# Survivor: The Amazon

## May the best prepared win

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Amazon's planned entry into the Australian market has generated intense speculation about the outlook for incumbent players. While Amazon will undoubtedly take some retail share, our research suggests the major impact of Amazon will be to accelerate fundamental changes in the ways companies interact with their customers:

- price transparency will increase
- cost to serve will likely need to fall for those facing direct competition, and
- the customer experience will be enhanced.

The experience of retailers offshore has been highly dependent on their response to a changed industry structure driven by Amazon's entry. Much like a season of 'Survivor', the winners and losers in this new competitive landscape will be determined by the strategies they choose and their ability to execute on these plans, no doubt facing a series of challenges along the way.

With Amazon preparing to launch its Australian domestic operations in late 2018, the pace of innovation and change is set to accelerate in a range of sectors across the Australian market. Companies will need to evolve in order to remain competitive in this new environment. There has been plenty of notice that Amazon is coming and companies can learn from experiences in foreign markets: to do nothing is not an option.

At the outset, it is worth observing that Australians already have a high propensity to spend online. Amazon will take some retail share and its impact will be greater in certain identifiable segments. However, its real impact will be on the service offering people expect and prices people are willing to pay.

Once we have formed a view about the valuation scenarios, we need to determine how to evaluate a company's progress in meeting the opportunities and challenges Amazon presents.

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From our perspective, there are four key aspects in assessing the impact of Amazon across the Retail, Consumer Staples and REITs sectors of the market which will feed back into our evolving view about the valuation range for a company.

**Assess incumbents against our framework for the future**

We have identified five key strategic pillars that need to be assessed to evaluate the way a company is adapting to the evolving environment. An overarching assessment needs to be made about management's capability to evolve their strategy and execute the plans. An assessment also needs to be made about balance sheet strength (an important component of our process) and the company's capacity to acquire the necessary talent, particularly 'new economy' talent.

**Understand Amazon's business model to see how customer obsession drives disruption**

As background, we explore Amazon's business model, in particular, the many impacts of its customer obsession and how this can disrupt industry structure.

**Look at the key variables that will shape Amazon's Australian expansion**

Amazon's impact on the Australian market will be highly dependent on a range of variables around its own decisions, the actions and positioning of competitors and the response of consumers to new retail opportunities.

**Consider the risks Amazon faces in penetrating the Australian market**

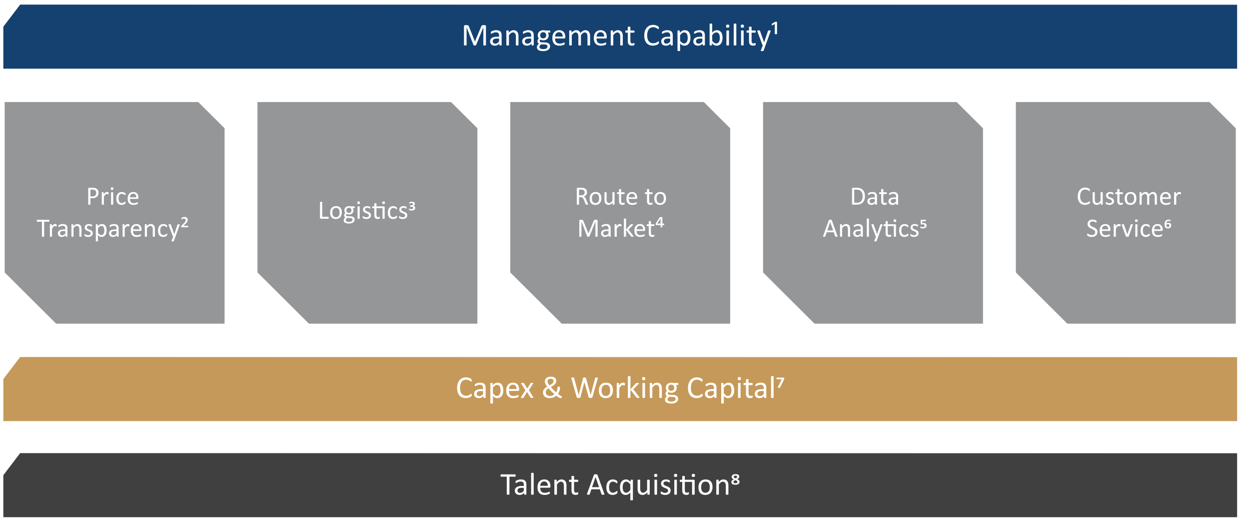
We explore the risks for Amazon given the nature of the Australian business and economic landscape.

Each of these points is explored in more detail below. First up, we will consider the task confronting management.

## Assess incumbents against our framework for the future

Amazon's impact on an incumbent retailer, product provider or retail landlord will be highly dependent on how the incumbent responds. As a result, we assess the outlook for an incumbent in two stages. First, we form a view around valuation with key assumptions guided by international experience. Second, we assess a corporate's delivery on the changes required to realise our valuation. This section explores this second stage in more detail.

From our analysis of Amazon's business model and its strategy and success offshore, we have identified five key strategic pillars of change that will assist companies to adapt to the new competitive landscape and three underlying capabilities necessary to implement these changes. This framework will allow us to assess the quality and viability of a company's response to Amazon and hence, form a view on its future market position and ultimately its valuation.






**1. Management capability**
We need to assess whether management has the capability to evolve its strategy and execute on plans to adapt to the shift in consumer habits. Companies able to adapt and innovate will survive and even prosper after the arrival of Amazon. In contrast, those that are unprepared may be forced out of the market.

**2. Price transparency**
Amazon's arrival will give consumers a tool to instantly cross-check prices to ensure they are getting a fair deal. While retailers may not need to match Amazon's prices, margins may need to reduce to create a competitive market price. Where consumer branded products have sought to hold Australian pricing above that in other markets, we would expect Amazon to assist in breaking this down for the benefit of the Australian consumer. However, it will likely reduce the gross margin of Australian retailers.

**3. Logistics**
Amazon's delivery capabilities have revolutionised the retail industry and have driven a virtuous circle of increased sales which are reinvested in the supply chain to offer better service, leading to more volumes sold. The introduction of Kiva robots has reduced warehouse operating costs by around 20% (this video about Kiva robots is worth a watch: https://www.youtube.com/watch?v=6KRjuuEVEZs). The next step is last mile delivery, with 'Prime Air' already delivering parcels via drones.

To compete with Amazon, brand owners and retailers will need to collaborate to create faster, flexible and more reliable supply chains to reduce costs and meet new delivery expectations. Companies may choose to leverage Amazon's fulfilment capability to drive sales, in which case actively managing inventory and optimising product design will be key to success.

**4. Route to market**
Amazon will drive changes in how consumers shop, presenting both an opportunity and a risk for traditional retailers. A combination of a strong online and physical presence will be critical for retailers and consumer packaged goods providers.

Online and in-store sales will become increasingly interdependent as customers may choose to 'look and feel' in store and buy online, or vice versa. A company's digital interface, delivery capability and online range will be increasingly important, while store footprint is likely to be consolidated.

Prime real estate will become increasingly sought after as companies move to flagship-style physical stores to engage consumers. Further, consumer packaged goods companies may choose to leverage Amazon's scale to grow sales and/or to develop their own direct-to-consumer online platform. Each of these approaches offers opportunities if done properly; we will monitor which approach companies choose to take and how they seek to achieve this.

**5. Data analytics**
Through its huge data warehouses and sophisticated

analytics capability, Amazon knows its customers better than anyone else and makes rapid, data-driven decisions. For instance, it is estimated that Amazon changes its prices tens of millions of times globally every single day. To keep pace, retailers will need to invest in their own ability to collect, analyse and apply insights from data to increase loyalty, create personalised experiences and make quick decisions based on what their customers want.

Australian retailers have data – the question is whether they will be able to use it. Companies that already have sophisticated data analysis capabilities should be able to defend against Amazon's arrival; others will need to increase their online presence and invest in the area to remain relevant in a landscape where data is critical to success. Shopping centres will be able to harness data on how customers spend to engage customers, allowing them to optimise the physical shopping experience to defend against the convenience of online retail.

**6. Customer service**

Amazon's 'customer obsession' will force companies to adjust their strategies in an environment of increased price transparency, decreased margins and higher customer expectations. Given Amazon's broad goal of becoming 'the everything store', traditional retailers need to specialise and differentiate to engage their customers. This may be done through a focus on premium or private label offerings, investment in the in-store experience or targeting products and consumers unattractive to competitors. Bricks and mortar retailers have a natural advantage in service and experience which can be leveraged to create an engaging buying experience both in-store and online. Whatever approach is taken, a strong focus on customers will be essential.

**7. Capex & working capital**

A flexible capital structure will be required to close surplus stores, reconfigure supply chains, invest in online presence, increase data capabilities and improve the overall retail experience. The short-term focus of equity markets is a clear disadvantage for listed companies competing with Amazon, which is prepared to lose money for over five years before becoming profitable in a region. A company's financial health and capability to implement the major changes required will be key determinants of its ability to survive. Further, companies with negative working capital cycles (i.e. those that receive customer payments before paying their suppliers) are more of a concern if their sales revenue declines as Amazon captures share. These are critical factors we will look at in assessing a company's ability to adapt to the new environment.

**8. Talent acquisition**

Amazon's teams of PhD mathematicians, economists and behavioural scientists have been a key driver of its success. To establish an online presence, optimise logistics and understand data on their customers, companies will need to attract and retain the necessary talent from a limited pool. Existing capability in these areas will be a major source of competitive advantage and we will monitor the focus placed by management on this area going forward.

Now that we understand the analytical framework, we will look at how Amazon places customers at the core of its business and how this drives disruption.

## Understand Amazon's business model to see how customer obsession drives disruption

In assessing the way in which customer expectations and the retail industry more broadly will change, it is important to understand the drivers of Amazon's success: primarily an unrivalled logistics network, a capacity to decimate industry margins, a 'customer obsession' and a willingness to experiment (and fail).

At its core, Amazon is a powerful logistics business overlaid with a retail business. Its low-cost structure allows Amazon to offer market-leading prices and revolutionary delivery services that have changed the way people shop. Lower prices and better service lead to increased sales, allowing Amazon to further invest in and expand its logistics network in a virtuous circle.

***The power of logistics: unrivalled delivery service will drive growth in online sales***

Amazon's low-cost structure is driven by continual investment in automation and efficiency throughout the logistics supply chain. This highly efficient logistics chain has allowed Amazon to continuously outpace competitors in terms of its delivery capabilities. The launch of Prime in 2012 changed the nature of the online retail industry with free two-day shipping (one-hour in some locations). While this offering is expensive for Amazon given subscribers purchase more, bundle less and require fast delivery, the significant uplift in volumes has allowed it to expand its distribution network into a 'hub-and-spoke' system that gets packages as close to the customer as possible before relying on third parties.

Amazon continues to innovate, introducing automation to its warehouses (which reduces costs by 20%), employing teams of PhD mathematicians to find the efficient frontier between speed and cost for each item sold and experimenting with drone delivery which could make delivery cost per item almost negligible.

Amazon's market-leading delivery service has driven growth in online sales in the markets it has entered. This is caused not only by customers migrating to Amazon, but by other retailers improving their online platform and delivery capabilities. Given Australians already have a high tendency to shop online, the extent to which online share of retail sales is able to grow remains to be seen.

However, a combination of an online and physical presence will become increasingly important for retailers.

***'Your margin is my opportunity': focus on price and service critical as price transparency grows***

Cost savings are passed through to the customer via lower prices (as Bezos has threatened, 'Your margin is my opportunity') creating an improved customer experience and increasing trust. The website is now the first port of call for the majority of American shoppers who use it as a search engine and price comparison website. Prices change tens of millions of times globally every day as algorithms constantly seek out and match or undercut the lowest prices offered by competitors.

***Not afraid to fail: focus on innovation & experimentation means no market is safe***

Amazon is not afraid to fail, continually innovating and testing new models with the aim of increasing the portion of a household's budget it is able to obtain over the long term.

This is evident in Amazon's highly tailored approach to new markets. The extent and timing of product roll-out has been varied across regions, however Amazon has consistently been prepared to lose money for over five years before becoming profitable in a market.

An interesting example of Amazon's innovative entry to new markets is its use of Amazon Chai Carts in India. Amazon launched a fleet of mobile tea carts that visited reluctant vendors across the country, offering them a cup of chai and explaining the benefits of selling on Amazon, with the ability to register and launch their online sales on the spot. This strategy assisted Amazon in overcoming the challenge of the highly fragmented Indian marketplace, which consists of many small sellers who viewed e-commerce as difficult and time-consuming.

Amazon uses its sophisticated logistics network to move into categories under-penetrated by online retail. For example, Amazon has historically struggled to move into apparel, given the importance of fit, quality and in-store experience. Its recently announced Prime Wardrobe service aims to leverage Amazon's logistics capabilities to reduce friction in online apparel retailing by allowing members to buy up to 15 apparel/accessory items with free shipping and the ability to return items via free pick-up from their doorstep. A 10-20% discount is offered (depending on how many items are kept) to incentivise customers to keep items. Whether or not this is profitable for Amazon, it exemplifies the power of its logistics network in transforming the way customers shop and Amazon's commitment to experimentation to move into untapped product categories.

***Know thy customer: Amazon's deep knowledge of customers increases importance of data***

Amazon's high volumes sold have allowed it to create a huge collection of data that facilitates strong decision-making, process optimisation and targeted customer service offering. Amazon has recruited hundreds of PhD mathematicians, economists and behavioural scientists to study this huge collection of data to predict future customer behaviour, seeking to develop capabilities like pre-positioning goods before they are even ordered.

Through its third-party marketplace and ability to track consumer spending, Amazon has leading insight into what people like and how they spend, allowing it to create personalised online shopping experiences and sophisticated recommendations to maximise sales. It has also received negative publicity suggesting it replicates successful Marketplace products for a lower price.

With an understanding of Amazon's disruptive business model, the next issue to consider is the approach that Amazon adopts to entering the market. Amazon has entered a range of international markets with very different characteristics. The approach taken to addressing the Australian landscape will determine the extent of its impact.

## Look at the key variables that will shape Amazon's Australian expansion

After deciding on the locations of its first two Australian warehousing sites at Eastern Creek in Sydney and Dandenong South in Melbourne, Amazon looks set to build out its logistics network and begin sales in Australia in 2018. The way in which Amazon moves into a new market is highly region-specific and has exhibited varying levels of success. This suggests its roll-out in Australia could follow a number of paths.

In entering Australia, key variables we will monitor are:

- **Product roll-out – timing and range**

Releasing its full range of products has been key to Amazon's success in new markets. Its roll-out in Canada was very slow with significantly less products launched over a much longer period than more recent entries into Italy and Spain, which led to poor take-up of its platform. The most recent expansion into Mexico was aggressive with the full range rolled out at once. Having learnt from the Canadian experience, we expect Amazon to follow a similar pattern to its European launches.

The Prime offering is particularly important in driving sales, with subscribers spending more than double the amount spent by non-members. The launch of Prime has historically been a key point of inflection for Amazon's sales and online retail more generally.

- **Online penetration of product categories**

Amazon's success to date has also been highly dependent on product category. It has traditionally taken the most share in relatively commoditised categories such as electronics, sports, apparel (predominantly socks and undergarments) and physical/electronic media, such as books. Australia's department store and electronics industries are significantly over-stored on a global basis. Electronics and fashion are also relatively consolidated. This is negative for large retailers, which have more share to lose and less to gain as smaller retailers are driven out.

Amazon has been seeking to move into under-penetrated product categories such as clothing retail and grocery by removing frictions for customers. The recent Whole Foods acquisition represents a major step into the previously unsuccessful fresh grocery market, which could herald the arrival of a hybrid online/physical offering. However, we believe Amazon will struggle in the Australian grocery market given the strength of the Coles and Woolworths duopoly. Their 70% combined market share provides them with a lot of capacity to compete. In addition, supermarkets can gain an insight into how Amazon intends to attack the market from its offshore approach, giving them time to innovate and adapt. Amazon's non-perishables offering, Amazon Pantry, is likely to be rolled out quickly, however this has not significantly impacted grocery retailers elsewhere.

- **Geographic reach**

Australia's low population density will be a key challenge for Amazon in establishing its delivery capabilities. As a result, Amazon is likely to focus on the east coast with fulfilment centres expected in Sydney, Melbourne and Brisbane. It has been reported that Prime Now will be launched in Australia, however given the relatively low population density even in key cities, the geographic reach of the one-hour free delivery service is likely to be very limited.

- **Consumer take-up**

Australia has the third highest retail spend per capita in the world, behind only the US and Japan, and the third highest online spend per capita in Amazon's current markets. Amazon typically drives increased online penetration in its new markets. This high online spend prior to Amazon's entry may make Australian consumers particularly receptive to Amazon's offering, however growth in online retail in general may be lower than in other new markets due to the high starting point.

- **Competitive response**

The way in which retailers respond to Amazon's entry will determine the amount of market share Amazon is able to gain and whether they succeed or fail on an individual level. Australian businesses have the opportunity to learn from mistakes made offshore, where retailers have typically waited several years before consolidating store footprint, leading to margin declines for a number of years. Retailers that exhibit high levels of gross margin selling products available elsewhere, combined with high costs, are particularly vulnerable and need to significantly reposition themselves to avoid being crushed by Amazon's pricing model.

Amazon will not have everything its own way as it faces a number of risks in entering Australia given the nature of our business and economic landscape.

## Consider the risks Amazon faces in penetrating the Australian market

- **Political backlash**

Given the significantly lower staff numbers required in online stores, concerns Amazon will increase unemployment and decrease domestic income have been voiced and may grow.

- **Logistics challenges**

Australia's low population density will be a major challenge for Amazon in introducing the same delivery services it offers overseas. Logistical challenges have been a major issue in Canada, and Australia's similarly difficult geography poses a risk to the breadth of the Amazon offering.

- **Competitor response**

Australian retailers have the benefit of being able to learn from mistakes made offshore where companies were slow to respond to Amazon's entry by changing their strategy, building an online presence and consolidating floor space. A strong, timely response by Australian incumbents could prevent Amazon from gaining the same market share it has offshore.

- **Customer take-up**

Estimates as to the amount of online retail share Amazon is able to gain, and growth in online retail in general, vary. Given Australia's high level of online spend per capita, customers are likely to be receptive to Amazon's offering, however the extent to which online retail will grow remains to be seen.

- **Anti-competitive behaviour**

Some of the business practices adopted in the US would likely raise the ire of the ACCC.

In the US, Amazon has been able to fend off competition through aggressive, below-cost pricing and leveraging its scale to build high barriers to entry without attracting significant anti-trust scrutiny. For example, Amazon slashed prices on nappies and baby essentials and introduced a subscription 'Amazon Mom' program to stunt rival e-commerce platform Quidsi's growth, losing significant amounts of money in the process but intimidating the company to the extent that it agreed to be acquired by Amazon. Amazon then raised its prices and closed subscriptions to Amazon Mom.

Given US anti-trust law is focused on prices paid by consumers, these actions were not considered predatory. However, in Australia, this behaviour could be considered to have an 'anti-competitive purpose' and hence, be illegal. As such, Amazon may not be able to follow the same aggressive strategies it has in the past. It may need to innovate!

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We hope that you have found this analysis of some of the issues surrounding the entry of Amazon into the Australian market useful for your own deliberations.

## About the author

### Andrew Stanley | BEc, LLB, MAppFin, CA

Andrew has been with Ralton since its inception in 2006 and leads the investment management of Ralton's managed accounts. He brings over 25 years of funds management and investment banking experience having held senior positions with major investment banks in Melbourne, Hong Kong, Tokyo and New York.

In Andrew's last international role as Executive Director of UBS's Financial Structuring Group in Hong Kong, he developed a range of complex structured finance solutions for clients across the bank's investment banking, fixed income and equities divisions to address issues faced by corporate clients.

Andrew started his career at Arthur Andersen where he qualified as a Chartered Accountant, before which he tutored macro-economics at Monash University while completing his law degree.

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