

BKI Quarterly Report



Amazon – In the middle of difficulty lies opportunity

Welcome to the 15th edition of the BKI Quarterly Report, prepared by Contact Asset Management. As regular readers are aware, Tom and I use these missives to share our thoughts on topical issues impacting the BKI Investment Company Portfolio. Past issues include discussions such as the Benefits of Long-Term Investing, our View on the Banks and updates on Research Trips that we have undertaken. This report and previous issues can be found on the BKI Investment Company website at <http://bkilimited.com.au/quarterly-reports/>

In this edition, we cover a topic that is dominating headlines – the impending arrival of Amazon.com into the Australian market. We provide a brief history of Amazon.com Inc, discuss its successful model and then consider which Australian businesses will be challenged and which may benefit.

Amazon.com: is the apocalypse of retail (as we know it) here?

In the last few months, the following headlines are symbolic of the pent up fear of the impending arrival of Amazon.com (“Amazon”) into Australia:

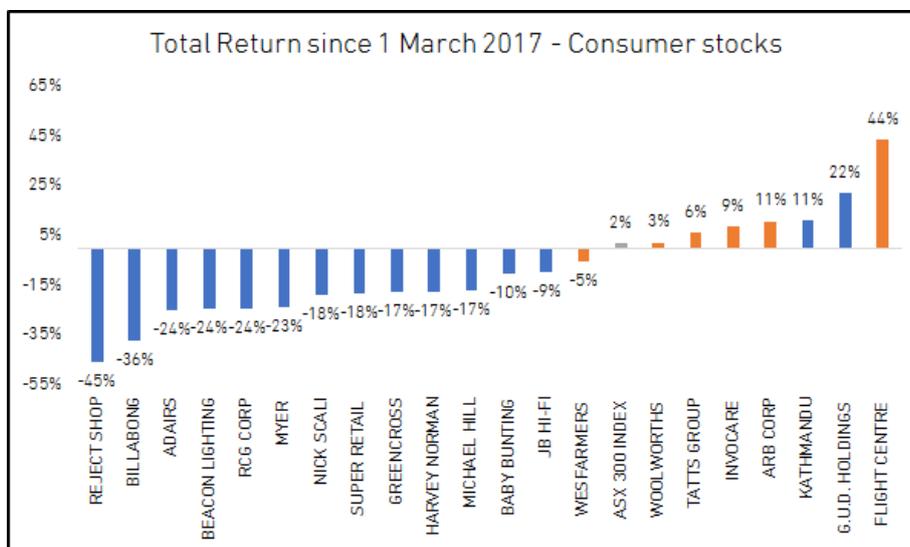
Amazon’s \$12b raid on Australian retail: Who’ll feel the pain and why (ABC, June 1)

Amazon’s arrival: retailers brace for shock arrival (The Australian, April 3)

Which Retailers will be Killed by Amazon? (FN Arena, March 8)

Aussie retailer’s shares tumble on Amazon threat (The West Australian, April 19)

The share price impact on several retailers has been severe. The following chart highlights the performance across the Consumer sector.



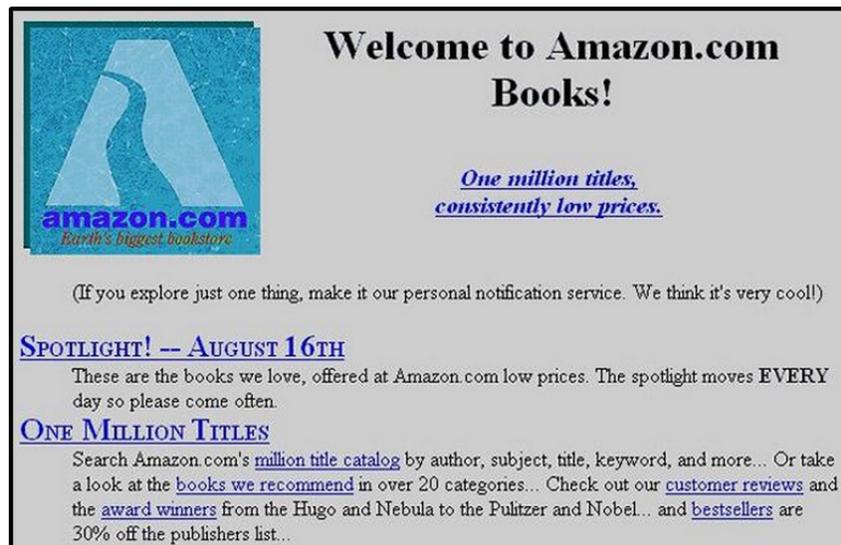
Source: Bloomberg. The Orange bars indicate stocks that are owned in the BKI Portfolio

Who is Amazon.com? A brief history

In the early 1990s, the Internet and the World Wide Web started to become mainstream. Business and household use expanded rapidly due to the ubiquitous nature of the analogue telephone network and the use of modems.

Today, almost 50% of the world's population has access to the internet at home (via any device type and connection). In 1995, it was less than 1%. One of the early pioneers who foresaw the ecommerce opportunity of the internet was Jeff Bezos, founder of Amazon.com in late 1994. After reportedly reading a report about the future of the Internet that projected annual Web commerce growth at 2,300%, Bezos, who was then 30 years old, left a promising career on Wall Street and incorporated Amazon in Seattle, Washington. Step one was the sale of books. In its 1997 Shareholder Letter, the company stated "*Amazon.com's objective is to be the leading online retailer of information-based products and services, with an initial focus on books.*"

The Amazon website in 1995



The screenshot shows the Amazon.com website interface from 1995. On the left is the Amazon logo, a stylized 'A' with a blue-to-teal gradient, with the text 'amazon.com' and 'Earth's biggest bookstore' below it. To the right of the logo is the heading 'Welcome to Amazon.com Books!' in a bold, black serif font. Below this heading is the text 'One million titles, consistently low prices.' in a blue, italicized serif font. Underneath is a line of text: '(If you explore just one thing, make it our personal notification service. We think it's very cool!)'. This is followed by a section titled 'SPOTLIGHT! -- AUGUST 16TH' in a blue, bold, serif font. Below the spotlight title is the text: 'These are the books we love, offered at Amazon.com low prices. The spotlight moves EVERY day so please come often.' The next section is titled 'ONE MILLION TITLES' in a blue, bold, serif font. Below this title is the text: 'Search Amazon.com's million title catalog by author, subject, title, keyword, and more... Or take a look at the books we recommend in over 20 categories... Check out our customer reviews and the award winners from the Hugo and Nebula to the Pulitzer and Nobel... and bestsellers are 30% off the publishers list...'

In 1995, Amazon generated US\$511 *thousand* in revenue. In 2016, the company reported US\$136 *billion* in revenue.

The Amazon of today is now the largest Internet-based retailer in the world. But retail is only part of the picture. Its internet services business (Amazon Web Services) is intertwined into the business. In simple terms, AWS generates revenue by leasing out server space to third parties. This division has underpinned profit growth for several years.

Amazon is also increasingly relying on third party retailers to drive sales. Third party sales, through Amazon Marketplace, now accounts for 40% of Amazon revenue. The sellers get access to Amazon's ecosystem and pay a 15% referral fee for the privilege. This service is now available in over 60 countries. The announcement from Amazon that it intended to open in Australia was partly motivated by a desire to attract third party sellers. Existing sites such as eBay are likely to be disrupted by Amazon Marketplace.

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The graphic below is a snapshot of the brands within the Amazon portfolio.



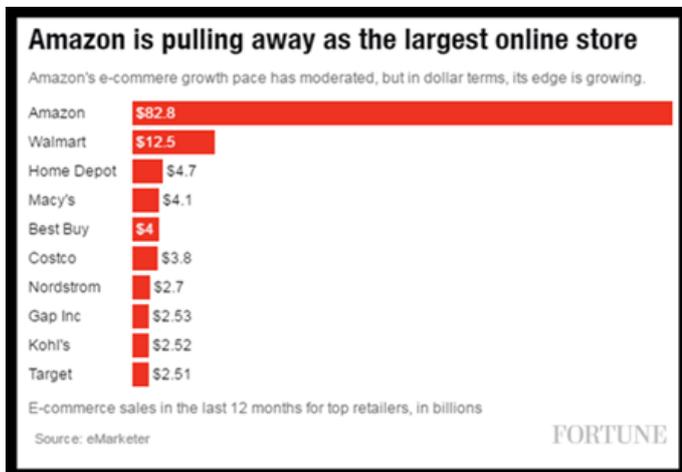
Why has Amazon been so successful?

There are obviously a number of factors that have contributed to the Amazon success story. However, at its core, the underlying driver of success has been a relentless focus on the customer – often at the expense of near term profits. The following quote from Jeff Bezos, Amazon CEO & President, is powerful:

“The most important single thing is to focus obsessively on the customer. Our goal is to be earth’s most customer-centric company.”

This unrelenting focus on the customer first and the bottom line second has been a critical factor in Amazon’s success. It has also made Amazon a very difficult business to compete with. One cannot understate just how determined Jeff Bezos is on competing on price to drive market share growth. In his e-commerce strategy, he has been focused on reaching scale/critical mass quickly moreso than anything else. This has been a successful strategy – Amazon has a massive 41% market share in ecommerce in the United States.

The following graphics illustrate how big Amazon has become.



368 Million Products sold on Amazon.com

as on May 4th, 2017

data bites by Scrapehero

Walmart.com has 4% the number of products that amazon.com has for sale



There are a number of attractive characteristics of the Australian market that would appeal to Amazon

When Amazon officially lands in Australia with its Fulfilment Centres (exactly when that is remains open to debate), it will have a significant advantage that it already has a substantial customer base. Australians have been accessing the Amazon Kindle store for over a decade and the existing customer base is said to be over 1 million. In addition to this customer base, we see a number of other characteristics which makes Australia attractive to Amazon:

- Australians have a relatively high disposable income
- We have high internet penetration and smartphone use
- Despite the size of the country, the population is quite concentrated – three cities have over 50% of the national population
- A relatively undeveloped online retail market.

In a recent Investor Day presentation in early June 2017, Wesfarmers shared the following slide. It shows the number of companies competing for a share of the consumer discretionary market. Wesfarmers believes it is an \$80 billion market. Several international retailers have already landed on our shores and are competing well. We believe that several businesses on this slide will be disrupted by Amazon.



How is BKI exposed to Amazon.com?

BKI Investment Company is purely exposed to Australian Listed Equities and cash – the company does not have the mandate to invest offshore and therefore cannot own Amazon.com. Nevertheless, the impact of Amazon is an important consideration for Australian investors.

From a high level, we remain cautious on a number of the Consumer Discretionary names but see other companies as Amazon beneficiaries. We discuss the winners and losers in more detail below.

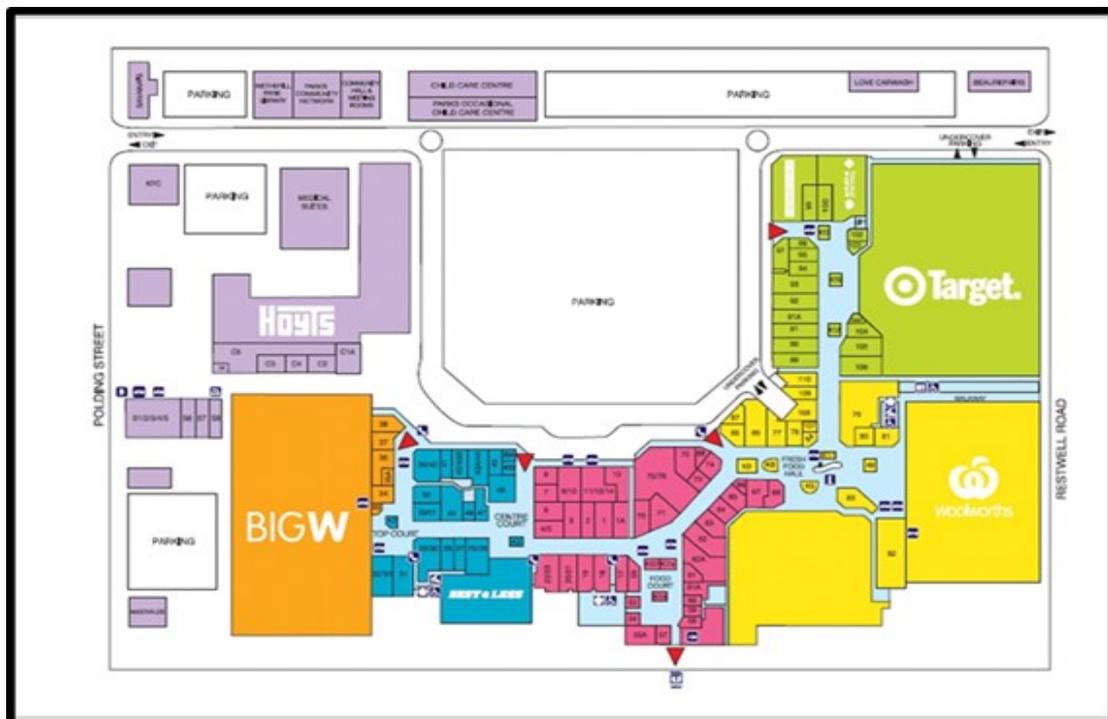
We are cautious on the Consumer Discretionary sector. While we do own a small number of companies in the space, ARB Limited, Flight Centre, Invocare and Tatts Group, there are a lot of companies that we don't own. Overall, BKI has less than 6% of the Portfolio invested in Consumer Discretionary companies.

At a macro level, there is an additional reason for our level of caution. The sector has the potential to come under increased pressure if we see a pullback in house prices, an increase in the savings ratio or benign wage growth. Indeed, we may see a combination of all three.

We are concerned about the long term earnings sustainability for the Department Stores, Apparel and Electronics

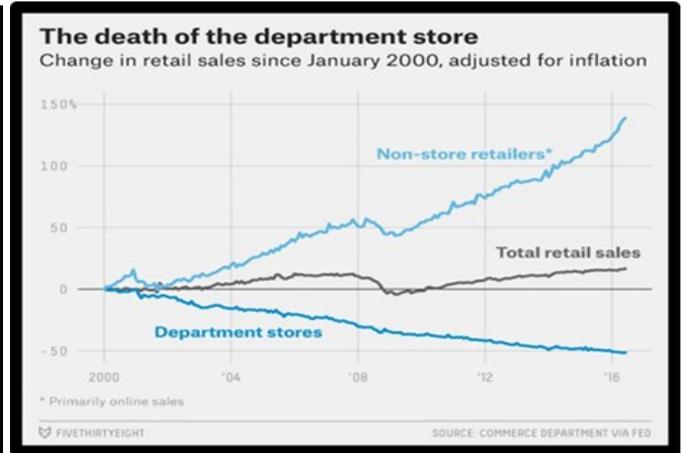
Simply put, the Department Stores are in trouble. The prevailing view is that the department store model is structurally challenged and will need to react quickly and change strategy to stay relevant. There is no quick solution here. On a ten year view, we find it difficult to foresee that we will still have three major discount department stores (Big W, Kmart and Target) operating in Australia.

The second order effect of this is on our shopping malls. As readers would be aware, the department stores occupy a significant proportion of the footprint of shopping malls. The following map of Stockland's Wetherill Park shopping mall is typical of the mall layout. Target and Big W take up a lot of space.



In the US, 440 department stores have closed in 2017 already. The more forward thinking operators are transitioning the mall to engage customers with more of an “experience”. They are investing in the food offering and placing different service providers, such as dentists and gyms, in the mall to drive traffic. We remain cautious on a number of the REITs which have large exposures to discount department stores as tenants.

The sector is shrinking. In the US, department stores accounted for 26% of apparel sales in 2005. Last year it was 11%.



Groceries will be harder for Amazon to disrupt initially

In recent weeks, Amazon announced a US\$14 billion acquisition of Wholefoods. Wholefoods is an upscale grocer with stores in some of North America's most desirable locations. This strategy is expected to increase the penetration of Amazon Fresh, which to date has been slow (by Amazon standards) to ramp up. Fresh food is a more difficult segment as the logistics of dealing with perishables versus books, electronics etc. is far more complicated.

Wholefoods has over 450 stores and a strong customer perception in the United States as being "fresh". The physical footprint is expected to enable Amazon to shorten delivery times and combat some logical issues. Wholefoods has quite a developed supply chain.

The impact of Amazon in Australia is expected to take longer to meaningfully impact the major Supermarkets. Woolworths and Coles have impressive supply chain systems and have supplier relationships in place. This will be a barrier to entry that Amazon will need to overcome. The route to market in Apparel and Electronics will be easier for Amazon than Fresh food.

Additional factors that will insulate the food retailers in Australia from Amazon in the near term also include:

- Cost - The cost of picking and delivering food is far higher than non-food.
- Scale - Local scale is important. A significant proportion of what food retailers sell is locally sourced. The incumbents have a distinct advantage here through scale.
- Perishable - Fresh food is perishable which creates additional distribution complexities for a new challenger.

Aldi is a useful example here. While the Aldi rollout continues to gather momentum, its growth has largely come at the expense of the independents (i.e. Metcash). At the abovementioned Wesfarmers Investor Day, the CEO stated that Coles market share is higher now than it was before Aldi arrived.

While Fresh has high barriers to entry, we are cognisant that Amazon has the potential to disrupt the packaged goods that are normally found in supermarkets.

One other dynamic is that Amazon has a private label offering. The company has already made progress with generic items such as batteries. The power of the Amazon private label will develop over time and is tied to data. Amazon will build knowledge of what items customers buy. It will then incentivise customers (through lower prices) to buy the Amazon private label product over the branded product. We see the scope for significant disruption here.

One innovation that will gain traction is Amazon's Alexa-controlled Echo technology. Using nothing but the sound of your voice, you can search the Web, create to-do and shopping lists, shop online, get instant weather reports, and control popular smart-home products - all while your phone stays in your pocket. The Echo Show device looks like an iPad but is going to be so much more. Tens of millions of households will soon have these devices in different rooms all over their homes, and they will have a significant impact on our lives. If you have time, I encourage you to watch the YouTube video on the introduction of the Echo Show. Either search "Introducing Echo Show" or use the following link: <https://www.youtube.com/watch?v=WQqxCeHhmeU>

What does this all mean for traditional bricks and mortar?

We continue to believe that there will always be a need for a physical store presence in some form. Amazon's strategy in buying Wholefoods actually supports this. Nevertheless, increasingly retailers will need to offer a combination of physical and on-line presence. Those retailers that offer the most seamless customer experience will be the long-term winners. It is about the ecosystem. A recent Bain and Company report noted that the biggest threat to Australian retailers is not Amazon's size and market share but its "customer obsession" and its ability to engage with consumers almost 24 hours a day through an ecosystem which includes fast and free delivery through Prime and Prime Now, connected devices such as Echo and Alexa and even daily fashion advice through its Look app.

The report went on to note that Amazon spent \$US16 billion last year on research and development to feed this system of innovation. This enables Amazon to engage with customers in a way that other retailers have never done. This does not necessarily mean the end for bricks and mortar retailers. However, when JB Hi-Fi has a market capitalisation of \$3 billion and Amazon is spending \$16 billion on R&D in a year, one can see the challenge that lies ahead. Traditional retailers will need to adapt and invest.

The ability to capture customer data and effectively use that data will be a game changer for those retailers willing to invest in technology. Those that do not will be destroyed by the likes of Amazon.

Who are the beneficiaries of Amazon's entry into Australia

The vast majority of the commentary surrounding Amazon's entry into Australia has been about the damage that the company will cause and little about the opportunities that will arise. As the old saying goes, "Some men go through a forest and see no firewood".

We see a number of beneficiaries of Amazon's arrival into Australia. Based on our analysis of the Amazon experience elsewhere, we believe that Amazon will need 3 – 5 fulfilment centres in the near to medium term. The increased level of activity will drive volume growth through our Ports, Road and Rail.

As a result, companies that are beneficiaries of increased economic activity will win. We see the likes of Transurban, Sydney Airport, Goodman Group, Australia Post, Lindsay Australia and QUBE Logistics as being well placed. Qube's new facility at Moorebank in Sydney's West is well positioned to help service the needs of this new ecosystem. We visited the site last month.

Conclusion - Stop being afraid of what could go wrong and start being positive about what could go right

In all, we believe that the "death" of Australian retail has been greatly exaggerated. Amazon will shake up the market – of that we have little doubt. However, the idea that Amazon is a 1,000 pound gorilla that will smash every bricks and mortar retailer in quick succession misses the point. We say this for two reasons.

Firstly, Australia boasts a number of high quality retailers who have the potential to adapt, protect their brands and benefit from a more efficient operating model. Often competition helps and often imitation is not a bad strategy. We all should take heed of Amazon's approach that a satisfied customer is the best business strategy of all. Australian retailers need to act - particularly on this idea where a combination of a physical and online presence will be crucial. Retailers need to be addressing this strategy now. Procrastination is the grave in which opportunity is buried.

Secondly, the Amazon modus-operandi is more interested in looking after the customer and not ruthlessly destroying the competition. Amazon may not be as ruthless as many perceive. Jeff Bezos may be a highly competitive business man, but one gets the sense that he also believes that blowing out someone else's candle doesn't make yours shine any brighter. He wants to win by attracting customers to Amazon. We think the following memo to staff (which is an excerpt from Brad Stone's book, *The Everything Store: Jeff Bezos and the Age of Amazon*) provides an interesting, yet rarely discussed, insight into the Amazon culture. It was penned by Bezos and was titled Amazon.love:

*"Rudeness is not cool.
Defeating tiny guys is not cool.
Close-following is not cool.
Young is cool.
Risk taking is cool.
Winning is cool.
Polite is cool.
Defeating bigger, unsympathetic guys is cool.
Inventing is cool.
Explorers are cool.
Conquerors are not cool.
Obsessing over competitors is not cool.
Empowering others is cool.
Capturing all the value only for the company is not cool.
Leadership is cool.
Conviction is cool.
Straightforwardness is cool.
Pandering to the crowd is not cool.
Hypocrisy is not cool.
Authenticity is cool.
Thinking big is cool.
The unexpected is cool.
Missionaries are cool.
Mercenaries are not cool."* – Jeff Bezos

Our take on Amazon in Australia is one of long-term optimism – particularly for the end consumer. Yes there will be losers, that is business. Nevertheless, as Albert Einstein said "*in the middle of difficulty lies opportunity*".

Will Culbert and Tom Millner

Contact Asset Management Pty Ltd.

Contact is the Investment Manager for BKI Investment Management Limited. Will and Tom are both shareholders in BKI.

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Office Level 2, 160 Pitt Street Mall
Sydney NSW 2000
Telephone +61 2 9210 7000
Fax +61 2 9210 7099
Web www.bkilimited.com.au
ABN 23 106 719 868