Amazon and Whole Foods: Grocery’s Continued Evolution

Amazon.com Inc.’s (“Amazon”) online retail strategy appears to be evolving with its recent announcement on June 16th to acquire Whole Foods Market, Inc. (Whole Foods). Though it is too early to know what the full impact will be on the supermarket business, Amazon’s decision to enter the brick-and-mortar retail landscape may help energize the $800 billion grocery industry and in the long run make the business an even more central part of people’s shopping habits.¹

One clear message from this action by Amazon is that the future of grocery retailing will be critically dependent on having physical stores in close proximity to the consumers’ residence. Well located grocery stores will be key to the omni-channel future of retailing for groceries as well as many other categories of goods. Far from threatening the long term value of grocery anchored retail properties, by their actions Amazon has just told the market that they are key strategic assets.

Whole Foods Strategic Footprint

After struggling for a decade to find a successful prototype for entering the grocery business, Amazon has offered to pay $13.7 billion for Whole Foods. Many in grocery and real estate circles had predicted that the company would ultimately have to buy an established grocer if they were to have any chance to “get big fast.” Assuming the acquisition closes, Amazon will gain access to Whole Foods’ customers who spent approximately $16 billion in the last fiscal year at over 460 stores. Though Whole Foods has a footprint that covers 42 states plus the District of Columbia, a significant concentration of their stores is located in urban markets along the east and west coasts. Furthermore, Whole Foods has approximately one million square feet of industrial space for distributing goods between suppliers and stores.²

Importantly, Whole Foods offers Amazon a physical presence in a number of demographically strong trade areas. According to S&P Global Market Intelligence, the average ZIP code with a Whole Foods has a popula-

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² Reuters, Even with Whole Foods, Amazon would need many more warehouses to reshape grocery delivery, June 24, 2017.
³ S&P Global Market Intelligence, Whole Foods expected to give Amazon a boost in demographics, geographics, June 20, 2017.
⁴ Green Street Advisors Strip Center Sector Update, May 19, 2017.
tion of 32,556 (about triple the density of an average U.S. ZIP code), and has an average household income of $117,322 (roughly double the national average). These locations place Amazon in close proximity to their core “Prime” members – a source of potential synergies going forward. But many more locations will be required to fill the numerous gaps in coverage that will exist post-closing. Occupancy of higher quality strip centers stands at a landlord-friendly 94.4% as of March 30th, and new retail construction remains at all-time lows. Simultaneously several grocers are expanding aggressively, including Aldi, Lidl, Kroger, Publix, Wegmans and Sprouts, among others. This fierce competition for strong locations will tend to support the value of grocery anchored centers, and makes it likely that more and larger grocer acquisitions are in the cards for Amazon.

**Grocery Market**

Whole Foods has a 1.7% market share of the food and beverage market in the U.S., leaving it in ninth place in the industry. If Amazon’s 0.8% estimated existing market share is added to the total, the combined share will push Amazon into 7th place.

**Food and Beverage Market Share**

![Food and Beverage Market Share Chart](source:Bloomberg)

While Whole Foods does not have the highest market share, it has generated relatively strong operating margins compared to some other larger public retailers selling grocery today. Based on recent financial disclosures, Whole Foods’ 4.5% operating margin was slightly lower than Walmart’s 4.7% but higher than many traditional supermarket operators’ margins such as Ahold/Delhaize’s 3.2% and Kroger’s 3.0%. While still relatively high,

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3. Ibid.
Whole Foods’ operating margin has been under pressure over the past few years, having fallen from 6.8% in 2013, as competition from traditional grocers in organics and prepared foods has increased. As a result, given Amazon’s own operating margin of 2.9%, the online giant may covet more than just physical locations as part of its Whole Foods acquisition strategy. At this point it is unclear whether or not Amazon will seek to drive already thin grocery industry margins even lower by reducing Whole Foods’ robust pricing more aggressively than Whole Foods had already been doing.

Operating Margins

Technology Evolution

There has been a great deal of speculation as to how Amazon could utilize Whole Foods’ store footprint and reputation for quality to drive sales and profits. First, Amazon may see Whole Foods as a gateway to sign up additional customers to its Prime membership program as well as sell more products to its existing 49 million Prime members. Up until now, Amazon has had mixed success in growing its food and beverage sales. Since starting the Amazon Fresh delivery service in Seattle in 2007, Amazon has only managed to grow its market share in grocery to 0.8%. However, the company’s growth rate in food is not that surprising given that e-commerce grocery sales have lagged overall e-commerce growth trends.

Based on data from the U.S. Census Bureau, e-commerce grew from 7.2% of retail sales in 2015 to over

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9 Bloomberg, Amazon Upsets the Grocery Cart, June 16, 2017.
10 U.S. Census Bureau; grocery e-commerce share based on reported e-commerce share of sales from food and beverage stores and non-store sales of food, beer, and wine.
8.0% in 2016. Though detailed data on e-commerce food and beverage sales from the U.S. Census Bureau tends to lag, the Census Bureau’s 2015 Annual Retail Trade Report released in March of 2017 suggests that e-commerce had less than a 2% share of total food and beverage sales,\(^\text{10}\) double its share since 2006. E-commerce is still a minor player in grocery retailing.

**E-commerce Share of Total Retail and Grocery Sales**

![Graph showing the increase in e-commerce share of total retail and grocery sales from 2006 to 2015.](image)

Source: U.S. Census Bureau; grocery e-commerce share based on reported e-commerce share of sales from food and beverage stores and non-store sales of food, beer, and wine.

Given Amazon’s leading 43% market share of U.S. online revenue, the company has a significant amount of data on the nation’s consumers and can likely use that information to better target grocery offerings both on and off-line.\(^\text{11}\) Amazon’s roll-out of click and collect lockers and development of “cashierless” technology via its Amazon Go concept are further ways Amazon may use new technology to spur grocery sales in the future. Heretofore, Whole Foods has been a relative laggard in adopting grocery retail technology. This can be expected to change rapidly under Amazon’s ownership.

**Competitive Threat**

Before Amazon announced its intention to acquire Whole Foods, many companies in the grocery business were already moving forward with various initiatives to make it easier to buy food using technology (omni-channel options). These efforts have included creation of new online delivery platforms such as Ahold’s Peapod...
and Walmart’s Jet.com, partnering with third-parties to deliver food, such as Whole Foods’ current relationship (and ownership interest) with Instacart for online sales, Sprouts’ use of Amazon’s Prime (now APN) service, to “click-and-collect” lockers and car loading services that allow customers to order online and pick-up in store, such as Kroger’s ClickList.

In order to stay ahead, many companies in the grocery business will need to invest in their operations, enhancing online resources, in-store technologies and “back of the house” capabilities that complement the demands of the multi-channel shopper. This new investment should dramatically increase the sales productivity and value of each store. The capital demanded to effect such change is likely to accelerate the already clear trend toward consolidation in the supermarket business. Companies with strong balance sheets can be expected to have a distinct advantage in the years ahead.

Sources of Risk

Given the halo-effect currently enjoyed by Amazon, there has been little attention paid to the risks inherent in Amazon’s acquisition of Whole Foods. Basic issues associated with merging two large companies clearly exist here, and stem from several sources.

- Amazon has no experience integrating an acquired company of the size and complexity of Whole Foods. Their previous acquisitions have been much smaller and less operationally challenging.
- Amazon and Whole Foods have very well developed but distinctly different corporate cultures that may come into conflict.
- Whole Foods’ customers have a unique relationship with the company. Fundamental changes to the Whole Foods customer experience could upset that relationship and lead to customer defections.
- “Experiential” retail is viewed as inherently e-commerce resistant. Going to the local grocery store, where we visit with neighbors, interact with the deli, produce and meat purveyors, sample various foods, smell the baked goods and stroll the aisles to find items we didn’t put on the list has a significant experiential component.
- While a subset of consumers prefers grocery delivery for a number of reasons, many continue to express concerns about allowing others to select their prepared entrées, produce, meats and other similar grocery items, as well as the inconvenience of having to be home to take the delivery. It is possible that home delivery, and even “click and collect” purchasing of such grocery items may turn out to have limited consumer appeal.
- Even the most successful grocery companies acknowledge the operational intensity and costliness of providing “last mile” availability of fresh, refrigerated and frozen food to their customers. This is not a current core competence of Amazon’s.
- Post-announcement, Whole Foods has been reported to be seeking store expansions to add fulfillment capabilities to their new and existing stores. Most shopping centers are developed to their maximum permissible square footage. Amazon’s realization of this possibly key expected benefit of the acquisition could prove to be difficult.
The New Center of Retail?

Grocery stores, and by extension many of the neighborhood shopping centers that are hosts to supermarkets, have long played an important role in providing necessity goods and services to America’s consumers. Does Amazon’s decision to make its first significant entrée into brick-and-mortar retail through a grocery store indicate the centrality of grocery to the retail industry? That may seem like hyperbole, but if one of the most technologically advanced firms believes in brick-and-mortar supermarkets, it may say something about the current and future importance of this asset class. Furthermore, will other large technology companies feel the need to invest in neighborhood retail venues in order to remain competitive in the multi-channel retail industry? Will Amazon’s acquisition of Whole Foods prompt other new partnerships that could further drive technological innovation and progress in the business? There are many questions to answer, but it does seem likely that the grocery store will continue to evolve while remaining a hub of retail activity and value.

Amazon’s decision to acquire Whole Foods, with its portfolio of locations possessing a very strong demographic profile, demonstrates the inherent and continuing strategic importance of the best grocery store locations, even to today’s most powerful on-line retailer. This is a strong positive signal about the future value of such real estate.

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12 Data as of September 2016; representing multiple property types.
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