

# Amazon Upsizing Australia Spells Trouble for Consumer Electronics Retailers

## Market discounting probability of Amazon succeeding in Oz.

### Morningstar Equity Research

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### Executive Summary

In an environment of rampant retailing sales growth from unsustainable, pandemic-induced, consumer appetite for food and discretionary products, underlying operational and macroeconomic issues have been masked. One of these is our concern for Australian retailers due to Amazon's aggressive infrastructure build in Australia. We expect the online retailer to nearly triple its local footprint in 2021, and continue to forecast Amazon securing a considerable chunk of Australian retailing turnover. By 2030, we forecast Amazon to account for about 25% of Australian online retail sales, or 5% of the total Australian retail market. Two retailing categories Amazon excels in globally are consumer electronics and books. The most exposed companies to a rapidly expanding Amazon within Morningstar's Australian coverage universe are JB Hi-Fi, Harvey Norman, and Kogan.

### Key Takeaways

- ▶ Australian consumer electronics retailer stocks offer little margin of safety. Massive shifts in consumer spending to goods from services while restrictions last, combined with unsustainable government wage subsidies have temporarily boosted discretionary retail sales in consumer electronics. However, JB Hi-Fi, Harvey Norman, and Kogan share prices imply a continuation of elevated sales, rather than the return to long-term trend as our intrinsic valuations suggest.
- ▶ We estimate Amazon's Australian gross merchandise value, or GMV, grew about three times faster than JB Hi-Fi's and Harvey Norman's Australian sales in 2020. We expect Amazon to continue growing faster than the competition in the medium term, driving consolidation in the consumer electronics market and hindering JB Hi-Fi and Harvey Norman from sustainably increasing their market shares. Conversely, as an online pure-play, we anticipate Kogan to grow in line with the overall online channel and increase its market share of the total category sales.
- ▶ Supermarket operators Woolworths and Coles are the least exposed retailers to Amazon's threat. Online fulfilment of grocery orders requires specialised warehousing, or an existing store network, as well as a dedicated last mile delivery fleet. We estimate Amazon's grocery sales, excluding in-store sales at its Whole Foods Market, to account for less than 5% of its global GMV.

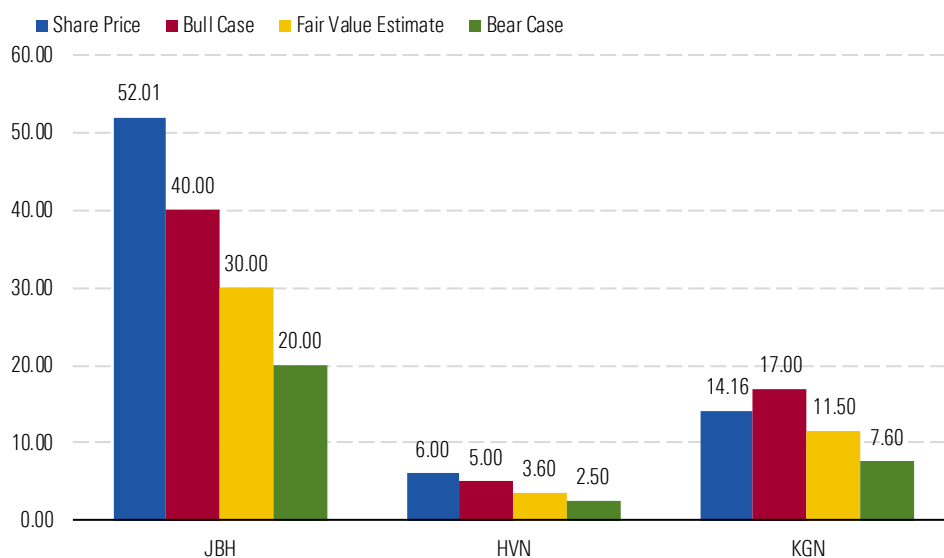
### Companies Mentioned (share price as of March 19, 2021)

| Name/Ticker                    | Economic Moat | Currency | Fair Value Estimate | Current Price | Uncertainty Rating | Morningstar Rating | Market Cap (Bil) |
|--------------------------------|---------------|----------|---------------------|---------------|--------------------|--------------------|------------------|
| JB Hi-Fi Ltd JBH               | None          | AUD      | 30.00               | 52.01         | High               | ★                  | 5.98             |
| Harvey Norman Holdings Ltd HVN | None          | AUD      | 3.60                | 6.00          | High               | ★                  | 7.48             |
| Kogan.com Ltd KGN              | None          | AUD      | 11.20               | 14.16         | High               | ★★                 | 1.51             |
| Amazon.com Inc AMZN            | Wide          | USD      | 4,000.00            | 3,074.96      | High               | ★★★★               | 1,548.44         |

### Market's Optimism for Electronics Retailers at Odds with Amazon's Robust Expansion Plans

We maintain our fair value estimates for JB Hi-Fi, Harvey Norman, and Kogan of AUD 30.00, AUD 3.60, and AUD 11.50, respectively. We continue to expect JB Hi-Fi, including its The Good Guys chain, and Harvey Norman's Australian franchisee network to retain their market shares in Australia, but it is unlikely the two omnichannel retailers will grow sales ahead of the overall consumer electronics and appliances market. We anticipate their large physical store sales to significantly underperform longer term and present a headwind to their omnichannel sales growth. We anticipate deteriorating store-economics and increasing investment in digital capabilities to restrict meaningful margin expansion.

#### Exhibit 1 Current Share Prices of Australian Consumer Electronics Retailers Offer no Margin of Safety



Source: Morningstar estimates.

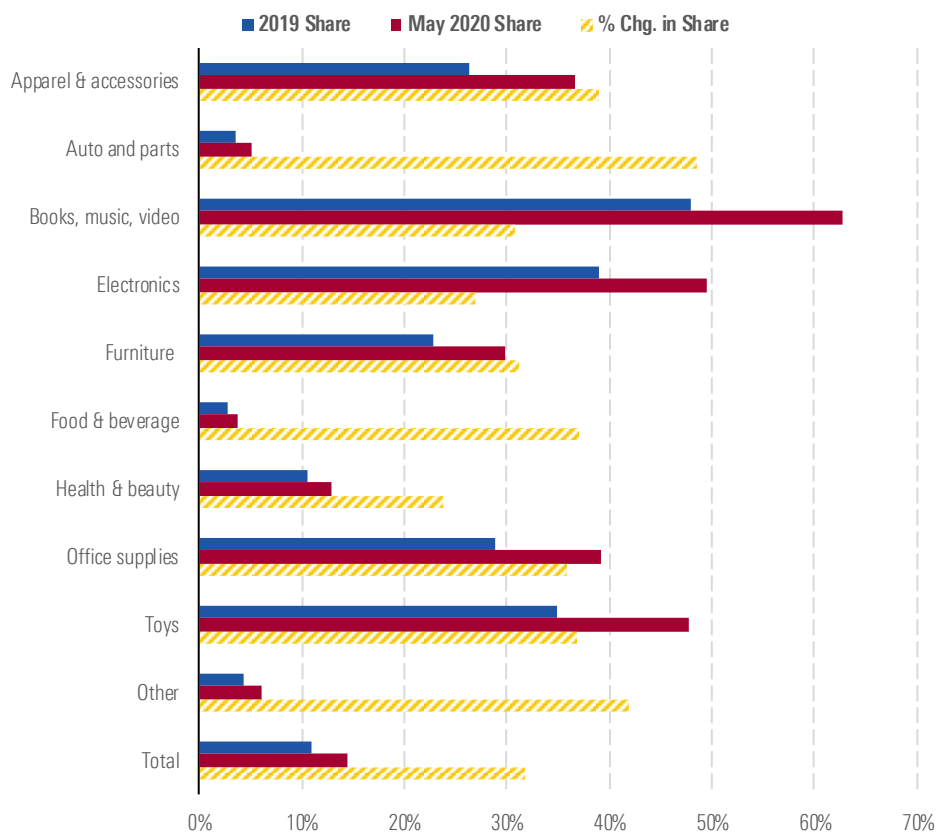
Note: Share prices as of March 19, 2021.

### Rising E-Commerce Penetration Translates to Fewer Sales Originating In-Store

We forecast a 10-year CAGR of 3% for the consumer electronics and home appliances category. This is much less than 8% growth in fiscal 2020, as well as our estimate of a 7% sales increase in fiscal 2021, but ahead of the average growth rate of 2% over the decade between fiscal years 2011 and 2020, according to the Australian Bureau of Statistics.

Consumer experimentation with e-commerce during the pandemic was very broad. Data from eMarketer in Exhibit 2 shows what kinds of products saw the most increase in e-commerce penetration during the pandemic. The percentage change in share was fairly consistent across products (with most products' e-commerce share increasing around 25% to 40%).

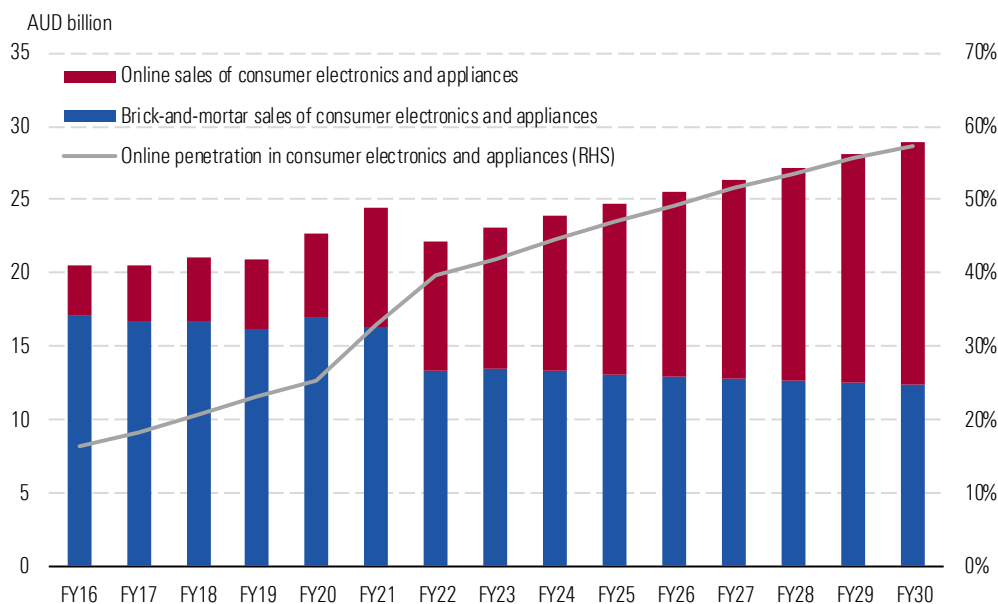
**Exhibit 2** Most Product Categories Fairly Similar in Terms of E-Commerce Gains in the U.S.  
E-commerce share (%) of total U.S. product sales by category



Source: eMarketer, Morningstar estimates.

The consumer electronics and home appliances category is highly amenable to e-commerce, due to its largely commoditised products—specifications are easily compared—and relatively low fulfilment costs. For instance, consumers generally purchase fewer and higher value items relative to the standard grocery order, reducing labour costs. Euromonitor estimates online penetration of the consumer electronics category in Australia at 30% in 2020, up from 25% in 2019. This compares with online penetration in Germany of over 30% in 2019, and almost 40% in the U.S. in 2019. During the recent height of pandemic online shopping, we estimate online sales penetration of consumer electronics reached nearly 50% in the U.S.

From fiscal 2022, we forecast online sales in the category to continue growing in line with the overall online channel, with a CAGR in the high-single digits, while we expect brick-and-mortar sales, excluding click-and-collect transactions, to decline by about 3% per year.

**Exhibit 3** All the Growth in Consumer Electronics and Appliances Retailing to be Online

Source: Australian Bureau of Statistics. Morningstar estimates.

Note: Figures including goods and services tax.

### Stores to Generate Fewer Sales, but Present a Fulfilment Option Online Pure-Plays Can't Offer

Despite our forecast for falling brick-and-mortar sales, we view JB Hi-Fi's and Harvey Norman's vast store networks as a competitive advantage online players and smaller networks lack. JB Hi-Fi and Harvey Norman have about 300 and 200 store locations in Australia, respectively. We expect the two market leaders to maintain market share by continuing to drive online sales by offering speedy click-and-collect fulfilment, which is unlikely to be matched by online delivery options in the medium term, including Amazon's. This suggests the companies growing their revenue in line with the overall consumer electronics and home appliances category, at about 3% annually past 2021.

Longer-term, however, Amazon could disrupt this advantage of Australian omnichannel retailers. In the U.S., Amazon is rolling out its 4-star stores, currently 29 across 17 U.S.-states, selling products in categories like consumer electronics, homeware, toys and games. Amazon's 4-star store ranges are curated based on proprietary data, including customer ratings and reviews. Beyond its 4-star stores and Whole Foods Market supermarkets, Amazon also operates other physical store formats, including Amazon Books and Amazon Fresh grocery stores.

We forecast significantly stronger sales growth for Kogan, averaging 11% over the next decade, because of its focus on the faster growing online channel. Without the drag of a legacy store network and sales mix shift to its more profitable marketplace, we expect Kogan's operating margins to gradually expand. However, current share prices are implying market share or profitability gains ahead of our estimates. We forecast Kogan to maintain its market share of

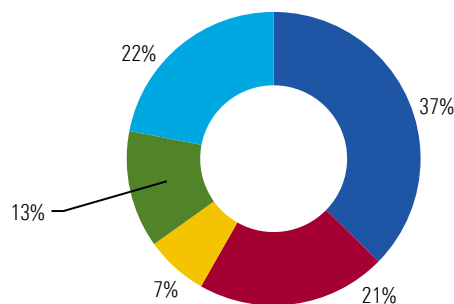
Australian e-commerce sales, but increase its share of the total consumer electronics and home appliances market to 7% by 2025, from about 4% currently.

We estimate Amazon's share of the Australian consumer electronics market at only 3%, less than Kogan at 4%, and much smaller than market leaders JB Hi-Fi and Harvey Norman, accounting for about a third and a fifth of the market, respectively. Amazon's Australian website went live in 2017, with only one relatively small domestic fulfilment centre—albeit Amazon already sold merchandise to Australian consumers via its U.S. website and Book Depository platform. Amazon's Australian business is still relatively small, accounting for 7% of all online sales and less than 1% of total retailing in 2020. This compares with its two largest markets of the U.S. and Germany, where about half of all online retail sales are conducted on its platforms.

However, we estimate Amazon's Australian sales increased over 60% to about AUD 2.6 billion in 2020, which we define as first- and third-party sales on its Australian website, as well as sales transacted on its U.S and Book Depository websites destined for Australia. JB Hi-Fi's online sales and Kogan's sales grew significantly faster than Amazon in 2020, at 130% and about 80% respectively. Harvey Norman's online sales are undisclosed. However, total online and in-store sales growth at JB Hi-Fi and Harvey Norman underperformed the online pure-plays in 2020, increasing by 23% and 20%, respectively, highlighting the relative underperformance in-store.

**Exhibit 4** By Fiscal 2025, we expect Amazon to be the third largest consumer electronics retailer in Australia

- JB Hi-Fi Australia, including The Good Guys
- Harvey Norman Australian Franchisees, excluding furniture sales
- Kogan.com
- Amazon consumer electronics and home appliances sales in Australia
- Other\*



Source: Morningstar estimates.

Note: Other includes specialist retailers like Apple, Bing Lee, Appliances Online, as well as non-specialist retailers like department stores and supermarkets.

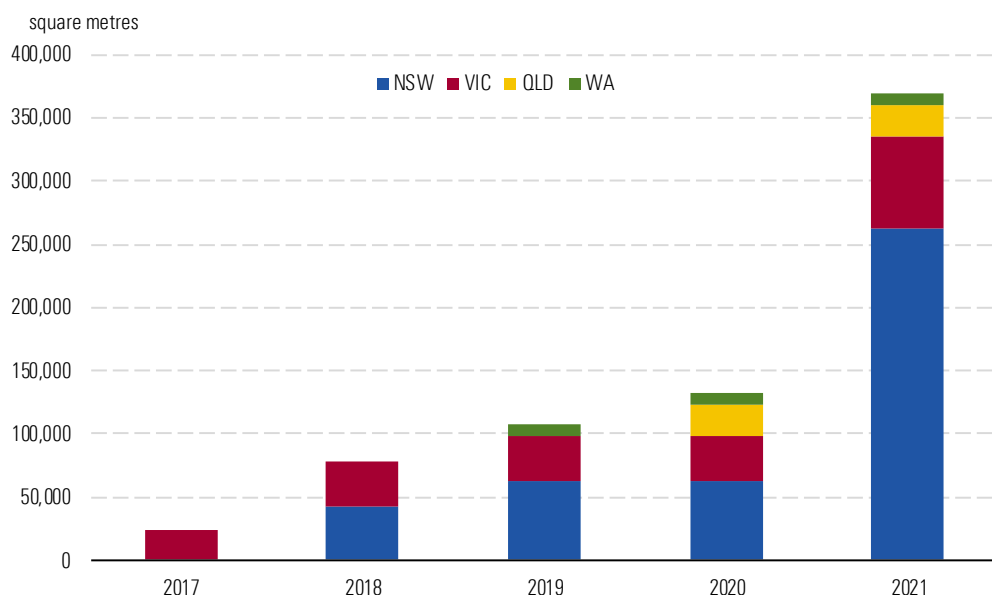
Amazon is poised to accelerate its market share gains in consumer electronics. We forecast Amazon to increase its category share to 13% by fiscal 2025, as shown in Exhibit 4, mainly to the detriment of smaller or non-specialised retailers, as it leverages its expanding infrastructure to improve delivery times, product range, and potentially its pricing on first party merchandise. We estimate Amazon generates about one-third of its one- and third-party sales on its U.S. website from consumer electronics, more than from any other category, and we expect Amazon to generate about a third of its Australian sales from consumer electronics too.

### Amazon's Large Investments to Improve Range and Service Could also Heat up Price Competition

Amazon is heavily investing in its Australian fulfilment capabilities to support its growth ambitions. We expect its footprint to increase by 179% in 2021, by adding new distribution centres in both Melbourne and Sydney, and on top of this Amazon's existing fulfilment centres still have significant spare capacity. We estimate the utilisation rate of Amazon's Australian fulfilment centres is some 60% lower than the global average, measured as GMV per square metre.

If Amazon reached similar utilisation rates at its current and planned Australian fulfilment centres as it averages globally, we estimate the infrastructure could support AUD 7.3 billion in domestically fulfilled sales, or AUD 8.9 billion including transactions on overseas websites shipped to Australia. We forecast Amazon to reach this sales level by 2025. ■■

**Exhibit 5** Amazon Is Preparing for Significant Sales Growth



Source: MWVPL International, realestatesource.com.au, Morningstar estimates.

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