From Amazon-Whole Food Market deal to Amazon's strategy

AUTHORS

CHENGHUI LOU
CHENGHUI.LOU@EDHEC.COM

Further reading recommended by the author:

THE EVERYTHING STORE: JEFF BEZOS AND THE AGE OF AMAZON
BY BRAD STONE

LITTLE, BROWN AND COMPANY
OCTOBER 2013

Link to the book review

On June 16th, Amazon announced a $13.7 billion deal to buy Whole Foods. The offer represented a 27% premium over Whole Foods' stock price. Some voices on the Internet believe it is a move that Amazon has finally taken a giant stride in traditional retailing, and the all-cash deal could be game-changing for the traditional supermarket business. As much as this publicized view is likely to be true, this article aims to give another interpretation of the deal and prove how Amazon's ambition stretch further: Amazon buys Whole Foods Market to boost its logistical prowess and provide logistics service for grocery business.

First, let's start with the goal of Amazon. How will Amazon sustain its growth? Before answering this question, we can take a look at how Chamath Palihapitiya, Social+Capital Founder, thinks of the company when being asked on Quora what company he would invest in if he could only choose one:

> *"AWS is a tax on the compute economy. So, whether you care about mobile apps, consumer apps, IoT, SaaS etc, more companies than not will be using AWS vs building their own infrastructure. Ecommerce was AMZN's way to dogfood AWS, and continue to do so, so that it was mission grade. If you believe that over time the software industry is a multi, deca- trillion industry, then ask yourself how valuable a company would be who taxes the majority of that industry. 1%, 2%, 5% - it doesn't matter because the numbers are so huge - the revenues, profits, profit margins etc. I don't see any cleaner monopoly available to buy in the public markets right now."*

From Amazon's 2016 annual report, Amazon's service sales accounted for 30.4% of its total revenue, rising from 21.2% in 2014. Service sales represent third-party seller fees earned, AWS sales, and certain digital content subscriptions – basically the taxes collected by Amazon acting as a platform. The company also stated in its 2016 10-k that its customers are consumers, sellers, developers, enterprises, and content creators. It is not hard to discern that Amazon is trying to be a platform for a broad range of economic activities, taking slices from each one of them. As Google, Microsoft and IMB are marching into Cloud business, though Amazon still dominates the market, it needs to find another growth driver in the long run – possibly from logistics service. Recent moves also signalling this endeavour are Amazon's leases of ocean freighters and air planes, and Amazon's investment in Plug Power Inc., a company that makes alternative energy technology for materials handling equipment.

Actually, Amazon has been experimenting with grocery logistics for some time. AmazonFresh, launched at 2007 in the Seattle area, has been operating the grocery delivery service, offering fresh produce delivered the same day as ordered. While Amazon does not disclose AmazonFresh financials, it is believed that Amazon's grocery service has never achieved a profit. Clearly, Amazon has not been able to figure out the grocery service by itself.

But where does Whole Foods Market kicks in? First, Whole Foods Market can boost Amazon's distribution network, since the supermarket chain has "440 refrigerated warehouses within 10 miles of probably 80% of the population. More importantly, it puts refrigerated distribution within 10 miles of probably 95% of Prime members", according to Michael Pachter from Wedbush Securities. Second, AmazonFresh will be supported by Whole Foods Market as a customer to build the logistical capability. The development of Amazon's grocery service will much resemble that of Amazon Web Services, initially built for internal evolution of the Amazon E-Commerce Platform and then launched as a platform for entrepreneurs, now probably the most crucial component in the entire Amazon machinery.

UPS is also stepping up its grocery business. On May, UPS-backed Silicon Valley upstart Deliv announced a new service called Deliv Fresh, competing with AmazonFresh. Those giant delivery companies such as UPS and FedEx have more experience in delivery service and supply chain management. So, what makes Amazon a formidable competitor?

First, Amazon logistic services will have a dedicated client, Whole Foods Market, with $14 billion sales in 2016. It means that the logistic services, for better or for worse, will be demanded, and improved over the course. Another significance of having a loyal customer is that the massive fixed investments upfront will be justified by logistic services used by Whole Foods Market, just as Amazon's e-commerce business is AWS' first and presumably biggest customer and enables AWS to operate on a huge scale.

Moreover, Amazon is positioned as a technology company, not an online retailer. It develops machine learning, data analytics, and complex simulations for supply chain optimization. From its career website, we get a sneak peek of how Amazon is focusing on this area, as Fulfilment Center hiring is listed as an individual hiring agenda on the front page. This is something only Amazon can do and want to do at the moment.

Last but not least, obviously we can predict that Amazon's logistics service will be very price-competitive, because low margin is Amazon's distinctive business philosophy. As high margins justify rivals' investments in research and development and attract more competition, low margins attract customers and are more defensible. Meanwhile, Amazon has a natural advantage in its cost structure and ability to survive in the atmosphere of low-margin businesses. From Amazon's stock performance, we see that over the Wall Street side Amazon doesn't get punished for taking on a low-margin project but get appraised for that. As Amazon has growing revenue sources from online retailing and AWS, and it has been profitable since 2015, the company will have more resources to invest in the infrastructure.

And why not think bigger? We should always bear in mind that Amazon is essentially a technology company. Jeff Bezos would not want Amazon to be a delivery company. From the company's "DELIVER WITH AMAZON" program that helps with the last mile delivery in a number of cities, we see that the company actually does not need to own ships and planes and compete with UPS and FedEx, instead it will be logistics algorithm provider, utilising machine learning, data analytics, and complex simulations, to sell solutions to anyone that not only needs delivery but also wants to do delivery in every corner of the world.

Sources: Factiva, Company Information, techcrunch.com, practicalecommerce.com, logistics.amazon.com, usatoday.com, quora.com

DISCLAIMER

About the article

This Article has been compiled by the author mentioned above and published by him via the EDHEC Student Finance Club ("**Club**" or "**ESFC**") platform. The club confirms that the author is an active member at the time this article is published, but emphasizes the fact that opinions and views given by the author in this article are his/her own views. ESFC takes no responsibility for the completeness or correctness of information provided. No investment advice is given with the text above and the reader should not take any financial position based on the information published in this article. The Club recommends extensive research by the reader before investing in any financial asset.

General

The article may be based on the information extracted from various sources including but not limited to various companies' and statistical agencies' websites, online portals, third-party research, annual reports etc.

No representation or warranty of any kind is or may be made with respect to the accuracy or completeness of, and no representation or warranty should be inferred from, any projections or futuristic statement contained herein or any underlying assumptions.

This article may include descriptions, statements, estimates and projections/futuristic statements with respect to current and anticipated performance of the underlying.

Such statements, estimates and projections reflect various assumptions and best estimates made by the participants concerning anticipated results, which assumptions and estimates may or may not prove to be accurate or correct. There are no assurances whatsoever that any statements, estimates or projections contained in this article, including without limitation any financial or business projections, accurately present in all material respects the underlying's financial and/or business position as of the respective dates specified and the results of its operations for any respective periods indicated.

No copyright or trademark infringement is intended in any form.