
Zara's Success is No Secret

One of the first things Steve asked me to do when I started at Forager was to identify my circle of competence. Five minutes in a room full of value investors and I realised there's one thing they know nothing about. Fashion. And unlike [Alvise](#), there are few things I enjoy more than a visit to a Zara store. In fact, as it turns out, I spend hours every week doing incidental scuttlebutt.

Retail is changing, but this shift is favourable for some

The retail industry is out of favour. Articles predicting the demise of bricks and mortar stores abound and the sentiment around the sector is generally one of pessimism. And with good reason. You don't need to be a **Myer** (ASX:MYR) shareholder to know retailers are struggling. Take a quick walk through your local shopping centre. Every second store is having a sale.

This blog is not going to be another hatchet job on the industry, though. In fact, it is quite the opposite. Yes, consumer preferences are changing. Yes, there are new competitive threats arriving almost weekly. But retail is a huge and growing part of the modern economy and plenty of people (myself included) still love the bricks and mortar experience. For the right concept well executed, opportunities for investors are immense.

How to succeed in the new retail industry

Fast fashion retailer Zara is a prime example. Zara is owned by the world's largest fashion retailer **Inditex** (BME:ITX) and operates more than 2,000 stores across 96 markets. Zara's sales increased about 12% a year over the last 15 years and Inditex investors have made nine times their money over the same period. Not bad for a dying sector.

The key to fast fashion is being fast

While the global apparel industry has been struggling, fast fashion has experienced significant growth. IBISWorld estimates that Australia's fast fashion industry grew at around 20% per annum over the 5 years to 2017-18, compared to the clothing retailing industry as a whole which grew approximately 4% annually over the same period. While it has earned its own category in the apparel industry, fast fashion doesn't really need a new name. Just think of it as more efficient retailing. As Zara shows, it's one way to succeed in modern retail.

Zara's design process is very efficient. New concepts take approximately three weeks to arrive in store, compared to traditional retailers that plan their ranges up to six months in advance. Zara's integrated supply chain, and the decision to keep more than half of factories in close proximity to key markets, makes this fast turnaround possible.

Data analytics are key in the design process

All stores receive new stock twice weekly and the quantity of each design received is kept small on purpose. The benefits of this strategy are two-fold. First, it creates an illusion of scarcity.

Consumers get FOMO [just like investors do](#), so impulse buying decisions are more likely when stock is low. It also keeps shoppers coming back to avoid missing out on new designs.

Second, sales data is fed back to head office on a daily basis. In addition to the generic sales data that is tracked by most retailers, Zara staff are specifically trained on collecting feedback from customers. This data is not just for reporting purposes, it is used to select which designs to focus on. Items that are not selling are quickly removed from stores and production is ceased. Designers will start working on a new product to replace the unpopular one. Zara quickly restocks products that are selling well.

A very different risk profile to traditional retailers

Traditional retailers are heavily exposed to obsolescence risk. Zara's inventory strategy reduces this risk and minimises the amount of stock that ends up on sale racks. Less obsolescence means more margin for shareholders. I can't find any specific details around inventory write downs in the Inditex accounts, however the Zara model of introducing new designs in small batches at least partially addresses this risk.

Higher sales at better margins is good. Doing it while using less inventory is even better. This translates to higher returns on shareholders' equity.

The showroom model

Fashion retailers need to operate in places that attract many people. Rent in these areas is expensive and you can't run a successful retail business by paying exorbitant rent and using the space like a distribution centre. So stores should either be treated like showrooms or distribution centres and the real estate should be chosen accordingly.

Zara is definitely using the showroom model, with store space used for storage kept to a bare minimum. Ikea is a good example of a successful retailer positioning stores as distributions centres. They are enormous spaces and generally in low-rent locations. The trick is not to mix the two.

Zara's distribution process also appears seamless. Stores are receiving stock twice a week and online purchases come with same or next day delivery in all major cities. And this year Zara plans to fully integrate physical stores with online.

This means if an item is not available online but is in a nearby store, the consumer can still purchase the item online and it will be dispatched from store. Management are adamant that it will not take up any additional floor space, with the picking and packing requiring only a chair and small table within existing stock rooms. This can only be a good thing for sales, streamlining deliveries and inventory management.

Traditional advertising is a thing of the past

Finally, advertising has changed dramatically and a successful retailer needs to adapt.

Have you seen a Zara advertisement on television? Instead of expensive traditional advertising, Zara relies on social media and word of mouth to spread brand awareness, which is not difficult

with more than 26 million fans on Instagram.

Many celebrities and social media influencers also post images of themselves in Zara clothing, tagging the brand and further spreading awareness. Customers can buy these items with just a few clicks from the Instagram app.

These new advertising platforms are competitive. But for those who execute well, it has never been easier or cheaper to build a brand than on Instagram. It is another sphere where the new competitors are annihilating the incumbents.

Finding your edge

The Australian Bureau of Statistics estimates that Australian households spent more than \$20bn on clothing and footwear in 2016. It is still a giant and likely growing industry. And as Zara and its copycats show, the opportunities are still immense for a well executed strategy.

As Peter Lynch famously wrote, an investor's best edge comes from investing in companies they understand. Keep an eye out for some retail stocks in the [International Fund](#) and some better fashion sense at our upcoming [Roadshow](#).

Want to know more about the style of investing we practice at Forager? Check out our page [what is value investing](#)
