EXCLUSIVE REPORT

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A Lean, Mean Comeback Machine

- Fierce Fans Power This Much-Loved Fitness Brand
- Looking Good and Looking for a Buyout

A Lean, Mean Comeback Machine

Fierce Fans Power This Much-Loved Fitness Brand

Looking Good and Looking for a Buyout

> *There's upside in this fitness outfit,*
> *An acquisition-target air about it,*
> *But let me mention, in addition,*
> *It's not a low-risk proposition.*
> *- Martin Fridson*

It was past bedtime, and little Andy and Jo Ann Taylor were buttoned snugly into their footie pajamas, a classic picture of 1950s-era good kids.

They weren't in bed, though...

The pair were curled up in the back seat of their parents' car, as dad Jack cruised the darkened streets of St. Louis, Missouri, looking for a customer who hadn't paid up.

After five years in business, Jack's small auto leasing company, Executive Leasing, had successfully expanded to three locations and 1,000 vehicles. But sometimes customers "forgot" to return that sharp Cadillac when the lease was up... and that's when tough World War II vet Jack turned repo man.

When no babysitter was available, the whole family sometimes went along for the ride. Mom Mary Ann rode shotgun until Dad spotted the delinquent vehicle (usually parked well back from the road at the customer's listed address).

Then Mom hopped into the driver's seat and chauffeured the sleepy kids home, while Dad slipped a spare key into the ignition of the wayward rental, and drove it quietly back to the lot.

Jack Taylor's talent for tracking people down would come in handy later in life.

In the meantime, though, Taylor would pivot his long-term leasing business into a highly successful short-term car rental company, Enterprise Rent-A-Car (named after an aircraft carrier he'd served on during the war). While most auto rental companies drummed up business at airports, Taylor tapped into a previously overlooked local market: families who needed a car for a weekend day trip or a temporary set of wheels after a car accident.

And, it turned out, there were plenty of those people. Taylor's company branched out to Detroit, New York, L.A. and beyond. By the mid-1990s, Enterprise had edged out its nearest rival, Hertz, to become the biggest car rental company in the U.S., with 2,000 U.S. locations and 62 in other countries. Jack moved to a chairman role, while son Andy – who'd slept in the back seat in footie pajamas – took over as CEO.

But growth brought problems. From the late 1980s to early 1990s, Enterprise's customers increasingly complained about dirty cars, late pickups, and poor service. So, just as he'd done years before on the dark streets of St. Louis, Jack decided to track the problem to its source.

Together, Jack and Andy developed a simple, two-question phone survey tool: the Enterprise Service Quality Index (ESQi). The survey asked customers two questions: "How was the quality of your rental experience?" and "Would you be likely to rent from us again?" Not surprisingly, customers who reported perfect satisfaction were three times more likely to come back to Enterprise.

While customer surveys are as old as Ancient Egyptian papyrus, it was the Taylors' follow-up strategy that broke ground...

It's not enough just to *find* the missing property, as Jack, the one-time repo man, remembered well. He still had to drive it home.

So, starting in 1996 – in a radical step – Enterprise tied employee compensation *directly* to the ESQi (a strategy Andy called "closing the loop"). If rental customers reported high levels of satisfaction on the survey, the Enterprise employees who'd served them got raises and promotions. If ESQi scores were low, the employees got demoted, or worse – fired.

Of course, there was plenty of grumbling (and a few attempts at "gaming" the survey). But long term, ESQi earned respect. Since 1994, when Enterprise first began tracking customer satisfaction, customer service ratings have gone up every year for the company as a whole.

And Jack Taylor's oft-repeated mantra – "Take care of your customers and your employees first, and the profits will follow" – seems to have proven true. Seventy-odd years after the elder Taylor launched his car leasing business with a fleet of just seven vehicles, Enterprise brings in about one-fifth of the total car rental revenue in the U.S. It posted $1.5 billion in 1994... $5.6 billion in 2000... and $35 billion (its best year yet) in 2023.

Today, Enterprise is run by the third generation of Taylors (current CEO Chrissy is the daughter of former CEO Andy). And the company remains proudly private: Warren Buffett once tried to buy it with no luck, calling it "the one that got away."

And Enterprise's legacy doesn't end there...

How Jack Taylor Accidentally Launched A Customer Service Cult

Jack and Andy Taylor's ESQi score is the inspiration for one of the world's best-known metrics of customer satisfaction, the NPS (Net Promoter Score).

In 2003, management consultant Fred Reichheld wrote an article in *Fortune* magazine called "The One Number You Need to Grow." In it, he described a "lightbulb moment" that hit him as he pondered the Taylors' ESQi surveys at Enterprise:

> ***"Enterprise's method – and its ability to generate profitable growth through what appeared to be quite a simple tool – got me thinking that the company might be on to something. Could you get similar results in other industries—including those seemingly more complex than car rentals – by focusing only on customers who provided the most enthusiastic responses to a short list of questions designed to assess their loyalty to a company? Could the list be reduced to a single question? If so, what would that question be?"***

In the end – after tracking 4,000 survey respondents over two years, with the help of a statistics firm – he came up with a question similar to Jack and Andy's two-question survey for Enterprise. It combined the Taylors' basic ideas into a single, more powerful query:

How likely is it that you would recommend this company to a friend or colleague?

And thus, the NPS system – a metric that's tracked by about two-thirds of Fortune 500 companies, and typically sees 1% in revenue correlated with every seven-point increase – was born. It's become a standard benchmark that shows big companies a quick picture of where their customers' loyalties lie.

Answers are scored on a scale of 1 to 10. 9 or 10 means the customer is likely to recommend the business – in other words, he's a "promoter." 7 to 8 means the customer is satisfied, but not enthusiastic enough to promote. And anything below 7 is considered a "detractor."

Obviously, a company wants net promoters, not net detractors. Any score above 70 (total percent of promoters, minus total percent of detractors) is considered excellent; that means 70% of your customers love you and are actively plugging your product. The passive middle isn't counted. (Apple's NPS is 75; Google's is 45.)

Granted, NPS can be a little reductive – and, in today's climate of "survey fatigue," it can be difficult to get people to self-report accurately. But the Taylors' idea, followed by Fred Reichheld's further development, created a long-lasting touchstone for how businesses track customer satisfaction.

Of course, the big question is what companies do about those numbers when they have them.

The company we're recommending in this issue has unmatched brand loyalty, as measured by NPS – with its five main products all boasting an NPS score of near or above the "holy grail" score of 70. However, it's had its share of stumbles. We believe its near-fanatic customer loyalty is why it will ultimately thrive, despite some recent and very public missteps.

The Undisputed Leader in Subscription-Based Fitness

The company we are recommending this month is a familiar one for *Distressed Investing* readers. It's **Peloton Interactive (Nasdaq: PTON)**. Peloton produces exercise equipment and offers a subscription-based fitness service. Its stationary bicycles, treadmills, and indoor rowers are equipped with internet-linked touch screens that stream live and pre-recorded fitness classes – available to fitness fanatics via a multi-tiered subscription model. But this report is not about a Peloton bond. We are recommending Peloton shares.

In our October 2023 report "**A Change of Gears**," we recommended Peloton's 0% coupon bond maturing February 15, 2026. At the time, these bonds were trading just under $750, which equated to an annual yield of 13.1%.

In that report we noted that Peloton – whose sales skyrocketed during the pandemic but collapsed afterward – was in the process of cutting costs to survive. We wrote:

> *"We believe that Peloton will come close to its targets for 2024 (year ending June 30, 2024) and generate positive cash flow in 2025."*

We still believe that to be the case – the company will likely achieve its target of increasing gross profits in 2024, and generating positive cash flow in 2025 (for Peloton this is the year that begins July 1, 2024). In fact, Peloton recently reported its results for the quarter that ended March 31, and the company generated positive free cash flow for a quarter – though only a modest $8.6 million – for the first time in close to four years. As we will discuss later, the company is likely to generate increasing amounts of free cash flow over the next two years – at the very least.

A lot of good has happened – and is happening – at the subscription-based fitness service. The company's 0% bonds we recommended have moved up in price, now trading around $88x. We are confident that Peloton's will be able to pay off these bonds when they mature in February 2026 – and quite possibly sooner than that.

Peloton's operating results are likely to improve over the next couple of years. The company had $794 million in cash as of March 31, and aside from our bonds it has no other debt coming due before 2029. The company has time to work on rebuilding its financial performance.

In that October report, we also discussed why Peloton would be a good candidate for acquisition by companies like Apple (AAPL), Amazon (AMZN), Nike (NKE), and Netflix (NFLX). We think a larger company or private-equity fund is interested in acquiring the company – and is part of the reason we are recommending the stock.

In this month's report we will update the Peloton story, and we will explain why we believe that the company's stock, though high risk, has significant upside potential from its current price of around $3.60 per share. We can imagine scenarios where the stock could be worth as much as 4x or 5x its current price. We can also imagine cases where the stock could be worth little or nothing. We think an upside scenario is more likely, and we view Peloton stock as a worthwhile speculation.

Much Happened in May

May was a very active month at Peloton.

On May 2, the company released its earnings report for its quarter that ended March 31. Revenue was a little weaker than expected, and operating profits were better than expected – but overall the results show a company headed in the right direction, as we will demonstrate.

At the same time Peloton announced the resignation of CEO Barry McCarthy, who took over for the founder, John Foley, in mid-2022. Two board members, Karen Brown and Chris Bruzzo, will serve as co-CEOs until the board finds a permanent successor.

On the same day, Peloton announced $200 million in new expense reductions – representing about 10% of total annual costs.

Later in the month, the company announced efforts to refinance its debt and extend the due dates on its bank loan and bonds. We will provide details of all of this when we look at Peloton's financials.

The Driving Forces of Peloton's Business

Peloton is separated into two core business segments: Connected Fitness and Subscriptions.

Connected Fitness

In 2014 Peloton began designing, manufacturing, and selling an exercise bicycle that was connected to the internet. It had a tablet screen and ran on Peloton's software. That was its only "connected" product at the time. Now, 10 years later, in 2024, the company offers these fitness options:

- **Bike:** This exercise bicycle is Peloton's signature product. It costs $1,445 new or $995 refurbished. It – along with all of Peloton's connected fitness equipment – requires an All-Access subscription. This subscription enables riders to stream and participate in more than 1,000 live classes each month – many featuring celebrity trainers – and more than 42,000 pe-recorded classes.
- **Bike +:** This advanced version of the Bike costs $2,495 new or $1,595 refurbished. It has all the features of the Bike, plus automatic resistance control and electronic braking. These extra features allow the instructor to automatically adjust the user's bicycle resistance level and speed – and simulate the leader's workout as it's happening.
- **Tread:** A connected treadmill with a tablet screen that enables the user to participate in live or recorded walking, running, and bootcamp classes, the Tread costs $2,995.
- **Tread +:** Costing $5,995, it features a larger tablet and a premium sound system, as well as advanced slat belt technology that makes running more comfortable.
- **Row:** Peloton's connected rowing machine sells for $2,995, and through the All-Access subscription, it connects to a wide range of low-impact, cardio, and full-body strength classes. Row's technology provides guidance, assistance, and other technology to personalize rowing workouts.
- **Guide:** This is a device with a camera that connects to a television or monitor. It provides an artificial-intelligence-powered personal trainer, which tracks time worked out and repetitions per set. The Guide costs $195 and requires a $24-per-month subscription This entitles the customers to take part in Peloton's strength programs and workouts, and includes access to its App+, discussed below.

Connected Fitness – Then and Now

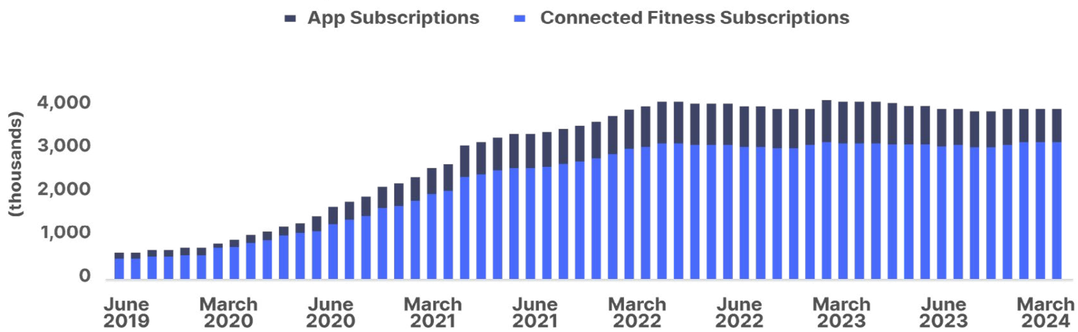
Offering Overview	2014	2024
Products	Bike	Bike, Bike+, Tread, Tread+, Row, Guide
Subscription types	All-Access Membership	All-Access Membership, Guide Membership, App+, App One
Content languages	English	English, German, Spanish
Disciplines	2 modalities (Cycling, limited stretching)	16 modalities, plus Lanebreak, scenic workouts, and gym plants
Instructors	6 (U.S.)	57 (global)
Total number of classes	2,100 studio classes	>42,000
Monthly classes	<400	1,000+
Total paid subscriptions	100,000	3.1 million paid Connected Fitness subscriptions 674,000 paid app subscriptions

Subscriptions

In 2014, a Peloton streaming subscription allowed users to participate in roughly 400 live classes taught by six instructors at the company's studio in New York City. Today, the company has 3.1 million All-Access members paying $44 per month.

Peloton's Growing Subscription Base

Total Subscriptions Grew At a CAGR of 67% From FY2018 to FY2023



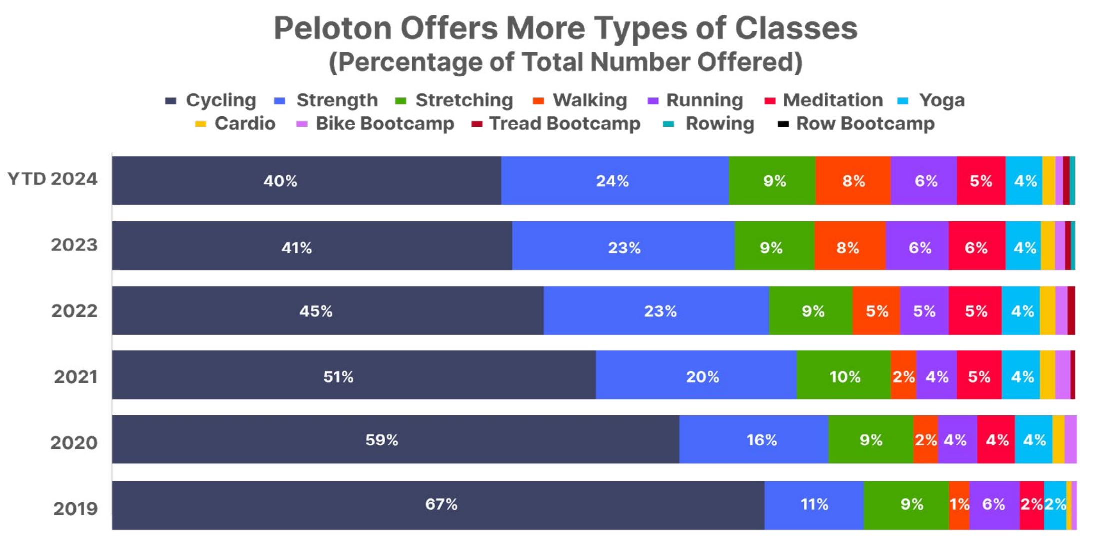
(thousands)	FY2018	FY2019	FY2020	FY2021	FY2022	FY2023	3FQ24
Connected Fitness Subscriptions	245	508	1,086	2,314	2,913	2,997	3,056
App Subscriptions	46	102	317	874	980	828	674
Total Subscriptions	291	610	1,403	3,188	3,188	3,893	3,730

These are the different levels of subscriptions:

- **All-Access:** Peloton's most popular subscription plan costs $44 per month and provides access to everything the company offers – more than 1,000 live classes each month, and Peloton's library with more than 42,000 and recorded classes.
- **App+:** This app-based $24-per-month subscription provides access to almost all of Peloton's content and can be used for workouts with any fitness equipment – but does not connect to any equipment the way the "All Access" subscription does.
- **App One:** A limited version of the App+, for $12.99 per month, it provides access to some of Peloton's content, and up to three live classes.
- **Guide:** The $24-per-month subscription provides specific content for use with the Guide device – it also includes App+ membership for up to five family members.

Peloton's live classes are led by 57 trainers. Some of them – for example Ben Alldis, Ally Love, and Cody Rigsby – have developed cult-like followings and have become well-known outside the Peloton community. These classes and these instructors are the reason why an impressively high 87% of subscribers renew each year.

This table shows how the types of classes streamed have evolved over the last five years:



The key points to note are:

- Cycling has decreased from 67% of all classes offered to 40% as Peloton has added new equipment
- Strength has increased from 11% of classes to 24%
- Walking-based classes have grown from 1% to 9% of the total
- Yoga and cardio have gone from 2% of classes each to 5% for yoga and 4% for cardio

Taken together, the present lineup of classes offers a range of lower-intensity classes suitable to the rapidly expanding over-65 demographic.

Finding New Ways to Reach Customers

Peloton launched the business in 2012 by selling Bikes (not yet connected to the internet) in its own retail showrooms and on its website. Its ability to oversee all stages from design through the final sale was instrumental in building brand recognition – but was not cost-effective. Now that Peloton has established its brand, it no longer needs its own retail outlets. As a result, the company has been closing the retail stores whenever the leases end. The faster Peloton can close its remaining retail stores – with minimal loss of sales – the quicker operating expenses will fall.

Peloton now uses a variety of third-party channels to reach customers:

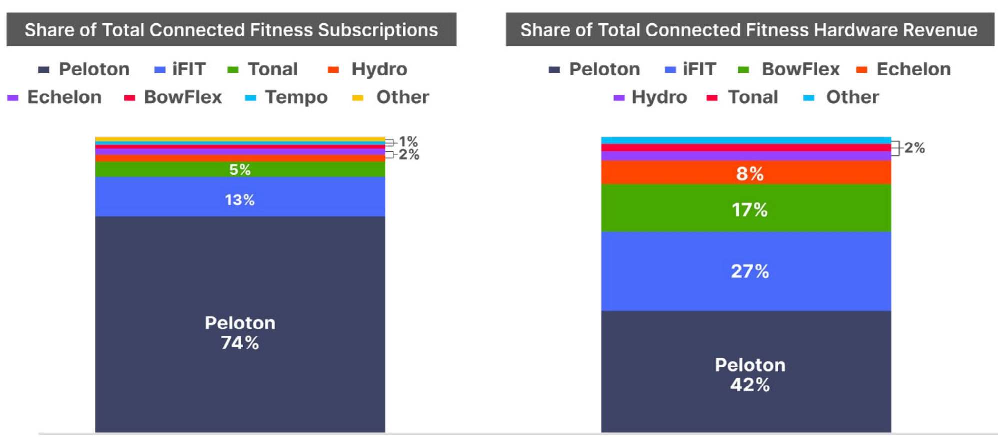
- Peloton's website and apps
- E-commerce sites like Amazon
- Retailers such as Dick's Sporting Goods
- Business-to-business sales, as in a recent partnership to provide Bikes, Treads, and Rows to Hyatt Hotels

Peloton Remains the Dominant Industry Leader

Peloton has a first-mover advantage in the sale of connected-fitness equipment and subscriptions to stream live and recorded classes. The company has a dominant 74% of connected-fitness streaming subscriptions – which is the high-margin part of Peloton's business. According to data from March 31, 2024, Peloton's nearest competition, iFIT, has a 13% share of the connected-fitness market.

At 42%, Peloton has the largest share of the lower-margin market for connected-fitness equipment, followed by iFIT with 27% and BowFlex with 17%.

Peloton Is the Leader in Connected Fitness



Steps to Increase Revenue

Cutting costs is a good way to improve profitability – but cutting costs and growing revenue is a better way.

Peloton is pursuing a variety of initiatives to increase sales, including

- **Rentals:** It offers a rental alternative for its Bike and Bike+ – for $89 and $109 per month, including full access to live classes and library. Company surveys show this program is bringing in new customers, as 60% of those who choose the rental alternative say they would not have bought the equipment or paid for the monthly subscription.
- **Peloton for Business:** The company also offers Peloton for Business – selling Connected Fitness equipment to hotels, apartment complexes, and businesses, and getting them to offer their guests, residents, and employees discounts on Peloton equipment and its All-Access membership.

  The partnership with Hyatt is a good example. The agreement goes beyond selling Bikes, Treads, and Rows. Peloton-branded workouts – for example, stretching – will be available on in-room televisions at about half of Hyatt's 800 hotels. Hyatt guests who purchase Peloton equipment will receive points in the World of Hyatt rewards program. (Peloton has a similar partnership with Hilton Hotels.)
- **International Growth:** The company is looking to outsource deliveries and installation of Connected Fitness equipment to raise the margin on foreign business and help grow profitability in these markets. To date, the company has seen mixed success internationally. Though Peloton does not break out its foreign sales – in Canada, the UK, Germany, and Austria – it indicated these international sales were not sufficiently profitable.
- **Broader Demographic:** Peloton is targeting a broader audience of users. Its typical customer is a white female between the ages of 35 and 54 with a household income above $100,000. The company is directing more of its marketing and programming toward men, younger customers – Gen Z (born in late 1990s and early 2000s) in particular is showing interest in health and wellness – and the rapidly growing 65-plus age group.
- **Targeted Equipment Sales** Management notes that although sales of treadmills outnumber exercise bicycles industrywide, Peloton's sales are heavily weighted toward Bikes. The company sees an opportunity to increase Treads sales with the recent return of the re-engineered Tread+, which was taken off the market almost three years ago after a small child was pulled under the rotating belt and died. It returned to market early this year – with an added safety guard – and is selling well.

Subscriptions Drive Company Financial Performance

In our October report, we discussed Peloton's meteoric rise during the pandemic – sales of Connected Fitness equipment peaked at $3.1 billion in 2021 having risen from $1.9 billion in 2019 – and suffered a dizzying fall afterward. Sales continue to fall – dropping to $1.0 billion in the 12 months ending March 31, although the pace of decline has slowed dramatically. If some of the company's growth initiatives catch on, Connected Fitness sales may have reached a bottom. Even without increasing sales, recently announced cost cuts should enable the company to generate a modest cash flow after accounting for corporate overhead.

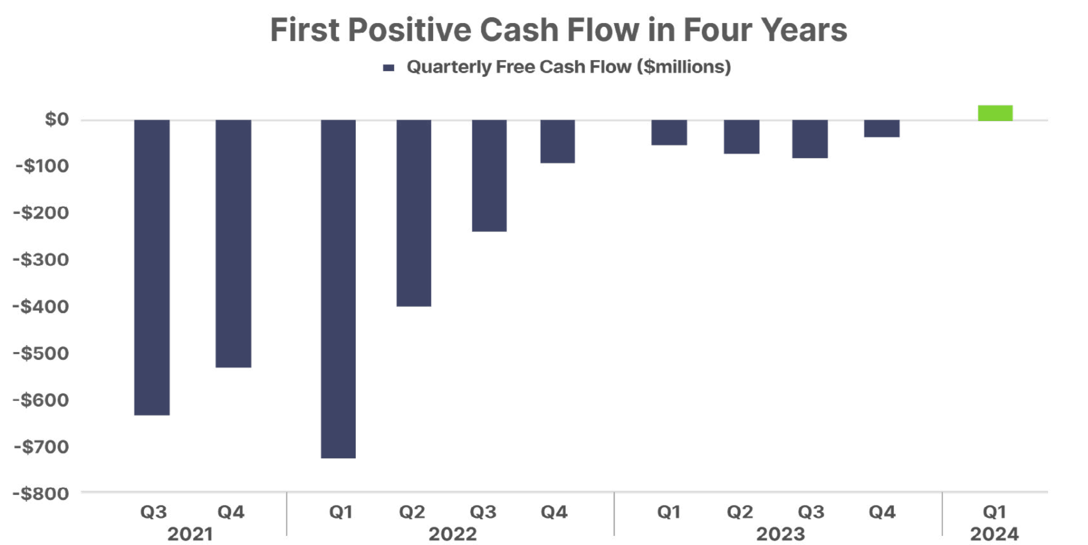
The story is much better for the Subscriptions business. Gross profit, which is total revenue minus the cost of providing the classes (operating studios, paying trainers, and maintaining the technology that allows the streaming service to work), has risen from virtually nothing in 2017 to more than $1.1 billion over the 12 months that ended March 31. Because not all subscribers renew, subscription revenue is falling 1.2% per month – which would translate to 13.5% over the course of a year. However, the company has been able to bring in new subscribers at a greater rate than it's losing them. This replenishment has enabled revenue and profit in the Subscriptions business to keep rising – albeit at a slow pace.

A Strong Picture for Peloton Financials
($millions)

	2017	2018	2019	2020	2021	2022	2023	12 Months Ending 3/31/2024
Revenue - Subscription	$33	$80	$181	$364	$872	$1,395	$1,670	$1,699
Costs - Subscription	($29)	($46)	($104)	($156)	($331)	($450)	($548)	($552)
Gross Profit - Subscription	$4	$34	$77	$208	$541	$945	$1,122	$1,147
Add back: Non-cash expenses		$4	$15	$24	$26	$49	$80	$76
Cash Contribution From Subscription		$38	$92	$232	$567	$994	$1,202	$1,223
Revenue - Connected Fitness	$186	$355	$734	$1,462	$3,150	$2,188	$1,130	$1,000
Costs - Connected Fitness	($115)	($200)	($428)	($834)	($2,237)	($2,434)	($1,329)	($1,051)
Gross Profit - Connected Fitness	$71	$155	$306	$628	$913	($246)	($199)	($51)
Gross Profit - Total	$75	$189	$383	$836	$1,454	$699	$923	$1,096
Year Ending June 30								

This growth in Subscriptions revenue and the softness in Connected Fitness sales continued in the most recent quarter. In the period that ended March 31, the Connected Fitness and Subscription businesses together generated $718 million in revenue – slightly below the $723 million in revenue in the same quarter last year. Subscription revenue rose in that period 3% to $438 million. Sales of Connected Fitness equipment fell 13.6% from $324 million to $280 million.

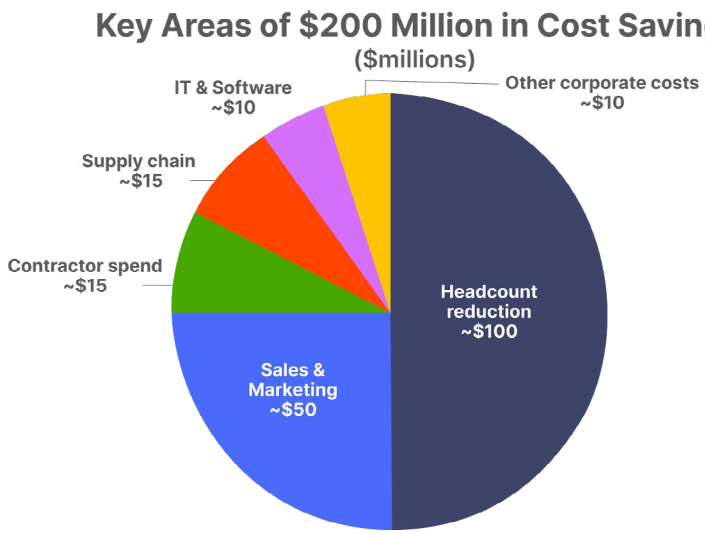
As a result of previous expense reductions, Peloton's operating costs declined 14.9%, which led to recording a better-than-expected operating profit of $5.8 million. This compared favorably with an operating loss of $18.7 million in the same period last year. As we mentioned earlier, the company produced positive ($9 million) free cash flow – operating profit minus capital expenditures – for the first time since 2020.



Source: Bloomberg

These are the financials of a company finding its footing as it crawls out of three years of bad performance. Not all signs are great, but things are moving in the right direction.

As mentioned earlier, Peloton announced $200 million in cost cuts. About half of the savings are related to a 15% reduction in the number of employees and will show up in full in next quarter's (ending September 30) results. The other half of the cuts – reducing sales and marketing expenses, no longer using outside contractors, and consolidating offices – will take place during the second half of this year and fully play out in the financial results by mid-2025. These cuts will begin to improve cash flow next quarter.



Very Little Debt Due Before 2029

Peloton's improving operations have enabled the company to extend the maturities on its debt. The total effect of these refinancings is to give the company a longer runway to build on the current base of business.

On May 31, Peloton announced that it had completed a comprehensive refinancing, extending the maturity on almost all the company's debt maturities until 2029. It entered into a new $1 billion bank loan maturing May 30, 2029, and issued $350 million in 5.5% convertible bonds that come due December 1, 2029. Together, after fees that we estimate at $20 million, Peloton raised roughly $1.33 billion.

The company used these proceeds plus approximately $210 million of its $794 million cash balance at March 31 to repay $1.54 billion in debt. Peloton paid off its $740 million bank loan and repurchased $801 million of our $1 billion issue of 0% convertible bonds maturing February 15, 2026.

As a result of these beneficial transactions, Peloton now has five years to rebuild its business before all but a small piece of its debt comes due.

Peloton's Current Debt Picture ($millions)	
0% convertible bonds due 2/15/26	$199
Bank loan due May 30, 2029	$1,000
5.5% convertible bonds due 12/1/29*	$350
Total debt	$1,549
Deduct cash (adjusted for refinancing)	($584)
Net debt	$965
Converted into stock	($350)
Net debt if 5.5% bonds are converted to equity	$615

*Convertible at $4.58 per share

Peloton expects to generate a modest amount of free cash flow in the current quarter – and increasing amounts over the next few years. Along with $584 million in cash currently on its balance sheet, Peloton also has $100 million available to borrow. We're confident the company will be able to repay the remaining $199 million of our 0% bonds when they mature in February 2026.

Why We See an Acquisition of Peloton as Possible

On May 7, five days after Peloton released earnings and announced that its CEO would be leaving, CNBC reported that large, private-equity investment funds were looking to acquire Peloton. There have been no follow-up reports since then, but with CEO Barry McCarthy leaving, it is a logical time for the company to put itself up for sale. We believe a buyer would pay considerably more than the current market price.

As a reminder, Peloton's revenue rose sharply during the pandemic and fell sharply once lockdowns ended. The company lost $$2.8 billion in 2022. Blackwells Capital, which in 2022 owned 5% of PTON stock, urged founder and CEO at the time John Foley to sell Peloton. Blackwells argued in a letter to the board:

> *"Strategic buyers in the media, technology, sporting goods, and subscription businesses would find Peloton an accretive acquisition, with many sources of synergy."*

At the time, Foley owned 12% of Peloton stock in the form of special shares that gave him 80% of the votes on all shareholder-related issues. Foley believed that if Peloton cut its expenses, its shares would be worth more than if they sold the company to an interested buyer. He effectively vetoed the idea of selling Peloton and approved hiring Barry McCarthy as CEO. McCarthy had been a senior executive at Spotify Technology (SPOT) and Netflix (NFLX) – both highly successful subscription services.

Foley now owns just 1.36% of the stock and can no longer block any board effort to sell the company. A sale process might even be made easier by the lack of a permanent CEO since a buyer would want to choose the new CEO. In short, we believe this is the right time to sell the company.

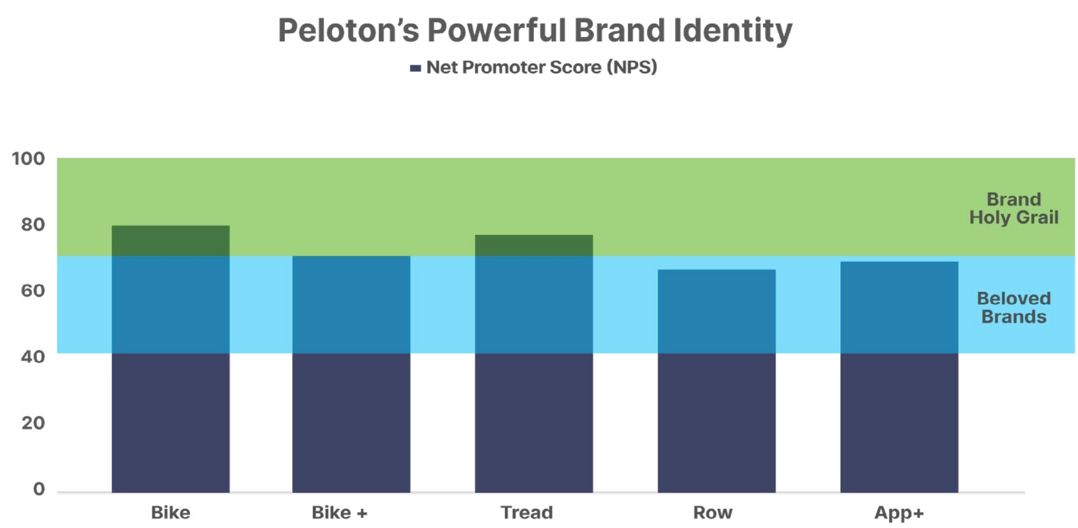
Demonstrating the Value of the Peloton Brand

Peloton is a valuable *brand* – and the leader in connected fitness. There is a high level of interest and excitement around what the company provides. Anytime Peloton offers a new fitness product or service, millions of loyal customers (and the media) take note.

A way to measure customer loyalty is through the widely-accepted statistic we referenced above called the Net Promoter Score ("NPS"). NPS, as mentioned, is a calculation based on how likely or not a customer is to recommend a particular product or service. The calculation represents the percentage of people who are favorably inclined to recommend something *minus* the percentage of detractors. The scale runs from -100 to +100.

According to surveying firm Delighted, the most beloved brands have an NPS of 50 to 70. Companies with a score of between 71 and 100 are considered to be the best in their industry – such as Apple at 75, Starbucks at 77, and Warby Parker at 80. This is the Holy Grail of NPS, and rarely attainable.

As recently as May 2024, Peloton's three main products – Bike, Bike+, and Tread — each has an NPS of 70 or better, and the Row and App+ subscription come very close to that rarified level at 67 and 68.



Potential buyers would also value Peloton's high-income customer base – 53% of subscribers have a household income of $150,000 or more, and 77% above $100,000. This higher-income demographic means current customers would have the ability to buy more Peloton products.

Peloton Is More Valuable to a Bigger Company

There are two main reasons why Peloton would be more valuable as part of a larger entity than as a stand-alone business. The first is revenue-based. A well-financed buyer can fund projects to build Peloton's brand. Consider this comment from Blackwells Capital 2022 letter to Foley, urging a sale:

> *"[The company could] become the central technology platform and one-stop shop for integrating all aspects of wellness... Partnerships could include gyms powered by Peloton software, telemedicine networks using data collected around individuals' fitness habits, nutritional programs with leading health food grocers and restaurants."*

Additionally, any company interested in buying Peloton would likely have a much larger customer base of its own to sell Peloton products to. Peloton has 3.7 million paying subscribers. Amazon has 300 million active customers, and 1.7 billion people use Apple's iPhone. Amazon or Apple getting even a tiny percentage of those customers to become Peloton members would increase revenue dramatically.

The second advantage has to do with cost. It's vastly more efficient to spread sales, general & administrative and research & development expenses (collectively, overhead) over these much larger bases – so more of each dollar that comes in ends up as profit. In this chart we compare these costs (as a percentage of revenue) at Peloton as well as Amazon, Apple, Netflix, and Nike – four companies we think could be a good buyer.

Overhead at Peloton Compared With Overhead at Potential Buyers

	Revenue 4/1/23 to 3/31/24	Sales, General & Administrative		Research & Development		Total Overhead	
	$millions	$millions	% of Revenue	$millions	% of Revenue	$millions	% of Revenue
Amazon	$590,740	$55,375	9.4%	$85,591	14.5%	$140,966	23.9%
Apple	$381,623	$25,378	6.7%	$30,348	8.0%	$55,726	14.6%
Netflix	$34,932	$4,480	12.8%	$2,691	7.7%	$7,171	20.5%
Nike*	$51,581					$16,862	32.7%
Average	$156,045	$14,929	9.6%	$16,520	10.6%	$26,586	17.0%
Peloton	*$2,699*	*$1,235*	*45.8%*	*$308*	*11.4%*	*$1,543*	*57.2%*

Peloton's overhead percentage	57.2%
Average overhead percentage of potential buyers	17.0%
Amount Peloton overhead would be reduced	70.2%

**Includes Research & Development and Sales, General & Administrative*

For a buyer, Peloton doing *exactly* the same amount of business as it does now would immediately be much more profitable. Reducing overhead from 57.2% of revenue to the 17% average of these companies would reduce Peloton's current overhead spending by 70.2%. Based on roughly $1.2 billion in overhead costs for the 12 months ending March 31, that would improve profitability by close to $850 million.

In the October report "**A Change of Gears**," we discussed the specific reasons why buying Peloton could further the goals of Amazon, Nike, Apple, and Netflix. The logic of these possible combinations remains as strong now as it did eight months ago.

Valuation

Most of Peloton's value is in its streaming Subscription business, which currently generates roughly $1.2 billion in cash before overhead. We will value this business by estimating its future cash flows, and then adjusting them to reflect their present value – what those cash flows are worth today.

The most important information needed to value Peloton's future cash flows is how the subscriber base will change over time. On March 31 Peloton had 3.1 million

All-Access subscribers and 674,000 App and Guide subscribers. The number of All-Access members has been rising slowly over the last few years. The number of App and Guide subscribers has fallen steadily since 2022.

In valuing the number of subscriptions, we need to adjust for differences in subscription costs. To simplify that calculation, we took $1.7 billion – the total subscription revenue for the year ending March 31, 2024 – and divided it by $528, the yearly cost of a $44-per-month All-Access membership. Consolidating the three subscription levels means we have the equivalent of 3.2 million All-Access members.

In arriving at our valuation range, we use five variables across three scenarios: the Base represents our best guess, the Conservative reduces each of the assumptions significantly, and the Upside assumes all of the variables are better than in our Base case.

Three Valuation Scenarios for Peloton

Variables	Conservative	Base	Upside
Subscriber loss per year	8%	5%	2%
Subscription price increase per year	1%	2%	3%
Direct cost of subscription revenue	34%	32%	30%
Buyer's overhead reduction	30%	40%	50%
Buyer's cost of capital	10%	8%	7%

We use these assumptions to estimate cash flow from the Subscription business over a 15-year and 20-year period.

Once we have a range of present values for the streaming business, we deduct Peloton debt – adjusted for cash on the balance sheet. Since all of our valuations are above $4.58 per share – the conversion price on the new $350 million in 5.5% convertible bonds due December 1, 2029 – we make the assumption that those bonds are converted into 76.5 million shares of Peloton stock. We also allow 10 million shares for management compensation and add both figures to the 353 million in current outstanding shares to arrive at 440 million shares.

Three Outlooks for the Subscription Business

	Conservative Case	Base Case	Upside Case
15-year net present value	$5.05	$9.22	$15.32
Current price	$3.58	$3.58	$3.58
Upside potential	41%	158%	328%
20-year net present value	$5.37	$10.31	$18.54
Current price	$3.58	$3.58	$3.58
Upside potential	50%	188%	418%

Based on Porter & Co. model

These ranges reflect the value of the Subscription business alone. The Connected Fitness business – which was very profitable during the pandemic – has only recently begun to generate a profit after accounting for the costs directly associated with the business. In the most recent quarter it showed a *gross* profit of $11.6 million. While this is a step in the right direction, the business does not even cover half of the $456 million in corporate overhead for the quarter.

With the Tread+ again available for sale after almost three years, and with Bike rental outpacing the company's (modest) expectations, there's a good outlook for the Connected Fitness business. As is the case for the Subscription business, if Connected Fitness were owned by a larger company, its relative overhead costs would be much lower – and the real universe of potential customers potentially much higher. The financials would look a lot better under the ownership of a larger business.

Given the current lack of operating profit, a buyer would probably value the business at a modest multiple of revenue. The Connected Fitness business generated $1 billion in sales for the 12 months that ended March 31. Based on discussions with a number of merger specialists, we believe the valuation would likely fall between 0.5x-1.0x revenue – or $500 million to $1 billion. Given our estimate of 440 million shares, this would add roughly $1.13 to $2.26 per share in value. We round this to $1 to $2.

Putting the valuation ranges for the Subscription and Connected Fitness businesses together, we arrive at this range of target prices for Peloton stock. While the range is broad – since it reflects a variety of assumptions – even the low end implies a $2-plus increase from its current price.

Porter & Co.

	Conservative	Base	Upside
Subscriptions*	$5.00	$10.00	$17.00
Connected Fitness	$1.00	$1.50	$2.00
Total value per share	$6.00	$11.50	$19.00

**Rounded, based on a midpoint of 15- and 20-year values.*

As a cross-check, we compare these valuations with Apple's $3 billion purchase of the high-end music-streaming service Beats in 2014. While privately held, Beats was estimated to have had revenue of roughly $1 billion – meaning that Apple paid 3x Beats' revenue.

If we value Peloton at 3x revenue, the result is $17.01 per share. At 2x revenue the stock would be worth $10.88 per share.

Peloton Stock Valuation at Two Multiple Levels

	3X	2X
Revenue $2.7 billion	$8.1 billion	$5.4 billion
Deduct debt net of cash	($615 million)	($615 million)
Value for stock	$7.5 billion	$4.8 billion
Divided by 440 million	$17.01 per share	$10.88 per share

Risks

The main risks for Peloton stock are:

- The company loses market share to its competition in the Connected Fitness business. Lower sales lead to reduced new subscription sales – which so far have more than balanced out monthly cancellations. Peloton's subscriber count could begin to decline.
- Peloton does not achieve its full expected $200 million in cost savings. While roughly $100 million relates to the reduction of employees and has taken place, the company will need to carry out the other roughly $100 million in cost savings.
- Peloton makes a bad choice in replacing outgoing CEO Barry McCarthy and growth initiatives do not materialize or are poorly executed.
- Because of its cost-saving efforts, Peloton is now dependent on third-party contractors for much of its operations. It designs but no longer manufactures its own equipment. The company is reducing its showrooms and relying more on selling through Amazon, Dick's Sporting Goods, and other retail outlets. Peloton uses contractors to operate its day-to-day technology. Problems with any of these suppliers could hurt operating results.
- Since the subscription business is built on streaming classes, a cybersecurity problem could have a significant effect on Peloton's business in the short- and long-term.

Risks relating to financing have declined but still exist. With the global refinancing completed, most of Peloton's debt – except $199 million of our 0% bonds maturing February 15, 2026 – does not come due until 2029. We estimate that Peloton's cash after the refinancing is roughly $584 million. With cost cuts the company should generate additional cash over the next few years. In short, we expect the bonds to be paid off in full at maturity.

Recommendation

We see potential for a large upside in Peloton stock, most likely in the context of a sale. We can also see a scenario where the company doesn't get sold, and the business deteriorates over time. In this latter scenario, the stock could be worth little – or even nothing. We think that scenario is unlikely. That said, we recommend purchasing Peloton's stock up to a price of $4.50 per share. The trading price of Peloton's stock is likely to be volatile, so slot this one in the high-risk/high-reward bucket.

Action to Take: Buy **Peloton Interactive (Nasdaq: PTON)** up to $4.50 per share

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To ask Marty a question for the June 28 Porter & Co. Open Forum, send it to **openforum@porterandcompanyresearch.com**.