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PRESENTATION

Operator

Good day, and thank you for standing by. Welcome to the Peloton Interactive First Quarter 2023 Earnings Call. (Operator Instructions) Please be advised that today's conference is being recorded. I would now like to hand the conference over to your speaker today, Peter Stabler, Head of Investor Relations. Please go ahead.

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

Good morning, and welcome to Peloton's fiscal first quarter conference call. Joining today's call are CEO, Barry McCarthy; and CFO, Liz Coddington. 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 laws.

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 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.

I'll now turn the call over to the operator for the first question.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question will come from the line of Doug Anmuth from JPMorgan.

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

Barry, it's clear you've made progress on the cost structure and free cash flow loss. But how should we think about your plan to drive growth? And in particular, can you give us an update on the FaaS rental model and how that's progressing so far?

W. Barry McCarthy - *Peloton Interactive, Inc. - CEO, President & Director*

Doug, thanks for the question. Well, look, our focus -- our job one is to ensure the viability of the business, which, a year ago, was in doubt, and I believe that is no longer the case. Because of our focus on driving -- rightsizing the cost structure, variablizing costs and driving the business towards our goal of breakeven free cash flow. Clearly, that has come at the expense of growth, and there will come a time when we begin to focus again on growth.

With my leadership team, we have already made that transition. But the question is -- I'm not framing this question at the end of my letter this quarter, how fast will we grow, what will the margin structure of the business be? We'll begin to see the answers to those questions take shape later this year as we lean into a number of the strategies that we've already articulated, like Fitness-as-a-Service and Peloton certified preowned; and expansion into our third-party retail partners; and as we lean into growth in our commercial business; and as we lean into relaunching the digital app business to, and in pursuit of, that goal of 100 million users, which I talked about when I first joined the business.

As it relates to FaaS, it's growing really fast. About 1/3 was less of new sign-ups. We're doing an average over the last 2 weeks of about 175 sign-ups a day. We've only kind of -- and we've only just begun leaning in on the web to growth. There's still unanswered questions about whether or not it would be financially viable for us long term. But what I've learned from the early growth is that we absolutely have to figure out how to make it work for us because it's enormously popular with users, and it's -- there's a considerable incrementality to it. And we are attracting to our subscriber base, a demo which we have not previously been able to access, so it's expanding our TAM.

So we need to look at the underlying economics. And the way we do that is by focusing on the monthly price, which drives churn. And we need to understand more about what percentage of those, over time, will exercise the option to buy out the bike. And probably, we will adjust, over time, the buyer options. Liz, anything you want to add to my summary with respect to FaaS?

Liz Coddington - *Peloton Interactive, Inc. - CFO*

No, I think -- the only thing that I will say is that we -- something about FaaS that's important to note, if you think about the growth of the business, is that the revenue profile and gross margin profile was a little bit different from our core business. And so as FaaS grows, we'll see that the revenue will take longer to be -- we're not getting the benefit of the purchase of the Connected Fitness hardware in the period because we'll get the rental income from that over time. So just highlighting that for everyone.

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

And is there any kind of -- I know it's still early, but any kind of target or outlook on what you think FaaS could represent as a part of sales over time?

W. Barry McCarthy - *Peloton Interactive, Inc. - CEO, President & Director*

Reminder -- you mean of the user base?

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

Or just new subscribers?

W. Barry McCarthy - *Peloton Interactive, Inc. - CEO, President & Director*

30% or more of new subscribers, more than that on a net basis, because there's effectively no churn across the installed base. So the percentages of gross versus net would be quite a bit different.

Operator

Our next question will come from the line of Edward Yruma from Piper Sandler.

Edward James Yruma - *Piper Sandler & Co., Research Division - MD & Senior Research Analyst*

I want to rotate a little bit towards this construct of growth. Two vectors, though: the app, I guess, which I think you guys noted you saw some softer results; and then maybe any insight into your view, Barry, on some of the newer modalities like Guide and Row.

W. Barry McCarthy - *Peloton Interactive, Inc. - CEO, President & Director*

Sorry, Guide and what was the other one?

Liz Coddington - *Peloton Interactive, Inc. - CFO*

Row.

W. Barry McCarthy - *Peloton Interactive, Inc. - CEO, President & Director*

And Row.

Edward James Yruma - *Piper Sandler & Co., Research Division - MD & Senior Research Analyst*

Row.

W. Barry McCarthy - *Peloton Interactive, Inc. - CEO, President & Director*

Yes. Coming back to FaaS for a moment, Doug, 1 additional comment. In my nirvana would be that we see attractive payback in somewhere between a year and 18 months. I think the product is viable, but not as a [dragger] for 2 years. And so when I talk about the financial viability of the product, it's sort of through that lens. But we're thinking about how we tweak price and buyout option and, directionally, monthly churn, if that's helpful.

[In terms] of growth in the digital app, we deemphasized it a little bit. Our strategy is to relaunch the digital app in the new year. It will be a different price value opportunity than it is currently. There'll be a tiered pricing associated with our content strategy -- a new content strategy. We're chasing the 100 million digital app users. The current product has never really grown bigger than 1 million.

We -- the overarching strategy here is to gain access to competitive Connected Fitness hardware platforms. About half the users, paid users of our digital app, at one time or another use, are Connected Fitness content on someone else's hardware. We've never actually marketed that use case. We're going to lean into it. The digital app has kind of come at the end of our marketing funnel. We're going to move it up to the top with a premium offer and try to lean into that growth opportunity.

In terms of Guide. Customer FaaS scores are really high. The unaided brand awareness is really low relative to other products, like 17. And the purchasing [sense] scores are higher or higher than any of the other products in our product line based on some research I saw overnight. So it's an opportunity we haven't really leaned into. I don't think we've quite figured out how to market it effectively. So it's doing okay, but it's not doing nearly as well as you would think it would do based on the metrics I just described.

With respect to Row. I think Tom Cortese and his team can be justifiably proud in having reinvented the Row category, like they reinvented the Bike category with the Connected Fitness content. The good news and the bad news about Row is, for this fiscal year, we expect to be inventory-constrained. And they have more demand than we will have units to sell, and that we're working to address those issues.

But at least, for the moment, it's been critically quite well-received. And we have just rolled it out through all of our showrooms as of yesterday, but in a limited number, like [16]. And so I expect the demand for Row to continue to grow as we increase people's exposure and the opportunity to get on and try it and see what's (inaudible) about it.

Operator

Our next question will come from the line of Justin Post from Bank of America.

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

Great. Can we talk a little bit about the kind of the 2Q sub guide? I think it's 30,000 subs, and you've got kind of retail kicking in, obviously, some rowers, and then it's holiday promotion time. How do you put that in context of your overall growth plans? What does it mean for the year?

And how are you thinking about the kind of reopening and macro challenges being maybe different this year than in future years? Maybe put all that in context. And then one quick one on the Fitness-as-a-Service. Is that contributing to slightly elevated churn? Or is it still kind of immaterial at this point?

W. Barry McCarthy - *Peloton Interactive, Inc. - CEO, President & Director*

Let me just do the churn piece. So it does have higher churn, but it's immaterial. It would be like a basis point. So I think we can ignore the effect of FaaS one on churn for the foreseeable future.

The sub growth during holiday is paced by the decrease in the spending, which is quite substantial on a year-over-year basis and on a sequential basis. We want to spend more, could -- we could have significantly more growth.

I guess the other comment I want to make about growth, and then I'll turn it over to Liz is, it's not very ambitious target. And there's good news and there's bad news in that. And then it is we'd like it to be higher, and we'll see what happens. But the good news is, there ought to be limited downtime in that number. And from a cash flow perspective, I think you're on the right side of that equation (inaudible) purposes.

Liz, anything you want to add?

Liz Coddington - *Peloton Interactive, Inc. - CFO*

Yes. I was just going to say that we have seen some research that indicates that the economy is a headwind for us as it is for many other companies. And that is certainly having an impact on near-term Connected Fitness hardware demand.

Operator

Our next question will come from the line of Eric Sheridan from Goldman Sachs.

Eric James Sheridan - *Goldman Sachs Group, Inc., Research Division - Research Analyst*

Maybe following up on Justin's on retail. Just how should we be thinking about the contribution from some of the new retail partners beyond just the December quarter? And how you think they can help evolve the distribution strategy in light of what may remain sort of dampened end-demand environment short term, which you're widening out the distribution narrative around the name? How should we think about those countervailing factors in terms of supporting growth as we turn the calendar into calendar 2023?

W. Barry McCarthy - *Peloton Interactive, Inc. - CEO, President & Director*

Let me say we have some of the same questions. We've broadened our retail strategy because we felt it was important to be where our customers are. But the only way to know how successful this strategy will be is to actually lean into it and see what happens. And then based on what we're learning, flex the business model in order to capitalize on the successes and minimize any losses. It comes at the cost of some margin.

How has it gone so far? Well, Amazon has outperformed our expectations for sure. We just launched DICK'S Sporting Goods. We have high expectations for it, but it remains to be seen how it will perform over time.

Anything you want to add, Liz, to that?

Liz Coddington - *Peloton Interactive, Inc. - CFO*

No. I think that covered it. But I do want to go back to the prior question that got cut off. I apologize, the fire alarm went off for a second in the middle of our call, which is unfortunate. So going back to that question around our guidance forecast. I was talking a little bit about the economy and creating a headwind for us and for many other businesses right now.

I do want to say that we do have confidence that our Q2 guidance forecast incorporates the latest on macroeconomic trends. And to Barry's point, we do have the ability to grow faster if we wanted to. But because we are trying to balance on delivering on our cash flow goals that we have not been overly aggressive in our guidance forecast for Q2.

I do want to point out that, again, FaaS and -- Fitness-as-a-Service and our CPO, which we -- has been a strength for us, and we're continuing to grow FaaS, CPO. We may or may not be able to do in Q2, we'll see. But we also witnessed secondary market activations being another opportunity for us to grow subscribers as well.

In the context of the overall year, we are still not providing any sort of full year guidance on revenue or sub. But what we said last quarter still holds in that we do expect revenue for the year to resemble the seasonality of fiscal '22 in terms of revenue per quarter, if that helps the folks with their modeling.

W. Barry McCarthy - *Peloton Interactive, Inc. - CEO, President & Director*

Just comment on -- I have 1 additional comment. So Liz touched on the growth in secondary market active subscription activation. That has grown significantly over the last year, and I expect it to be a source of operating leverage for us. And we're talking about how we can lean into that ecosystem and ensure that it's healthy and viable.

So (inaudible). This is someone who owned a bike, it became a potted plant in their home. They sold it in the secondary market. Someone bought it and had -- this someone activates the subscription and becomes a monthly subscriber into (inaudible).

Operator

Next question will come from the line of Lauren Schenk from Morgan Stanley.

Lauren Elizabeth Cassel Schenk - *Morgan Stanley, Research Division - Equity Analyst*

Can you hear me?

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

Yes. Go ahead, Lauren.

Lauren Elizabeth Cassel Schenk - *Morgan Stanley, Research Division - Equity Analyst*

On the Connected Fitness gross margin, still negative 12%, even excluding the recall impact. I guess with the restructuring changes largely behind us, what needs to happen to get that back into positive territory? And what's the rough time line for that?

Liz Coddington - *Peloton Interactive, Inc. - CFO*

So you're correct. First of all, yes, you're right. If we adjust for the Tread+ recall, we would have been at a negative 11.6% gross margin. We are expecting to see increases -- sorry, first of all, I want to highlight, before I even start talking about (inaudible), I want to highlight the improvement that we've seen in our gross margin quarter-over-quarter from Q4. So it's a tremendous improvement.

In Q2, our overall gross margin, we're expecting to be around 36%. And then for Connected Fitness, we're not guiding to that, but we are expecting to see continued improvement as we improve our middle mile and logistics costs and thus for final mile. We'll see those continue to improve over time.

One thing -- things that you put pressure on our gross margin, though, are things like FaaS, for example. So as FaaS continues to grow, that will put pressure because of the fact that we do take the expense for the delivery cost of the bike upfront. And then also the economics of third-party retail are such that they do put pressure on our gross margins as we consider the marketing expense associated with those channels as contra revenue.

So the key thing that I want to point out is that we are managing our business towards generating an improvement in gross margin and then also overall generating positive cash flow and positive adjusted EBITDA. So overall, we're -- we want to look at gross margin, but we need to also realize that some of these programs have just a different cost structure and profile. And it may bear out that we have some impact to gross margin, but we see a benefit elsewhere in the P&L, if that makes any sense.

W. Barry McCarthy - *Peloton Interactive, Inc. - CEO, President & Director*

If I could just tease out 1 additional nuance. Could you comment on how long you think it takes for the cost reduction in final mile and middle mile freight, those kinds of things that find their way through our balance sheet and into the P&L?

Liz Coddington - *Peloton Interactive, Inc. - CFO*

I think this is something that is going to take a little bit of time, but we are seeing the benefit every quarter gaining more and more traction. So I think probably by -- I don't want to give us the specifics. But hopefully, by the end of the year, we should be in a much better spot on that.

W. Barry McCarthy - *Peloton Interactive, Inc. - CEO, President & Director*

Just trying to tease out the average pricing versus [LIFO]. The only point is that as the economy and freight costs decline and we restructure our middle mile and last mile, because of the way we account for our inventory, it's going to take a while for those benefits to find their way into the P&L. We have the cash benefit, but we don't see the P&L benefit.

Liz Coddington - *Peloton Interactive, Inc. - CFO*

Yes. The point is that, like the freight cost, the one we bought some of that inventory on, that was more expensive. That will have to work its way through our inventory. And then the other piece is that our storage costs will continue to decline as we lap that inventory around. So those things will also be benefits as we lower our inventory position. That will be ongoing through the end of the year and probably into FY '24 as well.

W. Barry McCarthy - *Peloton Interactive, Inc. - CEO, President & Director*

And our storage costs have been very significant.

Operator

Our next question comes from the line of Shweta Khajuria from Evercore ISI.

Shweta R. Khajuria - *Evercore ISI Institutional Equities, Research Division - Analyst*

How much -- how does the accounting for these third-party retail partnerships actually work? So whether it's DICK'S Sporting Goods or Amazon or Hilton, how should we think about how you're accounting for in terms of subscribers revenue? And then, Liz, you also mentioned there is a contra revenue aspect of it. So it would be great to understand that.

And then the second is, Barry, if you could talk about how the leadership team and the company is organized now for growth. So how are growth initiatives internally managed as the leadership team reports to you? And which segments are focused on for long-term growth?

Liz Coddington - *Peloton Interactive, Inc. - CFO*

So as far as the third-party retailers go, we do have a couple of different models that we use to work with them. So in the case of Amazon, we have a wholesale model. So Amazon will buy the inventory from us and then they will resell it, and our revenue recognition will come at the time that we actually sell the inventory to them rather than when they sell it to the customer.

And the subscriber will come even later. So they have to sell the bike to the subscriber. It has to get delivered and then the sub has to activate. So think about that being a longer time frame from when the inventory gets sold to when we actually see the subscriber activation. There will be a disconnect in timing there.

With DICK'S, we have some wholesale types of model, but we also have a drop-ship model. So that's the case where somebody walks into a DICK's Sporting Goods, orders a bike or tread, and then they send a signal to us, and we then fulfill the order and deliver it to the customer. So in that case, we recognize the revenue at the time of delivery, like we do in our regular web sales. And so -- and the activation will be similar timing, we expect, as from when they get the -- receive their Bike, when we recognize revenue and we get the subscription. So there is a couple of different models going on there.

But as these different models, they're out over time, they're small right now, but they could have an impact on how we model out -- how we see the subscription growth -- revenue growth in comparison to the Connected Fitness growth.

W. Barry McCarthy - *Peloton Interactive, Inc. - CEO, President & Director*

And then there was a part of the question about contra revenue, Liz.

Liz Coddington - *Peloton Interactive, Inc. - CFO*

Yes. Well, it's -- basically, what happens is with -- we do have some marketing expenses that we -- that are in our agreements with -- particularly with Amazon. The way that those show up in our financials as -- is a reduction to revenue. And so that is -- it's just a different model than -- it doesn't show up in the marketing expense line.

W. Barry McCarthy - *Peloton Interactive, Inc. - CEO, President & Director*

Thanks for that. With respect to the leadership team and growth, I lead the effort. There's virtually no piece of the business that we haven't reorganized in some form or fashion. And there's been a substantial change in the composition of the leadership team.

Last quarter, we restructured our approach to the market. Some people left the business as a result, and we're in the process of leading the search for a new Head of Marketing. In the interim, the marketing team is reporting to me. And I'm spending a considerable amount of time focused on how we grow the business, how we work cross-functionally when we rolled out our various initiatives.

I'm quite proud of the team's performance with respect to the launch of Amazon, by way of example. There's virtually no function group in the business that wasn't touched by the complexity of that launch. This is equally complicated. FaaS is equally complicated. Certified preowned is also quite complicated. So it's about executing with precision and speed and risk-taking.

Operator

Our next question comes from the line of Deepak Mathivanan from Wolfe Research.

Deepak Mathivanan - *Wolfe Research, LLC - Research Analyst*

So first, Barry, churn, after making the adjustments for Canada, is around like 1.2%. It's certainly better than 1Q, but are you comfortable with these levels as you think about the next, say, 18 to 24 months? Can you give some color on the profile of customers that are kind of churning right now?

And then the second question, a little more strategic one. The channel expansion and distribution makes a lot of sense. But curious if we have explored opportunities to kind of leverage Peloton brand and content that you have for something in-person, maybe either under a franchise model or through kind of partnerships with other in-person fitness studios? And I would love to hear your thoughts on that.

W. Barry McCarthy - *Peloton Interactive, Inc. - CEO, President & Director*

I think the first part of the question, Deepak, was -- any color on who's churning? The short answer is no. Churn is one of the aspects of the business, along with Tom Cortese's Product Group and Jen Cotter's content team don't focus on. And the reason I don't focus on it is because it works well, and it's not even remotely broken. And there is no operating leverage to be had in my trying to say reduce by a couple of 4 basis points. It's just not going to happen.

What I am focused on with Tom's team, with Jen's team is in improving the user experience, primarily by leaning into personalization. We've made that a large focus area. There are a number of improvements that have already happened and are in process, both on your screen on a Connected Fitness device and in the digital app. My belief is that, with a more deeply personalized experience, we will see -- we will continue to see improvements in engagement. Engagement improved versus pre-COVID period, about -- just shy of 20% in the current quarter.

So I don't mean to signal that we have engagement issues, but I think it can be better still. And if it is better still, I think we will grow faster at a lower cost because we will have more organic growth because we'll have more delighted subscribers then. We believe that because that was the phenomenon we saw at Spotify, and that was the phenomenon we saw at Netflix. So this is my comments on churn.

And as it relates to leveraging the brand through in-person fitness, I spend quite a bit of time thinking about this. And this is a use case that I'm trying to attack with our digital app. And I think doing it that way is the better go-to-market strategy than trying to negotiate revenue-sharing split with other commercial businesses and having to pay what I think would be considerably higher. We used to rightsize the consequence of it becoming a commercial application.

So I'd rather sell to you and have you take your digital app wherever you want to take it to engage in our content. It could be your home. It could be the gym. It could be your friend's house. It could be outside while you're running. That's a much larger TAM for us and has a better margin structure for us.

Operator

Our next question will come from the line of Ron Josey from Citi.

Ronald Victor Josey - *Citigroup Inc., Research Division - MD*

Barry, I wanted to maybe walk back to turn around here and just about the free cash flow guidance. I think the letter talked about reaching near breakeven in '23. So if you could just help us a little bit more on the investments and also what makes you feel better about beating that 1-year time line and beating the goal here to getting to breakeven? So questions on free cash flow and breakeven in the back half.

And then any update on the ad campaign? I think we saw it in mid-September. Obviously, we know the guidance here for the holiday quarter. But talking -- just curious about the receptivity of the campaign.

W. Barry McCarthy - *Peloton Interactive, Inc. - CEO, President & Director*

I'm going to ask Liz to talk about the free cash flow guidance. And then I might ask you to repeat the second part of the question. I had a hard time hearing it, I'm sorry.

Liz Coddington - *Peloton Interactive, Inc. - CFO*

So while we haven't specifically guided to a free cash flow number at all, we talked about our goal of reaching free cash flow at breakeven or near breakeven by the second -- for the second half of the year. And we remain on track to being able to achieve that goal. It's not certain. There's always some risk. It's not a guaranteed outcome.

But you can see in our -- this quarter, we reduced our cash burn significantly from the prior quarter and the quarter before that. So we are making a tremendous amount of progress towards that goal, and we continue to remain focused on it. So that's -- there's -- that's our goal, and we're continuing to maintain that we'll be able to deliver on it.

W. Barry McCarthy - *Peloton Interactive, Inc. - CEO, President & Director*

I would add then a couple of things. One is, I've grown increasingly confident in our ability to forecast free cash flow based on our recent performance over the last few quarters. So Liz and her team have done quite a good job there, and we've made considerable progress. So that's point one.

Point two is a little color on cash flow. A quarter or 2 ago, I think there was the impression that because we have a lot of inventory, at least in the first half of the year, we've got a big tailwind as we liquidated that inventory and didn't pay to replace it.

That is true, but we also had a big headwind, and that was the settlement payments that we negotiated with our suppliers when we realized that we had contractually committed to more inventory than we had understood back in the March time frame. And those 2 kind of netted out across the entire year.

I think there's a net benefit in the order of $86 million, something like that. So it's entirely immaterial to the business, and I just want to make sure that, that nuance was well understood.

Liz Coddington - *Peloton Interactive, Inc. - CFO*

And that is certainly true this quarter, for sure, in Q1, that any inventory benefits that you see with inventory balances coming down is offset by supplier settlements for the quarter, more than offset.

W. Barry McCarthy - *Peloton Interactive, Inc. - CEO, President & Director*

The last point I want to make is with respect to restructuring. We recently eliminated roughly 500 heads in order to complete our rightsizing of the cost structure of the business. So we are done now. And in my humble opinion, there are no more heads to be taken out of the business.

And so from a cash flow perspective, we're going to meet our performance. The rest of the business needs to perform as we expect the business to perform, meaning our working capital dynamics need to be more or less aligned with our forecast. Our growth needs to be more or less aligned with our forecast. Cost for inventory needs to be aligned with our forecast.

We're not going to get there by taking additional heads out of the business and reducing operating expenses. And I just want to be -- I want to be clear with investors about that. I want to be clear with our employees about that. We are done. This is the go-forward team.

Liz Coddington - *Peloton Interactive, Inc. - CFO*

The last thing that I will caveat to that, just for completeness, Barry, is that we are still working through our first-party retail showrooms. And so we are -- that is one of those processes that just takes time to get out of some of these showroom leases. And so that will be the one ongoing piece that we will still have through the end of fiscal '23 and likely into fiscal '24 as well.

W. Barry McCarthy - *Peloton Interactive, Inc. - CEO, President & Director*

All already announced (inaudible) thanks for the clarity.

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

And Ron, could you repeat your question about the advertising campaign? We didn't understand it.

Ronald Victor Josey - *Citigroup Inc., Research Division - MD*

Yes. I appreciate the answers on the free cash flow. Just on the ad campaign, I think we saw it started -- at least, a new campaign started mid-September. And understood we have guidance here for the holiday quarter. But just curious on the receptivity of this recent campaign that we're seeing ads for the broader Peloton family of products. So any insights there would be helpful.

W. Barry McCarthy - *Peloton Interactive, Inc. - CEO, President & Director*

Well, let's think about it in terms of purchase intent. One, purchase intent for the brand is up slightly everywhere, except for Germany, where it's taken a slight hit because of the advertising campaign or not, hard to say, honestly. Second point I would make about advertising generally and not the campaign specifically is that, in the current market environment, our dollars are going a lot farther than they were a few months ago because the advertising market has softened considerably. And so we were able to acquire more media impressions for dollars spent than we were expecting coming into the holiday season. It means have you seen how that translates into growth, but it is the first tailwind we've seen in that marketplace in the long term.

Operator

Our next question will come from line of Aneesha Sherman from Bernstein.

Aneesha Sherman - *Sanford C. Bernstein & Co., LLC., Research Division - Research Analyst*

Yes. So Liz, you gave some great color on the hardware gross margins and the trajectory. I wonder if you could talk about the sub gross margin? And where do you think this could go as it scales up? And what -- can you give some color on where it was on an underlying basis? It seems like you had some one-off costs on music and things like that. So where are we underlying? And then where could it go as it scales up?

And then I have another question on inventory. It was down $100 million. Obviously, you have a lot more distribution points and FaaS, et cetera. Is $100 million a good run rate? I mean is that what you're kind of modeling through the rest of the year as you work through your existing inventory?

Liz Coddington - *Peloton Interactive, Inc. - CFO*

I'll take the part of the question around subscription margin first. So we did see some pressure on subscription margin, particularly in this quarter, down a bit from Q4, in line roughly with the prior year. There are a couple of drivers of that. One of them was just higher music licensing reserves for minimum guarantees, and that's related to just our subscriber growth and reserving for those.

We also had some elevated stock-based comp costs for Q1, and that was specifically related to our equity repricing and vesting acceleration. And so we don't expect any further pressure on subscription margin going forward. But we wouldn't expect in the very near term for it to go up substantially from where it's at right now.

The other question about inventory. So we do expect inventory to decline throughout the year. I don't necessarily have a view of how much it's going to decline quarter-by-quarter. One thing I do want to point out is we do have some inventory that we need to buy, specifically related to like the rower and -- but we will see continued sequential declines in inventory as we work through it over the course of the year and beyond.

Aneesha Sherman - *Sanford C. Bernstein & Co., LLC., Research Division - Research Analyst*

Okay. And 1 follow-up. Do you have any color on what the subs margin was ex those one-offs this quarter?

Liz Coddington - *Peloton Interactive, Inc. - CFO*

I couldn't quite -- I'm sorry, could you repeat that? I couldn't quite hear the first part of that.

Aneesha Sherman - *Sanford C. Bernstein & Co., LLC., Research Division - Research Analyst*

Sorry. I just had a quick clarification on the subs point. Do you have any color on where the subs margin would have been ex those one-off costs this quarter?

Liz Coddington - *Peloton Interactive, Inc. - CFO*

I don't have a specific number for you, but it's not -- it's -- say we're going to -- that it came down from where it was in Q4, you could say. It's hard to give you exact percentage of how much of that is related to the minimum guarantees in each piece. But I would say that where we're at now is a reasonable rough approximation of where we'll be for a while.

Operator

Our next question comes from the line of Mario Lu from Barclays.

X. Lu - *Barclays Bank PLC, Research Division - Research Analyst*

Just wanted to follow up on the comment you made earlier in terms of revenue seasonality for the rest of the year. I just wanted to confirm, is that related to total revenue or just Connected Fitness revenue for the rest of the year?

Liz Coddington - *Peloton Interactive, Inc. - CFO*

That would be total revenue.

X. Lu - *Barclays Bank PLC, Research Division - Research Analyst*

Got it. And then, Barry, you mentioned half of the digital subs currently is likely using somebody else's hardware. I understand some of the classes right now on Peloton Guides in the future, Row classes may be gated to only owners of Peloton devices. Can you talk a bit about this potential strategy of gating classes? And if that could be a significant uplift to convert digital subs over time?

W. Barry McCarthy - *Peloton Interactive, Inc. - CEO, President & Director*

I'm going to hold off on talking about the digital strategy until we roll it out, other than to say that it will have a freemium component and there will be gated Guides, yes.

Operator

And our last question will come from the line of Andrew Boone from JMP Securities.

Andrew M. Boone - *JMP Securities LLC, Research Division - MD & Equity Research Analyst*

On the guide, it feels like OpEx declines are starting to slow as we think about next quarter. Can you provide a little bit more detail around R&D and G&A? Understood headcount is kind of stable, but any help in terms of other items that may be involved there? And then can you talk about the consumer reception to self-assembly and how that's gone?

W. Barry McCarthy - *Peloton Interactive, Inc. - CEO, President & Director*

Sorry, the consumer reaction to what?

Andrew M. Boone - *JMP Securities LLC, Research Division - MD & Equity Research Analyst*

Self-assembly.

Liz Coddington - *Peloton Interactive, Inc. - CFO*

Self-assembly. So with regard to the OpEx -- we -- some of the changes that we made regarding that reduction in force, those were Q2 events. So we will see some declines in both G&A and R&D over the coming quarters. What you'll see in Q2, and that's reflected in our adjusted EBITDA guidance, is the fact that we will be spending more quarter-over-quarter on marketing as part of the holiday kind of promotion timing.

So that's -- so to the extent that you're looking at the guidance and trying to back into what that implies for G&A and R&D, there will still be some declines there, offset by some higher spending in the quarter for sales and marketing. I hope that addresses that question.

W. Barry McCarthy - *Peloton Interactive, Inc. - CEO, President & Director*

Let me say, longer-term, G&A just got to come down as a percent of revenue, just to be clear. It's structurally broken currently. I can see the path to fixing it. There will be some additional spending along the way. From an IT perspective, there are a number of things that need to be fixed. And when they're fixed, they become the road map towards significant cost reduction. And then do you want to, Liz, address that (inaudible) comment on self-assembly?

Liz Coddington - *Peloton Interactive, Inc. - CFO*

No. The -- I haven't seen much about self-assembly, aside from the fact that there hasn't been a lot of complaints about that. So to the extent that customers are not complaining about it, it's a good thing. And yes, so that will be the -- we are getting good star ratings on Amazon. So that, again, gives confidence that the self-assembly is working.

Operator

And that's all the time we have for Q&A today, and this does conclude today's conference call. Thank you for participating. You may now disconnect. Everyone, have a great day.

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

Thank you very much.
