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**INVESTMENT SUMMARY**

We propose a short position on Etsy Inc. based on their historically poor profit margins, increasing marketing expenses, and reversing vendor and buyer sentiment. These factors pose a dual challenge as Etsy attempts to appease investors while maintaining customer loyalty.

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**COMPANY DESCRIPTION**

Etsy is a peer-to-peer ecommerce website founded in Delaware in February 2006. Etsy generates the majority of revenue from transactions and listing fees, direct checkout fees, and promoted listing fees. Although it does have some presence internationally, more than 75% of revenue is generated within the United States.

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**INDUSTRY ANALYSIS**

Etsy operates in the peer-to-peer e-commerce industry and functions as a platform for handmade goods to be sold to users. Sellers list their products on the platform, from which Etsy makes a \$0.20 profit for each listing, and takes a 3.5% fee on each transaction made. Buyers simply search for the products they want based on a category (ex. jewelry, arts & crafts) and can add an item to a shopping cart to eventually purchase. The current industry is a very competitive space with no company controlling majority market share. Etsy's largest competitors include eBay, Craigslist, and Amazon - and these companies are continuing to increase services focused on homemade sellers. The future of the industry will only get more competitive as more players enter this space (as the barriers to entry are fairly low) and sellers gravitate toward a service that provides them with the highest margins and most benefits.

**Porter's Five Forces**

Etsy's buyers include the more than 50 million people registered as members on the service that can purchase goods from sellers. 15% of active buyers have been on Etsy for more than four years, and 81% of purchases made are repeat. Buyers have strong power because of the relatively smaller number of members using the service per shop. This means that buyers can simply switch to search for other items in various categories or for less expensive items. Even though the items sold through Etsy are unique and handmade, buyers have other options to choose from. Additionally, these buyers can also purchase goods from other services such as Amazon Handmade if they are not satisfied with the items on Etsy.

Etsy's suppliers are those who put their homemade or manufactured items on the service to sell to users. In the most recent 10-K, Etsy reported having 1.6 million active sellers with 13% of these having sold on the service for more than 4 years. The power of suppliers is low because it is difficult for those selling goods on Etsy to lock in customers or have recurring purchases. Although the items suppliers are selling are unique, there are many other options to choose from. Most of the items sold on the service are considered luxury goods and thus customers have large power in choosing whether to buy. If Etsy's suppliers are not satisfied with the service and find that they are not making any money or it is difficult to sell their goods, they can migrate to another service.

The threat of new entrants is fairly high for Etsy as it doesn't take much capital to set up an online shop for sellers and buyers to come together. The barriers to entry are fairly low in that if a new service caught on, suppliers would simply migrate to that shop instead of Etsy. Because there are several players in the space including eBay and Amazon Handmade, there is no one company that has majority of the market share. If a new entrant were to offer Etsy's service in a better and more efficient way that benefited both buyers and sellers, a large portion of Etsy's core users would migrate to another service.

Etsy's products are homemade and unique manufactured goods, and thus cannot be easily substituted with other products offered on the service. Etsy differentiates itself from other peer-to-peer e-commerce websites through its claim of products that are homemade and one of a kind. Because the products are not considered necessities, users can look towards other shops or services for the products they are looking to buy. Although the products themselves are individually unique, customers can find what they are looking for on a variety of other platforms.

The peer-to-peer e-commerce industry that Etsy operates in is particularly competitive as there are many other smaller services that offer handmade goods from sellers. Etsy's competitors include Amazon Handmade, eBay, and smaller handmade service companies that offer unique goods. Many of these newer services are starting to gain transaction as both buyers and sellers have not been happy with Etsy. The competition will only intensify as the overall market grows larger and new competitors start to take more market share.

### **Core Competencies**

Etsy's core competencies lie in its online marketplace which brings together buyers and sellers. Etsy needs to continue maintaining a trusted marketplace that emphasizes transparency between the two parties - this will be key in ensuring that users on Etsy continue staying loyal and engaged. Should sellers or buyers migrate this will have devastating consequences for Etsy. Additionally, the technology that enables the platform and transactions including mobile commerce will need to continue improving.

### **Opportunities and Competitors**

Etsy's opportunities lie within macroeconomic trends of online and mobile commerce, consumption, and manufacturing. The company wants to continue connecting users in a diverse and global marketplace and give exposure to markets previously without access. Etsy also sees an increase for deeper engagement with the company through enhanced buyer and seller tools that give a more personalized shopping experience. A key opportunity is to make Etsy and everyday experience to connect people and have high engagement on the platform. Additionally, they want to offer Seller Services that make an impact to help people and expand the Etsy economy through partnerships. Competitors are planning to take more market share of this industry by incentivizing sellers to sell their goods through their platforms instead of Etsy. On the seller side, many companies offer software and services for sellers to create their own website instead of offering goods through another platform. On the buyer side, competitors are aiming to make it easier for users to purchase goods and find exactly what they need.

## **BUSINESS MODEL**

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Etsy's revenue is generated from the internet services it provides to customers and vendors. The majority of revenue comes from the following segments:

- 1) **Marketplace Revenue:** Transactions between vendors and consumers incur a 3.5% commission in addition to a \$0.20 fee for listing items. Marketplace revenue generates approximately 43.7% of gross revenue.
- 2) **Seller Service Revenue:** Additional fees incurred by vendors to advertise goods and gain a larger presence in their specific goods category (i.e. Women's Clothing, Jewelry, Men's T-Shirts). Seller services generate approximately 54.6% of gross revenue.

### **Etsy Segments**

- For the 2016 YTD, Etsy's generated 76% of revenue within the United States. The remaining 24% (\$60.1M USD) was generated mainly in Europe and other developed regions. Aside from a recently opened physical store in NYC, Etsy generates all revenue online.

### Revenue and Cash Expenditures

#### **Sources of Cash**

- Etsy has generated cash from selling shares and attracting investors in the past.
- Etsy has continuously reported net income losses and declines in cash balances, nullifying the effects of growing revenue.

#### **Historical and Future Changes in Revenue**

- Etsy has experienced strong revenue growth in previous years, but this trend has been slowing rapidly. Etsy reported 38.8% YOY revenue growth for 2015 compared to 67.6% for 2013. The downward trend is expected to continue as customer-referral growth slows. As of yet, increasing marketing expenses have failed to make up for this negative trend.
- Etsy posted a \$6.9M net income loss for Q3 2016, exceeding the \$6.3M loss in Q3 2015
- Etsy also warned in their Q3 2016 report that margins could fall as growth from promoted listings (the largest factor feeding seller services) levels off.

#### **Revenue Drivers**

- Although revenue was mainly driven by marketplace transaction fees in the past, Etsy has put an emphasis on growing their seller services revenue streams by improving their advertising offerings. Seller services growth accounted for more than half of revenue growth and continues to take a larger share of total revenue. As of Q3 2016, seller services generated 54.6% of gross revenue compared to 48.2% a year prior.
- Etsy has also invested in the development of a manufacturing marketplace which promises to connect small-batch, transparent manufacturers with vendors. This announcement corresponded with Etsy easing rules regarding the sale of manufactured goods on their website. While this will allow growing businesses to streamline production, it will likely have a negative impact on public perception due to their stray from handmade goods.

#### **Major Customers**

- Etsy has no major customers, instead they rely on large numbers of infrequent buyers.
- Although Etsy has boasted strong growth in active buyers, it is worth noting that "active buyers" is defined as having made at least one purchase in the past year. These buyers, in exhibit 2, have a tendency to place small orders ranging from \$10-\$45 USD.

- From our data analyses of orders between 2013 and 2016 (See Exhibit 1), 93% of customers have purchased 5 or fewer items in the past 3 years (although this statistic leans heavily towards 1 item, with fewer customers returning). Given the average order price from our data set of approximately \$45 (which is skewed by a small number of very large orders), the majority of customers generate between \$10 and \$225 in revenue (again, this statistic is heavily skewed, the majority of customers don't spend more than \$100).

### **Major Expenses and Cash Expenditure**

- Etsy has been plagued by worries over large increases in marketing-related expenditures in the past two years. These expenditures have been mainly directed towards advertising through Google AdSense and similar services but have failed to produce meaningful user growth.
- It is worth pointing out that despite user growth and increased Seller Services revenue, marketing expenses still caused Etsy to produce a net loss in Q3 2016 and before.
- Another less notable sources of cash burn is software and service development, which is necessary to maintain an edge over competitors. For example, Etsy purchased Blackbird, an AI search engine, for \$8 million late last year.

### **Sales & Customer Profile**

- Revenue has been growing at a slower rate than in the past, despite increasing advertising expenditures through google adsense and other services.
- 93% of customers have ordered 5 or fewer items in the past 3 years (See Exhibit 1). This, combined with the average order price of \$10-\$45, indicates that marketing expenditures will have a low positive yield in terms of generating user and revenue growth

### **Increased Marketing Expenses**

- Marketing expenses are expected to continue rising as organic user growth slows. See these points.

### **Sales Process**

- Etsy does not take part in the actual sale of goods; it acts as an intermediary between small-scale local vendors and customers. The only way in which Etsy is involved in shipping is through its "shipping" service which offers vendors automatically produced shipping labels for each sale.

### **Drivers of Business Model**

- The business model relies on organic user growth which is sustained by a positive public perception. This model will fail in the long-term due to Etsy diluting their market offerings by easing standards on manufactured and cheaply-made goods. As the marketplace becomes diluted and more profitable sellers invest in advertising through Etsy's Promoted Listing service, the small-scale handmade vendors who gave Etsy its positive public perception will be pushed out of the market. Therefore, in an extreme case where large sellers dominate, Etsy will essentially face direct competition with Amazon and eBay.
- Pushing out the original small-scale handmade vendors will lead to a declining quality reputation as users realize that Etsy was not able to maintain their core value of promoting handcrafted goods.

### **Model Sustainability**

- Etsy's reliance on word-of-mouth advertising and public perception will eventually lead to declining sales and an increase in marketing expense as the business attempts to sustain revenue. Margins will most likely fall as Etsy finds itself unable to balance revenue and

expenses. Specifically, increased marketing expenses along with lower than expected revenue growth.

### **Analysis of Competitors**

- Etsy does not have privileged access to the vendors who choose to use its services. Should vendors become unhappy with Etsy's services, they can decide to switch to other platforms such as Amazon Handmade.
- Amazon Handmade is not as fleshed out as Etsy, but Amazon has the userbase and investment capability needed to expand and improve their services offered to both consumers and producers.
- As Etsy eases manufacturing restrictions, there will be little left to distinguish their services from those provided by other websites like Amazon as well as small-scale custom apparel printing services.

## THESIS & KEY POINTS

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**1. Etsy's current share price is predicated on strong top-line growth, Etsy faces the dual challenge of delivering free cash flow to investors as it attempts to transition into a sustainable business.**

Etsy's seller services program is representative of the company's efforts to monetize its existing user base. However, this monetization effort will serve to curtail the growth in the number of buyers and sellers in the marketplace since large sellers will begin to develop a small moat around their marketplace with advertising and preferred listings. Therefore, new buyers will face greater competition as they attempt to enter the marketplace. In addition, the recent purchase of Blackbird Technologies is indication of management's attitude around monetizing its existing user base. While certainly not solely a negative, we believe that the monetization of the existing user base sacrifices long-term growth for short-term cash flow.

In addition, Etsy's status as a niche marketplace inherently limits its opportunities to grow its existing line of business. Ultimately, we envision Etsy being dominated by a few large sellers who reinvest their high margins into seller services while new seller growth curtails as a result. Although this situation itself would not be negative, this situation would prematurely constraining user base growth, which is a key driver of top-line growth. In this scenario, Etsy would essentially become an alternative to eBay or Amazon where large sellers dominate the marketplace and begin to gain pricing power. From a financials standpoint, we see investors being disappointed by overly optimistic growth prospects as Etsy's monetization efforts curtail user growth.

**2. Etsy will have to increase expenditure on marketing in order to fight customer churn and continue growing its seller base, a situation leading to decreased margins.**

As consumers begin to notice a deterioration of product quality, Etsy will be forced to spend on marketing as its word-of-mouth advertising wanes when consumers begin to note a deterioration of product quality. For instance, Etsy's recent decision to redefine "handmade" to encompass manufactured goods as long as they are of original design is indicative of a shift in the company's core value proposition to consumers. From Exhibit 1, we already see that the majority of customers infrequently purchased items. As the aforementioned large sellers begin to dominate Etsy's platform, Etsy will also have to spend to grow its seller base. However, these efforts will prove difficult as there exists a natural constraint on the size of the marketplace for artisan goods. In addition, the niche marketplace will begin to face competition from Amazon's Handmade and other parties. At this time, we see Handmade as typical of Amazon's strategy whereby it attempts to enter new marketplaces while exiting them if they prove unprofitable. We expect the level of competition to increase if Etsy is able to prove the sustainability of its business model.

## PERCEPTIONS

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- Etsy is viewed as the extreme of the sharing economy where users are on the platform to spend extra income on items they want and sellers use their free time to make items to put on the website. On the 10-K, it was said that the vast majority of sellers on Etsy are based from home meaning that they are selling items on the platform not as a full-time job but as a side gig. As challenges around how to regulation the sharing economy start to become more prevalent this may deflate investor sentiment. Additionally, Etsy has issues surrounding the privacy of the data it collects and has a poor track record of protecting customer data and

privacy. Etsy has not been doing a good job of taking advantage of the switch to mobile commerce and has a long way to go to capitalize on this market. Even on its website platform, Etsy has become less popular (as shown by a dropping Alexa popularity rank) while competitors like eBay have become more popular. Abuse of customer data?

- Some have claimed that Etsy will expand internationally, but this will not happen as international markets are already extremely competitive and Etsy does not have the resources to grow its business geographically. International markets are fairly developed as China has Alibaba, various European countries have services like DaWanda and ezebee and other growing economies do not have a need for craft products. Especially because Etsy's sellers are located in the U.S., an international expansion would only increase shipping costs. This would essentially overwhelm any benefit for international buyers to get exposure to Etsy meaning that Etsy's potential market will be limited to first world markets.
- Furthermore, the jump in 2015 July sales from exhibit 4 was attributable to an update to the Google search algorithm. Google also stated that Etsy would be one of the beneficiaries of this new algorithm. However, management characteristically touted this increase as proof of organic growth. Therefore, investors' revenue models predicated on 2015 data are inflated for this idiosyncratic boost to sales.
- The majority of sell-side analysts who have covered Etsy have maintained a hold or buy recommendation. Having said this, the company is not extensively covered by banks who were not involved in the IPO. (Goldman Sachs and Morgan Stanley were both involved, so their recommendations may be overly-optimistic.) Analysts at Citi have also been optimistic, stating add-on services (such as promoted listings) as a potential source of long-term upside. However, the long-term value of add-on services has yet to be decided, as it may end up hurting the company by monetizing the user base too quickly rather than focusing on growing the user base.

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### INVESTMENT TIMELINE

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- Etsy's IPO in April of 2015 marked a high point for share price at \$27.58 as investors viewed Etsy as an extension of the sharing economy. By December of the same year, it had fallen to below \$10 per share due to poor financial stability and excessive cash burn rates. Between August and October of 2016, the share price has hovered steadily between \$12 and \$15 after Q2 earnings spurred optimism regarding future financial stability.
- Etsy is currently experiencing a reversal in investor sentiment as buyers and vendors alike lose faith in Etsy's support for small businesses. In the past four months, Etsy's share price has fallen by 18% as analysts and investors worry about whether or not the business model will be sustainable. Quarterly earnings have played a large part in the overall decline, displaying Etsy's inability to generate a net income.
- We believe Etsy's share price will continue fall for several years as it is unable to increase margins without sacrificing the volume of transactions. The low average purchase size and recurring buyers statistics indicate that Etsy must continue spending large portions of its revenue on marketing in order to attract new business. Furthermore, recent vendor testimonies indicate worsening sentiment which will be a costly issue to address.

### SIGNPOSTS

- Public opinion data is important to keep track of in order to understand the impact Etsy's manufacturing and advertising policies are having on vendors and consumers. Statistics such as organic growth, average purchases per user, and vendor growth rates should be monitored.
  - News regarding the effects of Etsy's new manufacturing policy should also be followed closely. Specifically, it is important to keep track of how strictly it enforces the "small business mindset" which values goods quality over vendor profit margins and business expansion. If the manufacturing policies are not strictly enforced, there will be little left to distinguish Etsy from businesses like Ebay as vendors switch to manufacturing low-quality goods.
  - Quarterly reports will also shed light on whether or not Etsy is able to grow profit margins, increase revenue at the same pace as previous years, and slow down marketing expense growth.
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### RISKS

- At the moment there is only speculation on as to how well Etsy will be able to integrate manufactured goods and product advertising into their business model. If Etsy manages to integrate these aspects successfully, the website will likely continue to experience, although not at the pace seen in previous years.
  - Having said this, it will be very difficult for Etsy to balance the exposure of hand-made vendors and larger manufacturing vendors to customers. This is will be challenging due to the fact that more profitable sellers will be able to invest in more advertising and exposure for their products.
  - Taking into account the lackluster customer growth and the leveling off of Seller Services, Etsy's upside will most likely be muted even if they are able to balance the two aspects mentioned above.
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**VALUATION**

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# Etsy Inc. (ETSY) – Short

## Valuation Output

(In USD \$MM except per share data)

Firm		Per Share	
Enterprise Value	\$610	Number of Shares	112.699
Debt	\$12	Target Share Price	\$6.97
Cash	\$188	Current Share Price	\$12.95
Equity Value	\$786	Upside/Downside	(46.2%)
Terminal Value Type	Perpetuity		

		Revenue Growth				
		45.0%	40.0%	35.0%	30.0%	25.0%
WACC	11.0%	\$6.66	\$6.49	\$6.32	\$6.14	\$5.97
	10.5%	\$6.99	\$6.81	\$6.62	\$6.44	\$6.25
	10.0%	\$7.36	\$7.16	\$6.97	\$6.77	\$6.57
	9.5%	\$7.78	\$7.57	\$7.36	\$7.14	\$6.93
	9.0%	\$8.26	\$8.03	\$7.80	\$7.57	\$7.35

## Assumptions

Historical Operating	
Revenue	\$342.7
Gross Profit	227.2
Operating Profit	24.2
Cash Taxes	(28.6)
D&A	10.7
Capex	(35.7)
Net Working Capital	275.8
Free Cash Flow	(47.0)
Cash	188.0

WACC	
Equity Value	\$1,460.0
Total Debt	11.9
Risk-Free Rate	1.6%
Beta	1.30
Equity Risk Premium	6.5%
Debt Interest Rate	5.0%

Future Operating	
Revenue Growth	35.0%
Step	(5.0%)
Gross Margin	66.0%
Step	(0.5%)
Operating Margin	6.6%
Step	0.0%
D&A Margin	2.0%
Step	0.0%
Capex Margin	0.2%
Step	0.0%
NWC Margin	2.5%
Step	0.0%
Tax Rate	39.0%

Terminal Value	
Multiple	
Growth Rate	2.0%

VAR AND EXHIBITS

Upper Order Limit	Frequency	% of Total
5	326051	92.97%
10	14897	4.25%
20	5467	1.56%
30	1558	0.44%
50	1116	0.32%
100	820	0.23%
200	410	0.12%
500	276	0%
1000	71	0%
2000	30	0%
10000	7	0%
<b>Sum</b>	<b>350703</b>	<b>99.99%</b>

Exhibit 1: Number of Recurring Users

Orders per Month of Quarter

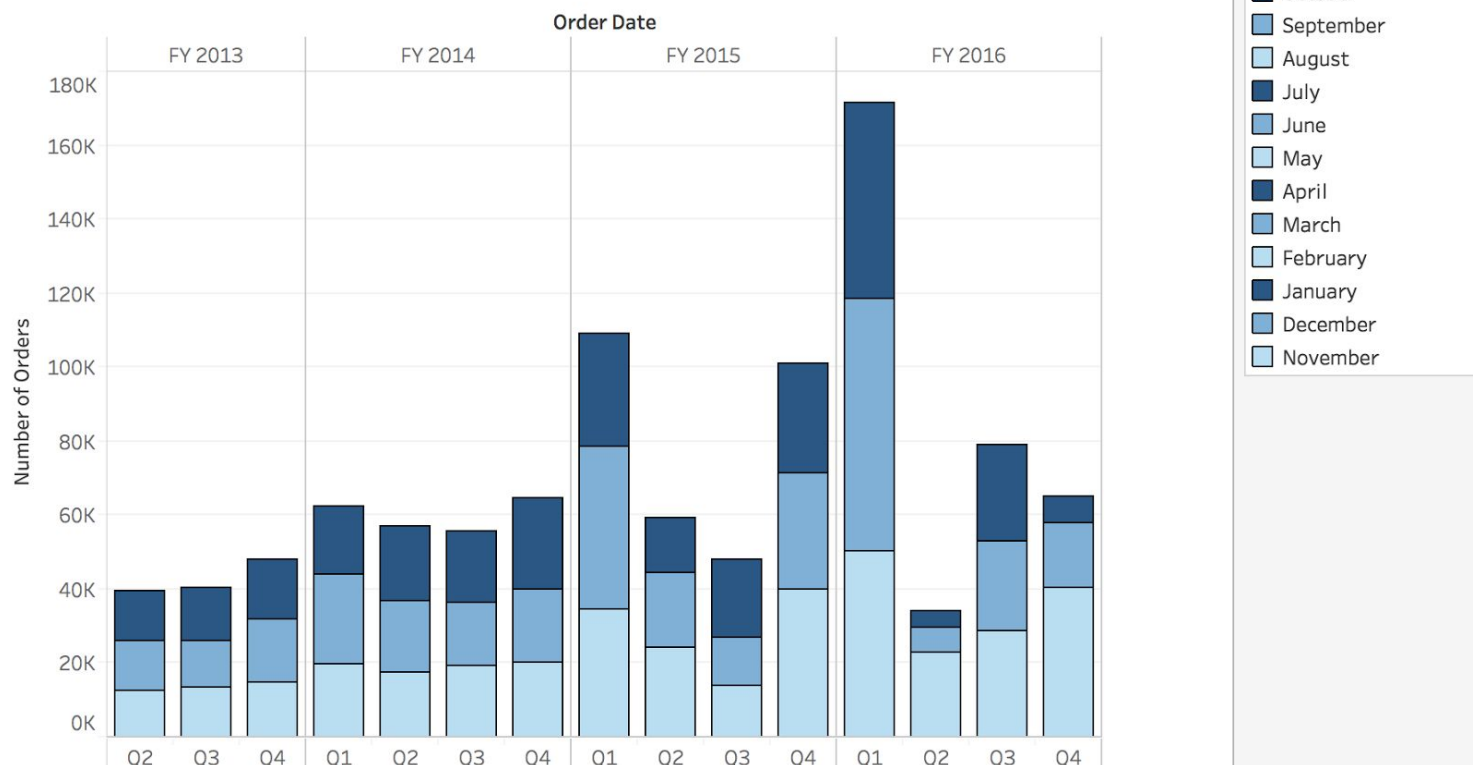


Exhibit 2) Number of orders per month of each quarter. Lightest rectangle represent first month of quarter followed by the second and third months in darker colors.

Exhibit 3:

# Etsy Inc. (ETSY) – Short

Average Order Price per Quarter

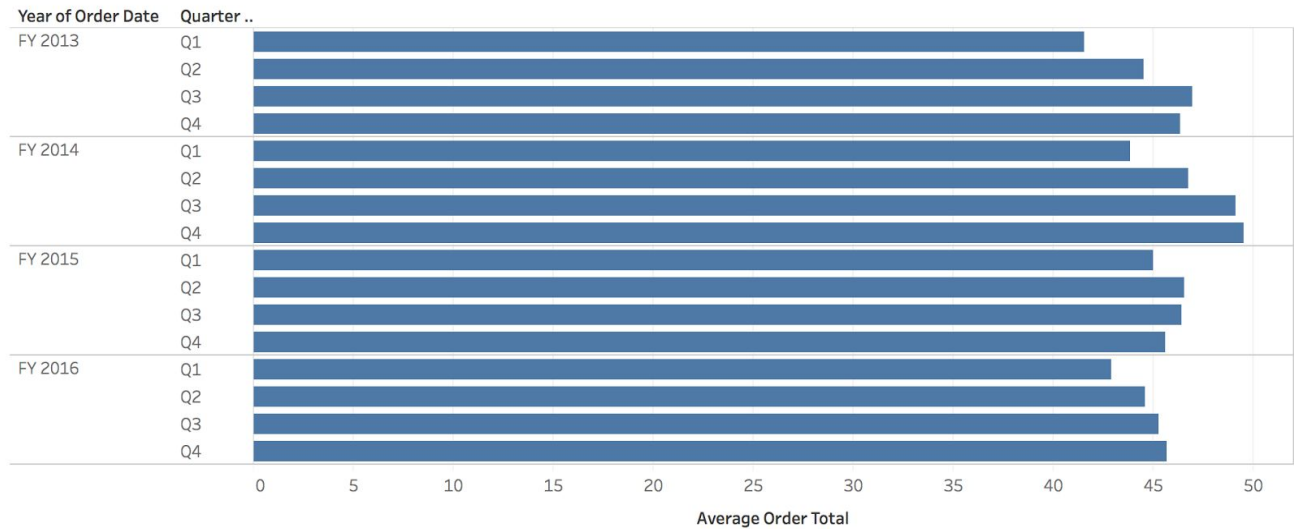


Exhibit 3) Average order price by quarter since 2013.

**Exhibit 4: Etsy Daily Sales**

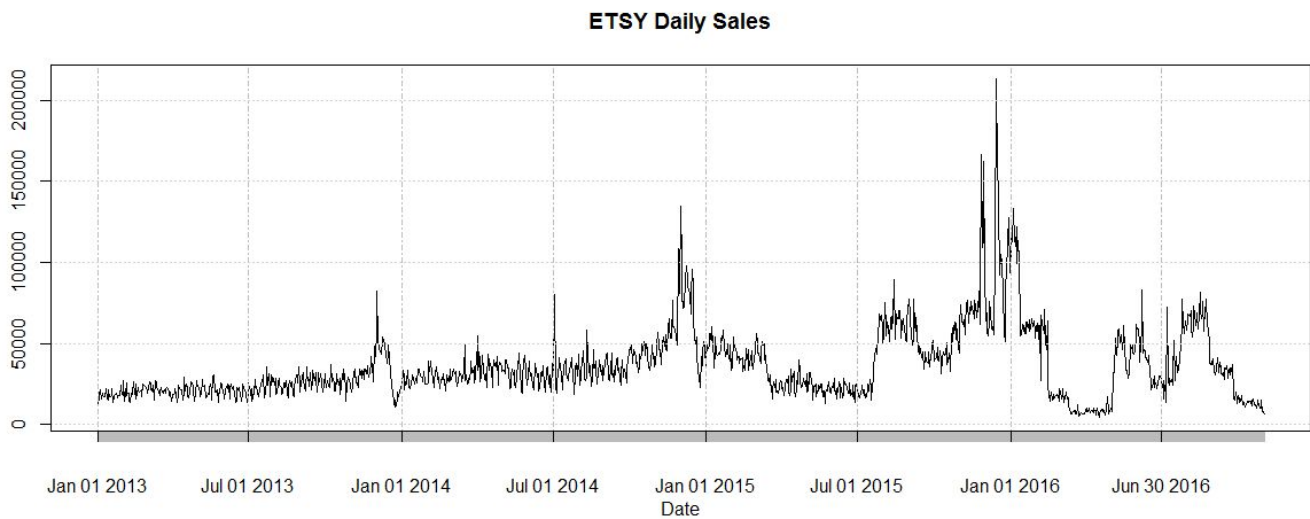


Exhibit 4) Daily Purchases from 1/1/13-10/31/16

\*NOTE: There are potential limitations to this data. As the data are only a limit sample of receipts from certain people's emails, we must assume that they represent a random sample of the population.