Case Study

Inside H&M's $4 Billion Inventory Challenge

By Sarah Kent and Hannah Crump

The world's second-biggest fast-fashion retailer is combatting sluggish growth and shrinking profits. Its inventory levels have ballooned into a $4 billion problem — a powerful reflection of the challenges facing the company, and the fashion retail sector at large.

Executive Summary

H&M group's 'cheap, but chic' retail model helped it dominate the high street for much of the last 20 years, but it has struggled to keep up with the rise of online retailing. CEO Karl-Johan Persson has spearheaded a years-long transformation strategy to combat shrinking profits and tackle ballooning inventory levels.

This case study explores H&M Hennes & Mauritz AB's long-term strategy to survive and thrive in the new retail paradigm. The company has recognised the need for sizable, long-term investments in order to keep pace with digitisation and meet evolving consumer demands. Its years-long transformation programme has focused on key pain points that are affecting retailers across the sector:

- As H&M group's consumers migrated online and competition from e-commerce increased, the company invested heavily to improve its digital offering. It's been rewarded with rising online sales and burgeoning engagement from its over 40-million-member strong loyalty programme.
- H&M group's high inventory levels have worried investors and forced the company to sell product at margin-eroding discounts. The company's overhauled its logistics infrastructure, enabling it to match up products and consumers more effectively.
- Against an onslaught of online competition, H&M group has been battling declining footfall at its stores. Closures have increased, but the company sees a future in physical retaiI. It's focused on improving its product offering and is betting on sleeker, more modern stores, better tailored to local consumers.
- As one of the world's biggest fashion retailers, H&M group has a treasure trove of data. The company is investing in artificial intelligence and data analytics capabilities to better read trends.

H&M group's efforts are beginning to pay off, but this is still a work in progress. Sales are improving, but inventory remains at elevated levels. Ultimately, to keep up with the rapidly evolving market, the company will need to keep investing and remain flexible and responsive to consumer expectations of an increasingly streamlined and personal shopping experience.

In an uncertain market, can a global retailer that has fallen behind the times survive? The Business of Fashion examines why H&M group is struggling, and how its transformation strategy is playing out.

History

How H&M's Rise Stalled

$4b
Unsold stock at the end of 2018

-40%
Profit in 2018 compared to 2015

366
Stores closed between 2015 and 2018

80%
Manufacturers in Asia

Source: H&M

H&M group started life in 1947 as a womenswear store in Västerås, Sweden. It was originally known as Hennes, only acquiring the second part of its name in 1968, when it took over Mauritz Widforss — a Stockholm-based hunting and fishing store that helped it expand into men's and children's clothing. It floated on the Stockholm Stock Exchange in 1974, and by 1980, had started on a path of expansive growth across international markets.

"The initial idea was to provide fashion for everyone, to democratise fashion so we have equality," said Chief Executive Karl-Johan Persson in an interview with The Business of Fashion. In addition to being CEO, he is also the grandson of founder Erling Persson. He is the third generation to head up the family company, and despite facing very modern challenges, maintains a strong commitment to the company's founding philosophy — updated to reflect contemporary concerns about fashion's impact.

"To take fashion-quality and sustainable products — both socially and environmentally — and to make that available to the world, that's our aim," Persson said, acknowledging that those goals won't come easy. "It's going to cost a lot; it also requires a long-term mindset — and that, we have."

Persson inherited a business that has grown dramatically since its early years in Västerås. It opened its first store outside Scandinavia in London in 1976, expanding across Europe in the 1980s and 1990s. In 2000, H&M opened its first US store, continuing its international expansion.

By 2009, when Persson became CEO, the company was present in more than 30 countries and operated nearly 2,000 stores. It had diversified beyond the original H&M, adding a range of labels with different business models, price points and target consumers to its arsenal. It launched contemporary brand Cos in 2007, then a year later acquired fashion company FaBric Scandinavien AB along with its brands Weekday, Monki and the soon-to-be-defunct Cheap Monday.

H&M group's cheap-but-trendy offering had helped it grow into a multi-billion-dollar behemoth, churning out billions of dollars in annual sales across thousands of stores in dozens of markets. Though best-known for cheap, disposable clothing, it also gained high-fashion credibility through wildly popular, limited-run collaborations with luxury designers like Karl Lagerfeld and Stella McCartney

Today, H&M group can be found in over 70 countries and nearly 5,000 stores. Its brand offering has expanded to include H&M Home, & Other Stories, ARKET and Afound. Troubled denim brand Cheap Monday is slated to close this summer. However, H&M remains the group's core brand, accounting for roughly 90 percent of stores globally (see Exhibit 4).

Alongside other fast-fashion players like Topshop and Zara, H&M revolutionised the apparel market. The European players' "cheap, but chic" offering fuelled their growth into retail giants, putting immense pressure on once-trendsetting retailers like Gap Inc. Their winning formula was based on a wide and shallow approach that brought the latest trends from the runway to stores at an unprecedented cadence and at prices that undercut their competitors.

H&M group was also among the first to spot and exploit the opportunity in high-low collaborations. Alongside companies like American retailer Target Corp., it helped popularise limited edition collaborations between mass market retailers and luxury houses, starting with Karl Lagerfeld in 2004.

But now, the original fast fashion pioneers **risk being beaten at their own game**. The fashion retail sector has undergone a dramatic upheaval, hit by a tidal wave of digital disruption. Savvy and nimble online-only brands — from giants like Amazon.com Inc. to upstarts like Boohoo Group Plc and Fashion Nova — are rewriting the retail model that drove H&M group's growth. It has been hit offline by increased competition as well, from lower-cost sellers like Primark and mid-tier operators like the owner of arch-rival Zara, Inditex SA.

Meanwhile, H&M group's offering has missed the mark with customers in recent years, and it has scrambled to square its ambitions to be a leader in consumer-pleasing sustainability initiatives with its core identity as a fast-fashion retailer. The result has been a steep drop in profits and an alarming rise in unsold goods — a potent and costly symbol of the challenge at hand.

The Problem

The $4 Billion Challenge

In 2018, H&M group stunned observers when it disclosed in its first-quarter report that its inventory levels had surged above $4 billion. The news came hard on the heels of an unexpected drop in quarterly sales in late 2017 — an early warning of the pain to come. The company's problems sent the share price plummeting to it its lowest level in more than a decade, but the inventory levels have proved the more persistent challenge.

Between 2014 and 2018, H&M group's inventory levels nearly doubled as its designs missed the mark with consumers and sales growth slowed. While five years ago, it held just 90-days-worth of inventory in stores and warehouses around the world, more recently, that level has topped 140 days, according to Citigroup calculations.

"The world is changing, the competition is increasing," said Persson. "There are a lot of distressed companies competing a lot with discounts on prices as well. A lot of things are going on so we — like any other company — we have to continuously improve, improve, improve."

Underlying H&M group's problems is a failure to adapt fast enough to shifts in technology. As the company's customers migrated online, it failed to move with them. That's "where it really hit H&M," said Tom Enright, research vice president on the global supply chain strategies team at consultancy Gartner Inc. "[H&M's] revenue model for a long time was store based. They didn't have the power of their sales coming from the online channel compared to other retailers."

Its old-school logistics model has also struggled to keep up with the new breed of **ultra-fast-fashion e-tailers,** and rival Inditex's famously efficient supply chain. Around 80 percent of H&M group's manufacturers are based in Asia, making it harder for the company to respond swiftly to trends unfolding in core markets in Europe and North America. By contrast, Inditex's Zara uses agile supply chains based on **sourcing production close to headquarters** to take products from design to shop floor in a matter of weeks, enabling more accurate forecasting of demand, and reducing the likelihood of overstock. Its position as the world's biggest fast-fashion retailer by sales has been unassailable for years.

On top of these structural issues, H&M group has struggled to keep consumers engaged with its core H&M brand. Persson told analysts and investors in February 2018 that the group "didn't cater well enough for the core customers." The result was lower conversions and a decline in traffic to many stores, he said.

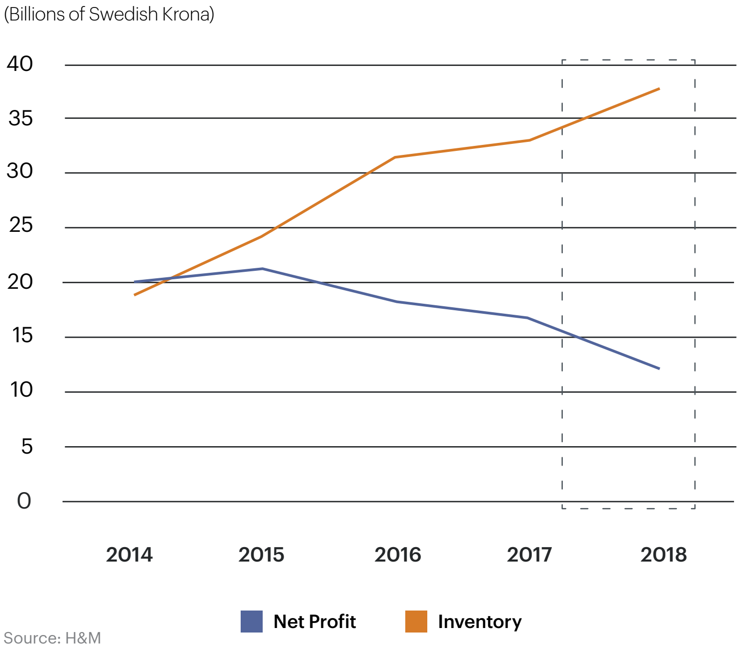
These mis-steps have hit the company's bottom line hard. Its net profit has slipped lower every year since 2015, falling 40 percent from 20.9 billion Swedish Krona ($2.2 billion) four years ago to 12.7 billion Swedish Krona ($1.4 billion) last year. Sales growth slowed substantially over the same period, declining from double digits in 2015 to no more than 6 percent in each year since through 2018.

At the same time, H&M group's inventory levels have proved an intractable — and expensive — problem. While the company said the increase is partly to do with improved invoicing processes introduced in 2016, there's no getting around the business challenge it reflects. Faced with mounting competition and sluggish sales, the company has resorted to steep, profit-eroding discounts. Between its second quarter of 2015 and fourth quarter of 2018, its cost of markdowns in relation to sales increased year-on-year every quarter. The largest spike was felt in the third quarter of 2017, when the cost of markdowns increased three percent compared to the previous year (see Exhibit 5).

The company's woes reflect broader challenges that are shaking the entire retail sector, creating significant challenges for the company's plans to resolve its issues.

Exhibit 1: Overstocked and Under Pressure

Over the past five years, H&M group's inventory has ballooned. Meanwhile, net profit has declined.



Source: H&M

Market Context

The Retail Apocalypse

"The fashion retail sector has undergone a dramatic upheaval, hit by a tidal wave of digital disruption."

H&M group is not alone in its attempt to weather the retail storm. Throughout America's malls and across Europe's high streets, traditional retailers are struggling to compete with more nimble digital players. These newcomers are unencumbered by the high rents that accompany brick-and-mortar retail, and have tapped into a rich vein of young, digitally native consumers who are abandoning physical stores in favour of online shopping. According to Deloitte, 28 percent of US Millennials spend more online than in store compared to 20 percent of Boomers.

While the world's biggest fast-fashion retailers — H&M group, Fast Retailing Co Ltd. and Inditex — are still opening new stores, the pace of growth has slowed significantly (see Exhibit 6).

For traditional retailers, "it's going to be table stakes to integrate online and offline," said Natan Reddy, senior intelligence analyst at CB Insights. To remain competitive on speed-to-market and meet consumer expectations of a streamlined shopping experience, companies with analog supply chains must adapt an omnichannel model. "Everyone has to invest in supply chain and operational technology if they want to be competitive," said Reddy (see Exhibit 7).

If they don't, nimble competitors with new business models stand ready to topple existing behemoths. Consumers are buying more than ever, but they're spending much less. According to Deloitte, the proportion of expenditure American consumers are devoting to clothes has halved over a 30-year period, declining from 5 percent to 2 percent, even as sales volumes have increased.

While H&M group may have started the trend towards cheaper clothing at higher volumes — contributing to the woes of other retailers — they now face increased pressure from online-only players. Companies like Boohoo and Fashion Nova have supercharged the fast fashion business model. They've cut lead times as short as a few weeks, churning out new products at even lower prices, and they're communicating more fluently with younger consumers **through social media.**

The fallout has been compared to a **retail apocalypse**. According to property consultancy Colliers International, nearly 900 stores have or will become vacant as a result of CVAs — or Company Voluntary Arrangements, a form of British insolvency — between January 2018 and June 24 2019. As of June 28, more than 7,000 store closures had been announced in the United States, according to Coresight Research.

The casualties include denim fashion brand Diesel SpA, whose American unit **filed for bankruptcy** in March 2019, and Topshop-owner Arcadia Group, which filed for bankruptcy in the United States two months later. In the United Kingdom, Arcadia was narrowly saved from **administration after squeezing a CVA from its landlords.**

Even retailers that seem to be taking all the right steps are suffering. Both Abercrombie & Fitch Co. and Nordstrom Inc. have made moves to experiment with in-store formats and step up online sales, but the companies remain under pressure. Abercrombie posted its **slowest rise in quarterly same-store sales in two years** at its surf-themed Hollister brand in May, while Nordstrom's net earnings in the first quarter of 2019 were nearly 60 percent weaker compared with the same period a year earlier.

"The battle of discounts is hurting everyone," said Joaquin Villalba, a former logistics manager at Zara and CEO and co-founder of Nextail, a software service company that brings artificial intelligence to retail inventory management. "If you operate better then you might need to discount less."

Where does H&M group go from here? The problem "shouldn't be unsolvable for a company like H&M," said Roger Lay, director of digital experience and innovation at Deloitte Digital. But rapid **self-disruption** is vital for the company to remain competitive.

Strategy

The Transformation Plan

Source: H&M

"It's an ambitious undertaking and the stakes are high."

In early 2018, with the company's share price tanking, the Persson family faced their investors.

"We know that there are some uncertainties about where the H&M group stands, and there are a few aspects and doubts. We are here today to straighten those out and correct any potential misunderstandings. We understand the need to be more transparent and to provide additional information," Karl-Johan's father and company chairman Stefan Persson told attendees gathered at the company's first ever investor day last February — a nod to the pressure the company was facing.

His son went on to provide more detail on the company's plans to improve its customer offering, invest in technology and infrastructure, and drive growth. The company made "some mistakes, but the good part is we know what it is, and we know how to improve it, and that obviously, we're working hard to improve now," the CEO said.

He hasn't been afraid to spend money in order to stay competitive, targeting every aspect of operations in an effort to modernise and remain relevant in a rapidly changing and challenging retail environment.

"To be the best, you have to constantly reinvest," Persson told The Business of Fashion. "It takes a lot; it's not only money and the new systems and so on, but it's also new ways of working for people."

The company is working towards a tangible shift in the way it sells its clothes and the profits it generates. Its efforts have ranged from housekeeping — refreshing design offerings and modernising storefronts — to a fully-fledged overhaul of its supply chain and tech systems.

It's an ambitious undertaking and the stakes are high.

"H&M was born as a brick and mortar retailer… we were master of that domain," said Martino Pessina, president of H&M in North America. "We're in the phase of, we think we know what we have to do, and we are really stepping on the gas to go according to our plan."

Ultimately, the company's underlying mission hasn't changed significantly. H&M group still aims to provide fashion-quality products at a democratic price point. But now, it wants to deliver that offering in a more efficient, sustainable and profitable manner.

"We believe we can do that in a good way and also, of course, package that in a nice shopping experience online, offline, and make it easy for customers," Persson said. "If we do that well — and better than the competition — I think we have a great chance of being successful for many years to come."

Here's how H&M group is trying to ride the upheaval in the retail world, hoping to not only survive, but maintain its position as a dominant player.

01 — The Digital Upgrade

"Within this field, in certain areas, we have had a little bit of an IT debt."

$1b

Capex planned for 2019, with more than half skewed to digital

Earlier in 2019, H&M group launched a new digital experiment: a **fashion advice forum** called Itsapark. The website — still in beta testing — offers users the opportunity to give and receive advice on a range of topics, from what to wear to a festival to how to keep makeup looking fresh on a summer commute.

The company's experiment with a social-media platform that has the potential to provide valuable data on consumer behaviour and desires illustrates much broader ambitions to make up its digital deficit.

The company is pouring money into an ongoing digital transformation, hoping to catch up with faster-moving and digitally native competitors. This year, it's planning capital expenditure of around $1 billion, with over half of that skewed towards digital investments. Its brands are now sold online via a single e-commerce platform, supported by a network of new and modernised warehouses and closer integration between online and physical stores.

"I think within this field, in certain areas, we have had a little bit of an IT debt," Persson said. "We have invested billions... in setting up a good IT infrastructure that will stand over time, and be scalable and stable."

H&M group is in the midst of rolling out a slew of consumer-friendly initiatives intended to encourage shoppers to engage across platforms. For instance, in 20 of the company's roughly 70 markets, customers can now use their phone to find something they saw online in a nearby store. Conversely, consumers already out shopping and struggling to find an item they want in their size can scan the product's QR code to find it on the web shop in all 48 markets where H&M is currently available online. Its expansion is ongoing.

Click-and-collect is available in 11 markets, with plans to expand further in 2019. Next-day delivery is an option in twelve markets and the company's looking at rolling out same-day delivery in several geographies. Its **customer loyalty programme** doubled in size to more than 30 million members last year and currently boasts more than 43 million. Members get special perks and H&M gets valuable user data and a ready audience for targeted advertising.

It's not exactly a revolution, however. Consumers have come to expect services like click-and-collect from faster-moving and digitally native competitors like Asos Plc, which also offers visual search, same-day delivery and try-before-you-buy. On the other hand, H&M group's efforts are bringing it onto a more competitive footing. The company's online performance has improved significantly, reaching 15 percent of total sales in 2018.

"It's a lot better than what we saw previously, and getting towards best-in-class," said Citigroup analyst Adam Cochrane. There was a "fear that others have overtaken them," but compared to many other retailers, the company has managed to build its online sales substantially, he added.

The ultimate goal is to capture and retain consumers as they migrate online. The company said H&M is already one of the most visited fashion sites in the world and work is continuing to increase the number of markets where it has an online presence.

By contrast, "a lot of retailers out there haven't made the investments and many can't afford it," said Fredrik Ivarsson, equity research analyst at Kepler Cheuvreux. "They're way too late to the party."

It's not an area where H&M group can afford to get complacent. The company was a comparatively early mover on e-commerce, starting online sales in 1998. By contrast, rival **Inditex didn't enter the market until 2010**. But the Spanish retailer isn't messing around. It has laid out an ambition make its brands **available online anywhere in the world by 2020**, a sign of the growing importance of online sales. Moreover, the power of digital is only likely to grow, with companies like Instagram stepping up efforts to act as sales platforms.

02 — The Infrastructure Investment

"For decades, the company thrived on what now seems like an old-fashioned business model."

Underpinning H&M group's shift to more digital operations is significant investment in updating and upgrading its physical infrastructure.

For decades, the company thrived on what now seems like an old-fashioned business model, farming out its production to low-cost manufacturing hubs like China and Bangladesh in order to offer cheap prices to Western consumers.

But that benefit was offset by a sprawling and slow supply chain — a liability in the increasingly fast-paced world of digital commerce. In many ways, the company is still playing catch up with more nimble players who are able to understand and respond to consumer trends in a matter of weeks. By contrast, H&M group's mis-steps balancing supply and demand in recent years have directly fed into its expensive inventory problem.

"For H&M, if you're ordering clothes manufactured in China en masse every number of months, that entire process takes a long time to filter down into stores," said CB Insight's Reddy. "It's very hard to match what's going to be popular three months down the line, so you end up with a big mismatch in terms of what's popular by the time it gets to the floor."

While around 20 percent of the company's manufacturers are now based in Europe — roughly double the level in 2013, when H&M group first started publishing its supplier list — around 80 percent of the factories that produce clothes, shoes and accessories for the retailer are still based in Asia. Nearly a third are based in China, bringing **new risks** in the form of **potentially hefty US tariffs**. America is H&M group's second-biggest market, and if Donald Trump were to follow through on threats to step up import duties against Chinese goods, it could hit the company hard. Persson said the company is looking at ways to mitigate the impact of any new duties.

Taking on H&M group's sprawling supply chain is no mean feat. The company works with more than 2,000 factories and releases a plethora of new styles every year across its global network of roughly 5,000 stores.

"Of course we need to be better," Persson acknowledged. "The H&M brand has grown much bigger today. We're present in 70 plus markets so the complexity of the H&M group is much, much bigger. If we continue to do things the same way, all other things being equal, inventory management will be much, much more complicated."

As it looked for ways to drive more speed and efficiency, the company brought in consultants to help understand and map its sprawling sourcing network. It has built a detailed picture of the number of logistics centres it uses, their size and their ability to cater for online and brick-and-mortar.

That work has led to ongoing efforts to overhaul its infrastructure. It opened three new warehouses in its fourth quarter of 2018, adding 230,000 square metres of storage in Germany and Poland. At the same time, it's modernising and automating existing sites, and has plans to open two new omnichannel warehouses in Europe and a high-tech logistics centre on the US West Coast.

To help better keep track of its ballooning inventory, the company's also introduced Radio Frequency Identification, or RFID, across fifteen markets. The technology allows it to track and manage inventory more easily. Using RFID is not yet standard practice among fashion retailers, said Deloitte's Lay.

At times, these changes were painful. In 2018, H&M group had to shell out 250 million Swedish Krona ($26.5 million) to resolve teething problems with its new logistics systems in the US, France, Italy and Belgium. To smooth out ongoing changes and upgrade the online platform in its biggest market, Germany, it incurred an additional 450 million Swedish Krona ($47.7 million) in costs across its fourth quarter of 2018 and first quarter of 2019. Profits were also dented in its second quarter of 2019 as a result of costs related to the ongoing transformation.

The company said the investments were worth it and will pay off long term. The changes have resolved capacity constraints that slowed the company down in some markets last year, though the new systems still aren't operating at full efficiency. They also allow for a broader range of products and faster deliveries, leaving room for future growth.

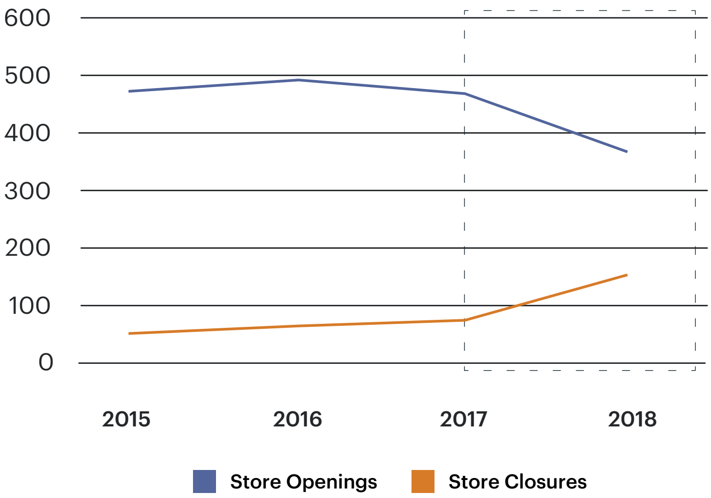
"Automation, new management systems, we know there's a risk there will be short term disruptions," Persson said. "Most likely, the work will have an efficiency dip before it gets up to better efficiency levels, but that's part of the long-term plan that we have."

03 — The Facelift for Physical

Exhibit 2: Shrinking to Grow

The H&M group is shrinking its retail footprint in some areas to favour more profitable sites.

(Number of store openings and closures)



Source: H&M

Source: H&M

H&M group's problems go well beyond prosaic supply chain concerns.

While it's pushing to grow newer brands like Cos, Arket and & Other Stories, around 90 percent of its roughly 5,000 stores globally are under the H&M banner. That's a problem because the company has struggled to maintain sales at its core brand, resorting to profit-eroding markdowns as consumers shifted online and inventory ballooned.

To stop the rot, the company has made some tough decisions. It will close its struggling Cheap Monday brand this summer, and it's working to rationalise its broader store footprint. It's shrinking in Europe, renegotiating leases and upgrading shop-fronts. In June, it announced it would slow the growth of its footprint further, reducing the net new openings planned for 2019 by 45.

"It's super important to improve the shopping experience," Persson said. "With customer expectations increasing all the time, we need to provide a shopping experience in the physical stores that is better than what we have today."

The company's made it a priority to work on consistently improving its products in an effort to differentiate itself in a crowded and increasingly competitive market. "The most important thing we have to constantly improve are the collections," Persson said in June. Its work to upgrade its stores is also ongoing.

Over the last few years, H&M group has piloted new store concepts, experimenting with different interiors and product displays. It's taking the results of those experiments and looking to roll out the most successful efforts on a bigger scale. It's aiming to tailor the offering in each store to the respective customer group and location.

Supply chain improvements are also having a knock-on effect here, preventing inventory build-ups that meant, in the past, customers were having to navigate clothes racks holding discounted winter coats during the height of summer. The company said it's already seeing results, with an increasing number of full-price sales.

But the ongoing improvements may not be enough to make up for the slow-down in store expansions and return H&M group to the level of sales growth it once enjoyed. Since 2015, when the company's sales soared nearly 20 percent, it hasn't been able to achieve more than 6 percent year-on-year growth. However, there are signs of improvement here, with sales rising 11 percent in the six months to May 2019 — the first half of the company's fiscal year.

04 — The Future-Proofing Play

Going forward, the company is determined not to repeat earlier mistakes of coming late to industry-changing technologies and trends.

It's investing heavily in data analytics and artificial intelligence, and promoting itself as a leader in the fashion industry's efforts to operate more sustainably.

The company has hired teams of math whizzes and data scientists to write complex algorithms that can interpret thousands of data points from across the H&M empire in a bid to help better predict trends and plan how to stocks stores.

It has brought on former fashion trend forecaster and Cambridge Analytica whistle-blower, **Christopher Wylie**, as director of research to explore how AI can help fashion better tackle its sustainability crisis.

"A lot of fashion companies look at the supply chain and mechanics from production to distribution, but actually understanding consumers will help you optimise the supply chain because you will better understand what it is they want to buy or they don't want to buy," Wylie told The Business of Fashion's annual VOICES gathering in November 2018. "Investing in AI will allow you to not only better match your units of clothing to your customers and therefore make more money, but you'll also be able to make more money with less units, or less waste."

Indeed, the opportunity this kind of technology presents to retailers is significant. According to consultancy McKinsey & Company, artificial intelligence could add between $400 billion and $800 billion of value to the retail sector. But at the same time, AI is in its infancy, and investing heavily in the wrong areas now could prove a costly mistake.

"The challenge for retailers is to not get seduced by new technology like AI… because it's the latest thing," said Gartner's Enright.

Still, H&M group's size gives it an advantage over smaller competitors: a valuable horde of data points. In 2017, its core H&M brand received 5 billion visits to its stores and websites and conducted 800 million transactions. That's a treasure trove of information that could translate into a significant payoff if interpreted correctly.

Better trend forecasting can also help H&M group avoid the huge piles of inventory and related markdowns that have plagued the company in recent years and hampered efforts to bolster its sustainability credentials. Early prototypes have shown that the company can use those data points to help detect trends 3 to 8 months in advance.

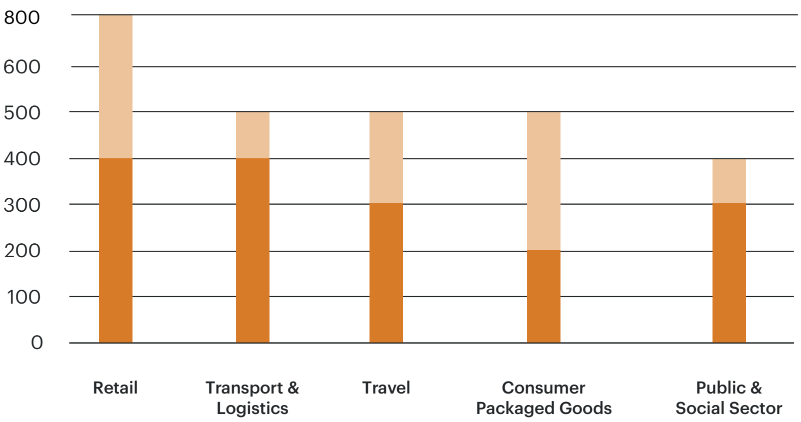
"We're doing things nobody's done before," said Arti Zeighami, H&M group's head of AI. "It's not about coming in on par with everybody else, it's actually about bypassing them."

"It's not about coming on par with everybody else, it's actually about bypassing them."

Exhibit 3: The Value of AI

According to McKinsey, artificial intelligence could create between $3.5 and $5.8 trillion in annual value across nineteen industries. Retail stands to benefit the most.

(Potential value in $ billions)



Source: McKinsey

Results

H&M's Scorecard

11%
Increase in sales in the first half of 2019

>43m
Members of H&M's loyalty programme by mid-2019

$4b
Inventory levels have remained stubbornly high

-11%
Profit in the first half of 2019

Source: H&M

What's working?

After years of work, there are **signs the strategy is beginning to pay off**. In the six months to May 31 2019 — the first half of H&M group's fiscal year — the company's sales increased by 11 percent, bolstered by a growing number of full-price sales and increasing market share in many countries.

"We are showing signs that we are on the right track," Persson said in June. "The plan we believe a lot in… the important thing is we execute on it, and we are doing that."

While the company acknowledges there's still room for improvement, its efforts to modernise its supply chain compare favourably to peers. It came sixth in Europe in Gartner's annual supply chain ranking this year, and 16th globally.

Its push to pick up digital consumers is also bearing fruit. Digital engagement is on the rise with online hitting 15 percent of sales in 2018. Its customer loyalty programme has surged to more than 43 million members, while online sales continue to rise.

Meanwhile, it remains committed to Persson's ambition to make the high-street retailer a leader in sustainable fashion — a tall order, but a direction the company believes will resonate with consumers.

"Sustainability should not be for a few or a luxury thing," Persson said in Stockholm in April. Ultimately, beyond any investment or data analysis, the most important thing is "the ability to create fashion that is appreciated by many, design-wise, quality-wise, price-wise, sustainability-wise," he said.

What problems remain?

At least one thing hasn't changed: H&M group's $4 billion pile of stock.

While inventory levels are off the record 18.9 percent of sales they hit in 2018, they remain elevated at 18.2 percent. Higher sales in the company's fiscal first half of 2019 haven't been strong enough to really dent stock levels, which increased in outright value to 40.4 billion Swedish Krona ($4.3 billion) at the end of May. As a percentage of sales, they remain well above the company's target of 12 to 14 percent.

Meanwhile, H&M group's ambitious transformation plans are adding hefty costs that have eroded profits. Despite strong sales growth, the company's net profit slid nearly 11 percent in its first half compared to a year earlier, dampened in part by less favourable exchange rates. Selling and administrative expenses increased 12 percent year-on-year, reflecting costs associated with store and online expansion, as well as the company's ongoing transformation efforts.

"Many challenges and hard work remain, but we see that we are definitely on the right track," Persson told analysts in June. "While costs have affected profitability short term, we are convinced that our initiatives and strong customer focus will contribute to gradually improved profitability and to a positive long-term development for the H&M group."

The company is betting on its ongoing investments to help navigate the uncertain state of the market in an intensely competitive environment. Investors are watching with caution. H&M group's share price is up nearly 40 percent from its March 2018 low, but remains well off levels seen before the company's problems emerged.

"I think they've gone to better than average but [the transformation is] far from complete," said Citi's Cochrane.

Looking Ahead

01 — How will H&M reduce its inventory pile without further profit-eroding markdowns?

Executives have repeatedly batted back questions about inventory levels with reassurances that the products currently in stores and warehouses don't represent a problem. They say the inventory is of higher quality than in previous years, which means it can be sold at full price. But analysts remain sceptical that the company has the issue under control. "I have difficulty seeing them walking that inventory level down to the target they have by 2020," said Kepler Cheuvreux analyst Ivarsson. To add further urgency to the challenge, an overstocked company with an excess of product on its books is not a good look for a company eager to market itself as a leader in sustainable fashion.

02 — Can H&M group keep up with the need for speed?

H&M group will need to work hard to align supply and demand, and match the velocity that consumers have come to expect from nimble online players. As noted in The Business of Fashion and McKinsey's annual **State of Fashion** report, "companies still playing by the old rules, with prolonged end-to-end product development processes, face increased fashion risk and excess inventory if they are not able to match customer demand." With the majority of H&M group's manufacturing taking place in Asia, it's at a disadvantage to competitors with more agile business models. In an era of fast-changing preferences, swiftly matching production with trends driven by consumers and social media will become increasingly important.

03 — Will rethinking brick-and-mortar reclaim store footfall and build brand loyalty?

H&M group store closures have increased, but the company sees a future in physical retail and is still growing its store numbers every year. It's betting on sleeker, more modern stores, better tailored to local consumers and streamlined with the company's online offering to entice consumers. Added bells and whistles like a cafe, in-store events or pop-ups can prove an additional draw for consumers, turning a store into a destination. But footfall doesn't necessarily translate into in-person sales today, and experience isn't a silver bullet to save physical stores, making it important for retailers to balance their digital and brick-and-mortar offering. "The store needs to promote the online business and the online business needs to promote the store," Gartner's Enright said.

04 — How will data dominate?

The use of rich data and granular customer insights to inform decisions offers companies more knowledge than ever before about how consumers shop and what they want. As one of the world's biggest fashion retailers, H&M group has a treasure trove of data, but it's only just beginning to figure out how to leverage it. It has implemented artificial intelligence in different areas of the business, from predicting trends to setting prices. But the company is still in the pilot phase for many projects. "The challenge is not to get seduced by new technology like AI machine learning in the sense you need to have it because it's the latest thing," said Gartner's Enright. Instead, H&M group has to work out where and how data adds the most value and insight. It's a huge opportunity for brands able to interpret information swiftly and translate that into product. On the other hand, ignoring or misreading these signals can result in big problems.

05 — What does it take to keep up with digital disruptors?

According to research firm Euromonitor International, online sales of apparel and footwear globally are expected to increase at a compound annual growth rate of 12 percent between 2018 and 2023. Brands need to keep investing in their digital offering to keep up with evolving trends. But the organisational strategy of established companies operating in mature markets is often not an effective breeding ground for disruption and they risk getting left behind by competitors better placed to innovate. But H&M group has big ambitions. The company's continuing to invest heavily in its online offering and its accelerating its efforts to adapt to changes in consumer behaviour.

Appendix

Exhibit 4: H&M Brand Footprint

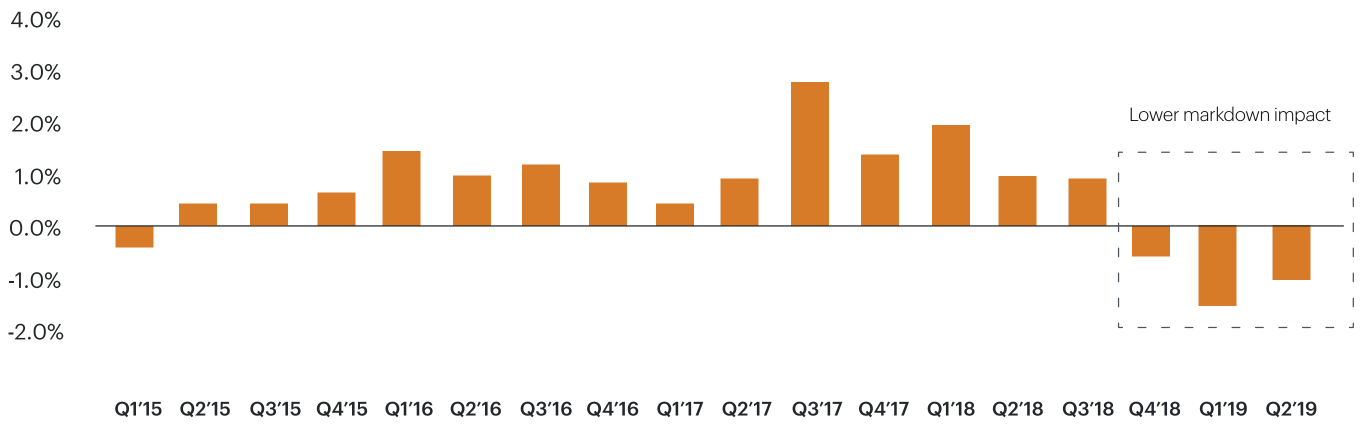
BRAND	Stores	Physical Markets	Online Markets
H&M	4,433	71	47
COS	270	41	21
WEEKDAY	38	10	18
CHEAP MONDAY *	1	1	18
MONKI	127	16	19
H&M HOME	8	50	40
& OTHER STORIES	70	17	15
ARKET	16	6	18
AFOUND	5	1	1

Source: H&M, data is as of 30 Nov 2018
*Cheap Monday will close down in summer 2019

Exhibit 5: H&M's Markdown Battle

The cost of markdowns in relation to sales increased year-on-year each quarter from Q2 2015 until Q3 2018. It's only in the last few quarters that the company has seen signs of improvement.

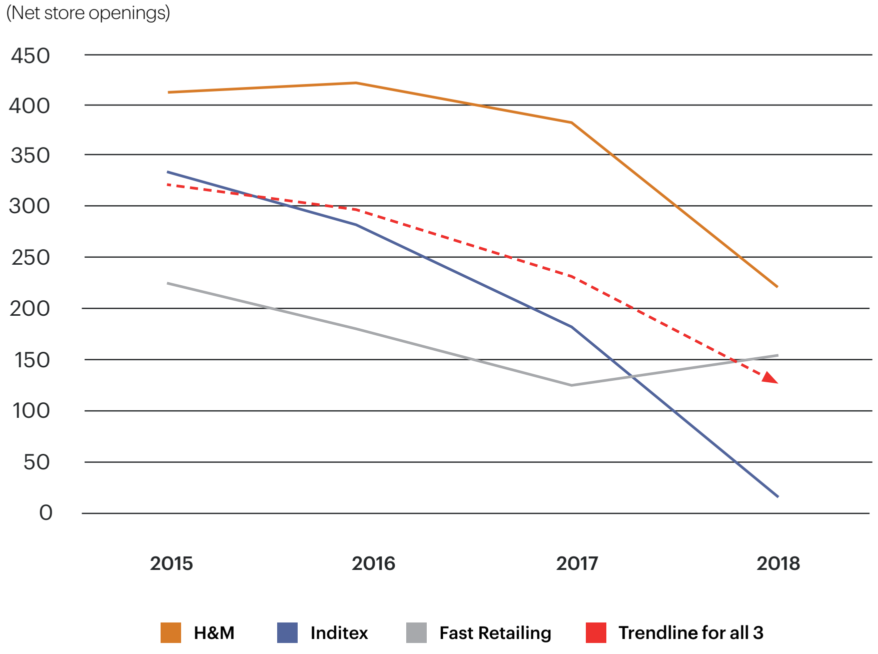
(Percentage change in the cost of markdowns in relation to sales)



Source: H&M

Exhibit 6: Trending: Profits Over Presence

The world's biggest fast-fashion retailers' net store openings have been declining.

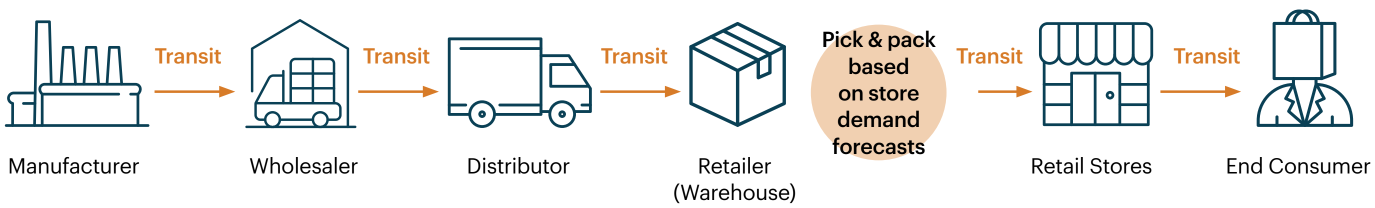


Source: H&M, Inditex, Fast Retailing, BoF Analysis

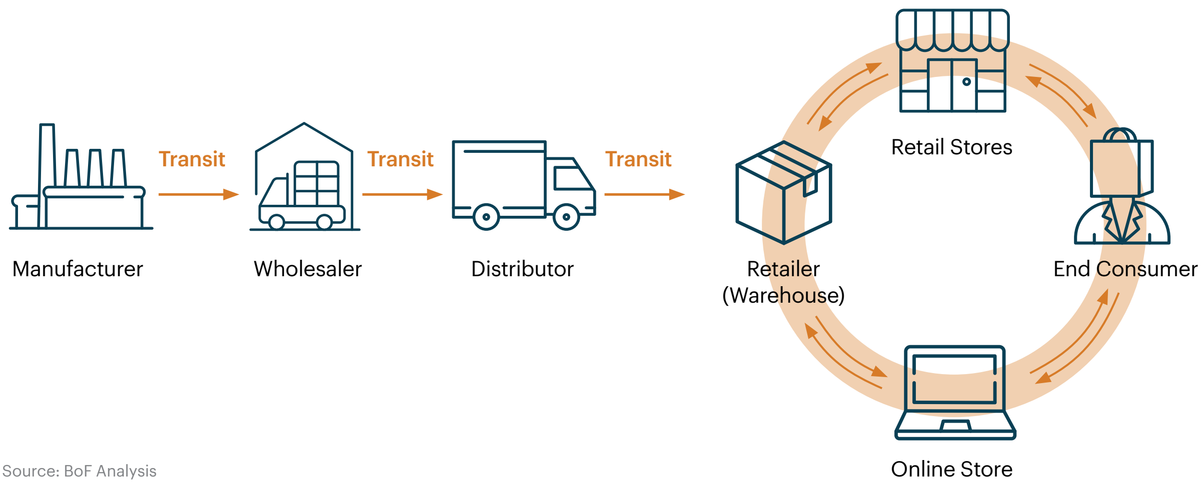
Exhibit 7: Supply Chain Wars: Analog vs Omnichannel

Retailers are having to build more sophisticated supply chains as consumers buy more online.

Analog



Omnichannel



Source: BoF Analysis

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