The Art of Saying No: The Investments We Rejected
Part I

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We have written many times about the reasoning behind our investments and have described in detail the underlying businesses and our valuation of them. However, I believe there is as much, possibly more, to learn from those investments that we spent time researching and chose to pass on. We don't need to swing wildly at every pitch. We don't even need to swing at every strike. Unlike in baseball, you don't stop investing if you miss three strikes. An investor can wait for the perfect pitch and then hit it out of the park. And the way to do that is to perfect the art of saying no.

Some of the investments we chose to pass on were a matter of valuation, some a question of risk or red flags, and some simply an inability to reach the necessary conviction to pull the trigger. No matter the reason, a study of the companies which we ultimately did not invest in opens up a window into how we approach investing that is missing if we only look at the companies which we ultimately did invest in. Without further ado, welcome to the inaugural edition of The Art of Saying No: The Investments We Rejected.

The Setup

The year was 2019 and our attention was drawn to a company that was preparing to enter the public markets for the first time via an IPO. It was a consumer product company selling a high-end product with a cult-like fanbase and rapid growth. What initially attracted my attention was the intriguing business model — the idea was to sell the product at roughly breakeven and make their money from the ongoing monthly subscription. And to top it off, management described the company as already "effectively profitable". An already profitable company with rapid growth from a well-regarded product? What was not to like? The company was … Peloton.

Background

Peloton was founded in 2012 and started selling their first product, an internet-connected stationary cycle, about two years later. The Peloton Bike was a high-end premium cycle for a mid-high-end price. The twist was that it was a connected bike, with a huge touch screen and a constant feed of live and on-demand classes of all sorts and all levels, led by mini-celebrity star instructors. Peloton paid star-level salaries to hire the best of the best, and pretty soon, a person could choose from thousands of past classes or join a live one, competing against others or just against themselves. Over time, Peloton added new products, such as the Peloton Tread, a high-end treadmill, and new classes, such as yoga or outdoor running.

The Peloton hardware was definitely high-end and attracted a hard-core, cult-like following, which is of course quite positive for any consumer-oriented business. They grew very rapidly, expanding product categories, geographies, and demographics. A chart of their revenue was basically straight up and to the right, having doubled revenue each year for a few years in a row. The mix of high-end exercise bikes and treadmills with a huge library of live and on-demand classes set them up as competition to both traditional equipment makers (such as NordicTrack and Nautilus) as well as boutique gym classes (such as SoulCycle and Flywheel), and Peloton was winning.

The business model was to sell the exercise machines at cost and make money on the monthly subscriptions, leveraging the fixed costs of their instructors, studios, and streaming platform over hundreds of thousands of monthly subscribers. I found the core of this business model to be very attractive; indeed, the business model is what attracted me to research Peloton in the first place. In theory, as they scaled their customer base, they would become hugely profitable as they amortized relatively fixed costs over more and more monthly subscriptions. In various interviews over the years, management had revealed that Peloton was already profitable and cash-flow positive by the end of 2015, quite early in the startup cycle. In 2018, management repeated that they were "effectively profitable" on an adjusted basis.

Why We Rejected

First of all, it turned out that "effectively" profitable was not all that effective. At times, I have been guilty of using adjusted numbers myself, and there are definitely times where that is a legitimate way of analyzing a company. In this case, however, Peloton was guilty of using EBE, Earnings Before Expenses. Basically, Peloton was not profitable by any stretch of the imagination, *unless* you agreed to ignore their sales and marketing expense. Which is patently ridiculous. Given the huge expense they were incurring to sell and market their product, they were not at all profitable, and in fact, the losses were getting worse.

Their lack of profitability did not have to totally negate the possibility of investing in them. Truth be told, at this early stage of their lifecycle as a rapidly growing company, it was quite understandable if they were not yet profitable. They had decent gross margins; they were not actually selling the equipment at breakeven anymore, but turning a nice profit on the equipment itself, in addition to the strong and growing margins on the monthly subscriptions. Investment for the future by growing their customer base through outsized sales and marketing efforts was an understandable strategy.

But given the lack of profitability, the nosebleed valuation at which they went public was the nail in the coffin. Peloton IPO'd on September 26, 2019 at $29 a share. Even after closing down the first day and gradually drifting lower over its first month of public trading, it still fetched a market cap of about $6 billion. For a company making about $1 billion in *revenue* (although rapidly growing), and *losing* about $200 million a year. Sure, things could work out, but only if everything lined up perfectly. However, it is quite rare for everything to go perfectly. As deep value investors, our first mantra has to be that valuation always matters, and at that price, we were not interested.

The Rest of the Story

Just a short while later, in the beginning of 2020, COVID took the world by storm. With COVID came widespread lockdowns, work from home, and social distancing. This was extremely favorable for Peloton's business, with tons of people having extra free time and a newfound desire to exercise, yet gyms were closed and even public outdoor spaces were left deserted. In the second calendar quarter of 2020 (the months of April through June), subscriber growth charged ahead, revenue almost tripled, and the company swung from a moderate loss to strong profitability. And even as lockdowns waned somewhat, business momentum remained strong. Peloton was a COVID darling, and the stock shot up, along with its sales and subscriber numbers. The sky was the limit, or seemed to be. In fact, when we wrote in October 2020 on Bubble Investing, exhibit #1 was Peloton:

> For those unfamiliar with their story, Peloton sells connected exercise equipment (exercise bikes, treadmills, etc.) with large screens that connect to live and on-demand fitness classes covering the gamut of class types, skill levels, and lengths. They sell their high-end equipment for a premium price, with the gross margin intended to cover the marketing spend needed to attract new customers and the meat of the business being the recurring monthly subscription revenue. Even before they went public, we were intrigued by their products and

> business model, and we spent significant time researching the company. Ultimately, we chose not to buy stock when they went public a year ago, mostly due to valuation.
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> Somewhat predictably, Peloton benefited from general lockdowns and gym closures, but perhaps less predictably, they benefited to an extent few dreamed. In the months of April-June, subscriber growth charged ahead, revenue almost tripled, and the company swung from a moderate loss to strong profitability. And even as lockdowns have waned, business momentum remains strong. The stock responded by skyrocketing from a March low of about $20 to its recent close of about $140, a market cap of ~$40 billion and a gain of 7x! Would I prefer to have been invested in a stock that shot up 7x? Absolutely, but only if I don't have to forgo my deeply-held investment principles to do so. At present inflated prices, Peloton is a ridiculously speculative and risky investment. The amount of growth that must occur in the future to sustain the present price is extreme, and I, for one, do not want to be there if and when that bubble bursts.

Peloton's stock surge had a bit more juice to it, and just a few months after this analysis, the stock peaked at ~$170, up another 20% from when we wrote the above paragraphs, and up about 7.5x from its post-IPO lows. Then, the wheels came off.

It was not one specific thing that tripped them up, but a confluence of many factors together with extreme mismanagement. During the pandemic, demand soared and outstripped supply by far, with delivery times rising rapidly. Although the prudent reaction would be to raise supply while keeping in mind that the pandemic-fueled surge would not last forever, management chose instead to go all in. They massively and expensively increased their manufacturing capacity, spending hundreds of millions of dollars to build manufacturing plants as well as purchasing Precor, a third-party manufacturer. When the surge in demand slowed, they were left with massive overcapacity and underutilization, as well of lots of expensive inventory which they struggled to offload even at a loss. Gross margins on hardware flipped from highly positive to negative, even before accounting for the massive sales and marketing expense needed to move product. Eventually, they sold their unfinished manufacturing plants for pennies on the dollar, and attempted but failed to sell their Precor acquisition.

Around the same time, a child was caught in the Peloton Tread and died, which prompted an expensive recall and redesign of their treadmill (after almost two months of foot-dragging and negative press). At the same time, costs throughout the company were skyrocketing, with ridiculously bloated general overhead as well as very high sales and marketing expenses. Company management showed itself completely incapable of any form of cost discipline whatsoever. Starting in the beginning of calendar year 2021, even before the pandemic surge had fully reversed, they returned to posting massive losses, after their brief flirting with profitability. It was almost breathtaking how they managed to spend like drunken sailors.

The stock price dropped from its peak and continued to drop as losses kept getting bigger and bigger and rapid revenue growth turned to rapid revenue decline. At the end of March 2022, about a year after hitting its all-time peak, the stock slipped back below its IPO price and never looked back. Today, it is trading at $6.77, with a market cap of about $2.7 billion.

Peloton needed everything to go perfectly to justify its original valuation. Everything did not go perfectly. Some things went better than perfectly (the pandemic brought their product to front and center of mind), but they managed to royally botch their handling of that. And many other things went far, far less than perfectly.

Postmortem & Lessons

We feel that we made the right call with Peloton. Despite Peloton's intriguing business model, the model was yet unproven and their valuation was too stretched. This second point bears repeating, as valuation always matters. The valuation here was so high as to need everything to align perfectly without a hitch to deserve and grow into that valuation. That is the crux of why we passed on investing, and, as value investors, that was absolutely the right call. Although we missed out on their rapid (in hindsight, unwarranted) rise, we thereby also missed out on their rapid decline. In hindsight, our foresight was prescient.

What needs to be underlined is that a core part of any serious investing framework has to be valuation. However good the story, and however bright the future, valuation *must* be part of the equation. The very rich valuation at the beginning of Peloton's path in public markets was the true harbinger of doom from an investing standpoint.

Perhaps the most interesting part is that now, at a much lower valuation and multiple changes of management, Peloton may finally make sense as an investment. They *should* be able to turn themselves back to profitability with proper management, although time will tell if they actually execute. If they do, they still have a core of loyal fans, with 3 million customers paying monthly subscription fees bringing in a gross profit of more than $1 billion annually. Equipment sales are back to being profitable on a gross margin basis and has room to improve further. If they can control costs like a normal company (that's a big if, although it shouldn't be), they can become a highly profitable and growing company. At the present market cap of $2.7 billion, it may actually make sense as an investment.

Moral of the story: Valuation always matters.