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Company Update

Anne Stevenson-Yang
anne@jcapitalresearch.com

+1 860 391 6094

boohoo.com (BOO LN)

Trust Us

- ## Massaged results
  We suspect that boohoo's superior sales growth and paper profitability could derive from off-balance-sheet related parties that accept losses in return for the proceeds from sales of highly valued shares. This is the only explanation we see for implausible growth that derives entirely from a subsidiary owned by the CEO's sons.

- ## PLT's margins likely to be in the forties
  Based on our analysis of similar companies, we think PrettyLittleThing, the boohoo subsidiary reporting 57% gross margins and 191% sales growth, may actually be able to achieve GM of between 40-47%. We speculate that boohoo makes up in share sales for what subsidiary owners may lose on sales to boohoo.

- ## Prepare for dilution
  Management has garnered £90 mln from share sales in just nine months since last July. If our hypothesis is correct, boohoo will be issuing more shares in 2018 to maintain the illusion of industry-beating growth.

- ## Just not competing
  Even setting aside potential manipulation, we think boohoo is not a plausible competitor in the online retailing space. boohoo tells investors it will compete with ASOS, Zalando, and Amazon by fulfilling all orders from one warehouse in Burnley, even as competitors build fulfillment infrastructure around the world. We call nonsense.

- ## Lowered TP: 111.63 GBp
  Using a DCF model and optimistic assumptions about margins, we come to a target price of 111.63 GBp, 25% lower than where the stock is now trading.

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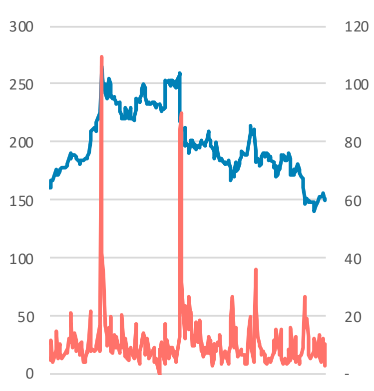
Price (GBp)	151.25
Market Cap GBP (£) mln	1,738.60
Price Target (GBp)	**111.63**
Difference	**-25%**
Price last adjusted	6/13/17
Earlier target price (GBp)	131.30
P/E	**54**
P/B	10.43

boohoo.com (BOO LN)
last share price in BGp (left, blue) and volume in mln shares (right, pink)

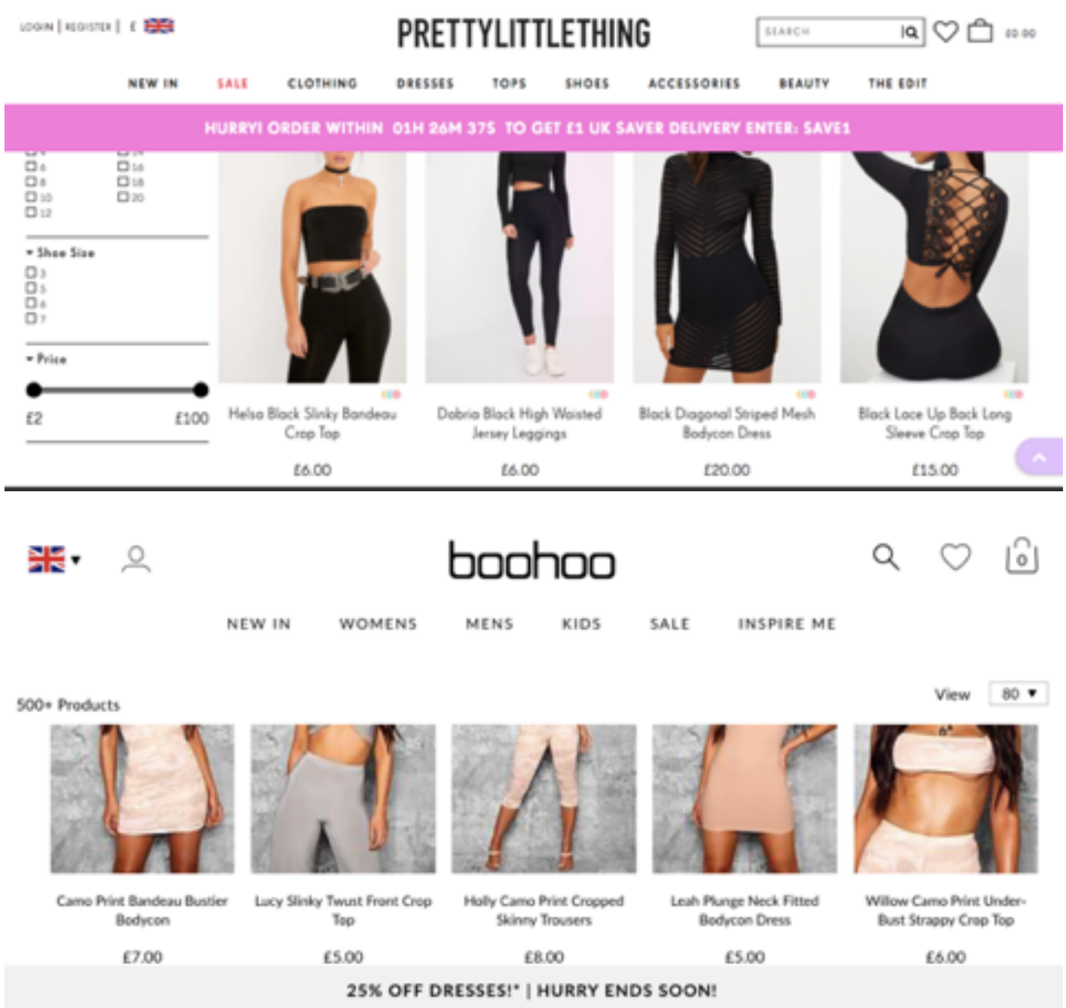


Source: Bloomberg April 20, 2018

Margin Call

When boohoo reported its four months to December 31 sales results in January, everything looked pretty similar to the company's chief competitor, ASOS—the 25% sales growth for the company's boohoo division sales, the 50.7% gross margins for boohoo. Except that it didn't, because boohoo reported 107% sales growth and 52.5% GM. The difference came from PrettyLittleThing, a website 66% owned by boohoo and operated by the CEO's three sons that looks, feels, and operates pretty much exactly like boohoo but somehow manages to grow 7.6x as fast and offers better margins.

If you believe PLT's super-fast growth at super-high margins despite bargain-basement prices, you are more trusting than we are.



Screenshots from the British PLT and boohoo websites | Source: J Capital, April 13 2018.

If you can't tell the difference between the websites, that's because there is none. The companies share business offices, warehousing and logistics, advertising and promotion, and probably procurement.

Boohoo gives us no reason to believe in its competitive advantage except that the customers are young and hip and investors aren't.

In its AIM Admission Document, boohoo said of PLT:

> "PrettyLittleThing's product range is geared more towards niche, high end fashion than boohoo, however it does operate in the same market space."

High-end or not, PLT's average order value in 2017 (AR FY2017 pages 8-9) was lower than boohoo's, at £33.18 versus £37.76 for boohoo. This compares with ASOS's reported £70.86 for H1 2017 (half year results published April 11, 2018, page 22). With an average order value only 47% of ASOS's average, offering basically the same products from the same set of suppliers, there is no plausible reason why PLT should offer gross margins nearly 600 bps higher than ASOS's.

In fact, we estimate that PLT's actual margins are likely in the mid-forties. If that is true, then owners—mostly the Kamani family--may personally be incurring losses in order to achieve high paper profits. Why would they do that?

I'll gladly pay you Tuesday for growth booked today

Coinciding with BOO's performance on margin are significant BOO share sales by the Joint CEOs and the Kamani family in 2017. Mahmud, Rabia, and Nurez Kamani sold a total of 36.57 mln shares into the private placement conducted in early June 2017. At the private placement price of 220 GBp, this netted the family £80.45 mln and left them with an approximate 33% interest in the company. Co-CEO Carol Kane also opted to cash out of a portion of her shareholding in the company, waiting until September 27, the day of the FY18 interim result, to offload 4.65 mln shares at an average price of 230.1 GBp. Kane netted ~£10.7 mln GBP from the sell-down.

This £96 mln could help the Kamani family and Kane--who is a director of three of the supplier companies including PLT--extinguish debts elsewhere. We count 53 companies co-located with boohoo and with cross directors and owners, and a handful located at a nearby shared office space and incubator owned by the CEO's brother Jalaludin Kamani. Many of these companies are suppliers to boohoo. Should true margins for the combined company be a more realistic 47% (see below for further detail), we estimate that £1.126 bln would be required over the FY18-FY26 period to cover losses in wholesale entities associated with the margin inflation. That is if 100% of the sales proceeds are dedicated to meeting break-even targets, which we doubt.

PLT is the most egregious outperformer on margin, but we are also very

Anne Stevenson-Yang
anne@jcapitalresearch.com +1 860 391 6094

skeptical of boohoo's continued gross margin outperformance--54.4% for retail sales. Listed peers ASOS and Zalando report 48.0% (H1 2018) and 43.7% (FY 2017), respectively. BOO's margins not only beat its online peers but also top industry behemoth H&M, even though BOO purchases just 2% of the volume of H&M. And, while H&M sources largely from emerging markets, BOO maintains that it sources 50% of its stock from suppliers located in the U.K.

Table 1. Gross Margins vs. Peers

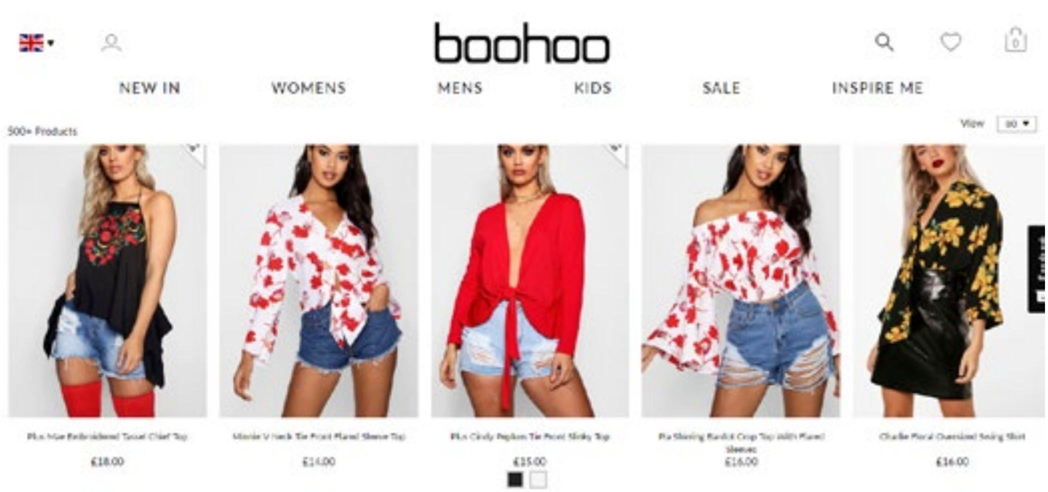
Gross Margins	2013	2014	2015	2016	2017	2018 Consensus	Purchases *(USD M)	Purchases rel. to H&M	Purchases rel. to Zalando
Online									
booho.com plc (group)	54.5%	59.1%	60.8%	57.8%	54.6%	52.8%	193.6	2%	6%
ASOS	51.2%	51.8%	50.1%	50.0%	49.8%	50.7%	1,300.6	11%	41%
Zalando	43.3%	43.3%	45.1%	44.2%	43.7%	43.6%	3,185.7	28%	100%
Bricks and Clicks									
H&M	59.1%	58.8%	57.0%	55.2%	54.0%	53.5%	11,546.8	100%	

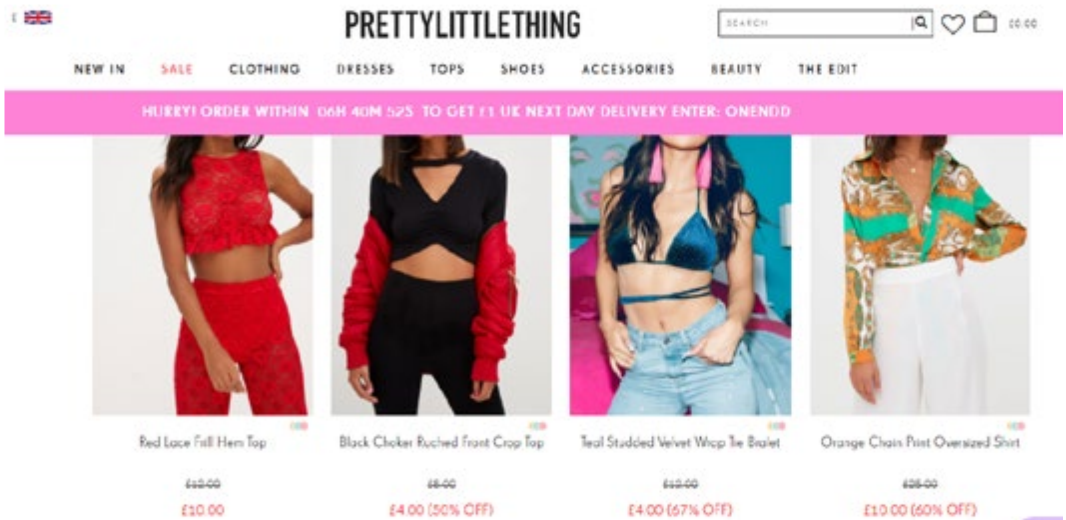
* Fiscal year 2017

Source: Bloomberg, boohoo.com plc

All this outperformance is achieved at radically low prices. Take the blouses BOO sells on boohoo.com and PLT. The average full price for a sample of 80 blouses currently for sale by BOO (full retail price, April 16), was £17.45 on boohoo.com and £16.09 on PLT.

We estimate manufacturing costs for this stock based on a survey of 44 Chinese and Korean apparel manufacturers conducted in late 2013. The survey revealed that manufacturing costs for a large run of a basic design blouses are as low as $3.93 in China and $12.54 in the more developed Korea. We es-





Boohoo.com and PLT blouse inventory | Source: J Capital, April 16 2018.

timate manufacturing costs in the U.K. at around 1.75 times higher than in Korea. Meanwhile, Drapers Online, a UK Fashion trade journal, reports that shipping and duty on a simple T-shirt that retails for ~£25 is around £1.75.

Figuring in the average of EM- and U.K.-sourced blouses, we come to the amounts in the tables below:

Table 2. Boohoo and PLT blouse (average margin)

Boohoo		Pretty Little Thing	
Average Selling Price (£)	17.45	**Average Selling Price (£)**	16.09
Average COGS (£)	9.20	**Average COGS (£)**	9.20
Gross Profit (£)	8.25	**Gross Profit (£)**	6.88
GPM	47.3%	**GPM**	42.8%

Source: J Capital estimates

BOO would say that its completely own-brand sales convey a margin benefit. But BOO outsources 90% of its designs, according to our interviews, so the branding is not really an advantage—as is clear from the low prices.

Market's expectations

After hitting an all-time high 273.25 GBp on September 6, 2017, BOO shares have fallen by around 47%, indicating that the market's growth expectations have declined significantly. But the stock still trades at a lofty 51.8 times consensus FY18 EPS estimates. And the street seems to appreciate that competition will cause BOO's margins to fall toward those of peers such as ASOS as it continues to grow. This implies that sales growth will have to be all the stronger to offset margin the expected compression.

Table 3. BOO Share Price Implied Sales Expectations

	2017A	2018E	2019E	2020E	2021E	2022E	2023E	2024E	2025E	2026E
Sales (£M)	294.6	569.1	791.0	1,067.9	1,281.5	1,537.8	1,845.4	2,214.4	2,657.3	3,055.9
Sales growth rate		93.2%	39.0%	35.0%	20.0%	20.0%	20.0%	20.0%	20.0%	15.0%

Source: Source: Bloomberg, J Capital Research

Even if you buy the margins—and we don't—ecommerce companies simply require a lot of infrastructure investment, and BOO is not putting in the facilities.

Sitting out the logistics arms race

With the UK, currently BOO's largest market, expected to clock slower growth than other markets, it is clear that the responsibility of supporting the stock price will rest squarely on growth from the U.S. Key to achieving growth will be BOO's investment in logistics infrastructure.

Online peers ASOS and Zalando are investing heavily. ASOS, for example, is building global infrastructure capable of supporting ~£4 bln in net sales and will spend £200-220 mln in FY18, its second consecutive year of accelerated capex. The new ASOS distribution network will span across geographies in the U.K., Europe, and the U.S. Supporting this network are separate returns processing centers disbursed throughout the markets ASOS serves.

At its FY17 result, ASOS highlighted the launch of "ASOS Instant" into London, standard delivery in Italy and Spain of four days, and a new Saturday cutoff for Monday delivery in key European markets.

Zalando is also investing in a decentralized, "Hub and Spoke" network across Europe to support its future growth, optimize performance, and reduce delivery times. Having spent €244 mln in 2017, the company will invest €350 mln in 2018 in three new hub sites, which will increase the number of hub sites to seven, with four spoke sites to support an overall logistics capacity of >€10 bln in sales.

Meanwhile, BOO is planning to fulfill all orders globally from its Burnley and Super Site warehouses in the U.K. It plans to spend £182 mln over FY 2019-FY 20220 in addition to the £62 mln in FY 2018 on additional capacity at Burnley, the new Super Site and the associated technology to automate processes at the warehouses. We fail to see how they can hope to compete in the U.S. without the requisite distribution investment.

One way or another, we don't like BOO's chances

Consensus estimates coming into the full year result indicate that the street continues to buy the boohoo story exactly as it is being served up. We have serious doubts that BOO is as successful as it purports to be.

Even if BOO were on the up-and-up, we would remain skeptical that BOO can deliver the growth the market sees as probable due to inferior logistics infrastructure. Success in the U.S. with Nasty Gal will be paramount to meet current expectations baked into the share price, yet the company plans no investment in warehouse infrastructure in this crucial market. Finally, should the company's margins in fact be accurate, and the CEOs' share sales thus not motivated by accounting hijinks, then the only remaining interpretation for the sell down is that management is not confident in delivering the sales growth that the market currently prices in.

Table 4. Valuation Scenarios

	Sales CAGR assumption (FY19-FY26)	Valuation (GBp)	Justified FY18 P/E
Base Case	10%	66.46	23.7
Upside	23%	111.63	39.9

Source: J Capital estimates

Taking all of this into consideration, we view fair value for BOO significantly below its prevailing market price. We give the company our upside valuation, offering the benefit of the doubt.

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