

Amazon takes on Australia

Is this the end for brick-and-mortar retail?

by Michael Moran

In April 2017, Amazon.com Inc announced plans to enter the Australian market with local fulfilment centres. Currently, Australians purchase goods from Amazon through Amazon US. Market reaction has been negative, as both retailers and retail A-REITs have since underperformed by a large margin. Headlines proclaiming the impending death of brick-and-mortar retail due to online purchasing abound in Australia and elsewhere in the developed world. In short, conventional wisdom today says the shopping mall is dead. We believe a more nuanced

view about the future of retail is in order. In the following, we review the implications of Amazon's entry into Australia and broader considerations for A-REIT investors.

Although it might seem most retail goods are purchased online today, the truth is only about 10 percent of global retail sales are completed online. This share is consistent in most places around the world, even in the United States, where Amazon has been operating since the 1990s. Online sales have been growing at a double-digit pace each year worldwide, however, far outpacing the growth in other retail sales. Amazon, as the world's largest online retailer, has recorded amazing revenue growth of approximately 29 percent compound annual growth rate over the past 10 years. Given its size and growth, it is fair to assume Amazon will have an impact on Australia's brick-and-mortar retail stores, but understanding how much impact and when it

Examining the quality of retail centres

will occur is key to identifying the opportunities and risks for investors. On the latter question of timing, we believe it will take Amazon a number of years to reach scale in Australia. Consider, for example, Amazon has more than 70 fulfilment centres in the United States. For Australia, it has planned the opening of a single fulfilment centre. The immediate impact of this will be another positive for owners of logistics facilities, which have benefited greatly from the growth in online sales this cycle. Online retailers need to store their goods somewhere, and this is how large, modern logistics facilities benefit. But if logistics property owners are winners, does that mean retailers and retail A-REITs are losers? The situation is not so concrete. First, change and disruption are not new to the retail industry but, through it all, the winners have been the highest-quality properties. Second, we know from past market entries by Amazon that it generally does not surpass 2 percent share of all retail sales within the first five years. This should give retailers and retail landlords some time to adapt to the post-Amazon world. One known is Amazon's entry into the Australian market will serve to push down prices and profit margins, which is good for the consumer but bad for retailers. So there is likely to be a modest negative effect for both traditional retailers and their landlords.

While high-quality centres are not immune to the loss of a tenant, we have found they are best positioned to replace tenants that leave. When identifying what defines a "high-quality" shopping centre, a few factors can assist:

- **Sales volume:** Sales per square metre is one of the first, and most easily understood, measures of quality, because it is intuitive that more sales for tenants means a higher-quality shopping centre.
- **Presence of elite tenants:** Tenants will pay for proximity to other tenants capable of bringing in more shoppers, so the presence of



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Chadstone in Melbourne ranks as one of the country's leading shopping malls, based on annual sales.

an elite tenant, such as Apple Inc, is another sign of quality.

- **Trade-area demographics:** The best centres are typically in locations where household incomes are high and rising.
- **Supply constraints and competitive position:** Centres that hold dominant positions in their trade areas due to location, tenancy, and/or planning and land availability limitations tend to hold up best across cycles.
- **Physical quality:** All real estate is capital intensive and regularly needs to be maintained and updated, so high physical quality of a centre is important.

Nuances of Australian retail

Without question, online retail has been on the mind of Australian retail landlords for some time. Amazon's arrival in 2018 is only the latest in this evolution. So far, the response from landlords has been to increase the experiential component (eg, dining, leisure, services precincts). Larger landlords with trophy assets, such as Scentre Group and Vicinity Centres, have gone further to stress the importance of the customer experience as a differentiator to the mostly-transactional nature of online shopping. Scentre, for example, hired the former chief brand officer of Starwood Hotels & Resorts Worldwide to be the director of customer experience. These malls also have unique attractions; for example, Melbourne's Chadstone (one of Australia's best-performing malls in terms

of overall annual sales, and owned by Vicinity) recently opened the first Legoland Discovery Centre in Australia. For trophy assets, the strong demographics and unique attractions will continue to be attractive for retailers that want to maintain at least some physical presence.

One caveat to the increase in experiential components in a mall is food/dining retail has its limits. In general, shoppers will eat at one food location per visit, so unless shopper traffic increases, any additional food retailers will dilute sales from existing food retailers. This phenomenon was recognised recently in Singapore, where the answer to falling productivity has been to add more food retailers. In talking to the major retail landlords, the anecdotal tipping point appears to be when 25 percent to 30 percent of the mall space (net-leasable area) is occupied by food tenants.

What we can conclude for retailers is Amazon's arrival will widen options for consumers while putting pressure on prices. The retail offer in Australia (both local online and offline channels) generally has been weaker, but with Amazon's entry into Australia — along with other international retailers in recent years — an increase in the quality of the competition likely will lead to weaker retailers being pushed out. For landlords, it shows the mall is not static, and remixing must be an ongoing and central strategy if a mall is to maintain its relevance. Amazon will simply be another factor pushing landlords to remix.

Non-trophy malls are the most vulnerable to the impact of online retail. By contrast, we expect nondiscretionary supermarket/convenience retail

will, on the whole, remain relevant. It is notable the two major supermarket chains in Australia have had online delivery as an option for almost two decades, but overall penetration of online grocery sales is low, at less than 2 percent, according to a recent report from Bank of America Merrill Lynch.

Effects of population on retail

The effect of Amazon on retail in Australia may be muted by the country's low population density. A cost-effective logistics network is a prerequisite for an online retailer to be competitive. Based on the 2016 census, 40 percent of Australia's population is located in Melbourne and Sydney. Given that, it is no surprise Amazon has, so far, focused its efforts on finding logistics facilities in Melbourne and Sydney. It will be interesting to see how Amazon approaches its Australia rollout beyond these two population hubs.

Much of the presumed Amazon impact is based on transposing the United States experience directly to Australia. This approach ignores an array of relevant differences, led by the fact Australia has much less retail space per capita than does the United States (see graph, below). Because of this, Amazon's impact might not be as great, given the lack of redundant retail space.

Another relevant factor in estimating the impact of Amazon's opening in Australia involves an assessment of the existing online landscape in the country. Analysis from Bank of America Merrill Lynch notes Amazon US has the largest market share today, followed by eBay Inc. This begs the question, would there be some level of cannibalisation when some of the same consumers switch from buying from Amazon US to Amazon Australia? While spending online in Australia will grow with Amazon's opening, it remains to be seen if the impact will be as large as expected.

We also need to take into consideration relative pricing, in the event prices for Amazon Australia goods exceed those for goods from Amazon US. That factor is currently at play in Singapore,

where Amazon launched its Prime Now service in July 2017 to further its presence in the Asia Pacific region. Anecdotal feedback after this launch is the pricing of available goods is higher than those charged by Amazon US. Therefore, the Prime Now service for Amazon Singapore is likely to be attractive for time-sensitive purchases and likely will evolve over time.

Similar to Australia, the mall space per capita in Singapore (54 square metres of gross leasable area per 100 people) is well below the level in the United States (219 square metres of gross leasable area per 100 people), as illustrated in the graph below. Population density is high in relative terms, making the Singapore market attractive for Amazon and much easier from a logistics standpoint. It has been noted Singapore is simply a foothold into the high-potential Southeast Asian market.

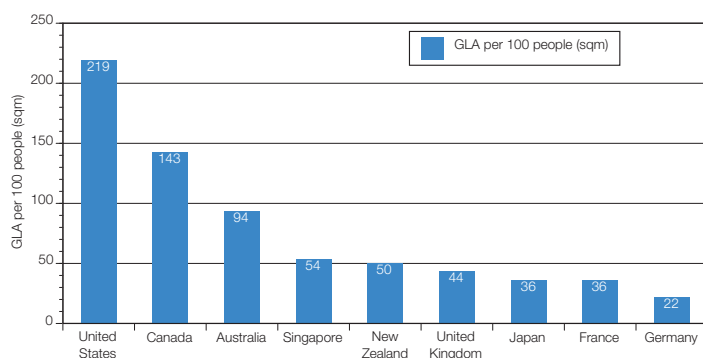
Is the future of retail online?

We do not anticipate a future in which all sales occur online. While e-commerce will continue to gain market share — and Amazon's entry into Australia likely will hasten that trend — we can look at the US market for insights about Australia's retail future. Despite the rapid growth of online shopping and Amazon's high capture rate of online sales growth in the United States, the ongoing importance of physical presence is being demonstrated by the continued expansion of omnichannel retail models. Under an omnichannel approach, retailers use multiple methods to sell their goods, including online and phone-based sales, catalogues, and physical stores. The expansion of formerly online-only retailers into physical locations, a movement known as "clicks-to-bricks", is a notable development. Examples of online retailers opening physical retail locations in the United States include Warby Parker Retail, Bonobos Inc, Athleta Inc and, most important, Amazon. Amazon's decision to open bookstores, after putting most of the large bookstores out of business the past two decades, as well as its recent acquisition of grocer Whole Foods Market, suggests there always will be a need for high-quality brick-and-mortar retail.

Is there an opportunity in A-REITs that own retail real estate? Since the announcement of Amazon's entry into Australia, retail A-REITs have sold off, trading at an 8 percent to 12 percent discount to NAVs. We see this as a market overreaction and believe high-quality A-REITs typically should trade at modest premiums to net asset value, given all their positive attributes, and the near- to intermediate-term effects from Amazon will be muted. ♦

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Global population density and retail area



Source: Shopping Centre Council of Australia

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