

# Flash analysis

Credit Analysis

## Airlines

### >>> Who's afraid of Amazon?

January 2020, Elena Sternberg

*Setting up an airline is a challenging and expensive undertaking given the high start-up costs and many operational risks. Still, the fleet of Amazon Air, founded in 2016, was launched with 10 cargo planes and now, three years later, has been increased to 50 aircraft. As a result of this rapid development, Amazon Air is now the fourth largest all-cargo operator measured in fleet size, right behind DHL, UPS and Fedex.*

**From leading online retail to the world's fourth-largest cargo airline**

Amazon plans to expand its fleet to as many as 70 aircraft in 2021. This is to be made possible, among other things, by leasing another 15 B737-800 aircraft from Gecas, a leasing arm of General Electric. The cargo planes operate in a large airport network that connects 25 cities in the USA. The facility at the international airport in Cincinnati (Ohio, USA) is being turned into a cargo hub for USD 1.5 billion. After the scheduled completion in 2021, it will be able to handle 100 Amazon cargo planes with 2,000 employees, twice the current fleet size. While the delivery rate for its own parcels was around 10% at the beginning of 2017, Amazon now delivers about every second parcel in the USA itself.

**Strategic planning is half the battle on the road to success**

In addition to the speed of delivery to prime customers, Amazon's strategy also generates other advantages for the Group: the cost savings in its own delivery operations, for example, are around 30% when compared to the use of integrators. By moving away from the traditional supply chain and using gateways for direct flights to the destinations, the overall process is much more efficient. In addition, all data is processed internally to optimise the processes even further. Not least of all through the use of innovative in-house solutions. For Amazon and other providers, the logistics of the last mile is the biggest challenge. On the one hand, the process has to be optimally designed from an economic point of view and, on the other hand, Amazon wants to meet (or exceed) the expectations of its customers, which is why this last step in the supply chain is also increasingly integrated into the overall picture. The company's own delivery service, for example, is being expanded with small regional partners working on behalf of Amazon. In addition, parcel boxes called Amazon Locker will be set up. There are also plans to establish "Amazon counters" at retailers similar to those at DHL, Hermes, GLS and other logistics companies, as well as to enable parcels to be delivered by drone in the long term.

**The transformation from customer to direct competitor**

According to the consolidated financial statements, Amazon's shipping costs increased to USD 27.7 billion in 2018. Even though this only accounts for just under 13% of total operating expenses, they went up by 27% compared with the previous year. Comparing with the growth since Amazon Air was founded, the growth in costs was 33% in 2017 and 40% in 2016. This trend is likely to continue with the planned expansion of the fleet, as it is more cost-effective for the company to make its own deliveries. This is tough for the competition: if the world's top-selling online retailer increases its own delivery rate in the USA from 10% to 50%, this will certainly have noticeable consequences. Currently, the U.S. Postal Service is the main casualty. In 2018, the U.S. Postal Service reported a net loss of USD 3.9 billion due to the dramatic decline in letter and parcel volumes. The core business of the U.S. Postal Service has been "last-mile logistics". An attempt to impose higher fees for this service proved unsuccessful. This part of the supply chain is increasingly being handled by Amazon's logistics division itself. To this end, 20,000 new vehicles were ordered last year and delivery robots for the last mile were developed and tested. According to Fedex, Amazon only accounts for 1.3% of its turnover, which is why it has decided not to extend the cooperation agreements with Amazon, which expired in September 2019. Many experts interpret this as a clear signal that Fedex no longer regards the online trader as a partner, but clearly as a competitor. UPS is pursuing a different strategy and actively participating in Amazon's growth. After all, the largest integrator in terms of fleet size generates about 10% of its turnover with Amazon. However, the possibility cannot be ruled out that the potential marginalisation will put

enormous pressure on margins. Ironically, Amazon mentions the competitive environment in the transport & logistics sector for the first time in its financial statements under risk factors.

### How does Amazon operate in this country?

Germany is the second largest market for the online retailer after the USA. Amazon is working on controlling large parts of the logistics itself in Germany. By the end of 2019, Amazon is expected to have more than 20,000 employees in Germany. Most are employed at the 13 logistics centres and six distribution centres at various locations around the country. Most sites rely on innovations, for example, by using transport robots as conveyors and pallet lifters, which make a key contribution to facilitating work and speeding up processes. Deliveries are currently made both by Amazon itself and by DHL. The company's own deliveries are made by subcontractors, in the city centres mostly in "inconspicuous" white vehicles. For the Deutsche Post Group, this makes the online retailer both a major customer and a competitor. With the optimized delivery logistics, Amazon is putting the Bonn-based company under price pressure on the one hand, while on the other hand, the sales achieved via Amazon are presumably declining similar to the competitors in USA due to increasing own delivery service. Although no customer accounts for much more than 2% of revenues, the rising threat through Amazon cannot be neglected.<sup>1</sup> Another factor is the switch to the less expensive provider Hermes. Deutsche Post's latest profit warnings show how serious the situation is. Share prices reflect this development.

### Can Amazon Air also gain a foothold in Europe?

Unlike in the USA, Amazon does not operate its own cargo planes on the European shipping market. It is here that the online retailer draws on the capacities of its business partners. These are mainly aircraft of the DHL subsidiary European Air Transport, which provides aircraft to Amazon during the day and to the express division of Deutsche Post in Europe at night. The frequency of flights by aircraft carrying Amazon parcels has increased considerably in recent months at the most important locations in Germany for this purpose, namely Cologne/Bonn and Leipzig/Halle airports. Similar to the Cincinnati/Northern Kentucky airport in the USA, the retail giant is also using DHL's expanded distribution centre in Leipzig and is developing it into its own transport hub. This is also attracting other cargo airlines to the location, such as Cargo Logic Germany. The airline has now received its flight licence after some delays and will focus on express cargo in the e-commerce segment. In competition with DHL – and as a potential transport partner of Amazon. Everything seems to indicate that, in parallel with ground transport, the intra-European flight networks of the online retailer will be further expanded as a reliable and fast alternative.

### Why is Amazon so successful?

Even though Amazon has not been an innovation pioneer in all fields, the company has always managed to jump on the bandwagon at the right time and actively shape and spearhead numerous trends. Unconventional business management and risk taking create new growth areas and huge economies of scale. Amazon now offers third-party providers their own storage and transport services on its platform based on the same model as in retail, thus generating additional revenue. Amazon pursued a similar path after entering the cloud services sector, which now contributes 58% of the group's operating profit under Amazon Web Service (AWS) as the world's largest cloud.

### Market power continues to grow steadily

The online retailer will continue to aggressively expand its air and land transportation network – and possibly also container line network. This is driven on the one hand by the online giant's dynamic growth: sales are growing at double-digit rates in all divisions. On the other hand, logistics costs outside North America are too high: Amazon continues to incur operating losses in its international business because quick delivery to prime customers is too cost-intensive. It is therefore to be expected that the company's own delivery and freight capacities will also be gradually expanded in Europe. It is only a matter of time when and in what form Amazon Air comes to Europe.

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<sup>1</sup> Subject to change on 02.03.2020. In the further version this passage was: „With the optimised delivery logistics, Amazon is putting the Bonn-based company under price pressure on the one hand, while on the other hand, the sales of the DHL express division are declining similar to the USA due to the loss of market share. And it is probably much more than the 1-2% of sales that have been officially acknowledged so far.“ (Source: Im Interview: Frank Appel, Börsen-Zeitung as of 03.01.2020).