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PTON.OQ - Q2 2021 Peloton Interactive Inc Earnings Call

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OVERVIEW:

Co. reported 2Q21 total revenue of $1.065b and net income of $63.6m or $0.18 per diluted share. Expects FY21 total revenue to be $4.075b or better and 3Q21 revenue to be approx. $1.1b.

CORPORATE PARTICIPANTS

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Peter Coleman Stabler *Peloton Interactive, Inc. - SVP of IR*

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to Peloton Interactive's Second Quarter 2021 Earnings Conference Call. (Operator Instructions) Please be advised that today's conference is being recorded. (Operator Instructions)

I would now like to hand the conference over to your speaker, Mr. Peter Stabler, Head of Investor Relations. Please go ahead, sir.

Peter Coleman Stabler - *Peloton Interactive, Inc. - SVP of IR*

Good afternoon, and welcome to Peloton's fiscal second quarter conference Call. Joining today's call are John Foley, our Co-Founder and CEO; President William Lynch; and CFO Jill Woodworth.

Our comments and responses to your questions reflect management's views as of today only and will include statements related to our business that are forward-looking statements under federal securities law. Actual results may differ materially from those contained in or implied by these forward-looking statements due to risks and uncertainties associated with our business. For a discussion of the material risks and other important factors that could impact our actual results, please refer to our SEC filings and today's shareholder letter, both of which can be found on our Investor Relations website.

During this call, we will discuss both GAAP and non-GAAP financial measures. A reconciliation of GAAP to non-GAAP financial measures is provided in today's shareholder letter. With that, I'll turn the call over to John.

John Paul Foley - *Peloton Interactive, Inc. - Co-Founder, Chairman & CEO*

Thanks, Peter. Good afternoon, everyone. Thank you for joining us today to discuss our second quarter results. Global demand for our products was strong throughout the quarter, and we added a record number of new Connected Fitness subscriptions. We also launched our new Peloton Tread in the U.K., produced over 2,100 new classes for our on-demand content platform and added more software features to continue building the best member experience in global connected fitness. And our members are clearly responding as we again posted substantial year-on-year engagement growth in the quarter.

Over the last several quarters, we have been very focused on significantly growing our manufacturing capabilities. Fifteen months ago, we bought Tonic, one of our Taiwanese-based third-party manufacturing partners, which has allowed us to significantly scale our Bike and Bike+ production. And over a year ago, we broke ground on a new Tonic plant in Shin Ji, and we're pleased to report that this facility is now up and running.

With the desire to have greater control over our own supply chain destiny, we were proud to announce our biggest acquisition to date, Precor, and we're excited to welcome the Precor team into the Peloton family. Precor is a leading global manufacturer of commercial fitness equipment. Our acquisition of Precor will allow us to produce Peloton products here in the U.S. and fast track our ability to build a large domestic manufacturing footprint over time. Importantly, Precor has deep manufacturing and R&D expertise, which will help us bring new hardware products to market more quickly and better position us to serve our North American member base over time.

Precor's product portfolio and sales team will also accelerate our commercial business where we see a significant opportunity to grow Precor's franchise while introducing the Peloton platform to an even greater number of fitness enthusiasts in channels such as hospitality, multiunit residential buildings, corporate campuses and colleges and universities. As we mentioned in our transaction announcement, we expect to be producing Peloton equipment in the U.S. by the end of this calendar year at Precor's North Carolina facility and expect to close the acquisition early this calendar year. Pending a successful close, we will offer more thoughts on Precor next quarter.

Though we're beginning to see the benefits of our extensive supply chain investments, our delivery wait times remain elevated. As with last quarter, continued strong demand for our products, West Coast port delays and COVID-related delivery challenges have prevented us from returning to our normal order to delivery wait times and unfortunately, forced us to reschedule many deliveries. To address this issue, we will continue to invest heavily in systems, teams and manufacturing capabilities to ensure we don't disappoint our customers going forward.

Importantly, we are going to do everything we can to get back on the right side with our new members. In order to do that, we are investing over $100 million in expedited shipping to reduce the wait times for our products. This expense will include air shipments, expedited ocean freight and incremental costs to get containers to other ports that are less congested.

Member support has also been and will continue to be a critical investment area for us. To help address the support needs of a rapidly growing member base, we've more than doubled the size of our member support team over the past year. We will continue making significant investments to get our products to the U.S. with more certainty and with greater speed. We have also significantly lowered marketing spend even during our typical peak selling periods. We are determined to do what it takes to reduce our delivery times and get certainty to customers on the delivery dates we offer. In a moment, Joe will offer more color on how these investments impact our guidance for the balance of the year.

We are very excited about the new Tread, which went on sale in the U.K. on December 26. And we're pleased with the U.K. market reception, particularly as it represents the first time we've offered a Tread product to our international members. U.K. Tread sales have exceeded our expectations and our early reviews have been overwhelmingly positive. The success of this launch and the fantastic reception of this new product has forced us to reconsider our schedule for our new Tread rollout in North America. Our launch plan originally called for a limited market launch in the U.S. on February 9 in conjunction with a launch in Canada. In the U.S., we had planned to start delivering nationally in April.

To adjust to current market dynamics and to better equip our U.K. and Canadian teams to fulfill expected demand with high levels of customer service, we've decided to allocate additional resources to those markets and adjust our U.S. rollout schedule. For many of those eagerly awaiting our U.S. launch, this is no doubt disappointing. But these additional weeks will enable us to build a deeper inventory footprint, helping us deliver a better member experience once deliveries commence. Our plans for a February 9 Canadian launch are unchanged.

We will begin selling a limited number of new Peloton Treads in the U.S. starting on February 9 to consumers who have expressed early interest in the Tread. This limited sale will be restricted to a few select ZIP codes. We will then move to a full U.S. rollout, excluding Alaska and Hawaii, on May 27.

Now some operational highlights from the quarter. We added 333,000 net Connected Fitness subscriptions in the quarter, bringing our end of quarter Connected Fitness membership base to 1.67 million, up 134% year-on-year. As of December 31, we had over 4.4 million global members, inclusive of our nearly 625,000 digital subscribers. Digital continues to be a high-growth sales channel for Connected Fitness products, and we have been pleased with both the exceptional growth in digital subs over the past several quarters as well as our improved upsell conversion rate to our Connected Fitness products.

Our member engagement continued to soar in Q2 with Connected Fitness subscription workouts growing over 300% to 98.1 million. That's an average of over 1 million workouts per day in the quarter. I'm also happy to report that in January, we saw our first day of over 2 million workouts. In Q2, we averaged 21.1 monthly workouts per Connected Fitness subscription versus 12.6 in the year-ago period, an increase of 67%.

We continue to see particularly strong growth across our collection of floor-based classes as members increasingly embrace our full-body fitness content. A great example is our Bike Bootcamp series that combines bike-based cardio and off-bike strength training. In this quarter, Bike Bootcamp classes were taken nearly 2 million times by our members.

As we've mentioned previously, enhancing our Strength offering is a key strategic focus for us. The addition of Pilates classes to our Strength vertical was welcomed warmly by our member base with over 1 million classes taken since launch. We will continue to build on the success of our Strength content pillar over the coming quarters.

Beyond adding new fitness modalities and class varieties, we're always on the lookout for groundbreaking partnership opportunities. As you may have seen, we've teamed up with the global megastar Beyonce to produce a series of themed classes, and we're proud to be joining her in supporting students of 10 historically black colleges and universities with free 2-year Peloton digital memberships.

Our most recent collaboration is with Shonda Rhimes, the hottest executive producer on the planet today. We worked with Shonda to produce the Year of Yes, an 8-week class collection spanning multiple fitness disciplines focused on overcoming fears, maximizing potential and discovering the inner athlete in all of us. Our world-class content and music teams have a robust content pipeline over the next several quarters to further delight our member base.

Lastly, to our entire Peloton team, thank you. Your unwavering commitment to our members is a source of inspiration for me every day and we want to thank our members, especially our newest ones and those awaiting their deliveries for their patience as we work hard to get their products to you as quickly as possible. Now over to you, Jill.

Jill Woodworth - *Peloton Interactive, Inc. - CFO*

Thanks, John. I will start with a review of our second quarter results. In Q2, we generated total revenue of $1.065 billion, representing 128% year-over-year growth, exceeding expectations across all geographies. The primary drivers leading to revenue outperformance versus guidance were strong continued demand for Bike, Bike+ and Tread+, lower-than-anticipated financing rates, strong apparel sales and better-than-expected churn.

During Q2 and into the remainder of the fiscal year, we are working closely with our global payment providers to improve our member experience. In the U.S., we have already begun to roll out delayed payment capture to a portion of our customers, which means we are adjusting our transaction process to collect payment closer to the time of delivery rather than at the time of sale. This change does not impact revenue results or our forecast as we recognize revenue at the time of delivery. But over time, we will have a dramatically lower level of customer deposits, which are recognized on the balance sheet. We expect to finish our global rollout of delayed payment capture in Q4 of this fiscal year.

Moving on to gross margin. Gross margin for the quarter was 39.9%. Connected Fitness product gross margin was 35.3%, an expected year-over-year decline of 385 basis points. The leading driver of this decline was the September 9 price reduction of our original Bike and expedited shipping expenses incurred in Q2, as noted during last quarter's earnings call. Subscription gross margin was 60.3% and subscription contribution margin was 65.3%, slightly ahead of expectations, with greater-than-expected leverage of fixed costs and some variable cost efficiencies as well.

Average net monthly Connected Fitness churn was modestly better than expected at 0.76%. As John noted, we continue to be pleased with the high level of member engagement on our platform driven by new content, fitness verticals and software features, building on our promise of bringing more and more value to our membership.

Total operating expense as a percent of revenue was 34.4% compared to 55.5% in Q2 of last year. Sales outperformance drove significant leveraging of operating expenses in the quarter. Sales and marketing expense represented 16.7% of total revenue versus prior year period 34.4% as we operated with limited marketing spend as we continue to work through our supply and demand imbalance. Importantly, over the past several months, we've built significant additional capacity at Tonic and through our third-party manufacturing partners. We are extremely pleased that our current manufacturing capacity exceeds demand, a trend that will accelerate as we move through the back half of the fiscal year.

General and administrative expense was 13.2% of total revenue versus 16.6% in the prior year, even with significant continued investments in our teams and systems allowing us to scale our business operations. Research and development expense was 4.5% of total revenue versus 4.4% in the year ago period. We expect R&D as a percentage of revenue to remain in this range as a percentage of sales as we continue to build best-in-class hardware and software teams.

With better-than-expected sales, gross margin and operating expense leverage, our fiscal '21 Q2 adjusted EBITDA was $116.9 million, representing an adjusted EBITDA margin of 11%. Net income for Q2 was $63.6 million or $0.18 per diluted share. Lastly, we ended the quarter with $2.1 billion of liquidity and have additional liquidity in the form of an untapped $250 million credit facility.

Now on to our outlook. In Q3, we expect revenue of approximately $1.1 billion, representing 110% year-over-year growth. As with recent quarters, we carried a substantial number of backlog deliveries into the quarter. In Q3, we forecast end-of-period Connected Fitness subscriptions of 1.98 million, representing 123% year-over-year growth. For Q3, we expect average net monthly Connected Fitness churn to stay under 0.75%.

As John mentioned, port congestion issues continue to negatively impact our product delivery windows. As you may have seen, the Executive Director of the Port of Los Angeles recently reported that port unloading times are currently 4x longer than they were a year ago. It's clear to us that additional significant investments are required in the near term to help us navigate these congestion issues and get products to our members more quickly and with certainty.

The majority of our air shipping expenses will be in Q3 for Bike and Bike+ so that we can dramatically improve product wait times and minimize reschedules for our newest members. The spend also incorporates elevated pricing for ocean freight from Asia, which is currently 3x higher than normal rates and reflected in our forecast. We expect these expenses to have a material but short-term impact on our Connected Fitness gross profit margin in Q3, while the impact to Q4 will be more muted. We believe these outsized shipping costs will largely abate by June as we build up significant inventory stateside in the coming months.

We expect Q3 gross margin of approximately 35% comprised of Connected Fitness gross product margin of approximately 29% and a subscription contribution margin of approximately 64%. The leading driver of year-on-year deleverage of our Connected Fitness product margin is the higher shipping expenses I just mentioned, the price reduction of our original Bike and a mix shift to Tread. Importantly, we continue to focus on Connected Fitness subscription lifetime value and net customer acquisition costs. Despite the significant investments in the quarter on expedited and air shipping, our adjusted Connected Fitness gross margin continues to more than offset our customer acquisition costs.

For our Subscription segment, we expect continued fixed cost leverage to be partially offset by increased cost of higher member engagement and continued strong growth of Digital subscriptions, which carries a lower gross margin profile. Over the long term, we continue to expect that our Subscription contribution margin will exceed 70%.

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Turning to operating expenses. Sales and marketing for Q3 and Q4 will increase as a percentage of revenue when compared to the first half of fiscal '21 as we ramp marketing spend, including support behind the launch of our new Tread. In terms of phasing, we expect Q3 and Q4 to have roughly similar spending levels as a percentage of revenue. For the full year fiscal '21, we expect sales and marketing expense though to be materially lower as a percent of revenue when compared to fiscal 2020.

With regard to G&A, we've accelerated some of our system and people investments, and importantly, in R&D, we've been able to accelerate the hiring with engineering acqui-hires. While we're pulling forward some investments, this spending is focused on people and technologies that will accelerate our development of new products and features. Rolling all of this up, we expect adjusted EBITDA of $10 million in Q3.

Moving on to full year expectations. For fiscal '21, we are raising our estimate of full year total revenue to $4.075 billion or better, representing 123% year-over-year growth or higher. In the second half of fiscal '21, we expect quarterly sequential revenue growth as we bring down our delivery backlog, build adequate inventory as a result of our shipping and manufacturing investments and resume marketing spend. The increase in revenue guide for the balance of the year is primarily driven by the continued, robust global demand for Bike, Bike+ and strong U.S. demand for Tread+. We expect our new Tread to be a more meaningful contributor to performance in fiscal '22.

For fiscal year '21, we now forecast 2.275 million ending Connected Fitness subscriptions or more, and average net monthly Connected Fitness churn to stay under 0.8%. Due to the increase in shipping costs for the balance of the year, fiscal '21 gross margin is now expected to be approximately 39%, down from our previous full year guidance of 41%. Including investments for air shipments, expedited ocean shipping and shipping price increases, we expect Connected Fitness product gross margin of roughly 34%. Other drivers include our recent Bike price reduction and continued mix shift to Tread products.

We now expect Subscription contribution margin in fiscal '21 of approximately 65%, up 100 basis points from last quarter's guidance as we expect to continue to see additional leverage and fixed cost of content production and some variable cost efficiencies. These will be partially offset by continued, expected, elevated engagement levels, higher digital subscriber growth and continued investments in global fitness and wellness programming.

As a result of our incremental expedited shipping and accelerated G&A and R&D spend, we leave our adjusted EBITDA guidance unchanged at $300 million or better. These short-term investments in shipping our products are obviously impacting our near-term profitability. But we must invest in our member experience is our first priority. And these investments today will allow us to resume marketing spend so we can maintain our leadership position in global connected fitness.

I will now turn it over to the operator to take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question will come from Doug Anmuth with JPMorgan.

Douglas Till Anmuth - *JPMorgan Chase & Co, Research Division - MD*

One for Jill and one for John. Jill, you mentioned that manufacturing capacity exceeds demand. I just want to clarify, is that strictly because you've ramped capacity? Or are you seeing any change to demand due to extended order to delivery times?

And then, John, just on the Precor opportunity. Hope you can talk a little bit more about how you're thinking about the commercial space and the opportunity there. And then also if there's any way to quantify or provide any more color just around the manufacturing capacity and the benefits just in terms of proximity there as well.

John Paul Foley - *Peloton Interactive, Inc. - Co-Founder, Chairman & CEO*

Thanks, Doug. We're going to switch over. I'm going to take the first one, and I think William can talk about Precor. We are not seeing a softening of demand. That is absolutely not what's happening here. We are seeing incredibly strong organic demand even in the face of light marketing, as you know.

The successes that we're seeing in getting order delivery down and getting our backlog down are 100% based on incredible upgrades in our manufacturing capacity, up over 6x -- 6x increase in just the last 12 months in our capacity. Of note, we're now making more bikes on a monthly basis than we did in all of fiscal 2018. So it's a herculean effort based on our in-house manufacturing teams and our third-party partners. And so yes, I hope that answers your question, but it's absolutely not a softening of demand that now what we're seeing. We're seeing robust demand.

Jill Woodworth - *Peloton Interactive, Inc. - CFO*

Yes. And I would just highlight, obviously, that's reflected in the revised revenue guidance that we've given for Q3 and Q4. Obviously, in Q3, we're working through a substantial backlog of orders. But we're still seeing very strong organic demand across all geographies, across all products.

William J. Lynch - *Peloton Interactive, Inc. - President & Director*

And then Doug, on Precor, we love the commercial opportunity. In fact, since the announcement, if you look at inbound from some of those channels that John mentioned, universities, schools, clubs, hotels, hospitality, it's been enormous, the curiosity about what this could mean in terms of delivering a combined Precor-Peloton experience in the commercial channel. So that thesis, which was 1 of the 3 primary reasons we did the acquisition. The first being the manufacturing capacity and scale and the team, frankly, we just fell in love with that team. We're more excited than when we were going through that transaction. So it's yet to close, and we'll provide an update as it does. But on that aspect, yes.

And then in terms of expanded manufacturing capacity, that was kind of premise one. And as we've said, we expect U.S. manufacturing with Precor in the back half of the -- not until the back half of the calendar year, and that's unchanged. That is still the plan, and that's what we're tracking towards as we close.

Operator

Our next question will come from Edward Yruma with KeyBanc Capital Markets.

Edward James Yruma - *KeyBanc Capital Markets Inc., Research Division - MD & Senior Research Analyst*

I guess, first, you've had a really impressive expansion of new modalities, types of programming. As you see someone engaging in just in something beyond the bike, doing floor, doing other verticals, what happens to their churn? What happens to the overall kind of workout per Connected Fitness device?

And then I guess, Jill, a question on marketing. You guys have been able to keep the line on marketing for an extended period of time. I know it's a funny time with COVID, but how does it make you think longer term about the role of marketing spend as a percent of overall sales?

William J. Lynch - *Peloton Interactive, Inc. - President & Director*

Yes. This is William. On the modality, what we see -- and it is interesting to watch how the expansion in different verticals that John mentioned, Pilates most recently, has deepened engagement. And I'll mention Strength, which we've identified as one of the core pillars along with Cardio. Strength, we know, is a huge category in fitness. The growth in Strength in terms of engagements, 5x year-on-year, 500% growth in Strength. And so all these investments we're making in making that all-access membership more valuable in terms of getting household members engaged is working.

We don't know if it's correlation or causation, but what is absolutely true is that the more modalities that a member is engaged with and their profiles are engaged with, the stickier they are, and that's within an incredible retention rate among the overall membership. But the more we can get them into those other modalities, Stretching, Strength or Pilates, et cetera, the more valuable they are to us.

Jill Woodworth - *Peloton Interactive, Inc. - CFO*

Yes. And then on the marketing question, we've never given a long-term target in terms of sales and marketing as a percentage of revenue. And of course, over the last almost year now, I can't believe it's been a year, we've clearly been able to rely on organic growth of our business. And a lot of that has been attributed to the fact that we have a very high NPS score, and we have very happy members who recommend our products to others.

But marketing is critical for us going forward. In our humble opinion, we've got incredible new products that we want to spread the word about. We're really excited about the new Tread. So as we expand our product portfolio, as we expand into new geographies where we're starting from very low brand awareness, marketing is an incredibly critical component to continuing -- us to continue to drive growth over the next few years. So we don't have a target in mind. But as we said earlier, you will see us in the next couple of quarters be a little bit more offensive.

Operator

Your next question will come from Justin Post with Bank of America.

Justin Post - *BofA Securities, Research Division - MD*

Great. Maybe one for John or William and then -- both. So for the first one, just thinking about the opening next year. Some of the e-commerce companies had a slowdown in September and October and then reacceleration due to lockdowns. Did you see anything in the fall? And how are you thinking about that?

And then secondly, can you give us more detail on the U.K. launch? I know there's a lot of anticipation for the new Tread. What you've seen and any clues on how big that market could be versus the bike market?

John Paul Foley - *Peloton Interactive, Inc. - Co-Founder, Chairman & CEO*

Yes, I'll take the first one. When the vaccine was announced in the fall, you saw a reaction to the stock but we did not see any reaction to our sales or demand. We still have not seen any softening since that vaccine was announced and since the vaccine has been rolling out. So other than investors getting nervous, the consumers are still feeling like they want to work out at home. The experience, to William's point, is the best in the world and it's getting better as we launch more software features, more content types, more access on more different platforms.

And I think what you're seeing is everyone's starting to realize that working out at home is a better place. It's a better value. And so we're very bullish on our sales opportunities on the other side of the opening, to your point. And like Jill just said, we're excited to get on the offensive and start marketing because the story is incredible, the products and the experiences are incredible, and they're getting better by the month. So we remain very, very bullish on our opportunity. We haven't seen any softening of demand.

William J. Lynch - *Peloton Interactive, Inc. - President & Director*

And then on the Tread launch in the U.K., as John noted, we're -- we couldn't be more excited. In fact, it's exceeding our expectations. We decided to launch in the U.K., one, because they had not had the Tread platform. But two, it also gave us our second largest market, the ability to learn a lot, which we think was a really prudent decision and Kevin Cornils and that amazing international team were able to launch that product at the end of last year. And if you look at almost every metric, customer reviews being most meaningful for us, we start with the product experience and the customer experience and work backwards on everything. But then sales, word-of-mouth, lead conversion, all of it. And so that gave us a chance to take a step back and say, let's make sure as we launch Canada next week, we're in a really good position on supply.

But we've always maintained that Tread was going to be a fiscal year '22 story in terms of volume. And we're solving for short, mid-, long term with that platform. We think it's one of the biggest growth engines for the company in the foreseeable future. And as you look at the U.K., there's nothing we're seeing, in fact, just the opposite. It's -- we're more bullish than we've ever been on the new Peloton Tread.

Operator

Our next question will come from Jason Helfstein with Oppenheimer.

Jason Stuart Helfstein - *Oppenheimer & Co. Inc., Research Division - MD & Senior Internet Analyst*

I think for a lot of us, your gross adds came in a bit lower for the reasons you talked about. But digital subscribers came in meaningfully higher. What can you just tell us about the conversion rates or any color you can share about digital subscribers moving over to Connected Fitness. And then given that you're taking up guidance for the year, even though you are pushing out Tread, just if you can share a little color because clearly -- the bike side is clearly going to come in even more than you expected because there's an offset of some Tread assumption that you're now taking out of the full year guidance.

John Paul Foley - *Peloton Interactive, Inc. - Co-Founder, Chairman & CEO*

Thank you, Jason. Yes, we continue to be very bullish about our investments in the digital platform. I'll remind you that investments in digital aren't just good for that business on its own. But it's good for our Connected Fitness members who have Bikes or Treads and also get that digital platform as part of the $39 membership for their whole household. So that's one of the things that's helping drive engagement as they might be traveling and might want to go for a run or do yoga in their hotel room or whatever or go down to the gym and take a Bootcamp class on somebody else's treadmill. So we're excited about the investments because they're kind of a twofer as it were. But purely, the digital business, we did have an incredible quarter thanks to Karina and Matt and that team with not just with the content but with the software. And the year-on-year growth is, I think, 6x, which was fantastic.

And like Jill alluded to, the conversion from digital members, digital subscribers, to Connected Fitness subscribers is something we do track, something we do care about. It's one of our theses that if we introduce our great instructors and our great music and our great community and our great content and software to members in a very low friction, $12 a month way, and they see what we're bringing and why the experiences on Peloton are different, that they're eventually going to want a Peloton Bike or Peloton Tread. We are absolutely seeing that. It continues to be one of our best lead gen channels, and it's getting better as we get smarter with it. So it's a great question. We're very excited about it.

Jill Woodworth - *Peloton Interactive, Inc. - CFO*

Great. And to answer your question, despite the fact that our new Tread is a couple of months delayed, what is then the driver of the increase in revenue outlook for the balance of the year. We've always maintained that our new Tread was going to be a very immaterial contributor to fiscal '21. So the strength in our revenue guidance is continued to be driven by Bike, Bike+, Tread+, all geographies, which are growing much faster than the U.S.

So the overall health of the business is incredibly robust. But I will say we've always maintained that it was going to be a very small contributor to '21. So that's -- it's not moving the needle.

Operator

Our next question will come from Scott Devitt with Stifel.

Scott William Devitt - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

Connected Fitness sub additions suggest that deliveries will be moderating slightly in the March and June quarters and there is new capacity ramping as you suggested. So I was wondering if you have a sense yet of when to expect delivery lead times back to historical levels. I think I heard in Jill's comments that maybe back half of calendar 2021.

And then secondly, you have plenty going on right now, but it still would be great to better understand how you're thinking about the full hardware offering over the long term. And specifically, how you think about Strength via devices like resistance-based strength and rowing. Is there a fundamental belief at the company as to whether Strength will ultimately require hardware or not?.

John Paul Foley - *Peloton Interactive, Inc. - Co-Founder, Chairman & CEO*

Yes, I'm glad you asked, Scott. We plan to get back to normal order to delivery on our bike product line way before the end of this calendar year. I would say by -- in mid- to late spring, we should be in the below 4-week order to delivery time frame. So we are putting points on the board and eating into the backlog, and we're going to be back in good shape before you know it. So it's not going to take us the rest of this calendar year by any stretch.

The -- on the hardware for Strength, it's a good question. I think there is a question mark, on -- in my own head on that. I see us potentially innovating on both on just a content-only offering. If you're familiar with 20 years ago, there was a big business called P90X and -- or Beachbody. And people are getting fantastic strength workouts on the back of just content alone in their hotel rooms. That is not to say that we are not considering and innovating on a Strength hardware platform. We don't have anything to announce right now, but we are pursuing both options, and I personally am excited about winning no matter what the answer to that question is.

Operator

Our next question will come from John Blackledge with Cowen.

John Ryan Blackledge - *Cowen and Company, LLC, Research Division - Head of Internet Research, MD & Senior Research Analyst*

Great. Two questions. On the launch of the lower price Tread in the U.K., any early learnings on demand relative to your expectations? Like does it change production output plans? And also just any color on member satisfaction.

And then just a question on brand, with the pandemic, we see the shift in behavior to working out at home aside from incredible demand you're seeing for the hardware and Digital subscriptions. Just any way to frame the impact on the brand.

William J. Lynch - *Peloton Interactive, Inc. - President & Director*

On the -- I'll take the U.K. launch and Tread, we're just -- we're taking estimates up full stop based on what we've seen in the U.K. and we felt like we had baked in a plan that had a strong forecast there. And based on what we've seen early, we've taken it up. And that's really informed the decision on moving out the U.S. launch, general availability, 60 days, as John noted. We're going to be rolling out some orders here in the U.S. but the general availability moving it out 60 days because we think this is a rocket ship in terms of a product platform, and there's a lot of demand for it.

We've talked about the Tread market in the past vis-a-vis bike and the demand for running and bootcamp style workouts. John's talked about the efficacy of those workouts. Bootcamp as a content modality is one of our fastest growing on Tread+. So everything we're seeing, as we noted with U.K. on Tread, and then we'll learn next week from Canada, but all early signs there in terms of leads in Canada suggests the same thing, strong demand for that product.

John Paul Foley - *Peloton Interactive, Inc. - Co-Founder, Chairman & CEO*

And to your question on the order to delivery impacting our brand, we track -- go ahead.

John Ryan Blackledge - *Cowen and Company, LLC, Research Division - Head of Internet Research, MD & Senior Research Analyst*

John, not really not ordered -- not that impact. Just the shift in behavior and just the shift to working out from home, we're seeing it impact the hardware and subscriptions, but just the impact on the brand, like the -- everyone talks about pull forward of demand for the hardware, but how about the impact on the brand? And also any color on the shipping delays and that impact that would be helpful.

John Paul Foley - *Peloton Interactive, Inc. - Co-Founder, Chairman & CEO*

Yes. You're -- I'm struggling to understand your question. It's around a pull forward or...

John Ryan Blackledge - *Cowen and Company, LLC, Research Division - Head of Internet Research, MD & Senior Research Analyst*

Go ahead, sorry.

William J. Lynch - *Peloton Interactive, Inc. - President & Director*

We do research on consumer perceptions around home fitness and going back to the gym, et cetera. I don't know if this is what you're getting at, but as we study the consumer and we have quarterly tracking, and we do bespoke research. And what's clear is the shift into the home is not a COVID-led phenomenon. It has accelerated it. But we see, if anything, as we emerge to whatever the new normal is that the norms haven't changed. There is a secular shift into fitness in the home. As John has said before, it's a better experience and a better place at a better value. And consumers are all seeing that.

And so everything we've seen in the data, I think Jill has talked in the past about some of the bespoke research we've done on going back to the gyms and consumer perception on that vis-a-vis home workout suggests that certainly, COVID has been a tailwind for our demand. But in terms of demand for Peloton products and Connected Fitness in the home, we see continued momentum in foreseeable future.

Operator

Your next question will come from Ron Josey with JMP Securities.

Ronald Victor Josey - *JMP Securities LLC, Research Division - MD & Equity Research Analyst*

I wanted to talk a little bit more about Tread. And William, I think you just sort of talked about this. But with the delay of 60 days, go into May here in the U.S., can you just talk about the plans maybe you might have to ensure a quick, smoother rollout? So I think next week, we talked about pre-sale in certain ZIP codes here in the states. And then just tactically speaking, when things normalize, maybe less than 4 weeks, as we talked about, order delivery times would be the same across all devices. I just want to make sure that's true as we think just tactically as Tread rolls out and how we might think about that.

And then just a quick follow-up. Jill, you mentioned bringing more bikes and Tread to the states ahead of demand. And maybe just talk about the rollout of the network there and the build-out of the warehouses, how that might work.

John Paul Foley - *Peloton Interactive, Inc. - Co-Founder, Chairman & CEO*

Yes. For the new Tread, to William's point, it was such a fantastic success in the U.K., both on the sales and now on the -- now that we're delivering the product, the reception from the experience. And we know this from having -- my wife and I have had one of these Treads in our apartment in New York City for over a year. The experience, the software, the content, the classes are so fantastic, and we are now making thousands of them going to tens of thousands of them very quickly.

And so we're making them. We're delivering them. We've been running on them. We've been doing bootcamps for a long time. So there's not a lot of ambiguity around how fantastic this product is and how we're manufacturing it and delivering it using our existing delivery folks. So there's not a lot of wobble, to your point, as far as the launch in the States.

The biggest thing that informs the push from out 6 or 8 weeks here in the states was 2 things, is the stronger-than-anticipated demand in the U.K., and we didn't want to frustrate those members as they're ordering these Treads. And we want to make sure that they have plenty of inventory. And then we extrapolated that same strong demand in the U.S., and we didn't want to get off on the wrong foot with order to delivery with that new product line in the States. So I think we made a prudent decision. But the plan and the execution against that plan are rock solid, and we're feeling great. Not only about the rollout, but about the product itself and the experience that our members are already having on that platform.

William J. Lynch - *Peloton Interactive, Inc. - President & Director*

And then on OTD across all devices, we don't -- we want to solve for a reasonable OTD, for sure. We don't try to calibrate across product lines to make sure it's exactly on the pin. I mean especially with a new product where it's really more challenging to forecast demand than it is on a more mature product line like on the Bike product line.

And so for better or for worse, we think it's for better. Peloton has to make a lot of things across a lot of product lines these days. Frankly, in Fitness, there is no analog. No one's making in terms of scale of hardware, the kinds of volumes we are. And so we're building a supply chain that has not been seen before in Fitness. And so when you're approaching a new product, where demand has more variability, there's more beta to it than on other product lines, what you're trying to do is put yourself in the best position as you start to read the early sales results.

And that's what we're trying to do with Tread and to say we're going to manage it perfectly with Bike -- the Bike product line. That's not what we're trying to do. We're just trying to get ourselves in a reasonable position. We feel good about where we are in Bike, and we're going to manage it as best we can as we launch Tread.

Jill Woodworth - *Peloton Interactive, Inc. - CFO*

Yes. And I'll start the second question, but I have a feeling William may want to weigh in here. We're clearly using the $100 million to expedite the shipping of products so that we can get product into our warehouses stateside. There's obviously been numerous reports about the issues that are going on, right? There's container shortage. There is extended time of containership sitting out on the ocean, there is a backlog to get those containers unloaded.

And so this investment is essentially to circumvent all of those issues so that we can prioritize getting our major warehouses stocked up for us for our third-party 3PL partners. So that we can take down that order to delivery as quickly as we possibly can. At the same time, we're still going to be using standard ocean freight over time, which is our typical model. But we're certainly in our forecast now taking all of these new factors into consideration when we're planning out when that inventory is going to hit. But this $100 million is going to give us a massive jump start.

Operator

Our next question will come from Youssef Squali with Truist Securities.

Youssef Houssaini Squali - *Truist Securities, Inc., Research Division - MD & Senior Analyst*

So Jill, just on that last point, just to be clear. So this $100 million is going to be deployed over the next couple of quarters to bridge the gap until you're fully functional on the shipping side. Does that get you back to that 2 to 3 weeks that is ideal? Or starting next year -- your fiscal next year, i.e., in a couple of quarters, you may need to subsidize shipping with additional funds? So just that's the first question.

And second, on Precor, I was wondering if you can maybe flesh that out a little bit in terms of the strategic rationale of that acquisition, but probably things like what other products are they manufacturing right now that could help you accelerate the rollout of new customers to -- I'm sorry, the new products to new customers? And how much of your manufacturing statewide will that ultimately account for over time?

Jill Woodworth - *Peloton Interactive, Inc. - CFO*

So I'll take the first one. As we all know, support issues and COVID are incredibly fluid situations. And so it's hard to give you absolutes. But I can tell you whether it's now or in 6 months, 1 year or 2 years, we're obviously going to always do what's best for our members. And so I can never say never that we won't use expedited shipping.

But what I can say is that we do expect that this $100 million, which we recognize is a very large investment, we believe will get us back to normal shipping protocol by the end of this fiscal year. So the one element of the increase in cost that we're obviously using with air shipping and expedited ocean is also the fact that the shipping costs have actually increased a fair amount as well.

I think the last we looked it was about 3x of what we would normally pay. Good news is, is that shipping costs in a regular freight model are only 2% to 3% of our total COGS. So that could persist for months and months and months, and that's easy for us to absorb from a margin perspective. But we believe this is 100% going to get us in a very good position where we can better manage OTD.

John Paul Foley - *Peloton Interactive, Inc. - Co-Founder, Chairman & CEO*

I'll take the Precor question. As William said earlier, we love their commercial business. They have incredible products, product lines. They've got a great brand. They've got great service. We like that for all sorts of reasons. We like their facilities, their existing facilities, as we've talked about as well.

The third thing and the biggest thing that William alluded to that excited us most is their team. And their team knows how to make quality fitness equipment better than anyone in the world. And with Peloton, who now -- we're 8 or 9 years into our own quality fitness equipment, represents the 2 greatest quality fitness equipment manufacturers globally. And it's their in-house expertise of knowing how to make treadmills and bikes and all kinds of fitness equipment in scale, high quality, and that know-how and that R&D, not only the R&D on the products, but the R&D on the manufacturing is going to allow us to be very surefooted in the coming quarters as we invest in U.S. manufacturing and getting ready to make millions going to tens of millions of treadmills and bikes in the U.S. So that, to Jill's point, we don't have to move them all around the world. We can have in-location manufacturing plants, which is great for U.S. jobs. It's great for cost as you think about the transportation. It's great for flexibility where we don't have to come through the ports if there's congestion.

And as we become the global dominant fitness experience business, we want Asian manufacturing, we want U.S. manufacturing, and it creates optionality for us to service different markets from different points of entry. So we're very excited about that Precor and what that team represents to our supply chain globally moving forward.

Operator

Our next question will come from Heath Terry with Goldman Sachs.

Heath Terry;Goldman Sachs Group, Inc., Research Division;MD & Senior Internet Equity Research Analyst

Just wanted to dig a little bit deeper into how you're thinking about marketing, especially as you catch up as planned to sort of where -- to consumer demand. Obviously, it had been a massive benefit to the bottom line, having the backlog and the demand that you have from consumers. How do you think about wading back into that, the pace and, I guess, impact to profitability, whenever that does have to happen?

William J. Lynch - *Peloton Interactive, Inc. - President & Director*

Heath, it's worth noting that, I think Jill alluded to this, the expedited shipping investment brings down OTD. So -- and that gets inventory into warehouses, which is going to allow us to get aggressive with marketing, really for the first time since the spring of last year. So in Q3 and Q4 in the guidance that Jill provided, in our plan, we've got a substantial increase in marketing. And we want to market. We want to fuel the growth of -- we've had amazing organic growth. We want to further fuel that growth and increase -- we look at leading indicators like purchase intent on Bike+ and Bike. Interestingly, we launched Bike+, it dropped the price of Bike, and we really couldn't exploit those opportunities from a marketing standpoint. So we've got what we believe is an unbelievable product and experience in the way of Bike+ and really haven't gotten to tell the story with our amazing marketing team. And so we want to do that.

We also want to talk about the value that the Bike, the original Bike offers at $49 a month with the amazing financing offer. So we're going to get back to going aggressively into marketing. That plan is reflected in our guidance as we get into the backlog and bring down OTD, that marketing works even more efficiently.

And so that has the team really excited, and we believe positions us well, not only as we end this fiscal year, but going into '22 as we build demand. And also, I should have mentioned for Tread as well, talking about new products and digital. And so yes, there's a substantial increase in marketing, as Jill said in the opening statement, investment built in, as a percent of sales, built into Q3 and Q4. And the way we think about that is if we can acquire a customer well within our CAC thresholds for marketing, and we know it fuels growth for us, we're going to take that -- advantage of that opportunity.

Operator

Our next question will come from Bernie McTernan with Rosenblatt Securities.

Bernard Jerome McTernan - *Rosenblatt Securities Inc., Research Division - VP & Senior Research Analyst*

When you think about customer lifetime value, how does the shipping -- higher shipping costs kind of impact that equation? I believe you said you don't expect these new short-term shipping initiatives to flip the calculation on the net customer acquisition costs. And then as a follow-up, what went to the decision to pay more for shipping now versus 6 months ago, for example? Is it because of more supply coming online with Shin Ji?

Jill Woodworth - *Peloton Interactive, Inc. - CFO*

Great. So thank you for bringing up, I think, one of the favorite ways I have of looking at our business model, and that is clearly lifetime value of our subscriber base. And the thing that we've always loved to highlight, especially as we've gone very negative CAC in the last several quarters, is the fact that we earn a gross profit on our Connected Fitness products. And we're in a position even with these investments such that those gross profit dollars offset -- more than offset all of our customer acquisition costs on a fully loaded basis, which means thereafter, we have a very high margin, long lifetime value, given our low churn of our subscriber base, value of our subscribers.

So from our standpoint, certainly, this does not change that equation at all. It just goes back to the rationale as to why we don't care about gross profit margin percent, we care about the gross profit dollars. And obviously, with the growth in our revenue base, and even with the ramp in marketing spend expected in the next 2 quarters, our net customer acquisition costs are negative in Q3 and Q4 and certainly for the full balance of the fiscal year.

William J. Lynch - *Peloton Interactive, Inc. - President & Director*

And then on the second part of your question on why the expedited shipping now versus 6 months ago. This is meaningful, and we appreciate the question in that 6 months ago, if we looked at it, it wouldn't have helped because if you looked at what we were manufacturing on a daily basis versus what we were selling, that was in a deficit, that equation. Meaning we were building the backlog. With COVID, in effect, pulled our business plan in a year. And so we were just reacting to that, and it takes a while to ramp source components and everything that goes into the production of our fitness equipment.

Now as John noted, we ramped production and manufacturing, added 2 facilities such that pulling in and shortening in effect the lead time on logistics, one, allows us meaningfully to drive down OTD and backlog. But two, we've got more inventory coming on the ocean behind that. And so that's what makes those investments worthwhile. Had we done it before, you were just kicking the can down the road and it would have been solving short-term OTD, but there's no light at the end of the tunnel.

Now as John noted, there's light at the end of the tunnel. So we thank our teams who have, I think, John used the term Herculean effort, we think the teams and the capability to ramp that production. But it puts us in a really -- a much more favorable position, and it doesn't show up immediately in OTD, but it puts us in a much more favorable position than we were 6 months ago. And in that ramp in manufacturing, we think is going to be a competitive advantage for us in the future to support growth.

Operator

Thank you. Ladies and gentlemen, thank you for participating in this evening's question-and-answer session. I would now like to turn the call back over to Mr. John Foley for any closing remarks.

John Paul Foley - *Peloton Interactive, Inc. - Co-Founder, Chairman & CEO*

Thank you much. So in closing, I want to reiterate that we are a company, as you know, that is obsessed with our members' experience. Today, we are putting our money where our mouth is, this $100 million commitment to our members to get on the right side of the line with them, something we're very excited to do and makes sense for our brand and for our new members.

We are not using hope as a method, so to speak. These extraordinary circumstances obviously require extraordinary actions, and that is exactly what we're taking. I'd like to again apologize to all of our new members who haven't had a great experience in the last few months with their deliveries. Know that we care about you, and we're taking action.

To our team of almost 8,000 people globally, thank you for all that you do. I know it's been a tough and stressful 12 months since we've been deep in the COVID world. But we're getting there on all fronts, as you know. We are, as far as I know, the fastest-growing scale consumer technology company in the world. You should be proud. Your hard work, creativity and innovation continues to be an inspiration to me personally and to anyone who gets to see you in action. Let's keep pushing, and I'm confident that we will surprise the world in the coming years.

Until then, until next time, thank you, everyone, for tuning in.

Operator

Ladies and gentlemen, this concludes today's conference call. Thank you for your participation. You may now disconnect.
