

Whole Foods Is Becoming Amazon's Brick-and-Mortar Pricing Lab

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Summary. When Amazon bought Whole Foods, the online retail giant essentially bought a bricks-and-mortar retail laboratory. More precisely, it bought a network of 456 customer-friendly testing facilities which welcome roughly eight million...

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Speculation continues to percolate on the implications of Amazon's recently completed \$13.7-billion purchase of Whole Foods. Did Amazon buy the pioneering organic food and grocery chain to gain instant access to its brick-and-mortar stores in attractive neighborhoods? Do Jeff Bezos and his team want to exploit the vast cross-selling opportunities because of the presumed similarities between Amazon Prime members and Whole Foods customers? Is this an end-run around Walmart, who

until this deal looked set to dominate online grocery ordering? Is Amazon trying to capitalize on the growing trend of mail-order meal kits?

The answers to all of these questions are probably “yes.” But the most important implication of this acquisition lies buried under a barrage of headlines about cheaper avocados and stacks of Amazon Echo speakers in the aisles at Whole Foods stores.

Last month, Amazon bought a laboratory.

More precisely, it bought a network of 456 customer-friendly testing facilities which welcome roughly eight million “volunteers” each week. Amazon’s relentless price testing in the online world anchors its competitive advantage. Its unrivaled base of knowledge allows it to use price as a communications tool, a recruiting tool, a psychological weapon, and a value driver in ways that transcend the basic mechanics of supply and demand and profit and loss. Now Amazon can supplement that knowledge with direct, proprietary insights about the offline retail world.

The importance of price in Amazon’s strategy with Whole Foods extends far beyond the recent, simplistic “Hey, lower prices at Whole Foods!” headlines. What Amazon will now study in the brick-and-mortar world – and more importantly, what it learns and how it applies the insights – can transform consumer retail in the United States. By buying Whole Foods, Amazon gets virtually limitless possibilities to test products and services, test price points and assortment interactions, redefine the price perception for organic and healthier foods, merge offline and online shopping experiences, and perhaps test home delivery or store pickup with ideal early adopters.

I see Amazon's price strategy with Whole Foods, fueled by constant testing and experimentation, to evolve in three steps: changing price perception, growing the market for healthy foods, and then applying insights to other offline retail sectors and services.

Changing price perception

In the first week alone, the way which Amazon announced its price changes at shelf showed the sophistication it brings to such challenges. For many of their key value items, shoppers saw large, co-branded posters which announced the price change. The posters prominently featured the product name, the former (higher) price, the new (lower) price, and the message "more to come" at the bottom. Including both prices, as opposed to an "X% off" approach, reinforced the fact that many of the changes crossed key "whole dollar" thresholds. Avocados went from \$2.50 to \$1.99. Almond milk dropped from \$3.99 to \$2.99. Vine-ripe tomatoes were reduced from \$2.99 to \$1.99. While price research is not universally clear on the subject, the presumed power of undercutting these psychological thresholds is high.

This is an initial and basic step in altering price perception. The "more to come" is clever invitation for customers to remain on the lookout either for further price cuts or for cuts on other items. This step goes hand in hand with the media attention these price changes drew. That publicity is not an accidental by-product of Amazon's efforts.

The truth is that Amazon loves to talk about price and never misses an opportunity to initiate or participate in a discussion about it. Its own corporate statements and filings reflect this, summed up most succinctly in the statement: "We believe that offering low prices to our customers is fundamental to our future success." In its last 10-K filing, Amazon stressed low prices as a source of competitive advantage and only rarely cited it as a risk factor. Half of those latter references, in fact, mentioned the risk

as regulatory constraints which may affect Amazon's ability to continue to offer low prices. Compare that to Whole Foods, whose latest 10-K filing makes far fewer references to price, and cites low prices not only as a clear risk factor, but also one which contributed to its recent declines in operating income and net income.

Amazon must change that price perception in the stores, in the media, and internally. In simplest terms, when people search online for "Whole Foods" and "price" in the future, they should see no traces anymore of the "Whole Paycheck" reputation or negative articles about asparagus water for \$6. What better way to do that than overwhelm the bad news with huge splashes about price cuts and the promise of more to come?

Amazon's work and its testing is only beginning, though. In the online world, Amazon has succeeded in establishing a low-price reputation and becoming a default search destination for thousands of products, *without* actually offering the lowest prices. My colleagues in the London office of Simon-Kucher & Partners tested that hypothesis a few years ago by examining book prices. They found very interesting results. For the 100 top selling products, the so-called key value items (KVI) Amazon had lower prices than other retailers. But for the rest of the assortment, Amazon had higher prices in the majority of cases.

How far does Amazon need to go in cutting prices at Whole Foods? The challenge is to understand precisely how far to cut, on how many items, and in which stores, in order to change price perception favorably and achieve Amazon's twin objectives of more traffic (eg, more transactions) and bigger baskets. Owning the Whole Foods "laboratory" turns this question from an intriguing theoretical one into a solvable problem with a lucrative answer.

But an important caveat here is cost. We must assume that low costs – both in purchasing and in operations – are not the biggest strengths of Whole Foods. Amazon may successfully implement some of its outstanding process and logistics know-how, but the cost side is still liable to limit pricing latitude. Even if “Amazon doesn’t need to make money on groceries” as *The Wall Street Journal* wrote (a tenet which I do not accept), it still cannot afford to lose money on groceries permanently.

Growing the market for healthy foods

Amazon’s quest to change the perception of Whole Foods’ prices are closely tied with what should be their larger goal: growing the market for Whole Foods’ products. There is a difference between being the largest natural and organic foods supermarket in the United States (which Whole Foods already is) and one which will define, grow, and control the category over the long term. To reach that position and assume that role, Amazon must not only change the price perception of Whole Foods, but the entire category itself.

Mission-driven companies like Whole Foods often work under the belief that their core audience is finite and their ability to expand it through advocacy and evangelization has practical limitations. Where are these audience limits for fresh, natural, organic products? Answering this question is critical for Amazon’s success, and now it has the ability to test, recalibrate, and test again.

Price perception plays a key role here. The general perception is that organic foods tend to be considerably more expensive than food without that designation. The reality is that price premiums show wide variation, with organic foods even cheaper in some cases. A 2015 [study](#) by *Consumer Reports* showed price differentials for organic foods ranging from -13% to +303%. A [study](#) in 2010 by the US Department of Agriculture (USDA)

showed price premiums ranging from 7% to 82% for organic foods.

What changes – and of what magnitude – are needed to change the public perception of the category? This is a complex, time-consuming experiment which Amazon has apparently already launched. Getting the right calibration will allow Amazon to preserve loyalty among current Whole Foods shoppers and transform occasional ones into committed ones. But it can also lure in customers who have yet to sample the category itself, perhaps turned off by price gaps at their customary food and grocery stores.

The caveat here is what I call the “Gestalt” nature of Whole Foods. Whole Foods is a holistic shopping experience, not just a pricing game. Organic food – the way food, fruits, produce are produced and presented – resonates with a certain group of usually well-to-do, health conscious shoppers. Will this holistic positioning be affected by more aggressive pricing? A telling case – actually in the opposite direction – is J. C. Penney. When Ron Johnson was announced as the new CEO, the share price of J.C. Penney went up by 50%. Ron Johnson created and ran the hugely successful Apple Stores. He applied the same trading-up strategy to J. C. Penney, half of whose sales traditionally were price promotions. Johnson discontinued this practice and introduced upscale products. When Johnson took over in 2012 the share price achieved a maximum of \$42.44. Today it stands at \$3.99. Johnson was fired. The lesson of this case: a radical repositioning of a store is a risky undertaking. This applies both to trading down and to trading up.

Another risk to Amazon’s apparent strategy with Whole Foods is presented by German hard discounters Aldi and Lidl. Both are ramping up investments in the United States. Shoppers in Europe already know the transformative effect their growth can have. To say that these retailers win because of low prices undersells their capabilities. Aldi and Lidl are highly refined and integrated

systems whose purchasing power, logistical expertise, labor costs, and other operating costs confer advantages which few traditional retailers have any can hope to compete against for any length of time. But of course, Amazon is far from a traditional retailer.

It is tempting to conclude by saying Amazon has begun a bold experiment. But “bold” is not accurate. The acquisition of Whole Foods by Amazon is a rational, calculated move which gives Amazon full control over a retail test environment which is focused, filled with passionate and dedicated customers, and at the same time large enough to provide Amazon with insights it can cash in on in other retail sectors, now and especially over the long term. The real value of this deal for Amazon may not be in growing Whole Foods’ customer base, or even one day dominating the grocery category, but in what they *learn* from doing so.

Hermann Simon is the author of the newly published *Confessions of the Pricing Man*. He is the founder and chairman of the consulting firm [Simon-Kucher & Partners](#).



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