
INVESTMENT SUMMARY

Investors are currently underpricing Etsy's short-term and long-term prospects due to the company's continuous investments in its marketplace which include machine learning search applications and international expansion. Etsy will also benefit from a positive feedback loop by entering the \$44 billion craft supply market which will cause global active user growth to accelerate. We recommend a long position in Etsy with a target share price of \$15.39 within the next 12-18 months.

COMPANY DESCRIPTION

Etsy, Inc. is an e-commerce technology company that operates a marketplace where people around the world connect, both online and offline, to make, sell and buy unique goods. The company offers handmade goods and craft supplies.

Etsy was founded in June 2005 in Brooklyn, New York.

INDUSTRY ANALYSIS

Etsy inhabits an arts and crafts niche in the e-commerce industry. The goods on Etsy.com are produced by individuals or small companies and sold to its web visitors. Thus, Etsy competes with many online retailers that sell jewelry, arts and crafts, clothing, and other accessories. These include all-inclusive online retailers such as Amazon and eBay, arts and crafts online retailers such as Folksy.com and Artfire.com and many "brick and click" retailers including Macy's, Kohl's, Target, and Walmart. While many of these companies sell a broader range of products than Etsy, many of their product offerings overlap. Although the brick and click retailers do not sell products made by individuals or small producers like Amazon, eBay and Folksy.com, their sale of similar items makes them strong competitors with Etsy. In addition to its primary site, Etsy offers Etsy Wholesale, a C2C section of its site. There are a variety of small and large online wholesalers that compete with boutique stores nation-wide to sell jewelry, clothes, and crafts similar to those offered in Etsy's main segment.

Competition within the e-commerce industry is high. There are many online sellers, and a small number of them have heavy influence over the market. In fact, Amazon captures 34.5% of online retail visitors, while "brick and click" retailers maintain the next three largest spots with Wal-Mart (6.03%), Target (3.18%) and Best Buy (2.78%). While Etsy holds a smaller online market share than these competitors, it holds a relatively large market share of the artistic online sales category giving it some power in this competitive space. In 2015, Etsy recorded over \$2.4 billion in sales compared to the 250,000 sales made by its most direct competitor, Folksy.com, which focuses primarily on selling in the United Kingdom. **As a result, while Etsy holds relative power in the online retail space as a whole, it holds great sway in the art, jewelry, and accessories segment of e-commerce.**

The power of Etsy's suppliers is very low as a large number of small, private sellers use the marketplace to sell similar goods. The company had more than 1.5 million sellers on its site in 2015, a number that continues to grow through domestic and international expansion. These suppliers do have some power however because they could sell on alternative marketplaces such as Amazon or eBay in the case that Etsy's seller terms become unfavorable. Shipping and delivery services also act as suppliers and due to the small number of these companies, they do indeed have some leverage. Lastly, search engines generate sales for Etsy and thus have power as well. The power of buyers in the industry is low and is getting weaker as the number of online shoppers rises. Currently 40% of internet users purchase goods and services online (more than one million online buyers), a number which is projected to grow. Brick and mortar options are the most common substitute for online retail. Stores that sell clothing artwork and handmade crafts serve as substitutes for Etsy's products. Still, these stores do not offer C2C selling options offered by Etsy. Thus, **Etsy faces a low threat from substitutes.**

Etsy's core competencies for success primarily include continuing to **improve its brand recognition and advertisement to stay ahead of its competitors**. Etsy has a high dependence on SEO as a large number of its customers find products through Google searches that allow them to compare price offers from multiple sources. By improving its SEO, Etsy will not only increase sales but also make the site a more attractive option for potential sellers. In its 10K, Etsy focuses on its primary difference from its competitors: the company does not pressure suppliers to reduce costs in order to mass produce goods at the lowest possible prices. Instead, Etsy attempts to find unique goods rather than mass produced goods. Continuing to expand on this differentiation is an important model to continue in the future. Incorporating offers that could appeal to its customer base, such as donating a portion of sales of certain products (similar to the Amazon Smile program), are important to keep the company relevant and improve sales.

BUSINESS MODEL

- **Etsy operates a marketplace where people all over the world connect, both online and offline, to make, sell, and buy unique goods.** Through its platform, Etsy facilitates online transactions of unique, hard-to-find, difficult-to-replicate products between **1.6 million sellers** and a global, growing base of **24 million buyers**.
- Etsy generates revenue by charging a fee or commission on the product listing and product sales on its platform ("Marketplace revenue") as well as services the company offers to sellers for payments, shipping labels, and marketing. **Marketplace revenue is made up of two drivers: a \$0.20 listing fee that sellers pay for each item they list and a 3.5% transaction fee they pay for each completed transaction.** Seller Services revenue includes the fees sellers pay Etsy for services such as Promoted Listings, prominent advertisement placements on in-site search results, Direct Checkout, payment processing, and Shipping Labels.
- One of Etsy's relatively new seller-oriented services is **Pattern** which allows sellers to quickly create their own custom websites to highlight their own brands and leverage the hard work they've already put into their Etsy shops. Pattern aligns with Etsy's long-term goal of supporting sellers beyond the core Etsy marketplace. **Etsy Manufacturing** is another seller service which connects Etsy sellers with values-aligned manufacturers.
- Etsy is also expanding its **Wholesale** offering which enables Etsy sellers to sell their unique products to select retailers. Some of retailers that have partnered with Etsy use its platform and seller base to add unique items to their stores include Macy's, Whole Foods, Lou & Grey and Land of Nod.
- Sellers on Etsy generated **Gross Merchandise Sales (GMS) of \$2.4B** of which 43% came from purchase made on mobile devices in 2015. **Twenty-nine-point eight percent (29.8%) of Etsy's 2015 GMS came from an international buyer or seller outside of the United States.** By focusing on local communities around the world, Etsy believes that it will broaden the reach of its global platform. Eventually, Etsy wants to grow its international GMS to represent 50% of total GMS.
- Etsy is committed to upholding the values of transparency, sustainability, and community and, through its operations, Etsy aims to minimize the harm and maximize the benefit that Etsy has on people and the planet and the publish an annual Progress Report to publicly report its results. B Lab, an independent nonprofit organization, has certified Etsy as a **B Corp** for its adherence to certain social and environmental standards.
- According to MorningStar **Etsy has grown its revenue by 54.19% each year over the last three years.** Etsy reported Q3 2016 earnings on November 1st, 2016. During Q3 2016, Etsy grew its Gross Merchandise Sales by 19.1% compared to Q3 2015 to \$677.2 million (run-rate of 2.7088 billion dollars). GMS would have been up 20.1% on a currency-neutral basis. Growth in GMS was supported by 11.3% year-over-year growth in active sellers and 20.1% year-over-year growth in active buyers. The proportion of international GMS was 30.4% in Q3 2016.
 - **Total revenue was \$87.6 million**, up 33.3% year-over-year, driven by growth in both Marketplace and Seller Services revenue. Marketplace revenue grew 18.3%, driven by growth in

transaction fee revenue and growth in listing fee revenue. Seller Services revenue grew 50.1% year-over-year and was driven primarily by revenue growth in Direct Checkout, which continued to benefit from the integration of PayPal.

- **Gross profit for the third quarter was \$58.2 million**, up 40.3% year-over-year, and gross margin was 66.5%, up 330 bps compared with 63.2% in the third quarter of 2015.
 - On the expense side, **Marketing expenses grew 13.3% year-over-year** and were driven by brand marketing spend, particularly on YouTube and Facebook and employee-related costs.
 - **Product development expenses grew 30.6% year-over-year**, primarily due to higher employee-related costs. Product development slightly decreased as a percentage of revenue to 17.0% compared with 17.4% in the third quarter of 2015.
 - **G&A expenses increased 43.9% year-over-year** driven by increased employee-related costs and overhead expenses, including depreciation expense related to Etsy's new Brooklyn headquarters. G&A expenses increased as a percentage of revenue to 25.1% compared with roughly 23.2% in the third quarter of 2015.
 - Finally, **net loss for Q3 2016 was \$2.4 million, compared with a net loss of \$6.9 million** in the third quarter of 2015. Non-GAAP Adjusted EBITDA for the third quarter was \$13.1 million, and grew 109.8% year-over-year.
 - **Etsy expects revenue growth of 20-25% through 2018**
- In 2016, Etsy also acquired **Blackbird Technologies**, a machine learning company that combines image recognition and natural language processing using advanced Deep Learning and Artificial Intelligence techniques. Etsy hopes that Blackbird's Technology will help the firm improve the quality and relevance of search on Etsy.com.
 - Lastly, just recently Etsy launched a new corporate initiative called **Etsy Studio** which is a marketplace for materials that can be used by DIY creators to make things. This brand-new marketplace for creative materials will put Etsy in more direct competition with craft suppliers such as Michaels Co. and Jo-Ann Stores, Inc. Etsy Studio will have about 8 million items at its launch in April, and will offer instructions and tutorials for creating various items to users. Big box craft suppliers, in contrast, only carry about 40,000 items typically in their brick-and-mortar locations. Etsy suppliers will get early access to Studio so they can cross-list their Etsy.com products ahead of Studio's launch in April. Etsy also recently introduced **Shop Manager**, a dashboard that brings together inventory, marketing, payments, shipping, and other types of services for sellers. Seller services made up more than 50% of Etsy's third-quarter revenue last year.

In conclusion: **"Etsy is very much a technology company...** Sometimes investors and others confuse us as a commerce site, but we do some incredibly sophisticated work with machine learning and A.I. [artificial intelligence]." -Etsy CEO Chad Dickerson

THESIS & KEY POINTS

1. Etsy will continue to invest in and roll out various **Seller Services** which will add meaningfully to its top-line and could trickle down to Etsy's bottom line sooner than investors anticipate.
2. The **Etsy Studio initiative will help Etsy broaden its user and seller base** and will allow the company to better serve the \$44 billion U.S. crafts supply market compared to traditional retailers.
3. Additionally, **Etsy's marketplace business model lacks the overhead and inventory costs of its traditional retail competitors** which should aid Etsy in its pursuit of profitability and could eventually contribute to industry-leading margins.

4. As suggested by data analysis (see supplements below), **Etsy maintains a wide network of buyers and sellers with concentrated buying in affluent cities and suburban areas.** The typical cart totals per user confirm Etsy's value proposition to the consumer of delivering **middle-price, vintage goods to consumers.**
5. Lastly, **sellers truly respect Etsy's commitment to sustainability and community,** will remain loyal to Etsy and its platform and will be key players in helping Etsy improve its marketplace and keep the firm one step ahead of Amazon and eBay.

PERCEPTIONS

Several misperceptions were found using VAR data. One potential investor mentioned, "If Amazon saw enough opportunity in their sales model, it could fairly easily turn on an Etsy-lite, and use low margins to put Etsy out of business." In fact, in order to directly compete with Etsy, Amazon.com has launched Handmade at Amazon, a new store for invited artisans to sell their unique, handcrafted goods to Amazon's customers worldwide. **However, Etsy's craft goods selection is 100 times that of Amazon.com.** Many investors often express their concerns on the industry in general, because a few giant companies like Amazon.com and eBay seem to dominate the e-commerce sector, thus reducing the growth potential of Etsy.

However, it is critical to understand two main facts about Etsy. First, **Etsy is known for its specialization in certain types of products, which are vintage items and handmade accessories and jewelries, thus attracting and establishing loyalty with a certain target group of suppliers and customers.** The faithfulness of Etsy's seller and buyer bases contributes to Etsy's "network effect", a virtuous phenomenon where a good or service gains additional value as more people use it. Etsy's products have received lots of positive comments from customers because of their unique designs and exceptional qualities. Etsy definitely has the ability to differentiate its brand image from other e-commerce giants. Also, Etsy is relatively cheaper than its competitors, as many customers noted that there is a higher selling fee for eBay compared to Etsy.

Another misperception we discovered is the misguided view that Etsy's operational model is ineffective which, we believe, is partly a reaction to the many negative customer reviews Etsy's products have received recently as well as Etsy's lack of profitability.¹ Though these statements are true, Etsy's financial statement in 2016 shows different results. First, the reason Etsy's cash dropped significantly from \$271 million to \$188 million in three quarters of 2016 is that Etsy spent a large amount of cash in investing activities, particularly in purchasing marketable securities. Etsy's cash outflow from purchases of property, plant and equipment (PPE) was as high as \$34 million USD, and the cash outflow from purchases of marketable securities was as high as \$108 million USD, whereas it only spent \$9 million to purchase PPE and \$18 million for securities by the third quarter of 2015. These results in fact imply that Etsy is preparing itself for the rapid expansion of the firm in the future, and this outflow is signaling a positive trend rather than demonstrating the firm's operational and financial weakness.

In addition, the company reported that its operational margin rose from -5% to +5% in three quarters of 2016. Though the company had a net loss of 8 million USD by the third quarter of 2016, it is important to note two facts. Its EBT was positive (\$13 million USD) by the third quarter of 2016 whereas its EBT was negative (\$-30 million) by the third quarter of 2015. So, the income tax was the primary reason the earnings went negative in 2016, thus also demonstrating that its operational model is not problematic. It is believed that as the company grows, its revenue can easily cover the income tax expense. In addition, the net loss has dramatically decreased when comparing 2015 to 2016 data, for the net loss was around \$49 million USD in 2015 but the net loss was

¹ Please refer to <http://investorplace.com/2015/05/etsy-stock/#.WKPtbm8rLX4> for more information

only 8 million in 2016. Now, a natural question is, if Etsy spent a large amount of cash for investment, does it still remain solvent? Etsy's current ratio was 4.4 in 2015 and surprisingly the current ratio went up to 4.5 in 2016, despite the large amount of cash outflow in 2016. This was possible because Etsy purchased a great amount of short-term investments (rising by \$61 million USD) to balance out its cash outflows and thus to remain solvent.

INVESTMENT TIMELINE

- A key catalyst for Etsy shares will be the release of its Q4 2016 earnings after the close of the market on February 28th, 2016. On average, Analysts expect Etsy to earn a GAAP profit of \$0.01 per share for the fourth quarter of 2016. **Etsy's Q4 revenue growth should be robust thanks to record-breaking Holiday Season shopping and a dramatic rebound in consumer confidence and sentiment.** We recommend initiating a position in Etsy on the long side in order to profit from what could be a dramatic rerating of the stock after its earnings announcement. However, there is a risk that even if Etsy beats its revenue and earnings expectations, the stock could still sell off. When Etsy beat its Q3 revenue expectations and raised its full-year guidance in November, the stock was down 13% due to an announcement that the CFO was also stepping down. Nonetheless, we see limited potential for this type of idiosyncratic post-earnings reaction in the coming Q4 release.
- **Long-term investors should also keep an eye on the roll-out, implementation, and reception of Etsy Studio around April of this year after Etsy's Q4 earnings release.** We believe that with Etsy Studio, Etsy could become an established player in the under-served craft supply market over the long-term.
- Over the long-run, Etsy is poised to financially benefit from its defensible position as a trailblazer in peer-to-peer e-commerce and could even become an attractive takeover target for a larger technology company given its compelling revenue growth, cash-rich balance sheet, experienced management team and market-leading position in a growing, niche industry. **James Cakmak, an analyst at Monness, Crespi, Hardt & Co, has stuck his neck out and said that eBay should acquire Etsy in order to more effectively take on Amazon.com.**
- The prominent technology-focused hedge fund Tiger Global Management LLC owns 7.5% of Etsy's shares outstanding and has been invested in the company since Q2 2015 when Etsy went public. Some of Etsy's other well-known investors include D.E. Shaw, Paulson & Co., Citadel Advisors, CalPERS and Millennium Management LLC.
- In regards to the price action, Etsy's stock seems to have bottomed out around \$7/share in February 2016 and looks to be forming a base from which it has steadily risen since early 2016.

SIGNPOSTS

- The growth and proportion of revenue related to Seller Services should be closely scrutinized by investors to see whether Etsy's growth initiatives are taking off.
- Investors should also pay attention to how Etsy is developing its technology through improved search capabilities and machine learning initiatives.
- Watch Etsy's expansion potential within international markets, while tracking revenues from returning customers within the United States (particularly since

RISKS

- A major competitor for Etsy is Amazon Homemade, particularly since Amazon is a dominant player in the e-commerce business
 - A similar risk is present with EBay, which focuses on peer-to-peer transactions
- Etsy's reputation is contingent on the quality of its sellers, particularly since their craft products represents Etsy's platform
- Etsy's brand image could be eroded if it loses its traditional, vintage, and homemade

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transaction data indicates that Etsy has a wide customer base in the US)

offerings, particularly if it sources through China

VALUATION AND FINANCIAL INFORMATION

Projecting share price from EV/Revenue yields a target share price of \$15.39.

The comparable companies were chosen based on their similarity to Etsy's business model. EBay, Amazon and Alibaba all serve as online market places and thus are closest related to Etsy's business model. Additionally, Target has been included because of its status as a "brick and click retailer" which generates much of its sales online. Lastly, Shopify Inc. has been included because it provides a platform for sellers to launch their business in e-commerce.

Due to their variety in size and scope, these companies collectively represent Etsy's closest competitors and embody each aspect of the company's business model. While arts and accessories online retailers such as Artfire.com and Folksy.com better represent Etsy's business model, their small size and the fact that they are private companies means that they are not financially similar to Etsy and thus have not been used in this valuation.

EV/Revenue was used to find target price because as a growing technology company, Price to Earnings and EV/EBITDA do not accurately provide valuation information for Etsy. Due to the high cost of growing a budding technology company, EV/EBITDA and P/E are currently less accurate than EV/Revenue, a fact that will change as the company matures and development expenditures fall. Comparing Etsy's enterprise value to its total sales offers better insight into the company as Etsy is well established enough that its revenues have begun to mature to an amount that better represents the company's value and capabilities.

Company Name	Ticker	Share Price	Market Cap	Enterprise Value	TTM	EV/Revenue	
						FY1	FY2
eBay Inc.	EBAY	\$34.01	\$36,557.2	\$38,368.2	4.3x	4.1x	3.9x
Amazon.com, Inc.	AMZN	840.45	399,100.7	393,532.7	2.9x	2.4x	2.0x
Alibaba Group Holding Limited	BABA	101.83	253,975.0	252,730.1	12.2x	11.1x	8.5x
Target Corporation	TGT	65.64	36,875.3	48,470.3	0.7x	0.7x	0.7x
Shopify Inc.	SHOP	60.43	5,043.6	4,643.3	11.9x	12.2x	8.2x
Low			\$5,043.6	\$4,643.3	0.7x	0.7x	0.7x
Median			36,875.3	48,470.3	4.3x	4.1x	3.9x
Mean			146,310.4	147,548.9	6.4x	6.1x	4.7x
High			\$399,100.7	\$393,532.7	12.2x	12.2x	8.5x
Etsy, Inc.	ETSY	13.20	1,486.2	1,227.7	3.6x	3.4x	2.8x

DATA EXHIBITS

Note: The visualizations and graphics below were generated through R. Data was sourced from Point72 and the U.S. Census Bureau

US Population Density
Data for Zip Code Tabulated Areas in 2012

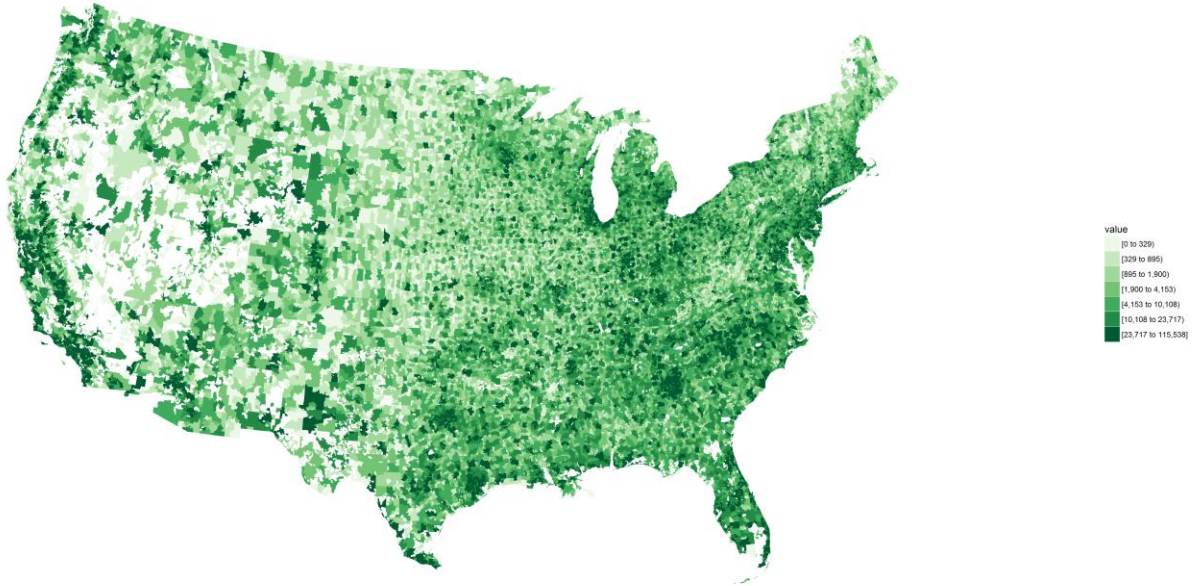


Figure 1 – For reference, a 2012 choropleth map representing US population density from the United States Census Bureau.

ETSY Purchases by Zip Code Frequency
Transaction data from January 2013 to October 2016

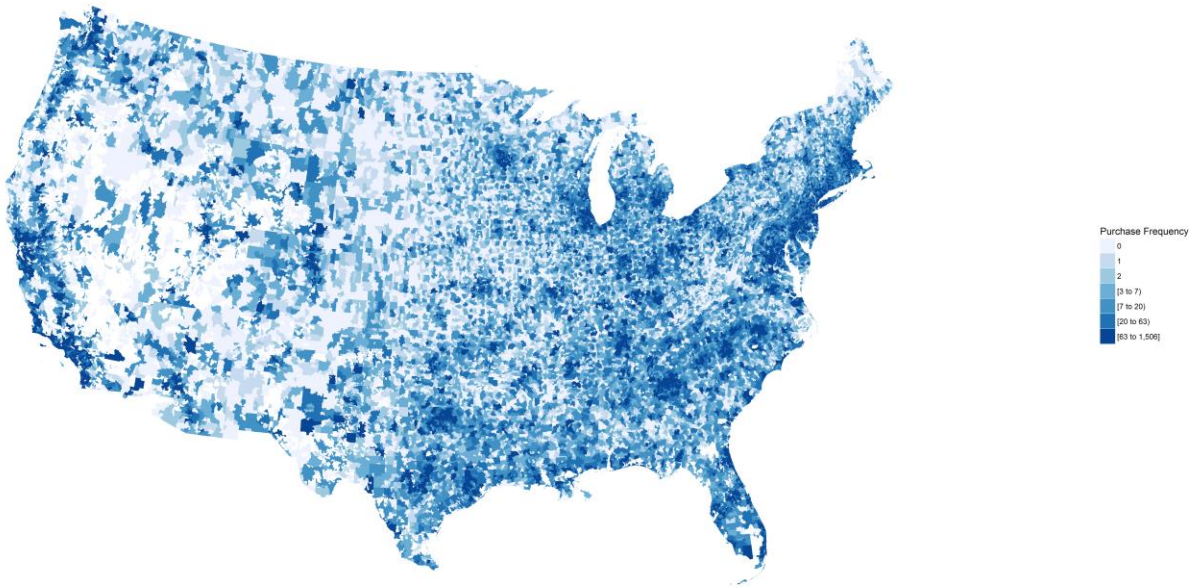
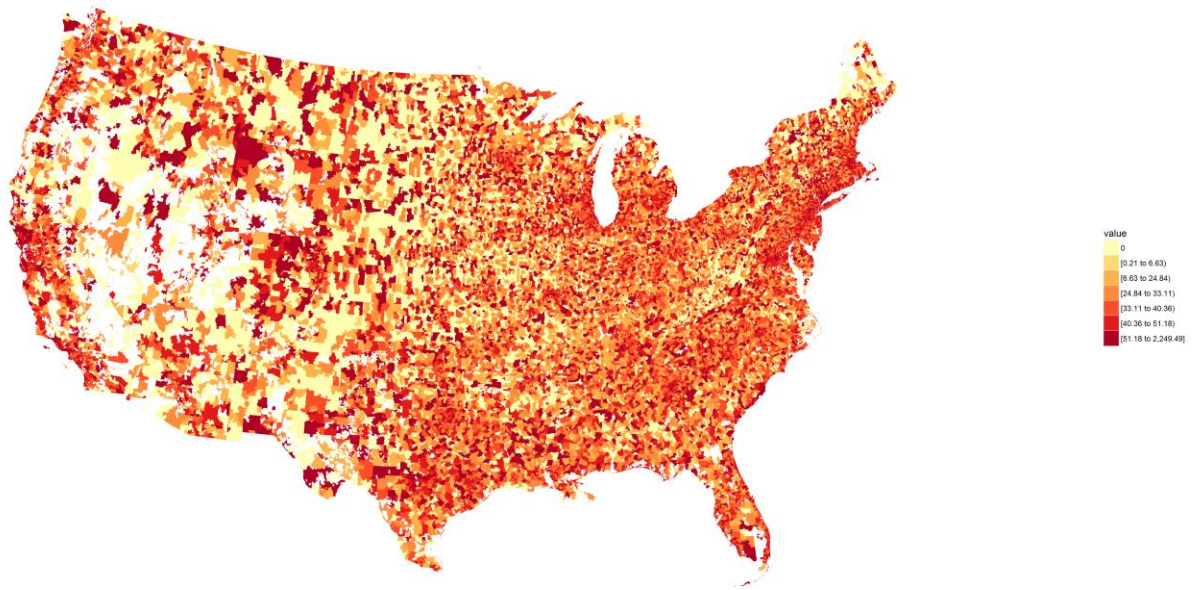


Figure 2 – Purchase density of delivery ZIP codes for Etsy purchases. Note Etsy's wide distribution across the United States, with frequency directly corresponding with population density and size.

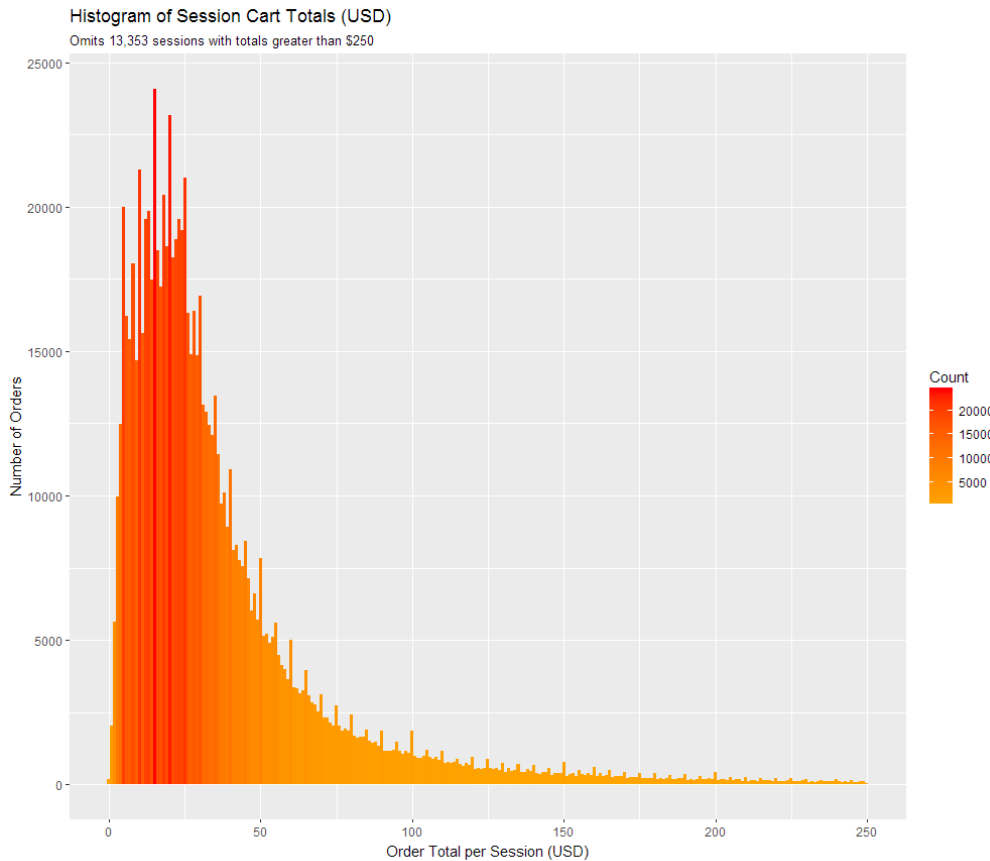
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ETSY Average Purchase by Zip Code
Transaction data in U.S. Dollars from January 2013 to October 2016



Source: Point72 Asset Management

Figure 3 – Interestingly, it appears that with an increase in population density, there appears to be a positive relationship with average order size (average price). We attribute much of the high average purchase totals per session to more affluent suburban areas. Note the high averages in rural areas (likely due to individuals making high-volume or high price-point purchases).



Source: Point72 Asset Management

Figure 4 – It is interesting to see that most individuals are not making either extremely small or extremely large orders. This corroborates our company analysis, where Etsy targets middle-income consumers with few high price-point luxury products.

