CASE 16

Amazon.com, Inc.: Driving Disruptive Change in the U.S. Grocery Market

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On June 16, 2017, Seattle-based e-commerce giant Amazon.com, Inc. acquired Whole Foods Market, Inc., one of the leading natural and organic foods supermarket chains in the United States, in an all-cash transaction valued at approximately $13.7 billion. According to analysts, the deal touted to be Amazon's biggest acquisition to date, marked a turning point in the company's strategic efforts to crack the $800 billion U.S. grocery market. The deal also marked Amazon's big entry into the brick-and-mortar retail space. The shares of big box retailers such as Wal-Mart Stores, Inc,[1] Target Corporation,[2] Costco Wholesale Corporation,[3] and The Kroger Co[4] tanked with investors worrying about the far-reaching implications of the deal.

> "By purchasing Whole Foods, Amazon is set to disrupt the $800-billion grocery market in the same way it upended the publishing and consumer electronics industries. Now Amazon is right where it wants to be: everywhere. It has surpassed its original goal of being the 'everything store' and is fast on its way to becoming the 'everything everywhere' store,"[5]

said Sean Kervin practice director, customer experience, at Clear Peak, a management & analytics consulting firm.

Jeff Bezos, CEO of Amazon, realized that the e-commerce giant could not win the grocery game with its pure online format. He saw brick-and-mortar stores playing a key role and hence acquired Whole Foods. In addition, by early 2018 Amazon also rolled out a high-tech convenience store format sans cashiers or check-out lines called Amazon Go and AmazonFresh Store Pickup Services. According to some analysts, while grocery was a huge opportunity for Amazon, operating in this new business might pose some new challenges including intense competition, razor thin margins, delivery of perishables, and bringing the convenience of digital shopping to the grocery business.[6] Some analysts felt that Bezos was taking a risk by making a major investment in an unsteady operation like Whole Foods, which could potentially be a drag on the e-tailer. They wondered–Can Amazon eventually change the way customers buy groceries? Can it manage brick-and-mortar well and redefine convenience? Can Amazon disrupt the grocery industry and the broader retail sector in a major way?

COMPANY BACKGROUND

Amazon was founded in June 1994 by Jeff Bezos. He came up with the idea of selling books to a mass audience via the Internet. In June 1995, Bezos launched his online bookstore, Amazon.com, named after the Amazon River. At the beginning, Amazon's business model was based on the "sell all, carry few" strategy where Amazon offered more than a million books online, though it actually stocked only about 2,000. The remaining titles were sourced predominantly through drop-shipping wherein Amazon forwarded customer orders to book publishers, who then shipped the products directly to the consumers.

Over a period of time, Bezos realized that his earlier business model would not sustain the kind of growth he was looking for and decided to diversify. In 1998, Amazon expanded beyond books to include all sorts of shippable consumer goods such as electronics, videos, and toys and games. This led to a reversal of its business model from a "sell all, carry few" strategy to a "sell all, carry more" model. In early 2000, Amazon started offering technology services through its e-commerce platform called Amazon Enterprise Solutions. Over the years, Amazon disrupted the online retail industry and transformed itself from an e-commerce player to a powerful digital media platform focused on growth and innovation. Amazon's business model was based on capturing growth through innovative disruption. The four pillars of Amazon's business model were low prices, wide selection, convenience, and customer service.

Bezos was the key architect in building a customer-centric company, transforming Amazon from a modest Internet brand into a tech behemoth as the company moved into completely new product categories such as e-readers and enterprise cloud computing services. In 2002, Amazon identified a new area of growth by launching Amazon Web Services (AWS), a platform of computing services offered online for other websites or client-side applications by Amazon. In 2005, Amazon launched a free shipping program for its customers called Amazon Prime,[7] wherein customers received free two-day shipping on their purchases for a fee of $79 per year. According to industry observers, the program disrupted the retail industry by enveloping more customers into its fold and enhancing customer loyalty.

In 2006, Amazon developed a new business model aimed at serving an entirely different customer–the third-party seller. The company offered fulfillment services to sellers through the Fulfillment by Amazon (FBA) program under which merchants sent cartons of their products to Amazon's warehouses while Amazon took the orders online, shipped the products, answered queries, and processed returns. In late 2007, Amazon set up its research division Lab126 and launched the Kindle e-book reader. The e-book reader was a business model not only alien to Amazon but also potentially disruptive to the publishing industry.

In July 2009, Amazon acquired U.S.-based online shoe retailer Zappos. In 2012, it forayed into the world of designer fashion, selling high-end clothing, shoes, handbags, and accessories through its website Amazon Fashion. In April 2014, the company entered into the highly competitive video and games streaming market by releasing Fire TV. Three months later, in an ambitious strategic move, Amazon debuted in the crowded smartphone market with the launch of the Fire Phone, which, however, failed to make a mark. The same year, Amazon launched Echo, a hands-free speaker that could be controlled with voice from across the room for information, music, news, sports scores, and weather.

In order to bring the company closer to customers, Amazon opened its first physical store on the campus of Purdue University in West Lafayette, Indiana, in February 2015. It also began testing a drone delivery service. In June 2015, Amazon invested $100 million to launch its first standalone corporate venture capital unit called Alexa Fund, which funded Alexa Voice Service, the cloud-based voice service that powered Amazon Echo.

In 2016, Amazon's net sales increased 27 percent to $136.0 billion, compared to $107 billion in 2015. The company's sales increased an additional 25 percent between 2016 and 2017 to reach $118.6 billion (see **Exhibit 1**).

EXHIBIT 1 Amazon Inc. Consolidated Statement of Operations, 2014–2017 (in millions of $, except per share data)

	2017	2016	2015	2014
Net product sales	$118,573	$94,665	$79,268	$70,080
Net service sales	59,293	41,322	27,738	18,908
Total net sales	177,866	135,987	107,006	88,988
Operating expenses				
Cost of sales	111,934	88,265	71,651	62,752
Fulfilment	25,249	17,619	13,410	10,766
Marketing	10,069	7,233	5,254	4,332
Technology and content	22,620	16,085	12,540	9,275
General and administrative	3,674	2,432	1,747	1,552
Other operating expenses, net	214	167	171	133
Total operating expenses	173,760	131,801	104,773	88,810
Operating income	4,106	4,186	2,233	178
Interest income	202	100	50	39
Interest expense	(848)	(484)	(459)	(210)

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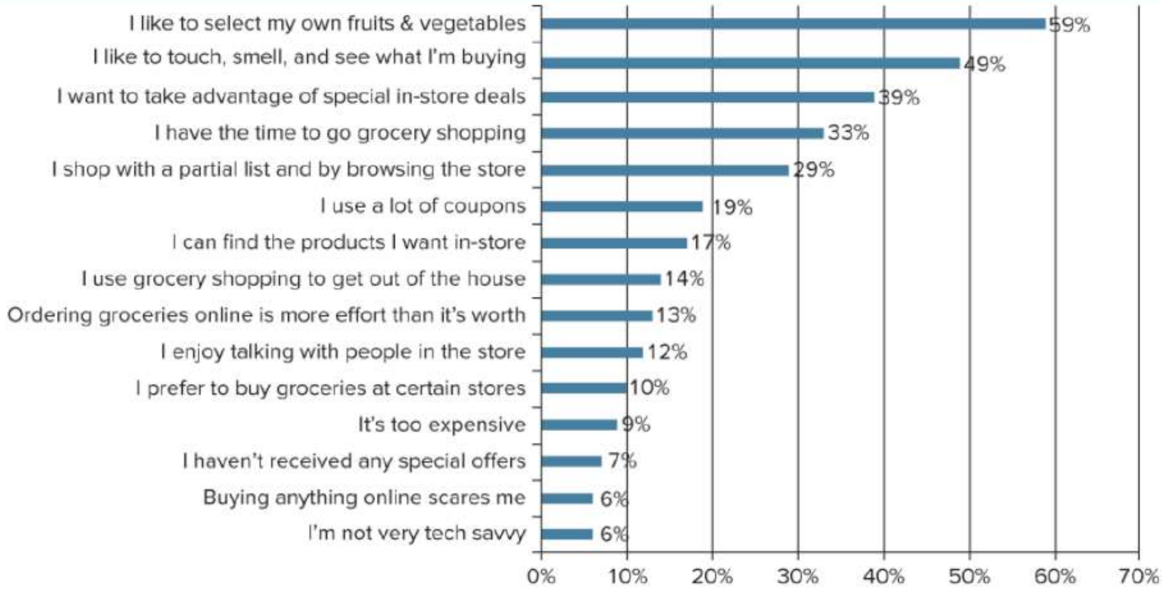
However, AmazonFresh faced problems inherent in the home delivery service including excessive wastage of food, management of refrigerated warehouses, hiring additional delivery people in each new market, and logistical complexities. The high cost of the losses caused by food spoilage was an issue with AmazonFresh that the company had never faced with its other businesses. Moreover, the customers' desire for a personal experience, reluctance to have someone else picking their items, and its pricey membership model were some of the factors that limited the expansion of AmazonFresh (see **Exhibit 2**). According to Neil Saunders, managing director of GlobalData Retail, *"As much as we believe [AmazonFresh] has solid long-term potential, we think the logistical complexities and the low margin nature of grocery mean that it will be an expensive drag on profits for the foreseeable future."* [8]

EXHIBIT 2 Survey of Consumer Barriers to U.S. Online Grocery Purchases, 2015



Source: **http://www.businessinsider.com.**

For about six years, the company tested and refined various operating models of AmazonFresh and the business extended to most of Seattle. In 2013, AmazonFresh expanded to Los Angeles and San Francisco and continued to experiment in these new cities with different subscription, fulfillment, and delivery models. For instance, AmazonFresh's free loyalty program in Seattle called "Big Radish" offered free or discounted delivery based on a customer's total spending within a certain time period and the order size. The subscription model in Los Angeles and San Francisco called "Prime Fresh" was an upgraded version of Prime.

Following a lukewarm response to AmazonFresh, Amazon launched Prime Pantry in 2014. This service allowed Prime members to shop for groceries and household products in everyday package sizes rather than bulk for a flat $5.99 delivery fee per box. Through Prime Pantry, Amazon could expand its selection and offer thousands of items to Prime members that were otherwise prohibitively costly to ship for free individually. In December 2014, Amazon launched Prime Now under which items were delivered to the customers within two hours of ordering without any added shipping cost. Exclusively available to Prime members, Amazon further expanded the offering to include one-hour delivery from local stores offering items such as groceries, prepared meals, and bakery items. For reordering frequently used household items and groceries, Amazon launched the Dash Button in March 2015. Dash Buttons were available to Prime members for $4.99 each. With Dash, customers could scan items at home, in store, or even on the move and add them to their basket. Reportedly, orders using Dash Buttons were placed more than four times a minute, which worked out to about 5,760 orders daily.

Though Amazon has been building up its online grocery delivery services, the business did not gain much traction. According to Nielsen online, only 4.5 percent of shoppers made frequent online grocery purchases in 2016, slightly up from 4.2 percent in 2013. While the total grocery market was worth $781.5 billion in 2016, online sales represented just $9.7 billion. *"Online grocery is failing. There's just not a lot of demand there. The whole premise is that you're saving people a trip to the store, but people actually like going to the store to buy groceries,"*[9] said Kurt Jetta, CEO of TABS Analytics.

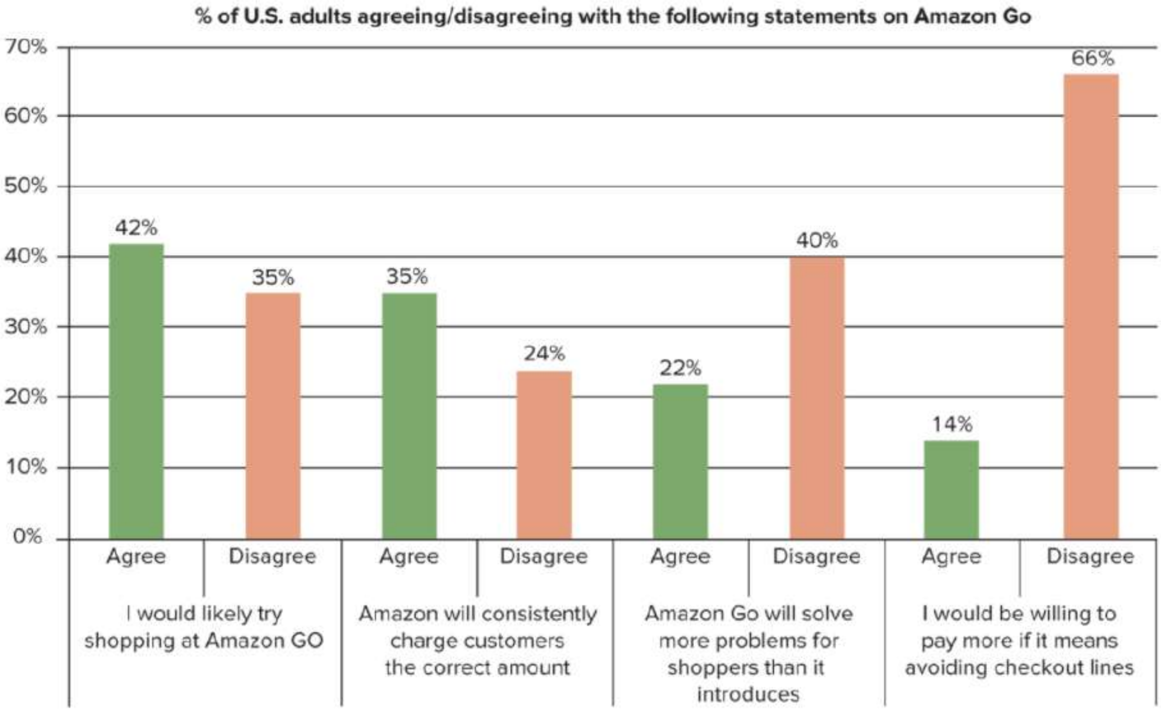
FROM CLICKS TO BRICKS

According to analysts, Amazon was unable to entice shoppers to buy groceries online the same way they bought other items. *"The grocery space in general is something of a quagmire, beset by thin margins and complicated operations, and many of Amazon's efforts remain experimental,"* [10] remarked Daphne Howland, a contributing editor for *Retail Dive*.

Realizing that many people remained reluctant to purchase fresh food online, Bezos thought that it would be difficult to crack the competitive grocery segment without having some type of brick-and-mortar presence. He decided to experiment with a convenience store-like format. The new grocery experiment started in December 2016 with the beta launch (Amazon employees only) of a convenience-style grocery store called Amazon Go, in Seattle. The "Just Walk Out" technology in the store allowed customers to shop and checkout without having to pay at a cash register. Customers needed to download an app and then swipe their smartphones as they walked through the store's entrance. Every time a customer with the app picked up an item it got tracked on the phone. If an item was put back on the shelf, it was deleted. As customers exited, they received a digital receipt on their phones, and the amount due was debited from their Amazon account automatically. The technology used at these stores included computer vision, machine learning, and artificial intelligence.

The "just grab and go" store was expected to open to the public in Seattle early 2017 but the opening was delayed due to some kinks in the technology. The store's automated systems were disrupted when the store became crowded with more than 20 people or if customers moved too quickly. After fine-tuning the concept, Amazon opened its checkout-free convenience store to the public in Seattle on January 22, 2018. The company planned to open as many as 2,000 such stores in the future in a bid to dramatically alter brick-and-mortar retail. **Exhibit 3** provides concept approval survey ratings for Amazon Go.

EXHIBIT 3 Survey of Consumer Concept Approval Ratings for Amazon Go, December 2016



Based on a survey of 1,039 U.S. adults in December 2016

AMAZONFRESH STORE PICKUP SERVICES

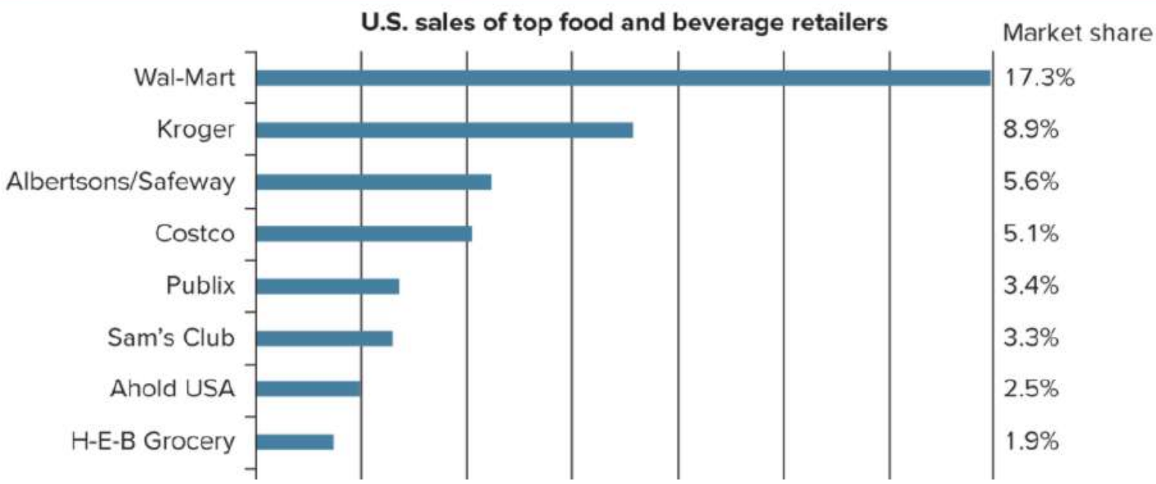
In the United States, curbside pickup options were facing problems such as subpar produce and long wait times for pickup. Considering those issues, in March 2017, Amazon opened its first "click and collect" grocery pick-up stores exclusively for its Prime members at two locations in Seattle. Called AmazonFresh Pickup, the stores allowed its Prime customers to place the order online and to drive in and pick up groceries from the pickup locations at a chosen time. Orders were bagged in as little as 15 minutes after they were placed. There was no order minimum and the service was free for Prime members.[11]

In June 2017, Amazon partnered with Sprouts Farmers Market LLC, a supermarket chain, to offer one- and two-hour delivery of products from the grocer to its Prime members in the United States. Amazon offered one-hour Prime Now delivery of Sprouts items for $7.99, while two-hour delivery was provided at no additional cost through the company's Prime Now app. Sprouts offered delivery through Prime Now in several cities, including Los Angeles, San Diego, Austin, Denver, and Dallas.

AMAZON ACQUIRES WHOLE FOODS

Whole Foods pioneered the organic food movement in the United States with emphasis on high-quality and pricey organic offerings. As of 2016, Whole Foods accounted for 1.2 percent of the U.S. food and grocery market share (see **Exhibit 4**). Since the beginning of 2016, the organic retail chain had been facing declining sales, stiff competition, and increasingly price-conscious consumers. Whole Foods was also struggling to shed its "too pricey" image at a time when customers wanted more natural foods at more affordable prices. In February 2017, the retailer reported sales decline at its stores for seven consecutive quarters (4Q 2015 to 1Q 2017), and was under pressure to put itself up for sale (see **Exhibits 5** and **6**).

EXHIBIT 4 Largest U.S. Food and Beverage Retailers, 2016



Source: Cowen and Company.

EXHIBIT 5 Whole Foods Market Inc. Consolidated Statement of Operations (fiscal years ended September 25, 2016, September 27, 2015, and September 28, 2014) (in millions except per share amount)

	2016	2015	2014
Sales	$15,724	$15,389	$14,194
Cost of goods sold and occupancy costs	10,313	9,973	9,150
Gross profit	5,411	5,416	5,044
Selling, general and administrative expenses	4,477	4,472	4,032
Pre-opening expenses	64	67	67
Relocation, store closure, and lease termination costs	13	16	11

Operating income	857	861	934
Interest expense	(41)	–	–
Investment and other income	11	17	12
Income before income taxes	827	878	946
Provision for income taxes	320	342	367
Net income	$ 507	$ 536	$ 579
Basic earnings per share	$1.55	$1.49	$1.57
Weighted average shares outstanding	326.1	358.5	367.8
Diluted earnings per share	$1.55	$1.48	$1.56
Weighted average shares outstanding, diluted basis	326.9	360.8	370.5
Dividends declared per common share	$0.54	$0.52	$0.48

n.com/118642233/files/doc_financials/2016/Annual/2016-WFM-10K.pdf.

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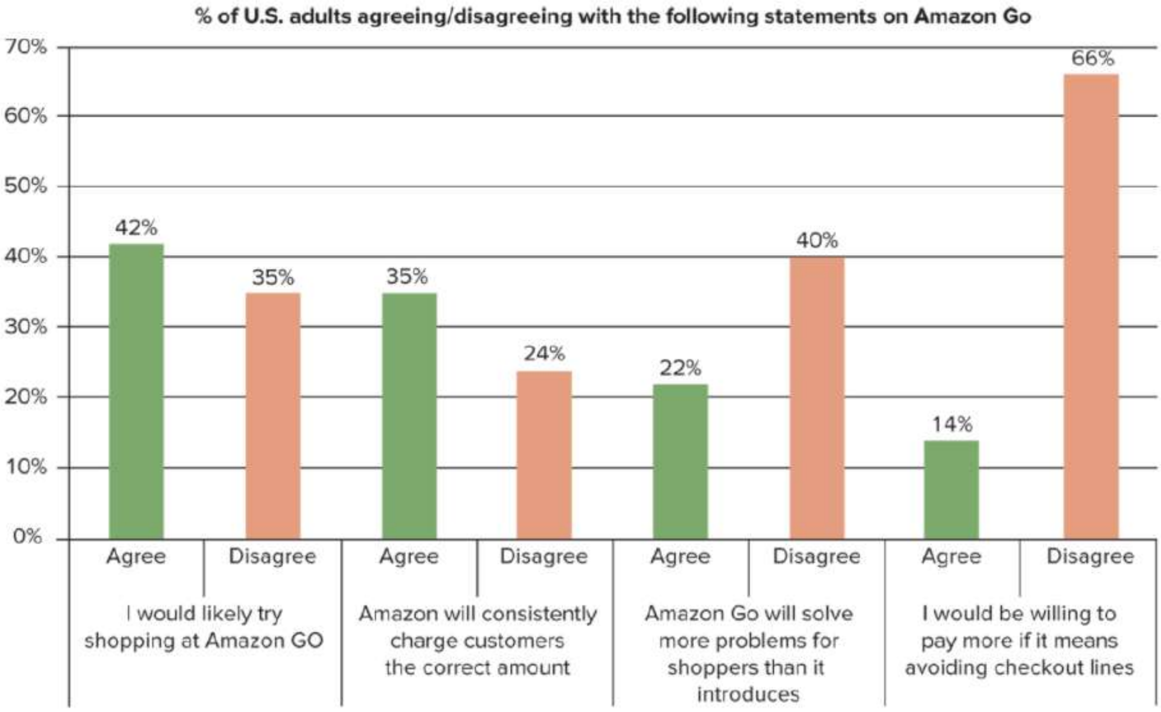

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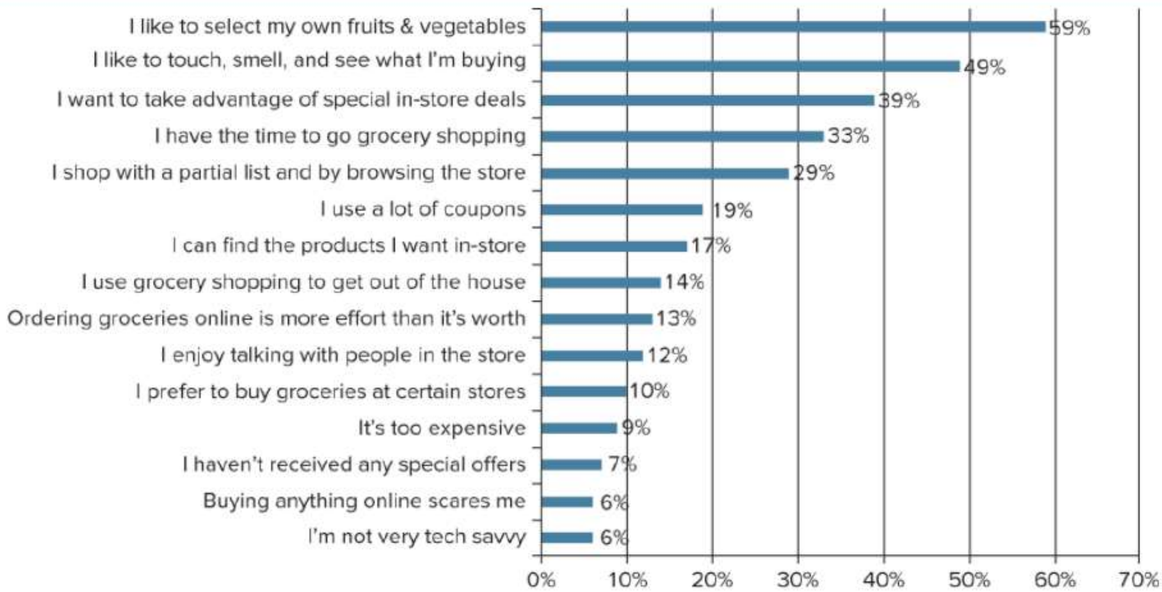

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On June 16, 2017, Seattle-based e-commerce giant Amazon.com, Inc. acquired Whole Foods Market, Inc., one of the leading natural and organic foods supermarket chains in the United States, in an all-cash transaction valued at approximately $13.7 billion. According to analysts, the deal touted to be Amazon's biggest acquisition to date, marked a turning point in the company's strategic efforts to crack the $800 billion U.S. grocery market. The deal also marked Amazon's big entry into the brick-and-mortar retail space. The shares of big box retailers such as Wal-Mart Stores, Inc,[1] Target Corporation,[2] Costco Wholesale Corporation,[3] and The Kroger Co[4] tanked with investors worrying about the far-reaching implications of the deal.