August 31, 2015

# Wayfair is the Most Mispriced Stock Citron Research has Seen in Years

# Fair Value Under $10

## Citron Exposes Wayfair's Admission of the Fatal Flaw in their Business!

**Wayfair makes Citron feel like apologizing to every company we have written about in the past 5 years. Compared to Wayfair, (NYSE:W) ... you all have viable business models. Any analyst who defends this stock is clueless about furniture retailing and even more clueless about e-commerce.**

**First, it must be appreciated that Wayfair is <u>not</u> a battleground stock.**

Shake Shack, FitBit, Tesla, Ambarella and GoPro: Each of these stocks has passionate bulls and bears of equal conviction. While each of these stocks still sells at nosebleed multiples, each has a disruptive, cult like, or blue-sky prospect, which longs and shorts will continue to debate.

Wayfair is not a Battleground! **There is no bull case whatsoever and Citron will prove it**. As we have previously tweeted, Citron admired the work of the Friendly Bear published last week on Seeking Alpha explaining why Wayfair's current business is in the doghouse:

http://seekingalpha.com/article/3443236-dont-get-zulilyd-by-wayfairs-overstocked-valuation

While acknowledging Friendly Bear's piece, Citron elaborates on the real context of Wayfair's actual business prospects, predicting that its stock will soon end up in single digits. We will defer to the Friendly Bear for all relevant information about Wayfair's dangerously high customer acquisition costs.

Meanwhile, for longs, a challenge: Finish this sentence:

Wayfair is the next ___________________________??? Exactly.

# It's Overstock!!

First we would like to stress the obvious, which everyone except the company and the analysts will admit. Wayfair is Overstock, plain and simple. The only difference is that Overstock has better brand recognition and higher traffic. 74% of all Overstock sales are furniture and home goods. Here is a quick comparison of the two companies:

| | Wayfair | Overstock |
|---|---|---|
| Home and Garden | 95% | 75% |
| Drop Ship Product Transaction | 95% | 90% |
| Revenues, last 6 months | 916,123,000 | 786,357,000 |
| Net gain (loss) | (46,470,000) | 4,407,000 |
| Price / Sales (ttm) | 2.18 | .32 |
| Website Rank | **160th in the US** | **138th in the US** |
| Enterprise Value | **3,390,000,000** | **402,690,000** |

What is more amazing is that in Wayfair's analyst report from Evercore we see a consumer survey showing that in the past 12 months **more people shopped for home goods on Overstock than Wayfair.**

Exhibit 60

**Mind Share of Retailers Online and In-Store**

*On which of the following websites/ stores have you shopped for home furniture/ goods during the last 12 months? Please select all that apply.*

| | Home Goods | | Home Furnishing | |
|---|---|---|---|---|
| | Online | Store | Online | Store |
| Amazon | 58% | -- | 35% | -- |
| Walmart | 41% | 61% | 29% | 37% |
| Target | 34% | 51% | 22% | 31% |
| Department Stores | 31% | 44% | 19% | 26% |
| Bed, Bath & Beyond | 28% | 42% | 14% | 20% |
| Overstock | 18% | -- | 13% | -- |
| Wayfair | 10% | -- | 9% | -- |
| Pier 1 | 7% | 10% | 6% | 9% |
| Pottery Barn | 7% | 8% | 6% | 6% |
| Williams-Sonoma | 6% | 7% | 3% | 4% |

*Source: Evercore ISI Research*

With only slightly more top line revenue, Wayfair is running 5x the amount of commercials as Overstock. Notice even the advertising agencies make the apples to apples comparison.

| | Number of Spots | National Airings | Airing Rank | Spend Rank |
|---|---|---|---|---|
| Wayfair | 29 | **2,806** | 236 | 297 |
| Overstock | 85 | 506 | 981 | 747 |

http://www.ispot.tv/brands/Id3/wayfair and http://www.ispot.tv/brands/d32/overstock-com

Both companies even have the same corporate strategies.

**This month Overstock partners with HGTV:**
http://www.furnituretoday.com/article/522546-overstock-partners-hgtv-urban-oasis-home

**And a few months ago Wayfair partners with HGTV:**
http://www.homeaccentstoday.com/article/519317-wayfair-partners-hgtv-fixer-upper-stars

**For those who are not convinced this is the same business as Overstock: take this.**

**While never PR'd by Wayfair, local news stories have confirmed that as of this month Wayfair has committed to open a 1 million Sq Ft. warehouse facility in Cincinnati. (so much for the "asset light" model)**
http://www.cincinnati.com/story/money/2015/08/26/wayfair-distribution-center/32398239/

This happens to be two miles away from the Overstock warehouse in Cincinnati.
https://www.internetretailer.com/2013/03/07/overstock-looks-east-new-warehouse-near-cincinnati

**And BOTH companies also operate Warehouse shipping Distribution Centers in Utah.**

## So how does studying Overstock help us understand where Wayfair will trade in 12 months?

(OSTK) was spending a similar portion of its gross revenues on marketing until 2006-2007, when it reduced this unsustainable spend rate to around 10% of sales. What happened? Revenue growth fell from 63% per year in 2005 to -3% in 2007 and never really recovered….Nothing more to be said. https://www.newconstructs.com/danger-zone-wayfair/

Wayfair actually intentionally shuns the comparison (incredibly, they refuse to mention Overstock as a competitor in their SEC filings.) The **ONLY** conceivable rationale for this omission is if they acknowledge Overstock as a comp, it becomes apparent to all that **Wayfair's stock is not worth more than $10 a share.**

***" Will someone please come to my office and sit on my hands to keep me from covering my short at $30 …
and then come back and bash my knuckles so I don't cover at $20!"***
***-- Andrew Left, Editor, Citron Research***

## Before we prove why Wayfair will face the same uphill battle as Overstock in selling furniture/home goods online, let's look at the fallacy of their last quarter.

Wayfair's stock surged earlier this month after reporting seemingly strong numbers. The bulls cheered the fact that marketing spend declined marginally, relative to its revenue growth. The analysts were quick to tout this as a breakthrough – and validation of their business model.

We have seen this movie before. … Saving money by realizing marketing efficiencies while riding the wake of a short-term marketing blitz is a one-time event. It cannot be extended in a linear fashion, **especially when you are competing with Amazon, Target, and Walmart.**

# Watching History Repeat Itself

The one-time event of Wayfair's most recent quarter is the **IDENTICAL** play Zulily ran in Q1 2014, which drove the stock to its peak, from where it plunged by over 70%. From the Zulily Conference call when the stock was over $50:

Shawn Milne - Janney Capital Markets

Thank you and thanks for taking my question. I wanted to go back to the **marketing efficiency**, I mean, pretty remarkable, I mean, your business was up about $130 million in revenue on, just under $6 million and I mean, incremental marketing spend? Can you help us around what some of the -- what channels were most productive and I don't know if you can maybe give out some mobile app downloads update and what you saw from that channel and I have one follow-up?

Darrell Cavens - Chief Executive Officer

Sure. I think if you look at our channels, we don't disclose the kind of difference between each one and what we are seeing across channels, but what I can say is, we saw great efficiency across all our channels. We continued to see kind of strong diversity across the channels there.

For those who need a visual reminder, here's the chart:


Zulily's one-time "marketing efficiency" euphoria bounce, against a background of reality.

**Wayfair is not even as efficient as Overstock or Zulily….look at this startling chart to understand what a bad business they have created.**

**No True Competitor**

| Company | Ticker | ROIC | NOPBT Margin |
|---|---|---|---|
| Amazon | AMZN | 2% | 1% |
| Overstock | OSTK | 39% | 1% |
| Zulily | ZU | 29% | 2% |
| Wayfair | W | -76% | -11% |

*Sources: New Constructs, LLC and company filings.*

## Analysts take notice:

Anyone who believes that a vertical market retailer selling furniture exclusively online is a good business model does not understand the furniture/home furnishings category and does not understand e-commerce. Will analysts please understand the shortcomings of this "asset light business model."

## The Fallacy of the “Asset Light” Model in Furnishings Sales

> ***"Wayfair brags that they have an “asset light” business model. That is like a homeless man bragging that he doesn’t have a mortgage."***
> ***-- Andrew Left, Editor, Citron Research***

So let’s get this straight:

**Walmart** has 4,500 stores around this United States that each serve as return centers and you are bragging that you don’t...

**Target** has 2,000 possible return centers and you are bragging that you don’t...

**Restoration Hardware** has created the most beautiful stores in the country that connect emotionally with the consumer and you bragged that you don’t...

**William Sonoma** has 600 of its brand stores throughout the most strategic parts of the county … but you brag that you have 0.

Lastly, **Amazon** has built out a distribution system with technology and warehouses on a scale that the world has never seen…but again, you brag that you are **“asset light”**.

In the universe of high end furniture **the ONLY model** that works on large scale is omni-channel selling. This is not the isolated opinion of Citron Research, this is 20 years’ worth of experience of industry experts and billions of dollars in profits ALL AGREEING on the point.

For those who think Williams Sonoma and Restoration Hardware are “bricks and mortar” stores, it should be noted that **both companies generate 50% of all their revenues online** -- and they do so profitably. These are not merely stores with websites, they are omni-channel retail companies.

Wayfair CANNOT survive being an online seller of mid to high end furniture and home goods without physical locations….plain and simple. If you do not believe Citron, than believe the words of home decorating “Bible” ***Architectural Digest***:

> “But as anyone who’s ordered a light fixture or piece of upholstery online can attest, when you haven’t seen the item in person, there’s always a looming element of uncertainty. Is the color true to the way it looks on-screen? Are the proportions right in your space? “

http://www.architecturaldigest.com/blogs/daily/2015/07/one-kings-lane-showroom

If there is any way you believe that Wayfair is investable because it is unique and revolutionary, it must be pointed out that they are selling their own branded furniture in the most non-revolutionary way possible: **Catalogs!** Just like the Sears and JC Penny of old….and exactly what their most experienced and low multiple profitable competitors do:

[http://www.birchlane.com/v/request_catalog/display](http://www.birchlane.com/v/request_catalog/display)

> ***"Asset Light?" Deploying million-square-foot warehouse projects, catalogs and high-rent district furniture showrooms?***
>
> ***-- Andrew Left, Editor, Citron Research***

Citron has to conclude that to the analysts, "Asset Light" means "un-modeled expenses".... e.g. you guys don't have the slightest idea what it takes build a profitable furniture / home furnishing company.

Note the following chart…there is only **one** company that is a pure play Internet in the home furnishings space: Wayfair. That is not an accident – it is because it is a losing proposition.

Exhibit 48

**Home Furnishing Market Share: Top 20**

*Sales mix per company as % of total HF PCE*

| Home Furnishing Market Share | 2008 Share | 2011 Share | 2013 $mn | 2013 Share | 2013 YoY-% |
|---|---|---|---|---|---|
| 1 Walmart | 10.4% | 10.9% | $19,530 | 7.6% | 2.0% |
| 2 Target | 5.5% | 5.1% | $12,127 | 4.7% | -6.0% |
| 3 Bed Bath & Beyond | 3.0% | 4.0% | $11,406 | 4.4% | 6.8% |
| 4 Home Depot | 3.9% | 3.8% | $10,211 | 4.0% | 4.0% |
| 5 Lowe's | 4.2% | 4.2% | $8,782 | 3.4% | 6.5% |
| 6 Sears | 4.7% | 4.2% | $7,177 | 2.8% | -12.3% |
| 7 Costco Wholesale | 1.6% | 1.8% | $6,777 | 2.6% | 8.9% |
| 8 TJX | 1.5% | 1.8% | $5,808 | 2.3% | 6.4% |
| 9 Kmart | in Sears | in Sears | $4,937 | 1.9% | -13.2% |
| 10 CVS | -- | -- | $4,915 | 1.9% | -3.5% |
| 11 IKEA | 1.0% | 1.5% | $4,607 | 1.8% | 7.0% |
| 12 Sam's Club | 1.2% | 1.5% | $4,568 | 1.8% | 1.6% |
| 13 Macy's | 1.4% | 1.5% | $4,466 | 1.7% | 1.2% |
| 14 Amazon.com | 0.7% | 1.4% | $4,007 | 1.6% | 15.1% |
| 15 Kroger | 1.3% | 1.6% | $3,929 | 1.5% | 6.1% |
| 16 Williams-Sonoma | 1.3% | 1.3% | $3,923 | 1.5% | 8.5% |
| 17 Kohl's | 1.2% | 1.5% | $3,429 | 1.3% | -1.0% |
| 18 Ashley Furniture | 0.9% | 1.1% | $3,115 | 1.2% | 5.8% |
| 19 Berkshire Hathaway | 0.9% | 0.9% | $2,891 | 1.1% | 15.3% |
| 20 Best Buy | 0.7% | 1.1% | $2,511 | 1.0% | 11.2% |
| ***Total Size Based on PCE ($mn)*** | **$240,421** | **$236,809** | **$256,721** | **50.3%** | **8.4%** |
| 24 HSN | 0.3% | 0.4% | $1,974 | 0.8% | 7.5% |
| 25 QVC | 0.9% | 1.0% | $1,812 | 0.7% | 8.1% |
| 29 Restoration Hardware | 0.2% | 0.3% | $1,460 | 0.6% | 28.3% |
| 41 Wayfair | -- | -- | $915 | 0.4% | 52.5% |

*Source: Company Data, HFN, Evercore ISI Research*

Has Wayfair really cornered a unique strategy? Or has it just committed itself in a margin race to the bottom, pitted against Target and Walmart in the low-to-mid omni-channel, and highly sophisticated prestige brand-building omni-channel retailers on the high end, all while dodging the full-court-press of Amazon's dynamic pricing?

Citron has provided readers some additional research illustrating how omni-channel retailing is the only route to profits in scale at the high end of the furniture business.

Multichannel Retailing Drives Growth for Restoration Hardware
http://marketrealist.com/2015/06/multichannel-retailing-drives-growth-restoration-hardware/

**Williams-Sonoma's e-commerce sales grow 8.4% in Q1 --Online sales account for 51.7% of the home-furnishing chain's overall sales.**
https://www.internetretailer.com/2015/05/21/williams-sonomas-e-commerce-sales-grow-84-q1

**How Williams-Sonoma Finds Success in the Digital Age**
http://multichannelmerchant.com/marketing/williams-sonoma-finds-success-digital-age-06102014/

Why Is Omni-Channel Retailing So Important For Bed Bath & Beyond?
http://www.forbes.com/sites/greatspeculations/2015/02/12/why-is-omni-channel-retailing-so-important-for-bed-bath-beyond/

Why Furniture Retailers Need an Omnichannel Strategy
http://www.bevyup.com/2015/03/furniture-retailers-need-omnichannel-strategy/

Enabling Omnichannel Commerce: The Next Big Thing in Furniture Retail
http://www.blueport.com/blog/enabling-omnichannel-commerce-the-next-big-thing-in-furniture-retail

## Wayfair and E-commerce

If you think Wayfair faces challenges against branded high-end omni-channel retailers -- this is **nothing** compared to the challenges they face online at the low end.

First of all, nearly all consumers motivated to shop online in this category want to "save money". How difficult is it for them to Google search for the lowest-cost source for nearly any item they are interested in?

## The Elephant in the Room: Amazon's Dynamic Pricing Model

It is impossible for Wayfair to compete against Amazon on pricing. Here is a recent interview given to Bloomberg with Wayfair's CEO in which the interviewer actually names specific products and prices, calling painful attention to cheaper pricing on Amazon on many items.

http://www.bloomberg.com/news/videos/2015-08-13/wayfair-furnishing-a-revenue-path-to-profitability [ 3:00 ]

Here is how Amazon makes it completely impossible to compete with them on price: **Dynamic Pricing**. By using algorithms to change prices on millions of items hundreds of times a day, every day, Amazon makes sure that any product showing a meaningful sales volume trend will always have a lower price at Amazon; therefore they will either win the customer or at best, obliterate the margins of competitors.

Amazon implements **2.5 million changes per day to pricings** … take that, Wayfair.

Wayfair will contend that they will "out-merchandise" Amazon. So as long as your users DO NOT KNOW HOW TO USE GOOGLE…..you might have a business. Just plain stupid.

**Citron has read every analyst report as of the last quarter, and, unfathomably, not a single one of them even mentions the word "Amazon".**

**Note to analysts: If you think you can "analyze" an E-Commerce company and not even refer to Amazon, it is time you quit your job and take up another line of work.**

## A Browsing Tour of E-Commerce

There are millions of ways to demonstrate just how difficult and competitive this space is. After earnings last week, the Bloomberg interviewer referenced above immediately questioned the future of the company that can't offer better pricing than Amazon:

http://www.bloomberg.com/news/videos/2015-08-13/wayfair-furnishing-a-revenue-path-to-profitability

Citron wanted to illustrate that the vast majority of goods that are less expensive on other sites (namely Amazon) so if any potential customers refer to a Google search -- Wayfair loses.

In order to avoid the appearance of having "cherry picked" a few items, Citron went to "Favorite Wayfair Purchase" links selected by Wayfair's own management on their executive profile page.  Let's see what we found: "Meet the Team" page:

| Wayfair "Meet the Team" | Role | Favorite Item from Wayfair | Wayfair Price * | Competitive Source | Competitor's Price * |
|---|---|---|---|---|---|
| Niraj Shah | CEO | Alessi Anna G. Corkscrew by Alessandro Medini | 67.00 | Amazon (Citron admires the yellow one) | 60.00 |
| Steve Conine | CTO | Linie Design Ronaldo Lime Rug | 1,926.00 | Goedekers | 1,174.99 |
| Liz Graham | Vice President of Sales and Service | Majestic Pet 64" Bungalow Sherpa Cat Tree | 143.99 | Amazon | 113.97 |
| Greg Konicki | VP of Warehouse Operation | Uniflame Outdoor Firehouse | 154.99 | Amazon | 133.98 |
| James Savarese | Chief Operating Officer | Hooker Furniture Melange Fleur-de-lis Mirrored Credenza | 1,8827.0 | Amazon | 1,448.70 |
| Jack Wood | Chief Information Officer | Burgundy 15 Bottle Wine Cabinet | 239.99 | Amazon | 179.97 |

## Price Match Policies

Walmart and Target also have aggressive price match policies.  While they clearly don't have the price change flexibility that Amazon does (changing prices on shelf tags and POS scanner systems is a bigger task than just changing the price displayed to an online customer) clearly nobody is going to be able to expand gross margins competing against Target and Walmart either, much less having to go head-to-head against Amazon.

# Many Happy Returns?

The power of omni-channel marketing is just as impactful in the low-to-mid end of the home furnishings sector.  As anyone who has ever bought furniture online knows, the biggest risk is that today's online furniture purchase winds up in your garage tomorrow.

**Walmart and Target offer return policies that Wayfair can't possibly ever compete with**.

While Wayfair online buyers are stuck with paying return shipping fees, buyers at **Walmart.com** and **Target.com** can return products bought online to any **Walmart**

**or Target** store location. (**Except,** notably, in the case of Walmart.com items "fulfilled by Wayfair!)

| " Wayfair items cannot be returned to Walmart stores or to Walmart.com." |
| --- |

Because furniture items are often bulky, this could be a $50 hit on a $200 purchase, to keep the item from winding up in your garage.

It is Citron's opinion that many consumers will continue to consider it a superior value to pay a slightly higher price merely for the level of "return assurance" and convenience afforded by box stores like Target or Walmart.

# Incredibly, Wayfair admits yet another major flaw in their business model... in their own words.

Through a rarely publicized artifact of their business called "Get it Near Me" in which Wayfair sells ads to retail furniture stores, Wayfair offers up a one line admission that proves in their own words the inherent flaw in their business that cannot be changed. What you are about to read is all you have to know to pinpoint why this Unicorn is doomed to certain death.

**Although the vast majority of consumers go online to begin their research for a major home purchase, the vast majority of consumers will ultimately make their purchase at a brick & mortar store. This presents an incredible opportunity for retailers to get the attention of consumers as they conduct their research.**

http://advertising.wayfair.com/advertise/advertise-industry-retail.php

The company states in its own "Get it Near Me" FAQ:

**Q: If Wayfair sells furniture, why would I want to advertise on your sites? Aren't we competitors?**

Yes and no. As an online-only retailer of furniture, most people use our sites as a way to conduct product research **before going to one of their local "brick and mortar" furniture stores to make a purchase.**

http://www.getitnearme.com/faq.asp

Wayfair's "Get it Near Me" program is all but an admission that Wayfair's core business will never change consumer home goods buying behavior to the point that the company will be profitable.

## A Note About Customer Satisfaction

The most obvious indication of the problems with the Wayfair business model is the extraordinary amount of customer complaints online. When selling non branded merchandise, for which you do not control the ship dates, and the product is often too large to return easily (have fun returning a sofa), you have an uphill business model. Maybe that is why Wayfair's "asset light" model continues to lose money while their omni-channel competitors rack up profits quarter after quarter. Everyone knows just google “Wayfair complaints” and your head will spin.

# Management is Deceiving Investors

A recent Bloomberg interview with Wayfair CEO Nirah Shah just proves how clueless he is about his own business. This is the same guy who couldn’t figure out to start a furniture “brand” until Google changed its search mechanisms. Citron adds comments on his statements.

http://www.bloomberg.com/news/videos/2015-08-13/wayfair-furnishing-a-revenue-path-to-profitability

“We got 200 bp of advertising leverage
which drove the profit line” [0:30]

**No! It did not drive a profit line.**
**It made you have a smaller loss -- big difference!**

“Home is a 250 billion retail market and as it is shifting online --
we think there will be a big winner and ...
we are having success at being that winner” [0:50]

**How are you a winner-- with 200 million in accumulated losses**
**after being at the business for 13 years --**
**while your competition, both high and low end,**
**have generated billions of dollars in profits in the same category?**

“For the first 9 years of this business we were profitable” [1:10]

**You were? As the filing of the S-1 your company had**
**$190 million in cumulative losses before you went public**
**and the number has done nothing but escalate.**
**There is a difference between generating a small profit**
**as a private company and trying to scale a business.**

## How many times have investors read this dishonest description of Wayfair?

> " To **transform** the way people shop for their homes"
>
> *-- Wayfair's "Our Mission": Q2 2015 Investor Presentation*
>
> "As we continue to deliver a **truly differentiated retail experience** from start to finish…"
>
> *-- Niraj Shah, CEO Wayfair*

What is transformative here? Using the internet to buy goods?? What is the differentiated retail experience? The only thing differentiated is the ability to lose hundreds of millions of dollars while Wall Street allows insiders to dump stock at a staggering pace -- that truly is differentiated in the furniture and home furnishings space, where their competitors are held to the burden of making a profit.

## Conclusion- Why Wayfair Will NEVER achieve mass-scale profitability -- simplified.

There are only 3 numbers of significance that stand in the way of a path to profitability for Wayfair:

- Gross Revenues
- Gross Margin
- Marketing Costs

The company's much touted recent quarter netted them a 4% loss on revenues which were up 66.45% over the prior year's quarter.

The law of large numbers has claimed billions of investor dollars invested in internet companies over the years. Unless you have a viral strategy, paying for traffic flow is an extremely high risk strategy. If it doesn't bind long-term customers, you have flushed your investor's money on nothing. Etoys and pets.com are but two examples among hundreds of forgotten URL's which used ad spend trying to carve out online turf for a vertical market.

Meanwhile, the margins on online furniture, and the brutal realities of dynamic pricing strategies, promise that this company is unlikely to ever see margin expansion, and in fact, **margin contraction** is in fact a very real risk. Wayfair's gross margin, which the company has been unable to expand by even one point over several years, is so narrow that driving revenues higher alone won't get this company into the green.

So Wayfair won't become profitable, regardless of the size of the top line, without **slashing its all-in marketing costs to the low teens**. At the moment those costs are 21.08% of gross, having peaked in 2014 at 24.81%

With an intense marketing spend (for instance, running 5x more TV ads than Overstock), the transactions generated from this ad spend aren't profitable. The company "hopes" that a large percentage of these first-time buyers will become long-term customers of Wayfair. Evercore's model, for example, has this company losing an additional 80 million through the end of 2017, and even then just breaking even. **And to merely <u>break even</u> 2 1/2 years from now, they are required to hit the trifecta of:**

- **steep revenue growth …**
- **... while slashing marketing spend by nearly 3 points less than current quarter's "lowered" rates....**
- **And, despite withering competition, carve out marginally positive gross margins too.**

**For those reasons, Wayfair is the most mispriced publicly traded stock Citron has seen in years -- with 80% downside.**

**Cautious Investing To All**