



FEATURE ARTICLE:
AMAZON'S AUSTRALIAN AGENDA



in the way he moved. The courtesy he showed towards Miss Montag made a striking contrast with the way she had been treated by K. Nonetheless, Miss Montag did not seem to be cross with K. as it even seemed to him that she wanted to introduce the captain. K. however, did not want to be introduced, he would not have been able to show any sort of friendliness either to Miss Montag or to the captain, the kiss on the hand had for K., bound them into a group which would keep him at a distance from Miss Bürstner whilst at the same time seeming to be totally harmless and unselfish. K. thought, however, that he saw more than that, he thought he also saw that Miss Montag had chosen a means of doing it that was good, but two-edged. She exaggerated the importance of the relationship between K. and Miss Bürstner, and above all she exaggerated the importance of asking to speak with her and she tried at the same time to make out that K. was trying to ruin everything. She would be

35%

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At its peak, with nearly 400 stores nationwide, Blockbuster Video stores were a staple in most towns and cities across Australia. Today, however, only 12 stores remain; a number widely expected to continue to approach zero. Where did Blockbuster go wrong? While the industry around it was changing because of the widespread adoption of the internet, Blockbuster was steadfast in its pride of a business strategy that had enabled the company to rake in millions of dollars in prior years. In 2007, Netflix started providing online-streaming content, having foreseen the looming technological revolution in both personal computing and internet usage. Netflix is now available in almost every country in the world, and Blockbuster was left to declare bankruptcy in 2010.

Alas, this month's feature article is not about the pitfalls of Blockbuster, nor the successes of Netflix. However, the example is relevant given the feature article discusses Amazon.com's (Amazon's) looming entry into the Australian retail market. Despite its humble roots as an online book retailer, Amazon is now a titan of e-commerce, logistics, technology, hardware, data storage and media. Amazon's international success at gaining market share and putting inefficient and resistant-to-change retailers out of business has had many traditional Australian retailers shaking in their boots. We discuss why we consider Amazon's business model will enable it to be a major market disruptor should other Australian retailers take the Blockbuster approach and be resistant to the ever-changing technological landscape. However, Amazon will also face some unique Australian challenges that other international retailers have underestimated when putting down roots in Australia. That said, Amazon does have a robust track record in overcoming such hurdles, so we can expect the company to have a significant impact on Australia's retail market, its labour market and its productivity.

1.1 From Paperbacks to Everything...

Amazon has relatively humble roots considering it is now the largest online retailer in the world. Go-getter Jeff Bezos founded the company in July 1995 as an online book retailer. Within the company's first two months, it had sold books to Americans in all 50 states and to people in over 45 countries. Two years after its launch, the company went public, and floated on the Nasdaq with a market capitalisation of US\$438 million. The retailer quite quickly expanded beyond just books, selling CDs and DVDs by 1998 and toys and electronics by 1999. Twenty-two years

later, the company has transformed itself into an 'everything' store, selling hundreds of millions of products to global consumers every year.

Amazon is clearly not just a book retailer anymore. Some of the company's more notable business ventures have included:

- Amazon Marketplace: enables third-party sellers to sell new and used products for fixed prices alongside Amazon's own offerings;
- Amazon Fresh: grocery delivery service available in select cities around the world;
- Amazon Prime: subscription-based fast shipping program for orders of any amount, as well as access to videos, music and cloud storage;
- Amazon Web Services: provides cloud computing platforms to individuals, companies and governments, on a paid subscription basis;
- Amazon Go: bricks-and-mortar checkout-free convenience store selling groceries and pre-made meals; and
- Amazon Studios: develops television shows, distributes and produces films and comics from online submissions and crowd-sourced feedback.

An Increasing Global Footprint

Even from Amazon's early days, it had a global footprint. Within months of its launch as an online book retailer, it was selling and shipping books overseas. Since then, it has expanded its Marketplace offering to Canada and Mexico, to parts of Europe and parts of Asia. Expanding its operations to Australia is the next step in its plans of global dominance.

Figure 1: Amazon's Global Footprint, as of March 2015



Source: Amazon Investor Relations

1.2 Amazon's Business Model

Per Amazon's 2016 Annual Report: *'We seek to be Earth's most customer-centric company. We are guided by four principles: customer obsession rather than competitor focus, passion for invention, commitment to operational excellence, and long-term thinking.'*

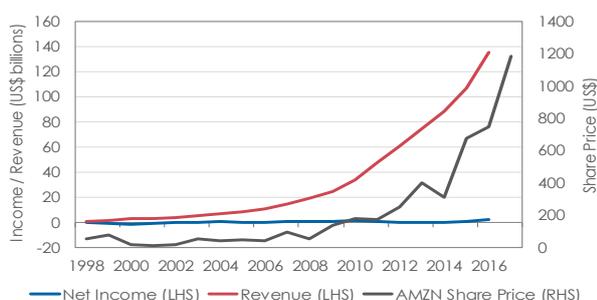
Amazon's business model relies heavily on the cycle of a company cutting prices to attract customers, increasing sales and, in turn attracting more customers. The large customer base allows it to harness the benefits of economies of scale (including through its logistics and distribution system), which then allows the company to cut prices again. Amazon has all but mastered the e-commerce retail sector, as evidenced by its nearly 45% market share of all US e-commerce sales. Its focus on customer experience, particularly through its low prices and its fast delivery times, has proven successful at far outpacing its peers in terms of overall e-commerce market share in the US.

Despite its growing dominance as measured by market share, Amazon has yet to generate much in the way of actual profits. This is a result of the strategy that Bezos has adopted since the beginning. Per the company's 1997 Annual Report (which Bezos has referenced in every annual report since), one of the company's key investment philosophies is: *'We will continue to make investment decisions in light of long-term market leadership considerations rather than short-term profitability considerations or short-term Wall Street reactions.'*

Amazon went public in 1997, and lost money for the next six years, and even today, barely ekes out a profit. To the firm's leadership team, the poor quarterly earnings results and the low annual profits were less significant than surging sales growth which is driven by ensuring exceptional customer service and keeping prices low.

Chart 1 shows the company's track record of very strong sales growth, yet flat net income since the company went public in 1997. Bezos has shown that he is not interested in building up Amazon's profit margin, but rather prefers to keep prices low to steadily gain market share. Amazon's investors endorse its approach to playing the long game and reinvesting its profit, by bidding up the company's share price, also shown in Chart 1.

Chart 1: Amazon's Sales, Net Income & Share Price



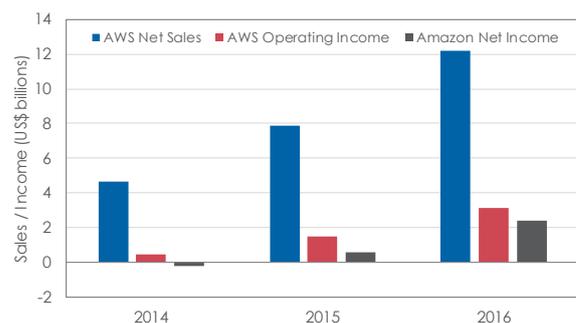
Source: Amazon, Whitehelm Advisers

This approach has been incredibly beneficial for Amazon because the bidding-up of the share price

has meant that it has been greeted with massive amounts of free-flowing capital. It has given the company a significant amount of freedom to be innovative, and to take risks that sometimes eventuate in failures. Additionally, this approach comes with the added benefit of minimising the company's tax burden. Amazon has paid just US\$1.4 billion since 2008, despite having added US\$220 billion in value to its stock over the past two years.

Amazon Web Services, Amazon's cloud computing service, was officially launched in 2006. Today, it is the most dominant cloud computing provider, and for Amazon, it is financing a huge portion of its expansion and development. The chart below shows the net sales and net operating income for AWS over the past three calendar years compared to Amazon's net income as a whole (includes AWS and Amazon's American and international businesses). Clearly Amazon has been relying on the success of AWS to prop up the rest of its business.

Chart 2: AWS Sales and Operating Income, 2014 - 2016



Source: Amazon, Whitehelm Advisers

1.3 Its Expected Footprint in Australia

Australia is another piece to Amazon's long-term goal of creating a global distribution network that connects buyers and sellers from every corner of the globe. Per a statement from Amazon in April 2017:

'Amazon Web Services launched an Australian region in 2012, we launched a Kindle Store on Amazon.com.au in 2013, and we now have almost 1,000 employees in the country. The next step is to bring a retail offering to Australia, and we are making those plans now. We are excited to bring thousands of new jobs to Australia, millions of dollars in additional investment, and to empower small Australian businesses through Amazon Marketplace. We are optimistic that by focusing on the things we believe customers value most – low prices, vast selection, and fast delivery – over time we'll earn the business of Australian customers.'

It is expected that the Amazon Marketplace will initially focus on general merchandise such as

electronics and toys, and will expand its offering as it finds its footing in the Australian market. However, at the company's first public forum in Australia on 13 November, it disclosed that it would be rolling out its Marketplace to entail both its proprietary goods as well as those from third-party providers. Up until that point, it was uncertain if Amazon would forge ahead with a softer launch before launching into its full offering.

Amazon's plans to introduce Amazon Marketplace is expected to be a disruptive force to the Australian retail sector. Per Amazon's Director of Operations for Australia, Robert Bruce: *'This new fulfilment centre will stock hundreds of thousands of products which will be available for delivery to customers across Australia when we launch our retail offering.'*

Amazon's breadth across markets, both from geographical and product offering perspectives, combined with its history of not being focused on profits, has allowed the company to withstand years of poor performance in particular segments of its business. As a result, we can expect Amazon to play the long game in Australia. In other words, Amazon will likely be happy to not turn a profit for several years, provided it is gaining market share.

1.4 The Unique Australian Challenges

We are not anticipating that Amazon's entry into Australia will be flawless and the company will gain market share with the blink of an eye. Bricks-and-mortar retailers have been king in Australia for a long time, so the company with solely an online presence will have to change consumer habits and perceptions. Additionally, Australia is a country that is almost as large as the United States, but with less than 10% the number of people. Australia's population is concentrated, but only in particular pockets which are often thousands of kilometres away from each other. Wages are high, postage and shipping costs excessive and red tape dense.

Consumer Habits

Obviously, Amazon is an online business, so its success in Australia is highly dependent on Australian consumers' appetite for online shopping. Many Australian consumers still avoid online shopping, in part because they are concerned about credit card fraud, the quality of products and return policies. Australia lags many of its developed market peers in terms of the portion of total sales that get made online, at just 4.4%, as compared to 14% for the UK, 7% for the US and 6% for Canada.

Internet Speeds and Penetration

Internet access is ultimately paramount to Amazon gaining access to Australian consumers. The ABS

tracks household internet access statistics, however its most recent data point was as of 2014-15, in which 86% of Australian households had internet access. Unofficial statistics report that 98% of households currently have internet access.

However, much to the dismay of many Australians, the country's internet speed leaves much to be desired. Per testing conducted in September 2017 by Speedtest, Australia's internet speed ranks 55th in the world, well behind that of many of its developed market peers, and is instead in the mix with countries such as Panama, Belarus and Serbia. While the National Broadband Network roll-out continues, well-documented problems are proving to present a large challenge to increased internet speeds. While slow internet speeds are unlikely to cause Australian consumers to never shop online, frustration over slow speeds may cause some to continue to frequent bricks and mortar stores rather than to make the shift to online shopping.

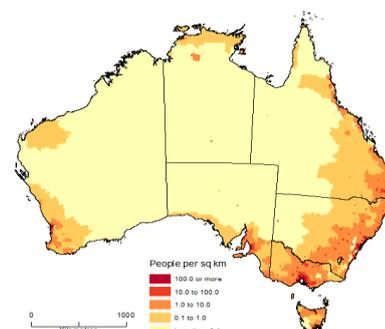
Higher Wages and Operating Costs

Australia has historically been an expensive place to operate a business. The country has higher wages than many of its developed market peers. Additionally, Australia has a relatively heavily unionised workforce, and particularly strict guidelines for retail workers. These include high penalty rates that get paid to retail workers on holidays and weekends. Amazon is set to hire thousands of Australians, and so the company could face higher wage costs here than they do abroad.

Market Size & Population Density

Australia's population is a less than a tenth the size of the United States, and its land mass is only 20% smaller. It is the sixth largest country by land mass, but is the sixth sparsest country in terms of population density. While Sydney and Melbourne are populous, as compared to other major cities around the world, their population densities are still remarkably low. A graphic of Australia's population density is shown in Figure 2 below.

Figure 2: Australia's Population Density, June 2016



Source: ABS

Amazon has gained market share through its cheap and fast delivery offering, which is significantly easier in countries with dense populations. In the US for example, Amazon's fulfillment centres have been placed in such a way that they are able to service a great deal of customers across a wide region. Even with a far denser population, there have still been plenty of complaints from Amazon customers in smaller towns in both the US and Canada regarding slower than expected delivery times and steep surcharges on shipments. This could become especially problematic in Australia considering the prevalence of small towns in remote parts of the country. Additionally, Australia is not able to capitalise on cross-border fulfillment centres like Canada and Mexico can with distribution centres in the US, and such as those that exist across Europe.

Government Oversight and Tax System

As we discussed in a previous section, Amazon pays surprisingly minimal tax in the relevant jurisdictions because of its business model of barely eking out a profit to reinvest in further business ventures. At the Financial Review Retail Summit in early November, Federal Small Business Minister Michael McCormack has said that the federal government would be watching closely for any signs that Amazon might be intentionally operating at a loss year after year, chasing sales growth and market share capitalising on its status as a top international brand. McCormack is cognisant of the impact that Amazon's retail arm operating at a loss and paying minimal taxes could be extremely disruptive to existing Australian retailers.

At the same summit, Australian Small Business and Family Enterprise Ombudsman Kate Carnell indicated that she was still waiting to see the contract that Amazon will allow small Australian businesses to operate on its Marketplace platform. Carnell is alluding to the fact that in the United States, Amazon's terms and conditions stipulate that the company reserves the right to refuse service, terminate accounts, cancel orders, remove or edit content or terminate rights to use Amazon services at its discretion. Such clauses are now illegal in Australia when it entails a small business of under 20 employees and the contract is less than A\$300,000 for a year, or A\$1 million for a multi-year deal.

1.5 Impact for Australian Retailers

Amazon has the potential to significantly disrupt Australia's retail sector in several different ways. First, as Amazon steals market share, incumbent Australian retailers will see their sales growth slow or even decline. Amazon is also expected to offer substantially lower prices for the same or similar products, which, in turn, forces Australian retailers

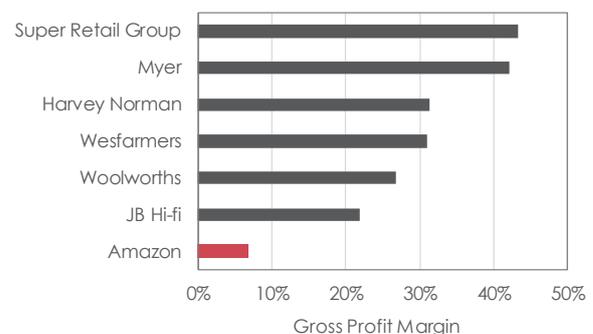
to lower their prices as well, another contributing factor to lower revenues. Amazon is also expected to force its Australian competitors to invest more in their stores, their online shopping offering and their delivery services to maintain any sort of competitive advantage over Amazon.

The Australian retail market has faced tougher times in general over the past year, despite relatively strong employment indicators. In September, retail figures disappointed, given that volumes of goods sold was primarily propped up because retailers had dropped prices to entice shoppers to spend. The sluggish retail sector has largely been attributable to both international and domestic factors. International competition has pushed prices down, while the stagnantly low wage inflation, high household debt, flattening house prices and rising utility bills have caused Australian consumers to reduce their spending.

Will Australian retailers be able to compete?

As we have already discussed throughout this feature article, Amazon is an extremely large company, but it is very lean in the profits category. In 2016, its gross profit margin (gross profit divided by sales revenue) was just 6.8%, as compared to some of Australia's top retailers who have gross profit margins greater than 20% and as high as 44%.

Chart 3: Gross Profit Margin for Amazon and Australian Retailers, as of 2016



Source: Macquarie, Whitehelm Advisers

But, Australian retailers also face high operating costs, including marketing, leases, wages and advertising. For example, Wesfarmers and Woolworths both have operating expenses greater than 24% of sales revenue, while Harvey Norman's, Myer's and Super Retail Group's are all approximately 40%. Amazon will face some of these high operational costs by conducting business in Australia, such as wages, but its predominantly online presence and status as a global brand will likely minimise its advertising and leasing costs.

Likely a more indicative measure is the net profit margin rather than the gross profit margin which is

the net profit after tax divided by sales revenue. For most of the big Australian retailers which we have already discussed, their net profit margins are in the range of 2-3%. This shows that they are operating on a narrow buffer given both the volume of goods sold and their current pricing. If Amazon comes to Australia and its prices are 30% lower than the current retailers, Australian retailers do not have the room to cut prices while still turning over a profit. Provided Australian consumers get on board with online shopping, this could take considerable market share away from Australian retailers quite quickly.

Australian Retailers Will Need to be Nimble

Given that we expect Amazon to capitalise on its strong electronics and apparel offerings, we expect companies that operate in these sectors to be those most at risk of feeling the wrath of Amazon. At least initially, we expect that sectors that rely on more customer service, including the automotive, hardware and grocery sectors to be relatively better positioned to compete with Amazon.

To compete on price, Australian retailers will likely need to find ways to become leaner and more efficient. Some Australian companies have already started getting prepared by setting up task forces to deal with Amazon's looming entry into the market. In 2016, Wesfarmers' Managing Director Richard Goyder said that Amazon *'will eat all our breakfasts, lunches and dinners'* unless local retailers become more innovative and barriers to competition are removed. Such companies are aware that they need to start getting prepared for Amazon's entry now, rather than waiting to see what Amazon does.

Goyder's point about innovation is an important one for all Australian retailers to keep in mind. It was a lack of innovation and a resistance to change that left Blockbuster in Netflix's dust. If Australian retailers want to compete and stay in business, they will ultimately have to become more innovative, both in terms of how to lower their prices, but also how to offer services such as online shopping and fast delivery.

Australian companies will likely need to invest significantly in their supply chains to try to minimise manufacturing and distribution costs. Companies will also have to focus on prioritising the customer experience. This is one of the main reasons why Amazon has been so wildly successful at gaining market share over the past two decades. Retailers who focus on improving their 'last-mile' strategy, or the fast delivery of their goods, in turn improving their customers' experience will likely have a better chance of standing their ground compared to companies who believe that no change to current practice is required. Additionally, companies that

further develop their online shopping experience, through easier checkout processes, and updated websites are likely to maintain their customers.

Some retailers will likely have a head start on fighting off Amazon. Companies that own or even have long-term exclusive access to top brands will inevitably be more resilient to competition. This is because consumers are less concerned about price when they are after a brand name. Such companies, Breville or A2 Milk for example, do not necessarily have the most efficient and strongest supply chains, nor do they have cheap production costs. But the power of a brand name is far more important in such cases. Amazon cannot readily substitute leading brand-names with superior products, nor cheaper and inferior products.

Small Retailers Could be Big Winners

Reportedly, 500 Australian businesses have already signed up to sell their products on Amazon Marketplace once it launches in Australia. The third-party seller arm of the Amazon business provides a significant opportunity to many small businesses in that they are able to access a far-wider reach of Australians through the platform. Amazon charges a commission on every product that Amazon sells through the service, so such retailers will see their margins reduced, but the broader exposure is likely to more than offset this margin compression.

On 13 November 2017, Amazon had its first public forum for the businesses that are set to sell their products. The forum provided more clarity as to the fees that Amazon will charge such businesses. According to the new head of Amazon's Australian Marketplace, Fabio Bertola, the company will waive the normal monthly access fee of A\$49.95 for several months. This fee is in line with those charged in other countries. The fees (or commissions) charged for each sale on the platform will range from 6-15%, depending on the products sold.

Australian retailers have historically had access to a similar service through eBay, and the latter believes that it has a stronghold on third-party seller platforms. eBay's Chief Marketing Officer, Tim MacKinnon, naturally critical of his company's greatest competitor, said: *'There's a lot of hype around Amazon and it's going to be difficult for them to match expectations. We have two out of three of the top 10,000 Australian retailers on our platform, 60 million listing on the website and that's the level of selection people expect. I just can't see how Amazon will be able to match that.'*

eBay has invested a great deal recently in its shipping and logistics capabilities, to improve delivery times, and has launched a massive marketing campaign to highlight the strength of its offering. Regardless of

which platform proves to be more successful, smaller retailers will be the benefactors.

1.6 Economic Implications

In the United States, traditional retail employs approximately 16.5 million people, which is equivalent to approximately 10% of the entire workforce. It has been estimated that approximately six million of those are employed in the product lines that are expected to be the most likely to be affected by the continual shift towards e-commerce. Donald Trump based his presidential campaign on the loss of manufacturing jobs to China and Mexico, but the transformation of the labour market caused by technology may prove to be a much bigger issue for Trump to deal with.

Consider the following chart. The red line shows the year-on-year growth in employment for ‘non-store retailers’, or those stores which only have an online presence. Over the past seven years, jobs growth in this slice has been positive, reaching almost 9% in 2014. The grey line shows the jobs growth for internet-sensitive stores, or those that are likely to be most disrupted by a move to e-commerce (including general merchandise; sporting goods, hobbies, books and music; clothing; and electronics). The jobs growth in this category has been significantly flatter, and turned negative in 2017.

Chart 4: Employment Growth in US Retail Sector



Source: FRB of St. Louis, Whitehelm Advisers

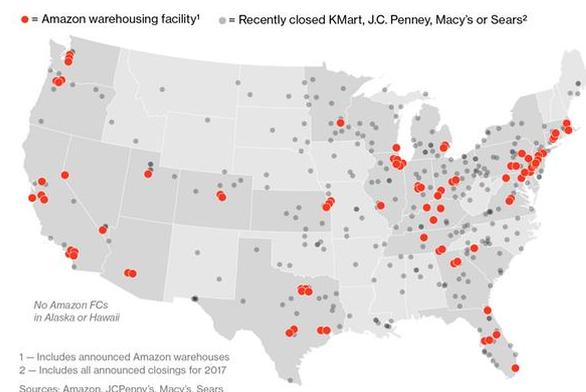
The Amazon Effect, and in general, the rise of automation in workplaces around the globe, has caused there to be a shift in the labour market. There has been and will continue to be a shift from a demand of low-skilled labour to perform routine tasks (such as retail in-store jobs) to higher-skilled cognitive labour. Economists call this effect skill-based technical change, which refers to the shift of demand toward more highly skilled workers relative to the less skilled because of technological progress.

In the case of Amazon, it is important to note that jobs are not disappearing entirely as the e-commerce

company expands. Of course, they are hiring more people every year, for both work in their offices as well as their warehouse and distribution facilities. Oftentimes, the jobs relating to the latter involve routine and sometimes physical labour, which seems like a reasonable substitute for the jobs lost by the closing of department stores. But

Figure 3 below shows the mismatch between where the jobs are being lost and where the new ones are being created.

Figure 3: Depiction in the Shift in the Labour Market in the United States



Source: Bloomberg

At Amazon’s mid-November public forum, it touted the fact that it plans to add thousands of jobs for Australians to scoop up. However, we expect that similarly to the US, the jobs will be highly geographically concentrated, in the main capital cities of Melbourne, Sydney and Brisbane. Finally, if retailers start shuttering their bricks and mortar stores, job losses would be scattered around the country.

Tax

In the United States, the government has historically given tax breaks to build stores and to locate their headquarters domestically. But as retail stores close with the trend to e-commerce, the property tax receipts decline, which causes there to be a shortfall for the funding required to maintain and invest in new infrastructure and schools. Local governments also take in less sales tax as retail stores close. As a result, the push to online retailing has already had a significant impact on the local tax base, meaning that the local residents are on the hook for making up for the missing money, or will otherwise see a reduction in services provided by the government and a lack of investment in infrastructure.

As we previously indicated, the Australian government is aware of Amazon’s history of paying extremely low taxes, and the Australian Tax Office (ATO) is already doing its best to ensure that Amazon pays its fair share of taxes. The government has

introduced a diverted profit tax, often referred to as the 'Google tax', which has been designed to encourage greater compliance by large multinational enterprises with their tax obligations in Australia.

The diverted profits tax only came into effect on 1 July 2017, so it is not yet clear how effective it will be in terms of ensuring multi-nationals pay their fair share of taxes. We expect that regardless, Amazon will likely be doing its best to ensure that it can avoid paying significant volumes of tax, and that the ATO will be doing its best to avoid this situation. If Amazon is successful, we can expect some of the tax shortfall to land on the shoulders of taxpayers. In other words, Australian consumers have the potential to benefit from Amazon's entry through lower prices and high-quality customer service, but could bear the brunt of Amazon's low tax contribution.

Inflation

Inflation has been stagnantly low in many developed market countries, significantly lower than the levels seen in the 1970s and 1980s. In the 1990s and early 2000s, globalisation was one of the contributing factors to lower inflation because of the impact that it had on the cost of manufacturing, and in turn, products. Now, online retailers are causing retail markets to rethink the supply and distribution of goods, making the sector more efficient, which has the potential to be a further deflationary force on prices.

Additionally, the internet provides consumers the ability to 'shop around' incredibly efficiently and effectively. Furthermore, it allows consumers to substitute cheap digital goods for more expensive physical ones, such as what Netflix did to Blockbuster by providing online streaming content.

The RBA is aware of the potential implications that Amazon could have in terms of price inflation, indirectly addressing Amazon's entry into the Australian retail market in the media releases

corresponding to several recent interest rate decisions.

1.7 Conclusion

Undoubtedly, Amazon will prove to be a force to be reckoned with as it gets settled in Australia. Its service offering allows it to charge prices that are double digit percentage points lower than those of traditional Australian retailers. To avoid the same fate that Blockbuster suffered at the hands of Netflix, Australian retailers will need to be nimble to adapt to the continuing trend towards e-commerce and to compete on price. This will prove difficult for some Australian retailers given their already compressed profit margins.

We consider that Amazon will be a market disruptor in Australia, but that this will be an issue that develops over the medium to longer term rather than immediately. The uptake of internet shopping is still very low in Australia, and Amazon can only grow in prominence as more retail purchases are made online. This country could also prove challenging because of the size of the land mass, the tougher distribution networks, and the high operating costs that the country is known for. Yet, because of Amazon's ability to play the long game thanks to its size and profitability in other market segments, we expect Amazon to be persistent.

Ultimately, in the near term, we consider Amazon's entry into the Australian market a positive one in terms of the cheap prices and fast delivery options for consumers, but over the medium to long term, it will prove to be destructive for the country's discretionary bricks and mortar retailers. Only time will tell which retailers are up for the challenge.

This feature article is a condensed version of a more in-depth article. If you are interested in accessing the longer-form version, contact Nicole McMillan at Nicole.McMillan@WhitehelmCapital.com