

Inditex analysis 2011

Business



**ASSIGN
BUSTER**

Financial Analysis 1 Executive Summary In this document we analyze Inditex, a major fashion retailer in the world, which is rapidly expanding into emerging markets. We argue that Inditex provides a strong and unique value proposition for fashion buyers, and that it holds a powerful position over its suppliers and among its competitors. In addition, neither their value proposition nor their industry position is currently threatened, and their strategic expansion in higher margin emerging markets is providing major opportunities for growth. From a financial perspective, the data show that the company's profitability is among the best in the industry, only surpassed by one of its main competitors, H. In this comparison however, Inditex's ROE and ROA figures are distorted by the large quantity of cash currently on their balance sheet. In addition, one of Inditex's strategic advantages is that it is extremely efficient in its management of inventory and receivables, and can also exert tremendous pressure on its core suppliers through its vertically integrated model to obtain beneficial terms of credit.

This results in a negative operating working capital situation, which provides the company with a strategic advantage in terms of financial flexibility and cash flow. Finally, we have analyzed plausible strategies that the company may follow in the short term and based on this information we consider Inditex to be a very safe and lucrative investment opportunity. 1. Overview Inditex is a Spanish corporation and the world's largest fashion group. It is made up of almost one hundred companies dealing with activities related to textile design, manufacturing, distribution and retail sales.

Inditex currently runs over 5, 000 stores worldwide and owns 8 concepts (brands). The group designs and manufactures almost everything sold in its

stores, and has developed a logistics system focused on maintaining low inventories for distributing new fashions quickly and at low cost. Amancio Ortega, Spain's richest man, and the world's 7th richest man, is the founder and was chairman of Inditex until 2011. He retains a 59.29% stake in Inditex, which provides him effective control of the company. 2.

Industry Analysis Porter's five forces framework was used in order to examine the competitive characteristics of the fashion retail industry in which Inditex operates. Buyer power: Although purchasing volumes in the fashion sector are usually small, buyers do have strong bargaining power since the costs of switching to another brand are insignificant and competitor products are readily available. In addition, price is an important decisive factor in the buying decision, thus creating a very price sensitive market. Cutting costs through outsourcing to low-income countries is therefore a commonly observed strategy among retailers. In the financial statements, this strategy would translate into lower fixed assets and COGS. Supplier Power: Fashion trends change rapidly, which increases pressure on retailers to turn over their inventories quickly.

But individual suppliers do not hold significant bargaining power vis-avis the large retailers, such as Inditex, because the cost of switching to new suppliers is minimal. This allows retailers to exercise more bargaining power over suppliers and can be translated into lower COGS and/or lower payables turnover. In addition, Inditex has a substantial share of the equity in many of its suppliers, increasing its power over them. Threat of Substitutes: It is fair to say that there is no immediate threat of substitute products in the clothing industry as such. In a narrow sense, a threat of substitutes exists in terms of

<https://assignbuster.com/inditex-analysis-2011/>

customers choosing less fashionable and cheaper products, but not in the wider sense of substituting clothing as a whole.

Another potential threat regarding substitutes is not directly related to products, but rather to the sales channel utilized. Internet purchases may pose a limited substitute threat to Inditex's store network. Although Internet sales in the fashion industry are not likely to replace store buying completely, at least in the short term, E-commerce in the industry has doubled during the last 5 years. Threat of New Entrants: On the national level, entry barriers in the fashion industry are rather low. However, the large internationally operating companies achieve significant economies of scale as well as cost efficiency thanks to their vast experience in the production and distribution process, and their significant bargaining power over suppliers. The advantages of being in the industry for years become apparent when examining a company's distribution process.

The effects of this experience are efficient inventory management, low inventory levels and high inventory turnover. These cost/experience advantages create entry barriers that are difficult to overcome for new entrants, especially in the low-price fashion segments Inditex is operating in. However, local competitors do emerge and can pose a direct threat. Desigual is one example in the Spanish market. Rivalry among existing firms: Strong buyers' power and lower entry barriers on a national level have resulted in a large number of firms in the fashion space. This leads to fierce competition, and consequently the average net profit margin in the fashion retail industry is more than 400 base points lower than the S 500 companies average (7, 23% vs.

11, 47%). On the international level however, the picture looks different. The entry barriers described above make it difficult for new multinationals to emerge. In addition, a handful of large international retailers can use their relative size to exercise significant power over their suppliers, and make use of their experience for cost-efficient distribution and inventory management. As a result, a small number of large international retailers manage to achieve high profit margins.

These direct competitors are Inditex' largest threat, especially when expanding into new geographic territories. In this analysis, we consider GAP and H with the latter being Inditex' most direct and threatening competitor. Hence in our discussion, we have often focused on a direct comparison between H and Inditex.

3. Comparative Strategy Analysis Nature of Products:

The Company's competitive strategy is a mixture of differentiation and cost leadership. But being somewhere in between, the current economic crisis poses a threat to Inditex.

As a result of the crisis, the price-sensitive customers could switch to the competitor with absolute cost leadership. In particular, H carries trendy clothing choices which are cheaper than Zara. If price becomes an even more important factor in the buying decisions of the overall fashion market, this could pose a threat for Inditex. This is particularly the case for Inditex's home market in Spain, being one of the countries most affected by the current economic crisis.

Degree of Integration within Value Chain:

Inditex group is a vertically integrated retailer involved in almost all stages of the production process from design, manufacturing and logistics, to sales in its own stores.

The group outsources only a small part of its production to suppliers, and in most cases, Inditex holds significant equity stakes in those suppliers. The vertical integration of Inditex differentiates it from its competitors, most notably H, which outsources most of its production. Also, while competitors like H produce in Asia, Inditex has maintained most of its production close to or within Europe, with manufacturing concentrated in Spain, Portugal and Morocco. This business model, accompanied by a strict low inventory policy, allows Inditex to adapt to changes in fashion trends very quickly which forms part of Inditex's principal value proposition to their customers. A new product design can be brought from the drawing board to display in shops in about 2 weeks in Europe and 3 weeks outside Europe.

This is especially relevant in a fast changing industry like fashion. ³ This results in a financial vs. operating trade-off, where the group achieves more favourable trading conditions and integration with its suppliers (as will be further discussed in the analysis of operating working capital below), but European manufacturing also translates into higher COGS, which is reflected in a lower gross margin vis-a-vis H (see profitability analysis below). In addition, vertical integration results in a higher quantity and proportion of non-current assets on the balance sheet (47, 05% for Inditex, compared to 30, 8% for H) ¹, and a lower return on assets (19, 07% compared to 32, 91% for Inditex) ² since Inditex owns considerable amounts of property, plant and equipment. This also leads to higher capital expenditures for maintaining the existing infrastructure (5% of total sales vs.

4% for H). Moving along the value chain, Inditex sells its product exclusively through own brand stores. As mentioned above, Internet sales pose a threat

<https://assignbuster.com/inditex-analysis-2011/>

to the fixed store industry. In response to this, Inditex has identified Internet sales as a major growth initiative. A latecomer in the internet market, Inditex launched the first Zara Home online store in 2007, and the first Zara online store in 2010.

They now have internet sales platforms in 17 European countries as well as the US and Japan. The Group's other brands launched online stores in 15 European countries simultaneously in 2011. In the long-term, they plan to extend this trend to other continents as well. Degree of Geographical

Diversification: Although Inditex is active in 78 countries across the world, the company is heavily dependent on the European market, where 80.57% of total sales in 2010 were generated (33.46% in Spain, 47.

11% in Rest of Europe). Consequently, the group has identified international expansion, specifically in the Asia-Pacific region as an integral part of its growth strategy (alongside Internet sales). Currently only 9.53% of sales are generated in Asia and the Rest of World (remaining 9.9% generated in the Americas), and the group's heavy exposure to the European market is one of the most important risk factors for Inditex, especially if the European debt crisis continues.

In 2010, the group opened 75 Zara stores in China (45% of all 2010 Zara store openings), doubling the number of stores in the country within one year. Inditex also entered into a joint venture with Tata Group in India in 2009, enabling the company to open its first store in the country in 2010. This is of key importance given that the global retail development index (GRDI) currently rates India as the most attractive national retail market.

While H tends to enter one country at a time, Inditex has expanded rapidly globally (It has also opened up stores in regions as diverse as Kazakhstan, Chile and Australia in 2011). Given the efficient inventory management upon which Inditex's business model is based, this is a risky strategy, especially when expanding to developing countries without reliable transport infrastructure.

In contrast, H&M, has built distribution centers near many of their international locations in order to cut down lead times and potential logistical costs. This global distribution infrastructure is still lacking at Inditex, as they have chosen to continue to supply stores with goods from distribution centers mostly in Europe. Going forward, it is doubtful whether Inditex can continue its internationalization with the current business model being based on similar Eurocentric production and distribution. The group will likely need to establish an additional production base in Asia and eventually in the Americas to serve these regional markets. Degree of Industry Diversification: During the last decade, the group has diversified through the acquisition and creation of different brands and, in the case of Zara Home, moved beyond the fashion segment.

This is different from H&M, which does not have significant brand diversification. But Inditex still heavily relies on its flagship brand Zara, which constitutes 63.85% of the group's total revenues. In addition, Inditex's brands (with the exception of Zara Home), though focused on different groups, have significant overlap amongst themselves. Inditex is therefore only diversified in terms of brands, but not really in terms of products.

Hence, cannibalization is a threat, both between and within brands. As an example, Inditex runs 1,925 12 Bloomberg Data (2010 Fiscal Year End) 4 stores in Spain with multiple stores per city. The majority of those are Zara stores and target the same market, and therefore potentially compete with each other for customers. .

Profitability In selecting between alternative investments, relative profitability is a principle determining factor, and when combined with thorough risk analysis regarding the drivers of that profitability, yields the proper decision matrix. Therefore, to aid in defining this matrix, we first outline the relative profitability of Inditex vs.

two of its main competitors, and then analyze the profitability drivers behind its relative performance to deduce the inherent levels of risk within these drivers. **Competitive Analysis of Profitability:** The main indicators of profitability are ROE and ROCE. For Inditex and its primary competitors, these ratios are very similar, since minority interests are absent (GAP Inc. and H&M) or represent only a tiny fraction of the firms' equity (Inditex 0.58% in 2010). As a consequence, we chose to use ROE for our analyses, as this ratio is more readily available.

In terms of overall profitability (See Figure 1), Inditex is one of the industry leaders, with an average ROE of 29.76 % ($\pm 2. \%$) over the last 6 years, 900 base points higher than the industry average (20.76%). If we compare this measure among Inditex's and its primary competitors, we see that GAP Inc. is significantly lower (ROE 21.12%) whereas H&M is substantially above (ROE of 42.45%). It is worth mentioning that during the period 2007 – 2009,

corresponding to the peak of the financial crisis, the spread between Inditex's and H's ROEs expanded slightly, but this tendency has recently reversed in 2010. However it is still too early to conclude whether this trend has relevant staying power moving forward. The significant differences in ROE between companies are based on fundamental operating, financial and investment decisions at the management level, which differentiate Inditex from its competitors, and in particular, from H&M.

In terms of profitability components, Inditex's ROE can be decomposed into its traditional building blocks, returns on assets (ROA) and capital structure leverage (CSL), items with varying degrees of influence as a consequence of management's choices regarding the business model and strategy (See Table 1). Studying the recent evolution of ROA for Inditex we see that after a peak in 2007, it has been decreasing until 2009, after which it has begun to recover in 2010. This is likely a result of the financial crash at the end of 2007 and the subsequent economic crisis, which restrained sales growth at Inditex through the 2008 and 2009 fiscal years. Following this, a substantial recovery took place in 2010, likely due to rapid international expansion, especially in the Asian and Americas markets. A similar ROA trend is observed for H&M (though not for GAP Inc. whose ROA was previously negative), and therefore this trend appears to be primarily externally driven, and can likely be ignored in the competitive analysis of profitability and comparisons of underlying internal drivers between companies.

Inditex's capital structure leverage has been steadily decreasing since 2005, indicating that a higher proportion of its assets are currently being financed by equity (Capital Structure Leverage decreased by 14% between 2005 and <https://assignbuster.com/inditex-analysis-2011/>

2010) 3, principally as a result of retiring interest-bearing debt, resulting in lower overall profitability. Comparing to Inditex's primary competitors, H&M and GAP Inc. , we see that both competitors have capital structure leverage that is flat or trending up over the last 6 years. The important conclusion of this analysis is that in all three indices (ROE, ROA & Capital Structure Leverage), Inditex falls between these two companies, but with all three profitability components averaging closer to those of the Gap Inc. than H&M. The data show that although Inditex has a more levered capital structure than H&M, its ROA is 3 Bloomberg Data (2010 Fiscal Year End) 5 ignificantly weaker than H&Ms.

To summarize, H&M stands out in terms of its relative profitability when compared to both Inditex and GAP Inc. , as it shows significantly higher overall profitability then the other two, with significantly higher ROA outweighing significantly lower capital structure leverage in the overall equation. Main Profitability Drivers & Inherent Risk/Trade-Offs High Margins: Mass produced fashion of the Inditex (Zara) variety is dependent on large volumes of sales, where small differences in the gross margin can have large effects on overall profitability. Overall, Inditex has had an exceptional average gross margin over the past 6 years of operations (57. 04% \pm 1.

14%) relative to the current industry average (50. 58%). They have been able to command higher price mark-ups on their cost of goods sold consistently, not as a result of cheaper outsourcing of production to Asia, but as a consequence of continuous fashion and operational innovation. They have succeeded in maintaining strong relationships with suppliers, maintaining a good market image, performing customer research and

continuous adaptation of stores to customer preferences. Most of all, the exceptional gross margin is the result of a very sophisticated and efficient, vertically integrated design, production and distribution system, which puts products in front of consumers sooner and then changes them quicker, resulting in higher demand, and better pricing power. The principal trade-off in this business model, from the standpoint of the gross margin, is the resulting lack of supplier flexibility vs.

the benefits of direct control and security in Inditex's supply chain. That is, because Inditex is so vertically integrated, they have higher costs than competitors who can and outsource production to the lowest bidder (usually in lower-cost jurisdictions, i. e. Asia). This trade-off becomes clear when examining the gross margin of H, who does not manufacture any products themselves and outsources everything to the lowest cost producers among a huge network of Asian suppliers. H's average gross margin over the last 6 years is 3.

percentage points higher than Inditex (See Figure 2), because it can exert significant pressure on suppliers to lower their COGS because they can easily switch between many available competitors. Conversely, H&M carries the associated risk of overdependence on those vendors, and exposure to unexpected supply shocks resulting from unforeseen events, because it has little or no control over them, and less guarantee of steady inventory supply. In addition, the lack of significant quality control / quality assurance over the supply chain in this business model can be dangerous for the overall brand image. Additional implications of this same trade-off become apparent when

examining the operating margin and the operating working capital of Inditex. Although Inditex's operating margin (16.

6 % \pm 1. 1%) is significantly higher than the industry average (10. 66%) it is still lower than H (22. 36 \pm 0. 81%).

This effect is due to Inditex's vertical integration. The firm owns most of its plants and employs many more assets for manufacturing, so it is more capital intensive than H&M. As a result, its operating margin includes a significant provision for depreciation of these long-term assets over time. Furthermore, as a result of the mostly European jurisdictions where Inditex has chosen to keep a majority of its production, it is subject to higher overall operating expenses (wages and rent) than H&M, and greater inherent risk of operating expense inflation (CAGR of operating expenses increased by 13. 45% between 2006 and 2010). Conversely, as Inditex does not engage in advertisement, its overall SG&A expense is lower than its competitors.

The overall result of these factors is that the average spread between the gross margins of Inditex and H&M (3. percentage points) grows to a 5. 76 percentage point difference when looking at their relative 6 year average operating margins. H&M's more flexible operating model, with less long-term assets, and distribution centres spread throughout the world, results in a net boost to their operating margin, despite higher SG expenses. 6 Overall, Inditex has an excellent average profit margin over the last 6 years of 12.

52% \pm 0. 8%, when compared to an industry average of 7. 23%, and with slightly positive margin growth. Again, Inditex's profit margin is significantly higher than GAP Inc. (6.

62%). GAP Inc. is generating high sales in proportion to their invested capital, but their return on sales is very low, probably due to high cost of goods, critical integration problems, or significantly higher labour costs. That said, Inditex's average profit margin is much lower than H's (16.48%) over the same period, and H&M's profit margin appears to be expanding at a slightly faster rate, though the difference does not appear significant. The advantage H holds is more obvious when looking at the timeline.

During the recent economic crisis, Inditex suffered a stronger compression of its profit margin than H, but last year Inditex has made up significant ground in this category. In summary, the major differences in profit margin drivers between Inditex and its principal competitor H, are their relative cost of goods sold (~4% higher for Inditex) and the depreciation of its fix assets (mainly PP, higher for inditex). This is the result of Inditex' vertical integration model and Euro-centric production and distribution locations, whereas H&M has opted to outsource its production, particularly in Asia, and therefore holds lower assets and lower costs. That said it is worth pointing out that over the last 6 years, Inditex has managed to improve its cost of goods sold margin (a decrease from 43.8 to 40.

7%). In addition, Inditex has lower SG&A expenses, due to its policy of zero spending on marketing, which helps make up for part of the difference in operating expenses due to its larger capital asset depreciation. One note of caution however, general and administrative expenses have increased (from 34 to 35.5%) due to increased proportions in wages and rent as a result of its rapid expansion strategy. Profit margins explain only part of the reason why H&M has a higher ROA than Inditex.

To see the whole picture we have to look at the efficiency component, namely the turnover of assets. Low Efficiency / Asset Turnover: Inditex has been one of the market leaders in sales for some years, but even though they grew sales during the crisis, their growth dropped significantly between 2006 and 2009, only recovering the market leading position last year (2010). Over this entire period though, Inditex has been increasing its sales at a higher percentage than the industry average year-over-year, whereas H&M is just above the average, and GAP Inc. sales were shrinking between 2005 to 2009, and just last year began growing slowly. Despite this exceptional sales growth, Inditex has consistently shown a lower rate of asset turnover than both its main competitors.

This relatively low value indicates that Inditex doesn't utilize its assets at the same level of optimization as its main competitors, and overall asset turnover is showing a slightly downward trend recently (See Figure 3). This is somewhat surprising given the fact that one of Inditex's principal advantages is operational efficiency, and its just-in-time policy of inventory management. Looking at the details, we understand that the primary reason for the low asset turnover is not lack of operational efficiency, but the fact that Inditex has been accumulating assets in the form of first property, plant & equipment and then cash, over the last 6 years. In fact, prior to 2006 and up until the beginning of 2007, Inditex was heavily re-investing in their retail chain growth and in their supply chain integration, which included purchasing outstanding stakes in their German joint venture and expanding their production and distribution assets at the same rate as cash flow was growing. Since 2007 though, the investment in PP&E and other non-current

assets has plateaued, and has not kept up with cash flow generation. In view of the continued growth in cash flow and net income, the result has been that the cash to total assets ratio has increased steadily from 20% to 35% over the last 4 years (See Figure 4).

There are several possible reasons for this, but closer examination of the balance sheet yields two principle alternative explanations, as we will discuss later. 7 Looking at 2010 figures we see that Inditex has 47% of its assets as non-current assets, and 34% of those are PP&E (the balance are mostly leases)(See Table 2). This highlights one of the main differences with H&M's business model, where their balance sheet only shows 30% of assets as non-current (and 26% as PP). We understand that this is because Inditex has followed a policy of vertical integration along the value chain, owning the vast majority of its stores (not franchising) as well as the design, production and distribution centers which supply them. Therefore, overall, Inditex has significantly lower fixed assets turnover in spite of growing revenues, because these additional assets don't have the same sales/asset as retail stores. More specifically though, looking at the trend in recent years since 2006, it seems that Inditex's investments in PP have not kept up with their traditional business model of re-investment in the supply chain and distribution, while they have been expanding their retail network rapidly, particularly in Asia, as well as developing on-line sales platforms.

This is evident because total non-current assets as a proportion of total assets has decreased significantly from 62. % in 2006 to the current 47% of total assets, while Inditex's current strategy continues to see it expand its retail network by ~10% annually, particularly in emerging markets such as <https://assignbuster.com/inditex-analysis-2011/>

India, China and Brazil. The resulting accumulation of cash perpetuates the issue created by the prior accumulation of PP&E, in that the asset turnover continues to be lower than the competition, with a corresponding negative effect on overall profitability. The difference being that cash is distorting this ratio, while the underlying asset use efficiency is actually improving. The solution for this would be simple: Inditex could simply distribute the excess cash and improve its profitability overnight.

In the liquidity analysis below, we will further discuss possible reasons why Inditex is building up such a high cash position. In summary, Inditex has significantly lower asset turnover than its competitors, and the trend is also slightly negative, because of a larger proportion of assets to sales in general on its balance sheet, despite more rapidly growing sales, resulting in lower overall profitability. Up until 2007, this was the result of their vertical integration strategy. However, the key underlying factor, the asset mix, has been changing rapidly, and recently we are seeing cash on the balance sheet substitute for PP&E in overall importance, indicating a trend away from re-investment of profits in non-current assets, and the accumulation of cash. Negative Operating Working Capital and Capital Structure Leverage: Inditex has exceptionally high operational efficiency.

A clear example of this is that they manage to have relatively higher inventory turnover than H&M, despite much larger operational inventory requirements as they have a vertically integrated supply chain (more transformation steps from design to sale take place within the company). In addition, the average days accounts receivables are outstanding for Inditex (27 days) is well below industry average (73 days) and H&M's average (51

<https://assignbuster.com/inditex-analysis-2011/>

days) in 2010. This operational efficiency is explained by the fact that they don't rely on external distributors or retailers, that they control their entire supply chain, and that they do not offer significant in-store credit or credit card services, so most payments occur on a cash basis, or through outside credit providers (which pay on a monthly basis). In the last two years though there has been a decrease (-28%) in the accounts receivable turnover rate, and this may be attributable to their growing global supply chain and distribution network, which may be affecting this efficiency. In addition, while analysing the accounts payable turnover, it is evident that the most significant advantage Inditex enjoys is that it pays for its purchases on account after a significantly longer period than their competitors.

This implies that Inditex has been very successful (and probably aggressive) in negotiating favorable credit terms with their suppliers. Reason for this could be the overwhelmingly dominant position Inditex holds over its suppliers in Spain and parts of Europe. Moreover, Inditex often owns stakes in the suppliers which could give them a measure of control over their operations. Finally, the high cash ratio of 1.28 may give confidence to suppliers that Inditex will be able to meet its short-term liabilities, which helps them to extend these credit terms.

The combination of high operational efficiency and exceptional credit terms for accounts payables allows Inditex to operate with a negative operating working capital (See Figure 5). This is not a sign of financial distress, but rather of managerial efficiency, and produces a unique effect on the balance sheet (See Figure 6). Both Inditex's and H capital structures are based primarily on equity. The companies have both decreased long-term & short-

<https://assignbuster.com/inditex-analysis-2011/>

term debt (interest bearing) over the years, and they now approach zero. The key differentiator between their capital structures is that by operating with negative working capital, Inditex maintains a larger quantity of liabilities in the form of accounts payable (72% of total liabilities, or 25% of total liabilities and shareholder's equity) on the balance sheet when compared to H (6.

7% of total liabilities and shareholder's equity). By doing so, Inditex gains an advantage by leveraging its supplier network to increase its capital structure leverage in an interest free manner (assuming accounts payable do not carry any interest). This in turn boosts underlying profitability or return on equity. This is the result of an investment decision by the management in their supply chain to achieve vertical integration and then exercising their buying power over the suppliers who are further down the value chain and gives them an operating advantage over their competitors, which helps close the gap caused by tighter margins and less asset turnover in terms of overall profitability. All told, it will be a challenge for Inditex to maintain this negative operating working capital when it expands globally.

The company may not be able to achieve the same credit terms with suppliers in Asia, as it does not have the same bargaining power as in Spain and neighbouring European countries, unless it is able to integrate supply chains in a similar way in emerging market geographies. 5. Financial Position Analysis Short-term liquidity and excess cash: Inditex currently has excellent short-term liquidity. In the recent years, it has accumulated significant amounts of cash holdings which the company has used to reduce its short-term debt. The operating working capital management described above

further improves Inditex's short-term financial position as it does not need to obtain financing for its operations.

This is also reflected in the balance sheet as short-term borrowing is decreasing to a negligible number. Cash, Current and Quick ratios have been increasing significantly over the years (See Figure 7). The Current Ratio has increased to 1.96 in 2010. Compared to H, the ratios are still lower. This is because of the high values of accounts payable that Inditex maintains as part of its business model.

The expenses to cash ratio for Inditex has been coming down over the years as well. Inditex can operate without a cash inflow for 116 days while H and GAP can operate for 80 and 56 days respectively. This is a huge positive for Inditex as the company is less likely to be affected by a sudden market slowdown. Working capital (broadly defined as current assets minus current liabilities) has skyrocketed over the last five years. As argued above, this is the effect of the accumulation of cash and reduction of investment.

Inditex has gone from an early increase in PP of 20 to 30% in the first half of the decade, to a nearly zero incremental increase in 2008 and 2009. Total capital expenditures have since increased by 13.4% in 2010 y-o-y, a sign that Inditex is again boosting investment. But it seems like Inditex has not been able to invest as quickly as it amasses cash. In 2010, cash constituted 34% of total assets, way higher than the industry average.

Idle cash is invested short-term, which provides additional revenue for Inditex. This effect is measurable when looking at the difference of EBIT margin (18.3%) and EBT (18.5%) margin in 2010. Hence, cash management

<https://assignbuster.com/inditex-analysis-2011/>

was able to boost profitability through interest earnings by 20 base points in 2010. But the large amount of cash affects ROA and ROE as it increases the level of total assets.

Investing the cash in the operating business might indeed yield better profitability. 9 Therefore, the resulting build-up of cash on the balance sheet suggests some possible alternative explanations. First, Inditex has adopted a conservative strategy due to the economic crisis during the last three years, in response to its heavy dependence on the European market (~80% of sales), and is building up cash to ensure liquidity and long-term solvency. Second, that Inditex is building up cash in order to have the flexibility to take advantage of acquisition opportunities, particularly in emerging markets in order to diversify its distribution network, something it recently signalled with its failed attempt to purchase a Chinese retail chain (Giordano) with significant distribution capacity. This option suggests a continuation of the current business model, in which Inditex continues to re-invest in their operations and set up distribution (at a minimum) and possibly also manufacturing in emerging markets, to continue integrating its supply chain and improve operational efficiency in these new markets. Currently, the concentration of unified manufacturing and distribution of products from inside or near Europe has resulted in longer delays in providing new fashions to emerging markets, which are geographically distant.

Since this is part of the core value proposition of Inditex to its retail customers, it would build on their existing competencies to offer the same to new customers by integrating their supply chain domestically (or at least regionally) in emerging markets. A third alternative is that Inditex is building

<https://assignbuster.com/inditex-analysis-2011/>

up cash temporarily, and intends to return it to shareholders through dividends, without re-investing significantly in integrating their supply chains in emerging markets. This would imply that they are modifying their business plan slightly, and will be adopting a hybrid model going forward, in which they will outsource more production and distribution locally in emerging markets, resulting in less capital intensive operations, and returning excess cash to shareholders in the form of dividends, something which has also been signalled recently. This policy may be a result of the planned retirement of the chairman, Amancio Ortega, as he is currently 75 years old. Perhaps it also reflects the adoption of a less capital intensive structure, similar to H model, at least for areas outside Europe, in order to benefit from the same higher profit margins, and eventually higher asset turnover.

Long-term solvency: In line with Inditex' superior liquidity position, the company does not face any long-term solvency risk. Non-current liabilities make up 2% of total liabilities, and these 2% comprise of deferred taxes and pension liabilities. Inditex has cleared all of its long-term debts. However, both competitors GAP and H do not possess long-term financing either (See Figure 8). Risks: Currency Risk – The group operates across the world and is vulnerable to currency fluctuations. Inditex has signed forward exchange contracts to account for this risk.

6. Summary / Recommendation Inditex has been extremely successful over the years with its vertically integrated business model. The firm has become the major global retailer with a diversified set of retail brands operating all over the world. Inditex has also managed to achieve negative working

capital, which allows it to finance its inventory and receivables as well as positive excess cash flow, through its suppliers, with the strategic benefit and adaptability that this brings. Its financials are in extremely good shape, well above the industry average, with almost no long-term solvency risk or short-term liquidity risk.

Inditex's only major competitive threat today is H, which follows closely in terms of sales growth and yields a better return to investors. However, as we have argued Inditex's relatively low values of ROE and ROA are due partially to the greater proportion of PP and cash in its balance sheet. This situation raises Inditex's positive prospects. First, cash availability brings flexibility and resilience to changes in the market. Second, a sudden expenditure of this cash in the form of dividends would bring an immediate return on the investment, while raising the profitability 10 ratios dramatically. This, indeed, has already occurred during 2011, when dividends have increased 30% from the previous year reaching an astonishing 50%.

Third, because this availability of cash allows Inditex to continue to enter quickly into emerging markets it can be used to extend the company's growing life cycle phase. In fact, in 2011 they unsuccessfully tried to buy a Chinese chain (Giordano). For these reason we consider Inditex a potentially profitable investment in both the short and long term. However, this company is not free of risk. One of the main issues that we have is that the company is still owned by Mr. Amancio Ortega.

Although he has recently stepped down from his position of chairman and CEO, he still owns 59% of the shares. This might lead to decisions that are

not in the best interest of the company, but rather of the main shareholder. We consider this a minor risk, since Mr. Ortega has shown a remarkable vision and commitment to Inditex over the years. A second risk related to the first one is in regards to the leadership transition and the appointment of a new CEO of the company, Mr. Pablo Isla Alvarez de Tejera.

He is a wellknown lawyer with powerful connections within the government, but his experience as CEO is very limited. A third potential risk we foresee is the viability of Inditex's business model in a global market. It is clear that the centralized structure that worked so well in the "small" European market is no longer efficient on a global scale. The recent trend of reducing investment in PP leads us to believe that Inditex may be planning to diversify its business model as part of its growth in emerging markets, relying on a local distribution chain or outsourcing part of these operations, while keeping its vertically integrated structure in Europe. It is still early to determine if this will be a successful strategy.

Another concern is not related to the company itself but with the current conditions of the market. Recent news presents a grim prospect for the global economy, particularly Europe, where Inditex sales are concentrated. This is a strong lurking variable that distorts any possible analysis and forecast. In this report we have chosen to leave this consideration out for simplicity, nonetheless it is very important to keep it in consideration once taking a final decision on this investment. Finally, as the current Price/Earnings multiple is over 20, well above industry averages, and competitor's multiples, particularly H (16.

56), it is advisable to wait for a contraction in this ratio in order to better time the investment. 11 Appendix 12