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The Elevator Pitch

Zooplus (ETR: ZO1, Price: €122) is the leading online retailer of pet food and supplies in Europe. Generally, in a commoditized market such as selling pet food, the lowest cost provider with the best customer service has the "right to win". We believe that Zooplus will be this winner, given its structural cost advantage versus its competitors (which we explore below). Additionally, customer satisfaction is extremely high, and we can clearly see customers' appreciation for the company's value proposition, as evidenced by the 94% sales retention rate. These unbeatable low prices and high customer satisfaction have led to a 31% annualized sales growth rate since 2010, while still possessing a long runway for continued expansion.

We believe the market is underestimating the long-term earnings power of the firm and consequently significantly undervaluing the company. For instance, the stock is currently trading at 0.9x 2016 sales while comparable acquisitions have taken place at 2 – 6x multiples. Additionally, we believe at maturity, the business will have normalized operating margins of 8 - 10%, implying a valuation of ~10x normalized EBIT.

This is extremely cheap for a dominant company with 50% market share in its category, a clear and growing advantage versus competitors, and profitable growth of 20 - 25% per year going forward. As the business grows, this will only increase its competitive advantage due to economies of scale, resulting in lower cost of goods and shipping costs per order. It is hard to put a static price target on a company growing its value so quickly. However, if these factors play out, we believe the company will compound its intrinsic value and earnings power at a rate similar to its top-line growth going forward, resulting in a **return of ~19 - 22% per year** (with the added possibility of multiple expansion too).

Exhibit 1: Zooplus (ETR: ZO1) Stock Chart
Since May 2008 IPO

Source: Google Finance

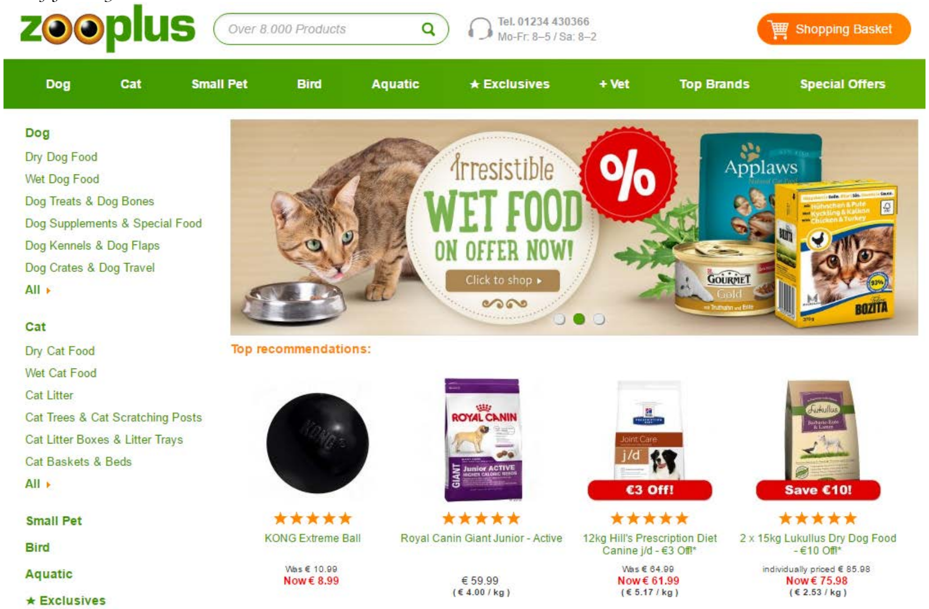
The Business

Zooplus is currently the third largest pet food and supplies retailer in Europe (#1 online), and is on track to be the largest within the next three years. Close to ~90% of its business is focused on dogs and cats supplies, and ~80% of the business is comprised solely of pet food. Interestingly, the lucrative food segment is also the fastest growing at 32% y/y.

Pet food sales are highly recurring in nature since pet foods are a necessary purchase for pet owners (if you don't want Fido to starve!). The leading sales driver of pet food is low price. Additionally, pet food has a long expiration period, which means that pet owners have an incentive to buy in bulk for lower prices.

Exhibit 2: Zooplus.com Home Page

As of January 6, 2017



Source: Zooplus.com

In traditional brick and mortar stores, however, it is difficult for consumers to buy in large bulk since they have to physically carry these 30lb bags of food home. Moreover, Europeans live in dense and urban cities where they use public transportation. The nature of European geography makes it even more difficult for pet food buyers to carry heavy items home from stores.

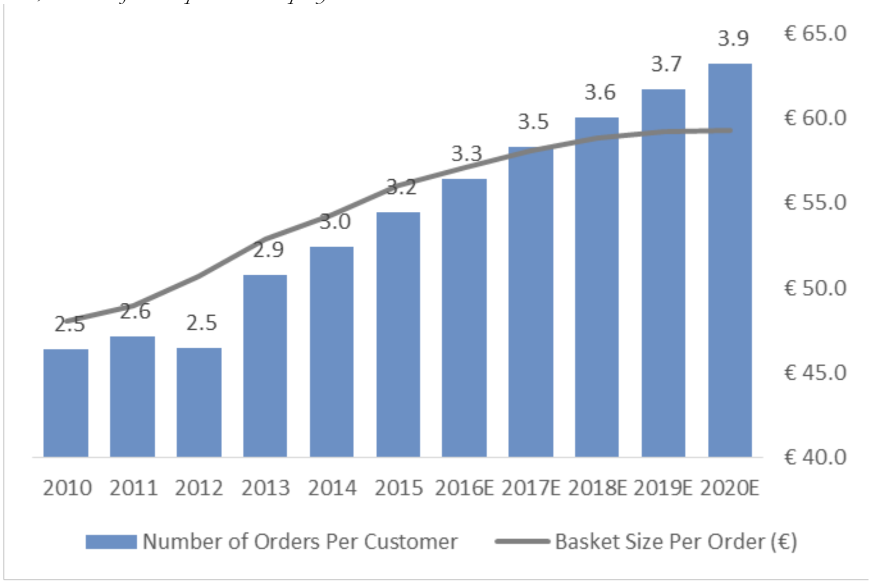
Zooplus and other online competitors solve this issue by shipping the product directly to the customer's door. Over the last few years, customers have clearly found this service valuable, as they have not only been ordering more times per year (4.7% CAGR), but also buying in larger quantities each time that they order (7.9% CAGR).

Exhibit 3: Zooplus Market Share

In €, as of 2015

Source: Euromonitor; Company Data (Q3 2016 Earnings Presentation)

Exhibit 4: Orders per Customer vs. Basket Size per Order
In €, number of orders per customer per year



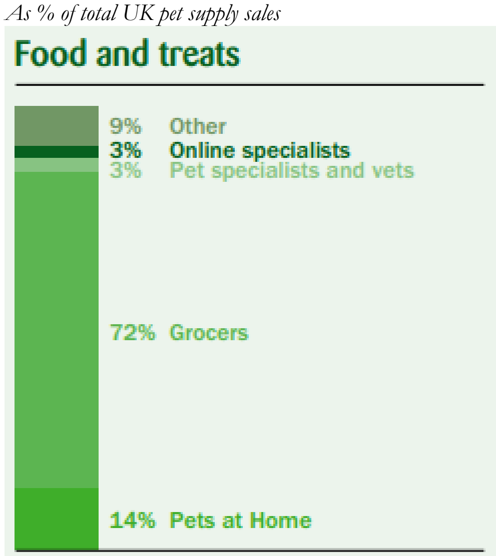
Source: Hayden Capital; Company Data

The Competition

Brick & Mortar

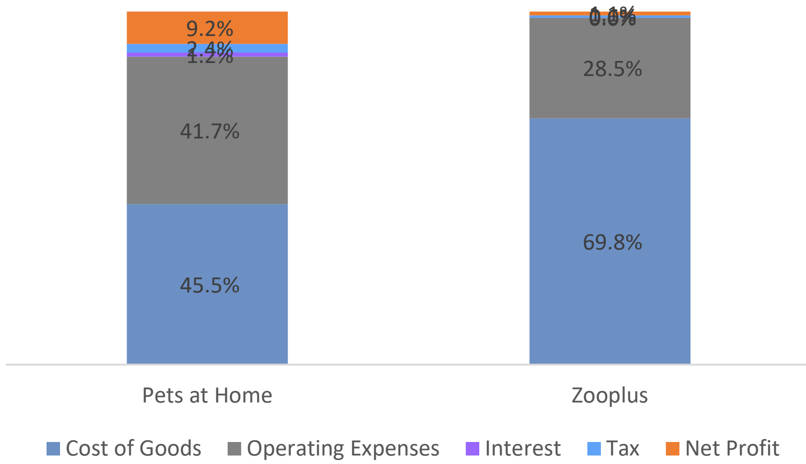
Currently within the pet food industry, the bulk of purchases are still made at old-fashioned brick & mortar stores. This segment is primarily comprised of supermarkets / grocery stores and specialty pet stores. The largest retailers are Fressnapf (Sales: €1.5BN) and Pets at Home (LON: PETS; Sales: €1.0BN), both traditional European specialty pet stores. Within certain markets, for example the United Kingdom, grocery stores dominate the market.

Exhibit 5: UK Market Share Breakdown
As % of total UK pet supply sales



Source: Pets at Home (2016 Annual Report)

Exhibit 6: Brick & Mortar Margin Profile
As % of sales



Source: Hayden Capital; Company Data

Generally, larger companies have more negotiating power with suppliers to bring down the cost of goods (COGS). Currently, Zooplus is slightly behind the product procurement scale of Fressnapf and Pets at Home. However, brick and mortar stores carry a high fixed cost (rents, in store personnel, etc.), needing to sell their products at higher gross margins than online stores. The structural cost advantage of Zooplus as an e-commerce retailer more than makes up for the higher COGS over its brick and mortar competitors (as illustrated by Pets at Home). For example, we can see Zooplus's operating expense margin is 13% lower than that of Pets at Home.

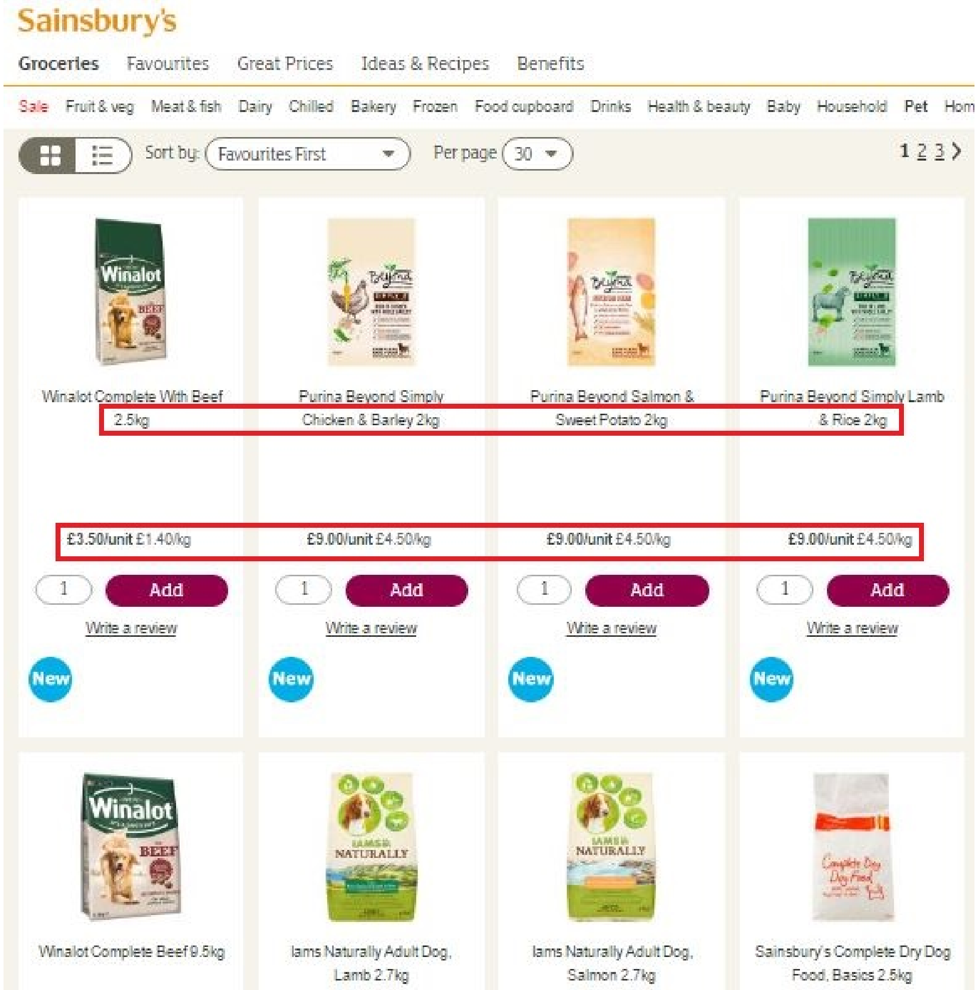
As a result, Zooplus is able to price on average 5% below the price of similar products of brick and mortar, and even cheaper for private label good (see Exhibit 11).

The nature of Zooplus as an online retailer also gives it an advantage, as customer tend to spend more per order, as they can purchase larger quantities online than in-store. The example illustrated below shows the best selling products at Sainsbury (a leading grocer in the UK). This segment is important as grocers have up to 72% of the market in countries such as the UK. The price per kg for nationally branded products are ~GBP 3.5-4.5kg, which is comparable or slightly more expensive than Zooplus. However, more importantly, we can see the top products are all of small size, at only ~2kg (vs. Zooplus' typical 15kg).

We believe this is evidence of the broader inconvenience of brick & mortar (not just unique to Sainsbury), and the hassle of transporting large bulky bags of pet food home from the store. Since prices are similar or even cheaper, we believe that over time customers will discover and gravitate to the convenience of online delivery, thus providing a natural tail-wind to the sector.

Exhibit 7: Sainsbury's Top Dog Food Sellers

As January 4, 2017



Source: www.sainsburys.co.uk/

Online

On the online side, Zooplus is by far the largest player with 50% of the market share across Europe. We estimate Amazon is the second largest, at ~20% market share[1]. The rest of the online pet supply market is extremely fragmented, and split among over ten other regional players.

Brick and mortar has started establishing an online presence also, but it's still not a big focus for them, and thus not as large of a risk. Additionally, many of the specialty pet store (such as Fressnapf) price their goods *higher* in-store than on their websites.

Additionally, the United States is a good case study – where Petsmart and Petco both have online presences, and yet haven't been successful in taking share away from Chewy.com's dominant 51% position (including

[1] We have heard from industry sources that Amazon is estimated to be "slightly over one-third" the size of Zooplus in the pet food and supplies category. Zooplus also stated on its Q2 2015 call that Amazon is the second-largest competitor in the category.

Additionally, management stated on the Q4 2015 earnings call, "…it's particularly difficult to find out how they do in sales in a specific category but from supplier talks, we have indication that their share of the market is substantially smaller than the share of Zooplus. Given the fact that Amazon grows as a company slower than we do, and they add categories, it's fairly safe to assume that the long term trajectory of growth in our category will be below our level."

subscription). By comparison, Amazon only has 35% market share in the US, while Petsmart and Petco for all their brand value only have 2% and 3% respectively[2]. We believe the European market will play out very similarly.

Exhibit 8: Pet Food Online Market Share in United States
As % of total online pet food sales

Source: www.petfoodindustry.com

Similar to Wal-mart vs. Amazon in the United States, we believe the European brick & mortar players are too late to the game. Zooplus, founded in 1999, has already had a 17 year head start in gaining scale. Furthermore, despite a strong network of physical stores, we suspect logistics will still be an issue for the brick & mortar retailers. Establishing a logistics network is difficult and expensive. Last mile is the most expensive portion of shipping costs, and the logistics network that traditional retailers have is geared towards getting hundreds of units of the same SKU to stores at the cheapest price. Getting just one unit to an individual's doorstep, without the benefit of sharing the last mile delivery expense with other items, requires another logistics capability entirely.

For example, it's likely this was the case with Wal-mart's decision to acquire Jet.com in the US. Wal-mart has a strong physical network of stores, with many located within a 20 minute drive to their customers. However, their decision to purchase Jet.com was still partly based on the logistics expertise that Wal-mart lacked, in getting products directly to the customer's doors. This, combined with Jet.com's scale contribution and online traffic, are why Wal-mart paid at least 6x sales ($3BN on less than $500M in sales) for this acquisition[3].

> *"It's a relatively low-margin industry, so you can't have loss and you can't have damage. One of our biggest challenges as we move forward is how we get physical volumes if we want to double and triple in size. It's all about setting up our warehouse, distribution and logistics to handle that kind of volume… [regionalizing distribution centers is] the only way if you want to make money outside your home state."*
> *– Michael Frizell, Founder of Australia's Pet Circle*

[4]

[2] Petfoodindustry.com; "Infographic: Top 10 pet food brands, websites for online sales"; April 28, 2016 (LINK)

[3] Recode.net; "Walmart is buying Jet.com for $3 billion"; August 7, 2016 (LINK)

[4] Intheblack.com; "The $8 billion business battle over your pets"; April 1, 2016 (LINK)

In sum, it's all about logistics. Logistics costs (getting an item to the customer's door) makes up 20% of an average order's total price, which is the largest line item of all the expenses. Those who can ship at the cheapest price per order is likely to have a structural cost advantage versus competitors.

Given that Zooplus is the largest of the online competitors and their scale offers distribution efficiency that smaller players don't have, it's logical to estimate that the smaller private online start-up costs (such as Fetch, Zoofast, etc.) are much higher. This is where Zooplus' dominant 50% online market share gives them a significant leg up over competitors, as their natural cost advantage gives them the ability to provide the lowest price. Due to the commoditized nature of the product, this is a "winner take all" industry, where the company that can offer the lowest prices wins.

The Thesis

The thesis for Zooplus can be summarized as:

Growing Revenues

Low prices and great customer service will allow Zooplus to retain a high percentage of its exisitng customers. This allows Zooplus to...

Launch More Distribution Centers

Revenue growth will lead to justifying the cost of launching more distribution centers in more countries, and meeting the +€100M threshold per country served. The DC densification effort will lead to...

Margin Improvement

Lower logistics and shipping costs will result in expanding margins. The company indicates a ~5% increase in margins for countries with a dedicated distribution center (for example, the mature German market has 15% logistics cost vs. overall company 20% cost). When this occurs, the company will...

Achieve Normalized Operating Margins of ~9% At Maturity

This is comprised of 4% operating margins under current logistics structure (higher than currently reported margins, due to a higher mix of returning customers at maturity) + 5% logistics savings. Note that for conservativism, this does not include an assumption for gross margin improvement at industry maturity (despite smaller competitors likely being squeezed out of the industry at maturity, which allows room for pricing increases). At this normalized margin, it implies...

Zooplus is Undervalued, Trading at Only 10x Normalized EBIT

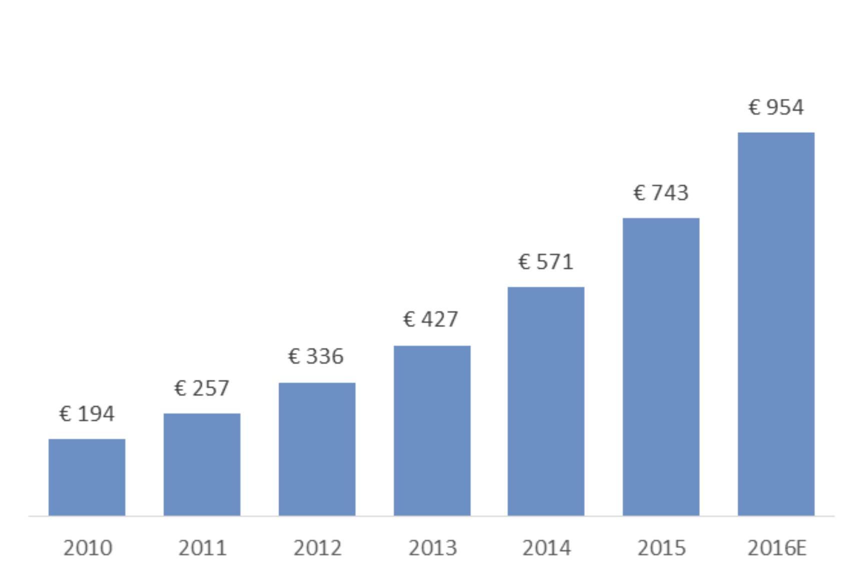
We believe this is extremely cheap for a company that is still growing 20-25% per year, which when factored with the overall pet care ecommerce industry growing ~15% per year, gives it a long runway for continued growth.

Sales Growth

In order to achieve the margin levels we project, the first step will require Zooplus to continue growing and densifying their customer base across Europe.

Since 2010, Zooplus has grown revenues at 30% per year. Over this time period, we estimate their market share has grown from <1% of the total European pet care industry to 3.6% today[5].

Exhibit 9: Historical Revenues
In €



Source: Hayden Capital; Company Data

While it's impossible to predict the company's exact future growth rate, we believe there is a great chance that the business will continue to take share and benefit from an industry tailwind. We estimate that over the medium term, the overall online channel will be able to capture ~16% of total industry sales (vs. 6.8% today). For Zooplus, these factors should translate into +22% revenue growth rates over the next several years.

Sales Growth Driver #1:
Online Industry Growth – Consumers Shifting from Offline to Online ("The Pie's Getting Bigger")

Since 2010, the overall online pet care industry has grown at 15.2% annually worldwide (vs. 2-3% for the overall industry), as consumers have shifted from offline to online[6]. Compared to other continents, Europe naturally has more favorable demographics for online shopping, due to the dense urban environment lending itself to more frequent use of public transportation and bicycles.

For instance, a 2010 study found that only ~57% of Europeans drove for their daily commutes, compared to 85% of Americans. Additionally for short errands (for instance, buying groceries or pet supplies), 70% of Europeans used a bicycle, foot or public transportation vs. only 30% of Americans[7]. This is crucial, as these

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[5] Zooplus indicates a 2011-15 industry CAGR of 2 - 3% in their Q3 2016 earnings presentation. At a 3% CAGR, this implies a €21BN market size in 2010 compared to Zooplus' €194M in sales.

[6] Petfoodindustry.com; "How Pet Owners Are Influencing Online Global Pet Food Sales"; August 1, 2016 (LINK)

[7] The Atlantic – City Lab.com; "9 Reasons the U.S. Ended Up So Much More Car-Dependent Than Europe; February 4, 2014 (LINK)

habits lend itself very favorably to an online business that ships heavy bulky items – no one wants to carry a 30lb bag of dog food on their bike every month, when they can have it delivered to their door for cheaper.

On top of this, there are signs that Europe is actually *under-penetrated* in online pet care sales, compared to other developed nations. For instance, despite the United States' "driving culture", surveys indicate that 19% of urban dog owners (12% of total dog owners) regularly had their dog food delivered to their home[8]. This is 2 – 3x the current market share of online pet food sales in Europe[9]. If Zooplus can match a penetration rate of ~16% in Europe in the medium-term, this equates to an annual revenue of ~€2.3BN, or 250% higher than its current revenues[10]. Based on the industry growth alone (assuming Zooplus doesn't take share), this still results in a 14% annual revenue growth rate. However, we believe Zooplus should grow *faster* than the overall industry, as they take market share.

Exhibit 10: Total Addressable Market

In €

Medium Term TAM	
Current Pet Care TAM	€ 25,000
x Current Online Mkt Share in Europe	6.8%
= European Online Pet Care Sales	1,700.0
x Industry Growth Rate	15.2%
x Number of Years	7
= Online Sales in Medium Term	€ 4,577
Current Pet Care TAM	25,000
x Pet Care Industry Overall Growth Rate	2.0%
x Number of Years	7
= Total Industry Sales in Medium Term	€ 28,717
Online Sales in Medium Term	4,577
/ Industry Sales in Medium Term	28,717
= Online Mkt Share of Total Industry	**15.9%**
memo: Zooplus Mkt Share of Online	*50.0%*
memo: Zooplus Sales in Medium Term	€ 2,289
memo: Zooplus Sales CAGR	*14.0%*

Source: Hayden Capital; Company Data

In the retail industry, the primary competitive advantages are price and customer service. And in a commoditized market, the company able to provide the lowest prices is going to capture a disproportionate chunk of the market. We believe this will be Zooplus. If you can get the same bag of dog food online for >5% cheaper than your local pet store or other online stores, without having to lug it back to your home, and with great customer service, why wouldn't you order from them?

[8] Petfoodindustry.com; "Online Pet food Sales: Still in Learning Mode"; June 14, 2016 (LINK)

[9] Assuming similar basket size and order frequency, between online and brick & mortar purchases.

[10] Given that Europe is denser than the United States, we use a blended rate between the US urban penetration rate (19%) and the US overall penetration rate (12%).

Sales Growth Driver #2:
Gaining Market Share – Via Lower Prices & Superior Customer Service ("Taking a Bigger Piece of a Growing Pie")

If we look at Zooplus' prices, it's clear that they are lower than its competitors (Exhibit 11) As previously described, they are able to save on costs vs. brick & mortar, since it doesn't need to pay for expensive store space in city centers, and doesn't require as many employees (store associates, cashiers, etc) to fulfill a given order. Compared to other online retailers, Zooplus' scale offers it a tremendous competitive advantage.

Considering that a regional logistics network and distribution centers are primarily fixed costs, being able to spread this fixed cost over a much larger order volume allows Zooplus to have much lower shipping costs per order versus other online competitors. Additionally, as the largest online player in Europe, they are also able to purchase its goods in bulk at cheaper prices (i.e. similar to shopping at Costco). These competitive advantages will only grow stronger and widen Zooplus' moat as the company grows larger.

An Illustrative Example:

Using very rough numbers, let's assume a distribution center costs €5M to set up in France. Currently, Zooplus does ~2.1M orders across France (€119M in sales / €56 per order). We estimate competitors (excl. Amazon) to be less than 1/5th the size of Zooplus, for ~425K orders per year. Using these rough numbers, this would equate to a €2.38 fulfillment cost for Zooplus vs. €11.76 for competitors. This is a difference of €9.38 – an amount that Zooplus can pass onto its customers in the form of lower prices. On an average of €56 per order, this equates to 14% in savings per order (if Amazon didn't use the distribution center for other items also). As the company grows the number of customers, this difference will only growth larger.

This is the power of economies of scale, and it's no wonder customers love Zooplus!

As shown below, Zooplus is able to pass on its cost savings, at an average price that is cheaper than both brick & mortar and other online retailers (note that the Fressnapf prices below are understated, as the company prices its in-store goods higher than online). Over the last few years, competitors have been engaging in a price war to defend their market share, which has resulted in gross margin erosion. However, Zooplus has successfully been able to grow despite this, and maintain its profitability by decreasing its operating expenses.

Lower prices hurt competitors more than it does Zooplus, and we believe that eventually competitors will reach a point at which they can no longer lower prices without taking a loss. In this environment, competitors who attempt to match Zooplus' prices would be forced to lose money on each sale. Eventually, we believe many of the smaller competitors will exit the industry at this point, with Zooplus emerging as the clear winner. With majority share and fewer competitors, the company will eventually be able to raise prices and expand margins[11].

[11] This is very similar to the strategy Wal-mart used versus competitors in the 1970's & 1980's, as well as Amazon over the last 20 years. The idea is to use your lower cost structure to your advantage, by lowering prices to a point where competitors are forced to lose money on each sale, and eventually quit. Afterwards with the market to yourself, the company is able to increase prices without competition.

Exhibit 11: Zooplus Prices vs. Pets at Home & Fressnapf
In €

United Kingdom

Pet Food	Pets at Home	Zooplus	Difference
Royal Canin Giant Adult - 15kg	€ 56.99	€ 52.99	(7.0)%
Royal Canin Vet Diet Dog - 14kg	69.99	69.99	-
Royal Canin Maxi Adult - 15kg	56.99	54.99	(3.5)%
Eukanuba Large Breed Mature - 15kg	53.74	47.99	(10.7)%

Average Price Difference	**(4.9)%**

Germany

Pet Food	Fressnapf	Zooplus	Difference
Royal Canin Maxi Adult - 15kg	€ 43.99	€ 43.99	-
Meradog Brocken - 12.5kg	16.99	13.51	(20.5)%
Happy Dog Sumpreme Africa - 12.5kg	59.99	59.99	-
Eukanuba Large Breed Adult - 15kg	37.99	37.99	-

Average Price Difference	**(2.2)%**

Source: Hayden Capital; Company Data

However, having the lowest prices isn't enough to keep customers coming back. In order to maintain its high retention rates, Zooplus must also provide great customer service and reliable delivery if they wish to grow the business. Currently, Zooplus takes a loss of -3% in the first year of a customer relationship, due to advertising costs and new customer promotions aimed at obtaining the relationship. It's not until the customer returns the second year that Zooplus makes +4% margins. As such, a high retention rate is not only indicative customer satisfaction, but is also crucial to the firm's profitability.

As the below charts show, Zooplus is fully aware of this and has been extraordinary at getting customers to come back to the site. For example, Zooplus has a very high 8.5 out of 10 on Trustpilot.com, versus Fressnapf at a comparable 8.5 and Pets At Home at a poor 2.7 (note correlation between low prices and high ratings). Additionally, the commonality among the reviews for Zooplus are the low prices, the speediness of delivery (usually ~2-3 days), and the excellent customer service if there are any issues.

Exhibit 12: Customer Satisfaction Ratings

As of January 3, 2017

Zooplus reviews

Great **8.5** from 0 - 10

1360 reviews on Trustpilot

Petsathome reviews

Bad **2.7** from 0 - 10

92 reviews on Trustpilot

Fressnapf reviews

Great **8.5** from 0 - 10

896 reviews on Trustpilot

Source: Trustpilot.com

Exhibit 13: Zooplus Customer Reviews

Most recent comments, as of January 6, 2017

Customer
8 reviews

Published 4 hours ago

Refreshingly easy

Easy process, great value for money, helpful phone service should you need it, efficient delivery, what's not to like?!

Ilona Davies
2 reviews

Published 22 hours ago

Savic Nestor Cat Litter Box in light green.

I've bought Savic Nestor Cat Litter Box in light green. My cat and I loved it!!)) it's a nice looking product which does the job, keeps mess and smell away. It was packed very good and arrived earlier than expected. Will definitely recommend this cat litter and the company.

Nikki Wragg
2 reviews

Published 34 hours ago

Glad I found these

I have placed a few orders now and always find the website easy, choice good and delivery is always reliable. My dogs love it !!

Last order had a few damaged items, food tubs, but this is probably the courier chucking the box around. All products still usable but just ashame that the resealable boxes are damaged.

Will definitely shop here again.

Barbara Heywood
2 reviews

Published 2 days ago

Super!

I ordered a large amount of dry dog food at a very good price, between Christmas and New Year; expecting to have to wait quite a long time for delivery but was informed that it would be two days later-faster than normal!
I was kept informed about what time slot to expect delivery to the hour and it was delivered exactly as I was told it would be. Super service from a super company!

Alan
2 reviews

Published 3 days ago
Updated 3 days ago

Really efficient customer service

After an initial disaster with delivery, which was not Zooplus' fault, the customer service team immediately sent me a new parcel out with an alternative delivery company which arrived in superfast time. The following week, my initial parcel finally arrived, so I received 2 packets of cat food for the price of one, which really made my, and my kittens', Christmas. Thank you Zooplus for your kindness, patience and generosity.
Alan

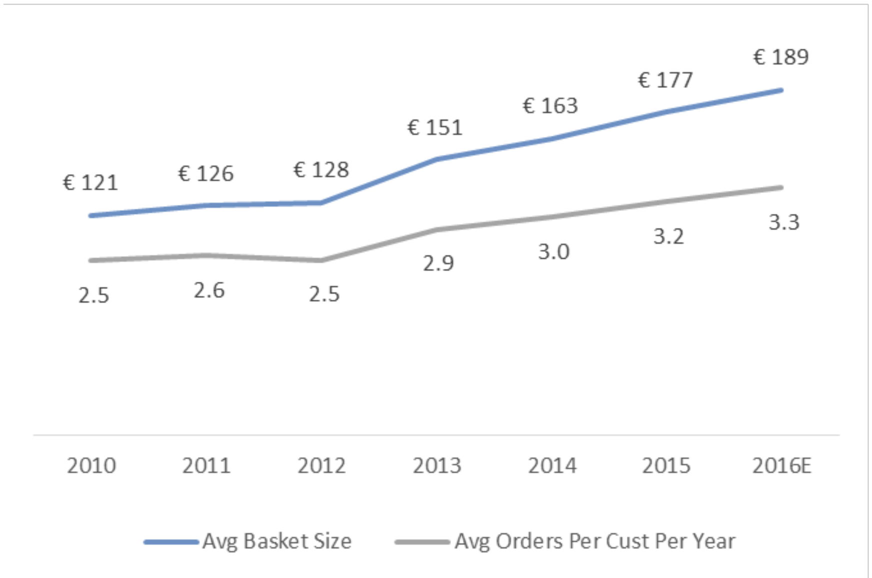
Source: Trustpilot.com

This high level of customer satisfaction can also been seen translating into the numbers. First, returns are only 2% of total orders - an extraordinarily low figure in the retail industry. Additionally, our analysis indicates that customer retention has steadily increased from 48% to 62% in just 6 years. Meanwhile, the average amount that a customer buys per order (basket size), has grown 8% per year, while the number of times a customer orders per year has grown 5% a year. Our analysis also indicates that repeat customers also spend ~34% more in the second year than the first. Combined, this has given the firm an eye-popping 94% overall sales retention rate!

Because of the high retention rate, Zooplus only needs to spend 1.5% of total sales in order to generate 30% sales growth. In absolute terms, this means the company only needs to spend €11M on direct marketing in order to increase sales by ~€200M, and generate a €7.5M earnings stream that renews at 94%. That's a return on marketing spend of almost 70% (€7.5M / €11M). This illustrates the power of Zooplus' cost advantage, and allows the saved marketing costs to be passed onto customers in the form of lower prices, thus perpetuating the flywheel.

Exhibit 14: Basket Size vs. Orders Per Year

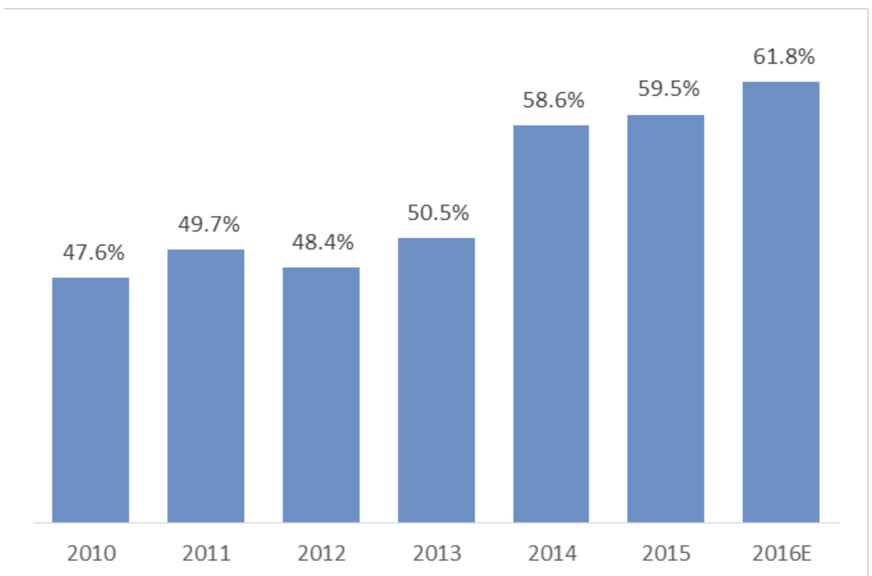
In €; Basket size is amount ordered in a year



Source: Hayden Capital; Company Data

Exhibit 15: Customer Retention Rate

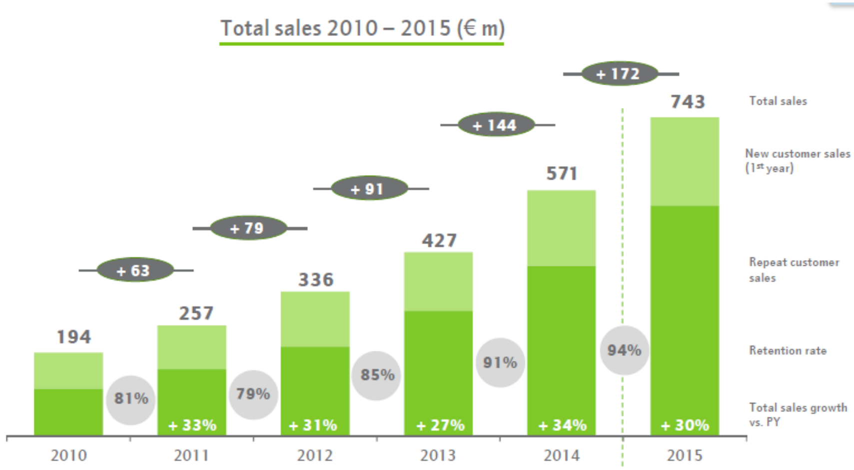
% of customers returning per year



Source: Hayden Capital; Company Data

Exhibit 16: Sales Retention Rate

% of sales retained per year



Source: Hayden Capital; Company Data

Exhibit 17: The Zooplus Flywheel

How Zooplus keeps its customers coming back

Source: Hayden Capital; Company Data

Due to low prices, superior customer service, and efficient marketing, we estimate Zooplus' sales engine will grow at 22% a year for the medium-term. Eventually the rate of growth will diminish as the company grows larger (it's only natural). However in the mean-time, management corroborates our high growth estimate, guiding towards "super linear" growth (higher yearly revenue increases on an absolute level) going forward. We believe that the industry tail-wind, combined with the previously discussed competitive advantages gives Zooplus a "right to win" and ability to take share, which will result in sales of €2.1BN by 2020.

> *"You can see that there is no S-curve in the making, in fact* ***it's super-linear growth****.*
> *And we* ***don't see any limits in the near-term future to keep up that speed of growth****."*
> *– Cornelius Patt, CEO of Zooplus (Q2 2016 Earnings Call)*

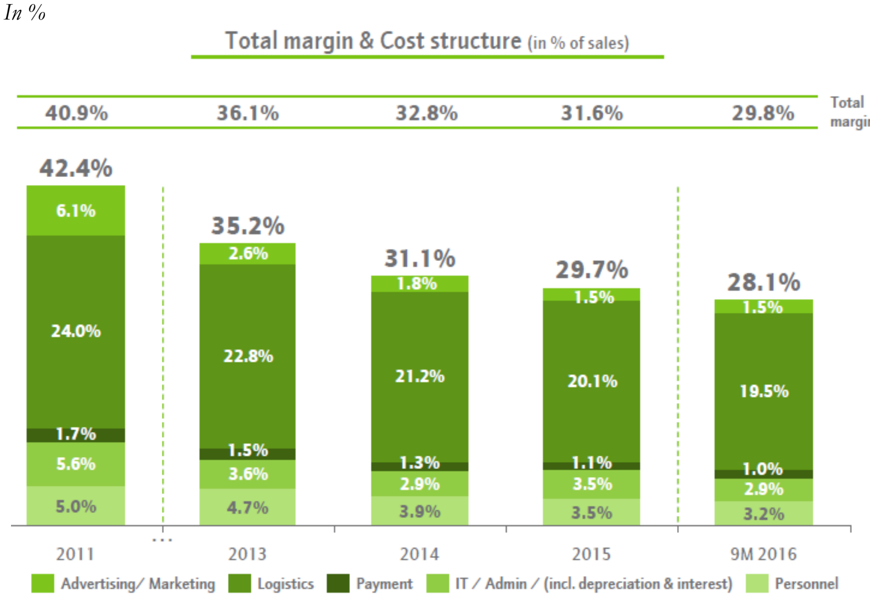
Margin Expansion

One of the most attractive aspect of this investment is that the faster sales grow, the quicker the margins expand. This is due to the operational leverage inherent in the business, and the ability to spread larger sales over a fixed logistics cost base. The bigger the company gets, the exponentially more profitable it's able to be.

Margin Expansion Driver #1:
Distribution Center Densification

Management has clearly indicated that when a given country reaches a threshold of €100M in sales, it would make sense to add a dedicated distribution center. Historically, these distribution centers ("DC") have saved ~5% of the cost structure compared to markets where goods need to be shipped from DC's nearby countries and across borders. Currently the company has 6 fulfillment centers, 4 of them added over the past 3 years.

Exhibit 18: Total Margin Structure
In %



Gross Margins have declined 11.1% since 2011 as competitors engage in a price war.

However, Operating Expenses Margins have fallen even faster (14.3%) over the same time period, as Zooplus grows more efficient due to scale.

This has allowed Zooplus counter the Gross Margin decline, and expand margins from a -1.5% loss in 2011 to +1.7% in 2016.

Source: Hayden Capital; Company Data

We can derive this ~5% margin benefit using a couple methods, and by estimating the impact of the 3 distribution centers launched between 2013-15.

Exhibit 19: Overall Logistics Savings
In €

Logistics Savings	
2013 Logistics Cost Margin	22.8%
- 2015 Logistics Cost Margin	20.1%
= Logistics Margin Savings	2.7%
x 2015 Overall Sales	711.3
= Logistics Savings	**€ 19.2**

Source: Hayden Capital; Company Data

For instance, if we use the company provided data in Exhibit 18, the logistics cost has decreased from 22.8% to 20.1% from 2013 – 2015. This equates to €19.2M in savings for 2015, due to the existence of these facilities. However, the 2.7% savings was at the overall company level, and is a blend between those countries with their own distribution center, and those that "borrow" from neighboring markets. In order to see how building a local distribution center within a particular country affects that country's margin structure, we'll next need to separate the two.

Exhibit 20: Dedicated Distribution Center Savings

In €

Distribution Center Location	Year Built	Sales Served	Est. Cost Savings
Horselgau, Germany	2000 / 2011	236	€ 12.4
Tilburg, the Netherlands	2009	84	€ 4.4
Wroclaw, Poland	2013	68	€ 3.6
Chalon-sur-Saone, France	2015	119	€ 6.3
Germany - France Border DC	2015	178	€ 9.4
Antwerp, Belgium	2016	84	€ 4.4

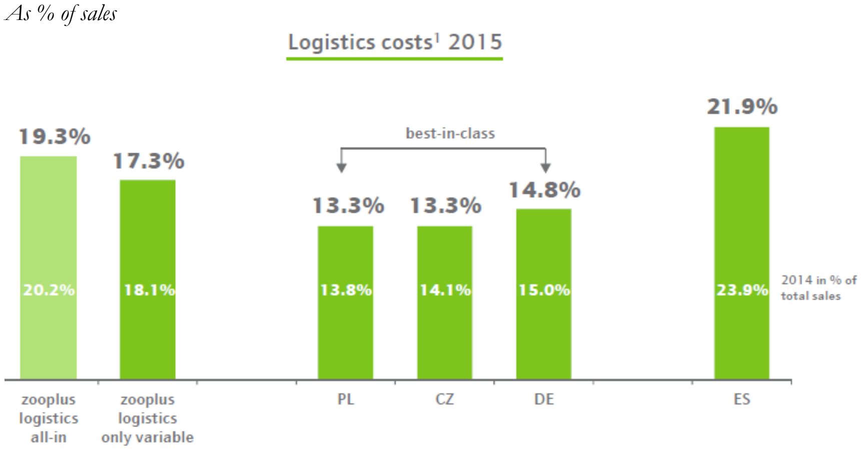
Total Cost Savings (2013-15)	€ 19.2
/ Sales Served	364.5
= Estimated Savings Due to Dedicated DC	**5.3%**

Source: Hayden Capital; Company Data

For the three DC's built between 2013-15 (Poland, France, Germany-France), we know the rough amount in sales that each facility serves. By reverse calculating the margin savings needed to achieve the €19.2M in savings, we can estimate how much a market's logistics costs go down by, when Zooplus launches a dedicated fulfillment center for that market. As shown above, we can calculate this figure to be ~5.3%.

Exhibit 21: Logistics Costs in Mature Markets

As % of sales



Source: Hayden Capital; Company Data

We are comfortable with that estimate, as in the Q4 2015 Earnings Presentation, management had indicated that Germany, it's most mature market, which has a dedicated DC, is able to achieve logistics costs of only 14.8%. This compares to the overall company cost of 19.3% (a 4.5% difference), which is a blend of both markets with and without DC's. This corroborates that the cost savings from launching a dedicated DC are quite substantial, and yield benefits of +5% margin accretion.

Equally interesting, it actually doesn't cost Zooplus all that much to launch each of these distribution centers. Zooplus partners with three logistics providers, who handle the operations of the fulfillment centers and provide the capital investment (capex) costs[12]. In return, Zooplus uses them on an exclusive basis for that region, with payment to the partners based on the level of volumes handled. Besides a couple million in

[12] The three logistics partners are Rhenus, De Rijke, and Katoen Natie (2016 Q3 Earnings Call)

inventory and technology costs, almost no addition capital is required from Zooplus, indicating a (very rough) estimated return on investment of +100% .

So why does management indicate a €100M sales threshold for a dedicated distribution center, if it only costs the company a couple million in inventory and technology? Although yet to be confirmed with the company, we hypothesize that it is because the logistics providers need to be able to make a minimum amount of revenues, before they agree to such a partnership. These logistics partners provide the real estate, warehouse, operational personnel, etc. All of these assets are provided for the sole benefit of Zooplus, so it's logical for them to require a minimum sales volume to justify this type of investment.

Exhibit 22: Unit Economics Of Logistics Partner

In €

Logistics Partners' DC Economics	
Overall Sales	€ 100.0
x Logistics Cost	19.5%
= Logistics Partners' Revenue	19.5
x Est. Op. Margin	9.5%
= Op. Income from Distro Center	**€ 1.9**
memo: Fedex's ROIC	*10.9%*
memo: Implied DC Capex	*€ 17.0*

Source: Hayden Capital; Company Data; Valueline

If we assume that Zooplus' 19.5% logistics cost is purely a pass-through to these logistics partners, this means that on €100M in sales the providers would make €19.5M in revenues. None of the providers are public; however we can use comparable public company margin profiles for a rough estimate. Using a blend of Fedex & UPS' operating margins as a rough proxy (6% and 13% respectively), this would imply that the logistics provider would only make €1.9M on the operation, even at €100M in total product sales. Assuming the partners have a similar ROIC profile to that of Fedex, it implies that they are committing ~€17M of their own capital to launch each distribution center (a great deal for Zooplus).

As a side note, it's very likely that the UK will be the next market that sees its own distribution center within the next year. Management has been giving hints at it, and this is a market that Zooplus still has a comparatively small market share at 1.6% (vs. 5.3% in Germany and 2.8% in France). Price competition has been intense, as the market is not as fragmented as say Germany's Mittelstand culture (LINK), and the UK big box supermarkets are a bigger threat. However, the cheapest prices will always remain king.

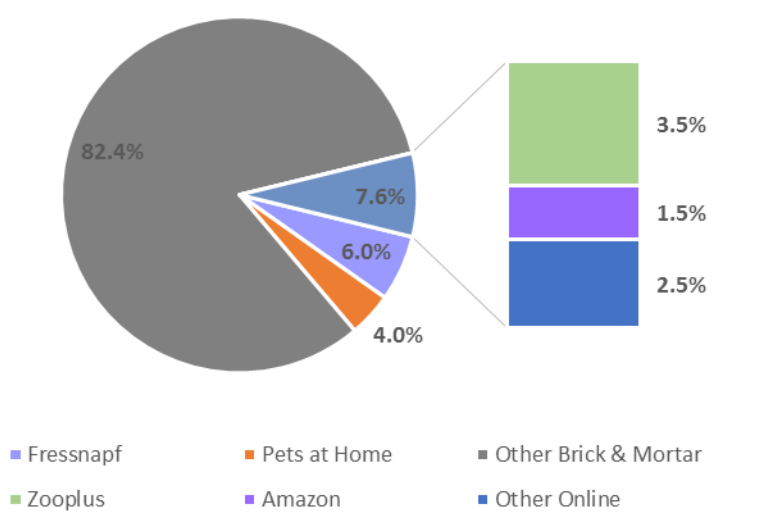
If Zooplus is successful in achieving the same ~5% savings by launching a dedicated DC in the UK, we predict that this will likely be passed directly onto the customer in the form of lower prices. If so, we expect Zooplus will see a disproportionate share gain in this industry. Even if Zooplus just gets to the company average of 3.4% share in the UK, this would add ~€80M to sales (8.8% of total revenues).

> *"I would say [in]* ***two to three years, as we double overall sales****… crucial markets like Italy, like Spain and also like the UK… will see the company making the threshold of €100 million. This is also again a ballpark figure that deviates market-by-market a little bit. But we see important large international markets making the threshold, allowing us to add new capacity in a very efficient way.*
>
> *And this is exactly why we push for growth, because… we haven't seen the end or the limit to cost optimization. And the nice thing is,* ***it's not only good for the cost structure, but also delivery speed and delivery satisfaction will increase****, as we are able to serve more and more of our customers out of local or nearby logistics installations."*
>
> *– Cornelius Patt, CEO of Zooplus (Q3 2016 Earnings Call)*

<u>Margin Expansion Driver #2:</u>
Greater Negotiating Power Over Suppliers

Beside lower logistics cost, increasing scale also has the added benefit of lowering the cost of goods. As Zooplus grows its order volume, the company will also benefit having more leverage over its suppliers, and thus be able to obtain its goods for cheaper. At an estimated 22% growth rate, the company will become the largest pet supplier in Europe within three years. We project cost of goods will benefit by several percent as this happens.

Exhibit 23: Pet Food Market Share
As % of total European market



Source: Hayden Capital; Company Data

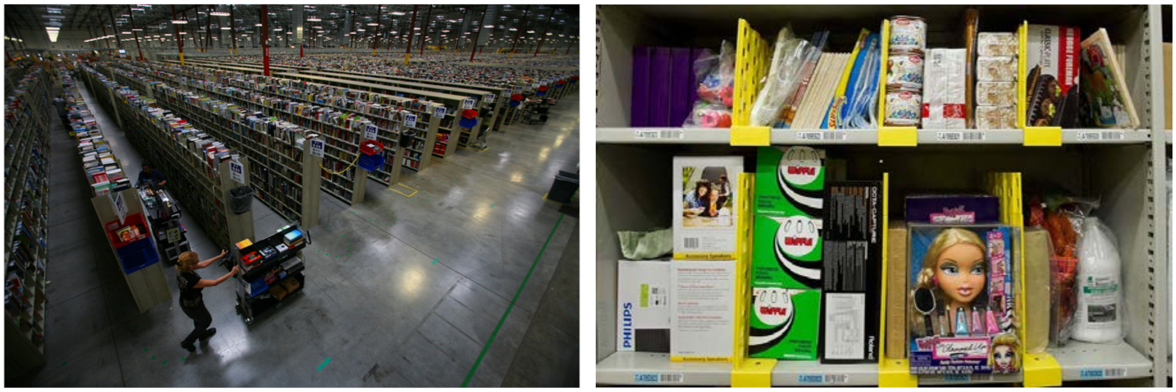
The Amazon Threat

As the second largest online retailer, and one with vast resources, it would be foolish to dismiss Amazon as a threat. However, there are a few factors that work in Zooplus' favor, that should keep Amazon at bay.

First, it's important to note that Amazon's distribution centers in Europe are not geared to handle the shipment of heavy, bulky items. The typical Amazon package is less than a cubic foot, and weighs less than 10lbs. On the other hand, Zooplus' typical order is over 30lbs and 4x as large. These are two drastically different package profiles, which require different types of distribution centers and layouts to manage the fulfillment process efficiently. For example, the aisles within the distribution centers must be wider to accommodate the larger items and machinery (i.e. fork lifts) to move them. Amazon's distribution centers look like libraries, with shelves notoriously cramped and stocked with unrelated items next to each other (see picture below). Zooplus' distribution centers look more like Costco, with wide aisles and neatly organized bags of pet food.

Exhibit 24: Amazon Distribution Centers

Amazon's cramped & disorganized shelves



Source: Google Images

Exhibit 25: Zooplus Distribution Center

In Chalon-sur Saone, France

Source: Zooplus 2015 Annual Report

Efficiency matters in this low margin industry. The simple fact is that the way Amazon's warehouses are not set up in most efficient manner for shipping pet food cost effectively. In order to reconfigure the warehouses for this business would require additional investment, which we suspect Amazon isn't willing to spend at this time.

First, it's very likely that Amazon is currently breaking even or barely making a profit in the pet food segment (as corroborated by Zooplus on the Q2 2015 earnings call). Given that opening a new dedicated warehouse requires a +€17M in set up costs (assuming Amazon chooses to continue launching its own DC's instead of partnering with a logistics provider, and for which Amazon would need several DC's in order to serve Europe), would it be worth Amazon's capital to invest into this business? Even we assume that if Amazon captures the other 50% market share that Zooplus doesn't have, that would still be only ~$1BN in sales today, or a drop in the bucket for Amazon and likely not worth their efforts.

Second, even this is a stretch, as evidenced by Amazon's market share in the United States, where it had a much better starting competitive position. Amazon bought Wag.com in 2011, the same year that Chewy.com was founded. Even though Amazon's business was founded at the same time, Chewy.com still managed to out compete Amazon with its vast resources, to take 51% of the market today.

If Amazon was unsuccessful competing in the US (likely because it was unwilling to invest aggressively in a different warehouse structure than what they already had with the core business), and was willing to give up the market, it's likely it will reach the same conclusion in Europe.

Additionally, if Amazon really wanted to invest into this vertical, wouldn't it make more sense to just buy out Zooplus instead? With shares trading at 0.9x sales, Zooplus is trading at a vast discount to the ~2x sales Amazon paid for Quidsi (Wag.com's parent)[13].

Other Risks

Besides the Amazon risk, there are a couple other scenarios that investors should be aware of. First, the CEO and co-founder, Cornelius Patt has been a visionary leader of the firm, and the loss of him would likely affect the trajectory of the business. However, its key to note that we don't anticipate Patt to leave anytime soon. Throughout the conference calls and discussions with analysts, it's clear that he is still excited by what the company can achieve and has indicated his plans for the next 10 years. This isn't a sign of someone who is willing to leave anytime soon. Additionally he helped found the company over 17 years ago, and himself and his family retain a large stake in the company of ~€40M.

There is always the possibility of Patt being forced to leave involuntarily by the board - however we view this as highly unlikely. Another co-founder and former CFO, Florian Seubert, started a private investment firm (Maxburg Beteiligungen) several years ago, and is now the largest shareholder at 14%. Additionally, Ruane, Cunniff & Goldfarb, a long-time investor since 2010, owns 10% of the company. It's unlikely these two large shareholders who control a fourth of the company would want Patt to leave.

Another risk is that the high headline multiple and low earnings (due to the company reinvesting into the business) may cause investors to disproportionately sell the stock in a market panic, as they place preference on near-term cash flows. While this is certainly a temporary quotational risk, we don't believe any such selling pressure would have an effect on the fundamental business. The company is profitable by this point, with future growth being entirely self-funded and there is no need to tap the capital markets (the company only has €2M in debt vs. €54M in cash). If the stock is sold off disproportionately in a market correction, we would be avid buyers.

Valuation

For a "compounder"-type of investment, such as Zooplus, it's tough to put a static price target on it. This is because if the thesis plays out, the company will continually grow more valuable year after year, as the online channel gains popularity over brick & mortar, and Zooplus takes share within the channel.

One way to estimate a valuation though is to see what the business would be worth at maturity (i.e. when Zooplus hits terminal penetration and can not grow faster than the industry anymore). Using other more mature online industries as rough comps, we conservatively estimate that the online pet food industry should be able to capture at least 20% of total industry sales at maturity.

Assuming that Zooplus grows its market share to 65% (the company is already at 50% and is growing 1.5x faster than the overall online industry), and realizes a normalized operating margin of 9% after its logistics network is built (returning customers have 4% margins today + 5% margin accretion from logistics savings),

[13] Techcrunch.com; "Amazon Buys A Lot of Diapers.com For $540 Million"; November 6, 2010 (LINK)

we estimate that the company will be worth €4.9BN. At the current online industry growth rate of 15.2%, it would take ~10 years to reach this state, resulting **a stock return of 19% per year**.

Exhibit 26: Zooplus Valuation at Maturity

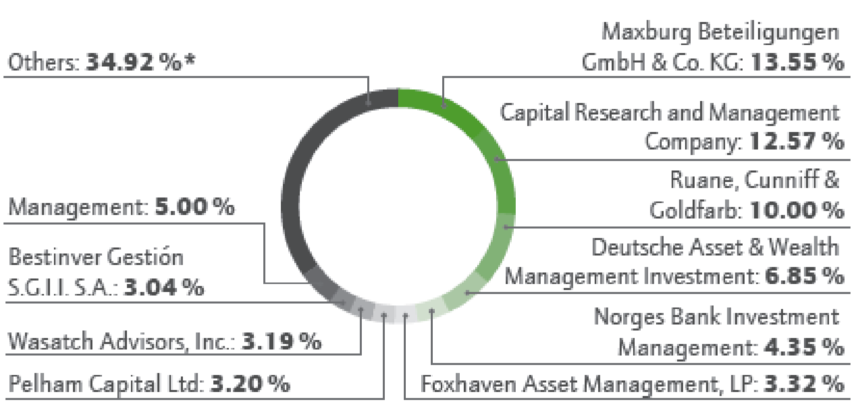
In € and millions

Valuation at Maturity					
Total Industry Sales	€ 33,647	€ 33,647	€ 33,647	€ 33,647	€ 33,647
x Online Market Share	10.0%	15.0%	20.0%	25.0%	30.0%
= Online Sales at Maturity	3,365	5,047	6,729	8,412	10,094
x ZO1 Mkt Share of Online	65.0%	65.0%	65.0%	65.0%	65.0%
= Zooplus Sales at Maturity	**€ 2,187**	**€ 3,281**	**€ 4,374**	**€ 5,468**	**€ 6,561**
x Normalized Op. Margin	9.0%	9.0%	9.0%	9.0%	9.0%
= Operating Income	**€ 197**	**€ 295**	**€ 394**	**€ 492**	**€ 590**
x Terminal Multiple	12.5x	12.5x	12.5x	12.5x	12.5x
= Enterprise Value	**€ 2,460**	**€ 3,691**	**€ 4,921**	**€ 6,151**	**€ 7,381**
memo: Upside / (Downside)	*185.8%*	*328.6%*	*471.5%*	*614.4%*	*757.3%*
memo: Years to reach maturity	*10.0*	*10.0*	*10.0*	*10.0*	*10.0*
memo: Stock CAGR	***11.1%***	***15.7%***	***19.0%***	***21.7%***	***24.0%***

Source: Hayden Capital; Company Data

Exhibit 27: Zooplus' Shareholder Base

As of November 2, 2016



Source: Q3 2016 Earnings Report

Exhibit 28: Management's Long-term Targets

The company's previously disclosed targets

Source: Zooplus' 2010 Annual Presentation & Q2 2013 Earnings Presentation

In the medium-term, we predict that Zooplus will be able to grow revenues at a 22% CAGR over the next five years, resulting in sales of €2.1BN by 2020. We believe the market is currently overlooking this opportunity, due to the artificially depressed margins, as the company reinvests its earnings power back into price investments and growth. As such, we believe the stock is currently extremely cheap, trading at 0.9x sales and 10x normalized operating income – especially for a company with no debt, which should grow sales 22% a year and operating income at close to 51%.

Our expectation is for the investment to provide a return at a rate similar to its fundamental growth over time, resulting in a **return of ~19 - 22% per year over the medium to long-term**.

Exhibit 29: Financial Projections

In € and millions

	2010	2011	2012	2013	2014	2015	2016E	2017E	2018E	2019E	2020E
Income Statement											
Sales	177.8	244.8	319.2	407.0	543.1	711.3	912.2	1,148.6	1,417.4	1,713.2	2,033.2
Other Income	15.8	12.3	16.3	19.9	27.8	31.3	42.2	51.7	63.8	77.1	91.5
Total Revenue	€ 193.6	€ 257.1	€ 335.6	€ 426.9	€ 570.9	€ 742.7	€ 954.4	€ 1,200.3	€ 1,481.2	€ 1,790.3	€ 2,124.7
memo: Chg y/y - Sales		37.7%	30.4%	27.5%	33.4%	31.0%	28.2%	25.9%	23.4%	20.9%	18.7%
memo: Chg y/y - Other Income		(22.2)%	33.0%	22.1%	39.4%	12.9%	34.7%	22.4%	23.4%	20.9%	18.7%
memo: Chg y/y - Total Revs		32.8%	30.5%	27.2%	33.7%	30.1%	28.5%	25.8%	23.4%	20.9%	18.7%
Cost of Materials	109.5	157.0	214.2	279.8	393.0	518.2	678.2	865.4	1,075.1	1,302.8	1,548.2
Gross Profit	84.1	100.0	121.3	147.1	177.9	224.4	276.2	334.9	406.1	487.5	576.5
memo: Gross Profit, excl. Other	68.3	87.7	105.0	127.2	150.1	193.1	234.0	283.2	342.4	410.4	485.0
memo: Gross Margin - Total	43.4%	38.9%	36.2%	34.5%	31.2%	30.2%	28.9%	27.9%	27.4%	27.2%	27.1%
memo: Gross Margin, excl. Other	38.4%	35.8%	32.9%	31.3%	27.6%	27.1%	25.7%	24.7%	24.2%	24.0%	23.9%
Personnel Costs	9.3	12.3	14.9	19.3	21.2	25.0	29.2	34.9	40.9	47.0	53.0
Logistics / Fulfillment	42.0	63.5	76.8	92.7	115.1	143.2	178.5	215.6	253.9	291.5	326.8
Marketing Costs	15.8	14.8	15.3	10.7	9.9	10.8	13.4	16.1	18.8	21.6	24.4
Payment Transaction Costs	1.9	2.8	4.8	6.2	6.9	7.8	9.7	12.2	15.1	18.2	21.6
Other	11.2	13.5	11.3	13.4	14.9	22.3	25.2	28.5	33.4	40.4	48.0
EBITDA	€ 3.9	(€ 6.8)	(€ 1.8)	€ 4.9	€ 9.9	€ 15.4	€ 20.2	€ 27.5	€ 44.0	€ 68.7	€ 102.7
memo: EBITDA Margin	2.2%	(2.8)%	(0.6)%	1.2%	1.8%	2.2%	2.2%	2.4%	3.1%	4.0%	5.1%
memo: Chg y/y		(274.7)%	(72.9)%	(365.3)%	102.3%	56.0%	31.1%	36.0%	60.0%	56.1%	49.5%
Depreciation & Amortization	0.6	0.8	0.7	0.7	0.7	2.6	1.2	1.9	2.7	3.6	4.6
Operating Income (EBIT)	€ 3.3	(€ 7.6)	(€ 2.6)	€ 4.2	€ 9.2	€ 12.8	€ 19.0	€ 25.6	€ 41.3	€ 65.1	€ 98.1
memo: Op Margin	1.9%	(3.1)%	(0.8)%	1.0%	1.7%	1.8%	2.1%	2.2%	2.9%	3.8%	4.8%
memo: Chg y/y		(329.2)%	(66.1)%	(263.7)%	118.6%	40.0%	48.0%	34.6%	61.4%	57.6%	50.7%
Interest Expenses, net	0.2	0.9	(0.0)	0.4	0.4	0.2	0.1	0.0	0.1	0.1	0.1
Earnings Before Taxes (EBT)	3.1	(8.5)	(2.6)	3.8	8.8	12.7	18.9	25.5	41.2	65.0	98.0
memo: EBT Margin	1.7%	(3.5)%	(0.8)%	0.9%	1.6%	1.8%	2.1%	2.2%	2.9%	3.8%	4.8%
Taxes on Income	1.1	(2.5)	(0.4)	2.0	3.5	4.7	7.1	9.6	15.4	24.3	36.7
Operating Net Income / (Loss)	€ 2.0	(€ 6.0)	(€ 2.1)	€ 1.8	€ 5.2	€ 7.9	€ 11.8	€ 16.0	€ 25.8	€ 40.7	€ 61.3
memo: Effective Tax Rate	36.0%	29.4%	17.4%	53.5%	40.4%	37.4%	37.5%	37.5%	37.5%	37.5%	37.5%
memo: Chg y/y - Net Income		(403.8)%	(64.7)%	(184.4)%	192.7%	52.0%	48.9%	35.2%	61.5%	57.7%	50.8%
Differences in FX Translation	0.0	0.0	0.0	0.1	0.0	(0.2)	(0.2)	-	-	-	-
Hedge Reserve	-	-	(0.1)	0.1	1.6	(1.5)	0.4	-	-	-	-
Total Net Income	€ 2.0	(€ 6.0)	(€ 2.3)	€ 1.9	€ 6.8	€ 6.3	€ 12.0	€ 16.0	€ 25.8	€ 40.7	€ 61.3
Per Share Data											
Basic EPS	€ 0.37	(€ 1.24)	(€ 0.35)	€ 0.28	€ 0.83	€ 1.12	€ 1.69	€ 2.28	€ 3.68	€ 5.81	€ 8.76
Diluted EPS	€ 0.37	(€ 1.24)	(€ 0.35)	€ 0.28	€ 0.83	€ 1.14	€ 1.66	€ 2.23	€ 3.61	€ 5.69	€ 8.57

Source: Hayden Capital; Company Data

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