EBITDA CATALYST

Your Opportunities. Our Insights. EBITDA, Catalyzed.

Peloton's Pricing Strategy: Racing Into Trouble?

- *Pricing Strategy*
- *Pricing Research*

November 2021

1: Peloton's Growing Trouble

Sometimes, an inflexible, one-size-fits-all pricing strategy can turn into a major liability in a rapidly changing market.

On Friday, November 5, shares of Peloton fell by over 35%. The stock is down over 2/3 from its January highs. In early trading Mon, it is down another 8%. For a company that not too long ago was unable to make enough product to satisfy demand and spent over $400M to acquire more manufacturing capacity, this seems like a stunning turn of events.

Peloton's Stock Chart YTD, as of Nov 5, 2021

Until, that is, one reviews the numbers Peloton posted in its quarterly earnings release after market close on Thu, and the impact of its latest changes in pricing strategy. Let's first dive into the very alarming financial outcomes:

Balance Sheet (vs last Qtr ending June '20):

- Cash & Marketable Securities: down over $660M … at this burn rate, Peloton would run out of cash in just one quarter
- Inventory up over $330M (accounting for half of the cash burn) to ~$1.27B (about 7-8 months worth of hardware sales at current rates) … the problem is no longer too much demand too little product

PELOTON INTERACTIVE, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(in millions, except share and per share amounts)

ASSETS	09/30/2021 UNAUDITED	06/30/2021
Current assets:		
Cash and cash equivalents	$ 612.6	$ 1,134.8
Marketable securities	311.6	472.0
Accounts receivable, net	81.1	71.4
Inventories, net	1,269.2	937.1
Prepaid expenses and other current assets	280.7	202.8
Total current assets	2,555.1	2,818.1

Income Statement (vs same Qtr 2020):

PELOTON INTERACTIVE, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE (INCOME) LOSS

UNAUDITED *(in millions, except share and per share amounts)*

	Three Months Ended September 30,	
	2021	2020
Revenue:		
Connected Fitness Products	$ 501.0	$ 601.4
Subscription	304.1	156.5
Total revenue	805.2	757.9
Cost of revenue:		
Connected Fitness Products	441.0	364.2
Subscription	101.4	65.0
Total cost of revenue	542.5	429.2
Gross profit	262.7	328.7
Operating expenses:		
Sales and marketing	284.3	114.6
General and administrative	240.3	108.6
Research and development	97.7	36.6
Total operating expenses	622.4	259.8
(Loss) income from operations	(359.7)	68.9

- Swung from $69M operating profit to $360M operating loss
- Gross Margin on Connected Fitness Products (e.g. bikes/hardware) dropped from ~40% to ~12%
- Nearly every item of operating expense is over 2x last year's, while total revenue grew only 7%. Given the SG&A increase, it is fair to say Peloton is now selling the hardware at a loss
- On a positive note, high-margin subscription revenue nearly doubled from same quarter year ago

Cash Flows Statement (vs same Qtr 2020):

PELOTON INTERACTIVE, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

UNAUDITED *(in millions)*

	Three Months Ended September 30,	
	2021	2020
Cash Flows from Operating Activities:		
Net (loss) income	$ (376.0)	$ 69.3
Adjustments to reconcile net (loss) income to net cash (used in) provided by operating activities:		
Depreciation and amortization expense	28.1	11.4
Stock-based compensation expense	52.9	29.6
Non-cash operating lease expense	19.2	13.3
Amortization of premium from marketable securities	2.5	1.7
Amortization of debt discount and issuance costs	8.5	0.1
Impairment of long-lived assets	0.6	1.3
Net foreign currency adjustments	5.2	–
Changes in operating assets and liabilities:		
Accounts receivable	(9.8)	(15.0)
Inventories	(332.4)	(118.0)
Prepaid expenses and other current assets	(40.4)	(18.2)
Other assets	(8.4)	5.9
Accounts payable and accrued expenses	56.0	156.4
Customer deposits and deferred revenue	40.6	157.4
Operating lease liabilities, net	(9.0)	11.3
Other liabilities	1.3	5.5
Net cash (used in) provided by operating activities	(561.0)	312.1

- Operating activities swung from $312 net generated cash, to negative ($561) cash drain, a swing of $873M in the wrong direction (higher than total revenue)
- Stock compensation expense doubled, suggesting ballooning hiring and stock awards as the problems are mounting

See the Peloton 10Q and letter to shareholders [here](#)

2: Pricing Strategy Impact

So, What's Pricing Got to Do With This?

For most of its existence, Peloton got virtually all of its revenue from two sources: the Bike, and the Subscription. Because the Bike revenue is all upfront and large, while subscription revenue is over time, the Connected Fitness Products (e.g., Bike, joined more recently by Bike+ and the treadmill (Tread), has produced the majority of Peloton's revenue.

Repeated one-size-fits-all, dramatic price cuts in core offering

Peloton twice took down the list price of the Bike:

- Sep 2020 from $2,245 to $1,895 (*16% cut*, while introducing the fancier Bike+ @$2,495)
- Aug 2021 from $1,895 to $1,495 (*further 21% cut*, widely seen as a response to last quarter's poor performance and slowing growth)

This leaves today's Peloton with its two main offerings, the Bike+ @$2,495 and the Bike @$1,495. The $1,000 difference is a 40% differential, and can buy over 2 years worth of the Subscription (see below). At this point, it is fair to see the Bike+ as more of a *price decoy* to make the buyers of the classic Bike feel like they're getting a deal (a-la the classic Williams Sonoma variety), than an actual segmentation strategy. Except, Williams Sonoma did not decrease the price of its original product.

On the Subscription side, Peloton has:

- A $39/month All-Access for the owners of one of its Connected Products. This price has stayed the same in recent years. Peloton smartly banked on the purchasers of its high-priced gear to be "stickier" due in no small measure to the "sunk" cost in the device itself. Those few who own multiple Connected Products pay this fee only once.
- A $12.99/month Digital subscription for everyone else (to use its classes on most digital devices AND available through some competitors' bikes as well). This was cut from $19.49 in late 2019.

It is well known that pricing % changes produce dramatic leverage in operating income. That works both ways! Peloton's price cuts on its core Bike were bound to savage its Connected Products profitability, even before the perfect storm of higher costs for commodities, energy, shipping, labor and components hitting every manufacturer out there.

In addition, Peloton's price slashing has been both in large increments, and across the board. It has not tried enough tools from the pricing arsenal such as time-limited promotions, bundling additional value elements, or expanding the optionality in its product line-up. Peloton's blunt approach to pricing suggests either knee-jerk reactions to slowing growth, or impatience to test and learn in more incremental ways. Maybe most of all, they reflect the limited optionality in its offering design.

Price reductions seen as increased acquisition costs for all-important subscription revenue

In fairness to Peloton, I should make a *global disclaimer that many decisions that appear completely wrong from the outside (and with the wisdom of hindsight), can look completely different with the data that only management has*. It is entirely possible that Peloton had planned its Connected Products prices as a classic price skimming strategy, which the COVID demand tailwinds extended even longer than it had hoped. If so, one wishes their price reductions would have been in smaller increments, to avoid cannibalization of higher margin customers.

Most importantly, ***the only price that hasn't changed @Peloton remains that flagship $39/month All-Access membership.*** That is hopefully a tell that there is in fact a strategy here, just one confronted with a lot of headwinds. The increase in high-margin subscription revenue is the silver lining in Peloton's numbers. Peloton is in effect buying subscribers, and it's paying for them by relinquishing profit margin upfront on the Bike. The CAC is going up with the receding pent-up demand of COVID-driven lockdowns being replaced by a more realistic level of demand. If so, however, Peloton should be set up to run a highly capital-intensive business, set up to "finance" the acquisition of these cash flow streams by selling $1,500 Bikes at or below cost. Splurging on operating expenses and stock options compensation like the outlier growth during the pandemic will last forever seems contrary to an understanding that the CAC's are going up. Finally, while Peloton is still seeing only low churn ~8% in its subscriptions, that too is (slightly) ticking up, and engagement (number of workouts / device) is down. With a Bike list price down ~40% from its original, the "sunk cost" element may be eroded in its ability to guarantee long-term stickiness.

It is tempting to say that Peloton made (and is making) some costly pricing strategy mistakes, but I stick to the caveat above. Unfortunately, whether poor strategy or a perfect storm of headwinds, or simply a lower TAM that is wearing thin, it is clear that the Peloton is paying a dear price, and honeymoon is over for both customers and investors. Peloton can use that ballooning R&D budget to hopefully wow us with better products, value, and pricing.

Skyline of beautiful Minneapolis, MN—proud home of EBITDA Catalyst

*"The single most important decision in evaluating a business is **pricing power**."*
— Warren Buffett

About EBITDA Catalyst® | Pricing as a System®

At EBITDA Catalyst, **pricing power is our superpower. And your catalyst.**

We are the trusted partner and advisor of middle market companies and private equity firms looking to accelerate value creation. Our Pricing as a System® framework centers on optimizing AND harvesting your pricing power, through the levers of Pricing Strategy, Analytics, Research and Execution, combined with Customer Retention & LTV.
Visit us to see how our insights benefit companies in Enterprise Software, SaaS, Ecommerce, Consumer Brands, Fintech, IOT, Manufacturing & more.
Learn how we catalyzed value creation at portfolio companies of leading private equity firms: Providence Equity, L Catterton, Golden Gate Capital, Vista Equity and more.

Model **your ROI**: ebitdacatalyst.com/roi-calculator

Contact Us

(888) EBITDA 8 | (612) 254-9999
ebitdacatalyst.com

Subscribe to our newsletter:
ebitdacatalyst.com/subscribe

Or use the QR code.