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PRESENTATION

Operator

Good day, and welcome to the Peloton Interactive Third Quarter 2023 Earnings Call. (Operator Instructions) After a few brief opening remarks, we will be immediately going into our Q&A session. (Operator Instructions) Please be advised that today's conference is being recorded.

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

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

Thank you, Sherry. Good morning, and welcome to Peloton's fiscal third 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 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.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) The line of Doug Anmuth with JPMorgan.

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

I just wanted to ask, Barry, if you could talk more about the upcoming changes in brand positioning? And just a little bit more about what you think is misunderstood around the brand, the products and how people use them, and how those changes in brand position can help drive growth going forward?

And then also perhaps, Liz, if you could just talk about the potential. I know that the DISH settlement will weigh on free cash flow in 4Q. Can you just update us on your path to positive free cash flow ex that settlement?

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

Good morning, Doug. Thanks to everybody for making time to join us this morning.

I'm not going to say too much about the brand repositioning. I want everybody to experience it along with the consumers at the same time. In the letter, I spoke about the fact that we're primarily known as a bike company, but the behaviors of our members extend well beyond that. Into many different categories of exercise and a large percentage of folks use no hardware at all. We have done a very good job of communicating that to prospective members, and we're looking to improve upon that. I think the advertising can be more inclusive than it has been historically.

And then lastly, of course, we have been promising to reintroduce the app that moment is soon to be upon us, and that will receive considerable focus in marketing relaunch as well.

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

And Doug, to address your question about free cash flow. As Barry mentioned in the shareholder letter, the DISH settlement and related expenses associated with that settlement will put pressure on our free cash flow in Q4. So if you exclude those items, we actually are pretty close within striking distance of achieving free cash flow breakdown. And we are -- the progress that we've made is very positive, continues to be positive.

Operator

(Operator Instructions) From the line of Ron Josey with Citi.

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

Barry, I wanted to ask about SaaS and Peloton and PCR, given both, I think, accounted for about 3/4 of new subs this quarter. And so talk to us a little bit more just how these products are going, how you're going to market with these products and how they're being differentiated relative to the full membership Understood there's nuances in between.

And then Liz I think this quarter, guidance calls for a little bit of a decline in subs, just a seasonally slower quarter. Would love to hear more insights in terms of what you're seeing there as well.

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

I'll let Liz take that guidance piece, and we'll talk about [VaaS] and the refurbished bikes. From a marketing perspective, we're doing nothing basically in support of those products. So people are finding them on their own. In some instances, there's a banner across the top of the home page which steers you towards one or the other. For the most part, you have to discover fast by clicking down a couple of layers on the web. So think of it mostly is organic pull-through.

Liz do you want to talk about the guidance piece?

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

Sure. Yes. So Ron, you alluded to the fact that we are guiding down on Connected Fitness subs for Q4. A few comments on that. So the fourth quarter is seasonally our toughest or rather our least efficient quarter for us to grow subscribers. Even with our best-in-class retention, we need a base level of growth additions to offset our churn, which, while still quite low, also tends to be seasonally highest in Q4.

Also important to understand that we are committed to growing our subscribers efficiently. And while we have -- as we expect to target a lower LTV to CAC ratio in Q4 than we did in Q3, our Q3 LTV to CAC was actually above a 2.

Our forecast assumes that we will maintain a strong financial discipline, and we will not overspend either via media spending or by cutting prices or flashing them to acquire unprofitable subscribers.

I also want to point out that we do have some uncertainties in our Q4 guidance. As Barry mentioned, we're in the letter, and as we've talked about already on the call, we are relaunching the brand to better communicate our value proposition, and we do expect that to widen our camels with time. And we're also reintroducing the app. And we don't know the impact that these launches are going to have on our Connected Fitness hub growth in Q4. We're cautiously optimistic about that but we have not baked any of that optimism into our guidance forecast for the quarter.

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

And when you speak about efficiency, you're talking about the long-term value to CAC ratio.

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

LTV-to-CAC ratio, exactly.

Operator

(Operator Instructions) From the line of Justin Post with Bank of America.

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

Great. Maybe 1 for Liz and 1 for Barry. First, on -- Liz, when you think about the app pricing and the tiering, how do you protect the Connected Fitness price while also offer a very robust app that people can use on other devices. How do we think about that?

And then, Barry, maybe a big-picture question added about 120,000 subs this year. I know there's a lot of macro and competitive headwinds and execution with the new team. How do you think about the right rate of growth for the company on subs as you look past this year? Was this an unusually challenging year and you're optimistic? Or is this kind of the new baseline? How do we think about sub growth from here?

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

Do you want me to take the first part of the question first?

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

Yes.

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

So Justin, we're not sharing today any details about our new app tiers and the pricing associated with them. But the way to think about it is that they aren't all going to offer the same offering to consumers.

So for example, what we offer for Connected Fitness is all of our content on our hardware along with access to the app, you kind of get everything is all accessed. The different app tiers will have different amounts of content experiences available to you at different price points. So that's how we're protecting the All Access membership in that regard.

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

Well, let me talk about the current environment and then try to share with you how I think about the new baseline, what some of the vectors for growth would be in a super challenging year.

I think since I walked in the door, we -- in restructurings and revaluation and write-down, something like $1.7 billion. And so there's been a tremendous amount of effort invested in, let's say, restructuring the business, rebuilding the lead team, the rest of it. And as a leadership team, we are still finding our rhythm building relationships and trust, all the soft tissue relationships that make teams great. That only happen over time. And so if we manage that process well, we will execute faster and the business will perform better with the passage of time. At least it's been my observation at my previous company.

Here are a couple of aspects -- vectors of growth. There are a couple of aspects of the business that we have been in the process of restructuring and we are only just beginning to see glimmers of the benefits of some of those efforts that we've invested. I'm thinking particularly about the commercial and corporate wellness business, we're starting to see some good momentum there. We're starting to see some good momentum in 3P. And we know we have a lot of learning to do to become a good partner in a B2B relationship. But that's showing signs of life.

International, I think will provide opportunities for growth for us. Also, we introduced new hardware platforms this past year. Let's take the row by example, still only has a 4% unaided brand awareness guide is at 1%. The app is at 5%. I think we have opportunities to improve all of those significantly.

Let's take the app by way of example. Even before we invested in making it better, the Net Promoter Score is 20% higher than our next highest rated product, which is Bike Plus, which has been quite successful for us, but only 5% of people even know it exists, which makes it 10x lower than bike. So there's lots of opportunity for us to lean into that, and we'll have a full year of Row.

At some point in our future, I anticipate we'll have a second treadmill product that was 2 years ago roughly that we withdrew to us from the marketplace. We don't control the timing on that, but we have invested a lot in our relationship with the government, and that relationship has dramatically improved since Tammy and her team have invested time in that with our engineering team. So I think that will be a vector for both.

So new platforms, new businesses, commercial, international, of course, we have new marketing leadership and we'll be leaning in aggressively to support them as they grow the business.

And then lastly, Jen Cotter and her team have really, I think, join signs of great progress for us in turning around our accessories and our apparel business. I think the apparel business, in particular, can be significantly more meaningful than it has been. And I'm excited about some of the initiatives that she's pursuing that we haven't discussed publicly that we'll unlock some growth opportunities there.

So sorry to be so long-winded, but that's kind of how I'm thinking about the new baseline and the vectors of growth.

Operator

(Operator Instructions) From the line of Edward Yruma with Piper Sandler.

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

I guess first one, broader question. I know you guys called out Amazon as being a success story. I wanted to understand if you had any more context behind the remainder of 3P, particularly physical retail like a Dick.

And then just a clarifying point on the relaunched app, will connected fitness devices have the option for a more a la carte subscription option? Or is that a -- is that to remain the All Access membership?

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

It will remain All Access membership. I'm going to ask Liz to comment on Dicks and 3P.

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

Yes, sure. I think the way to think about this is it's still very much a new partnership, a new relationship for us. Recall that we only launched that partnership back in November. So we've only got a couple of quarters under our belt with Dicks

And as Barry commented, it's also about us learning how to be a good wholesale partner to a retail business that is more traditional brick-and-mortar. That's not where our business has come from. We've been mostly web-centric in how we sell and how we deliver to our consumers. So we're still working through with Dick's how to be a good partner to them and how to leverage their channel so that we can both be even more successful.

Operator

(Operator Instructions) From the line of Eric Sheridan with Goldman Sachs.

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

First, you talked a lot about the commercial opportunity via the hospitality industry in the letter, and you've obviously got the Hilton partnership. Can we talk a little bit about what you think that means in terms of a driver for either the Connected Fitness subscriber funnel and/or bringing additional people into the digital app that maybe would utilize your hardware in a more nomadic, sort of business travel-type sense through partnerships like that? Just want to understand how you think about that as a stimulant to multiple different parts of the business.

And then in terms of the guidance you gave 1 quarter forward. I wanted to understand a little bit of some of the puts and takes in the gross margin guidance that we could better understand how some of the headwinds and tailwinds might evolve, not just in Q4, but as we roll forward into the next fiscal year.

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

I don't have -- I'll talk about the funnel in hospitality and ask Liz to talk about the gross margin puts and calls in the guidance. Really, I don't have too much to say about hospitality, except that it's been a fruitful source of consumer demand for us. Enormously productive, historically. I would anticipate that, that will continue on a go-forward basis. And so we like the hospitality business for 2 reasons. One, profitable in its own right. And two, it's a good source of future growth for us. Because, as you say, it helps lead the funnel.

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

I'll take the question about puts and takes for our Q4 margin. So first, just a reminder that our overall gross margin is actually expected to go up quarter-over-quarter to 41% versus the 36% that we had in Q3. And the main driver of that is the shift towards subscription revenue from hardware revenue because we do expect our hardware sales to be lower in Q4 versus Q3.

Our guidance does assume some expected pressure on Connected Fitness gross margins Versus is a seasonally weaker quarter for Connected Fitness hardware sales. We're also expecting some weaker sales and margin outlook for Precor as we continue to revamp that business. And then we do have about 200 basis points of impact to overall gross margin included in our guidance from anticipated onetime item that mainly impacts the Connected Fitness segment.

Operator

(Operator Instructions) From the line of Aneesha Sherman with Bernstein.

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

My question is about OpEx. So about a year ago, you were talking about -- or maybe your predecessors were talking about $2 billion in OpEx being the kind of watermark. You're tracking towards that at this point, and you brought down the cost base quite significantly on an underlying basis. Are you at the tail end of the OpEx improvement and cost cutting stage? Are you looking at this as kind of being the steady state level? Or are you looking for more improvement in the next year or so?

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

Yes.

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

Yes.

So going back to the restructuring plan that we outlined about a year ago, we don't have a perfect apples-to-apples comparison to that because we had a number of additional actions that have been taken since we set those targets. But if you actually exclude restructuring, impairments, reserves and settlements, our OpEx is down over $550 million on a trailing 12-month basis as of Q3. And if you can note, that does include the fourth quarter, which still had fairly elevated OpEx mainly in G&A and sales and marketing.

On the COGS side, we've had significant volume-based dependency when it comes to determining the cost savings there. And while our volume has come down, we've continued to make significant progress in optimizing our cost of goods sold over the past year. Our cost structure now reflects the impact of the restructuring actions that we took to outsource our last mile delivery, exit our own manufacturing and really effectively shift our high fixed cost business model to a much more variable cost model. From a cost structure perspective, we are in much better shape.

We do see some further opportunity to optimize cost of goods sold, particularly in the middle mile, and we're going to be working on that over the coming quarters. With regard to OpEx overall, we have made great progress. We're not finished, and we're going to continue to optimize. But the big step function improvement are likely not to happen. It's going to be more about identifying improvements as we go, things like reducing our professional services spend addressing our tech, which should drive some efficiencies. There may be some efficiencies and member support. We're going to continue to look at lowering our real estate costs over time.

So those are some of the areas where you'll continue to see further optimization over the coming quarters.

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

I would add that, on a go-forward basis, I think there's an opportunity for us to take the several categories where there are tens of millions of dollars of savings to be had as opposed to hundreds of millions of dollars of savings. So things related to IT infrastructure and Liz mentioned the middle mile. And this past year, we had a lot of suppliers' payments by way of settling out inventory commitments and things that are now in the -- after this quarter, will be in the completely in the rear-view mirror for us.

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

And if I can ask a quick follow-up for Liz. On your comment about Q4, can you reconcile your comments about seasonality and lower subs versus your guidance of only a modest increase in churn? Is it just about expecting lower gross adds?

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

So seasonally, it's both, right? So it's lower gross additions in the quarter expected because of the lower efficiency to go out and acquire them in the quarter, as well as a seasonal uptick in churn that we see -- we've seen every year.

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

If we were to relax the constraint we've imposed on marketing spending, if we were to relax the free cash flow goal that we've set for ourselves, we could absolutely grow faster. Well, we're not prepared to make that trade-off at the moment until it is kind of what it is.

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

The focus is as I was going to say, the focus is on LTV to CAC and making sure that while we're willing to go lower than we were at in Q3, it has to be relatively efficient.

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

First priority is free cash flow. Second priority is growth.

Operator

(Operator Instructions) From the line of Shweta Khajuria with Evercore ISI.

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

Liz, could you please remind us what promotions you ran in the quarter? And what your expectations are for the upcoming quarter and for maybe upcoming quarters? And then -- and in addition to maybe perhaps talking about just the overall demand environment.

And then the other follow-up question I have is on free cash flow. So excluding the settlement costs, you are striking distance from breakeven. Could you please help us, just remind us. Outside of growth that you expect coming in for the next year, where -- what are the key levers? And how should we be thinking about working capital for the next fiscal year?

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

Okay. I think there were a bunch of questions in there. We'll start with the question on promotions. So what promotions did we have in Q3. So if you recall, we went into the Q3 with a promotion in January related to kind of getting into fitness in the new year. That ended -- I don't have the exact date of the promotion, but that went for part of January.

And then we did have a promotion, we did have some referral rewards promotion. We also had a -- which is basically, if someone refers someone to Peloton, they get that person gets a discount and then the person who does the referral gets the credit for apparel purchase.

And we also did a spring promotion in March that had discounts on hardware purchases and bundles, as well as a promotion on our refurb products. And we also offered a financing promotion, where we would offer free financing -- or 0% financing for all of the term lengths for a period of time.

In Q4, we do have some promotional activity planned by Mother's Day, which actually launches today, our Mother's Day promo. So that will be starting today.

With regard to free cash flow and the question about working capital. So just for Q3 to give you a sense, we did have a cash tailwind from inventory. It was about to the tune of about $100 million net of any supplier settlements that we had in the quarter. We are nearing the tail end of those supplier settlements. We only have about $3 million left that will incur in Q4. For Q4, we also expect inventory to be a bit of a tailwind and source of cash but it will be materially lower than what we observed in Q3, again, in part because of the fact that we will be selling less hardware in Q3 in Q4 versus Q3.

And then we're not really providing much perspective on FY '24 yet. But as we move into FY '24, we expect the tailwind from inventory to continue to moderate over time because we will need to continue to -- we will need to produce Connected Fitness hardware inventory for specific SKUs.

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

I would say about the demand environment, uncertain. We've seen consumers respond very favorably to promotional activity in the current environment, maybe even more so than historically.

There's certainly no exuberance in the marketplace, but it's not frozen either. So it's kind of a mixed bag, and we're definitely uncertain about what's next in terms of the economic environment. Maybe the recession is soft landing. What happens with jobs. How uncertain your people. It seems like household incomes who had money still have money, they're able to spend. And then there's everybody else. For them, there's a lot of uncertainty.

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

Yes. And while there's certainly uncertainty. When we do our demand forecasting, we incorporate the latest trends that we see into our bottoms-up forecast. And so we believe our guidance contemplates some of that macroeconomic headwinds that may be -- that we may be observing, even though it's hard to explicitly identify what they are.

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

But we -- and since we have no explicit assumption around what's going to happen in Washington around the -- blast radius associated with the inability of Congress to resolve that with the President, just by way of example. So we're assuming the world continues on as we know it today, we'll see.

Operator

(Operator Instructions) From the line of Andrew Boone with JMP Securities.

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

Barry, I wanted to ask now that we're a year into the price increase. Just philosophically how you are thinking about subscription price increases going forward. Given your time in Netflix, it felt like there was a steady cadence there. Does that relate to Peloton?

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

I don't think so. For the longest time, Netflix's strategy was actually to reduce price and grow share. And it was only after they became dominant on a global basis did they extract a premium from the marketplace associated with the share.

So left to my own devices, I would be lowering prices, not raising prices. I think it's a very effective way to drive a virtuous cycle of increased engagement, increased word to map, lower marketing expense. You can increase value by making trade-offs against gross margin. And I would like us to be able to do that, but I don't foresee that being possible, given the financial constraints of the business.

You will see, as Liz commented increasing gross margins that are a function of structural shifts in the business, for instance. And that relates to the rate of growth in the subscription business versus the hardware business.

So by way of example, last quarter, subscription revenue exceeded hardware revenue by $30 million. This quarter, it exceeded by $100 million. It's growing significantly faster. I think that is a long-term trend in the business as I flagged, I think, in last quarter's investor letter. And -- but I don't foresee big structural changes in the gross margin of the subscription business itself or even of the hardware business itself.

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

Excluding the restructuring charges.

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

And eventually, that too would be in the rear view mirror.

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

And then I just wanted to touch on the underlying new subs that are coming on the platform. Are you guys seeing any change there in terms of income or age? Or anything else that would be worth highlighting?

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

No, not so much. With respect to the new marketing campaign, we will be reaching slightly younger. But that's a TAM play and an inclusivity play. But no changes, particularly. I have noted previously that as we're bringing in a slightly different demographic. It was slightly more female. It was high household income, interestingly enough. Is it professional women who value the optionality, that continues to be true. But it's not skewing the macro numbers, particularly.

Operator

(Operator Instructions) From the line of Mario Lu with Barclays.

Unidentified Analyst

Great. This is Alex Hughes on for Mario. Just had a couple of questions around the rower product. Do you have any updates on sales versus your internal expectations for that? And you guys launched the live rowing classes last quarter. Any update on user traction on that or how that's progressing?

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

You want to talk about -- versus expectations?

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

We aren't sharing explicitly what our sales are for the rower, but it is still a new product. And similar to what Barry said, our -- it doesn't have a high unaided awareness yet. So one thing to point out is that our current sales are actually pretty heavily skewed to our existing Connected Fitness subscribers, which is similar to what we saw with our Tread when we launched it. And so we are expecting sales to be more accretive to sub growth over time as to continue to build over time as we grow our unaided awareness of the product.

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

Let me add that it received very favorable critical reviews. I think it's made it much more difficult for some of the competitors in that space in particular. So it's grabbed a lot of share.

Liz mentioned that the awareness is still low. I think we have opportunities to work on that. Frankly, we didn't really know what to expect when we launched it. And that -- but the combination of the favorable critical reviews and then the reception from our users has been quite good. It's slight -- weighted -- Net Promoter Score is slightly below the Tread product. So think of it is on par with Bike and Tread, which I think for a new product is pretty good.

I think we have opportunities to continue to improve the content, but it's a new category for us, and I'm confident that we will. But that's not based on any research, by the way, that's just my own assessment as a user.

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

And then I just want to add, it's only available in the U.S. today, and we are looking to launch it internationally into other markets over time.

Operator

(Operator Instructions) From the line of Deepak Mathivanan with Wolfe Research.

Unidentified Analyst

Great. This is Zack on for Deepak. Just first on marketing, just given with the brand relaunch and the app relaunch later this month, how that could affect kind of the typical seasonality of marketing spend this year, or over the next couple of quarters, kind of relative to historical periods.

And then second, just on SaaS. Churn stepped up a little bit kind of quarter-over-quarter, now at 5%. Kind of how do we -- obviously, it's still early days. But how do we think kind of about the key drivers to kind of bring that down over the long term and that kind of give you confidence in the kind of the unit economics of that model over the long term?

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

Liz and I will tag-team this. In terms of seasonality, marketing expense Q-over-Q will decline this quarter versus last quarter, but it will be up slightly single-digit percentages kind of on a year-over-year basis. It was quite low a year-ago Q4.

And other than that, I don't expect particularly any big changes in the seasonal pattern. And the reason it's up year-over-year is, of course, is because we're leaning into the launch of app.

In terms of churn from my Netflix experience, I would say, it's all about the user experience Sorry -- I may be more clear. We report average churn. Average churn is a function of the average life of the user base. If you're pumping in a lot of new subs, they're going to churn at a higher rate than subsequently with your service for a long period of time, like say, 12 months. I've seen that in every subscription business that I've been a part of, and I've been a part of 3 of them now.

Churn declines over time. And my last 2 businesses, it was asymtotic at 12 months. We see something similar here. So when growth accelerates, churn picks up slightly. When growth slows down, the average reported churn ticks down. So to really understand what's happening with churn, you need to actually see the cohorts and see how, over time, the churn curve, is the slope changing? Is it shifting in parallel? Like what is happening? And that's how you drive increases in lifetime value.

So having said that, how do you bend the shape of the churn curve? You do that with engagement, largely. And you do that by controlling the quality of the subscribers that you acquire. And so let me start there. That's all about -- the responsibilities for that rest with marketing. And if -- again, you can generally judge how valuable a customer is going to be based on their retention very early in their life. And so you just have to self-regulate and acquire subs from sources that are going to meet your expectations in terms of churn.

In terms of engagement. Let's say, the last 3 quarters, we've seen a pretty good improvement about 5 percentage points in the base of customers, let's say, who are engaged with All Access product. The key, of course, is for Jen Cotter and her team of instructors continue to make great content. But that all by itself is not sufficient. If we make great content, but you can't find it, when you hop on your bike or tread or row might as well not exist.

And so the product team, the engineering team used to be great at driving personalization. And we have made that an investment priority when I walked in the door. I think we're making a lot of good progress there. We're also introducing some new categories of content, like Lane Break, where we're seeing really off-the-charts kind of engagement and give a slightly more male and a much younger MO. So we need to continue to -- same thing with Power Zones, by the way. So we need to continue to lean into those use cases, lean into personalization.

Sorry to be so long-winded.

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

I wanted to add just a couple of quick things. First of all, first half, I do want to comment that we are still within that 18- to 20-month payback period that we have been targeting, even with the slight uptick in churn that we've seen.

And then Barry comments about sales and marketing. So our sales and marketing overall expense is actually down, expected to be down year-over-year in Q4, but our media spend is expected to be up. So the overall sales and marketing function itself, which includes things like brand and creative and headcount and all those things is down year-over-year, but we're spending a bit more on media, to your point, around the brand we launch and the app.

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

Well, Fast as a great example of how it is you can make trade-offs between marketing spend, churn, growth in order to drive more overall profitability in the business. So Fast absolutely had the higher churn rate, but the incrementality is in the low 60s. And so even though the lifetime value, we estimate to be, in round numbers, half that of an All Access member, we're growing so much faster because of Fast, we're driving more profit.

And so we're willing to take the churn hit because of the increase in enterprise value that results from us deploying that strategy.

Operator

(Operator Instructions) From the line of Dana Telsey with Telsey Advisory Group.

Dana Lauren Telsey - *Telsey Advisory Group LLC - CEO & Chief Research Officer*

As you think about the shift of the business model and the relaunch of the app -- or the launch of the app that's coming, how do you see the shape of what the financial profile of the company should look like? Does the cadence quarterly or revenue streams, how you envision the mile on a quantitative basis?

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

Well, I'm not sure I fully understand the question. But as we've talked about, our business has shifted more towards subscription relative to Connected Fitness hardware. So as the app growth as a larger share of our business, that will continue to shift, and more of our revenue will be coming from subscription. And as we know, the gross margin of our subscription business is higher, so that will also continue to help improve our gross margins overall.

And it will expand the business. We'll continue to grow. We'll be able to get scale, which will mean that our OpEx as a function of revenue will come down. So it's leading us all in the right direction towards getting to our North Star goal, which is to be a bigger business with more subscribers and higher operating income and getting us to operating income breakeven over time.

But structurally, it's really more about that shift that we're continuing to see happen from the mix of Connected Fitness hardware to subscription. Now that doesn't mean that some of those app subscribers over time will also become Connected Fitness members, but we're going to have to see how that journey evolves, and we'll have products available for them however they want to join Peloton.

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

Building off of Liz's comments. If we're successful in growing the app business, we become increasingly an asset-light model. And it most definitely will change the working capital attributes of the business in a favorable way. Not to -- at the risk of something like Captain Obvious. And the margins will benefit as a result, both the gross margin and the operating margins.

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

Right. And remember, our North Star around growth is LTV to CAC ratio. So we're going to continue to evaluate how we grow our subscriber base in that framework.

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

I would tell you -- and if we're successful in deploying an asset-light model, we'd probably see faster growth in international. It's much easier to launch internationally an app product, than it is hardware business, for sure.

Dana Lauren Telsey - *Telsey Advisory Group LLC - CEO & Chief Research Officer*

And Barry, just following up on international, where international grew faster than the U.S. this quarter. What are you seeing internationally and leaning into the hospitality business, how do you see the pace of adds for new hospitality change joining the platform?

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

I'm going to hold off on answering that. I appreciate the question. I think hospitality for us primarily as a U.S.-based business, at least for the coming fiscal year. And then I think there'll be opportunities for us to go beyond that.

And in terms of international growth, I'm thinking primarily existing markets with a few additional new markets. But it's mostly -- it's re-architecting our go-to-market strategy in existing markets with increasingly culturally relevant content that unlocks the growth opportunities of those markets, pursue some co-branding opportunities for us. Just not a strategy that we've deployed. I think we're going to have an exciting announcement, by way of example, over the next couple of quarters in that regard to help accelerate our growth.

Operator

(Operator Instructions) From the line of Youssef Squali with Truist Securities.

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

Great. So Barry, the Peloton brand was built on just great quality physical product historically. As the business moves to an app-centric strategy, asset-light strategy, can you maybe just speak to the competitive advantages that you are bringing, the moat you're trying to build? And what gives you confidence that you'll be able to maintain the same type of advantage that you've been able to build in the physical world?

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

I think both Liz and I will comment here. From my part, I would say we faced many challenges in the past year, almost in every aspect of the business, except for content. Content is kind of the golden goose. Is the bike a great experience from a hardware perspective and better than things that had come before? It absolutely is. But the magic and the glue that binds the community with almost religious fervor amongst the members is the content and the instructors.

And so if we're successful in extending that into the app world and if we architect the app in ways that drive personalization so that you can find and engage with all that content in a -- quickly and in a frictionless way, then I think will do quite well. If we don't do those things, we won't.

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

Yes. I mean, I completely agree with your comments there Barry. The one thing that I will add is that it's important for us to continue to innovate on the content experience over time, and that is something that we are focused on doing, and we'll continue to do that. And over time, you'll see new forms of content coming from us. And that will be something that continues to keep that competitive moat there.

And so content is -- to your point, is really our secret sauce at Peloton, our golden goose at Peloton.

Operator

Thank you. That is all the time we have today for our question and answers. Thank you again for participating. This concludes today's program. You may now disconnect.
