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Zalando SE (ZAL.DE)

Q2 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 Q2 Results 2019. At our customer's request, this conference will be recorded. As 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 through this conference. Please go ahead, sir.

Patrick Kofler
Team Lead-Investor Relations, Zalando SE

Good morning, everybody, and welcome to our Q2 2019 earnings call. With me today is our CFO, David Schröder. And as always, this call is being recorded and webcasted live on our Investor Relations website, and a replay of the call will be available later today.

David, the floor is yours.

David Schröder
Chief Financial Officer, Zalando SE

Thank you, Patrick, and welcome also from my side. Our presentation today consists of three parts, our highlights of the quarter, our quarterly financials, and our outlook for 2019. As always, we will be concluding with Q&A. So, let's jump right in.

We are generally very happy with the development we've seen in the first half of 2019. We remain focused on executing our long-term strategy with full force. At the same time, more short-term, operating performance in Q2 is also looking very good. We are delivering the first strong quarter in a row. Our five main messages today are: the first, we see good progress with our strategy to become the starting point for fashion, recording the strongest ever Q2 active customer growth and the fastest site visit growth since 2013; second, we delivered a strong financial performance with GMV growth of almost 24% and an adjusted EBIT of €102 million, up €8 million year-over-year; third, we raised our profit outlook for the full year to the upper half of the initial €175 million

to €225 million range on the back of the strong half-year one performance. Fourth, we continue to improve our customer proposition by expanding our fulfillment network and broadening our assortment range. And you'll hear more details in a few minutes. And since we are further accelerating our platform transition, Zalando Fulfillment

Solutions, our fulfillment service for partners in the partner program is already a great success and shows very strong traction, and we are now about to take it even further.

During the presentation, we dive deeper into all of these points. Let's start by taking a look at the development of our convenience proposition and our European Fulfillment Network that powers it. Our fulfillment network is the backbone of our customers' convenience experience. This is due to two main reasons. First of all, it enables us to keep up with our fast growth. Second of all and more importantly, as we spread out more and more across Europe, it enables us to deliver faster and more reliably to more customers and make returns even easier for them.

Let me give you some tangible examples on how our convenience proposition improved in the second quarter. In Germany, we doubled the number of parcels delivered on same day and next day with midnight cutoff compared to Q1 through our own local delivery networks making us less dependent on the big last-mile carriers and offering our customers especially in the plus program an even better experience.

In Switzerland, we launched the same-day delivery pilot with the Swiss Post and their bicycle delivery company, notime, in Zurich. But we did not only speed up delivery for some of our customers in Germany and Switzerland, but we also introduced great new services in Italy and Poland. In Italy, we added over 15,000 new drop-off points for easy returns operated by the Italian Post. And in Poland, we made new pickup points available forPolish customers by our partner, Zabka.

In most of our markets we are now working with at least two or even more carriers, leading to an improved delivery performance and less dependency on individual carriers especially during peak times. At the same time, we've been ramping up a variety of new warehouses and extensions in parallel. And we are making good progress everywhere. As we are looking towards our ambitious growth trajectory for the upcoming years it is clear that we needed more warehouse capacity. Hence, we are starting construction of a new warehouse in the Netherlands close to Rotterdam. It will start to deliver parcels mid-2021 getting us even closer to our customers in Benelux and France and leveraging state-of-the-art technology to drive even higher levels of efficiency.

Once it is fully ramped up, our network will be able to handle about €14 billion in GMV, getting us closer to reach our €20 billion GMV target which we set for 2023/2024 earlier this year. As you know, our fulfillment network does not only enable a great customer proposition and the growth of our platform overall but also powers the business of our partners via Zalando Fulfillment Solutions. So let's talk a bit Zalando Fulfillment Solutions now.

Zalando Fulfillment Solutions continues to show tremendous traction across multiple key KPIs and more partners are already queuing up to join this great service. Over the past year, the Share of Partner program items shipped via Zalando Fulfillment Solutions increased by 200%. The total number of items shipped via Zalando Fulfillment Solutions increased by 400%. And the total number of partners who signed up for Zalando Fulfillment Solutions increased by 300% to now more than 100 partners. This means that one out of three partners has signed up for ZFS.

And we are now taking it even further by adding three key new features which will be piloted with selected partners this year. The first new feature isthat we'll add Switzerland as the first market subject to customs duties to our portfolio of 13 markets Zalando Fulfillment Solutions already serves, giving brands access to a very attractive market which has been complex to serve for many partners from their own logistics footprint.

The second feature is that we'll offer a direct integration between Zalando Fulfillment Solutions and our Offprice business, giving partners the option to sell remaining stock through our Offprice channel just like we do this on our own wholesale business, further increasing their stock flexibility and limiting their inventory risk.

The third new feature is that we'll develop Zalando Fulfillment Solutions into a multi-channel solution which is capable of not only solving orders for our – for our Zalando partner program, but also fulfilling transactions in alternative channels such as brands own e-commerce. These great new features will further strengthen the value proposition of Zalando Fulfillment Solutions for our partners, make it even more attractive for them to join the program if they have not already done so or to expand their business with us if they are already enjoying the service today.

After talking a lot about our convenience proposition into Fulfillment Services, let us now focus on another key pillar of our customer experience, our assortment. Already today, our customers can choose from a desirable and comprehensive assortment. But we still see a huge opportunity to make it even more complete. Our vision is to become the starting point for fashion, a place that consumers naturally gravitate towards when looking for fashion. In order to get there, we need to make sure that our customers have no reason to shop anywhere else because they can find everything they are looking for on Zalando. Hence, we are continuously expanding our assortment, focusing our efforts on three strategic dimensions to make this happen.

The first key dimension is assortment expansion through the partner program and connected retail. We aim for broader and deeper.

assortment access through the onboarding of additional brands and retailers to our Partner Program and connected retail. And we are happy to welcome to new retail partners that we find in the second quarter of this year. We connected London-based beauty retailer, FeelUnique, who is joining our Partner Program.

As a result, our customers can now shop beauty brands like Button London, Nuxe, and Lierac on Zalando. We also added the German KATAG group to our Connected Retail Program which will add another 50 offline stores to our Zalando platform. In total, around 1,300 shops already connected to our platform to provide our customers with even more choice.

The second key pillar of our push forward even better assortment is a strengthening of our high priced premium offering. Fashion credibility is very important to us as is the creation of an inspiring destination for our customers looking for premium fashion products. Hence, we strengthen our premium assortment from brands like Philip Lim and Marc Cain. More premium brands will follow soon so stay tuned.

The first pillar is focused on sustainable fashion. Our teams at Zalando as well as our customers are increasingly concerned about the future of our planet. Our customers demand for sustainable products is growing which we see for example in the increase of searches including keywords such as organic or care trade.

This is a topic the whole Zalando team deeply cares about which is why we have curated a selection of specialty label products and sustainable brands. We just recently expanded our sustainable assortment and great new brands will follow will soon be available on Zalando. In total, we already offer more than 15,000 sustainable products to customers on the Zalando.

This brings us to the review of our Q2 financials.

Let's start with top line. Our group top-line growth was strong with GMV growing by 23.7% year-over-year, allowing us to reach a GMV of more than €2 billion in Q2. We continue to grab market share by growing several times faster than the overall European fashion markets, as well as the European online fashion market.

Let's take a look at the different segments. The Fashion Store saw a 19.8% revenue growth. We are very happy with the strong performance of our core sales channel and we saw good reacceleration of revenue growth after only 16% in Q1 2019. This is equally true for both regions, DACH and also rest of Europe. Rest of Europe obviously continues to outperform DACH, but both regions grew significantly faster than in Q1. DACH 17%, instead of 12.6% in Q1, and rest of Europe, 22.8% versus only 19.4% in Q1. Looking at Offprice, we recorded 35.9% revenue growth. The growth reaccelerated nicely to more than 35%, and it was mainly driven by strong performance in Germany and our new markets, Spain and Poland.

There's one other segment, which we should talk about today, which is the Other segment, which saw a revenue decrease by 55% year-over-year. This segment, which includes a variety of emerging businesses, deserves a bit of more explanation this time. As communicated already with our Q1 reporting, we've changed our approach to our private label business set labels as a result of our platform strategy. These activities have been downsized and are now long – no longer reported in the Other segment, but are now part of the Fashion Store. This does not have any impact on external sales since it only affects internal into business unit revenue. As a result, the Other segment is declining compared to last year.

If you look at in more detail, however, Q2 2018pro forma revenue excluding that labels would have been around €25 million implying a year-over-year growth above 80% for our remaining emerging businesses. Our business continues to contain amongst others our Zalando Marketing Services, our styling service Zalon, our integration services [indiscernible] 00:12:11 as well as new ideas like our Circular Fashion 1 at Zalando Wardrobe.

Now let's move to our key customer metrics which probably even the strongest news that we have to report for this second quarter. Site visits, overall, rose by an outstanding 34%, the fastest growth since 2013. Active customers grew also faster than in the past few quarters surpassing 28 million in Q2. We added 3.7 million active customers year-over-year which is truly outstanding. And we have seen consistently for many, many quarters now, order frequency continues to climb up and now reached 4.6 orders per active customer in the last 12 months.

The basket size declined which we have seen happened over the past two years as a result of our push into new categories and markets, and also as a result of changing customer behavior continues to slow down. If we compare the last 12 months, basket size year-over-year, we see a decline of 2.6%. If we only look at the quarter-over-quarter development, our basket size decreased by just 0.8%.

There are two key drivers that have explained this development. First of all, we've, as you know, introduced a minimum order value for free delivery in now eight countries. And this is definitely supporting the basket size development in those countries. And, secondly, we saw higher average item values in Q2 due to favorable season mix, selling more fall/winter items than we had initially anticipated.

winter items than we had initially anticipated.

Going forward, we aim to continue our minimum order value rollout and we'll introduce and we'll be in France as a next step. As a result of this order frequency and basket-sized developments, GMV per active customer grew by more than 6% over the last 12 months. Let's now take a look at our profitability, absolute profit as measured by adjusted EBIT increased by €8 million year-over-year to €102 million. Relative profitability came in slightly below

last year mostly driven by higher marketing investment as we'll see on the next slide when we take a deeper look at the P&L.

We recorded the same overall trend both in DACH and Rest of Europe, seeing higher absolute EBIT, but slightly lower relative profitability. Offprice stayed rather stable in absolute terms, while the margin came down due to our entry into new markets, Poland and Spain, and due to the ramp-up costs incurred in our new Polish Offprice warehouse. The Other segment stayed roughly stable as we continue to invest into our emerging business portfolio.

Let's have a closer look at our P&L and let me comment on three key developments. The first development I would like to comment on is our gross margin which stayed stable overall compared to the previous year. The second key development I would like to focus on is our fulfillment cost ratio which improved significantly year-over-year. In general, we saw strong efficiency in our network driven by high levels of utilization across most of our sites due to our strong sales growth.

That was also supported, however, by an almost stable quarterly basket. We consider this to be a rather temporary effect and still expect an increase in our fulfillment cost ratio for the full-year 2019 as we continue to invest into scaling the network and into improving our convenience proposition. The last key development I would like to focus your attention on is our

marketing cost ratio, which increased year-over-year, driven by a deliver push in both performance marketing and brand marketing. We ran big beauty and summer brand marketing campaigns and moved from 360 day to 720 day, our high-based performance marketing. Strategically, we still favor long-term-oriented investments in our customer experience across assortment, digital experience, and convenience to drive customer satisfaction and retention.

However, we will continue to be aggressive on marketing whenever we see an opportunity to accelerate our growth and grab additional market share. You can see these tactics already paying off in Q2 when you look at our traffic growth and our active customer development. In midterm, we expect this to pay off even more as we now steer towards a 720-day ROI on performance marketing, in line with our strategy to create deep and long-lasting customer relationships.

Also please do keep in mind that we are comparing against a very low base from the first half of 2018 when we transformed our marketing team and our marketing approach. Back then, our marketing teams were regrouping, building a new marketing strategy, and moving from a budget-driven customer acquisition cost-based marketing approach to a value-driven higher-based marketing approach, which we now see bearing fruit.

As we conclude this section on quarterly financials, let us take a look at the development of our cash flow. Net working capital was clearly negative and even further improved year-over-year due to a very low inventory position, reflecting good sell-through, driven by strong sales in the spring/summer season. But it was also supported due to a slightly different timing of inbounds of next season products. We took in less volume end of Q2, and expect more volume early Q3.

CapEx spending is in line with our plan. As already in previous years, it is once again rather back-end loaded

Basically we see the same pattern as already experience last year. But it's important to note that all major projects are well on track. Overall, we recorded a positive free cash flow of €8 million for the first half of 2019 and our cash balance at the end of the first half year amounted to €954 million.

As usual, we would like to conclude the presentation with the updated outlook for the full year. For GMV, we anticipate growth between 20% and 25% for 2019. This is unchanged and in line with both our performance so far in 2019 and our mid-tone view going forward. For revenue we previously forecasted that revenue growth will be at the low end of the 20% to 25% growth corridor. In the first half of this year we saw very strong partner program performance and hence strong GMV growth of 23.3% but revenue growth of only 17.8%. Consequently, we now see revenue growth to come in around the low end of the 20% to 25% range.

For profitability, driven by the group's first half year performance, we raised our profit outlook and now expect adjusted EBIT to be in the upper half of our initial €175 million to €225 million range. On cap-related items, we anticipate net working capital to stay slightly negative at year-end and we continue to invest into logistics and technology as the infrastructure that enables our platform business and still expect capital expenditure of around €300 million euros for the full year.

We believe that with our strong performance in 2019 so far and our outlook for the rest of the year we are well on track to reach the goals we've laid out for the coming years at our Capital Markets Day earlier this year: to become the starting point for fashion, to continue to capture market share, and to show strong growth at solid profitability, while we execute our platform strategy and invest into attractive opportunities for long-term value creation.

That concludes our presentation. So let's now move into Q&A.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] The first question is from Mark Strauss, Pareto Research (sic) [Rocco Strauss, Arete Research]. Your line is now open.

Rocco Strauss

A

Hey. Yeah. This is Rocco Strauss from Arete. Hi. Two questions for me, please, David. First, I mean, could you talk about the feedback from brands with respect to ZFS especially on what are the main pushbacks you got over the past, like, say, two to three quarters and how will the new features that you're rolling out now have to address those.

And then, secondly, with the Rotterdam warehouse joining the network at some point next year, obviously, that will also be able to serve the UK and with your UK MD kind of indicating recently that there could be a step-up in above-the-line marketing in that region, I was just wondering what is causing this kind of like newer push into the UK again. Thanks.

A

Thanks for your questions. So let me start with the first question. It's I think clear from the numbers that we presented that

clear from the numbers that we presented that brands continue to be very much affected by [indiscernible] 00:21:46 proposition. We see more brands signing up. We see brands that already signed up increasing their volumes. So, I think that's a strong proof that the proposition is already very strong. At the same time, obviously, if we talk to brands we definitely see that they would like us to enlarge the proposition even more and with the three key features that we announced today. So, Switzerland of price integration and also our multi-channel approach.

We definitely think we will be able to serve the top three needs that are left that we hear from partners. I think the main thing that will result from this is that it will become even more attractive to put inventory into our fulfillment network because there's just less risk that it cannot be sold and they can also sell it across multiple channels which would make it very, very much easier for them to manage their inventory position in their overall supply chain.

Now, coming to your second question on the Rotterdam warehouse. I mean the main reason for choosing that location was mainly to serve the Benelux customers and also our French customers faster. But as you correctly pointed out it will also bring benefits for UK customers. Let me point out that that wasn't the main intent of putting that warehouse there. It's rather I would say a positive side effect of putting the warehouse in that region.

I'm not aware of any particular plans to be very aggressive in the UK. What I can tell you though is that we are definitely seeing obviously huge market potential in both the UK and Spain if we compare our current business size with the overall market size and therefore we'll definitely be looking at those two markets going forward. And if we see good opportunities to increase our business over there, we'll certainly go for it.

Operator: The next question is from

Volker Bosse, Baader Bank. Your line is now open.

Volker Bosse

Q

Yeah. Hello. Thanks for taking my question. Congratulations on the figures. I would point to smaller aspects. First, on connected retail, you said 1,300 stores are on stream so to say. Could you give us a bit more detail how is the acceptance of the offline partners? Do you see an increasing willingness of offline partners to join? And the second question would be regarding the beauty segment. You made a big push in April. So, could you share how was the response rate, how many beauty customers do you have, how is the cross-selling working? Perhaps, a bit more details on that would be helpful. Thank you very much.

A

Sure. So, starting with connected retail, I think it's already great that we have 1,300 stores connected to our platform already. And I think also with the recent announcement on [indiscernible] 00:24:41 and some more announcements to come, you would see that that network will grow even further. We think it's a great addition to our European fulfillment network because essentially it adds lots of smaller fulfillment centers to the network, fulfillment centers which don't require us to put in any CapEx, and also fulfillment centers that we don't need to run. But those can be run by the store owners and their personnel themselves. And also, from the store owners, we received great feedback because for some of them the volume they do with our platform is already surpassing the volume they do in their store. And that's obviously helping them to a large degree when they face declining frequency in there and put forth in their offline store. So, we really see this as one of the great exampleswhere we can also have struggling offline retailers to stay in business by offering them an alternative channel to sell their

product. And for our customers obviously it has the big advantage that they get access to an even broader and sometimes also deeper assortment for those items where we might be sometimes already sold out but that's still are available in some of those local offline stores.

On your second question regarding beauty, as you correctly pointed out, I think we started on a rather small level last year. We're just launching in one market. We have now progressively ramped up adding seven additional markets over the first half of this year, also increasing our assortment over time. We now are around 10,000 products from over 250 brands. And we see the category developing nicely although it's still early days for that category. So I think it's fair to assume that our overall business is yet not so much impacted by this category but it's definitely fast growing.

What we particularly like about the category is that obviously it presents us with an opportunity to increase our share of wallet with our customers. And then we also see that in many orders we have cross-sell opportunities, so close to two-thirds of the beauty are cases where beauty is ordered together with a fashion or shoe item, which obviously helps our order economics and also allows beauty to be a profitable addition to our business mix.

Operator: The next question comes from Anne Critchlow, Société Générale. Your line is now open.

Anne Critchlow

Q

Thanks. Good morning. My first question is about the trading through the months inthe second quarter. I know that June was very strong in the German apparel market for example. And then the second question is about your push into high-price premium brands. Is that a conscious decision to skew the assortment away from value fashion to support the basket size?

A

So, let me start to talk a bit about trading. What we definitely saw was that the quarter started a bit slower, mainly also due to the fact that Easter happened in April this year, whereas it happened in Q1 last year. But May and June were both really, really strong for us. And therefore, yeah, as you could see, we delivered a very strong quarterly result overall, while all the numbers that we know from the sector rather recorded no or very low growth over the same period. And that makes us confident that we actually were able to grab a significant market share over the course of the quarter.

Now, if we look at the high-price premium brands that you asked about, I think the main reason to target this segment is not so much the basket size, although it definitely helps there obviously. But the main reason is that, if you look at our proposition, so far, we've mainly served the midrange of the market, right. And if we look at where we could have even more opportunity for growth, it's both on the high end and on the low end. And as you know, on the low end, we are already working with great partners like Inditex and also some other top fashion players. And now we also see better opportunities on the high end. And we also see an increasing willingness of premium brands to sell on Zalando because they really like our digital experience and our overall proposition.

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

Andreas Inderst

Q

Yeah. Hello, everyone, good morning. I have two questions. First of all on your significant logistics expansion 12 warehouses pretty soon up I believe from around 5 currently in full operation. Given some of your key peers experience to major hiccups recently, how do you actually ensure that you don't face similar issues? So, maybe you can elaborate overall on your logistic rollout on your planning these kind of things.

Then secondly I noticed on page 15 of your presentation. On the outlook on the non-operating one-off site, it's now €60 million, down from €80 million. What is the key driver behind the reduction of one-offs related to share-based expenses? Maybe you can elaborate on that too. Thank you.

A

Sure. So, let's start with the logistics impact expansion. It's right we are definitely continuing to grow our network to also enable the future growth that we are targeting. And as you may be noticed when we commented about our Q2 development, we saw high utilization of the capacity that we have online today. So that really shows that we need to bring more capacity online to be able to manage future peaks in Q4 this year but also then in the years beyond. I think with regards to howwe make sure that those projects go well, I think one answer definitely is that we've done it a few times already, right? We have successfully ramped up five sites – five hubs and a few spokes, whereas maybe the example you're referring to is an example where that doesn't – haven't happened so many times before. And therefore, we just feel confident that we have the right playbook in place to ramp up the site successfully.

I think, second of all, over time, obviously, we've also refined our approach to those ramp-ups. So we've tried different approaches and I think we now figured out what the best ramp-up is and how much volume we should put in in every given month after start of first shipment to make sure that the site actually can have a successful ramp-up. And we also work closely together with our partners who operate our warehouses out of – outside of Germany to make these ramp-ups successful. So we are also very confident that they will continue to be the case for those sites that are still ramping up right now.

Second question regarding the EBIT adjustments, yes, it's correct that we reduced the adjustments that we include as part of our guidance from €80 million to €60 million. That is mainly due to the fact that we've changed our share base compensation scheme. We moved away from our old EIP program and now launched a new Zalando ownership plan for our employees and also for our leadership which has less of a front-loading effect than the previous program. And therefore, this year definitely benefits. If you look at it from a periodic point of view, the overall value of the program also from an employee perspective, however,is equivalent. So it's mainly a periodic effect that we are talking about.

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

David Gardner

Q

Thank you. The first question is sort of around fulfillment cost. In the release you call out the favorable assortment mix. How much of that is intentionally driven by you in terms of curation and minimum order values and how much of it is just sort of customer behavior on that? And then the other question is around I mean you're calling out the strong traffic. You've obviously stepped up marketing. But it implies that conversion has deteriorated quite

significantly. So could you just talk through some of the drivers of why conversion is down and what you plan to do to reverse that? Thanks.

A

Sure. So on the assortment mix I think it's important to understand some of that is driven by us and some of it is also due to external factors, right. So we just talked about one example where we drive the assortment mix very deliberately which is around introducing more premium brands and therefore also selling more of those premium products to our customers. That's something we can definitely influence. But there are also some factors where we have less influence. So for example, what we definitely saw for some weeks in the quarter is that after the quarter started quite funny it turned cold again and then we saw a higher share of all winter items or transitional items being sold versus summer-ish items. Since we have a more flexible stock position, thanks to our partner program but also thanks to the way we structure our wholesale contracts where we do a part or pre-season buying but then we also do in-season buying, we can react to those changes very nicely and

take full advantage of these demand swings that can happen over the course of a season. Your second question regarding the traffic and conversion development. So, first of all, we are really happy with that traffic development and see it as a proof that actually our marketing approach and you know that we change it over the course of the last year really works and leads to great results.

What we are personally not so worried about is the conversion rate development. Why are we not so worried about it? Because first of all it's quite normal that if you apply a lot of new customers, you'll see a slightly lower conversion than if you just were looking at existing customers. And since the marketing mainly drove new customers in Q2, that's quite a natural development that would have been expected. Second of all, I think it's also important to understand that we're becoming more of a platform business model yet we do obviously still on the majority of our profit with our transactional business.

But we also have business models now that rather monetize traffic, for example, our Zalando Marketing Services. And therefore, even if you don't see all the traffic leading to the same order growth in a period like Q2, you can definitely expect that it helps a business model like ZMS which we personally feel very confident about. And as we explained earlier this year in our Capital Markets Day, it will be one of the key pillars also of our future target model when it comes to double-digit profitability.

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

Simon Irwin

Q

Good morning everyone. Couple of questions for you. The first is just on the changes to two-step authentication which you've talked about yesterday. I'm just wondering if there is a concern that that might impact sales and conversion in 2Q. And secondly can you talk a little bit about warehouse mechanization? Obviously, the Rotterdam warehouses a much higher level of mechanization particularly in terms of picking put away etcetera. What does that say about the potential to retrofit some of the existing sites?

A

Okay. So, let me start with [indiscernible] 00:38:12. So the new pay service directors that will come into full force on September 14th. As you rightly point out, there will require two-vector authentication for some of our payment methods. So, mainly for credit cards, customers will be asked to not only provide the credit card details but also add a second factor to authenticate themselves and make the payment more secure.

While we obviously welcome the fact that payments will become more secure for customers as a result, we also understand that it will introduce additional friction into the checkout process and we are obviously working hard towards making sure that that friction does not get in the way of great customer experience. There are two main ways we are trying to do that. First of all, as you know already for the past few years, we've put a large emphasis on pushing deferred payments because we actually think that's the best way to shop fashion online.

Paying only what you keep after having decided what you return and not at the point of check out. And then I think we've reported in the past already that's close to two-thirds of our transactions take advantage of that payment offering. Most of it being based on invoice or bank accounts, which is completely excluded from this change that we are talking about. Therefore, I feel we are maybe even more insulated against this change, even if it might have some negative consequences on checkout completion rates than most of the other players in the industry.

The second thing we are obviously doing is we are preparing very well to have a good user experience for those customers who still prefer by credit card also after September 14. And therefore, we have already put in place a new checkout flow that is fully compliant with the new payment legislation. And we are currently testing that flow together with our banking partners and issuers. And from what all – what we are seeing so far, we are confident that it will work very well once the new legislation comes into full force. So, I think you should take away from that that we are very well-prepared for that change and that we have taken that into account when we did our guidance for the full year.

The second point you raised around warehouse mechanization is definitely an interesting one. So, if we look at [indiscernible] 00:40:39, it's going to be the most automated site so far. It will introduce a new generation of automation for our logistics network. For the first time, we will not only leverage standard conveyer technology and a [indiscernible] 00:40:54 like we've done in many of our previous sites. But we'll also introduce an automatic storage and retrieval system, so a shuttle that will further automate store and pick processes, and will allow us to achieve much higher levels of efficiency compared to what we've seen in the past.

To put it into perspective, we'll need roughly half of the amount of people that we need tooperate at a site like [indiscernible] 00:41:22 which is the first generation of automation technology. So that really tells you something about the leverage that we can get out of that new automation technology.

When it comes to our existing sites, yes, we definitely see opportunities to further advance automation there as well. It's mostly not going to be a big concept like shuttle technology, though. We are rather currently piloting warehouse robotics in some of our sites because those are typically the more flexible automation technologies that can also be introduced in Brownfield settings, whereas introducing something like a shuttle system would essentially require us to remodel the whole warehouse which wouldn't really make so much sense. And therefore, we focus our attention on warehouse robotics for the existing sites and on the shuttle technology for a new site like [indiscernible] 00:42:22.

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

Olivia Townsend

Q

Hi, everyone. Thank you for taking my questions. Firstly, given you're talking about ZFS, I was wondering if you could give us any more details on this in Q2, for example, any campaigns or new brands using the service. And the second question is just on ZFS, what proportion of partner program items were shipped using ZFS in Q2? Thanks.

A

All right. So, I think there's not so much more detail that we can reveal but one I think great campaign that we did was together with our strategic partner, Adidas, around the release of one of their new sneakers where we did not only support them with the traditional and fulfillmentservice that we offer to our brands but we also offered access to our local delivery networks and we also piloted this multi-channel feature that I was talking about, right. So essentially that was one great thing that happened in Q2. Otherwise, we mainly saw many new partners sign up that we are now in the process of integrating and that will join the program in the second half of the year. And we saw that the existing partners ramped up their volume and also further internationalized on the back of ZFS. And that obviously is also great news for the partner program overall but also for ZFS.

With regard to the ZFS share, I think we don't plan to reveal the exact number every single quarter. As we said last time, we'll do it once in a while also to make sure that you are updated on the progress. What's fair to assume, though, that after communicating last time that it was above 30%. It increased even more and we are still targeting to reach a level of something around 40% to 50% in the next 12 months. So that remains well on track.

Operator: The next question is from Tushar Jain, Goldman Sachs. Your line is now open.

Tushar Jain

Q

Yeah. Hi. Good morning. Just two questions from my side. First on the marketing investments, is there a disproportionate allocation of increased marketing in the DACH region? And second question on stable gross margin, given increasing proportion of premium brands and some benefit from [indiscernible] 00:44:57, I was just wondering if there is something negative which has impacted the gross margin in the second quarter. Thank you.

A

So on the marketing piece I think we would like to stick to our overall commentary and not break that further down to DACH or non-DACH regions. But it's fair to assume that you saw a similar.direction of development in India. So, also India in that we increased our brand marketing and performance marketing spend because we saw the opportunity to grab additional market share. On the gross margin, yes, overall, it stayed flat. If you look at the deeper drivers of it, obviously there's some back and forth on different drivers, but there's really no single notable development that we can and need to comment on at this point. So, it really was uneventful compared to what we saw last year as well. Normal trading pattern throughout the whole season.

Operator: The next question is from Adam Cochrane, Citi. Your line is now open.

Adam Cochrane

Q

Good morning. First question, can you describe how the minimum order value has moved in those eight markets in terms of customer behavior? Has it continued as you initially saw in Italy across those other markets or was there any markets where you had to maybe make some changes to the way that you're introducing the minimum order value because of different customer behavior?

And then secondly, you're sort of changing guidance to around rather than at, given the weaker sales base particularly in Q3, what – can you see in the outlook this made you a little bit more cautious in terms of the top line guidance, please.

A

So, let me start with your question on minimum value. I think with regards to minimum order value we really see the same pattern that we've also seen in the first markets, Italy, where we introduced it in the first instance. So, in all the markets where we introduced minimum order value so far, customers responded in the same way.

they reduce their ordering frequency a bit but they increased the basket size of every single transaction. And as a result, the profit contribution per order increases. And we can obviously reinvest part of that gain into even more aggressive customer acquisition which allows us to further fuel our growth. And therefore we are still very much happy with the developments that we've seen following the introduction of the [indiscernible] 00:47:43 in all those countries and therefore also now introduce it in the next country, France, as I said earlier.

MOE

On the guidance piece, I think it's important to differentiate two things. So yes, you rightly pointed out that we changed our wording for the revenue guidance from being at the low end to around the low end. That has more to do with the development in the first half year where we saw a revenue growth of only slightly below 18% and the continued acceleration of the Partner Program which makes it very unlikely that the revenue growth will return to the very high levels of the past where we only had the wholesale business.

And I think it's also very much in line with what we communicated at the Capital Markets Day earlier this year where we said for the next few years we expect GMV to grow in the 20% to 25% corridor which is then the value of all the sales the platform is driving; whereas revenue which for Partner Program only accounts commission and service revenue is growing at a slower rate of between 15% and 20%. And you should interpret our revised wording as a move towards exactly this mid-term outlook and, therefore, we see it fully in line with what we communicated earlier this year. It's just going a bit faster earlier this year. It's just going a bit faster than even we expected in terms of platform transition. And it doesn't have anything to do with Q3. I think for Q3, it's still too early to say where we'll come out. What we can definitely say is that we had a good end-of-season sale for the spring summer season which just concluded last week in most of our markets.

And now, we are obviously preparing for a great season start in September. But, as we know, from previous years, it remains to be seen how the season start will play out and the success of that season start which to a large degree determine the success of the overall quarter.

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

Michelle Wilson

Q

Hi. Good morning. I guess, a bit of a follow up on the guidance point. I think on the Q1 conference call, you were staring at Q2 EBIT could actually come lower year-on-year in Q2 and obviously is based in that guidance. I think what you're saying on the revenue front, it looks like revenue in Q2 is actually a bit disappointing versus your expectations. So, just wondering which cost line beat versus your expectations during the Q1 call.

A

Sure. So the main cost line that beat our expectations was the fulfillment cost line and also our overhead cost line. So, as you know from previous calls, it's not equal to the admin expenses because overhead is also recorded in other cost lines. But what we definitely saw in Q2 is that due to the higher utilization and due to the stable basket size, we had a very favorable development in logistics costs which we didn't anticipate to this extent. And therefore, we weremore cautious in what we said on the last earnings call for the Q2 profit. And also on overheads, as a result of our continued efforts to drive efficiency in the whole organization, we also see continuous progress and essentially need to scale our teams less to support our growth. And that is creating additional operating leverage, which we then also can reinvest into fueling additional growth, but which also contributes to a better bottom-line picture. So, those are really the two main drivers.

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

Jürgen Kolb

Q

Oh, thank you very much. Just very briefly because most of my questions have been answered. But in terms of your – the positive trend on the average basket size per customer, how do you expect with all the initiatives that you have implemented, how do you expect this to trend throughout this year, but also going into next year? Is there a chance that you – that we might see this average basket size move into positive year-on-year territory as of next year? Thank you.

A

I mean, as we've said, I think also on the last quarter earnings quarter, what we definitely think will happen is that the negative trend that we've seen in the average basket size per order will slow down, and it has slowed down already. But we also think that that's a good assumption for the quarters to come. What we do not expect is to be-that we are able to reverse this trend. And that's mainly due to the fact that, yes, we continue to drive growth in all areas of the assortment also in low price not just in premium. And, yes, we continue to grow stronger outside of DACH, then inside of DACH. And then, also has an adverse effect on basket size given theendorsed markets customer shops smaller baskets. And as an additional factor, we also see customer behavior continuing to change as mobile adoption grows more and more and so customers rather prefer to shop more frequently in smaller baskets.

So these trends will continue to in a way push basket's value down. And I think with the measures that we implement not only in [indiscernible] 00:53:40 but also other measures that we implement to average the customer experience and positively impact other economics. We are able to make sure that this does not hit to the bottom line that we actually see rather a slowing down of the trends that we've seen in the past.

Operator: This concludes our Q&A session. I would like to hand back to Mr. Patrick Kofler.

Patrick Kofler

Team Lead-Investor Relations, Zalando SE

Thank you very much for your attention and your questions. If you have any further questions in the course of the day or tomorrow or even next week, do not hesitate to reach out to the IR team. Otherwise, we wish you a great day and hope to see and speak to you soon. Thanks. Bye-bye.

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