Wayfair Has Become a Case study in Diseconomies of Scale

New 2019 Stock Target- $40

Wayfair has become a textbook case of anti-economies of scale; likely the start of the long-term change in trajectory of the stock.

As all Citron readers know we have been critical of Wayfair for years. But, as the company continues to beat on top line and miss on bottom line it is only time before they change their name to Overstock. This is what the $W Q3 fundamentals screamed.

If Wayfair stays on this path they might have to change their name to Overstock.

Maybe now Wayfair investors will start growing impatient with the company's false promises around a path to profitability.

An article from Barron's last week dubbed At Home Group (NYSE: HOME) the "Anti-Amazon.com" due to the company's success in selling home décor through massive stores at low prices with huge selection and NO SALES THROUGH ITS OWN WEBSITE.

https://www.barrons.com/articles/at-home-group-1540589894

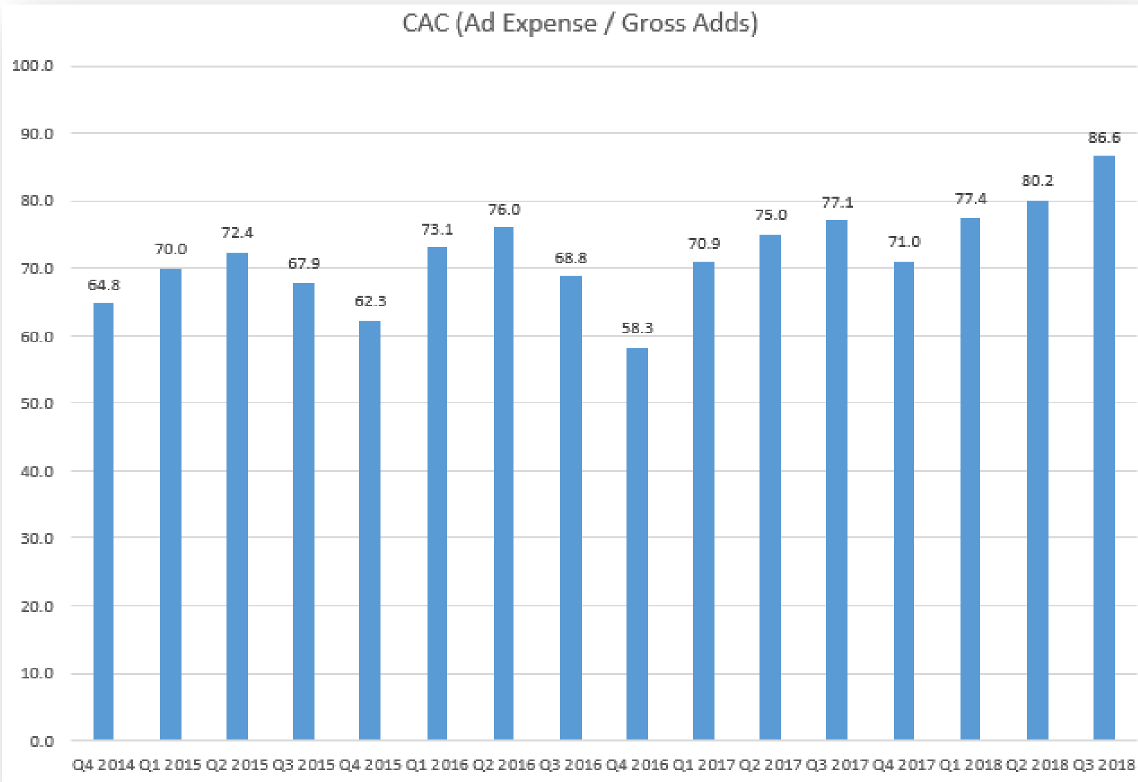
As Citron has always claimed "some categories are meant to be sold online and some in brick and mortar locations." Wayfair has shown that it can only grow through spending. Maybe it's not feasible to build a profitable business selling low-end furniture with free delivery without sacrificing growth?

With increasing competition in the furniture business from Amazon, along with competition from omni-channel retailers, there is no sign that the bleeding will stop or that Wayfair's business will rebound (source).

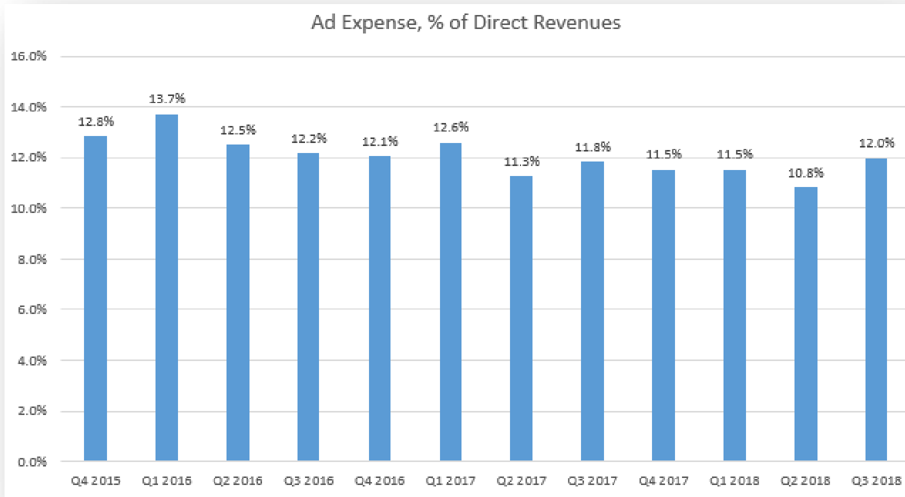
Short interest at a 3-year low and Citron is pressing.

Here are 3 charts that shareholders cannot ignore, and the company cannot disguise.

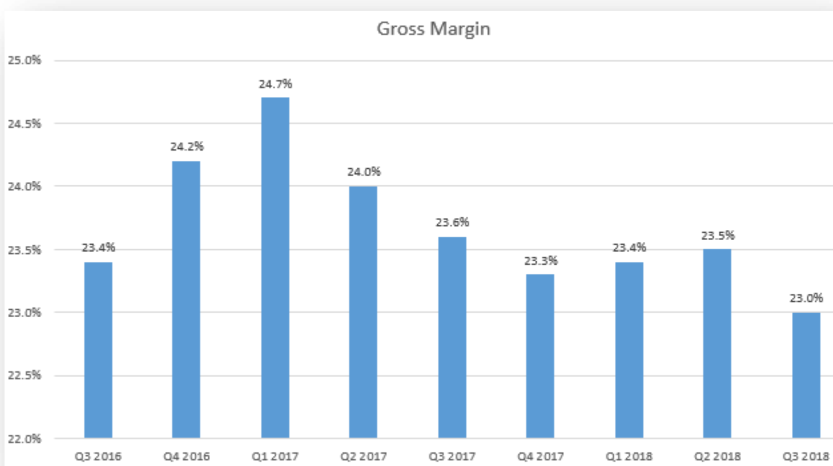
In terms of the usual themes, their customer acquisition cost as they used to define it (and is common in the marketing literature) continues to reach new highs, jumping to $86.6 in Q3:



Even if we were to view CAC as purely variable in nature, there were still signs of diseconomies of scale, with advertising expenses increasing as a percentage of revenues to 12% this quarter from 10.8% last quarter and 11.8% in the year ago quarter, despite revenues being up 43% over that period of time). Note that "bump" in the graph below:



Despite the large investments they made into Castlegate a couple of years ago, their gross margin has shown no signs of operating leverage. In Q3, we saw their gross margin weaken significantly to 23%, from 23.5% last quarter and 23.6% in the year ago quarter:



(The above chartwork and analysis came from Daniel Mcarthey and his team as expressed in this article")

While Wayfair has been stressing that a lot of these issues are due to their international business, it was notable in their investor presentation that their US Adjusted EBITDA margin was at its worst level in three years. It fell to -1.8% from +0.5% last quarter and +0.6% in the year ago quarter:

	Three months ended September 30,			
	2018		2017	
Segment Adjusted EBITDA				
U.S.	$	(26,036)	$	4,531
International		(50,369)		(27,203)
Adjusted EBITDA	$	(76,405)	$	(22,672)

Will this be the year that the stock price reflects the underlying weakness of the business? Why not??

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