Q3 2020 Earnings Call

Company Participants

- David Schroder, Chief Financial Officer
- Patrick Kofler, Head of Investor Relations

Other Participants

- Adam Cochrane
- Aneesha Sherman
- Anne Critchlow
- Charlie Muir-Sands
- Clara Kamenicek
- Clement Genelot
- David Holmes
- Jurgen Kolb
- Nizla Naizer
- Rocco Strauss
- Volker Bosse

Presentation

Operator

Dear ladies and gentlemen, welcome to the conference call of Zalando SE regarding the publication of the Q3 results 2020. At our customers' request this conference will be recorded. As a reminder, all participants will be in a listen-only mode. And after the presentation, there will be an opportunity to ask questions. (Operator Instructions)

May I now hand you over to Patrick Kofler, who will lead you through this conference. Please go ahead.

Patrick Kofler {BIO 20316412 <GO>}

Thanks for the introduction. And good morning, ladies and gentlemen, and welcome to our Q3 2020 earnings call. My name is Patrick, and I'm Heading IR office at Zalando.

With we today is our CFO, David Schroder. As always, we'll kick it off in a second with the prepared remarks by David, followed by the more interactive part of the session during the Q&A afterwards. I would like to ask you to limit your questions to two to allow as many people as possible to ask their questions. As always, this call is being recorded and webcasted live on our Investor Relations website and the replay of the call will be available later today.

David, I hand over to you now.

David Schroder {BIO 1716908 <GO>}

Thank you, Patrick, and good morning, everyone, thanks for joining us. As usual, we will elaborate on our strategic progress towards our starting point strategies. We will provide you with an update on our financial performance and we will also discuss our upgraded outlook for the rest of the year.

Before we dive into these details, however, let me reiterate that we are in a strong position both strategically and financially, which allows us to capitalize on the accelerated demand shift from offline to online, which has characterized this year so far. Thanks to the great work in our teams, we are able to further accelerate on our journey towards becoming a starting point for fashion. This has also evidenced by the five main messages that we would like to share with you today.

First, we were able to fully capitalize on the continued strong online fashion demand momentum, resulting in an exceptionally strong and profitable growth in Q3. Second, we made further progress towards our starting point vision by winning almost 3 million new customers, further enhancing our customer experience and accelerating our platform transition. Third, we continue to invest into further strengthening our customer experience by acquiring Mobile Body Scanning Developer Fision, which will enable even better size and fit advice for our customers going forward. Four, reflecting our ongoing strong momentum, we upgraded our full year 2020 guidance and are well prepared to deliver a successful peak season. Last but not least, acknowledging that these are very difficult times for the fashion industry overall and offline fashion in particular, we reinforce our support for our partners as the second COVID-19 wave sitting Europe.

Let's now continue with a more detailed strategic update. Our starting point for fashion strategy has become even more relevant this year, as the needs of fashion consumers and brands are very much aligned with the key building blocks of our strategy. Looking once again at our three strategic priorities, which we communicated when presenting our strategy at our Capital Markets Day in 2019, and which we reiterated again at the start of this year, we were able to make significant progress on each of them in the past quarter.

Starting with our strategic priority to grow our active customer base. We continued on the strong trajectory observed since April also in the third quarter. Once again, we were able to welcome close to 3 million new customers to our platform, implying a new customer growth of almost 20% year-over-year. Today, we are proudly serving more than 35 million customers.

Next, we were able to make progress along our priority to deepen our customer relationships, as evidenced by the continued increase of average order frequency. Over the past 12 months, we saw our customers shopping [ph] with us on average 4.8x a year which marks a new all-time high. This is particularly remarkable considering the significant inflow of new customers over the same period. Looking only at existing customers, the increase in frequency was even more pronounced.

Last but not least, we were also able to drive the platform transition at an accelerated pace. We want our customers to enjoy endless choices and we would like them to say, if I cannot find it, on Zalando it probably does not exist. Our progress on this priority is well reflected in a strong performance of the Partner Program, which once again grew more than 100% year-over-year in the past quarter. The strong performance was also supported by our Connected Retail program which contributed more than 6% to our Fashion Store GMV in Germany already.

Let me now provide you with more details on the progress with regards to each of these strategic priorities. Once again, over the past three months, millions of new customers shopped at Zalando for the very first time. We attribute this development to two main drivers. First, we see a continuation of an accelerated demand shifts from offline to online, although not as strong as in the previous quarter given that offline stores were open again, and consumers were able to spend most of their time outside.

Second, our increased marketing investments, which were in line with pre-corona levels allowed us to capture more consumer demand at positive ROIs over a 720-day horizon and tailing a significant marketing cost increased quarter-over-quarter. Our resulting active customer growth was generally broad based across Europe.

Nevertheless, let me provide you with two key examples of that growth. In Germany, our most mature market we saw an outstanding strong increase in new customers by more than 30% year-over-year. In Italy, a country which is still at an earlier stage on the growth curve. We were able to welcome around 50% more new customers than last year. When looking at the quality of these new customer cohorts, we continue to see very similar characteristics compared to previously acquired cohorts, especially the ones acquired in Q2, which showed an improved reorder behavior, as well as an improved customer lifetime value.

Going forward, we are committed to fully capturing the current market opportunity through increased marketing investments, particularly also during the Q4 peak trading period allowing us to create a more emotional bond with consumers and to further accelerate our market share growth. Next to growing our active customer base, we constantly strive to create deeper relationships with our existing customers to become their starting point for fashion. In the third quarter, these efforts are well received -- well reflected in three highlights, that I would like to share with you now.

Firstly, following our announcement in February, we launched our pre-owned fashion experience with in our main consumer destination. Addressing the growing customer needs of decluttering, crowded wardrobes and shopping fashion in a more sustainable manner. Combining pre-owned fashion with our unmatched convenience proposition, we have created a unique consumer proposition in the European pre-owned fashion market. Existing second hand online channels are often times characterized by a low level of convenience, trust and curation. At Zalando, customers can sell unwanted clothes to receive store credit and they can also purchase quality checked and highly curated pre-owned items from Zalando. At the same time, they can enjoy the same high level of convenience when it comes to payments, delivery and returns as for all other items on Zalando. The new experience has been launched in six markets, including Germany, France and Spain in the upcoming months more country launches will follow.

Secondly, we redesigned the entire user experience to offer our customers a more compelling and emotional look and feel [ph]. From our app and website to push notifications and out of all marketing. We thereby aim to offer our customers and even richer overall experience that we will further drive brand differentiation. Taking inspiration from clothing care labels to redesign makes us -- makes use of the symbolism as a way to create a distinct design language, reflecting the character of our brand. On top, we sharpened our welcome experience to make it even easier for new customers to take full advantage of our offer.

While these first two examples revolve around recent customer experience improvements, we also continue to invest into our long-term customer experience vision. With the acquisition of Zurich based Mobile Body Scanning Developer Fision, we made a further step to solve one of our customers biggest problems, finding the right size and fit. In our industry, there are no reliable sizing standards neither between nor oftentimes also within brands that customers can depend on. As a result, online fashion consumers are left guessing whether items will fit them and must engage in a process of trial and error in order to find the right fit.

At Zalando, we want to make a meaningful contribution to solving this challenge to further improve the customer experience and to also reduce unnecessary waste [ph] deriving from size and fit related returns, which are driving around one and free returns today. We can already provide sizes wise for 50% of items ordered today, but with the recent acquisition of fision, we can take size advice to the next level. Integrating the new technology into the Zalando platform we will allow us to provide a highly personalized experience to existing and especially also new customers as the body scanning app and virtual dressing room technologies allow consumers to generate precise body measurements and easily, see how a garment -- fit on their leveraging computer vision technology. We remain convinced that these and similar efforts targeted at deepening the relationship with our customers we will further increase customer lifetime value by driving customer engagement, customer satisfaction, order frequency and spend. This brings me to our third strategic priority, driving the platform transition.

Our platform transition is more than ever aligned with the need of our fashion industry partners to meet the increasingly digital consumer demand. The accelerated demand shift from offline to online has led many fashion players, especially those who are operating predominantly offline to further accelerate their own digital strategy. By offering our Connected Retail program, which connects thousands of brick-and-mortar stores with consumers across Europe Zalando has become part of the solution for many struggling brick-and-mortar stores.

Our network of stores has grown to 2,000 active stores, over 10x more than just a year ago, and these thoughts have already shipped millions of passes to consumers this year. As a result, Connected Retail is becoming a more and more significant part of our business and already accounted for more than 6% of GMV in Germany in Q3. Doubling down on this tremendous success, we plan to invest around EUR50 million next year to triple the number of actively trading stores in 2021.

Connected Retail has just been launched in three additional markets, namely Denmark, Norway and Finland and is therefore now available across in eight markets in total. With Austria, Switzerland, France, Italy and Belgium five additional countries will follow in 2021. To continue to grow our European store network at a fast pace, we will significantly ramp up our B2B sales efforts by establishing local sales forces, engaging into B2B marketing and striking local affiliate partnerships. Our main focus when it comes to store acquisition, we will be in metropolitan areas to establish 10 store networks through which we can create locally relevant choices and better more sustainable convenience for our customers, enabled by our proprietary local logistics platform.

Following the strategic update, and before I start to provide you with some more details on our financial performance, I would briefly like to shift your attention to our ongoing corona response effort, which is gaining and importance again, as the second wave of infections is challenging Europe. While, our decisive company wide response effort has allowed us to emerge stronger from the first wave then we went into it. We have to realized that this health crisis and the following recession are far from over. Therefore, I would like to reiterate our pre priorities on how we execute and even accelerate our strategy in times of rising infections.

Like an spring, our number one priority remains to protect the health and safety of our employees. We have reopened some offices to summer with reduced capacity as a voluntary alternative to working from home. At our logistic sites, were home office is not an option, we have invested heavily into a variety of safety measures ranging from strict social distancing, mandatory face masks to optimize ventilation and also including extensive on premise testing and contact tracing capabilities.

Going into fall, we've more than six months of learnings and we are confident that we are well prepared to navigate successfully through a second COVID-19 wave and deliver a successful peak season. Our second priority continues to be to defend the health [ph] of our business. As briefly mentioned, at the beginning of the call, we believe that we are in a significantly better position than its spring. Thanks to the engagement and strong execution of our teams. We've been able to get through the first wave much better than anticipated, resulting in exceptional financial results in Q2 and Q3.

And over the summer, we were able to raise EUR1 billion in additional capital making us financially more resilient and ever, and allowing us to invest through cycle. While in spring, our primary challenge was the very steep decline in demand in March and to beginning of April. We now anticipate that our primary challenge will be securing sufficient supply and ensuring business continuity across the supply chain.

Our third priority is to be part of the solution. We have realized that an early stage of the pandemic that our starting point for fashion strategy has become even more relevant, as the needs of our all fashion consumers and brands are very much aligned with the key building blocks of our strategy. While we suddenly find ourselves in a strong position and I'll also convinced that we will be able to successfully navigate through this wave. We are also aware of all the challenges that many of our brand partners and our industry overall are currently facing. As a consequence, we are reinforcing our support for our partners as the second wave is gaining momentum and new lockdowns have become a reality across many European countries. All of this is happening in the most commercially relevant time of the year with Cyber Week and Christmas trading still ahead of us.

We have just decided to launch a second corona response package for our partners. This package aimed at offering solutions for partners most immediate challenges. Namely decreasing footfall in their offline stores, limited online consumer reach and liquidity constraints in light of decreasing sales volumes. In order to support our partners in overcoming these pricing challenges, we will waive all commissions for Connected Retail sales to allow brands and stores to recoup lost offline revenues and to create a future proof digital strategy. We will also match our partners marketing investments via ZMS to increase their visibility of their brand and products across European -- our European customer base and to drive incremental sales. And lastly, we will provide liquidity support through early payouts for Connected Retail and Partner Program partners. Over the past decade, our partners have supported us tremendously and help us build Zalando to what it is today. We've grown together through our strong partnership and we are now on our partner side in these difficult times.

This concludes our strategic update. Let's now turn to our Q3 financials, and start with a more detailed look at our top line growth. Group top line growth in Q3 2020 came in very strong with GMV growing by 29.9% year-over-year to EUR2.5 billion, tracking significantly above our midterm growth aspiration of 20% to 25%. Growth was fueled by continued shift in customer demand from offline to online, outstanding growth in our Partner Program and a very strong performance of Zalando Lounge.

In Q3, we were again able to more than double our Partner Program GMV compared to the prior year. This also explains to a large degree the gap of around 8.3 percentage points between GMV and revenue growth, which is particularly well pronounced in the DACH region where the platform transformation is most advanced.

Now let's take a look at the development of each of the three segments. Our core sales channel fashion store so more than 25% GMV growth in Q3 across both regions. DACH recorded a very strong 25.1% GMV growth particularly benefiting from the platform transition. As already mentioned before, we saw strong growth in new customers and our most mature and home market Germany of more than 30%, driving GMV growth up to 30% in the quarter. The highest year-over-year growth rate since 2014. The strong growth in our home market has been particularly driven by a strong Partner Program as well as outstanding contribution from Connected Retail. Rest of Europe continue to outperform that with 28.7% GMV growth. The growth continue to be particularly strong in Southern Europe supported by the ongoing strong new customer acquisition in these markets.

Furthermore, we saw a continued outstanding performance of our off price segment in the third quarter of 2020 recording revenue growth of 62.4% year-over-year driven by our flash sale destination Zalando Lounge. Thanks to a highly engaged customer base. The other business segment started to grow again after several quarters of decline following the restructuring of our private label activities in early 2019, which had historically been reported in the other segment, but is now part of the fashion store.

Growth in the other segment has been mostly driven by Zalando Marketing Services which saw demand returning and external revenue growing by more than 40 -- 30% after an initial hit following the brands decision to cut back on marketing investments at the beginning of the COVID-19 pandemic. And by our integration businesses trade by Anatwine which benefited strongly from our overall Partner Program growth. These positive developments have been partially offset by our style advice service Zalon which suffered from lower interest in occasion based shopping from consumers and the introduction of the styling fee as part of our ongoing efforts to make the offer more scalable.

When looking at our key customer metrics, you can observe a positive trend in all of them. Site visits increased strongly by 26.8% year-over-year. Active customer growth continue to accelerate to 20.7%. The highest year-over-year growth since the fourth quarter of 2015. Customer order frequency reached a new all-time high of 4.8 orders per active customer over the past 12 months. And the average basket size again showed a positive development increasing by 1.2% year-over-year, driven by a lower return rate and a change in product mix. As a result of these order frequency and basket size developments, GMV per active customer continue to grow by almost 5% over the last 12 months.

Let's now turn to profitability. In addition to a very strong growth momentum, we were able to achieve an extraordinary strong adjusted EBIT in Q3 of EUR118.2 million representing a 6.4% margin which marks the highest profitability level ever in our structurally weakest quarter. The strong performance was enabled next to the strong top line performance by substantial one-off effects caused by an ongoing benefit from lower return rate and the reversal of the inventory right down of Q1 of EUR35 million.

When looking at the regional profit distribution, we delivered strong profitability across DACH and rest of Europe. Both being able to increase the absolute and relative profitability year-over-year. Especially the improvement and profitability in rest of Europe is noteworthy as we were able to increase profitability strongly, while at the same time, we may deliver it over proportional investments into customer acquisition efforts to drive growth and market share gains. Off-price and other businesses also increase their profitability both in absolute and relative terms year-over-year.

Let's now take a closer look at the main effect that led to this positive development of visibility in the third quarter. Gross margin increased 3.3 percentage points year-over-year supported by the reversal in the allowances of goods on the back office strong commercial performance throughout the spring summer 2020 season. Additionally, further improvements were driven by better buying conditions and less price investments, thanks to very strong consumer demand. Our fulfillment cost ratio improved year-over-year as a result of a higher level of utilization and therefore also improves efficiency across our logistics network. And as a result of improved order economics benefiting from a lower average return rate. Our marketing cost ratio decreased slightly year-over-year.

During Q3, we continue to step up our game on customer acquisition and engagement investment supported by our ROI-based marketing approach to capture the full demand opportunity arising from the accelerated channel shift to online. In terms of marketing cost ratio, we are now almost back to pre COVID levels as evidenced by the 2.7 percentage points quarter-over-quarter increase. Finally, our admin costs continue to improve year-over-year as a result of our increasing economies of scale, ongoing savings and cost efficiency measures.

Turning now to our cash related items. Net working capital continue to be negative and even significantly improved year-over-year. They were mainly two drivers behind this development. Firstly, we saw a strong increase in payables reflecting the strong growth of our Partner Program as well as our rent up marketing investments in Q3. Secondly, we recorded a relatively lower increase in inventories, reflecting both a good season start as well as delayed for winter inbound deliveries as COVID-19 negatively affects global fashion supply chains.

CapEx spending is in spending is in line with our plan. But below last year's level as a result of our revised CapEx plan for 2020 as communicated during the Q1 earnings call in May. Similar to previous years CapEx is back loaded again, as larger some are built towards the end of the calendar year. Mainly due to the outstanding operational performance, as well as lower CapEx we recorded a very strong positive free cash flow of EUR213.1 million for the third quarter 2020 up more than EUR300 million from minus EUR88.7 million in the prior year period. As a result of the very strong operational performance as well as the successful closing of two tranches of convertible bonds in early, August. Our cash balance amounted to almost EUR2.6 billion at the end of the third quarter.

Let us now turn to our upgraded full year outlook. Based on the continued strong consumer demand and our exceptional performance over the past two quarters, we upgraded our full year 2020 guidance the second time since the outbreak of the COVID-19 pandemic, as outlined on October 8. For GMV, we now anticipate to grow between 25% and 27% for 2020, in line with our performance year-to-date, but above our pre-COVID guidance of 20% to 25%. As a result of our accelerated platform transition and the increasing Partner Program share we expect revenue growth to trade GMV growth and to come in at 20% to 22% this year.

Driven by a strong business performance year-to-date, we also increased our full-year profit outlook and now expect adjusted EBIT in the range of EUR375 million to EUR425 million. This development is supported by significant tailwind from changes in customer behavior we currently experienced, such as a reduced return rate for example. At this time, it is difficult to foresee if and for how long these tailwinds will continue into next year.

On cash-related items, we believe our guidance unchanged and continue to expect negative net working capital as well as CapEx of EUR230 million to EUR280 million to fund our ongoing investments into our European logistics network and into our technology platform. While our upgraded full-year guidance reflect our general confidence and optimism for the remainder of the year. 2020 continues to be a year of unprecedented uncertainty. Although, we are well prepared and confident for the upcoming peak season, we cannot completely foresee the future impact that COVID-where have on both European consumer demand, as well as global fashion supply chains.

Let me close this presentation by reiterating that Zalando has a clear strategy and a clear direction. Our vision is to become the starting point for fashion in Europe and our key strategic priorities remain to grow our active customer base to deepen customer relationships and to drive the platform transition. We expect the next 12 to 18 months to be characterized by a high degree of uncertainty, as a result of the ongoing pandemic.

But also, to offer opportunities based on our strategy and business model. As we are currently finalizing our plans for the year to come, it is our clear ambition to capture this unique growth opportunity and to drive market share gains by continuing to grow multiple times faster than the overall European online fashion market. To enable this accelerated growth, we will increase our investments along our key strategic priorities while remaining in line with our mid term margin guidance. Based on our strong 2020 performance and our strong balance sheet, we are prepared to invest full cycle and to drive long-term value creation in pursuit of our vision to become the starting point for fashion.

That concludes our presentation. Let's now turn to Q&A.

Questions And Answers

Operator

(Question And Answer)

Thank you. Ladies and gentlemen, we will now begin our question-and-answer session. (Operator Instructions) And the first question is from Rocco Strauss, Arete Research. Your line is now open, please go ahead.

Q - Rocco Strauss {BIO 16754312 <GO>}

Hi, good morning, Patrick and David. Like two questions for me, please. I mean, just to follow-up on the comments you made around marketing spend. Could you update us on Zalando Media Services and how brands use this across wholesale end partner program with respect to what type of campaigns they're actually running with you here, and potentially what the split is between wholesale and partner program with regards to ZMS budget?

And then, secondly, I mean, given that we're getting a significantly larger number of requests from like ESG-focused investors. Could you kind of update us a bit more around like you do.More initiatives and connect the dots here with Zalando circular and potentially also with connected retail in terms of the -- like the quickly accelerating number of associated stores that you're seeing that could potentially offer pickups at some point down the road? Thank you.

A - David Schroder {BIO 1716908 <GO>}

Sure. So let's start with your questions on marketing on ZMS, I think we were mostly happy to see that after a certainly difficult second quarter. Brand demand has rebounded and we are now seeing once again, good growth rate for ZMS, around 30% in Q3. We see that brands are predominantly using ZMS right now to drive sales on the platform by increasing their visibility. So, our most popular product is still the product listing ads. We see a bit of a lesser demand at the moment for branding campaigns, which is probably, yes, just due to the overall situation these brands are in, right? But the main focus is on -- yes, so finding a solution to grow their sales or at least to mitigate some of the lost sales impact they see in the offline business and not so much in big branding investments.

Looking more into the future, we actually think that we will probably see, once the pandemic eases, a return to brands being interested in both, right? So not only driving immediate performance, but also in building the brand because that's also what we have seen before the dynamic started. Looking at wholesale and partner program brands, first of all, I think it's important to understand that we also have many hybrid brands doing both business models with us. But then I think I'm happy to reiterate once again that ZMS is broadly used, both by wholesale brands and also by partner program brands. But I'm not able to provide you with a more detailed split.

Regarding sustainability, I think we have definitely seen some good progress in the third quarter. We talked about pre-owned during the presentation. So that's obviously a big addition offering true circularity on our platform. To give you an indication, I think in Q3, we bought, yes, more than 100,000 fashion items -- in October alone, we bought more 100,000 fashion items from consumers, and we sold tens of thousands of items back to consumers. And so it's definitely in scaling mode right now. Obviously, a lot of work remains to be done, right? So, we want to take this to additional countries. We also want to further improve the customer experience, but we are definitely excited with the early positive feedback that we are seeing from consumers, and that is also reflected in our KPIs.

To maybe also mention a few other key developments. We have more than doubled our assortment in more sustainable fashion since the beginning of the year and now offer more than 60,000 sustainable fashion items. We've lately also introduced the sustainability flag as a way for consumers to discover more sustainable choices also in the beauty category. And we've also launched our second exclusive capsule collection, so steps big impact, which was a collaboration with eight sustainable fashion designers from different countries across Europe. And yes, that has already had a significant contribution to our GMV overall, and there's obviously also more ongoing work on reducing -- further reducing our carbon footprint, increasing the sustainability of our packaging. So I think we are moving full throttle on our do more strategy and are convinced that we are also on good track to reach our targets there.

Operator

The next question is from Aneesha Sherman, Bernstein. Your line is now open. Please go ahead.

Q - Aneesha Sherman {BIO 20963827 <GO>}

Hi, good morning. I have two questions, please. The first one is about the debt raise that you did earlier this year to invest into strategic opportunities. So you mentioned in your prepared remarks, David, fulfillment and technology. Are those the two main areas you're expecting to invest in? And can you provide an update on what timeframe roughly you expect to invest this raised capital over? And then my second question is about luxury. You've been working on the luxury platform. Can you provide a timeline of when you expect to launch that? Is it going to be Q4? Or is it going to be 2021? And is that going to be run a wholesale or via the partner program commission model? Thank you.

A - David Schroder {BIO 1716908 <GO>}

Yes. So let's start with your question on our convertible bond offering. It has definitely put us into a strong position when you look at our balance sheet to invest through-cycle and to also execute bigger investments. I think those investments aren't just targeted at fulfillment and technology because we obviously, as you know from the past, we have quite a few exciting growth opportunities lined up across the full spectrum of our strategic priorities.

So I think we can use these investments to further grow our active customer base by, yes, expanding our geographic footprint, by further driving categories where we are not yet at a significant share, like beauty, for example, also like premium and luxury. We can also use that to further deepen customer relationships that has to do a lot with technology, but it also has to do a lot with, for example, our premium membership program plus and with adding additional capabilities, like you saw in the last quarter around 5 and 50, I think there could be more capability-related investments in the future.

And yes, last but not least, there's obviously also more to come in terms of further expanding our European fulfillment network, both in terms of the larger warehouse network. But increasingly, also when it comes to our connected retail platform and our local delivery networks, right? So I think we gave you a hint by saying that we invest EUR50 million alone into our connected retail program in the next year, and that's obviously only one part of our overall investment portfolio. And we think that's actually great because it just shows us that we have a lot of investment and, therefore, also growth potential over the years to come.

Now turning to your second question around luxury or premium, as we call it. I think premium is continuing to be a strong contributor to our business overall. It's particularly also very popular with our younger customer cohorts, where we've seen the most growth in the 25 to 34-year age bracket. And obviously, it also offers us the opportunity to significantly increase the GMV per active customer through this category. We've seen some exciting new brand launches in Q3 with, for example, Alberta Ferretti, Machine Putuo or also MCM. And we've signed many more brands that are about to launch in spring/Summer 2021 that you're going to learn more about in the coming months. And so I think we are very happy with the development that we are seeing in this category. Just to maybe potentially to correct the potential misunderstanding. We are not intending to launch a separate luxury destination. We are really scaling the premium proposition within our main platform.

Operator

And the next question is from Volker Bosse, Baader Bank. Your line is now open. Please go ahead.

Q - Volker Bosse {BIO 3285382 <GO>}

Yeah. Hello. Volker Bosse, Baader Bank. Thanks for taking my question and congratulations on the great figures. Two questions. First is regarding connected retail. You want to triple in 2021 the number of stores. Any long-term target in regards to number of stores to be acquired or any targets in regards to percentage of GMV or percentage of ship items, which should come out of the connected retail distribution? And the second question is regarding Vision, the acquired body management company. Could you provide some details? How does that system with fashion works? And yes, when will it be implemented into your website? Is it already in ready-to-use application or is still R&D spend to be done in order to bring it up to life, so to say? Thanks.

A - David Schroder {BIO 1716908 <GO>}

Sure. So let's start with your connected retail question. I think, first of all, we are excited to see how strong the traction of connected retail has been this year. I think increasing the number of stores by the factor of 10 is quite significant. If you think about where we are coming from, I have a bit the impression, possibly, and I think that's also shared by the company at large that this is actually the model that is perfectly positioned for this -- for the special circumstances that we are currently seeing. It allows us to offer our customers an even better experience, but also allows us to offer great solutions to our brand and retail partners.

Now with regards to targets, I think we are now focused to scale as quickly as possible. And therefore, we aim to triple the number next year. Long term, obviously, even more as possible. So I would say the sky is the limit. We have, yes, depending on which source you look at, we probably have between 300,000 and 400,000 thousand obviously, to acquire a fair share of that, especially in metropolitan areas because that would then really enable us to offer a great local choice as well and also to connect local consumers to local stores in a more meaningful way, enabling both very fast delivery within hours or the same day based on our local delivery networks, but also enabling a more sustainable way of shipping and returning merchandise, and that's what we are excited about.

Now turning to your second question on our size and fit acquisition vision. So it was mainly a capability or technology investment. And what it really does to us is that it propels us forward in our ability to help customers with their size fit issues. Our own team that has been actively working on this for a while, has mainly focused on data-driven approaches to solving this challenge, right? So based on the vast amount of data we have, both on our customers, but also on products, we are able to predict size and fit for already roughly 50% of our orders at the moment. But what we have always been struggling with is how to deal with especially new customers, right, where once they join our platform, we obviously have either no or fairly limited data to help them in terms of size and fit. And that's where Vision comes into play and their technology.

So with that technology, customers have the choice to take two pictures of their body, which then allow us to already offer them a fairly accurate prediction on size and fit of different products. And therefore, it really extends the benefits that we have been able to order to existing customers also to new customers. And that's what we are really excited about. It's not a technology that is already live on our platform, but we'll obviously be pushing forward to integrate this new technology as fast as possible to also reap the benefits for customers as quickly as possible.

Operator

The next question is from Clement Genelot, Bryan Garnier. Your line is now open. Please go ahead.

Q - Clement Genelot {BIO 20592414 <GO>}

Good morning. Two questions from my side, if I may. The first one, connected retail. Why not launching connected retail in France, which is a country where we obviously efficient stores currently closed? My second question is regarding logistics. Do you expect bottlenecking logistics with a third-party delivery partners potentially struggling to enroll higher online volumes in November and December because of revenue lockdowns? Because here, my fear is that could lead to indeed higher logistics costs. Thank you.

A - David Schroder {BIO 1716908 <GO>}

Yes. So on connected retail, I don't know whether that got across earlier in my presentation. But actually, the good news is we are also going to load France. It's just happening in the coming months, and we're not yet live. So we definitely see the same great potential in France that we also see in other markets. I think it's just fair to say that the team is fairly busy with the high volume that we are already processing now and also all the new country launches that we've done since July. But yes, obviously, we are working hard to bring this great offer for customers and partners live in as many countries as possible, and that's why we announced those five additional country launches, including France today.

On logistics and particularly, the outlook for Q4. I mean, it's fair to say that Q4 is always a challenging quarter for logistics in many ways, right? So even without corona, it's a time of the year our own warehouses, but also our carrier networks are running at max capacity. And this year, I think it will post a particular challenge for two reasons. One is volume-related because, as you know, most carriers actually reported to already operate at Christmas volumes during, yes, the first wave of the pandemic.

So if you now add the Christmas effect on top, it's just getting even more challenging. And the second reason is obviously that we need to, yes, ensure we have sufficient capacity to fulfill those customer orders and the higher consumer demand while also making sure that our employees stay healthy and safe. And that obviously means that we cannot scale as aggressively as we have done in previous years. And I think that will be a challenge to the whole industry, also to Zalando, obviously. But we have, yes, worked closely internally, but also with our carrier partners, to ensure that we can deliver a great peak season and also strong growth during those special events like Cyber Week and Christmas.

Operator

And the next question is from David Holmes, Bank of America. Your line is now open. Please go ahead.

Q - David Holmes {BIO 19142716 <GO>}

Good morning, guys. The first question is just on gross margins. I think they were up strongly in Q3, even stripping out the inventory reversal. So just wondering how you're thinking about the moving parts into Q4 on gross margins? And then the second question is just on the practicality of connected retail. I just want to make sure I understand how the system works on that? Do you do it yourself? Is it the shops or is it click and collect or is there a mix here? Thanks a lot.

A - David Schroder {BIO 1716908 <GO>}

Yes. So on the gross margin, I mean, typically, we see an even better gross margin in Q4 than in Q3. So I think, seasonally, there should be some opportunity to show a better gross margin in Q4 than we've now reported for the full year, I think that will mean that gross margin is most likely roughly flat year-over-year. And therefore, we can fully compensate the negative impact that we've seen in the first months of the year.

On connected retail and how we fulfill it, at the moment, all those orders are fulfilled by the local stores themselves. So store clocks or store systems would take these clothes off the rack and pack the parcel and hand it over to carrier partners. In the future, as I tried to outline, especially in metropolitan areas, we aim to really integrate that with our own proprietary local delivery networks to offer an even better solution for customers in terms of delivery, speed and convenience, but also to make the experience even easier for our connected retail partners because we could then even pick up those parcels at their store locations in a very convenient manner.

Q - Clement Genelot {BIO 20592414 <GO>}

Got it. Thanks guys.

Operator

The next question is from Anne Critchlow, Societe Generale. Your line is now open. Please go ahead.

Q - Anne Critchlow {BIO 15255202 <GO>}

Thanks. Good morning. I've got two questions, please. One is just a follow-up on Volker's question about body scanning. Is it fair to say that it would take a very long time to get all the items on the platform scanned and therefore, we should expect quite a long time line for this sort of technology going live? Are we thinking more about years rather than, say, a few quarters? And then the second question is just on inventory. Do you have any shortages currently in any particular categories? And do you think this caps your growth in the fourth quarter?

A - David Schroder {BIO 1716908 <GO>}

Yes. So starting with your first question on body scanning. I mean, the overall effort to meaningfully reduce related returns and also improve the customer experience, for sure, is an effort that rather takes years than just months or quarters. If we look at the body scanning in particular, however, I think it's important to understand that we can obviously combine the vast amount of data that we already have on our products with the measurements that consumers can do with this body scanning technology.

So what this technology is not intended for us to measure all the articles. That's where we already have lots of data and continue to collect data because we sell all these merchandise on a daily basis, as you know. It's more intended to help us create size profiles of consumers to map this against the article data that we already have and collect. And therefore, once we integrate this technology into our experience, we would expect an immediate positive impact on the customer experience and also on the return rate, especially if we see consumer adoption of that service in high numbers.

Second question on supply constraints or supply shortages, as you call them. As you know, we've been working very hard with a dedicated task force ever since the summer to make sure that we can mitigate the potential supply constraints. And I think, overall, I'm happy to report that we are in a better position than a few months ago. That being said, however, we also continue to see significant delays and disruptions in fashion supply chains. So it's definitely going to remain a challenging season, and we are especially now focusing our attention in making sure that we have enough supply coverage for Q1 and the start -- at the end of this season, the start of the new season, whereas we are probably well covered for Q4.

Operator

And the next question is from Charlie Muir-Sands from Exane BNP Paribus. Your line is now open. Please go ahead.

Q - Charlie Muir-Sands {BIO 16294853 <GO>}

Yeah, thank you for taking my questions. Two, please. The first is you were in Q2 to give us an update on how you were seeing the start of the next quarter. I wondered if you could share what you're seeing in October with respect to both sales and also returns rates. And then, secondly, with your respect to your comments regarding plans for the outer year and your prioritization of investing to achieve growth above the industry. I just wondered if that's to clarify. Did you mean that you're likely to still aim to drive growth with margins in the 2% to 4% range? And in the context of that, the EUR50 million that you're talking about investing for connected retail, is that OpEx or CapEx spend? Thank you.

A - David Schroder {BIO 1716908 <GO>}

Yes. Thanks for these questions. I think on current trading, we maybe should, first of all, all realize that the fourth quarter really depends a lot on November and December with the peak trading happening around Cyber Week and Christmas. But what I'm happy to report is that we had a good start in October, and so everything seems to be set up for another strong quarter that we aim to deliver.

What I can also tell you is that with the recent emergence of a second wave of infections and the recently announced lockdowns that have been implemented in the past days, we have not seen a major impact on demand so far, and that's very different to the first wave in spring, as you know, there, at least for a few weeks, we saw a significant negative demand impact, and that doesn't seem to be the case for now. That being said, I think we'll all need to continue to observe how the infections continue to spread and also how governments think about future measures. And therefore, it's obviously difficult to extrapolate that development from just a few days to the coming months. But we remain optimistic based on our good preparation that we'll also be able to weather the second wave in a good way.

On future plans, I think what we mainly wanted to get across in my earlier comments, is that we continue to really see this not only as a time of unprecedented uncertainty, but also at a time of significant opportunity for our business, mainly when it comes to accelerating our growth and also accelerating our strategic journey. And this is probably going to be true for another 12 to 18 months as long as the dynamic continues and also as long as we see an accelerated shift of consumer demand from offline to online.

And this is obviously what we really want to capture for us because we think that it's just going to make sure that we, yes, reach our targets even faster and also get an even more meaningful market share, which obviously also creates a more valuable company. And therefore, we are happy that we actually have lined up a great investment portfolio for next year in particular, where we can invest into several different growth drivers that will ensure that we can continue to grow at an accelerated rate and fully leverage the tailwind from the consumer demand side.

I'm happy to also confirm that we will stick to the 2% to 4% margin corridor. So this definitely includes what I said earlier about the connected retail investment and also other investments that we intend to do. But different to this year, I think we will be in a position to invest the surplus EBIT that might come from tailwinds such as stronger demand or also continued return rate impact into driving additional growth this year. I think we were a bit obviously taken by surprise by all these developments.

But for next year, I think we are now in a better position to fully leverage these developments. Looking in particular, the EUR50 million connected retail investment, most of that will be OpEx. So growing the team, but also investing significantly into sales and marketing efforts on a local level. There will be some limited CapEx due to the capitalization of technology investments as we continue to improve our products and services for connected retail partners.

Operator

And the next question is from Adam Cochrane, Citi. Your line is now open please go ahead.

Q - Adam Cochrane {BIO 4816951 <GO>}

In terms of -- two questions. Firstly, can you just talk about the new customer behavior that you have -- from the customers that you recruited pretty much in 2Q and maybe 3Q as well, and whether that cohort behavior is following the usual patterns or whether you're seeing a slightly higher churn as many time has moved on? And then, secondly, in terms of that return profile. Would you be able to indicate the benefit in the third quarter from lower returns year-over-year? So whatever the impact on the EBIT uplift from the lower returns rate was? Thanks.

A - David Schroder {BIO 1716908 <GO>}

Sure. So on new customer behavior, I'm happy to report that we continue to see healthy customer characteristics, as indicated earlier during the presentation. So when we look at reorder behavior, when we look at spend and yes, other sort of consumer cohort health KPIs, we see that these cohorts perform at least as good as previous cohorts. Actually, they seem to be performing even slightly better. And therefore, we have a strong indication that the customers that we were able to acquire in Q2, but also in Q3, are really adding lots of value to our platform.

On the return rates impact, yes, I'm happy to specify the impact a bit more. So in Q3, we've seen return rates decline year-over-year in the mid single-digit percentage area. If you recall, in Q2, it was high single digit. So we've seen an increase in return rate quarter-over-quarter, but it's still down year-over-year. And it's also fair to say that the increase in return rates happened at a slower pace than we initially anticipated, and that meant that we saw a double-digit million amount in terms of positive effect for Q3. Obviously, slightly smaller than what we saw in Q2, given also that the return rate change year-over-year wasn't as pronounced.

Operator

The next question is from Jurgen Kolb, Kepler Cheuvreux. Your line is open. Please go ahead.

Q - Jurgen Kolb {BIO 1504907 <GO>}

Yes. Thank you very much and good morning to all of you. First question, again, also on the return rate. I believe in the last call, you mentioned that the return rate has gotten back to a somewhat more normalized level. And I was wondering if you've seen a further increase to the more or less 50% in October? Or if you have even seen due to the second kind of lockdown that this return rate has again maybe stabilized on a lower level? That's the first question.

The second one, you mentioned that you obviously gained flexibility with the convertible bonds. And you mentioned geographic footprint extension maybe or category extension. I was wondering if you could maybe share some additional thoughts on especially the category side, you mentioned beauty, obviously. But could you also picture that Zalando uses that opportunity to maybe go into even a different category that might be adjusting to fashion, but maybe something else that you find right now possible or attractive given the environment. Thank you very much.

A - David Schroder {BIO 1716908 <GO>}

Sure. On the return rate, happy to clarify. I think what we've seen in Q3 is obviously that the return rate was not the same low level that was in Q2, but it also wasn't yet back to the level that we had seen pre corona. So it's fair to say that it's somewhere in between. And with regards to potential return rate tailwind in Q4. I personally feel it's a bit early to tell because the effect of the second lockdown is not yet really reflected in any of the numbers that we see, right? So it was just announced in most countries a week or two ago. So that means that we will only observe the impact over the coming weeks.

What we see in terms of early indicators is that customer mobility is negatively affected in these countries following the lockdown in Q2 in particular. This has always been a leading indicator for also lower return rates. But we can't really foresee whether that same correlation will be true in Q4. It's just, I think, an early hint that it could be the case, and we'll obviously be happy to update you with our next quarterly set of results.

On your category expansion question, I think what we are most focused on right now is to really double down on the new categories that we already recently launched, right? So I think beauty, obviously, is a key focus for us because I think it's still far away from the potential this category has from us. Our market share in that category is still much lower than in all the other categories that we offer. And therefore, our first priority will be further scale this category. And as mentioned, yes, throughout the year. Second focus will be on our premium category offering. That obviously doesn't mean that we can't also imagine further fashion and lifestyle categories as additions in the future, but there's no concrete plan to launch anything in the coming months. And we'll all obviously update you if that changes.

Operator

The next question is from Nizla Naizer, Deutsche Bank. Your line is now open. Please go ahead.

Q - Nizla Naizer

Great. Thank you. My first question is on the connected retail stores. You mentioned that you have 2,000 now on the platform, and you're giving them sort of assistance by not charging them a commission. But hypothetically, if you had a charge to the commission, could you sort of give us some color on what that revenue component could have been like? As in what is the opportunity that we're looking at from the sort of connected retail stores. And once you do start monetizing them, what sort of opportunity? Is it in terms of revenue contribution? That would be great.

Secondly, on the lower than average returns in Q3. Could you give us some color as to what it was driven by -- assuming that mobility did go back to normal for most of Europe, was it due to a category mix shift? And if that's the case, would that be more of a normalized sort of development going into next year or is it still a one-off if sort of consumer purchasing habits on Zalando has changed more considerably rather than as just a one-off? So some color there would be great. Thank you.

A - David Schroder {BIO 1716908 <GO>}

Yes, three questions. So on connected retail, maybe one easy way to picture the financial potential of connected retail is to see it as fairly comparable to our partner program business, right? So we've talked a lot in the past about how we think about monetizing this through both commissions and advertising, and the same is obviously available in our connected retail program. So yes, not for the coming months since we waived commissions. But beyond that, obviously, we will charge commissions again. They are in line with the commissions that we charge in the partner program overall, so somewhere between 5% and 25%.

And we also offer advertising services for connected retail stores. We're actually working on also offering more local advertising services for the stores because we think that might be particularly interesting to them. And therefore, I think we see the same monetization potential and also margin potential in the connected retail business that we also see in the partner program overall. And there, I think you can, yes, maybe have a look at our long-term margin aspirations of 20% to 25% margin in terms of revenue for that part of our business in the very long term.

Turning now to your question on returns. In Q3, I think the key main drivers were not related to mobility, as I said, yes, almost no country has any lockdowns anymore. Customers really enjoy to be outside again and to not be as restricted. And therefore, the main drivers really were a changed product mix. We still see a higher interest in more categories like sports, beauty and basics. And a lower interest in occasion, where like dresses or suits, where obviously, return rates have been traditionally higher, and that's impacting our return rate in a positive way. The second key driver has been customer mix. So as discussed with our Q2 results, we see a higher share of new customers, which is driving return rate down. But over time, we expect these customers to adopt also the same return behavior that our existing customers have. So structurally, that shouldn't be a long-term driver.

And second, we also have a higher share of male customers, which is also helping our return rate in the mix. Regarding your questions towards next year, I think I wouldn't extrapolate what we see this year for next year and just consider the new normal. Because I think once the pandemic eases, we would also expect the occasion-based categories to pick up again, and we would also expect at least not the same pace of the offline to online shift to be the case anymore. And therefore, also the customer mix probably won't play as much in our favor as it does right now. And therefore, the question really becomes how long will the special dynamic continue to provide us with tailwind? And that's obviously something that's very hard to tell and where we can only update you as we move along.

Operator

And the last question for today is from Clara Kamenicek, MainFirst Bank. Your line is now open. Please go ahead.

Q - Clara Kamenicek {BIO 20989092 <GO>}

Thanks for taking my questions. I have two. The first one is on Black Friday and Cyber Monday. So in the DACH region, that will fall into the lockdown period with restrictions on how many people can be in stores. Do you think that there will be an even bigger spillover from brick-and-mortar than there already is? And do you have any specific expectations for those days that you could share with us, maybe already more brand sign-ups or inventory increases? And regarding Christmas, probably more people will order Christmas presents online. Are there any measures that you're taking to counteract a potentially higher return rate in Q1 next year?

A - David Schroder {BIO 1716908 <GO>}

Yeah. Good questions. Yes. Good questions. I mean, you're mentioning the 2 key events that are ahead of us. And similar to the previous years, we'll obviously try to make them big events, especially for our customers. But I think this year, also very much for our partners. And if you look at our implied growth aspiration for Q4, obviously, you can expect that also during Black Friday, Cyber Monday and Christmas trading, we have a strong growth aspiration. Otherwise, we wouldn't get to that number that we shared with our upgraded guidance. I do not want to share any more specific targets with you regarding those special lens. But rest assured, obviously, we have done these events a few times now, and we think they are great events, not only in terms of driving sales on our platform, but also in acquiring many new customers, which then will also obviously help us to continue on our strong growth next year.

Maybe one last comment on critics trading. I think it's fair to say that, yes, we might see some benefit on our business. But it's also, I think, fair to say that the categories that we offer are not necessarily the ones that are most sought-after as a Christmas present. Maybe a bit more potential in beauty, but many fashion categories are not among the top 10 Christmas presents that people typically do. So yes, I think we also shouldn't overestimate the potential for Christmas trading in particular.

And with regards to the return rate question, I think we've learned in past years that especially on Christmas presents, obviously, there is a special return dynamic, given that people need to buy in advance, then they give it to someone, and then someone needs to decide whether they want to keep it. So we see a slightly longer time period between order and a potential return. But what we do not see is a significantly elevated return rate as such.

Operator

And this concludes today's Q&A session. And I hand back to Patrick Kofler for closing remarks.

A - Patrick Kofler {BIO 20316412 <GO>}

Yes. Thanks for listening in. Unfortunately, we're not able to get on the plane today and travel to see you physically, but we'll make sure to connect with you in a virtual way, which has worked quite well over the last few months. Then if you have any questions on today's results over the next couple of days or even today, please do not hesitate to reach out to the IR team here. I guess, you know how to reach us. And that leaves me with thanks again for the participation. Enjoy the rest of the day, and most importantly, stay safe. Take care. See you next time. Bye-bye.

Operator

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