m3property Update

Amazon, Online Retailing and the Retail Property Sector in Australia

November 2017

Amazon's expansion in Australia will accelerate growth in the online retail market and this will result in reduced growth in turnover of some shopping centres. Whilst major Australian retail landlords are fairly well positioned to compete with growth in online retailing, the impact on retail property will vary centre by centre and will depend on the centre's tenant mix, location and management.

The Past Six Months

It has been just over six months since Amazon announced that they would be expanding their offering in Australia. We still do not know exact details on the timing, launch structure or range of services that Amazon intends to make available. However, Amazon recently held a teleconference with potential marketplace vendors (there are already over 500 registered sellers for the Australian Marketplace) and noted that the service is likely to start late this year or early 2018. We also know that they have leased a warehouse in Dandenong South (Victoria) and are rumoured to have leased a warehouse in Eastern Creek (New South Wales).

Whilst at the start of 2017, Australian retailers were seemingly unprepared and unfazed by Amazon's expansion into Australia, it appears as though retailers are starting to recognise the need to adapt and improve their services and offerings, both in-store and online. Over the past six months, a number of large retailers have announced 'coping mechanisms' (such as cost cutting, improvements to delivery and pick-up options, decentralisation of online sales and improvements to in-store services) to compete with the growing online sector.

Australia ≈ Canada?

In the countries that Amazon is currently operating, it accounts for anywhere between 1% and 25% of total online sales. In Canada, where Amazon was established in 2010, the company now accounts for 13% of total online retail sales. Amazon has not yet significantly disrupted the Canadian retail market. This has been attributed to the country's low population density, which makes fulfilment more difficult and costly. Furthermore, Amazon delayed selling its Prime membership in Canada until a number of years after being in the market. However, since making the Prime membership available in Canada, Amazon's market share has grown rapidly and the country's retail market will continue to evolve as a result.

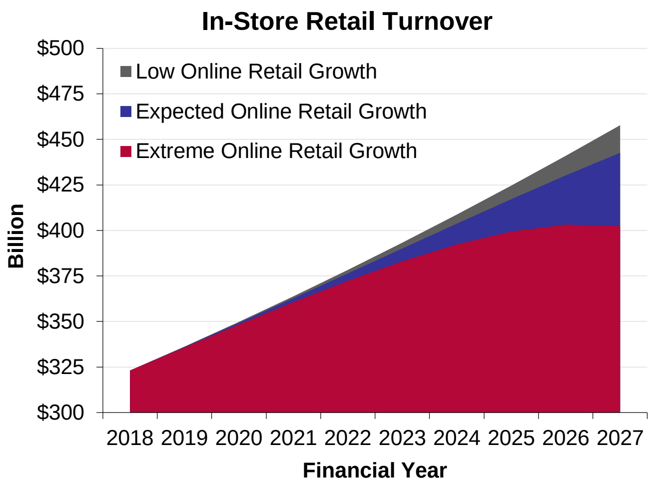
The effect of Amazon's expansion on Australian retailers and retail property is expected to be similar to how it has played out in Canada. Like Canada, the low population density of Australia will be a moderate barrier to entry and may see Amazon choose to introduce a restricted offering initially, such as an east coast only offering, or the delayed rollout of its Prime membership.

Whilst Australia has a low population density, it is actually one of the most urbanised countries in the world. According to 2016 population data, around two thirds of the Australian population live in the Greater Areas of Capital Cities. Over the year to June 2016, Greater Capital Cities accounted for 77% of total population growth. Because of this, if Amazon's initial offering is only available for capital and major cities of the east coast, lower population density will not be a significant issue. Nonetheless, over the longer term, Australia's low population density will become less of an issue as the company builds scale here.

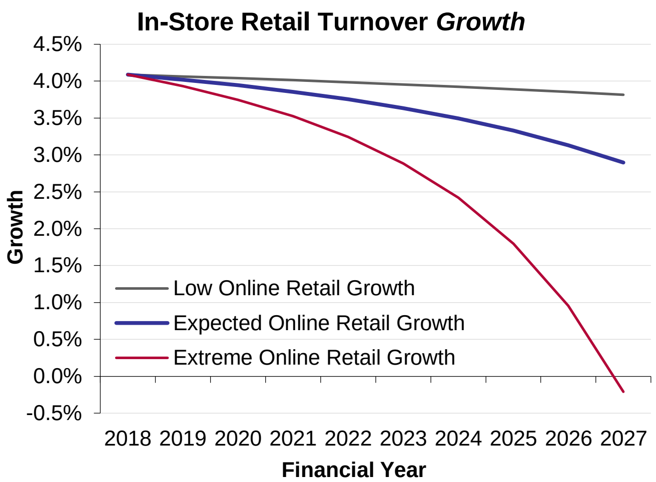
The Effect of Online Growth on In-Store Turnover

What is likely to occur following Amazon's expansion into Australia, is an acceleration in total online sales growth. This will result in reduced turnover for some retailers. The following charts show a selection of scenarios for in-store retail values and growth based on low, extreme and expected growth in online retailing, and assuming average total retail trade growth of 4.5% per annum over the coming decade.

The low series (grey) assumes online retail growth of 10% per annum. Based on this scenario, in-store retail growth declines but remains moderately strong. The extreme series (red) assumes online retail growth accelerating to be 25% by 2027. If this occurs, which is not likely, in-store retail *growth* would decline more substantially and the *value* of in-store retail trade would also decline. What we actually expect to occur (blue) lies somewhere between these two scenarios, with online retail growth reaching circa-15% by 2027. Based on this scenario, in-store retail growth would gradually decline over the coming decade to be just less than 3% as at 2027.



Source: **m3**property



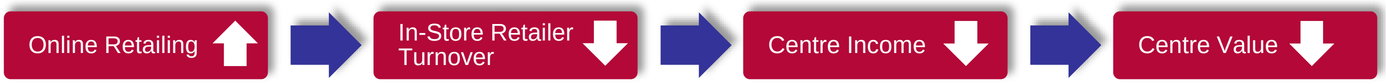
Source: **m3**property

The Effect of Online Growth on Shopping Centre Values

The most likely scenario in terms of the effect of Amazon on centre values overall is that reductions in retail turnover within centres will reduce turnover rents. This is likely to be combined with reduced demand for space from rationalising retailers, which results in reduced competition for space, and therefore market rents may decrease. Centres are also likely to see cost increases in terms of attracting customers and maintaining tenants, as well as reduced revenue from the increased churn of tenants.

Overall, a centre's reduced net income is likely to reduce the value of the centre to potential investors. While simplified, it is worthy to note that if retail yields are stable, a reduction in centre income will result in a proportionate decline in the value of a centre.

However, if potential investors expect the value of a centre to fall due to reduced centre income, they are likely to require a higher yield on acquisitions. Yields are therefore expected to soften following Amazon's expansion, until there is more certainty around the effect that Amazon is going to have on centre revenue. Once there is more certainty, we expect that investors will no longer require a yield premium.



What are Centre Owners Doing?

Overseas, the response to growth in the online sector by major centre owners has been mixed. Some are investing in technology, others are repositioning their retail property portfolio, while some are yet to make any substantial changes to their management strategies or portfolio. This scenario is also being emulated in Australia. This year we have seen some retail REITs divesting non-core centres as well as retail property owners investing in ways to attract customers.

Centre owners are increasingly trying to broaden the appeal of their centre as a consumer destination as opposed to a shopping destination. Larger institutional owners are increasingly looking to provide more service-based tenants as well as incorporate food and beverage precincts in new developments and centre redevelopments. Modern food and beverage precincts differ substantially from traditional food courts and are intended to be a destination for consumers to visit, whether or not they plan to do any shopping.

Owners are also adjusting the tenant mix to include gyms, medical centres, hair and beauty services, education and child care centres, interactive games/toy retailers and office space. Centres are increasingly offering services such as valet parking, personal styling, free wifi, justices of the peace and electric vehicle charging stations. International retailers are also proving to be popular tenants with landlords due to the increased foot traffic they usually generate.

Survivors and Sufferers

Given the risk Amazon (and the wider online retail market) poses for bricks and mortar retail, investors will need to weigh up the risk and return on a centre-by-centre basis. It is expected that there will be a large divergence in the performance of different centres going forward, with centres expected to increasingly reflect economic growth, demographic composition and competition in the catchment area, management and preparedness of the centre, and the performance of anchor tenants. Going forward, investors are likely to place an increased weighting on forecast centre income growth over bond rates when making investment decisions.

The centres that are expected to perform well are:

- Centres in regional locations or low population density areas (at least in the short to medium term before Amazon has built scale);
- Centres that are customer focused and have proactive management;
- Centres that are already responding to growth in online retail by adapting the tenant mix to include more food, entertainment and services;
- Centres with tech-savvy owners and managers;
- ‘Fortress Centres’ with low competition in their catchment;
- Centres in key tourist areas;
- Small neighbourhood centres with a focus on convenience; and
- Centres in high population growth areas and areas with favourable demographics.

Centres that may come under pressure include:

- Centres in oversupplied catchments or with weak demographics;
- Centres with owners who are not willing to adjust to the structural change occurring;
- Fashion and electronics focused centres;
- Centres with a focus on poorly performing anchors;
- Poorly managed or run down centres; and
- Secondary centres with weak sales and foot traffic.

Our Retail Property Services

m3property has a reputation for providing independent and trusted valuation advice to our institutional, private investors and financier clients. Our team operates across Australia delivering quality valuation and consultancy advice. Our Retail Valuation Team is supported by our national research capability with representation in each state.

m3property offers a diverse range of valuation services covering:

- Mortgage Security Valuations
- Rental Determination / Advice
- Asset Reporting
- Acquisition Valuations / Due Diligence
- Portfolio Valuations
- Feasibility - Development
- Consultancy Advice
- Expert Witness Engagement

Our Retail Experience

Western Australia

Lakeside Joondalup
Westfield Carousel
Northgate SC
Southlands Boulevarde
Harvest Lakes
Stockland Baldivis
Karrinyup SC
Maddington SC
Stirling's SC
Bunbury Forum
Halls Head Central

South Australia

Westfield Tea Tree Plaza
Elizabeth SC
Colonnades SC
Arndale SC
Golden Grove Village
The Stables

Victoria

Emporium Melbourne
Mildura Central
Westfield Fountain Gate
Keilor SC
Campbellfield Plaza
Brimbank SC
Bendigo Marketplace
Westfield Geelong

Tasmania

Eastland SC
Northgate SC
Meadow Mews SC
Channel Court

Queensland

Mount Ommaney
City Centre Plaza
Sunshine Plaza
Caneland Central
Sugarworld Village
Derragum Village
Noosa Civic SC
Westfield Strathpine
Clifford Gardens
Stockland Cairns
Stockland Rockhampton

New South Wales

Macarthur Square
Wollongong Central
Charlestown Square
Stockland Merrylands
Rhodes Waterside
St Marys Village
Salamander Bay
Lidcombe SC
Stockland Forster
Plumpton Marketplace
Marrickville Metro
Warriewood Square
Deepwater Plaza
North Rocks
Roselands SC
Rouse Hill Town Centre

ACT

Westfield Belconnen
Chisholm Village

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