

The Rise and Fall of Peloton: Financial Perspective

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Management

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Abstract

The case presents an overview from different business perspectives of Peloton Interactive, an American exercise-equipment and media company that was established in 2012 by John Foley. The company through its strategic decisions and marketing campaigns achieved significant growth since its inception but the home fitness company thrived when the whole world was under lockdown. Despite the revenue boost, Peloton could not sustain its spike due to mismanagement, flaws in sales estimation, marketing mishaps, and scandals. The case seeks to analyze different verticals of the company in the form of potential expansion to Asia-pacific, scale-up dilemma, repositioning through marketing strategy, and estimating the fair value of the company's stock through valuation.

Individual Case Study

This case is to be taught to Master's students enrolled in "Advanced Financial Management" and "Financial Modeling." The case explains the rationale behind assumptions that are used in DCF Valuation to be able to come to the conclusion of buying the stock of a company or not.

Keywords

Valuation, Financial Analysis, Cash Flow, Expansion, International, Forecast, Wellness, Market Analysis, Cost, Industry Research, Fitness, Pandemic, Positioning

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Group Part

Introduction

In 2011, John Foley, the president of Barnes and Noble lived in a condo with his wife and children in New York City. Foley was an MBA graduate from Harvard Business School and had earned his Bachelor of Science in industrial engineering from Georgia Tech Institute of Technology. He was an avid cyclist who enjoyed going to his weekly boutique fitness classes. However, as his career and family responsibilities became more demanding, he struggled to find the time and flexibility to attend the classes he cherished. Out of his frustration, Foley thought of an idea which would revolutionize the fitness industry by bringing the excitement and community of boutique fitness facilities into the convenience of health enthusiasts' homes. Foley would then have the opportunity to leverage his tech and business experience to create Peloton, an interactive and innovative fitness platform that offers flexible, high-quality, home-based instructor-led workouts.

The visionary pitched the business idea to his colleague Tom Cortese and several co-workers (Hisao Kushi, Yony Feng, and Graham Stanton) who joined the founding team and Peloton Interactive was officially established on January 3, 2012 (Sherman 2020). In fact, the word "peloton" is of French origin and it means "a large pack or cluster of bicyclists in a road race, riding closely together to reduce wind resistance and conserve their energy" (Dictionary s.d.).

The First Prototype

Once the team was onboard, the founders realized that they would need to build a prototype bike. The initial idea was to create a minimum viable product that uses an existing

bike that can be wired to the customer's tablet. However, the founders did not find a bike in the market that suited the company's needs nor did they want to partner with a tablet maker that would risk putting the company in an unfavorable position; therefore, the founders decided to build a bike that would incorporate its hardware and software from scratch. The founders carried out extensive research to learn about the advancements in electronics technology and manufacturing. After gathering 400,000\$ as initial capital from angel investors in February 2012, Peloton was linked with Taiwan-based manufacturer that provided Peloton's first prototype bike. Due to miscommunication with the manufacturer the first prototype bike was built 40% larger than required (Sherman 2020).

Within a span of 10 months, by the end of 2012, Peloton's numerous failed attempts to raise further capital came to an end as Peloton received \$3.5M in Series A funding from numerous business angel investors that supported the company. After having an initial prototype to work with, the founders shifted attention to marketing the product and raise market awareness. They launched a campaign on Kickstarter to raise market awareness which helped the company in terms of advertisements but not sales (Winchester, Erin e Bass 2021). Unfortunately for Peloton, after the correct proportions were sent to the manufacturers, the newly received prototype bike had serious design flaws which made the bike wobbly. However, the company still managed to sell its first prototype bike on the platform for an initial price of \$1500 (Dismuke 2022).

Vertical Integration

Peloton's active presence on social media and its increasing sales reached \$10M in annual revenue in 2014; it also secured \$10.5M Series B funding from Tiger Global Management (TGM) and resumed to launch its first consumer-ready internet connected 2000\$ exercise bike. The funding made way for Peloton to start scaling its business as the company

had already begun the process of recruiting top of the line instructors that have magnetic personalities which allow them to transmit the unique Peloton experience to the community (Peloton, Annual Report 2020). The funding also helped Peloton open its first brick-and-mortar studio in Manhattan which served as a space for the instructors to film content (Winchester, Erin e Bass 2021).

In 2015, the surge in demand for Peloton's products continued rising. With this increasing demand, the operations of the became harder to handle especially maintaining an efficient delivery process. Customers complained about the delays of delivery of their bikes. Peloton was still reliant on third-party companies to deliver and install the bikes in customers' homes (Sherman 2020). This ultimately led to problems as the logistics companies were not up to Peloton's standards. Foley and the team realized that a change must be done in order to guarantee the level of service that matches their customers' expectations.

Right in time, Tiger Global Management, the New York-based hedge fund and private equity, additionally funded Peloton with \$30M in a series C funding round which was invested in setting up an internal delivery unit, increasing the brick-and-mortar stores, accelerating production of its bikes, and enhancing the efficiency of its logistics (Winchester, Erin e Bass 2021). The newly created internal delivery unit has field specialists offer product education, assistance with account set up, and tips and recommendations for product care and content selection (Peloton, Annual Report 2020). The company marched through 2015 with \$50M in annual revenue and \$150M in 2016 (Murray 2020).

By 2018 the subscription-based fitness platform was finally able to resort to its first venture capital investing and raised 550\$ million at 4.1 billion valuations according to Pitchbook (Clark 2018). Prior to that, Foley and his team faced strong rejection from VCs as they failed to convince them with their revolutionizing product. Peloton then introduced its second bike offered for 4000\$ and extended its product portfolio to reach a target a bigger

scope of customers and diversify its revenue. Also, Peloton introduced new subscription program that requires no equipment such as Yoga classes and high-intensity interval training and announced the expansion plan overseas to the UK.

Peloton acquired Neurotic Media a B2B music aggregation and streaming service (Winchester, Erin e Bass 2021). This acquisition would help Peloton use the power of music to enhance the customer's music experience which would create a fully immersive experience for its customers through providing a unique fitness experience with over two million songs under license which makes Peloton at the intersection of fitness and music (Peloton, Annual Report 2020). By 2019, the company had sold 577,000 bikes and treadmills (Clark 2018).

In August 2019, the technology platform filed for an initial public offering. Shortly afterwards, in October 2019, the company acquires Taiwanese manufacturing company, Tonic Fitness Technology for \$47.4M paid in cash (Dismuke 2022). Although Peloton had previously mitigated the risk of a single-source supply by maintaining adequate inventory and developing contingency plans for cases of disruption, Foley and his team wanted to increase their control on the supply chain and reduce unexpected delays as well as price increases. Although the full acquisition would not come into light until 2020, this step would allow Peloton to further develop in scaling production.

Since Peloton's IPO, the founders have invested great effort in scaling the business in multiple categories. Until a point where Peloton achieved its capability of producing its own hardware, software, supply chain logistics, retail spaces, and content. Table 1, shows the funding levels that Peloton received and utilized to become a fully integrated company.

Towards the end of the year, in December 2019, Peloton continues its backward integration by completing the acquisition of Precor USA, a fitness equipment manufacturer with the hopes of leveraging the technical team at Precor to accelerate innovation and invest in research and development. Hence, Peloton gained 625,000SF of manufacturing space in

North Carolina and Washington (Dismuke 2022).

Date	Type	Investors	Amount (\$, millions)
February, 2012	Seed	Angel Investors	\$0.40
December, 2012	Series A	Angel Investors	\$3.50
July, 2013	Crowdfunding	Kickstarter	\$0.30
April, 2014	Series B	Tiger Global Management	\$10.50
April, 2015	Series C	Tiger Global Management	\$30
December, 2015	Series D	L Catterton	\$75
May, 2017	Series E	Fidelity Investments	\$325
August, 2018	Series F	TCV	\$550
September, 2019	IPO	Underwriters: JP Morgan, Goldman Sachs	\$1,160

Table 1 Peloton's Funding. Note: Data From Wilhelm, Alex. "As Peloton Preps for an IPO, a Look Back at Its Funding History." Crunchbase News, February 12, 2019. <https://news.crunchbase.com/venture/as-peloton-preps-for-an-ipo-a-look-back-at-its-funding-history/>.

Growth and Expansion

The Covid pandemic turned out to be a lift for Peloton as its revenues were boosted and the financial stability of the company improved drastically. The social and behavioral changes induced by the lockdown measures which drastically affected the world, forced people to pursue alternative means to maintain their pre-pandemic activities. The implications of the pandemic led to a boom within the home-fitness industry as peoples' emphasis on wellbeing increased during the lockdown period. This significantly increased the demand on Peloton's products which resulted in a backlog of bike deliveries across the geographical locations in which Peloton was operating.

Significant investments within manufacturing and logistics were necessary to moderate this sharp increase in sales and reduce the order-to-delivery window. At the same time, Peloton's plans to expand to Australia were set to launch in 2021. With that in mind, the long-term growth strategy laid out by the founders included plans to build Peloton's first US factory based in Ohio with the purpose of supporting growth, drive production efficiencies and accelerate Peloton's speed-to-market (Peloton, Annual Report 2021).

Home Fitness Industry Overview

The Home Fitness Market Size was worth USD11,3 billion in 2021 and is projected to grow to USD 17.3 Billion by 2030 (Acumen Research and Consulting 2022). With the increase of health awareness, the increasing prevalence of obesity, and the importance of a healthy lifestyle, more people have turned toward the convenience of the virtual fitness market. For working professionals, it means not having to constantly juggle between their work, family and gym anymore, as more digitally connected solutions are offered to them. It goes without mentioning that the COVID-19 pandemic played a big role in the expansion of the home fitness industry.

At the peak of the pandemic, the fear of the virus, along with government restrictions and worldwide lockdowns, resulted in a halt of gyms and health clubs hindering the fitness equipment industry. Consequently, as a solution, people started using home fitness alternatives and gyms were obliged to increase their digital presence. In fact, thanks to COVID-19 pandemic, 40% of Americans exercised at home for the first time (Acumen Research and Consulting 2022).

The impact of the pandemic and the growing interest in health and fitness also led to the emergence of more career opportunities to support the huge demand for certified fitness instructors. Many gyms started offering virtual which allowed members to work out from their own homes. Wellness app downloads increased by 46% during the first half of 2020 (Acumen Research and Consulting 2022). Not only were people more enthusiastic about the home fitness solutions but the most motivated invested in upgrading their home gyms and purchased home fitness equipment.

The North American market is the largest home fitness equipment market, and it was particularly impacted due to the magnitude of its obese population, who adopted healthier

habits to improve physical and mental wellbeing, and to enhance body stamina, and muscular strength. The home fitness equipment industry is a highly competitive market, which requires a huge focus on research and development, product innovation, and adaptability. (Mordor Intelligence 2022).

Analysts in the fitness industry expect that post-pandemic exercises will resemble the workplace and that a hybrid model will develop. (Gregory 2021) Individuals will be looking for flexible options that allow them to find a balance between at-home and in-studio exercising.

Marketing at Peloton

Dara Treseder, the Senior Vice President of Marketing, Membership, and communications at Peloton had done an excellent job consolidating the fitness brand's marketing organization as well as strengthening the sense of community in Peloton's userbase from the moment she started working at Peloton in August 2020. Her responsibilities included managing Peloton's marketing activities, consumer strategy and insights, communications as well as driving business growth and international expansion. (DiTrollo 2021)

Treseder created her first campaign "We all have our reasons" with the purpose of celebrating members' stories and enhancing the sense of community featuring real Peloton members instead of actors (McCoy 2021) She had also signed a multiyear partnership content with Beyonce on November 2020 rooted in the celebration of music and pro-social initiatives (Peloton 2020) . She also played an important role in the design of the company's Champions Collection which included eight Olympic competitors highlighting Usain Bolt, who became part of the Peloton community and made customers feel as though they were exercising with their favorite athlete in the same level (Garrity 2021). She also stimulated the company's expansion to Australia and took part of the launch of new products into the market (Q.ai -

Powering a Personal Wealth Movement 2022)

Overall, Treseder instilled the sense of community within her team and based their marketing decisions on empowering Peloton's members' communities and giving them a voice to make them feel heard. She made them feel they had a say in what was being offered to them and that they had a two-way communication. Members were now the focus of Peloton's marketing efforts (DiTrollo 2021)

Under Treseder's leadership, the marketing team touched every aspect of connection between the brand and its users and audience. On June 2021 they launched the campaign "Nothing like working out from home" which showed an always expanding selection of training alternatives, top-tier classes, and music that could accommodate any household's lifestyle. (Shots News 2021)

Furthermore, over the past three years, Peloton transformed from a fitness brand to a worldwide entertainment brand by utilizing content with fitness instructors who acted as influencers and through signing agreements for content collaborations with well-known celebrities like Beyonce and Shonda Rhimes (DiTrollo 2021). And it is precisely this content that served as the backbone of Peloton's offerings beyond the equipment itself. It was the creation of content, the personalities involved and the instructors; all the communication channels and the creation and nurture of a community (and sub communities) (McCoy 2021) in such ways that allow the business to thrive in the long term (Treseder 2021)

Peloton, as a brand, is indeed aiming to move people up the Maslow's hierarchy of needs by helping members fulfill their needs of love and belonging by being part of a close community; their need of esteem by improving member's self-esteem and by gaining status and recognition through features such as the leadership board in their platform; and ultimately the Self-actualization need by enabling and motivating members to achieve their own fitness condition potential.

Treseder and Peloton leveraged on the digital transformation that the pandemic brought to the health and wellness aspect of life and was able to gain thousands of new users thanks to its authentic content and variety (Treseder 2021) as well as the need of exercising and taking care of oneself at home while the world was closed. In fact, Peloton's yearly ending Connected Fitness subscriptions increased by 214% as it is shown in Figure 1.

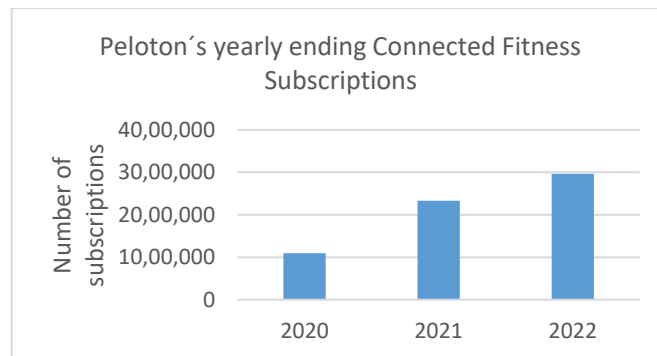


Figure 1 Peloton's Yearly ending Connected Fitness Subscriptions

The success of the company during the pandemic was uncanny as they experienced rapid expansion as lockdowns and work-from-home arrangements fueled a big home workout revolution (Q.ai - Powering a Personal Wealth Movement 2022). Executives believed it would continue this way and even Treseder, when asked in an interview what she believed would happen after the lockdowns were over, said "During the pandemic, it (Peloton) was helping keep you connected to people, helping with your physical and mental health. Guess what? After the pandemic, it's still going to help you with that." (DiTrollo 2021) however, she underestimated the impact that the removal of restrictions and the reopening of the world and the gyms had on Peloton's business.

During the pandemic lockdown there was indeed an increment of awareness in the population regarding fitness and wellness. In fact, in a study conducted by Ipsos it was found that 62% of Americans stated that their health became more important to them after the pandemic (IPSOS 2021) however Peloton's stock plunged as the Covid restrictions eased and people returned to the office and gyms reopened. The promise of sense of community Peloton

was bringing to their members during lockdown did not seem as appealing to new customers as they now could get it from in-person activities like the ones they did before Covid. New Competitors came into play offering cheaper alternatives than Peloton's hence reducing its market share; and gyms were no longer such an indirect competitor as gyms such as Planet Fitness started offering memberships costing as little as \$10 per month (Patel 2022). Planet Fitness's memberships were at 97% of pre pandemic totals and their revenue increased by 46% compared to the same period a year ago while on the same day that this was announced, Peloton's shares fell by 40%.

The continuous drop in revenue and stock price was of extreme concern to investors and Peloton's stakeholders. McCarthy had been CEO of the company for approximately 4 months and, at this point and even though he has already implemented some executive decisions to start to turn the ship around and take Peloton back to its glory days, there was still much work to do. It is July 2022 and the Fiscal year 2022 has ended and the annual report has been issued. He expects all the leaders from the organization to be on their top game for the Strategy Meeting that will be held to discuss the financial performance results and which show the poor performance the company had during its most recent fiscal year and to determine the organizational strategy for the next fiscal year.

Treseder and her team must review the company's current marketing strategy and come up with a plan that ultimately increases the company's sales in a competitive, sustainable and forward-thinking manner.

Target Market

Peloton's target market is the people that have problems balancing their busy family obligations and their careers; however, they have the space and money (Saiidi 2016). Most of Peloton's users are within the ages of 35 to 65 years old (Saiidi 2016). The age range of 35

years and older forms 70% of Peloton's market demographic (Curry 2022). These fitness enthusiasts are from higher income households and are able to afford the high entry price of the Peloton stationary bike; they are willing to pay for the quality and have household incomes of \$50,000 and higher (McDon 2021). Peloton's target group is likely to overlap with boutique fitness gym customers, having a high risk of snatch-ups

Peloton's marketing strategy was heavily reliant on the fitness instructors who were motivating, energetic and enthusiastic (Murray 2020). The instructor's encouraging and entertaining attitudes attracted the participants into the classes forming a community. The connectivity of Peloton's interactive platform allowed the instructors to boost engagement with the participants by calling out their names during the workouts. All in all, the success of Peloton's marketing strategies resulted in a 95% retention rate and a churn rate of 0.65% (Farrell e Gupta 2022). The success of Peloton was also boosted by social media, as Peloton's instructors were brand ambassadors and influencers and they utilized their large social media presence to boost Peloton's brand reputation (Murray 2020).

Product Portfolio

Peloton's portfolio can be categorized in two groups. Connected Fitness Products and Subscriptions. Within the first category, the best sellers are the Peloton Bike and the Peloton Bike+ of which sales derive a significant majority of the company's revenue (McCarthy, et al. 2022) These were the first products the company launched and became famous for. The Bike consists of a nearly silent belt drive, a 22" HD touchscreen with built in stereo speakers and a resistance knob for manual control at a selling price of \$1,445.

The Bike + comes with a 24" 360-degree rotating display that allows members to easily move and tilt the screen to be able to do additional workouts on the app such as stretching, strength or yoga. It also has a resistance knob for manual control however

resistance can also be controlled digitally allowing members to enable an “Auto Follow” function which allows the Bike+ to change the resistance automatically to follow the instructor’s workout. It has a powerful built-in soundbar and subwoofer system which provides an improved audio and an in-studio experience for members. All these additional features make this Bike + more expensive with a selling price of \$2,495.

The Tread, with a price of \$2,495, was the affordable version of the Tread+ which price was \$4,295. After the Tread + was recalled and Peloton decided to discontinue it, they increased the Tread price to \$3,495 to boost its image as a premium product (Song 2022) . It features a sleek belt drive, 24” touchscreen with integrated soundbar and subwoofer, incline control knobs and jump buttons as well as a heart rate monitor integration. It is intended for use with both on-Tread and floor-based bootcamp programs.

The newest device the company soft launched in April 2022 is the Peloton Guide. It is an Artificially Intelligence device that uses machine learning and an innovative camera to allow members to track their moves, count their repetitions and get credit for staying on track with the exercise. This device’s price is \$295.

The last products that are part of the Connected Fitness Products are categorized as accessories and apparel. The range of offering is very wide and includes items such as cycling shoes, earbuds, workout mats, weights, bottles, shorts, shirts, and jackets amongst others.

The second category of products is Subscriptions. The All-Access Membership is a requirement for all Connected Devices (the Bikes, Tread and Guide). For the Bikes and the Tread, the subscription price is \$44/mo and it is a requirement to pay such subscription to be able to use the equipment. It allows members to create a profile for everyone in the household. It includes access to the entire library of live and on demand classes and in-app metrics like Strive Score, heart rate and burned calories monitoring. It includes Access to the Peloton App and just one Subscription is required if the member has more than one Peloton machine which

is the case of 6% of Peloton's Connected Fitness Subscriptions. (McCarthy, et al. 2022)

Next, there is the Guide Membership for \$24.99. This subscription is required if the member has the Peloton Guide and is not currently paying an All-Access Membership (which covers the Peloton Guide as well). It allows the creation of up to 5 profiles per household and it offer thousands of live and on-demand classes across disciplines plus advanced metrics like Movement Tracking, Body Activity and Self Mode to help improve the user's form. Just like the All-Access Membership, it includes the Peloton App to use from home or on the go.

Lastly, there is the App Membership offered at \$12.99/mo for the public who does not own a Peloton product. The app includes all classes and workouts except those designed to be used exclusively on the Bikes, Tread or Peloton Guide. This Membership allows the creation of one single profile, and it has a 30-day free trial period.

Jogging, walking, Bike and Tread bootcamps, yoga, Pilates, weightlifting, stretching, meditation, and floor aerobics are among the Peloton Digital routines. In fiscal year 2022, 56% of the workouts completed by members in the platform were non-cycling which goes to show a growing and strong interest in these new verticals. Peloton's workouts are accompanied by a broad catalog of music and are thoughtfully designed to be authentic and engaging thus increasing member's motivation and sense of community. They use performance data to better understand Member's habits and to adapt and optimize their offer based on class type, length, music, and other factors (McCarthy, et al. 2022)

Sales & Advertising

The marketing team's goal is ultimately to maximize revenue by increasing brand awareness and buyer's intent of the company's equipment and subscriptions through a combination of brand and product-specific performance marketing. The main marketing tool the company has been using for the promotion of their products, which was proven to be their strongest medium for communicating the features of the Peloton platform, is video.

Advertising has been done primarily on broadcast and cable television, social media platforms such as Instagram and Facebook as well as Hulu and YouTube. (McCarthy, et al. 2022)

Peloton has a strong social media presence with over 3 million followers across different platforms being Instagram the one with the highest number of followers: 1.9 million. The company has leveraged on the strong sense of community they have built amongst their members and has been able to maintain a loyal and engaged social media community despite their post pandemic losing streak.

The company approaches influencer marketing in a unique way as they don't partner with influencers per se but rather hire Instructors who bring their unique style and personality to their classes gaining followers in the Peloton App which later translates into social media followers for both the influencers personal accounts and the Company's. Instructors then become brand ambassadors and are even showcased in ad campaigns as they gain notoriety. Bottomline, instructors are turned into influencers who increase the sense of community and loyalty of members towards Peloton. (Extol 2022)

Additionally, the company created a Refer a Friend program which refers members with \$100 off from Apparel purchase every time they refer a friend, and they buy one of the workout equipment (Bike, Bike+ or Tread). The referred friend also receives up to a \$100 discount towards accessories purchased with their equipment. There can only be up to 6 referrals per calendar year by an All-Access membership account holder. (Peloton 2022)

Peloton sells their products through several sales channels. Products are sold mainly through their E-commerce platform where members can examine reviews and place their order. If further assistance is needed, they can get in touch with the company's inside sales representatives for one-on-one sales consultations 7 days a week.

Their second sales channel consists of Showroom Sites. There are 135 retail locations across the United States, Canada, the United Kingdom and Australia. They are located in

upscale malls and premium street locations in major urban markets. These Showrooms allow customers to try out Peloton's products and experience interactive demonstrations and they serve as locations for the company to host events which strengthens the brand engagement and loyalty. 75% of these retail locations are large Showrooms between 1500 to 3000 square feet which showcase the Peloton Equipment as well as accessories and apparel, and private areas so potential sellers can do "test rides". Micro stores are usually 300 square feet and are placed in visible "center-court" areas. They represent 5% of the retail locations. Finally, the Concession stores, accounting to 20% of their retail sites, consists of a rented space in a partner's retail location in the UK, Australia and Germany.

They also have a small percentage of their sales attributed to the commercial and hospitality markets which helps increase Members's engagement and loyalty thanks to the convenience of being able to use the Peloton Bike when travelling. In total, there are approximately 18,000 Peloton Bikes in over 8000 commercial locations. Additionally, and after they closed the acquisition of Precor they also sell their fitness equipment to commercial partners in hospitality, companies, multi-family residential, education facilities, YMCA, country clubs and commercial clubs. Lastly, Peloton has a Corporate Wellness Program offered to employers and insurers in which they provide their employees with subsidized access to the Peloton Subscriptions. (McCarthy, et al. 2022)

Peloton has a partnership with Affirm, a financing company that allows consumers to purchase products or services from online retailers and pay them off in regular monthly instalments on a Buy now, Pay later (BNPL) basis. (Lake 2022) Customers do not have to process any down payment and their APR is 0% when they are financing the equipment for 12 months; and 4.99% when they choose 24, 39 or 43 months. (Peloton 2022). Treseder had been also contemplating working on a proposal to discuss in the Strategy Meeting in which the company would make equipment even more accessible to consumers by allowing them to

rent them at a monthly cost, with the possibility of cancelling or buying out at any point. In March 2022, Peloton launched a trial period in the states of Texas, Florida, Minnesota and Colorado for members to rent the Peloton Bike (Valinsky 2022). She is considering expanding this option Nationwide and to include the rest of the Peloton's equipment, but she does not know yet if this would be an attractive option for potential customers and what would be an appropriate monthly cost that would maximize the profit of the company as well as the amount of new members subscriptions.

Competition

Peloton mainly competes for consumers joining its Connected Fitness Subscriptions and keeping them engaged by offering innovative technology and user-friendly interface and attributes. Peloton's competition is made up by presential fitness classes, gyms, at-home fitness equipment and content, and health and wellness apps (McCarthy, et al. 2022) Its most comparable competitors in terms of product offering and location are Equinox, Life Fitness, iFit, Lulu Studio Mirror, Echelon and Zwift.

Equinox was voted as the Best Gym in America by Fitness Magazine. They feature world-class personal trainers, group fitness classes, and spas. They are also de owners of Soul Cycling which consists of an indoor cycling class with their branded soul cycle bikes which are also available for individual purchase at a price of \$1500 with a \$39.99/mo required membership access to the Equinox+ apps (Equinox, 2022)

Life Fitness manufactures high-quality, dependable, and long-lasting gym equipment. They have partnerships with gyms and sell their products for individual at-home use as well. They offer free access to over 500 workouts on their Life on Demand+ applications which include interactive life escape courses. Treadmills prices range from \$3199 to \$7,425 and bikes from \$1729 to \$3194. (Life Fitness 2022)

NordicTrack is a subsidiary company owned by iFIT which is a fitness app that can

be accessed by personal devices or specific brands of workout equipment at a price of \$39/mo. It enables customers to broadcast on-demand fitness courses for a wide range of workout genres from the comfort of their own homes. (Crider, 2022) NordicTrack produces treadmills (interactive models going from \$1,199 to \$4,499), strength training equipment, ellipticals, exercise cycles (studio interactive bikes from \$1,999 to \$2,299), and accessories.

Mirror is an interactive fitness start-up owned by Lululemon. It is a high-end training mirror with a 43" full-HD display that works as a personal trainer and boutique fitness studio. (Sassos, 2022). It works with a \$39/mo membership program called Lululemon studio which grants access to thousands streaming and in-person workout options and the possibility to attend classes at stores for free (Holman, 2022)

Echelon is Peloton's most direct and comparable competitor. It offers smart connected gym equipment with live or on demand classes. Its membership costs \$39.99/mo which allows up to 5 profiles, thousands of classes, leadership boards and vast library of workout music (Mathe, 2022). Bikes range from \$800 to \$1480 and their tread has a cost of \$1977.

Finally, Zwift which is a massive multiplayer online running and cycling fitness program that allows users to interact, train and compete in a virtual world. Customers can decide to purchase the Zwift Hub which costs \$499, or they can use any compatible smart trainer or bike. The required monthly membership is \$14.99/month. The company also sells apparel and accessories such as cycling gear, training mats, bottles, etc. (Zwift, 2022)

Introduction to Peloton's Turnaround attributing to Covid Pandemic

The Covid pandemic was a blessing in disguise for Peloton as its revenues skyrocketed and the overall financial status of the company improved significantly. The pandemic caused changes in many people's lives as they started realizing the importance of well-being and health and they had more free time available which increased the demand for virtual exercise

sessions and fitness equipment. Additionally, people who used to work out in gyms were forced to look for alternatives at home due to lockdowns. (Iglehart 2020)

Prior to the Covid pandemic, Peloton was gradually expanding as its revenues kept doubling year-on-year since 2017. The company's connected fitness subscribers increased drastically too as it witnessed an annualized growth of 145% reaching 551000 subscribers in 2019 from 35000 in 2016. Despite the increased revenues, investors weren't excited about Peloton's prospects as the company had the third-worst public debut of the last decade. (Winck 2019) Additionally, the company had peculiar revelations in its IPO documents which stated that it had notable flaws in its internal controls. It discovered flaws in four separate areas: Control over information technology systems, separation method of different accounting duties, review methods of unspecified journal entries, and reconciliation and analysis of some important accounts. (Wolverton 2019) Peloton Interactive priced its IPO at \$29 a share and the home fitness equipment company opened in Nasdaq stock exchange at \$27 the following day, hence \$2 below expectations, and the share dropped by 11% on the first day of trading.

Owing to consumers using Peloton bikes while staying at home due to the pandemic, the company was finally able to steer itself in the right direction after years of modest growth trajectory. The first quarter sales of financial year 2021 saw an increase of 232% from \$228 million to \$757.9 million, exceeding the forecast of \$748.1 million. (Frazer 2021) Peloton reported that their earnings increased to \$69.3 million, or 20 cents per share, from a loss of \$49.8 million, or \$1.29 per share on a Year-on-Year basis.

However, the company mentioned that the profits will be reduced and re-invested because it had to swiftly open new manufacturing units and because it was preparing for the extra delivery expenses Peloton will spend during the busy season of Christmas.

Throughout the pandemic, Peloton proved its ability to retain customers. The monthly churn was 0.65% during the first quarter of financial year 2021, compared with 0.75% in the

quarter before. The company's users not only bought the bikes but also continuously used them. Its subscribers were working out 20 times a month on an average which was an increase from the monthly workout rate of 12 a year prior. Peloton planned to continuously ramp up its content production to ensure that its users do not get disinterested in the bikes and to attract new customers. The company eventually produced over 2,400 new classes during the quarter. (Lauren 2020)

With the company declaring an exceptional revenue and earnings growth, its stock kept skyrocketing since the pandemic began. Majority of company stocks not only in the United States but across the globe kept falling but investors foresaw the potential in Peloton during the pandemic and as a result, the stock price grew by a whopping 434% in 2020. Analysts remained bullish on the company and kept raising its target price as the stock made higher highs.

Health Concerns against Peloton

The company started facing challenges that not only affected the financial stability but also the overall operations and brand value of Peloton.

In March 2021, a six-year-old child died after an accident involving Peloton's Tread+ treadmill. More information about the accident were not disclosed to protect the family's privacy however, on March 18, CEO John Foley made a press release mentioning how they were aware of a "small handful of incidents" with the Tread+ where children had been hurt and how it was devastating to the company. He reminded members to "review and follow all the safety warnings and instructions" Peloton provided (Foley, A Note from Peloton CEO John Foley about Tread+ 2021). Despite this statement, no further actions were taken at the time. Following the news of this tragic death, Peloton's shares fell by 4%.

On April 17th, 2021, the Consumer Product Safety Commission (CPSC) issued an urgent warning to consumers about the “danger” of the Tread+ prompting them to stop using the product immediately if they had children at home. (Consumer Product Safety Commission 2021) Immediately after, Foley issued a statement condemning CPSC’s “unilateral” press release as it was “Inaccurate and misleading”. He stressed the importance of following security guidelines but assured consumers that there was no need to stop using the treadmill. (Peloton 2021)

On May 5th, 2021, and after the child’s death and over 70 incident reports Peloton received about similar accidents in which allegedly there were second and third degree burns and broken bones occurring to adults, pets and children. (Chaffin 2021) Peloton announced two voluntary recalls in which members were warned about two of their treadmills’ safety issues. They were prompted to stop using them immediately and to “contact Peloton for a full refund or other qualified remedy.” (Peloton 2021) Foley also apologized for his former remarks and for not recalling the treadmills sooner. After the recall was issued and after Foley’s public apology, Peloton’s share value dropped by 15% and reduced the market capitalization by \$4.1 billion in just one day. (Stevens 2021)

Investors Wary after Discouraging Results

Things were starting to look bad for Peloton as its share price kept decreasing and the situation turned from bad to worse when the company released the results of Quarter 1 of Financial Year 2022. The exercise equipment company fell short of the market expectations as it presented a loss of \$376 million or \$1.25 per share compared to a profit of \$0.24 per share the previous year which left its shareholders discontented. Additionally, Peloton provided a bleak forecast for the current year which mentioned a decrease in its estimations for subscribers and revenue. In contrast to a previous forecast of \$5.4 billion, the company anticipated sales to range between \$4.4 billion and \$4.8 billion. The stock had its greatest one-

day decline ever as a result of this announcement, falling by 34% (see Figure 2) which brought its market valuation down to roughly \$18 billion from over \$26 billion the day before. (Robertson 2021)



Figure 2 Stock movement of Peloton since IPO (Source: TradingView)

The reopening of the economy and ease in restrictions did not go well for the company as people started to go to gyms after being clogged up in their homes for such a long time.

The company tried to incentivize the customers by reducing the price of one of its popular bikes by \$400 and increasing its advertisement spending. Despite these efforts, its sales grew just 6.2% in the first quarter of 2022 which was the slowest growth rate for more than a year. (Deka 2021)

After an exceptional 2021 for Peloton, it anticipated a higher sales forecast for the year 2022 which resulted in a high inventory. Peloton, in 2020, in anticipation of higher demand made mis-managed decisions which added to its problems. The company had acquired fitness equipment manufacturer Precor for \$420 million and also revealed plans to invest \$400 million in the construction of a manufacturing unit in the United States of America. (Thomas,

Peloton to halt production of its Bikes, treadmills as demand wanes 2022) The company did not foresee a situation where the demand for its products will fall after the Covid spike which is exactly what happened. After two disappointing quarters of 2022, the company was left with thousands of its products stranded in warehouses. Subsequently, Peloton decided to halt production temporarily. It decided to halt Bike manufacture from February to March. Production of the more expensive Bike+ had already been ceased from December 2021 until June 2022. Additionally, the company delayed the production of its treadmill machine until February 2022. (Thomas, Peloton to halt production of its Bikes, treadmills as demand wanes 2022)

A Growing Feeling of Deception amongst Investors

Peloton was starting to lose its credibility as the executives began making contradictory statement regarding capital needs of the company. On November 4, 2021, its Chief Financial Officer Jill Woodworth, while responding to a question said, “we don’t see the need for any additional capital raise based on our current outlook.” However, just 12 days later, on 16th November, the company announced \$1 billion worth of public stock offering. (Powell 2021)

In January 2022, contrary to the optimism portrayed by the executives of the company, it was in the news again regarding massive insider selling. As per the filings with Securities and Exchange Commission, the company’s executives sold \$500 million worth of their holdings before the stock price of the company started plummeting. CEO John Foley himself sold 16% of his overall stake in the company worth \$119 million beginning from November 2020. (Frank 2022)

John Foley and few other executives had been pledging a big portion of their shares and the banks started getting worried after Peloton’s stock price plummeted by over 80% in

the last 1 year. Foley had pledged around 20% of his overall holding in the company which were 3.5 million shares to take loans from Goldman Sachs for his personal benefits. Goldman Sachs approached Foley to add more collateral as their concerns grew while watching the mismanagement at Peloton unfold. (Peterson 2022)

Peloton, in May 2022, raised \$750 million in debt to maintain a smooth functioning after CEO Barry McCarthy claimed the company to be thinly capitalised. The total debt reached \$1.5 billion, and the deal was completed so swiftly that the company did not obtain a rating on the debt. (Rennison 2022)

Outside Factors Worsening the Situation

The macro factors started effecting the company as the supply chain costs increased throughout the globe attributing to the global chip shortage and the Russia-Ukraine War. As a result of the increased supply chain costs and inflation, the company started charging its customers for delivery and installation which effected the already existing demand turmoil and the equity shareholders kept making losses. (See Figure 3)

Peloton fired its supply chain managers for their mismanagement and appointed a new supply chain head to turnaround the crisis.

The company made a big decision to cease all of its in-house manufacturing and outsource it to a Taiwanese manufacturer in order to smoothen the burden on its supply chain and also reduce costs. The decision was seen favourably by the investors as the share price increased 6% after the announcement. (Jenkins 2022)

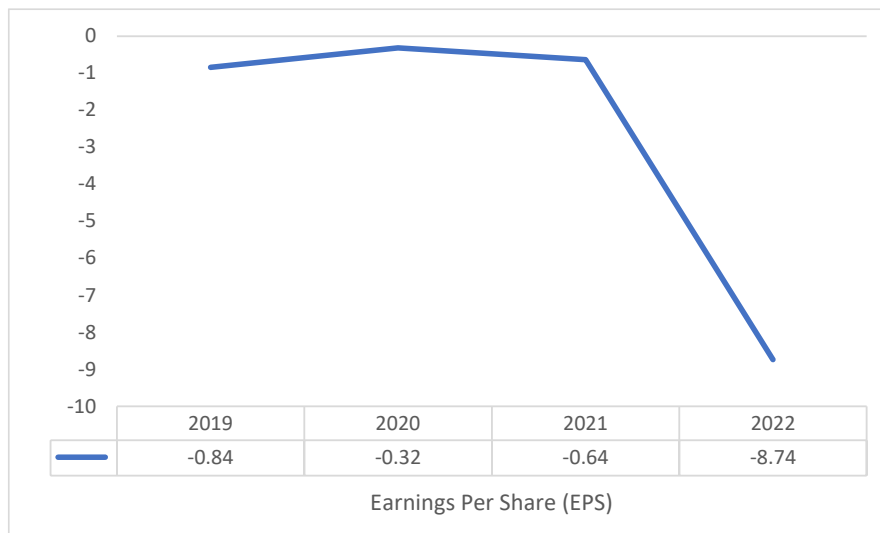


Figure 3 Earnings Per share of Peloton (Source: Yahoo Finance)

Peloton started facing more troubles not only internally but also externally as one of its strongest competitors, iFit started catching up and slowly began to surpass Peloton on a few spheres. From 15% the year prior and 10% two years prior, iFit's advertising expenditure as a percentage of revenue increased to 22% in the year ended 2021. On the other side, Peloton's ad spending as a percentage of revenue dropped from 24% two years ago and 17% the year before to 10% in the same period. While iFit continued to increase its advertisement expenditure to have a better presence amongst its customers, Peloton reduced its expenses due to its cost cutting measures. In the quarter that concluded in September 2021, Peloton's revenue increased by just 6%, down from the 232% growth Peloton reported during the same period last year. On the contrary, iFit's revenue growth in the quarter versus a year earlier was 28%, down from the 112% growth recorded in the same quarter a year earlier. Both companies witnessed a correction in their revenues, however, iFit saw a better revenue growth. (Johnson 2021)

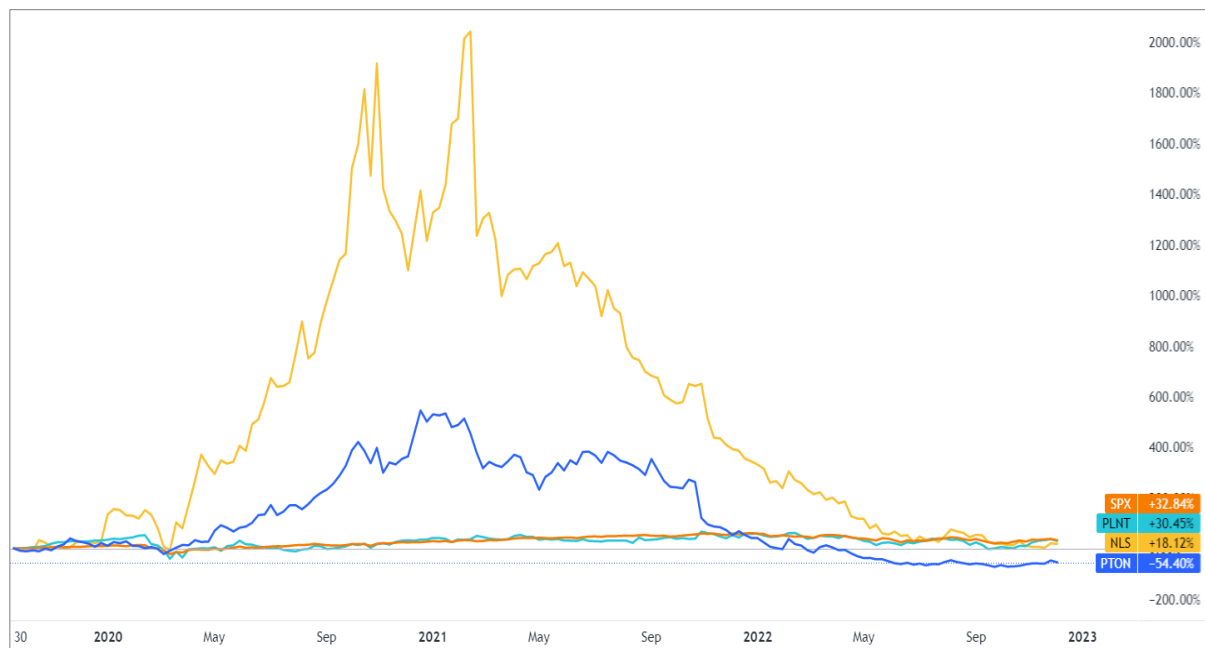


Figure 4 Returns Comparison (Source: TradingView)

The chart above (See Figure 4) represents the returns for equity investors of S&P500 (SPX), Peloton (PTON), and two competitors of Peloton namely Planet Fitness (PLNT) and Nautilus (NLS). As visible, Peloton has been the worst performing stock amongst all with a negative return of 54.4%. The market S&P500 has been a much better performer than Peloton at 32.84% and even the competitors of Peloton have delivered better returns to its investors at 30.45% and 18.12% respectively. With a negative return, the investors will most certainly be looking at alternate options. However, the company has proved that it has the capability to have a high growth and with better management decisions, the company might be able to have a turnaround and thereby attract the investors back.

The end of John Foley's Era and a New Beginning for Peloton

To talk about Peloton's moral, the downturn started with the first deception that happened in August 2019, when the technology platform filed for an initial public offering.

At that time, the home connected fitness company disclosed 500,000 active subscribers paying between 12.99\$ and 44\$ per month and went public in September 26. Peloton Interactive priced its IPO at \$29 a share, the top of its original forecast range between \$26 and \$29 (Trainer, Forbes 2019)

Under the ticker "PTON.", the home fitness equipment company opened in Nasdaq stock exchange at \$27 the following day, hence \$2 below expectations, and the share dropped by 11% on the first day of trading same. Nevertheless, Peloton was still able to raise \$1.16 billion and the fitness company was valued at \$7.6 billion and went public with a dual class share structure. At that time, Bloomberg stated that it the third-worst public debut of the last decade, and according to Yahoo finance, this price action and this market reaction might indicate that investors weren't excited about Peloton's prospects (Udland, Yahoo Finance 2019).

During the first half of 2021, the company had 6743 employees which was almost as double as the number of individuals working for Peloton the previous year, however, in November of 2021, as a consequence of the 34% share price drop, the company decided to halt hiring across all departments as part of its cost cutting strategy to “realign with its sluggish revenue and user growth” (Thomas, CNBC 2021). The management team decided they would also cut down marketing spendings and limit showroom development as Foley started to undergo the overconfident valuation of the company during the pandemic and lack of anticipation the reopening impact would have on the connected home fitness company and the overall industry. The Peloton's organizational morale was low and to make matters worse, Business Insider published an investigation covering Black employees complains about pay disparity.

A group of employees formed “black@peloton” group, composed of over 200 employees, and met with Michael Gettlin, a Peloton vice president responsible for salaries, to

voice their concerns about the nonconformity of wages in comparison to industry's standards convenient to their position and experience level (Samantha 2020). Moreover, they denounced the disparity between them and their Caucasian colleagues' salaries. In fact, one member of black@peloton declared that after questioning several white coworkers he discovered that he was paid \$15000 less for a similar job position.

Furthermore, another member disclosed that the starting salary that he was offered was way below his colleagues that joined just a few months later. Peloton's response was that geography and experience are also taken into consideration, thus members in the same level can be paid differently. The general overall feeling amongst these employees was that the company was not genuinely creating an equitable workplace, they considered that the company was generally "extremely cheap when it came to their internal employees" but the black community in particular (Samantha 2020).

Foley declared that Peloton was paying its employees among the top 10% in the industry for similar roles, pointing out the stock reward offered to permanent employees. Nevertheless, it was reported that based on the company's most recent proxy filing Foley was being paid at a ratio of 317-to-1 compared to a median employee, we can see in the table (2) below that Foley is among the CEOs with the highest compensation in the US:

Peloton executive compensation among highest in the US			
Ticker	Company	CEO	CEO Pay
CVS	CVS Health Corporation	Larry Merlo	\$21,939,098
IP	International Paper Company	Mark Sutton	\$21,911,137
GM	General Motors Company	Mary Barra	\$21,870,450
LMT	Lockhead Martin Corporation	Marillyn Hewson	\$21,516,613
EL	The Estee Lauder Companies, Inc.	Fabrizio Freda	\$21,435,428
HCA	HCA HealthCare, Inc.	R. Johnson	\$21,419,906
PTON	Peloton Interactive	John Foley	\$21,400,000
NEE	NextEra Energy, Inc.	James Robo	\$21,358,742
CSCO	Cisco Systems, Inc.	Charles Robbins	\$21,284,339
ABBV	AbbVie Inc.	Richard Gonzales	\$21,271,869

Table 2 Compensation ranking in the US (Source: WUTIS - Equity Research)

As a response, Peloton increased the starting wage of its hourly workers by \$3 which bring the starting hourly wage to \$19 as a first step in their action plan to fight racial injustice and committed to invest \$100 million over the next four years to fight racial injustice and inequity in our world and to promote health and wellbeing for all (Foley, A Message from our Cofounder and CEO John Foley 2020). Moreover, Foley hired an external consultant to conduct a pay-equity analysis and committed to solving the job opportunity mismatch by investing \$20 million in learning and development programs (Foley, A Message from our Cofounder and CEO John Foley 2020). Some members of black@peloton also expressed a lack of workforce diversity efforts, which Peloton addressed by pointing out that 31% of their senior members were “people of color”.

Unfortunately, the trouble of the connected fitness company does not stop here, on the 9th of December 2021 there was a very unfortunate product placement in the notorious tv show Sex and the City’s “And just like that” as the protagonist’s husband, Mr. Big (played by Chris Noth) suffers a heart attack that causes his death in the arms of his wife after finishing his 1000th ride in a Peloton bike. Suzanne Steinbaum, a cardiologist and member of Peloton’s health and wellness advisory council responded that “Riding his Peloton bike may have even helped delay his cardiac event” in the view of the extravagant lifestyle of Mr. Big and his antecedent hearth problem (Dani 2021). Although this death was fictional it caused bad publicity to the company because people started questioning the reason behind the producer’s action against Peloton.

In fact, the episode launched, was the one too many for the home fitness company, causing the company’s stock to drop by 14%, especially after a child’s death in March of the same year and their consequent recall of treadmills (Blake 2021). Following the tragedy of a little kid that was pulled under the treadmill and died and others that were injured, the U.S. Consumer Product Safety Commission issued in 17th of April a warning to the user of the

Tread+ that have children and pets to stop using the machine and Peloton has to recall it's 12500 treadmills against a full refund after struggling to prove that they were harmless. (Los Angeles Times 2021).

In an attempt to overcome all this bad publicity, the home fitness company filmed an online add featuring Chris Noth the actor of Mr Big, yet it was another PR scandal for Peloton. Few days later, the company was forced to remove the ads and every related publication as two women accused him of Sexual assault. Noth was accused of sexual misconduct toward two women in Los Angeles 2004 and New York 2015, which the actor firmly denies (France 2021).

Few weeks later, more bad publicity came as another main character of another show called "Billions" had a heart attack while riding a Peloton on the season 6 premier episode that aired in January 2022 (Jacobs 2022). Peloton stated that they had never agreed on the use of their name or equipment in the show and that no equipment was provided to the production (Jacobs 2022).

Peloton's moral in December went even lower as Peloton shares dropped 73% since the beginning of 2021 (Wayt 2021). Controversy, John Foley hosted an exclusive Christmas party at a New York's luxury Plaza Hotel for some of Peloton's instructors and their plus 1 (Wayt 2021). This was frowned upon not only because the company was going through financial distress, which caused management to halt hiring completely, but also because Foley chose to limit its guest list to instructor's only instead of sharing the holidays spirit companywide. As a response, Foley issued a statement indicating that even though there were some instructors at the party, it was not a company event, and it was entirely founded by him.

By January 2022, the demand for Peloton's luxury equipment decreased and the company announced that they were stopping the construction of a \$400 million planned factory in Ohio that was projected to open around 2000 jobs for the area, as they were slowing

down their “Peloton Output Park (POP) manufacturing plan” (Barrabi, New York Post 2022). This decision would represent \$60 million in restructuring capital expenditure, and Peloton also declared that company is shifting its in-house warehouse and delivery operations towards third-party suppliers to cut the costs (Barrabi, New York Post 2022).

A month later, In February, Peloton took a major step to overhaul its management as it announced that its cofounder John Foley is relinquishing his role as CEO and is set to become executive chair. Foley was under pressure from the investors as this decision came soon after Blackwells Capital, which is an activist group that own 5% of the stake in Peloton, publicly published an assessment of the company’s performance pressing Peloton to consider selling the company and urged to fire Peloton CEO James Foley amidst the late financials turmoil’s (Snodgrass 2022).

Therefore, Barry McCarthy was announced as James Foley’s successor to save the sinking ship and take over the turnover plan.

New Management and Future of Peloton

Barry McCarthy was retired for some time and while he was busy managing his private investments and playing golf in his free time, he had been wanting to reenter corporate life. Peloton was all over the news, the many self-perpetrated or not scandals, the impact of the decline in demand, the share price decrease, and the struggle of the company to maintain the traction gained during the pandemic. In the sight of these tabloids McCarthy, as a long time Peloton enthusiast, got curious about the business of the fitness connected company and started doing his research (Hirsch and Sorkin 2022).

In fact, Barry and his wife used Peloton’s bike on a frequent basis (Thomas and Lucas, CNBC 2022), the tech executive believed in the brand and believed that the product market fit existed. The customer’s love and loyalty for Peloton is undeniable and is expressed by Peloton’s monthly churn, which is less than 1%. Indeed, Peloton’s most attractive feature is

its retention rate and the customer fidelity that it had throughout the year, the following figure (5) displays peloton retention rates per fiscal year, and we can see that the average rate is high and remain at an average of 93% per year.

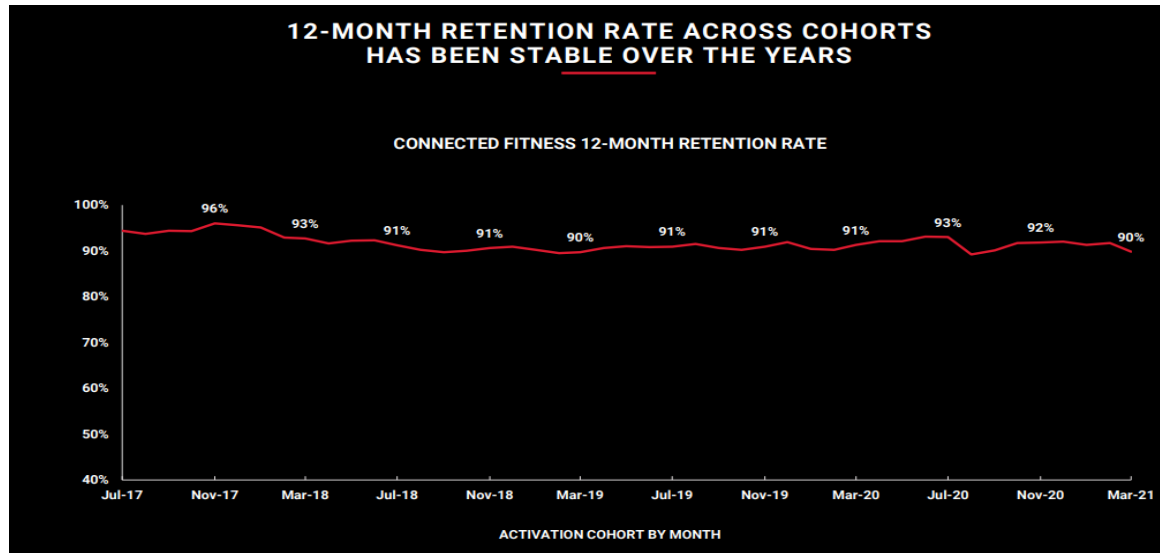


Figure 5 Peloton Retention Rates (Source: Peloton- Lender Presentation)

Given the circumstance, Barry reached out to TVC, one of Peloton's earliest investors, and expressed his desire to help Peloton get out of trouble (Hirsch and Sorkin 2022). Foley and the Peloton board were looking for the best succession CEO for several months and when McCarthy was brought to their attention, they immediately knew it was the perfect match (Hirsch and Sorkin 2022).

McCarthy is a seasoned executive who worked for big enterprises and has extensive experience in subscription-based business models. The tech executive worked as Netflix's CFO during more than 10 years and during that time he was able to take the company public while it was still mailing shows to customers in the form of DVDs. In 2010, Netflix began streaming television shows and movies on its website, later that year Barry exited the movie streaming platform (Thomas and Lucas, CNBC 2022).

Moreover, in 2014, Barry joined the board of Spotify, in which he started working the following year. During the 5-year Barry worked in the music streaming platform he lead a remarkable trouble-free initial public offering without incurring any traditional fee. McCarthy

left Spotify in 2020 but remained part of their board along with his seat at the board of Instacart (Thomas and Lucas, CNBC 2022).

All in all, Barry McCarthy was the perfect man for the job, he has expertise in consumer-facing business, subscription-based business models and had also worked closely with founders in the past (Hirsch and Sorkin 2022).

Shortly after being selected and approved to assume the CEO role at Peloton, McCarthy received an employment offer in which the company agreed to pay him \$1 million annually. He would also get up to \$150,000 for relocation expenses as he would be moving his family from California to New York and finally he would also get the option to purchase “8 million shares of Peloton’s Class A common stock” (Thomas and Lucas, CNBC 2022). McCarthy had agreed to lead an effortful mission. He was going to start his CEO role in a sinking boat of slowing sells, approximately \$1.5 billion of inventory and a loss of \$439 million during its last quarter. A company whose share prices plunged by 80% over the past 12 months dangling sometimes even below its initial public offering price (Hirsch and Sorkin 2022).

The plan is to readjust the cost structure while reinvesting in growth by engaging in a potential product line extension or by entering new market in order to attract new customers, and for this Foley is not excluded. In fact, Foley would continue to have a strong presence in the company as he remained Chairman for Peloton which would represent an additional challenge to McCarthy as he would have to navigate a complex relationship with his predecessor (as him and other insiders would have veto power since they control the majority of Peloton’s shares) (Hirsch and Sorkin 2022). He was going to challenge the status quo of the company in order to implement his initiatives and to change Peloton’s culture.

McCarthy did not have the intention of being the charismatic leader John Foley had been. Foley’s moto was that Peloton was a Family. McCarthy viewed things differently and

stated they were not a family but rather a sports team trying to win the Super Bowl (Jackson 2022). As McCarthy said "I love John's strengths, but I'm running the company" (Jackson 2022). Will the new management led by McCarthy succeed in turning around the spiral of events at Peloton? What corporate level strategies should McCarthy take to stabilize Peloton's business? Will Peloton discover and exploit new market opportunities to regain investors' trust?

Individual Part- Kartikey
The Rise and Fall of Peloton: Financial Perspective

Substantive Issues

The primary objective of an investor is to generate the maximum returns on their investment. Understanding the fundamentals of a company is of imperative importance as it helps to determine the fair value of a company which serves as a basis for rational decision-making during Trading, Investing, and Mergers & Acquisitions. There are various estimations that need to be considered while computing the intrinsic value of a company's stock. However, in a company as Peloton where the financials have been inconsistent, a conundrum arises while forecasting the elements of the valuation that ultimately effects the final question of whether the stock price of the company is over-valued or under-valued.

Pedagogical Objectives

- Understanding the rationale behind making estimations for valuation
- Understanding the process of valuing a company through Discounted Cash Flow (DCF)
- Understanding the decision-making process keeping in mind the financial implications
- Assessing the effects of variation in certain elements on the final intrinsic value

Target Audience

The case is to be taught to master's students that are enrolled in the courses "Advanced Financial Management" and "Financial Modelling." The students are required to have knowledge of valuation process, financial statements, and excel skills. Students are tested on their decision-making process, analytical skills, general business knowledge, research skills, and critical thinking.

Suggested Classroom Teaching Plan

It is important to firstly provide a detailed explanation about the situation of Peloton to the students as this will help them get comfortable with the topic which will enhance their critical thinking. To improve their estimations and calculations, the case should be presented as a group work and then a similar case for the final exam which will be a take home exam. The groups would be required to deliver a presentation in the last class to showcase the results. During the lectures, the scope of valuation and business drivers alongside the steps to calculate operational and investment cash flows and subsequently the free cash flow should be explained. The importance of correlation, risk free rate, market risk premium, beta, and diversification should also be discussed. Later, the effect of Cost of Equity, Cost of Debt, and Capital Structure on the Weighted Average Cost of Capital should be discussed which will provide the students with a complete overview of the DCF model.

Suggested Discussion Questions

1. What are the key business drivers used in computing the Free Cash Flow to the Firm and what are the rationale used while making assumptions for them?
2. What is the importance of Weighted Average Cost of Capital (WACC) in the calculation of Terminal Value and what are the steps to calculate WACC?
3. What conclusions can be drawn if the intrinsic value of the stock is over-valued or under-valued?
4. Without re-calculating the entire discounted cash flows, how is it possible to re-assess the intrinsic value of the company's stock after altering the values of crucial variables?

Literature Review

This dissertation will use the Discounted Cash Flow (DCF) Valuation model to ascertain if the share price of Peloton Interactive is over-valued or under-valued.

DCF Valuation measures the intrinsic value of a company by assessing it based on the discounted value of future cash flow. The model is extensively used by professionals in investment banks, consultants, and managers for various functions that it is even referred to as “the heart of most corporate capital-budgeting systems.” (Steiger 2008)

The valuation of Peloton Interactive relies on two essential components which are The Free Cash Flow to the Firm (FCFF) and the Weighted Average Cost of Capital (WACC).

After calculating these two components, each future FCFF will be discounted by the WACC to compute the present value of each future FCFF. The Terminal Value must be added to the total of the discounted FCFF to calculate the Enterprise Value (EV). The next step involves obtaining the equity value by subtracting the debt. Lastly, to calculate the share price of Peloton, the equity value must be divided by the total amount of outstanding shares.

Free Cash Flow to the Firm

FCFF is the cash generated by the core operations of a company that is available to be distributed to all capital providers.

EBIT (Earnings Before Interest & Taxes) = Revenue – Cost of Revenue – Operating Expenses

*FCFF = EBIT * (1- Tax Rate) + Depreciation & Amortization – Capital Expenditure (CAPEX) – Change in Net Working Capital*

Opportunities for Student Analysis

Revenue

Revenue estimation is the most crucial part of the valuation process as an incorrect estimation not only hampers the overall calculation but also misleads the investors of the company.

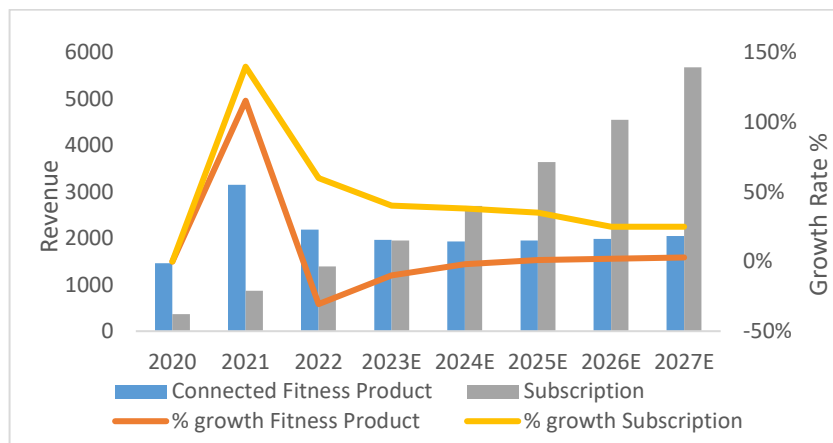


Figure 6 Revenue Forecast (Source: Own calculations)

Peloton has two lines of business i.e., Connected Fitness Product which involves selling fitness equipment and Subscription which involves selling access to online interactive fitness platform.

The Global Home Fitness Equipment Market is expected to grow from \$10.73 billion in 2021 to \$14.74 billion by 2028 at a 4.6% Compounded Annual Growth Rate (CAGR) during the forecast period. (Fortune Business Insights 2022) During the year 2021, Peloton benefitted from the Covid boom which massively increased its revenues. However, the company could not retain its customers who preferred gyms when the economy reopened, and this resulted in the revenues dropping by 31% in 2022. (See Figure 6) Peloton forecasted the upcoming holiday-quarter's revenue to be below estimates owing to the challenging macro environment. (White 2022) Additionally, the global economy is expected to enter a recession and Peloton being a non-essential product might get affected as consumers set stricter priorities and reduce their spending. (Quelch 2009) As a result, this

revenue line is expected to have a negative growth in 2023 which will last until 2024 owing to a slow economy. The negative trajectory is expected to reverse in 2025, however the growth rate will remain low as the company shifts its focus to Subscription business.

Peloton's new CEO, Barry McCarthy, mentioned his plan to focus on the subscription model and rightly so as the Global Online Fitness Market is expected to grow from \$11.39 billion in 2021 to \$79.87 billion in 2026 at a CAGR of 49.12%. (Research and Markets 2022) The growth rate of Peloton's subscription business has been extremely high in the recent years and with the company now shifting its focus, the revenues are forecasted to grow at a CAGR of 30% until 2027. The lower than industry growth rate will be a result of the company gradually entering the maturity stage from 2025. The slow global economic growth will have trivial effect on Peloton's subscription model as consumers are less likely to cancel subscription-based services than they are to look for savings in other areas. (National Research Group 2022)

Cost of Revenue

The next step is the estimation of Cost of Revenue which is the sum of all expenses incurred directly by the company in producing, marketing, and delivering its goods and services to a customer.

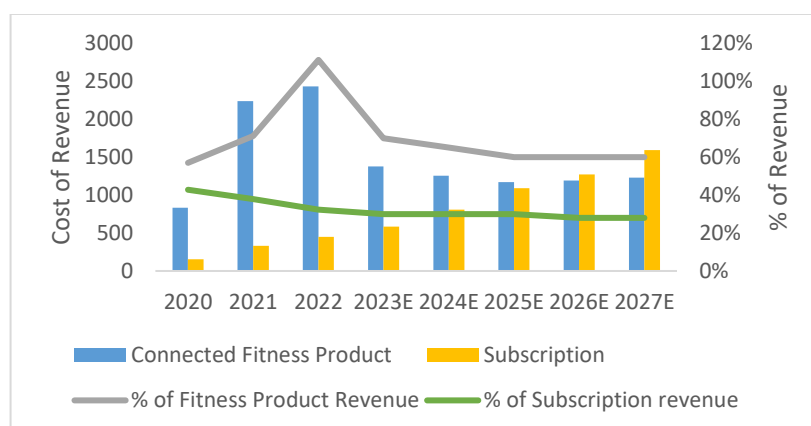


Figure 7 Cost of Revenue Forecast (Source: Own Calculations)

The sudden increase in Peloton's Cost of Revenue for the Fitness Product line is

attributed to the tremendous increase in revenue in 2021 due to the Covid Pandemic. In 2022, however, the revenues fell but the cost of revenue increased (See Figure 7) and surpassed the revenues primarily due to an increase in inventory reserve. The increase in inventory reserve was due to Peloton's expectation of higher sales in 2022 after the revenue spike in 2021. In 2022, Peloton announced a closure of its manufacturing plants and outsourcing of its production in order to reduce its Cost of Revenue. The benefits of production outsourcing will not be immediate as it the complete transition from manufacturing to outsourcing will take time. This decision will result in a lower cost to revenue ratio of 70% in 2023 from 111% in 2022 which will eventually fall to 60% in 2025 and will remain constant until 2027.

Peloton should not expect drastic improvements to its gross margin as the unforeseen costs corresponding to outsourcing can be significant itself and might nullify the expected cost savings. (Meixell, Kenyon and Westfall n.d.)

Peloton maintains a sizeable gross margin for its Subscription line with the number being 68% in 2022 and consistently rising from the last 2 years. The company is increasingly spending on music royalties and platform streaming costs to grow at a high rate. The gross margin is expected to rise marginally to 70% in 2023 and remain constant as the company already has better efficiency as compared to the industry median margin of 50%.

Operating Expenses

The next step in the calculation is the estimation of Operating Expenses which are expenditures that a company incurs through its regular business operations and consist of Sales and Marketing, Administrative, Research and Development, Impairment, and other related costs.

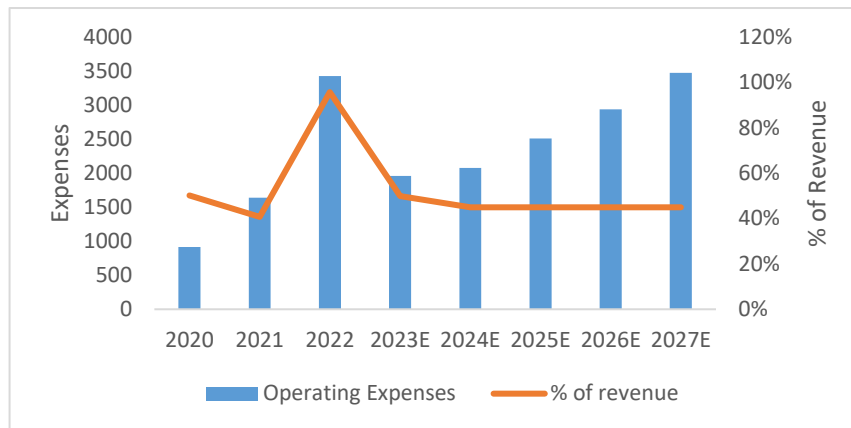


Figure 8 Operating Expenses Forecast (Source: Own Calculations)

The operating expenses of Peloton, in percentage of sales, remained stable until 2021 but the year 2022 saw a substantial increase of 96% (See Figure 8) due to high irregular expenses such as Impairment expenses, Supplier settlements. Its new CEO has been stressing on reducing the expenses considerably which is visible through advertisement cut-offs as well as layoffs and therefore there was a sudden increase in the Restructuring expenses as it paid severances to its ex-employees. The company is expected to further reduce its expenses and has anticipated Restructuring expenses in 2023 which will result in the expenses as a percentage of revenue to fall to 60%. From 2024, the expenses are expected to remain constant at 55% as substantial cost-reduction would have a negative effect on the personnel and marketing plan.

Earnings Before Interest and Tax (EBIT)

After the forecasting of Revenue, Cost of Revenue, and Operating Expenses, the EBIT is to be calculated.

<i>in million \$</i>	2020	2021	2022	2023E	2024E	2025E	2026E	2027E
Revenue	1825.9	4021.9	3582.2	3921.3	4565.4	5375.4	6271.1	7187.4
(-) Cost of Revenue	989.2	2569.8	2883.8	1963.9	2044.9	2197.2	2477.6	2770.4
Gross Profit	836.7	1452.1	698.4	1957.4	2520.5	3178.2	3793.5	4417.0
(-) Operating Expenses	917.6	1639.8	3432.4	2352.8	2510.9	2956.5	3449.1	3953.1
EBIT	-80.9	-187.7	-2734.0	-395.4	9.5	221.7	344.4	463.9

Table 3 EBIT Calculation (Source: Own Calculations)

The EBIT has been negative for the last 3 years, however, the EBIT decreased significantly in 2022 (See Table 3) due to a rise in cost of revenue because of high anticipation of sales which did not occur and certain irregular operating expenses. With a change in management and its cost cutting strategy as well as production outsourcing, the company is expected to bring down its operational costs. Peloton is also starting to shift focus on its subscription line which has been growing at a high rate and therefore, the revenue is expected to rise, which will result in a positive and growing EBIT from 2024.

Depreciation and Amortization (D&A)

The next step is the addition of Depreciation and Amortization to the EBIT. The average depreciation and amortization expenses as a percentage of PPE (Property Plants and Equipment) and Intangible Assets for the last 3 years is 10.6%. With Peloton outsourcing its production, the PPE is estimated to reduce drastically over the course of next 2 years as the company will take time to sell of its manufacturing assets. The PPE is expected to reduce by 43% in 2023 (See Figure 9) and 22% in 2024 and will remain constant from 2025 after further reducing by 21%, thereby reaching the pre-manufacturing level of 2019.

Peloton has been acquiring developed technologies which is resulting in increased intangible assets. This technological innovation is crucial as it will help Peloton maintain its levels of business competitiveness. (Gracia 2014) The company increased its intangible assets by 1% in 2022 and is forecasted to increase by a fixed rate of 1.5%.

Consequently, the depreciation and amortization expenses as a percentage of PPE and Intangible Assets will reduce to 9% in 2023 and 8% in 2024 and will remain constant at 7% thereafter.

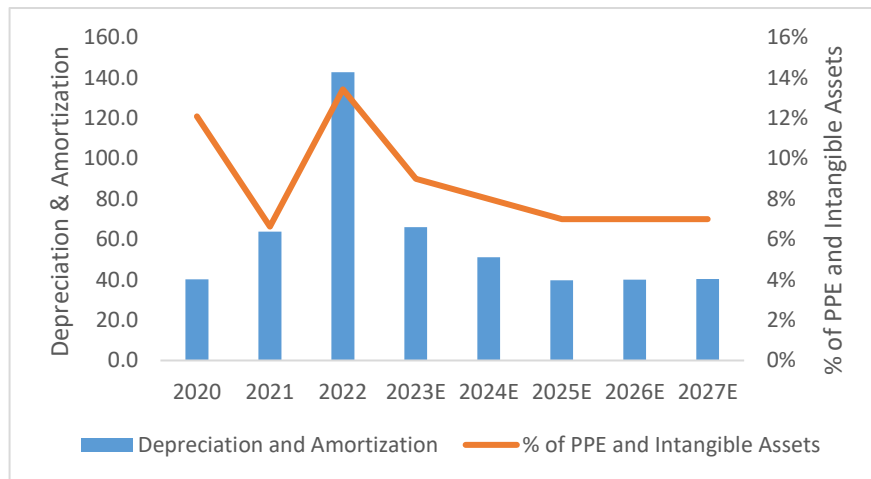


Figure 9 D&A Forecast (Source: Own Calculations)

Capital Expenditure and Net Working Capital

Under the Investing Activities, the calculation of these components is required. Capital Expenditure (CAPEX) is amount spent by a business to acquire, repair, update, or improve Property, Plants, Equipment, or Intangible Assets.

Since Peloton will be outsourcing its production and it is investing in developing new technologies, the CAPEX is forecasted to be 5% higher than the Depreciation & Amortization Expenses so that the company fulfils its replacement costs and invests for its asset base to grow.

Net Working Capital (NWC) is the difference between a company's short-term assets and its short-term debts and liabilities. It is calculated by adding the average stocks and trade debtors and subtracting the trade creditors.

After facing inventory troubles, Peloton is expected to be extra cautious with its inventory management and therefore the days in inventories is estimated to reduce by 1% (See Table 4) each year until 2027. With Cost of Goods Sold expected to decline from 2023, the average stocks will subsequently fall as well. Peloton is expected to reduce its days in receivables as the company has negative cash flows and it would want to collect its receivables more quickly to maintain a stable cash flow. The value is estimated to reduce by

1% each year until 2027 as a very low Days in Receivables indicates strict credit policy which might turn away its customers. With Revenues gradually increasing, the trade debtors will increase subsequently. Peloton has a very high days in payables and since it is facing issues from various spheres, the company would want to maintain good supplier relations and therefore the days in payables are expected to reduce by 3% each year until 2027. As both Cost of Goods Sold and Average Stocks are expected to decline, the Purchases will fall too which will subsequently reduce the trade creditors.

<i>in million \$</i>	2019	2020	2021	2022	2023E	2024E	2025E	2026E	2027E
Average Stocks	80.8	190.6	590.8	1,020.8	685.6	706.7	751.8	839.3	929.1
COGS	518.8	969.3	2540.7	2836.9	1924.6	2004.0	2153.3	2428.1	2715.0
% of Cost of Revenue	98%	98%	99%	98%	98%	98%	98%	98%	98%
Days in inventories	56.1	70.8	83.7	129.5	128.2	127.0	125.7	124.4	123.2
Trade debtors	18.5	34.6	71.4	83.6	90.6	104.4	121.7	140.6	159.5
Revenues	915.0	1,825.9	4,021.9	3,582.2	3,921.3	4,565.4	5,375.4	6,271.1	7,187.4
Days in receivables	7.3	6.8	6.4	8.4	8.3	8.2	8.2	8.1	8.0
Trade creditors	196.7	361.7	989.1	797.4	376.3	465.1	489.7	543.6	587.9
Purchases	574.6	1079.1	2940.9	3266.9	1589.4	2025.1	2198.3	2515.5	2804.8
Days in payables	123.2	120.7	121.1	87.9	85.2	82.7	80.2	77.8	75.5
Operating Net Working Capital	-97.4	-136.5	-326.9	307.0	399.9	346.1	383.8	436.3	500.7
Variation in Net Working Capital		-39.1	-190.4	633.9	92.9	-53.8	37.7	52.5	64.4

Table 4 NWC Estimation (Source: Own Calculations)

Free Cash Flow to Firm (FCFF) Results

To calculate Net operating profit less adjusted taxes (NOPLAT), corporate tax rate of 21% was assumed. (See Table 5)

<i>in million \$</i>	2020	2021	2022	2023E	2024E	2025E	2026E	2027E
EBIT	-80.9	-187.7	-2734.0	-395.4	9.5	221.7	344.4	463.9
tax rate	4%	-5%	1%	1%	21%	21%	21%	21%
NOPLAT	-84.2	-178.5	-2753.6	-399.3	7.5	175.2	272.1	366.5
(+) Depreciation & Amortization	40.2	63.8	142.8	66.1	51.1	39.7	40.0	40.3
(-) CAPEX	71.0	442.5	241.8	69.4	53.6	41.7	42.0	42.4
(-) Change in Working Capital	-39.1	-190.4	633.9	92.9	-53.8	37.7	52.5	64.4
FCFF	-75.9	-366.8	-3486.5	-495.5	58.8	135.4	217.6	300.1

Table 5 FCFF Calculation (Source: Own Calculations)