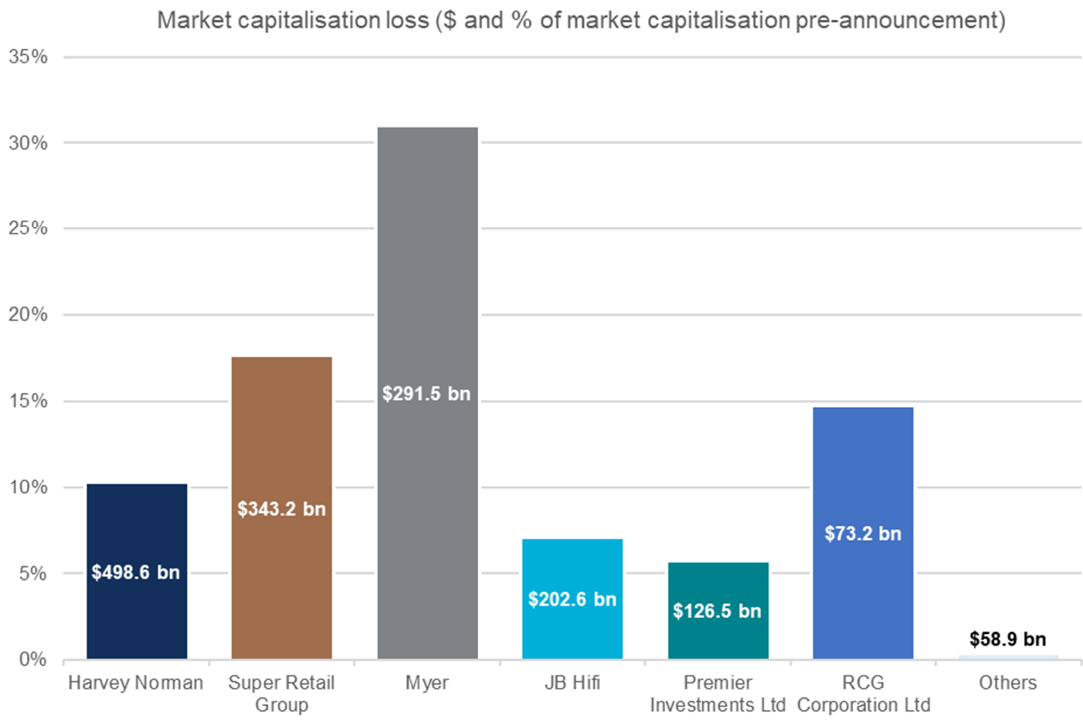
THE AMAZON EFFECT MORE PAIN IN THE RETAIL JUNGLE?

From revenue stream to river of gold

Named after the biggest river in the world, Amazon started in 1994 as an online bookstore and is now the **world's largest retailer by market capitalisation** – and the **largest online retailer by revenue**. Amazon's blueprint for its incredible success and phenomenal growth stems from its pre-established logistics operations, dynamic pricing strategies and an extensive, ever-growing product range. Its pioneering business model successfully combined **data driven decisions with a customer-first focus** in service and experience.

The 1.6 billion dollar bombshell

Entering the Australian market in 2012 via the launch of the Amazon Web Services, Amazon introduced its Kindle store, and the year after expanded customer access to overseas products on its Australian website. The jungle remained relatively quiet for the next four years until April 2017 when, after increasing speculation, **Amazon formally confirmed its plan to roll out a full retail offering here**. The result? Since then, approximately $1.6 billion of market capitalisation has been lost from ASX-listed retailers (non-food). The big losers are the big retailers Myer, Super Retail Group, Harvey Norman, and JB Hifi, in that order:



Source: Leadenhall analysis

What about earnings?

Leadenhall also assessed the earnings impact on these listed retailers by the implied $1.6 billion decline in market capitalisation, with the following high-level assumptions:

- An average cost of capital of 9.0% for the Australian retail industry
- A five-year period for Amazon to reach a reasonably steady state in Australia
- A long-term growth rate of 2.5%

… resulting in the following discounted cash flow model:

Discounted cash flow analysis

(A$m)	Year 1	Year 2	Year 3	Year 4	Year 5	Terminal value
Cash flow before tax	81.5	97.8	117.4	140.8	169.0	
Less tax impact	(24.4)	(29.3)	(35.2)	(42.2)	(50.7)	
Total cash flow losses	**57.0**	**68.5**	**82.2**	**98.6**	**118.3**	**1,865.4**
Disc factor (@ 9.0%)	0.96	0.88	0.81	0.74	0.68	0.68
Present value	**54.6**	**60.2**	**66.2**	**72.9**	**80.3**	**1,265.8**
Total net present value of cash flow losses	**1,600.0**					

Source: Leadenhall analysis

As shown above, a net cash flow loss of $118 million in year five equates to a loss in value of $1.6 billion. This represents pre-tax earnings of $169 million per year – or 6.8% of earnings before interest and tax ("EBIT") for these retailers.

Perfect storm – or storm in a teacup?

The following scenarios show what it might take for ASX retailers to lose that 6.8% of EBIT:

Scenario analysis

(A$m)	Status quo	Lost volume	Reduced price
Revenue	**1,000**	**984**	**993**
Cost of good	(570)	(561)	(570)
Gross margin	**430**	**423**	**423**
Overheads	(330)	(330)	(330)
EBIT	**100**	**93**	**93**

Source: Leadenhall analysis

As you can see, a 2% reduction in volumes or a 1% reduction in prices would lead to **an average 6.8% fall in EBIT** for those retailers. To gauge how likely reductions of this scale are, take a look at other markets in which Amazon operates:

- **Revenue loss** – Amazon has 5% of total retail market share in US and Japan, 3.5% in UK and 1% in Canada, while it currently has 0.6% (excluding food retail) in Australia. On those figures, **a 2% increase in market share appears to be eminently achievable here**.
- **Reduced prices** – data on price reductions is less concrete, although anecdotal examples are available. Office Depot prices in the US fell by approximately 15% from their peak following price competition from Amazon. **If Aussie retailers dropped prices by 10% their profits would be wiped out** (assuming costs stay the same).

The impact of a 1% swing

Then there's the likely impact on both price and volume to consider – if Amazon takes only 1% more volume, and causes incumbent retailers to drop prices by an average of 1%, our assessment of **the total loss in value of the listed retailers is $3.3 billion**. Here are some of the various possibilities:

Sensitivity Analysis (A$bn)

Market share	Price reduction			
loss	0.5%	1.0%	1.5%	2.0%
0.5%	1.6	2.1	2.6	3.1
1.0%	2.8	3.3	3.8	4.3
1.5%	3.9	4.4	4.9	5.4
2.0%	5.1	5.6	6.0	6.5

Source: Leadenhall analysis

However…

Please note that a number of factors may weigh against this conclusion, including that:

- The market may have already allowed for any risk prior to Amazon's announcement and some of the loss in value quantified here may already be reflected in the retailers' prices
- Costs are assumed to be constant for the purpose of this analysis – however, some are partly variable (such as turnover rents) and others could reduce in difficult trading conditions
- The analysis is based on overall averages and the precise impact will vary for individual companies.