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Long: Etsy Inc. (NASDAQ: ETSY)

Investment Horizon: 1-3 Years

Share Price	165.82
EV	21.27B
Shares Outstanding	126M
EV/EBITDA	35.2x

Business Overview:

Etsy, Inc. operates two-sided online marketplaces that connect buyers and sellers primarily in the United States, the United Kingdom, Germany, Canada, Australia, France, and India. Its online marketplaces include Etsy.com, Reverb.com, and most recently Depop.com. The company offers approximately 85 million items in its various retail categories to buyers. It also generates revenue through various seller services. The current CEO is Joshua Silverman who joined the Etsy board in late 2016 and became CEO in May 2017. His previous experience includes being a senior executive at eBay and chief executive of Skype. After becoming CEO, he pivoted Etsy's focus to sales growth while maintaining Etsy's dedication to inclusion and social justice. Etsy's share price rose 50% in the six months following Silverman's tenure as CEO and is up 1165.42% since May 2017.

1) **Etsy.com (93% of revenue)**

Marketplace (75% of Etsy revenue)

Launched in 2005, Etsy has occupied a growing niche in the e-commerce sphere that specializes in handmade, customized, personalized, vintage, and craft supply products. The product is further differentiated from traditional e-commerce given the emphasis on interaction between buyer and seller; functions to facilitate Q&A between both parties are available and commonly used on the site. Additionally, Etsy has impressive global penetration with 43% of sellers being located outside of the United States in 2020 and 38% of sales occurring outside the United States. Revenue generation occurs in two main ways: a 5% transaction fee on every transaction made and a $0.20 listing fee for every item listed that must be renewed every four months.

Services (25% of Etsy revenue)

Etsy provides many services that provide sellers tools to be successful: Etsy Payments, a payment processing service; Etsy Ads, an advertising platform; and Etsy Shipping Labels, which allows sellers in the United States, Canada, the United Kingdom, and Australia to purchase discounted shipping labels. In addition, the company offers a $10 a month subscription to Etsy Plus which includes Shop Manager dashboard, a centralized hub for Etsy sellers to track orders, manage inventory, view metrics and statistics, and have conversations with their customers; Targeted Offers, a sales, promotion, and social media tool; educational resources, such as blog posts and video tutorials; Etsy Seller Handbook; and Etsy Teams, a platform to build personal relationships with other Etsy sellers.

2) **Reverb.com (7% of revenue)**

Marketplace

Reverb, Etsy's wholly-owned subsidiary, operates as a separate marketplace and was founded on the principle that buying and selling musical instruments should be easy. This two-sided marketplace connects buyers and sellers of new, used, and vintage musical gear from all over the world. Reverb's buyers and sellers range from beginning musicians looking for their first instruments, professional musicians that utilize the platform to expand their tools, local music stores that use Reverb to do more business online and the largest music retailers in the world that use Reverb to reach an even larger audience. The main source of revenue are 5% transaction fees on every sale made.

Services

Reverb has several services that drive growth in the marketplace and relieve friction in the purchase funnel. Advertising: Reverb's on-site advertising platform, referred to as Bump, enables Reverb sellers to gain prominent placement on Reverb in exchange for a higher percentage of their items' final sale price. Reverb Shipping Labels: Reverb provides sellers access to shipping labels at significant discounts, which reduces the cost and time it takes Reverb sellers to ship musical gear and provides transparency through tracking information about when a buyer can expect to receive their item. The ability to print the shipping labels at home reduces the cost and time it takes Reverb sellers to ship items to Reverb buyers, reduces the chance for administrative error through features such as auto population of shipping addresses, and automatically provides tracking information when available and shipping notifications to buyers.

3) **Depop**

Depop is a recently acquired subsidiary of Etsy that operates in a similar format with a two-sided market between buyers and sellers. Depop is a marketplace for unique clothing items and second-hand fashion that combines practices of traditional e-commerce and social media. This results in a marketplace where users can gain followers, bump posts, and achieve influencer status. Revenue is generated on a 10% transaction fee on every sale made.

<u>Reasons For Mispricing:</u>

1) The market misunderstands Etsy as traditional e-commerce competing against Amazon. It's more analogous to the **second wave of e-commerce** companies like Shopify. This misclassification contributes to Etsy's cheap multiple.

    a. Amazon represents the first wave of e-commerce, commoditizing the online marketplace industry and creating an uncrossable moat of cheap prices and fast shipping times. Etsy doesn't have to cross this moat however, because **Etsy isn't competing with Amazon**. Etsy is best characterized as the second wave of e-commerce that excels in providing niche, unique products that are impossible to commoditize. It has a differentiated supply, providing curated products that Amazon will never be able to provide, and thus can capitalize on all the gaps Amazon leaves behind. CEO Josh Silverman explains it well:

"If you're going to buy something that comes with a barcode, you're going to buy it from most likely Amazon… And then, there's going to be room for a few other people that do something really different. And I think Etsy is very well positioned to be one of those other places" – **Etsy CEO Josh Silverman**

Shopify is a much better comparison as a two-sided marketplace where sellers can provide unique non-commoditized products. **Currently Etsy is trading at a trailing P/E of 56x, while Shopify trades at a trailing P/E of 115x**. Given that both these companies represent the second wave of e-commerce, it's clear that Etsy is trading at a very cheap multiple.

b. Unlike Amazon, where the goal is for consumers to spend as minimal time possible shopping, **Etsy is designed to be a social shopping experience**. 28% of shoppers spend 3 minutes or less on an Amazon purchase; in contrast, Etsy is designed to recapture the experience of shopping by providing a curated, discovery-focused experience across a variety of unique and limited products.

   Apart from the different experience, Etsy is also adopting social media practices into its e-commerce platform. Unlike Amazon, and even its closer competitor Shopify, Etsy is a platform to develop relationships and follow influencers. Basic features from buyer-seller chatting before and after purchases to structural design choices like the ability to gain followers as a buyer or seller, transform Etsy from solely a marketplace to a social ecosystem. Every buyer has a unique customer preference, and the ones with best taste are rewarded with a strong following. Every seller has unique products, and the ones that maintain touch with their consumers on top of having good products also gain a following. **The result is more than just brand loyalty, but human connections.**

   Other e-commerce platforms may be able to replicate the buyer-seller interaction of Etsy, or even buyer-buyer interactions as they recommend products to each other, but **Etsy is uniquely able to foster seller-seller interactions**. 37% of sellers on Etsy describe support from other sellers as meaningful, and 48% have recommended the products of other sellers. Add in the presence of massively popular influencers on Etsy and Etsy subsidiaries like Depop and it's easy to see why the product Etsy offers is highly different from traditional e-commerce – a difference that's not priced in.

2) The market underestimates Etsy's relevance in the current economy. The most obvious way is the tank of Etsy shares when the market began pricing in features of a post-COVID economy. In short, many "COVID stocks", companies that were perceived to only do well in the radically different landscape during the pandemic, fell heavily in late

April 2021 as vaccinations were being widely administered and concern about COVID began to wane. Etsy in particular fell from $208 per share on April 29th to $157 on May 6th although **nothing had fundamentally changed about the company**. The argument goes that because 2020 saw huge user growth in companies that excelled in a COVID environment, 2021 growth will be dampened because more traditional market environments will return. This argument may hold merit for companies like Zoom and Peloton, who have obvious alternatives in a world without social distancing, but it's less true for Etsy. In Etsy's case, the pandemic served as a catalyst for huge user growth as many discovered the e-commerce platform – but given Etsy's high retention rate (80% of users are repeat customers) and largely unaddressed total addressable market (the e-commerce TAM is estimated to be in the trillions), Etsy will likely not see user growth decline; if anything **network effects will keep the ball rolling**.

The second way the market underestimates Etsy's relevance in the current economy is by pricing it as an aging e-commerce platform. Founded in 2005, there is a narrative that Etsy is a loser in the e-commerce race and is struggling to hold a tiny market share that Amazon is quickly eating up. However, **Etsy was ahead of its time and will succeed during this second-wave of e-commerce**. Once Amazon paved the way for normalizing online shopping through cheap prices and fast delivery, experience based online platforms were primed to succeed. Etsy has stuck around since 2005 because it fulfilled an important niche, but in 2021 the role it serves is no longer a niche but the growing and fundamental desire for a curated shopping experience. The huge multiples given to newer companies like Shopify are prime examples of market irrationality as a comparable company with a larger moat is flying under the radar.

Competitive Advantages:

1) **Etsy is the frontrunner in an industry that benefits from significant network effects**. Sellers want to be on the platform with the most buyers (more revenue) and buyers want to be on the platform with the most sellers (more options). It makes over 700x the revenue of it most direct competitor, Poshmark, and makes comparable amounts in revenue to Shopify (although their business models are similar, Shopify is host to a wider variety of sellers at the cost of differentiated supply, and yet their revenues are still comparable). 80% of Etsy users are repeat users suggesting that as users continue to flock to Etsy they are likely to stay and increase profitability**.** It will be difficult for competitors to steal market share from Etsy because that would require convincing buyers and sellers to migrate from the largest marketplace to a newer one with less proof-of-staying-power. A more likely scenario would be competitors introducing marketplaces that Etsy users simultaneously use, but this wouldn't be a significant drag on revenue given that users would rather spend money with the platform they're more familiar with and trust. Social media components compound the network effects because consumers will stick to the platform they have followers on and that they follow people on. The credibility factor also compounds the network effects in this industry because purchasing items from independent sellers involves some risk. Etsy's customer support and longstanding

industry presence provide a level of trust consumers need those newcomers and independent sellers can't develop quickly.

2) **Etsy provides a differentiated supply that competitors can't replicate**. 78% of Etsy buyers say they come to Etsy to find products they can't find anywhere else. Etsy has the most sellers when it comes to vintage/ handmade goods, and its subsidiaries Depop and Reverb are the focal points for unique fashion and second-hand instruments respectively. On top of that, Etsy integrates features of social media that make the shopping experience more interconnected and enjoyable. Shopping recommendations are provided based on artificial intelligence algorithms leading to a highly curated experience. While other competitors like Amazon have made online shopping quick and easy, Etsy has a differentiated product by making online shopping enjoyable. Other two-sided marketplaces like Shopify with a huge variety of items and sellers also suffer from the same commoditization. And the most direct competitors like Poshmark stand on the other side of the moat due to Etsy's lead position in the industry.

<u>Catalysts:</u>

1) At the beginning of June 2021, Etsy acquired the clothing-resale app Depop for $1.6 billion. Depop brought in $70 million in 2020 which is 100% year-over-year growth. While it's still lagging behind competitors Poshmark ($262 million) and ThredUp ($186 million), it's only tapped the US market for a couple years and is poised to surpass its competitors because of its immense popularity with Gen Z users. 90% of Depop users are under 26 and in the UK where Depop is based out of it's estimated that one in three individuals from 15 to 24 are Depop users. This can be attributed to the Instagram-like layout of the app and the host of influencers that are on Depop and other social media like TikTok which functions as a self-created organic advertising source for Depop. In the short-term, Depop's contributions for Etsy will be priced in after the 2021 Q2 earnings report and 2021 10K. In the longer-term, Depop is playing a huge role in bringing Etsy's user-base from primary Millennials to Gen-Z.

2) COVID accelerated e-commerce trends ushering in the second wave of e-commerce even more quickly. As the pandemic subdues, consumer habits and comfortability with online shopping will remain, leading to a shift from quick and easy online shopping to a more discovery-based approach akin to window shopping but online. 21.3% of all retail sales were made online in 2020 as opposed to 15.8% in 2019. As physical retailers continue to struggle marketplaces like Etsy will deliver the enjoyable shopping experiences that malls and brick and mortar independent sellers used to.

<u>Risks and Mitigants</u>

1) **Competitors**
Etsy has two kinds of competitors, gigantic two-way marketplaces like Amazon Handmade, Facebook Marketplace, and Shopify, as well as niche product focused marketplaces that are more analogous to Etsy like Poshmark. The winner out of these second wave e-commerce platforms will be the one with the most scalable differentiated

supply. The largest obstacle that only Etsy can hurdle is being able to scale without losing differentiated supply. Amazon Handmade does not have nearly the amount of sellers Etsy has and will struggle to gain it without the social media compounding network effects that Etsy has. Amazon Handmade can rapidly increase sellers and buyers by integrating Handmade closer to the massive traditional Amazon marketplace, but that will come at the insurmountable expense of loss of differentiation (the closer Handmade becomes to traditional Amazon, the more similar it will become, in terms of size and supply). Shopify falls into the same trap as sellers are shifting towards mass manufacturing – it doesn't have the same homemade craft identity as Etsy. Facebook Marketplace is primarily used as a craigslist type platform that has zero focus on creativity and is a catch-all resale platform from used cars to random appliances. And the more analogous competitors like Poshmark may be comparable to Etsy in differentiated supply, but are nowhere near as scalable because of Etsy's moat.

2) **House of Brands Critique**
Etsy is starting to use a "House of Brands" model where the parent company operates a lot of related subsidiary companies. Currently it owns itself, Reverb, and Depop, but more acquisitions down the line are expected. A common criticism of this model is that subsidiary companies will begin to cannibalize each other and dilute profits by inadvertently competing. But the House of Brands approach for Etsy is genius in two ways: first, each subsidiary does not overlap too much in consumer base, and second, the differences in the subsidiaries allows Etsy to solve the scalable differentiated supply problem. Consumers looking for particular crafted jewelry on Etsy will be different from those looking for instruments on Reverb and those looking for custom apparel on Depop, meaning profits are not cannibalized. More significantly, because all these subsidiaries are not integrated into a giant Etsy marketplace, they all have their own particular identity and thus maintain a differentiated supply. House of Brands is exactly the strategy to use to avoid the pitfalls of Amazon Handmade and Shopify because it maintains a scalable differentiated supply. As long as CEO Josh Silverman stays at the helm, we can expect more acquisitions that add to this scalable differentiated supply.

Valuation:

Etsy's undervaluation due to market irrationality and strong moat against competitors coupled with event-based catalysts and market tailwind based catalysts make it an excellent investment.

There was minimal segmentation in Etsy-filed reports but I used independent statements of Reverb to roughly split Etsy into its two main components (Etsy and Reverb). I then used independent statements made by Depop to project revenue and added to Etsy's top-line. Revenue growth rates across the board have been in the triple figures for all three of these companies, so in my 5-year DCF projection I assumed an initial top-line growth rate of 85% that tapers down to 5% by 2025. EBITDA margins have grown from 10% in 2017 to 32% in 2020, and I projected them to get to 43% by 2025 and stay there. I calculated Etsy's WACC to be 6.55% resulting from its debt-heavy capital allocation and low interest rates. Overall **the implied share price I arrived at was $265.80, a 60.3% upside from its current share price** and only 5% higher than Etsy's 52-week high.