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Long FTCH - $9.68 250% Upside to $32

Summary: Farfetch is an online luxury marketplace trading at 4.5x sales. I believe Farfetch represents an opportunity to capitalize on a large overreaction by the market to a bad 2Q (down 60%) and buy a fast-growing marketplace with huge white space very cheaply. On their 2Q earnings call, FTCH announced the acquisition of New Guards Group, which was perceived as a bad non-core acquisition, a large gross profit miss, and the departure of their lo ngtime COO. I am positive on the acquisition and regard the gross profit miss as temporary and non-thesis changing. No special insight on the COO. Farfetch is not impaired long term. Over the next 3 years, Farfetch should compound revenues at a 32% growth rate and rerate from 4.5x sales to 6x sales for 250%+ upside.

Business: Farfetch operates an e-concession model – boutique partners + brands directly sell on Farfetch's marketplace while controlling the inventory + pricing + presentation. Farfetch charges a ~30-35% take rate to fund marketing expenses in addition to offering fulfillment capabilities. Farfetch also owns 3 other companies, Curiosity China, which specializes in marketing to Chinese consumers, Stadium Goods, a reseller of high-end sneakers (1^{sthand} + 2^{ndhand}), and New Guards Group, a collection of luxury streetwear brands.

Thesis

1. **Positive on NGG acquisition vs. very negative market view**
    a. NGG owns a fast-growing collection of luxury streetwear brands of which Off-White is the jewel. See more in Appendix.
    b. Bears see NGG as a non-core acquisition potentially taking resources away from the fast-growing marketplace business, compounding the bad optics of 2Q19
    c. **There is visible strategic rationale behind acquisition -**
        i. **Strengthens Farfetch brand through halo effect of being associated with high end luxury brands which lowers CAC**
            1. Off-White is a brand on par with traditional luxury brands like Prada, Balenciaga, Fendi, etc according to the Lyst Index (see more in Appendix) and Google search trends, and is exceptionally culturally relevant, especially for younger consumers
            2. Off-White and streetwear brands heavily favored by young Farfetch consumers (average customer is 34)
            3. **Large potential for Off-White exclusive drops + marketing to make Farfetch destination of choice for consumers, driving sales of other brands while consumers are on Farfetch and lowering average CAC**
                a. Other online multibrand marketplaces do not have this marketing channel
                b. Exclusives are important for differentiation in retail environment vs. only competing on price
                c. Somewhat uncharted territory – have personally never heard of private label actually drawing traffic through channels other than through price/value
                d. Potential dilution of NGG brand strength due to them not being seen as "independent" anymore
            4. At the very least NGG benefits from complete access to FTCH marketplace data and potentially preferential placement.
        ii. **Highly accretive and cheap transaction**
            1. Purchase price was $675M, half in stock, half in cash against $95M in LTM pre-tax earnings
            2. 2018 revenue growth was ~90%, and is projected to be 20-30% for next year
            3. Lower quality luxury names (Tapestry, Kors) trade at 15x+ EBIT with far lower revenue growth (5-10%)
        iii. **Low cost optionality on creating further new viral brands**
            1. NGG started with only Marcelo Burlon, but organically attracted designers with its creative ethos and marketing/production capabilities
            2. Off-White, now a $200M+ rev business was founded in 2013 under NGG umbrella from $0
            3. Several nascent brands have organically followed – Kirin, A Plan Application, Heron Preston, any of which could eventually be as impactful as Off-White
    d. Concerns revolve around handwavy strategic fit
        i. Even if concerned about "non-core" this is NOT worth ~$2.5B wiped off market cap
        ii. Acquisition was made at an extremely favorable price regardless
2. **Gross margin miss is temporary**
    a. Platform order contribution margin ("gross margin") fell from 45% in 2Q18 to 28% in 2Q19
        i. Cause of margin miss was due to heavy promotions across luxury retailing space
        ii. Market has extrapolated the margin miss into the future and is concerned that economics are impaired permanently
    b. **Farfetch is taking concrete steps to restore gross margins**
        i. **Management is committed to reducing promotional activity going forward**
        ii. Management conversations with luxury brands have signaled they understand the negative effect of excess promotions well, and they will be pulling back from promotional activity
        iii. Luxury brands will also begin punishing + pulling back stock from retailers that participated heavily in the promotional activity
    c. Downside is future revenue growth will be at 30-35% vs. 40-45%+ previously
3. **Farfetch has a solid value proposition**

a. **Value proposition – Brands – minimizing downsides of the multi-brand sales channel while offering online + heavily international sales exposure at a lower take rate.**
    i. Brands would ultimately like to sell everything through their own channels, but that's not possible as consumers like choice (it's why department stores first came about).
    ii. ~80% of luxury products are sold in a multi-brand environment. Brands have two options, sell retail or on Farfetch.
    iii. At traditional retailers, they cannot control presentation of the product, markdowns, or stock availability, which are controlled at Farfetch through the e-concession model.
    iv. All this is done at a lower take rate, 30-35% take rate, vs a retailer which would charge an effective 45-50% take rate (their gross margin).
    v. Aforementioned levers - presentation, promotions, and stock are of paramount importance to luxury brands
    vi. Retailers that take on inventory simply cannot compete because at market weakness, they will rush to unload stock through promotions that destroy luxury brand equity.
    vii. Great international access - Farfetch revenue is roughly equally distributed around Americas, EMEA, and APAC

b. **Value Proposition – Consumers – huge selection of stock + new exclusives with NGG brands**
    i. Huge selection – $3B of stock made available by brands + retailers vs. other online retailers with much smaller selection due to working capital issues
        1. Believe consumers will naturally migrate to retailer with largest stock, especially in luxury fashion where access to inventory is highly important
        2. Due to partnerships with boutiques + asset lite model, Farfetch has long tail of SKUs
            a. Stock comes from differences in buying patterns by boutiques + stock from past seasons
            b. Many SKUs not available on other marketplaces – either too niche, from past seasons, or past
    ii. New exclusives previously touched upon, which should be a large traffic driver.

4. **Farfetch is exposed to heavy secular trends + has a long growth runway**
    a. **Secular Trends**
        i. **Farfetch is heavily benefiting from the great move to online in luxury.**
            1. Overall luxury market (ex. Beauty) is $250B worldwide
            2. Online penetration is only roughly at 10% vs. overall apparel penetration at ~25%.
            3. Online luxury is growing at ~20% vs. overall luxury growth at ~5%, and within that 20% space, Farfetch has been growing at 40%.
            4. **Over the next 3 years, FTCH revenue should compound at ~30%.**
            5. Farfetch is neck and neck with Yoox Net-a-Porter (YNAP) in terms of current GMV, ~$1.9B for Farfetch vs. YNAP at $2.3B but YNAP is growing GMV at ~17% vs. Farfetch at double that.
        ii. Farfetch benefits from scale flywheel –
            1. Farfetch has largest selection of inventory which attracts consumers ->
            2. More brands come due to large customer count -> #1
            3. Larger scale leads to expanded consumer mindshare + lower cost /unit -> Profit
        iii. Farfetch has large native presence in China that positions it well for the future
            1. China is their 2nd biggest market after Americas, will account for ~45% of all luxury spending by 2025
            2. JD owns a 14% stake in Farfetch and has a strategic partnership with Farfetch
            3. Farfetch has completely built out presence – fully native apps, native payments, large physical presence, Curiosity China (focused on marketing to Chinese consumers), in addition to large % of revenue from China already
    b. **Long Growth Runway – growth should moderate less than street expectations**
        i. Growth in penetration
            1. Farfetch is not fully penetrated in terms of brands
                a. Ferragamo, Moncler, Givenchy, in addition to other top brands still do not sell on Farfetch
                b. As seen above, scale flywheel is a powerful attractor
        ii. Expansion into hard luxury - watches, jewelry, handbags vs. current focus on apparel + shoes will cause growth to moderate less than expected
            1. Currently ~60% of Farfetch revenue is apparel vs. apparel's ~22% market share globally
            2. Brands have only recently launched jewelry + watches as categories
            3. Hard luxury growth will outpace apparel growth and help moderate declines
    c. **Leading scale online luxury marketplace is a valuable acquisition target**
        i. Plenty of retailers, brands, etc looking to build presence in online luxury – free call option on acquisition
            1. Walmart, Amazon especially have no luxury presence at all
            2. Kering has no owned e-commerce solution and currently lets Farfetch handle their backend.
            3. Alibaba, JD and Tencent all recognize the potential that the Chinese luxury market has especially
    d. Further potential levers
        i. Further expansion of the brand platform to other brands to drive more if NGG acquisition pans out
            1. Impacts of NGG remain to be seen on CAC costs, but if the acquisition works, this is another large driver

Risks

- NGG acquisition disappoints

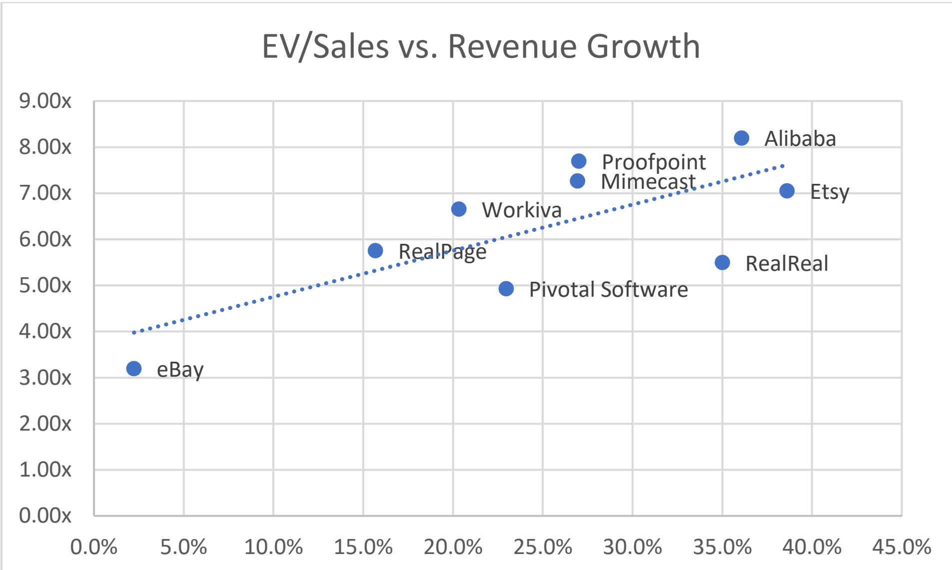
- Continued perception that streetwear trend could be a fad vs. durable luxury like Gucci, Prada, etc.
    - Off-White shows durability in interest – Google search trends + Lyst Index show continued interest in offering – see Appendix
    - Realistically there's no way to read the fashion tea leaves consistently, however, I trust Farfetch to read trends better than average
- Continued poor reception of acquisitions
  - Personally not 100% sold on all of Farfetch's acquisitions, and remains to be seen if the street feels the same
    - New Guards and Stadium Goods were great opportunistic acquisitions at good prices, but fail to see direct quantifiable synergies between the two acquisitions that directly bring in more revenue
    - Management harps on "platform for luxury fashion", but again, this is handwavy
  - NGG is more of a test of managements' thesis r.e. driving traffic, lowering CAC, and new brand optionality
    - If you agree with managements' thesis, then NGG was probably the best acquisition to test it out, if not, then very little would make you agree with the acquisition
    - Downside case would be NGG has no impact on CAC and brand optionality but remains an attractive luxury asset that can easily be sold off
  - However, management seemed chastened on a roadshow after 2Q earnings and recognized the horrible optics of the situation. Didn't commit to stopping M&A but signaled they would work on integration first.
  - Hard to impair value of marketplace asset as long as they continue to execute, which they have done until now.
- **Long term profitability concerns**
  - **Unsure of how exactly long-term margin structure will shake out for Farfetch**
    - Management guides to long term EBITDA margins of 30%, gross margins of 55-60% vs. -18% EBITDA margins and 45% gross margins currently
    - So far, Farfetch has shown little operating leverage on G&A, technology expense, and demand generation expense, especially not enough to underwrite a 45% EBITDA margin uplift
    - Hard to underwrite such extreme operating leverage
      - Other marketplaces, EBAY, ETSY, were run close to breakeven before turning on profit spigot, very unlike Farfetch which is still deeply unprofitable
      - In addition, Farfetch has lower gross margins and higher involvement in selling process (fulfillment, direct demand generation + marketing expense of items), leading to structurally much higher cost per $ of GMV
  - **Mitigant 1 – quibbling between 15% or 30% long term EBITDA margins will not drive the stock over the next 3 years**
    - Underwriting an imaginary 10% EBITDA margin on 2022E sales of $1.3B creates Farfetch at 20x current EV/2022 EBITDA
      - Valuation compares very favorably to similar growth companies with similar long-term margin targets
    - Essentially, stock is cheap enough that as long as Farfetch unit economics work and they can execute on capturing a large % of online luxury sales, Farfetch will be extremely valuable
    - Also believe Farfetch should not be focused on profitability for next 3 years – white space is far too large to be any more profitable than breakeven
      - Ultimate market share could be ~$50B GMV vs. only $2B today assuming 35% share of 35% online penetration of $400B luxury market
  - Mitigant 2 – Although Farfetch has not shown much operating leverage yet, there is a lot of fat to cut –
    - Seems to be a conscious choice to focus on growth first, make investments in technology + marketing and worry about profitability
    - Farfetch is still closer to the investment part of the curve vs. the harvesting part still
    - G&A is ~35% of Rev., Share based payments are 20% of Rev., Technology expense is 10% of Rev.
      - Each could be cut in half or more leading to 35% margin improvement, even assuming no change in demand generation expense
  - Mitigant 3 – Cohorts from 5 years back already show insights into steady state gross margins at ~70%
    - Customer cohorts from 2014 are driving 55% contribution margins on their orders, or 70% after demand generation expense is added back
      - Element of survivorship bias, but doesn't seem unreasonable to get to the 60% guidance
- Risk of being squeezed out by luxury triumvirate (Kering, LVMH, Richemont)
  - Kering, LVMH and Richemont collectively control around 20-30% of the luxury goods market, and all may have enough scale to pursue their own multi brand marketplaces vs. selling on Farfetch
    - Richemont already owns YNAP, LVMH has a very late start but is creating their own multi brand online store, Kering uses Farfetch.
  - Mitigant 1 – Farfetch still represents more favorable multibrand channel than wholesale to retail, in addition to 30% not being impactful enough to stifle Farfetch
    - Large brands just below the triumvirate (Tapestry, KORS, Prada, etc) still need distribution, and Farfetch's value proposition is still attractive
  - Mitigant 2 – Only LMVH seems to be directly wading into competition with Farfetch

- LV, Dior, etc are not sold on Farfetch, but Richemont doesn't have that big a presence within fashion, and Kering happily sells on Farfetch

Valuation

I value Farfetch at 6x 2022E marketplace revenue and value the NGG acquisition at cost for conservatism. 6 * 1.6B = 9.6B + .7B = $10.3B EV, or 250% upside. Farfetch should exit 2022 with around 25% revenue growth.

6x sales compares very favorably with marketplace + SaaS peers on a growth/valuation framework – see chart below



Note: I use SaaS peers as long-term secular trends are equally powerful + margin targets are similar, and there are only really 2-3 marketplace peers – EBAY, ETSY and Alibaba. Most of the other use a 1P model, lowering long term margins.

Appendix

1. **NGG**

NGG consists of Off-White, Marcelo Burlon, Heron Preston + 5 other smaller brands. Off-White represents a very large portion of the revenue.

Off-White has been 1, 2, 1, 2 in each of the last 4 quarters on the Lyst Index, a ranking of the hottest fashion brands by a competing online luxury marketplace, consistently above brands such as Balenciaga, Gucci, Burberry, etc. Lyst takes into account social media engagement, sell through, and a whole host of other metrics.

Below is a google search trends analysis that mostly backs up the Lyst Index.