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Zalando SE (ZAL.DE)

Q1 2019 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Dear, ladies and gentlemen, welcome to the Conference Call of Zalando SE regarding the Publication of the Q1 Results 2019. At our customer's request, this conference will be recorded. As a reminder, all participants will be in a listen-only mode. After the presentation, there will be an opportunity to ask questions. [Operator Instructions]

May I now hand you over to Patrick Kofler, Team Lead Investor Relations, who will lead you for the conference. Please go ahead, sir.

Patrick Kofler

Team Lead-Investor Relations, Zalando SE

Good morning, ladies and gentlemen, and welcome to our Q1 2019 earnings call. As usual, with me is Rubin Ritter, our Co-CEO of Zalando; and new on the table is David Schröder, our new CFO. As always, this call is being recorded and webcasted live from our Investor Relations website, and the replay of the call will be available later today.

Rubin, I will now hand over to you. Please go ahead.

Rubin Ritter

Co-Chief Executive Officer, Zalando SE

Yes. Thanks, Patrick, and welcome also from my side. Thank you for joining the call. First of all, I would like to also welcome David on the call. As of April 1, he's our new CFO. Many of you, well, know him. He has been with the company for nine years as our SVP Convenience, and in that role he has been building some of our core capabilities around logistics, payments, and customer care. So, he knows our business inside out, and I'm sure he will make a great CFO. We have decided to do this Q1 earnings call jointly. And after that, David will take the lead on these calls and I will join only selectively.

So, as always, our presentation has four parts. I will start with the highlights of the quarter and then David will lead you through the Q1 financials in detail and the outlook for 2019. And then we will conclude with our Q&A. So, let's get started.

Obviously, I'm really happy with the results of the first quarter. We have I think a really strong comeback after the disappointing Q3. We're able to now post two quartets, which beat expectations. And to kick off the call, I would like to give you the five main messages upfront.

So, message number one is that in the first quarter we had really solid financial performance with strong GMV growth, a bit weak revenue growth, but that was also expected, and then a positive surprise on the EBIT.

Message number two is that we will confirm our guidance for the full-year, which is a combination of strong growth and solid profitability, in line with our long-term outlook that we have given on the Capital Markets Day.

Message number three is that we are progressing really well in our strategy to be the starting point for fashion. Of course, we want to build an exciting proposition to customers, which is underlined by a new all-time high in NPS, and we want to continue to grow our reach, which is underlined by really strong traffic growth of about 30%.

Message number four is that we continue to progress on the platform transition, so the Partner Program, as well as the supporting services, ZFS and ZMS, continue to scale at fast pace. And then message number five is that we continue to align the company on a more focused strategy, ensuring that we have the focus on the right priorities and the right investments to make sure that we are able to show growth in the coming years.

David will dive deeper and go into detail on the first two messages, and I will give more detail on messages three, four, and five on the following pages.

So, as you know, customer satisfaction has been our number one priority for a long time, and obviously that has not changed. NPS is at an all-time high, 4 points above the prior year. If we look back five years, actually the first quarter NPS is up more than 20 points, which I think underlines a really strong long-term trend to make Zalando more and more attractive for customers.

Key drivers in the first quarter have been great customer feedback in terms of our on-site inspiration, our assortment, and the variety of products that we are listing, as well as value for money. I would also like to underline that we have reached this all-time high in NPS despite the minimum order value that we have introduced by now in Italy, Spain, Ireland, and the UK. And I think this really underlines that customers understand the step, and it is not a step that, as many people were asking or maybe also feared, is undermining our proposition. And it also shows that the direction to the average customer relationships is working.

Now, this idea of the averaging also brings me to Zalando Plus because this is clearly one of the most important long-term levers that we have to de-average our customer relationships. We have the goal to make sure that our best customer sign up to Plus. We want to give them the best service that fashion e-commerce has to offer. And as a result of that, we want to deepen our relationships with these customers.

We see in the first test, that we have been doing over the last seasons, that Plus customers spend more with us over time and also show higher customer satisfaction. So, as a next step, we have been opening up Zalando Plus to all customers in Germany, and we continue the international roll-out. We are aiming to launch at Switzerland, France, and Italy in the coming 12 months.

At the same time, of course, we work further to improve the proposition of Plus. So, as one important element, we have started to give Plus customers early access to our most exciting assortment parts. (00:05:42) So, lately, that has been the Nike Air Max 720, which we have launched first to our Plus memberships.

On the Capital Markets Day, we also highlighted the importance of the Partner Program for our long-term success. We have also explained how Zalando Fulfillment Solutions and Zalando Marketing Services support the growth and viability of the Partner Program. So, we are very excited to give an update on the progress of these initiatives only two months later.

Looking at ZFS, as we know, we are creating a win-win-win situation for partners; and for Zalando, it means that we get better efficiencies and better economics; and for our customers, it means that they get better service and the benefits of just receiving one shipment. ZFS continues to scale really fast. In the first quarter, we already shipped more than 30% of Partner Program items, which is up from 25% just one quarter before and up significantly year-over-year. We are very positive about this trajectory and expected to continue also in the coming quarters.

On ZMS, as you know, that is a service that allows partners to attract traffic to products that they are listing on our platform. To make their progress more visible, I would like to look, together with you, at a KPI, which shows the share of ZMS-sponsored PDP views. So, PDP stands for Product Detail Page, and this KPI is calculated as the Product Detail Page views that are coming through ZMS at placements divided by all Product Detail Page views that we have.

So, in the first quarter more than 1.5% of all PDP views were paid views, so coming through ZMS, which is up about 100 % compared to last year. If we look at benchmarks, we see that on large e-commerce platform, that share is somewhere between 8% and 12%. So, that underlines the growth potential that we have in that business. And on the Capital Markets Day, we also underlined the margin potential that this business has for us.

Now, I briefly also would like to comment on Zalando Payments Solutions. As you know, payments is an important lever for customer satisfaction and also lever to drive conversion, and we have quite unique tools in our company to use these levers, for example, the risk management that allows us a really broad offering of invoice payments. So, we are really happy that BaFin has issued an e-money license for Zalando Payments. We think that is a great achievement, first of all, because it underlines our capabilities and our professionalism in that area; and secondly, because it makes it easier for us to offer a payment processing services to the partners that list product on our platform. So, in a way, Zalando Payments Solutions is becoming the third partner-facing servers next to ZFS and ZMS.

On the Capital Markets Day we also talked about the importance to focus in our strategy, to focus our priorities, and to focus our investments to make sure that we can reach our ambitious long-term financial and strategic targets. In the first quarter, we made two important choices to create more focus. The first choice was the discontinuation of Brieselang. As you know, that was our first owned fulfillment center, so it was an important milestone for the company back in 2011.

Over time, it became clear though that Brieselang has several challenges. As a site, it is too small. In terms of its location, it is not really adding value to our network, and it also suffered from a lack of automation that was difficult to fix. As a result, the site was operating at a cost disadvantage and was also producing long lead times to our customers.

So, as of end of Q1, the site is operated by our logistics partner, Fiege, and we have started to open the site to third-party business to make sure that, over time, the third-party business can supplement the ramp down of the Zalando business in that site.

The second choice we have made is refine private label strategy. It is at the core of our strategy to offer a broad and exciting assortment to our customers. On that I mentioned, we have been making great progress over the last years. We have gained more and more access to better and better brands, and these brands give us even more access to their full assortment. We expect this trend to continue, especially with the Partner Program.

Now, of course, this creates challenges for our private label business. Essentially, we are increasing the competition for our private label business quite substantially. So we have decided to shift direction from the old direction, which was around building fashion brands, to a new direction where we use private labels more selectively and more strategically to fill the remaining gaps and the remaining white spots that we see in our assortment, for example, around leather shoes and accessories.

This is also underlined by a new organizational setup, which means that we integrated private labels into our category management and that we'll also drive this effort with a smaller team. I think these have been two really important choices to create clarity and focus in our teams.

And with this, I would like to hand over to David to take you through our financials.

David Schröder

Chief Financial Officer, Zalando SE

Thank you, Rubin. As already mentioned, we are happy to report a solid financial performance for Q1, both in terms of growth and profitability. Let's start with the top line first. Let's look at GMV growth, which came in really strong in the past quarter.

GMV grew by more than 23% to more than €1.75 billion, well inside our growth target corridor of 20% to 25% for the full year. This growth was broad-based. We saw strong demand growth across all segments and regions. We were especially pleased that also our Fashion Store DACH business, which you know is our most mature business model and region, performed well with close to 20% GMV growth in the past quarter. Lastly, we saw an outstanding Partner Program performance in Q1 with brand partners very actively participating in end-of-season sales activities and offering attractive deals to our customers.

As a result of this strong Partner Program performance, revenue, which only takes into account Partner Program commissions, grew significantly slower than GMV, which as you know takes into account the full value of all merchandise sold on our platform. Revenues as a result grew 15.2%, leading to a gap of almost 8 percentage points between GMV and revenue growth in the past quarter which are certainly more pronounced than it has been before.

Next to the strong performance overall Partner Program, there's another more technical reason for this gap. Because GMV and revenue are recognized at different points in time, GMV at the point of order and revenue at the time of delivery, growth rates can differ quite materially as a result of financial shifts between quarters. In the specific case of Q1, significantly more revenue shifted out of the quarter into Q2 then shifted into the quarter from Q4 also when compared to the previous year.

Let me also briefly touch upon our smaller segments, Offprice and Other, since you might perceive their revenue growth rates as being particularly low this quarter. Offprice reports revenue growth below 14%, driven by very strong comparables in the previous year which were also highly impacted by financial shifts back then. Considering the two-year revenue CAGR of 38% and a Q1 GMV growth above 30%, we are still satisfied with the growth trajectory of our Offprice business.

Since there's no Partner Program business to explain the data between revenue growth and GMV growth for Offprice, the gap can be fully explained by revenue recognition effects, which are typically very pronounced in this business model since you see longer delivery times associated with flash sales campaigns.

Now, our Other segments, which includes our private label business as well as our emerging businesses like Zalon and Zalando Marketing services, revenue growth came down to less than 3% as a result of the announced restructuring of our private label business. If we look at our emerging businesses only, we recorded very strong revenue growth significantly above overall group level.

Let's move on to our key customer growth and activity metrics. There, we saw the following positive developments which supported our top-line growth in the past quarter.

First, our active customers continue to grow strongly by more than 14% year-over-year, surpassing 27 million customers by the end of Q1. And as Rubin mentioned, those customers were happier than ever before.

Second, customer order frequency reached a new all-time high of 4.5 orders per active customer over the last 12 months.

Third, average basket size for the last 12 months continue to decline by 3.9%. However, when we compare the single quarter average basket size of Q1 2019 against Q1 2018, we only see a minus 0.4% reduction and, hence, a significant slowdown of the negative basket size trend that we've seen in the past.

This can be mostly attributed to two things. First of all, our strong trading performance, as well as the introduction of minimum order values in Italy, Spain, UK and Ireland, which clearly pays off without negative side effects on customer satisfaction. We therefore plan to introduce a minimum order value in additional countries, specifically in the Nordics end of May. As a result of these order frequency and basket size developments, annual GMV per active customer grew by more than 7% in the past year and also reached a new all-time high.

Now let's look at the bottom line. In addition to our strong growth and positive customer development, we were able to achieve a healthy profit in Q1, which historically has been a seasonally challenging quarter due to a combination of our winter end-of-season sales and spring/summer season start. Overall, we recorded a positive adjusted EBIT of €6.4 million. This was a result of a successful fall/winter end-of-season sale with healthy stock clearance, as well as an earlier season start versus last year with a significant volume of full price spring/summer season merchandise already being sold in March.

Looking at our different segments, we saw positive year-over-year development in Fashion Store across all regions, as well as our Other segment excluding restructuring expenses for our private label business, which Rubin alluded to in his part of the presentation, while our Offprice segment showed lower profitability year-over-year. The key drivers for lower Offprice profitability were the revenue recognition effects that I mentioned earlier, as well as higher fulfillment costs resulting from market entry in Spain and Poland and the ramp up of our new warehouse in Olsztynek in Poland.

Let's take a more detailed look at our P&L where I would like to mention the following key developments. As a result of our strong trading performance in Q1, including a generally lower level of discounting compared to the previous year, gross margin recovered and is up plus 1 percentage point year-over-year. Following the historical trend over the past years, fulfillment costs continue to increase as a result of continued investments into our convenience proposition, ongoing expansion and ramp up of our European logistics network, and increasing carrier costs in line with general market developments.

Thanks to our continued focus on logistics network and process efficiency, though, fulfillment costs only increased by minus 0.5 percentage points year-over-year. Marketing costs remain almost flat in relative terms while we increased absolute spend from €82 million to €96 million year-over-year.

While all these key developments are very visible in our P&L, there's one last development that is very important but is less visible which deserves your attention. Thanks to our ongoing focus on overhead cost efficiency, we recorded substantial savings which are not fully visible in our admin cost line but has spread across all major cost lines. As a result, we see increasing operating leverage which makes us more competitive overall and enables us to further fuel our growth engine.

To conclude the financial update on the first quarter, let's take a look at our cash flow and its main components apart from the operating results. As expected, net working capital continues to be slightly negative and CapEx is well in line with prior years in our guidance. We finished the quarter with a free cash flow of minus €78 million and a strong cash balance of €870 million.

After this, we will – let's now move on to the outlook section. Based on our strong Q1 results, we confirm our guidance for the full-year 2019, which we shared with you a few weeks ago at our Capital Markets Day. We continue to expect GMV growth of 20% to 25% and revenue at the low end of this corridor, as we remain focused on capturing market share and the Partner Program is expected to continue to grow over proportionately. We also still expect an adjusted EBIT between €175 million and €225 million. Furthermore, we anticipate net working capital to stay slightly negative and CapEx to come in at around €300 million in 2019.

With this, we conclude our presentation and are now happy to take your questions. Thank you.

QUESTION AND ANSWER SECTION

Operator: Ladies and gentlemen, we will now begin our question-and answer-session. [Operator Instructions] The first question is from [ph] Charlie Muir-Sands, (00:20:42) Exane BNP Paribas. Your line is now open.

Q

Yes. Good morning, guys. Thank you for taking my questions. The first one I had was, can you quantify the impact of IFRS 16 on EBIT, please? I know it's going to be a relatively small number, but I just want to understand that.

And secondly, could you elaborate a bit more on the margin evolution between the DACH and the Rest of Europe division? [ph] Clearly (00:21:12) DACH improved but Rest of Europe did not, so I just wondered if you could clarify what's going on there. Thank you.

David Schröder
Chief Financial Officer, Zalando SE

A

Sure. Thanks for your question. So, let's start with IFRS 16 first. As you know, IFRS 16 impacts basically balance sheet, P&L and cash flow statement. Specifically, with regards to the P&L in Q1, we saw a positive impact on EBIT of roughly €2 million. And for the full year, we expect the positive impact of €7 million, which has been factored into our guidance obviously.

With regards to your second question, margin development in DACH versus Rest of Europe, as we discussed during the presentation, we actually see an improvement in both regions, although the bigger one is certainly in DACH. This can be largely explained by the fact that compared to the previous year, we saw a particularly better trading environment and much better season start in DACH, and therefore, that region benefited over proportionately.

Let me add, though, that also for the DACH region, we're very happy to see that we did not only deliver solid profitability but also very strong growth. And as you know from the past, this has been one of our key focus points to find the right balance between strong growth and solid profitability, particularly in that most mature region.

Operator: The next question is from Jürgen Kolb, Kepler Cheuvreux. Your line is now open.

Jürgen Kolb
Analyst, Kepler Cheuvreux SA (Germany)

Q

Yes. Thank you very much. Two questions from my side as well. First one, you apparently or obviously improved your Q1 numbers and better than expected. At the same time, you mentioned that you had some – maybe some pull forward effect from Q2 as the trading environment is somewhat better compared to last year. But how should we – why wouldn't you increase your full-year guidance given that you sound very optimistic and bullish for the achievements that you've done or how well we should be reading into the current trading in Q2? That's the first one.

And the second one, on your e-payment acceptance from the BaFin, what are your expectations here in terms of the KPIs that you expect from that additional payment solution and when and where will it be introduced, in what period? Thank you.

David Schröder
Chief Financial Officer, Zalando SE

A

Thanks for your question. So regarding the questions with focus on Q2 and the full-year guidance, so it's absolutely correct. We had a good Q1. And in Q2, we see trading continue on a good level. Spring/summer season didn't only start well in March, but we really see it also progressing well. And therefore, you should really expect a normal growth pattern for Q2, with a much smaller gap between GMV and revenue growth because especially those revenue recognition effects will be much smaller than in the first quarter.

Looking at EBIT, I think you made the right comment in saying that some of the Black Friday sales got [indiscernible] (00:24:34) compared to the previous year. So you should definitely expect that some of the EBIT that, for example we recorded in Q2 last year, has been moved and [indiscernible] (00:24:45) to Q1.

Why don't we update our full-year guidance? I think part of the reason obviously is this [indiscernible] (00:24:53) of profit from Q2 to Q1. Another reason obviously is that traditionally and also this year, most of our profit will be generated in Q2 and Q4 and those periods have only started, and therefore, we don't see any necessity to change our guidance at this point.

With regards to your second question on the e-money license so, first of all, we are very happy that we finally obtained the license from BaFin. It's a very important milestone for us for two reasons. First of all, it allows us to further scale and grow our marketplace business. You might be aware

that due to the new PSD2 regulation on European level, actually, all marketplaces that transfer funds between consumers and partners need to hold an e-money license or need to work with an institute that holds such a license.

And the fact that we now have this license in-house actually enables us to process payments in-house just like we did in the past, offering our customers great choice of local payment methods and also deferred payment methods without relying on a third party and without sharing margin with a third party.

I think what it also does is that for the future, it allows us to create additional offerings for our customers, specifically, for example, in the area of consumer credit and other financing options. Thus, this is something we will definitely explore but where we don't have anything to communicate at this point in time.

Operator: The next question is from Magnus Råman, Handelsbanken. Your line is now open.

Magnus Råman
Analyst, Svenska Handelsbanken AB

Q

Thank you. I have a question, firstly, on gross margin. I mean, several retailers have shown some gross margin relief at the start of the year, and the same goes for you. Do you think this is anything – that this has to do with generally easing price competition in the market, or is it mostly related to those normalized trading conditions that you mentioned, thereby being normalized weather conditions, inventory levels, et cetera.

And then, secondly, I have a question on fulfillment cost. I mean, we recorded here almost a complete hold to the decrease in average basket size. And nevertheless, you still have slight negative leverage on fulfillment cost. And you mentioned here, for example, higher carrier costs and network investments. But you also have the positive effects from discontinuation of Brieselang and your supply for further roll-out of minimum order value. So perhaps you could shed a bit light on your view on fulfillment cost leverage in the coming quarters driven by these different factors. Thank you.

David Schröder
Chief Financial Officer, Zalando SE

A

Thanks for your question. So regarding gross margin, we definitely feel that it was mainly driven by this more normalized trading environment, obviously, also by increasing economies of scale on our side, to a smaller extent. So I think it's a bit too early to say right now how the season will progress, but I think what definitely is the case is that it was, for quite a long time, a season where we saw an early and healthy start. And that should obviously help the whole industry and it's also helping us to improve our gross margin. We do expect a positive development of gross margin also for the full year, slight increase compared to the previous year. So it didn't come as a surprise to us that also Q1 showed this positive development.

With regards to your second question on fulfillment cost leverage, so as we pointed out in the presentation, we really think this increase of 0.5 percentage points is small given the amount of convenience improvements and also investment into our European logistics network that we are doing. I think you have to consider that out of our 11 fulfillment centers, 5 are still in ramp-up mode. So especially [ph] La, our Stockholm (00:29:21) site, all three sites in Poland, they are all in ramp-up mode, and therefore, obviously not operating at a high level of utilization and efficiency. And this is obviously something that you see reflected in that cost base.

With regards to the discontinuation of Brieselang, I think that's a slight misunderstanding. So we handed over the operations of the site on April 1, but our service provider will continue to operate that site and also to outbound operations at that site for the next 12 months. And only after summer 2020 where we switch that site to returns handling only, and therefore that's also the time when you should expect some positive impact from handing over Brieselang to a third-party service provider, which is not the case right now.

Looking at other key drivers of fulfillment costs, yes, it's true, we obviously benefited from relatively stable basket sizes year-over-year. At the same time, we had those carrier price increases which started in the second half of 2018 and we are now seeing the full-year effect this year for the first time. I think there's a general market development ongoing. You can also read in the press all the time that carriers are raising prices all across Europe. I think we're in the fortunate position that we are able to negotiate lower increases than many smaller merchants, but we are still seeing those increases, and therefore, you also see them reflected in our fulfillment cost line.

And last but not least, since you also mentioned MOVs, it's important to understand that we do not net the fees that we receive from customers against the fulfillment costs that we incur. This is something that I know some other retailers do but we do not. So you will find our fees recorded as revenue. And therefore, our fulfillment cost line does not benefit directly from those fees, but indirectly benefit from stabilization of order economics.

Operator: The next question is from Volker Bosse, Baader Bank. Your line is now open.

Volker Bosse
Analyst, Baader Bank AG

Q

Yeah, hello, gentlemen. Congratulations on the good figures. Two questions, first, starting with Connected Retail. How is that business progressing and what is currently the number of onboarded retailers or shops, and are there any prominent new members to be announced?

And the second question – conflict would be around the Beauty segment. You did not mention it at all so far. So, any news to share with us from that front, and do you have any first indications how customers are responding to your marketing push which you just started in April? Every comment would be very helpful. Thank you very much.

Rubin Ritter
Co-Chief Executive Officer, Zalando SE

A

Sure. So, let me make some comments on those two initiatives. As you know, Connected Retail is an effort that we have been driving for some time, and it has several objectives. One is to even further deepen our partnership with our brand partners, but also to start to work with retailers to make sure that they can benefit from our reach and, I think, from the customer side to make sure that we even further extend our assortment and that we are also able to offer even faster delivery, especially in urban areas where we can then start to really shift from store, which should allow delivery times that are more measured like in minutes or maybe hours and not in days.

And on that side, we continue to make progress, we continue to integrate partners into this business. And we also continue to see growing volumes and good indications. On the other hand, we also know that it is really a long-term effort because connecting offline stores into our system is a big and complex exercise. We have by now about 700 stores connected but, of course, we're working to extend that even further.

But given that also not all these stores rely on a – that they're very easily adaptable digital infrastructure, there is a lot of work to be done and we continue to believe in the long-term outlook of this, but it's also like an initiative where it's difficult to think in quarters, but really more in longer-time horizons.

In terms of Beauty, well, that is going very well. As you know with Beauty, our goal is to further extend our assortments to make use of the big reach that we have created. More than 900 million visits for first quarter is really strong and we know that our customer base has a big interest in that category. So we are doing several initiatives to broaden our assortment to onboard new brands. We are also working on the international rollout of Beauty. You mentioned the campaign that we started a couple of weeks back, and all of these initiatives I think are really heading into the right direction. As you know, we do not disclose many KPIs by category and we also don't intend to do that for Beauty. But we continue to work on these initiatives and we are positive about the progress that we see.

Operator: The next question is from David Gardner, Morgan Stanley. Your line is now open.

David J Gardner
Analyst, Morgan Stanley & Co. International Plc

Q

Hi. Thank you. The first question is on the minimum order values. I'm just thinking, is €25 sort of a high enough level given your sort of average basket size is closer to €60. Could you give us a sense of what percentage of orders today would fall below that threshold of €25?

And secondly, on Fulfillment Solutions, you talk about 30% of items, but how does this equate as a sort of percentage of GMV, given we get the sense that brands are sort of putting their lower-priced items through ZFS at the moment? Thanks.

David Schröder
Chief Financial Officer, Zalando SE

A

Sure. So, on your question regarding minimum order value, it's actually great that you feel that it's too low because we are actually obviously staying focused on providing our customers with a great proposition. And therefore, just like in the past, our goal is to offer them a great level of convenience, meaning that they receive a relatively better experience with us than they would get from any local competitor.

And that's also the theory behind the MOVs that we put in place so far and that we aim to put in place in the Nordics soon. So we always look at local individual market environment and analyze what competition is doing and make sure that even after the introduction of MOV, our offering, the combination of the MOV threshold but also the shipping fee that goes with it is the most competitive offering in the market. And yeah, so therefore, that's by design and we think that's the right choice to make sure that we do not only manage to ensure heavy order economics but to also make sure that our customers stay satisfied and continue to increase their activity on our platform.

With regards to your second question on ZFS, it's absolutely correct that we see a higher share of partners in ZFS with low price items. Also, that is actually something that we welcome and then we also had in mind when we created the program. Because one key issue in the past was that many of our partners could not offer their attractive low price, entry price assortment in our partner program given that for those items, single item shipments typically wouldn't be economical. And therefore, with ZFS, we've created a way for our partners to also ship those items and offer those items to our customers at low price points that weren't possible before. And so, it's absolutely correct that the share of items shipped in ZFS exceeds the share that ZFS has in GMV, but we won't disclose the exact GMV share.

Operator: The next question is from Paul Bonnet, Bank of America. Your line is now open.

Paul Bonnet
Analyst, Bank of America Merrill Lynch

Q

Hi. Good morning, everyone. Thank you for taking my questions. So, two questions from my side. Can you give us some granularity a little bit on the average basket value? Because it was still down a little bit although you obviously have put the MOV in Italy, Spain, UK and Ireland. So, I guess the average basket value is up in those markets. So, where has it been going down in the other markets?

And then the second question is on the cash flow statement. I think you had a big shift in receivables. Can you explain that a little bit? Thank you.

David Schröder
Chief Financial Officer, Zalando SE
A

All right. With your first question on average basket value, I hope you understand that we won't disclose information on single markets. What I can confirm, though, is that we saw increasing baskets in the markets where we introduced some minimum order value year-over-year as you would expect and as was intended with this effort.

With regards to your second question on the cash flow statement and, I guess, more closely related to working capital, it is true that we saw an increase in the volume of receivables. Receivables volume increased stronger than revenue. And that was largely driven by a higher invoice offering rates or deferred payment offering rate, which our customers perceive as, in many cases, their preferred payment option. And therefore, due to our improved and continuously improved risk management efforts, we were able to further increase that offering, leading to a higher level of receivables.

I think the second contribution, next to a higher offering, also was a very strong sales particularly at the end of the quarter. And if you have strong sales, especially in the last week of the quarter, you will see incoming payments only in the quarter after that. And that also contributed to a higher volume of receivables end of Q1.

Operator: The next question is from Andreas Inderst, Macquarie. Your line is now open.

Andreas Inderst
Analyst, Macquarie Capital (Europe) Ltd.
Q

Yeah. Thank you very much. I have two questions. The first one on your restructuring of the private label business, what is actually the impact on full-year sales related to the trimming down of these activities? And is it included in the full-year guidance?

And then my second question is related to your inventory position. It's up 20% year-on-year. How do you regard your inventory position right now? Did you think it's clean? How [ph] is it ageing? (00:41:04) Thank you very much.

Rubin Ritter
Co-Chief Executive Officer, Zalando SE
A

Sure. So, let me take the first question and then David will focus on the second question. So, on private label, as I have mentioned, our approach to private label will be more focused. So, we will be reducing the number of SKUs, but we'll focus them more on really where we see white spots in our assortment. And as a result of that, we would expect a lower share of private label sales in our mix. But in return I think what we get is a much higher sales per item for our private label, which should also make that business even more attractive to us. And we also expect that, given how our assortment is growing, we'll be able to compensate for lower private label sales with increased third party and other brand sales.

So, we hope that we will keep the overall impact on our top line quite small. And, of course, that is also part of our full-year guidance.

David Schröder
Chief Financial Officer, Zalando SE
A

And I'm happy to continue with your second question on the inventory position. Actually there we see a different number than what you mentioned. So, we see an increase in inventories of 11% year-over-year, which we feel very comfortable with. Also, to quickly comment on your question regarding the happiness with the profile of our inventory position, I think we are very happy with it. We have strong sell-through of fall/winter merchandise in the end-of-season sale, and also our inventory position on the new season looks really healthy.

Operator: The next question is from Simon Irwin, Credit Suisse. Your line is now open.

Simon Irwin
Analyst, Credit Suisse Securities (Europe) Ltd.

Q

Thanks for taking my calls. A few quick ones. Can you just talk a little bit more about staff numbers? [ph] They're (00:43:03) slightly down year-on-year and it's been a better trend for a year despite the fact that you're opening and ramping distribution facilities. So, where have you taken the staff numbers out?

Secondly, can you talk a little bit more about your kind of attitude to brands clearing on the site as to whether you think it's a good thing or a bad thing because it kind of impacts the perception of Zalando, say, being seen as a clearance channel or something along those lines?

And thirdly, can you just talk about the depreciation charge, which, according to the cash flow statement, is up significantly year-on-year?

Rubin Ritter
Co-Chief Executive Officer, Zalando SE

A

Sure. So, let me start on your second question with respect to brands clearing on the site. So, [ph] it depends. (00:43:53) When we look at our wholesale business, obviously, we are, ourselves, in charge of how assortment gets cleared, and then we have a number of mechanisms that allows us to do this. Obviously, first of all, trying to really place the right orders and ordering the right items using a lot of also algorithm-based ordering to make sure that we really have our assortment set up in the best possible way.

But then, of course, we needed to use discounting, but also to use our Offprice channel to clear inventory. And actually, over time, we have seen that we have been getting better and better and also more effective in clearing inventory in a good way, both that in terms – that it doesn't harm our brand positioning as a full-price channel but also, economically, to make sure that we really clear our assortment in a good way.

Now, in the Partner Program, we have observed for a long time that brands were quite reluctant to discount on Zalando, which, on the one hand, is of course a good thing because we don't want brands to sell all-season merchandise, and that's something we don't allow for. And clearly, we don't want them to see us primarily as a clearing channel. On the other hand, we also would like them to really use discount as a trading driver because discounts are just part of the fashion business overall.

So, actually, I was happy to see in the first quarter in the same period that brands have been also quite present with discounting and making sure that they use also Zalando to sell the merchandise that they have left after the season. I think there's actually a big opportunity to also open that up even more in terms of using our Offprice channel to clear inventory from older seasons. I think that can also be an attractive part of our ZFS offering to make sure that brands really have great options to clear the inventory that they put into our warehouses.

So I think bottom line is clearly the Partner Program is positioned as currencies and merchandise. But, of course, we also want to offer them ways to clear merchandise that has not been selling well in the season and therefore also offer customers the benefit of attractive prices.

David Schröder
Chief Financial Officer, Zalando SE

A

So, let me then continue with your question regarding staff levels. It's absolutely correct that if you compare total number of employees year-over-year, you don't see a big change. [ph] That gives us some (00:46:12) explanation.

So, I think with regard to your comment on continued expansion of our European logistics network and why that doesn't show up in those numbers, the answer is quite simple. Because for all the new fulfillment centers that we started in the past few years for our big hubs in Poland, but also for our smaller size in Sweden, and Italy, and in France, all these are service-provider operated. So, we didn't have to build up much on head count for that. We only have a small team at each site to work hand-in-hand with the service provider who's actually managing the whole workforce and operating the site on our behalf.

What you also obviously see is an impact from restructuring efforts that we've done in line with the strategy that Rubin mentioned to become more focused. And also, [ph] just to (00:47:07) make sure that we have an optimal set up in all areas. It was particularly the case in marketing in last year. And this year we are seeing a similar exercise in our private label business, which obviously also reduces the number of people working in those areas.

It's important to note though that, overall, we are still hiring and creating lots of open new positions, but those are very focused on the areas where we see high value. So, examples include our Partner Program business and the related services, ZFS and ZMS. It's definitely true for our [ph] app teams (00:47:48) and it's also the case for other teams across the business, which are working on implementing our strategy.

Coming to your last question on the depreciation charge, I think the main driver to explain that change is really IFRS 16 where we, for the first time, now created this right-of-use asset on our balance sheet, which we linearly depreciate over time. And that alone leads to an additional depreciation of roughly €75 million for the full year, which explains most of the difference.

What you will also see is that as the degree of automation of fulfillment footprint increases, so do also depreciation charges. But what we get for this in return is obviously lower level cost and higher productivity [indiscernible] (00:48:47).

Operator: The next question is from Olivia Townsend, UBS. Your line is now open.

Olivia Townsend
Analyst, UBS Ltd.

Q

Hi, everyone. Thanks for taking my questions. My first question is could you just talk a bit more about the drivers of ZFS growth in Q1? For example, did you have any significant new ZFS partners or [ph] with growth (00:49:11) from higher volume from existing partners? And do you have an estimate for the volume of Partner Program items on ZFS during Q2?

My second question is, for the full year, are you expecting any negative impact on basket economics as the number of mixed, wholesale, and Partner Program orders continues to grow? If you could share any numbers around the proportion of mixed baskets, that would be great. Thank you.

David Schröder
Chief Financial Officer, Zalando SE

A

So, with regard to ZFS, as Rubin mentioned, we see a very strong growth dynamic still in place both year-over-year and quarter-over-quarter. The team has continuously able to add more new partners and also to increase the business with existing ones. Lately, the major impact have actually come from two key drivers, internationalizing with partners that were already on board but were serving only certain markets, and most of our partners actually start in our biggest market, Germany. But then with the help of ZFS they are able to internationalize much faster than they were in the past where they had to basically get their own logistics processes adapted to each single country need. And now they get all this with one single ZFS integration. And the second driver was really new partners joining. I think though that in the first quarter it was mainly smaller accounts that joined, and we expect some bigger partners to join in the coming months.

On the development of order economics, as I said, we are really happy with how it has played out in Q1. With regards to the impact of Partner Program, it's correct that as the share of Partner Program rises, directionally, the number of shipments per order increases and the number of items per shipment decreases. That's directionally true. However, that's exactly one of the key reasons why we created ZFS.

So, with the help of ZFS, we can actually make sure that this impact is mitigated to a large extent. And as ZFS grows, and you know from the CMD, the Capital Markets Day a few weeks ago, that our ambition is to grow the ZFS share far beyond 50%. In the next couple of years, we will also be able to mitigate that effect to a large extent.

Operator: The next question is from Georgina Johanan, JPMorgan. Your line is now open.

Georgina Johanan
Analyst, JPMorgan Securities Plc

Q

Morning. Thanks for taking my questions and two for me, please. The first one, just to follow-up on the average basket value, is it possible to share the moves year-on-year in the quarter and [ph] partly the trend (00:52:21) for last year actually on a shipped basis because of course the numbers that we get on a GMV basis will include the whole proportion of GMV that you don't ship? If it's possible to get that, please.

And then also, I think if my calculations are right, conversion dipped slightly year-on-year by around 20 basis points. I'm not sure if that's because of sort of low discounting activity, or if you could just give any color around that, it would be appreciated, please. Thank you.

David Schröder
Chief Financial Officer, Zalando SE

A

All right. So, on the first questions regarding more details for the average basket size development, I think we only disclose the figures we talked about, so relating to total GMV, and therefore we are not able to provide any more detail on shipped baskets.

Regarding the second question on the conversion rates dip. It's true, there was a slight dip at the same time I think we have to acknowledge that traffic grew substantially by almost 30% as Rubin explained. And as is typical with such a high traffic growth, you have varying degrees of traffic quality and therefore some of the traffic did not converge at the exact same level as it did the year before. However, overall, we are still seeing very strong GMV growth as you know. So, the overall equation of traffic increase and conversion developments makes a lot of sense for us.

Operator: The next question is from Mr. Strauss at Arete Research. Your line is now open.

Rocco Strauss
Analyst, Arete Research Services LLP

Q

Yes. Good morning. I think most of my questions have been addressed by now, but maybe two more general ones. On Partner Program growth, which I believe leads to an accelerating number of SKUs on the platform, and, Rubin, you spoke about the averaging of customers before, I was just wondering what you can do to prevent the website from becoming overly cluttered? How we can still drive inspiration with the additional items you get on to the platform on a personal level, and how you can prevent customers from scrolling through kind of endless lists of similar products? And secondly, on Connected Retail, are there any ambitions to kind of introduce store pickups anytime soon? Thanks.

Rubin Ritter
Co-Chief Executive Officer, Zalando SE

A

Sure. So, I'll [ph] give (00:55:01) two brief questions because I think we still have some people in the queue.

So, on the first question, yes, Partner Program is driving our growth by significantly increasing the number of SKUs that we offer to our customers. And that, of course, makes the whole notion of creating a more personalized experience even more important. And I was really happy to see that in the first quarter the very high level of customer satisfaction, NPS, really was driven by increases in both the feedback that customers say our assortment is getting even more attractive, but also that our on-site inspiration is improving. And that's exactly the type of development that we want to drive.

And we are really convinced that through technology, we will be able to solve that riddle between limitless assortment and very individual personalized experience and inspiration by the way that we sort products for customers, by the way that we curate full outfits, and especially [ph] in the app to (00:55:58) create new ways for customers to discover our vast assortment.

On your second question on Connected Retail, for now the focus is really on allowing stores to ship to customers, and that takes priority over allowing customers to pick up items in stores, because obviously from a – so offering location-based services also introduces some new complexities. So, focus is really on shipping items to customers from stores.

Operator: The last question is from Michelle Wilson, Berenberg. Your line is now open.

Michelle Wilson
Analyst, Joh. Berenberg, Gossler & Co. KG (United Kingdom)

Q

Hi. Thanks for taking my questions. Two for me, please. First of all on ZMS, you gave us the data that 1.5% of PDP is coming from ZMS and compared it to the bigger platforms that have an 8% to 12% share. Are you able to generate the same kind of fees for that services to the larger platforms? Is there anything structural – any structural differences we should think about in terms of conversion rates on fashion compared to general merchandise and how that might affect the revenue potential, or do you have any differences between the marketplace model where there's only one seller of a brand versus where there can be multiple sellers of the same product?

And then secondly, just a couple of clarifications to help with modeling. Firstly, how does the Partner Program mix in Q1 this year compared to last year? And then also you mentioned that some Q2 EBIT has been pulled forward into Q1. Are you able to quantify that? And you mentioned that some Q1 revenue was actually pushed into Q2. So, do those two things net out to a lower EBIT margin in Q2? Can you help us with what to expect there?

Rubin Ritter
Co-Chief Executive Officer, Zalando SE

A

Sure. So, starting on ZMS, yeah, you mentioned we are currently at 1.5%. We see other platforms or leading platforms in that regard to be between 8% and 12%. And I think that just indicates that there's really vast growth potential going forward. And we also have been able to show really fast growth over the last 12 months. So, I think that is something that, overall, makes us excited and shows us that there is a big opportunity. Of course, I'm not able to tell you today what the exact share for Zalando in the future will be, but I think it's fair to assume that it can be significantly larger.

In terms of structural differences, I think, of course, there are many structural differences. I mean, some of these platforms that we use as a benchmark operate in other geographies. Some of them sell other products. On the other hand, I don't really see why it should be vastly different. So, of course, one big benchmark that we look at in that regard is Tmall and, of course, that's also very focused around fashion. I think another effect that we have on our platform and in our customer behavior is that we have a astonishingly high number of customers that look just for general terms, right? So, they look not for a specific brand, but they look just for a jacket. And that means that, of course, the way that we show product has a high impact on how they convert. So, I think that actually works.

So, if you just look from a pure ZMS perspective, I think that works in our favor that there can be a big incentives for brands also to position their product in a more prominent way on our platform. So, all in all, I think this shows that this is an exciting opportunity. There's a long way to go but we are growing it and we are seeing progress. And I think that's the message overall.

So, let me take your questions on Partner Program mix and Q2 developments. So, with regards to Partner Program mix, we are not disclosing new Partner Program shares at this point in time. What we did disclosed a few weeks ago was that we said it surpassed solid double-digit levels within last year already, and that's the trend that we see continuing. So, you can assume that quarter-over-quarter and year-over-year that share keeps increasing. And as in the past, we will update you at some point how that share is developing.

David Schröder
Chief Financial Officer, Zalando SE

A

On the Q2-related questions, so how do we see growth and EBIT development in Q2. I think on growth, I already commented. Basically, we are seeing good trading continue. And as we mentioned earlier, there is some shift from Q1 into Q2 and the majority of the gap between GMV and revenue growth that was caused by those shifts in Q1.

I think what's important to take into account as well though is that this year, apart from last year, Easter is fully situated in Q2 not like last year where part of it was in Q1 and part of it was in Q2. And it's seasonally a slightly weaker demand period. So, there's some counterbalance to the higher revenue shifts from Q1.

On the bottom line, I think it's also fair to assume that the majority of the EBIT surplus that we recorded in Q1 compared to the previous year can be treated as a [indiscernible] (01:01:32) of EBIT when comparing Q2 last year to Q2 this year.

Operator: As there are no further questions, I would like to hand back to Patrick Kofler for some closing words.

Patrick Kofler

Team Lead-Investor Relations, Zalando SE

[audio gap] (01:01:52) for joining us today. If you have any further questions, do not hesitate to reach out to the Investor Relations Department. Otherwise, have a great day and speak to you soon. Thank you.

Operator: Ladies and gentleman, thank you for your attendance. This call has been concluded. You may disconnect.