

Introduction

Amazon is the world's leading e-commerce platform, with over US\$130bn of B2C sales across various product categories. Amazon is speculated to enter the Australian market in some capacity in the foreseeable future, which will be a major threat to the retail landscape in Australia as it seeks to own the consumption pattern of the household via the introduction of **Alexa** (a cloud based service, marketed as an intelligent personal assistant, capable of voice interaction, music playback, making to-do lists, setting alarms, streaming podcasts, playing audiobooks, and providing weather, traffic, and other real time information) and change the way goods are delivered to the family home.

Amazon's Echo. Hands-free speaker that delivers Alexa to your home



Amazon seeks to control the market and uses price as a weapon along with superior fulfillment. To ensure JCP's portfolios are appropriately positioned for such a scenario, JCP commissioned a proprietary investigation to be conducted by L.E.K (a multi-national management consulting firm) to develop a view of Amazon's most probable approach to the Australian market and the likely impact on the Australian retail sector.

The project was focused on using proprietary insights harboured from over 50 expert interviews across property, retail, eCommerce, digital, logistics/supply chain, media & marketing and tax, both domestically and off-shore. These interviews were supplemented with a proprietary consumer survey with over 2000 respondents. In addition, several secondary sources (press and media, institutions, industry bodies and government) were engaged to further consolidate the project findings.

The primary objectives of the project were to establish:

- **Whether a physical entry by Amazon into Australia is inevitable;**
- **How it would most likely be structured; and**
- **The probable consequences for the Australian retail sector.**

In their home market of the United States, Amazon has built a powerful B2C platform with tight control of customer experience, continuous innovation and great breadth. Amazon is so powerful that circa 80% of shoppers start their shopping journey in the Amazon search bar, rather than using Google.

Current Australian revenues are estimated to be between \$500 - \$700m p.a., with ~12 million visits to the site per week, with media and electronics being the leading categories. Total Australian retail ecommerce sales are currently around \$20bn p.a., implying Amazon has ~3-4% share. However, the review and product information authority Amazon has in the Australian market infers they have a much broader reach to the Australian consumer than their sales suggest.

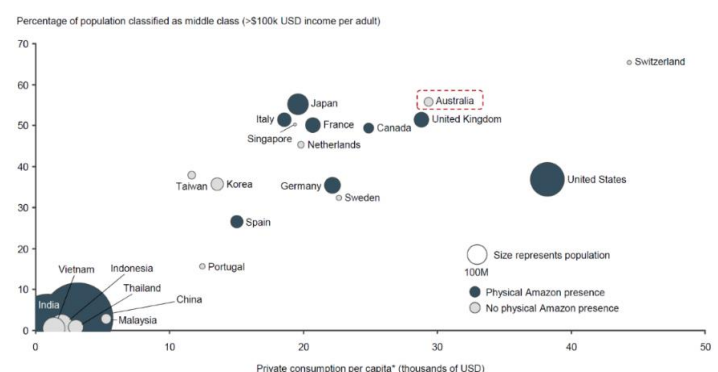
Should Amazon launch a more formal presence in Australia, potentially with Amazon Prime (access to streaming video, music, e-books, free shipping and a variety of other Amazon-specific services and deals) as its spearhead, it is expected to have material disruptive consequences for local Australian retailers. The specific impacts would depend on the category and supply chain strategy that Amazon chose to pursue, as well as the structure of any Australian Amazon Prime offering.

Key learnings:

1. Australia is an attractive market for Amazon:

- Australia is among the largest wealthy western markets not yet entered by Amazon in a meaningful way.
- Australia has a high proportion of middle class and high private consumption, with relatively limited ecommerce competition and low online sales penetration (~12% versus 40% in the US and 29% in the UK for online penetration in the electronics and appliances category, with Amazon having 65% share of the category in the US).
- The population is concentrated into five main city centres (65% of Australia's population is located in the top 5 cities), with wealth concentrated into an even smaller number of postcodes.
- Prices in Australia remain higher than in other developed countries (higher labour and freight costs are partly to blame) and Australian consumers are early adopters of technology.
- eBay is currently the strongest player in the ecommerce landscape, and does not offer a compelling fulfillment / delivery proposition.

Wealth Demographics, key countries (2016)

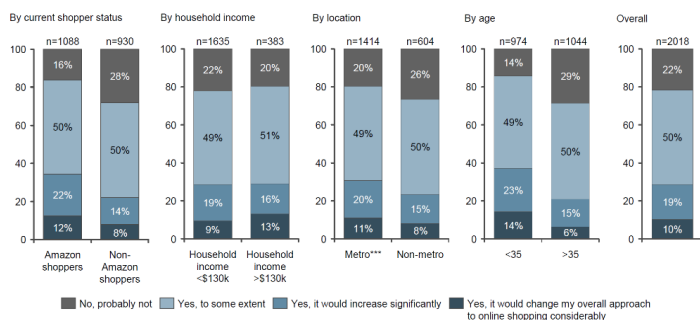


Source: LEK

2. There is latent consumer demand for Amazon in Australia:

- Amazon is the second most popular B2C online retailer in Australia with 55% of respondents to our proprietary survey having purchased from the site at some point in time. 15% of respondents have made **several** purchases from the website within the past year and an additional 23% once or twice within the past 12 months.
- Approximately 30% of the proprietary consumer survey respondents indicated that if Amazon developed a meaningful Australian retail presence, they would either increase their online spending significantly or would change their overall approach to online shopping considerably. Another 50% of respondents indicated they would change their shopping habits to some extent. This was particularly evident in younger respondents and metro respondents, with household income not a material determinant.
- Unsurprisingly, books and media are the most popular categories, however this is likely due to prohibitive delivery costs at present.
- 83% of online shoppers surveyed believe Australians pay too much for global branded products.
- If priced correctly, 49% of respondents indicated they would be interested in subscribing to an Amazon Prime standard offer, with 15% indicating they would be 'extremely interested'.

Self-predicted increase in spending, if Amazon developed a meaningful Australian retail presence



Source: LEK

3. Amazon likely to implement a 3-step entry with a soft launch in late 2017:

- Several expert interviews revealed that the removal of the GST exemption in July 2017 may act as a catalyst for Amazon's entry into Australia (at that point there is no longer an advantage to not having a physical presence).
- **Step 1:** Soft launch from Singapore (Technology friendly, good talent pool and a good hub to enter South East Asia and Australia) in 2017. Singapore to act as a virtual distribution centre, with a combination of goods stored and goods that are flown overnight from Singapore.
- **Step 2:** Single Distribution Centre (DC) in Australia by mid-late 2018, without a Prime offer, but improved shipping terms (within 1 year of entry).

- **Step 3:** 2-3 DCs by mid-late 2019, supporting a national Prime subscription offer (within 2 years of entry).
- Amazon to initially use third party logistics providers for last mile delivery and evolve to control fulfillment through Amazon owned fleet over time.

4. Initial Amazon impact to be concentrated in a few key segments:

- The proprietary consumer survey revealed respondents were most likely to increase spend online in movies, music & games; electronics & computers; and toys, kids & baby.
- Not surprisingly, we expect Amazon is likely to take a material share of electronics, toys, media and sports in its first few years. In addition, we believe they will provide a very strong mother and baby offering, likely to impact the supermarket channel.
- Key attributes susceptible to an Amazon entry are: reliance on branded goods; focus on price leadership; lack of loyalty program; substandard customer experience; and poor financial health at the time of entry.

Specific company exposures:

- **JB Hi-Fi** is expected to be impacted the most due to its vulnerability across category (specifically consumer electronics and small branded products which are easy to ship and the largest contributor to margin), customer experience and a sub-standard loyalty program. It will need to invest in improved online presence, fulfillment, customer service and returns to compete. We estimate an Amazon entry would result in a 15% reduction in revenue and 2% reduction in Gross Profit Margin for JB Hi-Fi over 3 years.
- **Harvey Norman** is expected to be more resilient due to category diversification (e.g. furniture and bedding) and its position as the channel of choice for high-end brands bringing new products to market. We estimate an Amazon entry would result in a 10% reduction in revenue and 1% reduction in Gross Profit Margin for owned stores over 5 years.
- **Discount Department Stores** are likely to be less vulnerable, with Big W the most at risk. JCP's base case expectation is that Big W will confront difficulties developing a point of differentiation or relevance with the consumer and while we recognise there may be some businesses that may endure over the medium term (e.g. Kmart), we see the sector remaining under pressure in the presence of an Amazon threat.
- **Auto-retailers; Super Retail Group and Bapcor (who operate over 133 Auto Parts stores across Australia)** will be significantly disrupted as Amazon has had good success extending its reach into the auto market in the United States.
- **Coles and Woolworths** are initially most susceptible in the mother and baby categories, as well as dry grocery. We expect Amazon to have a compelling fresh offering within 12 months of entry (FY18) and model the super market channel losing 5% of sales and 1% of Gross Profit Margin over 10 years. This excludes the impact

JCP Investment Partners – Investing in Practice

Amazon Entry to Australia – Welcome to the Jungle

April 2017

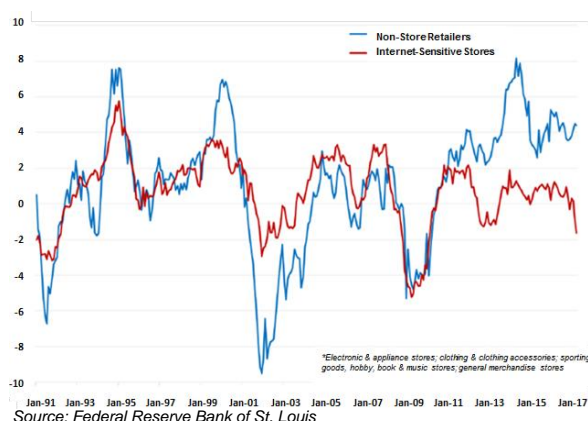
of continued growth from the discounters, with Aldi alone forecast to gain 4% share during this time.

- **Industrial properties developers such as Goodman Group** will benefit as new distributions will be built at the expense of retail malls (VCX and SCG).

Portfolio Positioning:

- While we continue to avoid the discretionary retail space due to a lack of income growth, an overheated property market and elevated levels of household debt, our belief that Amazon's entry is imminent means we have increased our short exposure in JB Hi-Fi (now -1.25%) and maintained our short position in Harvey Norman (-2.00%).
- Similarly, we continue to dislike Super Retail Group due to its regional exposures to a slowing consumer, inflexibility around inhibitive lease obligations given a new store based growth model and the susceptibility of their sports category upon arrival of Amazon. As such, we have increased our short exposure to -2.50%. We have also initiated a new short position in Bapcor (-1.00%).
- We remain short/underweight the retail malls in Australia given our expectation that declining sales from speciality stores, impacted by Amazon, will limit the retail REITs' pricing power to increase rents. As illustrated in the chart below, US retail employment in internet sensitive sector stores has fallen substantially in recent years, whilst employment at non-store retailers has improved. With 10.1% of total employment in Australia (ABS Feb 2017) comprised in retail trade, the introduction of Amazon to Australia is expected to place further strain on the retail sector, with total employment in the retail sector already down 4.5% since the peak in late 2015.

US Employment in the Retail Sector [% change yoy]



- We believe the timing of Amazon's Fresh offer is earlier than the market appreciates and are acutely aware of the 'sticker shock' likely to occur upon the announcement of an Amazon entry into the Australian market. As a result, we have taken the opportunity of recent share price strength to trim our over-weight position in Woolworths, with a view to buying should markets overreact to the downside upon an Amazon entry.

Conclusion:

Following completion of our proprietary investigation into Amazon, which involved speaking to over 50 global experts across varying industry sectors, as well as conducting a consumer survey of over 2000 respondents, JCP is of the firm belief that Amazon will enter the Australian market, with a soft launch expected pre-Christmas 2017.

We believe Amazon can rapidly build market share through aggressive pricing in categories it perceives to be over-priced in Australia (initially electronics, media and sports), which would be amplified following establishment of a local distribution and logistics operation.

JB Hi-Fi is clearly the most vulnerable, closely followed by Super Retail Group, Bapcor and the Discount Department Stores. Supermarket chains are at lower risk initially. However, it is our firm belief that while the financial impact on some retailers may occur in the medium term, the immediate share price reaction could be significant upon announcement of an Amazon entry. This creates a short opportunity at present and a buying opportunity should markets overreact.

We remain underweight/short JB Hi-Fi, Harvey Norman and Super Retail Group and have reduced our long position in Woolworths during the recent share price strength and will look to add to Woolworths if it is oversold on the Amazon threat. We remain underweight retail malls in Australia and have exposure to industrial property via Goodman Group in some portfolios.

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