BRYAN, GARNIER & CO

INDEPENDENT RESEARCH

28th November 2016

Luxury & Consumer Goods

Zalando

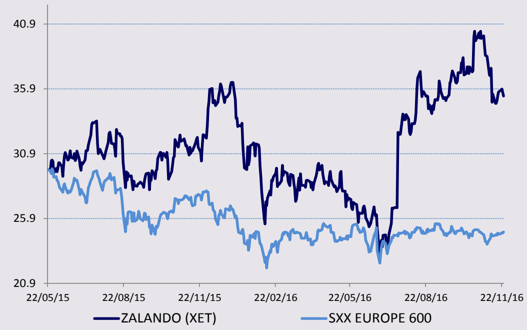
IN SHORT: Zalando, the web category killer

Fair Value EUR39 (price EUR35.35)

NEUTRAL
Coverage initiated

Bloomberg	ZAL GR
Reuters	ZALG.DE
12-month High / Low (EUR)	40.4 / 23.0
Market capitalisation (EURm)	8,739
Enterprise Value (BG estimates EURm)	7,942
Avg. 6m daily volume ('000 shares)	560.7
Free Float	30.9%
3y EPS CAGR	52.5%
Gearing (12/15)	-133%
Dividend yields (12/16e)	NM

YE December	12/15	12/16e	12/17e	12/18e
Revenue (EURm)	2,958	3,678	4,543	5,578
EBIT(EURm)	107.50	197.89	276.03	380.77
Basic EPS (EUR)	0.49	0.45	0.70	1.00
Diluted EPS (EUR)	0.29	0.52	0.73	1.02
EV/Sales	2.63x	2.16x	1.73x	1.38x
EV/EBITDA	55.0x	32.9x	23.5x	16.8x
EV/EBIT	72.5x	40.1x	28.5x	20.2x
P/E	NS	68.0x	48.2x	34.6x
ROCE	43.1	38.1	36.4	39.4



This introduction is intended as a description for investors who would like to get to know Zalando. It complements our sector report (« Serving Consumers not Uberising Them! ») which details our investment summary and valuation, leading to our Neutral recommendation (Fair Value of EUR39).

As we point out in our sector report, no truth is indivisible and e-commerce players that have enjoyed a clear success share only the common denominator of having a coherent offer that seems to fit into one of four main models:

- In the first model, the e-merchant offers a comprehensive range at the best price. **Amazon** fits best this notion of a web-hypermarket, substituting "everything under the same roof" with "everything under the same site".
- In the second model, a web category killer such as **Zalando** multiples flows on high rotation product lines such that it becomes the natural destination for all internet users looking for a specific product.
- In the third model, the expertise of a **Yoox Net-A-Porter** is so great in a niche segment that it is difficult fo another web-merchant to **1/** source and **2/** sell a similar product, in such an intimate framework and at the best price.
- In the fourth, the Brick & Mortar retailer is capable of reconciling a more predictive way of serving consumers (via click and data) while maintaining social ties (via collection from a physical store network).

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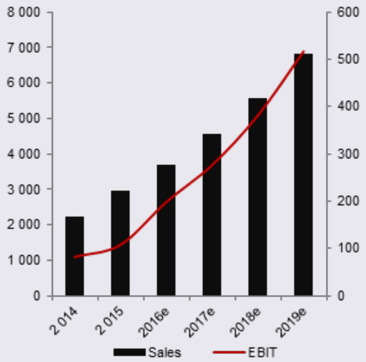

Company description

Operating in 15 countries, Zalando is Europe's leading online fashion platform for women, men and children. The group offers its customers a one-stop, convenient shopping experience with an extensive selection of fashion articles including shoes, apparel and accessories, with free delivery and returns.

Simplified Profit & Loss Account (EURm)	**2014**	**2015**	**2016e**	**2017e**	**2018e**
Revenues	2 214	2 958	3 678	4 543	5 578
Change (%)	*25,7%*	*33,6%*	*24,3%*	*23,5%*	*22,8%*
Current EBITDA	108	142	242	335	456
Change (%)	*-%*	*31,6%*	*70,6%*	*38,6%*	*36,2%*
EBITDA	87,9	124	223	317	438
Current EBIT	82,0	108	198	276	381
Change (%)	*-%*	*31,1%*	*84,1%*	*39,5%*	*37,9%*
EBIT	62,2	89,4	180	258	362
Financial results	-4,5	-3,0	-9,0	-9,0	-9,0
Pre-Tax profits	57,8	86,6	171	249	353
Tax	-10,5	34,9	-59,8	-74,6	-106
Net profit	47,3	122	111	174	247
Restated net profit	54,3	73,2	132	187	260
Change (%)	*-%*	*34,7%*	*80,8%*	*41,4%*	*39,2%*
Cash Flow Statement (EURm)					
Operating cash flows	104	135	195	296	405
Change in working capital	-13,4	1,1	2,7	1,3	1,5
Capex, net	-51,0	-60,0	-201	-227	-223
Free Cash flow	39,4	76,0	-2,6	70,4	183
Financial investments, net	0,0	-172	-94,2	0,0	0,0
Dividends	0,0	0,0	0,0	0,0	0,0
Capital increase / buyback	510	6,4	2,1	0,0	0,0
Other	71,5	17,8	-57,1	0,0	0,0
Decrease / (Increase) in net debt	621	-71,6	-152	70,4	183
Net debt	-1 030	-959	-807	-877	-1 060
Balance Sheet (EURm)					
Tangible fixed assets	111	128	246	338	412
Intangibles assets	29,0	48,8	123	199	273
Cash & equivalents	1 051	976	822	892	1 076
Other assets	595	963	1 215	1 404	1 629
Total assets	1 786	2 116	2 407	2 833	3 389
Shareholders' funds	1 127	1 271	1 412	1 649	1 978
L & ST Debt	20,8	17,6	15,2	15,2	15,2
Others liabilities	638	827	980	1 169	1 396
Total Liabilities	1 786	2 116	2 407	2 833	3 389
WCR	-3,7	-2,6	-5,3	-6,6	-8,1
Capital employed	136	174	364	531	677
Ratios					
Operating margin	3,70	3,63	5,38	6,08	6,83
Normative tax rate	30,00	30,00	30,00	30,00	30,00
Net margin	2,45	2,47	3,60	4,11	4,67
ROCE (after tax)	42,11	43,15	38,06	36,40	39,38
Gearing	-109	-133	-175	-188	-187
Average number shares					
Number of shares, diluted	230	254	255	255	255
Data per Share (EUR)					
EPS	0,21	0,49	0,45	0,70	1,00
Restated EPS	0,24	0,29	0,52	0,73	1,02
% change	*-%*	*22,1%*	*80,5%*	*41,2%*	*39,1%*
Operating cash flows	0,45	0,53	0,77	1,16	1,59
FCF	0,17	0,30	-0,01	0,28	0,72
Net dividend	0,0	0,0	0,0	0,0	0,0

Source: Company Data; Bryan, Garnier & Co ests.

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1.1. Zalando's DNA

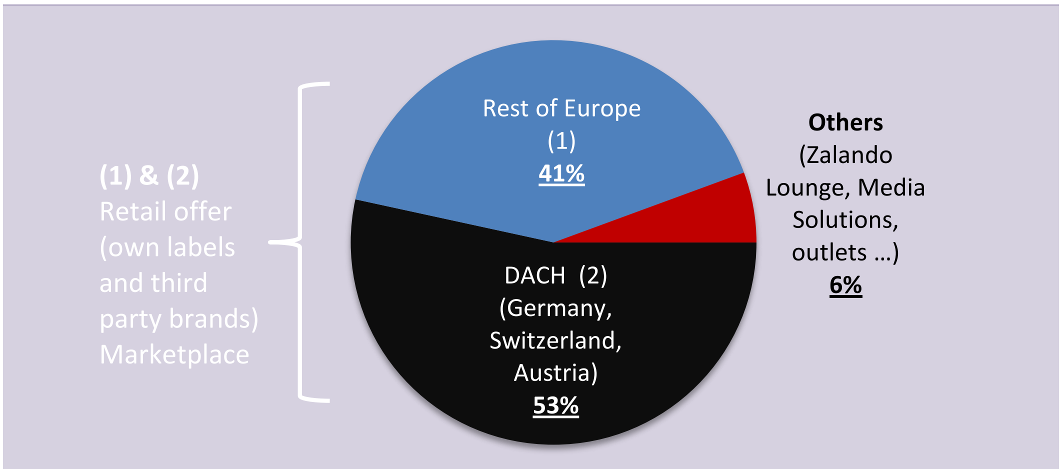
1.1.1. Weighting of Zalando business

Fig. 1: Zalando among the European leaders in internet B2C (2014)

Company	Country of origin	Online turnover in Europe (2014)
Amazon	USA	EUR 24,230mn
Otto	Germany	EUR 6,452mn
Apple	USA	EUR 3,750mn
Tesco	UK	EUR 3,533mn
Home Retail Group	UK	EUR 2,328mn
Cdiscount	France	EUR 2,235mn
Zalando	Germany	EUR 2,214mn (EUR2,958mn in 2015)
E.Leclerc	France	EUR 1,900mn
Shop direct	UK	EUR 1,876mn
Next Plc	UK	EUR 1,863mn
Vente Prive	France	EUR 1,700mn
Asda	UK	EUR 1,700mn
Metro Group	Germany	EUR 1,500mn
John Lewis	UK	EUR 1,460mn
Carrefour	France	EUR 1,176mn

Source: E-commerce in Europe; Company Data; Bryan, Garnier & Co ests.

Fig. 2: Zalando retail offer and services as a percentage of sales (2015)



Source: Company Data; Bryan, Garnier & Co ests.

Fig. 3: Specifics of countries where Zalando is present (2015)

Country	Retail sales (YoY growth)	B2C sales (EURbn / growth)	B2C share of GDP	Internet users (>15yo)	E-shoppers (>15yo)	Mobile share in online sales	Spending per e-shopper (EUR)
UK	**+4.1%**	157.1 (**+11%**)	6,1%	93%	81%	20%	3,625
France	**+3.8%**	64.9 (**+14%**)	3,0%	87%	67%	15%	1,780
Germany	**+2.8%**	59.7 (**+13%**)	2,0%	89%	73%	15%	1,157
Spain	**+3.6%**	18.2 (**+12%**)	1,7%	80%	42%	NA	1,089
Italy	**+1.8%**	16.6 (**+16%**)	1,0%	68%	34%	NA	938
Netherlands	**+2.3%**	16.1 (**+16%**)	2,4%	98%	93%	15%	1,242
Denmark	**+1.2%**	11.7 (**+18%**)	4,4%	97%	80%	NA	3,111
Sweden	**+7.0%**	9.7 (**+12%**)	2,2%	92%	72%	NA	1,668
Switzerland	**-1.1%**	8.5 (**+12%**)	1,4%	92%	67%	NA	1,815
Belgium	**-0.3%**	8.2 (**+34%**)	2,0%	86%	74%	12%	1,188
Norway	**+0.6%**	7.9 (**+2%**)	2,3%	97%	76%	NA	2,467
Poland	**+6.6%**	7.6 (**+18%**)	1,8%	70%	37%	NA	632
Austria	**+1.6%**	7.5(**+14%**)	2,2%	85%	58%	NA	1,759
Finland	**+0.0%**	7.2 (**+10%**)	3,5%	93%	78%	NA	2,170
Luxembourg	**+6.6%**	0.6 (**+13%**)	1,2%	98%	78%	NA	1,635

Source: Eurostat; E-commerce in Europe; Company Data; Bryan, Garnier & Co ests.

1.1.2. Origins and shareholding structure of Zalando

Zalando was created in 2008 by Robert Gentz and David Schneider, two German students who sold flip-flops via the Ifansho website. The company then integrated the Rocket Internet programme (managed by the three Samwer brothers), a German business angel and incubator specialised in e-commerce (more than 200 start-ups to its credit). According to the legend, inspired by the Zappos model (US slipper sale website) to which it added the name of Alando (a peer of eBay, created by Rocket Internet), Zalando was then created to sell shoes to the German market. Today, the company is independent from Rocket Internet which simply acted as an incubator.

Strengthened by its success, the group started its international expansion as of 2009, starting with Austria. In 2010, it extended its range to fashionwear and started its activities in France and the Netherlands. Going from success to success, new country websites were set up in 2011 (UK, Italy, Switzerland and Austria), 2012 (Sweden, Belgium, Spain, Denmark, Poland and Finland) and 2013 (Norway and Luxembourg).

Zalando was floated on the German market on 1st October 2014 with the issue of 29.5 million new shares. The offer was 10 times oversubscribed, leading to a flotation price of ER21.5 at the top end of the price range (EUR18-22.5), and EUR524m in capital raised. This operation valued Zalando at EUR5.3bn (or 2.4x 2014 sales).

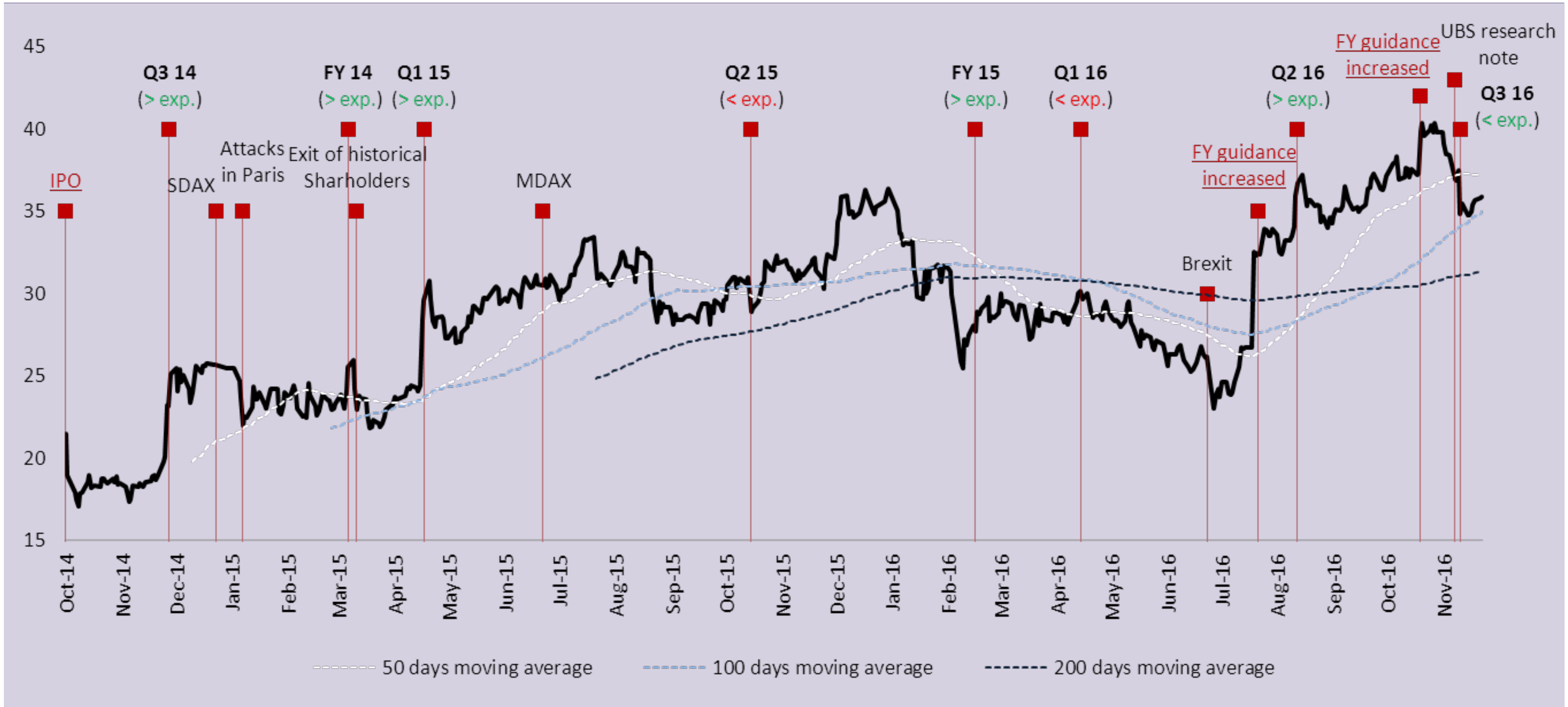
Rocket Internet has had no direct capital ties with Zalando since August 2013, with the incubator having sold its shares to other entities of which Swedish group Kinnevik. In contrast, the Samwer brothers have a personal stake via the Global Founders fund of 8.77% vs. 17% initially. From a purely operational stance, Zalando is managed by a trio of co-CEO's: David Schneider, Robert Gentz and Rubin Ritter (arriving in 2010).

Fig. 4: Zalando shareholders at end-June 2016

Shareholding	At 07/2016
Kinnevik (Swedish fund)	31.7%
Anders Holch Povlsen	10.0%
Global Founders (Samwer brothers)	8.8%
Baillie Gifford	6.9%
Tengelmann Verwaltungs	5.0%
Founders	3.7%
Vanguard World Funds	3.0%
Public free float	30.9%

Source: Company Data; Bryan, Garnier & Co ests.

Fig. 5: Zalando equity story (since August 2014)



Source: Datastream; Company Data; Bryan, Garnier & Co ests.

1.1.3. SWOT analysis

Strengths	Weaknesses
An offer (1,500 brands) and services (online, outlets, marketplace, smart data), served by a proprietary technology.	The business is unevenly distributed and dependent on the historical DACH region (around 53% of sales).
Unrivalled customer and logistics service in the industry (free delivery and returns, 100-day retraction period).	One of Zalando's main strengths (i.e. free returns) is also one of its weaknesses (high return rates).
A pioneer in the online textiles and fashion segment, Zalando boasts an active customer base of 19.2m consumers.	
Opportunities	**Threats**
Sources of fresh growth (especially in eastern Europe and Northern countries) via the opening of peripheral logistics centres.	Amazon (still little present in certain European countries) is a real threat for a mass-market web-merchant.
Potential extension of the offering to men's wear with women accounting for around 75% of the active customer base.	Demands in terms of wages imply a social risk to the detriment of the group's image and logistical efficiency.
Rising momentum of market place (~5% of business volume), structurally more profitable than the core website.	Fraud potential associated with the multiplication in deferred payment means offered by Zalando.

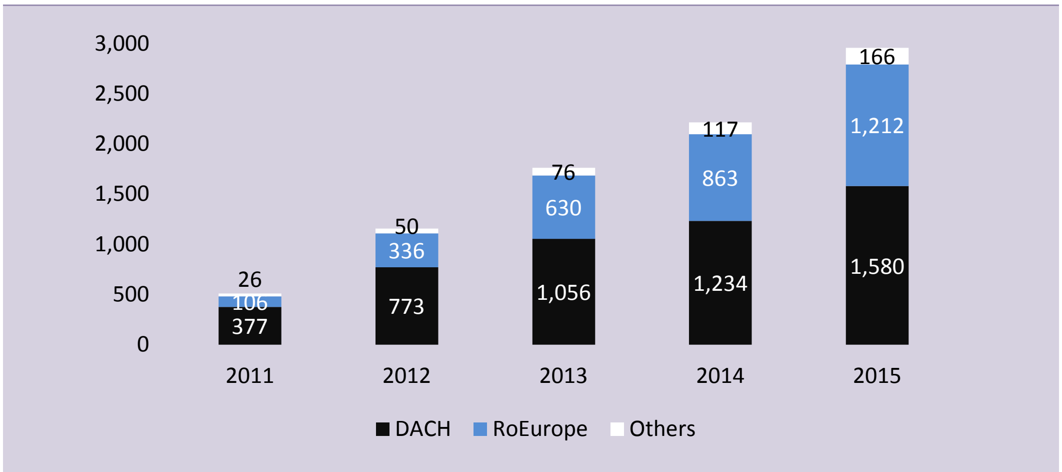
Source: Company Data; Bryan, Garnier & Co ests.

1.2. Strategy at the service of top-line growth

Zalando has rapidly become one of the main European leaders in online clothing with sales of EUR2.96bn in 2015 (+1,821% over five years, or a CAGR of 81% since 2010) generated in 15 European countries as set out previously. Sales momentum remains driven by **1/** an extensive assortment and **2/** a diversified range of services feeding a rapidly expanding customer base.

1.2.1. A comprehensive assortment

Fig. 6: Breakdown of Zalando sales - EURm



Source: Company Data; Bryan, Garnier & Co ests.

The retail offer (~94% of sales)

A number of articles are bought wholesale from third-party brands and retailed by Zalando. Other brands (Mint&Berry, Zign, Kiomi, Even&Odd) are more freely designed and manufactured by Zalando (since 2010). These distributor own-brands (~12% e of sales) are theoretically more profitable and are aimed at diversifying the offer and not substituting existing brands.

Fig. 7: Selection of Zalando partner brands

Top Marques	Marques Sport	Créateurs Luxe
Toutes les marques	Toutes les marques	Tous les créateurs
ONLY	Nike	MICHAEL Michael Kors
Mango	adidas	Ralph Lauren
Morgan	ASICS	BOSS
Topshop	Reebok	ARMANI
Anna Field	Puma	DKNY
Tommy Hilfiger	Lacoste Sport	KARL LAGERFELD
GAP	The North Face	Pinko
Dorothy Perkins	New Balance	Sonia by Sonia Rykiel
NAF NAF	adidas by Stella Mc	See by Chloé
Lacoste	Cartney	Filippa K
	Onzie	

Source: Company Data; Bryan, Garnier & Co ests.

Zalando therefore offers more than 200,000 articles (1,500 brands) in its retail range. Rotation is fairly high (1,000 new references added each day). Since recently, the selection process has been based on a rating system (assessment of quality, safety and execution risks associated with each brand and product), prior to wholesale purchase negotiations.

Entry-level associated offers

At the end of season, Zalando has several options for running down unsold goods: it can **1/** send the articles back to their suppliers, **2/** run a promotional campaign on its classic website or place them on Zalando Lounge, **3/** transfer them to one of the three physical stores. These two latter options make up the majority of Zalando's entry-level offers in ready-to-wear.

Zalando Lounge (represents the great majority of sales in "other segments" which, themselves, represent around 6% Zalando's sales)

Zalando Lounge is an ephemeral private sales site. Launched in 2010 (Germany, Austria), it was gradually extended in 2011 (France), 2012 (the Netherlands, Belgium), 2013 (Finland, Sweden) and 2014 (UK). A mobile application has complemented the site since 2015.

The offer covers clothing, shoes, accessories and household items (towels, candles, furniture etc.) benefitting from aggressive discounts (up to 75% relative to the recommended selling price). In 2015, 2,785 different brands were offered for sale.

This solution **1/** offers internet users discount prices on a wide range of brands, **2/** is a way of running down unsold goods, **3/** helps diversify distribution channels and **4/** provides Zalando precious information on its customers (which is then transferred to the brands).

The group estimates that the shopping club segment to which Zalando Lounge belongs was worth EUR7bn in Europe in 2015 (the segment is part of the European online fashion market estimated at EUR46bn) and remains dominated by Venteprivée (12.9% market share) and Showroomprivé (5.7% market share).

Outlets (minor contribution considering that, as of today, only three outlets are operational)

Zalando's entry-level range is also being strengthened by the opening of three factory outlet stores (Berlin, Frankfurt and Cologne). Goods unsold or returned for minor defaults are offered at discounts of around 40%. Originally, the Berlin outlet store opened in 2012 over 800m² was only accessible to consumers with a member card. Since the opening of a first sales point in Frankfurt in 2014 (1,000m²), all of the stores are open to the public (the second store was inaugurated at end-2015, standing out for its rise upscale, with its chic atmosphere contrasting with the image of a hangar housing boxes of unsold clothes).

Fig. 8: Zalando premium factory stores

Source: Zalando.

1.2.2. A diversified range of services

Apart from a range of products that is constantly widening, Zalando has also managed to diversify its revenue sources by developing services such as the marketplace and associated services destined for customers and supplier brands.

Marketplaces: Partner programme and Movmnt (mid-single digit in terms of the GMV)

The marketplace, accessible via the Zalando site, hosts transactions between individuals and third-party professionals (150 brands picked by Zalando). Sellers therefore benefit from the traffic (i.e. 138 million visits/month in 2015) and Zalando's smart data expertise, while maintaining control of the offer's contents (dedicated sales space) and delivery. The selling brands move within Zalando's secure ecosystem and pledge to respect the group's standards (delivery times and free delivery, retraction and return terms).

In return, Zalando levies a commission fee on the transaction amount (around ~12% e of the VAT inclusive selling price) that it books as sales for the marketplace. While it has no logistic expenses, it does have to shoulder the costs associated with content creation, payment and customer care as well as various associated costs (in all around 7.5% e of the VAT inclusive selling price). EBIT margin before marketing costs therefore works out to around 38%e.

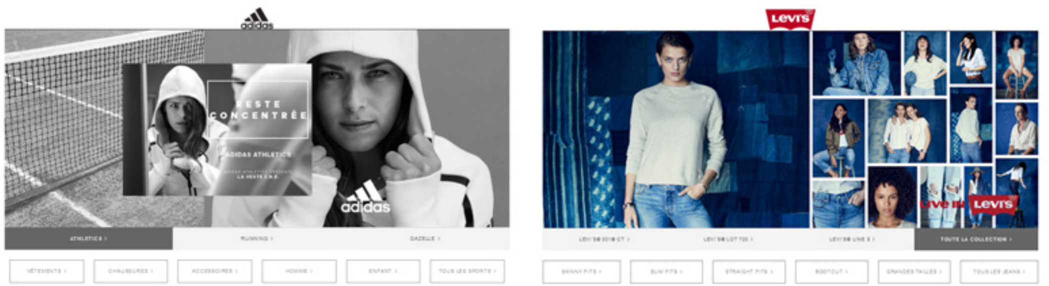
Fig. 9: Our ouderstanding of the market place if the brands take on logistics costs

In case of no fulfillment by Zalando	
Gross Market Value (GMV)	**100**
Commission	12%
Commission paid by the Brand	12
Net sales for Zalando	**12**
Content creation / Payment / Customer care & Others costs	-7.6
EBIT margin before marketing	4.7
As a % of sales	**38%**

Source: Bryan, Garnier & Co ests.

Note that the group is currently testing the option whereby it does shoulder logistics costs. Consumers continue to evolve in the same secure ecosystem. In contrast, since Zalando ensures the logistics, it is capable of grouping together in a single package the purchases that the customer has made with various sellers. Logistics costs are rebilled to the brands according to terms that we do not yet know. We are making no estimates in that this option is only in the test phase and that its contribution is marginal.

Fig. 10: Adidas and Levis corners on the French Zalando site



Source: Company Data; Bryan, Garnier & Co ests.

The group has also developed an independent marketplace named Movmnt, solely available via an application. It targets clients with small budgets that it puts in contact with factories aiming to run down unsold goods from past seasons, combined with significant discounts. Launched in 2015 (operational in Germany and in France), this marketplace remains a niche market with around 10 listed merchants offering around 1,000 articles.

Zalando Media Solutions (NM at this stage)

Zalando opened a services business, Zalando Media Solutions, in order to monetise the web traffic and increase the conversion rate. The subsidiary offers customised marketing services (targeted advertising and marketing campaigns, analysis of customer data etc.) destined for marketplace players but also brands listed on third-party platforms, social networks and bloggers (more than 40 campaigns in 2015 for more than 80 customer brands since its creation). This service requires little capital and is easily extendable to 150 partner brands and 1,500 retail brands with which Zalando already works. Its efficiency was strengthened thanks to the acquisition of Metrigo (specialised in real-time auction of advertising space) in March 2015.

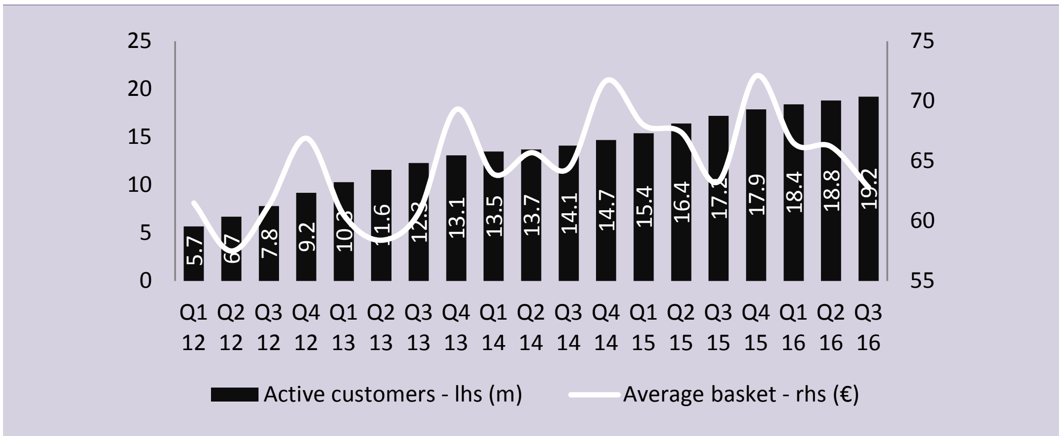
Zalando Zalon (NM at this stage)

Launched in May 2015, Zalon offers users on the Zalon website, and soon on the application, a free service in personalised advice on fashion. After creating an account, users fill in a questionnaire concerning their aspirations. The products suggested are of course part of the range offered by Zalando. The 200 professional stylists (employed on a freelance basis) are paid through commission fees based on the batches of clothes sold. The service is currently limited to Zalando's historical region (Germany, Austria, Switzerland), but could be opened in other countries shortly (already in the Netherlands).

1.2.3. Customer base in full boom

Thanks to a comprehensive choice, combined with an unprecedented quality of service in the online fashion market (a point we discuss later on), Zalando boasts **1/** an increase in its Net Promoter Score (10 absolute points in Q2 year-on-year), and **2/** sharp expansion in its customer base (quarterly CAGR in active customers, i.e. having placed at least one order over the past 12 months, of 7.3% between Q1 2012 and Q2 2016). The group's active individual customer base stood at 19.2 million (at end Q3 2016), which is a massive plus-point for attracting brands to the marketplace. This critical mass enables economies of scale on marketing costs, which alongside fulfilment costs, are the main cost item for an e-commerce group.

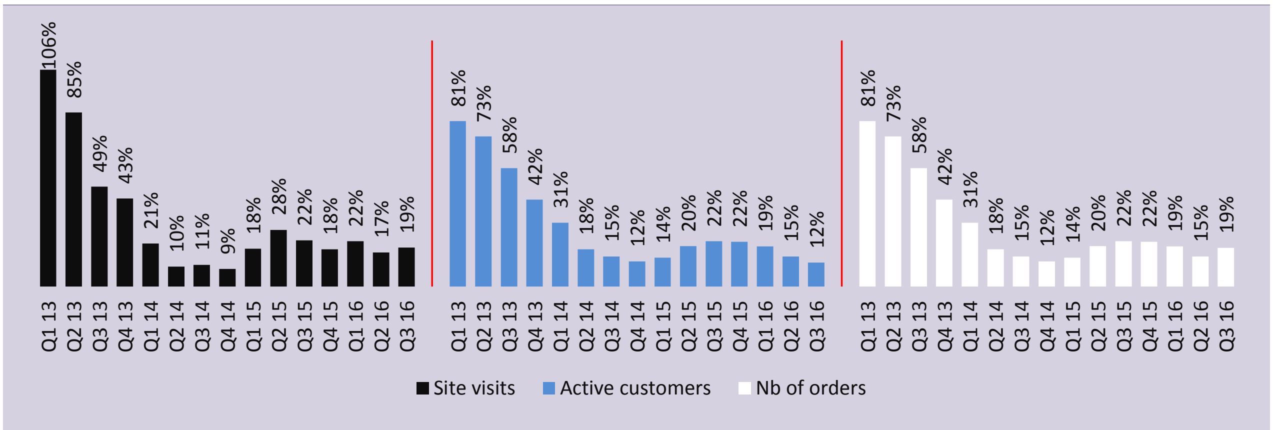
Fig. 11: Increasingly large base of spending customers



Source: Company Data; Bryan, Garnier & Co ests.

Although Zalando has gone beyond the start-up phase and triple-digit growth rates, its KPIs nevertheless reflect an increasingly clear presence of consumers: **1/** growth in the number of visits and active clients (20% on average) as well as change in the number of orders (~30% in recent quarters) is impressive, **2/** the average number of transactions per person is rising despite the sharp increase in the customer base, with customers placing 3.32 orders during the last twelve months vs. 2.36 in early 2012). Finally, **3/** the average basket is constantly growing and now totals EUR66 (vs. EUR61.5 in early 2012).

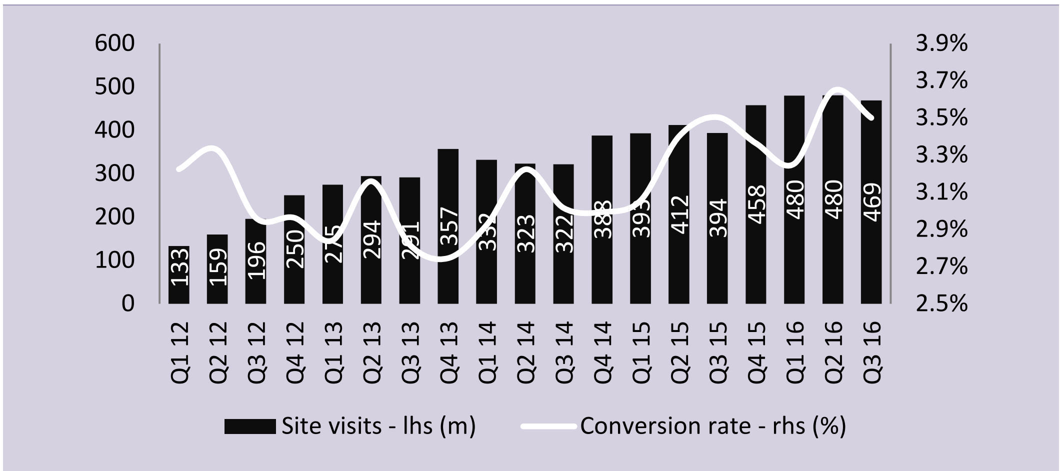
Fig. 12: Change in main Zalando KPIs (YoY growth)



Source: Company Data; Bryan, Garnier & Co ests.

The conversion rate (no. of orders/no. of visits) has risen over the period observed and now stands at 2.5-3.5%. This reflects Zalando's ability to transform the flow of visitors into customers, a statistic that is closely watched by observers. The rate is higher than the average noted in online fashion (2.2% in the UK or 1.9% in Germany for example). We nevertheless believe that its improvement could be restricted in coming years by the deployment of Zalando's mobile offer. Indeed, consumers use their mobiles and tablets to have a look rather than purchase.

Fig. 13: Higher than average conversion rates



Source: Company Data; Bryan, Garnier & Co ests.

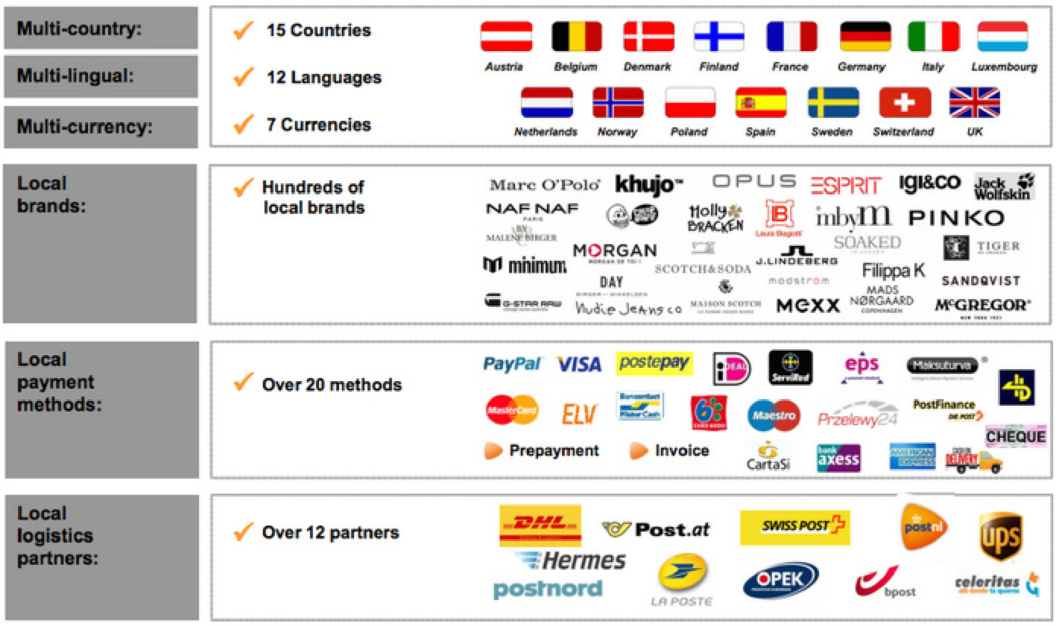
1.3. Comparative advantages: a local offer, proprietary logistics and technology

In an e-commerce backdrop whereby customers are far more frivolous, less loyal and capable of comparing offers from different rivals, Zalando decided to stand out for its personalised and quality services. The group puts the customer's aspirations at the heart of its strategy.

1.3.1. Offer adapted to each country (articles and payment means)

Zalando's classic retail offer breaks down into geographical regions, each one with its own website. While the purchasing service is centralised in Berlin, the assortment is nevertheless adapted to local cultures and trends. This solution is clearly less WCR-greedy since stocks are better managed. This tailor-made offer concept has been applied to the other Zalando sites (marketplace, Zalon, Lounge) and mobile applications.

Fig. 14: Overview of the diverse nature of Zalando's offer



Source: Tech.com; Company Data; Bryan, Garnier & Co ests.

In the same vein, the group has diversified the payment methods offered (more than 20 at present). First and foremost, these include credit card, PayPal and Apple Pay payments. However, the group also stands out from rivals by offering alternative payment means depending on the country: **1/** payment by cheque in France, **2/** cash-on-delivery in Italy, **3/** payment on invoice in the DACH region (Germany, Austria and Switzerland). Meanwhile, Zalando was confronted with a wave of mass fraud in the invoice payment segment in the DACH region in H1 2015 with ~EUR30m in unpaid goods, which took a toll on the margin during the period.

Fig. 15: Range of payment means offered by Zalando (2014)

Invoice = payment after delivery with a payment term of 14/30 days(1)	✓	✓	✓	✓	✓		
Credit cards	VISA	VISA	VISA	VISA	VISA	VISA	VISA
Electronic wallet	PayPal	PayPal	PayPal	PayPal	PayPal	PayPal	PayPal
Prepayment = offline bank transfer before delivery	✓	✓	✓	✓	✓	✓	✓
Local debit cards					Maestro	CB	postepay Maestro CartaSi
Local instant banking transfers out of customer's online banking		eps	PostFinance	iDEAL			
Direct debit by SEPA-Mandate	✓						
Offline document to order a payment from bank account						CHEQUE	
Cash on delivery = cash collection through carrier							✓

Source: Zalando; Bryan, Garnier & Co ests.

1.3.2. The king of logistics

Zalando has also and above all become known for the quality of its order handling services. Indeed, the group has adopted a free delivery and returns model (delivery charged at EUR5.6 on average in the sector and returns at EUR6.54), with the possibility of reimbursement within a 100-day period vs. 30 days previously. After-sales telephone services are free of charge and offered in all of the official languages of the countries targeted by Zalando. Brands that would like to subscribe to the marketplace (Partner programme) must comply with all of these requirements and offer the same services.

In order to perfect the customer experience, Zalando is currently testing a number of new return methods: **1/ 'click and collect'** whereby the customer places their parcel in their letter box for collection by the postal services, **2/ instant return** (arrival of a delivery person at the customer's home within an hour in order to collect the parcel to be returned), confined to Berlin for the moment. Meanwhile, the **Zipcart** mobile application offers same-day delivery of the order (experiment confined to Berlin and Cologne for the moment). During periods of high-affluence, contrary to certain rivals, Zalando does not compromise when it comes to delivery (by extending time-frames or exceptional billing).

1.3.3. Heading for a full coverage of Europe

Zalando's infrastructures, historically made up of three handling centres in Germany, adapt to the rise in volumes and the opening of new countries that are increasingly far off. These centres are massive warehouses ensuring storage, sorting, packaging, sending of products and reception of returned parcels. The opening of two new centres was announced during 2015: **1/** the centre at Lahr in Germany (130,000m² of which the automation is set to rank among the highest of all the warehouses), **2/** the satellite centre at Stradella in Italy (20,000 m²) which has been operational since early 2016 (60% of Italian orders are already handled there) but remains managed by a partner named Fiege (supplier of logistical services).

Fig. 16: Zalando's logistical handling structure in Europe

Source: Company Data; Bryan, Garnier & Co ests.

Zalando seems to be adopting a strategy to extend its network. Indeed, satellite warehouses in peripheral countries imply a far low delivery time and cost than if the parcels are sent directly from Germany. In the case of the very promising Italian market, the opening of the Stradella centre should therefore increase the satisfaction of Italian customers that are still beginners in e-commerce (only 20% of Italian consumers claim they have already made a purchase online). Note however, that the small warehouses generally have a less efficient automation and stock management system than the major centres. On the whole, we believe these satellite warehouses are probably a bit more expensive to run but reinforce the proximity with customers, and doing so, their satisfaction.

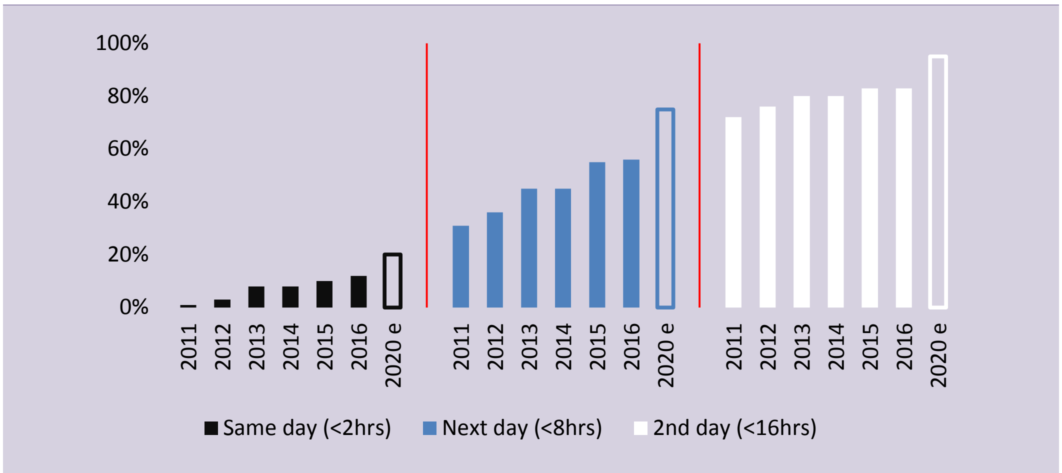
Fig. 17: Features of Zalando's handing centres in Europe

Fulfillment center	Country	Commissioning date	Operated by	Investment (€m)	Size (m²)	Employees	Automation
Brieselang	Germany	2011	Zalando	12	30	1,200	+
Erfurt	Germany	2012	Zalando	90	130	2,700	-
Mönchengladbach	Germany	2013	Zalando	90	130	1,800	+
Stradella	Italy	Q1-2016	Fiege (logistics service provider)	-	20	-	+
Lahr	Germany	Q4-2016	Zalando	130	130	1,000	+++
Stettin	Poland	Q3-2017	Fiege (logistics service provider)	150	130	>1,000	
Paris	France	2017					

Source: Company Data; Bryan, Garnier & Co ests.

Extending the logistical network helps to reduce the time needed to reach each segment of the European population. As the chart below shows, the logistical network has improved with the opening of the centres in Briesland (2011), Erfurt (2012) and Mönchengladbach (2013). By 2020, the group aims to reach 20% of the European population on the same day the order is placed and 75% the next day.

Fig. 18: Share of European population reachable by the Zalando network



Source: Company Data; Bryan, Garnier & Co ests.

Construction of logistical centres in France and Poland (probably operational as of summer 2017) should therefore help the group to **1/** strengthen its logistical structure in western European countries (so far poorly accessed), **2/** reduce delivery restrictions in Poland and northern countries and **3/** prepare an eventual offensive in new eastern-European markets.

1.3.4. Proprietary technology at the heart of the strategy

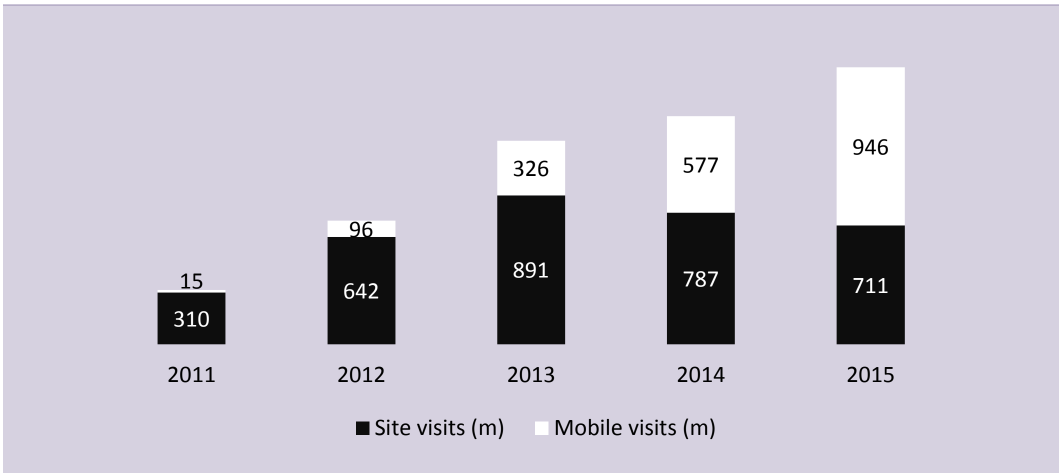
All Zalando home-made

Apart from the depth of the offer and customer satisfaction, technology is a pillar of Zalando's strategy. In order to fully control its ecosystem, the group therefore develops and manages most of its software systems internally (this R&D and maintenance division covers all IT associated with websites, mobile applications, order taking, payments and logistical processes). This choice avoids all dependence on a supplier and helps optimise performances. At the end of June 2016, 1,600 staff (!) were employed in this department, a portion of which in Dublin (site dedicated to data analysis) and Helsinki (site dedicated to mobile channels).

All eyes focused on the smartphone

In Helsinki, 50 employees develop modular applications or customer-facing products. Zalando should therefore step up its already historically buoyant launch rate, following Movmnt (marketplace for factories), Fleek (marketplace for discovery of new clothing and trends), Seen At (a social network for photo and opinion sharing) and Zipcart (offering same-day delivery). This momentum in R&D has helped the mobile channel take off to such an extent, that since mid-2014, mobile traffic has outstripped flows from classic e-commerce (57% vs. 43% of visits in 2015). It above all attracts younger and more curious customers focused on entry-level products and difficult to convert into sales.

Fig. 19: Zalando mobile flows



Source: Company Data; Bryan, Garnier & Co ests.

Acquisition of technological skills by M&A

Zalando has undertaken numerous acquisitions in the technological field. These have more precisely concerned the segment of introducing customers to brands via the marketplace. Management is not rejecting the possibility of getting its hands on any target that could help it perfect its expertise in this field. And since it would like to evolve towards a more predictive way of shopping, smart data is probably one of its priorities. Indeed, interpretation of data is an efficient way of estimating customer needs, in order to provide them personalised recommendations and to limit the bother of returns that weigh on profitability.

Fig. 20: Recent capital operations at Zalando

Company	Date	Type of operation	Field of business
Nugg	Jan-16	Acquisition (100%)	Data management and analysis
Metrigo	Mar-16	Acquisition (100%)	Advertising
Anatwine	May-15	Participation (initially 20%, then 35%)	Customised marketing services to integrate the marketplace
Amaze	May-16	Acquisition (100%)	Fashion social networks
Tradebyte	May-16	Acquisition (100%)	Introduction of brands/marketplace
Le New Black	May-16	Minority stake	Customised marketing services to integrate the marketplace

Source: Company Data; Bryan, Garnier & Co ests.

1.4. Zalando financial performances

While Zalando passed the break-even point in terms of EBIT for the first time in Q2 2014 and in 2014 on an annual basis, management has also placed the accent on market share gains rather than the margin rate (this is why the group incites its customers to use services that are normally rebilled, especially product returns).

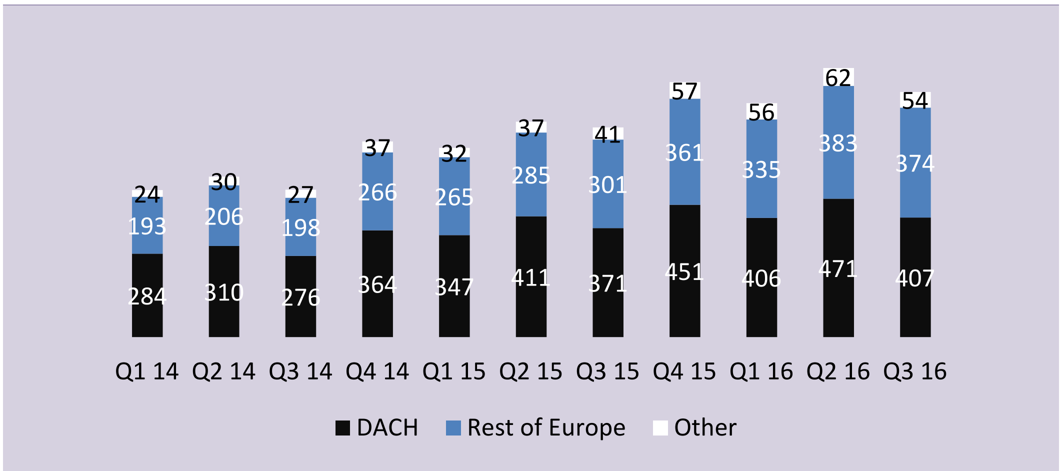
Fig. 21: Zalando return rates (2015)

Source: Company Data; Bryan, Garnier & Co ests.

1.4.1. Topline

Zalando's activity remains unequally divided between the business units. The majority of its revenues stem from the DACH region (Germany, Switzerland, Austria) which is the group's historical area (51.4% of sales in Q2 2016). This share has nevertheless tended to narrow in favour of the rest of Europe business unit (**1/** opening of new countries, **2/** start-up of logistical centres) for which client acquisition potential is higher. The "others" category (made up of Zalando Lounge and to a lesser extent, Zalando Media Solutions and outlets) has recently taken off thanks to Zalando Lounge. Its contribution to sales nevertheless remains limited.

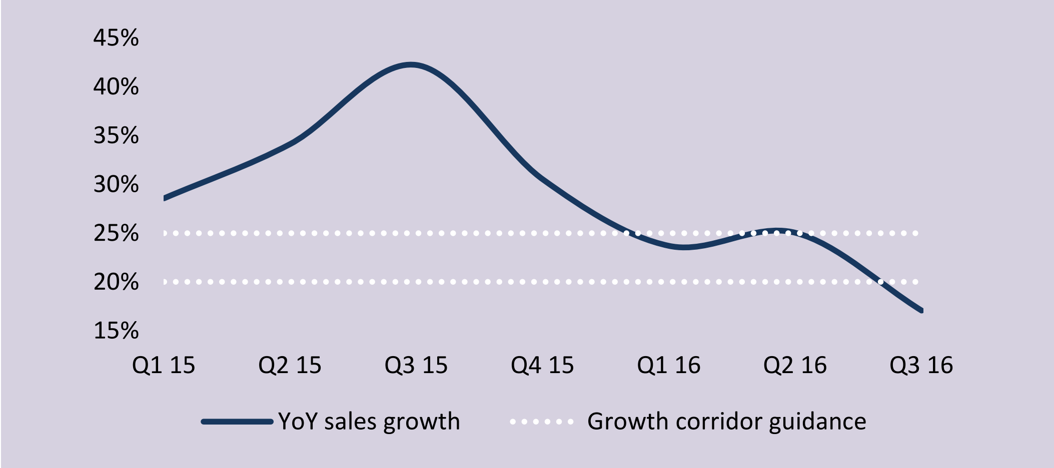
Fig. 22: Change in Zalando quarterly sales by business unit (EURm)



Source: Company Data; Bryan, Garnier & Co ests.

So far, management has proved to be conservative in terms of sales growth guidance, given that the group has exceeded the upper end of the target range every year since the IP0 (i.e. 20-25% growth).

Fig. 23: Change in growth relative to guidance

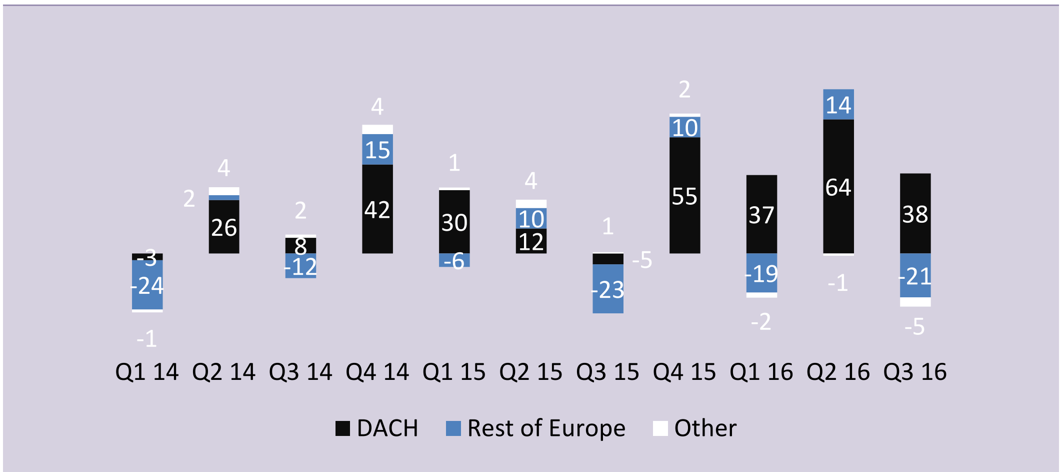


Source: Company Data; Bryan, Garnier & Co ests.

1.4.2. Bottom line

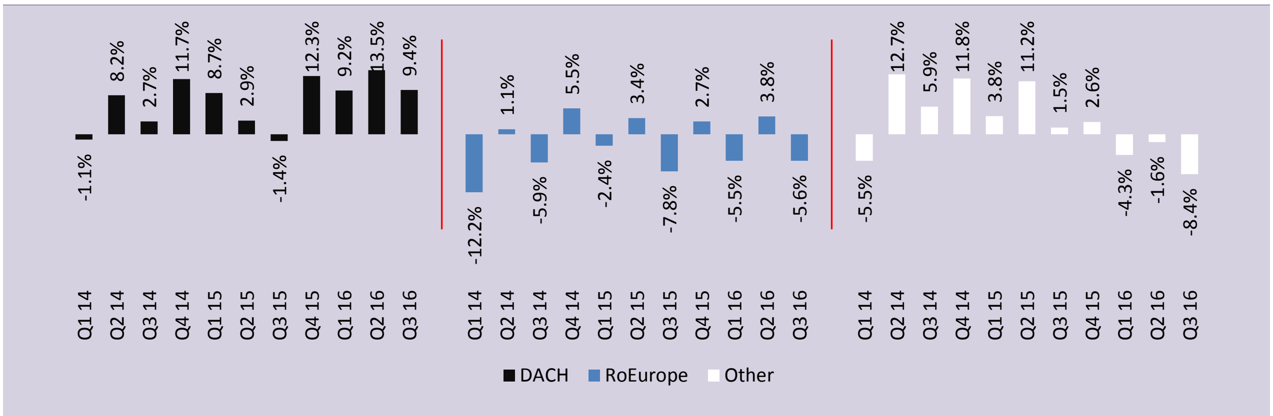
The degree of maturity of countries is reflected in the operating margin level released by the group. The rate reached 5.8% at the end of 2015 in the DACH region (growth of 28% in 2015), whereas the rest of Europe had a negative rate of -0.8% (sales growth of 40% in 2015). Profitability in the "others" segment remains penalised by Zalando Lounge, whose business model based on granting significant promotions damages the margin.

Fig. 24: Change in Zalando quarterly EBIT by business unit (after SBC costs)



Source: Company Data; Bryan, Garnier & Co ests.

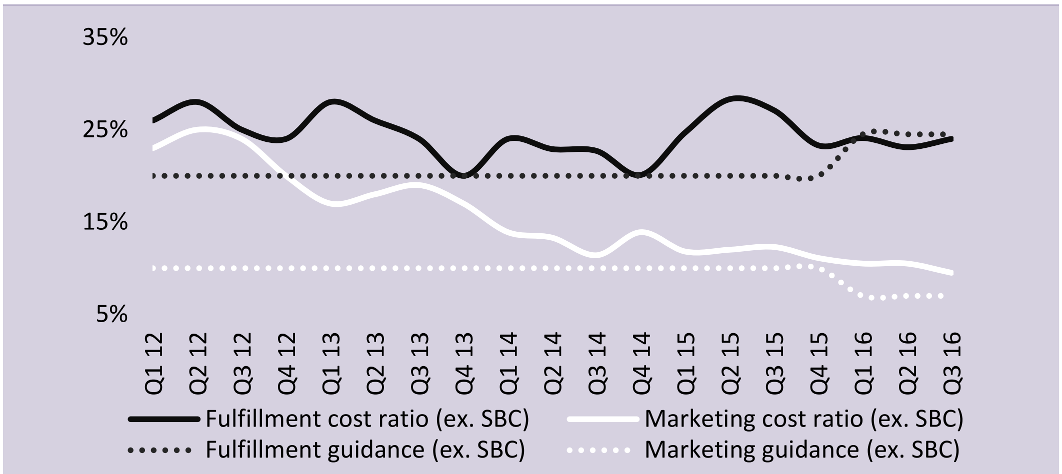
Fig. 25: Change in operating margin by region (after SBC costs)



Source: Company Data; Bryan, Garnier & Co ests.

As for the majority of rivals, logistical and marketing costs represent a dominant share of Zalando's sales (one-third in Q3 2016). Whereas marketing costs have not stopped falling (reaching critical mass and economies of scale), logistical costs have tended more to stagnate (extension of distribution network, extension and opening of new logistics centres).

Fig. 26: Changes in handling costs and logistics costs (% of sales, ex. SBC)



Source: Company Data; Bryan, Garnier & Co ests.

As such, guidance for fulfilment costs (24/25% of sales excl. Stock Based Compensation costs further out vs. 23.7% in 9M 2016) prompts questions. Their change is dependent on the opening and rise in momentum of future centres in Paris and Stettin in Poland (the automation of which is set to be less pronounced than at Lahr). As far as marketing costs are concerned, management estimates that they could reach 6/8% of sales excl. SBC costs further out vs. 10.2% in 9M 2016.

In view of these parameters, adjusted EBIT margin forecasts (before equity-settle share-based payment) for 2016 have been lifted twice: **1/** the first time (just before the Q3 publication) to 4-5.5% vs. 3-4.5% initially; **2/** the second (during H1) to 5-6% vs. 3-4.5% previously. H1 already showed a margin of 5.9%.

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Distribution of stock ratings

BUY ratings 00%　　NEUTRAL ratings 0%　　SELL ratings 00%

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