Peloton Interactive, Inc.: Valuation During a Global Pandemic

Teaching Notes

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Case Summary

Students are put into the shoes of Lauren Truxton, an analyst at a fictional investment firm, who must make a recommendation on whether the current valuation of Peloton Interactive, Inc. (NASDAQ: PTON), a manufacturer of home fitness products including bicycles, treadmills, and connected fitness subscriptions, is sustainable, or a temporary result of the Covid-19 shutdown that will reverse once gyms and fitness centers reopen. Students need to select an appropriate valuation methodology, considering not just the short history of the firm as a public company, but also the extreme market volatility as a result of the pandemic. Based on their analysis, instructors should encourage students to decide whether to sell their hypothetical shares in Peloton for a sizable capital gain or stay in the stock for the long term.

Teaching Objectives

Students should be able to:

- explain and differentiate between dividend discount, free cash flow, and market comparable valuation models;
- analyze the relative strengths and weaknesses of the valuation methodologies and select which is most appropriate in a given context;
- identify what data are needed to complete each of these valuation methods from a large number of data sets and to develop a strategy for locating and analyzing that data; and
- evaluate the differences between valuing a new startup company that has never earned an operating profit, and more established firms with long histories of profitable operations.

Research Methods

This case is based on the actual experience of an investment management firm that holds shares in Peloton Interactive. As discussed in the case, the firm had acquired a significant share position in the company during the IPO, and needed to decide based upon their analysis of the value of the company whether to retain their position, or to realize their considerable gains. In the case, the investment firm's name, the names of the research staff, and the size of the company's position were changed to protect the confidentiality of those involved.

Suggestions for Effective Teaching

With the proliferation and expansion of data collection and analysis tools, such as Bloomberg, Capital IQ, and FactSet, the research analyst has never had more information available to value a company. With a minimal amount of training, an analyst can download into a valuation spreadsheet years of data on a subject company as well as possible peer groups. Many valuation templates are widely available that are automatically linked to these databases, giving the idea that valuation can be done with only a few clicks of a mouse.

While no analyst desires to go back to the days of collecting data from paper 10-K's and 10-Q's, it is important to recognize that it is still vitally important to think through the strategy needed to complete the valuation. For example, in the case of Peloton, its first year as a public company was during a time of an unprecedented shutdown of the world economy. Faced with the closure of fitness centers and many people working from home, there was a strong demand for at-home fitness solutions. While Peloton was well positioned to benefit from this, many question whether those trends continue as the economy reopens. In the case, the student is asked to consider the foundational assumptions of widely used valuation models, and consider each model's appropriateness to the situation regarding Peloton.

In teaching the case, my experience has been that having the instructor act as a "devil's advocate" can force students into a greater understanding of valuation. Acting in the role of a skeptical investment committee member, the instructor can challenge whichever methods are recommended, forcing the student to think through the basis of dividend discount, DCF, and market comparable models.

Next, the student has to select which data are most appropriate for calculating risk measures such as the weighted average cost of capital. Here again, the dilemma is not how to find information about Peloton, but being able to decide what is the right information, given the company's short history as a public company. Discussion Question 3 asks about investors' consideration of possible dividends—I have found the Q&A sessions between company management and research analysts, during industry conferences or earnings-release conference calls, to be helpful. Recordings of these calls are available on the Investor Relations section of Peloton's website.

The ways in which another company can be considered "comparable" are addressed in Discussion Question 4. The two possible comparable companies, Nautilus and Netflix, are vastly different, and the valuation results will be very different depending on which one is used, and yet there is a good argument for either. Students who read through the case very carefully may also recognize that William Bainbridge, the investment company's chairman, may have a vested interest in the outcome of this decision.

Discussion Questions and Answers

1. Based on your understanding of Peloton, and the purpose of the valuation that Lauren Truxton has been asked to perform, which of the valuation approaches do you think would be the most appropriate? Which do you think would be the least appropriate?

In this question, the student should realize that since the company has not paid any dividends, and is unlikely to in the foreseeable future, dividend discount models would not be appropriate. Reading through the history of the company, and the evolution of the Internet-based fitness industry, the company is unique, and it will be difficult to defend a proper set of comparables. DCF methodology is most likely to be the method given the most weight by investors. That said, within the DCF methodologies, there are several multi-stage approaches to forecast company lifecycles that can be employed.

Since the firm has no permanent debt, results from both free cash flow to the firm (FCFF) and free cash flow to equity (FCFE) should be similar.

The issue of Peloton's excess cash should be addressed. Given that the company is cash-flow positive, the cash should be subtracted as usual in the determination of enterprise value.

2. What information would you need in order to estimate the weighted average cost of capital for Peloton? Since Peloton has only been publicly traded for one year, how would you estimate the beta for the stock using the CAPM?

For a weighted average cost of capital calculation, you should start with the relative market values of debt and equity in the capital structure. Since Peloton has no permanent debt financing, it should have a weight of zero; so, the equity component is 100%.

The expected return on the market should be the historical average return to the S&P 500 Index. The risk-free rate is usually based on the existing 3–5-year Treasury Note Rate. Beta, the volatility of the stock in comparison to the volatility of the market, should be calculated by using a regression of the excess returns on the stock versus the excess returns on the S&P 500 Market Index. Given the short time that Peloton has been publicly traded, weekly volatilities should be used.

3. Many of the companies that are in the digital services space have not generated any profits, yet have had remarkably high returns for their shareholders. How do you think investors in these companies evaluate these firms in the absence of profits?

Investors consider the capacity of the company to pay dividends in the future. For an investor who maintains an ongoing long position in an investment, there will be no opportunity to realize capital gains, and so the dividends are the predominant source of return. The FCFE and the FCFF are both indicators of the firm's future dividend-paying capacity, and include factors for non-cash charges such as depreciation, capital expenditures, and changes in working capital.

4. Two possible comparable firms were suggested for Peloton: Nautilus (NYSE: NLS) and Netflix (NASDAQ: NFLX). How would you choose which firm is the best peer comparable?

Nautilus is a traditional manufacturer of fitness equipment, such as exercise bicycles, elliptical machines, and weightlifting apparatus. It has many of the same risks that Peloton has in terms of supply chain, delivery, and service with regard to the bicycle-production segment. Nautilus is much smaller than Peloton in terms of market capitalization, and has not had the media exposure that Peloton has through its IPO. Teaching Notes Data 1 provides the live stock price of Nautilus, which instructors can reveal to students once they have answered Discussion Question 4 to see how the current stock value of the two firms (Nautilus and Peloton) compare.

Teaching Notes Data 1. Live Daily Stock Close of Nautilus, Inc.

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Netflix is one of the most successful companies in the digital technology space, and has transitioned from CD delivery to media subscription-based content. Netflix is much larger than Peloton, and is now one of the major producers of movies and digital content. Teaching Notes Data 2 provides the live stock price of Netflix, which instructors can reveal to students once they have answered Discussion Question 4 to see how the current stock value of the two firms (Netflix and Peloton) compare.

Teaching Notes Data 2. Live Daily Stock Close of Netflix, Inc.

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5. If you were in Lauren Truxton's position, would you hold on to Peloton's stock or sell? Why?

Once students have said whether they would choose to hold on to Peloton's stock or sell based on their valuation of Peloton, instructors can reveal Teaching Notes Data 3, which provides the live share price of Peloton. Students should then be invited to calculate their return on investment based on purchasing 150,000 of Pelton's stock at USD 29 a share in 2019.

Teaching Notes Data 3. Live Daily Close of Peloton Interactive, Inc.

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Further Reading

Peloton Interactive website: https://www.onepeloton.com/
Pinto, J. , Henry, E. , Robinson, T. , & Stowe, J. (2015). *Equity asset valuation* (3rd ed.). John Wiley and Sons.
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