

Citron Research Presents Peloton – Investors Peddling Themselves into Frenzy 2020 Target Price – \$5

Before we even start with the narrative, we are obligated to show the only chart that matters.

<u>Company</u>	<u>Enterprise Value in BN</u>	<u>Subscribers in MN</u>	<u>EV per Subscriber</u>
Peloton	\$8.8	0.6	\$15,631
Planet Fitness	\$7.8	14.1	\$553
Fitbit	\$1.3	27.6	\$47
Netflix	\$141.7	158.3	\$895
Roku	\$17.0	32.3	\$526
Stitch Fix	\$2.7	3.4	\$794
Match	\$20.3	9.6	\$2,115
Facebook	\$531.0	2,450.0	\$217
Spotify	\$23.4	248.0	\$94
Peer Average			\$655
Peloton vs. Peer Average			2286%
Peer Group Average EV per Subscriber			\$655
PTON Subscribers in MN			0.6
PTON Enterprise Value			\$369
Debt			\$484
Minority Interest			\$0
Cash			\$1,476
PTON Market Cap			\$1,361
Shares Outstanding			280
PTON Price Target			\$5

Unless Peloton invents a piece of equipment that works out for you – this is going to \$5 (which is still a \$1BN-\$2BN market cap).

Looking back over the past 5 years, one of biggest trading regrets held by Citron was not being more aggressive and staying short GoPro from the article we published in late 2014.

<https://citronresearch.com/wp-content/uploads/2014/11/gpro-final.pdf>

While Wall St was giddy over the new “must have product”, Citron maintained that GoPro sold a consumer electronics device that would eventually show decelerating growth as competition came into the marketplace. At the end of the day no matter how much lipstick Wall St put on this company, it was just a camera – the rest is history.

Disclosure: Yes, we own a Peloton bike just like we owned a GoPro, Fitbit, Blackberry, and even an ab roller... but who cares.

In this report, we won't restate the obvious points that have been made by numerous short sellers regarding Peloton's future. These include (but are by no means limited to):

- Obvious comparisons to GoPro and Fitbit
- History of fitness products in the public marketplace
- Dependence on the spin class trend and fitness fads
- A marketing plan that shows a niche audience
- The disingenuous rhetoric of management on the value proposition of Peloton ownership vs. a gym membership

Instead, we will focus on clear flaws in the Peloton business model and a management team that has been overly promotional while trying to justify an unrealistic valuation that is disconnected from all reality in the post WeWork economy. Combine this with a share structure that is designed to make long term shareholders sweat and we have all the makings of a compelling short.

Once you get past management's grandiose talks, you have a company that sells hardware and software.

Hardware

Citron gives credit to Peloton for creating a product that incorporates interactive classes into its hardware and combines it with an aspirational marketing campaign that has found its way into the homes of those who can afford it.

Note: the hardware aspect of this company has not changed in a meaningful way since the bike's introduction in 2014 when the valuation of the company was \$100MN. Citron need not dwell on the failure of Peloton's recently launched treadmill.

While Peloton has enjoyed a first mover advantage, the lack of differentiation of its bike has finally caught up to it as the competition is not only making virtually identical exercise bikes but ones that are both more affordable and functional.

Best Peloton alternatives: Top smart exercise bikes

It's hard to justify paying \$2,300 for a smart exercise bike. Luckily, there are a few alternatives to Peloton available.

<https://www.zdnet.com/article/best-peloton-alternatives-top-smart-exercise-bikes/>

It can be argued that competitors in the hardware space have used their second mover advantage to create better spin bikes that have swivel screens (e.g., allowing mat exercises), open platforms (e.g., allowing users to watch TV or Netflix while they are riding the bikes), and iPad attachments. None of these features are offered by Peloton.

In addition, competitors have done what Peloton was not able to do by expanding their digitally integrated at home fitness hardware offerings to new segments like Mirror, Tonal, boxing, rowing, etc.

The lack of differentiation between Peloton and its lower priced competitors is best highlighted by Peloton's lawsuits against Echelon Fitness and Flywheel Sports.

Note: legal experts don't believe Peloton has a real case as noted in Bloomberg Law:

"Peloton didn't invent computerized exercise equipment that could let users compete remotely with other users. Nor did it invent the touchscreen, the exercise bike, spin classes or on-demand programming."

<https://news.bloomberglaw.com/ip-law/pelotons-moat-depends-on-patent-challenges-it-may-not-win>

Consider this fact regarding Peloton's hardware – Peloton has spent almost \$600MN over the last 3 years in marketing to capture the high-income low hanging fruit while competition was low. Going forward, competition is so intense that some competitors are even offering to give the exercise bike for free with a digital subscription. Citron believes Peloton's glory days of hardware sales are in the rear-view mirror.

Exclusive offer from ProForm financing

FREE* Studio Bike Limited with 3-year iFIT membership

\$0	\$39	36	0%
No money down	per month	months	APR financing

https://www.proform.com/exercise-bikes/studio-bike-limited?gclid=EA1aIQobChMIIsKKm4fOj5glVCdVkJCh0ZowrIEAEYASAAEgLVYPD_BwE

Rather than taking Citron's word, spend 15 minutes researching exercise bikes on Google and you will see the aggressive marketing of Peloton's competitors.

By looking at just the hardware, as Peloton moves down market and away from the low hanging fruit, the company will inevitably compete with Amazon and the numerous lower priced alternatives if they intend to be anywhere close to consensus expectations.

No one owns this stock for the equipment multiple. If Peloton were to be considered an equipment company, it would be trading at \$5 today as the leading gym equipment manufacturers (e.g., Nautilus and Life Fitness) trade/have sold at an EV/Sales multiple of 0.3x-0.5x.

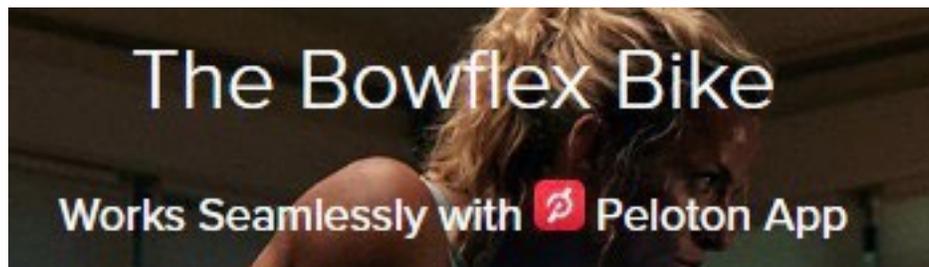
Digital

If you don't own Peloton stock for hardware you own it for digital. Let's now look at its digital strategy. First, Peloton is charging \$39 a month for a connected experience to those who have purchased a Peloton bike for \$2,245.

Yet, with the Peloton digital app a customer can pay \$12.99 for the same connected experience without having to pay \$2,245 for the bike. Peloton justifies this by saying the app is a lead gen source yet the company admits that less than 10% of digital subscribers end up purchasing a connected fitness product.

To put it in terms of digital content... Imagine if Netflix decided to increase its subscriber base by giving away its content to DirecTV subscribers for \$3 a month rather than \$12.99 and justified it by claiming they hoped to build enough brand loyalty that customers would eventually become Netflix subscribers. Would anybody buy that strategy?

Peloton's strategy has allowed its competitors to quickly exploit this flaw as they now advertise that their bikes can be used with the Peloton app.



Choose the Path that Fits You Best



Bowflex Bike
\$899
+
Use Your Own Device



Peloton Bike

\$2,245*

*Based on onepeloton.com
as of December 4, 2019.

As we move down market, the flaw in Peloton's digital strategy can be exploited by makers of any of the hundreds of bikes sold on Amazon for under \$500.

Defenders of Peloton might say the \$500 bikes are not "connected" – but welcome to 2020. You want to see how you take an inexpensive bike and give it better connectivity and multimedia experience than a Peloton.



For a one-time cost of \$12, you can convert your existing bike into a Peloton.

Maybe we are wrong -- there is a difference between the \$39 a month vs. \$12.99 a month plan.

PELOTON MEMBERSHIP	DIGITAL MEMBERSHIP
Access all classes via the Peloton Bike, Tread and app	Access all classes via the Peloton app
\$39/mo <i>Requires Peloton Bike or Tread</i>	\$12.99/mo
<div style="display: flex; justify-content: space-around;"> <div style="border: 1px solid black; padding: 5px; text-align: center;">SHOP BIKE</div> <div style="border: 1px solid black; padding: 5px; text-align: center;">SHOP TREAD</div> </div>	<div style="border: 1px solid black; padding: 5px; text-align: center;">SHOP APP</div>
<ul style="list-style-type: none"> ✓ Unlimited Peloton classes on the Bike, Tread and on the go ✓ 20+ live classes daily and thousands on-demand ✓ Unlimited user profiles ✓ A variety of class types including cycling, running, bootcamp, yoga, outdoor and more ✓ Includes Peloton App (access on iOS, Android, Fire TV and Web) ✓ Instructor curated training programs ✓ Live workout metrics including distance, heart rate, and resistance ✓ Detailed workout performance dashboard <li style="border: 2px solid red; padding: 2px;">✓ Live and on-demand class Leaderboard 	<ul style="list-style-type: none"> ✓ Unlimited Peloton classes on the go ✓ 20+ live classes daily and thousands on-demand ✓ One user profile ✓ A variety of class types including cycling, running, bootcamp, yoga, outdoor and more ✓ Access on iOS, Android, Fire TV and Web ✓ Instructor curated training programs

While heart rate and workout metrics are native to even inexpensive bikes, the only IP that Peloton appears to bring to the table is its leaderboard technology, which allows participants to compete against one another. For years, Peloton touted this as an advantage as it turned exercise into entertainment. While Citron believes this is used by a limited number of riders, it has been touted by Peloton management as a key differentiator.

For those of you who don't know the rest of the story, read about Foley's folly. While designing the bike, one night at a bar CEO John Foley told a collaborator that Peloton may be infringing on a Microsoft patent that covers "computerized fitness equipment that is designed to simulate race conditions with other users". Without holding this collaborator to a confidentiality clause, Peloton's collaborator acquired the patent, sued Peloton for infringing on their patent, and then partnered with SoulCycle and Echelon Fitness to introduce competing

products eliminating the only benefit of the \$39 a month subscription over the \$12.99 a month plan.

<https://www.buzzfeednews.com/article/douglasquenqua/spin-class-at-home-and-a-lawsuit-too-for-peloton>

<https://www.forbes.com/sites/kristintablang/2018/10/02/exclusive-soulcycle-and-peloton-designer-eric-villency-debuts-a-revolutionary-new-fitness-bike/#211258a54136>

<https://www.prnewswire.com/news-releases/designer-eric-villency-and-echelon-fitness-announce-partnership-300936333.html>

Management

While Peloton stock may move in the short-term on promotional commentary from management, the reality is that CEO John Foley has had a hard time with the truth. He has a reputation for “loose lips” and “shooting from the hip”. While these might be attributes of an aggressive entrepreneur, as a corporate CEO they can result in SEC violations and claims of outright fraud. Take for example his repeated claims about Peloton’s profitability. Needless to say, we all know that Peloton has never had a profitable year since inception.

- In 2018, Foley tells CNBC that Peloton is profitable
- In 2017, Peloton SVP of brand marketing says Peloton is “effectively” profitable
- In 2016, Foley tells Inc. that Peloton is profitable
- In 2015, Foley tells Bloomberg that Peloton is profitable

<https://www.cbsnews.com/news/peloton-ipo-how-much-is-just-spin/>

<https://www.cbsnews.com/news/why-would-the-ceo-of-hot-ipo-peloton-say-it-was-profitable-when-it-was-not/>

Foley’s loose language makes us question the integrity of his guidance and key performance metrics, most notably churn. As noted by Emory professor Dan McCarthy, Peloton’s churn disclosure just “doesn’t pass the smell test” as Peloton’s 0.65% churn rate implies that the average customer keeps the digital subscription for 13 years! Can we take the under?

<https://www.linkedin.com/pulse/peloton-hiding-retention-smoking-gun-its-churn-maybe-daniel-mccarthy/>

Lastly, Foley’s willingness to play fast and loose with the rules have resulted in the company being the subject of a \$300MN lawsuit from music publishers. Knowing that music is beyond essential to their business, this issue should have been resolved before the IPO but instead Foley has launched a countersuit against the National Music Publishers Association. Citron would love to dismiss this as sloppy management but we believe this was deliberate to deceive investors and manipulate the financials pre-IPO.

<https://www.businessinsider.com/peloton-users-complain-of-80s-music-after-300-million-lawsuit-2019-10>

While Foley was busy getting Peloton to IPO as soon as possible, the Peloton management team completely failed to innovate new products. The only product other than the bike that Peloton has launched, the treadmill, has not lived up to anyone's expectations and the company has missed the mass movement to mirrored interactive home gyms and digital weights as Peloton, a \$10BN company, is still a one trick pony.

Instead of innovating, Peloton has positioned itself as a media company. Where have we seen this before?

<https://fortune.com/2019/09/25/peloton-ipo-filing-media-company/>

<https://fortune.com/2016/08/31/gopro-media-company/>

Worse than the Commercial

Nothing better illustrates the incompetency of management and the future of this company than the CEO's comments yesterday at the UBS conference. Foley's remarks are filled with hubris and lack any clear path for Peloton to ever grow into its current market cap. In response to his backwards digital strategy that penalizes its best customers and how to extend his customer base beyond fitness enthusiasts, he describes his future customer as:

"They're not using the treadmill right now because it's a clothes hanger and it's dusty. Nobody likes running on a treadmill at home because it's boring... We can bring our insanely motivating fantastic instructors into your home, onto your 60-inch television screen... And with that subscription, they get yoga included. They get out to running included. They get cycling. They can go to their gym... We believe it's five years from now, two years from now, when your treadmill breaks, you're going to go to a Peloton store near you and you're going to see one of our two treadmills and you say honey, I don't want the dopey old treadmill from the dopey old fitness equipment company of yesteryear. I want it Peloton tread."

Are these the new users who are worth almost \$16K a piece to the company's EV?

There are more things wrong with the above statement than the now infamous commercial.

The assumptions made in the above statement are ludicrous:

- The Peloton app has taken someone with a dusty old treadmill to a fitness enthusiast overnight who runs and does yoga
- This person's dusty old treadmill happens to be in front of a 60-inch smart TV
- Whether it be Netflix, YouTube, CNN, or CNBC, this person has never used this treadmill until they could download the Peloton app
- Although the person is not a fitness enthusiast, they choose to pay \$12.99 a month instead of the plethora of free content on YouTube
- Most importantly, this person will eventually buy a \$3K-\$4K treadmill and pay \$39 a month for the exact same offering for which they had been paying \$12.99

Lock-up and Share Structure

Peloton management is clearly eager to cash out. In 2017 and 2018, Peloton repurchased almost \$200MN of stock from insiders including CEO John Foley, President William Lynch, COO Thomas Cortese, and Chief Legal Officer Hisao Kushi at as low as \$5 per share.

Peloton currently has a float of ~40MN shares. With Peloton's upcoming lockup expiry in March, an additional ~240MN shares will become available for sale. While we believe Foley will say or do anything to keep the stock up until the lock-up expires, that is OK.... we are patient.

Valuation

Post WeWork and a new market reality that more heavily scrutinizes money losing companies, why is Peloton trading at a market cap of \$10BN?

To put Peloton's ridiculous valuation into perspective, we compared the company's valuation on a per user basis versus other leading fitness, streaming, and popular apps. The takeaway is clear. Peloton at \$10BN or even \$5BN makes zero sense.

We have already established that you don't own Peloton for the hardware or the software. So, the only thing you own Peloton for is the subscribers. Let's compare Peloton vs. a range of peers.

On an EV per user basis, Peloton is 2,286% more expensive than the average of this peer group. If Peloton had the same value per user as the average of this peer group, the stock would be valued at \$5.

This is all you need to see

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Note to reader: by no means is Citron saying that Peloton's revenue will decline by 70% or 80% but even a small decrease in growth will result in a large decrease in share price. If Peloton ends up being a \$3 stock that would make this a \$1BN spin bike company. Nothing short of a huge success.

We promise that we will look back in 3 years and remember Peloton as a \$10BN company and our only regret will be that we were not short more.

Cautious Investing to All

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