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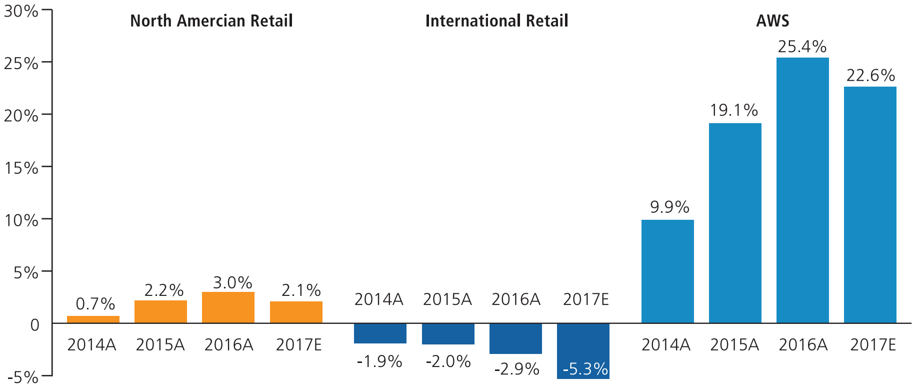
AMAZON: IS RETAIL PROPERTY IN TROUBLE?

There has been a barrage from the media about Amazon's pending 'devastation' of the Australian retail sector over the past 12 months. In this article we review Amazon's business strategy for other global markets, the potential impact of Amazon's entry on Australia, and outline which types of Retail property we believe will be more resilient to Amazon's impact.

Amazon Overview

While Amazon is large and well known throughout the world, it may not be widely known that Amazon's retail platform is not very profitable. Having failed to turn a profit for many years, Amazon is now marginally profitable, with the retail platform being propped up by Amazon Web Services (AWS). AWS operates across a wide range of products including Amazon's 'cloud' service. It generates the majority of Amazon's operating profit, but only comprises 10% of Amazon's revenue. Figure 1 illustrates the respective operating margins of Amazon's business segments; North American Retail, International Retail and AWS, demonstrating how AWS is sustaining the overall business.

Figure 1: Amazon's Business Segment Operating Margins

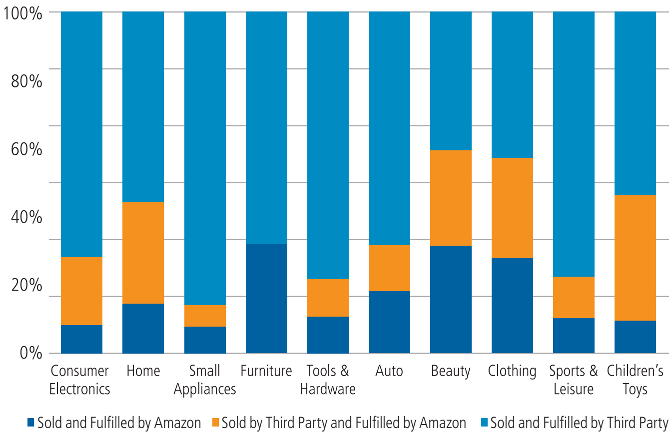


Source: Credit Suisse

Amazon's main products/services include:

- Amazon Web Services (AWS): AWS operates across a wide range of products including Amazon's 'cloud' service;
- Amazon's 'own' Retail Platform ('1P'): For product lines that are carried, sold and delivered by Amazon. This only makes up 1% of the 300 million products sold on Amazon's site.
- Amazon Market Place ('3P'): A 3rd Party Seller Platform which accounts for 99% of the items sold on Amazon. 10% of products sold on Market Place are then delivered by Amazon, with the remainder distributed by the 3rd party retailers. The breakdown of sales for each retail category is illustrated in Figure 2.
- Amazon Prime: Customers can become subscribers to guarantee faster delivery and subscription to Amazon's video streaming platform, which competes against Netflix.
- Amazon Fresh: An online grocery delivery service. Amazon has expanded its grocery platform through the acquisition of Wholefoods in August 2017. This brings a ready-made 'bricks and mortar' grocery store presence across 400 stores in the US. The online grocery sector has failed to gain traction with US consumers.

Figure 2: Amazon and third party product range and fulfilment



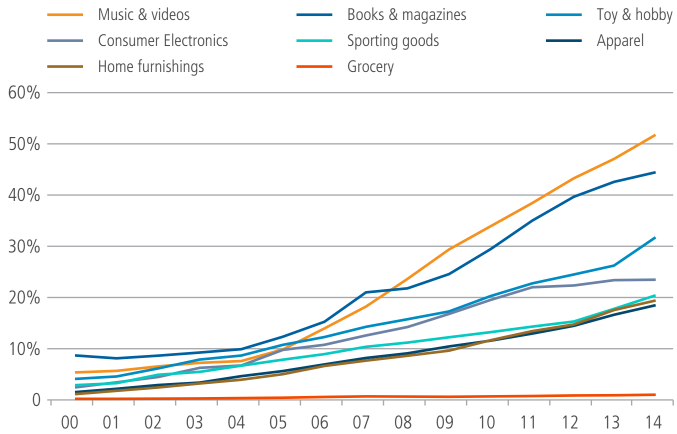
Source: Credit Suisse

Online Retail – Trends Across the Global Markets

Online retail has had mixed success across the world, proving to have higher penetration in more densely populated markets. Online sales in the US constitute 11% of total sales, with 'easy to ship' products such as books, DVDs, toys and electronics most popular. Online grocery sales have failed to gain traction with US consumers, with online sales representing only 2% of total grocery sales.

Figure 3 illustrates the extent of online sales in the US for each retail category. Total Amazon sales (including 3rd party Amazon Market Place sales) currently represents 38% of all US online sales, equating to 4% of total US retail sales.

Figure 3: Online Share Of Sales By Product Category



Source: US Census Bureau and SEC Filings

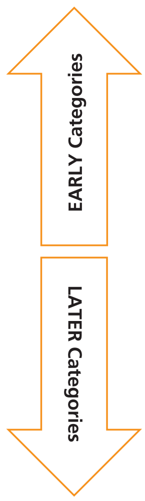
Online sales in the UK account for 15% of total sales. Online grocery shopping in the UK has been more successful, comprising 10% of total grocery sales. Online sales in Canada are on par with Australia, comprising 7% of total sales. Canada's population density is low, being the same as Australia, with 3 people per square km. This is in stark contrast to the US, Germany and the UK with population densities of 35, 234 and 269 people per square km respectively. Amazon launched in Canada in 2010, and is yet to have a material impact on Canadian retail sales.

Amazon's Australian Launch

Amazon launched in Australia in early December, commencing with several 'easy to ship' categories on its own '1P' and 'Market Place' (3rd party retailers) platforms. This mirrors what they have done as they have expanded across the global markets (illustrated by Figure 4).

Figure 4: Amazon's Global Category Rollout

Product Categories	US	UK	Ger.	Fra.	Jap.	Chi.	Can.	Ita.	Spa.	Mex.	Aust.
Physical Media	'95	'98	'98	'00	'00	'04	'02	'10	'11	'15	'17
Electronics	'99	'01	'01	'05	'03	'04	'08	'10	'11	'15	'17
Toys & Games	'99	'01	'04	'07	'04	'04	'13	'10	'11	-	'17
Home & Garden	'00	'04	'04	'07	'03	-	'09	'10	'11	'15	
Sports Outdoors	'03	'07	'06	'10	'05	'06	'10	'11	-	'15	'17
Jewellery & Watches	'03	'07	'07	'07	'07	'06	'10	'10	'11	'15	
Baby	'99	'07	'07	'09	'07	'06	'12	'12	-	'15	
Tools Hardware	'99	'04	'04	'13	-	'09	'11	-	-	'15	'17
Apparel Accessories	'02	'08	'08	'10	'07	'10	'15	-	-	-	
Health Personal Care	'03	'08	'07	'09	'06	'06	-	-	-	'15	'17
Shoes	'05	'07	'07	'09	'07	'06	-	'11	-	-	
Beauty	'04	'08	'08	'09	'08	'06	-	-	-	-	'17
Auto Accessories	'06	'09	'08	'13	'09	'09	-	'13	'13	-	
Digital Media	'07	'08	'09	'09	'10	-	-	-	-	'15	'17
Dry Goods	'06	'10	'10	-	'08	'10	-	-	-	-	
Office Supplies	'08	'09	'09	'09	'09	'10	-	-	-	-	'17
Fresh Food^	'07&'17*	'16	'17	-	'17	-	-	-	-	-	



Source: QIC and Morgan Stanley ^ Only in select cities e.g. Seattle, LA, SF, SD, NY, Phil, Bal, Sac, Den, Boston, Dallas, Chicago, London, Berlin, Tokyo 6 wards

Online sales in Australia currently comprise 7% of total sales, with approximately 80% of Australia's online retail spending concentrated on Australian online sites. Macquarie forecast that online retail sales will increase from 7% to 12% by 2025, and to reach an equilibrium level of 15% of total retail sales over the longer term. Total retail sales are forecast to grow by 4% p.a. over the next ten years, with online sales expected to comprise 30% of this growth.

An A.C. Nielsen survey undertaken in February 2017 demonstrated that Australians have a strong affinity for online shopping. However, the online affinity was predominantly limited to the 'generic' categories, such as books, electronics and apparel. When it came to food and groceries, only 18% of respondents said they would buy packaged groceries, 9% fresh vegetables and 7% fresh meat from Amazon.

One of the major challenges Amazon, and all other online-only business models face, is that they are expensive to operate, due to the cost of shipping, coupled with the high proportion of returned goods. This makes it difficult for internet-based retailers to achieve sustained profitability. This applies even in the US, where shipping costs are significantly cheaper than in Australia.

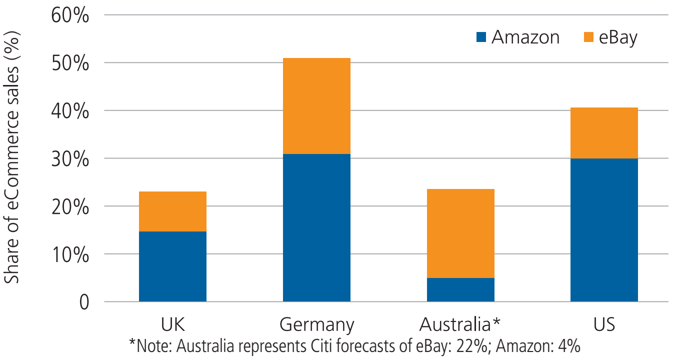
Which retailers will face the most disruption?

We believe that Amazon will certainly change the retail landscape in Australia. Based on the experience from other countries, retailers' margins will be squeezed as they try to compete with Amazon's pricing (especially with Amazon being able, and comfortable, to operate its international retail business at a loss). Retailers with inefficient and expensive operating platforms will be put under pressure. The general consensus is that some retailers and categories will be impacted more than others.

Given Amazon's push via Amazon Market Place, Amazon is more likely to be an immediate threat to eBay, with reports suggesting Amazon has already approached eBay's 3rd Party Sellers. Figure 5 illustrates eBay's current domination of the Australian online market, which contrasts with other global markets where Amazon has been more active.

Retailers that that sell 'commoditised' or generic products are expected to suffer the greatest level of disruption. This includes the department stores such David Jones and Myer; discount department stores (DDS's) such as Kmart, Target and Big W; electrical appliance retailers, sporting goods and the 'generic' apparel categories. Food is expected to be impacted to a much lesser extent, predominantly due to consumers' preference to select their own fresh groceries.

Figure 5: International share of online retail sales by website (%)



Source: Source: Citi Research

'Branded' apparel, footwear and cosmetics are expected to prove tough for Amazon to penetrate in Australia due to licensing arrangements as the major brands license their products in a way that prevents their sale on Amazon.

Retailers who are able to implement a true 'omni-channel' operating model are also expected to be more than a match for Amazon. 'Omni-channel' businesses utilise physical stores (embracing 'click, collect and return'), an online platform, mobile and social media. It is the most productive retail model, as it generates a higher level of sales than the pure online model, with customers typically making 'impulse' purchases when they return their goods bought online to the physical store (Figure 6).

Even Amazon has accepted that physical stores are required for some retail categories. In addition to its network of 400 Wholefoods stores, Amazon currently has 12 bookstores and has announced it will soon open a further three bookstores. In order to create a successful 'omni channel' business model, retailers need to have 'flag ship' stores in prime locations to showcase their products to consumers.

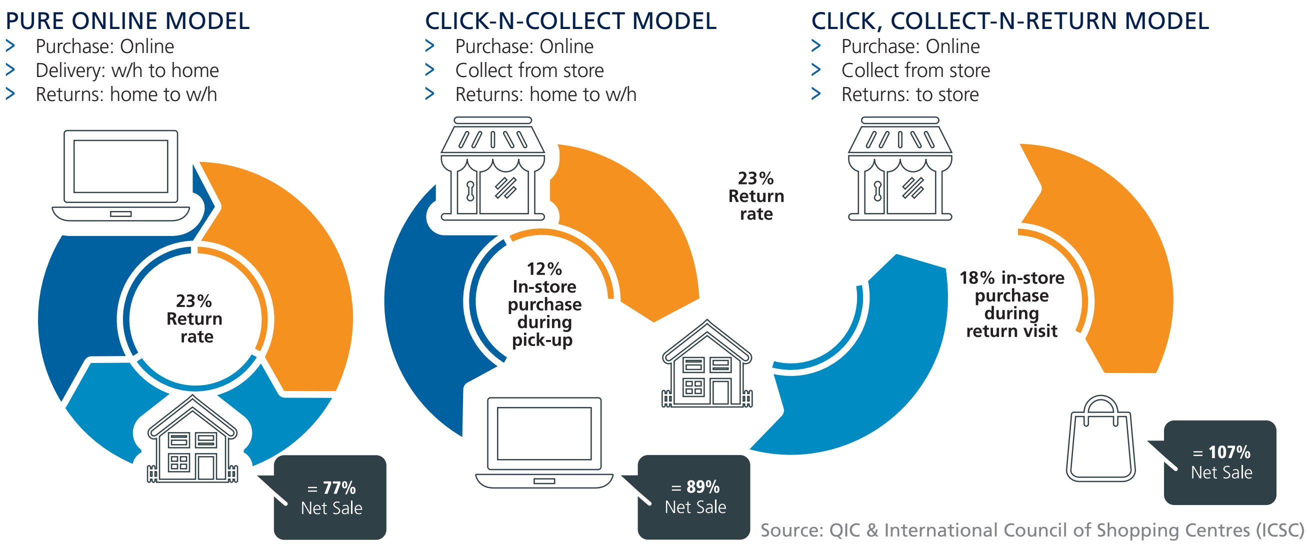
What does this mean for shopping centres?

> Based on the experience from the US, retailers will shrink their store footprint and position their 'flagship' stores in the top tier centres with high sales productivity. This will then create a cycle where the strong retailers attract stronger retailers, leaving the poorer quality Sub-Regional centres with an inferior mix of retailers. Customers will then be drawn to the top tier centres with their strong tenant mix. Macquarie has explored this concept further, and forecasts that the profitability of apparel retailers in Sub-Regional centres will come into question following Amazon's entry into Australia. Macquarie's forecasts indicate that apparel retailers' EBIT margins in Sub-Regional centres will fall to -1% due to lower turnover, in comparison their counterparts located in the 'prime' Regional centres (where forecast EBIT margins remain healthy at 8%)[1].

> In addition to the higher quality tenant mix at the top tier shopping centres, customers will be drawn to the 'experience' offered by these centres. Australian shopping centre managers have been investing in the customer experience for several years now, in preparation of Amazon's Australian launch. They have been enhancing the entertainment, dining, food and service offers at their centres to draw in customers; and at the same time, reducing the floorspace to apparel retailers which are at risk from the growth in online sales. For example, Vicinity Centres has reduced the floor space to female Apparel by 12%, whilst expanding the floor space dedicated to Food and Retail Services by 20% and 32% respectively.

> Supermarket-anchored neighbourhood centres are likely to be less impacted due to consumers preference to select their own groceries. Amazon's recent acquisition of Wholefoods in the US supports this reasoning.

Figure 6: Additional Sales Opportunities from In-Store Pick-Ups and Returns



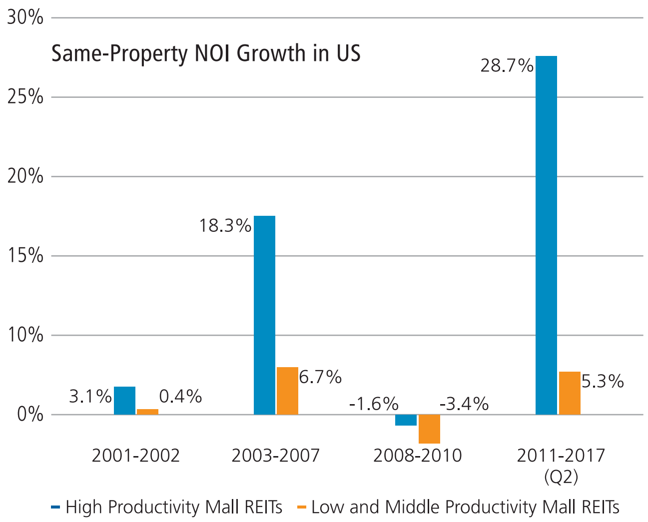
Source: QIC & International Council of Shopping Centres (ICSC)

1 Macquarie Research: "Listed Property Sector – Welcome to the Jungle" – 31 March 2017

- The lower quality, Sub-Regional centres have a higher exposure to the DDS category (Kmart, Target and Big W) which is already under pressure. Both Target and Big W are already experiencing a significant decline in sales across their Australian portfolios, bringing into question the sustainability of having three DDS retailers in Australia. Amazon's entry into Australia is expected to apply even more pressure to the DDS category, as Amazon is able to offer the same types of 'commoditised' products at a cheaper price. The DDS retailers have traditionally anchored Sub-Regional centres, drawing in customers to the centre for the benefit of the other specialty retailers. If DDS's lose their ability to attract customers, this would put further pressure on these centres.

Heitman's research on the US Retail real estate investment trust (REIT) sector provides support for this position, demonstrating that high quality malls have significantly outperformed the mid and low-quality malls (Figure 7) over many time periods.

Figure 7: High Quality versus Low Quality Shopping Centres



Source: Heitman

The net operating income (NOI) growth at the high-quality shopping centres (measured on a sales productivity basis[2]) was far greater than that achieved at the mid and low-quality malls.

So which shopping centres should investors own?

In the current environment of very low interest rates, property capitalisation rates (i.e. investment yields) are at their lowest levels in history, making it unlikely that capitalisation rates will compress further from current levels.

This means that it is critical that real estate managers are able to drive NOI at the asset level to generate attractive returns for investors. It is for this reason that investors need to own Retail property that can generate increased retail sales and therefore increase rents across its tenants.

JANA believes that the 'destinational' Super and Major Regional Shopping Centres such as Chadstone (VIC), Westfield Sydney (NSW) and Robina (QLD) will be more resilient to the impact of Amazon and best placed to continue to drive retail sales growth. We also believe that the convenient, supermarket-anchored neighbourhood centres are well positioned against online retail, due to consumers' preference to select their own groceries.

In contrast, the Sub-Regional shopping centres and lower-quality Regional malls, including centres anchored by discount department stores (DDS's) such as Kmart, Target and Big W, or centres with low sales productivity levels, are most under threat.

2 Sales Productivity measures how efficient a shopping centre is at generating revenue, defined as the sales generated per square metre of retail floorspace.

Conclusion

JANA does not anticipate that Amazon's move into Australia will be a major disruptor to the high-quality Super and Major Regional shopping centres, nor the convenience-based Neighbourhood shopping centres, which make up the vast majority of JANA's clients' property portfolios.

It is the lesser quality Sub-Regional shopping centres that we consider to be most at risk, as retailers move to consolidate store networks to the more productive 'fortress' malls which draw in more customers due to their 'destinational' aspects. This is currently being seen first-hand in the US, with the large-scale closure of stores in underperforming shopping malls across the country. Australian institutional Retail property managers have been on the front foot in preparation of Amazon's arrival into Australia, beginning to improve the entertainment, dining, food and service offers at centres to enhance the customer 'experience'.

It is JANA's view that Amazon's online retailing is not the behemoth that the media is making it out to be. The Retail sector is constantly evolving and those retailers unable to adapt to new trends will find themselves under significant financial pressure. In recent times, rather than the online threat, it has been the introduction of the international mini major 'fast-fashion' retailers, such as H&M, Zara and Uniqlo, that has been the main disruptor to the Australian Retail sector, resulting in several retailer casualties over the past 18 months. JANA maintains the view that well located, high-quality retail property remains a key component of our client's property portfolios going forward.