Is Amazon Invincible?

Store-Based Retailing at Tipping Point

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Store-Based Retailing at Tipping Point

In the minds of many investors and industry pundits, an existential battle is playing out across the retail sector that could potentially reshape the shopping landscape and displace some storied chains that seem stuck in a 20th century marketplace.

by Christa Hart, Khaled Haram and John Yozzo

Equity markets have long rewarded Amazon.com, Inc. ("Amazon") for expected growth it had yet to achieve but have only recently begun to penalize traditional retailers for anticipated market share losses that have yet to fully materialize. The market sell-off in the retail sector has been steep — far beyond what would be considered a reasonable reaction to sluggish sales and earnings — with valuation multiples for many large retailers currently at levels last seen during the Great Recession.

More than ever, Amazon remains the primary catalyst for change in a traditionally staid retail industry, as it extends its reach into additional product categories and finds new ways to alleviate the pain points of online shopping. Yet despite its impressive scale and track record of innovation, Amazon directly (first party or "1P") accounts for just 2% of U.S. retail sales (excluding autos and gas) and about 4%, including third party sales ("3P") via Amazon Marketplace. Moreover, the failure of several retail chains since 2016 is far more attributable to issues of specific underperformance, excessive leverage or redundancy rather than the encroachment of the online channel. So it might seem reasonable to ask if the perceived threat posed by Amazon and its growing online influence is exaggerated.

Amazon wins market share because it can be more price competitive than store-based retailers without undermining its business model, which generates huge profits from ancillary retail services. Quite simply, gross profit from product sales doesn't matter as much to Amazon as it does to conventional retailers.

It is indisputable that Amazon and other online businesses are taking sales and market share from traditional retailers and that these gains have accelerated in recent years. It's tempting to extend these current trends intact into the foreseeable future but the mathematics of natural growth say it won't happen that way. For all its popularity with shoppers, online sales growth eventually must moderate over time, and its market share will plateau. Even so, we expect that online market share of U.S. retail sales will have increased significantly by the time this occurs — likely doubling from its current 12% market share — and these gains will continue to accrue disproportionately to Amazon. *(More on this topic is coming later this month in our U.S. Online Retail Forecast.)*

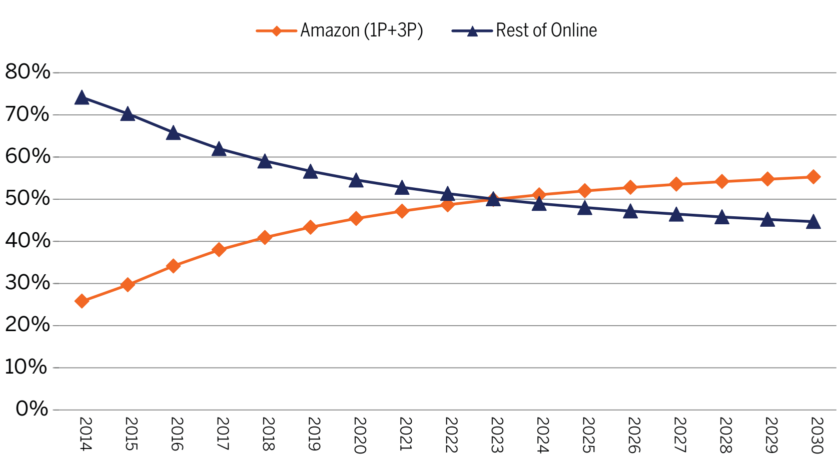
HOW HIGH THE MOON FOR AMAZON?

By 2027, we forecast that Amazon's total market share (1P+3P) of U.S. online sales will increase to 53.5% from 34.2% currently, representing nearly 11.5% of total retail sales (excluding autos and gas) vs. 4.0% today.

Our forecast model for Amazon, based on estimated sales (1P+3P) and market share derived from its recent "Big Reveal", expects Amazon to enjoy 20% sales growth (compounded annual growth rate or "CAGR") through 2020, at which time its online market share (1P+3P) will be 45%. By 2027, our model predicts that Amazon will have gained 19 percentage points of online market share compared with 2016 (**Exhibit 1**) and will account for 53.5% of U.S. online sales, just as total online sales of goods surpass the $1 trillion mark, with 3P sales accounting for two-thirds of Amazon's online sales in a decade compared with our estimate of 55% in 2016. That is a potentially daunting scenario for store-based retailers.

EXHIBIT 1

Market Share of U.S. Online Retail Sales



AMAZON'S BIG REVEAL

No, we're not referring to Amazon Alexa's new "skills", voice-activated purchasing or Prime Wardrobe. Rather we call attention to new and revealing financial disclosures in Amazon's most recent Form 10-K filing for FY2016 that included heretofore undisclosed breakouts of Amazon's retail products, seller services revenue and subscription revenue from 2014-2016, which were previously combined into a single-line item for public reporting purposes.

This is a big deal — a big reveal by Amazon that provides new insight when estimating the size of its 3P business (Amazon Marketplace) and its subscription-based revenue. It's now easier to reasonably estimate the size of its 3P business and combined (1P+3P) Gross Merchandise Value ("GMV"), which is considered the best measurement of Amazon's scale and the basis for estimating its market share.

These disclosures revealed the following noteworthy takeaways:

- Amazon's retail product sales (1P) growth of 19% (YOY) in FY2016 was robust, but less so than we thought. 1P sales accounted for 76% of Amazon's $121 billion of global retail-related revenue compared with 83% in FY2014.

- Subscription revenue growth is very strong. $6.4 billion of retail-related sales came from subscription services, primarily its Amazon Prime membership fees. This is more than double the $2.7 billion it booked as subscription services revenue in FY2014. Incredibly, it appears that the number of Prime members has at least doubled over the last two years. Most estimates of Prime membership in North America ("NA") are in the range of 50-55 million users.

- Seller services revenue is growing very rapidly. 19% of Amazon's retail-related sales in FY2016 (or $23 billion) came from services it provided to third party sellers — double the comparable dollar amount in FY2014, when it was 14% of retail-related sales. (These amounts exclude Amazon Web Services.)

Based on those disclosures, we estimate that Amazon's global GMV (1P+3P) was $206 billion in 2016, an impressive 32% increase over 2015. Collectively, these disclosures inform us that Amazon's 3P business is considerably larger than previously believed. Based on our analysis, Amazon's 3P GMV now accounts for more than one-half of its total GMV. We estimate that 3P GMV was 55% of Amazon's total GMV in FY2016 compared with 51% in FY2015 and 46% in FY2014.

Assuming that approximately 65% of Amazon's retail sales were in NA, we estimate that its GMV in NA was $133 billion in FY2016 with $59 billion in 1P product sales and $74 billion in 3P sales (**Exhibit 2**). This would imply that Amazon was involved in more than one-third (34%) of U.S. online sales in 2016 (15% market share for 1P GMV and 19% for 3P GMV). This compares favorably with an estimated GMV (1P+3P) market share of 30% in 2015 and 26% in 2014 (**Exhibit 3**). Therefore, Amazon's GMV (1P+3P) growth in 2016 and 2015 accounted for approximately 60% of total growth in U.S. online sales in these two years.

EXHIBIT 2

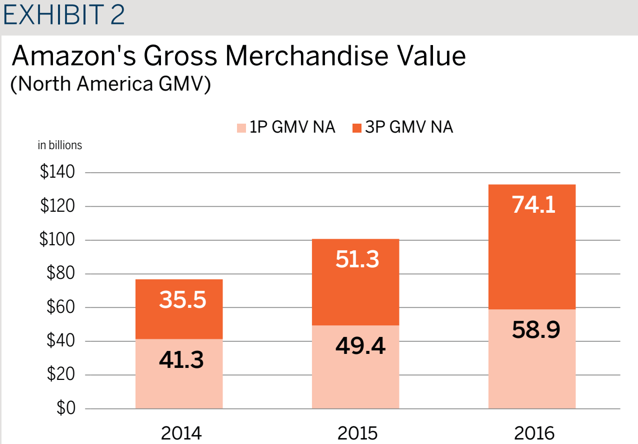
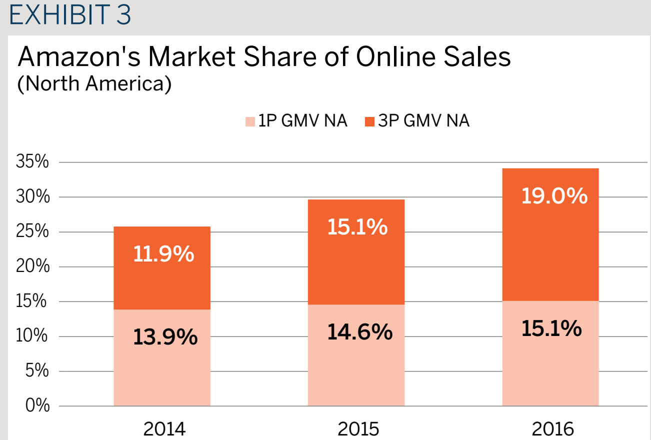


EXHIBIT 3



Note: 3P sales of products on Amazon Marketplace are not booked as revenue by Amazon; rather it charges merchants a commission, plus additional costs if the sale is fulfilled by Amazon, which it books as service revenue. This separate disclosure of retail-related revenue derived from 3P seller services allows us to estimate Amazon's 3P GMV with greater precision, as Amazon is generally believed to charge sellers an average commission of 15% of transaction value (excluding shipping charges). We can gross up seller services revenue (excluding shipping charges) in order to estimate 3P GMV.

AMAZON'S AURA OF INEVITABILITY

We doubt there's a large retailer out there that believes that Amazon's impact is overstated because its influence on retailing is not measured merely by its sales or market share, but by the changes it has exerted on those with whom it competes.

More than 20 years ago, Wal-Mart faced repeated criticism that it and the other big-box retailers it inspired were destroying small businesses. Supercenter stores, like Home Depot, PetSmart, Staples and Best Buy became the prototype for selling mass merchandise products and consumables at the lowest prices. Big-box retailing dramatically altered the shopping landscape in the late 20th century yet it never inspired the awe and fear that Amazon does today. There are a few reasons for this: technology and innovation have enabled Amazon to achieve such scale in a fraction of the time it took Wal-Mart and others; the transfer of market share from losers to winners is disproportionately benefiting one retailer — Amazon; and there appears to be little on the horizon that will slow its momentum.

It's very sticky. Nearly one-half of U.S. households are loyal Amazon shoppers — in fact, they pay to shop there. Amazon Prime is a killer advantage; survey data indicate Prime members spend about three times as much as non-Prime members. Moreover, there is a seasoning effect as well; the longer someone is a Prime member, the more money she spends on the site. In short, Prime is the critical driver of customer loyalty for Amazon and that is why it chooses to provide so many goodies along with a Prime membership. Prime members that take advantage of its free services, such as free two day shipping, streaming music and video, receive far more in value than its $99 annual cost. Moreover, Prime members may account for nearly one-half of all U.S. households but a considerably larger percentage of higher income households. On July 11 of this year, its third annual Prime Day, Amazon sales hit an estimated $1 billion, a 60% increase over the prior year and surpassed Black Friday and Cyber Monday sales in a humdrum summer shopping month. Some analysts partially attributed weak U.S. retail sales in August to the pull-forward impact of Prime Day and similar competing promotions by other large retailers.

We start shopping there. Consumer surveys indicate that a majority of all online product searches begin on Amazon — not on a search engine or retailers' websites. For Prime members, that percentage is a super-majority. Since Amazon is the starting point for most product searches, this represents a powerful advantage for Amazon, one that virtually ensures its continued online dominance. A growing number of brand name consumer product companies that once balked at selling their merchandise on the Amazon platform have since relented.

It moves prices. Amazon's dynamic pricing impacts competitors by lowering price points in most product categories. Retail prices have fallen in nearly all product categories after Amazon enters a market. In its most recent pricing survey, William Blair & Company noted that Amazon's prices (1P+3P FBA) were, on average, nearly 7% lower than in-store prices of 32 retailers for several hundred items costing more than $25 — this differential prevailing after several years of competing retailers narrowing the price gap. In this respect, Amazon's impact on retailing extends far beyond the sales it generates and fulfills. Those large retailers that have managed to hold their own against Amazon have done so only by being more price competitive and accepting lower profitability and return on invested capital. In recent weeks, sporting goods giants Dick's Sporting Goods and Foot Locker have been crushed by investors on weak sales, gross margins and lowered earnings outlooks for the remainder of the year that some analysts partially attribute to Amazon's continued expansion in these product categories.

All but the most exclusive brands and chains have abandoned any pretense of pricing power. Amazon is the driving force behind consumers' heightened price consciousness, and its asset-light retail business model compared with traditional retailers enables Amazon to move prices lower wherever it goes and absorb these price hits better than store-based retailers. A CNBC article exclaimed that Amazon *"may be single-handedly killing inflation,"* an exaggeration for sure but a topic of discussion for some Fed watchers.

It's more than it seems. Any discussion of the impact of Amazon on the retail sector has to recognize that its 3P sales, which we now believe account for a majority of its total GMV, are benefiting smaller and even some large retailers by giving them a global sales platform they otherwise wouldn't have. Many retailers with their own e-commerce-enabled websites still participate in Amazon Marketplace because they know that is where the web traffic is. One could argue that Amazon Marketplace has had a democratizing effect on retailing by giving smaller retailers a platform to compete against regional and national chains. Furthermore, a growing number of consumer product manufacturers are experimenting with direct selling to shoppers, often via Amazon Marketplace, such as Ethan Allen's recent launch of Design Studio on the Amazon site. Amazon's tremendous success as a selling and/or fulfillment platform for 3P products is likely a boon for many smaller retailers that use it — and for that Amazon is happy to take a generous "landlord size" cut of the action. Our forecast model expects Amazon's 3P sales to be approaching two-thirds of its total online sales by 2027.

Amazon may be the clear leader in the online channel, but its market share of total sales in many product categories is relatively small. That is not meant to downplay what Amazon has accomplished. However, contrary to popular impression, Amazon isn't eating everyone's lunch — it's merely snacking. But for companies with high fixed costs that are struggling to generate top-line growth, losing 5% or 10% of category sales to an interloper is painfully felt (and maybe even fatal). As a reference point, Amazon announced it would be entering Australia this year and Credit Suisse expects Amazon could achieve a 5% market share in most product categories it carries by 2022 — considerably less time than it took to hit that mark in the United States. Some long-established Australian retail stocks fell sharply upon the news of Amazon's plans.

There are no easy answers for large store-based chains and there are many examples of futility and disappointment when they compete in the online realm.

- Pier 1 Imports has seen its profitability cut in half even as an ambitious omnichannel initiative lifted online sales above 20% of its total sales.

- Bed Bath & Beyond has seen EBITDA margins contract by 400 basis points since 2014 as it battles sluggish sales and a much criticized slow transition to omnichannel.

- Urban Outfitters contends with weak sales growth and eroding operating margins even as its direct-to-consumer sales top 25% of total sales.

But it's just not enough. Initiatives such as those noted above have simply allowed retailers to run in place, perhaps to merely hold on to what they had. The online shopping channel led by Amazon will continue to be a pampering, money-saving experience for time-pressed, deal-conscious consumers and a burden for most store-based retailers. As enormous as its scale has become, the greater impact by Amazon on the retail sector is in pressuring price points and margins across product categories. Never a highly profitable industry, the U.S. retail sector must confront the unpleasant prospect that profits and return on capital will remain depressed for the foreseeable future.

Lastly, though the challenges they pose are formidable, Amazon and the online channel often are given too much attribution for killing off retail chains that already were moribund for a variety of other reasons. For instance, a Bloomberg article on the Chapter 11 filing of True Religion dutifully cited *"losses attributed to the consumer shift away from brick-and-mortar stores to online retail,"* but failed to give any mention to shoppers' lost appetite for $300 jeans. That likely mattered much more. Similarly, J. Crew, a pioneer in non-store retailing, is fighting to stave off reorganization whose cause would be mostly rooted in fashion miscues.[1,2] Some other prominent retail bankruptcies in 2017, such as Gymboree, Payless ShoeSource and rue21, were all post-recession leveraged buyouts with lots of debt [4-6X EBITDA] and limited financial wherewithal to tolerate the persistent underperformance that ensued. Other retail bankruptcies are coming, and the direct cause of their failure may have less to do with Amazon and the online shift than with strategic missteps or operating blunders, though you can be sure that the online impact will be mentioned prominently in the obituary. What the online channel, led by Amazon, arguably has done to some laggard retailers is expose their critical weaknesses and perhaps hasten a retreat or demise that already was underway for quite some time.

The views expressed herein are those of the authors and not necessarily the views of FTI Consulting, Inc., its management, its subsidiaries, its affiliates, or its other professionals.

1 Ewen, Lara. "How Mickey Drexler failed J. Crew -- and what James Brett needs to succeed." Retail Dive, 15 June 2017.

2 Ryan, Tom. "Mickey Drexler sends an email to J. Crew customers." RetailWire, 25 April 2016.

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