RBC Dominion Securities Inc.

Pearlstein's Corner

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3 Things Investors Can Learn from the Amazon – Whole Foods Deal

I was discussing this big event with a client a few weeks ago. I quickly reviewed the highlights and said, "What do you think?" He said, "Amazon is eating retail's lunch." He was right.

In mid-June, Amazon announced its intention to buy Whole Foods – its biggest acquisition ever. Whole Foods is the largest natural and organic foods grocer in the U.S., with a handful of stores in Canada. It is a niche player in a sector where sales growth has been a struggle.

If the deal goes through, Amazon, which already controls just over 40% of online retail sales in the U.S., will have a small slice of the grocery market (about 1.7%).

Today, the grocery market is dominated by firms like Walmart (14.0%) and Kroger (7.0%) in a massive $800 billion market space. Let's unpack this transaction to see what we can learn as investors.

Know What You're Looking for

Amazon has been trying to break into the grocery business for years, with very little success. As an online-only retailer, they have found it difficult to manage and distribute perishable food items, to deliver them successfully and to change the emotional connection that people have with the food they eat. It turns out that most people take satisfaction in buying their groceries and actually do want to personally pick their bananas, choose the ripest tomatoes and compare the various lettuces for tonight's salad.

Amazon's solution? Buy struggling Whole Foods with 430 locations in the U.S. Simply put, Amazon wants to become Walmart before Walmart becomes Amazon. Both understand that shopping will not fully transition online, nor operate entirely offline.

Amazon is looking for the right portfolio mix to meet their objectives. Smart investors should do the same.

Wait for Your Item to go on Sale

Prior to the Amazon announcement, its stock price was cut in half over a two-year period. It had posted declining sales every quarter for the past six quarters which resulted in declining sales, lower profits and a lower stock price.

In short, it was on sale and presented an interesting opportunity. Amazon jumped on it, before Walmart got the same idea. It's not for the faint of heart, but Amazon has taken risks before.

Amazon felt it was within its margin of safety – how much it was willing to see its investment fall in price without 'losing sleep' – and put Whole Foods into its shopping cart. The next day, Whole Foods increased by 27% – on paper, a short-term win for Amazon.

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Bigger isn't Always Better or Cheaper

So, why not buy Amazon, right now, since it's so big and good at what it does? Here are a few things to consider:

In retail, Amazon's core expertise is in operating an online business selling mostly hard goods. How will they manage to turn around a niche food retailer with 430 stores? It's not a guaranteed slam dunk, and remember, this would be the biggest investment they've ever made.

Compared to other growth companies like Apple, Facebook and Google, Amazon is working on basic everyday issues like getting to your front door with something that is faster, newer and better. These are tough, costly problems to solve.

Right now, Amazon is already expensive. Integrating Whole Foods will come at a price. Value Line, a well-known independent stock research firm, expects Amazon to increase or decrease in price by 5% a year over the next three to five years. For a growth company, that's not much. It appears most of the good news is already in the stock.

For most individual investors, it's probably better to wait for Amazon to go on sale. In fact, Jeff Bezos, Amazon's CEO and founder, gave a valuable tip in his very first letter to shareholders, way back in 1997. He said he thinks long term, meaning five to seven years, not five to seven months.

This can be a challenge for investors, especially when it relates to what is supposed to be a growth company, with all of its inherent risks.

What's Right for You?

Big names like Amazon can be tempting. They're always in the news, and they've completely disrupted many industries. Time will tell whether they can do it again and increase an already high stock price.

Does a company like this, at this stage in its life, fit into your plan? That may depend on your timelines and appetite for risk. If you don't have a plan, or the one you have needs a refresh, call me and we can review it.

Do you know someone who should read this?

Some of my clients have mentioned that they've shared my newsletters with other family members, friends or colleagues. If you know someone who might benefit from this, why not pass it on?

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