

A Work Project, presented as part of the requirements for the Award of a Master Degree in Finance from the NOVA – School of Business and Economics.

INDITEX GROUP EQUITY RESEARCH – DCF
APPROACH

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Abstract

This dissertation aims to assess the equity value of a listed company combining academic theory with appropriate valuation practices. The chosen company was Inditex, one of the main players in the Apparel sector around the world. Several reasons motivated this choice. First, Inditex has developed a unique business model, highly responsible for its differentiation and success on the market. It is characterized by its responsiveness, flexibility, and customer-orientation. Furthermore, the Group is currently facing a delicate situation, mainly due to the temporary closure of its stores as a consequence of the Covid-19 pandemic. In addition to a decrease in sales, the company's business model and the ability to respond effectively to external adversities were put under pressure. These factors added up to an interesting valuation challenge.

An analysis of the Apparel Industry and the company's business was carried out to determine its value. Considering Inditex's characteristics, the Discounted Cash Flow method was considered the most reliable approach.

In the end, a final target share price of 29,90€ was computed. In comparison with the current market price (26,04€ per share), the DCF model indicated that Inditex's stock price was slightly undervalued. Thus, there is upside potential to the price of its shares, translated into a buy recommendation.

Keywords: Valuation; Inditex Group; Discounted Cash Flow Model

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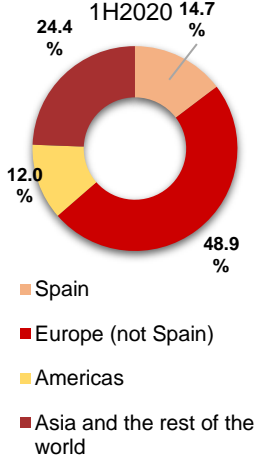
This report is part of the Equity Research report (annexed) and should be read as an integral part of it.

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Company Overview

Exhibit 1: Revenues by geographic area in 1H2020



Source: *Company data*

Inditex is a global fashion retail group headquartered in Arteixo (A Coruña, Spain) that designs, produces and commercializes fashion items, mainly apparel, footwear and accessories. The company, initially denominated as Confecciones GOA, was founded in 1963 by Amancio Ortega. In 1975, the founder opened the **first Zara store**, and its success was followed by the successive launch of new brands and international expansion. Ten years later, Inditex was founded to incorporate all companies under one banner.

Nowadays, Inditex operates in **202 markets on five continents**, selling products through its over 7.300 stores across 96 markets and its online platform in an integrated way. Revenues are segmented into four geographic areas: Spain, Europe (excluding Spain), Americas and Asia and the rest of the world. As of the first half of 2020, Europe accounted for the higher sales share (63,6%), 14,7% coming from the Spanish market (Exhibit 1).

The company is made up of eight brands that serve distinct market segments. **Zara** is the flagship brand of the Group and the one that generates the largest portion of revenues (Exhibit 2). It aims to shrink the gap between customers' needs and the fashion industry's offer at affordable prices. Still in the range of accessible brands are **Pull&Bear**, **Bershka** and **Stradivarius**. On the other hand, **Massimo Dutti** and **Uterqüe** are focused on high-end customers, producing high quality products. Regarding **Oysho**, its product line includes lingerie, beachwear, home wear and sport. Finally, Inditex also offers home furniture and decorative items under the brand **Zara Home**, reaching a broad spectrum of consumers.

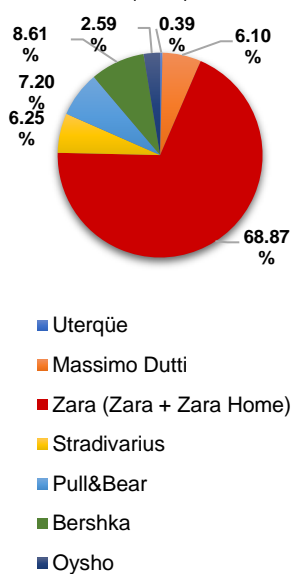
Today, Inditex is the world's largest fashion group, with more than **176.000 employees** from 172 different nationalities, who are responsible for the anticipation of customers' needs and consequent success of the Group's strategy.

Indices

Inditex first went public during its Initial Public Offering in 2001. Currently, its shares are listed on the four Spanish stock exchanges and the company integrates the **IBEX 35 Index** and **Euro STOXX 50 Index**.

Inditex is the company with higher **market capitalization** of the IBEX 35 Index. By observing the Exhibit 3, it is possible to note that the company's stock price clearly outperformed EURO Stox 50 from August 2017 until March 2020. In September 2019, analysts predicted that foreign exchange pressures were going to have a negative impact on sales, and Inditex's share prices fell as a consequence¹. This drop was accentuated by the Covid-19 crisis and the price reached a minimum of 21,19€ per share in October 2020.

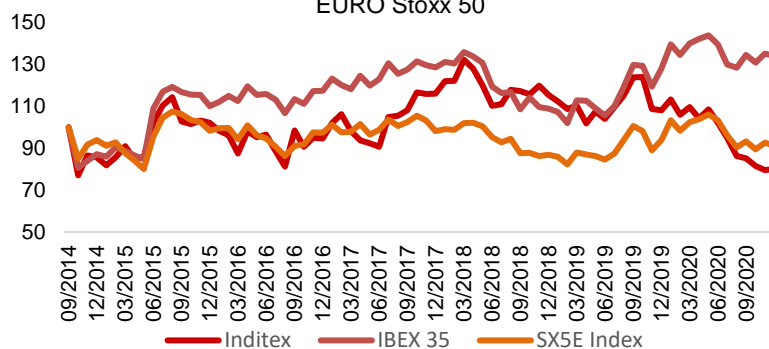
Exhibit 2: Revenues by brand in 1H2020 (in %)



Source: *Company data*

¹ <https://www.retailgazette.co.uk/blog/2018/02/zaras-shares-fall-3-year-low-analysts-drop-full-year-estimates/>

Exhibit 3: Relative Performance Inditex, IBEX35 and EURO Stoxx 50

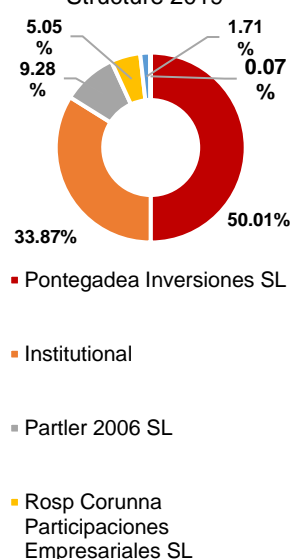


Source: Bloomberg and own analysis

In addition, the Group is included in **sustainability-based indices**, reflecting the strategy followed over the years to become more social and environmentally friendly. In 2019, it obtained a score of 4,9 (out of 5) on FTSE4Good Index and a score of 68 on Dow Jones Sustainability Index, 40 points higher than the industry average, being considered as one of the most sustainable retail companies for the nineteenth consecutive year by the latter Index.

Shareholder Structure and Dividend Policy

Exhibit 4: Inditex's Shareholding Structure 2019



Inditex's shareholder structure is dispersed (see **Exhibit 4**). The main shareholder is Pontegadea Inversiones SL, that accounted for 50,01% of the shares by the end of 2019. Institutional investors, who have the second highest stake, represented 33,87%. Additionally, Partler 2006 SL, Rosp Corunna Participaciones Empresariales SL and Retail holds 9,28%, 5,05% and 1,71% of shares, respectively. Lastly, Inditex owns 2.125.384 treasury shares that represents 0,068% of the share capital.

Since 2018, the **ordinary dividend payout is 60%** of the net profit generated in the year. The dividend policy also includes the possibility of a **bonus dividend**. Over the past few years, the dividend payout ratio has been growing, as well as dividend per share (Exhibit 5). Despite the impact of the Covid-19 pandemic, the Group plan to **maintain its dividend policy** (60% ordinary payout and bonus dividends), which gives a positive sign to investors and indicates that, even facing difficult times, the company is financial healthy.

Exhibit 5: Inditex's Historical Dividend Payout Ratio (2015-2019)

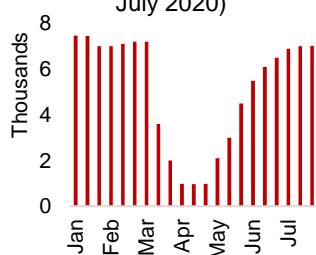
	2015	2016	2017	2018	2019
Dividend per share (in €)	0,52	0,60	0,68	0,75	0,88
Number of shares outstanding (in million)	3.113	3.114	3.113	3.114	3.114
Total dividends paid (in million €)	1.619	1.868	2.117	2.335	2.741
Net income available to shareholders	2.875	3.157	3.368	3.444	3.639
Dividend payout ratio	0,56	0,59	0,63	0,68	0,75

Source: Company data and own calculations

Impact of Covid-19

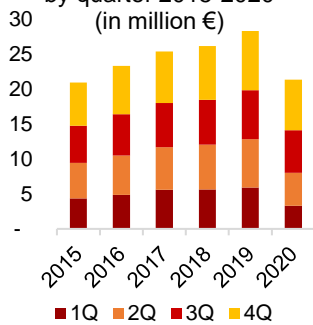
Until 2019, the Group grew steadily, having reached net sales of 28.2 billion euros and net profits of 3.6 billion euros by the end of the year. This performance was strongly impacted by the Covid-19 pandemic due to the temporary stores closure. By end of April 2020, only 965 stores remained open in 27 countries, out of a total of 7.469 (see Exhibit 6). At this time, the Group reported its first loss of 409M€. In the third quarter of 2020, Inditex registered a drop in net sales of 5.7bn€, when compared to the same period of the previous year (Exhibit 7).

Exhibit 6: Number of stores open (January-July 2020)



Source: Company data

Exhibit 7: Revenue by quarter 2015-2020 (in million €)



Source: Company data

Inditex has been progressively recovering its performance, mainly due to the strength of the business model and the online segment. However, it continues to face a challenging and uncertain environment. One example is the new phase of closures and restrictions established from 19 October in various markets. On the other hand, it is not clear the impact that the pandemic will have on the economy and, consequently, on consumers' purchasing power. This makes it even more difficult to predict sales for years to come. Nevertheless, based on forecasts for the industry², it is expected that the sector will recover the sales level of 2019 in 2022 and it will continue to grow in the following years, what will be discussed in the Section *Revenues Forecast*.

Valuation Assumptions

To determine the Inditex's value, we will start by identifying of what drives the company's business. In this section, we will discuss and explain a set of inputs fundamental to the DCF analysis.

Revenues Forecast

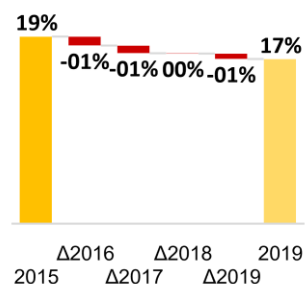
Inditex is planning to follow a strategy based on the same growth drivers as the Apparel Industry. In this way, we considered that by applying the industry growth³ in our projections for Inditex revenue development up until 2025, we will incorporate the impact of the Industry's value drivers (innovation, digitalisation, and sustainability) into the forecast.

On the other hand, Inditex has been growing according to the industry trend in each of the segmented regions, however showing some disparities. These disparities were counted as a marginal error, estimated through an average of the prior four years, excluding 2020 from our considerations. We considered it reasonable not to count with the year 2020 for the average estimation, in the succeeding years, since this atypical pandemic period does not reflect the usual marginal difference between the Group and the industry. Thus, in order to project Revenues as accurately as possible, we consider the **industry forecasts for the upcoming years in each of the Group operating segments**, together with the **percentage of growth discrepancy expected**. In this way, we consider that the usually positive marginal difference, in terms of growth, between Inditex and the industry places the company in a favourable position. In order to get a deeper understanding of what drives the company's performance, we analysed each one of the core business segments: Spain, Europe (excluding Spain), Americas and Asia and the rest of the world (Asia & RoW).

- Spain

Starting with the Group home market, **Spain**, has the highest market share, with 21% of the Apparel Industry sales in this area being captured by Inditex. Moreover, **this country is responsible for 17% of the Group's total revenues by 2019**, a percentage that has been decreasing for the past four years (Exhibit 8), not as a consequence of a reduction in sales, but rather due to the Inditex expansion plan, where other regions are gaining more space. Although, the company's strategy for the future does not place Spain aside, with a considerable investment projecting a studio for online productions, to be placed in the north of the country. Even though, it is forecasted that this area, as all the others, will reach a **negative peak in 2020**, reflected through a decrease of 1,6 billion euros in revenues, **16,3% below the industry results**, that

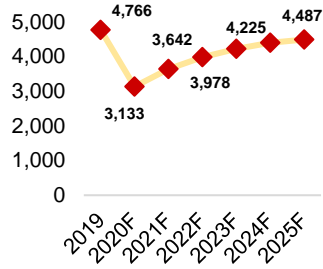
Exhibit 8: Decline in the Spanish market share of the total revenues, over the past 4 years (%)



² Statista, 2020

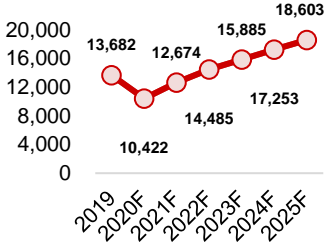
³ Statista, 2020

Exhibit 9: Revenues in Spain, from 2019 to 2025, in million €



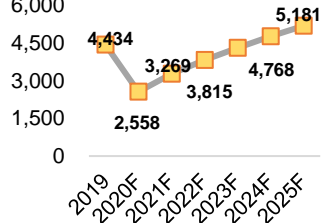
Source: Company data, Statista & Own analysis

Exhibit 10: Revenues in Europe (ex. Spain), from 2019 to 2025, in million €



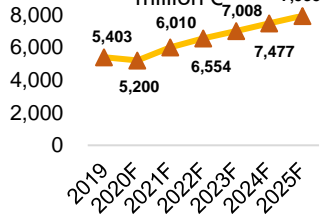
Source: Company data, Statista & Own analysis

Exhibit 11: Revenues in Americas, from 2019 to 2025, in million €



Source: Company data, Statista & Own analysis

Exhibit 12: Revenues value in Asia & RoW, from 2019 to 2025, in million €



Source: Company data, Statista & Own analysis

already anticipated a negative outcome of 34,2%. This is a result of Spain being one of the most affected countries in Europe. For Inditex, **Spain will be the region taking more time to fully recover from this situation**. At a revenue level, it will take approximately five to six years. Nevertheless, it is predicted to continue generating revenues that will follow a positive trend (Exhibit 9), which lead us to believe that the Group will be able to maintain its **competitive advantage** in this business segment, in the long-term, where almost half of the European stores are located.

- Europe (excluding Spain)

Looking at **Europe (excluding Spain)**, it is possible to understand that is one of the main focus of the company, since in 2019 this area represented **48%** of the Inditex sales, enhancing the **importance in the Group's performance**. Therefore, the company has been trying to diversify the distribution of its stores along this area, in order to have larger stores able to arrive to the most part of the population. However, the region felt the pandemic impact, projected to be severe in 2020, counting for a decrease in value of 17%. Industry's projections states that the recovery process will be quicker than in the Group home market, Spain. Still, the Group reached results below the industry projections by 6,75%. For the future, we expect Inditex to demonstrate an exponential growth above the industry average of 3%, by approximately 5% in 2025. Thus, we expect that the **area growth will be 8%**, corresponding to 18,6 billion euros in revenues, at this date (Exhibit 10). Hence, the projections will be grounded on the propensity to maintain this favourable growth trend, exceeding the apparel market, in the next five years, mainly due the **brand awareness** and the **consumer willingness to follow the Group's fashion trends**.

- Americas

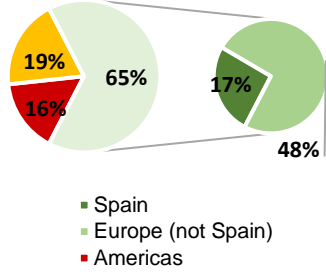
Concerning **Americas**, we are estimating the sales to increase from 2020 onwards, as illustrated in Exhibit 11. By 2023, we expect the economic impact of the virus to start to be surpassed. Even knowing that Inditex did not conquer a considerable position in the American market, **the Group is trying to gain market share** for the last five years, reaching almost 1% in 2019. In the long-term, this position is expected to be enhanced, with a **stable growth rate of 9%, almost 4,8% beyond the market expectations**, in 2025. In an area where competitiveness (in terms of variety) and cultural issues are huge obstacles to consider when approaching the market, even considering the increment in the number of stores, it might be extremely difficult for Inditex to achieve a dominant position there.

- Asia and the rest of the world

Regarding **Asia and the rest of the world**, Inditex is far away from gaining a significant position in the Asian market, having into account its **dimension, cultural dynamics, and intrinsic price competitiveness** effects. Despite the positive trend followed in the forecast, where the revenues are projected to increase more than 2,7 billion euros by 2025 (see Exhibit 12), at a **stable growth rate of 6%**, Inditex is expected to grow less 1,25% than the industry, estimated to 2023. On the other hand, this region is the one less affected by the Covid-19 crisis, registering a loss of just 200 million euros, recovered in the following year. This occurs mostly due to the capacity of the Asian market to manage and surpass the crisis, more rapidly than in Europe.

Analysing at a worldwide level, the online integrated platform, the global advanced radio frequency identification technology, the stock control system, and the integration with the physical stores, will allow Inditex to recover from COVID-19 crisis in a two-years range. Despite a 0,12% decrease in market share for 2020, it is expected a significantly quick recovery, exceeding the

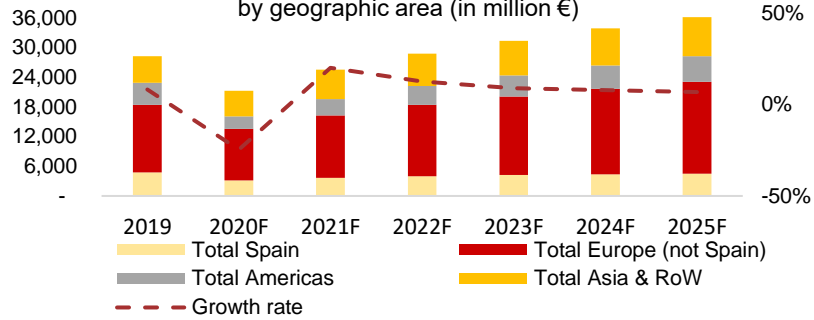
Exhibit 13: Sales by Geographic area, as percentage of Inditex total sales



Source: Company data

industry results in most of the regions, together with a gradual improvement of the company's performance comparatively to the market. Afterwards, **Inditex is forecasted to reach around 36,2 billion euros in revenues by 2025**, with an annual growth around 7% and a tendency to accomplish the steady state. In these projections, there are two important notes to retain. Firstly, almost 23,1 billion euros (65%) occur in Europe (Exhibit 13). Secondly, more than 9,4 billion euros are obtained through their online platform, taking us to the last analysis relatively to the revenue's generation, the sales channel.

Exhibit 14: Inditex Expected Revenues from 2019 to 2025 by geographic area (in million €)



Source: Statista 2020, Company data and own analysis

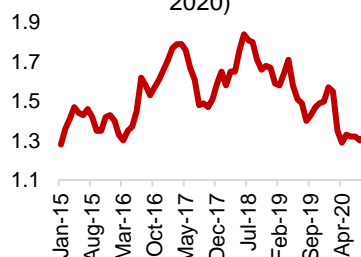
The channel customers choose or have the opportunity to use define a firm's development, if the corporation has an upgraded system ready to face this change, as Inditex has. This allowed the Group to avoid an extremely difficult situation in 2020, when consumers do not have a possible alternative and end up buying more than 30% of the items online. This historical propensity forced the company to have their online platform and logistic system ready, to correspond to the consumer needs, which was an advantage for Inditex considering the capital investments the Group has been doing. Thus, we expect the **online platform to represent 26% of the total revenues by 2025**, where this value reaches a stable point above the company's target of 25%.

Costs

Cost of Sales

The cost of sales includes mainly raw materials and consumables. These costs vary with some factors, such as the price of goods and the volume of sales. Starting with the price of goods, we analyzed the price of cotton, since it is the most common raw material used to produce Inditex's garments. As shown in Exhibit 15, prices have been highly volatile over the years. However, COGS did not follow the same pattern, as shown in Exhibit 16, making cotton prices bad inputs to forecast this caption.

Exhibit 15: Cotton prices in U.S. cents per pound (2015-2020)



Source: Index Mundi, 2020

Exhibit 16: Cost of sales in million € (2015-2019)



Source: Company data

Despite the efforts made by Inditex to manage costs in a very strict way, the average of the COGS as a percentage of sales increased in the past. Furthermore, the company is committed to become more sustainable, which implies the use of non-processed materials, such as organic cotton. This raw material is approximately 20% to 30% more expensive than “ordinary” cotton, mainly because the extra costs implied in its production and the relatively lower supply. Since Inditex is planning to continue to increase the percentage of organic cotton until 2025, we expect that costs as a percentage of sales will continue to increase from 43,8% in the first half of 2020 to 44,2% in 2025, following the same trend of the past 3 years (Exhibit 17).

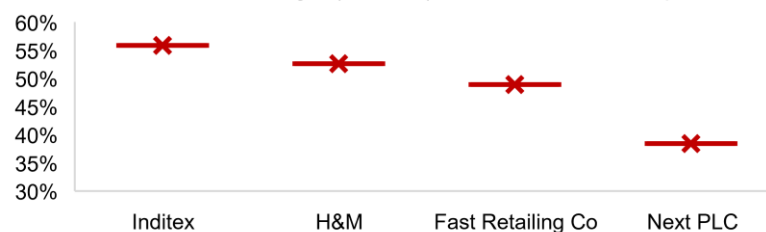
Exhibit 17: Cost of Sales Forecast (2020-2025)

	2020	2021	2022	2023	2024	2025
Cost of Sales (in million €)	9.351	11.277	12.697	13.859	14.975	16.013
% of Sales	43,9%	44,1%	44,0%	44,1%	44,2%	44,2%

Source: *Company data and own calculations*

Consequently, we expect **Gross Margin to decrease** from **56,2%** in the first half of 2020 to **55,8%** in 2025. According to Exhibit 18, Inditex is still performing better in terms of gross margin than its main competitors: H&M, Fast Retailing Co and Next PLC.

Exhibit 18: Gross Margin (FY2019) Inditex vs. Main Competitors



Source: *Bloomberg*

Personnel Expenses

According to the company, around 87% of the employees work at stores. Based on this, we assumed that the number of employees will depend mainly on the Group’s sales area because **higher stores should imply more employees**. The number of employees per 1,000m² decreased from 37 to 35 (2015-2018), however it remained constant between 2018 and 2019 (Exhibit 19). Therefore, it appears that the number of employees has reached its minimum and is no longer dependent on the stores area. For this reason, we considered that the **average number of the employees in the future will be of 35 (per 1.000 m²)**. On the other hand, Inditex’s total retail area is expected to continue to increase **2,5% per year**, following the strategy planned by the Group.

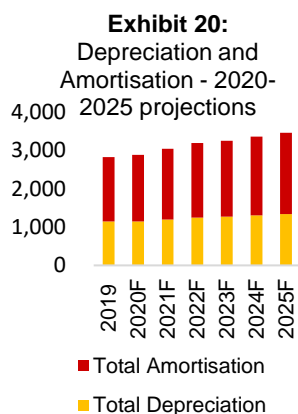
Considering the personnel expenses per employee, it is possible to see that they have been growing over the years. In the long term and generally **in line with inflation and labor availability**, the natural movement of this caption will be up. Building on this rationale, we assumed that the grow of the personnel expenses per employee will correspond to the nominal growth (taking into consideration the inflation and GDP). As expected, in 2020 there will be a decrease in this caption because of the Covid-19 pandemic. This is also consistent with the Inditex’s first half results, where the company reported that operating expenses decreased 21%.

Exhibit 19: Personnel Expenses – Historical and Forecast

	2017	2018	2019	2020	2021	2022	2023	2024	2025
Retail area (000m2)	4,739	4,962	5,087	5,214	5,344	5,478	5,615	5,755	5,899
Growth	7.4%	4.7%	2.5%	2.5%	2.5%	2.5%	2.5%	2.5%	2.5%
Nr. of employees	171,839	174,386	176,611	181,026	185,552	190,191	194,945	199,819	204,815
Nr. of employees (per 1000m2)	36	35	35	35	35	35	35	35	35
Personnel expenses (per employee)	23.1	23.7	25.1	23.2	24.7	26.0	27.2	28.3	29.4
Growth	2.79%	2.89%	5.76%	-7.57%	6.32%	5.38%	4.72%	4.16%	3.73%
Personnel Expenses	3,961	4,136	4,430	4,197	4,574	4,941	5,303	5,662	6,020

Source: Company data and own assumptions

Depreciation & Amortisation

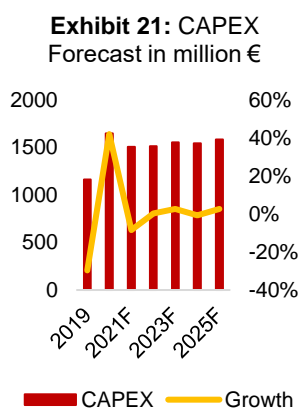


Source: Own analysis

In order to estimate the Depreciation amount, the main factor to consider is the Property Plant and Equipment (PP&E), since depreciation embodies a relatively stable 13% of this factor, on average, over the last three years. On the other hand, to project Amortisation, it is crucial to analyse the Rights of Use together with Other Intangible Assets, possible to forecast as a percentage of Rights of Use and Intangible Assets value, respectively.

Hence, as it is possible to see in Exhibit 20, the **Total Depreciation and Amortization** value shows a tendency to **increase in the next five years**. A fact that is explained through Inditex investment plan, in its majority related to **financing tangible and intangible assets**, by opening larger and more sophisticated stores with an extremely advanced technological system, connecting them to the online platform.

Capital Expenditures



Source: Own estimates

Inditex expansion has been possible by a significant amount of capital expenditures (CAPEX). From 2015 until 2019, PP&E increased approximately 1.8 billion euros, resulting in a position of 8.3 billion euros by the end of 2019. As previously described, the Group intends to open larger stores and implement the RFID technology in all stores and incorporate technologically advanced tools, until the end of 2022. The investment purpose is to ensure the completion of the global full integration process between stores and online, and the Group expects to employ a **total of 1.7 billion euros** between 2020 and 2022. From 2023 onwards, we believe that all current stores will be fully updated, and the amount invested in PP&E is meant to grow at the same pace as the new stores' area. According to Inditex's projections, it is estimated a gross space growth of 2,5% per year going forward. By the end of 2025, PP&E is expected to reach 10,454 million euros (see Exhibit 21).

On the other hand, one of the Group's key strategic pillars is digitalisation. It plans to invest around **1 billion euros** between 2020 and 2022 to develop the "Inditex Open Platform", where the digital transactions will take place. This amount was incorporated into the forecasts as being an investment in Intangible Assets. For the future, it is expected the online channel to continue to be responsible for an increase in Inditex's sales. Consequently, it is rational to continue to invest in this segment, contributing to the increase in future cash flows. Thus, we estimate intangible assets as a percentage of sales, considering the last 3 years. This rationale was built on the fact that in the past, intangible assets represented a relatively constant percentage of sales (2% per year). It seemed reasonable to consider that this relation will be maintained in the future, however with higher growth of 5% to keep up with the increasing trend of becoming even more digital.

Net Working Capital

An important determinant of value creation lies in the Group's capacity to optimize its working capital management. The changes in this input vary according to Inventories, Trade and Other Receivables in addition to Payables, as well as Income Tax Receivables and Payables, without disregarding Other Current Assets, and Working Cash.

Over the past few years, the **average holding period (AHP)**, determined as inventories as a percentage of COGS, has been decreasing. Thus, the time inventory stands in the warehouse has been lower, reflecting a sign of **good inventory management**. More efficiency in manage the inventory level is in accordance with Inditex's investment in building a global stock integration system and a single inventory position. As a matter of fact, when presenting the 1H2020 results, Pablo Isla stated that running the business with less inventory is an effort that is being developed by the Group, leading us to consider that the **AHP will continue to decrease** in the future at the same pace of the past. This measure was used as an approximation to forecast inventory levels.

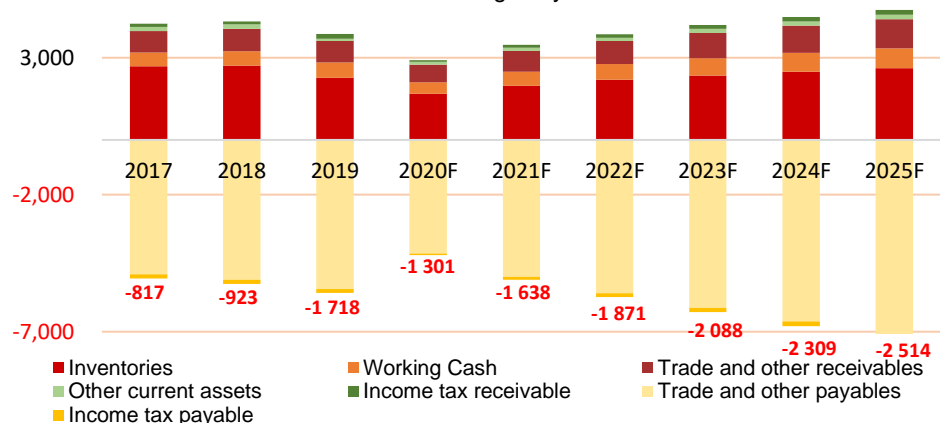
Regarding Trade and Other Receivables, in Exhibit 22 it is also possible to observe coherence in the **average collecting period (ACP)** during the last three years. Therefore, an estimation using an average of the ACP is a reasonable inference, assuming the company will **maintain its trade terms management conditions**.

Looking at Trade and Other Payables, Inditex has been persistently increasing the value, since 2017. While the average payable period had a small variation between 159 and 164 days. This means Inditex takes on **average 162 days to fulfill their accounts payable requirements**.

With respect to Income Tax Receivable and Payables, it varies according to the sales and cost of sales value, respectively, and consequently influence the core taxes amount. These parameters vary according to the taxation of each country. Not neglecting the Other Current Assets, which have been showing an increasing trend, in the last five years, except for 2019, representing an average 0.5% of revenues and just exhibiting a maximum of 0.2% variation. Considering the working cash, it was assumed that represents 2% of the total revenues.

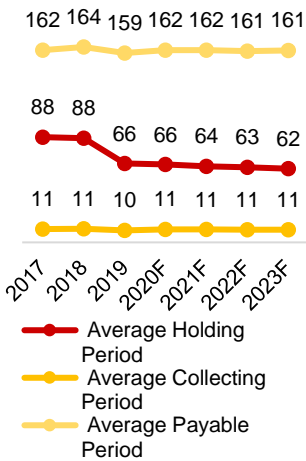
It is possible to observe that **Inditex formulates a negative working capital value in every financial year** (Exhibit 23), meaning the Group receives money faster than it pays to creditors. Not such a differentiation factor from the industry that also follows this operation tactic to finance its current activity, since it receives from customers at the moment they acquire the item, although hold the payments to suppliers.

Exhibit 23: Operating Working Capital components: relevance and evolution along the years



Source: Company data and own calculations

Exhibit 22: AHP, APP and ACP using the past 3 years to forecast 2020-2023 period



Source: Company data and own assumptions

Cost of Capital & Growth rate

Inditex is a company with a low level of leverage, translated into a debt-to-value ratio of 0,01. Therefore, it is almost a debt free company, that uses excess cash to finance its activity and investments. Given the low amount of debt, the weighted average cost of capital is very close to the cost of equity.

Exhibit 24: Cost of Capital inputs

Inputs	
Target D/EV	0,01
Risk-free rate	-0,58%
Tax rate	25%
MRP	6,75%
B _U (industry)	0,96
B _L	0,96
Cost of Equity	5,94%
Cost of Debt	0,05%
WACC	5,90%

Source: *Own estimates*

To determine the **cost of equity**, the Capital Asset Pricing Model (CAPM) was applied. The current yield on the German's 10-year Treasury Bond was considered as the **risk-free rate**, thus resulting in a rate of -0,58%⁴. Regarding the Market Risk Premium, it was considered to be **6,75%**⁵, based on a recommendation from KPMG. In order to determine the levered beta, we regressed Inditex' stock returns against market returns, using data from the last 5 years. The **MSCI World in EUR** index, composed by a considerable number of industries and companies and consequently, well-diversified, was chosen as a market proxy. In order to avoid biases associated with shorter periods of time, monthly returns were considered instead of weekly or daily returns. We arrived at a raw beta of 1,18. However, the standard error of this regression is 0,19, meaning that the true beta may lie in the interval between 0,81 and 1,55 (95% confidence interval)⁶. A widespread of the confidence interval makes this method very imprecise and has a huge impact on the company value. In addition, the regression's R-squared is only 39,69%.

To improve the beta estimation and cross-check the result achieved, we analysed 6 industry peers: H&M, Fast Retailing Co, Next PLC, Hugo Boss, JD Sports Fashion and American Eagle Outfitters, thus decreasing the **effect of idiosyncratic shocks**. Unleveraging the betas of these similar companies in terms of operating performance and capital structure led to an industry unlevered beta of 0,96. A beta of 0,96 implies that these securities' prices tend to be slightly less volatile than the overall market. By analysing the Apparel Industry's fundamental characteristics, it makes sense as the demand for fashion items is somehow linked to the state of the economy. Taking as an example the current situation due to the Covid-19 pandemic, there is much focus on purchasing essential items and fashion becomes an after-thought for consumers with less purchasing power. Nevertheless, this impact is felt mainly in the luxury segment. Since we are primarily considering fast fashion players, this may explain a beta below one. Lastly, the unlevered beta was re-levered by applying the Inditex's market debt-to-equity ratio of 0,01, yielding a **levered beta of 0,96**, as expected given the low amount of debt. Based on the computed parameters, Inditex's cost of **equity is 5,94%** and the **weighted average cost of capital is 5,90%** (Exhibit 24), both parameters very close as previously stated.

The perpetual growth rate is the rate at which we expect Inditex to grow throughout the years, until perpetuity. Therefore, this rate was computed considering the combination of the **terminal ROIC of 26,51%** with the **terminal Reinvestment Rate (RR) of 5,84%**, forecasted as an average of the last three years, since it is the period where the company starts presenting more stability and Inditex will not be able to maintain its cash flows growing at the same rate for eternity. As result, **the rate at which the terminal value is expected to grow is approximately 1,55%**. Given the relevance of this parameter, it will be challenged further through a sensitivity analysis, discussed later in this analysis.

⁴ As of 31 December 2020

⁵ Equity Market Risk Premium – Research Summary, 31 March 2020

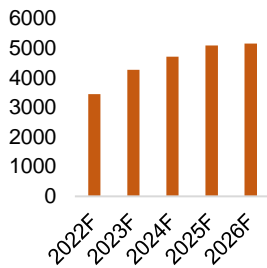
⁶ True raw beta = Raw beta +/- 1.96 SE

Valuation Outcome

Discounted Cash-Flow Method

The final firm value was determined through the DCF method, by discounting the forecasted free cash flows at the WACC, which in the case of Inditex is close to the cost of equity since the company presents almost no debt in its capital structure. We assumed that Inditex will **manage its capital structure to a target level**, which makes DCF the most suitable method to determine its value. As depicts in Exhibit 25, for the forecasted period ending in 2025, the free cash flow presents an **upward trend**, reflecting mainly the revenues increase, a strong working capital management, and the investment in CAPEX. Another crucial estimation is the terminal value, that reflects a steady-state performance. We arrived at a **terminal value of 4.439 million euros** and an enterprise value of **93.989 million euros**. Subtracting net debt and non-controlling interests, the equity value amounted to **93.567 million euros**. In what concerns shares outstanding, we considered that its number will remain constant in the future (**3.114.38 million shares**, not considering treasury shares). Finally, we arrived at YE2021 **target price of 29,90€ per share**, what corresponds to a **capital gain of 3,86€**, given the current share price of 26,04€ per share. Furthermore, it is expected the payment of a **dividend of 0,67€ per share**. This corresponds to a total return of 17,40% and, consequently, our model discloses a **BUY recommendation**.

Exhibit 25: Inditex's Forecasted Unlevered FCF



Source: *Own assumptions and calculations*