

Amazon Reinforces Importance of Brick-and-Mortar Presence, Leaps Into Grocery Business With Acquisition of Whole Foods

Amazon enters grocery business with \$13.7 billion purchase of Whole Foods. After testing a variety of concepts to enter the grocery store segment, Amazon recently announced an agreement to acquire Whole Foods Market for \$13.7 billion. The purchase gives the e-commerce giant instant access to the grocery store business, which accounts for consumer spending of more than \$636 billion per annum. More importantly, the purchase highlights the importance of omnichannel platforms, which incorporate a blend of brick-and-mortar establishments with an online footprint to drive traffic and sales. In addition, grocery stores are typically retail center anchors, underscoring the importance of strip and neighborhood centers in the retail landscape.

Growth of e-commerce highlights necessity of omnichannel strategies. E-commerce sales have increased by 148 percent over the past 10 years and now comprise 13.2 percent of core retail sales. This trend is shaking up traditional retail, causing stores that fail to offer unique services and an integrated online channel to falter. Stores offering unique positioning that blends online capabilities such as Domino's, Home Depot and Ulta have outperformed in this climate. Amazon's move into the brick-and-mortar space through pop-up stores in malls, physical bookstores and now through the acquisition of Whole Foods reinforces the importance of having both an online and real world presence.

Grocery sector has resisted e-commerce integration. While online sales have integrated successfully into a wide range of retail segments, Internet sales of groceries have notably lagged. Amazon, by way of its Whole Foods acquisition, is seeking an opportunity to establish a more meaningful brick-and-mortar presence in order to synergize its online presence with its ambitions for the broader retail landscape.

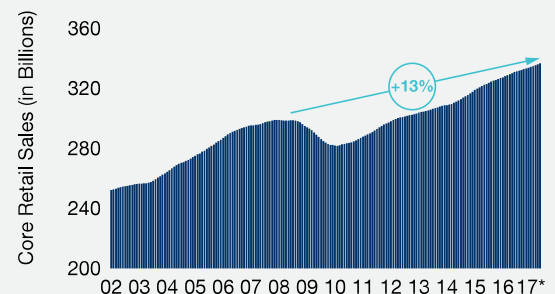
Grocery sector convergence with e-commerce likely to boost efficiency. As e-commerce becomes more intertwined with the grocery sector, greater efficiencies will emerge through the use of existing store space to fulfill online orders. Creating a hybrid model and a level of mutual dependency will open a new dimension of grocery store efficiency unknown to the sector to date. In addition, combining online convenience with brick-and-mortar experiences will provide a level of customer service that the Internet alone cannot create. As a result, retail changes moving forward will reinforce convergence, not a winner-take-all environment in the sector.

Amazon likely to drive innovation in brick-and-mortar segment. As a leader of e-commerce retail sales and distribution, Amazon will steer the sector toward innovation and a more integrated customer engagement model. As a result, the lines will blur on what constitutes traditional retail, further reinforcing the importance of brick-and-mortar spaces.

Key Observations

- **Omnichannel Retail Model Validated.** The Amazon purchase of Whole Foods reinforces the idea that retailers need both an online and real world presence. Amazon's entry into the grocery business will likely spark innovation and further convergence between online and traditional retail.
- **Retail Construction Remains Muted.** The measured approach to retail development, focusing on single-tenant and mixed-use multi-tenant spaces, has prompted significant vacancy declines in the sector. While headlines have focused on troubled mall tenants, retail center vacancy has reached a 16-year low.
- **Sales Activity Slows as Uncertainty Digested.** Rising uncertainty as numerous policy changes remain in flux has caused investors to assume a more cautious stance, even as operations remain robust. This has caused the pace of transactions to slow this year.
- **Pricing Edges Higher, While Cap Rates Remain Stable.** Despite a slowdown in transactions, pricing has moved higher over the course of the year. Additionally, cap rates have remained stable, providing a fertile environment for capital investment.

— Inflation Adjusted Core Retail Sales Steadily Advancing —



* Through May 2017; April 2017 dollars

Online Grocery Industry Gathering Traction

Consumers' preference for personally selecting fresh items has insulated the grocery business from intrusions by e-commerce, but the increasing consumer adoption of online shopping has started to shift the trend. Early entrants into this sector included pure-play e-commerce companies like WebVan. Although it generated modest success in dense urban markets such as San Francisco, adoption was limited. Traditional grocers including Safeway tried to leverage existing retail locations by adding online sales and delivery capabilities, but they have generated little traction. Peapod is trying to engage this sector and another entrant, Instacart, offers two-hour grocery delivery services. Walmart has also joined the fray, leveraging existing associates who will deliver items to online customers, while Midwestern grocery chain Meijer is also moving online. Amazon's move into the grocery business holds subtle differences from the competition. Amazon brings an e-commerce savvy customer base, a powerful Web portal, a penchant for innovation, a significant capital war chest, and a seasoned fulfillment and delivery system. It will blend these strengths with Whole Foods' 467 locations, existing supplier network and brand that is known for quality. Together, the unified offering has the potential to offer more than the sum of the parts, possibly reinventing the grocery business in the process.

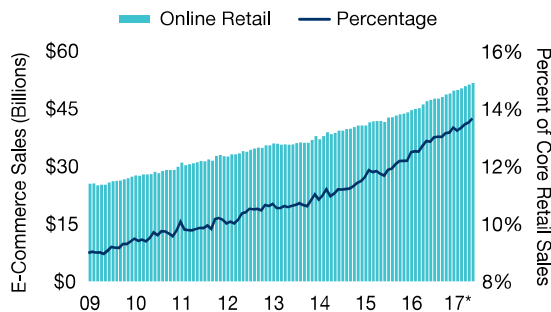
Rapid Grocery Expansion Heightens Competition

While Amazon's entry into the grocery business holds the prospect of an innovative model blending online retail with this stalwart segment, a range of grocery companies have committed to significant expansion. Publix is set to open 20 new stores this year, with Wegmans planning a similar expansion, primarily in East Coast suburban communities. Kroger plans to open 55 stores and Sprouts is scoping for 40 new locations nationwide. Adding to the mix, German grocer Aldi, which offers a no-frills, value experience, has announced a \$3.4 billion remodel of its existing storefronts together with a U.S. expansion that will add 900 new locations by 2022. Another German chain, Lidl has initiated an aggressive entry into the U.S., with plans for 100 East Coast locations by the middle of next year. Lidl's smaller 20,000-square-foot operations cater to value-minded customers.

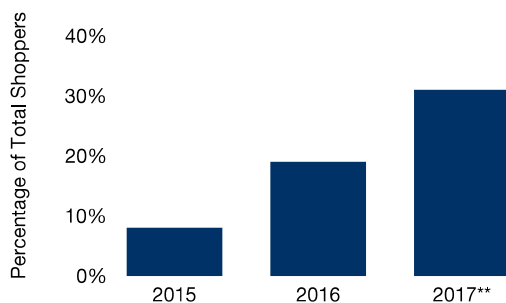
Expansions Strain Retail Space Availability

Significant grocery store expansion will strain retail space availability as vacancy rates now stand at 5.4 percent on a national level, the lowest in 16 years. Retail developers have been cautious in the postrecession era, adding an average of just 48 million square feet per year since 2010, roughly one-third the annual average from 2000-2008. Much of the construction in recent years has been pre-leased or net-leased properties, with little speculative additions. The noteworthy expansion by grocery chains, which typically anchor neighborhood and community centers, will likely outstrip available space and spark additional retail construction. The announced store openings by major grocers will absorb an estimated 25 million square feet, which could be difficult to source without additional development. As new grocery stores are built, in-line space will likely accompany it, pushing retail construction out of its currently flat trajectory and into a period of more aggressive development.

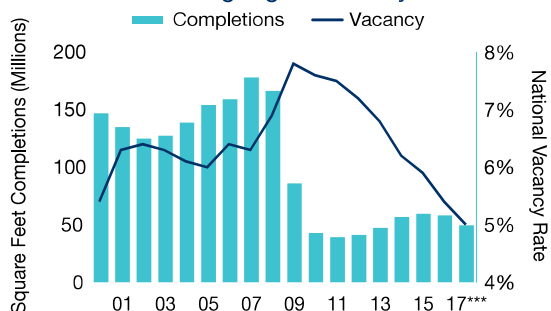
E-Commerce Remains Small Portion Of Overall Retail



Shoppers Likely To Buy Some Groceries Online



Minimal Retail Completions Driving Tight Vacancy



*Through May 2017

**Estimate

***Forecast

Whole Foods Purchase Provides Amazon Excellent Real Estate, Tech Testing Ground

Although Amazon has been testing a variety of concepts to enter the physical storefront sector, the purchase of Whole Foods Market puts the grocery sector directly in the firm's sights. In addition, the high-quality demographics surrounding Whole Food's existing footprint likely overlap heavily with Amazon Prime users, providing a built-in incentive for the combined firm to draw in more customers. While Amazon could have spent years opening a handful of locations, the acquisition turbocharges its efforts and provides a testing ground for frictionless shopping using a range of advancements including big data, machine learning and sensor technologies. The firm will likely expand the existing delivery service offered by Whole Foods by utilizing its extensive logistics operations to streamline service offerings and drive efficiency. Cross-selling opportunities across its many business lines are also likely within Whole Foods locations for Amazon products such as the Kindle, Echo, Fire and Prime-related benefits.

New Challenges Await Amazon and Whole Foods

While perception of the acquisition has generally been positive, aligning these businesses carries a variety of risk factors. Amazon needs to leverage the existing Whole Foods stores as distribution centers for a multitude of food products while retaining its existing customer base. Additionally, Whole Foods operates at a high-margin price point, yet Amazon has made lowering costs and margins a key factor of its success in gaining market share and consumer spending dollars. These strategic differences must be carefully integrated in order to realize the clear synergies between the brands. Amid pitched competition in the grocery sector, losing customers could be costly for both enterprises.

E-Grocery Evolution

2017	Shipt enters grocery delivery market with startup funds
2016	Amazon purchases Whole Foods Market
	Amazon begins grocery delivery as Amazon-Fresh
	Safeway and Albertsons begin home delivery
	Sprouts partners with Amazon to provide grocery delivery
2012	Instacart begins operations
	Postmates begins operations
2010	Von's begins delivery in certain locations
2002	Amid restructuring, Safeway ends home delivery
2001	WebVan closes
	Kozmo.com closes operations
2000	Safeway begins grocery delivery in select regions
1999	WebVan begins selling groceries online
1998	Kozmo.com begins one-hour delivery
1996	Peapod launches grocery delivery with partners

Major Grocers and Expansion Plans

Brand	Credit Rating	Store Size	Locations	2017 Expansion Plans
Kroger	BB	50,000	2,792	55
Albertsons/Safeway	D	50,000	2,324	5
Aldi	Private	15,000	1,608	900*
Publix	AA	50,000	1,146	20
Walmart Neighborhood Market	AA	42,000	698	30**
Whole Foods Market	B	40,000	467	18
Smart & Final	CC	17,000	308	15
Sprouts Farmers Market	B	27,000	261	41
Meijer	Private	225,000	225	7
Wegmans	Private	100,000	93	20
Lidl	Private	36,000	10	100***

*By 2022

**Estimate

***By mid-2018

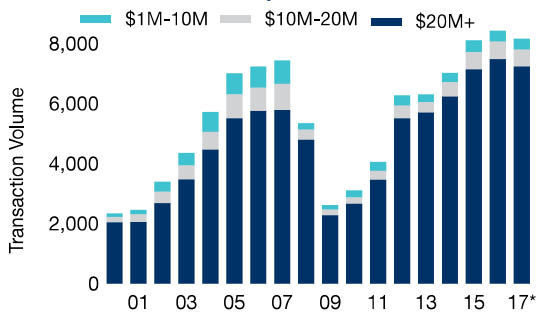
Uncertainty Weighs on Retail Transaction Activity; Sentiment Reflects Negative Headlines

Stemming from an uncertain political climate amid proposals in taxes, health-care and infrastructure, retail property transactions have slowed moderately through 2017 as investors maintain a cautious posture. Additionally, sentiment has been driven lower amid a continuous stream of headlines focused on the performance of department stores and mall-related apparel retailers, as well as increased e-commerce competition, resulting in waning confidence in the asset class as a whole. However, the impacts on the overall retail sector have been minimal to date, with sector performance remaining robust, driven by continued strength in the neighborhood and strip center segment.

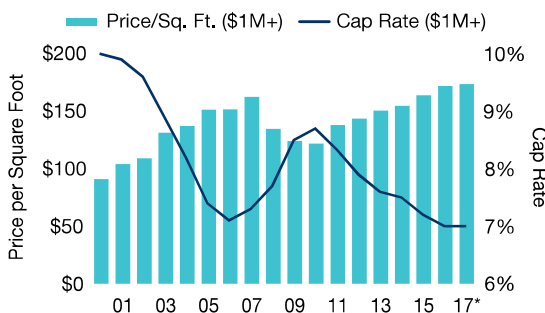
Prices Edge Higher; Interest Rates Remain Wild Card

While deal flow has eased from peak levels, prices have aligned with the robust operations and a tight vacancy rate. The national average price per square foot has risen to \$173 per square foot, up 6 percent from the last year. The slower pace of development has also boosted the market as merchant builders bring fewer assets to market than prior business cycles. The move up in prices has been accompanied by a moderate drop in cap rates to 7 percent, 20 basis points lower than last year. Interest rates have been a primary topic of discussion among investors, driven by the rapid rise in longer-term Treasury yields following the election. While interest rates have fallen back to pre-election levels, the volatility in the market has prompted a more cautious stance among investors. Additionally, the continued pace of Federal Reserve rate hikes and the prospect of the Fed shrinking its balance sheet have many anticipating upward movement in Treasury rates.

Multi-Tenant Retail Transactions Deals By Tranche



Multi-Tenant Retail Pricing Remains Stable



* Trailing 12 months through first quarter

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