappos does," Horn says.

As sales swell and the number of employees balloons, maintaining the Zappos culture is Hsieh's biggest challenge. "What keeps me up at night is

that half the people in the company weren't here last year," he says. Swinmurn stepped down as chairman in early November, handing the job over to Lin, whom he calls "more detail-oriented," and now devotes himself full time to making sure that the "wow" torch gets passed on, flame unquenched. "The managers doing the training are people who rose up through the ranks," says Swinmurn. "We have to hope they can communicate what we're about."

Zappos is also finally facing some tougher competition. Internet titan Amazon.com has begun selling shoes, while Nordstrom and other established retailers, such as Macy's, have figured out that they need to pay as much attention to their online businesses as they do to their physical stores.

Rob Garf, a research director at AMR Research, a technology data advisory firm, says Zappos should be on the lookout for retailers with effective "cross-channel" businesses, able to sell in malls, in mail-order catalogs, and on the Web. Based on an AMR Research survey, cross-channel shoppers during the 2005 holiday season spent 30% more than single-

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channel customers. The reason, according to Garf: "Although retail shoppers are increasingly savvy about the Internet, they still like to touch and feel products."

Some retailers with Internet arms, such as Best Buy and Barnes & Noble, have found that they can leverage their physical stores against Web-only pure plays like Amazon.com by offering next-day in-store pickup of items purchased on their websites. Garf sees both an advantage and a risk in this, however: "They have to provide a seamless experience along each customer touch point, which is difficult when you're dealing with a computer online, or a person in a call center, and the elements of a brick-and-mortar store, like the sales associates."

Zappos, however, can count on some new blood in the boardroom to deliver competitive muscle. Sequoia Capital, a legendary Silicon Valley venture capital firm that several times turned down the chance to invest in Zappos, changed its mind in 2004 and has since put some \$35 million into the

company. A Sequoia partner, Michael Moritz, 51, joined Hsieh and Lin on the Zappos board. Moritz is recognized as one of the savviest dealmakers in Silicon Valley, with a good eye for young companies with odd names and unusual business models run by young guys (he was an early investor in Google). To join him on the board, Moritz brought in Michael Marks, 55, former CEO of Flextronics Corp., an electronics manufacturing company that he took from \$93 million in 1993 revenues to \$15.9 billion in 2005. (In January Marks became a member of buyout giant Kohlberg Kravis Roberts & Co. KKR isn't a Zappos investor, though.) The four directors are looking for a fifth, an outsider. "We're open to anyone who would complement the board," says Hsieh. "We've been looking at people from other companies who are focused on the customer and employee experience."

Do these board changes—to be accompanied, perhaps, by the recruitment of more experienced managers—signal an impending public offering? After all, many a pre-technology-crash dot-com company eyeing an IPO hired older executives to dispel the idea that it was being run by mere boys. Not according to Moritz. "First, I'm much more interested in being a shareholder in a great company than in talking about, or thinking about, or dreaming about an initial public offering," he says. "Why go public if you don't need the money?" Moreover, he acidly rejects the "condescension implied by the phrases 'gray hair' and 'adult supervision.' No amount of either could do what Larry and Sergey have done or what Tony and his compatriots have done." (He's talking about Google founders Larry Page and Sergey Brin in the same breath as Zappos' Tony Hsieh, which must mean something.) "Now, I think it makes a ton of sense to harness all that passion and enthusiasm about a product or a service or a company with people who have complementary experience, and Zappos is building its management team. But I'll take passion over 'gray hair' any day."

Hsieh doesn't believe Sequoia will be pushing for a public offering soon. "They really are long-term thinkers and investors," he says. "They believe in us and want to see us grow the business." But Sequoia won't want to wait forever for a return on its \$35 million. Sooner rather than later—we're betting by 2007—this dot-com Cinderella will have to put on its glass slippers and make a grand entrance at the IPO ball. ☺