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Investment Banking

How Online Grocery and Direct-to-Consumer Models Are Reshaping Food Retail

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Amazon-Whole Foods merger increases pressure on grocers and food wholesalers

Traditional grocers explore new models for serving shoppers

Food manufacturers seek opportunities to sell directly to consumers

Food for Thought



How Online Grocery and Direct-to-Consumer Models Are Reshaping Food Retail

As companies across the food retail ecosystem grapple with the challenges of e-commerce and changing consumer behavior, Amazon's acquisition of Whole Foods significantly increases the pressure on traditional grocers, wholesalers, and manufacturers to adapt.

For the past two decades, the nearly \$800 billion food retail industry, relative to other consumer industries, has been largely unaffected by online competition. The logistical challenges of delivering fresh food over the “last mile” and customers’ reluctance to trust online providers with the task of selecting produce, meat, and other perishable goods have meant that the shift toward online shopping has been relatively slow to materialize in the food industry.

In the past several years, however, the pace of change has accelerated as the industry entered a “third wave” of online grocery and meal-kit delivery and other direct-to-consumer models started gaining momentum. The rate of change reached an inflection point in June, when Amazon announced that it was acquiring Whole Foods Markets for \$13.7 billion. We examine how retailers, wholesalers, and manufacturers are responding to the evolving threats and opportunities that e-commerce is creating in the food retail industry.

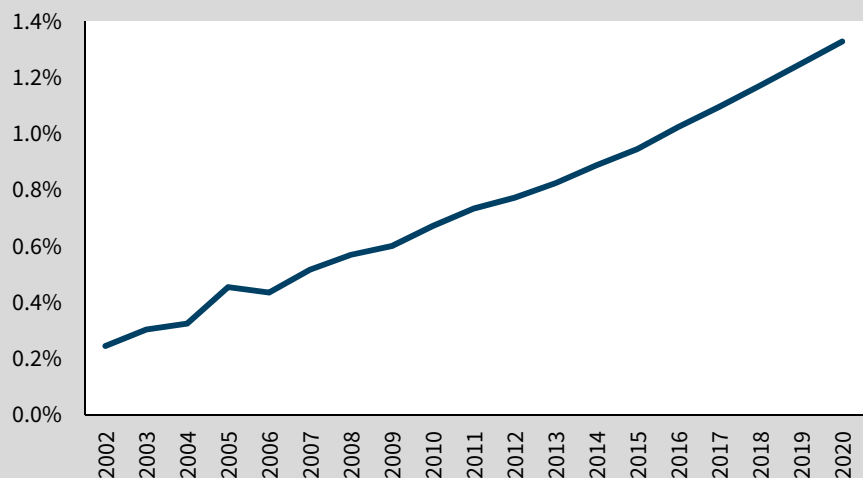
Consumers Sort Through New Models for Purchasing Food

The last several years have seen a proliferation of new ways for consumers to purchase food online and have it delivered to their homes. The first era of online grocery in the late-1990s was defined by companies, such as Peapod, that were vertically integrated and operated large distribution centers and fleets of delivery trucks. In the early to mid-2000s, the second era of online grocery saw traditional grocers looking to build out their own e-commerce capabilities. Now, we have entered a third wave of online grocery, one that is more accurately described as “outsourced grocery shopping.”

This approach involves leveraging the strengths of bricks-and-mortar grocery stores—namely the ability to manage the perishable nature of many goods and proximity to customers’ homes—all the while applying a third-party delivery model to it. Companies, such as Instacart, act as pure intermediaries and have partnerships with many grocery stores. Amazon Prime Now had used more of a hybrid model, supplying most of the non-perishable items in a shopper’s cart from Amazon’s distribution centers and then picking up the fresh goods from nearby best-in-class food retailers. But this approach is likely to change somewhat after Amazon’s

U.S. Online Penetration of Food and Drink Sales

Because of the challenges referenced in this article, online penetration of food and drink sales has been very measured. In 2002, U.S. food and drink online sales totaled \$1.4 billion (0.2% of the total market), according to Euromonitor. In 2016, online sales grew to \$8.4 billion (1.0% penetration). And by 2020, online sales are expected to reach \$11.5 billion (1.3% penetration).



Source: Euromonitor

acquisition of Whole Foods is complete.

Meanwhile, the meal-kit delivery industry, although still in its early stages, has begun to take hold. A few companies, such as Blue Apron, Plated, and Home Chef, have begun to gain scale, although Blue Apron's late-June IPO delivered disappointing results for investors, largely because of uncertainty created by the Amazon-Whole Foods merger. In the snack space, Naturebox and graze, which deliver healthy snacks directly to consumers' homes, have seen rapid growth.

The rise of online grocery and meal-kit delivery are forcing traditional bricks-and-mortar retailers to find new ways to stay relevant and make the shopping experience more convenient. For most shoppers, the biggest source of friction is the time it takes to purchase groceries. Retailers are looking to solve this problem in multiple ways, such as partnering with UberEats and Instacart, offering curbside pickup for orders placed online, and potentially partnering with or acquiring meal-kit delivery services.

Amazon-Whole Foods Merger Increases Pressure on Traditional Grocers

While Amazon's acquisition of Whole Foods has not fundamentally changed the trends that have been shaping food retail for years, this transaction has significantly increased the pressure on other retailers to address online strategies. With more than 450 stores, logistics expertise in handling fresh foods, and a strong reputation for providing high-quality, natural foods, Whole Foods helps Amazon address many of the "last mile" and trust challenges that, heretofore, have challenged Amazon's efforts to capture a larger share of a shopper's grocery cart.

It is important to note that Whole Foods serves a distinct, wealthier customer segment—one that correlates highly with Amazon Prime membership. Thus, if Amazon is going to reach the mass market with its grocery offerings, the company likely will need to make further acquisitions. Alternatively, the mass-market online grocery solution may come from traditional retailers, such as Wal-Mart or Kroger. Wal-Mart's 2016 acquisition of e-retailer Jet.com showed that Wal-Mart intends to directly challenge Amazon. Kroger, which has the largest U.S. footprint of any traditional grocer, can look to leverage its national store base.

Wholesale Distributors Adapt to Shifting Landscape

In addition to changing the competitive dynamic among food retailers, the Amazon-Whole Foods merger also has major implications for food wholesalers. These companies must think about how they can serve Amazon, which is more a competitor than a customer. For example, wholesaler United Natural Foods (UNFI) generates roughly 35% of its sales from Whole Foods. Post transaction, Amazon can supply Whole Foods with many of its non-perishable goods, so in a sense Amazon may simultaneously be UNFI's biggest competitor and its biggest customer.

It is also important to note that wholesalers and retailers employ merchandisers to decide what products retailers should put on the shelves. Amazon, however, relies primarily on data and analytics to make these decisions. So food wholesalers will need to rethink their approach to product selection when working with Amazon.

Direct-to-Consumer Models Create New Opportunities for Food Manufacturers

Consumer packaged goods (CPG) companies and other food manufacturers are exploring new models for reaching consumers and distributing their products. In the past, CPG companies have been hesitant to sell directly to consumers because of fears about impacting relationships with retailers. Now, however, the disintermediation concerns are being outweighed by the potential benefits of having a direct relationship with consumers and getting access to valuable information about their shopping behavior. Unilever's 2016 acquisition of Dollar Shave Club for \$1 billion shows how much CPG companies value the data and insights that direct-to-consumer models can generate. It is just a matter of time until these types of acquisitions begin occurring in the food industry.

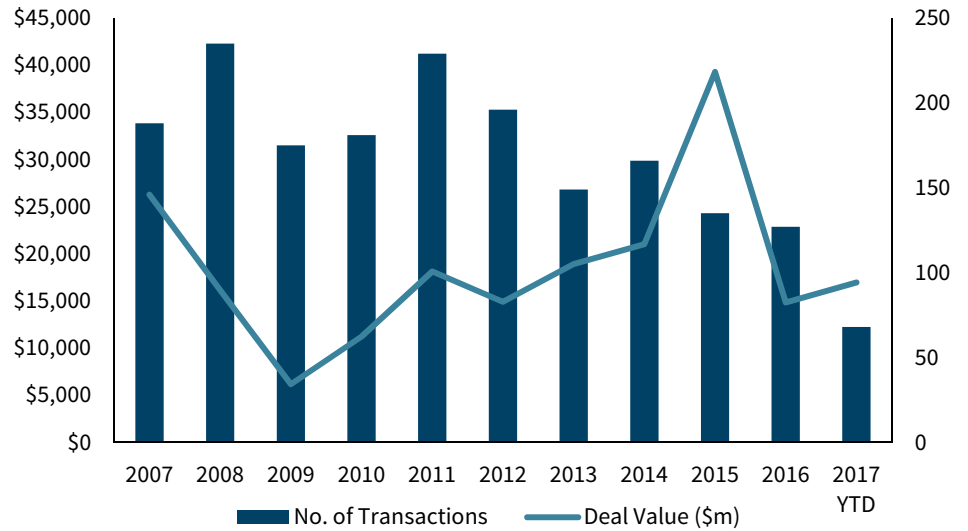
Across the entire food retail industry, the pace of change has accelerated over the past five years. While it will take time to displace the traditional retail model, strategic moves by both incumbents and upstarts will be closely watched and studied. We certainly believe the marriage of traditional food retailers and e-commerce models will accelerate, as will broader entry into the market by companies looking to solve the "last mile" challenge for fresh and perishable goods. Food distributors will need to become more aggressive in defending their positions and adapt to better serve a changing retail model that may likely include servicing smaller retail stores or a just-in-time focus from the consumer.

Market Analysis

We look behind the numbers to examine the market dynamics that are driving trends in the dealmaking landscape in the food and beverage industry.

Global M&A Activity – Food Retail

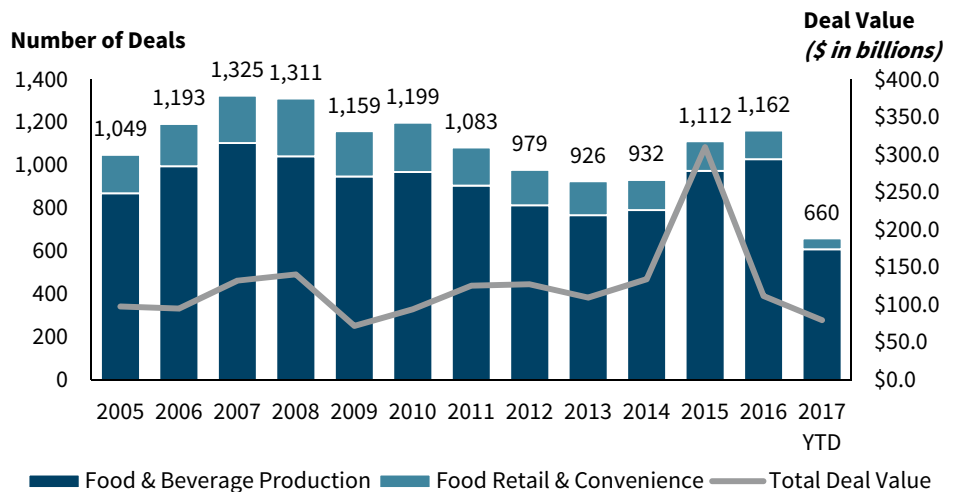
The pace of consolidation, in terms of the number of transactions, in the food retail industry has slowed considerably over the past seven years. Many traditional food retailers have reached necessary scale, and incremental acquisitions or mergers do not address current challenges for customer convenience that e-commerce can bring.



Source: Dealogic

Global M&A Activity – Food and Beverage Industry

Through the first six months of 2017, the food and beverage industry is on pace for the highest number of completed transactions since 2007. Amazon’s acquisition of Whole Foods should lead to an increase in food retail M&A as companies look to adapt to the shifting landscape.

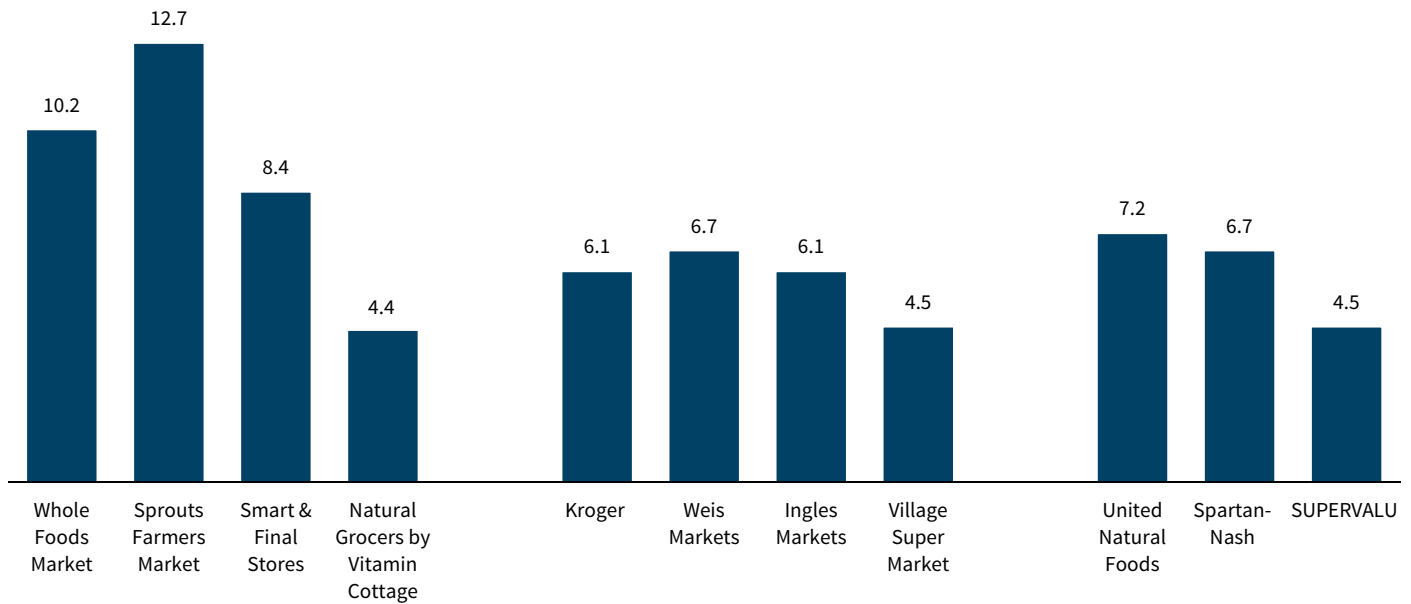


Source: Dealogic

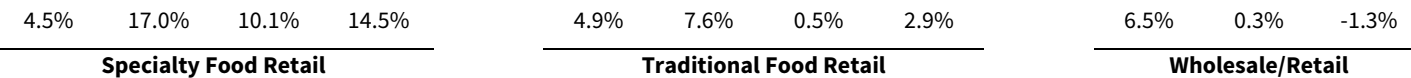
Publicly Traded Food Retail and Wholesale Valuations

Many factors are affecting the performance of publicly traded food retailers. As alternatives expand, however, and competition for the food retail dollar increases, market valuations will be highly correlated to sales trends for many of these retailers.

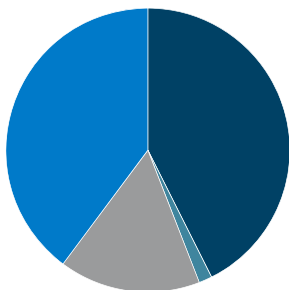
EV/LTM EBITDA Multiples



Historical 3-Yr. CAGR (Sales)



Source: Capital IQ and SEC filings



- Traditional Grocery - Supermarkets, Super Warehouses, Limited Assortment, and Small Grocery (42.6%)
- Traditional Grocery - Fresh Format (1.5%)
- Convenience Stores (16.1%)
- Non-Traditional Grocery - Wholesale Clubs, Supercenters, and Other (39.8%)


















Grocery Sales by Format - 2016

Despite serving an attractive, high-income segment, fresh format grocery stores, such as Whole Foods, represent a very small portion (1.5%) of the total grocery industry, according to Inmar Willard Bishop Analytics. An online grocery service for the mass market may likely come from a national retailer such as Wal-Mart or Kroger enhancing its e-commerce capabilities.

Source: Inmar Willard Bishop Analytics

Drawing on our deep sector expertise and the strength of our relationships, William Blair has built a leading food and beverage investment banking franchise. Business owners turn to us for outstanding execution for their M&A and capital-raising objectives.

Recent transactions include:

<p>Not Disclosed</p>  <p>has agreed to be acquired by</p>  <p>Pending</p>	<p>Not Disclosed</p>  <p>Split Lien Credit Facilities</p> <p>June 2017</p>	<p>Not Disclosed</p>  <p>has been acquired by</p>  <p>March 2017</p>
<p>\$125,000,000</p>  <p>has completed a recapitalization and minority investment in</p>  <p>January 2017</p>	<p>Not Disclosed</p>  <p>has been acquired by</p>  <p>November 2016</p>	<p>\$300,000,000</p>  <p>has been acquired by</p>  <p>September 2016</p>
<p>Not Disclosed</p>  <p>has been acquired by</p>  <p>August 2016</p>	<p>Not Disclosed</p>  <p>has been acquired by</p>  <p>August 2016</p>	<p>Not Disclosed</p>  <p>has been acquired by</p>  <p>June 2016</p>

**William Blair
By the Numbers**

300+

bankers globally with local cultural knowledge

2,000+

completed advisory and financing transactions

\$230+

billion in transaction value for our clients

Selected Upcoming Industry Events

September 2017

- 13-16 Natural Products Expo East, Baltimore, MD
- 14-16 All Things Organic – BioFach America, Baltimore, MD
- 25-26 IFE Americas Food & Beverage Show, Miami Beach, FL
- 26-28 Path to Purchase Expo, Rosemont, IL

October 2017

- 1-3 MUFSO Conference, Dallas, TX
- 7-10 National Frozen & Refrigerated Foods Convention, Orlando, FL
- 17-20 NACS Show, Chicago, IL
- 19-21 Produce Marketing Association Fresh Summit International Convention and Exposition, New Orleans, LA

November 2017

- 1-2 National Chicken Council – Annual Conference, Washington, DC
- 12-14 PLMA's Private Label Trade Show, Chicago, IL
- 14-15 Kosherfest, Secaucus, NJ
- 30-Dec 3 SOHO Expo, Kissimmee, FL

Access to Industry Leaders

William Blair is committed to providing the consumer and retail community with access to leading industry investors and corporations around the globe. To learn more about attending our upcoming conferences, please contact James Bertram at jbertram@williamblair.com.

Private Equity Conference – September 27-28, 2017, Chicago

One of the largest private equity conferences in North America, featuring presentations by 60+ privately held companies and attended by 300+ private equity investors.

William Blair Senior Investment Banking Team

Food and Beverage

James Bertram
Group Head, Consumer & Retail
+1 312 364 5426
jbertram@williamblair.com

Brent Smith
Head of Consumer & Retail M&A
+1 312 364 5392
bsmith@williamblair.com

Chu-An Lee
Director
+1 312 364 5216
clee@williamblair.com

John LeVert
Director
+1 312 364 5217
jlevert@williamblair.com

Food and Convenience Retail

Michael Siska
Managing Director
+1 312 364 5393
msiska@williamblair.com

Europe

Michael Collinson
Managing Director
+44 20 7868 4433
mcollinson@williamblair.com

Alexander Matthes
Managing Director
+49 69 509527 612
amatthes@williamblair.com

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William Blair’s investment banking group enables corporations, financial sponsors, and owner/entrepreneurs around the world to achieve their growth, liquidity, and financing objectives.

Drawing on the collective intellectual capital and deep sector expertise of a global team that reaches across more than 15 cities on four continents, the investment banking group brings a rigorous and innovative approach to corporate board advisory projects, mergers and acquisitions, and equity and debt financing. From 2012 to 2016, the team advised on more than \$230 billion in completed transaction volume.