CASE 16

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

Syeda Maseeha Qumer
ICFAI Business School, Hyderabad

Debapratim Purkayastha
ICFAI Business School, Hyderabad

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).

AMAZON'S ENTRY INTO GROCERY

Groceries, though the second largest category of retail sales after general merchandise in the United States, represented one of the largest and most under-penetrated markets for Amazon. According to a 2016 Euromonitor study, aggregate sales in the U.S. grocery market were $781.5 billion. However, grocery was a heavily capital-intensive business with intense competition and tight margins. Despite the challenges, Bezos wanted Amazon to establish its presence in the grocery sector as he sought to make his company the "everything store." Amazon forayed into the grocery business in 2007 by launching AmazonFresh, an online grocery delivery service that allowed customers to order fresh produce and groceries online. Customers could order from more than 500,000 items for same-day and early morning delivery. The AmazonFresh service was available exclusively to Prime members in select cities in the U.S. for an additional monthly membership fee of $14.99.

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]

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

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)
Other income (expenses), net	346	90	(256)	(118)
Total non-operating income (expense)	(300)	(294)	(665)	(289)
Income (loss) before income taxes	3,806	3,892	1,568	(111)
Provision for income taxes	(769)	(1,425)	(950)	(167)
Equity-method investment activity, net of tax	(4)	(96)	(22)	37
Net income (loss)	$ 3,033	$ 2,371	$ 596	$ (241)
Basic earnings per share	$6.32	$5.01	$1.28	$(0.52)
Diluted earnings per share	$6.15	$4.90	$1.25	$(0.52)
Weighted average shares used in computation of earnings per share				
Basic	480	474	467	462
Diluted	493	484	477	462

Source: Amazon.com, Inc., 10K report.

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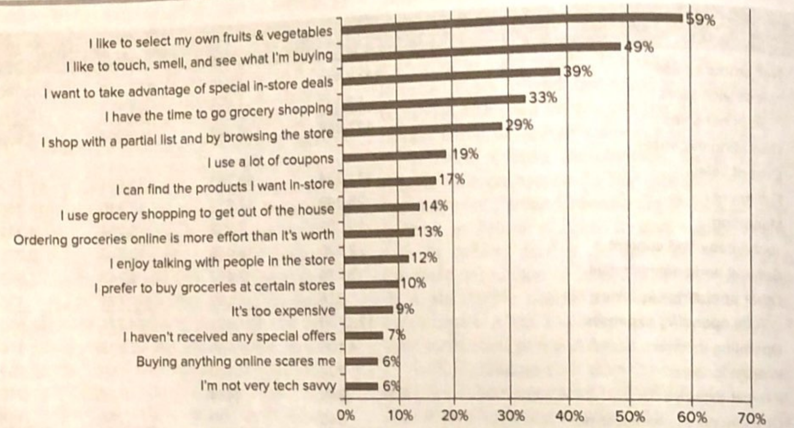
EXHIBIT 2 Survey of Consumer Barriers to U.S. Online Grocery Purchases, 2015



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

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*.

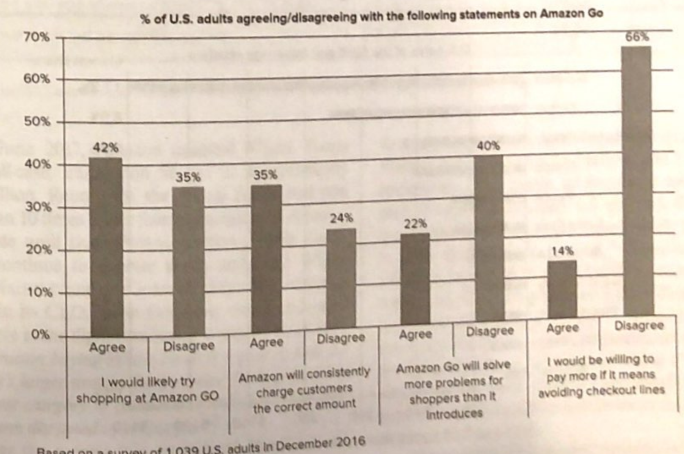
Realizing that many people remained reluctant to purchase fresh food online, Bezos thought that it would be difficult to crack the competitive grocery segment without having some type of brick-and-mortar presence. He decided to experiment with a convenience store-like format. The new grocery experiment 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.

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"

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



Source: YouGov.

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).

Meanwhile, even as Bezos was positioning Amazon to be the most powerful retailer in the world, he was aware that this goal could not be achieved without a physical presence, particularly in the grocery segment. Amazon controlled just about 1 percent of the U.S. food and beverage market as of 2016. According to Joseph Sebastian of Moneycontrol.com, *"When it comes to products like fruits and vegetables, most consumers across the world still like to touch and feel the product they are purchasing, as its directly for consumption. Delivery models, inventory-based, as well as hyperlocal, are more of a dud than a scud in this category in the U.S. at least. Globally many companies have struggled in the online grocery category, as it involves faster delivery and lesser shelf life."*[12]

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

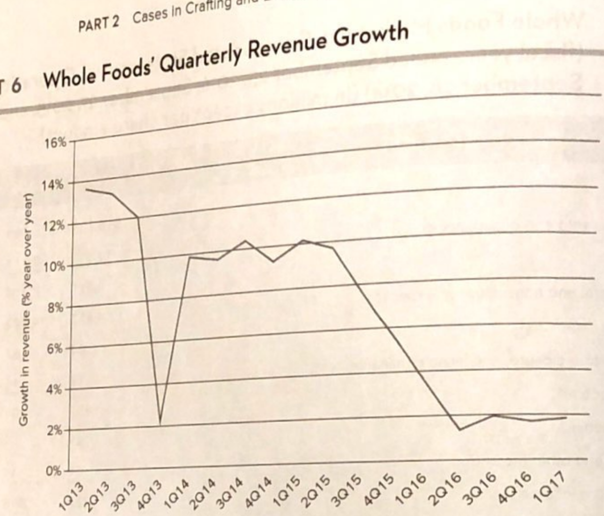
Source: http://s21.q4cdn.com/118642233/files/doc_financials/2016/Annual/2016-WFM-10K.pdf.

In June 2017, Amazon acquired Whole Foods in an all-cash transaction valued at approximately $13.7 billion. Reportedly, the Whole Foods deal was more than 10 times bigger than any acquisition Amazon had made until then. Post-acquisition, Whole Foods would continue to operate stores under the Whole Foods Market brand and John Mackey would continue to remain its CEO. Jason Goldberg, vice president of commerce at the digital marketing company Razorfish, said, *"Amazon buying Whole Foods is a good fit with the company's larger strategy for groceries. Fresh groceries is the biggest category of consumer spending in retail that hasn't been disrupted by online yet."*[13]

After the merger was announced, the shares of some of the largest grocery store chains in the United States took a nosedive (see Exhibit 7). The shares of Kroger plunged more than 9 percent while that of Walmart and Costco fell 4.65 percent and 7.19 percent respectively. The shares of Supervalu and Sprouts each dropped more than 6.5 percent. Reportedly, the decline in the six stocks erased nearly $12 billion in their market value in total.[14] Amazon's market valuation increased by $14.27 billion while Walmart, Kroger, and Costco together lost $18.8 billion in market capitalization on June 16, 2017.[15] Analysts said that the stock fluctuations revealed investor concern over the long-term threat of Amazon taking a significant position in the grocery space. They called it one of the most disruptive acquisitions in terms of the number of stocks it had impacted.

The acquisition catapulted Amazon headlong into the grocery space and provided it with a footprint in

EXHIBIT 6 Whole Foods' Quarterly Revenue Growth



Source: Whole Foods Market Filings.

EXHIBIT 7 Stock Price Changes of Leading U.S. Grocers, June 15, 2017 to June 16, 2017 (market capitalization in $ billions)

Grocer	Stock Price Change June 15, 2017 to June 16, 2017	Market Capitalization	U.S. Stores
Whole Foods	27.0% ↑	13	465
Amazon	3.1% ↑	476	–
Ahold* (Giant)	−5.4% ↓	26	2,260
Walmart and Sam's Club	−6.5% ↓	225	4,692
Costco	−6.9% ↓	74	510
Target	−8.4% ↓	28	1,807
Sprouts Farmers Market	−12.9% ↓	3	272
Kroger* (Harris Teeter)	−14.6% ↓	20	2,792

*Dutch company Ahold Delhaize owns U.S. grocery chains including Food Lion and delivery service Peapod. Kroger owns chains Dillons and King Soopers. Costco locations are in the United States and Puerto Rico.
Daria Cameron and Kevin Schaul, The Washington Post.

Sources: Bloomberg News, the companies.

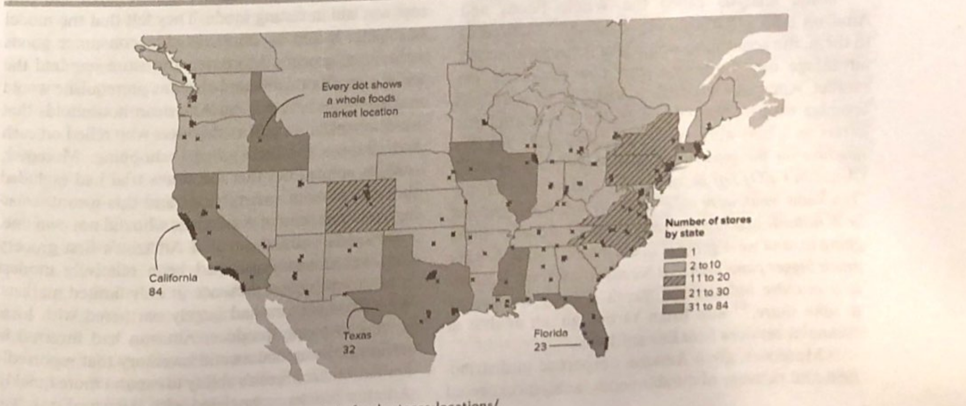
some of the most affluent urban areas in the United States (see Exhibit 8). Amazon would have access to Whole Foods' 465 stores across 42 states in the United States (460) and the United Kingdom (5 stores), besides a well-oiled supply chain. Whole Foods even had a strong private label business with its 365 brand products. Armed with those stores, Amazon could improve its distribution network and eliminate costs, reach more customers, and increase its overall market share, said experts. Moreover, Amazon's other grocery initiatives—AmazonFresh, Amazon Pantry, and Amazon Prime—would get a boost from Whole Foods's store network as well as its loyal, affluent customer base, they said.[16] In addition, Amazon would also pick up a stake in grocery-delivery startup Instacart,[17] an exclusive partner for Whole Foods' perishable business.

On August 23, 2017, the acquisition cleared its biggest hurdle as the Federal Trade Commission approved the deal. Post-merger Amazon had been slashing prices on some items at Whole Foods stores in the United States in order to attract customers. Amazon lowered prices of avocados, eggs, fruit, fish, and prepared food at Whole Food stores by as much as 50 percent. *"Amazon is trying to shed the 'Whole Paycheck' stigma at Whole Foods, and they clearly identified some key categories where they didn't think they were competitive and dropped some prices,"*[18] said Darren Seifer, a food and beverage analyst with market research firm NPD Group.

Many of Whole Foods' in-house brands, including 365 Everyday Value products were made available on Amazon's website, AmazonFresh, and Prime Pantry. Amazon Prime members could get these items delivered to their homes or to their local Amazon Locker free of charge. The retailer had even dedicated an area of its first automated convenience store, Amazon Go, to the private label products. Amazon also made its customer rewards program Prime Now the de facto Whole Foods customer rewards program. In February 2018, the retailer announced that Amazon Prime Rewards Visa cardholders would get 5 percent cash back on their Whole Foods purchases while non-Amazon Prime subscribers would get 3 percent cash back when they use their card at Whole Foods. In addition, Amazon and Whole Foods technology teams were integrating Amazon Prime into the Whole Foods point-of-sale system. The two retailers planned to innovate in additional areas including in merchandising and logistics, in order to lower prices for Whole Foods customers.

In February 2018, Amazon started free, 2-hour delivery from Whole Foods stores to Prime Now members on orders over $35 in four U.S. cities—Austin, Cincinnati, Dallas, and Virginia Beach. Amazon planned to expand the offer nationwide before the end of 2018.

EXHIBIT 8 Whole Foods Stores in North America, June 16, 2017



Source: http://fortune.com/2017/06/16/amazon-whole-foods-stores-locations/.

AMAZON SET TO DISRUPT THE U.S. GROCERY MARKET

According to some analysts, Amazon's acquisition of Whole Foods would disrupt three different markets–grocery stores, online shopping, and food delivery. The e-tailer would dramatically change the grocery landscape and threaten its larger rivals. It would eventually drive cost out of the supply chain at Whole Foods and lower prices to undercut rivals, they said. This in turn could force other big players in the market such as Walmart, Kroger, Costco, and Target to cut prices in order to survive. Analysts expected the partnership to kick off a wave of consolidations within the grocery space and leave other grocers under more pressure to compete. According to them, regional supermarket chains would be most affected as they would have to contend with not only competition with each other and nontraditional grocers, but also with a retailer like Amazon that had the financial capacity to price aggressively. The Amazon and Whole Foods deal could also be a gamechanger for consumers, vendors, and distributors, they said.

By building a physical presence, Amazon would undercut its biggest rival Walmart's on-the-ground advantages. Costco's yearly subscription model too could be disrupted with the introduction of a Prime-enabled grocery store. The acquisition would also pose a threat to other traditional grocers such as Kroger and Target that were already reeling from food deflation, they added.[19]

Some analysts called the Whole Foods and Amazon deal a "Grocery Apocalypse."[20] According to them, the acquisition would give Amazon an unfair advantage over traditional and new players in the market. Amazon's strengths in logistics, its scale, and leverage with suppliers could enable it to disrupt groceries as it had with bookselling, they said. *"It's very negative for the grocery business because I don't think (Amazon CEO) Jeff Bezos is going into this just saying, 'You know what, we're going to buy Whole Foods and just be a natural and organic grocer.' I think he says, 'We're going in, and we're going in in a big way.' I think he's got much bigger plans than that because the grocery industry is a massive industry and there's a lot of opportunity to take share,"*[21] said Brian Yarbrough, an analyst at financial services firm Edward Jones.

Moreover, given Amazon's expertise in distribution and delivery of durable goods, analysts expected the online behemoth to expand its footprint in food delivery and become a disruptor of the food service distribution models, particularly the independently-owned restaurant sector, which was a market worth about $256 billion in the United States.

Some industry observers even felt that Amazon's automation model, if widely adopted, had the potential to pose a huge threat to the retail workforce in the United States. They said the model would likely disrupt the labor force in the United States, which employed 867,920 grocery cashiers in 2016, according to the Bureau of Labor Statistics.

THE DOWNSIDE

However, some analysts were skeptical about the possibility of Amazon dominating the grocery sector as they felt that Amazon was still in an early stage of physical retail. They felt that traditional retailers would still have an upper hand over Amazon in the physical retail market given its lack of experience managing brick-and-mortar locations. According to them, the grocery business was highly competitive with survival driven by repeat business. The margins were thin, the product was highly perishable, and the supply chain expensive and complex. Moreover, there were some apprehensions about whether consumers would fully embrace grocery delivery as they generally preferred the tactile experience of handling fruits and vegetables and to pick out the groceries themselves.

Some analysts pointed out that Amazon Go concept was still in testing mode. They felt that the model was better suited to nonperishable consumer goods rather than grocery. Moreover, the store required the use of a credit or debit card and this prerequisite would exclude about nine million American households that were unbanked, as well as shoppers who relied on cash and coupons for their grocery shopping. Moreover, analysts pointed out that the stores trial had excluded shoppers without smartphones and this meant isolating about one-third of Americans who did not own one.

Experts pointed out that Amazon's first grocery initiative AmazonFresh had been relatively modest in its growth with a presence in only limited markets. Where competitors had largely partnered with local grocers to supply produce, Amazon had invested in refrigerated warehouses and inventory that reportedly limited AmazonFresh's ability to expand more quickly. Another problem associated with AmazonFresh was the high cost of losses caused due to food spoilage. Some customers had complained that the online store lacked the product range found in regular supermarkets. Moreover, a monthly fee in addition to the cost of a Prime membership made AmazonFresh a pricey service, they added. Reportedly, the service struggled, to the point where Amazon had to cut the rate for Prime users from $299 per year to $180 annually.

Some analysts were of the view the Amazon and Whole Food deal was barely a threat to the other established retailers like Walmart. While Whole Foods Market had just about 460 stores in the United States, Walmart operated more than 5,000 stores. Moreover, they said that Amazon could not use the Whole Foods brand to attract Walmart shoppers because the two stores appealed to different sets of customers.

CHALLENGES

According to some analysts, one of the biggest challenges for Amazon would be to operate its stores well as it was not an experienced brick-and-mortar retailer. Amazon would face some operational hiccups along the way as it transited its business model from an online pure-play to an integrated brick-and mortar offering, they added. The company might struggle with assortment and merchandising strategies in the physical locations, and with maintaining a balance with online integration.

Another key challenge for Amazon would be to resolve the "last-mile"[22] challenge of delivering fresh food to its customers by bridging the small distance from the distribution hubs to individual customers. Moreover, there was the problem of spoilage. Amazon Go stores would also face some challenges. These stores would require an extremely high investment to chase the niche consumer in high-volume areas with disposable income. Also, for a store that relied solely on technology to function, even minor operational hiccups could affect the entire operation and be a significant drain on time and resources. Another challenge would be how fast consumers would be able to embrace this kind of concept and technology fully.

According to analysts, what seemed to be lacking from Amazon's plan for groceries was in-store dining, which was one of the biggest grocery trends in the United States. Grocers were luring customers into stores with dining options. According to Chicago-based researchers NPD Group, sales of prepared foods from grocers, which included in-store and takeout dining, were up by nearly 30 percent since 2008 and accounted for $10 billion of consumer spending in 2015.

Amazon's competitors were unlikely to sit back as Amazon made its way into the traditional grocery market. Some were already taking steps to counter the e-tailer's moves. For instance, WalMart announced that it would start offering its products on Google Express. Moreover, German discount grocers Aldi and Lidl, who offered high quality products at low prices and a no-frills store environment, were slowly making inroads into the U.S. grocery market. Lidl started an aggressive expansion in the United States with plans to open as many as 100 new stores across the East Coast by the summer of 2018. Aldi, with more than 1,600 stores in the United States as of 2017, was aggressively expanding in the country and planned to increase its store count to 2,500 over a period of five years.

Another challenge for Bezos would be to scale up the production of organic produce if the demand for it went up in the future, said analysts. Though the demand for organic fruits and vegetables had increased, the number of acres used to farm those crops had remained about the same as it was particularly onerous for farmers to switch from conventional farming techniques to organic, they pointed out.

Some analysts said one of the earliest challenges for Amazon in the Whole Foods acquisition would be the management of different corporate cultures. While Amazon was an automation-oriented company with a customer centric culture, Whole Foods was a people-focused company with an approach to a more balanced set of commitments toward customers, employees, and communities. Calling the acquisition a risky move for Amazon, Megan McArdle, a Bloomberg View columnist, said, *"So while it's possible that the Whole Foods acquisition is a stroke of strategic genius, it's also possible that it may, in retrospect, turn out to be a bridge too far. Or more likely that it will turn out to be a mixed bag: costing some management headaches to keep a profit-challenged business going, without making or losing much money; enabling Amazon to get better at grocery delivery without making it strong enough to deliver a knockout blow to the competition."*[23]

THE ROAD AHEAD

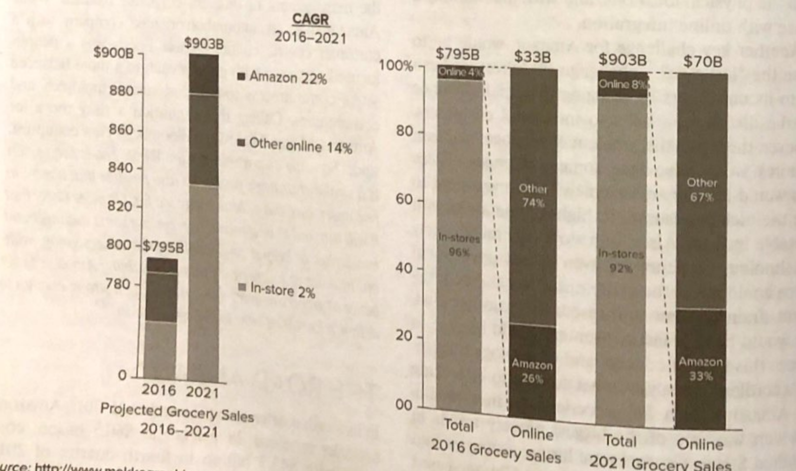
In its fourth quarter ended December 31, 2017, Amazon's net sales increased 38 percent to $60.5 billion, compared with $43.7 billion in fourth quarter of 2016.

The company reported a profit of nearly $2 billion in the quarter, the largest in its history. Physical store revenue in the fourth quarter, which came mostly from Whole Foods, was about $4.5 billion.[24] Amazon sold an estimated $11 million of Whole Foods' 365 Everyday Value products in 2017. Whole Foods products also helped push sales at AmazonFresh up 35 percent to $135 million in the last quarter of 2017. One Click Retail[25] estimated that Amazon sold nearly $2 billion in groceries in the United States in 2017. Its online grocery sales accounted for less than 3 percent of the roughly $800 billion U.S. grocery market.[26]

Bezos planned to open 20 convenience stores in some major cities in the United States by the end of 2018, according to internal company documents. The stores would be tested in two formats–a more traditional grocery merchandise stores and "click & collect" grocery pickup services. Bezos also had plans to open multi-format stores that offered private-label goods at low prices. Amazon's grocery business was projected to grow at 22 percent annually. According to Cowen and Company, by 2021, Amazon would control about 33 percent of the $70 billion online grocery market in the United States compared to 26 percent in 2016. As shown in Exhibit 9, online sales were projected to account for about 8 percent of the $903 billion grocery market in 2021 compared to about 4 percent of a $795 billion industry in 2016. *"The pot of gold at the end of the road for Amazon is groceries. The war for retail will be won in groceries. It's the largest category of consumer retail, and the largest untapped opportunity for Amazon,"*[27] said Cooper Smith, Director of Research at L2 Inc.

The stakes were high for Amazon as the company had been extremely persistent when it came to pursuing groceries. Some key challenges before Bezos were: blending the physical store experience with the convenience of digital retailing; managing the company's offline needs; successfully merging Whole Foods with Amazon to bring convenience and accessibility to a new high, and attracting customers. According to Chase Purdy, a business reporter for Quartz, *"Can Bezos do to groceries what he did to bookstores? And can he cast Whole Foods–a high-quality food store with sky-high prices–in Amazon's price-competitive image? If so, it will undoubtedly gin up concern in grocery-chain boardrooms across the U.S."*[28]

EXHIBIT 9 Growth in Online Grocery Sales, 2016 (Actual) to 2021 (Projected)



Source: http://www.mekkographics.com/amazon-is-poised-for-growth-in-grocery-sales/.

ENDNOTES

[1] The largest retailer in the world with 11,695 stores in 28 countries and e-commerce websites in 11 countries as of August 2017. In fiscal year 2017, the company generated $485.9 billion in revenues.
[2] An upscale discount retailer with 1,816 stores in the United States as of March 2017. In 2016, the company's revenues were $69.495 billion.
[3] A retailer with warehouse club operations in eight countries. Costco's revenue in 2016 was $118.7 billion.
[4] One of the largest grocery retailers in the United States, based on annual sales. Headquartered in Cincinnati, Ohio, the retail chain has nearly 2,800 stores in 35 states and the District of Columbia as of 2016. Its fiscal year 2016 sales were $115.3 billion.
[5] Sean Kervin, "The 3 Real Reasons Amazon Bought Whole Foods," June 21, 2017, www.clearpeak.com.
[6] Megan McArdle, "The Amazon Approach to Groceries Won't Replace Stores," June 20, 2017, www.bloomberg.com.
[7] In 2014, Amazon raised the annual fee for the membership to $99.
[8] Daphne Howland, "How Amazon is Disrupting Grocery," May 1, 2017, www.retaildive.com.
[9] Spencer Soper and Olivia Zaleski, "Inside Amazon's Battle to Break Into the $800 Billion Grocery Market," March 20, 2017, www.bloomberg.com.
[10] Daphne Howland, "How Amazon Is Disrupting Grocery," May 1, 2017, www.retaildive.com.
[11] Leslie Hook, "Amazon Launches Grocery Pick-Up Stores in Seattle," March 28, 2017, www.ft.com.
[12] Joseph Sabastian, "Why Amazon Acquired Whole Foods for About USD 14 Billion?" June 19, 2017, www.moneycontrol.com.
[13] Davey Alba, "Amazon is About to Transform How You Buy Groceries," June 16, 2017, www.wired.com.
[14] Evelyn Cheng, "Amazon's New Whole Foods Discounts Wipe Out Nearly $12 Billion in Market Value from Grocery Sellers," August 24, 2017, www.cnbc.com.
[15] "The Amazon Whole Foods Deal Made Walmart Costco and Kroger Lose 18.7 Billion in Market-Value," June 20, 2017, https://qz.com.
[16] Derek Thompson, "Why Amazon Bought Whole Foods," June 16, 2017, www.theatlantic.com.
[17] Founded in 2012, Instacart is an on-demand delivery start-up that promises grocery deliveries in as little as one hour.
[18] Sebastian Herrera, "Six Months after Amazon Takeover, are Prices Lower at Whole Foods?" February 28, 2018, www.512tech.com.
[19] George Watson, "Amazon's Purchase of Whole Foods Could Permanently Alter U.S. Grocery Industry," ,June 20, 2017, http://today.ttu.edu.
[20] Ben Levisohn, "Amazon's 'Unfair Advantages' and the Grocery Apocalypse," August 28, 2017, www.barrons.com.
[21] Ashley Nickle, "Analysts: Amazon-Whole Foods Merger is Major Disruption to Grocery Industry," June 16, 2017, www.thepacker.com.
[22] The last-mile refers to delivery space between a retailer and its customer base.
[23] Megan McArdle, "The Amazon Approach to Groceries Won't Replace Stores," June 20, 2017, www.bloomberg.com.
[24] Richard Turcsik, "Amazon's Whole Foods Revenue 'Slightly Better' Than Expected," February 2, 2018, www.supermarketnews.com.
[25] One Click Retail is a provider of e-commerce data measurement, sales analytics, and search optimization services.
[26] Heather Haddon, "Amazon Grocery Sales Surged, Thanks to Whole Foods," January 14, 2018, www.marketwatch.com.
[27] Dylan Byers, "What Amazon Knows: 'The War for Retail Will be Won in Groceries'," August 25, 2017, http://money.cnn.com.
[28] Chase Purdy, "Amazon is Buying Whole Foods Market for $13.7B—Threatening to Disrupt Three More Industries," June 16, 2017, https://qz.com.