INDEPENDENT RESEARCH

28th November 2016

Consumer durables

Fashion

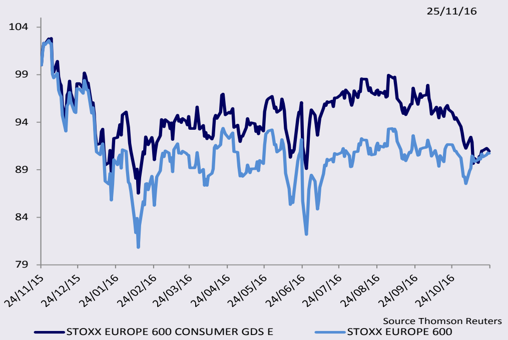
Serving Consumers not Uberising Them!

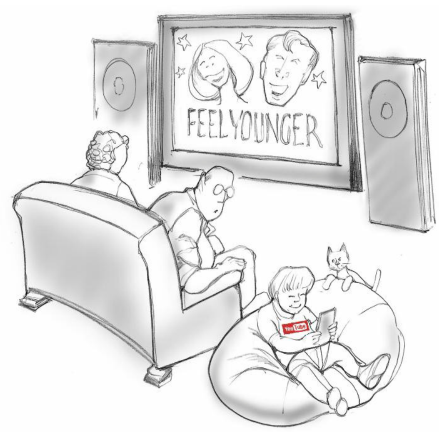
H & M		NEUTRAL	FV SEK295
Bloomberg	HMB SS	Reuters	HMb.ST
Price	SEK271,7	High/Low	SEK325,7/236,6
Market cap.	SEK449,683m	Enterprise Val	SEK441,010m
PE (2016e)	24.3x	EV/EBIT (2016e)	18.5x

INDITEX		BUY	FV EUR38
Bloomberg	ITX SM	Reuters	ITX.MC
Price	EUR32,395	High/Low	EUR34,585/26,75
Market Cap.	EUR100,964m	Enterprise Val	EUR94,621m
PE (2016e)	31.5x	EV/EBIT (2016e)	23.0x

YOOX NET-A-PORTER		BUY	FV EUR33
Bloomberg	YNAP IM	Reuters	YNAP.MI
Price	EUR25,81	High/Low	EUR35,65/19,6
Market Cap.	EUR3,502m	Enterprise Val	EUR3,453m
PE (2016e)	50.9x	EV/EBIT (2016e)	35.6x

ZALANDO		NEUTRAL	FV EUR39
Bloomberg	ZAL GR	Reuters	ZALG.DE
Price	EUR36,115	High/Low	EUR40,35/23,035
Market Cap.	EUR8,930m	Enterprise Val	EUR8,133m
PE (2016e)	69.5x	EV/EBIT (2016e)	41.1x





There are consumers to serve but who cannot be made subservient. Considering them as a kind of hermit, wandering shamelessly through an overpopulated digital desert is a degrading vision that contradicts their desire for authenticity. Although we believe in digital, we consider it cannot substitute real people and that physical stores, which are a millennium institution, will remain at the heart of commercial facilities.

- Every day we read that: the world-leading taxi-company has no car fleet (**Uber**); the leading hotel company has no accommodation (**Airbnb**); one of the most powerful retailers has no stocks (**Alibaba market place**); the most popular media firms create no content (**Twitter & Facebook**); the leading manager of leisure video contents operates no cinema (**Youtube**); a top-notch telephone company can function without infrastructure (**WhatsApp, Apple, Facebook**)... In short, orchestrated by the Millennial generation, the digital (r)evolution is not about to happen, it is already underway. Its commercial format, e-commerce (2012/15 CAGR of 15%e in Europe), goes hand in hand with the shortfall in growth at traditional retailers (2012-15e CAGR of 1.4%e in Europe).
- E-commerce players that have been successful only share the common denominator of a coherent offering, which we consider fits into one of four main models. **In the first**, 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 on the same site". **In the second**, a web category killer such as **Zalando** (initiated with a Neutral rating, FV@EUR39) 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**, the expertise of a **YNAP** (initiated with a Buy rating, FV@EUR33) is so great in a niche segment that it is difficult for 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). In this field, we initiate coverage of **Inditex** at Buy (FV@EUR38) and **H&M** at Neutral (FV@SEK295).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1. The digital (r)evolution?

1.1. The main points

1.1.1. In the beginning, there were the Millennials…

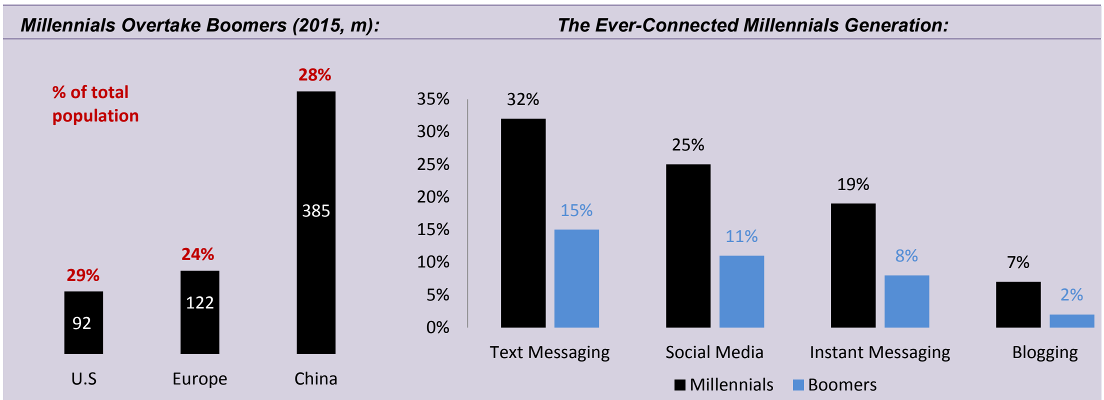
"Millennials" vs "Baby boomers"

To caricature, the Millennial, armed with his smartphone, is sprawled on the carpet in his room, drinking the words of a young Youtuber. Meanwhile, his grandfather is lounging in his leather club chair, envying the exploits of James Bond on his giant TV screen hooked up to a home cinema. Who understands this difference? However, these Millennials, or the Y generation, are at the heart of the digital (r)evolution that we attempt to decode during this report.

Born during the 1980-2000 period, the Millennials are currently dethroning the baby boom generation. They concern 385m people in China (around 28% of the total population), 122m in the EU (around 24%) and 92m in the US (around 29%). Beyond the demographical weight, this generation is set to account for more than a third of US retail sales by 2020 and even 53% of Chinese domestic demand (vs. 45% at present) according to consulting firm BCG. While this generation is not set to spend less, it is set to spend differently however!

Indeed, this generation stands out from older ones for its: **1/ hyper-connectivity** prompted by smartphones (penetration rate of 85-90% depending on the country); **2/ low attraction for property** (home, car etc.) on which sharing sites and Uber capitalise, **3/ rejection of traditional media and institutional messages, 4/ aim to create direct relations with brands,** especially via social networks. As such, banners must constantly provide them offers and no longer make do with simply welcoming these customers in their stores.

Fig. 1: The now unavoidable Millennial generation:



Source: Pew Research Center, Prosper Insight & Analytics

Does this spell the end to old economy brands? No!

With changes in purchasing behaviour, traditional brands could logically become obsolete, being replaced by **Amazon, Uber** and **Facebook**. However, in the ranking below, the US Y generation only lists three technological banners in the Top 10 of its preferred brands, only two of which are closely associated with the use of smartphones (**Apple** and **Samsung**). **Amazon** and **Google** only stand in 11th and 12th place respectively, whereas social networks and **Uber** are not even mentioned in the top 50. Two traditional retailers are present: **Walmart** and **Target.**

As far as China is concerned, since there are fewer historical brands, the Sino-Millennial generation is more affected by brands stemming from the digital revolution (**WeChat**, **Alipay** or the online retail site **Taobao**). This contrasts with western banners in the Top 10, which all belong to the ready-to-wear/sportswear category (**Adidas**, **Zara**, **Nike** and **H&M**).

Fig. 2: Brands preferred by Millennials in 2015:

Ranking	US	China (Tier 1 cities)
1	Nike	**Apple**
2	**Apple**	**WeChat**
3	**Samsung**	**Alipay**
4	**Sony**	**Taobao**
5	Walmart	Adidas
6	Target	Zara
7	Microsoft	Nike
8	Coca-Cola	Uniqlo
9	Jordan (Nike)	**Baidu**
10	Pepsi	H&M

Source: Moosylvania.com, RTG Consulting Group

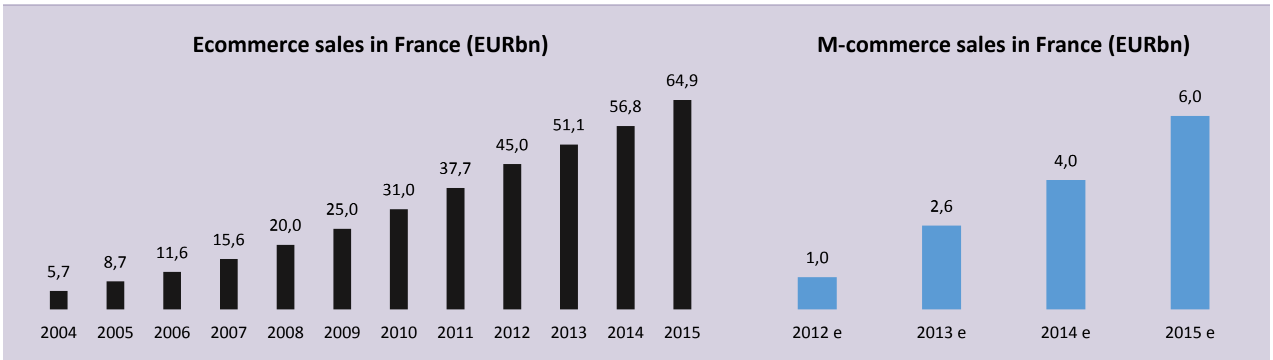
Two conclusions are conceivable and we use these as a leitmotiv in our report: **(i)** "Millennials" associate social networks and applications such as **Uber** with new "facilitating" information channels, **(ii)** the brands will not necessarily find themselves totally abandoned, but will have to adapt to new consumer methods (store closures, omni-channel strategy etc.).

1.1.2. …. and then there were the psychological markers

The leading global taxi company has no fleet of cars (**Uber**); the leading hotel company has no accommodation (**Airbnb**); one of the most powerful retailers has no stocks (**Alibaba market place**); some of the most popular media sources do not create contents (**Twitter & Facebook**); the leading manager of video contents does not operate a cinema (**Youtube**); a top-notch mobile phone company can work with no infrastructure (**WhatsApp, Apple, Facebook**)... In short, the digital revolution orchestrated by the Millennial generation is not about to happen, it is already underway and is upsetting our habits. Its commercial format, e-commerce is accompanied by salient psychological markers.

In France, for example, was **Fnac's** incredible outbidding for **Darty** (ie. 170p vs a valuation of 100p a few months previously) not symptomatic of an endemic malaise in growth and the lack of power of traditional players relative to pure internet players? And in the words of Alexandre Nodale, CEO of **Conforama**: *"Our independent advisor and our management had a clear valuation in mind for Darty. Our final offer of 160p per Darty share reflects the valuation criteria we use for every acquisition, including the return on investment* *and value creation*. The obstinacy of the small French group up against the giant **Steinhoff,** which owns **Conforama**, probably reflects a strategy of spite which, in competition with Amazon, consists of sharing costs rather than being able to dilute them via growth.

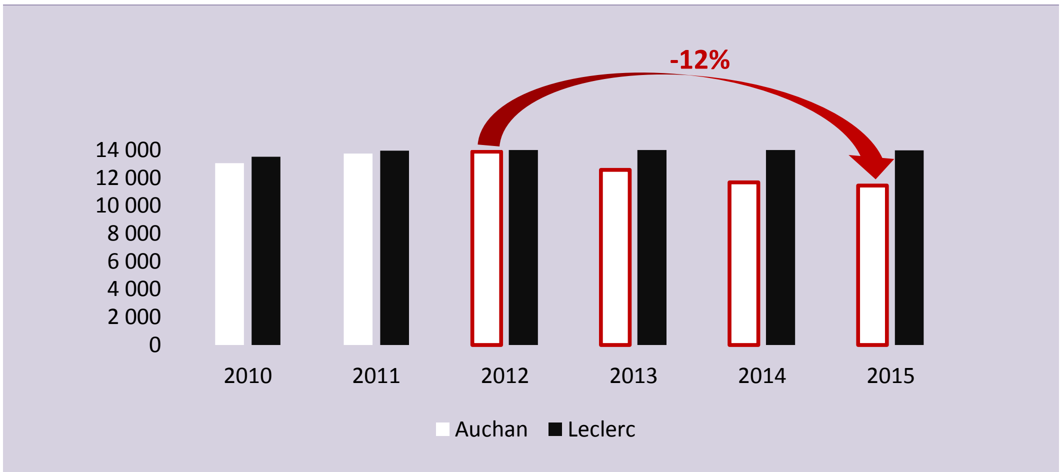
Fig. 3: E-commerce sales (B2C) and M-commerce in France:



Source: Fevad ICE; Bryan, Garnier & Co ests.

In a different tone, is it not striking that a group like **Auchan**, historically the best performer in the sector, can currently find itself in such a mess? How can the top pupil in its class suddenly find itself among the dunces as if it had lost its commercial fibre from one day to the next and stopped working talentedly? We believe that the e-commerce trend has something to do with this, especially when we take into account the size of **Auchan** hypermarkets (~10,000m² on average) and their exposure to non-food (~1/3). The comparison between the 50-year old hypermarket, a temple of consumption, and e-commerce is clearly highly symbolic. As such, we have decided to make this one of the leitmotivs of this report.

Fig. 4: Commercial density (sales per m²) at Auchan hypermarkets:



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

1.1.3. Endemic growth crisis and use of e-commerce

The need for growth naturally depends on demographics (potential for volume growth), inflation (potential increase in average basket) and market share gains over traditional players. However, today we can note **1/** apathetic demography, **2/** a de(sin)flationary trend; **3/** a saturation in the competitive backdrop, combined with a rise in capital intensity. Retailers are supposed to find a way out of this trap, in particular via top-line growth in emerging markets, and/or by optimising costs.

Fig. 5: Natural net growth in population in major countries in Europe:

%	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Belgium	0.16	0.20	0.22	0.21	0.21	0.23	0.22	0.17	0.15	0.18	0.10
France	0.43	0.48	0.45	0.45	0.43	0.44	0.43	0.38	0.37	0.39	0.30
Germany	-0.18	-0.18	-0.17	-0.20	-0.23	-0.22	-0.23	-0.24	-0.26	-0.19	-0.23
Italy	-0.02	0.00	-0.01	-0.01	-0.04	-0.04	-0.08	-0.13	-0.14	-0.16	-0.27
Netherlands	0.32	0.30	0.29	0.30	0.31	0.29	0.27	0.21	0.18	0.21	0.14
Poland	-0.01	0.01	0.03	0.09	0.09	0.09	0.03	0.00	-0.05	0.00	-0.07
Portugal	0.02	0.03	-0.01	0.00	-0.05	-0.04	-0.06	-0.17	-0.23	-0.22	-0.22
Spain	0.18	0.25	0.24	0.29	0.24	0.23	0.18	0.11	0.08	0.07	-0.01
United Kingdom	0.23	0.29	0.32	0.35	0.37	0.39	0.40	0.38	0.32	0.32	0.27
EU (28 countries)	**0.09**	**0.10**	**0.12**	**0.10**	**0.10**	**0.10**	**0.08**	**0.04**	**0.02**	**0.04**	**-0.03**

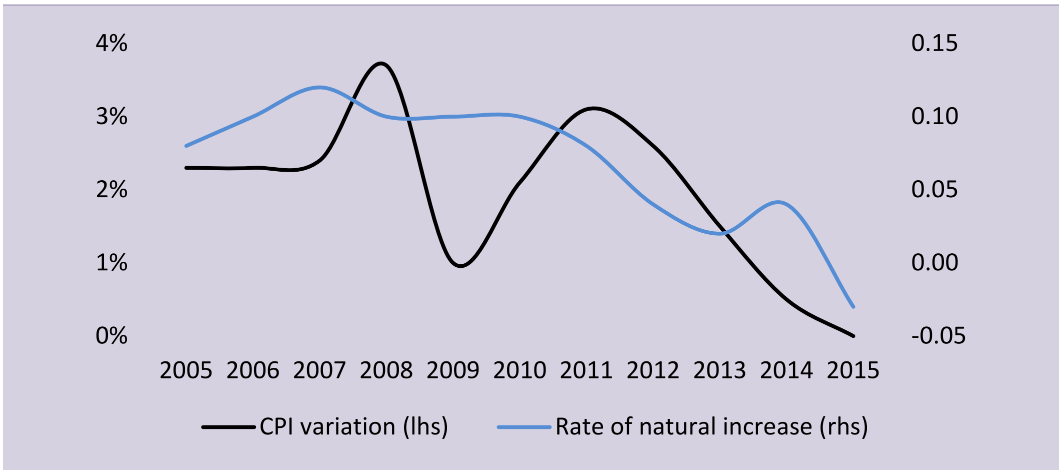
Source: Eurostat; Bryan, Garnier & Co ests.

Fig. 6: Average annual change in inflation (CPI) in European countries:

%	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Belgium	1.7	2.3	1.8	4.5	0.0	2.3	3.4	2.6	1.2	0.5	0.6
France	0.1	1.9	1.6	3.2	0.1	1.7	2.3	2.2	1.0	0.6	0.1
Germany	0.4	1.8	2.3	2.8	0.2	1.1	2.5	2.1	1.6	0.8	0.1
Italy	-0.1	2.2	2.0	3.5	0.8	1.6	2.9	3.3	1.2	0.2	0.1
Netherlands	-1.2	1.6	1.6	2.2	1.0	0.9	2.5	2.8	2.6	0.3	0.2
Poland	2.1	1.3	2.6	4.2	4.0	2.6	3.9	3.7	0.8	0.1	-0.7
Portugal	-0.6	3.0	2.4	2.7	-0.9	1.4	3.6	2.8	0.4	-0.2	0.5
Spain	3.2	3.6	2.8	4.1	-0.2	2.0	3.0	2.4	1.5	-0.2	-0.6
UK	1.5	2.3	2.3	3.6	2.2	3.3	4.5	2.8	2.6	1.5	0.0
EU (28 countries)	**2.3**	**2.3**	**2.4**	**3.7**	**1.0**	**2.1**	**3.1**	**2.6**	**1.5**	**0.5**	**0.0**

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

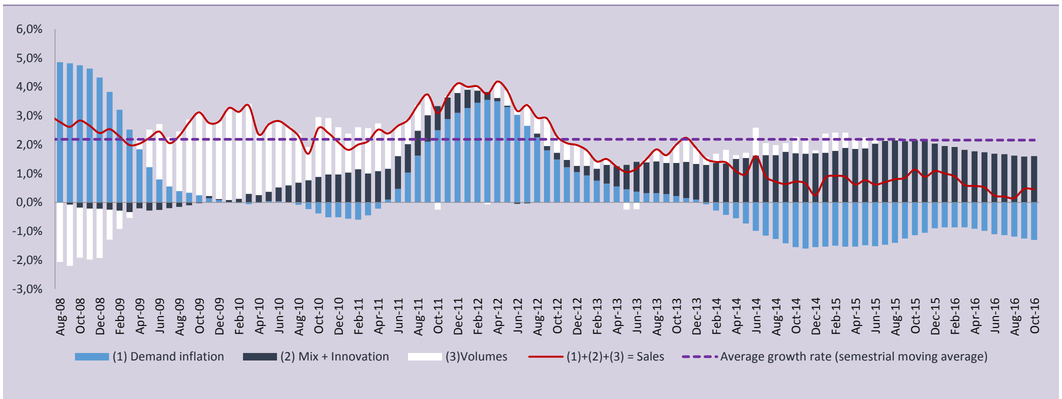
Fig. 7: Natural net growth in population vs. inflation in Europe:



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

The major concern is that **1/** emerging markets have run out of growth while **2/** the cost base, which cannot be scaled back significantly without hurting the business base, has already been widely optimised since the beginning of the crisis at many retailers. At the end of the day, fundamentals (demography and inflation in particular) penalise domestic bases, whereas emerging markets no longer offer the guarantees they did in the past. Today, retailers therefore need to fight and beg with consumers for a few measly points of growth by fine-tuning their offering. This is why, for example, growth in fast-moving consumer goods (hypermarkets and supermarkets) in France is currently exclusively driven by a positive mix-innovation effect (+2.2% YTD according to Nielsen), that offsets demand deflation (-1.3% YTD).

Fig. 8: **Breakdown of growth at French hypermarkets and supermarkets on the basis of a half-yearly moving average:**



Source: IRI; Bryan, Garnier & Co ests.

In the end, the need to deploy digital activity comes as growth in mature markets is fading into the twilight. Indeed, since 2011, sales in European retailing have grown 1.4% annually, underpinned by digital (BtoC), which has posted average growth of 17%! And in this anaemic backdrop, we are convinced that e-commerce should be considered as a non-price competitiveness factor, or the cost of acquiring new customers, in order to defend a piece of a pie that is not getting bigger.

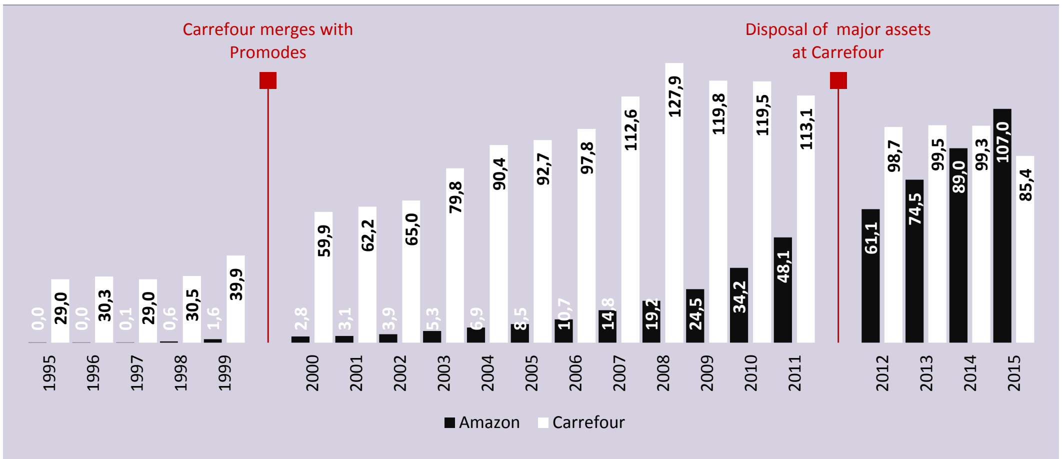
Fig. 9: Retail growth rate (including internet) and growth in e-commerce (B2C) in Europe:

	B2C (world)	B2C (Europe)	Retail sales*	GDP
2011	**USD968bn**	**18.4%** (EUR246bn)	2.4%	1.8%
2012	**USD1,196bn**	**17.7%** (EUR290bn)	1.2%	-0.3%
2013	**USD1,537bn**	**22.0%** (EUR354bn)	0.5%	0.5%
2014	**USD1,895bn**	**13.6%** (EUR402bn)	1.3%	1.8%
2015	**USD2,273bn**	**13.3%** (EUR455bn)	1.7%	2.6%
2016e	**USD2,671bn**	**12.0%** (EUR510bn)	NA	NA

** Retail trade, except of motor vehicles and motorcycles*

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

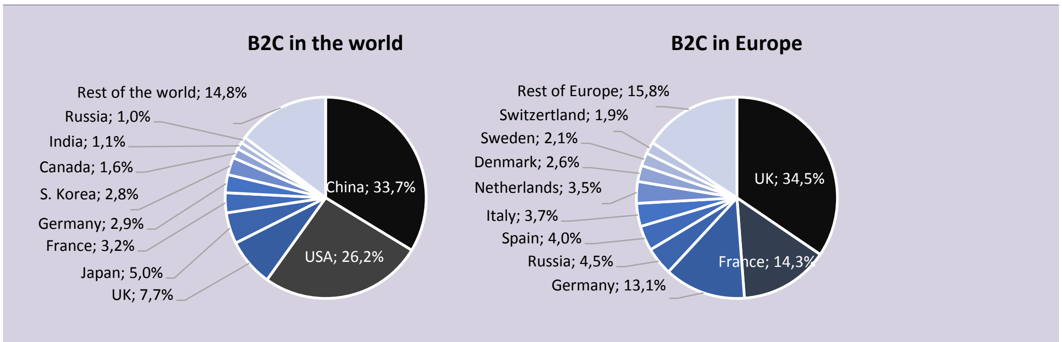
Fig. 10: Sales (USDbn) at Carrefour and Amazon:



NB: of course, this graph contains a bias due to the EUR/USD exchange rate. Nevertheless, it provides us with a good idea of the trends.

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

Fig. 11: Market share of various countries in overall B2C in the world and in Europe (2015):

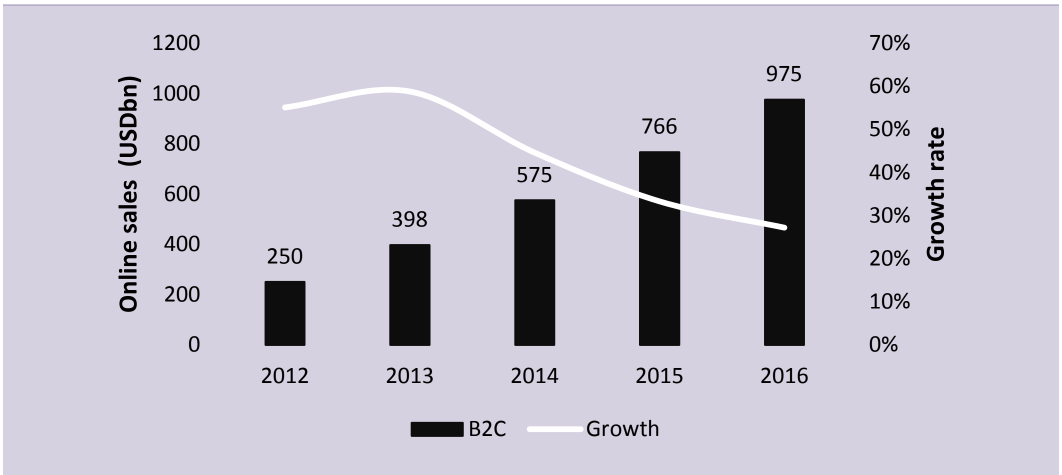


Source: E-commerce in Europe; Bryan, Garnier & Co ests.

1.1.4. The Chinese (e-commerce) and African (m-commerce) syndromes

In order to get an idea of the challenges of e-commerce, we have looked at emerging markets and the statement made by **Alibaba's** CEO for France, Sebastien Badault, about China (June 2016). Indeed, shortfalls in infrastructure have often turned new industrialised countries into digital innovation laboratories. It is therefore interesting to see what happens in these countries to assess what could happen in Europe. The example of China, which has witnessed a boom in e-commerce proves that things can change very quickly *("growth in e-commerce has been stupendous and in coming years is set to represent 42% of growth in retailing and 50% of this growth stems from rural areas… there are five product categories where e-commerce exceeds 40% of retail sales. In France, even in the strongest product categories, this level is closer to 20%. By 2020 in China, e-commerce is likely to represent more than 40% of sales in around 20 product categories")*.

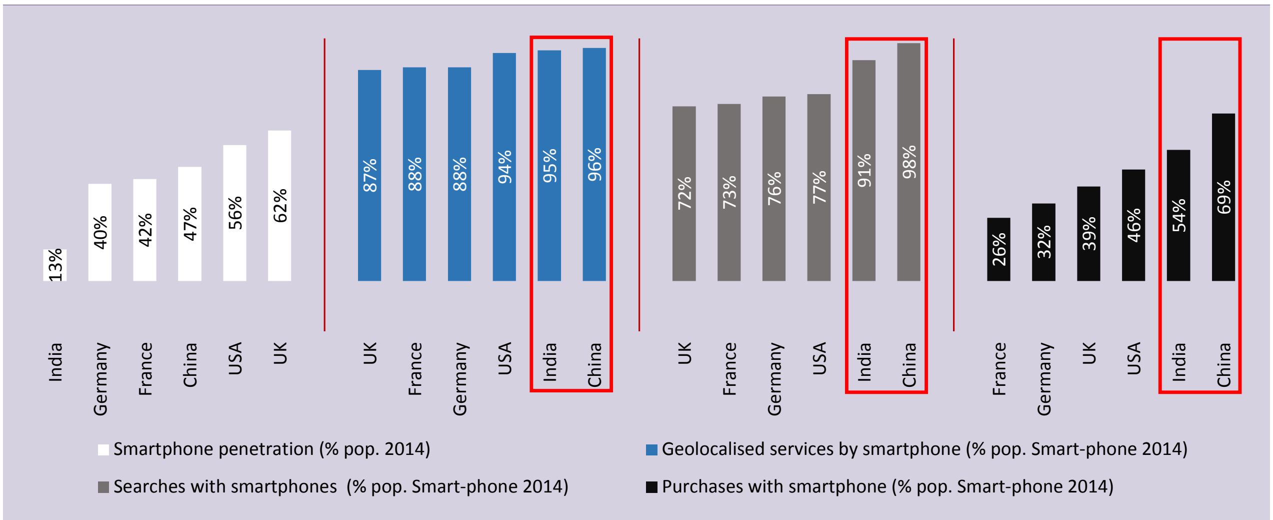
Fig. 12: Growth in e-commerce in China:



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

Since smartphones are an alternative to lacking IT equipment, we focus especially on m-commerce, which is taking off in emerging markets (*"In Europe, sales made via smartphones only account for 5-10% of overall sales. In China, 72% of purchases are made using a mobile device […]. AliPay on mobile, for example, has 400m users that not only buy products with their phones, but also pay for their coffees, cinema tickets, and rents as well"*). In July 2015, Orange therefore negotiated with the leading mobile phone operator in India, **Bharti Airtel**, to acquire four of its subsidiaries in Africa (Burkina Faso, Congo-Brazzaville, Sierra Leone and Tchad). In April 2016, alongside **Axa** and **Goldman Sachs**, it also took a stake of EUR75m in **Africa Internet Group (AIG)**, which owns the e-commerce site of African group **Jumia** and other websites present in the continent (**Kaymu**, **Hellofood**, **Jovago**, **Lamudi**, **Everjobs** and **Carmudi**).

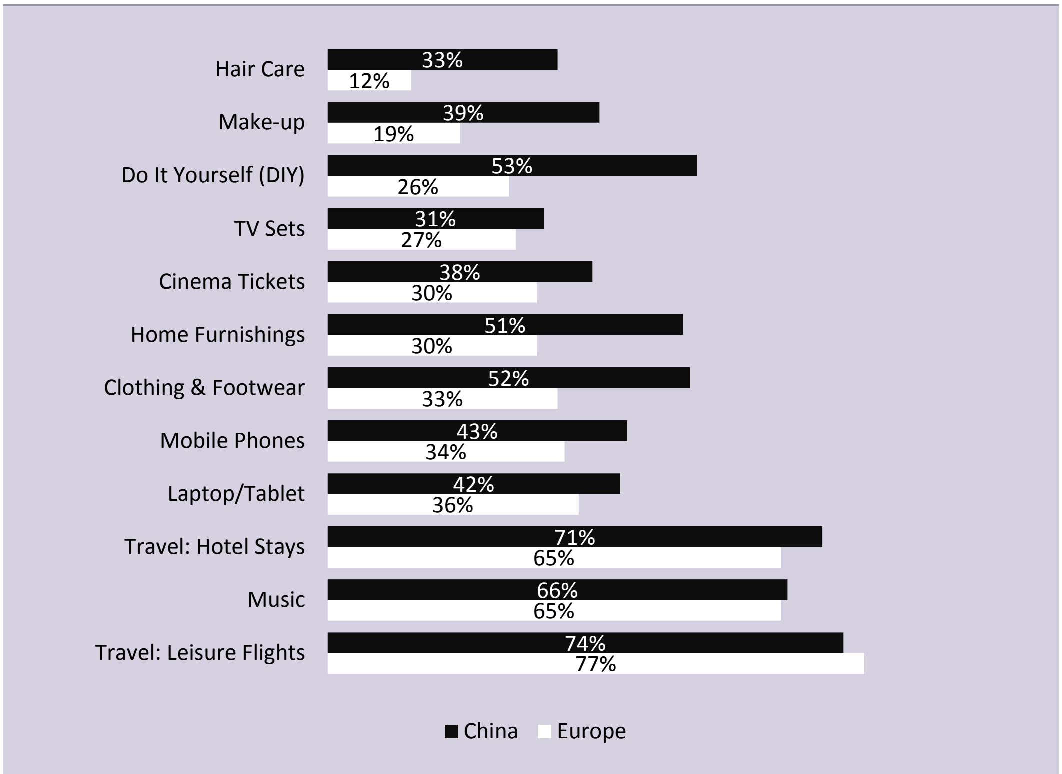
Fig. 13: Use of smartphones in emerging markets:



Source: Oliver Wyman; Bryan, Garnier & Co ests.

M-commerce is clearly driven by a new generation of consumers (Milllenials) ridding themselves of institutional messages *("The changes in China are also linked to a new generation of consumers: young people. 63% of growth is driven by young people")* and proving to be particularly fickle *("these consumers are looking for new products and things that other people don't have. They are not at all loyal to brands.")*. For traditional retailers, capturing this erratic consumer *("on average, a young Chinese consumer has seven contact points with a seller before buying online. Whereas we westerners favour e-commerce because it is practical, for them it is different, e-commerce is a hobby")* implies multiplying contact points (i.e. a omnichannel approach) and controlling the digital ecosystem.

Fig. 14: B2C sales by market segment in Europe and China (i.e. % of 2015 sales generated via internet):



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

***PS:** we have noted wide variations between estimates from different sources (E-commerce in Europe, Euromonitor, eMarketer etc.), which currently provide data on e-commerce. What interests us however, in this case, is the contrast that might exist between Europe and China….*

1.2. Financial equation of the "average" traditional player in the digital era

1.2.1. Fixed costs and sales mass

Clearly, the financial equation for a food-retailer is not the same as that of a textiles or household goods retailer. Asset turnover, the contribution margin and the fixed-cost structure differ considerably. Let's take for example an "average" retailer in order to illustrate the febrile nature of the financial equation for certain traditional operators in view of the ramp-up in e-commerce.

For our average retailer, fixed costs, which evolve independently of sales (overheads, IT, D&A etc.) represent a significant share of the P&L account (let's say 15% of sales). All other factors remaining equal, sales must therefore increase in order for the contribution margin (gross margin - variable operating costs, let's say 20% of sales) to cover fixed costs.

Apart from the erosion in natural growth factors, the difficulty for the company lies in the fact that these fixed costs, albeit independent of sales levels, are nevertheless affected by the natural cost inflation (~1.5%e in mature countries). To offset these effects, annual sales must therefore increase, if only by 1.5% lfl.

1.2.2. Financial equation compromised by anorexic growth

In a backdrop of anaemic growth, the retailer needs to bravely defend its share of a pie that is not getting much bigger in size. It needs to feed inter-brand competition (between rival products within a same store) in order to escape intra-brand competition (between rival stores selling the same product). Hence, the importance of the customer experience to retain consumers (queues for check-out, availability of products, quality/price, atmosphere etc.).

Indeed, the more a customer is loyal to a brand, the lower demand elasticity is and the higher margin potential is. As such, the aim of the retailer is to make its customers loyal to the extent that the constraint of having to change banner becomes a problem. **Monoprix**, in view of its exorbitant price positioning, probably backs this gamble (9% of **Monoprix'** most loyal customers generate 45% of its sales!).

1.2.3. Abolishing borders, fragmentation of media and flighty consumers

The process is all the harder in that consumers are ungrateful by nature. In food retailing in France, the brand loyalty indicator (which measures the banner's market share with its customers) only stands at 18% on average (vs. 32% in the best cases), whereas a customer visits around six different banners on average.

E-commerce, which removes physical barriers and multiplies possibilities, clearly heightens the consumer's flighty nature. Since the media is fragmented, consumers are increasingly less confident in institutional messages (health recommendations, advertising, corporate communication etc.), obtain information on social networks (the Millennial generation that adores its Youtubers) and wander shamelessly, depending on their influences, from one channel to another. E-commerce as a non-price competitiveness factor, therefore becomes extremely important for retailers to defend their own corner and capture new customers.

1.3. What consequences can we see?

1.3.1. Faced with e-commerce, only the most profitable stores are protected

Note that for our "average" retailer, the financial equation is based on a contribution margin and fixed costs of around 20% and 15% respectively, such that operating margin does not exceed 5%. Consequently, *ceteris paribus*, a 20% reduction in sales in favour of e-commerce (as we can probably see at the most vulnerable retailers), would wipe out any profits. In segments in the front line in terms of e-commerce (especially low-rotation non-food products), the sanction can be extremely fast. As such, the more profitable a store is, the longer it can shoulder an erosion in traffic to the benefit of internet sales, while continuing to create value and generate cash.

1.3.2. What about a collapse in volumes and a decline in the store network

The boom in e-commerce could have contagious effects on the traditional industry. In concrete terms, the least profitable entities could probably close a large share of their network, with, it goes without saying, hefty consequences in terms of territorial density, commercial negotiating clout and capacity to dilute the fixed cost base.

Post-disruption, once e-commerce has reached the market share that it should naturally have (who knows what this is? in the early 2000s, observers estimated it at 20% for FMCG), the survivors (i.e. the most profitable niche segments) would finally evolve into a cleaned-up and less competitive residual brick & mortar market.

We therefore favour these players. Clearly, we have a positive vision of category killers such as **Primark**, **H&M** and **Inditex**, which post operating margin of 15% on average. We believe in these institutions, which place the customers' desires at the heart of the debate.

Fig. 15: Operating margin of main players by consumption segment:

	2013/15 Sales CAGR	2015 EBIT margin
Ahold Delhaize	4,8%	3,7%
Carrefour	-0,2%	3,2%
Tesco	-1,7%	2,2%
Metro	-4,0%	2,5%
Average	**-0,3%**	**2,9%**
Dixons	-0,1%	3,9%
Fnac Darty	0,4%	2,1%
Kingfisher	0,4%	6,3%
Media Markt Saturn	1,3%	3,2%
Average	**0,5%**	**3,9%**
H&M	14,3%	15,0%
Inditex	8,6%	17,8%
Primark	12,8%	~13,5%
Hugo Boss	6,5%	16,8%
Average	**10,6%**	**16,5%**
Burberry	10,6%	17,9%
Hermes	11,8%	31,6%
Kering	5,5%	14,4%
LVMH	8,3%	18,4%
Average	**9,1%**	**20,6%**
Essilor	10,5%	18,2%
L'Oreal	4,0%	17,5%
Luxottica	8,0%	16,3%
Seb	5,3%	8,2%
Average	**6,9%**	**15,0%**

Source: Datastream; Bryan. Garnier & Co ests.

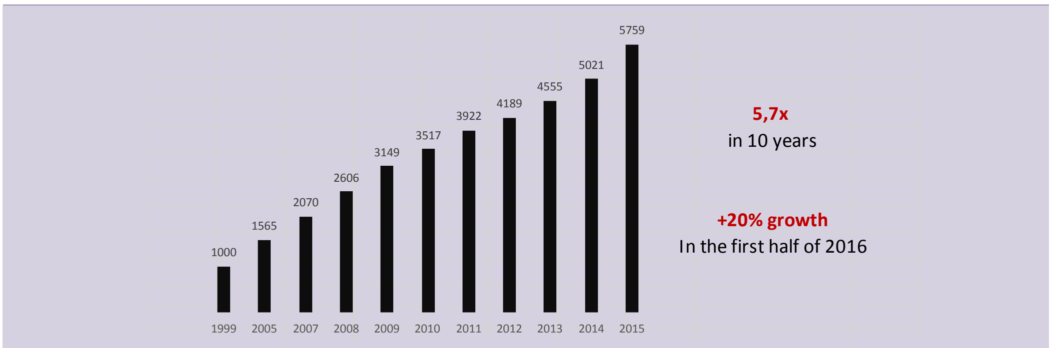
1.3.3. In an overpopulated internet desert, are we digital hermits?

"I believe that human beings will take control of their lives. I refuse the idea that new technologies will totally govern our lives. For this reason, we are maintaining our physical stores and quality of service and this is not a technological stance, but a philosophical stance. If we can merge the two stances, that would be a success", stated Georges Plassat recently (the digital review 30th June 2016). Some observers could raise their eyebrows at this, bearing in mind that Carrefour is currently being sanctioned for its e-commerce strategy. It nevertheless sums up a sociological movement that could seem contradictory at first glance.

We believe that digital, this informational fast-food, carries the seed of its own questioning. Indeed, influenced by the crowd of Youtubers and trendsetters, consumers are ridding themselves of institutional messages, which in their view, are becoming vehicles to serve the interests of the upper castes. Why is breakfast the most important meal of the day? Because this clearly suits the cereal agri-food lobby! Five servings of fruit and vegetables a day? Where is the academic reasoning behind this? etc. etc. And among all this cacophony, consumers sometimes prefer to rely on what is fixed and constant and needs no justification, that is to say nature.

NB. *The food segment illustrates very well this desire to return to nature. Millennials, in particular, pay strong attention to natural well-being. Very concerned about food ethics, they favour "organic" and "local" products containing no sugar, salt, gluten etc.… We remain astonished by growth rates of 15-20% for **1/** the French organic food market (EUR5.8bn in 2015 according to Agence Bio), underpinned in particular by agri-food scandals ("horsegate", palm oil, carcinogenic products etc.), longer lifespans and the health concerns associated with this. Similarly, we are dumbfounded by the deployment of banners selling **2/** fresh products, such as Grand Frais (170 stores for sales estimated at EUR700m in 2015 vs. EUR400m in 2012 and a margin probably well above standards in retailing), that a group like Carrefour (already no. 1 reseller of organic products in France...) would have every interest in studying closely. Added to this, **3/** regional products that are surfing on the "made in France" wave and the retailer possibly has a triptych of a future in an anaemic growth backdrop (something that Carrefour seems to have picked up on very well...).*

Fig. 16: Organic products market in France since 1999 (EURbn):



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

Because substituting physical for digital means cutting off social ties, masking the singularity of each person and making consumers digital hermits that are stuck in symmetrical consumption modes and social relations. And this is why the passion for digital goes hand in hand with a return to nature. Vintage decoration and old vinyl records, flea-markets and car-boot sales, local produce and our grandmothers' recipes […], are all anachronisms that are nevertheless the stuff of successful TV shows (Top Chef, Home Staging, Whealer Dealer, Antics Roadshow…).

And as Mr Plassat concludes: *"if, in the future, our customers need an indicator on their fridge telling them that they need milk, then we should be worried"*. As such, the aim is to place the customer at the heart of data, but clearly not to hide the customer in this data (to serve them not make them subservient). We believe that nothing can substitute the pleasure for consumers of choosing their own fruit, trying on a dress, pushing their way through a crowd, negotiating and becoming angry with a stall owner, reading a cartoon book or smelling the scent of paper. And physical stores, as a meeting point, are a millenium institution (**Zalando**, **Amazon**, **LDLC** and others are actually opening them) and store networks, a comparative edge for traditional players.

1.4. Retailers do not know which saint to worship

1.4.1. A wave of panic has taken hold of Wal-Mart…

A degree of panic has taken hold of the most emblematic retailer. Indeed, **Wal-Mart** rode with conviction into the battle for free delivery just as Amazon started to eat into its customer base. The giant replied in early July with a commercial operation in favour of its pilot programme for free delivery, the Shipping Pass, offering free deliveries to its customers for a one-month period. Fernando Madeira, Chairman and CEO of **Walmart.com** pointed out: *"ShippingPass costs half the price of another similar programme, namely $49"* (i.e. **Amazon's** premium service billed at $99, which in reality also includes a video, music and ebook on demand subscription).

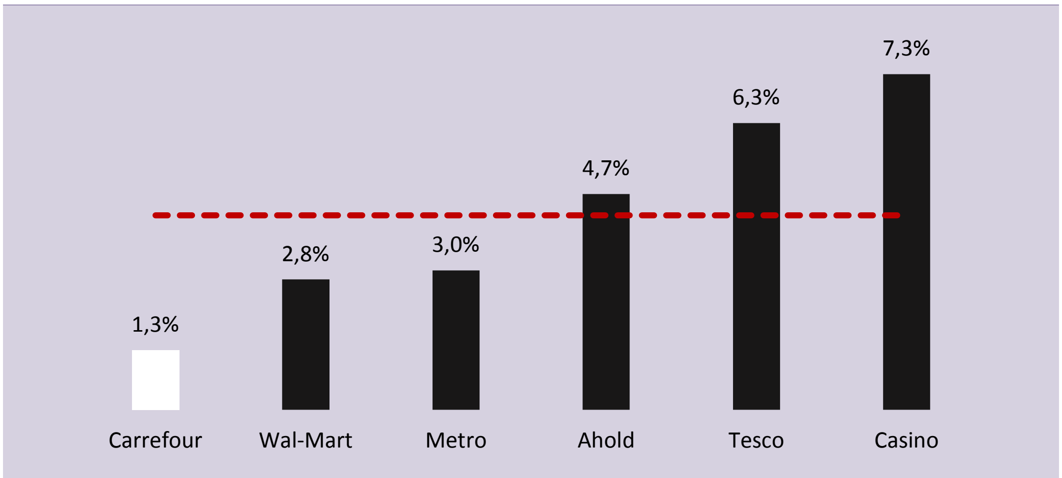
This initiative by **Wal-Mart** came after Q1 2016 results were presented, when CEO Doug McMillon, stated that growth in the e-commerce business (+7% over the period), was *"too slow"*. In addition, the US retailer has joined forces with Uber and Lyft drivers to deliver shopping done over the internet and continued to roll out drives in the US. Today, e-commerce represents around 3% of **Wal-Mart's** sales or a lofty EUR12.9bn. These strong initiatives contrast clearly with what some would call the wait-and see attitude at **Carrefour**.

1.4.2. … whereas the market is complaining about Carrefour's wait-and-see (?) attitude

The market has criticised Carrefour's lag in the e-commerce segment, with Mr Plassat arguing that there is no point in leaping head first into an unprofitable adventure. This stance for and against all was clearly sanctioned with the Carrefour share plunging 15% (vs. -7% for the index) in the two months following the Q1 2016 results presentation during which management gave its non-consensual message on e-commerce.

In the food segment for example, drive services now account for EUR5bn in France. Investors are surprised that a segment enjoying double-digit growth is of no interest to **Carrefour** during this sluggish growth period (and where every commodity offered provides another reason for consumers to favour one banner rather than another). Even if **Carrefour's** diagnosis of profitability is correct, investors are surprised at the low level of sales generated by the group in e-commerce (1.3% of 2015 sales).

Fig. 17: Estimate of 2015 e-commerce sales at food retailers (% of sales):



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

However, a retailer such as **Casino**, which was quick to launch its e-commerce via a pure-player vehicle (**Cdiscount**), has also been sanctioned on the subject. In the end, we have the feeling that investors do not know which saint to worship (should e-commerce be viewed as a vector for profitability or as an acquisition cost for new customers?). Mr Plassat's most ardent defenders would underscore the CEO's composure and his very just categorical imperative of profitable growth. However, we believe that certain pure player models can be exactly this. Depending on how traditional players react, they are either a threat or a vector for positive change.

***NB:** In reality, we believe that Carrefour is not in such a wait-and-see mode as it might seem (see our report: Tending towards premiumisation?). Since 2012, it has been reinforcing the ecosystem of its digital strategy at the service of consumers, that is likely to ensure its sustainability relative to pure internet players (**1/** acquisition of shopping galleries, **2/** densifying the network; **3/** moves upscale, particularly with organic, fresh and local products).*

1.4.3. What e-models are actually likely to create value?

In all eyes, the success of **Amazon** was probably irretrievable. In contrast, who could have foreseen the success of a company specialised in sock sales (**meschaussettesrouges.com**), which obtained exclusive web distribution rights from the Gammarelli family (the official Rome-based papal tailor specialised in ecclesiastical clothing) for red cardinal socks? Today, a number of models are likely to create value and are therefore a threat (or an opportunity?) for traditional players.

There is no indivisible truth and the e-commerce players that have enjoyed a huge success only share the common denominator of having a coherent offering, which seems to break down into four main models at present:

- In the first, 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 on the same site".

- In the second, 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, the expertise of a **YNAP** is so great in a niche segment that it is difficult for 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).

For each of these categories, profitability is a key point in our investment case. And there is no compromise. Indeed, we estimate that the fabulous prospects that e-commerce players show us do not rule them out from the value creation imperative that is specific to all financial undertakings. And so far, the players that have managed to show a clean bill of health are rare...

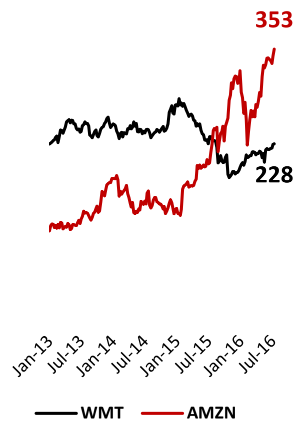
We review these four models throughout this report, in which we initiate coverage of **Zalando** with a Neutral recommendation (FV of EUR39), **Yoox Net-A-Porter** with a Buy recommendation (FV of EUR33), **H&M** with a Neutral recommendation (FV of SEK295) and **Inditex** with a Buy recommendation (FV of EUR38). These four companies each correspond to one of the four archetypes that we have described above.

2. Digital?

2.1. The web hypermarket: Amazon

2.1.1. The Amazon war machine

Market cap of Wal-Mart and Amazon (USDbn):



Source: Datastream

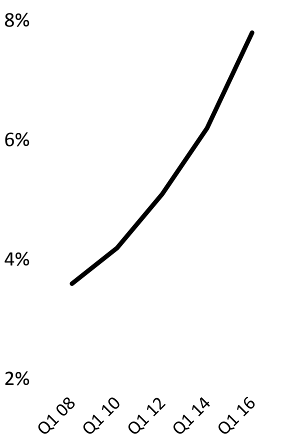
Amazon is one of the major symbols of this shift in consumption methods to e-commerce. The handover between the new economy giant and the no.1 in traditional retailing took place during July 2015 when Amazon's market capitalisation exceeded that of **Wal-Mart**. At present, the online site founded by Jeff Bezos in 1997 weighs 1.5x heavier than its traditional retailing rival!

This cross-over in the curves has not stemmed from sales volumes since sales at **Amazon** in 2015 (USD107bn) represented barely a quarter of those generated by **Wal-Mart** (USD482bn in 2015). In addition, **Amazon** is barely profitable (2.1% EBIT margin in 2015 vs. 5% for Wal-Mart), bearing in mind that margin improvement has never been one of the priorities in a business model based essentially on FCF generation (see elsewhere). And ultimately cloud services (AWS) drive profitability (around 7% of sales but 41% of EBIT).

So what do investors find so appealing about **Amazon**? We see two main reasons: **(i)** the feeling that Amazon will continue to play an active role in the development of e-commerce (the website already accounted for 12% of overall B2C sales in the US!) with, consequently, **(ii)** momentum that should remain very robust in terms of top-line growth (2015-20e CAGR of 19% whereas traditional retailers are faced with a growth crisis). We will see that these two reasons are totally relevant as far as the textiles and accessories market goes, this being the cornerstone of this report.

2.1.2. The impact of Amazon on the US textiles and accessories segment

Weight of e-commerce as a % of total retail sales in the US:



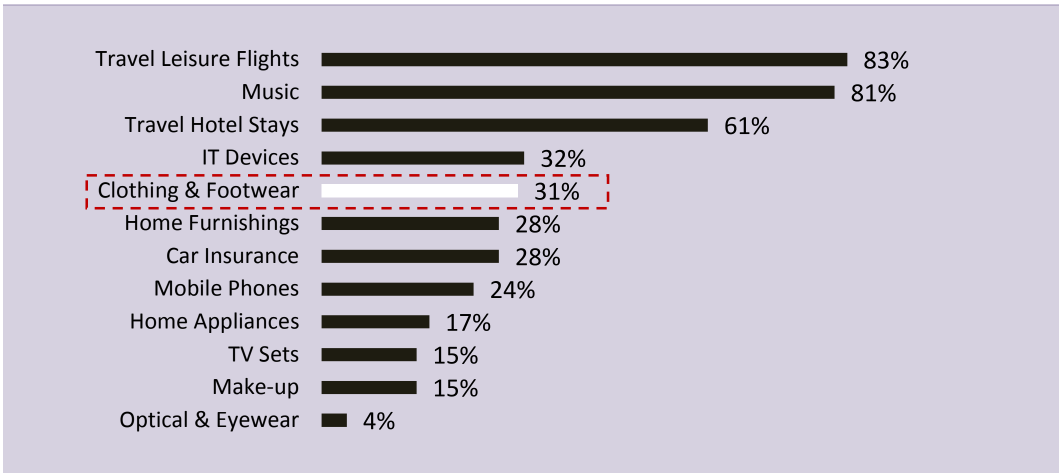
Source: U.S. Census Bureau

Although the rising momentum of e-commerce is global, the US is the country where the impact on traditional retailing is the most noticeable. **The online circuit accounts for around 8% of US retail sales in Q1 2016,** and as shown in the chart opposite, it grows by around one point a year (i.e. annualised growth of around 16%).

Nevertheless, its importance is spread more unevenly between the various retailing segments, as shown by the chart below. **The textiles and accessories segment is particularly concerned since 31% of clothing and shoes purchases in the US were made online last year,** double the amount for make-up sales (15%)!

The roll-out of omnichannel strategies by multi-brand retailers (e.g. department stores) and banners (e.g. **Ralph Lauren** whose internet sales represent more than 12% of total sales) contributed to the development of e-commerce. However, in our view, the important factor concerns **Amazon's** breakthrough in clothing sales. The website only entered the textiles and accessories segment in 2002. However, according to a number of experts, it already generated sales of around USD16.3bn (around 26% of its sales in North America) in the segment in 2015.

Fig. 18: Penetration rate of online circuit in 2015 by segment (US market):

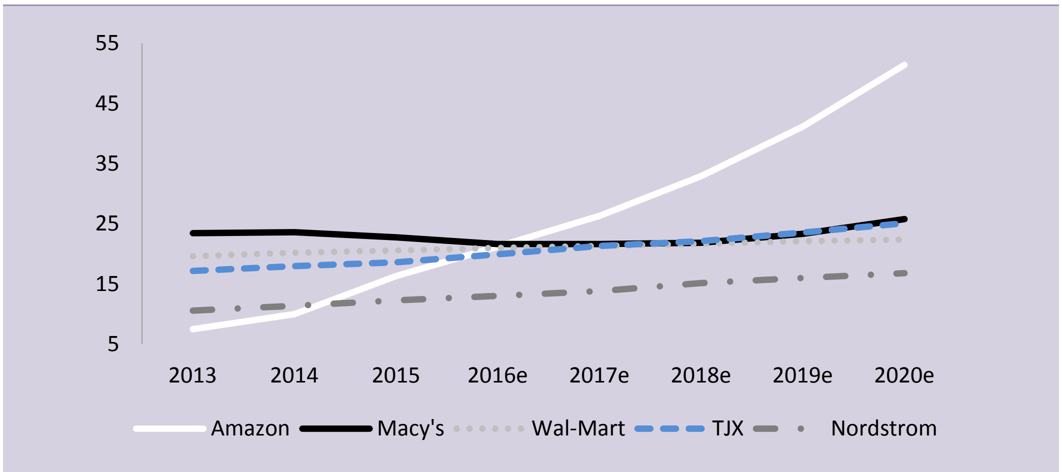


Source: Ecommerce Foundation; Bryan, Garnier & Co ests.

The following figures are a good illustration of changes in purchasing behaviour affecting traditional retailers. The chart below shows that **Amazon** is currently becoming the leading US clothing retailer and is likely to overtake **Macy's** in 2017 (with sales of around USD26bn compared with USD22bn for the department store chain).

More impressive still, **Amazon** is set to generate sales of USD51bn in 2020, or as much as the no. 2 (**Macy's**) and no. 3 (**TJX**) groups reunited! It is therefore easy to understand why retailers are desperately looking for solutions to offset the effects of lower footfall in their stores.

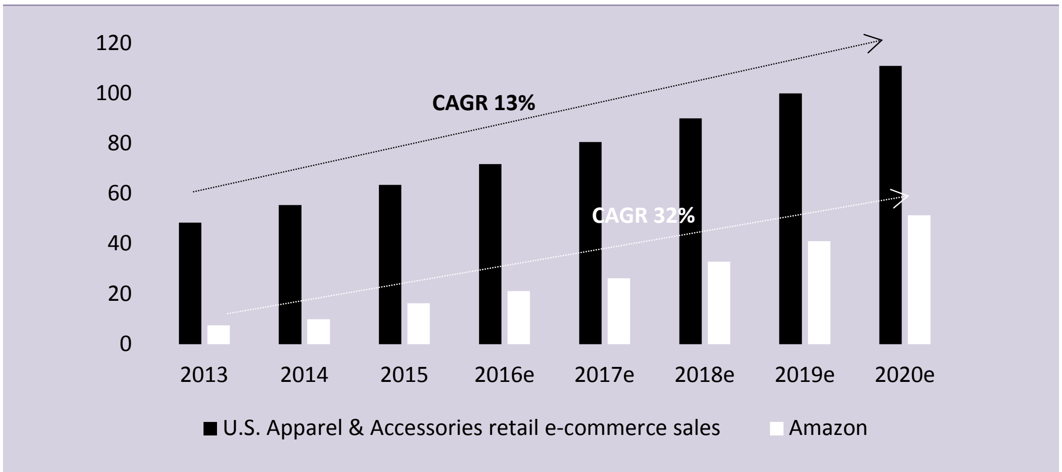
Fig. 19: Amazon vs. traditional retailers: changes in clothing and accessory sales in North America (USDbn):



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

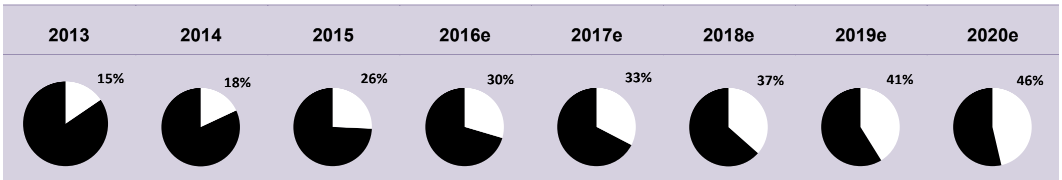
The rising momentum of **Amazon** is also reflected in the robust growth in its market share as set out in the two charts below: by 2020, 46% of online clothing sales in the US are set to take place on **Amazon**, vs. around 26% in 2015.

Fig. 20: Change in overall online textiles and accessories sales in the US and those of Amazon (USDbn):



Source: eMarketer, IBES, Bryan, Garnier & Co ests.

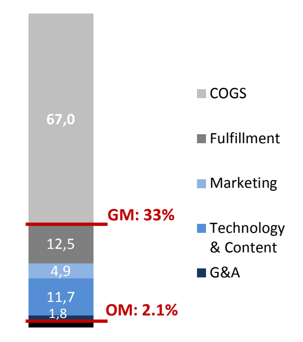
Fig. 21: Amazon market share (as a % of total online sales):



Source: eMarketer, IBES, Bryan, Garnier & Co ests.

2.1.3. Business model focused on top-line growth

Amazon cost structure (2015, % of sales):



Source: Company Data

Amazon is faced with the same issues as its traditional rivals: increasing sales in order to absorb its fixed costs and cover the high inflation in shipping costs (11.6% of 2015 sales vs. 9.3% in 2013). However, a crucial aspect of **Amazon's** business model exists that differs from other operators. Indeed, virtually all profits are ploughed back into: **(i)** moving into new ranges that are less profitable than mature categories, and **(ii)** improving the consumer experience.

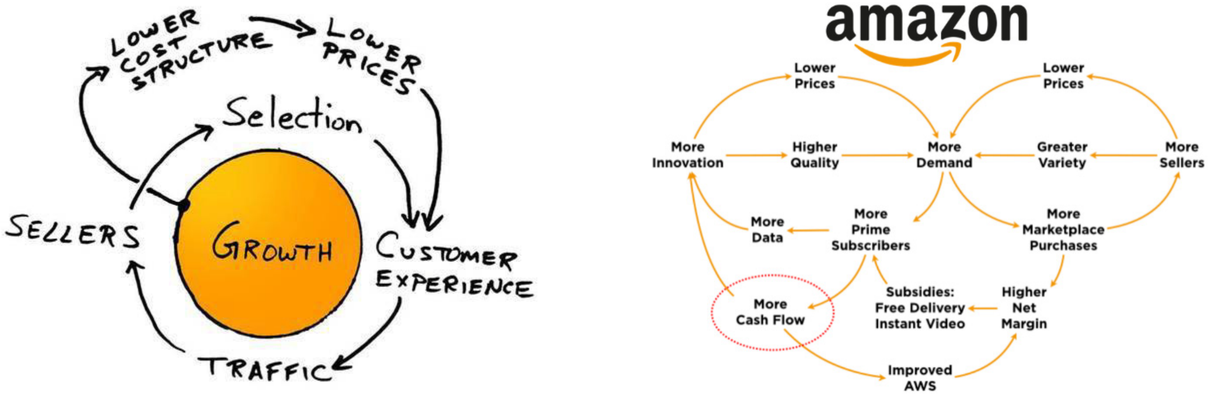
1/ A constantly expanding offer: Amazon's management has made choice its main competitive weapon relative to traditional retailing (which has a limited sales surface area) and other websites. To extend this offer, it has expanded directly in new segments. However, the most efficient solution was the launch of its marketplace in 2000, enabling third-party retailers or individuals to sell directly on its site. In 2015, these third-parties accounted for 50% of products sold on Amazon!

2/ Priority to consumer experience: to start with, rather than reduce prices, Jeff Bezos put customer relations at the heart of his strategy to win market share. Indeed, this drives frequency rates, heightens the conversion rate and prompts visitors to return. The first stage was to better guide consumers thanks to recommendation engines and customer opinions. In a second stage, the site launched the **Prime** service (2011) which offers delivery in 1-2 days to subscribers (or within an hour in major cities!). The proof of its success: the Premium service has some 80m subscribers, 54m of which in the US!

As such, the fact that Amazon does not have a high margin is not a handicap since sales growth catalysts are financed by high FCF generation, which is driven by the surge in volumes, primarily on the back of the two measures presented above.

Fig. 22: Amazon: why FCF generation is more important than margin widening (cash margin vs margin rate):

Top line growth is key to leveraging the cost structure... … and to generating FCF that is immediately reinvested



Source: Amazon; Nicolas Colin @TheFamily

The equation ROCE **(1)** = margin rate **(2)** x asset turnover **(3)** helps illustrate this commercial balance. In order to realise its value creation potential **(1)**, a retailer can implement a margin rate policy **(2)** by retaining productivity gains. This policy penalises the positioning and the price perception. It is therefore inappropriate. In contrast, in a healthy logic of cash margins, Amazon's strategy consists of passing productivity gains back to consumers. This helps increase traffic and volumes, to the detriment of rivals, and increase underlying asset turnover and **(3)** dilute the fixed cost base even further.

2.1.4. Many banners are reducing exposure

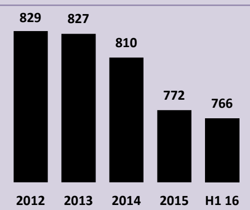
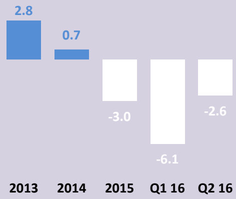
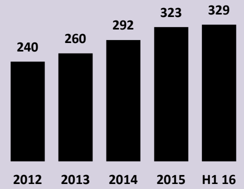
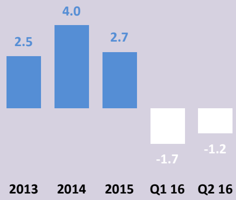
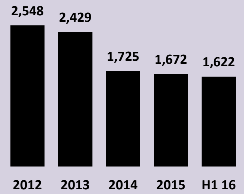
The majority of banners have been stumped by the ramp-up of the online circuit, which gained momentum with the emergence of m-commerce. In addition, the clothing market is affected by deflationary trends that benefit fast-fashion brands (**Zara**, **H&M**, etc.) and category killers (**Forever 21**, **Primark**, etc.). **Market research firm NPD pointed out that since the start of the year, almost 75% of clothing purchases were made at low-price retailers!**

Consequently, combined with this deflation, the decline in traffic has taken a toll on traditional banners. Property consultancy firm Green Street Advisors noted that commercial density (sales per square metre) in department stores plummeted 24% between 2006 and 2015 (~USD1,650/m² in 2006) whereas, at the same time, their sales surface area only decreased by 7%. Logically, numerous department store chains have announced their aim to reduce their store network in the US.

Mid-range chains are above all the most affected since they **1/** address a more volatile client base (looking for the best prices) and **2/** have generally not invested enough to optimise the customer experience (store renovations, extension of the offering, omnichannel strategy etc.).

As such, **Sears** is struggling to emerge from a number of difficult years, affected by the elimination of more than 900 sales points since 2012. **Macy's** is also set to close around 100 of its eponymous stores. In contrast, its upscale banner, Bloomingdale's, is not concerned by this streamlining plan. The same goes for rival **Nordstrom,** which has invested in the online circuit for more than 10 years (~21% of sales at present) and is now benefiting from its discount banner Nordstrom Rack (28% of sales group vs. 12% in 2005).

Fig. 23: Measures taken by main US department stores:

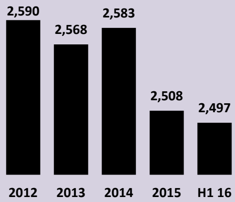
Company	Store network	Five latest quarterly comps (%)	Action plan / Cost-cutting measures
Macy's – FY ended January	 * *Macy's and Bloomingdale's*		In August Macy's announced **that it is closing approx. 100 of its stores** (or ~15% its total store network) early in 2017.
Nordstrom – FY ended January			**No downsizing plan** thanks to its successful expansion in e-commerce (Haute Look, Trunk Club) an in off-price retailing (Rack) => E-commerce accounted for 21% of total sales in 2015 (2020 target: ~30%)
Sears – FY ended January			Continues **aggressive expense reductions** by taking actions to further reduce costs by between USD550-650m in 2016. **Sears has closed 68 Kmart stores and 10 Sears stores** in July.

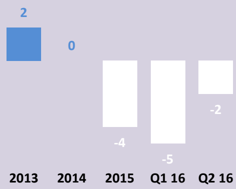
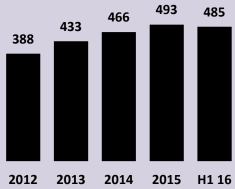
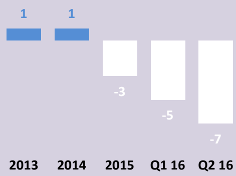
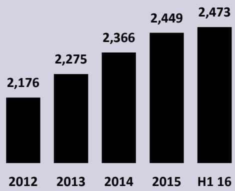
Source: Company Data, Bryan, Garnier & Co

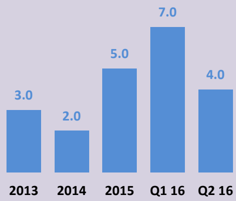
Like department stores, premium brands are especially affected by this change in backdrop since: **1/** They are suffering from poor performances by departments stores (which are their main wholesale clients - **Macy's** represents 11% of total sales and 25% of wholesale sales for **Ralph Lauren**). **2/** They are also stuck between affordable luxury brands (e.g.: **Sandro, Maje**) and fast-fashion brands (**H&M**, **Zara**, etc.) that have shorter production cycles and a better price positioning.

Note also the success of discount banners, with 75% of clothing purchases made in discount stores (on NPD data). Hence the success of **TJX**, which has a number of low-price clothing banners (T.J. Maxx, Marshalls, Winners, etc.). As the table below shows, the group is continuing to post same-store growth, while continuing to open stores in North America and throughout the world.

Fig. 24: Mixed situations depending on the banner:

<table>
<tr><th>Company</th><th>Store network</th><th>Five latest quarterly comps (%)</th><th>Action plan / Cost-cutting measures</th></tr>
<tr><td>Gap Inc – FY ended January</td><td>

* Gap, Old Navy and Banana Republic North America</td><td>
</td><td>Net closures of about 50 DOS in FY2016. Gap will also shut 75 Old Navy and Banana Republic stores overseas markets (o/w all its 53 Old Navy outlets in Japan) to focus on its North American market.
The store closures to result in annualized sales loss of about USD250 million but help save USD275 million on an annualized pre-tax basis.</td></tr>
<tr><td>Ralph Lauren – FY ended March</td><td>
</td><td>
</td><td>RL is cutting about 1,000 jobs (8% of the company's full-time jobs) and closing 50 stores (~10% its total store network)
FY17 restructuring measures should deliver USD180-220m of annualized cost savings on top of the USD125m savings achieved in FY16.</td></tr>
<tr><td>TJX Companies – FY ended January</td><td>

* Network in North America excl. home fashions</td><td>
</td><td>The company is not planning on closing any stores and in May, CEO Ernie Herrman said that he was confident that TJX could continue to open stores in the MT (+150 planned in 2016).</td></tr>
</table>

Source: Company Data, Bryan, Garnier & Co

2.2. The "web category-killer": Zalando Neutral, FV @EUR39

2.2.1. Attracting, retaining and monetising customers!

Zalando has rapidly hoisted itself among the top-notch European online textiles and apparel retailers with sales of EUR2.96bn in 2015 (CAGR of 81% since 2010) generated in 15 European countries. Sales momentum is based on a **1/** comprehensive assortment and **2/** a diversified range of services that feeds a rapidly expanding customer base (19.2 million individual customers at end-June 2016). This customer base is a breeding ground for information enabling an evolution towards a predictive way of selling, and which **Zalando** is now in a position to monetise.

Apart from a range of products that is constantly widening, the group has therefore diversified its revenue sources by developing associated services destined for customers and supplier brands (smart data, marketplaces etc.). **Zalando** has also become known for the quality of its order fulfilment services, having adopted free deliveries and returns (compared with an average of EUR5.46 for shipping and EUR6.54 for returns in the sector) with the possibility of reimbursement within a 100-day period (vs. 30 previously).

Although **Zalando** has exceeded the start-up stage (triple-digit growth rates), its KPIs nevertheless reflect an increasingly strong adherence by consumers: **1/** Impressive growth in the number of visits and active customers (20% on average), as well as in order numbers (~30% during recent quarters), **2/** a rising average number of transactions per individual despite the huge widening in the customer base (on average, a customer placed 3.32 orders during the past 12 months vs. 2.36 in early 2012). Finally, **3/** the average basket has constantly increased and now stands at EUR66 (vs. EUR61.5 in early 2012).

2.2.2. Significant uncertainty due to Amazon

Zalando's performances have been outstanding so far. In all proportion, we estimate that the group has reproduced on the web, the model that has led to the success of operators such as **H&M**, **Inditex** and **Primark**. Indeed, a web category killer such as **Zalando** multiples flows on high-rotation products such that the website becomes the natural destination for those looking for a specific product. The group has managed this by maintaining close relations with its customers to whom it offers an exemplary after-sales service.

However, without denying the German operator the merit of what it has achieved, we can only be worried about the penetration of **Amazon** in the textiles segment. Indeed, as mentioned previously (see Fig. 19), the retail giant is currently becoming the leading clothing retailer in the US and is set to exceed **Macy's** in 2017 (with sales of around USD26bn vs. around USD22bn for the department store chain). Based on the fact that major trends often take shape in the US before reaching Europe, we guess that **Amazon** could play an active role in the development of online textiles and apparel sales in Europe. This assumption opens a source of uncertainty that could hamper growth estimates.

Similarly, maintaining a net cash position whereas ROCE is at a ceiling and interest rates at a floor, clearly implies an opportunity cost. The question therefore concerns the acquisitions policy (subterfuge up against **Amazon**?) and the related hazards. However, the apparently astronomical valuations of e-merchants (2017 sales multiple of 1.7x and EBITDA multiple of 23x, according to consensus, for Zalando) can clearly only be justified to the extent that no disruptive element is likely to damage their momentum. As such, we have adopted a circumstantially cautious stance and are initiating coverage with a Neutral recommendation, backed by our valuation of EUR39.

2.2.3. We value Zalando at EUR39

DCF (50% of our Fair Value): EUR37

Our valuation is based on the assumption that Zalando's business volume could represent around 2.2% of the European fashion market by 2020 (vs. 0.9%e in 2016), while this market is estimated at EUR420bn in 2016. In 2020, we estimate that e-commerce could account for 20.5% of the fashion segment (vs 12.9%e in 2016), or a market share (GMV) of 10.6% for **Zalando** (vs. 7.1%e in 2016). As an indication, we understand that the group believes it is capable of replicating, on a European level, the market share that it currently has in Germany in the shoe-market, namely 5% (at this stage, our 2020 estimates are therefore far lower than this long-term projection, for which no horizon has been set).

In our explicit growth horizon, gross margin on sales excluding the market place is stable. Indeed, in a cash margin logic, we estimate that the gains associated with purchases and changes in the mix (own-label brands especially) should be ploughed back into prices, in order to ensure the growth corridor (20-25% further out). In contrast, the rising momentum of the marketplace (~15%e of GVM in 2020 vs around ~5% e to date, or an impact of around 45bpe on EBITDA margin, *ceteris paribus*) should clearly contribute to growth in the consolidated gross margin (45.2% in 2020 vs 44.4%e in 2016, bearing in mind that Zalando has a target range of 45-47% further out).

Finally, on management's estimates, distribution and marketing costs could represent 24-25% and 6-8% of sales respectively further out (excluding equity settled SBC costs). In our model, the sum of these two items represents 31.4% of revenues in 2020 (explicit growth horizon), the year when underlying EBIT margin reaches 8.3% (8.1% including SBC).

Fig. 25: Penetration rate of e-commerce in the fashion market and estimated Zalando market share

	2016 e	2017 e	2018 e	2019 e	2020 e
Overall market	**420**	**424**	**428**	**433**	**437**
Online (GMV)	54	63	71	80	89,49
Zalando (GMV)	3,8	4,9	6,1	7,6	9,5
E-commerce's market share of the overall market (GMV)	12.9%	14.8%	16.7%	18.6%	20.5%
Zalando's Market share of the overall market (GMV)	0.9%	1.1%	1.4%	1.8%	2.2%
Zalando's Market share of the e-commerce market (GMV)	7.1%	7.8%	8.6%	9.5%	10.6%

Source: Euromonitor; Bryan, Garnier & Co ests.

Our DCF valuation (EUR37 per share) accounts for 50% of our FV. It is based on a WACC of 9.3% (a risk-free rate of 1.6%, risk premium of 7.0% and a beta of 1.1x), since **Zalando** has a net cash position. As of 2020 and until 2025, we reduce growth in a linear fashion. In a normal average year, underlying margin stands at 8.3%, whereas growth to infinity (3%) is higher than the rate we apply to the best bricks & mortar players (i.e. 2%). In a catastrophe scenario whereby **Amazon's** ramp-up in the European textiles segment is so extensive that it obliges **Zalando** to reinvest all of its gross margin and productivity gains in prices (in order to remain in the growth corridor it has set) our DCF works out to EUR22.

Fig. 26: Our DCF, 50% of FV, works out to EUR 37EUR per share

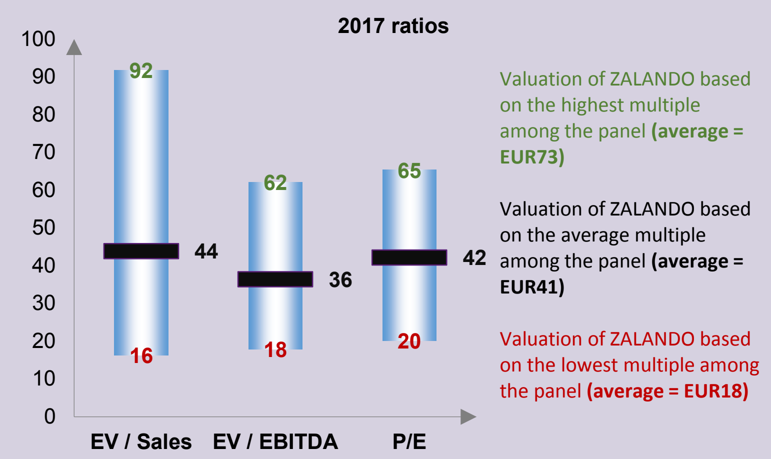
EURm	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	Normative
Sales	**3 678**	**4 543**	**5 578**	**6 813**	**8 236**	**9 710**	**11 159**	**12 492**	**13 612**	**14 426**	**14 859**
Variation (%)	24,3%	23,5%	22,8%	22,1%	20,9%	17,9%	14,9%	11,9%	9,0%	6,0%	3,0%
EBIT (before SBC)	198	276	381	516	686	809	929	1 040	1 134	1 201	1 237
Margin	5,4%	6,1%	6,8%	7,6%	8,3%	8,3%	8,3%	8,3%	8,3%	8,3%	8,3%
Tax	(59)	(83)	(114)	(155)	(206)	(243)	(279)	(312)	(340)	(360)	(371)
EBIT after tax	139	193	267	361	480	566	651	728	794	841	866
D&A	44	59	76	96	120	159	202	247	293	336	371
WCR variation	3	1	2	2	2	2	2	2	2	1	0
Capex	(201)	(227)	(223)	(238)	(247)	(283)	(316)	(344)	(363)	(373)	(371)
As a % of sales	5,5%	5,0%	4,0%	3,5%	3,0%	2,9%	2,8%	2,8%	2,7%	2,6%	2,5%
Operational cash-flow	**(16)**	**26**	**120**	**221**	**355**	**444**	**538**	**634**	**725**	**805**	**866**
Discounted Cash-flow	**(15)**	**24**	**100**	**167**	**247**	**282**	**313**	**337**	**353**	**358**	**386**
Sum of discounted cash flows	2 166										
Terminal value	6 303										
Net debt	(959)										
Provisions & Others	10										
Value of groupe equity capital	**9 417**										
Equity per share	**37EUR**										

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

EV/EBITDA relative to EBITDA growth (50% of our Fair Value): EUR42

Whereas growth is falling in the majority of consumer categories, the market values e-merchants primarily on the basis of sales multiples. However, the parameters that underlie analysts' sales assumptions are currently upbeat. As such, the methodology is particularly sensitive to changes in risk perception by investors. As such, by widening the panel of multiples and basing ourselves also on average EBITDA and net profit multiples, it would be possible to value **Zalando** at EUR41 (the peers we have chosen are **Amazon**, **Asos**, **Bohoo.com**, **Showroomprive.com** and **YNAP**).

Fig. 27: How would Zalando be valued on current multiples?



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

We have looked at these "static" multiples in the light of growth potential and have simply retained a profitability multiple given that the commercial success of an e-merchant is ultimately measured by the profitability it generates. We have ruled out PER, which for some companies is polluted by circumstantial factors (such as for example, the tax-loss carry-forward at **Zalando)**.

We have therefore retained an EV/EBITDA multiple relative to growth over 2016/19 for this same EBITDA. On the basis of consensus figures, since the panel average works out to 0.82x (vs 0.68x for **Zalando**), we value the German e-commerce player at EUR42 per share (50% of our FV). The average of our DCF valuation (EUR37) and this method (EUR42) works out at EUR39, pointing to upside potential of just 9.5% which backs our Neutral recommendation on the share.

Fig. 28: EBITDA multiple/growth in 2016/19 EBITDA

2017	EBITDA	16/19 EBITDA Growth	EV / EBITDA to EBITDA growth
Amazon	18.9	29.2%	0.65
ASOS	33.4	27.3%	1.22
Bohoo.com	43.2	35.9%	1.20
Showroomprive.com	10.6	29.9%	0.35
YNAP	17.0	28.4%	0.60
Average	**24.6**	**30.1%**	**0.82**

Source: Datastream; Bryan, Garnier & Co ests.

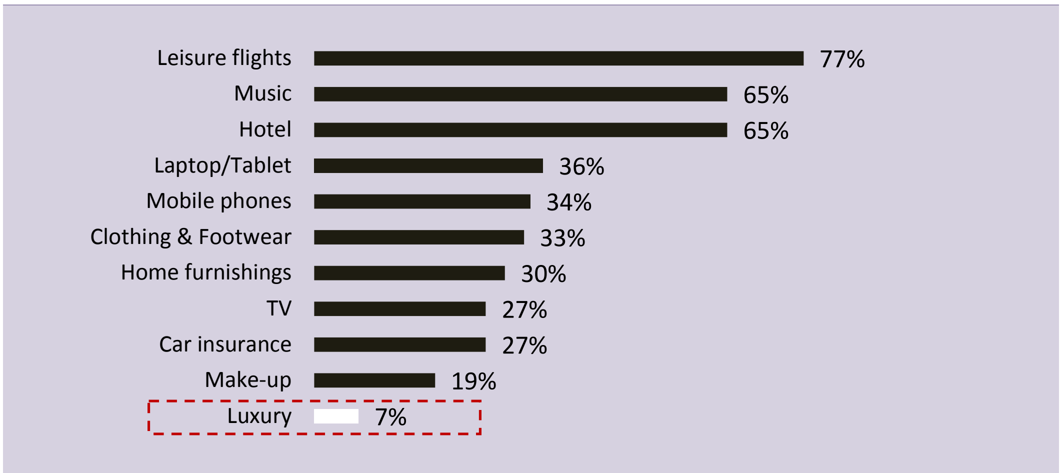
2.3. The web-niche: YNAP (Buy, FV @EUR33)

2.3.1. Luxury and e-commerce, two entirely opposing models…?

The growth imperative goes against the exclusive nature of luxury brands. Indeed, the aim is to produce exceptional items while using industrial processes, managing innovation and remaining present in iconic products, rounding out the network but avoiding overexposure and hence banalisation, multiplying contact points while maintaining an outstanding purchase experience. The luxury industry is therefore full of paradoxes.

For this reason, the internet penetration rate is still limited for the moment when compared with other consumer goods categories (around 7% vs. 33% for textiles for example). For many people, acquiring a luxury product only takes place in the intimate surrounding of a store on Avenue Montaigne in Paris, where the will of the consumer is pandered to. Removing intermediaries by using internet therefore threatens the purchasing experience and the very idea we have about luxury shopping.

Fig. 29: Penetration rate of online circuit in 2015 by segment (European market):



Source: Ecommerce Foundation; Bryan, Garnier & Co ests.

This is what several company directors have referred to, recently stating that e-commerce is not really taking off in the luxury segment (referring to brands such as **Louis Vuitton**, **Hermes**, **Gucci**…). Once again, we believe that nothing can replace the pleasure of choosing a product, trying on a dress or smelling a leather object, and that physical stores are a millennium institution.

2.3.2. … but which are reconciled in the affordable luxury segment

That said, consulting firm McKinsey has asked the question of who creates the messages and information that forge brand image, the brand or consumers? Indeed, 80% of luxury product fans use social networks at least once a month, 50% at least once a week and 25% at least once a day. And when a banner uploads an image to its Instagram account, around 10,000 additional images, embellished with the brand's hashtag, are also posted by consumers (source: Get wired for the ultimate luxury experience / July 2015).

The influence of digital and the potential of e-commerce therefore looks high and McKinsey estimates that in addition to the 7% of sales generated by the luxury segment online, 68% of purchases are influenced by at least one digital contact point. However, the degree of resistance to digital/e-commerce depends on selling prices (we understand that the channel represents less than 2% of sales at **Richemont** for example) and the extent of the standards demanded that goes with it (a client that spend several tens of thousands of euros on a hard luxury timepiece is entitled to expect an extraordinary purchase experience in outstanding surroundings in the Place Vendôme).

In contrast, the impermeable nature of affordable luxury to the trend is less intuitive. The presence of iconic products is less important in the segment, fashion is more ephemeral and exclusivity less expectant. In our view, it is therefore a perfect place to roll-out digital and e-commerce.

2.3.3. Synergies between the sites provide YNAP a niche profile

In the affordable luxury segment, **YNAP** operates multi-brand proprietary websites (**1/** Net-A-Porter and **2/** Mr Porter for articles that are in-season, **3/** Yoox.com and **4/** The Outnet for permanent off-season products) and, via contracts of an average duration of five years, corners on behalf of luxury brands (41 mono-brand sites so far). The risk is that partnered brands such as Kering could later decide to bring management of all of the websites for the brands they own back in-house (note the impact that the loss of the Kering licence had on Safilo's share price...). We believe that the market has this threat well in mind.

The company model is based on interactions between these various platforms and a predictive (data processing) and transparent (possibility of comparing products on multi-brand sites) way of serving consumers. In the first instance, multi-brand sites are a shop window and serve as an incubator for future corners, which then become a breeding ground for information. Indeed, thanks to the data collected, **YNAP** can permanently fine-tune the offers on its proprietary sites depending on the fashions and trends taking shape. Similarly, when it has not managed to do so on its in-season sites, **YNAP** can run down goods on its off-season platforms (like goods not sold in the corners can be placed on the **YNAP** multi-brand sites).

The comparative advantage for the company stems notably from **1/** its status as the first-entrant in a niche segment (Yoox was founded in 2000), **2/** growth potential that is well balanced geographically (170 countries served via eight logistics centre covering the main time-zones: Italy, US, Japan, China and Hong Kong), **3/** unrivalled logistical facilities (**YNAP** is the only luxury player to boast a fully automated logistical centre) and **4/** a customer portfolio that feeds a state-of-the-art data processing system (offering brands unique visibility on an exhaustive panel of potential brands).

2.3.4. We value YNAP at EUR33

DCF (50% of our Fair Value): EUR27

At this stage, our valuation is based on the assumption that by 2020 (our explicit growth horizon), internet is likely to have a market share of 11.5% in the luxury segment vs. 7% today (i.e. a market of EUR34bn). Between now and then, we estimate that **YNAP** could obtain 11% (vs ~10% at present) of this consumption category (i.e. sales of EUR3.7bn and a 2016/20 CAGR of 18%). Our assumptions reflect the group's forecasts for annual growth in sales of between 17% and 20% by 2020 at cc.

In a history limited to 2014 and 2015 pro forma, note that adjusted EBITDA margin totalled 8% at end-2015. This rate offers improvement potential of between 300bp and 500bp, based on the group's targets (i.e. adjusted EBITDA margin of between 11% and 13% by 2020). At this stage, our estimates are in line with these assumptions, since the ratio works out to 11.7% for 2020 (11.1% in reported terms) in our accounts.

Fig. 30: Penetration rate of e-commerce in the luxury market

EURbn	2016 e	2017 e	2018 e	2019 e	2020 e
Luxury market	**261**	**269**	**277**	**286**	**295**
Online luxury	19,3	22,2	25,6	29,4	33,8
Market share	7,4%	8,3%	9,2%	10,3%	11,5%
YNAP	**1,9**	**2,3**	**2,6**	**3,1**	**3,7**
Market share of online luxury	10,0%	10,2%	10,4%	10,6%	10,9%
Implied growth	13,3%	19,7%	17,3%	17,8%	18,3%

Source: Bain & Altagamma, Garnier & Co ests.

Our DCF valuation accounts for 50% of our FV. It is based on a WACC of 8.6% (risk-free rate of 1.6%, risk premium of 7% and beta of 1.0x), since **YNAP** is in a net cash position. The growth rate to infinity (3%) is slightly above the one we apply to luxury goods retailers. As of 2020 (explicit growth horizon) and until 2025, we reduce growth in a linear fashion. In a normal average year, underlying EBIT margin stands at 7.2%, capex (4.0% of sales) match depreciation and amortisation, while we maintain cash destruction due to a positive and rising WCR (the production cycle for luxury products implying significant stock levels).

Fig. 31: Our DCF, 50% of FV, works out to EUR27 per share

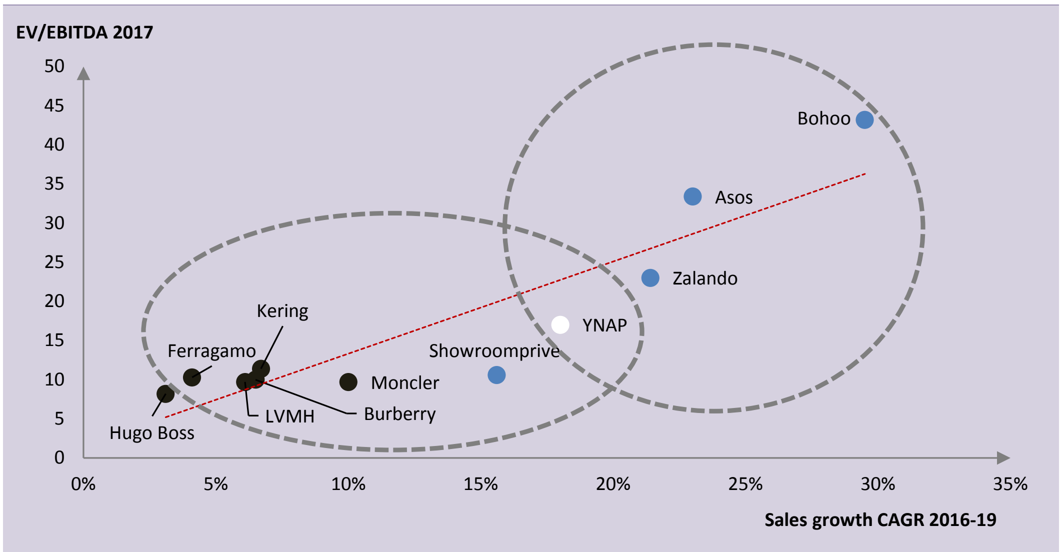
€ m	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	Normative
Sales	**1 886**	**2 257**	**2 647**	**3 117**	**3 686**	**4 265**	**4 827**	**5 340**	**5 772**	**6 092**	**6 274**
Variation (%)	13,3%	19,7%	17,3%	17,8%	18,3%	15,7%	13,2%	10,6%	8,1%	5,5%	3,0%
EBIT (excl. PPA / IPC)	97	109	144	200	267	308	349	386	417	440	454
Margin	5,1%	4,8%	5,4%	6,4%	7,2%	7,2%	7,2%	7,2%	7,2%	7,2%	7,2%
Tax	(29)	(33)	(43)	(60)	(80)	(93)	(105)	(116)	(125)	(132)	(136)
EBIT after tax	68	76	101	140	187	216	244	270	292	308	318
D&A	64	102	124	140	166	188	209	227	240	249	251
WCR variation	(8)	(14)	(14)	(17)	(21)	(21)	(20)	(19)	(16)	(12)	(12)
Capex	(144)	(158)	(159)	(156)	(147)	(171)	(193)	(214)	(231)	(244)	(251)
As a % of sales	7,6%	7,0%	6,0%	5,0%	4,0%	4,0%	4,0%	4,0%	4,0%	4,0%	4,0%
Operational cash-flow	**(20)**	**6**	**52**	**108**	**184**	**213**	**240**	**265**	**286**	**302**	**306**
Discounted Cash-flow	**(20)**	**6**	**44**	**83**	**131**	**139**	**145**	**147**	**147**	**142**	**144**
Sum of discounted cash flows	965										
Terminal value	2 655										
Net debt	(63)										
Provisions & Others	77										
Value of group's equity capital	**3 605**										
Equity per share	**27EUR**										

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

EV/EBITDA relative to EBITDA growth (50% of our Fair Value): EUR38

In order to assess the immediate perception investors have of **YNAP**, and how the market sometimes tends to focus only on sales growth when it comes to internet, we have set out sales growth at luxury players and e-merchants in the chart below, as well as the EBITDA multiples that are respectively attributed to them. While maintaining all proportion, it would seem that **YNAP** is valued more as a luxury player while having the growth prospects of an e-merchant. At first glance, it would therefore probably not be shocking to attribute it a sales multiple in line with that of internet peers, who are less profitable and more cyclical. This suggests a valuation for **YNAP** of around EUR38 per share, based on 2017 revenues.

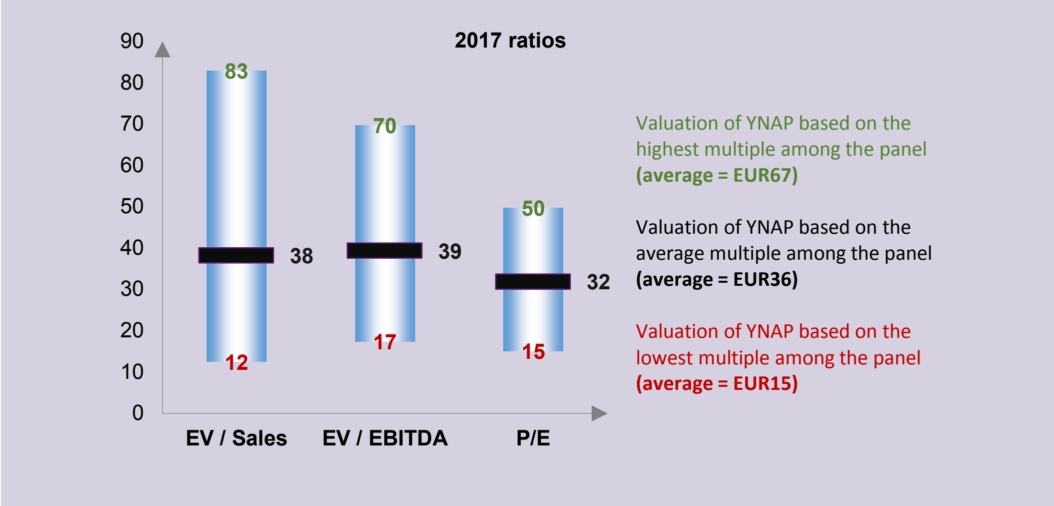
Fig. 32: How the market perceives and values YNAP



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

However, we are not restricting this analysis to sales multiples and have widened it to EBITDA and net profit ratios. We have retained the average of a panel made up of **Asos**, **Boohoo**, **Showroomprive.com** and **Zalando** (while waiting to include **Farftech** which could be floated within the next two/three years!). In doing this, it would be possible to value **YNAP** at EUR36 per share. We set out our conclusions in the chart below.

Fig. 33: How would YNAP be valued on the basis of current multiples?



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

However, as for **Zalando**, we have finally only taken into account the EBITDA multiple which we have related to growth potential (see our explanations in section 2.2.3), since the commercial success of an e-commerce player is ultimately assessed on the basis of the profitability that it generates. On the basis of the consensus figures, the panel average working out at 0.83x (vs 0.60x for **YNAP**), we value the Italian e-merchant at EUR38 per share (50% of our FV). The average of our DCF (EUR27) and this method (EUR38) works out to EUR33EUR, or upside potential of 33% which therefore underpins our Buy recommendation on the share.

Fig. 34: EBITDA multiples of luxury and e-commerce players (consensus)

2017	EBITDA	16/19 EBITDA Growth	EV / EBITDA to EBITDA growth
Amazon	18.9	29.2%	0.65
ASOS	33.4	27.3%	1.22
Bohoo.com	43.2	35.9%	1.20
Showroomprive.com	10.6	29.9%	0.35
Zalando	23.0	34.0%	0.68
Average	**25.8**	**31.3%**	**0.83**

Source: Datastream; Bryan, Garnier & Co ests.

Fig. 35: Multiples of luxury and e-commerce players (consensus Datastream)

	2016/19 Sales growth	2016/19 EBITDA growth	EV/EBITDA to EBITDA Growth	EV/Sales			EV/EBITDA			P/E		
				2017	2018	2019	2017	2018	2019	2017	2018	2019
YNAP	**18.0%**	**28.4%**	**0.60**	**1.5 x**	**1.3 x**	**1.2 x**	**17.0 x**	**13.1 x**	**11.7 x**	**42.6 x**	**31.8 x**	**24.1 x**
Zalando	**21.4%**	**34.0%**	**0.68**	**1.7 x**	**1.3 x**	**1.1 x**	**23.0 x**	**17.0 x**	**12.9 x**	**45.9 x**	**35.7 x**	**30.0 x**
Amazon	20.2%	29.2%	0.65	2.3 x	1.8 x	1.0 x	18.9 x	13.8 x	7.1 x	86.5 x	48.8 x	32.3 x
Asos	23.0%	27.3%	1.22	2.2 x	1.8 x	1.5 x	33.4 x	26.1 x	20.7 x	65.1 x	51.6 x	39.1 x
Bohoo.com	29.5%	35.9%	1.20	4.8 x	3.7 x	3.0 x	43.2 x	34.3 x	26.9 x	68.6 x	54.7 x	43.5 x
Showroomprive.com	15.6%	29.9%	0.35	0.7 x	0.6 x	0.6 x	10.6 x	7.7 x	7.0 x	26.9 x	19.9 x	16.4 x
LVMH	6.1%	6.6%	1.48	2.3 x	2.1 x	1.8 x	9.7 x	8.8 x	7.6 x	19.5 x	17.8 x	16.2 x
Burberry	6.5%	6.9%	1.45	2.1 x	1.9 x	1.8 x	10.0 x	9.2 x	8.1 x	18.7 x	17.5 x	15.8 x
Ferragamo	4.1%	5.8%	1.77	2.4 x	2.2 x	2.1 x	10.3 x	9.5 x	8.8 x	17.9 x	16.7 x	15.0 x
Hugo Boss	3.1%	7.7%	1.07	1.5 x	1.4 x	1.3 x	8.2 x	7.6 x	6.7 x	15.4 x	14.0 x	11.6 x
Kering	6.7%	9.3%	1.22	2.2 x	2.0 x	2.0 x	11.4 x	10.2 x	10.3 x	18.0 x	16.1 x	14.1 x
Moncler	10.0%	8.7%	1.12	3.2 x	2.9 x	-	9.7 x	8.7 x	-	17.8 x	16.2 x	14.8 x
Average e-commerce	**21.3%**	**30.8%**	**0.78**	**2.2 x**	**1.8 x**	**1.4 x**	**24.3 x**	**18.7 x**	**14.4 x**	**55.9 x**	**40.4 x**	**30.9 x**
Average luxury	**6.1%**	**7.5%**	**1.35**	**2.3 x**	**2.1 x**	**1.8 x**	**9.9 x**	**9.0 x**	**8.3 x**	**17.9 x**	**16.4 x**	**14.6 x**

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

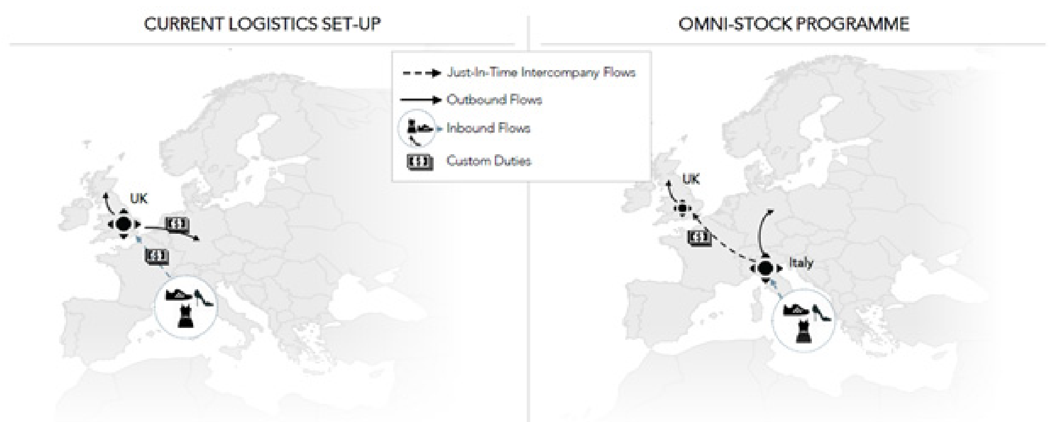
2.3.5. What about Brexit?

Concerning the recent decision by the UK to leave the European Union following the referendum vote on 23 June 2016, management has always demonstrated tranquillity. At this stage, fears concerning the slowdown in demand in the UK have already been taken into account in the 2020 strategic plan, whereas management is forecasting a decline in the UK's contribution to sales (12% in 2020e vs. 15.8% in 2015) given the extent of the market's maturity.

In concrete terms, in a pessimistic scenario whereby the GBP loses a further 10% each year between 2017 and 2019 to reach an exchange rate of GBP1.12 for EUR1 (vs. GBP0.85), the impact on our sales estimate would be limited to less than 1.5% a year *ceteris paribus* (i.e. excluding gains by the USD).

Furthermore, the consequences of setting up customs duties (included in the strategic plan as of H2 2018), in the absence of a readjustment in selling prices, would be limited to 10% of the UK COGS out to 2020. Las but not least, note that the roll-out of the omni-stock programme would help dilute the effects (see Fig. 36). The impact on margins should finally be limited in the end, given the good balance between costs and sales denominated in GBP.

Fig. 36: Towards a centralized European fulfillment organization



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

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3. Or physical?

3.1. Omnichannel and "Click & Collect"

While robust growth in online shopping had already changed consumer behaviour patterns, the boom in mobile internet (smartphones and tablets) stepped up the removal of barriers between the various channels, as shown by the chart below (Fig 37):

- **Multichannel:** the aim is to integrate several channels into a same system and multiply contact points with consumers in order to increase the penetration rate. In contrast, each channel is considered independently, with a distinct digital strategy in most cases (e.g. a physical brand which creates its own website or becomes referenced on a multibrand e-commerce site such as **Amazon** or **ASOS**). However, the risk of the channels eating into each other does exist (i.e. showrooming).

- **Crosschannel:** contrary to multichannel, this strategy implies closer interaction between the various channels, since their integration aims to make the consumer experience more fluid. This has to be fully coherent between the website and the physical network. The strategy fits with current consumer behaviour to research online before eventually purchasing in the store. Two good examples are **FNAC** and **Hugo Boss**, with respectively 81% and 75% of their purchases qualified as ROPO (***R****esearch* ***O****nline,* ***P****urchase* ***O****ffline*).

- **Omnichannel:** this strategy requires perfect convergence of offline and online channels in order for consumers to be able to purchase whenever and where-ever and by whatever means they like (in-store, smartphone, tablet). For **traditional retailers**, this implies: **1/** a digitalisation of the store network, with the emergence of interactive order points (to order unavailable products, personalised advice etc.) and the click and collect services, as well as **2/** transversal management of stocks between the offline and online circuits (to ensure that the products are constantly available). For **e-retailers**, this requires the development of a physical network (like **Amazon** which has started to open libraries and grocery stores in the US, or US eyewear brand **Warby Parker,** which was founded online in 2010 before launching its first stores in 2013).

- **Why the Click to Mortar?**: In the words of Jérémie Herscovic (SoCloz), "*an e-commerce site needs to look for growth in the physical market*". Indeed, "*when consumers go online, they look, surf and convert very little into purchases. However, buying this audience is very expensive […]. In contrast, in a store, the visitor comes in, can touch objects and consumes more easily. The solution therefore consists of converting the online audience into store traffic. Like this, the pure player amortises their costs*". In the furnishings segment for example, **made.com** launched an 840m² showroom this summer. The site's co-founder Julien Callède concludes: "*this showroom has increased both our conversion rate and the sales generated in the Paris region*" (in Liverpool, the same physical bet helped double sales in the region within six months).

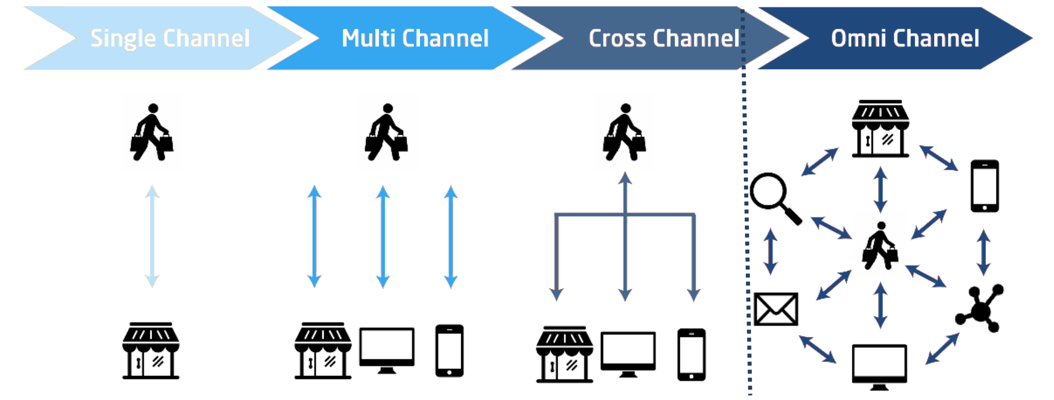
Fig. 37: A few examples of Click to Mortar:

Web-hypermarkets	Electrodomestic	Optical	Apparel	Furnitures	Others
Amazon	Grosbill	Warby Parker	Zalando	Miliboo	Birchbox
Ebay	LDLC.com	Sensee	Zalora	Etsy	Promovacances
Cdiscount		Direct-optic.fr	Spartoo	Oogarden.com	Alltricks.fr
Alibaba (suning)			Bonobos	Made.com	Picadilly Time
			Showroomprive.com		
			Venteprivee.com		
			Bazarchic		

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

Even though this digital transformation is causing painful adjustments for traditional retailers, a successful transformation creates new medium and long-term growth opportunities (greater proximity with customers, better reactiveness, increased brand awareness etc.).

Fig. 38: An unavoidable shift towards omni-channel:

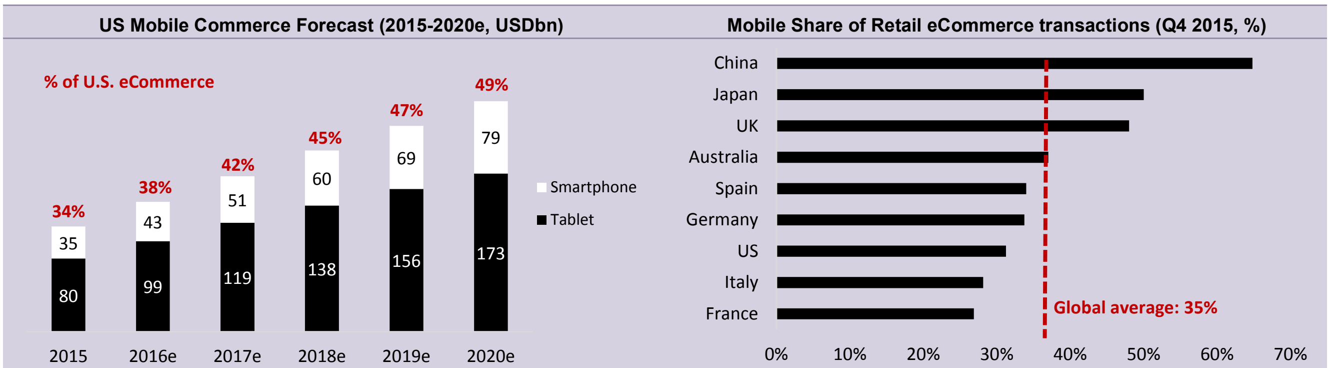


Source: Bryan, Garnier & Co.

3.1.1. Omnichannel faced with the hike in m-commerce

With the corollary of sharp growth in the smartphone equipment rate on a global scale (43% of mobile phone users, 52%e in 2018, or 2.6bn devices), m-commerce is in full swing. As the chart below shows, m-commerce in the US (tablets and smartphones) represented 34% of online spending in 2015, with this share set to approach 50% in 2020. Note interestingly, that China, which is already the leading e-commerce market in the world, leads the pack with market share of 65% in favour of mobile phones (see right-hand chart below).

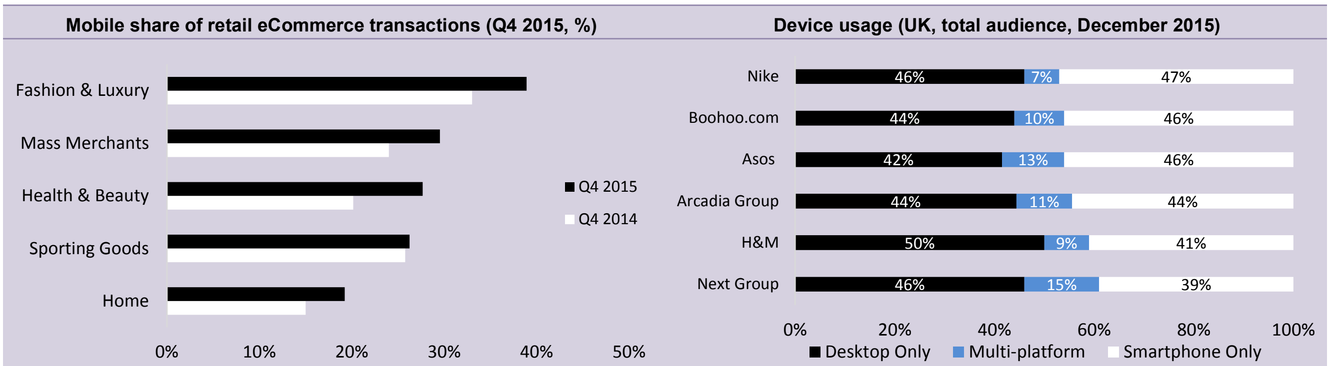
Fig. 39: M-commerce already represents 35% of online purchases in the world:



Source: Criteo, Forrester, eMarketer

With internet already a significant outlet for clothing sales in the US, the textiles segment is obviously the most concerned by purchases made on mobile phones (39% of online sales in Q4 2015). The same goes for the UK where m-commerce already accounts for 48% of online purchases: between 40% and 47% of traffic recorded on the brands' sites (represented in the right-hand chart below) is generated via smartphones and tablets.

Fig. 40: Ready-to-wear is the main segment concerned by the ramp-up in m-commerce:



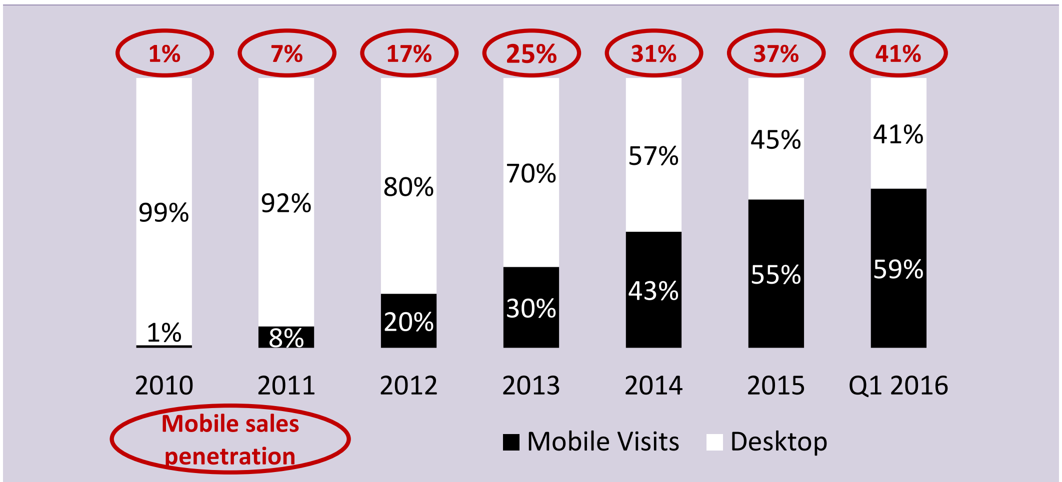
Source: Criteo, comScore

The premium/luxury segment also affected by mobile trends

During July, the Italian online luxury sales group **YNAP** (Yoox Net-a-Porter Group) organised a Capital Market Day, during which it underscored the significant contribution of smartphones to the group's growth: **at the end of Q1 2016, mobile sales (smartphones and tablets) represented 59% of traffic and 41% of sales** whereas this channel only accounted for 1% in 2010, as shown by the chart below.

Note interestingly that to explain the decline in online sales in H1 2016 (-5% lfl), **Hugo Boss's** management incriminated the poor compatibility of websites with smartphones and the low conversion rate with mobile phones relative to computers.

Fig. 41: Breakdown of traffic and sales between mobiles/computers at YNAP:



Source: YNAP; Bryan, Garnier & Co ests.

3.1.2. No, stores are not dead

The multiplication of store closure plans in North America does not spell the future death of all traditional retailers. Indeed, note that the **offline channel still represented 92% of total retail sales in the US in Q1 2016.** In our view, this is more of a knee-jerk reaction to the purchasing behaviour of the Millennial generation (see Chapter 1) and a strengthening of competitive pressure (e-retailers, discounters).

However, these banners should no longer focus simply on selling products and waiting for customers to come into their stores. In contrast, they should adopt a proactive strategy to developing relations (i.e. multiplying contact points) with their customers (e.g. social networks, **Youtube**, etc.) while offering them the best possible purchasing experience, irrespective of the channel taken. Of course, the physical network should be the base of this omnichannel strategy.

An example of a successful omnichannel strategy: Apple

We have seen that **Apple** is the favourite brand for Chinese Millennials and also ranks no. 2 in the US. This is a technological banner that has stood out over recent years for its omnichannel strategy based on an ambitious store opening policy (463 **Apple** stores at end-September 2015, vs. 317 five years earlier). Proof that retail development is strategic, the brand even head-hunted the former CEO of **Burberry** in mid-2014 (Angela Ahrendts) to take over **Apple's** direct distribution (stores and website).

Omnichannel retailing is very well suited to technological products, with attractive presentations combined with smart advice encouraging customers to try out the products. The website and the application enable customers to make appointments for training sessions (Genius Bar), pay for things or have their products repaired. At all times, sales staff are equipped with smartphones and/or iPads in order to facilitate the process. Finally, all stores offer the Click & Collect service. In all, everything is done for customers to buy the entire **Apple** experience and not just a product. And it works!

How to interact with consumers in stores?

Omnichannel distribution needs to meet two objectives: **(i) to offer a unified customer experience** on all channels and **(ii) to multiply contact points,** which are all purchase opportunities. Thanks to the in-store sales force, and shouldered by technological innovations likely to attract customers, a brand can satisfy these two demands.

(i) **Getting to know its customers (CRM):** with a very reactive supply chain, the CRM at **Zara** (Inditex) has revolutionised the textiles industry by enabling it to track changes in sales in each store in real time (to ensure that supply matches customer tastes). With an efficient CRM and smartphone geolocalisation, brands can inform customers of promotions and personalised flash offers, or prompt them to come and see new collections in stores (see left-hand photo below).

(ii) **iPads for digitalising the salesforce:** sellers can track the state of their stocks in real time, and present products that are not available in stores in order to avoid losing sales. **Burberry**, one of the most advanced groups in this respect, proposes that customers purchase its articles directly via iPad during or just after their fashion shows. The seller can even become a walking cash till, thereby making the customer experience more fluid.

(iii) **Augmented reality in stores:** this technology is already used by numerous brands (**Hugo Boss**, **Burberry**, etc.). It enables visitors to try on clothing/accessories virtually in stores, obtain opinions from their friends and post the photo on social networks. These virtual changing rooms extend the time spent in the store and improve the conversion rate.

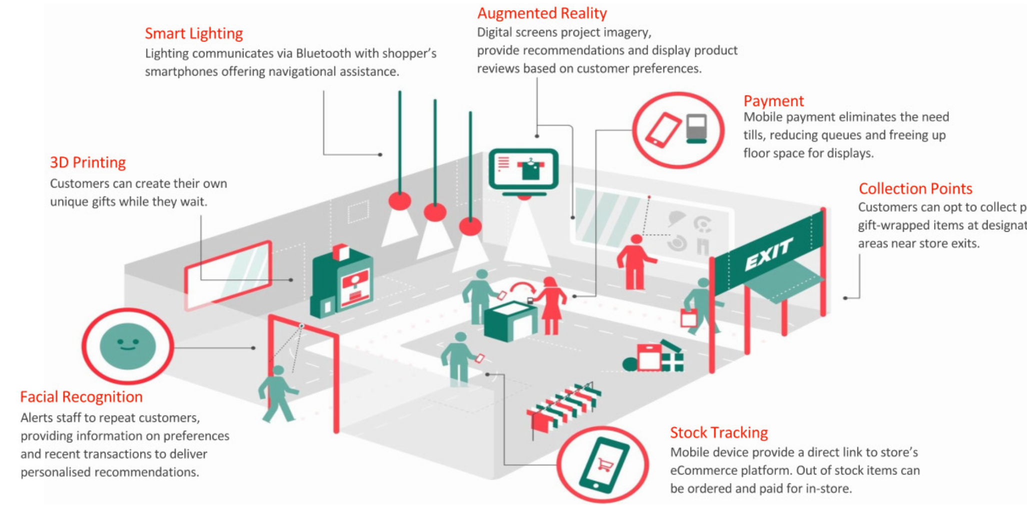
Fig. 42: Three digital solutions to connect to a store:

Geofencing and personalised offers	“Runway to Reality” at Burberry	Augmented Reality at Hugo Boss

Source: Company Data, Bryan, Garnier & Co.

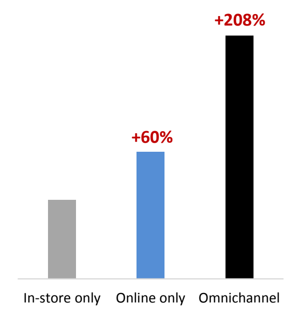
The digitalisation of stores enables a more efficient roll-out of the Click & Collect service: customers of a clothing brand can order the article they like online and then go to the nearest store to try it on. In the meantime, thanks to transversal stock management (stocks shared between all channels) and access to the customer's profile, sellers can prepare the article in order to save time. The customer then simply needs to pay for the item in the way they choose (classic or via mobile).

Fig. 43: Innovations to digitalise a store:



Source: Wirecard

Average basket by channel (US, base 100 = store only)



Source: Accenture

Omnichannel customers spend up to three times more than a traditional customer

Although this digitalisation of sales points requires high investments, according to the importance of the network, the omnichannel strategy can pay off if it is successful: as shown by the chart opposite, the omnichannel customer spends far more than those shopping online or in stores.

This tendency to spend is explained by two main factors: **(i)** digital innovation offers a far better purchasing experience since the customer is at the heart of the omnichannel strategy; **(ii)** multiple contact points are all purchase opportunities (website, offers sent by sms, advice from sales staff when customers collect their products from stores etc.). These direct and constant relations increase customer loyalty to the brand.

3.2. Omnichannel challenges

3.2.1. Changing the retribution system and KPIs

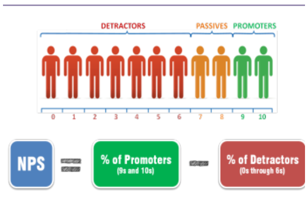
When the banners managed each channel separately, it was easy to following Key Performance Indicators in the online circuit and in stores. Whereas an increasing number of groups have adopted omnichannel retailing and consumers visit several channels (e.g. 80% of French consumers research online before buying in stores), this monitoring has become more complicated.

Classic indicators based on transactions (same-store growth, sales/m², conversion rate, etc.) have had to be reviewed since they do not take account of the contribution of stores to improving the customer experience and the banner's visibility. Indeed a number of brands have noted growth in internet sales when a physical salespoint was launched in a town. How can this contribution be measured?

From channel-centric to customer-centric. Groups such as **Hugo Boss** (*see chart below*) have therefore modified and enriched their KPIs as well as the remuneration system. The idea is to: **1/**

measure and reward the performance of levers that lead to a purchase, and not just value the final transaction (e.g. reputation rate, loyalty, traffic on social networks etc.), **2/** make sure that store KPIs take account of the customer experience (conversion rate, satisfaction index). Two indicators stand out at present:

Net Promoter Score:

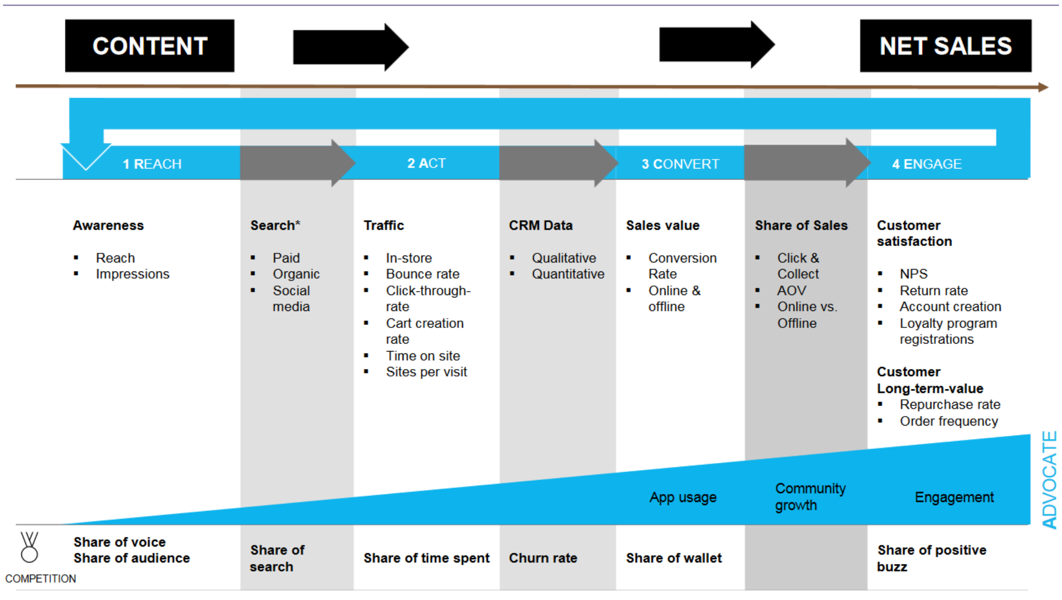


Source: Bain & Co.

(i) **Net Promoter Score (NPS):** the NPS is calculated from a simple question ("*How likely are you to recommend this product/service to a friend or family member?*" for example) helping to assess the level of satisfaction or loyalty of customers on a scale from 0 to 10. The final score is obtained by deducting the percentage of detractors from the percentage of promoters (see chart opposite). A score above 50 is considered as good. This has become one of the main performance criteria for managers at **Adidas Group** and **Hugo Boss** also uses it.

(ii) **Customer Effort Score (CES):** this indicator measures efforts that the customer needs to make during the purchase process. The CES is the object of a study carried out by Havard, which concludes that to make satisfied customers loyal, it is more interesting for a brand to minimise their efforts rather than always seeking to exceed expectations (here, digital should be seen as a facilitator). The standard question would be: "*How much effort did you have to make for your order to be processed?*", with the answer based on a mark ranging from 1 to 5.

Fig. 44: Hugo Boss has adapted its KPIs to omnichannel:

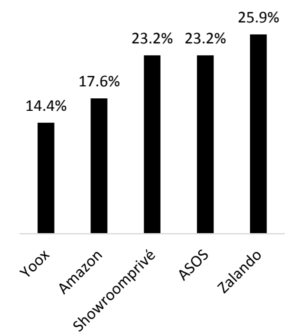


Source: Hugo Boss

3.2.2. The battle for the last kilometre and managing returns

Supply chain management, and especially logistics, is crucial for e-retailers. Indeed, the majority of studies show that speed and choice are the top criteria for online purchases, whereas price is often in third place. This is the reason why the supply chain is generally the main investment item for the majority of internet players.

Logistics and fulfilment costs (2015, % of overall sales):



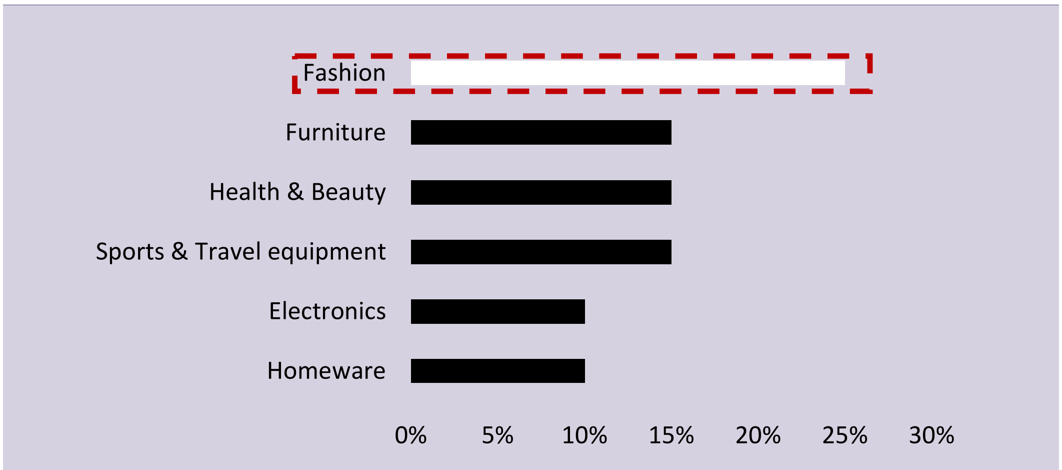
(Amazon = incl. net shipping costs)
Source: Company Data, Bryan, Garnier & Co.

As the chart opposite shows, logistics and fulfilments costs are often the leading expense item among operating costs. Differences between players can be explained by their different accounting methods and different average transaction amounts (e.g.: EUR352 at **YNAP** and EUR66 at **Zalando**).

In our view, this item is set to remain high over the medium term since: **(i)** the number of transactions is constantly rising; **(ii)** e-retailers are continuing to penetrate new markets (initial business volumes do not cover logistics costs); **(iii)** operators are launching new services which are costly on start-up (e.g.: same-day delivery); **(iii)** the returns policy is an essential point in the purchasing experience and is becoming increasingly attractive and hence costly (i.e. free for customers).

For traditional banners, investments prompted by the omnichannel strategy are taking a toll on profitability. Managing returned goods is particularly expensive. **According to a KPMG study, returning a coat implies a cost three times higher than fulfilment and shipping costs (GBP3-10)!** As the chart below shows, ready-to-wear banners are more concerned, since around 25% of internet orders are returned (exchanged or definitive return).

Fig. 45: Internet order return rate (UK, 2015, in %):



Source: KPMG

What about "Click-and-Collect"?

Favoured by banners as part of omnichannel services, the roll-out of Click & Collect requires hefty investment spending in terms of supply chain, in order to ensure the liaison between warehouses and the store network. Faced with these additional costs, below a minimum amount, the Click & Collect option had become a pay service at certain retailers: **John Lewis**, one of the main department store chains in the UK (40% of its sales over the internet), has decided to bill this service at GBP2 for all orders below GBP30, while **Tesco** charges an additional GBP4 for all orders under GBP40.

In the table below, we have studied delivery and return options offered by the UK websites of four traditional brands (**Burberry**, **Hugo Boss**, **H&M** and **Zara**) which manage their internet platforms directly. Although these do not have the same positioning (premium/luxury for **Burberry** and **Hugo Boss**, fast-fashion for **H&M** and **Zara**), services are nevertheless virtually identical, with the exception of **H&M,** which does not yet offer the Click-&-Collect service. As stated in the chapter on **Amazon**, websites are looking to offer the best purchase experience possible: for example, **Zalando** offers a free delivery service and above all returns possible for 100 days!

Fig. 46: Delivery and returns option on the UK website of four traditional ready-to-wear players:

Delivery & Returns	Burberry	Hugo Boss	H&M	Zara (Inditex)
Free Delivery?	YES – Free	YES – Free standard delivery (2-3 days)	YES – Free standard delivery (2-3 days) over 50 GBP	YES – Free standard delivery (2-3 days) over 50 GBP
Next Day Delivery?	YES – Free	NO – Not in the UK but Express Delivery (GBP19.95)	YES – Fee of GBP5.99	NO
Click-and-Collect option?	YES – Free	YES – Free	NO	YES – Free
Returns for online orders	YES – Free: all returns must be made within **1 month**	YES – Free: all returns must be made within **1 month**	YES – Free: all returns must be made within **1 month**	YES – Free: all returns must be made within **1 month**

Source: Company Data, Bryan, Garnier & Co.

Need to better harmonise the price policy

A study carried out by Havas LuxHub found that more than 70% of people questioned stated they used their smartphones when shopping in order to search for information on the products and/or compare prices. These new habits have prompted brands to harmonise their price policies, especially in Asia where customers are aware of the price difference with Europe.

However, as the table below shows, differences remain within the same region, given the competitive backdrop and consumer expectations. As such, a **Hugo Boss** suit is almost 30% more expensive in France than in Germany. Following a 20% price adjustment at the beginning of the year, the German brand pointed out that the price differential stood at 35% between France and Hong Kong and 50% between continental China and France. In terms of the price comparison for **Zalando**, and although this concerns the HUGO brand, it is worth noting that the site now maintains virtually the same price differences as on the **Hugo Boss** website (BOSS brand).

Fig. 47: Price differential between Europe and the US for Hugo Boss:

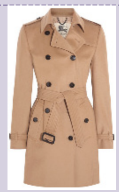
Retail price	Germany	UK	France	US
Hugoboss.com Regular-fit suit 'Jewels/Linus' by **BOSS** 	EUR499	GBP500	EUR655	USD795
Price in EUR (base 100= Germany)	100	119	131	143
Zalando Regular-fit suit by **HUGO** 	EUR479.95	GBP499.99	EUR655	n/a
Price in EUR (base 100= Germany)	100	124	136	n/a

** Exchange rates as of September 5th*

Source: Company Data, Bryan, Garnier & Co.

At **Burberry** unsurprisingly, continental Europe shows a slight premium relative to the UK market, both on its own website and on **Net-A-Porter**. In contrast, we noted a divergence in the US where, faced with a decline in footfall in its stores and department stores, the brand seems to have deliberately cut its prices. Note that a significant difference in prices exists between continental China and Europe, whether in terms of **Burberry** or **Net-A-Porter**.

Fig. 48: Price differential at Burberry:

Retail price		UK	France	Germany	U.S.	H-K	Mainland China
Burberry.com Westminster trench coat		GBP1,395	EUR1,795	EUR1,795	USD1,895	HKD17,000	CNY16,500
Price in GBP (base 100= UK)		100	108	108	102	118	133
Net-A-Porter **Burberry London** Kensington trench coat		GBP1,395	EUR1,506	EUR1,506	USD2,195	HKD11,860	USD2,659
Price in GBP (base 100= UK)		100	108	108	118	82	143

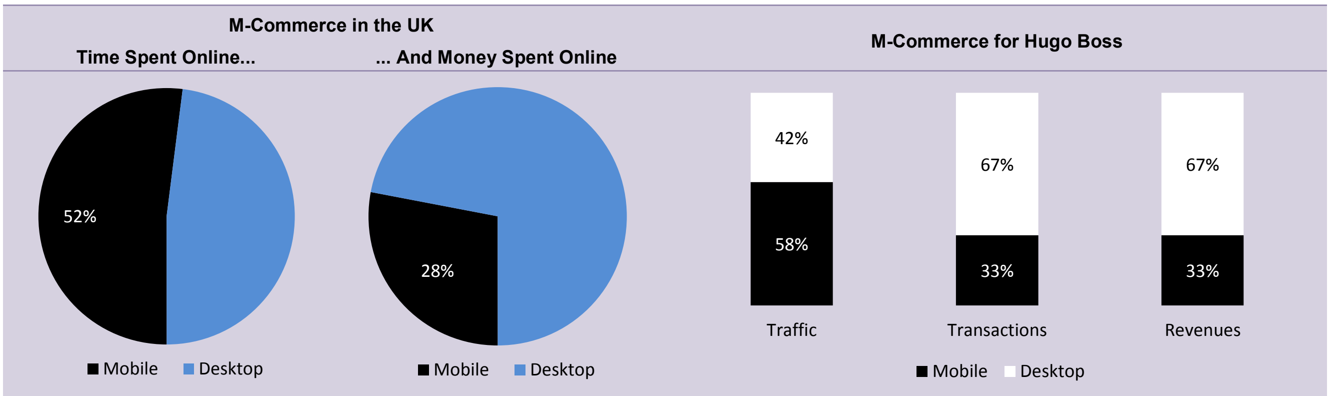
** Exchange rates as of September 5th* *Source: Company Data, Bryan, Garnier & Co.*

M-Commerce: how to increase conversion rates?

As we pointed out previously, mobile traffic (smartphones and tablets) has become dominant for virtually all players (67% at **Zalando** in Q3 16 / 59% in Q3 2015 vs 58% at **Hugo** Boss in Q3 2015). Indeed, clients use their smartphones to look for information before or during their purchases. In contrast, the majority of brands admit that mobile traffic has a far lower conversion rate than PC traffic (33% of sales at Hugo Boss).

Over the medium term, these conversion rates are set to increase, especially via the impact of applications (more loyal consumers and more frequent purchases) and increased compatibility of websites. However, experts agree in thinking that the priority is above all to facilitate gateways to other channels such as PCs or store visits.

Fig. 49: The mobile channel is used above all for information rather than purchases:



Source: Company Data, Bryan, Garnier & Co.

3.3. They've got it sussed: H&M and Inditex!

The global fashion market (ready-to-wear and accessories) is vast, amounting to more than EUR1,200bn. The 'mass-market' or 'accessible fashion' segment naturally represents the bulk of this market (c.EUR1,100bn) and remains highly fragmented since the two flagship brands, H&M and Zara, are likely to account for respective market shares of 1.7% and 1.4%.

The fragmentation of this market has enabled, firstly, the emergence of new brands like **Primark, Forever21 and Topshop,** which are pursuing very aggressive price strategies and have embarked on international growth and, secondly, the growth in internet players like **Amazon**, **Zalando** and **ASOS** offering a virtually-unlimited choice of items and increased customer experience.

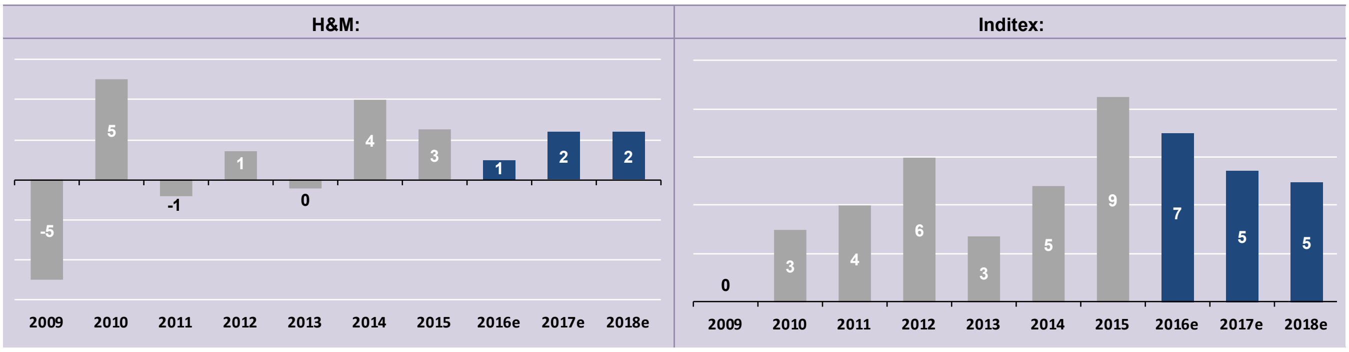
The H&M and Inditex groups do, however, dispose of some major assets they can leverage when it comes to contending with this competition. Even before the emergence of most of these online retailers, H&M and Inditex already had robust commercial strategies focused on: **(i)** international markets, **(ii)** multichannel (then omnichannel) and **(iii)** multi-brands, while **(iv)** shortening the lifespan of the collections to keep pace with changing fashions. In short, exactly what the internet players are trying to establish!

'Push' vs. 'Pull: these approaches are key to establishing the risk profile

Right from the inception, the Inditex group was built around a highly agile and responsive supply chain: **1/ it is customers who orient the design team** in terms of fashion trends, with feedback on their purchasing decisions passed up the chain by every store manager twice a week, **2/** approximately **60% of manufacturing is based "in proximity countries"** (i.e. Spain, Portugal and Morocco), enabling the: **3/ design and manufacturing of nearly 50% of a collection in the middle of a season** (this figure is particularly true for the Zara brand) and **4/ its delivery within some two weeks.** Inditex is thus less exposed to shifts in fashion and to weather conditions which are rarely mentioned in its communication.

The top-down approach of Swedish company H&M is more classical and is similar to that of the rest of the industry with the design team deciding the orientation for the collection. The same is true for the supply chain with **the bulk of manufacturing mainly located in Asia (c.80% of the total),** requiring six-month lead times prior to the delivery in stores and **making H&M, like the industry, sensitive to any changes in trend (fashion, consumers. etc.) and weather conditions.**

Fig. 50: Trend in like-for-like sales growth at H&M and Inditex (2009-18e, in %):



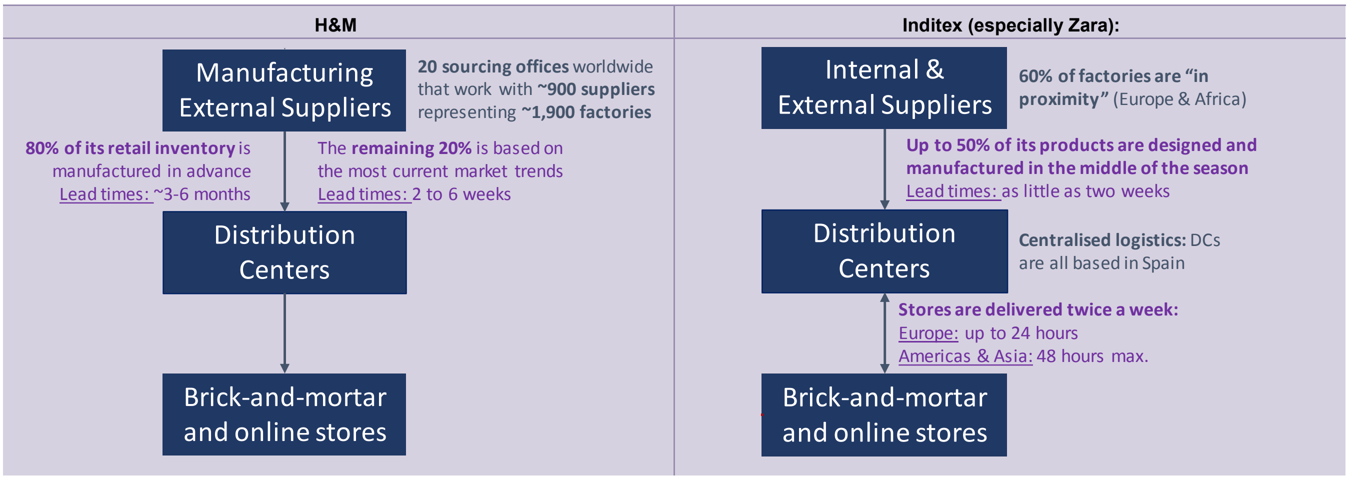
Source: Company Data, Bryan, Garnier & Co ests.

Short lead times are also beneficial for margin rates

In terms of its supply chain, **H&M** is close to the industry norms (manufacturing lead times of six months for 80% of manufacturing), making it sensitive to changing trends (fashion, consumption, etc.) and weather conditions. H&M, which generally discloses the impact at promotional level, stipulated that the growing proportion of mark-downs had a 25bp negative effect in 2015 and, in our view, the magnitude should be similar for 2016.

Inditex's greater flexibility with at least 50% of its manufacturing potentially taking place with a maximum lead time of a few weeks, enables the company to be highly responsive to any changes in trend linked to consumers or weather conditions. This high degree of responsiveness leads to a number of competitive advantages: **(i)** an unsold inventory rate of c.10% whereas the industry average is closer to 20%, **(ii)** a return rate of 25% to 30% against an average of c.50% for the industry and **(iii)** c. 80% to 85% of products are sold at full price against a c.60-70% average for the industry.

Fig. 51: The H&M and Inditex supply chains:



Source: Bryan, Garnier & Co ests.

The ramp-up of the online channel at H&M and Inditex

Although the two groups do not disclose their online sales we estimate that, in 2015, they represented around 7% of sales for H&M and c.5% for Inditex. Based on our 2015 online sales forecasts for H&M and Inditex, we have modelled the trends in these online sales (% of total sales) and their contribution to comparable store growth for each group over the 2016-18 period.

Fig. 52: H&M: e-commerce trend and contribution to LFL sales growth:

H&M	2015	2016e	2017e	2018e
If CAGR of 20% – Online as a % of total sales	7.0	7.9	8.6	9.4
Estimated contribution to LFL growth sales	**-**	**1.4pp**	**1.6pp**	**1.7pp**
If CAGR of 30% – Online as a % of total sales	7.0	8.5	10.1	12.0
Estimated contribution to LFL growth sales	**-**	**2.1pp**	**2.6pp**	**3.0pp**
If CAGR of 40% – Online as a % of total sales	7.0	9.2	11.7	15.0
Estimated contribution to LFL growth sales	**-**	**2.8pp**	**3.7pp**	**4.7pp**

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

Note that the ramp up of e-commerce seems to have a lesser theoretical impact on Inditex than on H&M. This is because **(i)** it accounts for a slightly lower proportion of sales at Inditex (c.5% of sales vs. c.7% for H&M), but also because **(ii)** our growth forecasts for total sales are more cautious at H&M.

Fig. 53: Inditex: e-commerce trend and contribution to like-for-like growth:

Inditex	2015	2016e	2017e	2018e
If CAGR of 20% – Online as a % of total sales	5.0	5.4	5.8	6.4
Estimated contribution to LFL growth sales	-	**1.0pp**	**1.1pp**	**1.2pp**
If CAGR of 30% – Online as a % of total sales	5.0	5.9	6.9	8.1
Estimated contribution to LFL growth sales	-	**1.5pp**	**1.8pp**	**2.1pp**
If CAGR of 40% – Online as a % of total sales	5.0	6.3	8.0	10.1
Estimated contribution to LFL growth sales	-	**2.0pp**	**2.5pp**	**3.2pp**

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

This growth in the online channel will be accompanied by additional operating costs (logistics expenses, costs involved in returns, etc.) but, in our view, this inflation should have only a modest impact on H&M and Inditex margins. The latter has stipulated that **one third of its online orders are collected in store and nearly two-thirds of returns are made in store.** H&M has not disclosed any information on this subject but we would expect the Swedish company to be witnessing the same phenomenon with its customers.

Omnichannel strategy: physical stores remain the focus of the growth strategy

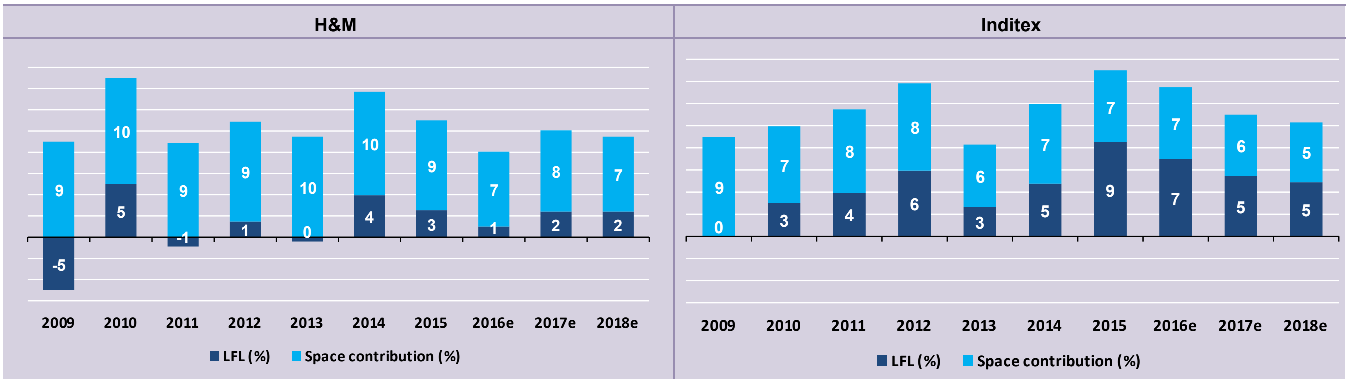
Despite the growth in the online channel, stores remain the favoured point of contact with customers at both H&M and Inditex. Furthermore, **their stores and window displays are the primary vector of communication when it comes to building their reputations** since, unlike nearly all the ready-to-wear players, **these two groups spend virtually nothing on advertising and marketing: 0% for Inditex and around 3-4% for H&M!**

H&M has maintained its objective of growing its commercial space by 10-15%/year. However, in our view, the Swedish group will be at the bottom end of the range for 2016-18 (c.10%), nonetheless implying the opening of at least 420 stores over the same period:

Inversely to H&M, at the beginning of the year, Inditex reduced its medium-term growth target for commercial space which now stands at +6-8%/year versus +8-10% previously. On our forecasts, the Inditex group should have nearly 8,000 stores by the end of the FY18 (January 2019), implying the opening of around 320 points of sales (of which 70 for the Zara brand alone) per year.

For the two companies, space contribution will be lower than in previous years (see *Fig. 54:*) and, in our view, investors will again be more focused on LFL growth. As a result, we are more comfortable with Inditex which should post higher comparable growth than H&M over the 2016-18 period, as shown in the following charts.

Fig. 54: H&M and Inditex: LFL sales growth (2009-18e, in %):



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

Valuation levels are underpinned by the strong earnings growth

H&M and Inditex are able to capitalise on their strengths (power of the brands, global presence, expansion in store networks, ramp-up of the online channel, etc.) to post a relatively robust growth profile for the 2016-19 period, as illustrated in the following table.

Fig. 55: 2016-19 CAGR in terms of sales, EBIT and EPS:

% change	Sales	EBIT	EPS
H&M	9.5	10.3	10.3
Inditex	10.5	12.1	12.0

Source: Bryan, Garnier & Co ests

As mentioned in this section, we see the Spanish group as offering a more defensive profile thanks to its customer-centric model and the high degree of supply chain responsiveness, enabling it to be constantly launching collections which are attuned to customer expectations. The greater confidence of the market is reflected in the trend in the two groups' multiples (see the following charts): on a 12-month forward P/E, **H&M** is trading at a modest 4% discount vs. its 2014-16 historic average whereas Inditex is trading at a 26% premium.

It is also worth reiterating that Inditex's gross margin is less sensitive to appreciation in the dollar (c.35% of COGS vs. >80% for H&M), making Inditex shares a potential 'safe haven' within the textile sector.

Fig. 56: 12m forward P/E multiples for H&M and Inditex (x):

Source: Datastream; Bryan, Garnier & Co ests.

While Inditex's EV/EBIT multiples are higher than those of H&M, the following table shows that, in terms of 'EV/EBIT to growth', **H&M** and **Inditex** are trading at similar levels (1.6x 2017e) thanks to better growth outlooks.

Fig. 57: 'EV/EBIT to growth' ratios of the main textile groups:

Companies	Market Cap (EURm)	2017e EV/EBIT (x)	2018e EV/EBIT (x)	EBIT CAGR 2016-2019e (%)	EV/EBIT to growth 2017e (x)	EV/EBIT to growth 2018e (x)
H&M – SEK	**45,369**	**16.6**	**15.0**	**10.3**	**1.6**	**1.5**
Inditex	**97,737**	**19.0**	**17.0**	**12.1**	**1.6**	**1.4**
AB Foods – GBP	20,789	16.9	15.6	13.3	1.3	1.2
M & S – GBP	5,492	11.3	11.0	7.2	1.6	1.5
Next – GBP	7,146	9.9	10.0	0.2	46.2	46.5
SuperGroup – GBP	1,242	11.8	10.5	15.1	0.8	0.7

Source: IBES consensus, Bryan, Garnier & Co ests

DCF valuation methodology

We are re-initiating coverage of H&M (Neutral – FV: SEK295) and Inditex (Buy – FV: EUR38). Our Fair Values are derived using the DCF methodology, our assumptions being detailed in the following tables (*see Fig. 58: and Fig. 59: next page*).

Fig. 58: H&M: DCF valuation:

SEKm	2017e *	2018e	2019e	2020e	2021e	2022e	2023e	2024e	2025e	2026e
Net Sales	**212 025**	**232 252**	**253 155**	**270 875**	**289 837**	**307 227**	**322 588**	**335 492**	**345 557**	**354 196**
% change	*10.1%*	*9.5%*	*9.0%*	*7.0%*	*7.0%*	*6.0%*	*5.0%*	*4.0%*	*3.0%*	*2.5%*
EBIT	26 397	29 264	32 024	35 078	37 534	39 786	41 775	43 446	44 750	45 868
EBIT margin (%)	12.5%	12.6%	12.7%	13.0%	13.0%	13.0%	13.0%	13.0%	13.0%	13.0%
Income taxes	-6 116	-6 773	-7 408	-8 068	-8 633	-9 151	-9 608	-9 993	-10 292	-10 550
Tax rate (%)	23.0%	23.0%	23.0%	23.0%	23.0%	23.0%	23.0%	23.0%	23.0%	23.0%
Operating profit after taxes	**20 281**	**22 491**	**24 616**	**27 010**	**28 901**	**30 635**	**32 167**	**33 454**	**34 457**	**35 319**
+Depreciations	8 693	9 987	11 392	12 189	13 043	13 825	14 516	15 097	15 550	15 939
-Change in WCR	2 458	2 556	2 641	2 817	3 014	3 195	3 355	3 489	3 594	3 684
-Investments in fixed assets	12 721	13 935	15 189	14 898	14 492	13 825	14 516	15 097	15 550	15 939
Operating cash flow	**13 795**	**15 986**	**18 177**	**21 484**	**24 438**	**27 440**	**28 812**	**29 964**	**30 863**	**31 635**

PV of terminal value	326,050
+PV of future cash flows (2017-26)	160,328
= Enterprise Value	**486,378**
Net debt (2017e)	-6,313
Other liabilities	449
Minority interest	0
Financial assets	2,338
Theoretical value of equity	**494,581**
Number of shares (m)	1,665
Theoretical FV per share (SEK)	**295**

** = 2017e: FY ending in November 2017* *Source: Bryan, Garnier & Co ests*

Fig. 59: Inditex: DCF valuation:

EURm	2017e *	2018e	2019e	2020e	2021e	2022e	2023e	2024e	2025e	2026e
Net Sales	**25 724**	**28 393**	**31 233**	**34 356**	**37 104**	**39 702**	**42 084**	**44 188**	**45 955**	**48 253**
% change	*11.0%*	*10.4%*	*10.0%*	*10.0%*	*8.0%*	*7.0%*	*6.0%*	*5.0%*	*4.0%*	*5.0%*
EBIT	4 728	5 219	5 809	6 459	7 050	7 543	7 996	8 396	8 732	9 168
EBIT margin (%)	18.4%	18.4%	18.6%	18.8%	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%
Income taxes	-1 103	-1 218	-1 336	-1 453	-1 586	-1 697	-1 799	-1 889	-1 965	-2 063
Tax rate (%)	23.0%	23.0%	23.0%	22.5%	22.5%	22.5%	22.5%	22.5%	22.5%	22.5%
Operating profit after taxes	**3 626**	**4 001**	**4 473**	**5 006**	**5 464**	**5 846**	**6 197**	**6 507**	**6 767**	**7 105**
+Depreciations	1 209	1 334	1 437	1 546	1 670	1 787	1 894	1 988	2 068	2 171
-Change in WCR	-126	-118	-156	-172	-186	-199	-210	-221	-230	-241
-Investments in fixed assets	1 543	1 704	1 562	1 546	1 670	1 787	1 894	1 988	2 068	2 171
Operating cash flow	**3 417**	**3 751**	**4 504**	**5 177**	**5 649**	**6 045**	**6 407**	**6 728**	**6 997**	**7 347**

PV of terminal value	74,755
+PV of future cash flows (2017-26)	36,774
= Enterprise Value	**111,529**
Net debt (2017e)	-7,718
Other liabilities	950
Minority interest	41
Financial assets	898
Theoretical value of equity	**119,154**
Number of shares (m)	3,113
Theoretical FV per share (EUR)	**38**

** = 2017e: FY ending in January 2018* — *Source: Bryan, Garnier & Co ests*

INDEPENDENT RESEARCH

28th November 2016

Luxury & Consumer Goods

Zalando

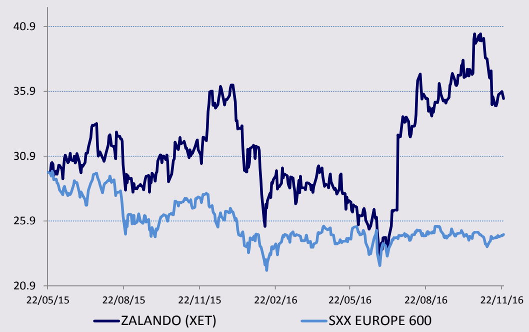
IN SHORT: Zalando, the web category killer

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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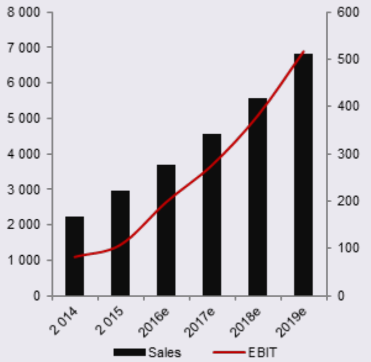

Company description

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

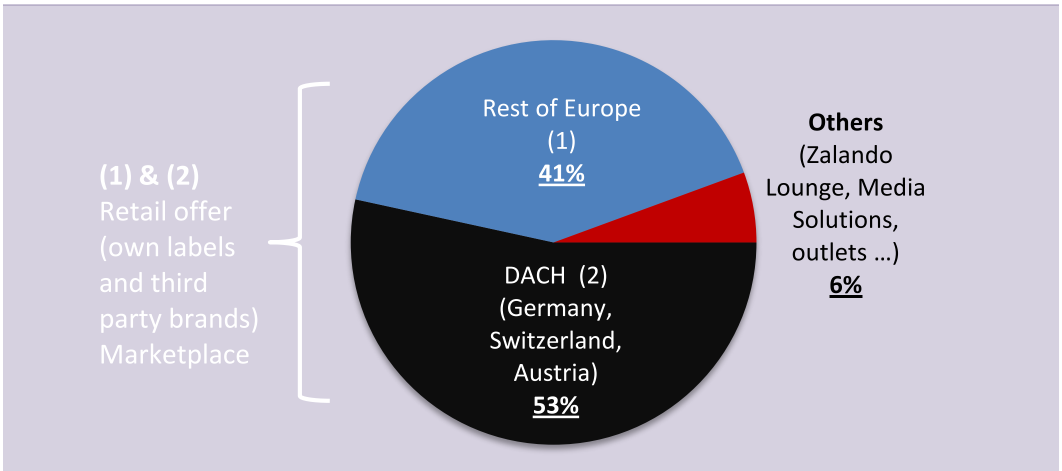
1.1.1. Weighting of Zalando business

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).

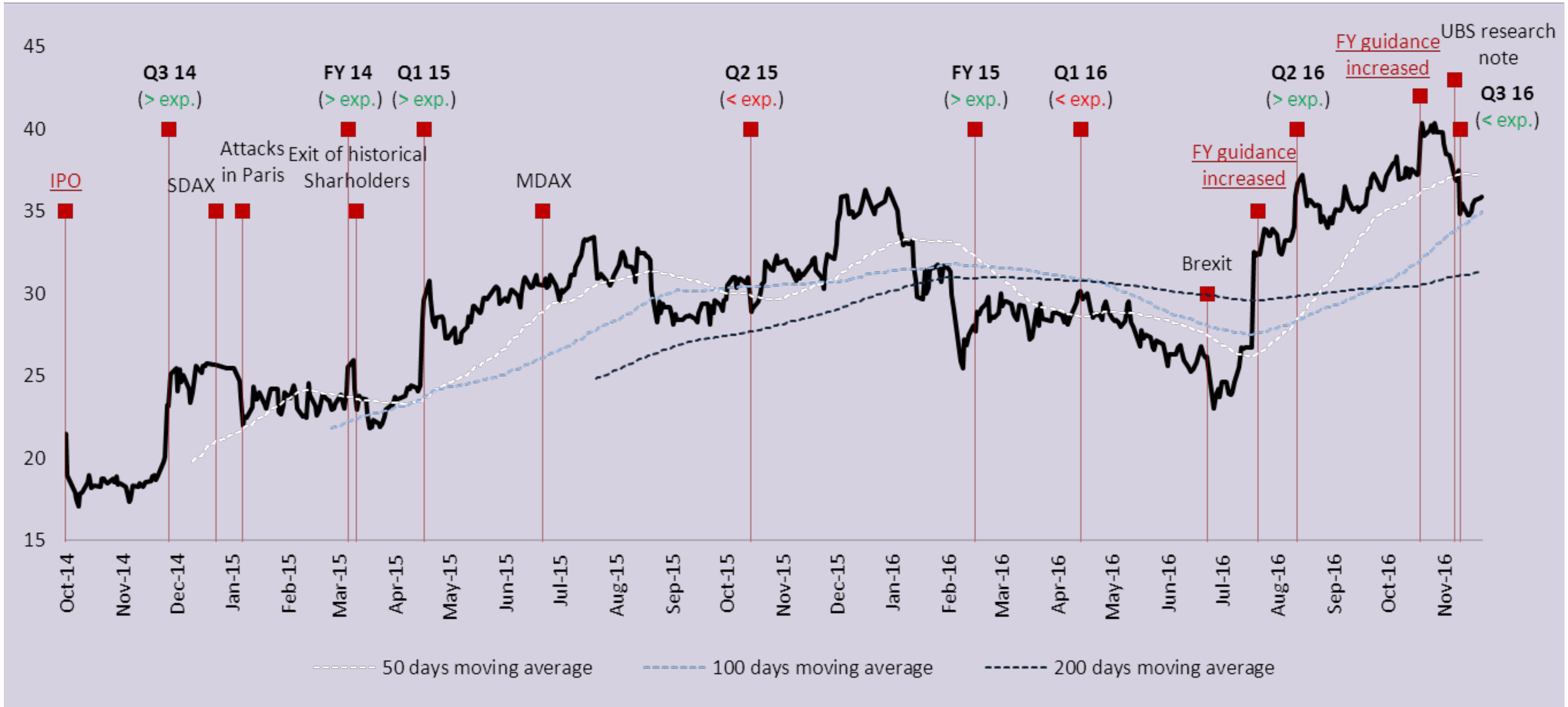
Rocket Internet has had no direct capital ties with Zalando since August 2013, with the incubator having sold its shares to other entities of which Swedish group Kinnevik. In contrast, the Samwer brothers have a personal stake via the Global Founders fund of 8.77% vs. 17% initially. From a purely operational 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.

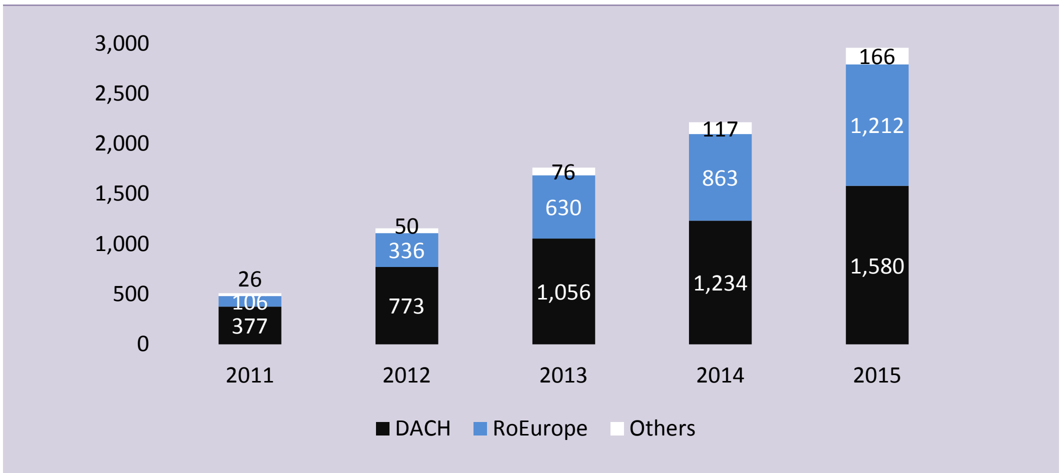
Source: Company Data; Bryan, Garnier & Co ests.

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.

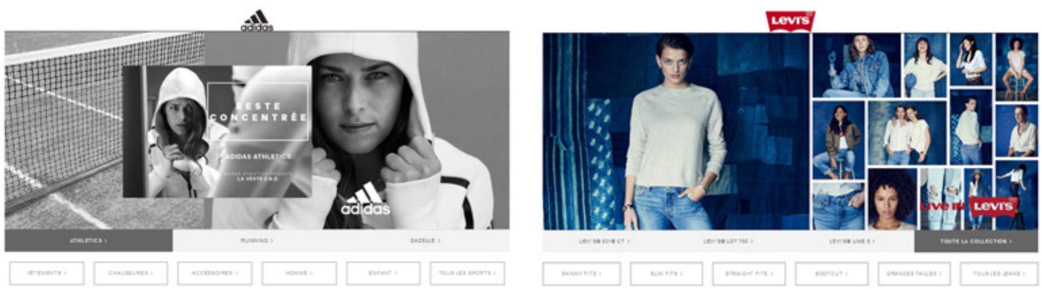
Fig. 9: Our ouderstanding of the market place if the brands take on logistics costs

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.

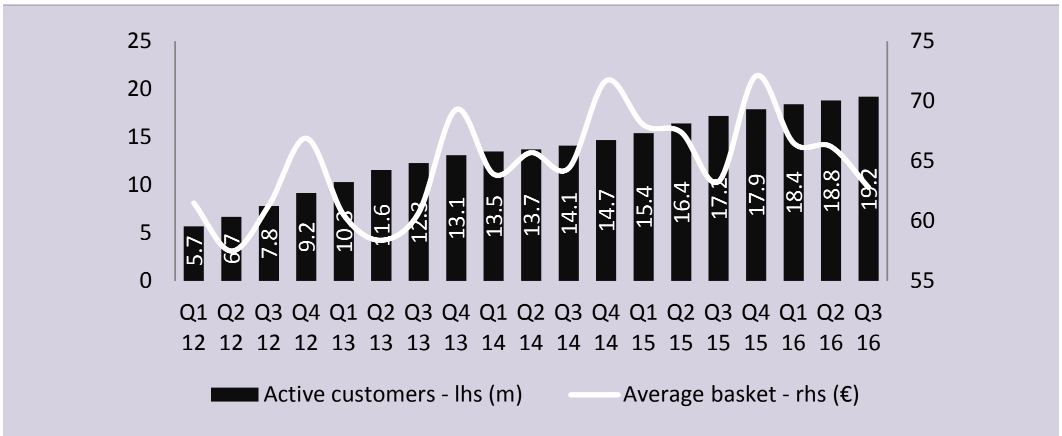
Zalando Zalon (NM at this stage)

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.

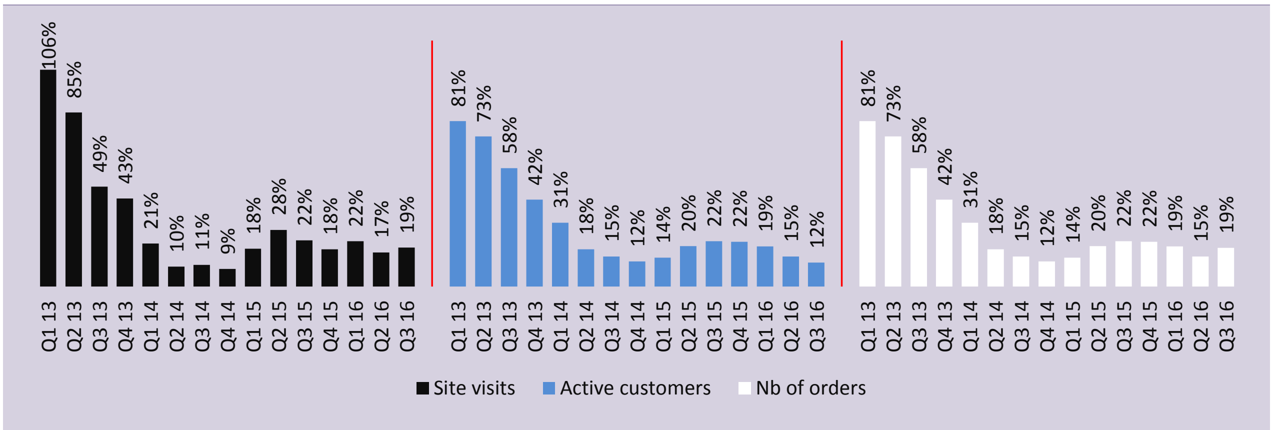
Fig. 11: Increasingly large base of spending customers



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).

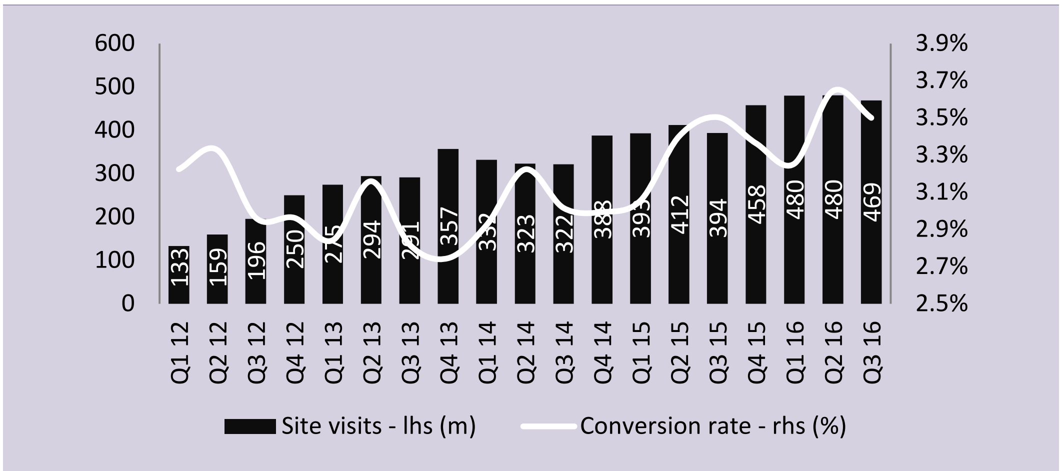
Fig. 12: Change in main Zalando KPIs (YoY growth)



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.

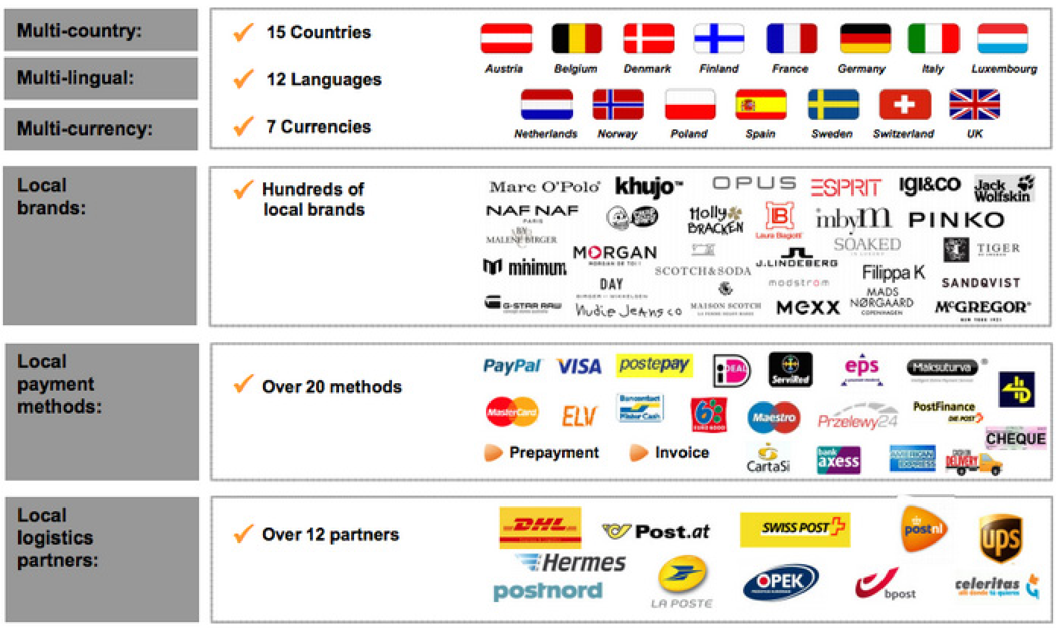
1.3. Comparative advantages: a local offer, proprietary logistics and technology

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.

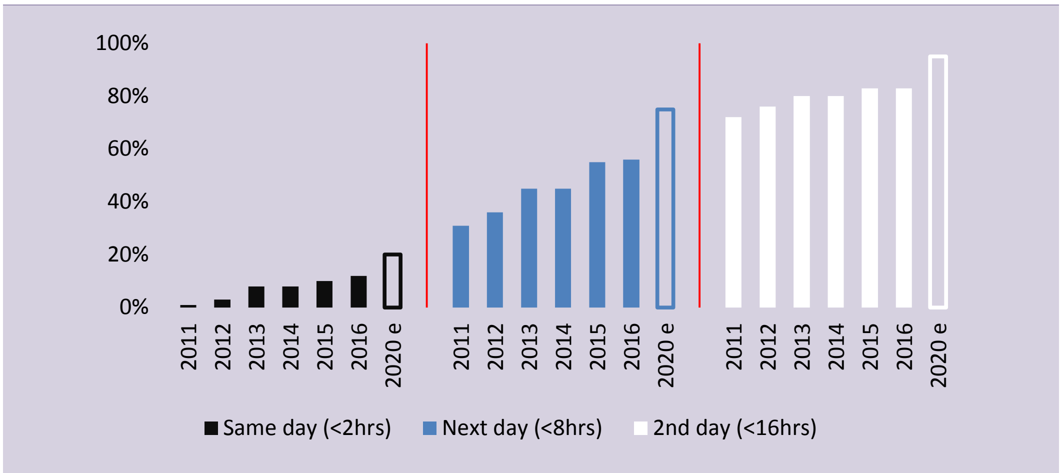
Fig. 17: Features of Zalando's handing centres in Europe

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

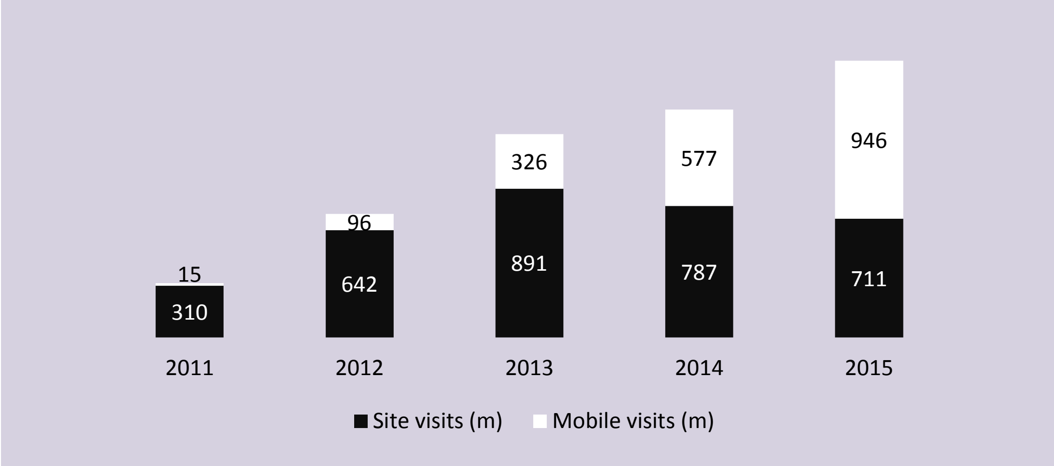
All Zalando home-made

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).

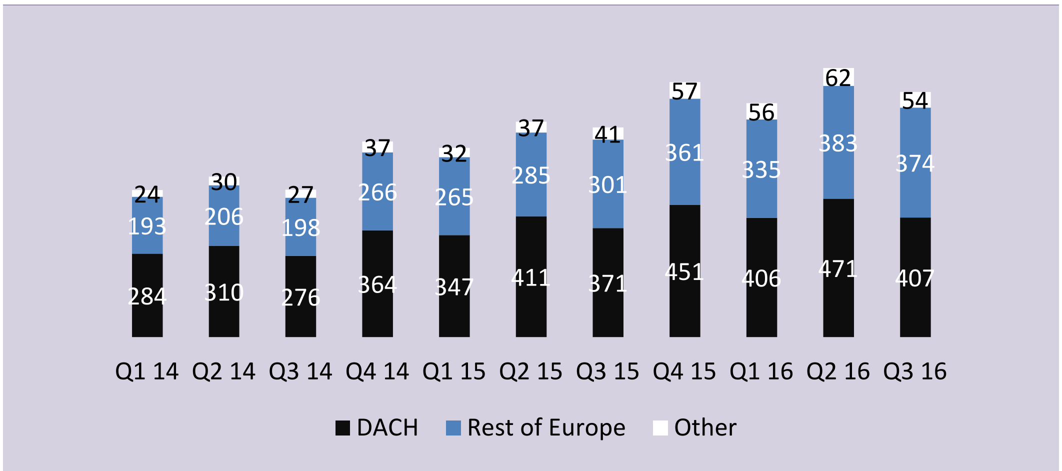
Fig. 21: Zalando return rates (2015)

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.

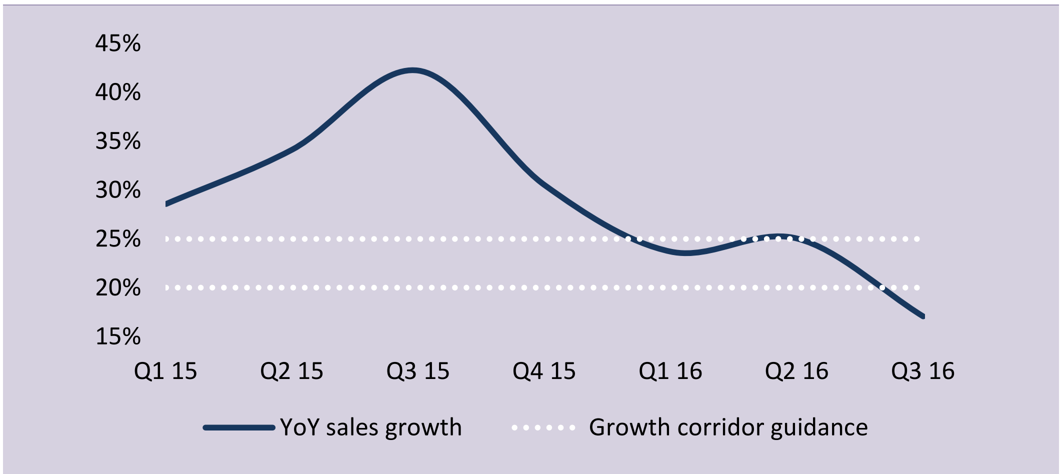
Fig. 22: Change in Zalando quarterly sales by business unit (EURm)



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

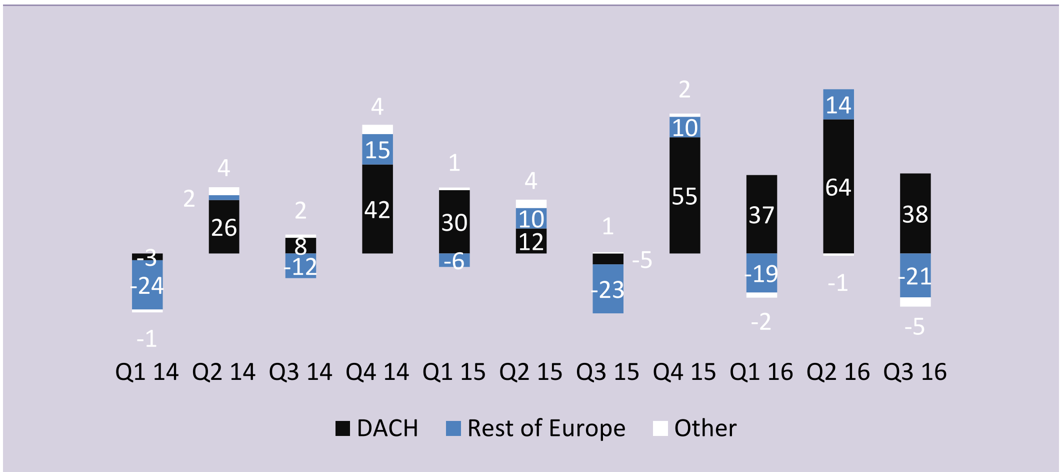


Source: Company Data; Bryan, Garnier & Co ests.

1.4.2. Bottom line

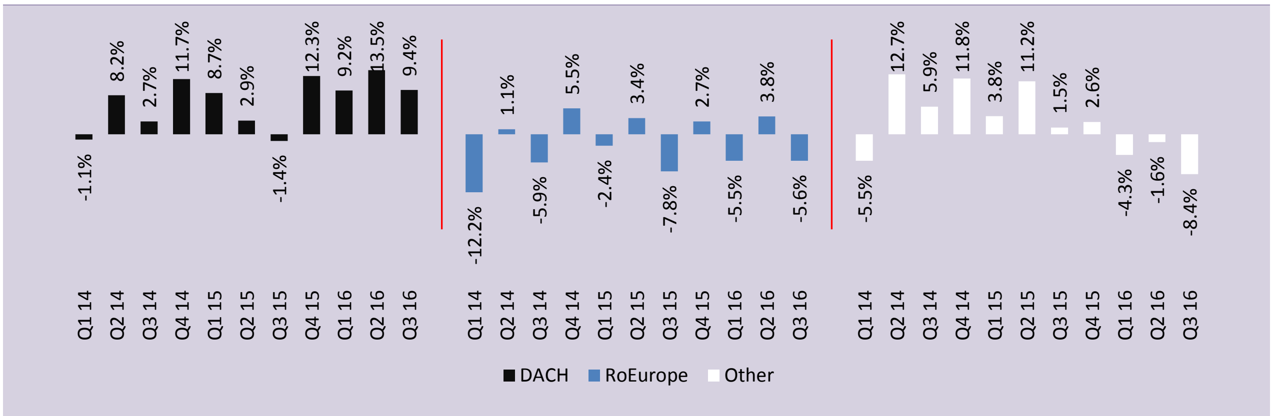
The degree of maturity of countries is reflected in the operating margin level released by the group. The rate reached 5.8% at the end of 2015 in the DACH region (growth of 28% in 2015), whereas the rest of Europe had a negative rate of -0.8% (sales growth of 40% in 2015). Profitability in the "others" 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.

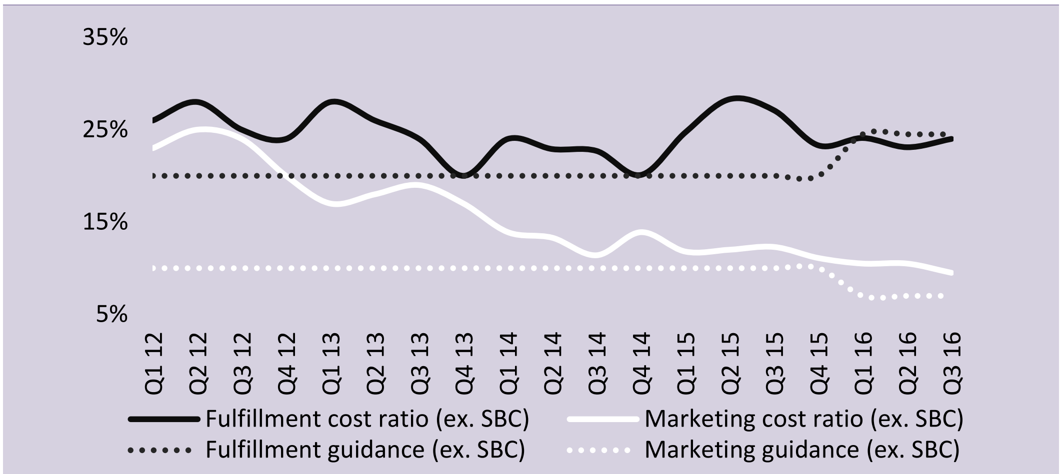
Fig. 25: Change in operating margin by region (after SBC costs)



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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BRYAN, GARNIER & CO

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INDEPENDENT RESEARCH

28th November 2016

Luxury & Consumer Goods

Yoox Net-A-Porter

IN BREF: Yoox Net-A-Porter, the « web-niche »

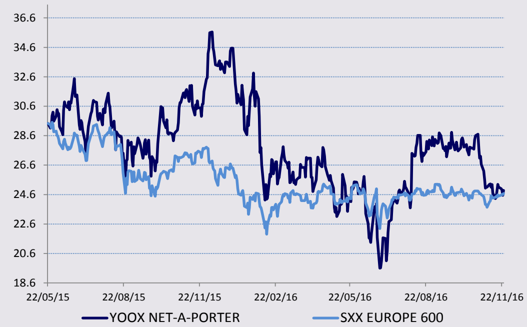
Fair Value EUR33 (price EUR24.89)

BUY

Coverage initiated

Bloomberg	YNAP IM
Reuters	YNAP.MI
12-month High / Low (EUR)	35.7 / 19.6
Market capitalisation (EURm)	3,377
Enterprise Value (BG estimates EURm)	3,328
Avg. 6m daily volume ('000 shares)	592.5
Free Float	38%
3y EPS CAGR	18.3%
Gearing (12/15)	-3,252%
Dividend yields (12/16e)	NM

YE December	12/15	12/16e	12/17e	12/18e
Revenue (EURm)	1,665	1,886	2,257	2,647
EBIT(EURm)	75.72	96.90	109.02	143.72
Basic EPS (EUR)	0.41	0.25	0.32	0.49
Diluted EPS (EUR)	0.46	0.51	0.57	0.75
EV/Sales	2.05x	1.76x	1.47x	1.24x
EV/EBITDA	25.6x	20.7x	15.8x	12.2x
EV/EBIT	45.0x	34.3x	30.5x	22.8x
P/E	54.6x	49.1x	43.4x	33.0x
ROCE	2.6	3.5	3.8	5.0



This introduction is intended as a description for investors who would like to get to know Yoox Net-A-Porter. It complements our sector report (« Serving Consumers not Uberising Them! ») which details our investment summary and valuation, leading to our Buy recommendation (Fair Value of EUR33).

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 **YNAP** is so great in a niche segment that it is difficult for 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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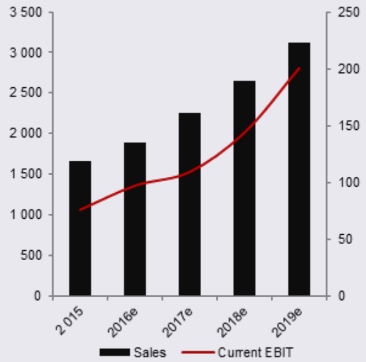


Company description

Yoox Net-A-Porter is the world's leading online luxury fashion retailer as a result of a game-changing merger with Yoox and Net-A-Porter. The group built a unique business with an unrivalled offering including multi-brand in-season online store and multi-brand off-season online stores, as well as numerous online flagship stores.g

Simplified Profit & Loss Account (EURm)	2014	2015	2016e	2017e	2018e
Revenues	1,272	1,665	1,886	2,257	2,647
Change (%)	*-%*	*30.9%*	*13.3%*	*19.7%*	*17.3%*
Current EBITDA	106	133	161	211	268
Change (%)	*-%*	*25.7%*	*20.8%*	*30.9%*	*27.3%*
EBITDA	85.7	126	148	196	251
Change (%)	*-%*	*47.5%*	*17.4%*	*31.9%*	*28.1%*
Current EBIT	59.0	75.7	96.9	109	144
Change (%)	*-%*	*28.3%*	*28.0%*	*12.5%*	*31.8%*
EBIT	38.8	69.5	50.2	60.1	92.3
Change (%)	*-%*	*79.1%*	*-27.8%*	*19.9%*	*53.4%*
Profits from associates	(0.69)	0.59	0.0	0.0	0.0
Financial results	4.2	0.75	(2.6)	0.0	0.0
Pre-Tax profits	42.3	70.9	47.6	60.1	92.3
Tax	(18.9)	(17.4)	(15.3)	(18.0)	(27.7)
Net profit	23.4	53.4	32.3	42.1	64.6
Restated net profit	43.3	59.7	67.3	76.3	101
Change (%)	*-%*	*37.8%*	*12.7%*	*13.4%*	*31.8%*
Cash Flow Statement (EURm)					
Operating cash flows	40.9	46.2	118	178	223
Change in working capital	(16.8)	8.9	(7.4)	(13.5)	(14.2)
Capex, net	(38.4)	(60.6)	(144)	(158)	(159)
Free Cash flow	(14.4)	(5.5)	(33.8)	6.1	50.0
Financial investments, net	(1.2)	(30.0)	(5.5)	0.0	0.0
Dividends	0.0	0.0	0.0	0.0	0.0
Capital increase / buyback	21.8	15.6	100	0.0	0.0
Other	24.6	51.7	3.0	0.0	0.0
Decrease / (Increase) in net debt	30.7	31.9	63.7	6.1	50.0
Net debt	(30.7)	(62.6)	(126)	(132)	(182)
Balance Sheet (EURm)					
Tangible fixed assets	35.7	111	113	89.9	44.9
Intangibles assets	35.7	1,842	1,771	1,816	1,862
Cash & equivalents	128	193	281	288	337
Other assets	256	657	745	870	1,002
Total assets	455	2,804	2,910	3,064	3,246
Shareholders' funds	158	2,037	1,977	2,019	2,083
L & ST Debt	96.8	131	155	155	155
Others liabilities	200	637	778	890	1,008
Total Liabilities	455	2,804	2,910	3,064	3,246
WCR					
Capital employed	110	2,014	1,952	1,988	2,003
Ratios					
Operating margin	4.64	4.55	5.14	4.83	5.43
Normative tax rate	30.00	30.00	30.00	30.00	30.00
Net margin	3.41	3.59	3.57	3.38	3.80
ROCE (after tax)	37.47	2.63	3.47	3.84	5.02
Gearing	(515)	(3,252)	(1,564)	(1,524)	(1,142)
Average number of shares					
Number of shares, diluted	0.0	131	133	133	133
Data per Share (EUR)					
EPS	NM	0.41	0.25	0.32	0.49
Restated EPS	NM	0.46	0.51	0.57	0.75
% change	*-%*	*-%*	*11.2%*	*13.2%*	*31.5%*
Operating cash flows	NM	0.35	0.89	1.34	1.67
FCF	NM	(0.04)	(0.25)	0.05	0.37
Net dividend	NM	0.0	0.0	0.0	0.0

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

Table of contents

1. Two soul sisters

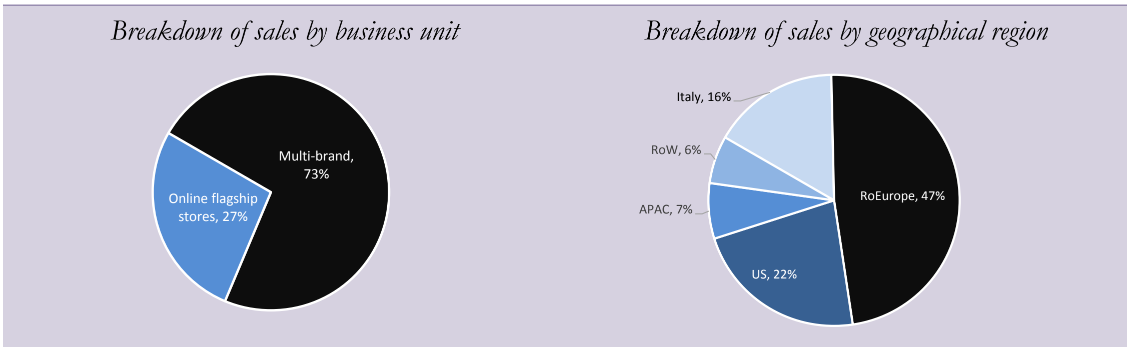
1.1. Yoox: six of one…

Yoox Group was created in Italy in 2000 by Federico Marchetti, a former banker, who was animated by the idea of combining internet and fashion for the first time. Since its creation, the group focuses on selling mid and upscale articles and targets "sophisticated" clients to the detriment of attractive promotional and cut-price sales.

This niche positioning was strengthened in the affordable luxury segment with the opening of The Corner.com (2008) and Shoescribe (2012) and enabled Yoox.com to break even three years after its launch. The model is easy to export since the company is currently present in 170 markets compared with only 57 countries in 2009.

Yoox Group was floated on the Italian market on 12th March 2009 (only IPO in Italy that year) at the price of EUR4.3 per share, at the high-end of the valuation range (EUR3.6-EUR4.5) for a market capitalisation of EUR217m. The operation enabled the group to raise EUR95m, destined at underpinning business in Asia. As of 2013, the share integrated the Italian stockmarket's benchmark index, the FTSE MIB.

Fig. 1: Presentation of Yoox – 2014 (pre-merger)



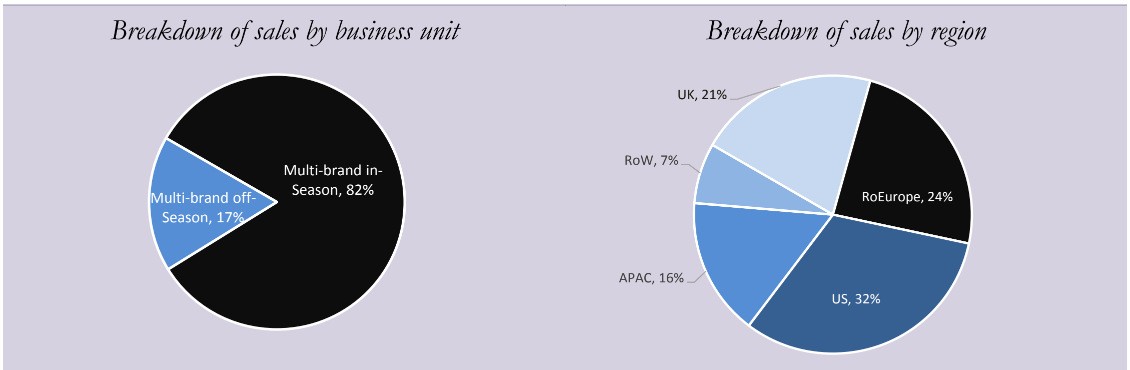
Source: Company Data; Bryan, Garnier & Co ests.

1.2. NAP: …half a dozen of the other

Net-A-Porter Group was founded in the UK in 2000 by Natalie Massenet, previously a fashion editor for specialised UK magazines. The group rapidly became one of the favoured online addresses for wealthy fashion lovers.

Sales development then focused more on upscale fashion lovers. This niche positioning rapidly caught the eye of global luxury player Richemont, which bought a stake in the group as of 2002. This was constantly increased until the group took control of Net-A-Porter in 2010.

Fig. 2: Presentation of NAP – 2014 (pre-merger)



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

1.3. A marriage of convenience

Birth of a global leader in online sales of affordable luxury articles

In October 2015, via a share swap offer, Yoox Group logically undertook the merger/absorption of Net-A-Porter (valued at GBP950m, or EUR1.44bn), its alter-ego in the online affordable luxury segment. Indeed, Yoox Net-A-Porter (YNAP) combines the multi-brand proprietary business of Net-A-Porter (Net-A-Porter.com, MrPorter.com and TheOutnet.com) with the expertise of Yoox in the development and management of dedicated websites for third-party brands (know-how strengthened by the joint-venture with Kering concerning eight corners focused on the French group's brands). So far, 41 mono-brand websites are currently supervised by the company.

The merger created Yoox Net-A-Porter (YNAP), one of the leaders in online fashion sales with pro-forma 2015 sales of EUR1.7bn generated in 180 countries. Federico Marchetti remains at the head of the new group, while the founder and CEO of Net-A-Porter, initially destined to become Executive Chairman, resigned just a few weeks before the operation was completed.

Fig. 3: Presentation of YNAP – pro-forma 2015

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

Richemont (which had acquired 93% of Net-A-Porter's capital) obtained 49% of the capital and 25% of YNAP voting rights and is obliged to maintain its stake for a three-year period. Meanwhile, Federico Marchetti reduced his pre-merger stake from 9.8% to 4.8% after the merger, then 3.9% at end-June 2016. A capital increase of up to EUR200m was initially planned following the merger-absorption, in which Richemont was supposed to take part (EUR100m was finally undertaken via a private placement in April 2016 with the Alabbar fund).

Fig. 4: Shareholding structure of new YNAP group

Shareholding	At 06/16
Richemont	49%
Federico Marchetti (Yoox founder)	3.9%
Renzo Rosso (Diesel founder)	4%
Mohamed Ali Rashed Alabbar	3%
Fil Limited	2%
Public free float	38%

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

Ramp-up and potential operating synergies

With an average basket of EUR481 in 2014, Net-A-Porter's customers are positioned in a more upscale segment than those of Yoox (EUR200). These more selective and extravagant customers are also fewer in number (0.8m vs. 1.3m in 2014). The integration of Net-A-Porter helped Yoox move upscale with an average basket totalling EUR352 in 2015, albeit without a reduction in the client base (2.5m in 2015) and the number of orders taken on a pro-forma basis (7.1m in 2015).

Net-A-Porter has always been less profitable than Yoox (7.7% EBTIDA margin vs. 9.6% despite its more upscale positioning). It only became profitable during 2015, just prior to the merger of the two groups. In addition to complementary geographical aspects, the merger offers high synergy potential that should bring the margin to levels that are rare for an e-commerce player.

Initially estimated at EUR60m/year as of 2018 (after integration of the logistics process, sales platforms and technological support), synergies were reassessed at EUR80m/year. EUR95m in non-recurring cost-reductions are also expected between 2015 and 2018, primarily concerning capex.

Fig. 5: An apparently beneficial move upscale

	Yoox Group (2014)	Net A Porter Group (2014)	Yoox Net A Porter Group (2015)
Online stores	Yoox.com TheCorner.com Shoescribe.com Corners including JV with Kering	Net-a-porter.com MrPorter.com TheOutnet.com Corner for Jimmy Choo	Yoox.com Net-a-porter.com MrPorter.com TheOutnet.com Corners including JV with Kering and Jimmy Choo
Net revenues (EURm)	524.3	753.8	1,665
EBITDA (EURm)	50.1	58.3	126.0
EBITDA margin	9.6%	7.7%	7.6%
Employees	885	2,455	3,901
Monthly unique visitors (m)	15.2	9.0	27.1
Active customers (m)	1.3	0.8	2.5
Average order value (EURm)	202	481	352
Orders (m)	3.4	2.4	7.1
Conversion rate	1.9%	2.2%	2.2%

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

Fig. 6: Strong complementary aspects in off-season and corners

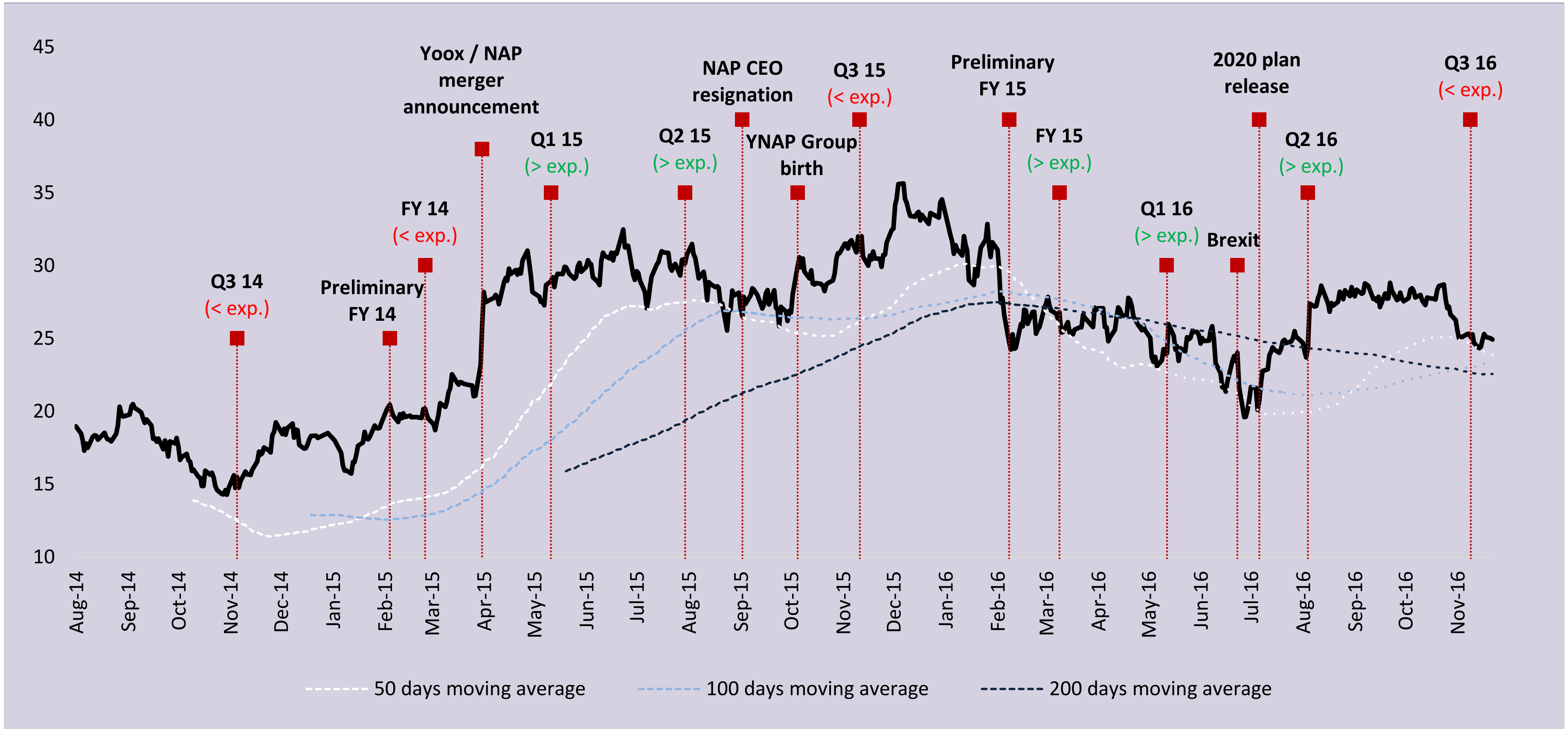
	Yoox Group		Net-A-Porter Group	
In-Season	SHOESCRIBE	Created in 2012. Focused on women footwear	NET-A-PORTER	Created in 2000. Fashion items destined to women
	THECORNER	Created in 2008. Online store for men and women	MR PORTER	Created in 2011. Fashion items destined to men
Off-Season	YOOX.COM	Created in 2000. Destocking of exhaustive fashion items for men, women and children	THE OUTNET	Created in 2009. Destocking of more exclusive premium fashion items for an olde female clientele
Corners	KERING	Since 2012, JV with Kering to handle its 8 brands' websites (Saint Laurent, Bottega Veneta, Alexander McQueen ...) 33 other brands (Marni.com, Diesel.com, Valentino.com ...)	JIMMY CHOO	Since 2007, JV with Jimmy Choo to handle the brand's retailing website

Cannibalisation between Yoox et NAP's websites offering the same kind of products (leading to the Shoescribe & TheCorner's closure in 2016)

Offer's complementarity between Yoox and NAP's websites

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

Fig. 7: Yoox equity story (Yoox Net-A-Porter since August 2014)



Source: Thomson Reuters; Bryan, Garnier & Co ests.

1.4. SWOT analysis of Yoox Net-A-Porter

Fig. 8: YNAP SWOT

Strengths	Weaknesses
Niche market expertise that cannot be improvised (first entrant, revered by some of the most well-known brands).	Contrary to a number of rivals, YNAP bills its deliveries and returns, at a higher than average cost.
In the mono-brand division, the experience gained previously in the multi-brand segment is a guarantee of strong credibility...	The level of stocks could be improved. It needs to be optimised as the omni-stock programme is rolled out.
… whereas intimate relations with the brands, via mono-brand corners, help secure supply in the multi-brand segment.	
Opportunities	**Threats**
The penetration rate in e-commerce in luxury is currently low at 7%. It offers several years of growth for sector players.	All mergers (October 2015) present execution risks, especially when logistics are at the heart of the system.
Cross fertilisation between the various site categories, enabling the group to be constantly up-to-date with the latest fashions.	On principal, Amazon is a threat for e-commerce players (in 2017 it is set to be the no. 1 US textiles retailer).
A breeding ground of synergies can still be exploited following the merger (more than 300bp potential improvement in the margin out to 2020).	Further out, retailers could decide to bring their e-commerce brands back in-house (especially Kering).

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

2. A unique offer in the affordable luxury segment

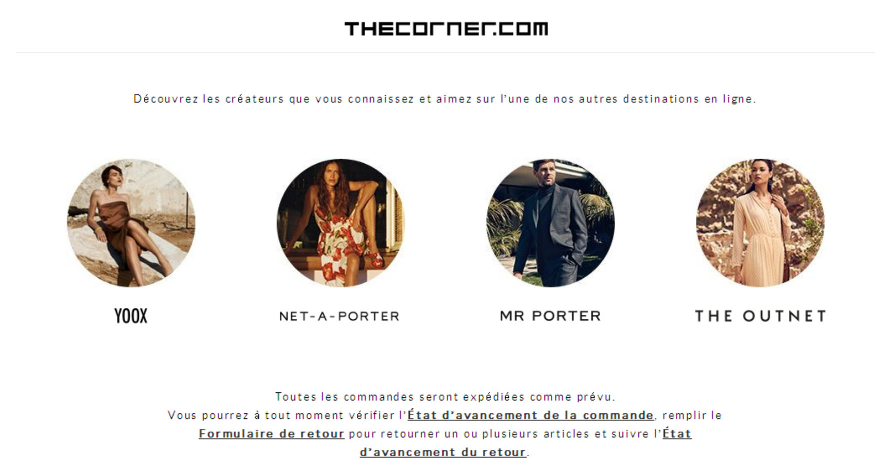
2.1. A comprehensive in- and off-season offering

YNAP manages 47 sites selling fashion articles in the affordable luxury segment, divided into three categories: **1/** multi-brand in-season sites (covering recent articles from around 350 brands), **2/** multi-brand off-season sites (which run down products stemming from 1,000 different brands from previous seasons or from other group websites, destined to be sold at a discount), **3/** mono-brand flagship sites (41 including eight for the JV with Kering) managed on behalf of third-party brands (see section 2.2).

The in-season segment (Net-A-Porter, Mr Porter) had been reorganised within the new group given the similarities with a number of sites in terms of offer (very similar styles or brands and the same price range - see figure 6) and customers (virtually half of the active customers on The Corner and Shoescribe were also Net-A-Porter and Mr Porter users). At the end of 2015, YNAP therefore announced the closure of TheCorner.com and Shoescribe.com (initially part of Yoox Group) by the summer of 2016.

Note that these two sites only accounted for 2.4% of pro-forma sales at end-September 2015, hence the low risk attached to reorganisation. The websites are still online and, in order to limit the loss in customers, redirect users to other addresses belonging to the group. This operation has helped streamline market and structural costs. YNAP is therefore aiming to improve the profitability of the Net-A-Porter sites, which was initially weaker than for the Yoox sites.

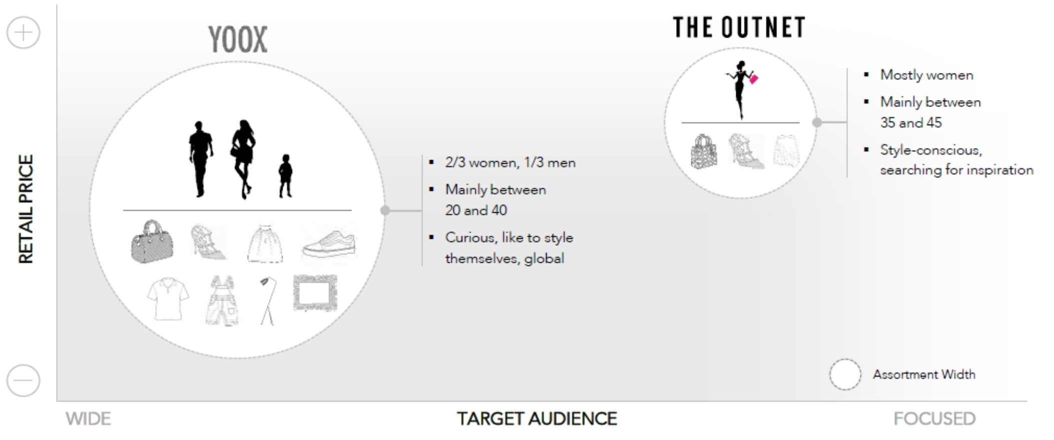
Fig. 9: Site reorganisation: rapidity without brutality



Source: TheCorner.com.

Off-season multi-brand websites are not currently part of the reorganisation, even if the offer stemming from the merger of Yoox and Net-A-Porter is set to become more upscale with the addition of The Outnet (initially owned by Net-A-Porter). Via the Yoox site, this off-season segment was previously targeting a large category of customers (women, men, children) to whom a comprehensive rate of fashion products was offered. The Outnet (stock run-downs) currently provides more exclusive premium fashion articles for women aiming to change their system (older customers who are more demanding and prepared to spend more).

Fig. 10: Moves upscale in off-season



Source: Yoox Net-A-Porter.

2.2. Niche market expertise in the mono-brand corner segment

Since its creation in 2000, Yoox has acquired so much experience in the online luxury segment that numerous high-end banners have entrusted it the management of their websites (32 brands, as well as eight Kering brands via a joint-venture with the French group). Meanwhile, until the merger, Net-A-Porter simply managed the Jimmy Choo corner via a joint venture. Today, YNAP manages 41 mono-brand corners.

In concrete terms, the YNAP role consists of managing the sales platform, settlement processes, deliveries and returns. In addition, in agreement with the brands, it can offer consumers services in **1/** "Click & Collect" (online order and collection of the product in the brand's physical stores), **2/** "Click & Reserve" (after reserving online, the customer pays for and collects the product at the store) while ensuring **3/** "Ship From Store" (which consists of soliciting stock from another store if the article is lacking in the store where the customer is supposed to collect it from). Finally, via its smart data expertise, **4/** it can advise brands on their offer.

Under the framework of the joint venture created with Kering in 2012 (51% Kering, 49% Yoox), the brands maintain exclusive control of the store via the product assortment, editorial content, artistic direction and digital communication. YNAP simply makes its platform available and manages settlements and deliveries. The joint venture is consolidated in Kering's accounts, and Kering pays YNAP on the basis of a percentage of sales. After seven years of operation, Kering and YNAP will have the right to respectively exercise a buy and a sell option on the share owned by the e-merchant in the joint-venture. The risk is that Kering could later decide to bring management of all of the websites for the brands it owns back in-house (note the impact that the loss of the Kering licence had on Safilo's share price...). We believe that the market has this threat well in mind.

2.3. Cross-fertilisation concept in an upscale ecosystem

The strength of YNAP's business model is based especially on the cross-fertilisation concept between the sites' various categories. Indeed, the multi-brand platforms serve as a shop-window and incubator for future corners, which then become a breeding ground for information.

As such, thanks to the data collected (2.5m active clients and 27m unique monthly visits), YNAP can permanently fine-tune the offer on its proprietary sites depending on the trends and fashions taking shape. Similarly, when it has not managed to run-down stocks on its "in-season" sites, YNAP can shift them to its "off-season" platforms (as articles not sold in the corners can be found on multi-brands sites).

The concern with fine-tuning the offer lies in the presentation of upscale products (professional photographs, 3D views, videos). The clichés stem from specialised studios owned by the group, with around 99 of these throughout the world, close to distribution centres (US, UK, Italy, China, Japan and Hong Kong). More than 250 photographers, stylists, photo retouchers, cameramen and editors are involved in this activity that primarily covers the products sold by the in-season multi-brand sites.

It goes without saying that YNAP has adopted an omni-channel content strategy. In this respect, the offer is accessible on mobile devices (95% of luxury goods customers have a smartphone whereas mobiles account for 55% of YNAP's visitor flows and 37% of orders).

3. Heading for an industrialisation of the model

3.1. Densifying coverage

In geographical terms, the presence of Net-A-Porter in the US (32% of its 2014 sales) and in Asia (16%) advantageously rounds out Yoox's high exposure to Europe (63% of its 2014 sales). Indeed, the US and Chinese markets are larger than Europe and offer higher growth potential, with customers who are more used to online purchasing and are more spendthrift. In Europe, each entity enables the group to benefit from its leadership position in the domestic market (Italy for Yoox and the UK for Net-A-Porter).

Via a logistics network of eight centres (250,000m² in) throughout the world, YNAP delivered seven million orders in 180 countries in 2015. Out of all of the destinations, 25 benefited from a premium delivery service (same-day delivery). This high-quality service is ensured by a proprietary fleet of 55 vans throughout Italy, the east coast of the US and in Hong-Kong. The remaining orders are handled by a third-party provider. Delivery is billed to the customer (between EUR6 and EUR30 depending on the timeframe chosen), returns are free but with a retraction deadline of less than 30 days.

YNAP's global logistical network is currently dependent on supply from the Bologne centre (147,000m²) historically owned by Yoox. However, in order to reduce costs and delivery times, the group has not stopped extending its distribution capacity. The space dedicated to logistics should therefore rise from 250,000m² in 2015 to 340,000m² in 2020, by the opening/extension of satellite centres. Italy should therefore welcome a new entity for which building started in H1 2016 and should be fully operational in H1 2018 (58,000m² for an investment of EUR30m). The United Arab Emirates should be equipped with a similar space in H2 2017 and this should help the group attack the Middle Eastern market. Asia and the US will also see their network increase in 2018 and 2019 respectively. In addition, the group's recent interest for Russia, prompted by the potential economic recovery, could encourage it to extend its network in Eastern Europe.

Fig. 11: Extension of logistical capacity

Country	NAP	Yoox	YNAP 2015 (m²)	YNAP 2020 (m²)
Italy		x	147,000	205,000
UK	x		17,600	17,600
US	x	x	49,000	43,000
Japan		x	2,300	4,800
China		x	3,000	6,200
Hong Kong	x	x	14,000	14,100
United Arab Emirates			-	ND
?			-	?
Total			**250,000**	**340,000**

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

Fig. 12: Yoox Net-A-Porter logistical structure – 2020 plan

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

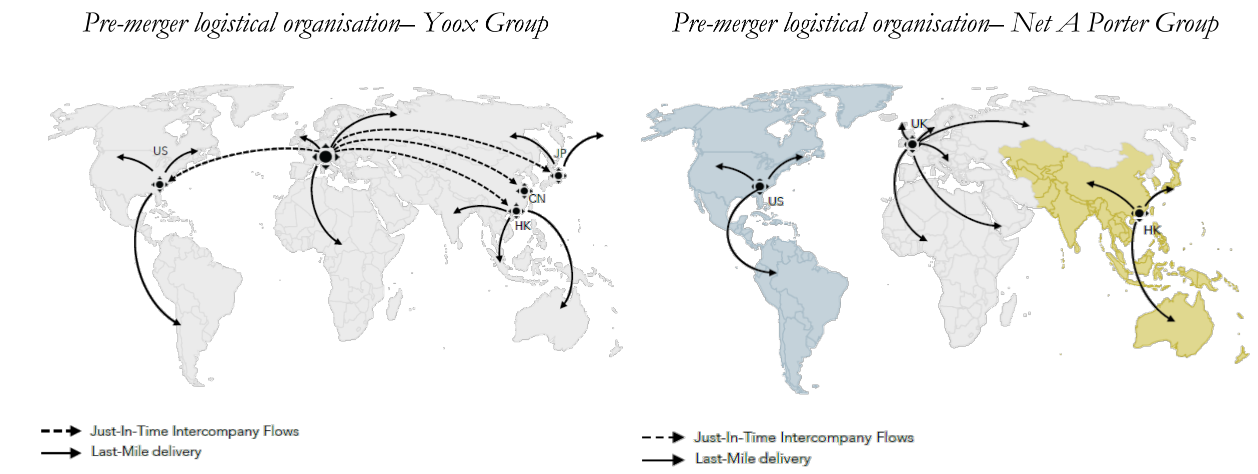
3.2. Harmonisation of logistical processes

1/ When YNAP undertakes delivery/settlement on behalf of third-party brands and for multi-brand sites, its own logistics chain is directly solicited. In contrast, **2/** when the group simply collects orders and reservations on behalf of the banners (Click & Collect, Click & Reserve and Ship From Store), it leaves its partners to handle in-store delivery and is therefore only indirectly concerned by logistics. These direct **(1)** and indirect **(2)** flows are destined to be optimised thanks to the multiplication in synergies between the platforms.

1/ Concerning direct flows

In historical terms, Yoox' logistical structure is based on its main logistics hub in Bologne, whereas the organisation at Net A Porter is less centralised and initially includes three major centres (US, UK, Hong Kong). Each of these works independently and feeds secondary platforms, while directly ensuring a number of orders.

Fig. 13: Two different organisations



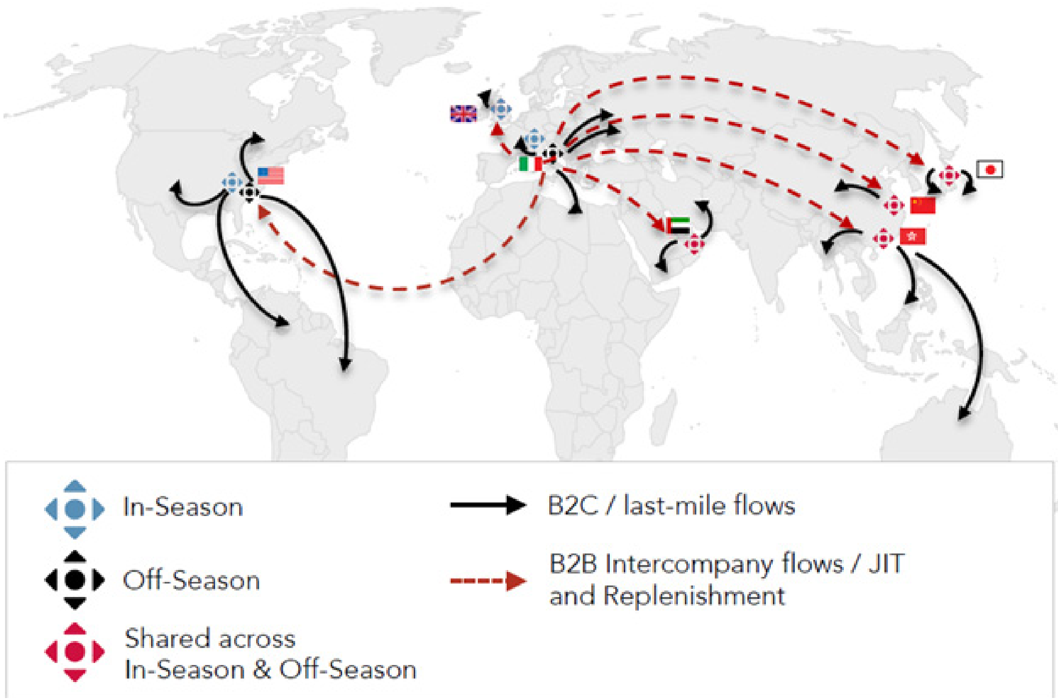
Source: Yoox Group; Net A Porter Group.

At end-June 2016, YNAP had more than 8.7m articles in all of its logistical centres. In order to manage these stocks, the new organisation maintains the centralised scheme established by Yoox and therefore remains dependent on Bologna. This hierarchy nevertheless integrates more secondary poles to supply, these being increasingly well connected in order to optimise flows.

Indeed, YNAP is currently working on a smart stock-allocation programme ("omni-stock") aimed at providing a degree of flexibility to the allocation of reserves between the various logistical centres, in order to protect itself as far as possible from the risk of shortfalls or of overstocking. Further out, YNAP executives will have real-time access to this information.

This programme should be operational between now and 2018. Yoox' former in-season sites will be the first to migrate to this system, as of Q4 2016 (transfer of the off-season business is planned for H2 2017). The former Net-A-Porter sites are then set to follow, and then in Q3 2017, the mono-brand sites managed on behalf of third-party brands (for classic delivery payment).

Fig. 14: New post-merger organisation (including 2020 plan to extend the logistics network)



Source: Yoox Net-A-Porter.

2/ Indirect flows

When the consumer opts for the Click & Collect option, the brand's logistics chain is solicited and Yoox is simply an order-taking platform via the mono-brand corner. An order management system software then places the corner in contact with the brands' physical stores and distribution centres, making the omni-channel strategy more fluid. In order to do this, the group decided to call on the expertise of IBM as of 2016.

3.3. Outsourcing expertise in logistical software to IBM

The standardisation of the logistical processes has stemmed from the partnership created with IBM in 2016. In addition to a single IT platform (the e-commerce suite), IBM developed the order management system software and is currently working on the "omni-stock" programme. This partnership is apparently diluting the proprietary technology, which some clearly consider regrettable. A number of executive staff, including the group's head of technology, Hugh Fahy, have therefore left the group.

At the same time, YNAP is planning to recruit more than 100 staff in its technological division, between the Bologna and London sites, in order to accompany the ramp-up in the technology necessary for converging the systems and developing mobile services (55% of visitor flows, but just 37% or orders). Out of the EUR800m in capex planned for 2015-2020, 74% is set to be invested in technology (21% for operations with the opening of new handling centres).

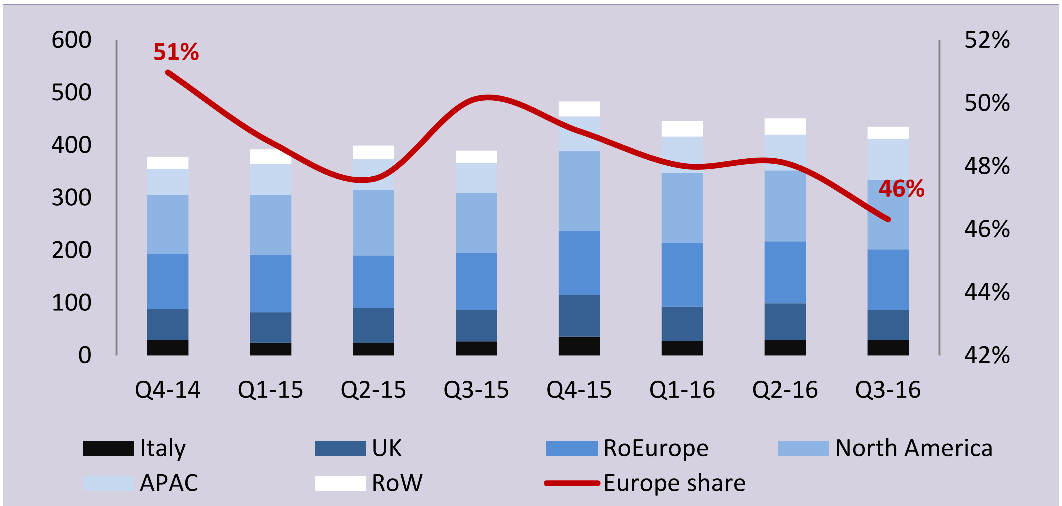
4. YNAP financial performances

4.1. Growth in the online luxury market

The group is highly exposed to two main regions, North America (30% of sales) and Europe (48%), both of which are developed and receptive to e-commerce. The contribution from Europe has nevertheless tended to decline (48% in Q2 2016 vs. 51% pro-forma in Q4 2014), given the ramp-up in Asia.

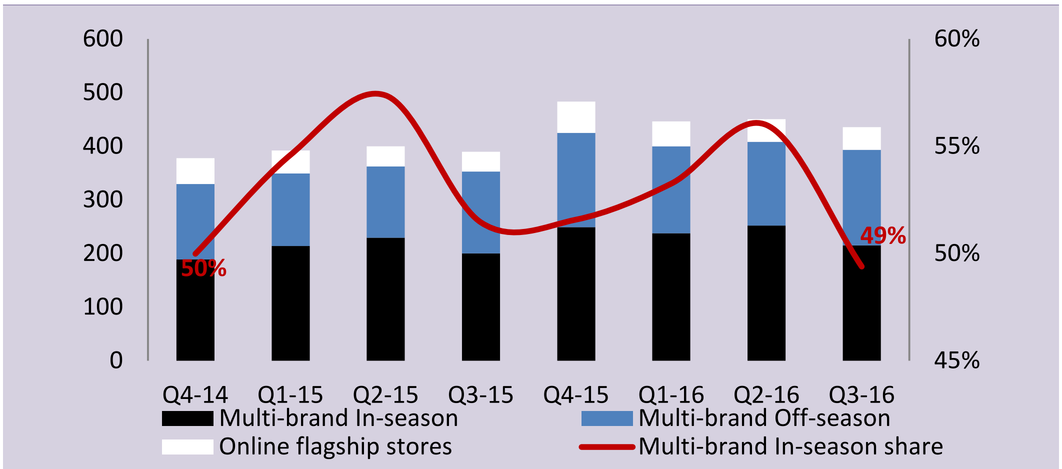
Like the Middle East, Asia merits specific attention. Indeed, China represents huge development potential for e-commerce with growth rates of around 33% at present and potential still to explore (36% of the population over the age of 15 have already made purchases online).

Fig. 15: Increasingly diversified geographical exposure (EURm)



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

Fig. 16: Sales driven by Net-A-Porter.com and Mr Porter.com (EURm)



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

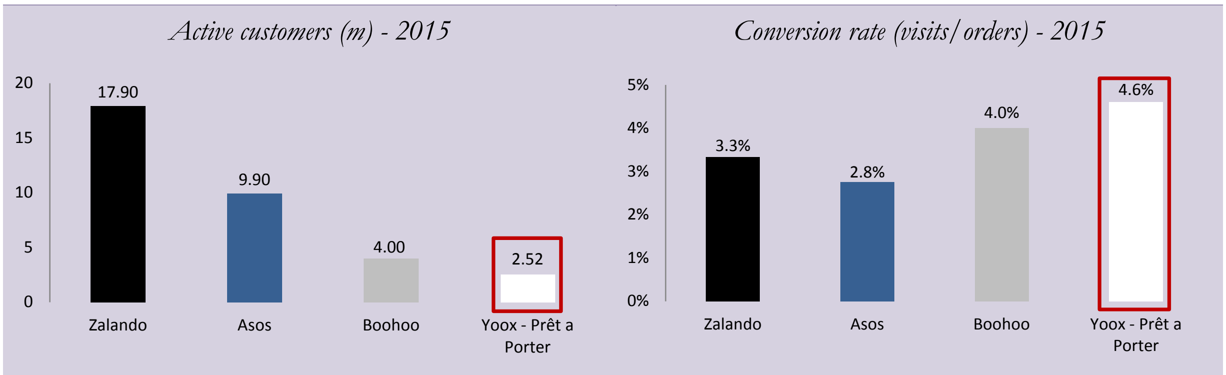
Fig. 17: Characteristics of three major regions for e-commerce (2015)

Country	E-commerce B2C turnover (EURbn)	E-commerce B2C (YoY growth)	E-shoppers (% of population >15yo)	Spending per e-shopper (EUR)
European region	455	+13%	43%	1,540
China	682	+33%	36%	1,855
US	530	+12%	67%	3,428

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

Given its far more upscale positioning than rivals such as Asos and Zalando, YNAP's active client base (i.e. those having made at least one purchase over the past 12 months) is smaller (2.5m customers in 2015 on a pro-forma basis). However, this more restricted customer base also seems easier to convert into sales, with YNAP boasting a conversion rate of 4.6% (far higher than its European peers in mass market segments).

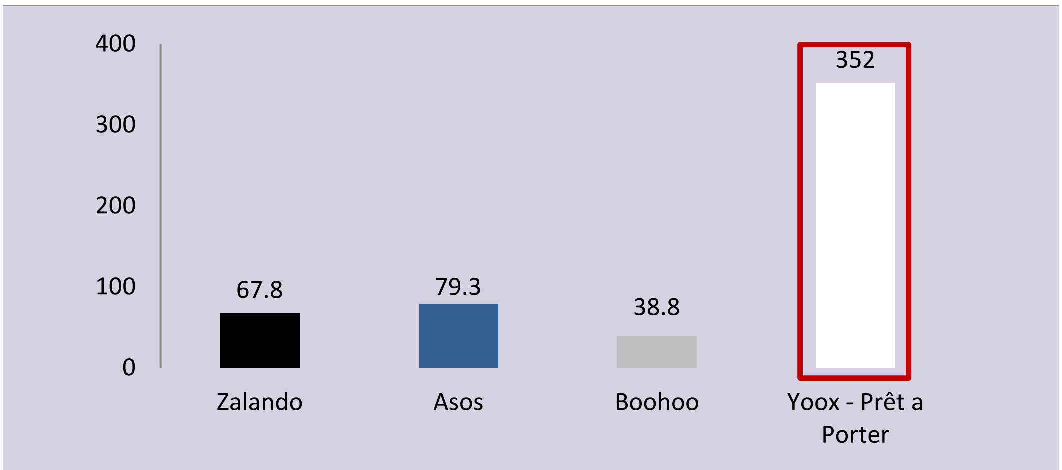
Fig. 18: Luxury: fewer customers but more easily converted



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

The range of luxury products offered and the customer purchasing power targeted drives an average basket of EUR352, more than four times higher than average baskets at European peers. Note that this even climbs to EUR600 if we only look at the group's in-season business (Net-A-Porter, Mr Porter).

Fig. 19: High average basket makes Yoox a luxury player



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

With a customer base looking for quality and strong brand image, the group does not need to make huge efforts in terms of handling orders (the majority of customer satisfaction having been undertaken upstream, when the product is presented). As such, YNAP does not offer free delivery (which costs between EUR6 and EUR30 for customers) and only grants a 14-28 day time-frame for customers to change their minds and return the products. This strategy contrasts with policies at other players, like Zalando, which offer free deliveries and returns.

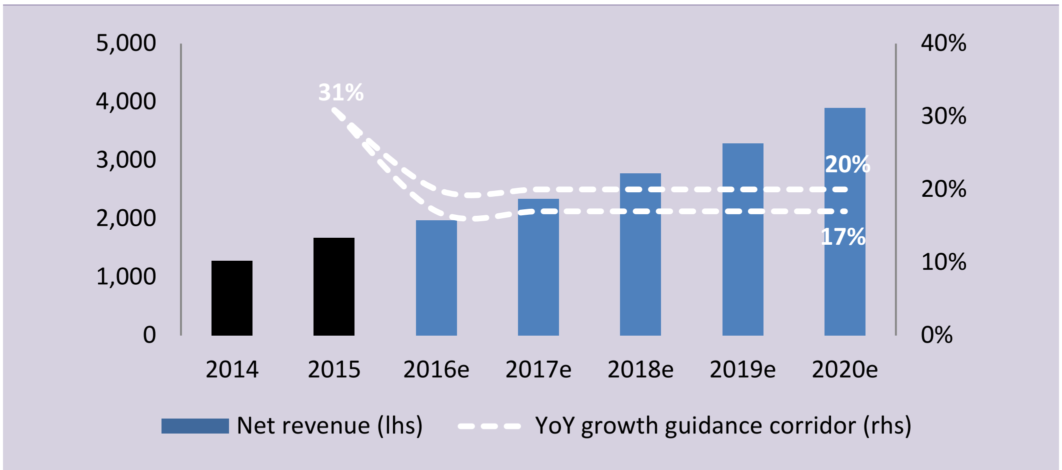
Fig. 20: Fewer efforts in order handling

	Delivery time	Delivery cost	Retraction/return time	Return cost
Yoox	1-6 days	€9.5-€30	14 days	Free
Net A Porter	1-6 days	€7.95-€25	28 days	Free
The Outnet	1-6 days	€10-€25	28 days	Free
Mr Porter	0-3 days	€6-€25	28 days	Free
Boohoo	5 days	€6-€9	14 days	Free
Zalando	1-6 days	Free	100 days	Free

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

YNAP is targeting average sales growth (at constant exchange rates) of between 17% and 20% by 2020. This estimate seems coherent to us, given the segment's potential and the market share gains made by the group so far. The impact of closing TheCorner.com and Shoescribe (off-season multi-brand) in Q2 2016, should be very limited over 2016, given the low contribution to sales (2.4%).

Fig. 21: Reasonable sales targets (EURm)

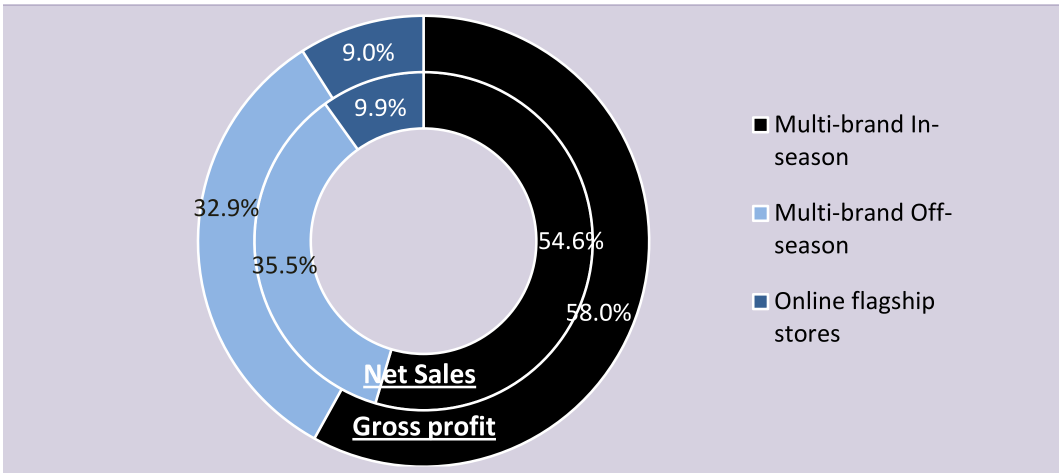


Source: Company Data; Bryan, Garnier & Co ests.

4.2. Profitability

Gross margin is primarily driven by the in-season multi-brand sites (Net-A-Porter and Mr Porter, which post a rate of 42%), whose more expensive products are destined for customers less sensitive to prices. Whereas the business only generates 54.6% of the group's sales, it contributes 58% of gross margin. This situation contrasts with the off-season multi-brand sites (Yoox, The Outnet), which offer unsold products from past seasons at lower prices and margin levels (36.7%). The mono-brand sites managed on behalf of third-parties only generate a gross margin of 36.1%.

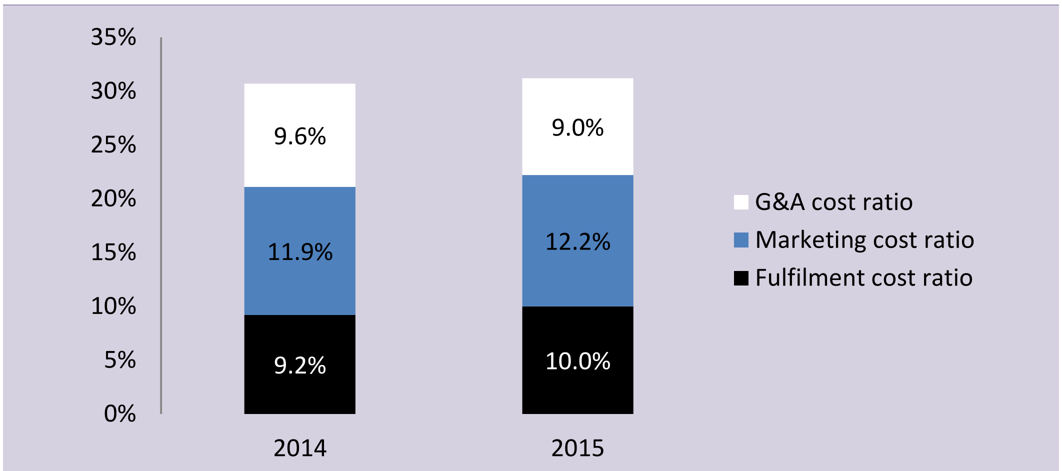
Fig. 22: Breakdown of net sales and gross margin by business - H1 2016



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

As for rivals, the main source of spending for YNAP concerns marketing and logistics, which represent 22% of sales Note that these two items tended to increase in weight in 2015 following the merger. Indeed, a period of overlapping and doubling of certain operating costs was witnessed until the structures were integrated and standardised.

Fig. 23: Main spending items (% of sales) – pro forma (excl. IPC)



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

Fig. 24: Marketing expenses now higher than those of rivals (2015)

	Active customers (m)	Conversion rate	Basket size (EUR)	Marketing cost (EURm)	Marketing cost (% sales)
Yoox - Prêt a Porter	2.52	4.6%	352.0	203.13	12.2%
Zalando	17.90	3.3%	67.8	354.96	12.0%
Asos	9.90	2.8%	79.3	65.78	5.0%
Boohoo	4.00	4.0%	38.8	22.85	10.2%

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

Based on historical adjusted EBITDA margin limited to 2014 and 2015 in pro-form terms, note that the margin totalled 8% at the end of 2015. This rate offers improvement potential of 300-500bp, based on the group's targets (i.e. between 11% and 13% of adjusted EBITDA margin out to 2020). At this stage, our estimates are in line with these assumptions (ie 11.7%).

Management has identified four sources of leverage to achieve this: **1/** EUR80m/year in synergies as of 2018; **2/** margin improvement potential at Net-A-Porter, historically less profitable than Yoox (7.7% of EBITDA margin vs. 9.6%), **3/** the implementation of the omni-stock programme and **4/** momentum in own-brands (structurally more profitable than national brands) which should represent 10% of net sales in the off-season multi-brand business by 2020.

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BRYAN, GARNIER & CO

INDEPENDENT RESEARCH

28th November 2016

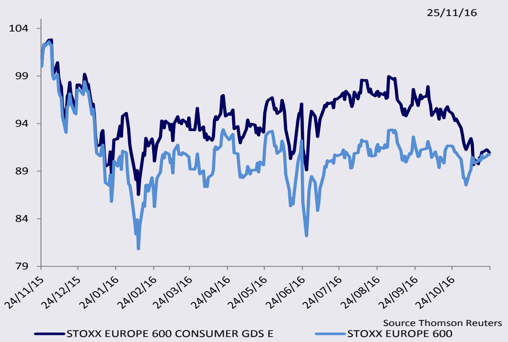
H&M/Inditex

Fast-Fashion: a fast-changing industry

H&M/Inditex

H & M		NEUTRAL	FV SEK295
Bloomberg	HMB SS	Reuters	HMb.ST
Price	EUR268,3	High/Low	325,7/236,6
Market cap.	EUR444,056m	Enterprise Val	EUR435,383m
PE (2016e)	24.0x	EV/EBIT (2016e)	18.2x

INDITEX		BUY	FV EUR38
Bloomberg	ITX SM	Reuters	ITX.MC
Price	EUR31,395	High/Low	34,585/26,7555
Market Cap.	EUR97,847m	Enterprise Val	EUR91,504m
PE (2016e)	30.5x	EV/EBIT (2016e)	22.2x



We are reinitiating coverage of Inditex (BUY, FV: EUR38) and H&M (NEUTRAL, FV: SEK295). Both continue to enjoy strong growth profiles (EPS CAGR 2016-19e: +12.3% for ITX and +10.2% for H&M) but, in our view, Inditex offers a more defensive profile in this competitive industry.

- **The 'mass-market' or 'accessible fashion' segment of the global market is vast (c.EUR1,100bn) and remains very fragmented** since the two flagship brands, H&M and Zara, are likely to account for respective market shares of 1.7% and 1.4%. However, these two global brands need to contend with growing competition from new brands (Primark, Forever21, etc.) which are pursuing very aggressive price strategies and, secondly, the **growth in internet players** (Amazon, Zalando, ASOS, etc.) offering a virtually-unlimited choice of items and increased customer experience.
- **The H&M and Inditex groups dispose of some major assets they can leverage when it comes to contending with this multiform competition**. Even before the emergence of most of these online retailers, H&M and Inditex already had robust commercial strategies focused on: **(i)** international markets, **(ii)** multichannel (then omnichannel) and **(iii)** multi-concept, while **(iv)** shortening the lifespan of the collections to keep pace with changing trends.
- **In our view, Inditex is the best equipped to thrive in this environment:** its 'pull' strategy (= collection design based on customer purchasing decisions) and ability to launch a new collection within just two weeks (vs. 6 months for the industry) thanks to centralised, vertical integration, enable Inditex to enjoy mark-down and unsold inventory rates amongst the lowest in the industry. Furthermore, its new strategy combining flagship stores (= fewer DOS openings) and online offer (c.5.5% of 2016e sales) minimise the risks to earnings growth (EBIT CAGR 2016-19e: +12%).
- **H&M: some outstanding doubts.** The group generates c.8% of 2016e sales over the internet but is bearing the brunt of competition from discount brands (Primark, etc.) whereas its supply chain is similar to that of the industry (80% of manufacturing realised with 6-month lead times), making H&M more sensitive to changing trends. The earnings growth (CAGR 2016-19e: +10%) is more volatile due to sourcing in USDs (c.80%), an ambitious DOS opening plan (surface growth: +10-15% per annum) and plans to launch one or even two new brands in 2017.

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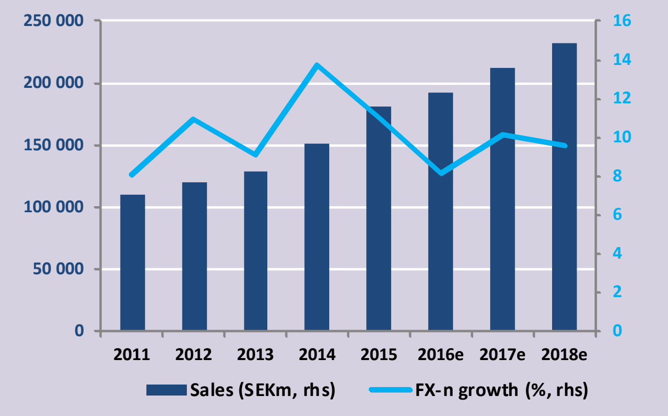
Table of contents

1. Presentation in six charts

1.1. H&M

Sales (SEKm) and FX-n growth (%) over 2011-18e

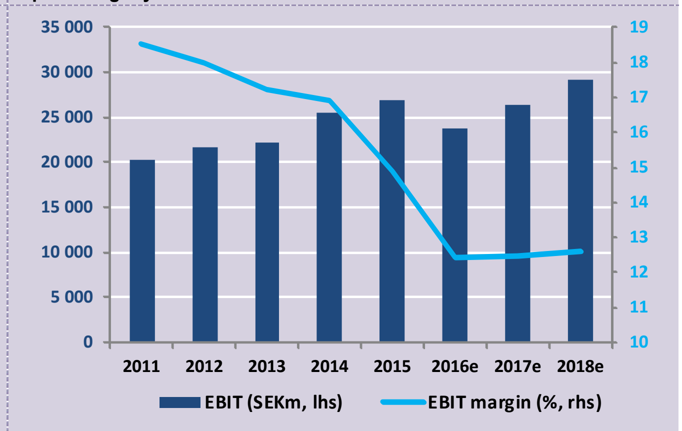
We believe that **FX-n growth expected over 2016-18e will be mostly driven by new space** (~7% on average).



Source: Company Data, Bryan, Garnier & Co ests

EBIT (SEKm) and EBIT margin (%) over 2011-18e:

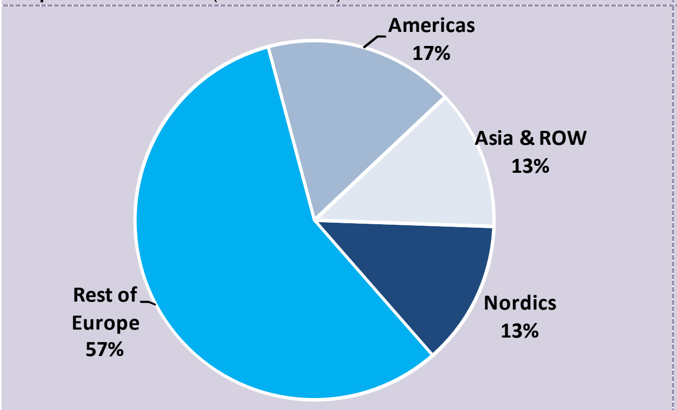
On our estimates, the **EBIT margin should stabilize in 2016 (at 12.4%) and improve slightly over 2017-18.**



Source: Company Data, Bryan, Garnier & Co ests

Sales Breakdown by Region (2015, %):

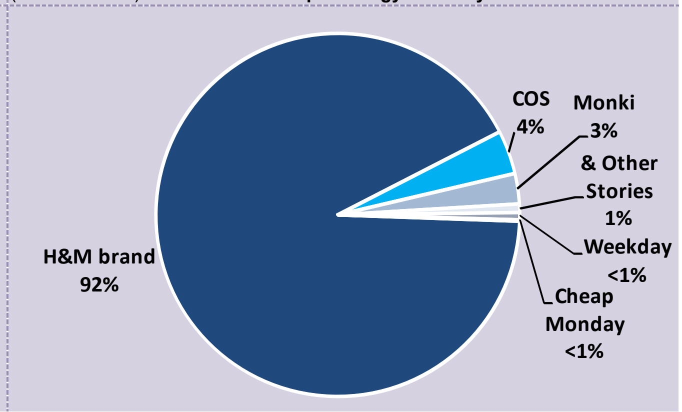
Germany is H&M's main market (~18% of sales) and the Group has **a bigger footprint on US market** (~12% of sales).



Source: Company Data

Sales Breakdown by Brand (2015, %):

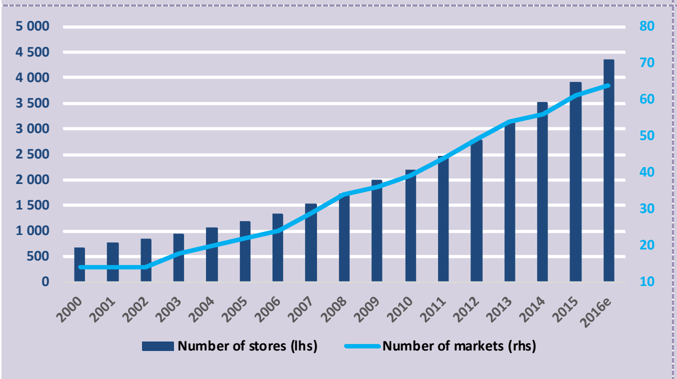
The H&M **Group is less diversified and more reliant on its eponym brand** (~92% of sales) as the **multi-concept strategy was only introduced in 2007.**



Source: Bryan, Garnier & Co ests

Store Network (2000-16e):

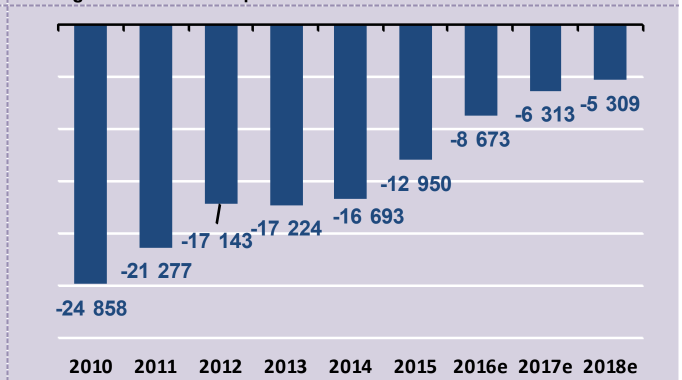
By the end of FY16, **H&M will have more than 4,300 stores in approx. 64 markets.**



Source: Company Data

Net debt or cash (SEKm) over 2010-18e:

H&M has burnt a substantial proportion of its cash pile because of **pressure on margins** and **heavier capex investments.**

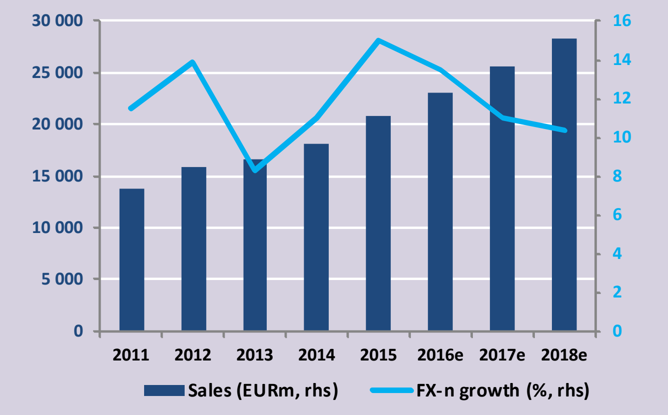


Source: Company Data, Bryan, Garnier & Co ests

1.2. Inditex

Sales (EURm) and FX-n growth (%) over 2011-18e

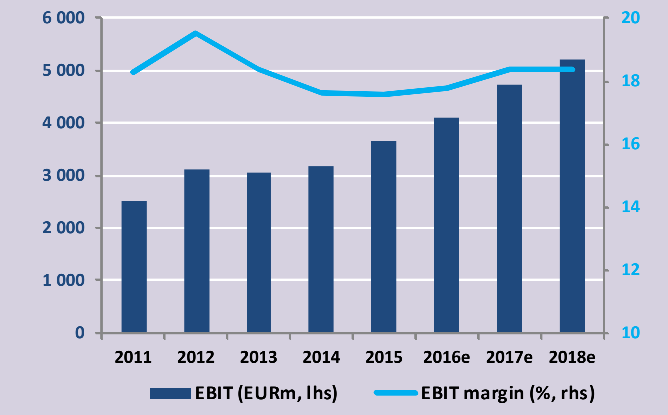
We believe Inditex should **continue to grow sales in the double-digits over 2016-18 (average LFL performance: approx. 6%).**



Source: Company Data, Bryan, Garnier & Co ests

EBIT (EURm) and EBIT margin (%) over 2011-18e:

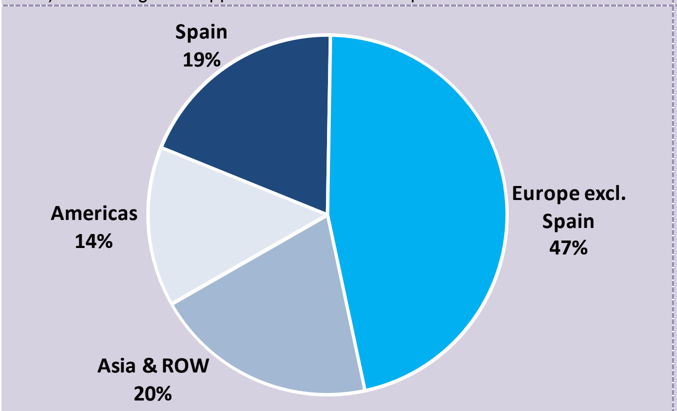
On our estimates, **the EBIT margin is set to expand gradually from 2016**, driven by a less adverse FX environment and a positive operating leverage.



Source: Company Data, Bryan, Garnier & Co ests

Sales Breakdown by Region (2015, %):

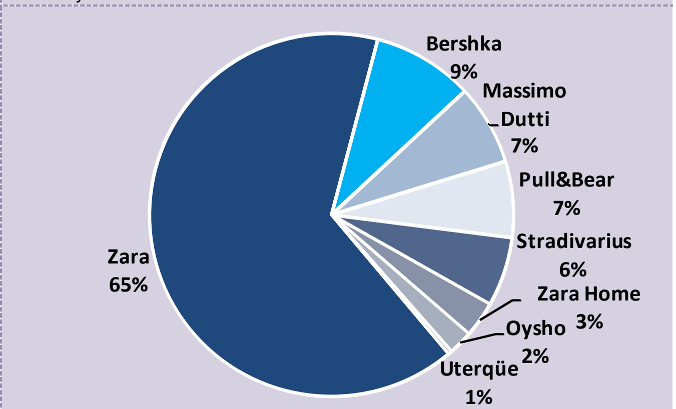
Spain is Inditex's biggest market (~18% of sales) whilst the **US** (~4-5% of sales) harbours growth opportunities for the Group.



Source: Company Data

Sales Breakdown by Brand (2015, %):

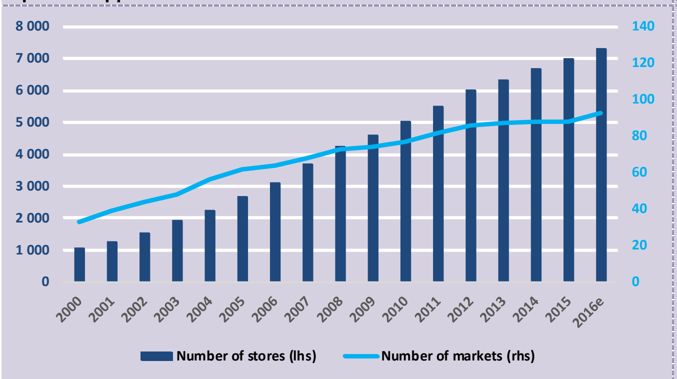
Zara accounts for 65% of group sales but the multi-concept strategy is underway.



Source: Bryan, Garnier & Co ests

Store Network (2000-16e):

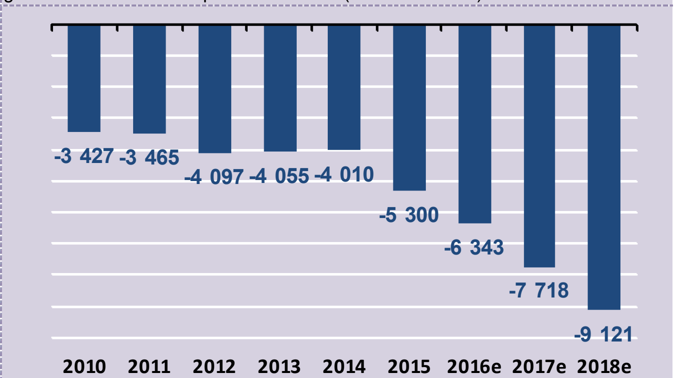
Inditex should count over 7,300 stores by the end of FY16, **Zara stores represent approx. 31%** of the total store network.



Source: Company Data

Net debt or cash (SEKm) over 2010-18e:

We expect Inditex to build up a significant cash pile by 2018e given the FCF generation and lower capex investments (as a % of sales).



Source: Company Data, Bryan, Garnier & Co ests

2. Two global leaders in "accessible fashion"

The global fashion market (ready-to-wear and accessories) is vast, amounting to more than EUR1,200bn. The 'mass-market' or 'accessible fashion' segment naturally represents the bulk of this market (c. EUR1,100bn) and remains highly fragmented since the two flagship brands, H&M and Zara, are likely to account for respective global market shares of 1.7% and 1.4%.

The fragmentation of this market has enabled, firstly, the emergence of new brands like **Primark**, **Forever21 and Topshop,** which are pursuing very aggressive price strategies and have embarked on international growth and, secondly, the growth in online players like **Amazon**, **Zalando** and **ASOS** offering a virtually-unlimited choice of items and increased customer experience.

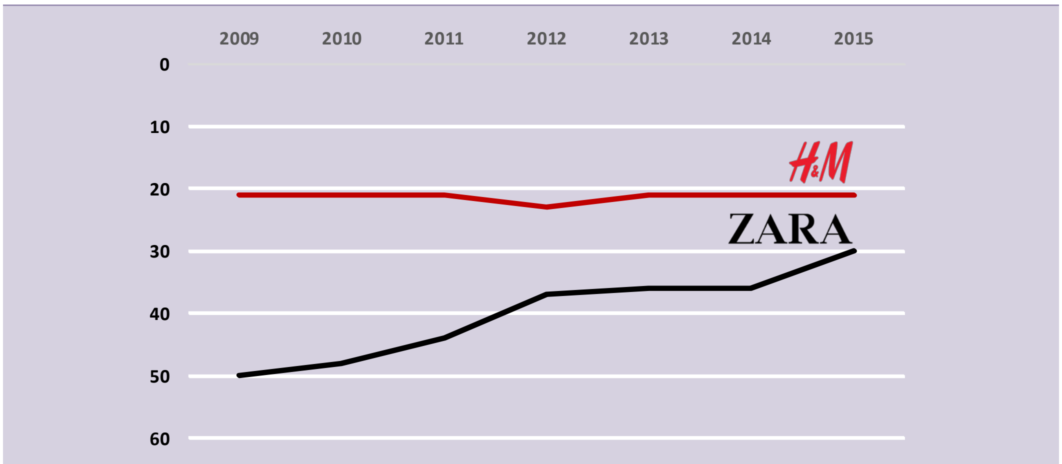
The H&M and Inditex groups do, however, possess some major assets they can leverage when it comes to contending with this competition. Even before the emergence of most of these online retailers, H&M and Inditex already had robust commercial strategies focused on: **(i)** international markets, **(ii)** multichannel (then omnichannel) and **(iii)** multi-concept, while **(iv)** shortening the lifespan of the collections to keep pace with changing fashions. In short, exactly what the internet players are trying to establish!

2.1. Major strengths when it comes to attracting consumers

2.1.1. The two flagship brands are in robust health

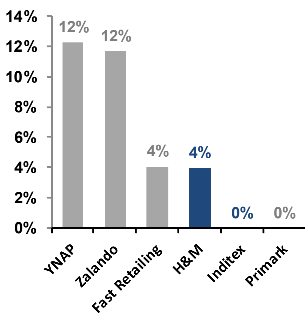
The brand strategy and design company, Interbrand, publishes an annual ranking of the 100 most valuable global brands, based on their operating performance, the role of the brand and its ability to influence consumer choices and its prospects. The following chart shows that, for many years, the **H&M** brand has occupied 21st place in this ranking whereas **Zara** moved up from 50th to 30th place between 2009 and 2015. There are no other accessible fashion brands in this ranking.

Fig. 1: Interbrand ranking of H&M and Zara (2009-2015):



Source: Interbrand

Weight of advertising spend (2015, % of sales):



Source: Company Data Bryan, Garnier & Co ests.

The reputation and success of these two brands is all the more remarkable in that the two groups spend very little on marketing (H&M: c.4% of total sales according to our estimates), or even nothing at all in the case of Inditex. It is true that these two groups can now rely on the development of the **social media** where advertising is looked after by the consumers themselves, but it is especially the **physical stores and their display windows which are the main vector in brand marketing,** hence the strategic choice of the locations for future stores.

2.1.2. 'Fast-Fashion' = accelerated international development

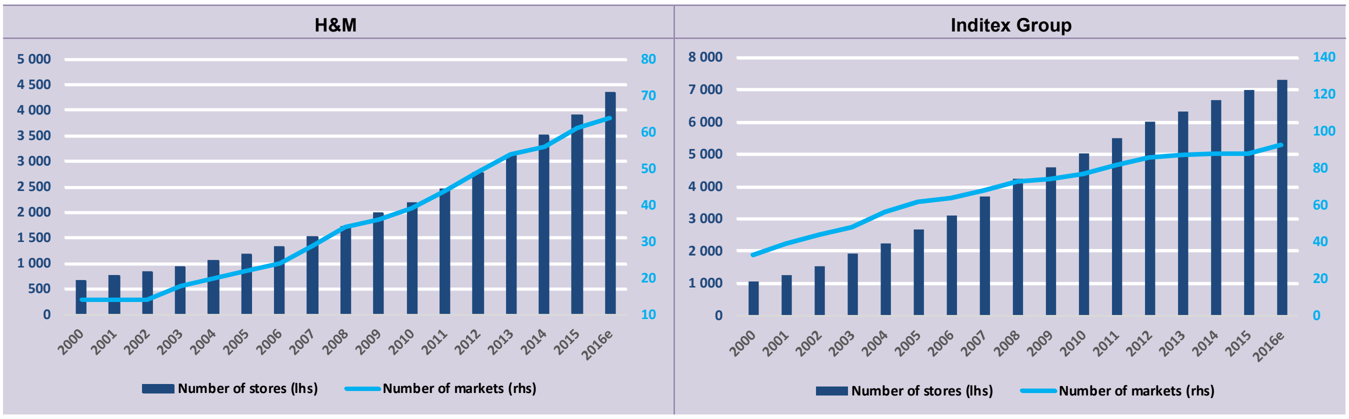
Backed by two brands which play very effective roles as standard bearers in a highly-fragmented global market, the two groups significantly accelerated their international development as of the early 2000s:

(i) **H&M:** Whereas the Swedish group was present in only 14 countries with 682 stores in 2000, it is expected to operate in 64 markets by the end of the year (Porto Rico, New Zealand and Cyprus opening in 2016) with more than 4,300 stores worldwide. The **H&M brand** is naturally present in these 64 countries and represents close to 92% of the total number of stores.

(ii) **Inditex:** The group's history may more recent than that of H&M, but Inditex was already established in 33 countries with 1,080 stores in 2000. At the end of 2016, Inditex should maintain its advance with at least five new market openings this year (Aruba, Paraguay, Nicaragua, Vietnam and New Zealand) bringing the total to 93 countries, and manage more than 7,300 stores of which 2,100 for the **Zara** brand alone.

It is worth mentioning two interesting differences between the two groups: **1/** the proportion of sales in the domestic market is naturally more sizeable for Inditex (Spain = c.19% of 2015 sales) than for H&M (Sweden: c.5% of sales) but nonetheless remains one of the latter's ten main markets and **2/** Inditex is ahead in terms of the international roll-out of its other concepts which are already in more than 55 countries on average, versus an average of 12 for those of H&M. It is true that H&M's multi-concept strategy is more recent than that of Inditex.

Fig. 2: A rapid international roll-out since the early 2000s:



Source: Company Data

2.1.3. A multi-concept strategy to 'cover all the bases'

One of the competitive advantages of an ASOS, Zalando or even YNAP in the premium/luxury segment, is the vast choice of items available on their websites whereas traditional retailers obviously have a limited amount of commercial space. To contend with this competition, H&M and Inditex are deploying a segmented multi-concept-based offer (or multi-brand) to reach the widest-possible ready-to-wear customer base, in terms of style, age bracket and price.

H&M: the multi-concept strategy dates back to 2007

The H&M group's growth has been exclusively based on its eponymous brand as highlighted in the following table. The launch of the multi-concept strategy thus dates back to 2007 with the launch of H&M's upscale **COS** brand (2007), then the acquisition of **MONKI**, **WEEKDAY** and **Cheap Monday** in 2008. **& Other Stories** is the most recent concept, launched in 2013. Given this fairly recent history, **the H&M brand still represents nearly 92% of the total number of stores** (H&M does not disclose its sales by brand)

The H&M brand has always been positioned in the 'value fashion' segment with a very broad apparel customer base (Women, Men, Children) and two sub-concepts outside textiles: H&M Home (2009) and H&M Beauty (2015). The other concepts have slightly higher positioning (e.g.: COS and & Other Stores are positioned just below 'affordable luxury') where the pressure on prices is less intense.

Lastly, H&M will pursue this multi-brand strategy since, in 2015, the CEO announced plans to **launch one or even two new brands in 2017,** which will be '*radically different from the current roster of in-house brands*'.

Fig. 3: The H&M group's six brands (data at end November 2015):

Brand	H&M	COS	MONKI	& Other Stories	WEEKDAY	Cheap Monday
Founded In…	1947	2007	2006 / 2008 *	2013	2002 / 2008 *	2004 / 2008 *
Number of Stores	3,610	153	106	30	20	5
Number of Markets	61	30	13	10	5	4 (35 in wholesale)

** Joined H&M following the acquisition of Fabric Scandinavien AB (2008)* *Source: Company Data*

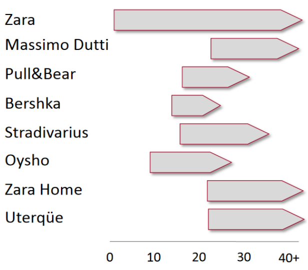
Since 2004, the **H&M brand has every year worked in partnership with designers and/or luxury brands** to launch limited edition collections. This enables the brand to strengthen its reputation with aspirational customers (or those with higher spending power than its usual customers) and to compensate for its lower exposure to higher price segments. The pricing level for the limited collections is thus on average 30% higher than the price positioning for the brand.

Fig. 4: Some examples of 'capsule' collections:

Year	Designer / Brand
2004	Karl Lagerfeld
2005	Stella McCartney
2009	Jimmy Choo
2015	Balmain
2016	Kenzo (launched on 3rd November)

Source: Company Data

Target customers for the Inditex brands, by age bracket:



Source: Company Data

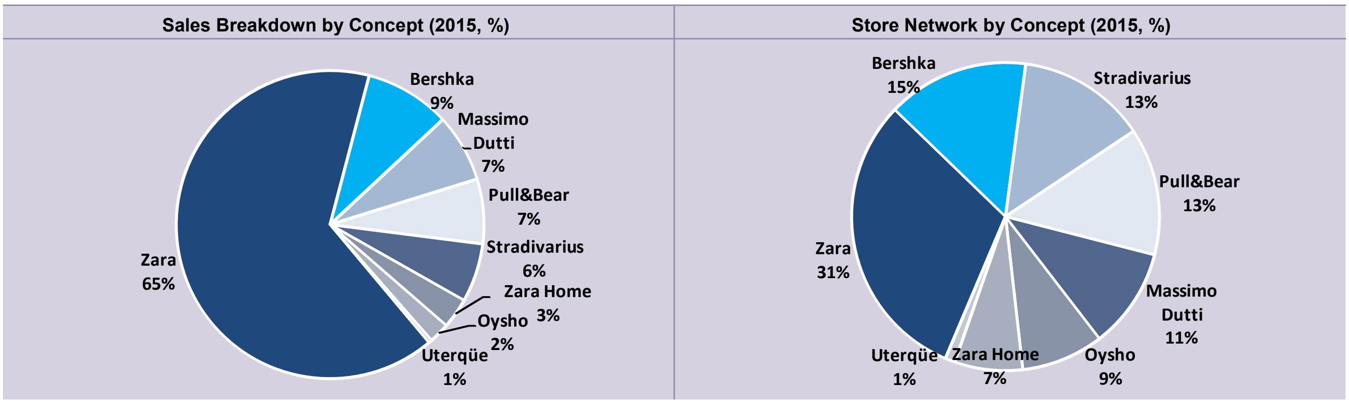
Inditex: multi-concept already effectively mastered

Inditex's experience in terms of multi-brand strategy dates back even further in that it began in 1991 with the creation of **Pull&Bear** and the acquisition of **Massimo Dutti**. Then came the creation of **Bershka** (1998) and the purchase of **Stradivarius** (1999). Lingerie brand **Oysho** was launched in 2011, followed by **Zara Home** (2003) and **Uterqüe** in 2008.

Like the H&M brand, Zara addresses the widest possible customer base (Women, Men, Children) and all age brackets as shown in the chart on the left. It was however vital to have an even-more segmented offer addressed at young people (Bershka, Oysho) and adults who also have higher purchasing power, explaining the higher price positioning of Massimo Dutti (superior mass market) and Uterqüe (entry level affordable luxury).

Since Inditex's multi-concept strategy has been in place for longer, the group has had time to successfully develop other brands, making it slightly more diversified than its Swedish competitor since Zara represents 'only' 65% of sales, even if this percentage has seen virtually no change in recent few years (Zara contributed 64% of sales in 2009).

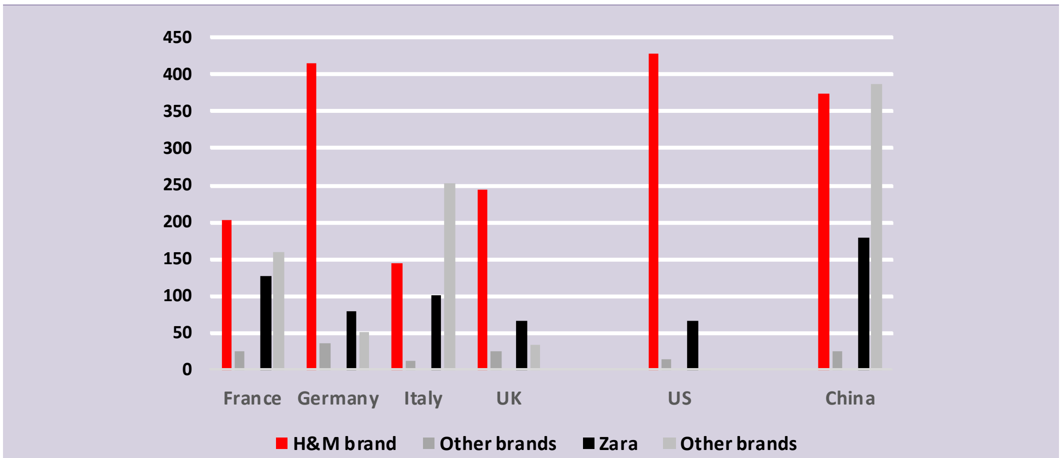
Fig. 5: Sales and store breakdown by brand 2015, in %):



Source: Company Data

With the exception of Germany (H&M's number one market) and the United States where H&M has found it easier to grow than Inditex, the latter generally numbers more stores that its competitor thanks to the presence of points of sale for the other brands. Of the four leading European markets, Zara accounts for on average 50% of the country's points of sale, versus 91% for H&M. In Spain, Zara stores represent only 25% of the total!

Fig. 6: Breakdown of H&M/Zara stores vs other concepts:



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

2.1.4. Main challenge: adapt to the consumer as rapidly as possible!

H&M: A classical supply chain close to traditional players

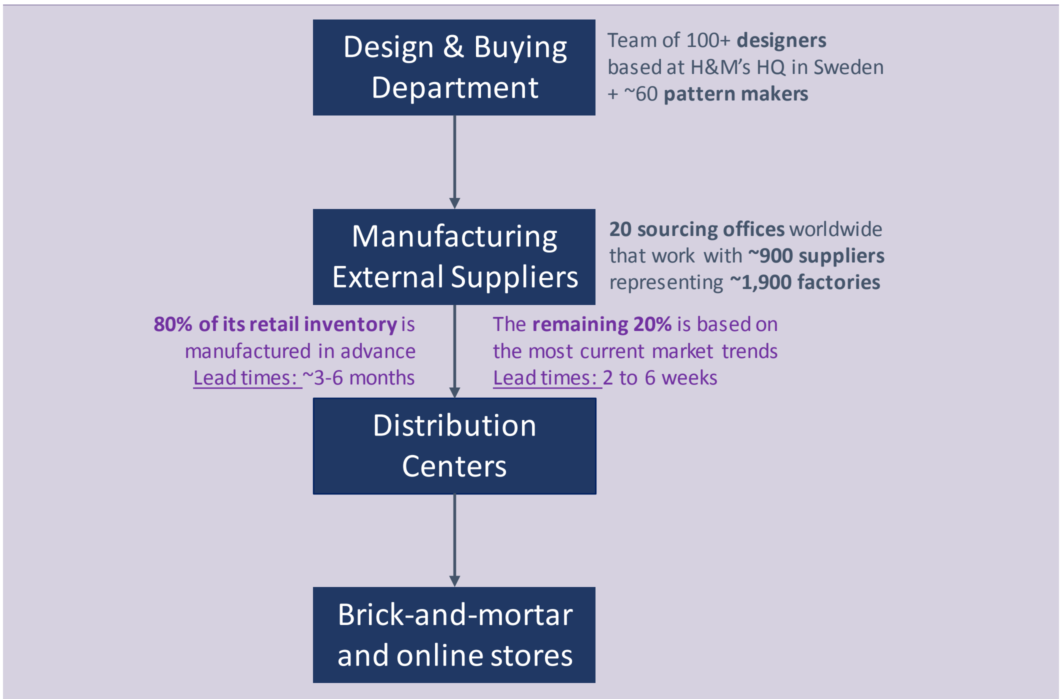
As shown in the chart on the next page, the H&M supply chain is more classical than that of its Spanish competitor, whether this be top down at the level of collection design (everything starts with the design team) or the supply chain lead times given that its manufacturing is mostly located in Asia.

(i) **Design:** H&M's design team regroups over **one hundred designers and is entirely based at its headquarters in Stockholm**. For more than 20 years, this team has been headed by Margarita van den Bosch who has now taken more of a back seat and oversees only the H&M capsule collections.

(ii) **Manufacturing:** once a collection has been designed, H&M's 20 sourcing offices are responsible for entrusting its manufacturing to 900 suppliers (representing more than 1,900 factories). Nearly **80% of sourcing is from Asia** and the fact that the collections are global means that H&M can thus concentrate the volumes, giving it purchasing conditions which are key to its price-competitiveness. Note also that **80% of its retail inventory is manufactured in advance (3 to 6-month lead time)**, these figures remaining close to textile industry norms.

(iii) **Distribution:** the references produced are then shipped to the **H&M warehouses located world-wide.** One warehouse can cover one or several countries depending on the size of the market.

Fig. 7: H&M's simplified supply chain, close to industry norms:



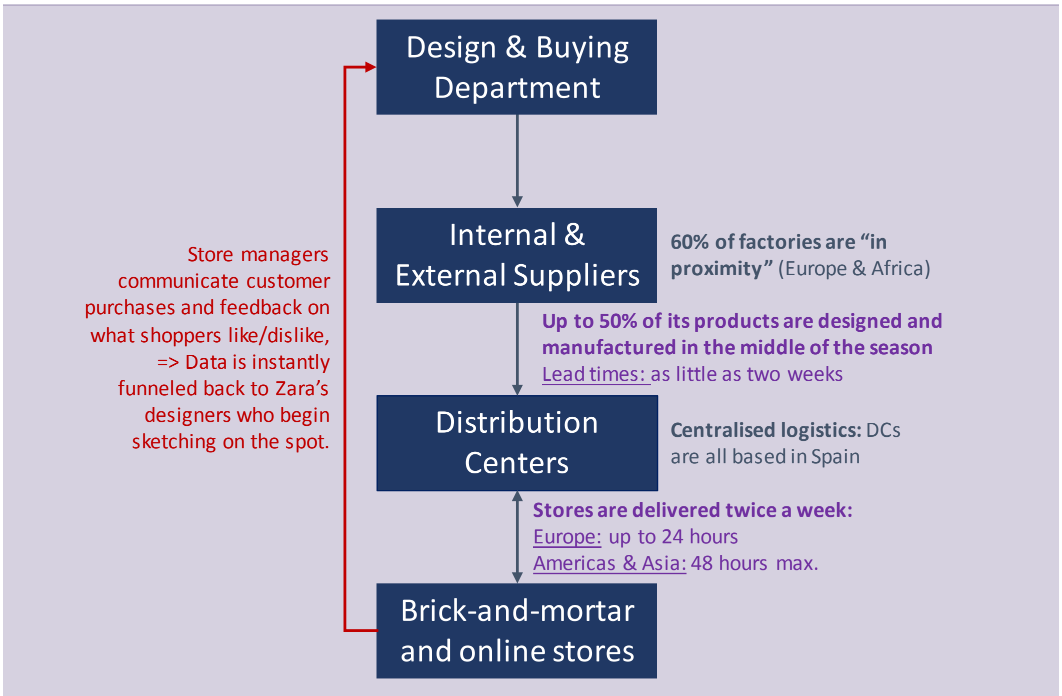
Source: Company Data; Bryan, Garnier & Co ests.

Inditex: revolutionary and unrivalled vertical integration

With regard to the organisational chart below, it is legitimate to say that Inditex has invented a proprietary supply chain which is unrivalled in the textile industry. This clearly responds to the definition of fast fashion (short manufacturing cycles and a relatively short product lifespan compared with the industry norms) and has been conceived to ensure maximum 'adherence' to consumer trends.

The following simplified organisational chart clearly illustrates this integration which is unique in the industry, placing the consumer and responsiveness at the heart of every stage.

Fig. 8: Inditex's vertical integration is unique in the industry:



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

The stages listed below primarily concern Zara but most also apply to Inditex's other brands.

(i) **Store Manager:** since Inditex directly controls its distribution, the founder effectively understood the key role the stores could play in analysing sales trends, **with each store manager responsible for feeding back consumer reactions, which models are selling and any product failures to** the designers to rapidly adapt the upstream design and manufacturing.

(ii) **Design:** while the design teams also produce most collections in advance (c.37,000 designs per year, of which c.20,000 for Zara), they work closely with the sales and merchandising teams who relay the feedback from store managers to be able to be constantly adapting the manufacturing. **Note that around 15% of a store's retail proposition changes every week and the lifespan of a model in stores is generally fifteen days**.

(iii) **Manufacturing:** this has also been organised to be able to rapidly react to changing consumer trends: **1/ nearly 60% of manufacturing is located in "proximity countries" close** to the design centres and warehouses which are all located in Spain, Portugal, Morocco, etc.), **2/ up to 50% of a collection can be designed and manufactured in the middle of a season (minimum lead time: two weeks)** whereas only 15% to 25% of the collection is programmed six months in advance (vs. 80% for H&M) and **3/ Zara has over ten own plants** to manufacture the most complex pieces (jackets, coats, etc.) within very short lead times (two weeks).

(iv) Distribution: unlike the other groups, **Inditex has a centralised organisation since 100% of the retail inventory passes through the group's warehouses in Spain.** Store managers place orders and take deliveries twice a week (lead times: max 24 hours for Europe, 48 hours for the Americas and Asia). While this centralisation may look onerous at first sight, it enables the company to ensure that the models in each store/country keep pace with the consumer trends and sales.

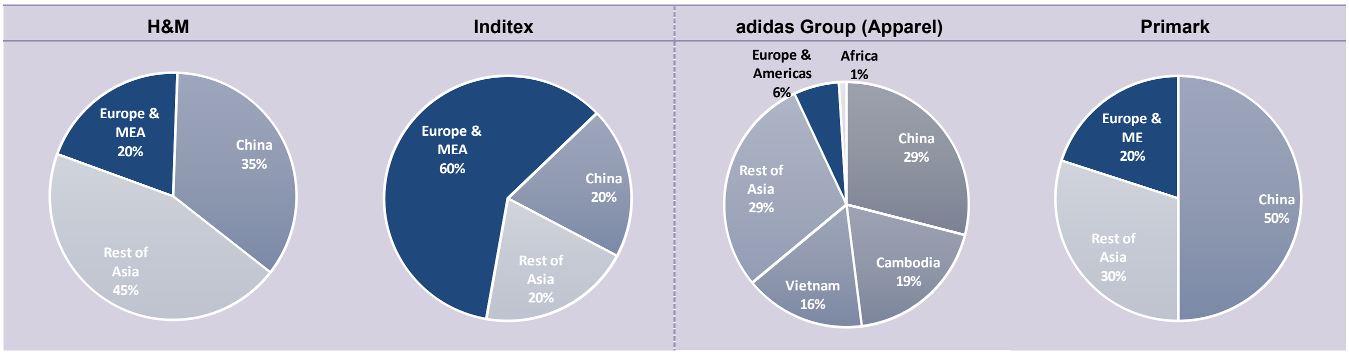
The responsiveness and adaptability of its offer to changes in fashion (and to weather conditions) enables Zara to keep its markdowns low (c.15%-20% vs. industry average of c.30%-40%) together with a very low unsold inventory rate (c.10% vs. c.15%-20% for the industry).

In our view, this responsiveness is Inditex's main competitive advantage, not only compared with traditional retailers but also with the internet players. The latter will have a wider choice of products but their sourcing mainly takes place in Asia, making them slower to adapt their offer.

In effect, most of the ready-to-wear brands locate their manufacturing in Asia, as seen in the following charts. **H&M's** sourcing is close to that of adidas Group and Primark but **Inditex** really stands out with 60% of its manufacturing in European or neighbouring countries (Turkey, Morocco, Africa).

This sourcing makes the group less sensitive to moves in the dollar (~35% of Inditex's COGS vs. >80% for H&M). Note that last year's appreciation in the dollar has had a significant impact on the gross margin rates of most textile players.

Fig. 9: Sourcing breakdown for four ready-to-wear players:



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

2.2. Omnichannel at H&M and Inditex

Although the two companies do not disclose their online sales we estimate that, in 2015, they represented around 7-8% of H&M sales and c.5-6% of Inditex sales. We shall see that the influence of this channel is set to increase over the next few years, but that it is even more important for these two companies to successfully implement an omnichannel strategy to minimise the risks of cannibalisation (= reduction in footfall in the physical stores), especially given their plans to open several hundred new stores a year in the medium term.

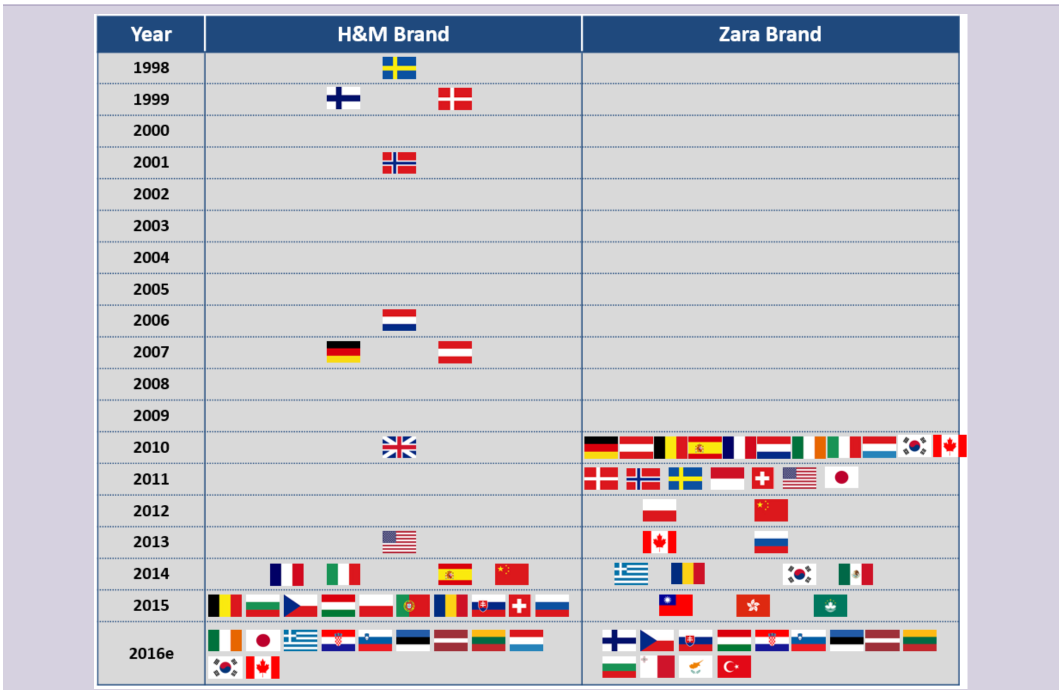
In our view, omnicanal will be a catalyst for sales growth. It will, on the other hand, be more difficult precisely to measure the contribution of the online channel to results. However, one thing is sure: not having an e-commerce platform presents a major risk. **Primark**, for example, has seen its annual comparable store growth decline by 2% (to end September) for the first time in 16 years, this decline is due to an inability to purchase online from the brand's website.

2.2.1. The online deployment continues

The fact that the proportion of e-commerce is slightly higher with H&M than with Inditex can be explained by the increased share of its eponymous brand within the group but also because H&M rolled out its first e-commerce website in 1998, i.e. twelve years before Zara. However, as of 2010, Zara launched platforms in 11 countries, their deployment having been more aggressive in recent years:

- **The H&M brand** should have an e-commerce website available in 34 countries by the end of the year (vs. 23 at end November 2015);
- **Zara** has an e-commerce website in 40 countries versus 27 at end January 2016. Note that, since April 2016, all the Inditex brands will have at least a presence in the 28 EU countries.

Fig. 10: E-commerce: H&M started 12 years before Zara:



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

In our view, by the end of the year, H&M and Inditex will thus have an online presence in respectively 34 and 40 markets that account for around 90% of the two groups' sales. As a result, while the opening of commercial websites in new markets will contribute to the growth of online sales, the main catalyst will be the growth in sales on the existing websites, operating in the main markets of the two companies.

Based on our 2015 online sales forecasts for H&M and Inditex, we have modelled the trends in these online sales (% of total sales) and their theoretical contribution to comparable store growth for each group over the 2016-18 period.

Fig. 11: H&M: e-commerce trend and contribution to like-for-like growth:

H&M	2015	2016e	2017e	2018e
If CAGR of 20% – Online as a % of total sales	7.0	7.9	8.7	9.5
Estimated contribution to LFL sales growth	-	**1.4pp**	**1.6pp**	**1.7pp**
If CAGR of 30% – Online as a % of total sales	7.0	8.5	10.2	12.1
Estimated contribution to LFL sales growth	-	**2.1pp**	**2.6pp**	**3.1pp**
If CAGR of 40% – Online as a % of total sales	7.0	9.2	11.8	15.2
Estimated contribution to LFL sales growth	-	**2.8pp**	**3.7pp**	**4.7pp**

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

Note that the ramp up of e-commerce seems in theory to have a lesser impact on Inditex than on H&M. This is because **(i)** it accounts for a slightly lower proportion of sales at Inditex (c.5% of sales vs. c.7% for H&M), but also because **(ii)** our growth forecasts for total sales are more cautious at H&M.

Fig. 12: Inditex: e-commerce trend and contribution to like-for-like growth:

Inditex	2015	2016e	2017e	2018e
If CAGR of 20% – Online as a % of total sales	5.0	5.4	5.8	6.4
Estimated contribution to LFL sales growth	-	**1.0pp**	**1.1pp**	**1.2pp**
If CAGR of 30% – Online as a % of total sales		5.9	6.9	8.1
Estimated contribution to LFL sales growth	-	**1.5pp**	**1.8pp**	**2.1pp**
If CAGR of 40% – Online as a % of total sales		6.3	8.0	10.1
Estimated contribution to LFL sales growth	-	**2.0pp**	**2.5pp**	**3.2pp**

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

2.2.2. Physical stores remain the focus of the growth strategy (for the moment)

Despite the growth in the online channel, stores remain the favoured point of contact with customers at both H&M and Inditex. Furthermore, **their stores and window displays are the primary vector of communication when it comes to building their reputations** since, unlike nearly all the ready-to-wear players, **these two groups spend virtually nothing on advertising and marketing: ~0% for Inditex and around 3%-4% for H&M!**

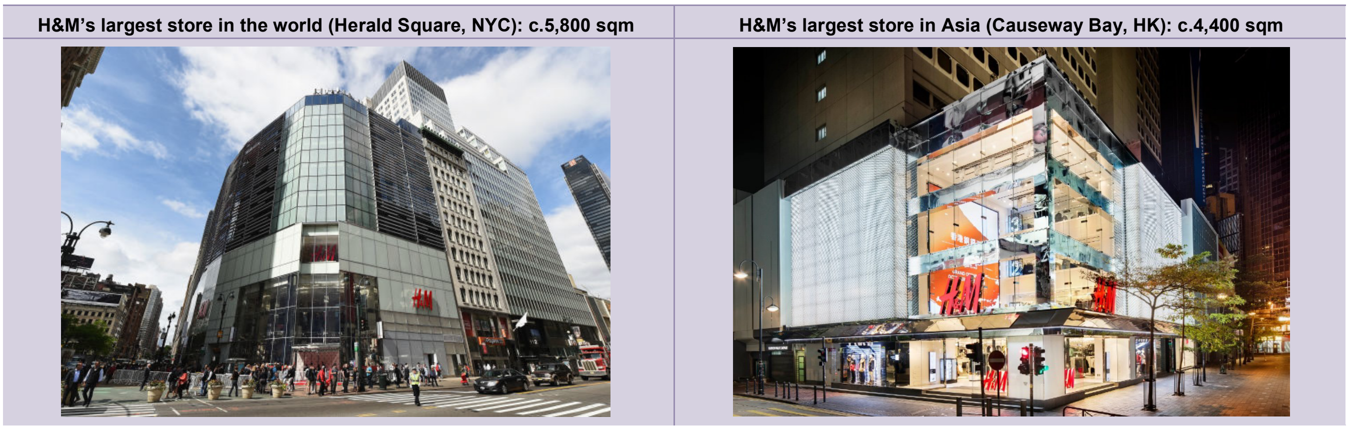
The retail strategy for the H&M and Zara brands is very similar to those of the higher-end players: concentrate in particular on the opening of flagship stores in areas where the commercial potential is greatest. As addressed later in this section, we are effectively seeing an increase in average store size year after year.

H&M: a steady 10-15% space expansion every year

H&M is maintaining its objective of growing its commercial space by 10-15%/year. However, in our view, H&M will be towards the bottom end of the range for 2016-18 (c.10%), nonetheless implying the opening of at least 420 stores over the same period:

(i) **H&M brand:** brand expansion will represent a little under 80% of the total openings for the period. This brand naturally has the potential to conquer new markets in addition to the more than 61 countries where it is already present but also to reinforce several of the Top 10 markets for which the market share is below 0.5%, like the **US** (445 DOS at end August) and where the brand is enjoying more rapid success than Inditex, and **China** (400 DOS). Note that the average size of the new stores (>1,500m²) is higher than the historic average (1,300-1,400m²), driven notably by the flagships which often exceed 3,000m² (*see Fig 13*) since these new stores dedicate space to the home (H&M Home) and beauty (H&M Beauty) in addition to the usual categories.

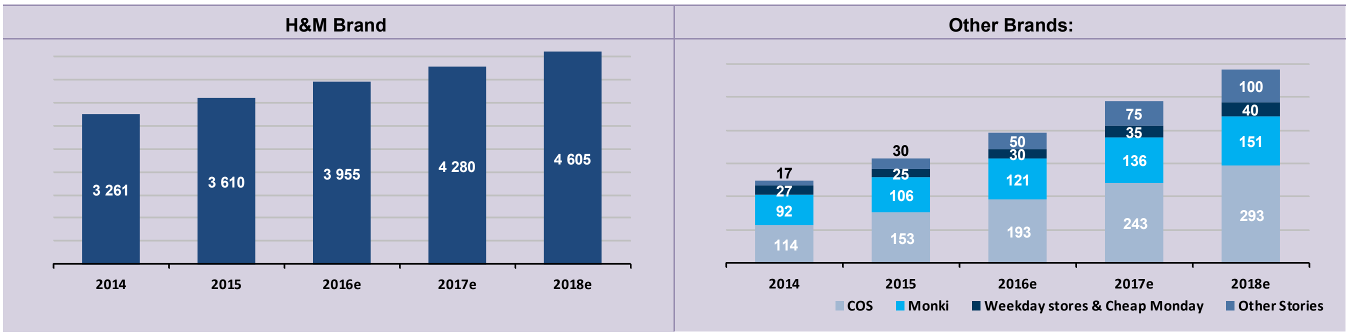
Fig. 13: Two examples of H&M flagships opened in 2015:



Source: Company Data; Bryan, Garnier & Co

(ii) **COS:** Its upscale positioning in mass market retailing offers attractive growth prospects when faced with the move up market represented by the 'affordable luxury' brands. The brand has already shown that it could diversify internationally since it numbered 177 DOS in more than 30 countries at the end of August, but can still develop along with brands such as **Banana Republic** (Gap, 668 DOS of which 607 in North America) and **Massimo Dutti** (Inditex, 749 DOS) which also operate in this market segment. Note that the COS stores and those of H&M's four other brands have a smaller average floor area: we estimate this figure to be around 450m² for **COS**, **Weekday** (+**Cheap Monday**) and **& Other Stories** and 275m² for **Monki**.

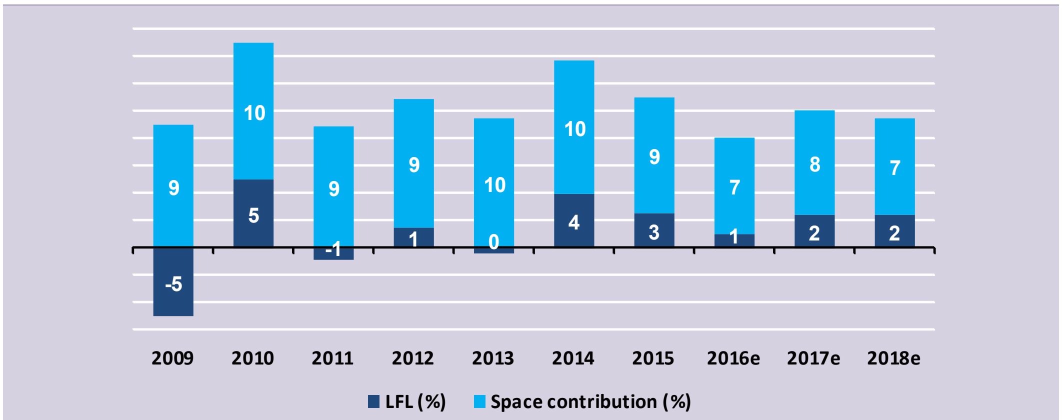
Fig. 14: Trend in the H&M group's store network (2014-18e):



Source: Company Data; Bryan, Garnier & Co

H&M's FX-n growth trend since 2009 is presented in the following chart. Between 2016 and 2018, we thus forecast around 10% growth in commercial space (i.e. the bottom end of the medium-term guidance of +10-15%), in addition to productivity of 60% in 2016, followed by 70% in 2017-18, i.e. a space contribution of between 7% and 8% over the period.

Fig. 15: Trend in H&M's FX-n growth rate (2009-2018e, in %):



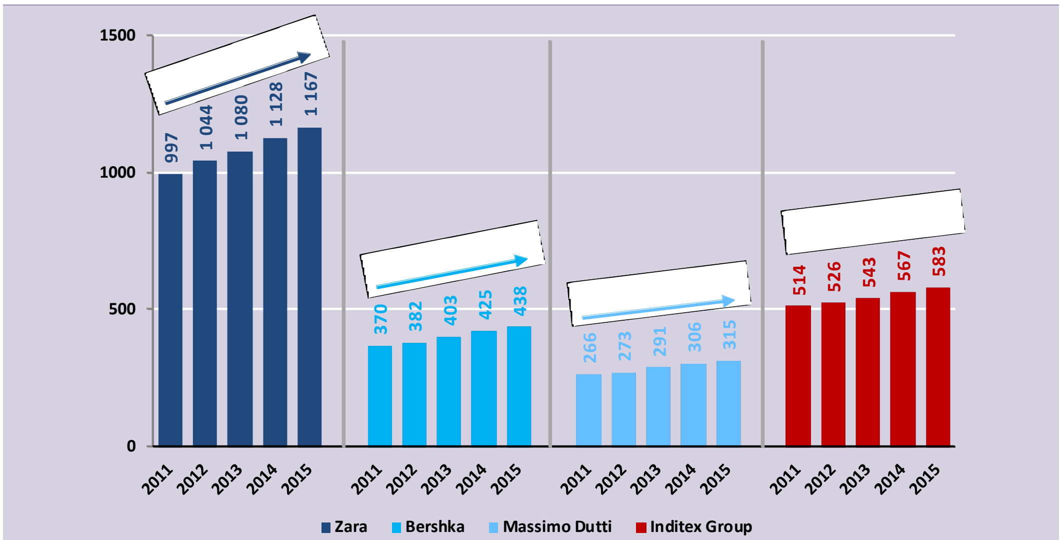
Source: Company Data; Bryan, Garnier & Co ests.

Inditex: towards fewer openings but the size of the stores is also increasing

Inversely to H&M, at the beginning of the year, Inditex reduced its medium-term growth target for space expansion, which now stands at +6-8%/year vs. +8-10% previously. While it is true that the Spanish company already has more stores than its leading competitor (FY15: 7,000 stores versus 3,924 for H&M), the CEO has also explained that, taking into account the growth of the online channel, this new guidance reflected the group's plans to open fewer points of sale but larger in size.

The following chart shows that, for the three leading Inditex brands, **the average floor area of the stores increased by 4% over the 2011-15 period and by more than 3% for the Inditex group.**

Fig. 16: Average floor area of Inditex stores (in m²):



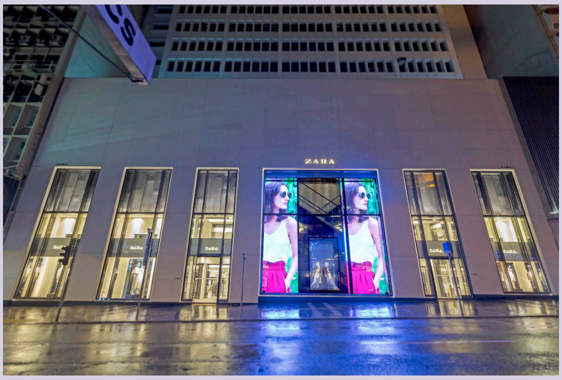
Source: Company Data; Bryan, Garnier & Co ests.

In March 2016, the Zara brand opened its new flagship store in New York's SoHo district (4,400m²) while the brand's largest store can be found in Hong Kong (5,100m²). It is interesting to note that Zara (and H&M) continues to open stores in markets like the United States and Mainland China where numerous brands are seeing a decline in footfall in their stores.

Fig. 17: Two examples of Zara flagship stores:

Zara's flagship store in SoHo (NYC): 4,400 sqm

Zara's flagship store in Hong Kong (Queen's Road): 5,100 sqm



Source: Company Data; Bryan, Garnier & Co

H&M and Inditex: priority given to the best locations

The following table lists the world's ten most expensive retail locations, which are also highly sought after by luxury brands. Note that, despite their 'value' positioning, H&M and Zara do not hesitate to open stores in the same streets!

In addition to the need to take advantage of the natural traffic in these commercial thoroughfares, these flagships play a key role in communication and the development of the reputation of these brands which spend very little on advertising (or even nothing in the case of Inditex!). In our view, this shows the decompartmentalisation of consumer purchasing habits; they may purchase luxury products but they are also customers of H&M and/or Zara. This trend is accelerating as the Millennial generation comes to prominence.

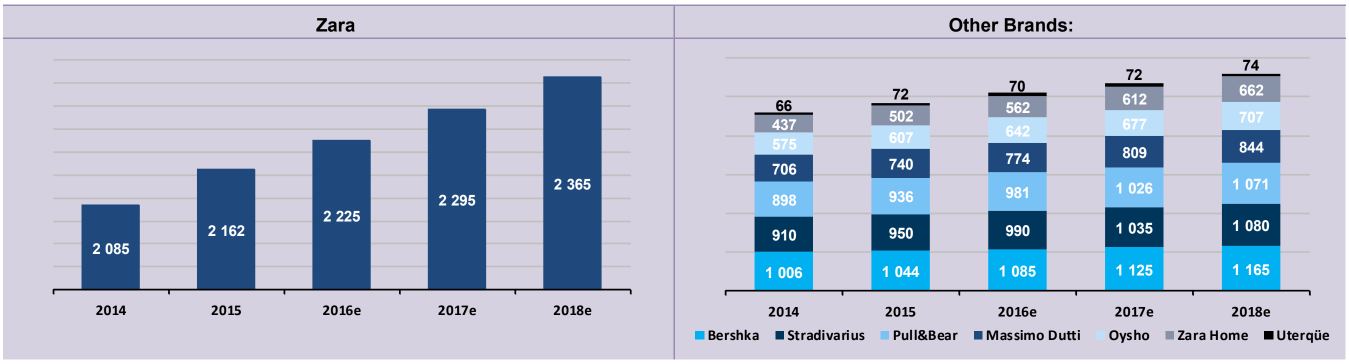
Fig. 18: The H&M and Zara stores are close to those of the luxury brands:

Rank	City	Street	H&M	Zara	Comments
1	**New York**	Upper 5th Avenue (49th-60th)	✓	✓	H&M store is on 5th Av & 48th
2	**Hong-Kong**	Causeway Bay	✓	✓	
3	**Paris**	Av. des Champs Elysées	✓	✓	Two Zara stores + 1 Zara Home
4	**London**	New Bond Street	✓	✓	H&M and Zara stores are on the corner of Oxford St. and New Bond St.
5	**Milan**	Via Montenapoleone	✗	✗	
6	**Sydney**	Pitt Street Mall	✓	✓	
7	**Zurich**	Bahnhofstrasse	✓	✓	
8	**Tokyo**	The Ginza	✓	✓	
9	**Seoul**	Myeongdong	✓	✓	
10	**Vienna**	Kohlmarkt	✗	✗	No Zara store but Massimo Dutti is there

Source: Cushman & Wakefield, Company Data, Bryan, Garnier & Co.

Based on our forecasts, as shown in the charts on the following page, the Inditex group is expected to have nearly 8,000 stores by the end of the 2018 fiscal year (January 2019), implying the opening of around 320 points of sales (of which 70 for the Zara brand alone) per year.

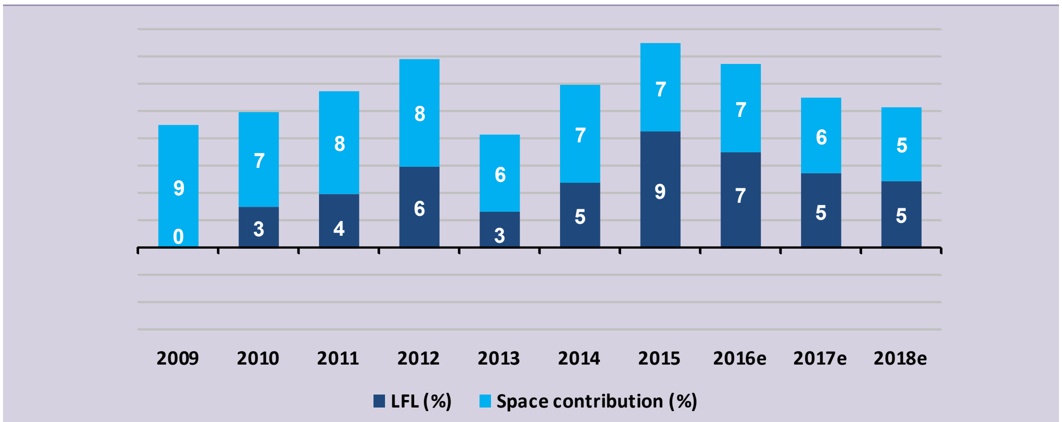
Fig. 19: Trend in the Inditex store network (2014-18e):



Source: Company Data; Bryan, Garnier & Co

The reduction in the growth target for commercial space is reflected in our space contribution forecasts below (c.6% in 2017 and c.5% on 2018), which assume productivity linked to the additional floor area of 75% over the 2017-18 period.

Fig. 20: Trend in Inditex FX-n growth (2009-2018e, in %):



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

2.2.3. What's the situation with 'Click-and-Collect'?

The **Inditex management** recently unveiled two interesting trends**: one third of online orders are collected in store and nearly two-thirds of returns are made in store.** H&M has not disclosed any information on this subject but, since its online channel is slightly larger than that of Inditex as a percentage of sales, in our view the Swedish company must be witnessing the same phenomenon with its customers.

These consumer habits thus justify the relevance of the omnichannel model, in which stores remain an obligatory step, representing two important advantages for the brands:

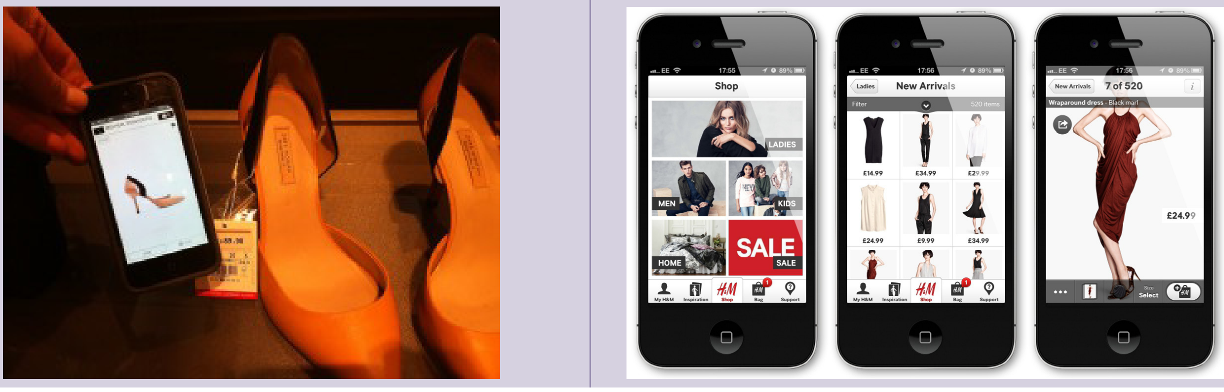
(i) **Logistics costs remain under control** and, in particular, those associated with returns (such costs can represent up to 14-15% of sales for players like ASOS and Zalando)

(ii) **New purchasing opportunities:** customer visits to stores effectively represent an additional opportunity to sell them one or several additional items and enhance the purchasing experience.

The two groups have developed mobile applications to give their customers continuity with the physical store. Customers obviously have the opportunity to purchase online using their smartphones but the main aim of these applications is to lure their users to one of the brand's stores. They receive promotional offers and alerts on the arrival of new products. In the event an article is not available in the store, visitors can then scan the barcodes and immediately verify online availability.

Fig. 21: Mobile applications to attract footfall to stores:

Zara App: scan any barcode to check in store availability	H&M App: buy online and receive push offers



Source: Company Data; Bryan, Garnier & Co

The 'Click and Collect' service illustrates the roll-out of an omnichannel strategy by the brands, even if its implementation requires significant supply chain investment to ensure the link between the warehouses and the store network. To contend with these additional costs, below a minimum purchase amount, a charge is made for the 'Click and Collect' service by some retailers like **John Lewis** (40% of its sales on the internet) which has decided to charge GBP2 for any orders worth less than GBP30 while **Tesco** charges an extra GBP4 for orders below GBP40.

We have compared the delivery and return options offered by **H&M/Zara** and those of **ASOS** and **Zalando**, two leading mid-range fashion e-retailers. The following table shows that H&M and Zara offer virtually identical services to those of the online players. On the other hand, in our view, H&M et Zara have a significant advantage with their stores. They can offer a better customer experience within the framework of 'click-and-collect' (verification of sizes, fitting rooms, advice from sales staff, additional purchases, etc.) and returns (reason for the return, immediate exchange, orientation/advice on an alternative solution, etc.)

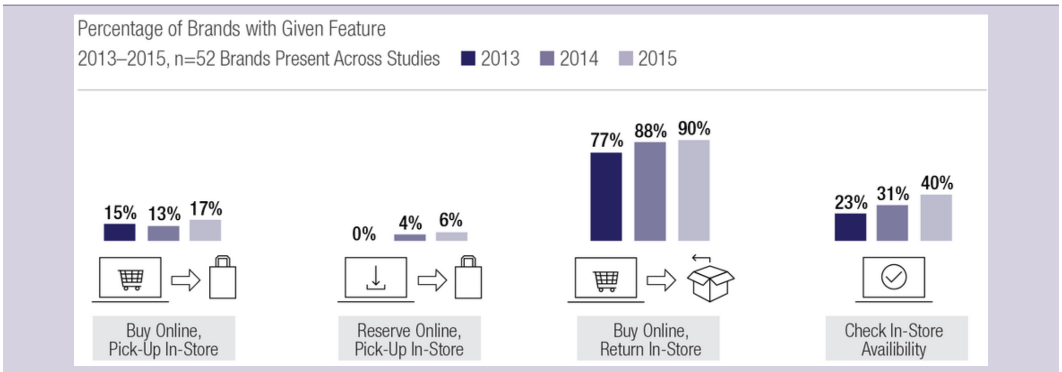
Fig. 22: Delivery and return options on UK commercial websites:

Delivery & Returns	H&M brand	Zara (Inditex)	ASOS	Zalando
Free Delivery?	YES – Free standard delivery (2-3 days) **over GBP50**	YES – Free standard delivery (2-3 days) **over GBP50**	YES – Free standard delivery (2-3 days) **over GBP20**	YES – Free standard delivery (2-4 days) and **no minimum**
Next Day Delivery?	YES – Fee of GBP5.99	YES – Fee of GBP9.95	YES – Fee of GBP5.95 and free over GBP100	YES – Fee of GBP5.95
Click-and-Collect option?	YES – **Free**	YES – Free but not available everywhere (e.g. France)	YES – Fee of GBP5.95 and free over GBP100	YES, in a Parcel Shop – **Free**
Returns for online orders	YES – **Free**: all returns must be made within **1 month**	YES – **Free**: all returns must be made within **1 month**	YES – **Free**: all returns must be made within **28 days**	YES – **Free**: all returns must be made within **100 days**

Source: Company Data, Bryan, Garnier & Co.

Paradoxically, while 90% of the textile brands reviewed by the digital marketing consultancy L2 already enable their customers to return their products in stores (thereby avoiding sizeable logistics costs), they offer very few additional services like online reservation/purchasing + in-store product collection which require substantial investment at the level of the supply chain (synchronisation of inventory management, etc.). **H&M and Inditex are thus some way ahead of their industry when it comes to the omnichannel strategy.**

Fig. 23: Omnichannel strategy: H&M and Inditex are ahead relative to the rest of the industry:



Source: L2 Digital IQ Index

2.2.4. The social media: H&M is more active than Zara

The following table shows that H&M is more committed to the social media than its Spanish competitor, and particularly Facebook and Twitter. The two brands use the social media to unveil their new collections and reinforce the links with customers while minimising marketing expenditure, especially in the case of Zara.

However, in our view, H&M's strong presence on these platforms may be explained by the fact that it regularly calls on muses (e.g.: Gisele Bündchen, David Beckham, etc.), particularly when it comes to promoting its 'capsule' collections which create an enormous buzz on the internet.

Fig. 24: The brands and their presence on the social media:

Social Media	H&M brand	Zara	adidas	ASOS	Gap brand	Mango	Nike	Primark	Zalando
Facebook *(Likes)*	28.8m	24.7m	25m & 29.1m *	4.4m	8.2m	10.3m	27.2m	4.7m	4.1m
Instagram *(Followers)*	17.4m	14.4m	11.4m & 15.5m *	5.1m	1.5m	5.8m	65.9m	3.6m	334k
Pinterest *(Followers)*	295k	302k	82k	534k	140k	65k	Nike Women: 10k	56k	DE: 7.5k FR: 3k
Twitter *(Followers)*	8.19m	1.19m	2.9m & 3.5m *	1.0m	675k	774k	6.66m	182k	DE: 17k FR: 16k
Youtube *(Views)*	117.8m	3.2m	72.3m & 51.3m *	23.3m	17.7m	10m	179.3m	3.2m	15.6m

* = *adidas Originals* *Source: Company Data, Bryan, Garnier & Co.*

2.3. H&M and Inditex: our 2016-18 sales growth forecasts

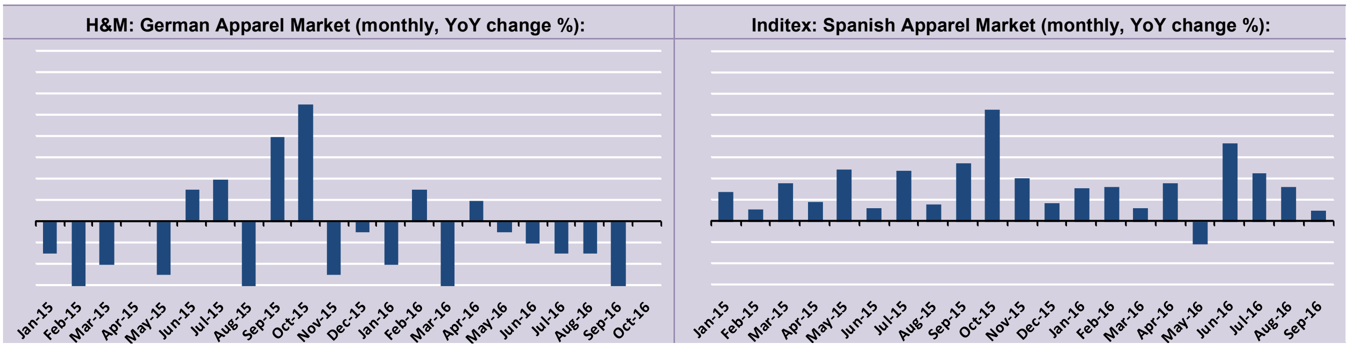
Although the global economic environment remains weak, we expect H&M (2016-18e CAGR: +8.7%) and Inditex (2016-18e CAGR: +10.8%) to deliver strong sales growth. The two groups will continue to pursue their strategies based on: **(i)** their ability to execute well and outperform the global market **(ii)** the ramp up of omnichannel and **(iii)** store openings.

2.3.1. How are they performing in their respective leading markets?

H&M generates 18% of sales in Germany (market share: c.5%) and Spain also accounts for 18% of Inditex sales (market share: c.15%). In these markets, which are relatively mature for each of the groups and despite different market conditions, this analysis shows if the strategy and execution are good, something that will naturally have an incidence on their like-for-like growth.

The following two charts highlight the more favourable market conditions for clothing in Spain relative to Germany, despite a slight downturn in recent months explained by Spanish concerns given the absence of a government although this political crisis was resolved in late October. The German market remains negatively affected by cautious German consumers and somewhat unfavourable weather conditions relative to the timing for the unveiling of collections (no real winter early in the year and very little sun over the summer).

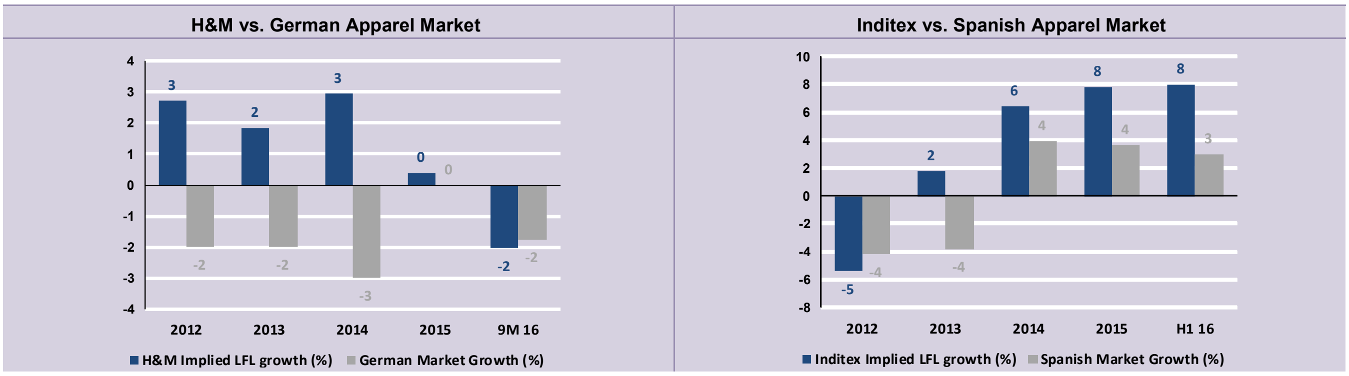
Fig. 25: Trend in the ready-to-wear market in Germany and Spain:



Source: Textilwirtschaft, INE, Bryan, Garnier & Co ests.

While **H&M** has regularly outperformed the German market in recent years, this has not been the case this year with a like-for-like decline of 2% given a difficult German market and the increasing competition from Primark (21 stores in Germany), whereas **Inditex** has maintained very strong momentum in Spain (BG estimate: c.+8%e vs the domestic market at c. +3%).

Fig. 26: Implied LFL performances vs the German and Spanish markets:



Source: Textilwirtschaft, INE, Bryan, Garnier & Co ests.

2.3.2. Responsiveness to changing trends: Inditex has the advantage

As seen in section 2.1.4, H&M's supply chain and sourcing are fairly traditional and similar to those of the rest of the industry: a 'top-down' approach (with the design team deciding the orientation for the collection) and **manufacturing mainly located in Asia (c.80%).**

As a result, around 80% of the collections are designed and ordered six months prior to their delivery to the stores, **making H&M, like the industry, sensitive to any changes in trend (fashion, consumers. etc.) and weather conditions,** as seen in the following table:

Fig. 27: H&M sales are sensitive to unfavourable weather conditions:

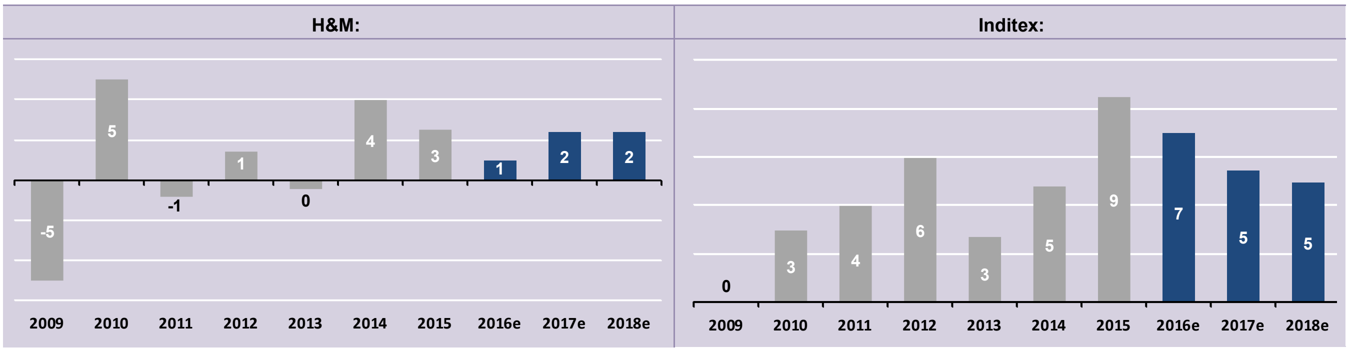
Month	FX-n growth and implied LFL (%)	H&M comment:
March 2016	+2% / -6%	*"Weather conditions in March last year were favourable for the season, while the opposite is true this year"*
April 2016	+5% / -3%	*"The cold spring which continued into April in several of H&M's large markets has had an unfavourable impact on sales of transitional garments"*
August 2016	+7% / -1%	*"Sales development in August had a very good start. But sales were negatively affected in the second half of the month by exceptionally hot weather in most of the group's markets"*
September 2016	+1% / -7%	*"The unseasonably warm weather in September had a very negative impact on the H&M group's sales in the month of September"*.

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

Right from the inception, the Inditex group was built around a highly agile and responsive supply chain: **1/** every store manager gives product feedbacks to store product teams and place an order with the central logistics DCs twice a week, **it is customers who orient the design team** in terms of fashion trends, **2/** nearly **60% of manufacturing is based 'in proximity'** (i.e. mainly in Spain, Portugal and Morocco), enabling the: **3/ design and manufacturing of c. 50% of a collection in the middle of a season** (this figure is particularly true for the Zara brand) and **4/ its delivery within two weeks of the original design.**

Inditex is thus less exposed to shifts in fashion and to weather conditions which are rarely mentioned in its communication. It does not disclose monthly like-for-like growth figures but, during the H1 16 2016 results released on 21 September, Inditex stipulated that sales had increased by 13% on a FX-n basis over the first seven weeks of the first half (1 August => 18 September), i.e. estimated LFL growth of 7-8%.

Fig. 28: Trend in like-for-like growth at H&M and Inditex (2009-18e, in %):



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

2.3.3. Growth of online sales and price harmonisation under way

Like numerous brands, H&M and Inditex have launched a strategy to harmonise prices at global level. However, the rapid price review in the following table reveals that H&M's pricing strategy is more homogeneous than that of Zara.

Note that, due to sourcing mostly based in Asia, **H&M** orders substantial amounts of products destined to be sold in virtually all of its markets, making the pricing strategy more transparent but potentially also exposing the company to an exchange rate risk if the brand cannot/wants to increase its prices in the event of a depreciation in some currencies like, for example, the GBP.

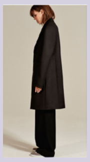
Fig. 29: A reduced price gap at H&M…:

	Spain	UK	France	Germany	China	US
Cold Shoulder Dress Price in local currency 	EUR39.99	GBP29.99	EUR39.99	EUR39.99	CNY349	USD49.99
Price in EUR (base 100 = Spain)	100	86	100	100	118	115
Wool-blend Coat Price in local currency 	EUR99	GBP79.99	EUR99	EUR99	CNY899	USD129
Price in EUR (base 100 = Spain)	100	99	100	100	123	120

Source: HM.com (14 November 2016), Bryan, Garnier & Co ests

At **Zara**, the price differential remains substantial even within the euro zone (+33% in France and Germany vs. Spain) even if it has been reduced with some countries thanks to currency exchange rates (GBP, CNY). Although most of the collections are destined for the whole world, the brand adapts the volumes and size of some collections as a function of the demand and trends in each country, making the price gap less of an issue in the short term. However, the Inditex group plans to pursue these harmonisation efforts over the next few years.

Fig. 30: … while it remains substantial at Zara:

	Spain	UK	France	Germany	China	US
Knot Skirt Dress Price in local currency 	EUR29.95	GBP29.99	EUR39.95	EUR39.95	CNY299	USD49.90
Price in EUR (base 100 = Spain)	100	115	133	133	135	153
Long Masculine Coat Price in local currency 	EUR149	GBP179	EUR199	EUR199	CNY1,999	USD299
Price in EUR (base 100 = Spain)	100	138	133	133	181	184

Source: Zara.com (14 November 2016), Bryan, Garnier & Co ests

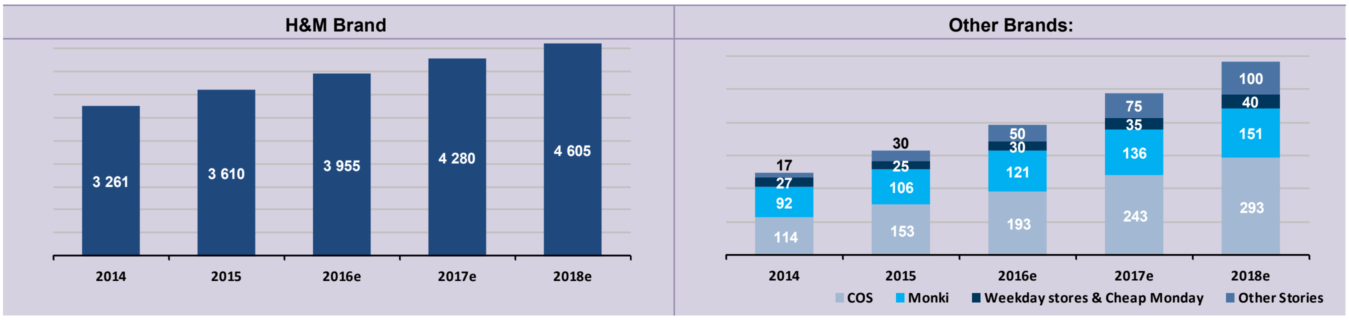
Based on our forecasts, in 2016 online sales should represent around 8% of H&M's sales (*see Fig. 11:*) and 5.5% at Inditex (*see Fig. 12:*). The growth of this channel is likely to make a positive contribution to the two groups' like-for-like growth: based on a CAGR of 20%, we derive a theoretical positive impact for H&M and Inditex of respectively 2 percentage points and 1 percentage point as of 2018.

2.3.4. 2016-18: towards a slower space expansion

Although H&M and Inditex had already numbered a respective 3,924 and 7,013 stores in 2015, the 'mass market' or 'accessible fashion' segment of the worldwide ready-to-wear market is very large (c.EUR1,100bn) and highly fragmented since the two flagship H&M and Zara brands are estimated to command respective market shares of 1.7% and 1.4%. Hence, they still have the option to expand their store networks.

H&M has maintained its target of increasing its space by 10% to 15% per year. **Our forecasts are based on the bottom of this range (c.10%), implying the opening of at least 420 stores over the 2016-18 period, not including the launch of new concepts.** At the end of September, the CEO of H&M reiterated that one or even two new brands *'would be completely different from the six existing brands'* would be launched in 2017, potentially implying a larger new store opening programme than in our assumptions.

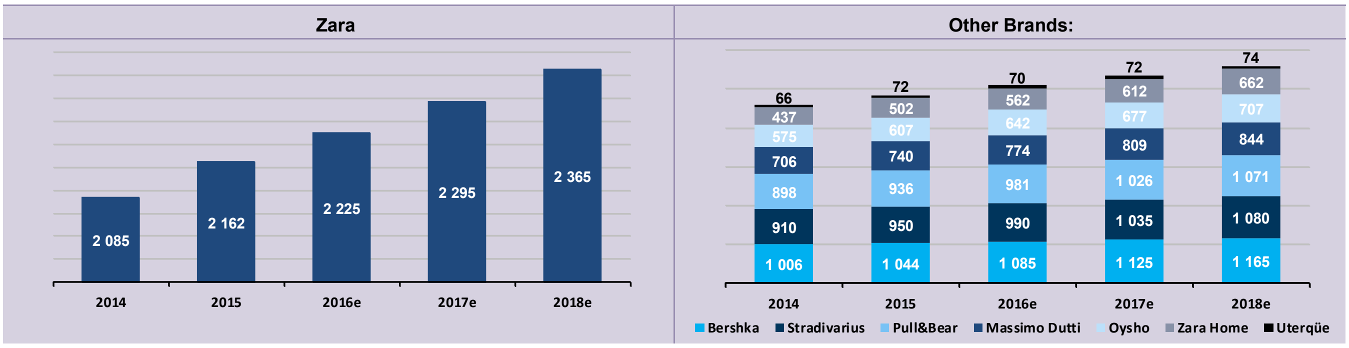
Fig. 31: Trend in the H&M group's store network (2014-18e):



Source: Company Data; Bryan, Garnier & Co

Inversely, early this year **Inditex reduced its MT growth outlook for space expansion (+6-8% per annum against +8-10% previously),** i.e. around **320 new stores per year** on our forecasts. To justify this reduction in guidance, the CEO mentioned the ramp-up of the online channel and plans to open fewer stores but larger in size. In our view, **this strategy would make the cost structure less exposed to a possible "operating deleverage"** (i.e. weak LFL growth, combined with opex inflation).

Fig. 32: Trend in the Inditex store network (2014-18e):

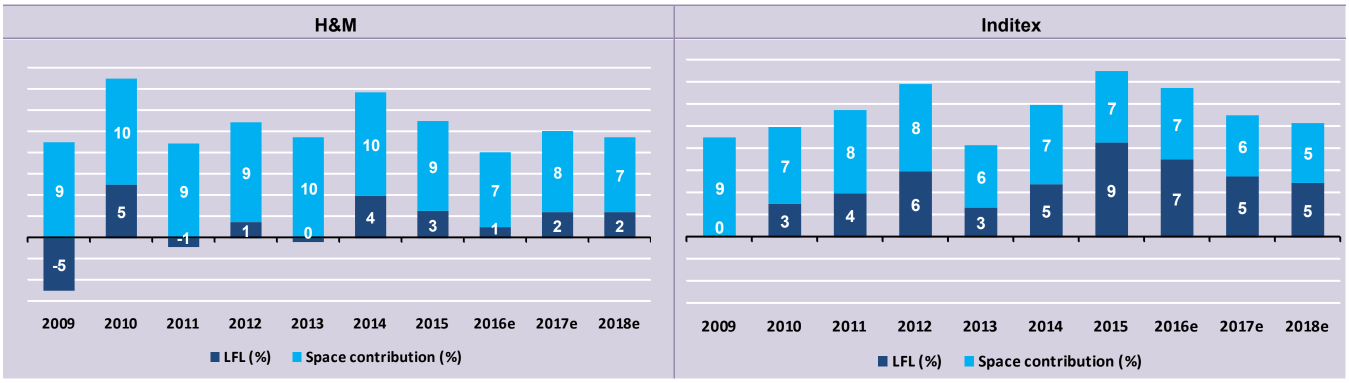


Source: Company Data; Bryan, Garnier & Co

Between 2016 and 2018, we are thus forecasting space expansion growth approaching 10% for **H&M** (medium-term target of +10-15%) and return on new space of 60% in 2016, followed by 70% in 2017-18, i.e. a space contribution of between 7% and 8% over the period. As regards **Inditex**, the slowdown in the growth target for space expansion is reflected in our floor area forecasts below (c.6% in 2017 and c.5% in 2018), implying return on new space of 75% over the 2017-18 period.

For the two companies, the space effect contribution will be lower than in previous years, as shown in the following charts. In our view, investors will again be more focused on like-for-like growth!

Fig. 33: H&M and Inditex: trend in FX-n growth (2009-18e, in %):



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

2.4. Our profitability forecasts for 2016-18

H&M and Inditex continue to invest and open stores within an increasingly competitive industry and with very limited pricing power since they operate in the mass market/value segment of clothing. In this section, we thus analyse the risk factors (sourcing, currency, price deflation, etc.) that could negatively impact profitability levels and the levers with the potential to increase them.

2.4.1. The flexible supply chain is also beneficial for gross margin rates

As highlighted in 2.3.2 concerning the difference in agility at the level of the supply chain, **H&M's** supply chain is close to the industry norms (lead times of six months for 80% of production), making it sensitive to changing trends (fashion, consumption, etc.) and weather conditions. H&M, which generally discloses the impact at promotional level, stipulated that the growing share of markdowns had a 25bp negative effect in 2015 and, in our view, the magnitude should be similar for 2016.

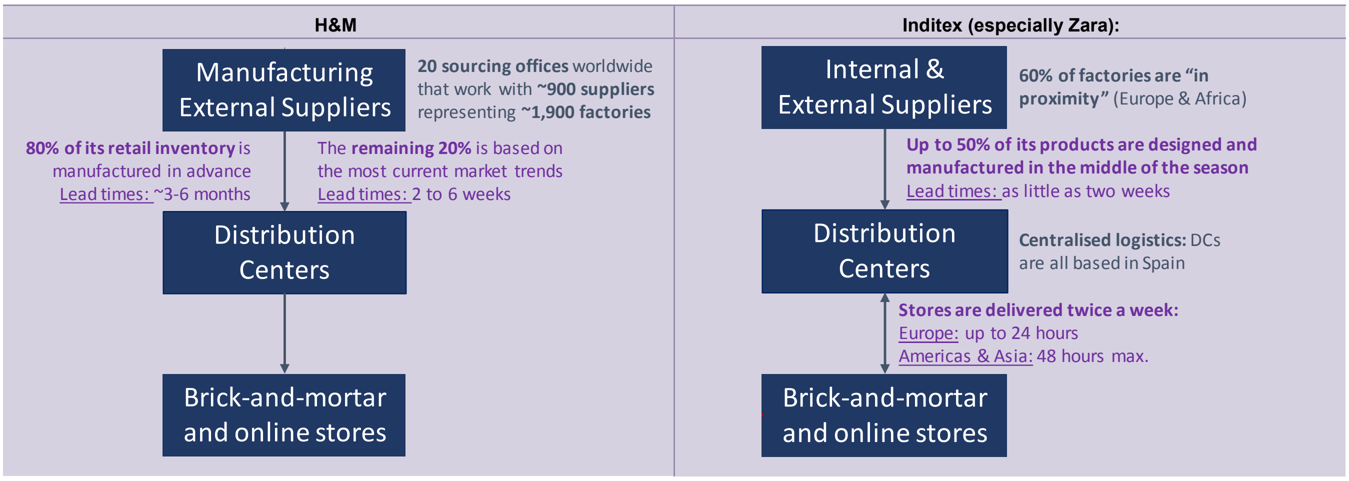
Inditex's greater flexibility allowing at least 50% of its manufacturing within a maximum lead time of a few weeks, enables the company to be highly responsive to any changes in trend linked to consumers or weather conditions. **This shortening of lead times can also be found in the stores since any one article remains in the store for no more than fifteen days on average and is not the subject of replenishments.** This approach offers a number of advantages relative to the rest of the industry:

(i) **Unsold items represent less than 10% of its inventory whereas the industry average is closer to 20%.**

(ii) **The return rate is 25% to 30% against an average of 50% for the industry,** making the management of returned products less complex and cheaper (for the online channel) especially when nearly two-thirds of returns are made in the group's stores.

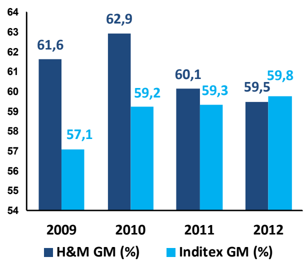
(iii) **The positive consequence is that around 80% to 85% of Inditex products are sold at full price against a 60% to 70% average for the industry.**

Fig. 34: The shorter the manufacturing lead times, the better it is!



Source: Bryan, Garnier & Co ests.

Trend in gross margin rates (2009-12, in %):



Source: Company Data

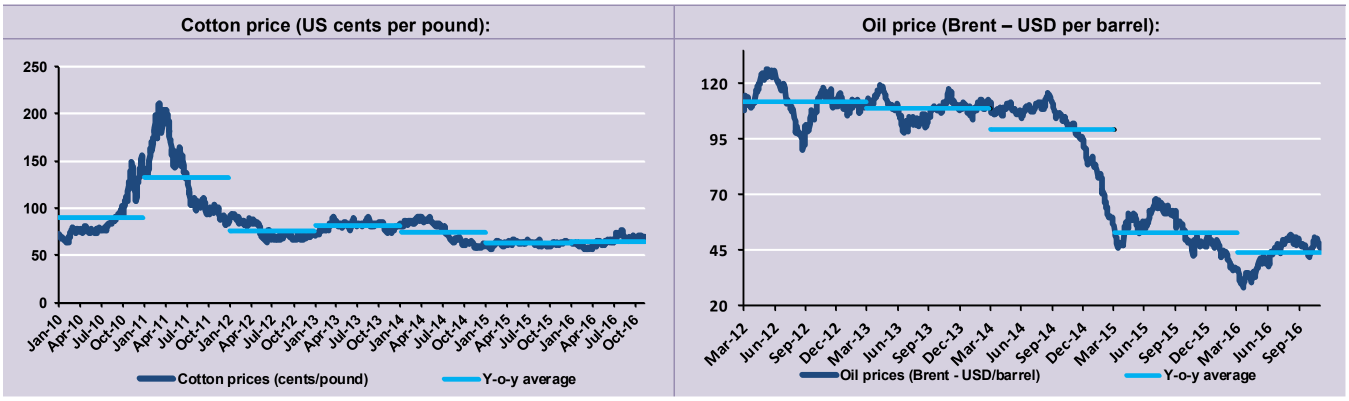
2.4.2. The raw materials environment is not a threat in the short term

The main raw material to which H&M and Inditex are exposed is clearly **cotton**. Since procurement contracts are generally negotiated six months in advance (80% of H&M manufacturing, up to 50% of Inditex manufacturing), **any move in the cotton price has a lag effect of around three (Inditex) to six months (H&M) on the gross margin rate.**

As seen in the lhs chart below (*Fig. 35*: , the last time the cotton price soared higher was in 2010-11 with a material negative impact on the gross margin rate at H&M and Inditex in 2011-12 (see chart on the left). Unlike many competitors (particularly sports equipment companies) H&M and Inditex chose not to pass on this inflation in higher prices although the latter managed to absorb the shock rather more effectively thanks to its structural flexibility and vertical integration (productivity/efficiency gains offsetting the increase in sourcing costs).

Oil prices also need to be watched in that it can have two repercussions: **(i)** it can influence the prices of other materials used in the manufacturing of clothing and footwear (nylon, rubber, etc.) and **(ii)** have an impact on logistics costs. The two charts below show that, in 2017, the two companies need not fear a major increase in their COGS linked to raw materials and transport.

Fig. 35: The raw materials environment is not a threat in the short term:



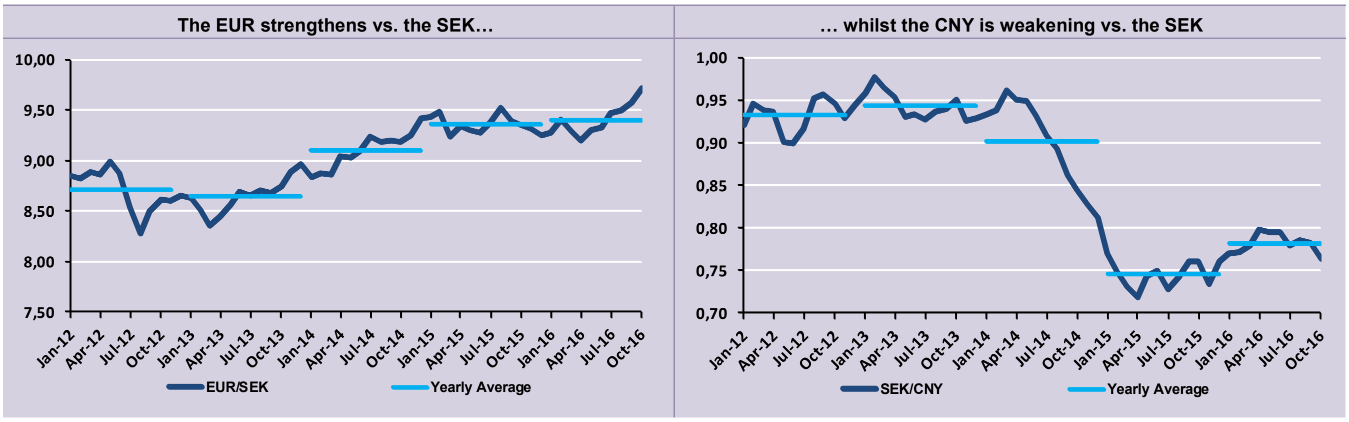
Source: Datastream; Bryan, Garnier & Co ests.

2.4.3. A progressive lull at currency level

As for all companies with a significant proportion of their manufacturing in Asia, **H&M** had to cope with the highly unfavourable hedging conditions resulting from the soaring dollar in 2015. On our calculations and the indications given by the management, the strength of the dollar is likely to have led to a negative impact of between 200bp and 500bp on the gross margin rate over the last six quarters (Q2 15 => Q3 16).

In our view, the pressure on the gross margin rate should still represent a modest negative in Q4 16 (to end November 2016) but, thanks to a slight depreciation in the CNY combined with a stabilisation in the EUR/USD exchange rate (*see Fig. 36: on the following page*), this impact could reverse as of Q1 17 (to end February 2017). The depreciation in the Swedish krona relative to the euro, which admittedly benefits sales (positive currency conversion impact since 43% of sales) does, however, need to be watched although around 20% of manufacturing is invoiced in this currency.

Fig. 36: Currencies: the worst is behind H&M:

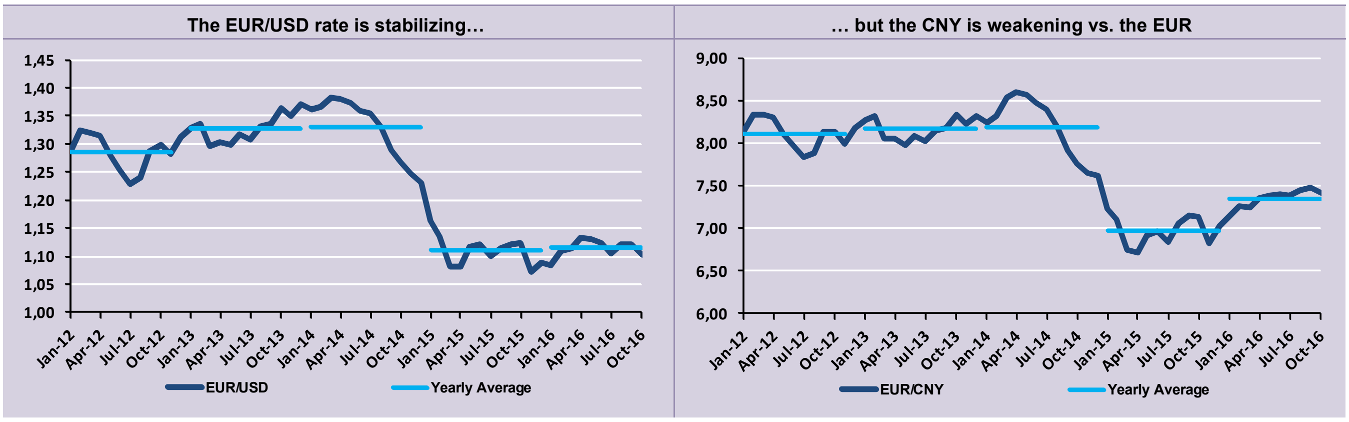


Source: Datastream; Bryan, Garnier & Co ests.

Thanks to manufacturing mostly located in "proximity" countries, around 60%-65% of Inditex's COGS is euro denominated and the remainder (c.35%-40%) is purchased in USD, versus c.80% for the rest of the industry. The transaction risk linked to the dollar is thus markedly lower at Inditex than with its competitors.

Due to its centralisation strategy (= all the HQs and logistics DCs are located in Spain) the bulk operating costs are in euros. **According to our calculations, around 60% of the cost structure (COGS and OPEX) is likely to be euro denominated, compared with c.45% of sales.** Everything else being equal, **a 10% reduction in the euro would lead to a theoretical 5.5% impact on sales and 18% on EBIT.** As a result, Inditex is more sensitive to the currency conversion risk.

Fig. 37: Even if Inditex were less impacted, the environment is also improving:



Source: Datastream; Bryan, Garnier & Co ests.

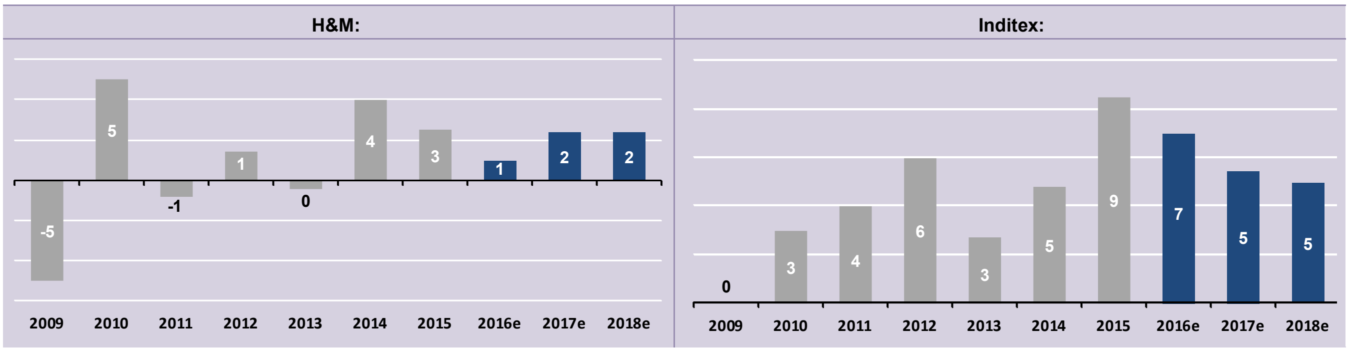
2.4.4. OPEX: the sources of operational leverage are mostly found in the stores

Benefiting from the store opening effect is fine for driving sales growth but posting comparable store growth is even better, especially at the level of profitability. Furthermore, remember that H&M and Inditex should see their space contribution decelerates slightly over the next few years, meaning that investor attention will turn more to performance on a LFL basis.

This issue of operational leverage is naturally shared by all the brands that have opted to control their distribution (headed by the luxury goods companies), but it is even more true for H&M and Inditex who are continuing to expand their store networks. Furthermore, more selective locations for stores and a progressively larger average store size are leading to some inflation in operating costs which must be contained.

Against this backdrop, we would be more comfortable with Inditex which is expected to post higher like-for-like growth performances than H&M over the 2016-18 period, as shown in the following charts.

Fig. 38: Trend in like-for-like growth at H&M and Inditex (2009-18e, in %):

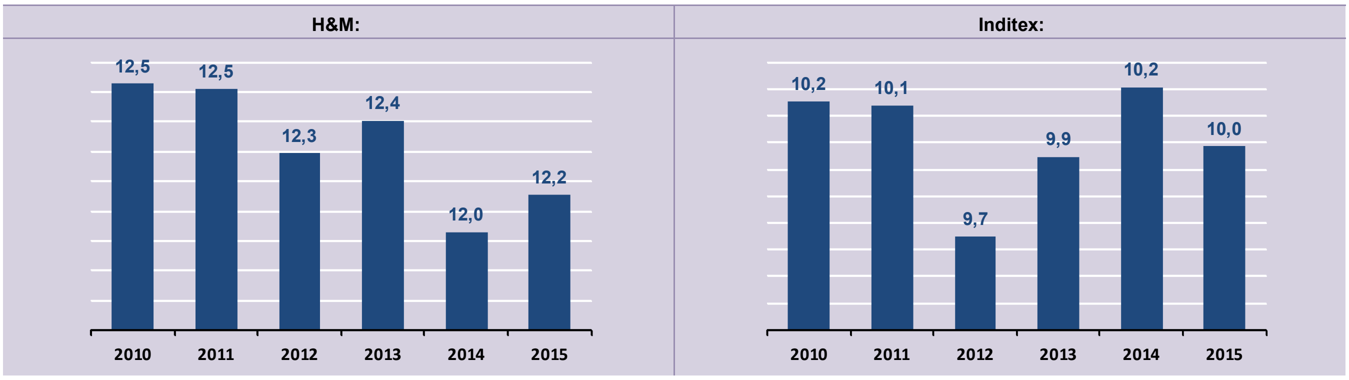


Source: Company Data, Bryan, Garnier & Co ests.

Rents remain under control

H&M and Inditex rent virtually all their stores except some Zara stores whose buildings belong to the founder Mr. Ortega. As seen in the following charts, rental costs have been fairly stable for the two groups in recent years, **at around 12% for H&M and 10% for Inditex**. In our view, the Spanish company has more leverage potential on this cost line since it has decided to open fewer stores but larger in size.

Fig. 39: Trend in rental costs (2010-2015, % of sales):



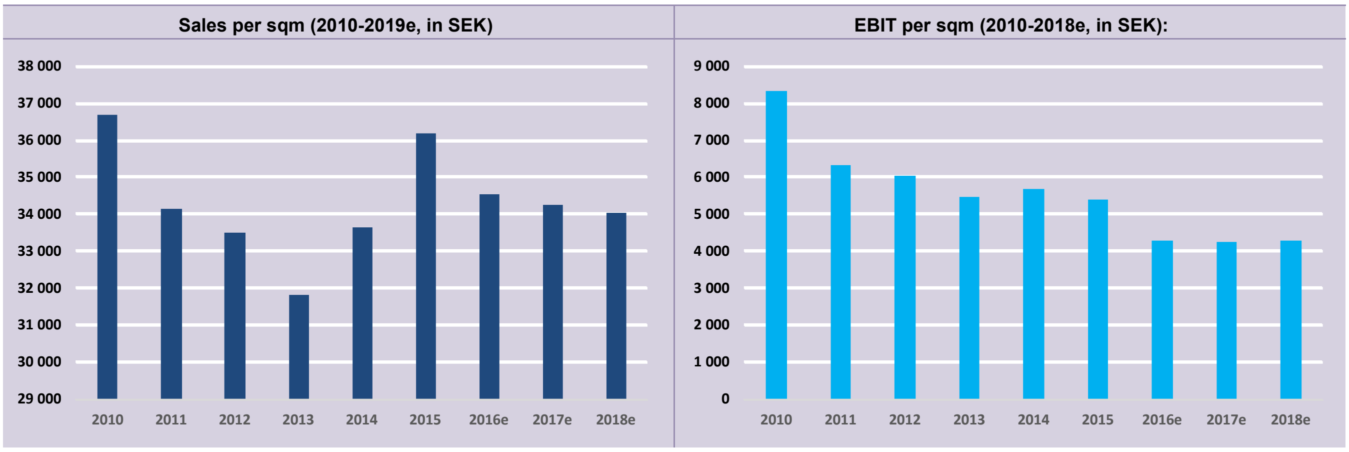
Source: Company Data, Bryan, Garnier & Co ests.

Ongoing ratio erosion at H&M before stabilising in 2018?

H&M does not disclose its total selling area. Our assumptions progressively increase the average size of an **H&M store** (1,350m² in 2015 => 1,430m² in 2018) since we understand that the new stores have an average floor area of at least 1,500m² to present the H&M Beauty and H&M Home concepts. The **COS**, **Weekday** and **& Other Stories** brands have an average store size of 450m² while those of **Monki** are smaller (275m²).

This erosion in the sales per sqm and EBIT per sqm ratios illustrated in the following charts reflects: **(i)** the negative like-for-like growths (2011, 2013) or performances not strong enough to leverage the operational costs like this year (+1%e) and **(ii)** a decline in profitability since 2010 marked by the substantial level of investment (IT, online, retail expansion) and external factors such as the currency impact and higher sourcing costs.

Fig. 40: H&M: sales/m² and EBIT/m² ratios

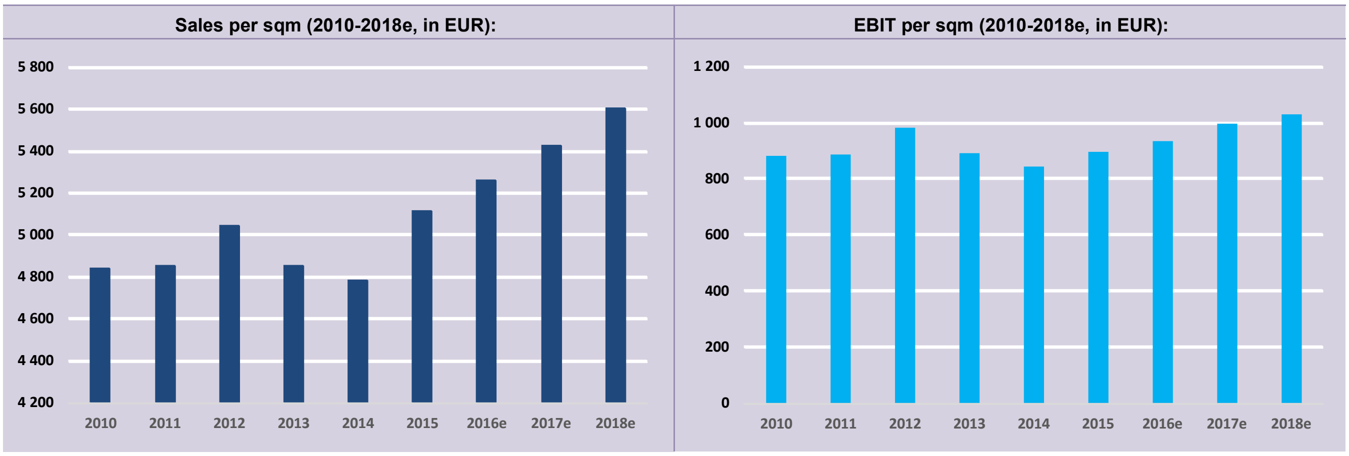


Source: Company Data; Bryan, Garnier & Co

The rebound begun in 2014 will continue in future

Inditex has also invested massively in recent years (logistics, IT, online, etc.) while suffering from a negative currency effect. This phase is, however, almost behind us and, since we are forecasting fairly strong life-for-like growth (+7%e in 2016, +5%e in 2017-18), the group will be able to capitalise all the more on its investment.

Fig. 41: Inditex: the ratios are improving:



Source: Company Data; Bryan, Garnier & Co

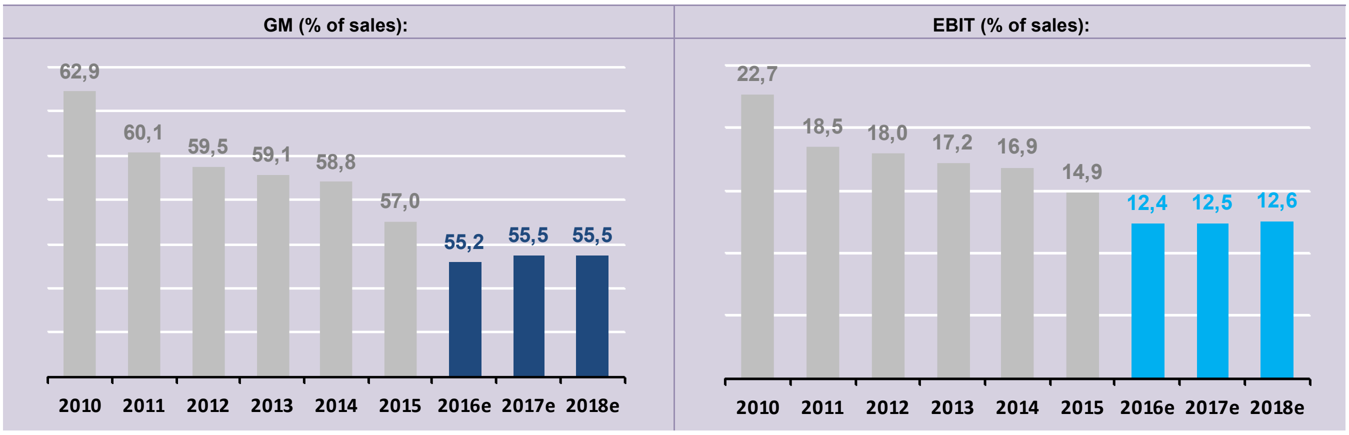
2.4.5. Summary of our profitability forecasts

H&M's gross margin rate fell sharply between 2010 and 2015 (-590bp) under the impact of very negative raw material (around -250bp between 2010 and 2012) and currency effects that the group opted not to pass on in price hikes. The Swedish company also invested significant sums in reinforcing its sourcing teams and developing its other brands (including the launch of & Other Stories in 2013).

Now that the bulk of the investment cycle has been completed and the currency environment is almost returning to normal, we see H&M being able to slightly increase its gross margin rate in 2017 (+30bp) and stabilise it at around 55.5%. Beyond the currency issue, there are two limiting factors on these forecasts: **(i)** the proportion of markdowns could have a more-negative-than-expected impact (little risk of this in H2 16 in our view) and **(ii)** they do not include investment linked to the launches of one or even two new brands in 2017.

While the fall in the gross margin rate is the main reason for the decline in EBIT margin (-780bp between 2010 and 2015), the "operating deleverage" is also responsible, with total opex moving from 40.2% of sales (2010) to 42.1% (2015). Despite a high opening rate, with LFL growth rates of c.2% in 2017-18, in our view the group will also manage to stabilise the weight of its operating costs at these levels and may even benefit from a slightly positive leverage effect in the event of higher LFL growth.

Fig. 42: H&M: trend in gross margin rates and EBIT (2010-18e, % of sales):



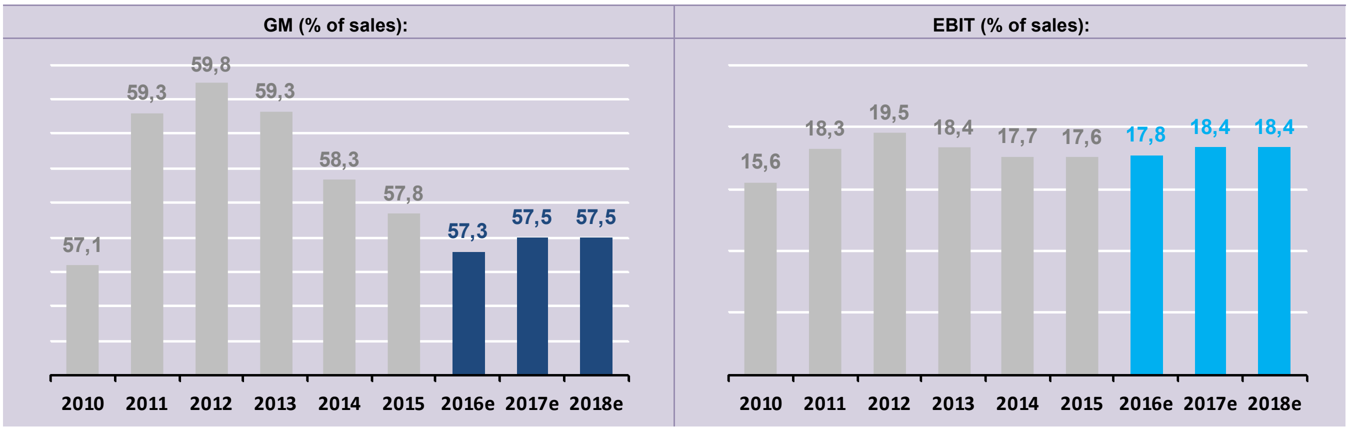
Source: Company Data; Bryan, Garnier & Co

Inditex's GM rate has also suffered from the same negative factors as its Swedish competitor, namely COGS inflation and an unfavourable currency effect, but also investment in its other brands (distribution centres, IT, online). However, thanks to its business model which is unique to the industry, these impacts have been lower, with a decline in GM rate limited to 200bp between 2012 and 2015, while remaining at a level higher than in 2010.

In our view, Inditex will also be able to slightly improve its gross margin rate in 2017-18 (+20bp vs. 2016e to 57.5%). We see Inditex as better armed to maintain its prices in this competitive environment thanks to its supply chain, the strength of its brand and its slightly higher positioning than H&M.

We see the potential leverage effect being higher at Inditex which will: **(i)** slow its store opening rate (=> lower increase in rents and salaries), **(ii)** not launch new brands and **(iii)** benefit from the ramp up of its 'other brands' thanks to the investment made over the past few years. Operating costs should thus fall by 100bp to 34.4% relative to 2015.

Fig. 43: Inditex: trend in gross margin rate and EBIT (2010-18e, % of sales):



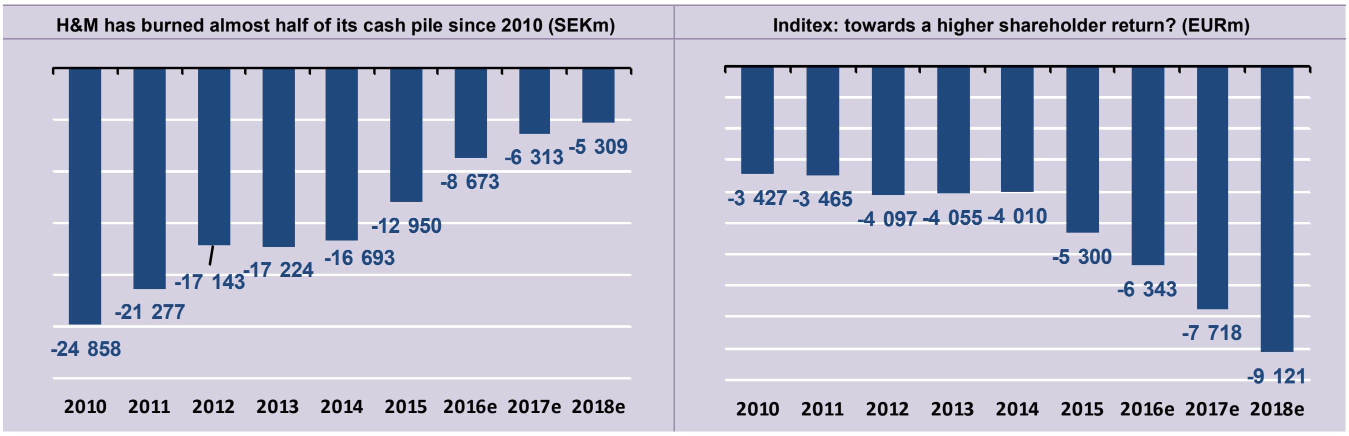
Source: Company Data; Bryan, Garnier & Co

2.5. Cash: two contrasting situations

H&M and Inditex were in a fairly comfortable net cash position in 2015 as seen in the following charts. However, **H&M** has 'burned' more than half its net cash in recent years since it wanted to maintain a relatively generous dividend payout (*see next page*) despite a significant level of investment and declining profitability. On our forecasts, this trend will prevail at least until 2018 since H&M has no plans to sacrifice its attractive payout ratio.

Inditex is in precisely the reverse situation, the Spanish company being expect to double its cash pile between 2010 and 2016. While capex may have been higher as a % of sales (8% on average over the period vs. c.6% for H&M), Inditex's profitability has proven more resilient while the payout rate is some twenty points below that of H&M.

Fig. 44: Net cash position: two contrasting situations:

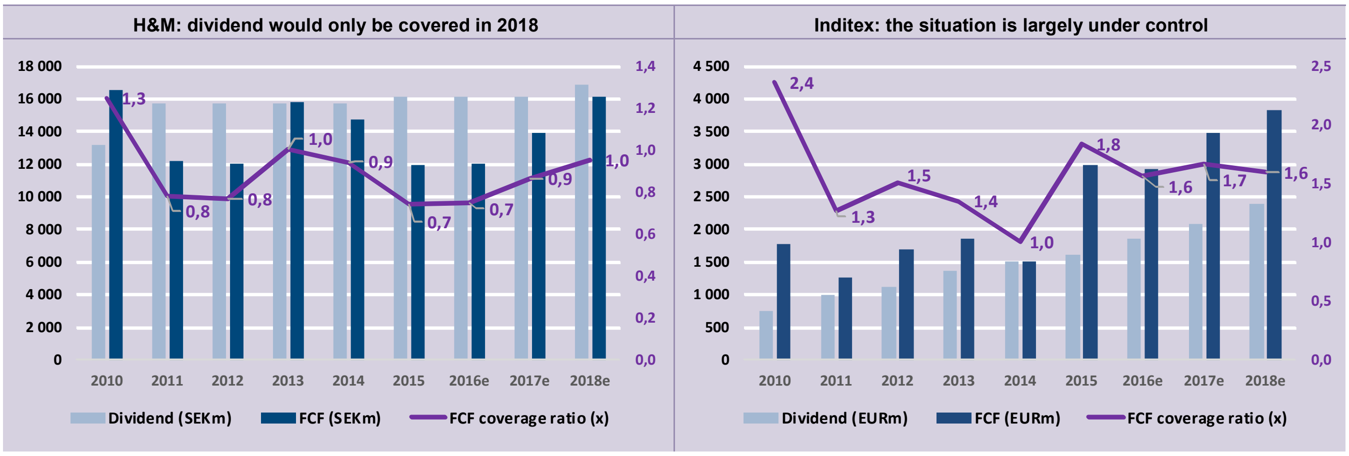


Source: Company Data; Bryan, Garnier & Co

The situations outlined above are reflected in the following charts. Since 2011, **H&M's** FCF generation has not been high enough to cover dividend payments since the group has always maintained a very high level of payout (c.90% on average between 2010 and 2015) and this generous dividend policy is expected to be maintained. As indicated in the left-hand chart, it is only in 2018 that FCF generation (reduction in capex as a % of sales, stabilisation in profitability) is expected to fully cover the dividend payment. According to our forecasts, this payout will remain above 80%.

Inditex's FCF generation comfortably covers its dividend payment, particularly since the payout rate amounted to a little over 60% for the 2010-15 period, substantially below that of H&M. At this stage, we expect a 65% payout between 2016 and 2018 but, in view of the very positive net cash position and a slowdown in the rate of store openings, investors are increasingly expecting an increase in this payout rate.

Fig. 45: No emphasis on dividends:



Source: Company Data; Bryan, Garnier & Co

3. Valuation

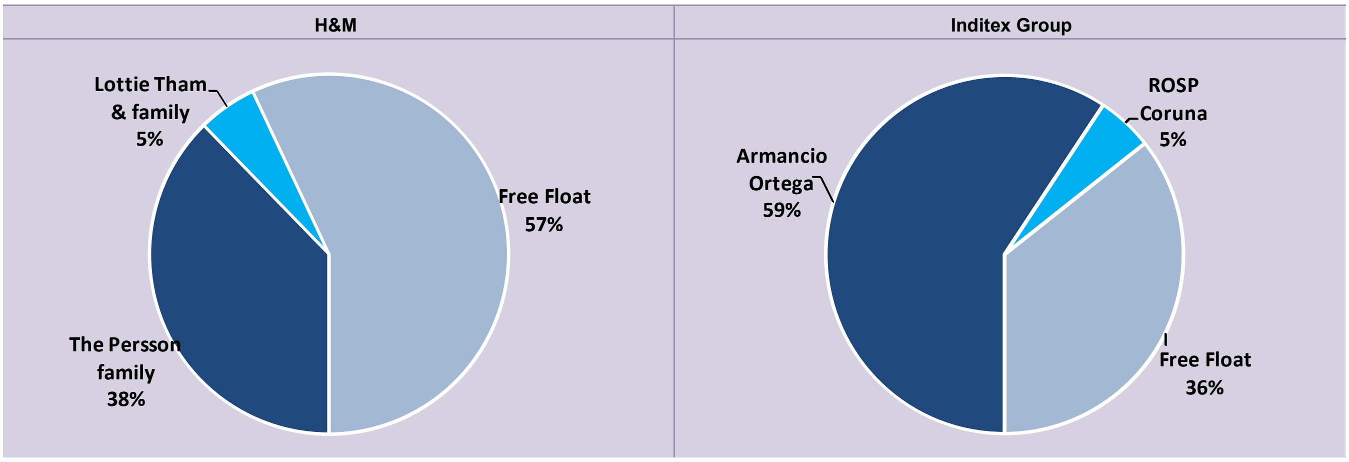
3.1. Groups still owned by their founding families

The heirs to the founder of the **H&M** fashion group (Erling Persson) are fully involved in H&M's operational management since one son (Stefan Persson) is Chairman of the Board of Directors and his grandson, Karl-Johan Persson, has been the group's CEO since 1 July 2009. Stefan Persson holds all of the 194.4 million 'A' shares (unlisted) together with more than 403 million 'B' shares (listed for trading) through a holding company known as Ramsbury Invest AB. In total, members of the Persson family hold 37.7% of the shares and 69.7% of the voting rights. Note that Stefan Persson's sister, Lottie Tham, holds 5.3% of the share capital and 2.6% of the voting rights.

At **Inditex**, the founder Amancio Ortega naturally remains the main shareholder with 59% of the share capital and voting rights. His shareholding is regrouped in two family holding companies: **(i)** Pontegadea (1.558 million shares = 50% of the share capital) and **(ii)** Partler 2006 (289 million shares = 9.3% of the share capital). The Pontegadea holding company is also represented on the Board of Directors by Amancio Ortega's wife, Mrs. Flora Pérez Marcote. Lastly, the ROSP Coruna holding company (c.5% of the share capital) regroups the shareholding owned by Amancio Ortega's daughter (Sandra Ortega Mera).

Since 2005, Pablo Isla has been CEO of Inditex and even became Chairman of the Board of Directors in 2011 when Amancio Ortega took more of a back seat.

Fig. 46: Shareholder structure of H&M and Inditex (% of total shares):



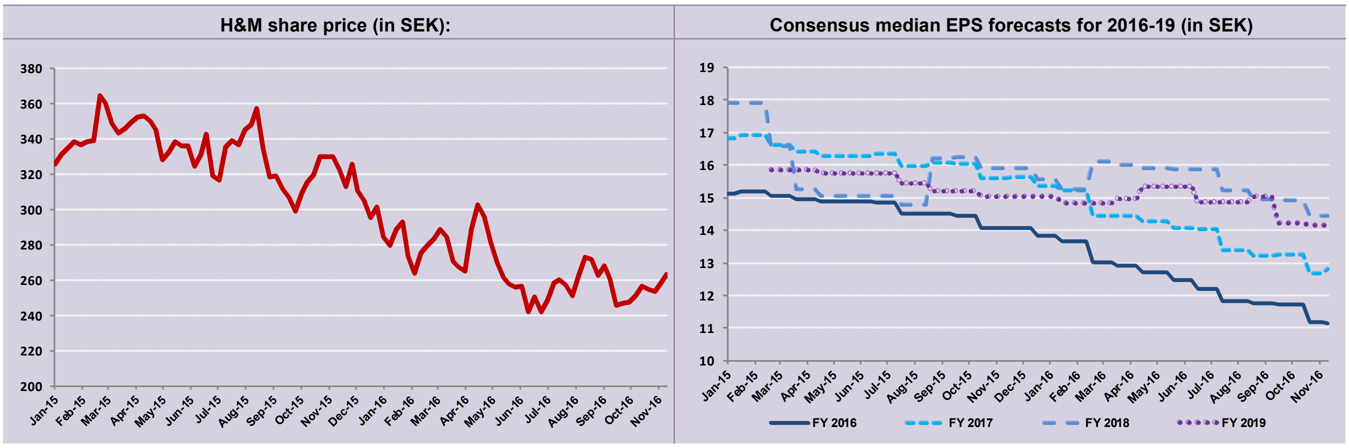
Source: Company Data; Bryan, Garnier & Co

3.2. Consensus expectations

The **H&M** and **Inditex** share price performances (*see left-hand charts and Figs 47 and 48*) are consistent with the earnings forecast revisions made by the market. Since early 2015, the median consensus has revised down its 2016 EPS forecasts for **H&M** by 26% given the very unfavourable currency environment and a negative "operating deleverage" on the Swedish group's margins (top-line growth insufficient, inflation in operating costs).

This year, the market has cut its 2017 and 2018 estimates by a respective 17% and 7% but, in the past few weeks, the downwards spiral seems to have slowed in that H&M is gradually exiting the negative currency effects. Can we then conclude that the bear phase is definitively behind us? We are not totally convinced of this since the consensus seems fairly aggressive in our view, forecasting respective 2017-18 operating margin increases of 50bp (BG: +10bp) and 20bp (BG: +10bp). This seems a bit punchy in view of the prudent LFL growth forecasts (=> little potential for leverage effect) and investments linked to the launch of one or even two new brands in 2017.

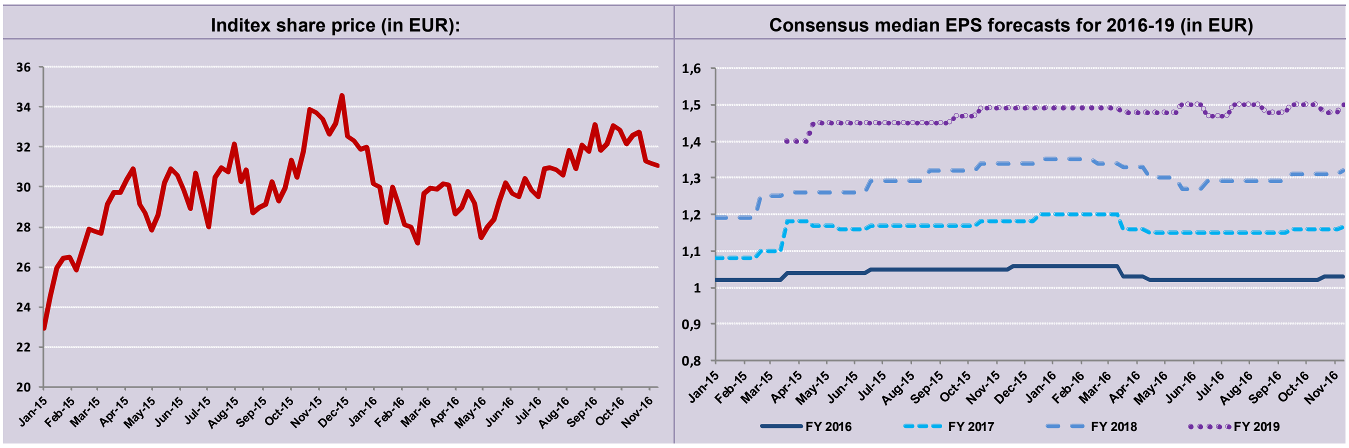
Fig. 47: Consensus expectations: an end to downgrades for H&M?



FY 2016: FY ending November 2016 *Source: Datastream; Bryan, Garnier & Co*

It is striking to note that the consensus expectations for **Inditex's** EPS have remained broadly unchanged (-3% in 2017 and -2% in 2018) since the beginning of the year. This low dispersal shows the market's confidence in the solidity of its business model and the relatively limited risk of disappointment (good historic track record).

Fig. 48: Consensus expectations: forecasts reflect the market's confidence:



FY 2016: FY ending January 2017 *Source: Datastream; Bryan, Garnier & Co*

3.3. H&M's and Inditex' multiples

3.3.1. 12-month forward P/Es

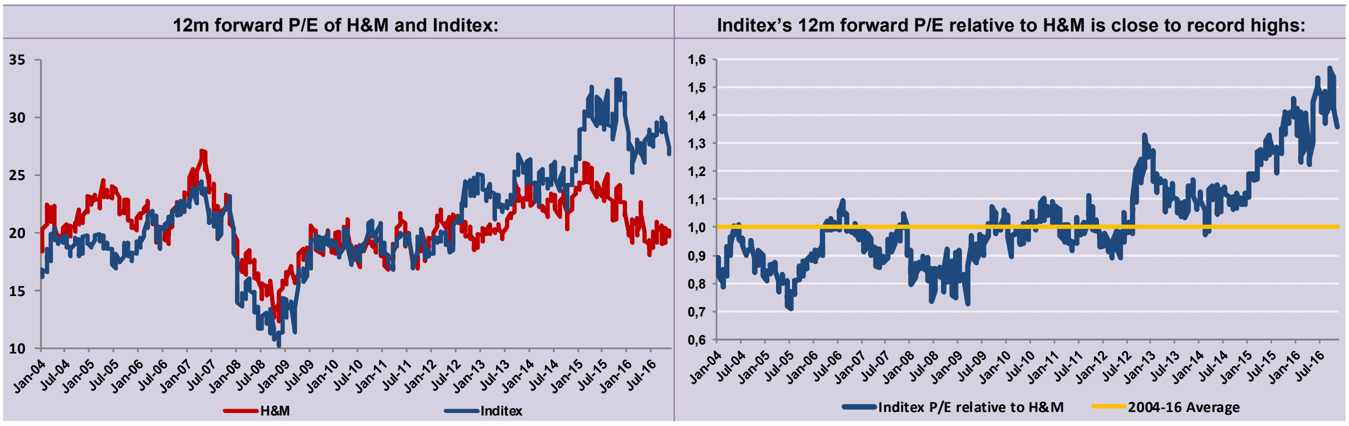
The charts show that, in terms of 12-month forward P/Es, the **H&M** and **Inditex** share prices had tended to trade in line. When we compare Inditex's 12-month forward P/E with that of H&M, we arrive at an average of 1x over the 2004-16 period (*see right-hand chart*).

However, as of early 2015, **Inditex** shares started to trade at a premium to **H&M** and the gap has steadily increased, reaching a new record of 60% in September 2016. The constitution of this premium was justified by the differential in terms of earnings growth momentum: thus, for the 2016 fiscal year, we are forecasting 11.5% growth in Inditex's EPS (to end January 2017) while H&M's EPS are expected to fall by 11% (to end November 2016).

Currently, Inditex is trading at a 36% premium, a level that seems to us to be sustainable given the superior growth outlook for the Spanish company (*see the following section*).

Admittedly the idea of switching back into H&M to play the reduction in this premium may seem tempting. However, this convergence could only be justified if the Swedish company manages to return to LFL growth figures similar to those of Inditex (+5-7%e) and to improve its profitability which has been in steady decline since 2010. Furthermore, the valuation remains at historic levels in absolute terms (19.7x on the 12-month forward P/E).

Fig. 49: Trend in the 12-month forward P/E for H&M and Inditex:



Source: Datastream; Bryan, Garnier & Co

3.3.2. Valuation/growth ratios

Given that H&M and Inditex trade at high multiples in absolute terms, it seems more relevant to compare this valuation with their growth prospects. Note that we already carry out this exercise with Optical g which also have high multiples.

In addition to the two global fashion leaders, we have also looked at other retailers operating in the ready-to-wear segment, all of which are in the UK: **(i) Associated British Foods** which owns the Primark brand (c.44% of sales and c.58% of group EBIT), **(ii) Marks & Spencer** (General Merchandise = c.37% of sales), **(iii) Next** and **(iv) SuperGroup** (Superdry brand). With the exception of SuperGroup (-7% ytd), the share prices of the other three UK retailers have seen a significant correction since the beginning of the year (-26% on average) due to difficult market conditions (UK consumers' wait-and-see attitude, online competition, GBP/USD transactional FX impact).

The following table shows that the 'EV/EBIT to growth' ratios for **H&M** and **Inditex** remain relatively affordable: while their spot multiples are effectively above those of the UK peers, this level of valuation is underpinned by a stronger growth outlook, particularly at Inditex.

Fig. 50: 'EV/EBIT to growth' ratios of the main textile groups:

Companies	Market Cap (EURm)	2017e EV/EBIT (x)	2018e EV/EBIT (x)	EBIT CAGR 2016-2019e (%)	EV/EBIT to growth 2017e (x)	EV/EBIT to growth 2018e (x)
H&M – SEK	**45,369**	**16.6**	**15.0**	**10.3**	**1.6**	**1.5**
Inditex	**97,737**	**19.0**	**17.0**	**12.1**	**1.6**	**1.4**
AB Foods – GBP	20,789	16.9	15.6	13.3	1.3	1.2
M & S – GBP	5,492	11.3	11.0	7.2	1.6	1.5
Next – GBP	7,146	9.9	10.0	0.2	46.2	46.5
SuperGroup – GBP	1,242	11.8	10.5	15.1	0.8	0.7

Source: IBES consensus, Bryan, Garnier & Co ests

In terms of PEG ratio, the H&M ratio is slightly below that of Inditex due to the underperformance of H&M shares relative to those of its Spanish competitor. We are forecasting double-digit EPS growth over the 2016-19 period. Note, however, that like other retailers in our sample, H&M's earnings growth is more volatile since its cost structure is more sensitive to external pressures like currencies, changes in trends and competitive pressure.

Fig. 51: PEG ratios of the main textile groups:

Companies	Market Cap (EURm)	2017e P/E (x)	2018e P/E (x)	EBIT CAGR 2016-2019e (%)	PEG 2017e (x)	PEG 2018e (x)
H&M – SEK	**45,369**	**21.7**	**19.6**	**10.3**	**2.1**	**1.9**
Inditex	**97,737**	**26.5**	**24.0**	**12.0**	**2.2**	**2.0**
AB Foods – GBP	20,789	22.2	20.0	11.3	2.0	1.8
M & S – GBP	5,492	11.5	11.3	3.1	3.7	3.6
Next – GBP	7,146	11.3	10.8	4.1	2.7	2.6
SuperGroup – GBP	1,242	16.5	14.6	13.6	1.2	1.1

Source: IBES consensus, Bryan, Garnier & Co ests

3.4. DCF-derived valuation

H&M: a FV of SEK295

As mentioned above, the top-line growth admittedly remains strong between 2017 and 2021, but it will mostly be driven by the store opening effect since we expect comparable store growth to average 2.5% over the period. Our top-line growth rate forecasts are then progressively reduced to converge with our growth rate to perpetuity of 2.5%.

We expect H&M's operational profitability to reach its low in 2016, before seeing a modest increase over the 2017-19 period (+30bp to 12.7%) thanks to a stabilisation in the currency environment and the beginning of an operational leverage effect as of 2019. From 2020, we forecast a normative operating margin of 13% which remains far from the historic high reached in 2007 (23.5%).

We arrive at a WACC of 7.2%, based on a risk-free rate of 1.6%, a risk premium of 7% and a beta of 0.80.

Fig. 52: H&M: DCF valuation:

SEKm	2017e *	2018e	2019e	2020e	2021e	2022e	2023e	2024e	2025e	2026e
Net Sales	**212 025**	**232 252**	**253 155**	**270 875**	**289 837**	**307 227**	**322 588**	**335 492**	**345 557**	**354 196**
% change	*10.1%*	*9.5%*	*9.0%*	*7.0%*	*7.0%*	*6.0%*	*5.0%*	*4.0%*	*3.0%*	*2.5%*
EBIT	26 397	29 264	32 024	35 078	37 534	39 786	41 775	43 446	44 750	45 868
EBIT margin (%)	12.5%	12.6%	12.7%	13.0%	13.0%	13.0%	13.0%	13.0%	13.0%	13.0%
Income taxes	-6 116	-6 773	-7 408	-8 068	-8 633	-9 151	-9 608	-9 993	-10 292	-10 550
Tax rate (%)	23.0%	23.0%	23.0%	23.0%	23.0%	23.0%	23.0%	23.0%	23.0%	23.0%
Operating profit after taxes	**20 281**	**22 491**	**24 616**	**27 010**	**28 901**	**30 635**	**32 167**	**33 454**	**34 457**	**35 319**
+Depreciations	8 693	9 987	11 392	12 189	13 043	13 825	14 516	15 097	15 550	15 939
-Change in WCR	2 458	2 556	2 641	2 817	3 014	3 195	3 355	3 489	3 594	3 684
-Investments in fixed assets	12 721	13 935	15 189	14 898	14 492	13 825	14 516	15 097	15 550	15 939
Operating cash flow	**13 795**	**15 986**	**18 177**	**21 484**	**24 438**	**27 440**	**28 812**	**29 964**	**30 863**	**31 635**

PV of terminal value	326,050
+PV of future cash flows (2017-26)	160,328
= Enterprise Value	**486,378**
Net debt (2017e)	-6,313
Other liabilities	449
Minority interest	0
Financial assets	2,338
Theoretical value of equity	**494,581**
Number of shares (m)	1,665
Theoretical FV per share (SEK)	**295**

** = 2017e: FY ending in November 2017* *Source: Bryan, Garnier & Co ests*

We are re-initiating coverage of the stock with a FV of SEK295 and a Neutral recommendation given the limited upside potential and a few risk factors which remain outstanding (volatility in like-for-like growth, operating cost inflation, investment linked to the launch of one or even two new brands in 2017).

Inditex: a FV of EUR38

We see Inditex being able to maintain double-digit growth between 2017 and 2020 with a good balance between like-for-like growth and surface effect. Remember that, over the medium term, the Spanish group plans to open fewer stores but the latter will be larger in size. As of 2021, we gradually reduce this sales growth to converge with our growth rate to perpetuity (2.5%).

Inditex's operating margin is expected to see a steady improvement over the 2017-21 period (60bp to 19%), which becomes our normative level of profitability as of 2021. In our view, this growth is less 'at risk' thanks to two main factors **(i)** stronger like-for-like growth (+5.5% vs. +2.5% for H&M) with reduced volatility thanks to the 'fast fashion' approach (very short manufacturing lead times and **(ii)** a slowdown in the number of store openings (lower opex inflation).

We arrive at a WACC of 7.4%, based on a risk-free rate of 1.6%, a risk premium of 7% and a beta of 0.85.

Fig. 53: Inditex: DCF valuation

EURm	2017e *	2018e	2019e	2020e	2021e	2022e	2023e	2024e	2025e	2026e
Net Sales	**25 724**	**28 393**	**31 233**	**34 356**	**37 104**	**39 702**	**42 084**	**44 188**	**45 955**	**48 253**
% change	*11.0%*	*10.4%*	*10.0%*	*10.0%*	*8.0%*	*7.0%*	*6.0%*	*5.0%*	*4.0%*	*5.0%*
EBIT	4 728	5 219	5 809	6 459	7 050	7 543	7 996	8 396	8 732	9 168
EBIT margin (%)	18.4%	18.4%	18.6%	18.8%	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%
Income taxes	-1 103	-1 218	-1 336	-1 453	-1 586	-1 697	-1 799	-1 889	-1 965	-2 063
Tax rate (%)	23.0%	23.0%	23.0%	22.5%	22.5%	22.5%	22.5%	22.5%	22.5%	22.5%
Operating profit after taxes	**3 626**	**4 001**	**4 473**	**5 006**	**5 464**	**5 846**	**6 197**	**6 507**	**6 767**	**7 105**
+Depreciations	1 209	1 334	1 437	1 546	1 670	1 787	1 894	1 988	2 068	2 171
-Change in WCR	-126	-118	-156	-172	-186	-199	-210	-221	-230	-241
-Investments in fixed assets	1 543	1 704	1 562	1 546	1 670	1 787	1 894	1 988	2 068	2 171
Operating cash flow	**3 417**	**3 751**	**4 504**	**5 177**	**5 649**	**6 045**	**6 407**	**6 728**	**6 997**	**7 347**

PV of terminal value	74,755
+PV of future cash flows (2017-26)	36,774
= Enterprise Value	**111,529**
Net debt (2017e)	-7,718
Other liabilities	950
Minority interest	41
Financial assets	898
Theoretical value of equity	**119,154**
Number of shares (m)	3,113
Theoretical FV per share (EUR)	**38**

** = 2017e: FY ending in January 2018* *Source: Bryan, Garnier & Co ests*

We are re-initiating coverage of the stock with a FV of EUR38 and a Buy recommendation. In our view, given its global, multi-concept strategy and backed by the 'fast fashion' organisation which is unrivaled in the industry enabling the company to respond effectively to the changing needs of consumers, Inditex is well-equipped to thrive within a competitive and volatile environment.

4. Appendix

4.1. H&M: multi-concept launch in 2007

In 1947, Erling Persson, the grandfather of Karl-Johan Persson who currently heads up the group, opened his first women's fashion store in Sweden and founded the Hennes brand ('for her' in Swedish). In 1968, Hennes acquired a Swedish hunting brand Mauritz Widforss and the group was thus renamed H&M. That same year, H&M also launched its men's and children's fashion lines.

The Swedish company's growth has long been based on its single eponymous brand which currently represents more than 92% of the total number of worldwide stores (H&M does not disclose sales by brand).

H&M only expanded its concept offer in 2007 with the launch of the **COS** brand in London. The following year, H&M purchased 60% of the Swedish fashion group Fabric Scandinavien AB for SEK564 million (the remaining 40% was to be acquired in 2010), giving it three additional brands: **Monki**, **Weekday** and **Cheap Monday**. In 2013, H&M launched **& Other Stories**.

It is important to note that H&M could launch one or even two new brands in 2017, which are likely to be '*completely different from the six existing brands*', according to the CEO.

Fig. 54: Presentation of the six brands (data at end November 2015):

Concept	Number of stores	Number of markets	Comments
H&M	**3,610** 92%	**61** **23 online**	**H&M** offers fashion and quality at the best price for women, men, teenagers, children and the home (**H&M Home** since 2009). The brand also sells cosmetics (**H&M Beauty** since 2015).
COS	**153** 4%	**30** **19 online**	**COS** (=" Collection of Style") was launched in 2007, it is a fashion brand for women and men with a modern and functional style. The price positioning (i.e. upper end mass market) is higher than H&M brand and the customer base is also older.
MONKI	**106** 3%	**13** **18 online**	**MONKI** is a fashion brand offering clothing and accessories primarily for young women. Yet, the brand is positioned within the mass-market (> H&M).
& other Stories	**30** 1%	**10** **13 online**	**& Other Stories** is the most recent format launched by H&M, launched in 2013.The fashion brand focusing on the whole look, i.e. selling clothing, shoes, bags, accessories and beauty to women. Like COS, the brand operates in the upper end of the mass market.
WEEKDAY	**20** <1%%	**5** **18 online**	**WEEKDAY** is a modern fashion and denim brand influenced by Scandinavian style, for women and men.
CHEAP MONDAY	**5** <1%%	**4 (35 incl. 2,000 wholesale retailers)** **18 online**	**CHEAP MONDAY's** collections are mostly sold via wholesalers. It is a denim brand selling clothing and accessories to men and women.

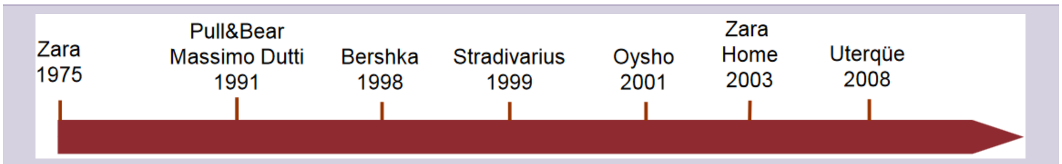
Source: Company Data, Bryan, Garnier & Co

4.2. Inditex: a multi-concept offer dating back 25 years

Having worked in the textile sector for many years, the founder of the Inditex group, Amancio Ortega Gaona, opened his first Zara store in 1975 at La Coruna in Spain, the Inditex holding company (= '**IN**dustria de **DI**seno **TEX**til') was founded in 1985 to regroup the different companies owned by Amancio Ortega Gaona.

The multi-concept strategy was launched in 1991 with the creation of the **Pull&Bear** brand at the time of the **Massimo Dutti** acquisition. Then came the creation of **Bershka** (1998) and the acquisition of **Stradivarius** (1999). The lingerie brand **Oysho** was launched in 2011, followed by **Zara Home** (2003) and **Uterqüe** in 2008.

Fig. 55: A portfolio of concepts that has been built progressively:



Source: Company Data

The following table presents the Spanish group's eight brands together with their positioning.

Fig. 56: Inditex's eight 'brands' (2015 figures at end January 2016):

Concept	Sales (EURm) % of total	Number of stores	Number of markets	Comments
ZARA	**13,628** 65%	**2,162** 31%	**88** **27 online**	**Zara** stores have men's clothing and women's clothing for customers of all ages, as well as children's clothing (Zara Kids).
Bershka	**1,875** 9%	**1,044** 15%	**70** **17 online**	Latest fashions aimed at a younger customer base than Zara (i.e. men and women from 13 to 23). Hence **Bershka's** price positioning is also the Group's most affordable brand.
Massimo Dutti	**1,498** 7%	**740** 11%	**69** **24 online**	More elegant design for men, women and children. **Massimo Dutti's** price range (just below affordable luxury) is one of the highest among the portfolio. The brand also has a Personal Tailoring service.
PULL&BEAR	**1,417** 7%	**936** 13%	**68** **21 online**	**Pull&Bear** focuses on casual fashion and sport styles for young men and women (i.e. 14 to 28). The concept has a value fashion position like Bershka.
stradivarius	**1,289** 6%	**950** 13%	**60** **18 online**	**Stradivarius** is a clothing fashion concept only for women from 18 to 35 years old. The price positioning is close to Zara's.
ZARA HOME	**666** 3%	**502** 7%	**53** **25 online**	**Zara Home** specializes in textile ranges for the home, which is completed by bedding and bed linen, tableware, bath linen and other accessories (dishware, glassware, etc.).
OYSHO	**452** 2%	**607** 9%	**42** **16 online**	**Oysho** has different product lines in women's lingerie, gymwear**,** sleepwear, beachwear, accessories and footwear.
UTERQÜE	**75** 1%	**72** 1%	**25** **16 online**	**Uterqüe** is a sophisticated women's clothing and accessory brand, positioned in the lower end of the affordable luxury segment.

Source: Company Data, Bryan, Garnier & Co

H & M

Income Statement (SEKm)	30/11/13	30/11/14	30/11/15	30/11/16e	30/11/17e	30/11/18e
Revenue	128,562	151,419	180,861	192,575	212,025	232,252
Change (%)	*6,4%*	*17,8%*	*19,4%*	*6,5%*	*10,1%*	*9,5%*
Change LFL (%)	*-0,4%*	*4,0%*	*2,5%*	*1,0%*	*2,4%*	*2,4%*
Gross Profit	76,033	89,052	103,167	106,301	117,674	128,900
EBITDA	26,359	30,628	33,341	31,390	35,090	39,251
EBIT	22,168	25,583	26,942	23,879	26,397	29,264
Change (%)	*1,9%*	*15,4%*	*5,3%*	*-11,4%*	*10,5%*	*10,9%*
Financial results	358	312	300	198	195	185
Pre-Tax profits	22,526	25,895	27,242	24,077	26,592	29,449
Tax	(5,374)	(5,919)	(6,344)	(5,538)	(6,116)	(6,773)
Minority interests	0,0	0,0	0,0	0,0	0,0	0,0
Net profit	17,152	19,976	20,898	18,539	20,476	22,676
Change (%)	*1,7%*	*16,5%*	*4,6%*	*-11,3%*	*10,4%*	*10,7%*
Cash Flow Statement (SEKm)						
Operating cash flows	23,590	24,949	26,647	26,050	29,169	32,662
Change in working capital	(250)	793	2,580	1,480	2,458	2,556
Capex, net	8,027	9,391	12,059	12,517	12,721	13,935
Financial investments, net	31,0	21,0	153	193	212	232
Dividends	15,723	15,723	16,137	16,137	16,137	16,944
Other	(22,0)	(448)	(539)	0,0	0,0	0,0
Net debt	(17,224)	(16,693)	(12,950)	(8,673)	(6,313)	(5,309)
Free Cash flow	15,813	14,765	12,008	12,052	13,989	16,171
Balance Sheet (SEKm)						
Cash & liquid assets	13,918	14,091	12,950	8,673	6,313	5,309
Other current assets	25,270	28,650	32,586	34,455	37,558	40,785
Tangible fixed assets	22,186	26,948	32,962	37,969	41,997	45,946
Intangible assets	2,004	2,737	3,937	3,937	3,937	3,937
Other assets	2,298	3,171	3,378	3,378	3,378	3,378
Total assets	65,676	75,597	85,813	88,412	93,184	99,354
LT & ST debt	0,0	0,0	0,0	0,0	0,0	0,0
Other liabilities	20,428	24,041	27,764	28,153	28,798	29,469
Shareholders' funds	45,248	51,556	58,049	60,259	64,386	69,885
Total liabilities	65,676	75,597	85,813	88,412	93,184	99,354
Capital employed	39,394	47,452	59,931	66,418	72,904	79,409
Financial Ratios						
Gross Margin (% of sales)	59,14	58,81	57,04	55,20	55,50	55,50
EBITDA margin (% of sales)	20,50	20,23	18,43	16,30	16,55	16,90
EBIT margin (% of sales)	17,24	16,90	14,90	12,40	12,45	12,60
Tax rate	23,86	22,86	23,29	23,00	23,00	23,00
Net Margin	13,34	13,19	11,55	9,63	9,66	9,76
ROE (after tax)	37,91	38,75	36,00	30,77	31,80	32,45
ROCE (after tax)	42,85	41,59	34,49	27,68	27,88	28,38
Gearing	(38,07)	(32,38)	(22,31)	(14,39)	(9,81)	(7,60)
Pay out ratio	91,67	80,78	77,22	87,04	82,75	82,75
Number of shares, diluted	1,655,072	1,655,072	1,655,072	1,655,072	1,655,072	1,655,072
Per share data (SEK)						
EPS	10,36	12,07	12,63	11,20	12,37	13,70
Restated EPS	10,36	12,07	12,63	11,20	12,37	13,70
% change	*1,7%*	*16,5%*	*4,6%*	*-11,3%*	*10,4%*	*10,7%*
BVPS	27,34	31,15	35,07	36,41	38,90	42,22
Operating cash flows	14,25	15,07	16,10	15,74	17,62	19,73
FCF	9,55	8,92	7,26	7,28	8,45	9,77
Net dividend	9,50	9,75	9,75	9,75	10,24	11,34

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

Inditex

Income Statement (EURm)	31/01/14	31/01/15	31/01/16	31/01/17e	31/01/18e	31/01/19e
Revenue	16,724	18,117	20,900	23,166	25,724	28,393
Change (%)	*4,9%*	*8,3%*	*15,4%*	*10,8%*	*11,0%*	*10,4%*
Change LFL (%)	*2,7%*	*4,8%*	*8,5%*	*7,0%*	*5,5%*	*5,0%*
Gross Profit	9,923	10,569	12,089	13,274	14,791	16,326
EBITDA	3,926	4,103	4,699	5,231	5,937	6,554
EBIT	3,071	3,198	3,677	4,119	4,728	5,219
Change (%)	*-1,5%*	*4,1%*	*15,0%*	*12,0%*	*14,8%*	*10,4%*
Financial results	(18,2)	14,5	10,1	0,0	10,0	15,0
Pre-Tax profits	3,053	3,245	3,743	4,169	4,794	5,296
Tax	(671)	(735)	(861)	(959)	(1,103)	(1,218)
Minority interests	(4,5)	(9,6)	(7,6)	(6,0)	(6,0)	(6,0)
Net profit	2,377	2,501	2,875	3,204	3,685	4,072
Change (%)	*0,7%*	*5,2%*	*15,0%*	*11,5%*	*15,0%*	*10,5%*
Cash Flow Statement (EURm)						
Operating cash flows	3,237	3,415	3,904	4,322	4,900	5,412
Change in working capital	121	102	(602)	(118)	(126)	(118)
Capex, net	1,250	1,796	1,518	1,506	1,543	1,704
Financial investments, net	159	29,2	22,3	23,2	25,7	28,4
Dividends	1,378	1,510	1,626	1,868	2,082	2,395
Other	370	22,3	49,8	0,0	0,0	0,0
Net debt	(4,055)	(4,010)	(5,300)	(6,343)	(7,718)	(9,121)
Free Cash flow	1,865	1,517	2,988	2,934	3,483	3,827
Balance Sheet (EURm)						
Cash & liquid assets	3,847	3,798	4,226	5,269	6,643	8,046
Other current assets	2,918	3,308	4,224	4,595	5,021	5,480
Tangible fixed assets	5,138	6,041	6,597	6,991	7,326	7,695
Intangible assets	642	684	695	695	695	695
Other assets	1,211	1,546	1,616	1,616	1,616	1,616
Total assets	13,756	15,377	17,357	19,165	21,301	23,531
LT & ST debt	4,7	10,1	11,0	11,0	11,0	11,0
Other liabilities	4,473	4,898	5,895	6,385	6,937	7,514
Shareholders' funds	9,278	10,469	11,451	12,770	14,352	16,006
Total liabilities	13,756	15,377	17,357	19,165	21,301	23,531
Capital employed	6,824	7,709	9,136	9,648	10,109	10,596
Financial Ratios						
Gross Margin (% of sales)	59,33	58,34	57,84	57,30	57,50	57,50
EBITDA margin (% of sales)	23,47	22,65	22,48	22,58	23,08	23,08
EBIT margin (% of sales)	18,36	17,65	17,60	17,78	18,38	18,38
Tax rate	21,98	22,64	23,00	23,00	23,00	23,00
Net Margin	14,21	13,80	13,75	13,83	14,33	14,34
ROE (after tax)	25,76	24,07	25,26	25,17	25,75	25,50
ROCE (after tax)	35,11	32,09	30,99	32,87	36,02	37,93
Gearing	(43,70)	(38,31)	(46,29)	(49,67)	(53,77)	(56,98)
Pay out ratio	63,44	64,75	64,98	65,00	65,00	65,00
Number of shares, diluted	3,115,562	3,113,773	3,113,152	3,113,152	3,113,152	3,113,152
Per share data (EUR)						
EPS	0,76	0,80	0,92	1,03	1,18	1,31
Restated EPS	0,76	0,80	0,92	1,03	1,18	1,31
% change	*0,7%*	*5,3%*	*15,0%*	*11,5%*	*15,0%*	*10,5%*
BVPS	2,98	3,36	3,68	4,10	4,61	5,14
Operating cash flows	1,04	1,10	1,25	1,39	1,57	1,74
FCF	0,60	0,49	0,96	0,94	1,12	1,23
Net dividend	0,48	0,52	0,60	0,67	0,77	0,85

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

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Bryan Garnier stock rating system

For the purposes of this Report, the Bryan Garnier stock rating system is defined as follows:

Stock rating

BUY	Positive opinion for a stock where we expect a favourable performance in absolute terms over a period of 6 months from the publication of a recommendation. This opinion is based not only on the FV (the potential upside based on valuation), but also takes into account a number of elements that could include a SWOT analysis, momentum, technical aspects or the sector backdrop. Every subsequent published update on the stock will feature an introduction outlining the key reasons behind the opinion.
NEUTRAL	Opinion recommending not to trade in a stock short-term, neither as a BUYER or a SELLER, due to a specific set of factors. This view is intended to be temporary. It may reflect different situations, but in particular those where a fair value shows no significant potential or where an upcoming binary event constitutes a high-risk that is difficult to quantify. Every subsequent published update on the stock will feature an introduction outlining the key reasons behind the opinion.
SELL	Negative opinion for a stock where we expect an unfavourable performance in absolute terms over a period of 6 months from the publication of a recommendation. This opinion is based not only on the FV (the potential downside based on valuation), but also takes into account a number of elements that could include a SWOT analysis, momentum, technical aspects or the sector backdrop. Every subsequent published update on the stock will feature an introduction outlining the key reasons behind the opinion.

Distribution of stock ratings

BUY ratings 55,7%   NEUTRAL ratings 32,9%   SELL ratings 11,4%

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