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The Fate of Grocers After Amazon-Whole Foods

Janus Henderson explores how future might play out for Wal-Mart, Kroger and others.

By JOSH CUMMINGS
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The future of the U.S. grocery industry took a dramatic turn on June 16 when Amazon.com announced its $13.7 billion offer to buy Whole Foods Market.

Amazon (ticker: AMZN) exchanged approximately 3% of its enterprise value for Whole Foods Market (WFM), arguably the most credible brand in the grocery-store industry, a sector which represents approximately 20% of core consumer spending in the U.S.

In the week that followed, the market value of Amazon increased by approximately $18 billion — more than compensating for the price tag of what was its largest acquisition to date. Over the same period, shares in Wal-Mart Stores (WMT) dropped 5%, Kroger (KR) tumbled 8%, Target (TGT) declined 9%, Costco (COST) slumped 13% and Supervalu (SVU) plunged a whopping 22%.

The message from the market is clear: The disruptive influence of Amazon's expansion within the estimated $800 billion U.S. grocery market means there is now less visibility into the future health of incumbent grocers.

Josh Cummings

There are three primary reasons for that change in outlook:

First, existing bricks-and-mortar grocers have profitable physical businesses to protect. They have to invest to expand and improve their digital capabilities to compete with Amazon, but are also motivated to protect the status quo, a conflict that will inevitably slow innovation.

Simply put, the legacy grocers are being forced to reallocate capital from a channel where they've enjoyed competitive advantages for decades to one where they are largely disadvantaged. That likely has bearish consequences for returns on capital and, ultimately, shareholder profits.

Over the course of history, retail models engineered to live on lower gross margin rates have taken market share. Wal-Mart is the largest U.S. grocer, accounting for at least 20% of the market by most estimates. Approximately 56% of Wal-Mart's revenue comes from the grocery category, and the company generated consolidated gross margins of about 25% last year.

Amazon, by contrast, earns an estimated gross margin in the low teens on its domestic, first-party product sales, while Whole Foods has a gross margin of approximately 34%. Time will tell, but those are likely to be headed lower.

The second problem is how to fund the required investment. E-commerce requires significant capital to reach scale. The money has to come from internally generated profits, assuming companies don't wish to dilute their existing owners. Trouble is, for many grocers that pool of capital isn't growing anymore.

Amazon, on the other hand, is drawing profits from its Amazon Web Services unit — the cloud-computing division that posted a 43% jump in 2017 fiscal first-quarter revenue to $3.66 billion, producing operating income of $890 million, 47% more than a year earlier. Against this backdrop, it's difficult to see how low-growth, low-margin incumbents can compete.

In addition to trying to protect existing profitability while spending to build a competitive digital presence, traditional grocers have a third hurdle that may prove to be the most problematic over the long haul — brain drain.

If you're a computer science graduate from a top school, do you want to start your career at a legacy grocery store operator that isn't growing and may not offer stock options and other benefits, or do you want to work for Amazon? The inability to attract the best talent is an often insurmountable headwind for organizations in stagnant or declining markets.

Some have concluded that Amazon's purchase of Whole Foods validates physical stores, but it's more nuanced than that and the transaction isn't a radical departure in strategy. The value engine for Amazon's retail business is Prime and it is rightly focused on increasing the value of a Prime membership over time.

One way to do that is to increase the frequency with which members interact with the Prime ecosystem. Food is the category people consume most frequently and the family shopping list does not change much from week to week. In that sense, grocery is a critical enabler of both frequency and loyalty.

But in order to deliver the highest-quality produce and prepared foods on a national scale, a grocer must have local scale in distribution. Amazon gets this with Whole Foods and in markets that tend to overlap nicely with its existing Prime membership base.

The fact that Whole Foods operates about 460 stores was not a top consideration, although Amazon is likely to make subtle or — perhaps, not so subtle — changes in an attempt to reduce the friction of the shopping experience.

Some version of a “click and collect” model is probably a winning formula in grocery, so it wouldn’t surprise us to see Amazon begin to roll out its AmazonFresh Pickup prototype within high-volume Whole Foods markets. It’s likely that a lot of customers would choose this option if it were made convenient enough.

Beyond that, the opportunity to cross promote Whole Foods with Amazon Prime is almost limitless. The economic value of a Prime membership already greatly exceeds its annual price tag, and adding fresh and packaged grocery under the most credible “house brand” in the industry will enable the Prime flywheel to keep humming.

Over the next 10 to 20 years or so, the landscape of the U.S. grocery market could look very different than it does today, with Amazon dominating affluent, college-educated urban consumers, Wal-Mart fighting it out with Kroger, Aldi, Lidl and the dollar stores, and many poorly capitalized incumbents simply disappearing.

Cummings is a research analyst at Janus Henderson Investors and is responsible for leading the consumer-sector research team.
