Industry insights

Westpac Institutional Bank

15 December 2015

Retail

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Summary

This report summarises the recent performance of the Retail sector, considers its risks and opportunities, and its resultant outlook. The outlook is based on analysis of key indicators for the sector and its key sub-sectors, as well as in-depth interviews with industry leaders. This ensures a match between the numbers and the reality of real-world operations.

Why Retail?

Retail is the largest sector in New Zealand. It employed nearly 186,000 full-time equivalent workers (FTEs) across New Zealand in 2014, and generated $12.7 billion in value, or 5.5% of New Zealand's GDP.

Retail is the primary means by which consumers meet their daily needs for groceries and clothing. It provides the tools and materials we need to maintain our houses and gardens. Retail allows us to purchase vehicles and the parts to keep them going. It is how we source the sporting goods, toys, or electronics that keep us entertained.

The sector is also arguably one of the most challenged in New Zealand – online competition, a squeeze on margins, and the risk of low-cost bulk competitors are just a few of the challenges to how traditional retailers operate.

Recent performance of the sector

Sub-sectors within retail have experienced mixed success since the 2008 recession and the growth in online trade. Key trends include:

- Food and grocery retail were largely immune from the hit to employment and value added that the recession caused in retail.
- With the exception of Recreation retail (sports, camping, gaming, toy, book, and marine equipment retailing), value added in the various sub-sectors has recovered to beyond the 2008 peak.
- The trend across almost all sub-sectors has been toward bigger businesses – larger formats and larger geographic reach – and more value added per store and per worker.
- Most sub-sectors have not added workers since the 2008 peak – improvements have come largely through technology and efficiency gains instead.

Outlook and what this means for New Zealand

We expect to see Retail spending slow over the next year as GDP growth moderates, unemployment rises, and wage inflation remains low. Population growth is currently an important positive, but will weaken from late next year. Longer term, we expect a more substantial dip in consumption spending with less population growth, a weaker exchange rate and a slowing housing market.

Specific trends and risks will vary significantly by sub-sector:

- **Ongoing competition from offshore online retail:** This will continue to hurt retailers selling books, electronics, cheaper undifferentiated or generic clothing, hardware and homeware the most. It will have less of an effect on businesses selling differentiated independent brands, bulk or fresh/live products. Government action to collect tax on online services is not expected to extend to goods, which means this problem is not going away soon.
- **Bigger presence:** Larger retailers in most sub-sectors are expected to expand their footprint, either through larger format stores that allow customers to get everything they need under one roof, or through greater geographic reach. Smaller retailers will need to offer something no one else does to remain competitive.
- **More discounting:** Discounting has increased across Homeware and electronics, Hardware and garden, and Recreation retail. We expect this to continue, with evidence suggesting the trend is growing in Food and grocery retail as well. The everyday discounts at full-price stores will make survival a challenge for outlet stores.
- **Bigger profits will come from cutting costs, not raising prices:** Retailers are already cutting the cost to serve. Examples include getting the customer to do more of the work (self-service checkouts), electronic labelling, transferring risk to the supplier through sale or return agreements, and reducing their supplier lists.
- **Product and service differentiation:** Differentiated products that consumers can't buy from an offshore or local online competitor will be most viable. In a lowest-price-wins environment, retailers will need to wow on service and product knowledge to create loyalty.
- **External factors will benefit some and not others:** Factors over which retailers have little control will create winners and losers. Examples include how recent house price gains are used; the trend for retirees to cash-up and move out of Auckland; the DIY-er generation created by cooking, renovation and gardening TV shows; and fears over terrorism that may see consumers buy cars or boats instead of travelling overseas.

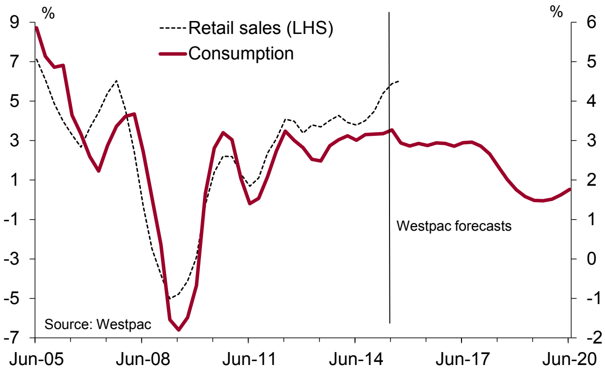
David Norman
Industry Economist

External factors: What lies in store?

- A number of factors the Retail sector has little control over are changing the operating environment.
- Rising house prices and a construction boom have encouraged people to spend more, or to cash up and buy somewhere cheaper, creating a windfall gain they can spend on other things.
- At the same time, reality TV, a growing social conscience, and fears over terrorism are affecting what people spend money on, and what they demand from their retailer.
- A weaker exchange rate has added to pressure on margins as not all cost increases can be passed through.
- We forecast the economy and housing market to slow in 2016 and beyond. Over time, slower population growth, higher unemployment, a weak dollar, and low wage growth will impact Retail.

The macro picture: change is afoot

Recent times have seen real Retail sales growth reach rates last seen before the 2008 recession. However, we do not expect this to continue unabated. We forecast the New Zealand economy to slow in 2016, with dairy prices well down on historical highs, the Canterbury rebuild having peaked, El Niño affecting meat and pipfruit production on the eastern seaboard, and the spending confidence associated with rising house prices beginning to weaken. These changes will be accompanied by higher unemployment, weak wage growth, persistently low inflation, and a weaker New Zealand dollar.



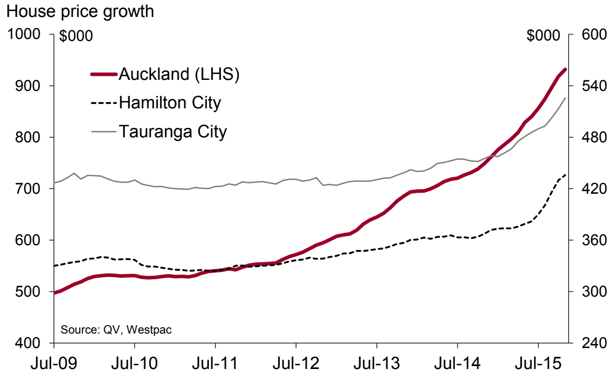
As population growth weakens, we expect to see a further fall in consumption demand, including Retail. We anticipate that private consumption, which includes a large Retail component, will slow modestly over 2016, before dipping more markedly toward the end of 2017.

Renovation and retirees: the impact of a housing boom

The recent construction boom in Auckland and Canterbury, and rising house prices in these and some other urban centres like Tauranga and Hamilton, are having a number of spin-off impacts on Retail.

The construction boom has created fierce competition to secure the business of the construction industry within the **Hardware and garden** sub-sector. Intensification in Auckland has created demand for container gardens and section-appropriate landscaping. As the rebuild begins to wind down in Canterbury, and new residential and commercial activity grows in Auckland, we would expect to see a shift in Retail fortunes based on geography.

The recent rise in house prices in Auckland and to a lesser extent Hamilton and Tauranga have created a wealth effect. People have more equity in their homes, which flows over into spending across Retail sub-sectors, including home renovation (although previous work by Westpac suggests this impact is muted.)[1] For instance, the average Auckland household that has been in the same house for the last seven years will have seen an increase in equity of $430,000.



Another change that many industry players highlighted is that with Auckland average house prices well over $900,000 by October 2015, many retirees are selling up in Auckland and moving elsewhere. Often this was to Tauranga, where

[1] See http://www.westpac.co.nz/assets/Business/Economic-Updates/2013/Bulletins-2013/Hair-of-the-dog-June-2013.pdf

retirees could buy a brand new three or four bedroom home for under $600,000. This would give them cash-in-hand of over $300,000, which could be used to buy a new car, travel overseas, or for wider Retail spending.

Although the Auckland housing market has already slowed, the price gap between Auckland and other parts of the country will likely mean the trend of retirees leaving Auckland will continue. This movement poses a significant benefit to the parts of the country that enjoy the inward migration and resultant spending although it places strain on other parts of the economy, such as infrastructure provision. We expect this pattern to continue.

In good conscience

A revolution in expectations from consumers has been taking place in Europe and parts of North America for many years with consumers increasingly focused on ethical or environmentally sustainable business practices. Major supermarket chains in those countries have undertaken campaigns seeking better sustainability practices from food suppliers in particular. This has, for instance, seen the rise of widespread seafood sustainability labelling, and fair trade and organic food product lines.

This change is expected to gather speed in New Zealand, and may well broaden to other sub-sectors. Many consumers want guarantees that their clothing was not made in a sweatshop, and that the retailer is a responsible corporate citizen. Consumer demands will impose additional costs on retailers if the additional costs of certification or verification cannot be passed on to manufacturers. However, there can be substantial financial benefits from first-mover status in this space.

Reality of the DIY-er

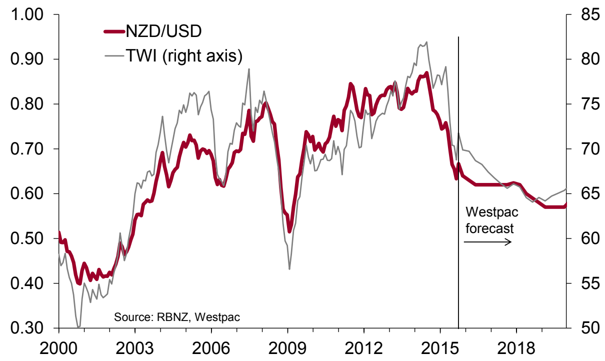
Several interviewees mentioned the prevalence of New Zealand versions of cooking, gardening and renovation reality TV shows as factors driving changes in consumer spending. These shows have led to the rise of DIY-ers who watched these shows and thought “if they can do it, so can I”.

This phenomenon had also driven demand for speciality ingredients and plants and products that had not been previously available in New Zealand. As a result, New Zealand manufacturers and retailers are far more often looking at opportunities for product placement in local versions of these shows, or as sponsors.

There is little sign that these types of reality shows are going anywhere soon although their individual popularity waxes and wanes, and we can expect reality TV to continue to drive retail sales.

I’d like to exchange this

The New Zealand exchange rate has fallen sharply in recent months. This change in the cost of imported goods has been partially passed on through higher prices, but in many cases, retailers are picking up the cost themselves. For instance, when an exchange rate change pushes a recommended price up to $109.99 from $99.99, there is a lot of risk that consumers will not accept the new price point. This pushes the retailer to absorb the price change.



The current weaker exchange rate follows a long period of strength in the New Zealand dollar. As the currency appreciated, it allowed retailers to increase margins by not passing through all the benefits of a stronger currency to consumers. We see some further decline in the exchange rate as likely, which will create more pressure at certain price points.

Fear factor

Awareness and perceptions of terrorism are on the rise again. Several businesses we spoke to raised this nervousness among consumers about travelling overseas. Those selling big ticket items like cars and boats could actually benefit from the reduction in desire for overseas travel as consumers switch to a new vehicle or boat instead of a trip overseas.

This concern over terrorism and its impact on spending will persist as long as terrorism remains on the front page of the news, and is affecting areas New Zealanders like to visit.

Offshore competition

- One of the biggest risks to bricks-and-mortar retailers is online competition – mostly from offshore, as online-only businesses in New Zealand are still a small (but growing) sub-sector.
- Offshore online competitors benefit from a loophole whereby they do not collect GST, implying an immediate price advantage of around 13%.
- This price disadvantage for New Zealand retailers is unlikely to disappear soon.
- In addition, offshore competitors often operate at a scale that gives them buying power that New Zealand retailers cannot compete with.
- Nevertheless, the level of competition for New Zealand retailers from offshore online traders varies widely by sub-sector (e.g. clothing versus vehicles) and by product category (e.g. bulky, fresh, global brand, or cheap).
- Non-bulky homeware and electronics, books and stationery, and to a lesser extent clothing and footwear stores face the highest level of risk from offshore online retail.

The GST conundrum

One of the biggest complaints retailers mention is the unfair advantage overseas retailers have in that they do not charge GST on sales to New Zealand purchasers. This puts New Zealand retailers at an immediate price disadvantage, and of course reduces the government's GST tax-take.Until action is taken here, this fillip to the New Zealand consumer comes at great cost to the tax man.

This action is easier prescribed than implemented. The current $400 threshold below which no taxes are charged on goods directly imported by consumers covers the vast bulk of products that consumers are likely to buy online anyway. Further, any effort to tax these imports is greatly dependent on the purchaser or offshore retailer correctly stating the value of the product.

The government is taking the first step in trying to ensure that overseas service providers, such as providers of online video content, collect GST from New Zealand viewers. But time will tell the extent to which that effort works, and it is a big leap from there to collecting GST on every product sold to New Zealand residents.

For the medium-term at least, the 13% price disadvantage for New Zealand retailers will continue to harm their operating environment.

Economies of scale

"Economies of scale" is seen as an archaic concept in a modern business world where buzzwords like "small and agile" abound. Yet as we point out elsewhere in this report, big is usually good. Bigger format stores, bigger companies, and in the case of online trade, bigger offshore competitors, all bring buying power advantages over smaller New Zealand retailers.

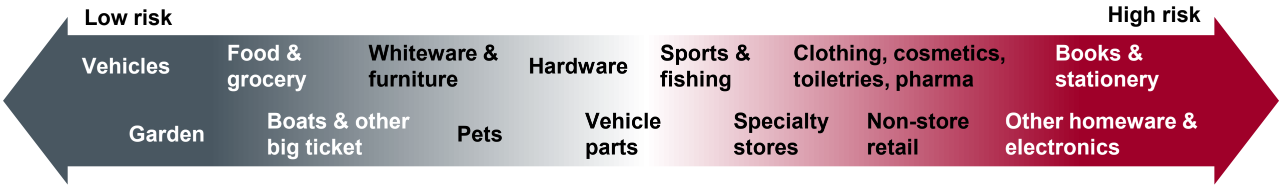
Even if we can eliminate the GST disadvantage, the challenge of offshore competition will not be gone. Large businesses with lots of buying power and distribution centres in countries with far lower wages than New Zealand will persist, making the retail world a hard one to compete within.

Who's most at risk from offshore?

The scale of this offshore online trader threat for many retailers is hard to overstate. Yet our discussions with retailers across sub-sectors showed a widely varying level of exposure to the challenge of overseas, untaxed competition. The level of risk is a function of the product categories that dominate a particular sub-sector, as we explore here.

Individual businesses with more exposure to fresh or live products, bulk products, or quality differentiated products, remain at lower risk than sellers of global brand, generic,

Level of risk from offshore online competition



or cheap products. At the lowest risk are sub-sectors characterised by a large fresh or live component, or bulk items. These include vehicle, boat, garden, and food and grocery businesses. At the other end of the spectrum, generic and global brand products, such as books, portable electronic devices, and cheap and global brand clothing and footwear are at greatest risk.

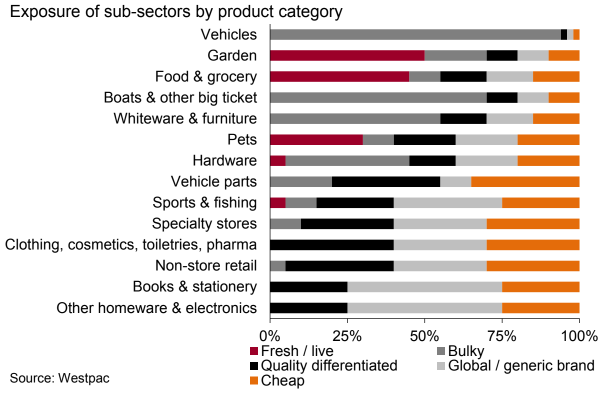
Our discussions highlighted that there are categories of goods even within each sub-sector of the Retail sector that may have very different risk profiles. We identified five categories of products with increasingly high levels of risk from offshore competition. The mix of these categories of goods across each sub-sector and even individual businesses gives an indication of their overall level of exposure to offshore competition.

The five categories of goods (from least to greatest offshore competition risk) are:

- **Fresh or live:** Products like fruit and vegetables, meat, bread, plants, pets and cut flowers face little if any competition from offshore. There are plenty of New Zealand operations providing online ordering and home delivery of these products, but competition from offshore is unlikely given biosecurity concerns and product perishability.
- **Bulky:** Products like cars, boats, jet-skis, whiteware, BBQs, or timber for the DIY-er's new deck are unlikely to be directly purchased by the consumer from overseas although once again, domestic purchases may be made online. These products are often also big-ticket purchases, which means people want to see them before paying.
- **Quality differentiated:** Independent New Zealand brands of a mid-to-high quality are at limited risk from overseas online stores. Examples include New Zealand fashion brands, or house brands adopted by hardware and homeware stores. Putting the name of the retailer on the product, especially if that retailer is a well-established, trusted local brand, will allow the retailer to attach a premium to that product, without any direct competition offshore.
- **Global or generic brands:** Name brand clothing and footwear, cosmetics, electronics, books, or sports equipment are highly exposed to "showrooming". Consumers visit bricks-and-mortar stores to test or fit products, and then search for the cheapest price online (often overseas where no GST is collected). This can be offset if global brands adopt global pricing, so that genuine branded products are priced similarly across the world. Generic products such as light bulbs with universal fittings, where the risk of product failure is perceived as minimal, may also be bought offshore at large discounts.
- **Cheap:** Low-cost, low-risk products such as cheap footwear, T-shirts, stationery or electronics accessories (USB cables for example) are at high risk of offshore online competition. Being low cost, the financial risk if they don't turn out to be as good as the purchaser hoped for is small. New Zealand businesses selling these lower-priced items will face very stiff competition.

We estimated the mix of product categories across different Retail sub-sectors as set out in the accompanying table.

Exposure of sub-sectors by product category



Source: Westpac

This mix across product categories by sub-sector implies an overall risk spectrum across sub-sectors as presented earlier in this section. Where individual businesses lie on that spectrum will depend on their mix of products across the categories. Thus we conclude that homeware and electronics, books and stationery, and to a lesser extent clothing and footwear stores face the highest level of risk, which is borne out by real-world experience.

Getting feet through the door

- Bricks-and-mortar retailers are adopting multiple strategies to attract customers into their stores in an effort to offset the attractions of online traders.
- The trend toward products constantly being discounted is growing, even entering the supermarket sub-sector, and is unlikely to be reversed soon.
- Under immense price pressure, retailers are having to find ways to reduce costs to remain viable. These include greater use of technology, reducing suppliers, and sale or return agreements.
- Retailers will increasingly have to differentiate offerings through own-branded and local products, improved service, and personalised marketing and customer experiences.
- Time-poor customers are increasingly looking for end-to-end products and installation services, whereby they pick what goes in the garden or renovation, but the retailer provides an installer.

With the rise of online trade, retailers (and shopping centre managers) have been under pressure to keep people coming into the store. Many industry sources we spoke to said they were confident they could make the sale once the customer walked in, but getting them in was the biggest challenge.

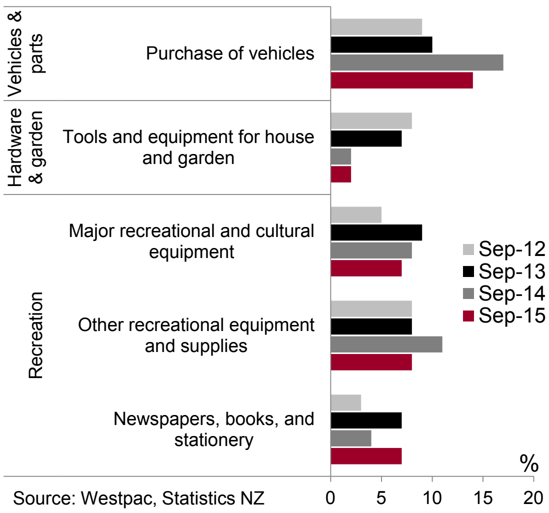
Cutting prices, cutting costs

The Homeware and electronics; and Clothing, cosmetics, toiletries and pharmaceuticals sub-sectors are characterised by high levels of discounting. This new normal whereby large proportions of product lines appear to be on sale at any given time, occurs for two reasons. First, it is a marketing tool. By marketing products as being well below a recommended retail price (RRP) even if there was never any real intention to sell the product at the higher price, the impression of a bargain is created.[2]

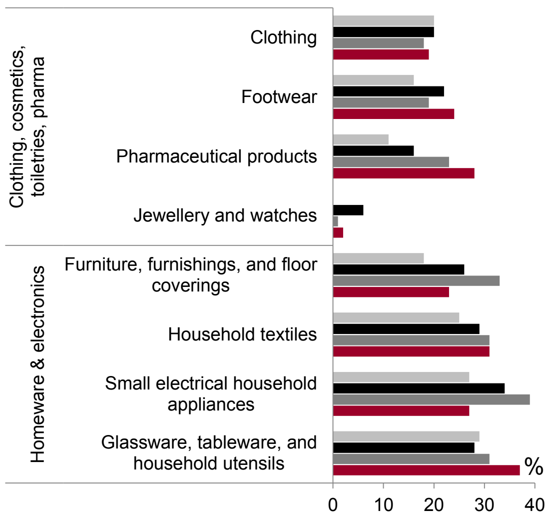
Second, and of greater concern from a retailer's perspective, is the need for discounting as businesses are forced to reduce margins to compete. Discounting is most prevalent when substitutes are easily available, when businesses need to shift stock, or when brand loyalty is weak.

But discounting is not always a good idea. When stores trade products carrying their brand, the risk associated with discounting is that their brand is perceived as poor quality.

Share of goods discounted



Source: Westpac, Statistics NZ



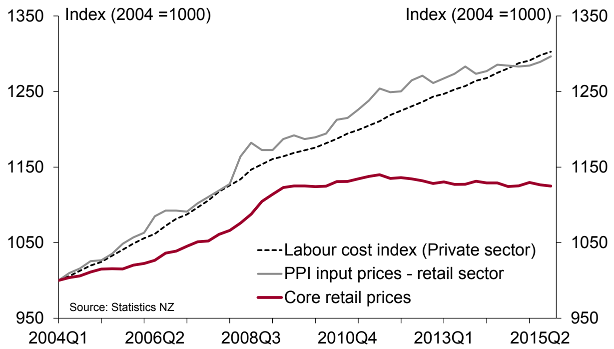
[2] Examples of this have been well publicised by *Consumer.org*.

Some industry sources indicated that they do not discount except for end-of-line products, and that to do so would be the end of their brand.

Many retailers spoken to believe the increased prevalence of discounting also sounded the death-knell for outlet stores, as the expectation among consumers is that they are already able to buy heavily-discounted products at full-price stores.

As they can't raise prices, retailers are looking to cut costs. Our recent report *What's been happening to retail prices?* highlighted the squeeze on retail margins in New Zealand.[3] Retail prices have been flat since 2011, while labour and other input costs have continued to rise.

Retail price and inputs growth, 2004 to 2015



Our discussions with retail sector stakeholders highlighted a number of strategies that retailers are using to make their businesses more profitable, focused on reducing the cost side of the equation.

- **Fewer suppliers:** In recent years, there has been a concerted drive in many sub-sectors to reduce the number of suppliers, with the goal of simplifying administration. Suppliers who do not provide a wide range of products, or who do not supply a single product that constitutes a large share of revenue for a retailer, have been abandoned. This reduces choice for consumers on the store shelf, but helps reduce the costs of operation for the retailer.
- **More store-level efficiency:** Stores that can get the customer to do more of the work themselves can cut staff costs. The most obvious example is self-service checkouts in supermarkets. At the same time, other technologies focused on improving efficiency in-store, such as electronic labelling, and digital maps that optimise routes for staff to assemble click-and-collect orders, are also becoming more prevalent.
- **Sale or return:** Bookstores and some clothing and footwear retailers are increasingly operating on a sale or return basis. If they cannot sell stock, it can be returned to the supplier. This passes the retailer's risk of unsold inventory onto the supplier.

Branded as different

The need for product and service differentiation has never been greater. As we discuss in the section on offshore competition, businesses relying on sales of cheap, or global branded products where shoppers can easily find an equivalent or identical product online, are at great risk.

The best way around this is product differentiation. This may be as simple as developing a house-brand for food and groceries or hardware products, or getting the supplier of certain products to package them differently from how they are sold at the store down the road. Fundamental to this approach, however, will be a strong, trusted brand. Consumers are unlikely to buy a brand they have never heard of from a retailer they don't know or trust.

In clothing and footwear, and specialty stores the big drive will increasingly be to develop differentiated products that are not easily purchased from other retailers online or in-store. Alternatively, stores may sell a "house of brands" as one interviewee described it, to limit their risk of being easily displaced by other retailers. In bookstores, the greatest growth is likely to be in sales of books with a local focus – rugby autobiographies, local cookbooks and the like – that do not face the same competition from offshore retailers.

To capture more spending per customer, businesses will need to extend their offering from products to associated services. In the case of large homogenous products like vehicles, add-ons may include finance, insurance or warranties. The service offering advantage offered by larger businesses (see also the section on whether big is better) may include vehicle servicing that ensures the customer stays with the retailer until the next vehicle purchase.

Other examples of expansion into services are emerging. These include Homeware and garden retail not just providing the products or plants you need, but offering an installation service, whether outsourced or in-house. Time-poor customers are often willing to pay to have their garden plants, paving and landscaping done for them, but still want the option of going to the garden centre and picking what goes in their gardens.

It's business *and* personal

Several industry sources pointed to customer demand for both personalised marketing and service. Doing this cost-effectively is a challenge. A number of industry players mentioned Countdown's OneCard scheme as an example of a successful personalised marketing programme. By having customers swipe their OneCard each time they shop, the OneCard scheme is able to identify which items that customer regularly purchases. This allows the scheme to promote products to particular customers based on their buying patterns.

[3] See http://www.westpac.co.nz/assets/Business/Economic-Updates/2015/Bulletins-2015/Whats-been-happening-with-retail-pricing-December-2015.pdf

Many businesses we spoke to are looking to develop loyalty programmes or other ways to ensure they can capture these customers and offer them a personalised marketing experience.

But customers also want to feel they are receiving personal service in-store. This moves retail from being “just shopping” to being an event or experience rather than simply a transaction. For instance, in higher-end clothing businesses, this may be achieved through highly-trained staff who are stylists rather than simply shop assistants, able to offer advice on which items fit together or look best on a customer. In this way, stores can offer a level of service that online traders cannot compete with, which justifies the price difference as customers are all but guaranteed to purchase the products that are best suited to them.

To create personalised experiences, shopping malls and individual stores are increasingly using events such as book signings, cooking classes, DIY workshops, and business-oriented discount, looking to sell products off the back of a positive client experience. Industry sources admitted that this approach could easily go wrong, but done well, was highly effective.

Omni-channel strategies

With the rise of online trade and social media, retailers need to be much smarter about how they reach customers. We have discussed the need for personalised marketing and service, but there is also a need to allow consumers to shop how they want to, and to get information where they want to.

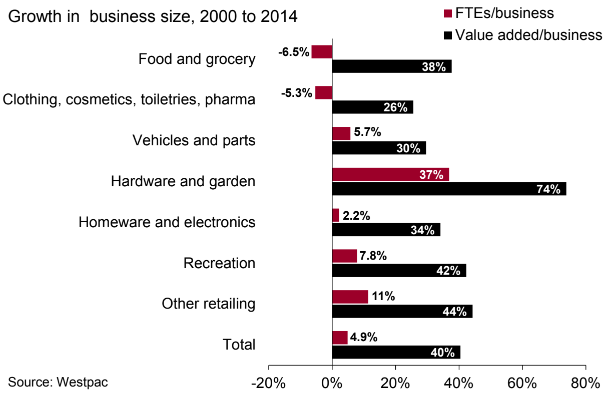
Retailers will adopt a marketing mix that combines traditional modes of mailers in letterboxes and TV and radio, as well as their websites, and increasingly social media and event marketing. They will sell to consumers online with home delivery, online by click-and-collect, or in-store. Many may also through other platforms such as Trademe.

The point is that no single channel is the silver bullet. To reach different groups of customers, businesses will need to have a broad strategy across marketing and sales channels.

Big is good, usually

- Retail businesses are getting bigger, particularly in terms of value added[4] per store, but mostly also in workers per store. Bigger may mean larger format stores, or a wider geographic footprint.
- This trend is strongest in Hardware and garden, but is widespread.
- Drivers include the need for greater volume or to cut out the middleman as margins fall, the desire to capture more of wallet by being a one-stop shop, growing geographic coverage to reach more customers, and the traditional benefits of scale in reducing costs.
- Some retailers are bucking this trend, most notably book and stationery stores, speciality stores, and some department stores, as stores take on more of a showroom feel, with less stock on display.
- Malls continue to grow in size and number, but face the challenge of remaining relevant, and of providing a recreation experience rather than simply a conglomeration of stores.

Over the last 14 years, employment (measured in FTEs) per business in Retail has grown slightly, up 4.9%. At the same time, value added per business has grown much faster, from $276,000 to $388,000 (up 40% since 2000), implying much large gains in value added per worker.



Source: Westpac

Several industry sources spoke of the benefits of scale. In some cases scale referred to the format of individual stores, while in most cases the implication was the benefit that came from larger enterprises (chains of stores) or a larger geographic footprint. Benefits of size were several:

- A larger format for individual stores allowed businesses to effectively be a "one-stop shop", an approach that has been particularly successful in Hardware and garden retail, but also increasingly in book, stationery and gift shops. This is attractive to customers as they could find everything they needed for a weekend's pottering around the house, or buying and wrapping a gift without visiting multiple stores. It allows the retailer to capture a larger share of the customer wallet.
- Larger businesses (whether size was reflected in one large business or several sites geographically dispersed) talked of the importance of volume to be successful in a retail environment where margins are squeezed. Examples include Vehicle retail, Hardware and garden retail, and big ticket Recreation retail. Some businesses were able to cite significant reductions in cost per unit sold as they expanded.
- The ability to tap into a bigger, geographically-dispersed market. Some businesses have focused on expanding across a city or across regional centres to access bigger markets. This larger market similarly allows them the scale required to succeed. This has occurred to some extent in Other retail (especially specialty stores), Vehicle retail and Clothing, cosmetics, toiletries and pharmaceuticals.
- Larger businesses were also able to adopt high-cost new technology that made their businesses more efficient. Smaller businesses could not afford these improvements.
- Larger scale businesses also make it more difficult for smaller new entrants to enter the market and compete.

It is worth noting that none of the industry players we spoke to indicated that they would look to reduce their overall reach. Many intended to add more sites (often by adding smaller format stores in regional centres), while others intended to reduce the number of sites but move to a bigger format.

[4] New Zealand GDP and the constituent value added by specific sectors or sub-sectors consist predominantly of pre-tax and depreciation profits (economic profits) and salaries and wages.

When small is better

A bigger store format was not always promulgated. Book and stationery stores, speciality stores, and even a number of department stores are looking at smaller formats. Rather than having massive amounts of product in-store, businesses are creating more of a showroom environment. One retailer with multiple stores across the country indicated that they believed the actual physical footprint of their stores would probably decline by 5% over the next 10 years.

To make this work, businesses have to incorporate technology such that there is a seamless transition between the physical product in-store, and a wider range of products available through their online offering, or via a click-and-collect service.

The post-Canterbury earthquakes concept of pop-up stores has also become more popular as a way of getting highly differentiated product close to the right market without committing to a long-term lease. This is unlikely to become a mainstream approach among larger retailers, but has been used with varied levels of success.

Vertical integration

Another way in which businesses in Retail expand at a time when margins are being squeezed is to integrate vertically. This could be Vehicle retail businesses that begin to undertake their own vehicle imports, working directly with agents in Japan for instance. It could also be clothing, footwear, or cosmetics manufacturers moving into direct retail of their products (in-store or online) so as to cut out the middleman.

In addition to allowing businesses to capture more of the value added at each stage of the supply chain, vertical integration allows businesses to better control their supply chain (in the case of a Vehicle retail business for instance), and ensure that product is reaching the right target market (in the case of a clothing or footwear manufacturer moving into retail).

We expect to see more of this integration as businesses look to other ways to expand margins that are squeezed by local and offshore competition.

The ultimate in size: Shopping malls

At the far end of the "big is good" spectrum is the large-scale mall, where shoppers can find everything they need under one roof, even if it is across multiple stores. New Zealand has been a relatively late adopter of the shopping mall model, but in the last decade or so there has been significant expansion in the number of malls, and their scale. A number of New Zealand malls are currently seeking consent for, or are already undergoing expansion. At the same time, a number of poorer-performing malls have recently been sold off, suggesting that malls are certainly not all successful.

Trends in New Zealand malls appear to be toward **predominantly chain stores** in both the food services sector (not covered by this report) as well as in clothing, footwear, and accessories. Some industry players commented that when a new mall opens, clothing and footwear chains feel pressure to open a store there so they don't lose market share, even when the returns might not be as good.

At the same time, international experience suggests that demand ebbs and flows for malls. They offer the benefit of a "one-stop" experience, the opportunity for recreation rather than just shopping (which is one reason malls do better on rainy days). However, malls must continually strive to remain relevant. Getting this wrong has dire impacts.

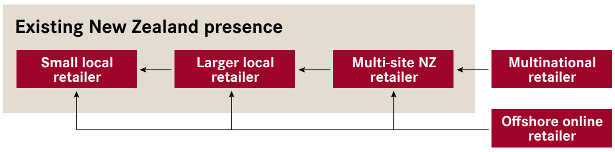
Part of remaining relevant is how malls deal with technology changes. The rise of online trading poses a genuine risk to malls. Bricks-and-mortar businesses make money when people come into their stores. Businesses that don't see foot traffic can't afford to pay higher rents, which is bad news for mall owners. Internationally, malls are developing apps that allow shoppers to plan their trip to multiple stores to simplify the shopping experience. Others are developing click-and-collect strategies across the mall rather than on a store-by-store basis.

We are likely to see successful malls continue to employ more technology, and focus on making the mall a destination where people choose to visit rather than feeling compelled to because they need to shop. On-site events, customer experience and social media will play a major role in the success or otherwise of individual malls.

There's always a bigger brother

New Zealand is a small market by global standards. This means our buying power is limited. Highly fragmented industries such as Vehicle retail, and specialty stores, are at a particular cost disadvantage when purchasing stock from overseas. Many sources across sub-sectors pointed out that overseas online competitors could sell products for less than New Zealand retailers could purchase them.

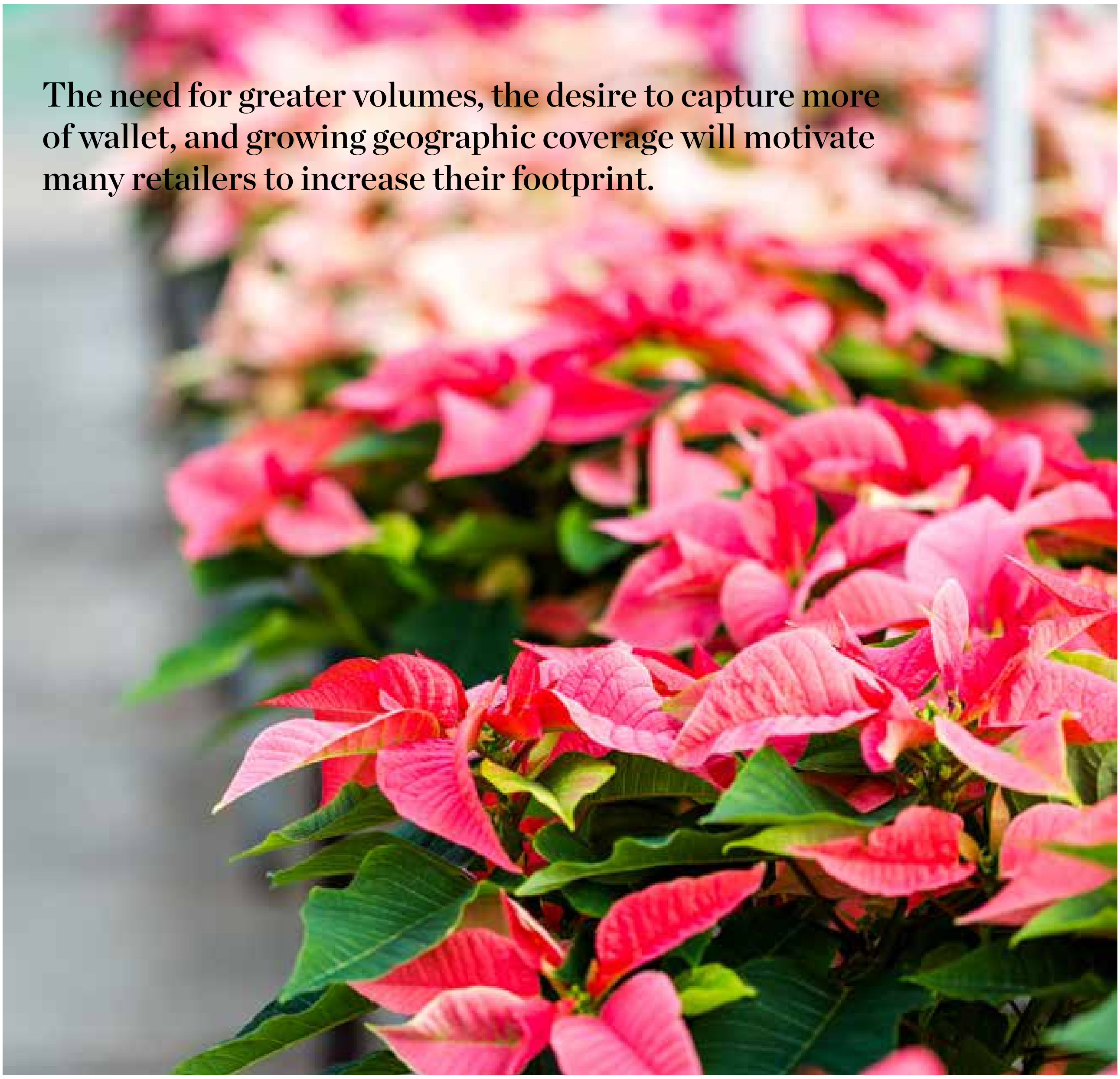
This means the risk always exists, at any size of business, that larger businesses with greater reach, broader product lines, or better prices may enter the market.



In the Food and grocery, and Homeware and electronics markets sub-sectors, the risk of super low-cost or global brand offshore entrants is significant. Changes happening in Australia provide an indication of the potential for these new businesses to develop here.

One factor helping retailers withstand the storm caused by overseas bricks-and-mortar retailers is the relative geographic size and small urban agglomerations in New Zealand. For instance, Ikea, the furniture and homeware business that has been rumoured to be entering the New Zealand market for several years, has only nine stores in Australia. Three of these are in Greater Sydney, with a population of 4.8 million. Two are in Greater Melbourne, with a population of 4.4 million. The smallest market served is Canberra, population 380,000, which has an annual average wage of over $88,000. In New Zealand, Auckland is the only market that could sustain this type of business.

The super low-cost international supermarkets are more of a threat to New Zealand retailers. For instance, Aldi Australia has more than 350 stores, or one for every 65,000 people. This suggests that a chain like Aldi could operate multiple stores in each of Christchurch, Wellington and Auckland. The question is whether they would be interested in operating, say, a 25-store network, perhaps as part of its Australian operation, or whether the smaller network here would be too hard to operate given the incumbents.



Retail and its sub-sectors

- The Retail sector is large (186,000 workers) and diverse. Food and grocery; and Clothing, footwear, cosmetics, toiletries and pharmaceuticals dominate, accounting for half of the sector's value added and 56% of jobs.
- Without the capital investment some industries require, value added per worker is lower than average.
- Since the downturn associated with the 2008 recession, all sub-sectors other than Recreation have seen value added return to pre-slowdown levels. But in all cases other than Food and grocery, the number of businesses has declined. And the only employment growth has been in Other retail, which includes online retail and specialty stores.
- This implies that the average size of individual bricks-and-mortar retailers in value added terms, and often in employment terms, has risen as the trend toward scale with its associated cost efficiencies gains momentum.
- As the New Zealand economy slows in 2016, unemployment rises and wage growth remains subdued, we can expect Retail growth to weaken.

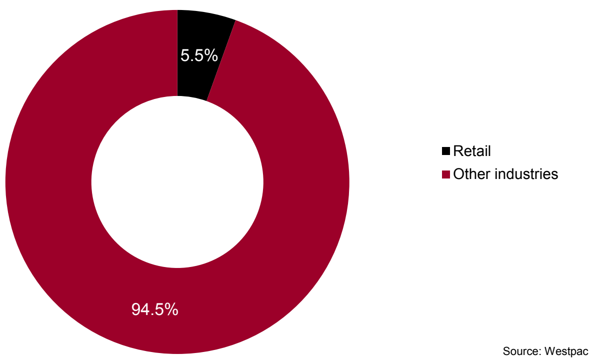
The Retail sector employed nearly 186,000 full-time equivalent workers (FTEs) across New Zealand in 2014, or one in 12 workers.[5] It generated $12.7 billion in value, or 5.5% of New Zealand's GDP.

As such a large employer, and with such a wide range of specialist areas, Retail is a diverse sector although as this study points out, many of the challenges its sub-sectors face are similar. For our purposes, we classify Retail into seven sub-sectors:

- Food and grocery
- Clothing, cosmetics, toiletries and pharmaceuticals
- Vehicles and parts
- Hardware and garden
- Recreation – which includes sports, camping, gaming, toy, book, and marine equipment retailing
- Homeware and electronics
- Other – which includes specialty stores not captured elsewhere (such as pets, prams, duty free, craft goods or variety stores) and the small but interesting Non-store retail (mostly online-only retail).

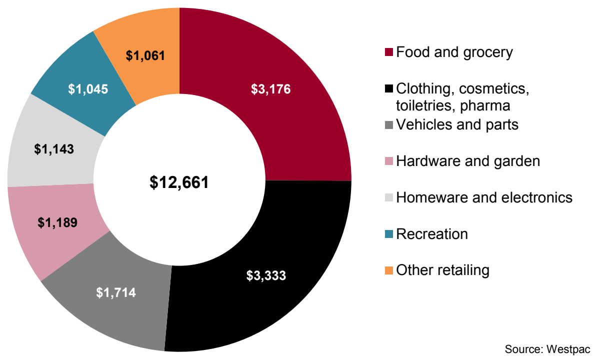
In terms of value added to the New Zealand economy, Clothing, cosmetics, toiletries and pharmaceuticals is largest, generating $3.3 billion in 2014. Food and grocery businesses generated nearly as much, while the other sub-sectors played smaller roles of between 8% and 14% of the total.

Retail value added, 2014 $m



Source: Westpac

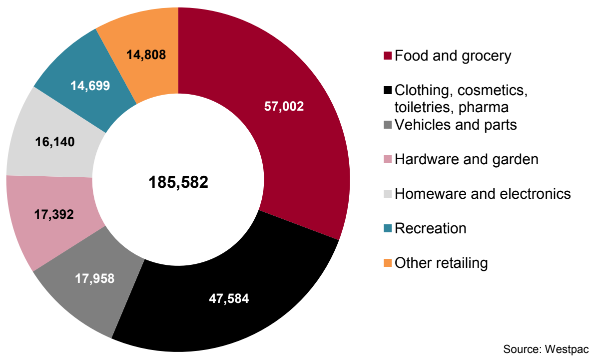
Retail value added, 2014 $m



Source: Westpac

[5] We define Retail using Statistics New Zealand classification codes. We include all of Division G other than Fuel retail, which was covered in our report on Transport, Logistics and Distribution.

Retail employment (FTEs)



Source: Westpac

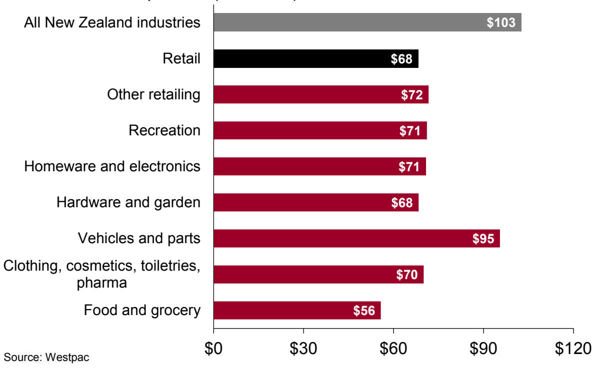
In employment terms, the picture is not dissimilar. However, it is immediately evident that Food and grocery retail employs a far larger share of workers than its value added suggests. This means that the value added per worker is substantially lower in Food and grocery retail than some other sub-sectors of the industry. At the other end of the spectrum, Vehicles and parts retail employs just 9.7% of Retail workers, but generates 14% of the value added.

Labouring on

Retail businesses are generally characterised by lower average value added (mostly profits and salaries) per worker, but a larger number of workers per business than other New Zealand sectors.

By comparing value added and employment, we can estimate the value added per worker across Retail and its sub-sectors, and compare this to national averages.

Retail value added per FTE (2014$000)

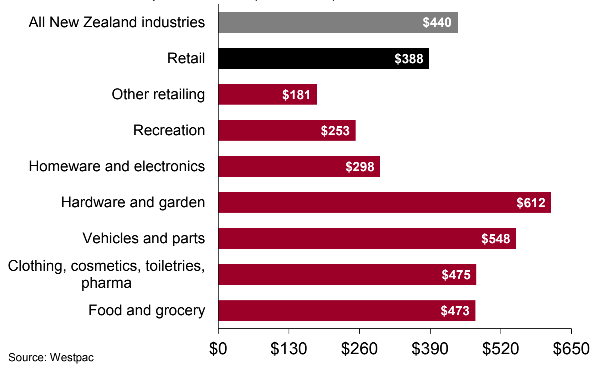


Source: Westpac

Value added per worker in Retail was generally well below the national average of $103,000 in 2014. On average, Retail workers generated $68,200 each in value that year. This is because of the labour-intensive nature of the Retail sector, which means the returns required per worker are not as high as for industries with large capital investments.

Within Retail, Vehicles and parts clearly generated more value per worker than other sub-sectors, at just under $100,000. Meanwhile, Food and grocery workers generated just $56,000 per worker. These extremes are not surprising. Vehicle sales businesses are reliant on strong cashflows and big upfront investments; they have to make large capital investments in vehicles that may remain unsold for weeks or months. They thus require a return on the capital invested that is much higher than businesses in the fast-moving consumer goods (FMCG) sub-sector of Food and grocery for instance.

Retail value added per business (2014$000)



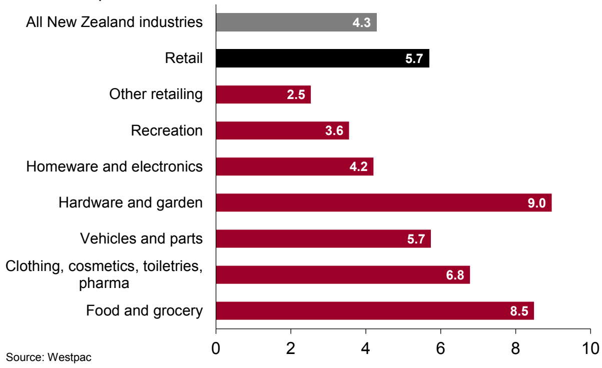
Source: Westpac

But the largest average business size within the sector is in Hardware and garden retail, which is dominated by a handful of large-format players. Although there are smaller businesses in the sub-sector which bring the average employment per business down, Hardware and garden businesses typically employ twice as many workers as the average New Zealand business.

Food and grocery businesses also tend to have a large number of workers because of the role of supermarkets in this sub-sector. As a result, despite the lower value per worker generated in Food and grocery retail, the sub-sector generates a relatively large amount of value per business, at $473,000 in 2014. The family-run dairy would contribute much less value added off its small employment base, while large supermarkets would employ many more people and generate much more in value added.

On average, Retail businesses are around a third larger than the average New Zealand business in employment terms. However, with a lower value added per worker, the average Retail business contributes less to GDP than the average New Zealand business.

Retail FTEs per business



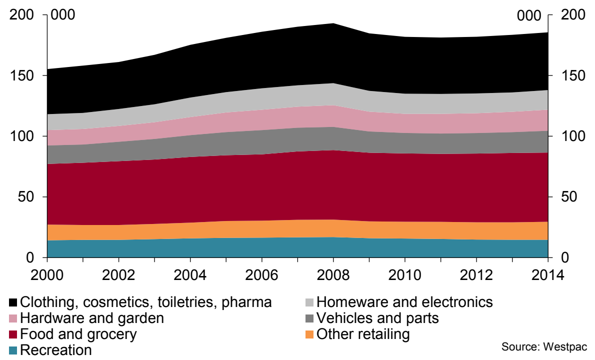
Source: Westpac

Everyone's gotta eat

Employment in Retail is highly responsive to times of economic growth or stagnation, and this responsiveness is more marked in sub-sectors selling luxury or non-essential goods.

The Retail sector grew steadily in the economic boom years through to 2008, then fell away to 2011 before growth resumed.

Retail employment (FTEs), 2000 to 2014



Source: Westpac

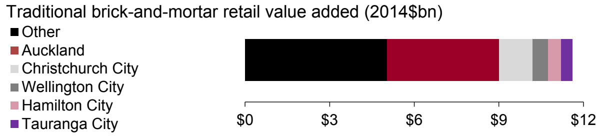
But fortunes varied widely depending on whether a sub-sector primarily sold necessities or luxury goods. For instance, Food and grocery; and Clothing, cosmetics, toiletries, pharma have not experienced up and downward swings to the same extent as they consist largely of products people cannot put off purchasing. Vehicle purchases, on the other hand, are often postponed when the economic outlook is weaker. Similarly, Homeware and electronics retail spending can often be delayed, making this sub-sector far more susceptible to the economic outlook.

Recreation, however, has been the sector hardest hit by the downturn from 2008. It has never fully recovered, and employment remains around 15% lower than at the peak.

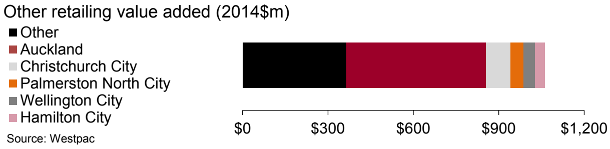
People pleaser

Retail serves consumers. As a result, retail businesses tend to be located proportionally across population centres. An important deviation from this rule is in Other retail, which includes commission-based and non-store retailing.

Traditional brick-and-mortar retail value added (2014$bn)



Other retailing value added (2014$m)



Source: Westpac

Two cities have a far larger proportion of these non-traditional retail businesses than their populations would imply – Auckland and Palmerston North. The latter in particular is an interesting case. Palmerston North generates only 1.7% of New Zealand's GDP, but produces 4.5% of Other retailing value added.

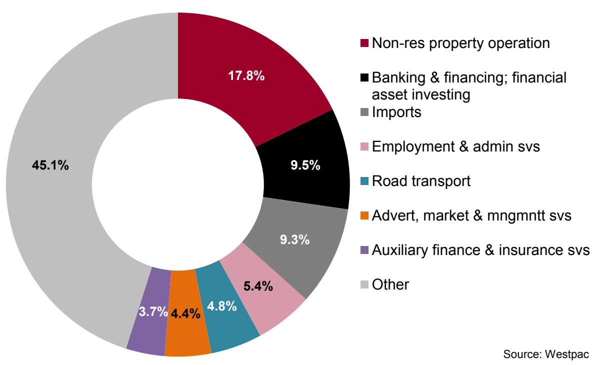
One reason for this is that non-store retail (such as online businesses run from home or from a warehouse) do not need to be in a major population centre; they simply need good access to population centres. Palmerston North is near Wellington region, Whanganui and Napier-Hastings, and is on a road and rail cross-roads. It has good air links with overnight mail and parcel flights to Christchurch and Auckland. These strong logistical links make Palmerston North a good choice for non-traditional retail.

Where inputs come from and outputs go

National input-output tables allow us to examine which industries are major suppliers to the Retail sector, and where the outputs of the Retail sector go. This helps clarify how closely the fortunes of certain industries are linked to Retail.

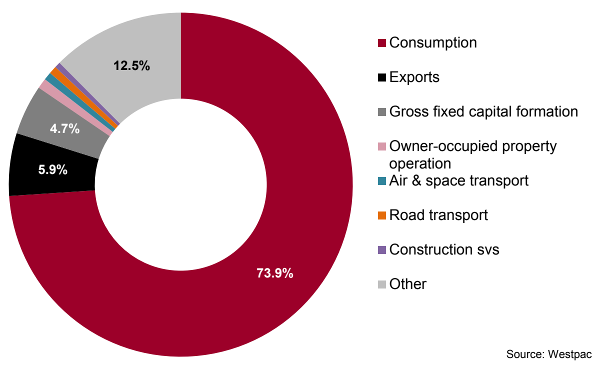
In previous reports, we have included input-output analysis for several of the sub-sectors (depending on data availability). However, the source of inputs, and where outputs go, are very similar across the different sub-sectors within retail, so it make sense to examine the key input and output industries at an overall level rather than in the discussion on each sub-sector.

Where inputs to the Retail sector come from



Source: Westpac

Where outputs from the Retail sector go



Source: Westpac

The Retail sector draws on a wide range of input industries. Key among these is non-residential property operation, a function of the large footprint many of these stores require. Services supporting these businesses include banking and finance; and advertising, marketing and management services. The importance of road transport in getting product to Food and grocery stores is highlighted through its 4.8% contribution to the intermediate inputs for the sub-sector.

A downturn in the Retail sector has big implications for these input industries. Higher retail space vacancy rates and/or lower yields are one clear outcome of a weaker Retail sector, with big implications for the property operators who have invested in retail space. Similarly, banks, financial service providers, and marketing firms derive large portions of their incomes from their Retail customers and when consumer demand is low, the flow-through of poor Retail performance hits these businesses.

The vast bulk of Retail output is consumed by households (74%). Some Retail outputs are exported, and a small proportion feeds into gross fixed capital formation. Falling consumer confidence, rising unemployment, and low wage growth mean weaker growth for Retail, because its fortunes are so tightly linked to the outlook for consumers.

With the New Zealand economy set to slow in 2016, unemployment rising, and as a result, wage growth expected to be weak, we may see a period of very limited growth for Retail.

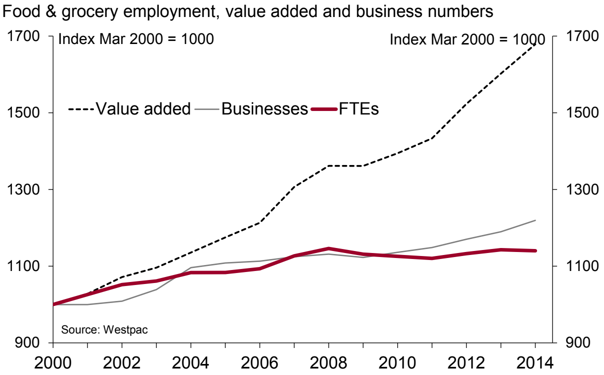
Food and grocery

- Food and grocery is one of the sub-sectors least affected by the economic environment, with growth in value added barely affected by the 2008 recession.
- Value added per store has risen sharply in Food and grocery retail in recent years, while employment has been flat.
- Average number of workers per store has actually fallen slightly as the rise of the supermarket has been partially reversed through an increase in specialty ingredients stores.
- The outlook for the sub-sector includes more discounting, an increased online presence, and a need for Food and grocery businesses to differentiate themselves through better customer experiences to increase loyalty.

More for less

The key trend in Food and grocery retail over the last decade has been almost uninterrupted growth in value added, accompanied by little employment growth and an increase in average business size as measured by value added per store.

Food & grocery employment, value added and business numbers



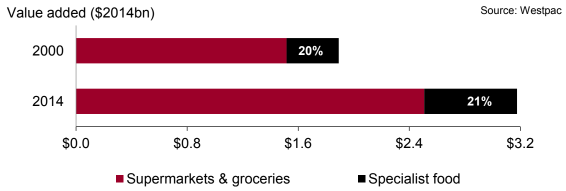
Employment peaked in 2008, and has since levelled off. In total, Food and grocery employment is up just 14% since 2000. By comparison, the value added by these workers has surged 68%, implying a productivity gain per worker of 47% since 2000, or 2.8% a year.

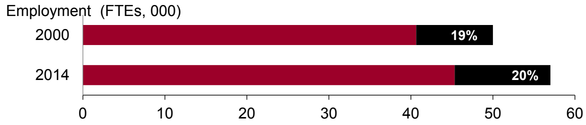
This productivity gain is far higher than the average seen across the New Zealand economy over the same period. It suggests that Food and grocery businesses have implemented technology and other efficiency gains that have allowed them to generate more value while keeping headcount flat. One example of this has been the introduction of self-service kiosks at most large supermarkets. This has reduced the number of staff members needed to service customers.

The number of businesses has increased at a moderate rate, which means that the average production per business has grown strongly as well. In short, slightly more businesses are producing significantly more value through few extra workers than in 2000.

The return of the specialist

Looking into the Food and grocery sub-sector in greater detail, it is evident that there has been a muted reversal of the trend toward having everything under one supermarket roof in recent years.





Supermarkets grew to dominate the Food and grocery sub-sector in the second half of the 20th century. Specialist food businesses, which include butchers, liquor stores, fruit and vegetable markets, and spice and imported ingredients stores, suffered as a result. As of 2000, Supermarkets and groceries (which in New Zealand include dairies) accounted for 80% of value added in Food and grocery, and 81% of employment. Since then, there has been a small turnaround in fortunes. Although the number of businesses has grown equally rapidly across both categories, employment and value generated by specialist food businesses has risen faster. Specialist food stores generated around 22% of value added by the Food and grocery sub-sector, and employed 20% of the sub-sector's workers by 2014.

This fits with anecdotal evidence of something of a revival in interest in specialist food, particularly in urban centres where the switch to larger format food stores was most rapid. Some areas where percentage growth in value added by specialist food stores far exceeded growth in value added by supermarkets and groceries over the 14 years include Queenstown-Lakes, Hamilton, Auckland, New Plymouth, Dunedin and Napier.

The outlook for food and grocery

A number of emerging trends in Food and grocery retail will impact the sub-sector. Many of these will focus on differentiating the offering from competitors on factors other than price although discounting will remain a major battleground.

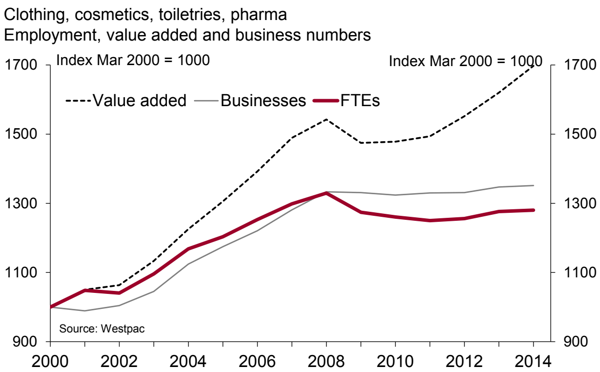
- **More discounting:** We expect to see an increase in the number of products being discounted, whether as a marketing tool or a genuine reduction in prices.
- **Increased online presence:** As in many sub-sectors, we expect to see an increase particularly in the click-and-collect offering of Food and grocery retailers.
- **More upgrades for an improved shopping experience:** With interest rates at their lowest in recent memory, many Food and grocery retailers are likely to use cheap credit to upgrade their stores to improve the customer experience in an effort to differentiate themselves.
- **Expanded loyalty programmes:** In a time of reduced brand loyalty, Food and grocery retailers will need to do more to create loyalty. We can except to see a lot more activity aimed at understanding customer needs and giving them reasons to shop at a particular chain.
- **Increased brand differentiation and promotion:** House brands have traditionally been marketed as cheap, reliable alternatives to branded products. As margins are squeezed, there is a lot of incentive to shift customers onto house brands, where margins are higher despite a price point that is often lower. This will require Food and grocery retailers to change perceptions of house brands, by promoting them as premium products.
- **More specialist stores:** The trend toward more specialist stores is likely to continue, but these businesses are likely to have higher turnover rates than the larger format supermarkets, as not all specialist offerings are likely to be as successful as the well-tested supermarket format.
- **Greater likelihood of a new supermarket entrant:** Auckland's growth in particular makes it an increasingly attractive option for expanding into a new market. Based on overseas experience, Auckland could probably support a chain of 25 super-low cost Food and grocery retailers. New Zealand retailers will need to prepare for this possibility by positioning themselves such that they are differentiated from any new entrants.

Clothing, cosmetics, toiletries and pharmaceuticals

- Clothing, cosmetics, toiletries and pharmaceuticals has seen the largest increase in business numbers across Retail since 2000 although growth has been flat since 2008.
- Most growth in value added and employment has been in clothing, footwear and accessories.
- We expect a major effort by the sub-sector to differentiate products and services to discourage showrooming and direct comparisons between brands.
- We expect more entry by manufacturers and importers into direct sales to consumers to prop up margins, while outlet stores will face a difficult operating environment.
- Retailers will boost their online presence, with a preference for click-and-collect services rather than home delivery, so as to ensure customers still visit their bricks-and-mortar stores.

Trying a size bigger

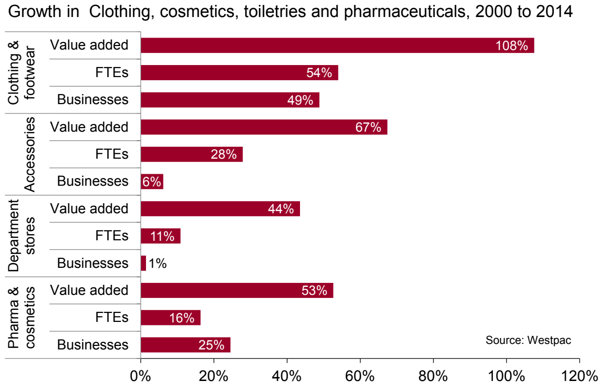
The number of stores in the Clothing, cosmetics, toiletries and pharmaceuticals sub-sector has risen, but the value added by the sub-sector has grown even faster. This suggests strong increases in the value generated per business, of around 24%.



The sub-sector was relatively resilient through the global and domestic downturn experienced between 2007 and 2010. Although there was a dip in employment and value added, the number of businesses remained stable. Yet in the years since, the number of businesses and workers have each only ticked up slightly while value added has surged.

The shoe fits

Delving even deeper within the sub-sector, it is evident that by far the strongest growth has been in clothing and footwear over the last 14 years. Value added by clothing and footwear stores has doubled, employment is up more than 50%, and the number of businesses has surged 49%. This implies that clothing and footwear stores on average generate around 34% more in value than they did 14 years ago in real terms.



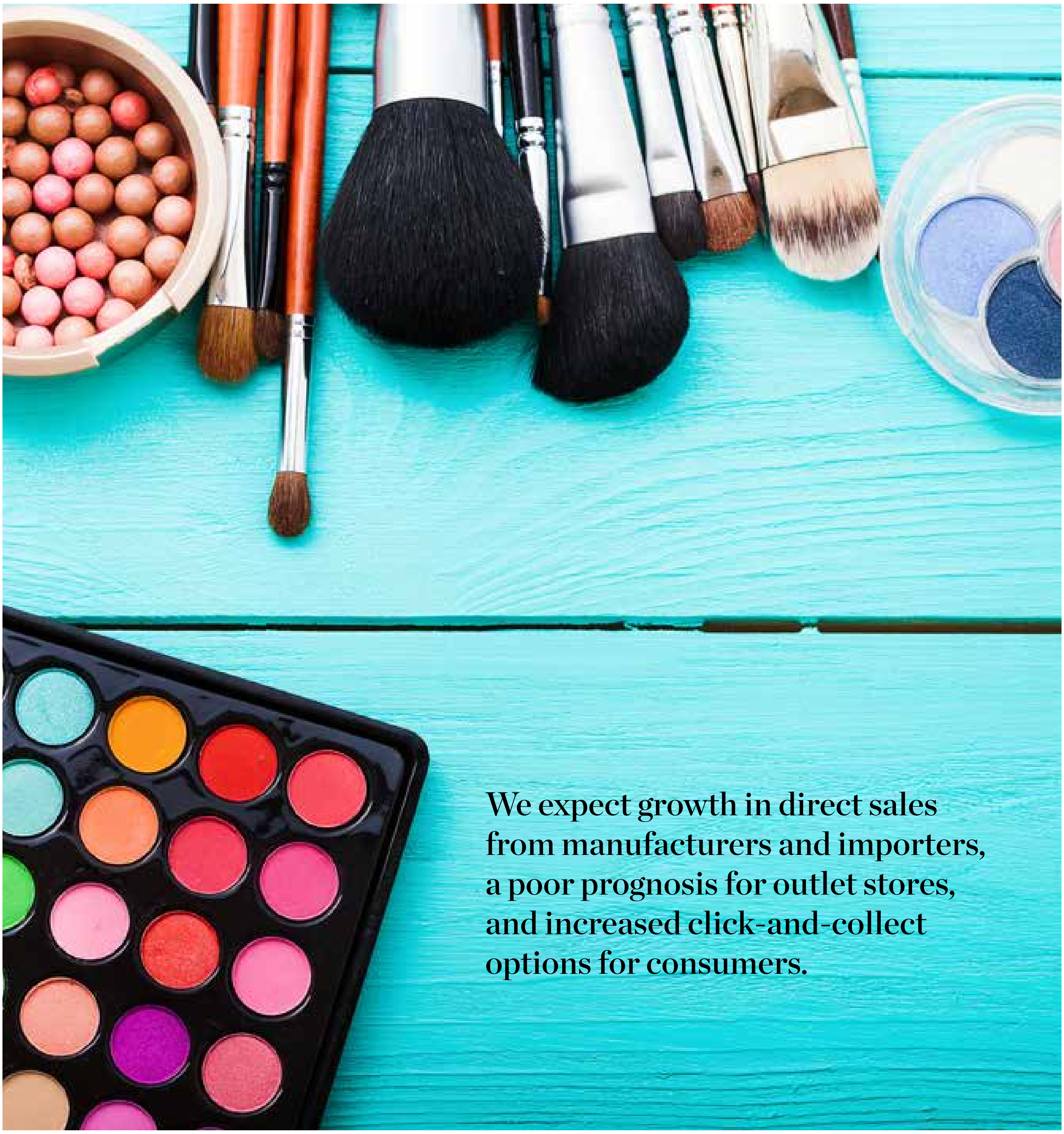
Other parts of the sub-sector have seen similar albeit more muted growth patterns. Generally, value added has grown strongest, with less movement in employment and business numbers. What is particularly surprising is that even in an era that includes the Global Financial Crisis (GFC), and a well-documented rise in online retail (often from offshore merchants), business numbers have increased. It is true that much of this gain occurred in the years to 2007, but even in the last 5 years, indicators have been remarkably stable.

The outlook for Clothing, cosmetics, toiletries, pharma

There are a number of trends that will continue to affect the sub-sector:

- **More differentiated products:** Low-cost and global brand retailers are at great risk from offshore online retailers. These businesses will struggle to survive without moving into higher-quality, independent brands.
- **Quality of service:** Following on from the move among successful businesses to differentiated, quality brands, stores selling higher-end product will need to continue focusing on quality of service to garner customer loyalty. Shop assistants will need to be trained to offer expert advice on products, rather than simply stacking shelves and working at the check-out.

- **Demise of outlet stores:** A further point related to the need for a quality product and service offering, will likely be a weak outcome for outlet stores. With increased discounting across many full-price stores, both as a marketing tool and as competition increases, outlet stores are likely to struggle in maintaining market share.
- **Increased vertical integration:** Manufacturers and importers of Clothing, cosmetics, toiletries and pharmaceuticals are likely to look for ways to approach the market directly, rather than using existing retailers, to capture a larger share of the margin on products they produce or import.
- **Increased online presence:** Clothing, cosmetics, toiletries and pharmaceuticals retailers are expected to scale up their online presence despite the risks and costs doing this can incur. Many retailers will likely promote click-and-collect over home delivery so as to still get the customer to come into the store. This provides the possibility of a further sale, and in the case of clothing and footwear, ensures the customer purchases the right size, avoiding the costs and time wasted on a returns process.



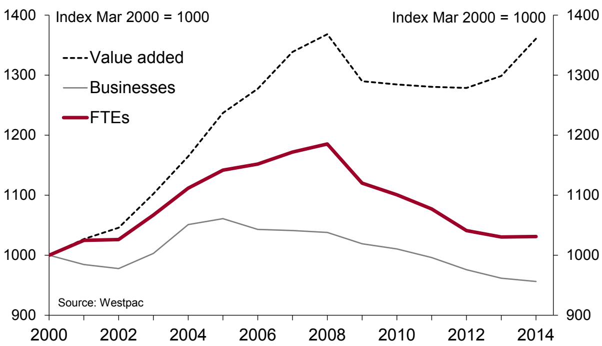
Recreation

- The recreation sub-sector includes sports and camping equipment, entertainment media, toy and game, book and newspaper, marine equipment retailing, stationery, antique goods, and flower retailing.
- Recreation has struggled to recover from the 2008 recession and changes in technology, including e-readers and offshore online traders.
- Sport and camping goods are on the rise, as are marine product purchases, but bookstores, and entertainment product stores are having to reinvent themselves.
- We expect bookstores to continue to become gift, toy and stationery stores, competing directly with stores that have traditionally been in that space.
- After several strong years, the marine products industry will likely slow as house price growth eases and as the economy overall weakens in 2016.

Fishing for efficiencies

By Retail standards, the Recreation sub-sector has had one of the more challenging few years. Growth was strong in the years to 2008 although the increase in the number of businesses was far weaker than for employment and value added.

Recreation employment, value added and business numbers



Since 2008, however, both employment and the number of businesses have steadily fallen. By 2014, there were fewer Recreation businesses than in 2000, making this sub-sector unique within Retail. Value added in the sector has rebounded, but by 2014 was still below 2008 levels in real terms.

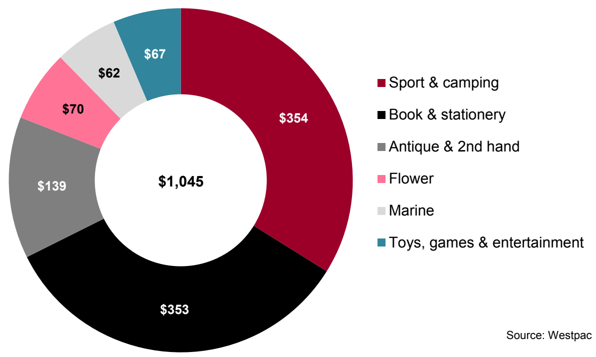
These results imply that businesses in the sub-sector have significantly increased the value generated per store. Value added per store has risen 42% since 2000, and value added per worker is up 32%.

Booking out

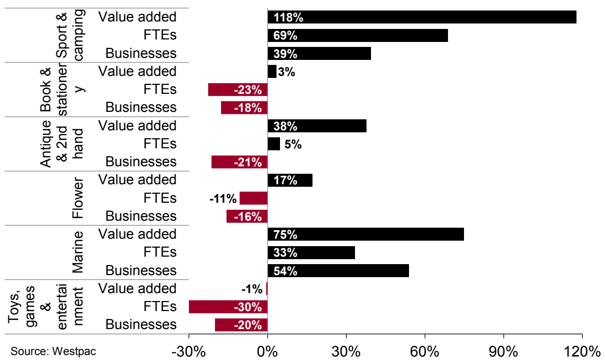
The Recreation retail sub-sector is diverse. This makes it less useful to talk about its fortunes at just a headline level. It is important to understand the composition of the sub-sector, as well as which parts of it have grown or not over in recent years.

Sport and camping retail accounted for around one-third of the sub-sector in 2014. The share contributed by Book and stationery retail was similar. The other components were all much smaller, at between $67 million and $139 million.

Recreation retail value added , 2014$m



Growth in Recreation retail, 2000 to 2014



But growth rates tell a different story. By far the strongest growth has been in Sport and camping retail. Just 14 years ago, this industry was 21% of the Recreation retail sub-sector, but with value added up 118%, the sub-sector is looking strong.

Westpac Institutional Bank

Meanwhile, Book and stationery retail has struggled. Once by far the largest employer and value generator in Recreation retail, the rise of online retail has seen value added stable at around $340 million a year, while employment and the number of businesses have fallen sharply.

Within **Book and stationery** retail, there has also been a reinvention of sorts. With e-books and offshore online bookstores, there has been a switch away from stores identifying as “bookstores” to more identifying themselves as “stationery stores”, which often includes a focus on selling gifts and toys as well. Employment in stationery stores has grown nearly 50% in the last 14 years, and has been relatively stable over the last six years. In this time, employment at bookstores has fallen 44%.

The **Marine** industry, including boats and fishing equipment, has also grown sharply. Much of this growth was pre-GFC. Employment is still down 14% on the 2008 peak, and value added is just now getting back to the peak. This does imply, however, that Marine businesses are able to generate the same value as they did seven years ago, with 14% fewer workers, which means productivity per worker has grown 2% a year since then.

Another industry that has found the technology revolution tough has been **Toys, games and entertainment.** CD stores have disappeared. Meanwhile, toy shops and gaming stores have had more mixed results. Overall, the number of Toys, games and entertainment businesses has fallen 20%, employment by 30%, and value added by 9%.

The outlook for Recreation

Over the next couple of years we expect a number of trends in Recreation retail:

- **Fewer big ticket orders:** The sale of big-ticket items such as boats, a luxury good, is relatively dependent on the economic cycle. Industry sources we spoke to suggested a strong order book over the next few months, but these were orders placed in the last year, when, for instance, Auckland house prices were growing strongly, giving people the equity they needed to make other large purchases. As house price growth falls, we expect sales of these luxury items to slow.
- **One-stop shop:** We expect bookstores to continue to morph into gift stores, with a greater focus on stationery, gift cards, and toys.
- **Toys and games for adults:** The rise of the adult colouring book, Star Wars toys and the like are seeing more adults than ever visiting toy shops for themselves rather than for children. We expect a this market to grow and for the blurring between bookstores and toys stores to continue.
- **Increased focus on local products:** On highly homogenous products like books, the only way to compete is to focus on local products like autobiographies of New Zealanders and local cookbooks. We expect the share of revenue derived from these kinds of products to rise.

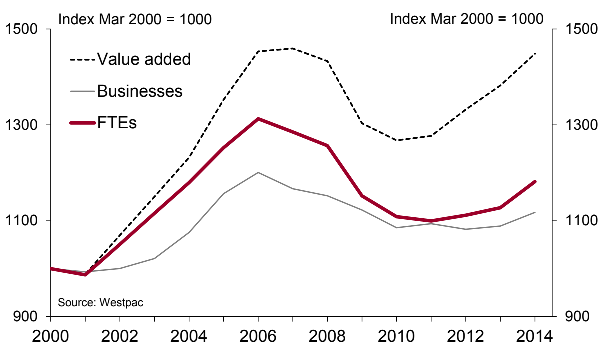
Vehicles and parts

- Vehicle retail businesses are only just recovering from the massive slump that followed flattening house prices and the 2008 slow down.
- All vehicle cost segments saw a decline in demand in 2008 and 2009. The high-cost vehicle market experienced the biggest swing in demand although it accounts for just 0.3% of sales on average. This fact counters the argument that the economic downturn did not impact the higher end of the market.
- Most growth has occurred in vehicle parts retail since 2000 although motorcycle sales have also grown sharply as petrol prices and congestion in major cities rose.
- The outlook is for greater consolidation and vertical integration in the sub-sector.
- We will also see an expansion of services offered by bigger players, such as finance, insurance and warranties, and increased online competition in the generic parts space.

Driven by productivity gains

Vehicle and parts retail experienced one of the deepest slumps as the 2008 recession hit. Employment fell 16% between 2006 and 2011, and value added dropped 12%. The number of businesses also declined during the slowdown, but at a much less dramatic rate. This implies that the average business size fell sharply in value and employment terms over that time.

Vehicles & parts employment, value added and business growth

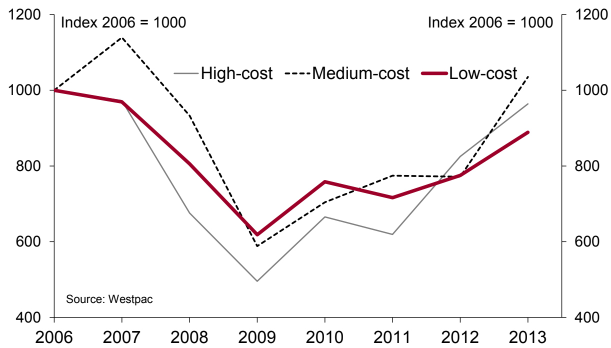


Since 2011, value added by the sub-sector has rebounded, and is now higher than it ever was. However, employment gains have been much smaller, indicating that sales yards are now operating a lot more efficiently, using fewer staff to generate more value. The number of shop-fronts has also seen tepid growth, with signs of more significant growth emerging in the last two years.

The economic cycle speed-bump

Some interesting patterns are observed when we consider the segments of vehicles sold in New Zealand. Our analysis divided vehicle brands registered in New Zealand into three segments, with average new vehicle prices below $40,000 (low-cost), below $80,000 (medium-cost), and above $80,000 (high-cost). On average, over the period from 2006 to 2013, low-cost vehicle brands accounted for 87.7% of first-time registrations in New Zealand. Medium-cost vehicles accounted for 12.0%, and High-cost vehicles were just 0.3%.

First-time vehicle registrations by vehicle price band



When the New Zealand economy began to slow and the economic slowdown hit, there was an immediate decline in the registration of high-cost and low-cost vehicles. However, sales of medium-cost vehicles actually grew in 2007. This may suggest some substitution out of high-cost into medium-cost cars, although not all of the change could be explained this way.

As the recession deepened, registrations of high cost cars plummeted to half of what they were in 2006, while the reduction in registrations of low-cost cars was not as marked (down 38%). Then, as the economy strengthened from 2011 onward, the growth in registration of high-cost vehicles accelerated away, while low-cost registrations grew much more modestly. Similarly, medium-cost registrations rebounded more sharply, suggesting substitution of low-cost cars for medium-cost brands.

These patterns imply that high-cost vehicle demand is far more responsive to the economic cycle than some suggest. At the time of the 2008 recession, indications were that those most affected were those on lower incomes, with poorer-paid jobs first to go. Yet clearly the segment of the market most likely to purchase expensive cars saw the greatest loss in demand during the economic downturn, and the biggest bounce as the economy picked up.

Accelerating motorcycle and parts sales

Within Vehicles and parts retail, the fastest growth has been in motorcycle and vehicle parts retail. The value added by Motorcycle retail, and by Tyres, parts and trailers, has risen more than 100% in 14 years. Much of this growth happened between 2000 and 2008, with growth subdued since then.

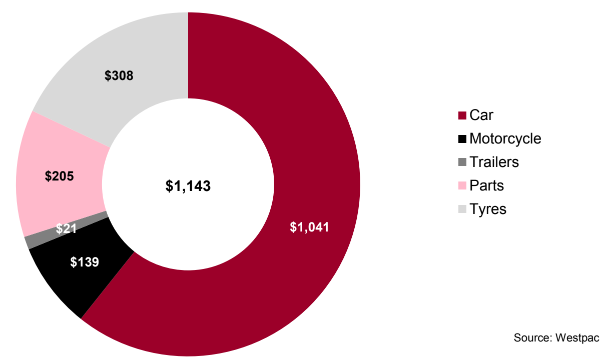
Meanwhile, the largest portion of the sub-sector – Car retail – has seen modest growth in value added over the 14 years. But employment is down and the number of businesses has fallen 4%. In all component industries, value added has grown faster than employment or the number of businesses, implying an increase in value added per business. With the exception of the relatively small Motorcycle retail industry, businesses are also larger in employment terms than they were 14 years ago. This fits well with the message we received from industry sources, that scale is crucial to surviving in what is still a fragmented sub-sector, particularly for Vehicle sales.

The outlook for Vehicles and parts

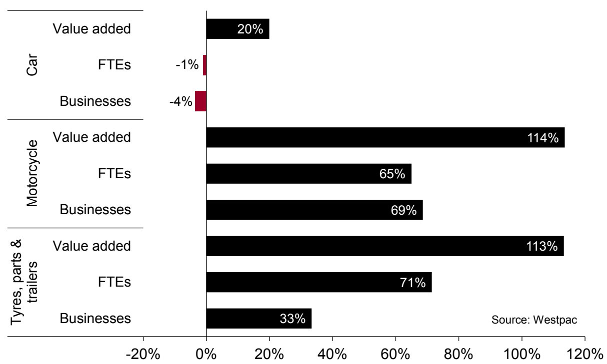
We expect to see a number of trends play out in the Vehicles and parts sub-sector over the next few years:

- **More consolidation:** According to Statistics New Zealand, of the more than 700 enterprises in tyres and vehicle parts retail, fewer than 10% employed more than 10 employees. The picture for vehicle retailers is similar. Yet industry sources indicated that volume is key to competing successfully in the vehicle retail space. This means that the shift toward larger sales yards, or more sales yards with shared back office functions, and vertical integration across wholesale and retail, are key for continued success.
- **Increased vertical integration:** Another way to improve efficiencies and improve margins is through vertically integrating vehicle import and sales businesses. At present, there are still a number of Vehicle retailers who do not directly import their own vehicles from overseas. Industry sources indicated that this number was falling, however. As the number of larger businesses grow, there is likely to be a greater shift toward businesses doing their own importing and retail sales. By cutting out the wholesaler, the vehicle retailer can capture more margin and also have a lot more control of the supply chain. By controlling the supply chain, they will be better placed to push for better shipping rates, and work directly with agents in Japan and elsewhere to secure vehicles at better prices, which will make them more profitable.
- **Expansion of services:** Larger Vehicle retailers are likely to look to expand their service offering to promote customer loyalty and increase their profit per sale. This will include service centres, and offering finance, insurance and warranty products.
- **More vehicle parts competition online:** There are already businesses that cater for the business-to-business (B2B) parts market and within the insurance claim space, but we may see more competition in online retail to the end-user. One major retailer already has an online presence but direct sales from a warehouse/distribution centre environment rather than from a bricks-and-mortar retailer is likely for standardised or generic products like motor oil, windscreen wipers, or floor mats. There is already some activity in the second-hand parts online market and we expect this to grow.
- **A switch away from high-cost vehicles:** We expect that as the economy slows, total new vehicle registrations will probably moderate, and the switch away from high-cost vehicles may re-occur.

Vehicle & parts retail value added , 2014 $m



Growth in Vehicles & parts retail, 2000 to 2014



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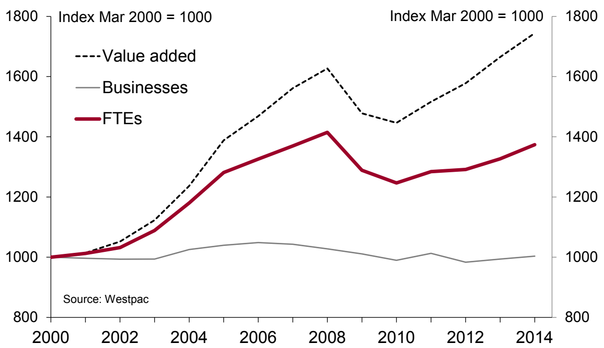
Hardware and garden

- More than any other sub-sector, Hardware and garden stores have increased in size as measured by employment and value added.
- Larger format stores are seeing much greater growth than smaller stores within the sub-sector as people increasingly look for a one-stop shop for their renovation and gardening needs.
- Reality TV and the rise of the DIY-er have stimulated growth, while construction trade business has been particularly important in Canterbury and now in Auckland.
- Online trade is likely to be in the form of click-and-collect due to the bulky nature of products, and time-poor customers are likely to want an extension from products into installation services from their local Hardware and garden store.

Building value

More than any other Retail sub-sector, Hardware and garden has seen a shift toward big box store formats. Over the last 14 years, the value added to the New Zealand economy by the Hardware and garden sub-sector has grown nearly 75%. Employment has risen nearly 40% while the number of businesses has remained flat.

Hardware and garden employment, value added and business growth



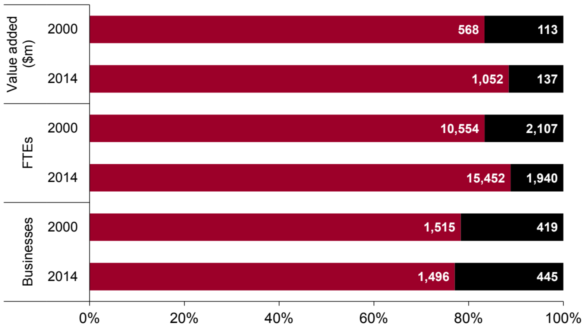
Source: Westpac

In other words, the value generated per business has grown 74%, and employment per business is up 37%. Not only does this highlight the increased role of large format stores that provide DIY-ers, trade, and gardeners with a wide range of goods; it also highlights the growth in the number of people who have moved into gardening or renovating as a weekend pastime.

Bulking up

The trend toward big box retail is strongly evident. While there has been some growth in value added and the number of businesses in stand-alone garden businesses, almost all the growth in absolute terms has been in hardware stores with associated garden centres.

Growth in Hardware and garden retail, 2000 to 2014



Source: Westpac, Statistics NZ

Value added by hardware stores (increasingly with attached garden centres) has risen 90%, compared to 20% for traditional garden centres. Employment has surged 46% at hardware stores, but has fallen 8% at garden centres. The only metric on which garden centres have grown their role is in the number of businesses, which have, contrary to trends across the entire Retail sector, increased despite a fall in employment.

The outlook for Hardware and garden

Trends for the sub-sector that we believe will continue to grow include:

- **Even bigger:** Average store size is expected to continue to grow, with smaller stores possibly disappearing from the landscape.
- **More new housing:** As new housing delivery ramps up in Auckland in particular, hardware stores will compete fiercely for the trade business.
- **More renovation and more veggie patches:** Many industry sources cited reality TV as a major part of the growth in this sub-sector. Numerous gardening and renovation shows had given the public the view that “normal people” could do more around the home. Many also mentioned the rise of the “young gardener” who has an interest in growing their own food.

- **Smaller sections don't mean fewer customers:** Industry sources did not see the move to smaller section sizes in large urban centres as a major inhibitor of growth. Many people are more likely to tackle a smaller low maintenance garden or vegetable patch than they are to attempt to maintain a large garden.
- **Extension into services:** An important change in the sub-sector is expected to be a shift toward providing installation services as well. Increasingly, people who are less inclined to spend their weekends in the garden are happy to pay for the installation of their purchases at the hardware or garden store. Stores will need to expand their ability to offer installation services through links to reliable installers, whether of kitchens or garden plants. Many customers want to purchase this "completed product" and the extent to which a retail business can also provide these end-to-end services may determine its success.
- **Click-and-collect:** With a large proportion of goods sold by Hardware and garden stores being bulky or live, the most likely online progression will be an increase in click-and-collect sales.

Homeware and electronics

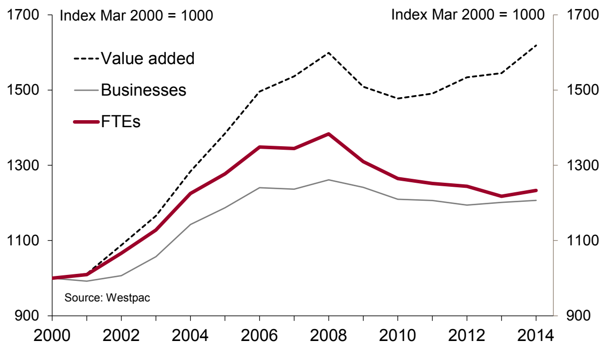
- Homeware and electronics consists of furniture, floor covering, houseware, manchester, electrical, electronic, and computer retail.
- The economic slowdown hit the sub-sector hard. Employment has never recovered although value added by the sub-sector has bounced back to 2008 levels.
- Despite strong offshore competition, the strongest growth has been in Electrical, electronics and computer retail.
- The outlook for the sub-sector is one of the most challenging. We expect more offshore competition, a continued environment of permanent discounting, and that only retailers who can turn over sufficient volume at lower margins will succeed.

Employment cuts out

After strong growth in employment, value added and business numbers across the boom years to 2008, Homeware and electronics experienced a sharp slowdown in the years that followed. Hardest hit was employment, which fell steadily year-on-year for five years, bottoming out 12% lower than at its peak by 2013. The number of workers in the sub-sector has never recovered from this decline.

Value added fell 8% over two years, but has since recovered and in 2014 passed the level seen in 2008. But the number of businesses has been flat over the past four years, after showing comparative resilience during the downturn compared to employment and value added reductions.

Homeware & electronics employment, value added and business growth



These combined changes have resulted in the average number of workers per business remaining broadly stable since 2000. However, the productivity per worker has surged 31% over the same period, or 2.0% per year.

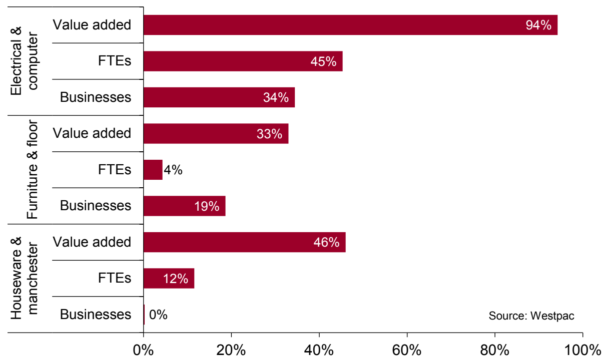
These results are stronger than one might expect given the rise of online trade and what that has meant for the Homeware and electronics sub-sector. In particular, achieving 2.1% in value added growth per year per business, or 34% in 14 years, is impressive given the level of competition this sub-sector faces and suggests an underlying resilience.

Electronics spark growth

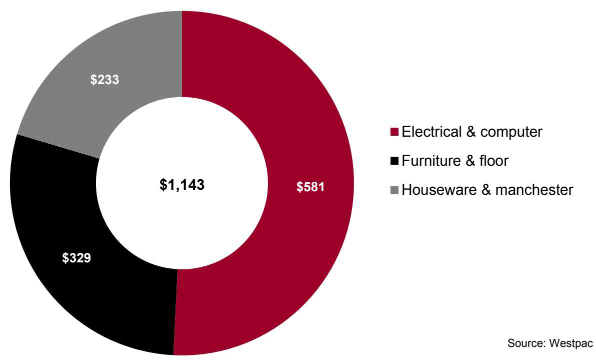
Electrical, electronics and computer retail accounted for 50% of value added in the Homeware and electronics retail sub-sector in 2014. But this was not always the case. Value added by Electrical, electronics and computer retail all but doubled over last 14 years, growing twice as fast as Furniture and floor retail or Houseware and manchester retail.

Across the other measures of growth – employment and business numbers - Electrical, electronics and computer retail also dominated.

Growth in Homeware & electronics retail, 2000 to 2014



Homeware & electronics retail value added , 2014$m



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The results achieved by Electrical, electronics and computer retail are remarkable within an environment of stiff competition both locally and online. Delving even deeper into the data indicates that, within Electrical, electronics and computer retail:

- Electrical, electronic and gas appliance retail has seen no growth since the 2008 recession.
- Value added in Computer and accessories retail has continued to climb.
- The smaller and rather unhelpfully named “Other electrical and electronic goods retail” has grown 93% in just the last six years.

Also worth noting is that in Electrical, electronics and computer retail, and in Houseware and manchester, the number of workers has risen faster than the number of businesses, indicating a shift to larger format stores. The trend in Furniture and floor retail has been the opposite; businesses have 13% fewer workers on average now than they did in 2000, as business numbers have grown faster than employment.

The outlook for Homeware and electronics

The outlook for Homeware and electronics includes a number of key trends:

- **More discounting:** Industry sources suggested that part of the reason the sub-sector has been able to grow despite stiff competition from online trade is the “permanent discount” approach that has been adopted in recent years. This marketing technique is based on the principle of certain products being on sale almost permanently. We anticipate that this kind of continuous discounting will remain a mainstay of the Homeware and electronics retail business model.
- **More house brands:** The move into house brands in electronics has had mixed results, but we anticipate a lot more house brands to appear in the homeware space. House brands allow the retailer to increase margins. The success of the house brand will depend on the retailer’s ability to promote it as a premium product; the market is unlikely to sustain a further increase in cheap brands.
- **Bigger formats:** The move to larger formats will likely continue in electronics, and toward larger chains dominating, as they have the scale to succeed in what is increasingly a volume business.
- **Expertise will matter:** Retail brand loyalty in this space is almost non-existent. Showrooming, whereby consumers evaluate a product in-store, but then search for the cheapest price online, will continue. In addition to having a sharp price, retailers will need to offer service and expertise, especially in the electronics sub-sector, to secure the business.

Other retail

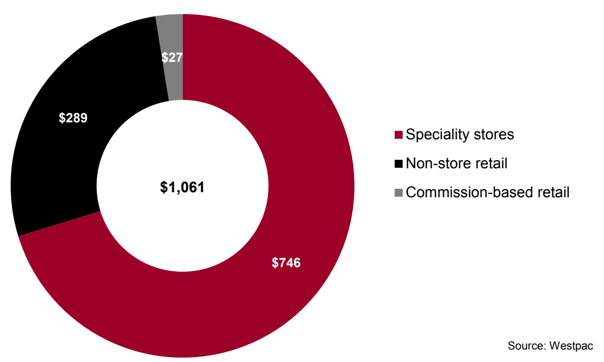
- Other retail includes specialty stores not captured elsewhere, such as pet stores, duty free stores, craft goods stores or variety stores. Crucially, it also includes non-store retail, dominated by businesses that conduct all their trade online.
- Value added by the sub-sector barely skipped a beat through the economic slowdown, while employment and business numbers have flattened.
- Specialty stores dominate the sub-sector, but the large growth in the last decade has been in Non-store retail, which has shifted from direct mail and catalogue businesses to online trade.
- Online businesses operating in niche products are likely to see some growth, while specialty stores will need to offer highly differentiated quality products rather than cheap, global brand or generic products to succeed.

Posting profits

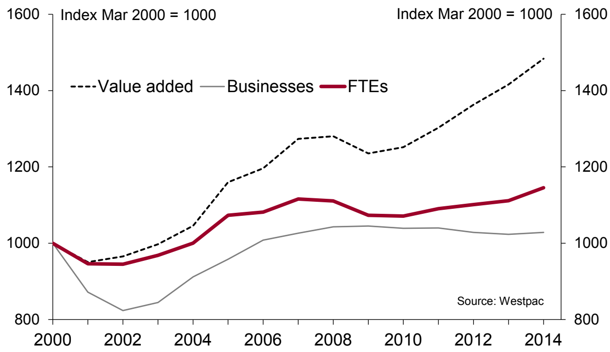
After a dip in the number of businesses in Other retail through the dotcom bubble burst in the early 2000s, the sub-sector has recovered strongly. Even the recession barely slowed growth in value added, while business numbers and employment stabilised.

Value added grew more than 50% in the 14 years since 2000, while employment grew nearly 20%. This implies that there has been limited growth in the average business size measured by number of workers, and nearly 50% growth in the average value added per business.

Other retail value added , 2014$m



Other retailing employment, value added and business growth



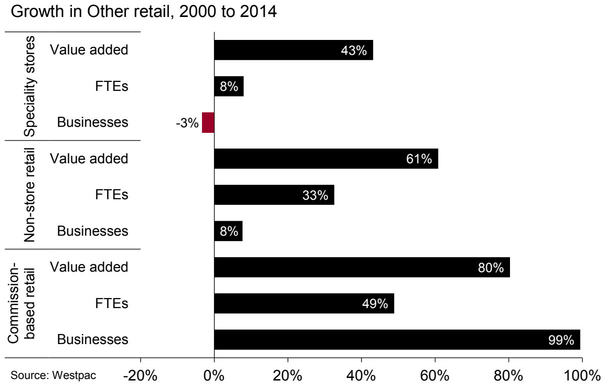
On line for growth

As of 2014, the Other retail sub-sector was still dominated by speciality stores that did not fit within any of the other retail sub-sectors already discussed in this report, such as pet stores, duty free stores, crafts, and op-shop type variety stores. These businesses accounted for two-thirds of the $1.06 billion of value added by Other retail.

But in the last 14 years, by far the largest growth has been in Non-store retail (predominantly online-only stores) and Commission-based retail. And although the highest percentage growth rates have been in Commission-based retail, its small size means the real story has been in online-only stores.

Value added by Non-store retail was $180 million in 2000, when the industry was largely driven by direct mail and catalogue models. By 2014, it generated $289 million in value and employed more than 4,000 FTEs, up from 3,000 in 2000. Business numbers have grown more slowly, but well ahead of bricks-and-mortar Speciality stores, where there has been a small decline in businesses.

Growth in Other retail, 2000 to 2014



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The outlook for Other retail

We expect to see a number of trends play out for Other retail over the next few years:

- **Growth in New Zealand-based online retail:** There is clearly an opportunity for continued growth of online retail in New Zealand. It offers the advantage of lower overheads as many of these businesses operate out of warehouses or even homes. However, there is also the disadvantage that comes from not having a bricks-and-mortar store where people can see and touch products themselves.
- **Online retailers will need to stand out to survive:** While niche online-only businesses are likely to see some growth, the increasing number of bricks-and-mortar businesses with an online presence, and the huge cost advantages of buying from overseas online agents who don't pay GST and who aggregate huge numbers of products will limit the increase. Online retailers will need to be selling either:
  - brands or generic products that are widely-available or accepted, and therefore where the risk for the consumer of purchasing online without physically seeing the product is small.
  - niche products not easily available elsewhere in New Zealand that are able to gain a reputation for quality in a short amount of time.
  - cheap products, sold for far less than in bricks-and-mortar stores with their higher rental overheads, where the price paid is sufficiently small for consumers to be willing to take the risk of receiving a poor quality product they have never handled themselves.
- **Further growth of aggregated platforms:** Aggregated platforms, like Trademe, which has helped the development of online-only businesses, are likely to see continued growth. These types of sites offer a "one-stop shop" and a way to rate the credibility and quality of New Zealand online-only retailers that stand-alone websites do not.
- **Specialty stores will need to differentiate product offerings:** They face many of the same pressures that stores in Clothing and footwear, Hardware and garden or Recreation retail face. If they sell international brands or cheap easily substituted products, they will struggle to grow in the current GST low offshore price environment. If they sell highly differentiated quality products, they are likely to be able to compete.

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