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Whole Foods Acquisition by Amazon: Analysis

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Abstract

Since its founding in 1994, Amazon has continued to grow its presence across the world, reaching into categories ranging from cloud computing and entertainment to books and smart devices (Selyukh, et al.). Its corporate culture, typically online in nature but still heavily valuing growth and expansion, was looking for another product category to add to its sales. It launched Amazon Fresh in 2007 as an online-based order-delivery service for food (Bizzaco and Liu). Meanwhile, the Whole Foods company, started in 1980, had been pursuing a growing category in the grocery sector- organic food labels. It focused on brick-and-mortar stores, with product variety catered to affluent customers with various diets and preferences. While initially successful, the company began to run stagnant in the mid 2000's as other major competitors had begun to jump on the trend, mitigating the competitive advantage that Whole Foods had built.

Amazon acquired the specialty grocery store Whole Foods in 2017 for 13 billion dollars (offering an over-evaluation of the business), after a bidding process involving many other companies (Petro). The grocery business was seen as attractive to Amazon for multiple reasons; Whole Foods had established itself well with its on-the-ground presence, something which Amazon Fresh lacked, and found difficulty with as it struggled to keep foods fresh for delivery. Whole Foods also had a loyal audience with a massive opportunity for data points, which Amazon, utilizing its technical expertise, could expound upon to their advantage. It further advantaged Amazon that this customer base was willing to pay price premiums for their products.

Did Amazon make the right choice in acquiring Whole Foods, despite its down-trending economic performance? Amazon will have to compete with a growing organic foods sector, including competition from overseas. They will also have to be mindful of the integration tactics

used to meld two very different corporate cultures. Will Amazon be able to leverage its online shopping expertise to this new realm of grocery stores in person?

Whole Foods History

Whole Foods Market began in 1978, when 25-year-old college dropout John McKee and 21-year-old Renee Lawson (Hardy) borrowed $45,000 from family and friends to open a Safer-Way organic food store in Austin, Texas. In 1980, John and Rene teamed up with Craig Weller and Mark Skiles to open the first Whole Food Market on September 20. On Memorial Day 1981, the worst flood in 70 years devastated the city of Austin, destroying all the store's inventory and damaging most of the equipment. The losses amounted to about 400 thousand dollars; the Whole Food Market did not have insurance. However, customers and neighbors volunteered to join the staff to repair and fix the damage. Lenders, vendors, and investors gave the store breathing space to get back on its feet, and it did not reopen until 28 days (about 4 weeks) after the flood. Whole Food Market began its expansion outside of Austin through mergers and acquisitions, entering new markets, buying a local chain, and turning it into Whole Foods. So, in 1984, the company expanded to Houston, then bought the Whole Food Company of New Orleans in 1988 for its first expansion outside of Texas. On January 23, 1992, the company owned a network of 12 stores in Texas, California, North Carolina, and Louisiana. Also, this year, Whole Foods acquired Bread and Circus, bringing the chain to the northeast. In 1997, the company owned 70 stores in 16 states and launched its private label 365 Everyday Value to combat its "Whole Paycheck" image. Finally, in 2002, the company first entered the international level by opening a store in Toronto. In 2007, the Federal Trade Commission challenged a merger with natural food chain Wild Oats over fear that it would become a monopoly on natural products. As a result, Whole Foods relinquished control of 13 stores after the FTC learned that McKee wrote anonymous blog posts critical of Wild Oats. Also, this year, Whole Foods crossed the ocean and opened a store in

London after buying the local chain Fresh & Wild. In 2013 it became the first network to label all products GMOs. In 2016, Whole Foods opened a new concept store, 365 by Whole Foods. Stores primarily stocked with Whole Foods' 356 Everyday Value brand are targeted at millennials with a focus on value. The first store opened in the silver Lake area of Los Angeles.

Before the Amazon acquisition, Whole Foods's stock had fallen 40 percent since 2006 as competition eroded its sales. In 2008, the company's shares fell 76 percent, and John McKee sold part of the company to private equity group Leonard Green & Partners LP. Despite the short-lived growth, competition became a big problem for Whole Foods, meaning consumers no longer needed to go to Whole Foods to get what they could find at Whole Foods. And the usual settlement scheme no longer worked since the competitors were more prominent and well-to-do, and they knew how to compete by offering goods at a lower price. Therefore, the deal with Amazon was a necessity for them.

Amazon, for its part, saw the potential early on, and Amazon Fresh did not catch on in the industry because selling fresh produce requires more hands-on experience than delivering a typical Amazon package. In addition, many of the things you buy at the grocery store spoil quickly, which means you need to get them home quickly, plus someone must be there to get the goods. This can be tricky, given how Amazon loves to streamline shipping routes and bundle items for maximum efficiency. And so, Amazon realized that it was more profitable to remodel an existing grocery store than to open one from scratch.

Whole Foods & Amazon Structure and Culture

It is highly apparent that Whole Foods & Amazon have highly different corporate cultures; Amazon is known for their tech centralized system, strengthened by efficient employee labor, variety of product availability and their market competing prices. Whole Foods in a similar manner, has a foundation of customer service, variety of foods catering to multiple diets, and is supplemented by its grouping of brick & mortar locations. Where Amazon & Whole Foods seem to bridge apart, however, is within corporate culture; with Whole foods sticking to more traditional American grocery store practices (and even relatively better when factoring employee benefits) the latter corporation is built off a system of efficiency and appearance, over the ability of decentralization & autonomy of work; Dennis Campbell references this as a "culture clash... Whole Foods has a very high-empowerment kind of culture, so these 'draconian' standards, telling people where to put things on the shelves and the loss of autonomy, employees were feeling angry from that." (Campbell). Together, this presents less of a grayscale situation, but rather, a situation of how Amazon's unique business model will be applicate to Whole Food's own unique circumstances.

The acquisition of Whole Food's by Amazon can be seen to have created an overall mostly positive situation with minor problems; it fared well in Amazon's favor by allowing access to a new set of shopper data and further developing business opportunities, like branching into produce shipping. The acquisition fared well for Whole Foods as well, in the manner of access to Amazon's assets along with its behemoth of a supply chain system. Positive movement of mergers also seem to favor the stock market, which was especially the cash boost for Whole Food's when its stock rose 28% due to the acquisition. What all these numbers and benefits of merging lack to represent, however, was the clashing of cultures that was to come, highlighted by active working cultures. The transition from a more unorthodox style of management & self-driven work from employees, over to Amazon's tightly knit managed and repetitive based working system, showed to wall-street a risky maneuver of merging; a tight rope act of sorts, in the way that worked out for Whole Foods-Amazon, but we can see loose-tight company cultures fail to find compatibility; from a data perspective, even the research of "4,500 international mergers from 32 different countries between 1989 and 2013" (Harvard Business Review), factoring in location, company size, etc. could see a hiccup with finances, and “Those with especially large cultural mismatches saw their yearly net income drop by over $600 million.” (Harvard Business Review).

Collectively the presentation of the merger of two varying business models shows as a clash of two beasts, one deep in the realm of physical stores, worker autonomy and a loose management structure, and the other, the antithesis of this. Corporate culture is a high reflection of a company and can even be read as an explanation of a company’s finances; what’s left to ponder is, what effects will Amazon’s unique solution have upon Whole Food’s methods & how will compatibility be considered?

Industry Attractiveness

The food and grocery market in the US is currently valued at 11.3 trillion dollars, which is expected to grow at a compound annual rate of 3.0% through to 2030 (Grandview). Because food and groceries are a basic commodity, consumers will always have a need for this market. In 2017, Amazon purchased Whole Foods (WF) for 13 billion dollars, acquiring a vast network of stores and customer data located both inside and outside of the United States. It is speculated that Amazon’s principal reasons for entering the market through this acquisition were due to the combination of Whole Food’s loyal and affluent customer base, as well as their “treasure trove” of customer data (Petro). We will look at this acquisition through two lenses- the Five Forces framework and the VRIO framework.

<u>Five Forces:</u>

Supplier Power: Medium: Groceries are an extremely common commodity in which thousands of stores are available to purchase from, ranging from small local businesses to large scale corporate entities. If we look at Whole Foods (Amazon) as the supplier, this indicates that they may not be able to have too much leverage of setting prices, as food is not rare, and buyers could go elsewhere. However, WF's operates primarily in a specialty sector of organics and specialty brands, which significantly increases the degree of rarity of many of their products. WF also has a loyal customer base that isn't particularly price sensitive.

Buyer Power: Medium: Consumers can choose anywhere to buy their goods from. Additionally, an increasing number of stores since the founding of WF in 1980 have started offering organic foods at lower margins (Stevenson). However, WF still has a lot of brand-name trademark company deals, meaning if you like a certain brand, you could only find it at WF.

Competitive Rivalry: Medium: Because of the sheer number of grocery store options, competition should reasonably be high. However, WF caters to a specific audience of people who like natural foods and sustainability, something that other places like Kroger or Costco don't cater to quite as much. Amazon also has a lot of scale in proprietary technology and money that could be used to differentiate the business to become more automated and cheaper, which would be harder for other businesses to copy easily. As of now, Amazon faces its largest competition from Aldi and Lidi in Europe, and Walmart in the United States (Simon).

Threat of Substitutes: High: Customers may have preferred brands or types of exclusive organic products that they will continue to buy through WF, but overall, one food label is always substitutable for another. If someone is following a recipe to make a dinner, the lack of access to a specific brand will not prohibit the dinner from being made.

Threat of New Entry: Low-Medium: Starting a local grocery store does not have a lot of intensive technological or experiential barriers, and as such, leaves the door open to new entrants. This being said, a new company entering the market would not have the same cost and efficiency advantages that WF under amazon can produce. Given Amazon's large money supply and technologically advanced equipment, the threat of new entry into direct competition with WF, especially considering its core offering of organic foods, remains low.

VRIO:

Value: Although the value of consumer food items is fairly low, margins and mass purchasing can lead to a high product value. Utilizing its technological capabilities, particularly in the realm of its online shopping experience, Amazon can add a lot more value through the WF acquisition. The combination of consumer data and increased technological efficiency will create a differentiated business model and enable lower prices. This will be difficult for others to imitate easily.

Rarity: Groceries are always needed by consumers, but because WF caters to an organic and brand-specific audience, its products become rarer and more difficult to find. Amazon is also a world leader in online shopping experience, with proprietary technology algorithms that could make customer grocery experience rare in comparison to other retailers.

Imitability: The cost and time requirements to build an audience like WF and/or a technological base like Amazon are immense, which makes imitating this structure very difficult.

Organization: Amazon has been highly successful at integrating its core competencies since being founded, expanding into many different market segments through its adept skills in managerial and technological implementation. Whole foods has less of a foundation here, as its core competency of selling organic foods began to be copied and sold cheaper by the year 2000 by other larger grocery stores, like Walmart. If Amazon works to integrate its organizational systems within WF, they may have a much better chance at optimizing their collective competencies.

Collectively, both the Five Forces model and the VRIO model show that the acquisition of Whole Foods by Amazon will not necessarily be a comfortable ride, if Amazon wants to remain competitive in the grocery market. While WF does offer some unique assets like organic and brand-specific items, Amazon brings more to the table with its extensive knowledge of customer trends, and its technological and organization efficiencies. Amazon stands to gain most in its ability to acquire and utilize the consumer data from WF, which will allow Amazon to further refine its algorithms.

Why Amazon Wanted Whole Foods

Amazon wanted whole foods for a plethora of reasons but the main one was to expand their business into the grocery store chain industry. Buying whole foods opened a new strain of income as well as attracted a new source of customers. Amazon could now implement its web store practices into physical locations and give customers the opportunity at grocery delivery rather than just delivering nonperishable packages.

Whole Foods was and still is a hotspot for wealthy individuals, focusing on organic goods comes at a price. They advertise themselves as being one of the best sources for healthy, natural, and organic foods. Subsequently Whole Foods merchandise is more expensive compared to equivalent items at Kroger or Safeway stores who carry your more traditional nonorganic and non-name brand items. Wealthier customers are the ideal customer to have, they spend more and are willing to pay top dollar for more premium items.

Buying whole foods gave Amazon their entryway into the grocery store industry, the top shelf customers but also the know how when it came to working in this new industry. Amazon was working on their grocery delivery systems and having Whole Foods employees on board made this an easier process to handle. Amazon also has long term plans to launch stores under the Amazon Fresh name and Whole foods was a learning experience on the path to having their own grocery stores.

Whole Foods occupied a very small percentage of the market compared to its major competitors, less than 2% while Kroger the largest grocery store chain owns about 10%. This meant whole foods could never compete in the same way as Kroger and some other companies.

This gave Amazon the opportunity to buy whole foods and give its benefits to prime members, operating on a small scale holding only high-end items meant they would be a fantastic choice for grocery delivery and Amazon could charge a premium.

Financials

Whole Foods was not showing financial success before being acquired by Amazon. Before being acquired by Amazon, Whole Foods had an annual revenue of nearly $16 billion. However, store sales had fallen for eight-straight quarters. Their struggles could be attributed to competitors catching up and capitalizing on their strategic advantage, organic food. Whole Foods faced immense pressure from their rivals including Kroger, Was-Mart, Amazon, and Blue Apron. According to Jon Springer the problem was "Consumers no longer had to go to Whole Foods to get what you could find in Whole Foods" (Stevenson). Comparing financial statements to the average Industry Median in 2017, we can see Whole Foods is behind in major financial areas. Looking at the table in Exhibit 2 Whole Foods is trailing almost 40% in Gross Profit Margin with a .15 higher debt to equity ratio. To try and bring sales up Whole Foods closed nine stores, all remaining commissary kitchens, and terminated two leases (Baertlein).

The highest Whole Foods' stock had ever been in October 2013, valued at $65 a share. The company was valued at $23.4 billion at this time. Amazon initially offered $41 per share which Whole Foods countered with $45. It is rumored Albertsons bid $11.7 billion equaling $36.30 a share to acquire Whole Foods two months before Amazon announced the acquisition (Wieczner). Four private equities approached Whole Foods in an attempt to strike a deal, but Amazon requested it be stopped.

Whole Foods' closing share price was $33.10 on June 15th, the last trading day before the announcement of the acquisition. On June 16th, 2017, Amazon announced it would buy Whole Foods valued at $13.7 billion. Amazon would pay $42 a share which was 27% higher than what

Whole Foods was valued at just days before. Not long after the announcement, Whole Foods saw their stock price slowly rise above the deal price (See Exhibit 2). Amazon also saw shares rise 1.38% bringing it to $988.67 a share. After the acquisition was announced competitors' stock went down, Walmart was down 5.47%, Kroger was down 11.16%, and Costco fell 7.46% (Little). Competitors were nervous for Amazon, an already established company, and were now entering their industry in a big way.

Jana Partners, the second largest shareholder in the company with an 8.8% stake, had several issues with the way Whole Foods had conducted business. In April 2017, after Jana Partners invested in Whole Foods, Whole Foods stock surged 10% and ended the day up 9.7% (McGrath). Before the acquisition Jana had proposed four new board nominees in an attempt to create shareholder value and execute strategic strategies. Whole Foods' CEO John Mackey, called Jana Partners 'greedy bastards' in response to pressure to sell.

Jana had a right to be concerned, looking at Whole Foods income statements there was a steady decline in ROA and operating income. Whole Foods ROA went down starting in 2014. Looking at Exhibit 3 there was a 7% decline in ROA from 2015-2016 and the year of the acquisition Whole Foods ended with a -.89% ROA. Additionally, from 2015-2016 Whole Foods saw a drop of about $605,633 in operating income. The costs of goods sold, and operative expenses are seen to rise from 2014.

Conclusion

Overall, the decision to acquire Whole Foods was a good idea. Whole Foods was in poor financial shape so the timing around the Acquisition was perfect from Amazon's perspective, and they held a lot of the grocery store industry knowledge that Amazon desperately wanted in order to later expand with their own stores and grocery shipment programs. Whole foods also held a new customer base with top tier customers that Amazon could tap into. While it was not a cheap acquisition and Amazon’s largest to date it made sense and ultimately brought Amazon a large amount of profit in the long run.

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Appendix

Exhibit 1

	Industry Median	Jan-2017	Apr-2017	Jul-2017
Same Store Sales	-	(2.4%)	(2.8%)	(1.9%)
4Q Growth		*(0.6%)*	*0.2%*	*0.7%*
Gross Profit Margin	77.0%	33.6%	34.1%	34.0%
4Q Growth		*(0.4%)*	*(0.8%)*	*(0.7%)*
EBITDA Margin	43.3%	8.2%	8.6%	7.9%
4Q Growth		*(0.1%)*	*(1.0%)*	*(1.0%)*
Operating Margin	39.1%	3.5%	4.6%	4.8%
4Q Growth		*(1.7%)*	*(1.9%)*	*(0.8%)*
Pretax Margin	36.8%	3.2%	4.3%	4.6%
4Q Growth		*(2.0%)*	*(2.1%)*	*(0.7%)*
Effective Tax Rate	20.6%	39.1%	38.9%	38.7%
4Q Growth		*2.2%*	*(0.7%)*	*(0.1%)*
Net Margin	29.1%	1.9%	2.6%	2.8%
4Q Growth		*(1.4%)*	*(1.2%)*	*(0.4%)*
Asset Turnover	-	0.77	0.58	0.57
4Q Growth		*(4.1%)*	*(1.2%)*	*(3.1%)*
Pretax ROA	-	2.5%	2.5%	2.6%
4Q Growth		*(1.7%)*	*(1.2%)*	*(0.5%)*
Pretax ROE	3.3%	4.8%	4.9%	5.1%
4Q Growth		*(2.3%)*	*(2.3%)*	*(1.0%)*
x Tax Complement	0.80	0.61	0.61	0.61
4Q Growth		*(3.4%)*	*1.1%*	*0.1%*
ROE	2.7%	2.9%	3.0%	3.1%
4Q Growth		*(1.6%)*	*(1.3%)*	*(0.6%)*
x Earnings Retention	0.67	0.53	0.56	0.44
4Q Growth		*(26.9%)*	*(19.5%)*	*(30.9%)*
Reinvestment Rate	1.8%	1.5%	1.7%	1.4%
4Q Growth		*(1.7%)*	*(1.3%)*	*(1.0%)*
ROIC	-	1.9%	1.9%	2.0%
4Q Growth		*(1.4%)*	*(0.9%)*	*(0.4%)*
Assets/Equity	8.71	1.94	1.94	1.91
4Q Growth		*1.4%*	*0.1%*	*(3.0%)*
Debt/Equity	0.14	0.32	0.31	0.30
4Q Growth		*(1.3%)*	*(2.5%)*	*(8.2%)*
% LT Debt to Total Capital	1.7%	24.1%	23.8%	23.2%
4Q Growth		*(0.3%)*	*(0.4%)*	*(1.6%)*
(Total Debt- Cash)/EBITDA	(1.32)	0.81	0.76	0.36
4Q Growth		-	*(20.3%)*	*(63.0%)*

Table 1: Whole Foods Market's Key Indicators – "Red-Flags" (quarterly).
Source: Thompson Reuters Eikon Database.

Exhibit 2

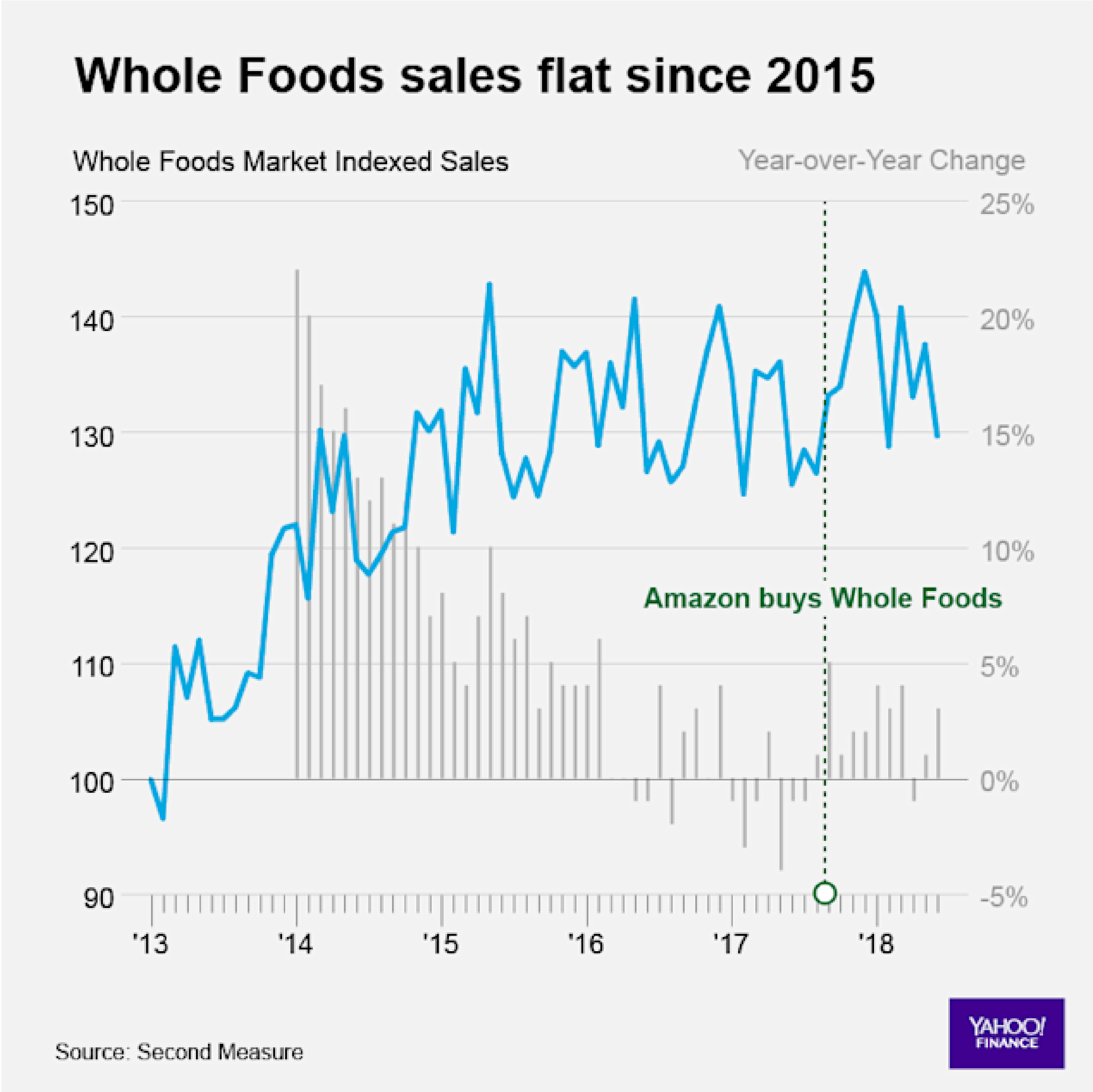
Whole Foods sales flat since 2015
Whole Foods Market Indexed Sales
Year-over-Year Change
150
140
130
120
110
100
90
25%
20%
15%
10%
5%
0%
-5%
Amazon buys Whole Foods
'13
'14
'15
'16
'17
'18
Source: Second Measure
YAHOO! FINANCE

Exhibit 3

Figure 1

INCOME STATEMENT	FY 2016	FY 2015
SALES	17,915,236	16,707,657
less cost of goods sold	-11,199,620	10,393,985
NET SALES	6,715,616	6,313,672
OPERATING EXPENSES	6,140,791	-5,133,184
GAIN FROM OPERATIONS	574,825	1,180,488
OTHER INCOME/EXPENSE	-108,712	-170,886
NET INCOME	466,113	1,009,602
prior to tax/rebate adjustments		

OVER $17 Million IN SALES!

BALANCE SHEET	FY 2016	FY 2015
prior to tax/rebate adjustments	*6/30/2016 365 days open*	*6/30/2015 364 days open*
ASSETS		
Current Assets	2,540,969	1,822,256
Property/Building/Equipment	11,939,889	6,769,509
Other Assets	214,663	2,781,914
TOTAL ASSETS	14,695,521	11,373,679
LIABILITIES		
Current Liabilities	1,487,197	1,155,241
Long-Term Liabilities	8,180,501	5,332,381
TOTAL LIABILITIES	9,667,698	6,487,622
EQUITY		
Owner Equity	3,987,904	3,419,052
Donations	16,436	17,276
Retained Earnings	1,023,483	1,449,729
TOTAL EQUITY	5,027,823	4,886,057
TOTAL LIABILITIES & EQUITY	14,695,521	11,373,679

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Figure 2

INCOME STATEMENT	FY 2017	FY 2016
SALES	19,495,984	17,915,236
less cost of goods sold	-12,232,685	-11,199,620
NET SALES	7,263,299	6,715,616
OPERATING EXPENSES	-7,023,386	-6,140,791
GAIN FROM OPERATIONS	239,913	574,825
OTHER INCOME/EXPENSE	-367,061	-108,712
NET INCOME *prior to tax/rebate adjustments*	-127,148	466,113

BALANCE SHEET	FY 2017	FY 2016
prior to tax/rebate adjustments	*6/30/2017 364 days open*	*6/30/2016 365 days open*
ASSETS		
Current Assets	2,073,333	2,540,969
Property/Building/Equipment	11,230,141	11,939,889
Other Assets	575,005	214,663
TOTAL ASSETS	13,878,479	14,695,521
LIABILITIES		
Current Liabilities	1,463,541	1,487,197
Long-Term Liabilities	7,545,419	8,180,501
TOTAL LIABILITIES	9,008,960	9,667,698
EQUITY		
Owner Equity	4,303,649	3,987,904
Donations	16,436	16,436
Retained Earnings	549,434	1,023,483
TOTAL EQUITY	4,869,519	5,027,823
TOTAL LIABILITIES & EQUITY	13,878,479	14,695,521