



FLAGSHIP

ASSET MANAGEMENT

Navigate Safely Forward

QUARTERLY TELESCOPE

Q2 2020



## Flagship Asset Management

Flagship is a **specialist global asset manager** founded in 2001.

We are 100% independent and fully owned by staff and directors.

Our mission is to be the navigators and global authority of your complete investment future, wherever it may lead.

## We manage global portfolios in three distinct strategies

Global Equity | Global Flexible | Global Fund of Funds

Our longest running strategies have track records spanning nearly two decades, and have generated returns of between 11.5% - 14.5% per annum since inception.

## We believe in long-term, valuation-based investment

Our investment approach is process-driven and rigorous, and our definition of quality is demanding and exclusive.

Our equity selection is focused. We own a maximum of 25 stocks, diversified across geography and sector.

About the cover image: *Mayflower* (a replica of which appears on the cover) was an English ship that transported the first English Puritans, known today as the Pilgrims, from England to the America in the fall of 1620. Just over 155 years later their ancestors would sign the Declaration of Independence, founding what is today the United States of America.



## Introduction

Welcome to our latest QUARTERLY TELESCOPE. We hope these quarterlies provide you with greater insight into our thoughts on global assets as well as how your global funds are being managed. In this quarter's Telescope, **Pieter Hundersmarck** discusses how our portfolios are currently positioned, our asset allocation, as well as our thoughts on the 'optically cheap' South African stock market. Finally, we discuss the investment case for **Zalando**, the leading online apparel retailer in Europe.



## About Pieter Hundersmarck

Pieter is the co-manager of the global funds at Flagship and has been investing internationally for over 14 years. Prior to Flagship he worked at Coronation Fund Managers for 10 years and also co-managed a global equities boutique at Old Mutual Investment Group. Pieter is a dual Dutch and South African citizen, and he holds a BComm (Economics) from Stellenbosch University and an MSc Finance from Nyenrode Universiteit in the Netherlands.

## Performance

*Note: All performance is net of fees. Periods longer than one year are annualized.*

Flagship Global Funds to 30 June 2020	YTD	1 Yr	3 Yr	5 Yr	10 Yr	S.I.
<b>Flagship IP WorldWide Flexible FoF (ZAR)</b>	<b>21.7%</b>	<b>24.9%</b>	<b>12.5%</b>	<b>9.0%</b>	<b>13.6%</b>	<b>14.3%</b>
Benchmark (SA CPI + 5%)	3.3%	7.4%	9.0%	9.9%	10.3%	10.4%
<i>Outperformance vs. Benchmark</i>	<i>18.4%</i>	<i>17.5%</i>	<i>3.5%</i>	<i>-0.9%</i>	<i>3.3%</i>	<i>3.9%</i>
Sector average	7.6%	11.8%	8.0%	6.4%	12.5%	12.1%
<b>Flagship IP WorldWide Flexible Fund (ZAR)<sup>1</sup></b>	<b>17.1%</b>	<b>21.2%</b>	<b>10.0%</b>	<b>5.8%</b>	<b>11.4%</b>	<b>11.7%</b>
Composite Benchmark	9.3%	12.0%	9.8%	8.1%	11.4%	9.5%
<i>Outperformance vs. Benchmark</i>	<i>7.8%</i>	<i>9.2%</i>	<i>0.2%</i>	<i>-2.3%</i>	<i>0.0%</i>	<i>2.2%</i>
Sector average	7.6%	11.8%	8.0%	6.4%	12.5%	11.0%

<sup>1</sup> Note that Flagship IP Worldwide Flexible Fund (ZAR) and the Flagship International Flexible Fund (USD) are managed as one strategy ("Our Flexible Strategy") since April 2019 with the only difference being the domicile and the fund currency.



## Q2 2020 – Volatility Strikes

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- Efforts to contain and control the spread of the COVID-19 pandemic were enormously destructive to global economies, many of which have only started to recover in the last few weeks. All major economies are currently forecast to enter recession.
  - Financial markets have recovered from their lows and are continuing to show broad based resilience in the face of poor economic news flow. Fiscal and monetary stimulus play a large role in this resilience.
  - Flagship portfolios were well positioned through the crisis and took advantage of multiple buying opportunities.
  - The Coronavirus has shifted societal consumption patterns and hence asset allocation for the near term. The outlook for certain industries like commercial property, general retail and travel remain poor.
  - In our flexible funds our stance is cautious. We remain overweight equities and hold zero bonds. Equity hedges were added to protect the portfolio from further market declines, and we hold close to the maximum position size allowable by regulation in physical gold (10%).
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*Efforts to contain the coronavirus have left deep holes in business and consumer balance sheets*

**Markets were incredibly volatile in the first 6 months of 2020.** The MSCI All Country World Index (ACWI) fell -21.7% in USD in Q1, before advancing +19.2% in Q2, to end down -6.7% for the 6 months to June 30.

Many records were set: the swiftest global stock market decline and recovery, the largest contraction in global GDP, the lowest oil price on record as well as the largest amount of government stimulus ever created.

Efforts to contain the coronavirus have left deep holes in business and consumer balance sheets. The enormous monetary and fiscal stimulus has so far avoided the worst outcome (a depression), but the global economy remains vulnerable. The IMF currently forecast a global contraction of 4.9% in 2020.

Markets have been broad shouldered in the face of adverse economic data. Looking in more detail we have noticed a bifurcation in stock returns per sector: technology companies with sturdy balance sheets, defensive consumer staples, and health care have outperformed, while travel, energy, and credit-exposed financials, among others, continue to suffer.

Like the Global Financial Crisis (GFC), the coronavirus pandemic will long be remembered for the unprecedented policy responses it elicited from central banks around the world. During the GFC, only two emerging market central banks carried out asset purchases: The Bank of Korea and the Bank of Israel. In the current crisis they have been joined by a host of others including Poland, Hungary, Malaysia, the Philippines and Indonesia. Even Turkey and South Africa, with much weaker balance sheets, are among the riskier countries that have joined in. This concerted policy response has been a key driving force behind the market's rapid recovery.



## Fund activity in 1H 2020

As share prices fell in February and March, we expected a wide time window to apply the available cash to falling stocks in our flexible funds. Instead, we had to act quickly: The S&P 500 declined by 33% from February 14th to March 23rd and within 8 weeks regained nearly all the ground it lost. Compare this to the nearly 4 years it took stocks to reach their previous highs after the lows of the GFC in March 2009.

In our Q1 2020 quarterly commentary, found [here](#), we wrote:

*“As bad as things seemed in the depths of March, this is not 2008. .... To be sure, this can and likely will lead to a severe drop off in economic activity for the next year, but the key ingredient to financial institutions failing - which is over-leverage - is missing. In this respect, the base case would be more akin to the short, sharp sell-offs which have accompanied the declaration of war during both World Wars and the Gulf War, or to the Oil Crisis of the 1970’s.”*

For now, it has evolved that our analysis of the situation was proven correct. We appear to have avoided an ‘L shaped’ or ‘U shaped’ future, and stocks have recovered from their March lows. But where to from here?

Our assumption of a sharp recovery allowed us to be opportunistic as value presented itself in March and April. We achieved bargain prices for shares that reflect the high quality we believe is essential for long term investing, such as Adobe, LVMH, HDFC Bank, Tencent, Booking Holdings and Tinkoff Bank (TCS).

Going forward, expectations of increasing or decreasing economic activity often provide a relatively good indicator for which direction the stock market will take, at least in the near term. When economies enter recession, financial markets tumble as lower economic activity leads to lower revenues, profits and earnings. Thereafter, the market begins discounting ‘when’ the economy will recover, and stocks typically rise as those expectations slowly become reality.

However, due to monetary and fiscal stimulus, as well as the expectation of a ‘back to business as normal’ by next year, the market recovery is now pricing in a lot of good news, and remains vulnerable to changes in that narrative.

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## Risk Management at Flagship is geared for the current landscape

*“It’s hard to predict when a storm will happen, but one thing is inevitable: it will happen. We cannot control these events; we can barely predict them. Risk is not symmetrical. You can make a lot of money in the good times, but if you aren’t careful, you’ll go bankrupt in the bad.” Jamie Dimon, 2002*

As Dimon says, there is a fine line between being prepared for the crisis at hand, and recognizing that crises are in fact a feature of the landscape in which we operate. As we work to understand the possible impact of the pandemic on economies and asset prices around the world, the most striking feature is the fragility of the recovery, and we remain watchful of what might happen when accommodating fiscal and monetary policies are removed.

At Flagship we build portfolios with the recognition that our biggest value to clients is to outperform during volatile markets. One of the foundational risk management processes we follow is our concentrated focus on high-quality stocks. Across our strategies, the equity component is comprised of a concentrated selection (20-25) of high-quality businesses. Rather than focus on the level of overall markets, our job is to ensure the investment cases behind these 25 businesses are robust, rather than focusing on the thousands of stocks that we do not own.

With this in mind, it is useful here to reflect that although equity indices have recovered, Flagship’s high-quality equities across all funds have outperformed the broader market during the last year of turbulence. The following table illustrates this.

*Table 1: Flagship equities versus the MSCI ACWI in ZAR*

ZAR returns to June 30, 2020	3m	6m	1yr
<b>Flagship International Flexible Fund Equity</b>	24.8%	25.9%	33.7%
MSCI ACWI	16.6%	16.9%	26.5%
<i>Outperformance</i>	8.2%	9.0%	7.3%
<b>Flagship Worldwide Flexible Fund Equity</b>	24.0%	24.8%	31.3%
MSCI ACWI	16.6%	16.9%	26.5%
<i>Outperformance</i>	7.5%	7.9%	4.8%
<b>Flagship Worldwide Flexible FoF Equity</b>	15.8%	20.6%	na
MSCI ACWI	16.6%	16.9%	26.5%
<i>Outperformance</i>	-0.8%	3.7%	na

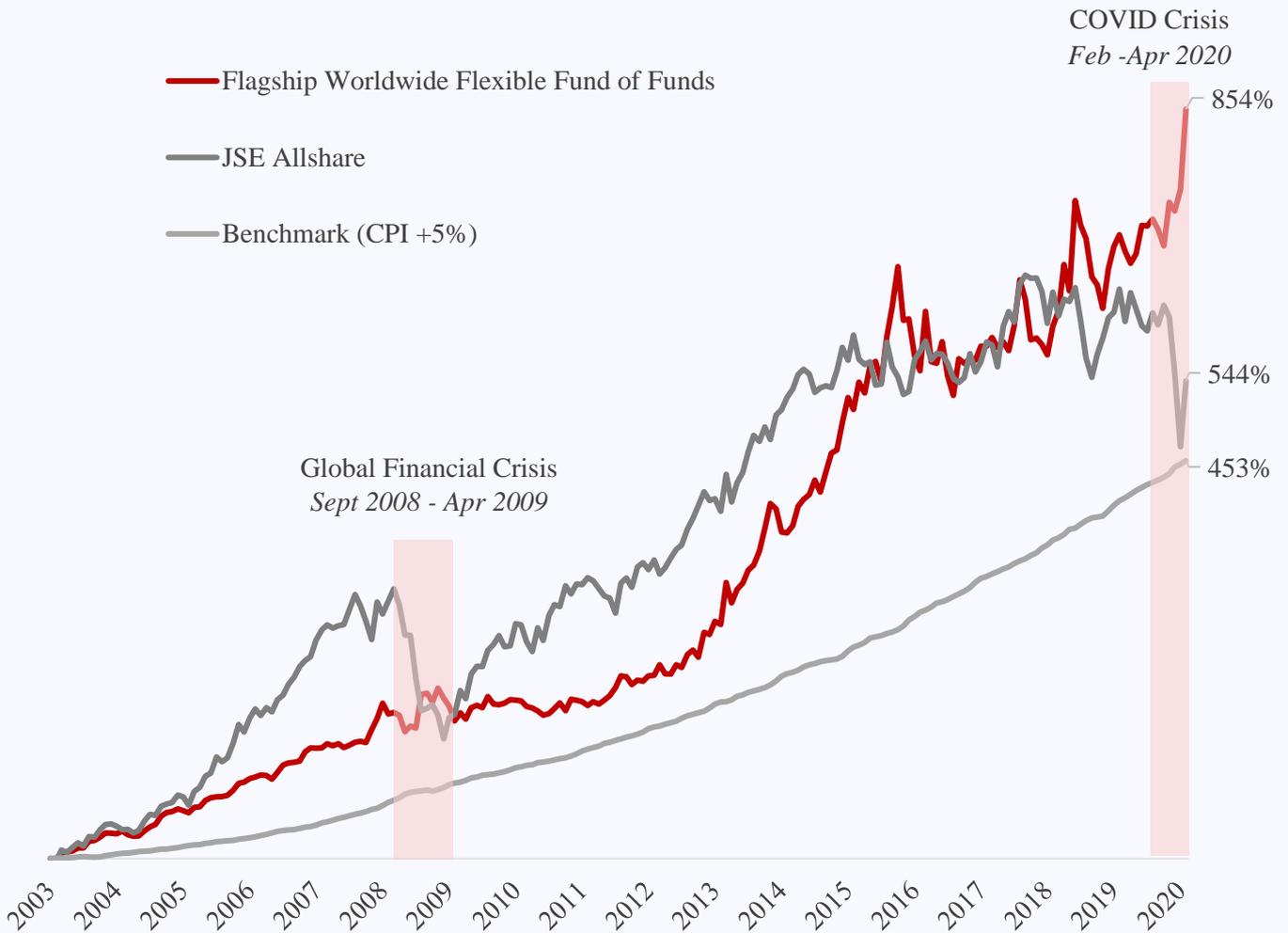
*There is a fine line between being prepared for the crisis at hand, and recognizing that crises are in fact a feature of the landscape in which we operate.*



It is pleasing that our selection of 25 equities is outperforming the broader market. We hope that the separate asset classes that we use in our flexible funds will always outperform their specific indices. However, it is in those times of underperformance that we hope to use asset allocation to achieve our investment goals.

While it is valuable to have outperformed over long periods, it is even more valuable to outperform *'when it matters'* as the chart below shows.

Chart 1: Flagship Worldwide Flexible Fund of Funds vs the JSE and its benchmark since inception





*Employees and employers will take full advantage of the technology that allows them to participate effectively in their work without sacrificing long term efficiency.*

## Longer term impacts of the Coronavirus

We use history as our best guide to better understand the longer-term impact of the coronavirus. Although each crisis is unique, the way human beings operate is rather consistent. In the face of adversity, humans pass through phases of initial (under or over) reaction, assimilation, familiarity and normalization. Recognizing these temporary phases can help us anchor to what humans 'return to' once the coronavirus pandemic subsides.

There is currently a widespread narrative that Coronavirus will change many industries in a radical, fundamental, and long-lasting manner. We resist this narrative of a 'new normal' or a 'new world', and believe blanketing the various Coronavirus-driven changes with the same brush is dangerous. In fact, when formulating investment strategies, we believe assuming radical long-term changes is a severe misjudgment of how humans fundamentally operate.

In our opinion it is too early to decide which industries will be impacted, and for how long. To solve the longer-term questions requires that we interrogate the particular circumstances of each industry.

Some answers are easy. E-commerce is clearly a short- and longer-term winner from the pandemic, as are online advertising businesses. Producers of hand sanitizers are clearly short-term beneficiaries. Many insurance providers as well as airlines and travel agents are clearly short-term losers.

Where the analysis becomes more difficult is when we factor in the various technological means we have at our disposal to maintain distance in a working context. In this sense we would agree with those that say employees and employers will take full advantage of the technology that allows them to participate effectively in their work *without sacrificing long term efficiency*.

We single out office space as an example.

The work from home phenomenon has received so much media attention that one could assume we can all sit in coffee shops for the rest of our careers, 'Zooming' to our meetings with no need for formal attire (or long pants and shoes for that matter).

The truth is more nuanced. Office space was already being rethought prior to COVID. Working from home, for some professions, is desirable and expedient, especially for jobs that require little supervision or collaboration, or for employees that live far from work. The virus has certainly accelerated a pre-existing shift.

However, many careers require collaboration, organic flow and prompt feedback loops. The creative industry, to use one example, requires human interaction to be successful: this means interruption, socializing, brainstorming and visualizing on a level that often demands humans be in the same space.

Relationships can certainly be forged online, but as anyone who runs an online business will tell you, it is difficult for screen meetings to replicate the bond created in physical interactions.



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Furthermore, for many people the option of working from home, either from an infrastructure or efficiency aspect, is simply not viable. There is little that companies can do to tackle this.

Naturally, we expect to see less office space used as companies take advantage of technology. The shift towards less congestion and more flexibility will provide benefits: up to a point. We expect many landlords to be forced to offer concessions on rentals, and perhaps a major rethink of what purpose offices should serve.

Importantly, the market has a way of re-pricing. Once office rentals are cheap, perhaps proponents of working from home may ask themselves if, at a much lower price, it may be worthwhile to have a space to work and collaborate from.

These arguments can be extended to other industries to a greater or smaller extent. In light of travel, hospitality and socializing, the longer term to us is crystal clear, we believe humans will, in the long run, travel and socialize at much the same levels as they have in the past. Put differently, we trust humankind to correctly balance “the risks to life” against “the things that make life worth living”.

## **Asset Allocation in the first half of 2020**

The largest change to our asset allocation in the second quarter was the increase in equity derivatives to protect the portfolios from a market pullback. We continue to find bonds unattractive in current market conditions and far prefer equities.

To understand why, we need to take a step back. Bonds are fixed interest instruments. As a buyer of a bond, you buy the right to a fixed income stream. The value of the bond fluctuates with the interest rate, which is in turn dependent on inflation expectations. For a constructive view on bonds (in any environment) one would need to believe that 1) the yield is attractive (ahead of inflation), OR that 2) the value of the bond will increase (which will only happen if interest rates fall further). Taking these two points in turn:

**Yield:** For any asset, an annual yield that is greater than inflation is attractive. If bonds were yielding 5%, and inflation was 3%, bonds would provide an attractive 2% real yield for the investor. In this scenario we would consider bonds, and if we believed that inflation would decline further, then the investment case for bonds would be clear. Currently, the highest yielding liquid government bond is the US 10-year bond, which yields 0.87% per annum. A selection of high-quality US corporate bonds trade in the 1-2% range, while inflation is near the 2% level (excluding the impact of COVID-19). As such, bonds do not provide any form of real yield, and we also don't expect inflation to fall further.

**Value:** For bond prices to rise in value, we are asked to believe that interest rates must decline from multi-decade lows, or even go negative (as in the case of Germany, Sweden, Japan and other large countries). Put simply, to believe that governments around the world will be paid to borrow money into perpetuity is highly improbable, and would expose our investors to substantial risk. Since corporate bonds are priced off of government curves, they too exhibit similar risk.



In summary, both government and corporate bonds provide us with little yield and very low long-term price opportunity. The selected equities that we hold in our flexible portfolios, in our opinion, are attractively priced in relation to their long-term prospects, and provide our investors with the very best protection against the distortions in the bond market.

## South Africa – a view from a global perspective

We are sometimes asked about our view on South Africa from an investment perspective. We note that local stocks look optically cheap, and our global portfolios are designed to take advantage of opportunities where we find them.

Our view is that our funds are designed to protect our investors from the vagaries of the local economy as well as the depreciating Rand (which has made South African's 7% poorer per annum from a global purchasing power perspective for over 25 years). Indeed, one of the establishing principles of Flagship Asset Management is the globalization investment opportunities for our clients. As a recent piece by co-portfolio manager **Kyle Wales** lays out [here](#), while your day to day life may be tied to South Africa, your investments needn't – *and arguably shouldn't* – be.

In light of current circumstances, we feel the need to elaborate further on this general response. This is in part driven by a disheartening conversation we had with a respected financial advisor who informed us that investing offshore still receives considerable pushback from the local asset management and advisor community. We still see substantial evidence of this 'home bias' reflected in official investment statistics, and which is correctly criticized by Kyle's article, as well as by other authors [here](#) and [here](#).

As global managers, we direct the bulk of our research efforts towards finding value across the globe. The US, Europe and Japan constitute over 80% of the value of global stock markets, so we tend to see these markets as our natural hunting grounds.

As an emerging market, South Africa has always formed a small part of the global investment landscape (alongside Brazil, India, Russia and other emerging markets) and as such has always been considered by our global funds as a potential destination for investor capital should opportunities present themselves.

However, value to us means investing where the rewards outweigh the risks, and in a nutshell, the future for South African businesses presents one of the worst risk reward tradeoffs we can find.

We would go one step further and say that we disagree with those that say South Africa is 'on the brink of' or 'peering into' the economic abyss. Rather, we believe it is already firmly here.

Why do we say this? To begin with, two decades of rising corruption and mismanagement have decimated the local economy to a previously unimaginable extent. The driving engine of economic growth, which includes a successful secondary and tertiary education sector, formal skills development, a supportive regulatory environment, friendliness to capital, and equal opportunity for all workers, are either nonexistent or facing enormous resistance from the government.

*While your day to day life may be tied to South Africa, your investments needn't – and arguably shouldn't – be.*



*Two decades of rising corruption and mismanagement have decimated the local economy to a previously unimaginable extent.*

More concerning, it is our view that these factors are deteriorating. India, for example, also falls short on many of these factors, although it's starting point was lower than South Africa, and there is no denying that India is moving in a far more positive direction than South Africa.

Politically, the situation remains dire. The current President, although a vast improvement on his predecessor, leads a party that has presided over the striking economic and fiscal decline of the past 20 odd years. It is telling to us that Ramaphosa's election in December 2017 has not in any way altered the trajectory set under the Zuma regime – even prior to the COVID outbreak. Corruption remains unprosecuted, unemployment over 30%, bond yields have risen sharply and the currency has weakened. Efforts by the finance minister to shore up the fiscus have been politically stymied.

Corruption is rampant. Each healthy industry or essential economic activity is being undermined – sometimes almost to the point of extinction – by the sheer weight of opportunistic elements attempting to exact rents from it. There is reasonable suspicion that initiatives such as a 'new' state airline, a national health insurance program and a state bank are all seedbeds to enable further rent seeking behavior, continuing a culture of corruption that is now firmly entrenched in the country.

In the recent past, these descriptions of corruption may have raised eyebrows as being dramatic. Now, it's simply an accepted facet of the SA political landscape. We can draw parallels to the 2014 - 2019 "Lava Jato" of "Operation Car Wash" corruption scandal in Brazil (more on this [here](#)), which led us to similar conclusions at the time, although we note that the corruption there was of much smaller scale, and the desire by the government to restore credibility to Brazil was far greater.

One of the first things we as global investors look for in a country (before we allocate capital to it) is respect for the rule of law and respect for the rights of property owners. On both these fronts, we do not see the kind of commitment we'd expect (hope for) from the SA government. On the contrary, due to a hollowed out national prosecuting authority, the government seems incapable of enforcing the rule of law towards those accused gross government negligence. It furthermore remains committed to its policy of land expropriation without compensation.

Add to this high crime rates, poor labour relations and weak macroeconomic policy initiatives, it would appear SA is simply not an investor-friendly environment. As such, we find it difficult to ascertain whether South Africa fulfills our basic investment considerations.

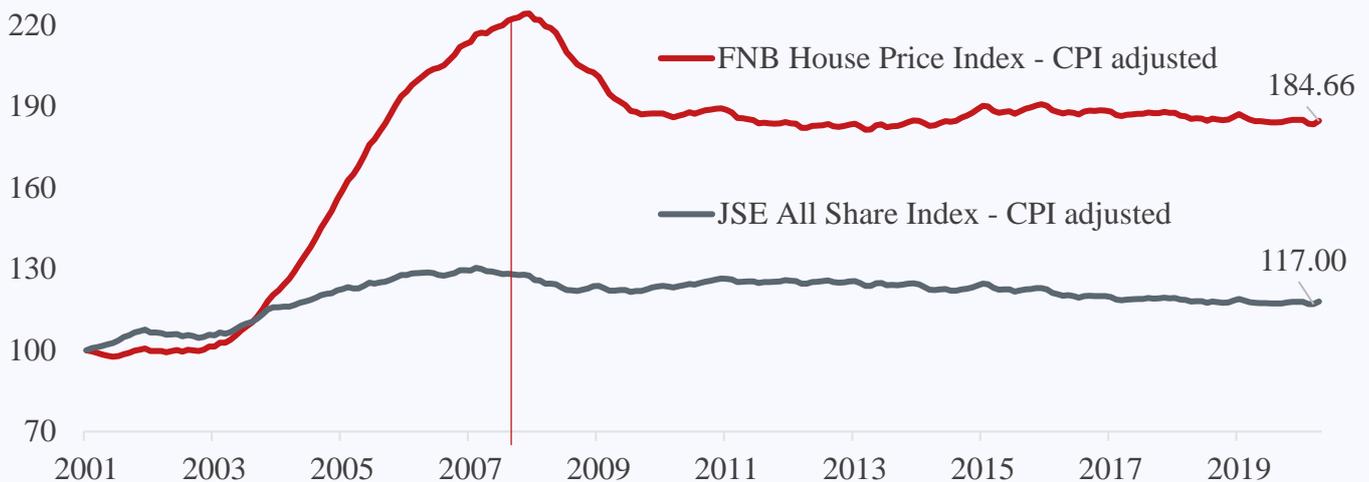
Clearly, the current state of affairs is worrying and South Africa's decline has not gone unnoticed by the global community. In the World Bank 'ease of doing business' ranking South Africa placed 84 in 2019 versus 34 in 2010 (we note India, famous for red tape, is placed 63). Worryingly, on 'enforcing contracts', South Africa has fallen to 102 versus 85 in 2010. It is telling that emerging markets specialists Tera Nova, after spending a month in South Africa earlier this year, provided one of the bleakest summaries that we have read on any emerging market:

[A month in South Africa: The road to nowhere.](#)



Global investor concern can perhaps be viewed as being overly negative. However, the values of most South Africans' major assets, being their homes and their share portfolios, have experienced real decline. As the chart below shows, the FNB house price index, when adjusted for inflation, is down 7.5% since 31 December 2007. The level of the JSE All Share is also 18% lower than it was in real terms on 31 December 2007. An index which excluded Naspers and Prosus would have performed far worse.

Chart 2: the ALSI and the FNB Property Index in real terms since 2001



*Beyond a cyclical recovery that will undoubtedly occur, the long-term outlook for the South African economy and its businesses is structurally negative.*

As global investors it is important that we take a balanced view of the opportunity set that all countries – including South Africa – provide us with. When conducting our analysis, we pay close attention to what elected officials are *doing* rather than what they are *saying*. This enables us to judge *action* rather than *rhetoric*.

In terms of action, South Africa has unfortunately done very little to address its major sociological and economic issues. Due in large part to the State's ineffectual management, implementation and oversight, little has been achieved in the areas of healthcare, education and infrastructure. The private construction industry has been decimated (partly due to the failure of the State to pay for work completed). Mining, a traditional large employer, is moving away from South Africa, not towards it. Education statistics continue to decline.

Even if action were to be taken, the tax rate on private citizens is one of the most onerous in the world<sup>2</sup>, and the large share of personal tax as a percentage of the total tax revenue means there is less headroom for government to allocate towards problematic sectors. This means growth initiatives need to be financed from existing budget allocations, or from debt. Currently, there is little room for fiscal maneuvering as debt servicing currently consumes 21 cents of every one rand raised in taxes. Interestingly, SA is the only country we study that presents deteriorating government finances as a 'revenue problem' as opposed to a cost problem (surely a budget has two elements, revenues and cost?).

<sup>2</sup> The Economist (11 January 2020) has pointed out that in general African countries find it difficult to raise taxes. In 2015 Nigeria collected less than 6% of GDP in tax. Tanzania, Ethiopia and Uganda all collected 13% or less of GDP and Kenya 17.5%. South Africa at that point was collecting a shade under 25% of (a far larger) GDP in tax. Interestingly, The Economist thought that the maximum potential figure for South Africa was 27% but in fact today's figure is between 28% and 30%.



In light of the above, we find it disturbing that besides minority interest groups that do their best keep the government honest through judicial review, the business community, as well as civil society, remain eerily silent to the ongoing decay. Equally strange is that the ruling party continues to receive widespread popular support in the polls.

We have read in the press how many local investors see South Africa as ‘cheap’ or ‘compelling’ and suggest that South African’s savings should contain a large allocation to the JSE. Our view is *firmly* the opposite: South Africa Inc. is cheap for very clear and readily apparent reasons, and beyond a cyclical recovery that will undoubtedly occur, the long-term outlook for the South African economy and its businesses is structurally negative.

While currently the ingredients for investing in South Africa are absent, we are of course on the lookout for analysis that changes our current narrative. As investors we aren’t rewarded for stating the obvious, but rather it is our job to understand rates of change. However, even listening to the latest budget speech one would think the current political leadership “came into power this morning” and found the country in this state, rather than having presided over its steady demise for the past 20 odd years. The recognition of deep-seated problems is a much needed first step towards their ultimate resolution.

Many books are waiting to be written on all that happened in South Africa over the past 10 years. We would rather read those books and perhaps be accused of not being optimistic or hopeful enough than invest our clients’ money here.

## Conclusion

We conclude with two dynamics that govern how we think about risk - and investing - in this uncertain time.

The first is the fact that Flagship employees and their families have a large proportion of their personal wealth invested in our various funds. This, together with our funds’ overriding investment objectives, forces us to think long-term, and also to view risk in a certain way. Risk management is not a hat we put on in times of crisis, it is a part of the way we value and select stocks, and how we construct portfolios from the bottom up.

The second is that investing is a journey of learning from experience. It’s up to us to accentuate our strengths and understand our blind spots. While we are currently going through a period of good performance, it is precisely now that we must be vigilant for blind spots in our asset allocation and stock selection to ensure we maintain the outperformance of our funds versus their benchmarks.

We seldom feel we know what the market will do in the near term. For now, we believe that conservative equity sizing across our funds, invested in a concentrated selection of stocks where the risk reward trade-off is asymmetric, is the best way to be positioned. Happily, we are not restricted in the manner in which we can achieve that positioning.

*Risk management is not a hat we put on in times of crisis, it is a part of the way we value and select stocks, and how we construct portfolios from the bottom up.*

## Zalando – the Fashion Platform of the Future



**Zalando ([www.zalando.com](http://www.zalando.com)) is the number one online apparel & footwear retailer in Europe with c.10% online market share.** It is a focused, pure-play online retailer which offers a one-stop fashion destination, including shoes, apparel and accessories, from over 2,000 global brands. Zalando's website attracts more than 4.2 billion visits per annum and as of Q1 2020 it had nearly 32 million customers in 17 European countries.

Zalando was founded in fall 2008, just days before the start of the financial crisis. In the early days, the small 7-man team worked from a shared apartment in Berlin which became a warehouse and office. The three founders' private cell phone numbers were the customer hotlines, and they took all the packages to the post office themselves. By offering free delivery and up to 100-day right of return, Zalando set new standards in online retail and grew quickly.

Today, Zalando is the European online leader, generating €6.5 billion in revenue and employing over 14,000 people. It is still headed by founders Robert Gentz, David Schneider and Rubin Ritter. Customer service has since been moved to a dedicated team, as has package delivery.

Rather than set its sights on becoming a large online retailer, Zalando's vision is to become the starting point for fashion related decision-making, sourcing, goods and services. This means doing more than just buying and reselling clothes: it means being the platform through which you find inspiration, compare and contrast, search, engage and shop. The analogy is akin to the role that Spotify and Netflix play in the consumption of music and visual content respectively.



Zalando's vision is to be a shopping platform, on which selling its clothes is the primary service supported by brands that operate their own 'shop within a shop' on the platform. It further seeks to provide data, marketing and order fulfilment support to these brands. In this sense its vision is akin to being an "online shopping mall" with added delivery and intel services to the shop owners, rather than, for example, to be a Zara or an H&M.

### Why do we like it?

Regular readers will know that we invest in businesses that exhibit high quality. In general, we look for businesses that have the following attributes.

- A capital light, scalable business model in a large addressable market
- Enduring competitive advantages that are regularly invested in
- Structural growth opportunities (as opposed to economic and market cycle growth only)
- A strong balance sheet and incentivized management

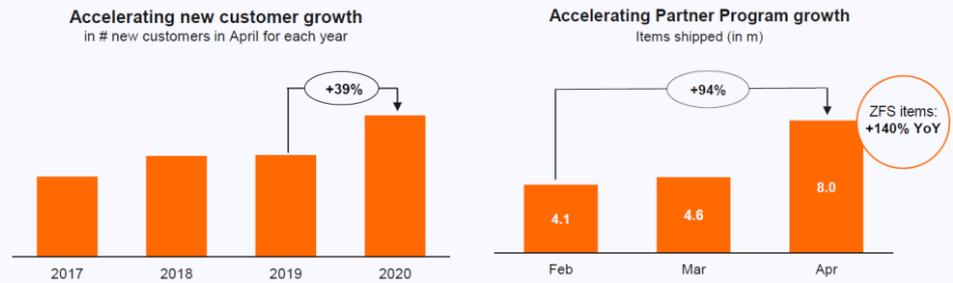
To find all these attributes in one company, and then to find this company at a good price, is rare. Zalando ticks all of these boxes.

### A large addressable market with structural growth

Euromonitor forecasts the overall European fashion market to reach €450 billion over the next 5 years. Within this, we believe Zalando stands to capture c. €20 billion of merchandise sales versus its current €8.2 billion. Should it reach €20 billion, there still remains much to play for.

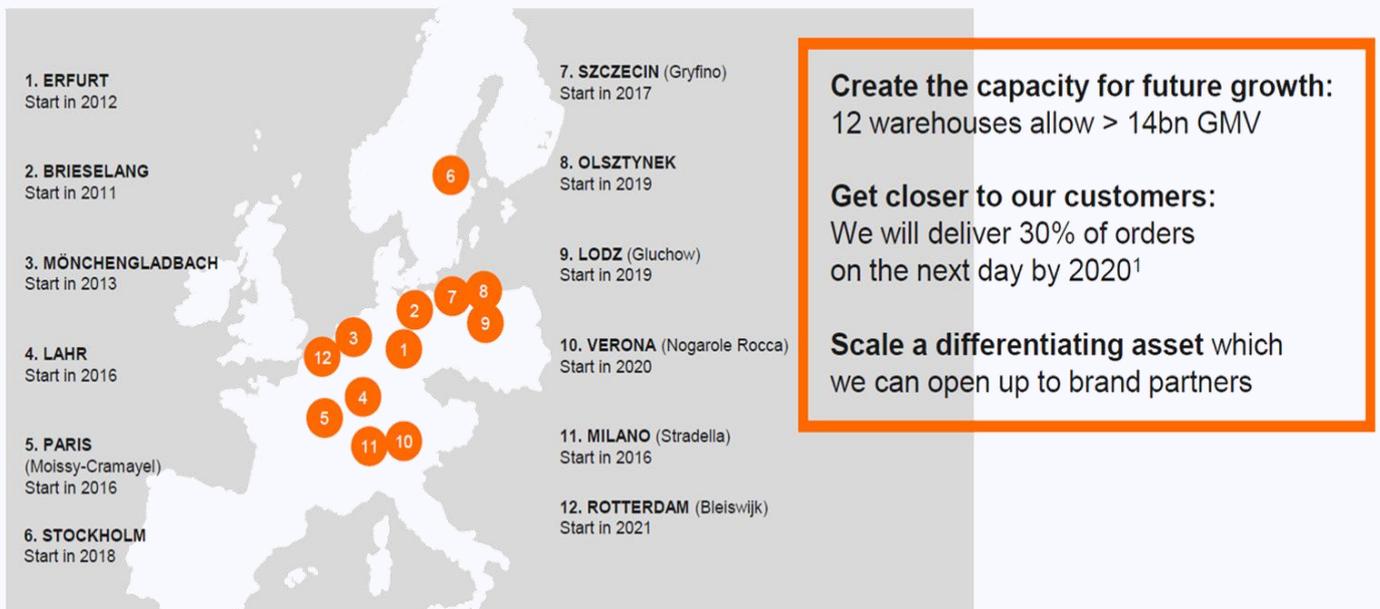
Structural growth exists as Zalando competes primarily online, while the vast bulk of its peers compete primarily offline (and are attempting to move online). Within the total apparel market, the share of online continues to grow, providing outsized benefits to a first mover like Zalando. Furthermore, with more customers on its app, it is easier for Zalando to attract other retailers onto the platform, in a virtuous circle.

The charts below are evidence of the success of its digital strategy over the past 5 years:



### An enduring competitive advantage of size and network effects

Similar to Amazon (another fund holding), Zalando’s business model required large upfront capital expenditures in warehousing, logistics and technology. These investments were so large that for many years Zalando never turned a profit. However, the capacity created by these investments, as well as the upfront customer acquisition spend, are the reason for the company’s dominance today. While the investment was ‘capital heavy’, it now allows the business to be ‘capital light’ as many of the growth drivers, from here, require little incremental capital. The extent of Zalando’s warehouse network throughout Europe is notable:



### Scalability benefit of being a multi-brand platform

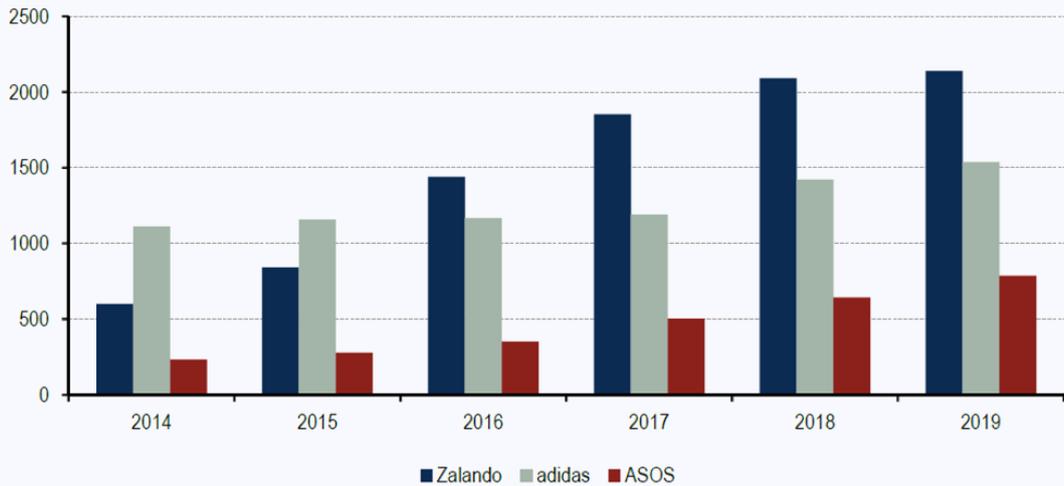
Even those few brands that have well invested e-commerce offerings are disadvantaged compared to multi-brand platforms. Because of Zalando’s breadth of offering, it experiences higher conversion rates than brands, i.e., you are more likely to find what you want. Higher conversion rates mean that Zalando can invest more aggressively in driving traffic. Zalando operates with more than 2,500 brands, the vast majority of which do not have this power to generate enough direct organic traffic.



## A moat that is invested in

From Zalando's genesis it has been a technology company, not a retailer. Put differently, Zalando is a technology business with a retail front end interface for customers. Zalando has invested in technology systems and staff that many retailers simply cannot afford to replicate. Even big brands with developed technology platforms (such as Adidas) have far fewer employees in technology than Zalando.

Chart 1: Zalando has well over 2,000 employees in technology



## Strong Balance Sheet

Zalando sits with nearly €1 billion of cash on the balance sheet and very little debt. This allows it the financial wherewithal to withstand shocks (as it has in the recent downturn) as well as fund its various opportunities.

## Value: what will be, not what is

The key to our thesis is the fact that Zalando is going to look very different in 10 years' time. We expect Zalando to successfully shift from an inventory-carrying wholesale model to a scalable, asset-light, commission-earning platform with lucrative fulfilment services and marketing revenue streams that are offered as add-ons to its platform partners ("the stores").

The new platform business will be 1) more scalable, 2) exhibit lower risk and more resilience, 3) contain less inventory exposure and 4) profit from a lucrative services component. This forms the valuable part of the investment case: higher profitability due to the mix of businesses. We explain this further below.



When Zalando sells something on a wholesale basis it books the full amount as a sale with an offset to “Cost of Goods sold”, however, when it sells something on a platform basis it only books the commission it earns as revenue and there is no offsetting “Cost of Goods Sold”. Despite platform Gross Merchandise Value (GMV) resulting in far less revenue being booked it generates similar operating profit (EBIT) per unit of GMV which results in higher reported EBIT margins for the company as a whole.

While precisely forecasting LT margins is challenging, we have conviction that Zalando has the necessary tools to drive material margin expansion, namely: scale, technology, infrastructure and data.

Table 1: The Zalando Business Model of the future

Zalando Target Business Model		Wholesale Business		Platform Business Model			Total Platform	Total Zalando
				Partner Program	Financial Services	Marketing Services		
Gross Merchandise Value	EURm	12,000	+	8,000	0	0	8,000	= 20,000
Commission / take rate	%	83%		15%	15%	3%		
<b>Revenue</b>	<b>EURm</b>	<b>10,000</b>	<b>+</b>	<b>1,200</b>	<b>900</b>	<b>600</b>	<b>2,700</b>	<b>= 12,700</b>
Gross margin	%	45%		80%	9%	90%	59%	48%
Gross Profit	EURm	4,500	+	960	81	540	1,581	= 6,081
Operating Expenditures		36%		58%	5%	35%		
Fulfillment		28%		25%				
Marketing		4%		30%	2%			
Admin		4%		3%	3%			
<b>EBIT</b>		<b>900</b>	<b>+</b>	<b>264</b>	<b>36</b>	<b>330</b>	<b>630</b>	<b>= 1,530</b>
EBIT Margin		9%		22%	4%	55%	23%	12%

## Summary

Opportunities like Zalando don’t appear overnight. Often our views on our investee companies are built by detailed interactions with the company, it’s investors and its peers. For Zalando in particular, we have been following the company since before it listed in 2011, have met with both Zalando management as well as the two founding investors (Kinnevik and Rocket Internet) on multiple occasions, and studied their peers (ASOS, Boohoo, GFG) extensively.

We are often asked what our ‘edge’ is when we value companies. We don’t have a large research team. We use public information. Our models can’t forecast the near future better than others. The answer differs per investment case, but one thread is the willingness to think long-term, and applying one’s mind to whether the full value of the changes that a business is going through are reflected in the share price. In Zalando’s case, we believe they are not.



## **In conclusion**

For many of you, we are the caretakers of a large portion of your global investments. We would like to use this opportunity to thank you for the trust you place in us, and emphasize how deeply committed we are to the responsibility you have placed in our hands. Despite the uncertainty that the next months will bring, we remain confident that we can achieve the objectives of all our funds and help you navigate through this difficult period.

Please contact the team if you have queries regarding your investment in Flagship, or if you would like to speak to one of the portfolio managers. Our (Zoom) ‘door’ is open. We thank you for your continued support.

*Regards,*

Pieter Hundersmarck and Kyle Wales



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