

2.1 Background to the Group

- Zalando is Europe's leading online platform for fashion
- ZALANDO SE and its 40 subsidiaries thus cover the entire supply chain of an online retailer
- Continued strategic investments to cement partnerships with customers and suppliers and in infrastructure
- Targeted investments in logistics infrastructure are an essential part of this
- Sustainability is integrated in Zalando's daily business

2.1.1 Business Model

Zalando is Europe's leading online fashion platform for women, men and children. The Berlin-based company offers its customers a one-stop convenient shopping experience with an extensive selection of fashion articles including shoes, apparel and accessories, with free delivery and returns.

Zalando's assortment of almost 2,000 international brands ranges from popular global brands, fast-fashion and local brands, and is complemented by private label products. Zalando's offering has been extended and enhanced with Zalando Lounge, which offers registered members special offers at reduced prices. The brick-and-mortar outlet stores in Berlin, Frankfurt and Cologne opened between 2012 and 2016 and serve as additional sales channels for excess inventory. The parent company, ZALANDO SE, was founded in 2008 and has its registered offices in Berlin. Zalando's localized offering addresses the distinct preferences of its customers in each of the 15 European markets being served: Austria, Belgium, Denmark, Finland, France, Germany, Italy, Luxembourg, the Netherlands, Norway, Poland, Spain, Sweden, Switzerland and the United Kingdom. The logistics network with five centrally located fulfillment centers allows Zalando to efficiently serve its customers throughout Europe, supported by fulfillment centers in Northern Italy, France and Sweden with a focus on local customer needs. Zalando's management believes that the integration of fashion, operations and online technology provides the capability to deliver a compelling value proposition to both customers and fashion brand partners.



Skip to p. 80

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GRI 102-2
GRI 102-4
GRI 102-6



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2.1.2 Group Structure

Governance and Control

The Zalando group is managed by its ultimate parent company, ZALANDO SE, based in Berlin, Germany, which bundles all management functions and generates the vast majority of group revenues. In addition to the parent company, Zalando is comprised of 40 subsidiaries that operate in the areas of fulfillment, customer service, product presentation, advertising, marketing, and private labels developed in-house. ZALANDO SE and its subsidiaries represent the entire value chain of an online retailer. ZALANDO SE has control over all subsidiaries, either indirectly or directly.

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As a result, group reporting essentially corresponds to the reporting for ZALANDO SE. Supplementary information concerning the separate financial statements is presented in section 2.6.

The Management Board of ZALANDO SE comprises three members, who are responsible for the group's strategy and management. Rubin Ritter is responsible for the Zalando online shop, finance, corporate governance, and corporate communication. Robert Gentz is responsible for the off-price and emerging businesses, and for human resources, strategy, and technology infrastructure. David Schneider's area of responsibility comprises the Partner Solutions and zLabels businesses, and the Zalando brand. Consisting of nine members, the Supervisory Board advises the Management Board and monitors its management activities. The Supervisory Board is directly involved in decisions of fundamental importance to the company. In particular, it reviews the financial statements and management reports and it reports on the audit to the annual general meeting. Zalando's Supervisory Board represents long-term investors, employees and independent experts. The remuneration of the Management Board and the Supervisory Board as well as the incentive schemes are detailed in the remuneration report. The remuneration report and takeover disclosures pursuant to Sections 289 (4) and 315 (4) HGB, which are components of the combined management report, are presented in the corporate governance report. The corporate governance report also includes the declaration of conformity.



Further Information
Corporate Governance Report
p. 52

Group Segments

ZALANDO SE's internal reporting structure is primarily based on a sales-channel-related perspective. The Management Board monitors the development of the business for the main sales channel, Zalando online shop, by breaking it down geographically into the regions DACH (Germany, Austria and Switzerland) and Rest of Europe. All other sales channels are grouped under the Other segment, which mainly comprises revenues generated by the Zalando Lounge and outlet sales channels and the new platform initiatives.

2.1.3 Corporate Strategy

With EUR 423bn¹⁴ in annual retail spent in 2016, the European fashion market is one of the largest and most attractive consumer markets in the world. In the last few years, we have witnessed a digitalization wave sweep over the entire fashion industry. A wide variety of industry players have embraced digital platforms and strategies in order to seize the opportunities arising from double-digit online growth rates. While the size of the overall fashion industry in Europe remained largely stable between 2010 and 2016, online fashion sales have more than doubled during the same period, expanding from EUR 24bn to EUR 51bn¹⁵. Growth has been driven by new technology, as it plays a key role in matchmaking supply- and demand-side players in the fashion industry. This has made it possible to connect the entire fashion ecosystem: customers, brands, retailers, manufacturers, stylists, content creators, logistics, and service providers. But most importantly, by opening up new opportunities to co-create value, technology is establishing new and more efficient ways to consume, produce, and invest in fashion.



Skip to p. 83



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14) Euromonitor, Europe excl. Russia; fashion excl. beauty category

15) Euromonitor, Europe excl. Russia; fashion excl. beauty category

Our Opportunity to Reimagine Fashion for the Good of All

The fashion market presents an exciting and attractive opportunity, but it is also a market that is characterized by specific challenges that create structural inefficiencies, raising operational costs and introducing pain-points throughout the entire customer shopping journey:

- Limited end-to-end transparency on inputs and production processes
- Faster fashion cycles
- Growing complexity of global supply chains
- Increasing importance of sustainability compliance practices
- Rapidly changing customer preferences
- Lack of accurate sizing and fitting solutions

We strive to find solutions that produce the best results for all in the fashion industry, be it customers, fashion brands, manufacturers, stylists, content creators, logistics or service providers. Every single stakeholder plays an important role – directly or indirectly – in Zalando's growing ecosystem.

We are well positioned to meet the challenges and seize the opportunities in the fashion industry. With a robust and growing presence in 15 markets, Zalando has become Europe's leading online fashion destination to more than 23m active customers. Our expanding technology and logistics infrastructure, combined with our customer reach – now surpassing 2.5bn visits per year – grant us access to almost 2,000 brands, for many of which we are their largest retail account. Our fashion competence is virtually unmatched, enabling us to position ourselves as brands' most trusted partner and customers' go-to fashion companion.

More specifically, we rely on the following strengths:

Our Focus on the Fashion Category and Localized Solutions

Given the idiosyncratic nature of the fashion ecosystem, successful industry players are required to build unique capabilities at each stage of the value chain. In this regard, our focus on the fashion category and strong partnerships with multiple fashion stakeholders has enabled us to develop a broad and comprehensive understanding of the needs of the fashion ecosystem. In turn, we leverage this expertise to design unique and compelling fashion experiences that delight customers and to develop industry-specific solutions that help brand partners grow.

To maintain a competitive edge in our home market, we leverage our central core strengths – advanced technological capabilities, vast fulfillment network, and direct relationship with suppliers – and focus on building highly localized solutions for each of our 15 European markets. We are committed to tailoring our services to local tastes and to making Europe accessible for fashion brands and retailers. Our thorough understanding of local specificities will continue to be a core differentiator.

Our Value Proposition for Customers

Zalando has gained customers' trust by consistently offering a unique fashion experience that provides inspiration, empowers customers, caters to their different needs, and gives them confidence in their personal fashion choices. A fashion companion that connects customers with fashion in new, fun, and inspiring ways by:



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- Offering an up-to-date, unique, and comprehensive assortment of in-season fashion merchandise
- Building the most fashion-competent destination via discovery and inspiration, catalog curation, as well as content and selection freshness
- Providing unique and vivid storytelling behind trends, brands, and products
- Delivering an unmatched level of personalization and relevance
- Offering a smooth, better-than-offline experience: the most convenient way to discover, check-out, pay, receive, and return fashion items

Our Value Proposition for Fashion Brands and Suppliers

Zalando has built credibility among fashion brands as a trusted fashion-competent and technology partner. We help fashion brands and retailers grow and tackle some of the most challenging and complex issues inherent in online fashion by:

- Providing technology and operations infrastructure that enables brands and retailers to optimize results across the entire value chain (e.g. through more accurate sales forecasts, insights into customer buying behavior, targeted advertising, and smart fulfillment services)
- Empowering brands to present themselves in a brand equity accretive, engaging way and enabling them to localize their content in every single country in which we operate
- Granting brands access to a vibrant fashion ecosystem where they can connect, create, and share value with different fashion stakeholders
- Offering instant access to the European fashion market through our unprecedented customer reach across Europe

Zalando's Platform Vision

Our platform strategy outlined in 2016 remains largely unchanged. We remain convinced that a platform business model provides the best approach to becoming the operating system of the fashion world, with multiple ways of integrating numerous fashion contributors and stakeholders, catering to their specific needs. We are dedicated to making sure our platform enables fashion stakeholders to grow with us and reach their full potential by offering them a wide array of digital and infrastructure services such as analytics, advertising, and fulfillment.



zln.do/en-platform-strategy

By moving towards a platform business model, we acknowledge that the best and most sustainable business solutions are being built jointly between multiple stakeholders in the fashion industry, and not solely within the walled gardens of a single company. From this perspective, we believe that by attracting a diverse set of key players active in the fashion ecosystem (e.g. fashion brands, manufacturers, stylists, content creators, logistics, and service providers), we can enhance our inspiration capabilities and convenience proposition at scale through:

- Overall increased availability of styles and sizes
- Access to the most sought-after brands
- Integration of credible niche/specialty players with unique content and assortment
- Long-tail and local inventory with volumes catering for the needs of specific fashion lovers
- Scalable personalization and more inspiring content, not limited to Zalando's production capacity (e.g. media partners, stylists)
- Tailored sizing and fitting advice provided by innovative technology partners
- Additional options to access local inventory and fast delivery solutions

Our strategy focuses on igniting and sustaining self-reinforcing network effects on the Zalando platform. By facilitating partners' ability to connect to our platform, we increase our merchandise selection and offering, inspirational content and curation, access to fashion expertise, and the range of delivery options available to customers. This, in turn, expands our customer reach, and vice-versa. The greater the number of players plugged into our platform, the better our ability to match and facilitate interactions between customers and partners at scale. Interactions and the subsequent data generated are at the heart of our platform business model.

Our Strategic Investment Areas

Investment in Our Customer Proposition

We will continue investing in four key customer propositions to strengthen our positioning as the most fashion-competent destination.

Assortment

In pursuit of our mission to offer a "one-stop" shopping experience for all, we will expand into the beauty category to ensure that our customers can truly buy a complete look across all price points and from head to toe. Furthermore, to remain customers' preferred fashion companion, we will continue to invest in ensuring that we always offer the broadest assortment selection, latest fashion trends, sustainable options, and the widest range of in-season fashion brands to cater to our customers' diverse fashion tastes and budgets. Additionally, we leverage zLabels, our private label offering, to create inspiring fashion brands and products to meet customers' specific demands and further enhance our product selection. We combine our assortment offer with continual inspiration and personalization to help our customers navigate the ever-changing world of fashion.

Convenience

We continue to invest in more personalized delivery experiences to take our customers on the smoothest fashion purchase journey possible with ultra-fast delivery, flexible payment options, and a hassle-free return process.

Brand

Our determination to enhance our brand equity is closely intertwined with our commitment to further strengthen our relationships with customers and suppliers. We invest in expanding our capabilities and boosting our fashion competence and credibility in order to ensure that we consistently meet our customers' and suppliers' expectations. Building stronger customer and supplier relationships is at the core of our brand equity, and it is what makes us one of the leading fashion destinations in Europe. We are also investing in strategic brand marketing initiatives to increase customer engagement. One such initiative is the Bread & Butter event, which acts as a platform for brands and consumers to directly interact with each other during the event and digitally.

Multiple Channels/Apps/Devices

As a customer-centric company, we invest in our capabilities to be present where the customer is, to innovate in order to tackle emerging and foreseeable customer needs and pain-points. It is about meeting the customer anytime, anywhere: be it on our mobile app, our desktop site, social apps, or other connected devices.



Skip to p. 85



zln.do/en-assortment



zln.do/en-post-order-experience



zln.do/en-bold

Investment in Our Supplier Proposition

To maintain our position as our fashion suppliers' preferred and most trusted e-commerce partner, we will continue investing in the following areas.

Wholesale Solutions

We invest in optimizing our wholesale capabilities by driving innovations through data and automation, and empowering our fashion partners to take more active ownership in selecting and pushing the right merchandise on the Zalando platform.

Partner Program

We invest in providing our fashion partners with an alternative solution through which they own inventory and retain control over pricing and assortment. Our goal is to reach a 20% – 30% share of enabled transactions.



zln.do/en-partner-solutions

Off-Price Solutions

We invest in developing both online and offline distribution channels to help brands effectively manage excess inventory across Europe without diminishing their brand equity.

Digital Services

We invest in providing a one-stop shop with end-to-end e-commerce services to help our partners connect with customers and successfully navigate the complex fashion ecosystem through advertising and media products, stock integration, payment solutions, customer analytics, and content management.



zln.do/en-zms

Fulfillment Services

We invest in expanding our fulfillment infrastructure to provide our brand partners with highly customized and reliable solutions through Zalando Fulfillment Solutions (ZFS), enabling them to sell their merchandise through our platform without having to worry about logistics concerns.



zln.do/en-zfs

Investments in Our Supporting Infrastructure: Technology and Operations

Our investments in technology and operations infrastructure strengthen our core foundation on which we develop compelling customer and supplier propositions.

Technology

We are investing in optimizing our logistics operations, enhancing our technology capabilities, and expanding our services powered by artificial intelligence (AI). Proprietary technology solutions form the backbone of Zalando and drive all workflows from purchasing to ordering processes and fulfillment.



zln.do/en-gift-finder

The technology underpinning our warehouse processes is constantly being upgraded to ensure that we stay ahead of the competition. We are committed to building some of the most-sophisticated fulfillment centers dedicated to online fashion. Accordingly, we are investing heavily to automate order fulfillment processes and to scale up our "Hub & Spoke" system in order to optimize performance and reduce delivery times. We are also investing to leverage the wealth of data available to us. For instance, fast replenishment algorithms are being introduced to provide recommendations on what fashion items to replenish and in what quantity.

2.1 BACKGROUND TO THE GROUP

Our focus is on expanding our technology talent pool by providing an attractive and innovative work environment. We recently announced the opening of our third technology hub outside of Germany, in Lisbon. The Lisbon Team will focus on developing an enhanced digital experience for customers visiting Zalando. This follows the expansion of our Technology Teams in Dublin, Helsinki, Dortmund, and Berlin. The focus of operations in Ireland is deep-data science and engineering, involving the development of measures related to building a real-time insight platform around fashion. In Finland, the Technology Team works on many of the cornerstones of the Zalando platform, including personalization and innovative customer-facing products. While in Germany, our Dortmund hub is working on optimizing the payment flow from checkout to refund, and the small-but-excellent Zalando Research Team in Berlin is focused on applying cutting-edge research to tackle challenges that customers face throughout the shopping journey.



zln.do/en-lisbon

Our investments in artificial intelligence are geared towards strengthening our search, personalization, and sizing capabilities. We are striving to enhance our understanding of user intention in order to improve sorting and personalized search. The focus of personalization is on building the infrastructure needed to extend product recommendations to personalized fashion advice. Furthermore, we have set up a dedicated Sizing Team to develop AI methods to improve sizing advice for customers and generate sizing insights for brand partners.



zln.do/en-sizing

Operations

Our focus is on enhancing our pan-European fulfillment network by opening up new facilities. Over the coming year, we plan to quickly ramp-up our new fulfillment center in Poland and to initiate new warehouse projects in Poland and Italy. Additional capacity will enable us to fuel our wholesale growth and further enable the Partner Program ramp-up through the scale up of our Zalando Fulfillment Solutions (ZFS). ZFS will in turn improve our delivery speed and help our partners to maintain or improve customer experience standards in all of our 15 markets across Europe. Our employees are the key to our operational success. Our commitment to create a healthy corporate culture and fair working conditions will continue to guide us as we strive to expand our European footprint.

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zln.do/en-logistics-network

We are confident that our platform strategy provides a systematic approach to building sustainable and differentiating advantages throughout the online fashion value chain. In the coming years, we will continue our efforts to further scale up our platform by connecting more fashion stakeholders, developing new technology solutions to tackle current and emerging fashion needs, and increasing our level of personalization to address customers' growing expectations.

Given the rapid pace and scale of transformation in the online fashion industry, we are aware that our vision and strategy will need to evolve accordingly. The magnitude of the opportunities and challenges ahead is great, but we trust that our relentless customer-centric focus combined with our demonstrated ability to learn and innovate will enable us to stay ahead of the curve.

2.1.4 Corporate Responsibility

Our purpose "Reimagine fashion for the good of all," is based on our ambition to tackle the endemic challenges that our industry is facing. These challenges include a lack of transparency in increasingly complex supply chains and related risks for people and the environment. As a company, we want to do



Skip to p. 89



zln.do/en-responsibility

our bit for a more sustainable fashion industry by providing a systemic contribution beyond our own business. We believe that our contribution is most effective if we combine our strengths in technology, fashion, and logistics and actively engage our customers, partners and employees.

Of course, at first we had to do our homework to get the basics right. However, we feel that we have reached a point where we could go one step further with our sustainability strategy (do.STRATEGY) and have defined additional strategic visions and targets in four key areas:

- Employees: we want to provide a workplace for the future and impact the future of work. This implies offering our employees a culture of continuous growth and development as well as an innovative and attractive work environment.
- Fashion: we want to contribute to a more sustainable fashion industry. It is our ambition to develop our online shop into a leading online destination for sustainable fashion and to further improve the social and environmental footprint of our private label products.
- Environment: we want to decouple our ecological footprint from our economic growth. To this end, we developed our first climate protection strategy and strive to take sustainable packaging to the next level.
- Corporate citizenship: we want to reimagine how corporates contribute to solving societal challenges. In line with the social Zalando principle, we intend to strategically invest 1% of our EBT in existing solutions for societal impact, e.g. to increase transparency in the supply chain, and help them scale.

We see a pressing urgency in addressing the challenges of our industry together with our partners, and we are eager to learn and iterate while striving towards a systemic contribution. At the same time, we are convinced that our sustainability strategy is also a key element for our future business success.

Additional information regarding our sustainability strategy and our separate combined non-financial report in accordance with Section 289b (1) and (3) and Section 315b (1) and (3) HGB (German Commercial Code) which is published together with the combined management report on the Company's website (<https://corporate.zalando.com/en/>) is provided in the separate section 1.2 Corporate Responsibility¹⁶ of the annual report.

2.1.5 Management System

In addition to revenue, EBIT, adjusted EBIT and capex, other key financial performance indicators for corporate management include EBIT margin, adjusted EBIT margin, the adjusted fulfillment and marketing cost ratios, along with EBITDA and adjusted EBITDA. Operating and free cash flows are also taken into account. The Management Board steers the company at a consolidated group level.

In addition to these financial indicators, Zalando also uses a range of non-financial performance indicators to manage the company.

- **Ratio of mobile site visits to total site visits:** users are making greater use of mobile devices to access the internet. In our effort to offer customers the opportunity to enjoy high-quality shopping on their mobile devices, Zalando continues to develop and refine its mobile websites



zln.do/en-do-strategy



Further Information
Corporate Responsibility
p. 12



Further Information
Report on Economic Position
p. 88

¹⁶⁾ The sustainability report is not part of the audited combined management report.

2.1 BACKGROUND TO THE GROUP

and apps. As a result, the ratio of shop visits from mobile devices to the total number of shop visits increased by around 5.1 percentage points in 2017, rising from 65.6 in 2016 to 70.7.

- **Number of active customers:** the Zalando group measures its success by the number of active customers. Each customer that has placed at least one order within the preceding 12 months (based on the reporting date) is considered active. Compared to the prior year, the number of active customers increased by 3.2m, rising from 19.9m to 23.1m in 2017.
- **Number of orders:** in addition to revenue, the number of orders placed is a key performance indicator for the management of the group. This indicator is monitored independently from the value of merchandise and is a key driver of growth. In 2017, the number of orders placed increased from 69.2m in 2016 to 90.5m.
- **Average number of orders per active customer:** the average number of orders placed by active customers during the last twelve months totaled 3.9 as of December 31, 2017 (prior year: 3.5). This KPI is an important indicator of the trust customers place in the company and is also influenced by customer age and shopping channel.
- **Average basket size:** similar to the number of orders placed, the average basket size has a direct effect on the revenue of the group. The average basket size (after returns) decreased slightly in fiscal year 2017 from EUR 66.6 to EUR 64.5. It is influenced by assortment composition, customer age, and shopping channel. Young customers who prefer fast fashion articles and shopping mobile tend to shop more frequently, but with a lower basket size.

2.1.6 Research and Development

Zalando develops key components of its software internally. This ensures that the software is aligned with the operating processes in the best possible way. For example, order and fulfillment processes in particular are supported using internally developed software. Important technical developments in 2017 included: on-site personalization initiative, Fashion Insights Platform, Smart Product Platform, Fashion Content Platform, product availability, Search & Personalization, same day delivery, and many more.



zln.do/en-personalization

Software development at Zalando relates to the structured, labor-intensive phase of programming and implementing significant system upgrades, further developing components and enhancing functionalities along the entire value and process chain.

Development work at Zalando is performed by teams of developers that are organized by the respective function or line, for example Fashion Store, Payments, Partner Solutions, Zalon, zLabels, Off-Price.

In 2017, the group recognized development costs of EUR 51.2m (prior year: EUR 57.7m), of which EUR 36.8m relate to prepayments and assets under development (prior year: EUR 36.4m). The increase in development costs is attributable to the enhancement of the above-mentioned software and new technical projects.

Research costs were immaterial.