Does The RealReal (REAL) Have a Path to Profitability?

Luxury consignment marketplace The RealReal (REAL: $17/share) IPO'd on June 28 at a price of $20/share. The stock reached a high of $28 on its first day of trading before steadily declining over the next two months to a low of $13/share on August 27. Since then, REAL has rebounded by 33% to $17/share.

This wild volatility reflects the key underlying question for REAL. Is it an innovative new business model that has found a profitable niche? Or is REAL, whose CEO previously ran Pets.com, destined to crash and burn in the same manner?

This report aims to help investors sort through REAL's financial filings to understand the fundamentals and valuation of this recent IPO.

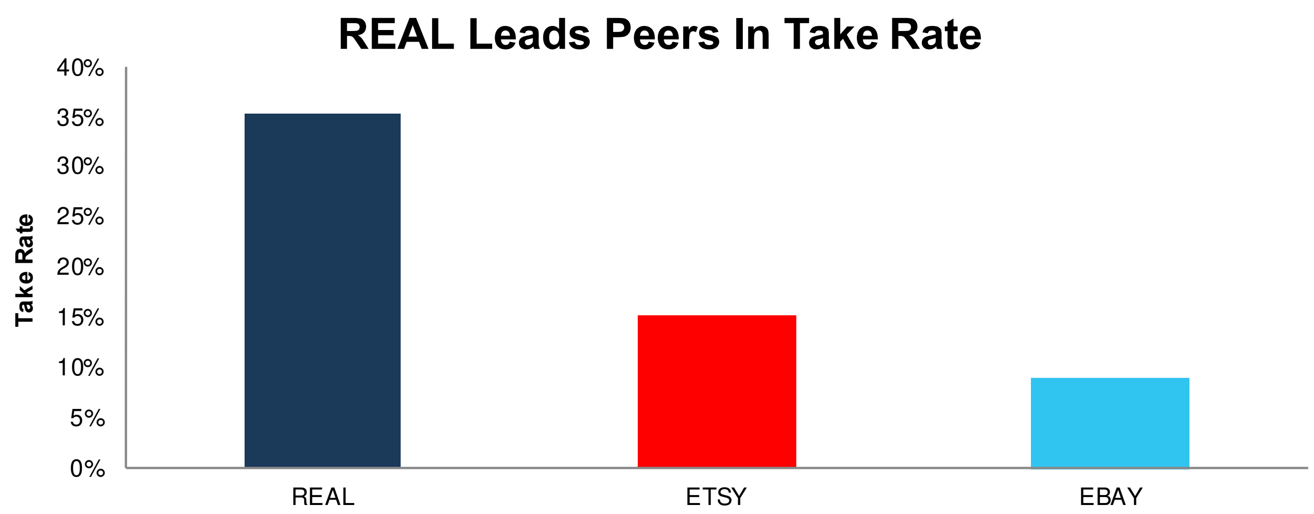
Filling an Underserved Niche

REAL operates an online marketplace that allows people to sell secondhand luxury goods such as designer clothing, jewelry, and art. In 2018, the company facilitated 1.6 million transactions with a total value of $710 million from over 400 thousand different buyers.

Selling and buying secondhand luxury goods online presents a unique challenge due to the proliferation of knockoff goods. If, for instance, someone posts a Gucci handbag for sale on eBay (EBAY), it's difficult, if not impossible, for any potential buyers to verify its authenticity. As a result, buyers will not want to pay full price, which means sellers of authentic goods will not want to sell on the platform. This creates a negative feedback loop that results in the majority of luxury goods posted on EBAY being fake.

REAL solves this problem by authenticating all the merchandise sold on its site and handling all elements of the sales process, including photography, pricing, fulfillment, and returns. This more intensive service allows REAL to retain a significant portion of the money buyers spend on its site. REAL's take rate, the percentage of each order that it keeps as a percent of revenue, was 36% in 2018. EBAY's take rate was just 9%, and craft goods marketplace Etsy's (ETSY) take rate was 15%, as shown in Figure 1.

Figure 1: Take Rate for REAL, ETSY, and EBAY for 2018



Sources: New Constructs, LLC and company filings

High Cost Business Model

While REAL gets to keep a much larger portion of the money spent on its site than its peers, it also has to spend much more to earn that revenue. It pays the cost of authenticating, merchandising, shipping, and accepting returns for all the items it sells.

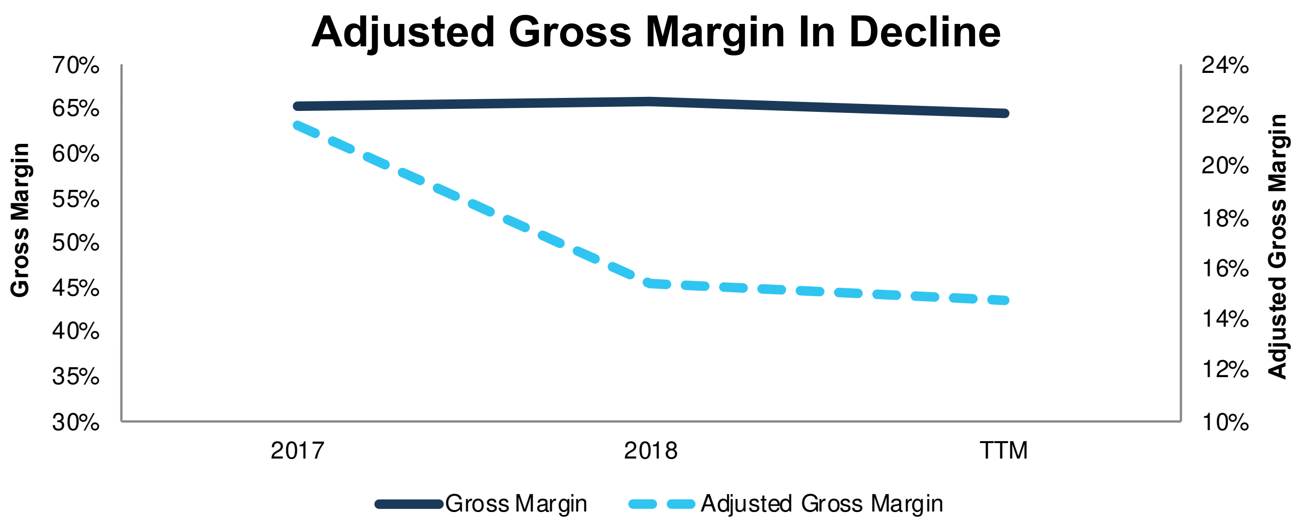
What's more, many of the above costs are not reported in cost of goods sold. Instead, they are reported as "Operations and Technology" expenses. According to REAL's S-1:

"Operations and technology expense principally includes personnel-related costs for employees involved with the authentication, merchandising and fulfillment of goods sold through our online marketplace, as well as our general information technology expense."

We would argue that many of these costs are directly related to the delivery of REAL's service and should be included in cost of revenue. By reporting these costs separately, REAL makes its gross margin look higher and presents a potentially misleading picture of its path to profitability.

Figure 2 shows that REAL's gross margin has stayed consistent at ~65% since 2017. However, if we include operations and technology expense as part of cost of revenue, its "Adjusted Gross Margin" declined from 22% in 2017 to 15% TTM.

Figure 2: REAL Gross Margin and Adjusted Gross Margin: 2017-TTM



Sources: New Constructs, LLC and company filings

REAL says that it expects operations and technology expenses to decrease as a percentage of revenue over the longer term, but Figure 2 shows that they're currently not making any progress towards that goal.

Overall, REAL's after-tax operating (NOPAT) decreased from -$47 million in 2017 to -$66 million in 2018, but its NOPAT margin improved slightly from -35% to -32% over the same time.

REAL seems like it should have a profitable business model. It fulfills an underserved niche and has relatively little direct competition. However, the company has yet to show significant concrete progress towards achieving profitability.

It's possible that this business is simply not a profitable space, which would explain why so few other firms have filled this niche.

Could REAL Benefit from a Recession?

While luxury goods manufacturers struggle during economic downturns, REAL's consignment business could actually benefit from poor economic conditions. Shoppers that normally buy new luxury items might substitute and buy used during a recession. At the same time, the company could also get a large influx of new sellers needing extra cash as well.

Of course, it's also possible that the overall decline in spending on luxury goods during a recession would more than offset this substitution effect and be a net negative for REAL. As with so many other recent IPO's, we've never seen this company operate during an economic downturn, so we have no real idea how it will perform. Still, there's at least some reason for investors to hope that this company is better equipped to handle a recession.

Public Shareholders Have Rights – A Break from Recent Norms

REAL's corporate governance also separates it from many other recent IPO's. While most companies now go public with dual-class share structures that give insiders and early investors extra voting rights, REAL has just a single class of voting stock. Public shareholders get to have an equal voice in corporate governance.

This voting power is especially important because shareholders have reason to be skeptical of REAL's leadership. Founder and CEO Julie Wainwright first rose to prominence as the CEO of Pets.com, the ill-fated e-commerce company that became the poster child of tech bubble excess in the late-90's.

Wainwright's resume won't give investors much confidence, but at least shareholders have the power to potentially replace her if REAL doesn't start showing signs of profitability.

DCF Model Reveals High Expectations

When we use our dynamic DCF model to analyze the future cash flow expectations baked into the current stock price, we see that REAL is expensive, but still has potential upside.

To justify its current valuation of $17/share, REAL must achieve 12% NOPAT margins (comparable to ETSY) and grow revenue by 23% compounded annually for the next eight years. See the math behind this dynamic DCF scenario.

If REAL can grow revenue at the same rate but achieve NOPAT margins of 19% (equal to EBAY), the stock is worth $30/share today, a 73% upside to the current stock price. See the math behind this dynamic DCF scenario.

A 23% compound annual growth rate seems very achievable for a company that grew revenue by 50% year-over-year through the first six months of 2019, so the issue is margins. Given the high take rate, REAL should be able to achieve comparable margins to its peers (with some cost controls), in which case the stock is undervalued. However, the poor performance of the stock since its IPO shows that investors are not satisfied with future promises and want to see progress towards profitability right now.

Critical Details Found in Financial Filings by Our Robo-Analyst Technology

As investors focus more on fundamental research, research automation technology is needed to analyze all the critical financial details in financial filings. Below are specifics on the adjustments we make based on Robo-Analyst[1] findings in The RealReal's S-1:

Income Statement: we made $11 million of adjustments, with a net effect of removing $9 million in non-operating expense (4% of revenue). You can see all the adjustments made to REAL's income statement here.

Balance Sheet: we made $124 million of adjustments to calculate invested capital with a net increase of $82 million. The most notable adjustment was $96 million in operating leases. This adjustment represented 204% of reported net assets. While most companies are now required to report operating leases on the balance sheet, REAL is classified as an emerging growth company and can delay its adoption of the new standard until 2020. You can see all the adjustments made to REAL's balance sheet here.

Valuation: we made $227 million of adjustments with a net effect of decreasing shareholder value by $227 million. You can see all the adjustments made to REAL's valuation here.

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Disclosure: David Trainer, Kyle Guske II, and Sam McBride receive no compensation to write about any specific stock, style, or theme.

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[1] Harvard Business School Features the powerful impact of research automation in the case study New Constructs: Disrupting Fundamental Analysis with Robo-Analysts.

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3. **Transparent** - Advisors should be able to show how the analysis was performed and the data behind it.
4. **Relevant** - Empirical evidence must provide tangible, quantifiable correlation to stock, ETF or mutual fund performance.

Value Investing 2.0: Diligence Matters: Technology is Key to Value Investing With Scale

Accounting data is only the beginning of fundamental research. It must be translated into economic earnings to truly understand profitability and valuation. This translation requires deep analysis of footnotes and the MD&A, a process that our robo-analyst technology empowers us to perform for thousands of stocks, ETFs and mutual funds.

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