AMAZON | WHOLE FOODS

A DARING STEP IN THE FOOD DEALS CRAZE – by Sylvia Blount

When you see more and more companies moving towards gaining significant tech footprint, you may wonder what is the logic behind Amazon (NasdaqGS:AMZN) acquiring Whole Foods (NasdaqGS:WFM) for almost $14 billion. After a closer look, this transaction seems more defensive and inspired by lack of good ideas rather than a true ‘concept’ merger.

Although, food related transactions come up like mushrooms every day, we start wondering whether Amazon is spreading in the right direction. What is interesting about acquiring Whole Foods? Certainly, when asked, commentators and analysts think of supply chain improvements and further access to organic and fresh products as major whys to this deal.

Amazon Go store in Seattle (WA), open only to Amazon employees.

So, after years of building an e-commerce empire, Amazon is now suddenly interested in brick-and-mortar retailing that, could improve operational efficiency and provide more product supply sources. All these motives appear to be exciting on paper, but could they really yield new revenues and costs synergies?

Hence, the real question is: Would Amazon be better off by acquiring this premium grocery chain, or by simply licensing its technology to retailers in order to create, let’s say, an empire of cashier-less stores? After all, it does not seem necessary to own a brick-and-mortar retailer to source the products that also happen to be perishable for the most part.

The answer might be found in the numbers.

Whole Foods store.

As survivor of the dot-com bubble, Amazon has been striving to demonstrate both good earnings and decent growth. Despite this effort, Amazon has not shown improvements while keeping relatively low profits and an almost insignificant earnings growth rate; which clearly cannot justify the Company's recent prices above the $1,000 threshold. Moreover, by simply looking at Amazon's P/E ratio of 187x (as of June 26th), we can imply that investors expect high growth, which translate into a CAGR of approximately 10% (assuming a WACC of 10%) and an earning margin of approximately 2%. Definitely some food for thought, considering that this growth rate seems *improbable* to materialize in the short run.

From a merger arbitrage standpoint, another aspect to consider is the current offer spread; today's Whole Food's price (June 26th) of $42.69 implies approximately -2% spread – given an offer price of $42 –, which represents an annualized return of -5%, counting on the deal closing by the end of this year. It is assumed that this merger could have been highly beneficial for Whole Foods' shareholders, with the $42 cash offer, however, at the current price per share all value added to the stockholders has evaporated.

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In other words, this creates a paradoxical situation where Whole Foods' shareholders should have no interest in accepting Amazon's offer because they could simply sell shares in the marketplace. Although, we are told that such premium reflects expectations for other bidders in the transaction, we find it to be highly improbable. If we look at the latest M&A activity in the food/delivery industry, even Walmart – which is currently considered as a possible new addition to the Amazon-Whole Foods contest – is moving in a completely different direction, by furthering its expansion in the e-commerce space with the recent acquisition of Bonobos (an online clothing store).

It is reassuring that Amazon is probably still looking at other acquisitions; in particular, the e-commerce giant could find in Grubhub (NYSE:GRUB) a very good match. Perhaps, a much better synergetic transaction compared to Whole Foods. In fact, Grubhub could give an incredible network of restaurants and active diners, bringing Amazon much closer to being the most dominant force in the delivery market. An Amazon-Grubhub deal could potentially make a lot more sense, since it would keep Amazon on speed with Walmart and others in the "all online" race.

What we know for sure is that Amazon is walking on a thin rope. A wrong acquisition could cost the company (and the entire market!) a very high price as we see the combination Amazon-Whole Foods as outdated and quite inconsistent with the general industry trend of digitalized shopping. So, if you own Whole Foods shares *sell* them now, hoping that this 'daring' merger is not a sign of living through a market bubble.

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