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Turbulence in the Grocery Aisles

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In an unexpected, blockbuster announcement on June 16, Amazon Inc., the nation's largest online retailer declared its intention to acquire Whole Foods Market Inc. in a friendly deal valued at \$13.7 billion. Rapidly growing Amazon, which in 2016 accounted for 43% of all online sales in the U.S.,¹ has made significant inroads in the retailing of books, music, electronics, clothing, baby goods and shoes but has to date been less successful in penetrating the \$800 billion U.S. grocery segment.

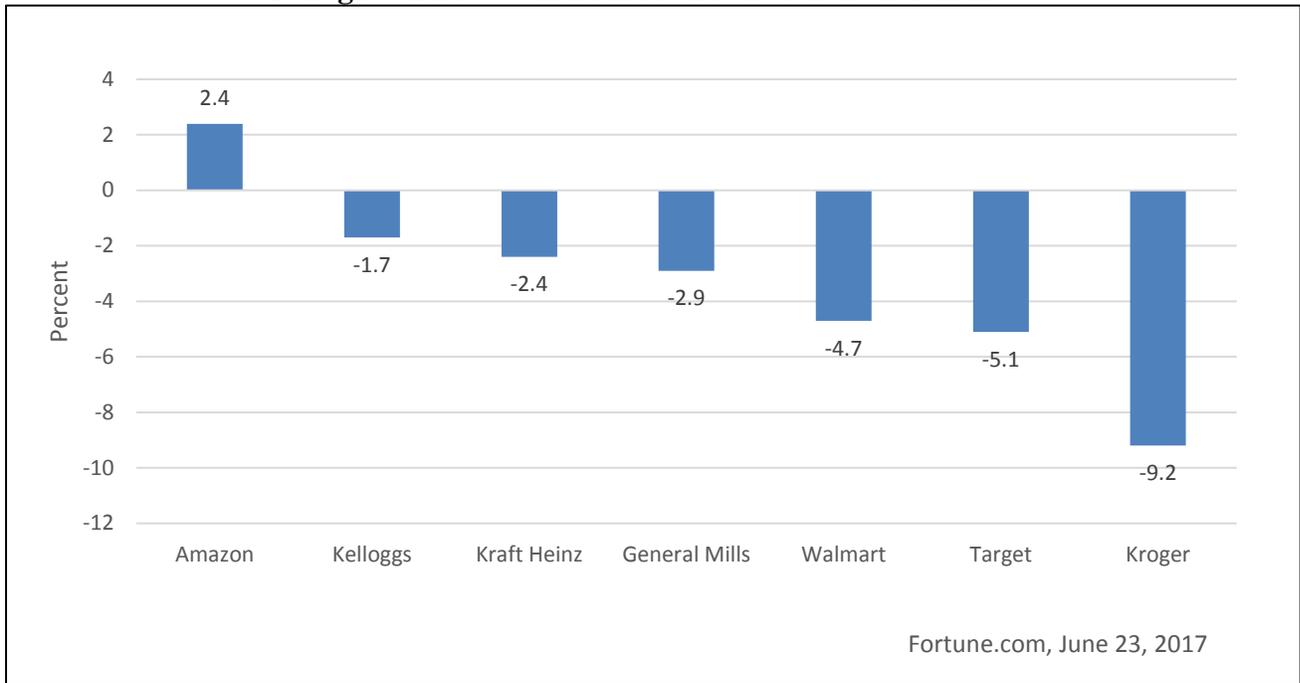
Whole Foods, the 9th largest supermarket retailer in the U.S. with 460+ stores and annual sales of \$16.5 billion,² will be Amazon's largest acquisition to date and will give the company scale and a national "brick and mortar" footprint in the intensely competitive grocery segment. While business media, Wall Street analysts and industry watchers are offering perspectives and speculation on the typically secretive Amazon's motives and future plans, one need look no further than food retailer market caps in the days following the announcement to gauge the potential impact on both food manufacturers and retailers.³

¹ *Digital Commerce 360*, 2/17.

² Company annual report, *Progressive Grocer* magazine, 5/17.

³ *Fortune.com*, 6/23/17.

Change in Stock Price between June 15 and 16 Closes



The post-acquisition path forward for Amazon is replete with strategic possibilities. First, here's what we know with some certainty:

Whole Foods is a less than healthy company, suffering from declining comparable store sales, a high-price image, slumping stock price and activist hedge fund shareholder (8.2%) Jana Partners LLC pressuring to add directors with retail expertise and/or consider a sale.

Traditional food retailers, the largest of which are Kroger, Albertsons, Ahold Delhaize, and Publix, are already under pressure from stagnant underlying consumer spending, overstored markets, deflationary conditions throughout 2016 and aggressive expansion by non-traditional discounters such as Dollar General, Aldi and Lidl. The latter two, hard discount limited assortment retailers hailing from Germany, have each announced expansion plans which will add 175-200 stores per year through 2022.

Large food manufacturers are losing market share to retailer private labels and more nimble, small "challenger" companies who are appealing to a changing consumer value equation that incorporates concern about production and processing practices, natural and simpler ingredients, and expanding definitions of health and wellness. Large activist shareholders are pressing companies to cut costs and combine in an effort to achieve cost synergies.

Amazon is a proven market share predator whose competitive advantages are different in nearly all aspects from traditional retailers. It's an innovation-machine with a focus on R&D and experimentation at the expense of short-term profit. It's a customer-centric

company that has established a powerful consumer ecosystem that is based on technological leadership, big data, cutting edge analytics, low prices and logistical prowess.

Amazon and Walmart, the two largest retailers in the U.S., are on a collision course and will compete for dominance in consumables retailing in the coming years. Walmart, the grocery leader with a 20% share achieved through its national network of large format supercenter stores, is investing \$ billions in its online retail capabilities, including the purchase of online grocer Jet.com for \$3+ billion in 2016. The flip side is Amazon, with well-developed online retail capabilities, almost no physical store presence and a less 2% share in grocery.

One of Amazon's core values is frugality and it has a proven history of driving down prices in the categories in which it competes in a big way.⁴ One of Amazon CEO's favorite aphorisms is "your margin is my opportunity."⁵

Food, simply because of razor thin margins and perishability, is an inherently difficult business for an online/home delivery model. Amazon began testing its full line (dry grocery and full perishables) Amazon Fresh concept in 2007 and has to date rolled it out in only a handful of large urban markets. Online grocery players like Ahold Delhaize-owned Peapod, Fresh Direct and Instacart have as yet not proven to be profitable on a freestanding basis.

Now for the strategic possibilities, speculative changes and possible effects on food industry players:

Expect a more price-competitive Amazon online retail food offering and Whole Foods store-based offering. Amazon gains significant scale and leverage with suppliers and may overhaul the Whole Foods supply chain, which currently operates with a relatively inefficient decentralized model. Whole Foods/Amazon are likely to pressure suppliers for lower costs ("your margin is my opportunity"). Price competition at retail is likely to become even more intense.

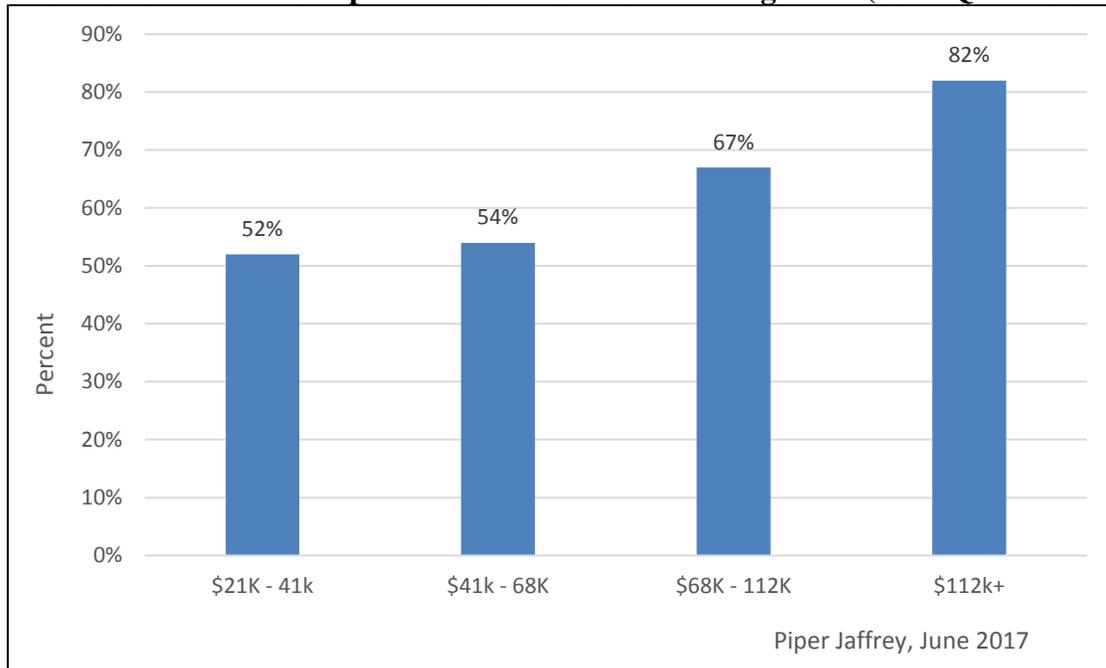
The hugely successful Amazon Prime subscription program, which provides free delivery and a growing array of other benefits, is likely to play a central role in future strategy. Prime's penetration of affluent households, combined with the fact that 62% of Whole Food's shopper are Prime members,⁶ opens endless marketing possibilities, including discounts offered to Prime members shopping at Whole Foods. It is likely that Whole Food's price image will improve. Amazon's "subscribe and save" automated replenishment model, in which customers receive discounts in return for brand loyalty, could be extended to retail.

⁴ *Wall Street Journal*, 6/26/17.

⁵ *Fortune* magazine, 12/3/12.

⁶ Morgan Stanley.

Amazon Prime Membership across Household Income Segments (First Quarter 2017)



Perhaps the most impactful result of the acquisition concerns the “last mile” complexity of perishables home delivery. Whole Foods gives Amazon a network of 460+ locations in attractive, densely populated urban markets which can be deployed as “mini-warehouses” for home delivery. Stores could also serve as pick-up points for a click and collect model, which is growing in popularity. These types of activities are likely to accelerate the penetration of online food retailing and in turn, further pressure the top line of traditional grocers.

Amazon’s technological leadership could benefit Whole Foods in numerous ways. For example, Amazon Go, currently in beta test, is a physical food store that features a proprietary check-out free shopping experience. Shoppers register once with card payment information, swipe a card (could be Prime) upon entry, fill their carts, and simply leave the store at their convenience. Needless to say, this could revolutionize conventional store-based retailing.

Amazon’s acquisition of Whole Foods has traditional food retailers scrambling to build scale, cut costs, and boost online capabilities as they prepare for a more price competitive, omni-channel future. Price and cost pressure on food industry suppliers will intensify in kind. Certain suppliers may benefit if Amazon chooses to selectively strengthen alliances with select suppliers as part of their subscription model of consumer replenishment.

One thing is certain – the Amazon/Whole Foods combination is a transformative event that will

forever alter the landscape of the food industry.

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