

By Perishable Pundit and Phoenix Media editor-in-chief Jim Prevor



This article originally appeared on [Perishable Pundit](#).

The market capitalization of Amazon.com is about US\$466 billion; that is billion, with a B. So the proposed US\$13.7 billion acquisition of Whole Foods, including debt, for which Amazon.com would not generally be liable, is a bit of roulette for Amazon.com, but not Russian roulette.

The thousands of articles that claim to explicate Amazon.com's strategy need to be viewed in this light: This is like you learning that your neighbor with a million-dollar stock portfolio took a flier and purchased a bit over US\$29,000 in a stock.

But that is not to say there is no meaningful risk to Amazon.com in looking to make this acquisition. The price/earnings (PE) ratio on Amazon.com stock is about 185. By comparison, the PE ratio is around 15 for Wal-Mart. It is this massive multiple that makes Amazon.com such a powerful company.

What justifies this high multiple for Amazon.com? Two things: First, an expectation of rapid growth; second, an expectation that the company will achieve very high returns on investment due to an asset-light business model. As long as Whole Foods remains what it is, a rounding error in the scheme of Amazon.com, the Whole Foods division will be lost, and the profits it generates will be valued at the rate Amazon.com profits are valued.

If, however, Whole Foods was to dramatically grow as a conventional retailer, it would soon weigh down Amazon.com's PE ratio — even if it was very successful! The nature of the internet is that whatever the upfront investment to develop the technology, once established, the marginal cost of handling additional volume is low.

Yet for conventional grocery, the formula is the opposite. Same-store sales growth, even of highly successful retailers, is measured in tiny increments. For the most part, if Whole Foods wants to double its sales as a conventional retailer, it has to double its store count. This is both difficult — thus slow — to accomplish and requires substantial investment on which the return is modest.

Do you ever wonder why a giant firm such as C.H. Robinson — publicly traded with an easy ability to raise capital — doesn't go out and just buy up D'Arrigo Bros of California, the Wonderful Companies, Duda or any other giant producers and the land base behind them? It is because its whole stock market valuation revolves around high returns on invested capital, and realizing those returns involves minimizing invested capital.

Just as C. H. Robinson doesn't want to own hundreds of thousands of trucks, rail cars, ships or planes, it doesn't want billions of dollars of land earning a percentage point or two on its balance sheet.

Which is why this deal will ultimately be problematic for Amazon.com.

It is easy to see why the shareholders of Whole Foods would want to sell. The company is stuck in a classic specialty food dilemma. It specializes in moving low volumes at high margins. This requires constant innovation and a willingness to reinvent oneself. It is why Frieda's always has new products coming out and why, despite innovating kiwifruit, Frieda's is not who you call if you want to book ten loads a week of kiwifruit.

There was a time Perrier was only available through specialty foods distributors and a time Whole Foods was one of the few sources for organic and natural products. Now both are mainstream. Wal-Mart sells much more organic food than does Whole Foods.

So, lacking some new product category with which to differentiate itself, Whole Foods has tried desperately to find a way to keep customer loyalty. We spoke critically of its efforts in a piece titled, [Whole Foods' 'Responsibly Grown' Program Turns Out To Be Pretty Irresponsible And Implies Other Farmers Are Not 'Responsible Growers'](#), as Whole Foods tried to imply that consumers could count on Whole Foods to sell products which were somehow more sustainable, more ethical, etc. — although, in fact, in many, many

cases, it is the same product sold elsewhere.

In any case, Whole Foods' efforts in this regard have been schizophrenic as it claimed its products were uniquely infused with values and ethics, and thus worthy of a premium, while the company's efforts were simultaneously devoted to persuading consumers that the chain did not deserve the "Whole Paycheck" moniker many have applied to it.

The bottom line is that Whole Foods was caught between a rock and a hard place, and this offer, like Jeff Bezo's personal offer for [The Washington Post](#), was a Godsend for Whole Foods (and, previously, *Washington Post*) shareholders. It is entirely possible that another retailer may come in with a higher bid for Whole Foods, but this is not because of the value of the company, but more because many retailers have an interest in making sure Amazon.com pays up for its opportunities. If Amazon.com did not buy the company, the next offer would likely not have been 3% less; it might have been 30% less.

So the win is clear for Whole Foods shareholders.

As for what Amazon.com gains? There are lots of things to put on the list: A procurement team, fine locations in good demographic areas that can be used as showcases for private label product and pick up points for click-and-collect initiatives, a distribution system useful for fresh product, a brand that resonates with the high demographic consumer, etc.

The issue is not that some of these things aren't useful or valuable — it is that most could have been acquired, in a format more suitable to Amazon.com's needs, for a small portion of the cost.

You see the overselling of synergy of ownership happening all the time in media acquisitions. Some investment banker has the idea to combine a content-producer with a content-distributor, thus ensuring that a movie has outlets in theaters, on cable, for theme park rides etc., while the distributor has an assured source of content.

The problem is, of course, that if this actually happens, the distributor is committed to sub-optimal content, so it ultimately is less successful with consumers than it could have been had it been free to select the most optimal content to play in its theatres, on its cable channels, to feature in its theme parks.

In other words, if Amazon.com needs click-and-collect spots, it would be better to make a deal with Walgreens, with more than 8,000 stores, than try to use Whole Foods with about 440 stores. Walgreens might even pay Amazon.com to bring people into their stores. If

Amazon.com needs refrigerated warehouses, they can be built in more optimal layouts, sizes and locations with a lot less than \$13.7 billion and, jeepers, procurement teams? We could put one together for Amazon.com and would only charge one billion!

The Whole Foods brand has power but also a reputation of being expensive. Its ability to scale is unclear. Its appeal — that these products are in some way ... through health, for the earth, ethically produced ... better than those of its competitors — is closely connected to its image as high-priced. Would anybody believe that a Ferrari or a Rolls Royce is still a Ferrari or Rolls Royce if the new model is cheaper than a Chevrolet?

There are many articles saying that Amazon.com will help Whole Foods lower prices with a more efficient supply chain. This is doubtful. Whole Foods has a high cost supply chain, both because it carries many low volume items and because its store locations are just a few in most markets. If Publix has 150 stores in a metropolitan area and Whole Foods has one by the university, it will have a more expensive supply chain.

More importantly, low prices will alienate all those who love Whole Foods. It is not credible to say, "We treat our employees better than anyone; we make sure our vendors treat their employees better than anyone else; we are more protective of the earth than anyone else, and we provide you with food fresher, more wholesome and more healthy than anyone else — and our food is also cheaper than anyone else's."

Indeed, one reason Amazon.com was willing to do this deal is that the Wall Street types are attracted to a brand such as Whole Foods and perceive it to have value. A lower scale brand might have made more sense but wouldn't encourage the maintenance of that 185 PE ratio!

There is value in everything. Sam Walton learned the grocery business by serving on the board of directors of Winn-Dixie. Then he crushed Winn-Dixie. Being deeply immersed in grocery may provide Amazon.com executives with similar insight. But, in the end, the magic number is that 185 PE ratio, and there the math is daunting.

As long as Whole Foods stays small or expands in scalable ways, such as Amazon.com selling the Whole Foods branded product online, the PE ratio can be supported, and the experiment, the toe in the water of grocery, can continue.

The minute Amazon.com has to announce an intention to pour billions of dollars into brick-and-mortar assets and holding inventory, the jig would be up, the PE would collapse, and the might of Amazon.com would be diminished.

Bezos will guard against this at all cost. As a result, that scenario will be unlikely to happen, so don't look for thousands of Whole Foods superstores rolling out across the country. It is more likely Amazon.com will learn for a bit, keep the brand and divest the brick-and-mortar — making arrangements with stores as needed for its physical contact needs with consumers.

Share prices of grocery companies dropped significantly after the Amazon.com/Whole Foods deal was made public. Some of this might be justified as part of a broader look at the grocery market, where deep discounters, such as Aldi and Lidl, are adding significant pressure on margins.

But the specific impact of the acquisition announcement was a fear that Amazon.com, intent upon securing market share in grocery, would be content to operate at break-even or even at a loss, content that it could profit from selling other products to customers buying food from Amazon.com/Whole Foods.

There is nothing new about this insight. Indeed, it is specifically the same fear engendered in grocery executives by Wal-Mart's rollout of supercenters. They feared that Wal-Mart would be content to sell grocery on a break-even basis just to draw consumers to supercenters, whereby consumers would buy high-margin general merchandise.

Of course, Wal-Mart found out that food is such a big business, and if you have any success, it overwhelms everything else. So what might have sounded like a reasonable theory when Wal-Mart's food sales accounted for one or two percent of total sales, stopped being very plausible when a majority of Wal-Mart's sales started coming from food.

In fact many retailers pursue perishable sales in order to capture the frequency of store visits. Amazon.com has a special incentive to capture perishable sales, as controlling this volume could give it a competitive advantage on delivering other products but — and it is a big but — this advantage only occurs if consumers buy the products for delivery.

In other words, if you can get consumers to rely on you to deliver them milk every day, and the consumers cover the cost of the delivery stop, you have a golden opportunity to sell other products on that same stop and can do it less expensively than any competitor.

Despite denials, this is why, in the end, Amazon.com would like to have its own delivery operation. If Amazon.com allows UPS to deliver goods for them, the company also is allowing UPS to offer delivery to smaller vendors with efficiencies made possible by Amazon.com's large volume.

If Amazon.com could move its delivery volume to its own platform, some producer trying to sell direct to consumers couldn't piggyback on the fact that UPS is stopping there anyway to get a low price on delivery. But, all this has very little to do with Amazon.com owning some upscale grocery stores.

You will read all kinds of grand statements — that this is all about Amazon.com becoming Wal-Mart before Wal-Mart can become Amazon.com or that, as Mark Cuban tweeted: "The Amazon Question. Can they get your groceries to you faster than you can get to the store to shop in an Uber/Lyft world? Yes"

In fact, though, the imperative at Amazon.com is to maintain that high PE ratio, and so, though it may learn a bit by owning Whole Foods, it just can't dig deep into the conventional grocery business without undermining that prime directive. So, Whole Foods is likely to remain permanently what it is today at Amazon.com: A small flier, suitable for testing and experimentation, but destined to never be much more.

www.freshfruitportal.com