Short: The RealReal

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Investment Summary

- **Recommend short position on The RealReal ('REAL', 'the Company'); price target of $10.8, implying a 41.0% return**

- **Market mispricing**: REAL is falsely seen as a novel marketplace in online luxury resale; a beat on 2Q19 take-rate expectations, along with questionable financial reporting practices as a recently IPO'd business, distracts investors from mediocre GMV growth trends, poor scalability, and rapidly intensifying competition

- **Investment thesis**:
  1) Street overestimates online luxury resale market opportunity
  2) REAL's unorthodox financial reporting masks weak scalability
  3) Lack of moats as an undifferentiated luxury marketplace

The RealReal

Financial Summary ($mm)	
Share Price	$18.3
Shares Outstanding	85.3
Market Capitalization	**$ 1,564**
Net Debt	307
Enterprise Value	**$ 1,871**
Revenue (LTM)	$ 282.8
Revenue Growth	52%
EV / LTM Revenue	8.6x
EV / FTM Revenue	**4.9x**
Peer EV / FTM Revenue	**2.9x**

Business & Opportunity Overview

- REAL is an online marketplace for used luxury goods, employing a consignment model with owners of luxury goods. The Company processes, authenticates, and lists consigned goods; once a sale is made, REAL ships merchandise to buyers, collecting a 30-40% take-rate on sold goods

	Forecast	Street	% Diff.
2020E Revenue	375	411	(9%)
2020E EBITDA	(115)	(65)	(76%)
Price Target	**$10.8**	**$28.5**	(62%)
% Return	*(41.0%)*	*55.5%*	*NM*

The opportunity exists because:

- Beat on take-rate in 2Q19 / 3Q19 distracts investors from mediocre GMV growth trends

- Analysts have yet to criticize REAL's financial reporting, given its nascency in the public markets (Jun-19 IPO)

- REAL trades at an unreasonable premium to a clearly defined set of marketplace peers; the case for a multiple reversion is increasingly clear and highly actionable

- **3Q19 UPDATE**: Share price down 22% since initial submission at $23.7, but in part attributable to wider peer marketplace valuation reversion (sales multiples down from 3.5x 2Q to 2.9x 3Q); thesis has yet to fully play out!

Thesis 1
Limited Market Opportunity

Thesis 1: Limited Market Opportunity

- Management and analysts reports frequently cite a ~$200bn market opportunity in luxury resale

- **However, the market is much more fairly sized at $17bn by GMV (~$6bn by addressable take-rate revenue)**

- The $200bn figure was proposed by Frost & Sullivan ('F&S'), a market research company hired by REAL to quantify its market opportunity <u>ahead of its IPO roadshow</u>…

- F&S (conveniently) fails to adjust for:
  1) Annual sell-through of existing stock
  2) Product type (apparel & accessories only)
  3) Geography (US-based; no int'l presence)
  4) Adoption of resale markets
  5) Online luxury adoption

Luxury Resale GMV Sizing		
	$ Value	**% Prop.**
Luxury Merch. Sold '13-'18	1,434,000	NM
Discounted / Resale Value	792,800	40-50%
Proportion Resold in 2018	118,920	15%
Proportion Apparel	66,595	56%
Proportion US Market	**$ 16,649**	**25%**
Proportion Currently Listed	5,500	33%
Proportion Resale Online	**$ 1,331**	**24%**

Thesis 1: Limited Market Opportunity

- Luxury resale market is challenged by the need to drive both resale listing and online resale adoption

- **Resale market adoption**: Only ~33% of luxury stock is actually listed on resale marketplaces, and this figure has remained relatively constant through 2015-2018; adoption take-off is unclear (est. 40% by 2025)

- **Online luxury adoption**: Online penetration currently sits at ~24% in the US, and many studies point to 25% as an upper limit on online penetration in luxury segments (consumer preferences for offline experiences); limited opportunity for incremental penetration (est. 35% by 2025)

Market Sizing ($bn)	2018A	2019E	2020E	2021E	2022E	2023E	2024E	2025E	CAGR
Total potential GMV	118.9	123.7	128.8	132.8	137.8	143.0	148.8	154.7	3.9%
Total GMV, US Apparel	16.6	18.2	19.9	21.5	23.5	25.6	27.9	30.5	9.1%
Total GMV, Listed Online	**1.3**	**1.6**	**1.9**	**2.2**	**2.6**	**3.0**	**3.6**	**4.2**	18.0%
Implied REAL Penetration	53%	63%	66%	69%	69%	69%	67%	64%	
Implied Street Est. Penetration	53%	62%	68%	75%	80%	85%	NA	NA	

An implied 85% pen. by 2023 suggests overly bullish GMV growth or that REAL will compete unprofitably, which warrants revision in its premium valuation.

Thesis 2
Weak Scalability

Thesis 2: Weak Scalability

- Merchandise authentication is a cornerstone of REAL's business model…but the cost burden is <u>buried in company financials</u> under "Operations & Technology" Expense

- Authentication is a variable cost, and should not be categorized as an operating expense; <u>REAL's gross margin is overstated!</u>

- Employee detail in filings, Glassdoor salary estimates, and LinkedIn role distribution are used to triangulate an **effective Gross Margin of 49%** (relative to 64% reported)

(1Q19 FTM Estimates)	Merch. Operations	Variable Fulfilment
Employee Count	480	241
x Annual Salary ($k)	$ 65.0	$ 46.8
Salary Expense ($mm)	**31.2**	**11.3**
% Sales	*10.2%*	*3.5%*

2020E Margin ($mm)	Forecast	Consensus
Total Revenues	375.2	411.2
Less Cost of Revenues	(135.7)	(147.4)
Less Variable O&T	(57.0)	???
Effective Gross Profit	**182.5**	**263.8**
% Gross Margin	*48.7%*	*64.2%*

Thesis 2: Weak Scalability

- There is a significant mismatch between analysts' analysis of REAL automation and financial forecasts:

- **Analyst 1**: Makes only one explicit reference to automation effort; "we think it costs REAL ~$1 per item to have product images for the website manually retouched…we think the company can cut out the majority of that $1…by using automation software." **Forecast**: 1400bps of O&T margin improvement through 2022

- **Analyst 2**: Notes that "[REAL] employs over 100 authenticators…each item goes through a rigorous authentication process that inspects various attributes including chemical composition of metal used, brand markings, date codes, serial tags." **Forecast**: validates mgmt.-guided 2022 EBITDA breakeven

Consensus incorrectly prices ~15%pp of operating leverage through 2022, grossly overstating REAL's earnings power and time to profitability.

Thesis 2: Weak Scalability

The RealReal's shares plunge as poor training and tough quotas cast doubt on 'no fakes' pledge

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- "CNBC spoke with nearly three dozen former employees and obtained internal company documents that show **not everything is authenticated by an expert** and employees work under strict quotas that lead to fakes being sold on the site."

- " 'It's so much product. It's really hard for someone to properly authenticate something **when they're not the best qualified** to be even doing that in the first place…and they're being rushed to hit a goal.' "

What authentication costs are investors underwriting??

Thesis 2: Weak Scalability

- REAL elects to report a significant portion of its R&D cost burden as "capital expenditures for proprietary software assets"

- This is no place for arguing the theoretical merits of capitalizing R&D costs; most of REAL's peers expense this cost burden, which generates inconsistencies in comparability for valuation

- Across the 6 leading coverage analysts, **no report makes explicit reference to capitalized costs of R&D in financial forecasts**

	Expenses	Capitalizes
REAL		x
FTCH	x	
ETSY	x	
EBAY	x	
BKNG		x
GRUB	x	
SFIX		x
LYFT	x	
TRIP	x	
UBER	x	

Consensus forecasts ignore a ~7%pp weight on operating margins, implying a further overstatement of long-term earnings power.

Thesis 3
Competitive Landscape

Thesis 3: Competitive Landscape

- REAL faces meaningful competition from well-capitalized competitors, scaled retailers with option-value JVs in the resale market, and established marketplaces with dormant assets primed for investment and scaling

- **Direct Competitors**:
  Vestiaire Collective
  Poshmark
  Tradesy

- **Partnerships**:
  Macy's & JCP partner with Thredup (Aug-19)
  Neiman Marcus invests in Fashionphile (Apr-19)
  JD.com invests in Secoo (Aug-18)

- **Dormant Businesses**:
  eBay Authenticate
  Farfetch Secondlife
  Thredup Luxe

Thesis 3: Competitive Landscape

- Despite touting a flywheel / network effect, REAL's lack of customer stickiness is apparent in its implied churn

- Using REAL's sparsely-reported KPIs, a rough customer waterfall can be generated to calculate an implied annual customer churn of 48-50%

- In context of comparable marketplace businesses: Spotify churn at ~50%, StitchFix churn at ~60%...**but REAL trades at a significant premium to both**!

Implied Customer Churn Calculation		
Customers in '000s	**2018**	**1Q19**
Buyer Acquisition Cost ($)	$ 139	$ 121
x Ad Expense ($mm)	(36.6)	(10.1)
(b) New Customers	**263**	**83**
(a) Beginning Customers	291	416
(b) New Customers	263	83
(c) End Customers	416	455
Lost Customers (Implied)	**(138)**	**(44)**
=(c) - (a) - (b)		
Implied Annualized Churn	*47.5%*	*50.1%*

Why pay a premium valuation for intense competition from incumbents & new entrants, and for subpar marketplace customer retention?

Thesis 3: Competitive Landscape

- Distribution of luxury goods is economically unattractive due to supplier squeeze; the top 5 brand houses account for ~40% of all luxury apparel sales in 2018

Legal Overhang

- Nov-18: Chanel files lawsuit against REAL, accusing the company of selling counterfeit merchandise

- Chanel previously filed an identical lawsuit against a REAL peer (Mar-18: Chanel v. WAGACA), and has historically won similar lawsuits (Jun-17: Chanel & Amazon resellers)

- None of the 6 coverage analysts meaningfully qualify or quantify this impact, **<u>implying the lawsuit threat has completely failed to weigh on earnings and valuation</u>**

Chanel is Suing The RealReal for Allegedly Selling Counterfeit Bags

November 15, 2018 / TFL

Chanel Files Ugly Suit Against What Goes Around Comes Around, Citing Fakes

March 15, 2018 / TFL

Valuation & Catalysts

Financial Forecasts

- GMV growth rapidly decelerates, reflecting US market saturation
- Revenue follows GMV trend, with take-rate only marginally pressured through 2023
- O&T variable expenses grows with revenues

Key Forecasts

- (9%) consensus difference in 2020E revenue
- EBITDA breakeven in 2025, relative to 2022 consensus est.

GMV and Revenue Build	2018A	2019E	2020E	2021E	2022E	2023E
Average Order Value ($)	446	444	442	446	451	455
Annual Orders / Buyer	3.8	3.9	4.0	4.0	4.0	4.0
Active Buyers ('000s)	416	570	693	832	981	1,138
Gross Merchandise Value	**711**	**989**	**1,231**	**1,492**	**1,779**	**2,084**
% Consensus Difference	*NM*	*2%*	*(2%)*	*(8%)*	*(14%)*	*(19%)*
Take Rate	36%	36%	35%	35%	34%	34%
Net Consignment Revenue	184	258	317	378	444	513
Returns Revenue	23	47	59	70	82	95
Total Revenue	**207**	**305**	**375**	**448**	**527**	**608**
% Consensus Difference	*NM*	*(2%)*	*(9%)*	*(15%)*	*(21%)*	*(27%)*
Cost of Consignment	(51)	(72)	(88)	(105)	(124)	(143)
Cost of Returns Revenue	(20)	(38)	(47)	(57)	(67)	(77)
Gross Margin	**137**	**195**	**240**	**286**	**336**	**388**
Ops & Tech Variable Exp.	(35)	(48)	(57)	(68)	(80)	(92)
Ops & Tech Fixed Exp.	(70)	(95)	(118)	(126)	(135)	(144)
Marketing Expense	(42)	(50)	(57)	(60)	(63)	(66)
Sales, G&A Expense	(64)	(106)	(135)	(145)	(155)	(166)
D&A + Adjustments	15	15	13	22	28	37
Adj. EBITDA	**(59)**	**(89)**	**(115)**	**(91)**	**(68)**	**(43)**
% Consensus Difference	*NM*	*(21%)*	*(76%)*	*(134%)*	*NM*	*(172%)*

Valuation

- REAL is best compared to a wide set of online marketplace peers; **Price Target at $10.8 (41.0% return)**

- **Base**: Mediocre revenue growth, subpar scalability, and accelerating churn will lead Street to realize REAL should trade in line with peers (at 1yr avg. forward of 3.9x)

- **Bull**: Rapidly decelerating growth and significant take-rate pressure would lead to comping against FTCH's depressed valuation (at 3mo avg. of 1.6x)

- **Bear**: Earnings beat in high-focus 4Q19 may temporarily push valuation to premium-marketplace levels, matching ETSY valuation (at 3mo avg. of 6.6x)

Multiples Valuation (EV / FTM Revenue)

Peers	Current	3mo avg.	1yr avg.
E-Commerce Marketplaces			
REAL	4.9x	5.0x	NA
FTCH	1.4x	1.6x	NA
ETSY	4.9x	6.6x	7.9x
EBAY	3.0x	3.2x	3.1x
Other Online Marketplaces			
BKNG	4.7x	5.1x	4.8x
GRUB	2.5x	3.2x	4.3x
SFIX	.9x	.9x	1.2x
LYFT	2.2x	2.4x	2.4x
TRIP	2.2x	2.7x	3.4x
UBER	2.5x	3.0x	NA
Average	**2.9x**	**3.4x**	**3.9x**
Median	**2.5x**	**3.1x**	**3.4x**

2020E	Multiple	Price	Return
Base	3.9x	**$10.8**	41.0%
Bull	1.6x	**$2.3**	87.5%
Bear	6.6x	**$20.8**	(13.2%)

Investment Catalysts

- **1) Reversion to natural take-rate**: REAL surprised markets in 2Q19 with a take-rate beat at 36.5% relative to ~35% est, which only reflected seasonality and not superior competitive positioning. Reversion likely to occur as soon as 4Q19; Winter quarter represents a more competitive quarter in the luxury market, historically pressuring REAL's take rate.

- **2) Macro pressures in luxury**: luxury resale markets are not insulated from macro shifts; persisting challenges in the wider luxury market will pressure REAL's earnings power, especially in high-focus 4Q19 / 4Q20.

- **3) Increased disclosure around scalability**: Street analysts are increasingly attentive to REAL's scalability efforts (2Q19, 3Q19 earnings); additional scrutiny around cost structure should catalyze share price reversion.

- **4) WGACA lawsuit outcome**: Activity in Chanel v. WGACA accelerates in 2H20 (earlier timeline than Chanel v. REAL); case proceedings will catalyze multiple reversion at REAL, reflecting legal overhang.

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