



**Submission to the Productivity Commission**

**Inquiry into the Economic Structure and Performance of  
the Australian Retail Industry**

**From REDgroup Retail**

**May 2011**

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## Executive Summary

### *Structural Challenges*

- The Productivity Commission Inquiry into the Economic Structure and Performance of the Australian Retail Industry was the result of lobbying by Australian retailers for a review of the regulatory settings that prefer offshore retailers over local retailers.
- Retailers are concerned by the GST and duty loopholes that require local retailers to collect taxes from Australian consumers that overseas retailers do not collect when goods are purchased for less than \$1000.
- This is an issue impacting discretionary retailers in Australia. It is also about securing a level playing field between offshore and local retailers - whether they are online or bricks-and-mortar is not of concern.
- As access to broadband and mobile technology improves, Australian consumers are increasingly discovering internet shopping. The high Australian dollar and an increasingly value conscious consumer after the Global Financial Crisis has accelerated a shift to offshore online shopping. Once there, consumers have discovered that offshore retailers can in some cases offer a larger range of products or lower prices than their local counterparts for a range of reasons.
- Now, local bricks-and-mortar retail stores are faced with the bifurcation of the browsing experience and the buying process at the very time the cost of doing business in Australia is increasing. Their revenue model is under pressure at the same time as their (highly fixed) cost base continues to increase.
- Retail rents, wage costs, electricity and other overheads in Australia are amongst the highest in the world.

### *REDgroup Case Study*

- REDgroup Retail is a case study worth noting. As Australia's largest book retailer, despite adapting to the consumer shift to online, REDgroup faced significant margin pressure from trying to compete with overseas online booksellers.
- Offshore corporate giants like Amazon (with a market capitalisation of USD 91.5 billion) are able to offer cheaper and more current titles as a result of local regulatory settings that favour them over local booksellers. They do not have to charge GST to Australian consumers and they are not restricted by parallel importation rules.
- As a result of difficult local market conditions, REDgroup Retail was placed into Voluntary Administration on 17 February 2011 in an effort to restructure the business and retain it as a going concern.
- We have learned from our experience that in the face of offshore competition and rising costs at home, the ongoing viability of the Australian retail sector is dependent on a collaborative approach by key industry stakeholders – retailers, landlords and Government.

### *Adapting to the New Reality*

- Retailers need to adapt to the structural changes driving consumers online. In addition to developing a multi-channel model, conventional bricks-and-mortar retailers will need to adapt their bricks-and-mortar model. Initiatives could include enhancing the in store experience, training staff to be product experts, smaller footprint stores with a more targeted product range and store loyalty schemes.
- Landlords too will have to adapt to the new retail environment - shopping centres becoming

destinations or “community hubs”, reviewing the mix of stores within each development to provide smaller footprint stores and “flagship” stores for online retailers, and reviewing rent models.

- From Government, there is a need to create a level regulatory playing field for Australian businesses that pay local taxes and employ Australians. Regulatory settings that distort the market, such as the GST and duty loophole, place undue additional pressure on local retailers who compete in a global market.

## Setting the Parameters

**This is not about online retailing versus offline retailing within Australia, but rather the structural and systemic change being felt by small and medium sized Australian retailers.**

We note that the Issues Paper released by the Productivity Commission in March 2011 looks at the retail industry as a whole. In our view, it is important to distinguish between discretionary and non-discretionary retailing, and recognise the fundamental differences between these two sectors.

In our view, adopting the Australian Bureau of Statistics' broad definition of "retailing" for the purposes of this inquiry is counterproductive, in that it masks the structural changes and depressed trading conditions chiefly being felt by the discretionary retailing sector.

Traditionally, non-discretionary companies are seen as safe harbours for investors, given purchases of food, petrol and other household expenditures such as utilities are key essentials of daily life. With cost of living increasing, the funds households have to spend elsewhere are being squeezed, with the negative impact of this most felt by non-discretionary retailers. To illustrate, of the best performing shares on the ASX, many of the notable examples are non-discretionary retailers. By contrast, discretionary retailers have been suffering profit downgrades and lacklustre results. During the reporting of interim results for 2011, half as many companies issued profit downgrades as upgrades, further stressing the bleak prospects for non-resources companies in Australia.

Research data that lumps discretionary and non-discretionary together are likely to obscure the true profitability challenges and financial difficulties being brought down on the overwhelming majority of Australian retailers, when the large food and petrol based players such as Woolworths and Wesfarmers are removed from the equation. Reliance on this wholesale data is also likely to be misleading, because it skews the profits being made by most companies in the sector and makes comparisons of overall profitability with international benchmarks unrepresentative.

Most critically, it hides the extent of exposure to the structural, systematic change being felt by most small and medium-sized Australian retailers.

Therefore, any decisions made based on figures and research that do not differentiate between discretionary and non-discretionary spend are inherently problematic, and we encourage the Commission to be mindful of the contradictions that exist in the broader sector and to consider the challenges facing discretionary retailers as distinct from sectors such as supermarkets and fuel retailing.

Also and importantly, the inquiry should not be characterised as online retailing versus offline retailing within Australia. Australian retailers recognise the opportunities offered by the rise in online shopping. Internet use by Australian consumers has changed dramatically in a very short space of time. There has been a 53 percent rise in 'at home' internet access since 2000, with high income earners having the greatest access. Goldman Sachs estimates that offshore internet sales have likely grown around 30 percent over the past 12 months.<sup>1</sup> Retailers are actively working to determine the best way of integrating e-commerce into their individual business strategies. The choice, convenience and price competition offered by online shopping is all good news for consumers and ultimately good news for retailers.

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<sup>1</sup> Goldman Sachs, *Thematic: Why Has Retail Sales Disappointed? And Will It Continue?* 30 November 2010

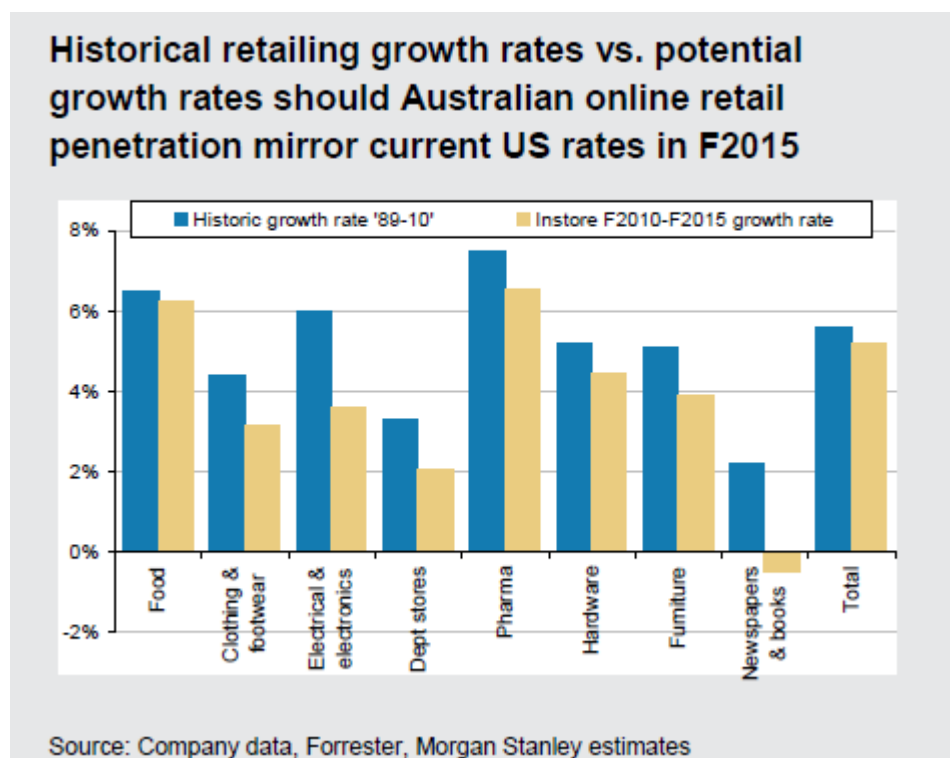
## Structural Winds of Change – The Rise of Online

The value of online spending on debit and credit cards has grown at an average annual rate of more than 15 per cent since 2005, while the growth in Australian consumers visiting online retail sites is outpacing increases in the global average.

It is clear that the growth in demand for online commerce in a relatively short space of time has presented significant challenges and opportunities for Australian retailers operating in both the discretionary and non-discretionary markets.

Morgan Stanley argues that the impact of online retailing is more of a threat than an opportunity to bricks-and-mortar stores, noting that although “in-store retailers can set up websites to capture the migration of sales online, sales leakage is inevitable, in our view. Brand recognition and buying power should help in-store retailers, but the low cost base of online retailers will probably offset these impacts in the long run.”<sup>2</sup>

Morgan Stanley also expects the impacts of the rise of online commerce to “be more pronounced in some categories compared with others. For instance, we estimate that the internet will take 117% of the growth in the Newspapers/Books category (with some in-store sales actually declining), 48% in Electrical and Electronics, 41% in Department Stores, and 34% in Clothing and Footwear categories.”<sup>3</sup>



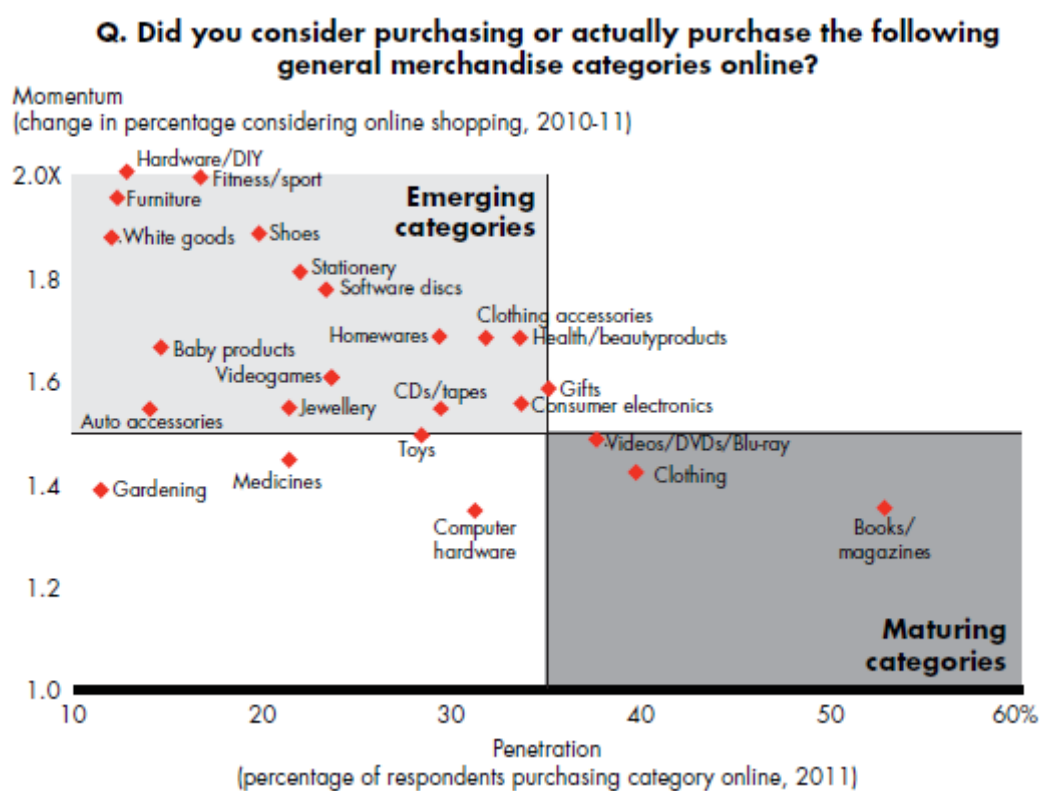
<sup>2</sup> Morgan Stanley, Internet Retail Boom Reaches Australia December 2010

<sup>3</sup> Morgan Stanley, Internet Retail Boom Reaches Australia December 2010

<sup>4</sup> Morgan Stanley, Internet Retail Boom Reaches Australia December 2010

Although the Reserve Bank of Australia has no official data on the total value of online purchases made by Australians, it readily concedes that online spend is growing at a rapid pace.<sup>5</sup> To support this position, data collected by the RBA suggest that since 2005, the value of online spending on debit and credit cards has grown at an average annual rate of more than 15 per cent.

The flight to online was particularly well documented in a report released by Bain and Company in April 2011<sup>6</sup> The findings revealed that online shopping has begun to reach mass adoption rates in Australia. Figures in the report suggest that the number of Australians who shopped online more than doubled in some categories in 2010 (see table below). It is important to note that books are the most exposed category to online sales. The highest growth categories online were those that have traditionally had low sales penetration in the near past, such as hardware, fashion accessories and furniture. These numbers are most striking when viewed in the context of weak retail sales growth in Australia overall.



To complement the findings of Bain and Company, Comscore, a leader in digital analytics, reported in February 2011 that the growth in Australian consumers visiting online retail sites is outpacing increases in the global average<sup>7</sup>. According to Comscore, more than 67 per cent of Australian internet users are visiting retailing websites, representing year on year growth of 12 per cent. When compared to a global growth rate of five per cent, the Australian consumers increasing appetite for online retailing is obviously considerable.

It is reasonable to expect that this trend will continue, particularly given the rollout of the National Broadband Network, which Access Economics argues will likely act as a catalyst for online retailing

<sup>5</sup> Commsec, Feb 7 2011 <http://australianexpatloans.com.au/blog/reserve-bank-of-australia-signals-interest-rates-on-hold>

<sup>6</sup> Connor, E. And LaFrenz, C. 2011, 'Direct Retailers Hear Ring of Success', *Australian Financial Review*, 9 April 2011

<sup>7</sup> Comscore State of the Internet Australia, February 2011

for both sellers and consumers.<sup>8</sup> Access to high speed internet will provide the opportunity for a larger number of individuals to spend more time browsing the web, therefore increasing the number of visits to the websites of retailers – both Australian and international. Australians will become even more familiar and consequently more comfortable with online purchasing.

Due to the surge in popularity of online commerce, Australian retailers are now operating in an open, highly competitive global market place and consumer behaviour is changing accordingly. It is an environment where the balance of power has shifted in favour of the consumer. As noted by Morgan Stanley, the internet:

- allows easier comparison of price and value between different retailers, domestic or international;
- increases competition, as retailers offshore (that generally operate with lower buying prices and lower cost bases) can ship to Australia;
- improves accessibility to goods that are otherwise unavailable in Australia;
- increases range offered, as stock doesn't physically need to be displayed; and
- is convenient for consumers, as all that is required is a credit card and internet access.<sup>9</sup>

In accordance with this power shift, the Australian consumer is approaching purchasing in the non-discretionary sector in a far more sophisticated manner than in the past. They are seeking transparency on price comparisons, peer generated product reviews and information about manufacturing and sourcing.

Social media is playing an important role in facilitating these processes. Australian retailers are increasingly engaging in social media in an attempt to effectively compete online.

According to the Nielsen Company, Australians spend more time on social media sites than any other country in the world.<sup>10</sup> Importantly for retailers

- 40% of online Australians now interact with companies via social networks.
- 86% of Australian internet users are looking to their fellow internet users for opinions and information about products, services and brands.
- 14 percent of online Australians 'follow' companies or organisations via Twitter.

Much of the growth in internet subscribers over the past 12 months (internet subscribers in Australia reached 10.4 million in December 2010, up from 9.5 million only 6 months earlier)<sup>11</sup> has been driven by the uptake of mobile devices with wireless connectivity capabilities. Consumers are downloading price comparison and shopping applications with location based functions such as Four Square on these devices, and they are heavily influencing buying behaviour.

One of the most readily observed outcomes of the increased sophistication of the Australian consumer as a result of both web surfing and information disseminated through social networking sites or applications, is the bifurcation of the browsing experience and the buying process. Recent media coverage suggests that consumers have begun taking advantage of the in-store advice and fitting assistance for a pair of jeans or sneakers or ski boots, and then once they have identified their item of choice in the correct colour or size, will then purchase the item at a discount online, often from an overseas e-commerce site.<sup>12</sup>

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<sup>8</sup> Access Economics, Household e-Commerce Activity and Trends in Australia, 17 November 2010

<sup>9</sup> Morgan Stanley, Internet Retailing Boom Reaches Downunder, 8 December 2010

<sup>10</sup> Nielsen 2010 Social Media Report

<sup>11</sup> ABS Data – Internet Activity, Australia Dec 2010

<sup>12</sup> Bitá, N., 2011 'Retailers fight online rivals', *The Australian*, 9 April



In an attempt to counter this behaviour some retailers have begun charging a fitting or try on fee. Sydney based ski store InSki is one such retailer who has implemented the fitting fee system. This behaviour is also being exploited by some online retailers with advertising campaigns such as “Try it on at Westfield, Buy it on eBay – Clever you!”

In summary, we are of the view that online retailing in Australia will continue to grow at an accelerated pace. Recommendations made by the Productivity Commission with regards to taxation or regulation in this space must treat online commerce as the new reality rather than a trend or a phase, and should seek to redress imbalances which hamper the ability of Australian retailers to effectively compete with international peers.

## ***Financial Challenges***

The long term viability of the domestic discretionary retail sector in Australia is under challenge. It is a fact that consumption fundamentals remain strong while domestic retail sales continue to suffer, clearly demonstrating there are underlying shifts currently taking place in the sector. Continued sagging retail sales suggest that the segment is facing much deeper issues than just the current dip in consumer spending.

Goldman Sachs notes that: “Given Australia's robust jobs growth, accelerating wages, double-digit wealth gains and elevated consumer confidence, the relative weakness of retail sales has been one of the biggest mysteries” of the Australian economy over the past 12 months.<sup>13</sup> This is a view shared by RBC fixed income strategist, Michael Turner, who commented to Australian media in February that: “The surprising thing is, if you take away white goods, electrical appliances, there doesn't seem to be much response to discounting. Overall it's pretty hard to get a read on the consumer at the moment.” In examining this dynamic, Goldman Sachs observes: “Australians are clearly spending their income, however the strength of the A\$ is facilitating a greater proportion of that income being spent offshore, which is beyond the reach of local companies and the Australian statistician.”<sup>14</sup>

The Global Financial Crisis created a particularly price-sensitive consumer and despite improving economic conditions there is evidence that this change in consumer behaviour has become semi-permanent or even marks a permanent shift. This trend towards value-seeking consumers has forced retailers to continue to offer significant discounts and sales prices to persuade price-conscious and spending-adverse shoppers to open their wallets. Again, this is counter to the usual cyclical trends in retail spending and signifies a new permanent pricing ceiling. With discounting still common, analysts are concerned there is little scope for top-line growth (and with it creation of new jobs, as well as economic value through the knock-on effect of profit expansion and contribution to federal and state tax revenues), with retailers forced to absorb rising costs.

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<sup>13</sup> Goldman Sachs, *op cit*

<sup>14</sup> Goldman Sachs, *op cit*

## ***Rising Costs for Retailers***

While pricing pressures continue unabated, this has not stopped retailers from being squeezed by rising costs, as we outline below. The key components of this are labour and rents – both of which are considerably higher for Australian retailers than elsewhere in the world.

Australia's retail labour costs are among the highest in the world and continue to rise.

Speaking on the National Australia Bank's monthly national survey for April, NAB senior economist David de Garis notes that wages and input costs are gathering pace, commenting: "We've seen now for three to six months a pick-up in the rate of growth of labour costs. A year ago, labour costs were growing at an annual rate of 1.5 per cent. They're now growing at 4.5 per cent."

Furthermore, a recent research report from CB Richard Ellis reveals that Australia's capital cities remain some of the most expensive when it comes to retail, with Sydney as the second most expensive market in the world and Melbourne and Brisbane in the top 10. The report notes that interest from international retailers, particularly in the fashion space, will put further upward pressure on retail rents.

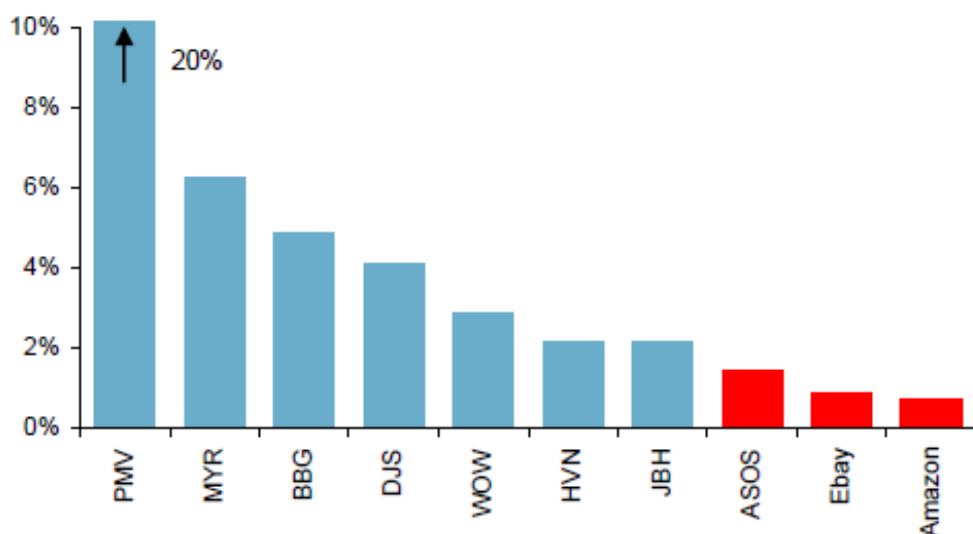
The new report says Sydney is the second most expensive after New York, with rent costing an average of \$US1,218 per square metre. The city has moved from last year's ranking, with the Westfield Pitt Street development pushing it from third to second. Brisbane comes in ninth, with \$US705 and Melbourne in 10th at \$US584. The report also shows that super prime rents, the highest which can be achieved in each CBD, are also rising, with Sydney rents reaching as high \$13,560 per square metre, while Brisbane rents have reached as high as \$7,8945 per square metre. Melbourne landlords in premium areas can pocket \$6,500 per square metre.<sup>15</sup>

Rental costs are a significant impost for physical store operators, ranging from just over 2 percent for JB Hi-Fi to in excess of 20 percent for specialty retailers. For instance, listed online retailers ASOS, Ebay and Amazon reported rent-to-sales of less than 1.5 percent.

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<sup>15</sup> CB Richard Ellis, Market View Pacific Region Retail, Third Quarter 2010

Exhibit 12

**Rent-to-sales ratio: F2010**

Source: Company data, Morgan Stanley Research (note eBay and Amazon are F2009)

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To aggravate the situation, bricks-and-mortar retailers are increasingly providing a browsing experience to shoppers - without an accompanying adequate revenue model. Bricks-and-mortar retailers offer customers a full service, including the ability to trial the physical product, which is a service that is operating from a higher-cost structure than comparable online sites. The lower cost structures of online sites – including the fact that offshore online retailers are not obligated to collect taxes in the form of GST on behalf of the government – allows them to offer cheaper prices than physical stores. There is considerable anecdotal evidence of a change in shopping behaviour where customers will take advantage of the in-store advice and fitting assistance for a pair of jeans or sneakers or ski boots, and then once they have identified their item of choice in the correct colour / size, will then purchase the item at a discount online, often from an overseas e-commerce site.<sup>17</sup>

Morgan Stanley notes that overseas-based online retailers (which they estimate comprises 40 percent of the Australian online market) avoid both the GST (10 percent) and import duty (up to 50 percent) for products under A\$1,000. These factors (which at 60 percent of the product price represent significant savings) allow online retailers to offer products cheaper than in-store retailers.<sup>18</sup>

In summary, what this adds up to is significant margin squeeze on Australian retailers. Retail prices were being constrained by the competitive pressures and the need to match on-line prices. At the same time, cost inflation in inputs such as labour, rents, the cost of raw materials, logistics and utilities expenditure are resulting in challenging conditions for Australian retailers.

<sup>16</sup> Company data, Morgan Stanley Research

<sup>17</sup> Bitá, N. 2011, 'Retailers fight online rivals' *The Australian*, 9 April

<sup>18</sup> Morgan Stanley Research, *Australia Retail – Internet Retailing Boom Reaches Down Under*, 8 December 2010

## Private Equity Ownership

**It is structural economic conditions that are impacting retail business in Australia far in advance of ownership models.**

The Productivity Commission issues paper raises Private Equity ownership of retail assets as a development to note within the retail sector. Private Equity ownership is one of many ownership models available to retailers. Others obviously include private ownership, public ownership and franchises.

Private Equity is likely to appeal to:

- Small family businesses or privately owned businesses looking for a capital injection, strategic support or an exit strategy
- Listed companies that are stagnating, looking for a capital injection or struggling with the pressures of public ownership (short term reporting horizons and the burden of investor relations)

*What is Private Equity?*

Private equity is simply a pool of capital from long-term private investors including superannuation funds and university endowment funds, who also invest in the public market, looking for investment opportunities beyond what they traditionally have access to on the public market. These investors contribute their funds to the pool for a fixed term and mandate their investment advisors (i.e. the private equity firm) to build a portfolio of investments on their behalf. Like any other company – listed or private – a portfolio company's ongoing funding requirements are met by a combination of equity and debt.

*Private equity investment in the retail sector*

Private equity has traditionally invested in small and medium sized retail businesses and start up operations (through venture capital). It has therefore increased overall levels of competition within the retail market and provided consumers with more choice. It also provides business owners with another avenue for sale and more competition when it comes to selling their businesses.

Typically, managers and advisors to Private Equity Funds work in partnership with the management teams of their portfolio companies to help those businesses maximise the performance of their assets and maximise growth. Private Equity provides the capital support to allow managers to pursue strategies that they perhaps have not had the capacity to fund under other structures. In this way they help unlock the value of those management teams and the businesses they run.

In Australia, there are plenty of examples of well known retail brands operating under, or having previously operated under, private equity ownership such as Rebel Sport, Super A-Mart, Witchery, Mimco, Bras'n'Things, Manassen Foods, Myer, Kathmandu, Crazy Clark's and Cellarmasters.

*Ownership structure not the issue*

For the purposes of this report, [] we argue that it is structural economic conditions that are impacting retail business in Australia far in advance of ownership models.

Other discretionary retail companies under public ownership structures have come under significant pressure, for example:

- Myer, in February this year, issued its first profit downgrade since it was taken over and restructured five years ago. In a trading update, Myer Chief Executive Officer, Bernie Brookes, said that trading in the past six months has been characterised by ongoing fragile consumer confidence and a highly competitive retail environment with widespread discounting<sup>19</sup>.
- Premier Investments, in February 2011, reported that its “disappointing sales performance [reflected] a very challenging retail environment, characterised by weaker apparel industry sales and extensive discounting”.<sup>20</sup>
- In reporting Total Sales revenue of \$411.7 million for the third quarter of the 2011 financial year, representing revenue growth of -1.4% compared to 3Q10, David Jones CEO Paul Zahra noted that “trading conditions were difficult throughout the quarter”. Zahra also noted that “there continued to be aggressive discounting by retailers as they tried to address conservative consumer sentiment”.<sup>21</sup>
- Target, in April 2011, reported that total sales declined 2.4 per cent to \$2.9 billion, with comparable store sales declining 2.4 per cent. Target Managing Director, Launa Inman noted that “trading continues to reflect the impact of price deflation across the market”.<sup>22</sup>
- Harvey Norman’s electrical and computer franchisees were both noted to have been affected by difficult trading conditions.<sup>23</sup>
- The Reject Shop announced a Downgrade to Profit Guidance in December 2010, noting an interest rate hike and reduction in consumer spending had resulted in overall sales being “significantly below expectations”.<sup>24</sup>

This is not to mention countless small businesses which have been impacted to the point of closures, but no doubt have gone unnoticed.

## REDgroup Retail Case Study

### *About REDgroup Retail*

REDgroup Retail (REDgroup) is the largest book and stationery retailer operating in Australia, New Zealand and Singapore. REDgroup’s retailing expertise stretches across large format destination retail, casual shopping centre outlets and the internet.

REDgroup is an Australian company owned by Funds advised by Pacific Equity Partners. The Australian arm of the business is made up of some of the most recognised brands in the segment. REDgroup currently operates 4 divisions within Australia:

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<sup>19</sup> Myer, ASX & Media Release “Update on Trading and FY2011 Outlook” Monday 7 February 2011

<sup>20</sup> Premier Investments, ASX Announcement, “Premier announces Net Profit After Tax of \$39.4 million”, 25 March 2011

<sup>21</sup> David Jones, ASX & Media Release, “David Jones Reports 3Q11 LFL Sales of -1.3%”, 11 May 2011

<sup>22</sup> Wesfarmers, ASX Announcement, “Third Quarter Retail Sales Results” 20 April 2011

<sup>23</sup> Harvey Norman Holdings Limited, ASX Announcement, “Sales for the nine months ended 31 March 2011” 21 April 2011

<sup>24</sup> The Reject Shop, ASX & Media Release “The Reject Shop Announces a Downgrade to Profit Guidance” 9 December 2010

- **Borders** has the deepest range of books and magazines in the market, with more than 200,000 titles. Borders offers customers a rich shopping experience, providing books, gifts and magazines in a relaxing, enjoyable atmosphere (many stores have cafes)
- **Angus & Robertson** is the most recognised book retail brand in Australia, with its focus on a sustainable value driven proposition
- **Calendar Club** is a chain of specialty calendar stores which operate over the Christmas period (October to January) in major shopping centres and other key retail precincts. Calendar Club is the leader in the seasonal calendar retail market and the number one seasonal retail concept in Australia
- **Supanews** is Australia's leading newsagency chain serving in excess of 10 million customers a year. Supanews has more than 50 stores on the east coast of Australia and has achieved 280 per cent growth in the past five years.

In addition to the physical bricks-and-mortar network of stores, REDgroup also has a sophisticated online and digital offering to cater to the changing needs of customers. Borders.com.au is the leading Australian online book retailing website, and the success of the eBook platform launched through a joint venture with Canadian firm, Kobo, in mid 2010 has exceeded even the most optimistic of expectations.

REDGroup Retail competes in the Australian market with local independent booksellers, other retail chains such as Dymocks, local online retailers and local discount department stores. We also now increasingly compete with offshore online book retailers such as the global giant Amazon with a market capitalisation of USD 91.5 billion and Book Depository based in the UK.

Before entering into voluntary administration in February 2011, REDgroup's book retailing footprint in Australia was extensive, with 26 Borders and 170 Angus & Robertson stores (53 of these franchised) with locations in all states and territories. The overall network employed over 2500 Australians.

REDGroup was placed in voluntary administration on 17 February 2011, to allow the business to be restructured. Unfortunately, during that process there have been multiple store closures and staff redundancies. At the time of preparing this submission the figures pertaining to remaining store numbers and workforce are unable to be provided as the Deed of Company Arrangement is being negotiated.

### ***Impact of offshore online commerce on the REDgroup business***

**Price discrepancies between books for sale in Australia and overseas markets and differences in availability of stock are borne primarily out of two areas – taxes collected and parallel importation laws.**

As has been previously noted in this submission, it is difficult to quantify the impact of the emergence of offshore online commerce in terms of revenue lost from the bricks-and-mortar network. What is clear however is that some categories are much more exposed than others. By way of example, JP Morgan estimates that online retailing of books and newspapers could grow by as much as 117 per cent by 2015, whereas clothing and footwear may see growth somewhere closer to 34 per cent.<sup>25</sup>

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<sup>25</sup> JP Morgan, Online Retailing - Reviewing the Competition Threats Posed by Technology and the Web, 24 December 2010

REDgroup recognised early the changing wants and needs of Australian consumers and the shift to online purchasing in the book retailing category. The business has been a leader in innovation in the Australian market, establishing the country's most successful online book retailing site and digital eBook platform.

An eBook is an electronic or digital version of a printed book. eBooks purchased through REDgroup Retail brands can be read on computers, eReading devices, on smartphones (iPhone / BlackBerry / Android) or the iPad.

REDgroup's partnership with Canadian firm Kobo Inc., a global eReading service, allows customers to purchase and download eBooks and eContent directly from REDgroup's transactional websites. Through the REDgroup eBook offering, Australians have access to more than 2 million book titles, including Australian content which is available nowhere else.

Despite the sophistication and ease of use of these online offerings, REDgroup attracts less share of wallet from Australian consumers than international competitors such as Amazon or the Book Depository.

Internal data compiled by REDgroup suggested that in December 2010, the combined market share of Australian visits to online book sites was approximately 10%, with REDgroup sales estimated at \$3 million, out of an estimated market size in excess of \$300 million. Our figures suggest that while Australian internet book sales are growing by 15%, Amazon is growing by upwards of 60%. We have observed that a key component in this situation is the understanding amongst consumers that books are consistently lower in price in overseas markets and that a larger number of titles are more readily available.

Title	Author	Publisher	Genre	Book Scan Feb Chart #	Borders Cost	Borders Sell Inc GST	Amazon Sell	Gardiners Sell	Ingrams Sell
Diary of a Wimpy Kid	Kinney, Jeff	Penguin	Children's	16	\$7.48	\$14.95	\$7.61	\$9.67	\$7.57
Midnight: Vampire Diaries: The Return	Smith, L.J.	Harper Collins	Children's	21	\$9.81	\$19.99	\$9.96	\$6.15	\$6.01
Awakened: House of Night	Cast, P.C. & Cast, Kristin	Hachette	Children's	22	\$14.99	\$29.99	\$9.95	\$6.15	\$9.76
I am Number Four	Lore, Pittacus	Penguin	Children's	26	\$8.48	\$16.95	\$10.84	\$7.03	\$6.73
Last Sacrifice: Vampire Academy	Mead, Richelle	Penguin	Children's	38	\$9.98	\$19.95	\$10.74	\$6.15	\$9.76
Tick, Tock	Patterson, James	Random House	Fiction	4	\$16.48	\$32.95	\$14.95	\$11.43	\$15.18
Girl Who Kicked The Hornets' Nest	Larsson, Stieg	Pan Macmillan	Fiction	6	\$11.35	\$24.95	\$12.20	\$7.03	\$6.73
The Lake of Dreams	Edwards, Kim	Penguin	Fiction	8	\$14.98	\$29.95	\$13.82	\$12.31	\$14.62
Empire of Gold	McDermott, Andy	Hachette	Fiction	11	\$11.93	\$24.95	\$10.24	\$11.43	\$16.83
Shatter the Bones	MacBride, Stuart	Harper Collins	Fiction	25	\$14.25	\$32.99	\$23.86	\$11.43	\$12.67
The King's Speech	Logue, Mark & Conradi, Peter	Pan Macmillan	Non-Fiction	15	\$16.50	\$29.95	\$10.43	\$11.43	\$8.11
127 Hours: Between a Rock and a Hard Place	Ralston, Aron	Simon & Shuster	Non-Fiction	18	\$10.45	\$22.99	\$8.19	\$7.03	\$4.33
Eat, Pray, Love: One Woman's Search For Everything	Gilbert, Elizabeth	Allen & Unwin	Non-Fiction	42	\$12.48	\$24.95	\$7.44	\$7.03	\$8.14
Unbearable Lightness: A story of Loss and Gain	De Rossi, Portia	Hardie Grant	Non-Fiction	57	\$17.50	\$35.00	\$15.99	\$13.19	\$14.10
Life: Keith Richards	Richards, Keith	Hachette	Non-Fiction	41	\$25.00	\$49.99	\$17.44	\$17.60	\$16.27

#### *Top 15 titles available Australia/UK/USA<sup>26</sup>*

Price discrepancies between books for sale in Australia and overseas markets and differences in availability of stock are borne primarily out of two areas – taxes collected and parallel importation laws.

<sup>26</sup>Data obtained from internal REDgroup Retail International Benchmarking report

## ***GST***

As an Australian retailer, REDgroup is obligated to charge Australians who buy their books locally GST for books that are also sourced locally. Yet when those same Australians buy books offshore no GST or duties are charged if the books are valued under \$1000. The GST loophole is therefore a distortion in what is now a global marketplace for books.

## ***Parallel Importation Restrictions (PIR)***

This submission is necessarily a book retailer's perspective on parallel importation laws and we recognise that it is in our interest to point out the pressures faced by book retailers as a result of these laws.

Parallel importation laws restrict a book retailer's ability to buy stock on the open international market. Where a book is not available in Australia a retailer cannot import it for as long as 90 days in order to give a local publisher the opportunity to produce the content. Once that book is published in Australia, the price is then set by the publisher, often not in relation to international pricing.

Within those 90 days a customer can go online and source that same book cheaply offshore. Current regulation is effectively channelling Australian consumers offshore into other competitive markets where parallel importing exists.

We believe that PIR is giving rise to a distortion in local pricing in what is now a global market for consumers. This distortion is putting undue additional pressure on local book retailers and impacting their viability.

While acknowledging that book publishers argue that Australian authors won't be supported in a market without PIR, we note that in 2009, The Productivity Commission held an inquiry into the Copyright Restrictions on the Parallel Importation of Books and recommended that these restrictions be abolished.<sup>27</sup>

The Federal Government did not follow the advice of the Productivity Commission and resolved to maintain the restrictions.

We recognise that this is not another inquiry into PIR but about the retail market generally and we raise this issue in that context.

## ***REDgroup's response to online pressures***

REDgroup realised that customers were not always aware that in many cases it was largely regulatory settings responsible for higher priced books in Australia when compared to overseas online sellers. In order to circumvent the perception that Australian booksellers were more expensive and be competitive on price with international book retailers online, REDgroup launched the 'Online Price Guarantee' in 2010. The guarantee applies to the delivered price of a book to Australia from borders.com.au. If a customer finds a book cheaper on Amazon (delivered to Australia) than on the Borders website, REDgroup committed to refund the difference plus 10% to the customer's credit card.

The impact of this offer was that REDgroup, in order to remain competitive with global booksellers, was forced to absorb the GST and the higher wholesale prices in Australia.

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<sup>27</sup> Productivity Commission, Restrictions on the Parallel Importation of Books Research report, 14 July 2009.



Measures such as the price guarantee are attractive to consumers in the short term, but are not sustainable with rising costs and in a global market while ever retailers continue to work within a market distorted by regulation.

## **Impact of Discount Department Stores(DDS)**

The Productivity Commission Report: *Copyright Restrictions on the Parallel Importation of Books* (14 July 2009) found that discount department stores account for most of the balance of sales made through “bricks-and-mortar” outlets. The DDSs focus on stocking the more popular bestselling titles and selling them at a substantial discount to the recommended retail price. While book retailers sell a mix of front list and back list titles, DDSs tend to sell a relatively high share of front list titles.

The report also concluded that there is strong retail competition on a range of ‘front list’ titles, with many discount department stores frequently selling bestsellers for substantially less than the recommended retail price. The Commission found that this puts pricing pressure on the retail book chains.

‘Discount department stores’ apply some downward pressure on prices in the segments that they choose to stock which are mainly front list ‘bestsellers’, as well as a selection of children’s, cooking and lifestyle books. Most of their books are offered at a substantial discount from the RRP. Typically, little if any specialist in-store sales support is provided to book buyers.

In their submission to the Productivity Commission, Penguin Group Australia said:

*“The Discount Stores sell all books stocked at less than RRP (Big W sells its backlist at RRP <35% and routinely reduces new books by 20%, for example)”<sup>28</sup>.*

That is not to say that Discount Department Stores are not also being challenged by competition from overseas online book retailers. Even the discount stores’ below recommended retail prices are being placed under pressure. In a recent book sale (which closed on 11 May 2011) Target was selling Australian title, *Kitchen Garden Companion by Stephanie Alexander* by Stephanie Alexander, at the reduced price of A\$69.00 including GST. UK online book retailer bookdepository.co.uk had the same title available at the same time for A\$40.00. The RRP in Australia for that book is \$125.

We note here that this is an Australian title that is available to be sold more cheaply by an overseas retailer back to the Australian market, presumably due to the absence of parallel importation restrictions and no requirement to charge GST.

## ***Consequence: The Traditional Range Proposition is Under Threat***

### **We risk dumbing down the range of hard copy books available to consumers in stores**

Bookstore customers have traditionally expected to see a deep range within the store. They want to see all the new releases, best sellers as well as a deep back catalogue. The Borders business model focussed on providing the broadest range of books in the broadest number of categories whereas Angus & Robertson offers a deep range in a smaller number of targeted categories.

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<sup>28</sup> Penguin Group Australia (2009), *Submission by Penguin Group (Australia) to the Productivity Commission*, Retrieved from [http://www.pc.gov.au/data/assets/pdf\\_file/0005/85739/sub212.pdf](http://www.pc.gov.au/data/assets/pdf_file/0005/85739/sub212.pdf) (accessed 10 May 2011)

That sort of deep range requires larger footprint stores and significant staffing levels at both front and back of store. This high cost model competes in the same market with:

- shallow book offers from the Discount Department Stores who rely on high volume sales and their multi-category offering across the store to sustain their slim margins on books; and
- Overseas online booksellers, such as global giant Amazon, with a relatively low cost base and access to lower wholesale prices with no parallel import restrictions applying to its business.

As a result of this increased pressure, REDgroup became more competitive on the price of its front and backlist books. We recognised this is a great outcome for our customers and one that we endorsed with initiatives like the "online price guarantee" where we offered to beat the price of books on competing websites.

However, these price pressures combined with rising costs of doing business (which are described below) put pressure on the margins book retailers are able to generate and these have long term consequences for employees, consumers and retailers alike.

### ***The demise of deep inventory bookstores***

If the margins on the front and backlist catalogue are unsustainable, physical bookstores with deep catalogues are under threat. As a result, we risk dumbing down the range of hard copy books available to consumers in stores. The bookstore stocking 25,000-30,000 titles will diminish, limiting choice for consumers in the hard copy book market. Obviously this has cultural implications in Australia where bookstores have played a key role in the promotion of Australian authors to the public.

### ***GST loophole and Parallel Importation Rules Exacerbate the Pricing Pressures***

While we recognise and encourage the fact that price pressure brought by competition from overseas online book retailers and discount department stores is a good outcome for consumers, we note that the GST loophole and Parallel Importation Rules are regulatory settings which exacerbate the price and margin pressures faced by Australian book retailers.

We have already explained that books are the most exposed product to online sales. The category is least able to cope with distortion in the local market and yet it is the category facing the most distortion as the result of regulatory settings. This is having a detrimental impact on the bookselling industry in Australia, including on jobs in the sector, as we will further explain below.

### ***Cost Pressures***

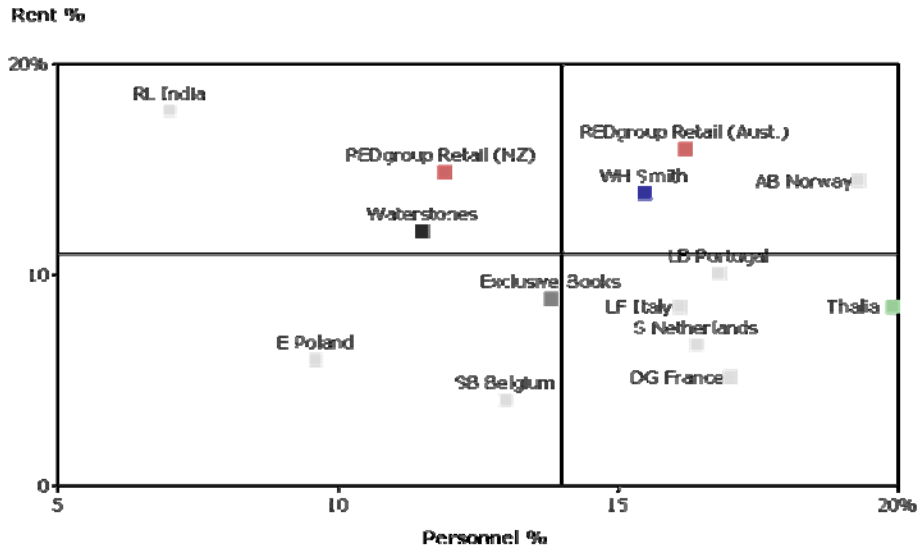
**At the same time as local booksellers are under increasing price pressure, rent and staff costs are increasing.**

When compared to other bricks-and-mortar book sellers around the world, the Australian arm of REDgroup Retail is faced with a relatively high personnel to sales ratio and a high rent to sales ratio compared to international book retailers, as demonstrated by the graphs below.

### REDgroup Retail

### Personnel/Sales% vs Rent/Sales %

*Red/WHS & AB have similar cost structures*



Source:

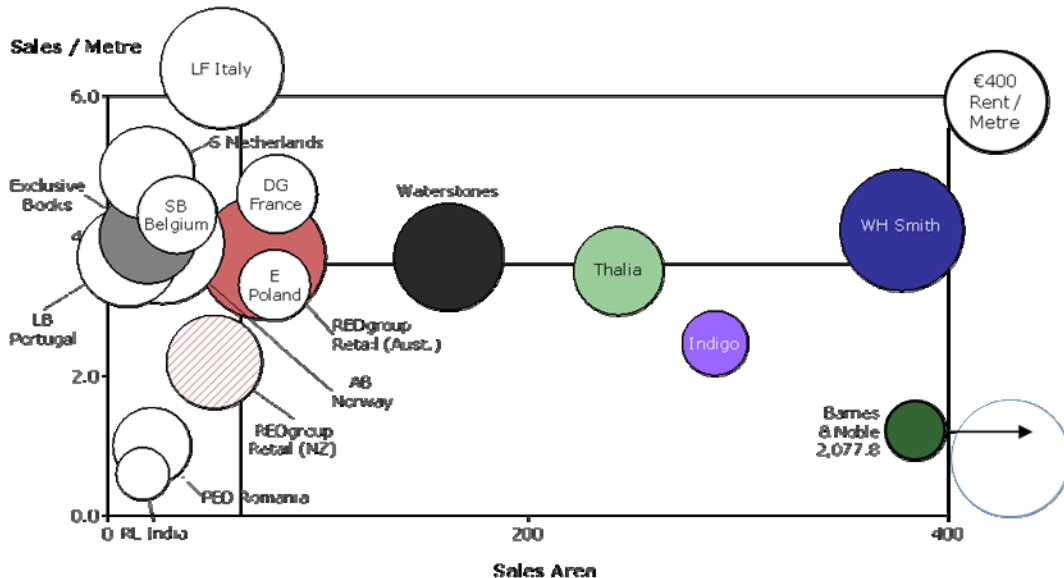
LI0412-SC - International Benchmarking v4 6

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### International Benchmarking

### Sales Density, Scale & Rents

*Red's Aus sales density is average but its rent/m at more than 500 € is the highest in the world*



Source:

LI0412-SC - International Benchmarking v4 3

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<sup>29</sup> Data obtained from internal REDgroup Retail International Benchmarking report

This is in addition to the continuing rise in the cost of inputs including utilities in the Australian market, which we have discussed in earlier sections.

### ***Need To Restructure***

As a result of difficult market conditions, on 17 February 2011, the Board of Directors of REDgroup Retail placed the company into voluntary administration. The aim of that decision was to:

*".. allow the company to accelerate the restructure of the business to implement a new business model that reflects the changing dynamics of the Australian retail market and consumer behaviour."*<sup>31</sup>

At the time of entering voluntary administration, REDgroup had already started the process of restructuring the business to adapt to the external pressures such as the more cautious consumer, the high Australian dollar, price pressures from overseas online book retailers, high rents and labour costs and inflation of other costs of doing business including electricity.

However a decision was made that voluntary administration was the best way to try and preserve the company as a going concern for the long term.

Working with the Administrators, REDgroup has closed loss making stores and is working to:

- reduce store footprints as it moves to carry less stock
- restructure the corporate back office to reduce costs (a process that was also started prior to Voluntary Administration) and
- bring down the costs of doing business in partnership landlords and suppliers

To date, 17 Borders and 59 Angus & Robertson stores have been closed, impacting over 1250 people, leaving 9 Borders and 61 Angus & Robertson stores, employing approximately 1050 staff. At the time of writing this submission, the company remains in voluntary administration. We are working with the creditors towards a Deed of Company arrangement.

### ***Private Equity Ownership of REDgroup Retail***

There is a perception that Private Equity assets are more highly leveraged than publicly listed companies. This is a generalisation and, rather than being reflective of the Private Equity model, it is more reflective of the boom in M&A activity in 2007 which saw high multiples paid for assets and lenders offering 'covenant light' funding. It is worth noting that, at the time that the Directors of REDgroup Retail made a decision to place the business into Voluntary Administration given significant financial pressures, the business had gearing of only 28% – far more conservative than the leverage used by most listed retailers.

## **Conclusion**

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<sup>30</sup> Data obtained from internal REDgroup Retail International Benchmarking report

<sup>31</sup> Letter send to Members of Parliament by Steve Cain, Executive Chairman, REDGroup Retail, 17 February 2011

**Overcoming structural changes and financial challenges to sustain a viable Australian retail industry in the long term will take a collaborative approach from the sector’s key stakeholders.**

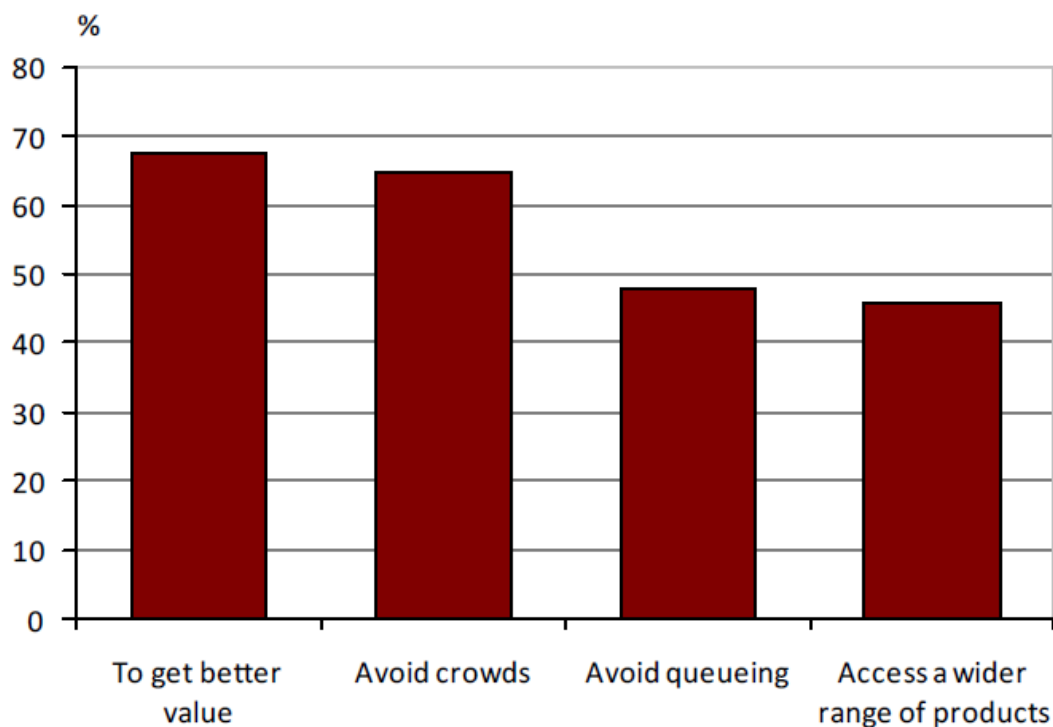
Although not intended as an exhaustive list, we have outlined a number of key initiatives to be considered for retailers, landlords and Government, which we believe would help to sustain the Australian retail sector against foreign online competition and rising costs in the Australian retail sector.

***Retailers***

Retailers in Australia have been caught in the perfect storm of events and must now adapt to the new retail reality. What the industry is facing is continued depressed discretionary spending, changing consumer behaviour in terms of online purchasing (and in the case of books the beginning of the migration to e-books), rising rents and staff costs, a high Australian dollar incentivising consumers to look offshore and unhelpful government regulation in the form of GST and duty loopholes and parallel importation.

There are a number of changes to be made and initiatives to be implemented to both stem the loss of revenue from bricks-and-mortar stores and also capitalise on the opportunities presented by the online market. We recognised that retailers have a responsibility to proactively adapt.

In a report prepared for the Department of Broadband, Communications and the Digital Economy in November 2010, key drivers of online purchasing were found to be monetary around value, but also experience based with immediacy and convenience (avoiding crowds and queuing) rating highly.<sup>32</sup>



Source: Sands and Ferraro (2010).

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<sup>32</sup> Household E-Commerce Activity and trends in Australia, Access Economics, November 2010

<sup>33</sup> Data obtained from internal REDgroup Retail International Benchmarking report

With shopping experience scoring so strongly, above even access to choice, retailers have the opportunity to entice customers in store by creating an enhanced in-store environment. This may be achieved by focussing on a unique directly sourced product with an exceptional service component. In this instance store staff would receive expert training in both customer service skills and the product range itself.

To give more attention to the customer experience large format stores may no longer be viable. What the customer appears to be seeking is a more personalised service not encumbered by the heavy foot traffic large destination stores tend to attract.

Downsizing of store formats will also be beneficial in combating the margin squeeze incurred as a result of the increasing overheads previously discussed. The consequence of smaller store footprints will be a reduced range specifically tailored to meet the needs of consumers in individual locations. With the purchasing process happening more often on-line, the need for high stock-weights on the shop floor is also diminished reducing further the need for large footprints

Franchising is another avenue to be explored by Australian retailers. The benefits include minimized system costs and the opportunity to develop closer relationships with customers. A franchised store has the ability to market locally, based on an understanding of the dynamics of the community within which it operates.

Other retailers will leverage the power of centrally located flagship stores in capital cities to build brand awareness and drive traffic to local stores or online platforms.

Offsetting revenue lost to the internet may require the introduction of new categories within bricks-and-mortar stores. REDgroup has already begun the process of diversifying the product mix in stores by expanding to gifting, stationery and novelty products to supplement sales.

In recognition of the bifurcation of the browsing experience and the buying process as a direct result of the value available online, retailers should consider the merits of monetising this new consumer behaviour. For this to work, customer service staff will need to become “experts” who are highly knowledgeable of the product sold within their stores. Consumers might be asked to pay a reasonable fee for the store staff’s expertise in fitting clothing or equipment or perfectly matching particular products to individual lifestyles. Leigh Warner, Director of Research at Jones Lang LaSalle has said that “some retailers have also already looked at innovative in-store solutions, such as the introduction of iPads for browsing.”<sup>34</sup>

Brand loyalty is an important consideration with the growth in online shopping and when challenged by an increasingly cautious consumer. Retailers wishing to grow their businesses - and maximise the value created by each customer – should think about building and maintaining genuine and productive relationships with their customers. Continued expansion of loyalty programs will allow retailers to manage inventory accordingly and fulfill customer wants and needs in store based on the insights gained through data collection. For retailers with an online presence, a loyalty program is a powerful tool for driving traffic to websites and leveraging multi channel opportunities.

## ***Landlords***

The nature of retailing has changed significantly as a result of the growth of online retail. We acknowledge that the growth of e-commerce has the potential to provide both opportunities and challenges to the existing retail sector.

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<sup>34</sup> Two Speed Economy Puts Heat on Landlords, Carolyn Cummins, Sydney Morning Herald, 20 April 2011

The trend for retailers to “multi-channel” will significantly impact how the sector operates, as well as the way in which it is viewed and utilised by the general public.

Trends within the e-commerce sphere such as “click and collect”, where physical stores are used as a collection point for online purchases, have the potential to impact significantly on the bricks-and-mortar stores, as mentioned previously.

Whether the continued growth of online retailing in Australia remains an alternative means of retailing, particularly as a way of gauging consumer reaction without investing in physical space, or proceeds to be the “death knell” of the bricks-and-mortar retail sphere is still to be seen.

This uncertainty is acknowledged among industry executives. Stockland Chief Executive Matthew Quinn, in his address to CEDA's annual property market outlook, noted anecdotal reports about the reluctance by major retailers and shopping centre developers to invest in bricks-and-mortar. Quinn admitted that online retailing was now a "threat" to the traditional shopping centre model.

"All we can do is future-proof our centres by making them the community hub, the village square if you like, so that people gravitate there for social reasons, not just to shop for the sake of it."<sup>35</sup>

This sentiment was echoed by Nathan Clark, Colliers International National Director of Retail. He said in order to adapt to the changing retail environment and to encourage consumers to spend domestically, major Australian retailers will need to continue to work with developers and investors to provide shopping destinations that will continue to attract consumers.

“A number of high profile shopping centres in Sydney, Melbourne and Brisbane have been subject to multi-million dollar refurbishments and redevelopments in recent years, in a drive to increase existing customer bases and push up moving annual turnovers,” he said.<sup>36</sup>

Within each shopping centre, we suggest that developers and landlords will have to look at the mix of types and sizes of stores available for rent as retailers start looking for smaller physical footprints. This is in-line with the shift for retailers to hold lower stock weights and the in-store experience shifting to browsing.

As the bricks and mortar retailer revenue model becomes increasingly challenged so will the current rental cost model. Landlords who have transparency of their tenants sales performance will need to review their rent models as retailers start to question the value of bricks and mortar stores beyond the “flagship” store in key locations or hubs.

## **Government**

This Productivity Commission review came about as the result of Australian based retailers arguing that overseas online retailers have a competitive advantage over them because Federal Government law exempts those overseas online retailers from collecting GST and duty for purchases less than AUD\$1,000.

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<sup>35</sup> Kim Christian, AAP, April 6 2011, Debt change leads to tighter margins, <http://news.theage.com.au/breaking-news-business/debt-change-leads-to-tighter-margins-20110406-1d47s.html>

<sup>36</sup> Colliers International Media Release: *Retail bricks to endure challenge from retail clicks*, February 02, 2011, <http://www.colliers.com.au/News/News-details.aspx?NewsId=%7B33DCC659-58D5-46C8-A637-42DE9E6357BC%7D>

As the Commonwealth Government has itself recognised, Australia's is a "patchwork economy" and the retail sector broadly is suffering. We are seeing price deflation, low consumer sentiment, rising landlord rentals and labour costs, which when coupled with the prospect of potential future interest rate increases and a historically high Australian dollar, the ability of small business to withstand global competition is stretched.

Overlay this situation with an inequitable tax and regulatory regime and Australian businesses are at a severe disadvantage. As we noted in a letter to Members of Parliament earlier this year:

*"We would like to be a globally competitive book retailer – an Australian Amazon. We have one of the leading online book sites in Australia and the leading ebooks platform, Kobo. Our Borders brand is ranked in the top five retailers in Australia. But we can't compete in a global market place when Australian Government policies are holding us back."*

We have already noted that retailers are facing depressed consumer discretionary spending, increasing rents and a high Australian dollar encouraging consumers to look offshore. We also note that retailers have a role to play in getting their own houses in order to be more attractive to the consumer in the face of online and offshore competition.

But the situation is being made significantly more difficult by Australian Government policy. As an Australian retailer, we are obligated to charge Australians who buy their books locally GST for books we source locally. Yet when those same Australians buy books offshore no GST or duties are charged.

If we tried to sell our products to consumers overseas, we would have to add local taxes and duties to our prices in many countries such as:

- The UK if the purchase is valued at over 18 pounds
- The USA if the purchase is valued at over USD200

Parallel Importation Laws also distort prices in the local market. Meanwhile, in a global consumer economy all our customers are able to go online and purchase the book overseas before we even have the chance to stock it in-store.

Once the book is published in Australia, often the local price is not set in relation to international pricing and Australian consumers are charged more for the privilege of buying books in Australia.

We cannot support a regulatory approach that favours offshore retailers who do not pay Australian taxes or employ Australians. In the long term interests of businesses, their employees and consumers we believe the Commission should recommend the Government amend existing regulation to ensure a level playing field as a matter of urgency.

ENDS