Wagner Road Capital Management

Online Clothing Retail & Resale

October 10, 2022

Contents

Introduction

In April 2021, I was interviewed by Women's Wear Daily for an article about fashion. In June 2021, I was part a panel of experts in a fashion convention… as a video game guy.

I am not a fashion expert. But you don't need to be a fashion expert to understand how different businesses compete with each other. The process that I use to evaluate an industry and find good companies is universal: competitive position, financial position, management, and growth opportunities. I'm taking this model and focusing on a small piece of fashion retail.

Retail in general is known for being brutally competitive. Sustainable advantages are rare, generally coming from a combination of price, quality, and an emphasis on the shopping experience (convenience, speed, etc.), with different businesses choosing different ways of competing. Over time, these differences must adapt to the spaces and places where people live and work. A short summary of retail's history demonstrates how difficult this can be:[1]

- From the 1900s through the 1940s, the spread of department stores began replacing specialty stores, allowing shoppers to shop in different departments within the same store. These were primarily along main streets and inside city centers.
- In the 1950s, as people moved to the suburbs, shopping malls consolidated different stores into one big building. Over time, downtown shopping areas became less influential.
- From the 1960s through the 1990s, the suburb trend continued with the introduction of "big box" stores (such as Wal-Mart) and "category killers" (such as Home Depot) that focus on a specific type of sales category.
- From the 1990s to today, ecommerce has increasingly moved retail from in-store to online, a shift so powerful that it has been labeled as the retail apocalypse. Commerce is no longer fully connected to where people live, but it still happens where people go—online.

The future of retail is overwhelmingly considered to be "e-tail", but it still needs to adjust to the fundamental desires of retail customers. Consumers are becoming more price-conscious, more socially aware, and more environmentally conscious.

[1] There are several good articles and blogs that summarize the history of retail in slightly different ways, but the outline is generally the same: Uppercase, lightspeed, BigCommerce, and CNU have all covered this topic.

These trends also exist in fashion, where a wave of recently-public companies has been capturing this part of the online clothing market. It's a much earlier stage than where I normally look for new investments (I prefer to wait until after some of them go out of business or combine with each other), but there are attractive features to these businesses—for example, they generally don't require major capital investments and still have founder-CEOs.

But they're not all exactly the same. Slight differences in business models reveal unique approaches to serving customers, with mixed results (so far). My own perspective groups these online businesses into sets of categories:

- Generalist Marketplaces – Known primarily for selling a wide range of goods, these companies take a cut from items that sell on their websites.
- Subscription Models – Customers pay a subscription fee for access to the service or receive some kind of personalized attention.
- Consignment Models – The business does all of the work to sell someone else's items in exchange for a fee, usually a percentage of the sale.
- Social Models – Emphasize a social experience or social network as part of the buying and/or selling experience.

All of these businesses are naturally benefiting from the growth of online sales: According to Morgan Stanley, e-commerce has grown from a total of 15% of global retail sales in 2019 to 22% today, and could reach 27% by 2026. This would represent a larger share of a still-growing industry (in absolute terms, it would be nearly double today's numbers). Despite being highly fragmented and extremely competitive, the potential growth is available. What we're looking at is how these different businesses might fit into the clothing portion of online sales, a very small piece of the overall market.

I will start with a description of where these companies fit in the industry, and then move on to more of the numbers and the influence of management. [2]

Generalist Marketplaces

Online businesses can be complex, especially the marketplaces that rely on attracting both buyers *and* sellers. These are known as two-sided markets, and they require both sides to build a sustainable business. This takes a lot more initial investment but, if it works, matures into a powerful company inside an industry with a few big winners. Our first group of businesses fits this model.

[2] Most of the company-specific commentary comes from company filings, conference calls, industry or company reports, customer reviews, and conversations with customers or people involved in the industry.

eBay (EBAY) and Etsy (ETSY) are two of the largest and most well-known online marketplaces. eBay was born in the dot-com boom, founded in 1995. Etsy came after the dot-come crash, in 2005.[3] Both of these companies have an eclectic range of items for sale, but our interest is limited to clothing for this review (from an investment perspective, we would obviously want to take a wider look at their competitive picture).

While it is possible to buy and sell clothing on eBay and Etsy, they aren't specifically designed for it, and they are intended for different demographics. eBay allows users to sell almost anything as long as it's clean, but it can be difficult for both buyers and sellers to deal with having an accurate description, shipping, returns, and other complications that go along with any type of online sales. Etsy simply limits clothing to either handmade or more than 20 years old. Neither is known for clothing.

These companies are massive markets, but they are generally not at the center of fashion.[4] I would not consider them to be serious threats to online businesses that specialize in clothing.

Subscription Models

Subscription services for clothing are unique, but they are part of a broader trend of more products becoming subscriptions (a quick search will show everything from food to electronics, pet products, and more). It's a business model that has to balance two key factors:

1. Customers think the service is worth the fee.
2. The fee is high enough to make money.

From my view, this type of business relies more on convenience and quality. Getting affordable goods is important, but the main attraction is having someone else do the proper maintenance or make the decisions about what to try. It may be cheaper for a customer to do those things on their own, but they're saving time by outsourcing it. Two of the most well-known clothing companies that fit this category are Stitch Fix (SFIX) and Rent the Runway (RENT).

Stitch Fix, founded in 2011, is not strictly a subscription service, but it fits the spirit of my description. Customers work with a personal stylist to understand what they need. Then the company sends a curated box of five clothing items to try on and charges a $20 styling fee. If the customer keeps anything from the box, that $20 is discounted from

[3] I'm excluding Amazon from these comments because eBay and Etsy are more available to individuals with unique items and used products.
[4] Etsy recently bought Depop, a company that follows the social model.

what they keep. If the customer sends it all back, they are still charged $20. These boxes can be delivered on a regular schedule or any time.

It sounds good, but reviews are mixed: the stylists need to be right about fit, budget, quality, and style. If they get any of those things wrong too many times, customers will quickly move on. It seems to be useful for discovering new styles, but not as attractive as an ongoing service—once people know what they want, they can get it at the store, a rare exception to the common trend of reviewing something inside a store and buying it online.

The business itself has struggled to make this model work. It has been losing customers, losing stylists, and losing money—with more losses expected. This year, the company also lost its CEO. The new CEO is exploring alternative service options, an indication that the model isn't working and the company is in "turnaround" mode.

Rent the Runway, founded in 2009 and still led by the company's founders, is a true subscription business. Customers can choose different subscription levels, from one shipment of 4 clothing items per month for $94/month up to four shipments for $235/month. There is also an option to rent without a subscription.

It is too expensive for most, but the value proposition is having access to a huge closet of luxury designer clothing that would normally be beyond budget or beyond the size of a city closet. Much of it is casual, but it's often used for the type of high-priced, nice clothing that is only worn a few times. Something that is taken as a rental can be returned after a big event, instead of purchased and discarded later. The people who like it seem to love it, and the people who stop using it are usually citing operational or customer service issues. As a service, it makes sense for the right demographic—according to management, 80% of their subscribers have a household income of more than $100,000.

As a business, I'm skeptical. The company relies on people going out for social and business events, something the pandemic temporarily wiped away. RENT has recovered from this challenge, but profitability remains elusive, and more growth is required to reach it.

To achieve a reasonable profit, the company must rent out clothing over time for more than it pays to acquire it, maintain it, and ship it. RENT considers 3 years to be the useful life for its rental clothing, after which time they are too worn out to be suitable for a rental. Then they are sold in "like new" condition. On an individual order basis, with only relevant clothing expenses, the company estimated a 31% profit for each order in 2021. Assuming that estimate is accurate, enough order volume *could* eventually cover the rest of the company's expenses.

So far, it hasn't been a profitable business, and the management recently announced a massive restructuring campaign, reducing corporate headcount by 24%. They are also focused on cost cutting with revenue sharing agreements (to avoid paying upfront for inventory), exclusive design partners, and logistics improvements (mostly automation). [5] On the other side, they are working on attracting more customers and enticing current subscribers to spend more. Put together, it's a plan that makes sense. But over the long term, it's extremely speculative—the service has to remain attractive in comparison to price, quality, and other alternatives, and the growth rates that management is expecting have to become a reality. Right now, it's not working. The company lost subscribers in the most recent quarter.

Consignment Models

Consignment businesses are well-known. There are hundreds of small consignment shops around the country. They evaluate items that people want to sell, choose what to put in their stores, and take a cut from the sales. This model has moved online as well. For clothing, two of the biggest are The RealReal (REAL) and ThredUp (TDUP).

The RealReal, founded in 2011, is an online consignment marketplace that specializes in authenticated luxury goods. The process is labor-intensive—items are picked up or dropped off, sent to an authentication center where they are verified as real, repackaged, and sold. The summary of this company's situation is very short: it's a difficult business with a lot of competition that has struggled to achieve profitability. As losses have increased despite rising revenues, the CEO stepped down this year, and the new management team is focused on "profitable growth."

ThredUp, founded in 2009 and still managed by the company co-founder, operates in a different part of the clothing consignment market. This company will accept almost everything, accessing a market that is many times larger than luxury alone (management estimates that 60% of their customers have a household income below $100,000). Sellers order a "cleanout kit" that they fill with their items and send to ThredUp. Then the ThredUp team processes these items at centralized warehouses and does all of the work preparing them and listing them, taking a cut from the sales. What cannot be sold is either recycled or returned.

The company sells itself as sustainable fashion, an environmental commitment that attracts both buyers and sellers. But the reviews are somewhat mixed. Buyers enjoy the wide selection of product choices, but sellers don't like how much control the company has over what sells, and they often think that they don't get enough money for what they send (the tradeoff, of course, is that the sellers don't have to do any of the work).

[5] Some market commentators have joked that the company is just the world's largest dry cleaner.

From a strategic perspective, the CEO claimed that they're taking the Amazon approach to profitability, spending as much as they can to quickly increase distribution capacity. This ambitious approach has led to overexpansion, forcing the company to make huge cuts in staffing (50% of the corporate workforce) and close a processing center. Combined with other expense reduction projects, management plans to breakeven in 2023. It's a business model that *could* work, but requires the company to maintain processing facilities and scale appropriately while managing costs and growth, something that the management has not been able to do so far.

Social Models

What I am calling the social sales model is somewhat unique to fashion, but it has worked in other markets. It's about the social connection that goes along with buying and using a product. I think of it like trying to buy or sell something on Instagram. For clothing, there are two major publicly traded US companies that fit my understanding of this model: Poshmark (POSH) and Revolve Group (RVLV). (Note: Before publishing this blog, POSH announced that it will be acquired by a South Korean Internet company. It will not be publicly traded for much longer.)

Poshmark, founded in 2011 and still managed by its cofounders, is an online clothing resale marketplace similar to eBay and Etsy that combines aspects of social media and social events to the buying and selling experience. Sellers do all of the work listing their items for sale and promoting them on the platform. When something sells, Poshmark takes a cut from the sale. There is no need for the company to maintain large warehouses or fulfillment centers. The only time the company gets directly involved in the process is to authenticate items that sell for more than $500.

The user experience varies widely because each seller is effectively operating their own shop, setting their own prices and doing their own advertising (this is done by "sharing" the listing on the platform, a form of engagement that is required to get more sales). And interactions between users have a big effect. Buyers are able to negotiate prices and ask for details about what is for sale, a feature that can be annoying for sellers when the buyers refuse to make serious offers. Buyers can also be frustrated by inaccurate listings (a common complaint on other platforms as well), but have the ability to get clarifying information on details such as color and fit. There are also social events related to the platform that enable and encourage more activity.

As a business model, it can scale quickly and appropriately without major infrastructure investments, and doesn't require anticipating fashion trends. The biggest investments are for attracting and retaining buyers and sellers, spending that can easily be adjusted to achieve either more growth or more profitability. Right now, management is appropriately focused on growth, and the company is working on international expansion and expanding into other sales categories. But these investments are still relatively unproven, and moving into more categories puts it more directly into competition with eBay.

Revolve Group, founded in 2003 by two co-founders who remain co-CEOs, is the most established of these online clothing companies. The company relies on fashion influencers to promote its platform, and hosts major events attended by some of the most famous celebrities in the world. It uses these connections to sell a variety of luxury clothing brands, including third-party brands and “owned brands” that the company created. It is always creating new brands and styles.

To summarize the business, RVLV is like a clothing store that operates entirely online. It has similar challenges that face both online companies and fashion companies, such as extreme competition and seeking out the latest trends, but I believe that the model has already been proven. The company founders have been committed to profitable growth from the beginning, and RVLV was an early adopter of both influencer marketing and big data prediction models. As a result of this head start, it is larger and more profitable than the other online clothing businesses that I’ve profiled here.

Like any fast-changing industry, these advantages are not guaranteed to last. Constantly introducing new brands and working with influencers prevents staleness, but others can copy this model and customers can easily choose another service. What others can’t copy as easily is the data behind these decisions, and the company’s relatively new loyalty program should secure more repeat customers, while international expansion represents a promising area for future growth.

Summary & Conclusion

I can’t outline every online clothing company in a reasonable amount of space. There are certainly some interesting international opportunities that I didn’t cover here—such as Mercari, Farfetch, and others—but reviewing the different flavors of online businesses helps for understanding where any newly-discovered company might fit. For online clothing companies, I came up with three general categories: Subscription Models, Consignment Models, and Social Models. There are other ways to look at it, but this was the easiest way for me.

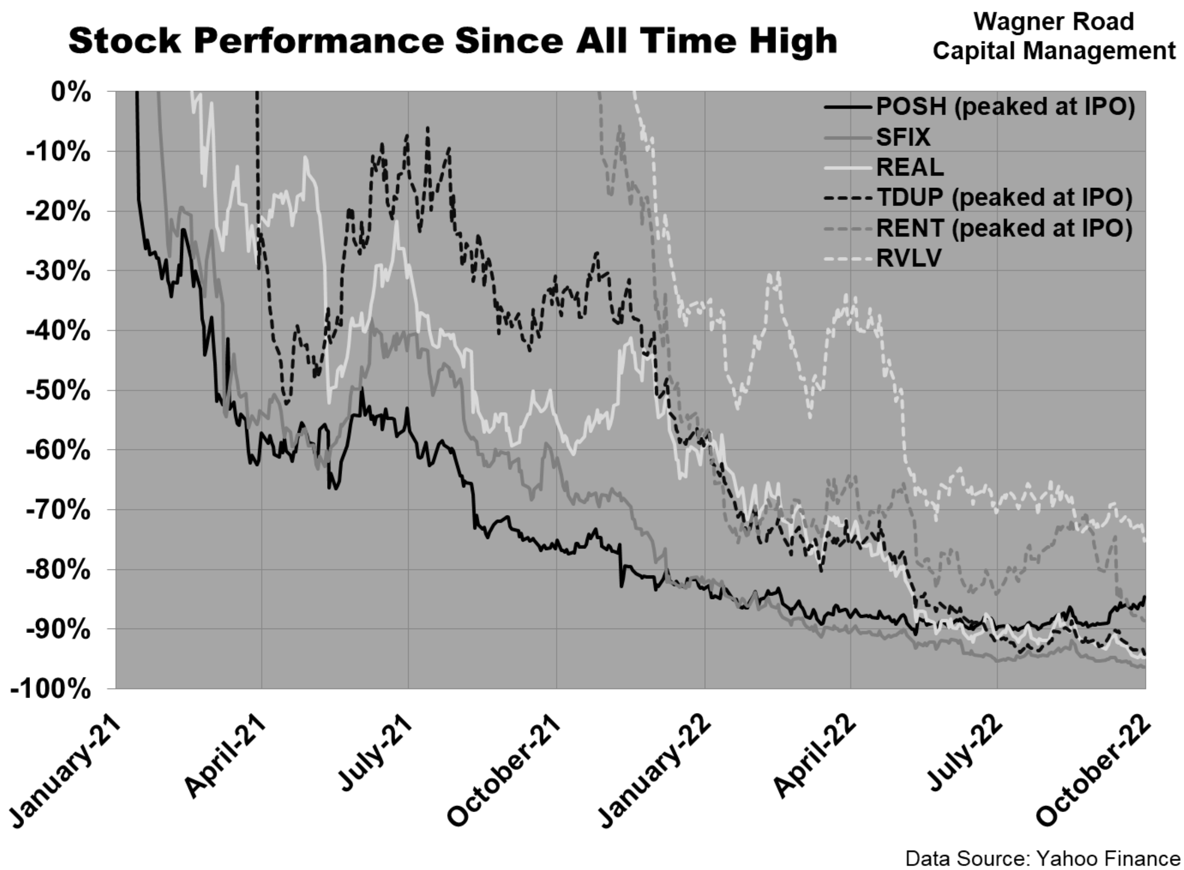
For this small sample, the social models are currently the most attractive. Beyond the current competitive status, a quick look at the numbers reveals different levels of success or distress.[6]

[6] Numbers are sourced from Morningstar and Yahoo Finance at the end of the quarter. Dollars are in millions.

	Subscription Models		Consignment Models		Social Models	
Company	Stitch Fix (SFIX)	Rent the Runway (RENT)	The RealReal (REAL)	ThredUp (TDUP)	Poshmark (POSH)	Revolve Group (RVLV)
Market Position or Business Description	A subscription service with one-to-one personalization from stylists.	A subscription service to rent out designer clothing and accessories.	Luxury resale with physical stores and online consignment.	Online consignment for all clothing and accessories.	Peer-to-peer marketplace mixed with social media.	Luxury clothing sold through influencer marketing.
Year Founded	2011	2009	2011	2009	2011	2003
Year Public	2017	2021	2019	2021	2021	2019
Market Cap	$475	$155	$150	$210	$1,120	$1,730
Cash	$212	$192	$316	$149	$581	$238
Debt	$170	$315	$601	$88	$11	$16
Revenue	$2,070	$266	$565	$285	$344	$1,060
Net Income	-$207	-$203	-$219	-$82	-$59	$85
Free Cash Flow	$9	-$123	-$180	-$89	-$2	$17
Net Margin	-10%	-76%	-39%	-29%	-17%	8%
ROIC	-38%	N/A	-36%	-32%	-14%	26%
ROE	-52%	N/A	-933%	-47%	-14%	27%
Debt/Equity	0.53	44.5	N/A	0.52	0.03	0.05
3-Yr Average Revenue Growth	9.5%	N/A	31%	25%	30%	21%
Management	(CEO left)	Founder is CEO	(CEO Left)	Founder is CEO	Co-founder is CEO	Co-founders are Co-CEOs

The similarities are more striking than the differences. If our definition of online clothing companies is “online-only”, then this is still a young industry. Most of these companies were founded between 2009 and 2011, right after the 2008 financial crisis (the other came right after the dot-com crash). They all went public within the last five years, most of them within the last two. And until recently, all were led by founder-CEOs.

The stock performances since going public have also been strikingly similar—and mostly terrible. After the enthusiasm generated from a potential online-only world created by the pandemic, the stocks came back to reality. Most of them are down more than 80% from their peak.



But I don't think that a group of busted IPOs is the end of the story for this industry. Ecommerce continues to become more popular. Reselling and buying used items continues to become more popular. What people want to wear will change over time, but they will always want to wear *something*. The important part is where they're going to find it and how a business can make money delivering what people want. That's what we're thinking about.

On a broader level, recognizing the stage of the industry as a whole is useful when thinking about other industries and other business models (and as the Poshmark acquisition shows, the next stage may be coming soon). It also makes it easier to recognize and appreciate the value of good businesses. And that's what we're looking for.

Andrew Wagner
Chief Investment Officer
Wagner Road Capital Management

Marketing Disclosure

Wagner Road Capital Management, LLC ("Wagner Road") offers investment advisory services and is registered with the state of Minnesota. Registration with one or more state securities authorities as a Registered Investment Adviser does not imply a certain level of skill or training nor does it constitute an endorsement of the advisory firm by the state securities authority. All content available in this blog is general in nature, not directed or tailored to any particular person, and is for informational purposes only. Neither this blog nor any of its content is offered as investment advice and should not be deemed as investment advice or a recommendation or offer to purchase or sell any specific security. The information contained herein reflects the opinions and projections of Wagner Road as of the date hereof, which are subject to change without notice at any time. Wagner Road does not represent that any opinion or projection will be realized. The information contained herein has been obtained from sources considered reliable, but neither Wagner Road nor any of its advisers, officers, directors, or affiliates represents that the information presented in this blog is accurate, current or complete, and such information is subject to change without notice. The information contained in this blog does not purport to be a complete description of the securities, markets, or developments referred to in this material. Any performance information must be considered in conjunction with applicable disclosures. Past performance is not a guarantee of future results. Neither this blog nor its contents should be construed as legal, tax, or other advice. Individuals are urged to consult with their own tax or legal advisors before entering into any advisory contract or investment.