Technology Strategy and Management

Amazon and Whole Foods: Follow the Strategy (and the Money)

Checking out the recent Amazon acquisition of Whole Foods.

In June 2017, Amazon announced it would acquire Whole Foods, the national grocery chain with nearly 500 stores, for $13.7 billion in cash. This is less than Whole Foods’ 2016 revenues of $15.7 billion, which included $507 million in net profits (3.2% of revenues). Whole Foods became a take-over target because of declining sales and profits as well as increasing competition in the cutthroat supermarket business.¹ By comparison, Amazon’s 2016 revenues were $136 billion, up 27% over 2015, with operating profits of $4.1 billion and net profits of $2.4 billion (1.8% of revenues). Amazon’s market value of around $480 billion is 3.5 times last year’s revenues. It is buying Whole Foods for less than one times its last year’s revenues (0.85%). Given that Whole Foods is actually more profitable than Amazon, which plows most of its potential profits into new business development and expansion, and since Amazon does not have to dilute its stock, this seems like a great deal for CEO Jeff Bezos. But is it? And what does this acquisition say about Amazon’s strategy?

Launched by Bezos in 1994 as a pioneering online bookstore, Amazon has always made deft use of physical assets as well as the Internet. It soon offered two million or more titles—far more than actual bookstores were able to stock. Later in the 1990s, Amazon added a platform service that linked buyers who wanted less-popular books with third-party sellers that held the inventory, a business now called Amazon Marketplace. Unlike Google and other Internet platforms, however, Amazon was never a completely virtual business. Bezos operated out of a warehouse that intercepted shipments from distributors and then re-sent the books to customers. The company also began to buy large numbers of best-seller books and stock them so Amazon could benefit from scale economies in purchasing and earn premiums from delivering the books quickly.

Eventually, Amazon expanded to other popular items suitable for sale over the Internet, ranging from elec-

¹ N. B. If you object to the use of an Internet-based business to discuss Internet-based businesses, please substitute canned fish for whole foods.
tronic goods to digital content (music and videos) to clothing. Amazon now sells some two million items. A decade ago it also launched Amazon Web Services (AWS) to sell excess computing and storage capacity from its massive data centers. In addition, Bezos experimented with his own products such as the successful Kindle tablet for e-books, the failed Fire smartphone, and the intriguing Echo/Alexa digital assistant and speaker device. More recently, Amazon opened a bookstore in Seattle to complement the online store, and it is experimenting with new technology (Amazon Go) that eliminates cashiers.

Until now, Amazon’s pieces fit together pretty well. Now the company is moving deeper into the low-margin grocery business. We have to wonder why.

Amazon’s financials are not particularly strong compared to other leading technology companies and Internet platforms, and mix products and services with varying profit rates. In 2016, sales of products accounted for 70% of Amazon’s revenues. Sales of services (mostly from selling third-party goods on Amazon Marketplace, revenues from AWS, some allocations from Amazon Prime membership fees, and some advertising) accounted for the other 30%. AWS produced only $12.2 billion or 9% of revenues (compared to 5% in 2014) but a whopping $3.1 billion (74%) of operating profits. By contrast, Amazon lost $1.3 billion on overseas sales of $44 billion, nearly one-third of revenues. It is also estimated that Amazon loses up to $2 billion per year on Prime Memberships. With 70- to 80-million members, Prime generated $6.8 billion in 2016 revenue. Prime offers free shipping, a lot of free digital content, and other benefits for a $99 annual fee or less in some cases. The free services are costly but encourage customer loyalty and seem to drive long-term sales growth.

Bezos’ interest in groceries goes back a decade, when he launched Amazon Fresh. Why? Volume. The annual grocery business in the U.S. alone was worth some $1.3 trillion in 2016, with Walmart (which has 4,500 stores) having the largest market share at 18%. Amazon and Whole Foods together would have a market share of about 3.5%. Amazon has figured out how to sell perishable and non-perishable groceries via the Web. It is not clear the company has figured out how to do this at a profit. Amazon can learn from Whole Foods how to sell groceries to upscale customers, but this market is shrinking.

Many customers are the same, however, so Amazon can try cross-marketing. About 62% of Whole Foods customers are Amazon Prime members. Perhaps Amazon can convert the 38%
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of Whole Foods customers who are not yet Prime members. Perhaps Amazon can expand the reach of Whole Foods through its Web presence and online delivery services. Perhaps the Whole Foods network of stores and warehouses can help Amazon in storing products or handling returns from Web purchases, or showcasing products for sale.

Are there significant synergies between selling books and selling lettuce, or between warehousing groceries and other items? Maybe, but maybe not. Synergies on paper are always difficult to realize in acquisitions. That is why, in many studies, at least two-thirds of acquisitions fail. In this case, Amazon will find that economies of scale and scope in the grocery business are not like the digital world. There may even be some economic penalties with expansion or automation if Amazon cannot maintain the quality and service that are hallmarks of Whole Foods.

Another argument against the acquisition is that the more sectors into which Amazon diversifies or integrates vertically, the more it resembles a conglomerate with no particular specialization or competitive advantage. Perhaps Amazon should use the $13.7 billion to expand AWS. This is Amazon’s most profitable business, but it is subject to intense competition from Microsoft, Google, IBM, and other companies.

Although the Federal Trade Commission approved the takeover in August, lawyers and analysts have raised long-term anti-trust concerns. Amazon disrupted the competition by pricing physical books, e-books, electronics, diapers, digital media, and other goods low—and sometimes below cost—to gain market share. Then it benefitted from increasing scale economies and positive feedback loops associated with digital platforms and network effects (see “The Evolution of Platform Thinking,” Communications, January 2010). That is, the more goods and services Amazon sells, the more customers it has, and the more likely it becomes that more buyers and sellers will use Amazon, especially if competitors vanish or falter. With weak or no competitors, Amazon is also free to raise prices.

Bezos’ goal does not seem to be profit, though, at least not in the short term. Rather, he seems intent on expanding Amazon’s reach. As noted in the title of a 2013 book on the company, Bezos wants Amazon to be “The Everything Store.” Whole Foods fits this strategy of retail expansion. It also fits Bezos’ apparent belief that, to expand its reach, Amazon needs to increase its physical presence. Why physical? Follow the money. Nearly 44% of U.S. consumers go first to Amazon when they want to make a purchase. However, the vast majority of purchases we make (about 92%) still occur in brick-and-mortar stores, not over the Internet. The value of this acquisition will be in how effectively and broadly Amazon is able to utilize the new physical platform it is buying.

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