Property trusts: What could go wrong (Part 3 - The Amazon threat?)

MAY 2017

This is the third part in our series on "Property trusts: What might go wrong?".

There are really only two kinds of business model. You can bring products and services together - bundling - or you can pull old bundles apart.

Newspapers were a great example of bundling. The advertising had nothing to do with the journalism other than the financing of it. It was the variety and depth of the journalistic bundle that created a mass audience attractive to advertisers.

The arrival of the Internet broke that model. Carsales.com, Seek and realestate.com.au took the classifieds while brand-based advertising went primarily to Google and Facebook.

The arrival of Amazon, the argument goes, will destroy Australian retail just as the Internet destroyed newspapers. Amazon is a giant bundler offering low prices, incredible range and astonishing distribution. That spells trouble for retailers and, by extension, shopping centres.

For retailers lacking a point of difference with online competitors, there's some truth to this. Credit Suisse[1] found that Amazon's arrival will most affect Myer, Harvey Norman, JB Hi-Fi, Supercheap Auto, Rebel, Amart Sports, Big W, Kmart and Target.

The question for investors in shopping centres is whether malls can adapt to what is likely to be reduced demand for floor space from troubled retailers. History suggests they can, through their own form of unbundling and a number of other factors:

1. The best malls have already adapted to the Amazon threat

As we explained in part 2, department stores - a bundle-based business model in its purest form - have already shrunk. The floor space that may otherwise have been a department store has been taken up by new international retailers like H&M, Uniqlo or Zara, plus outlets that don't face online competition - nail salons, gyms, restaurants and the like. The result is that in the space once occupied by a few retailers there are now many more smaller outlets. This actually enhances diversification of a shopping centre cashflows and increases its attraction.

The increased variety makes the best shopping centres more attractive, leisure-based destinations. There might be more adjustment to come but the best managers have already shown an ability to adapt, which is but one reason why Amazon won't "kill" Australian retail.

As Matt Jensen, founder of M.J. Bale told Commericalrealestate.com.au[2]:

"The theatre of shopping is expected to be quite compelling these days. You've got to entertain people as they part with their money and they're today looking for brands that do that."

Even Myer has cottoned on (sorry about that - Ed). Its new Warringah store on Sydney's northern beaches features mobile recharging points, free wifi and click-and-collect ordering services. The menswear department has a barber, fussball and air hockey while womenswear features vintage photo booths. The aim is to deliver a shopping experience against which online retailers cannot compete.

2. New chains are queuing up to replace those Amazon does threaten

But what happens if local brands fail to adapt to the extent needed? Well, there's a plethora of overseas brands queuing up to take their place, as this table from the *Australian Financial Review* makes clear:

Global brand explosion

Key new store openings in 2016

SYDNEY
- Tesla
- Microsoft
- COS
- Kit & Ace
- Cartier
- Frank Muller
- Forever 21
- Zara Home
- Vodafone
- Rituals Cosmetics

MELBOURNE
- Coach
- TAG
- Cartier
- Van Cleef
- Van Laak
- Maje
- Bang & Olufsen
- Valentino
- Lego Land
- Omega
- Luxottica Group
- Sketchers
- Reiss
- Sephora
- MRP
- Braun Bruffel
- Furla
- Sandro

BRISBANE
- Zara
- H&M
- Uniqlo
- Kit & Ace
- Pottery Barn
- Pottery Barn Kids
- West Elm

PERTH
- Gucci
- Culture Kings
- Sketchers
- Colette

SOURCE: FINANCIAL REVIEW

Macquarie Equities estimate 326,000 square metres of new demand from international retailers exists longer term (June 2016). This equates to 2.5 Warringah Malls or 1.5 Chadstones. International retailers are attracted not only by Australia's growing and wealthy population but also it's lethargic competitive environment. Retailers that haven't responded to the online threat and have grown fat on high margins, or those that compete primarily on price, will struggle, but these failures will be replaced by new expanding chains.

For shopping centres it was ever thus. The Internet has been around for decades, as has Amazon, but online sales still account for only around 7.2%[3] of total retail sales.

Those global and local retailers, plus online retailers like Peter Alexander rolling out store networks understand the limitations of a purely online presence. Going shopping, gathering to meet, eat and play, is an essential human activity that the Internet cannot replicate. How else to explain historically low vacancy rates of between 0.5% and 1.0% in the best mall assets, and the heaving crowds?

1. The Australian, 20 March 2017
2. https://www.commercialrealestate.com.au/news/the-australian-retailers-who-have-found-success-in-tough-times/
3. NAB and Quantium estimate, January 2017

3. In grocery, online is a tougher market than the US

What about Coles and Woolworths? Amazon, which has rolled out physical stores in the US to market its Amazon Fresh grocery lines, must look at the margins these retailers make with glee.

But without a store network Amazon may struggle. Our relatively low population densities, even in our biggest cities, will increase Amazon's distribution costs, as will higher wages, which is why we understand the incumbents currently run delivery services at a loss.

With online grocery shopping accounting for just 3% of total visits[4], unless Amazon can find a new model, the cost of convenience is likely to be beyond most Australians. As Gary Mortimer, Associate Professor at Queensland University of Technology, wrote in The Conversation, "With no physical stores, Australia represents a very small market for the retail giant."

Even in the US, where wages are lower, populations are bigger and densities are higher, Amazon's sales growth is slowing[5]. If Amazon hasn't destroyed conventional grocers where market dynamics are on its side, why would it do so here, where they aren't?

4. Retailers have more cards to play

Of course, Amazon's expanded local presence is likely to provoke a response. Retailers are likely to beef up their loyalty programs as they seek to lock in customers. They will also take lessons from leading global retailers, as has Myer, to deliver a more interesting retail environment. And they'll hone their cost structures to be more competitive.

But again, this is what retailers have always done. Those that succeed in transforming themselves will blossom; those that don't will eventually fail, replaced by new retail concepts that cater for new market tastes. In that sense, the Amazon "threat" seems over-hyped and overstated.

Amazon's expanded Australian presence will affect retailers in price-driven, commodity markets and those that don't adapt. Some will fail. But in the shopping malls across the land this is unlikely to lead to boarded up shops and empty floors. As we have seen, retailers and shopping centres have shown a great capacity to adapt. Amazon's arrival won't change that.

5. Amazon is more likely to cannibalise existing online sales

So, what will it change? Our research indicates that Amazon is more likely to cannibalise existing online sales than take market share from conventional retailers.

Currently, about 7.2% of total sales are conducted online. This figure will grow, albeit at a slowing rate as it has in recent times. Amazon's proportion of that figure, now modest, may well grow to around half. That's unlikely to affect shopping centres and their tenants but it might impact local online retailers like The Iconic and Shoes of Prey.

6. Amazon is shifting to a third-party model

But even here the issue is more complex than it appears. Media commentary seems to neglect the fact that Amazon Marketplace, a platform for other online retailers, accounts for half of all packages the company delivers[6]. Amazon may compete with the likes of The Iconic but it's also a potential customer.

In fact, Amazon is undergoing a shift to being a third party marketplace rather than a primary retailer. That means providing services to online retailers is gaining more importance than competing directly with them for sales. This reduces the threat to local retailers and may actually help existing retailers improve their online offer.

For these reasons, we think the media coverage of Amazon's arrival far outweighs its actual threat. Investors in Australia's best shopping malls have less to fear than the excitable commentaries would imply, APN AREIT Fund investors should sit back and enjoy the current yield of 5.99%[7]. The Amazon threat is overdone.

4. http://www.roymorgan.com/findings/7076-australians-yet-to-embrace-online-grocery-shopping-201612060915
5. Amazon fourth quarter sales result, Feb 2017
6. https://www.statista.com/statistics/259782/third-party-seller-share-of-amazon-platform/
7. As at 30/4/17. Current running yield is calculated daily by dividing the annualised distribution rate by the latest entry unit price. Distributions may include a capital gains component. Distributions are not guaranteed and past performance is not an indicator of future returns.

APN Property Group
A specialist real estate investment manager

We actively invest in, develop and manage real estate and real estate securities on behalf of institutional and retail investors. APN's approach to real estate investment is based on a 'property for income' philosophy.

Established in 1996, APN's listed on the ASX and manages $2.4 billion (as at 31 December 2016) of real estate and real estate securities. APN trades on the ASX under the code 'APD'.

Contact us
APN Property Group Limited

Level 30, 101 Collins Street,
Melbourne, Victoria 3000

Investor Services Hotline 1800 996 456
Adviser Services Hotline 1300 027 636

Email apnpg@apngroup.com.au
Website **apngroup.com.au**