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Capital Management

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Checkout Amazon
July 2017

Now that Amazon (ticker AMZN) has announced its decision to acquire Whole Foods for nearly $14 billion, analysts in nearly every sector are abuzz with the ramifications. Will Amazon crush the grocery stores, just like it has dominated other categories like electronics, apparel, shoes, pet food, office supplies, etc.? Will it strengthen its distribution hubs to further develop its online grocery-delivery abilities? Maybe it will build inventory of its Kindle e-readers, Echo speakers and other gadgets in its new 5.6 million square feet of gross space for easier regional shipping?

We believe this deal is primarily about the data. In our opinion, having 460 brick-and-mortar grocery stores will provide Amazon with a tremendous amount of data, which it will ultimately leverage into additional spending by its 70 million loyal Prime consumers. Morgan Stanley estimates that over 60% of Whole Foods shoppers are members of Amazon's Prime service. This tie-in is just the beginning of the treasure awaiting Amazon.

Will Amazon pull an Uber?

One of the great things about Uber is the simplicity of its transactions. As part of your Uber account setup, you link a traditional payment choice, whether that is a credit or debit card. Through the Uber app, you order your ride; and once you reach your destination, payment is handled and processed inside of the Uber app because you have already put your desired card "on file." All you have left to do is just say: "Thanks." This is valuable real estate for the card platform, because you are unlikely to change your payment choice after initially setting up an account. The ease of use and simplicity of the transaction has built Uber into a private company now valued at $70 billion (despite its recent public relations issues).

Most people do not realize, but Amazon entered the food business a decade ago. Its concept store, called *Amazon Go,* opened for employees last December. The truly interesting aspect of this project is the availability of its *Amazon Go* app. As many are aware, at Amazon's 5 physical bookstores, consumers can use their mobile phones to access book reviews and pay for goods, similar to the way consumers can use their Uber app. How Amazon will continue to take advantage of its "No Lines. No Checkout." service will be exciting to watch.

Checkout:

Quite possibly the most annoying aspect of grocery shopping (besides the music and parking) is the checkout process. After you finish up shopping, you then have to determine what lines are open and guess which one will have the shortest wait time. Do you qualify (within the acceptable dozen items) for the 10-and-under line? Which cashier seems to be scanning and checking people out the quickest? How can you avoid getting behind the one individual who still pays with a paper check?

Over the last decade, self-checkout lanes at Target, Wal-Mart, Home Depot and Lowe's have been a nice technological improvement from the traditional cashier experience. Self-checkout can speed up the process for the consumer, but its biggest benefit is to the retailer, who can employ fewer human cashiers and pay less in salaries. This advancement is fine, but it is really just the first step in improving the shopping experience.

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We liken this self-checkout upgrade to the change taxis made by putting card-payment devices in their vehicles – a positive, first step. Uber then built a better mousetrap, by embedding the payment process into their app. Amazon has a similar type of opportunity. Will it simplify and streamline the process? If it is successful, Amazon can bring extraordinary change not only to grocery stores, but also—and more significantly—to the entire retail landscape.

Amazon's Twist:

In its Seattle grocery test store, Amazon has been testing an interesting checkout experience for its consumers. Some are calling it a "radical re-definition" of the in-store payment process, but we believe it should have more impact on boosting sales than altering our current way of transacting. When a consumer enters the Seattle store, he/she scans their *Amazon Go* app with a QR (Quick Response) code. This identifies the person to Amazon and immediately qualifies that individual to transact. As the consumer puts goods into a basket, each product and its corresponding price are identified. This real-time, digital system provides Amazon with information about *who* entered the store and in what they are interested. Why does this matter? Well, Amazon can run data analytics on that individual and offer him/her more buying opportunities. If Amazon knows that the consumer has a newborn at home, why not market a BOGO (Buy One, Get One) for organic baby food or advertise a special deal on all-natural diapers? If Amazon knows that the consumer just put a great Pinot Noir in the cart, why not offer a lovely French cheese to pair it with? The technology can also remember that the consumer last purchased dairy a week ago, making that shopper due for another gallon of super premium, organic, lactose-free almond milk. Couponing becomes more efficient too. Instead of carrying paper coupons, consumers can have their app load and store digital coupons for easy and accurate usage. No more thumbing through a tangle of expired coupons.

With no lines to worry about and no need to pretend to ignore the National Enquirer headlines about what the Kardashians have been up to, the consumer can simply have goods bagged (in paper, plastic or organic hemp) and taken to the car. Add the behind-the-scenes marketing Amazon is sure to conduct, and the consumer will most likely increase spending. The key: Most retailers only know a consumer has entered a store during or after checkout. In our opinion…this is often too late. There is a tremendous amount of opportunity for Amazon to leverage by knowing who is in a store *before* the checkout is complete. The technology and data mining of a system like Amazon's has existed for some time, but retailers have yet to truly unleash this capability on buyers. We believe payment apps are the "Trojan horse."

More Questions than Answers:

The two largest components of our portfolio are the payments business and data & information companies. We have written numerous articles on the complex payment process (click here), the opportunity in mobile payments (click here), as well as the declining use of cash (click here). Following the Whole Foods transaction, certain payment players declined in price, confirming that at this point in time, there are more questions than answers.

Visa and MasterCard rules currently allow only banks to provide services for cards bearing their brands, which include the processing of payment transactions as an "acquirer." Will Amazon launch its own credit card? Until it becomes a chartered financial institution (maybe that is the next target or acquisition), Amazon cannot submit card payment authorization or settlement requests directly to those card networks. Because being a bank involves significant capital requirements with stringent restrictions, we would not anticipate Amazon picking this route. Will it just co-brand its name and partner with another financial entity? Will it build a strong loyalty program to enhance usage? As these decisions unfold, we believe the existing payment model will continue to benefit our investors. Many of our holdings are perfectly positioned to capture these transactions.

Payments:

Back to the Whole Foods acquisition, Amazon might ultimately decide to consolidate its payment platforms. It makes sense to leverage scale benefits and advantages by migrating all of its card payments to one processor. Currently, JP Morgan's Paymentech (ticker JPM) handles Amazon's transactions, while Whole Foods uses Vantiv (ticker VNTV). As more of a hybrid rather than a normal merchant, Amazon operates similar to PayPal (ticker PYPL) and Apple (ticker AAPL), in terms of what it is permitted to aggregate. Instead of simply handing off or outsourcing the payment transaction to an acquirer or processor, Amazon acts as a pseudo "Payment Facilitator." Under current card network rules, Amazon is allowed to process transactions on behalf of its "sponsored merchants." To simplify a complicated process, this means that Amazon is using a traditional

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acquirer to do the bulk of the heavy lifting or payment processing. Amazon cannot sidestep the issuing brands like Visa (ticker V), MasterCard (ticker MA) and Amex (ticker AXP), but it can be an interesting partner/significant other/player/participant. In our thinking, this is no different than what PayPal and Square (ticker SQ) have already accomplished and what Apple Pay is attempting.

Amazon will get payment advantages on costs to transact, but this is dwarfed by the potential to boost its sales. The data Amazon will be able to mine will significantly exceed any lowering of its payment acceptance costs. Just like the Uber transaction ties back to a Visa, MasterCard or American Express card, *Amazon Go* transactions will ride on top of the rails of traditional card payment. In the new Amazon checkout process, the traditional payment players (primarily the networks) still capture the transaction. That $150 transaction at Whole Foods ultimately will appear on your Bank of America, Wells Fargo or other credit card. Because *Amazon Go* transactions will likely be linked to a credit card, as opposed to the less profitable debit card that currently prevails at grocery store checkouts, payment players will benefit from juicier economics (i.e. more profit).

The Bigger Picture:

Amazon will receive scale advantages by migrating to one payment processor, but this is benefit #10, not priority #1. Even if Amazon moves all of its processing to JP Morgan's Paymentech, it really doesn't merit a ~ 5% decline in Vantiv's share price. We think this 2nd derivative impact misses the bigger point. Amazon now has the footprint of 460 physical stores and a plethora of information to experiment with. Revenue-boosting marketing initiatives and programs will be tested. Some will work; some won't. Amazon will ultimately tailor its offering to best suit the needs of its customers, a result that starts with its mobile payment app. We expect Amazon's loyal Prime customers to quickly download the app and anticipate Whole Foods to be only the beginning of its usage.

There will likely only be a few important apps that consumers will allow into their mobile wallets. We believe Starbucks has already placed a stake on its customers' phones, evidenced by caffeine junkies making 29% of their total transactions through the Starbucks mobile app. PayPal is attempting to migrate from online retail success to the physical world of interactions. Venmo is PayPal's free app to increase person-to-person payments. Visa and MasterCard both have excellent offerings attempting to provide modern-day versions of that static piece of plastic currently in your leather wallet. Both Apple Pay and Samsung Pay are in the early innings of getting their dedicated phone users to substitute mobile payments for traditional payments. With better merchant acceptance, this will work. We believe Wal-Mart and Target also can succeed, but they need to join the fight. Lastly, we believe *Amazon Go* will garner a valuable spot on your phone, becoming truly omni-channel by marrying Amazon's online dominance to its entry into the physical landscape through Whole Foods.

Conclusion:

Amazon's new checkout process will streamline a decades-old system, allowing consumers to better enjoy their shopping experiences. But we believe the ultimate benefit will be to Amazon's data mining endeavors and its ability to boost sales. For many of the payment companies we own, the behind-the-scenes payment process and economics stay the same, for now. Ultimately, we believe these payment players will benefit from this Amazon transaction. As an early adopter, we plan on being one of the first to test Amazon's one-click payment flow of the future – *Amazon Go*.

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